the art of boring™

EP 203 | Credit Markets: Caution, Compression, and Opportunity

[00:00] Kevin Minas: On this episode of The Art of Boring, I'm joined by Global Credit Portfolio Manager Brian Carney to unpack what he believes are some of the most pressing issues in credit markets today. We'll explore whether recent private market bankruptcies signal deeper systemic concerns, how to position for sovereign bond issuer risk in a sticky inflation world, and the impact of the AI-driven debt wave on credit spreads. We'll also discuss regulatory rollbacks in the lending markets, credit risk premium mispricings, and concrete portfolio actions for late cycle markets.

[00:35] Disclaimer: This podcast is for informational purposes only. Information relating to investment approaches or individual investments should not be construed as advice or endorsement. Any views expressed in this podcast are based upon the information available at the time and are subject to change.

[00:52] Kevin Minas: Hi Brian, thanks for joining today.

[00:53] Brian Carney: Good to be back, Kevin. Nice to see you.

[00:56] Kevin Minas: Why don't we start by getting into what we've seen a little bit in the news recently. There's been some unexpected bankruptcies in the private markets. Several senior lenders, big names, have been left with sizable write downs.

Optimists are calling these idiosyncratic events. The more skeptical view would be there's a major deterioration in private credit markets given, all the capital that's rushed into that space. I guess the question for you would be: Are these truly one-off, or are they the first tremors of a broader credit weakness? Where do you land in that debate?

[01:30] Brian Carney: Million dollar question, Kevin. I land on the skeptical side of that debate. But maybe just for our listeners, some of the companies we're talking about are First Brands, Tricolor, and Broadband Telecom, three private companies. And you're right, they've tagged some really senior lenders with significant loss.

Some of the biggest names on Wall Street are looking at losses cumulatively, in excess of a billion dollars. This is significant. I would say the optimists are calling them random events.
And I think they're taking some comfort in that fraud is alleged and is perhaps likely in some, if not all these cases. So, I guess criminal activity excuses poor underwriting and maybe we're expecting criminal activity to be limited. You can say, hey, these are one-offs.

The skeptical view, as you point out, is that this is evidence of systematic weakness in lending standards across markets, including private markets. And I would argue that these standards have been weakening for quite a long period of time. As we move further and further into the later stages of a normalization cycle, you're going to see more of this. Definitely in the skeptical camp. These are tremors. Investors should take note and we would expect more of these situations to come to light.

There are a few things that we're kind of watching. And I think investors can also watch in terms of other indicators. You don't just have to wait for companies to go bankrupt. You can watch delinquencies on mortgages,

car loans, credit cards. You can look at rating agency upgrade downgrade ratios, particularly in high yield, just general levels of corporate leverage and spreads between public and private markets.

None of these things in and of themselves are 100% predictive of pending doom. But taken collectively, they do give you a sense of where the market may be headed. And many of these indicators are giving us cause for concern.

[03:29] Kevin Minas: Another area potentially of concern would be you're seeing rising debt levels, kind of globally, but particularly in the US and other major economies. That's putting pressure on the yield curves, basically cost of funding for these countries. How should investors be thinking about, particularly their treasury exposure, U.S. exposure and term risk today? What's your preferred duration posture, given the steepening yield curves we're seeing and a lot of the policy uncertainty?

[03:56] Brian Carney: Great question. In the old days, if there was a crisis or you thought there was a crisis coming, you just sold what you had and you bought U.S. treasuries. They were the safest asset on the planet and every financial asset in the world gets priced off a U.S. treasury.

So, if you think there's a hint of trouble, you just go and buy U.S. treasuries and at a minimum, you're going to preserve your capital. If there is a question about the solvency or the credit quality of the United States, what do you buy then? The credit quality is under scrutiny because of growing debt levels, high deficits relative to GDP, call it administrative overreach by the White House.

All this calls into question the safety, or the relative safety, of owning U.S. treasuries. And you overlay inflation, which is not yet down to the Fed's 2% target. It’s unclear if owning, as an example, a U.S. treasury with a 4% yield is wise.

And layer on top of that the fact that other G7 countries, like France, the UK, and Japan are also struggling. You’ve got more than half of the G7 countries wrestling with similar issues, not the administrative overreach part, but the deficit situation. Our strategy positioning, I want to make clear, is the aggregate result of a series of individual credit determinations.

And even though the yield curve is steeper, as you point out, steeper in the U.S. by about 100 basis points over the last 12 months, which is significant. But we don't think you're compensated, still, for the risk of owning longer duration securities, whether that's credit priced off the benchmark or the benchmark itself. Our preference at the moment is for shorter duration in what we believe is an uncertain yield environment, both for credit quality concerns and persistent inflation concerns.

[05:43] Kevin Minas: Another shift we're seeing is around tech companies. There's a lot of talk about what's going on with AI on the equity side of the ledger. We're also now starting to see a lot more issuance by the big tech companies, the hyperscalers and others in the ecosystem.

They've got a lot of CapEx that they've got to do, and the credit markets have been quite open for business for them. What's your base case around this oncoming supply onslaught? How is the market going to digest it? Do you think there'll be a major impact on spreads or the credit curves?

Also, there's different parts of the market, I guess, that these things are getting funded through. If you could just give a little colour on that as well, that'd be helpful.

[06:21] Brian Carney: I think these are the things our investors, our clients, our listeners, should be thinking about. And AI and debt markets really haven't been two phrases that you've put together. The focus on AI has been exclusively an equity market phenomena.

Quite recently, it's become front and center in the debt markets, or it's on its way to becoming front and center. Our very simplistic estimation is that you could see upwards of a trillion dollars a year in new AI-related, being either funding data centers, the tech and data centers, or the power that runs the data centers. AI-related debt issuance in the public markets, the private markets, and the bank markets. That trillion dollar figure is double the average of the incremental borrowing in investment-grade and high-yield markets over the last 10 years.

It's a staggering number. The AI numbers in and of themselves are staggering. The amount of funding that might be done in the debt markets is staggering relative to what normal levels of funding for just general corporates are in the bond markets. And just to give you an example, over the last four weeks, kind of since we started our Mawer Perspectives journey, we've seen $100 billion of financing by Alphabet, Meta, and Oracle alone.

Some of that on balance sheet, some of that off balance sheet. One of those, Alphabet, did a 50-year bond at a spread just over 100 basis points. So, just a little more than 1% over the yield on a 30-year U.S. treasury. It's staggering.

The numbers are staggering and the prices that these borrowers are able to borrow at, is staggering. So, there are many lenders and we talked about borrowers, the AI companies borrowing. There are many lenders who've raised a lot of capital recently. And you think, do you use this term “dry powder” in private credit markets?

I think, at the moment, these lenders are likely ecstatic that they can deploy big amounts of capital quickly and at scale into these AI-related ventures. We’re very quickly, I think, using up that dry powder that exists in private markets, leveraged loan markets, and bank markets. Eventually, and perhaps very quickly, the markets that have been tilted in favor of borrowers may flip and be all of a sudden in favor of lenders.

All to say, this massive incremental borrowing that we're seeing should put upward pressure on credit spreads. Just as a base case, we could have investment-grade and high-yield spreads moving much closer to their long-term averages. In terms of investment grade, that would imply moving 20 basis points wider. That gets you halfway to their long-term averages. In high-yield, 110 basis points gets you halfway to their long-term average.

So, massive incremental borrowing, even a modest amount of widening, is quite possible over the next six months. I would say the winners would be the companies that raise funds early, and the losers are going to be the lenders who lend money early.

[09:24] Kevin Minas: Coming out of the great financial crisis, there was a lot of bank capital oversight, new rules, and a lot of non-bank lending that resulted from those regulatory changes post-great financial crisis. Recently, we're starting to see a little bit of a shift back, a deregulatory period with respect to bank lending and other areas of the market. Is that true? And if so, where are we starting to see those changes in deregulatory framework? Are there areas of the market that you're particularly concerned about? Or conversely, does this create an opportunity of some sort for an investor like yourself?

[09:58] Brian Carney: I think that's three or four questions, Kevin! There's no doubt there's been what I would call a very rapid reversal of all of that legislation that came out of the financial crisis, that was all put in place to help prevent another financial crisis.

That was the whole point of the Financial Stability Board and legislation that tightened up bank capital standards and all of that. And we're very quickly led by the U.S., seeing an unwinding of all of that. What does that mean?

It means corporations can be more aggressive in terms of their financial policies, their risk-taking, there’s less transparency, more leverage, and a lot of that in the unregulated markets. And quite frankly, it's not cool if you're a corporation, particularly in the United States, to talk about things like conservative financial policies and

deleveraging. It's much more fun and much more rewarding probably from the markets, particularly the equity markets, to talk about raising your dividend, buying back shares, and M&A activity.

There's lots of reasons as a lender to be concerned about that. Some of the things that are really concerning, push to semi-annual reporting, perhaps less. Most public companies now have to report quarterly.

So that gives investors or potential investors lots of information as they're analyzing a company. Talking about reducing that, lower capital standards for financial institutions, troubling elimination of living wills for banks. There's a whole host of things that are troubling and that will reduce transparency, increase risk-taking. And most of that is emanating from the U.S.

But if you're a regulator or a politician in any other market around the world, of course you don't want your financial institutions or your companies to be disadvantaged relative to the U.S. Perhaps, less enthusiastically, you are probably thinking about making those same types of changes so that your companies are disadvantaged versus U.S. companies.

In terms of where we're spending most of our time, primarily public companies, where the disclosure, even if it is reduced, will be better than it is for private companies. We also think this rush to private markets, fewer investors are spending time in the credit markets focused on what we call the public or quasi-public markets.

The last point I'll make is that the best managed companies will be able to navigate through this period. And we'll focus, and I think our colleagues on the equity side, will focus on the companies that are doing what's best for their stakeholders, not on finding loopholes so they can do things that they otherwise wouldn't do with a different administration in the White House.

[12:38] Kevin Minas: So I suppose, not great in terms of potential financial stability outlook. But I guess as an active investor, it sounds like maybe at the margin, there might actually be more dispersion. When you're sifting through companies, this is actually an opportunity for an active manager because all credits won't be created equal and there'll be perhaps some businesses that push things a little further than others. And if you're an astute investor, you can hopefully sniff that out.

[12:59] Brian Carney: I couldn’t have said it better.

[13:01] Kevin Minas: I'll try to keep the next question to just one question! You've talked about credit spreads being pretty compressed. That's been a consistent theme for quite a while now. That compression of spreads means that there isn't as much dispersion of spreads across issuers, presumably. Where in particular are you seeing the biggest areas of perceived mispricing, either it's just too tight or conversely, areas of opportunity?

[13:24] Brian Carney: Well, there are many more areas where things appear just too tight, where investors just aren't compensated for the risk of owning particularly lower quality credits. So, less and less differentiation between issuers with what we would say have dramatically different credit quality profiles.

You see that in the differentials spreads between public and private markets. Not too long ago, 500 or 600 basis points of difference. Today, maybe 300 or 400 basis points of differential. You see it between senior and subordinated debt of the same issuer. Again, spreads relatively tight.

So, we just don't believe investors are compensated for the risks in many of these types of markets. I always say to people who don't follow the credit markets, the best indicator is just the average spread on your typical lower quality issuer, your Michael Milken junk bond, high yield bond.

It's a little over 300 basis points today or 3%. The long-term average is about 5.4%. So just looking at that one indicator tells you that generally the market, despite some of the tremors we've seen, in spite of this looming threat of a flood of AI-related issuance, is still at the moment tilted in favor of borrowers over lenders.

[14:42] Kevin Minas: Given all the backdrop so far, what sort of concrete actions have you taken in the strategy that you run? How are you currently positioned now and where do you see opportunity?

[14:54] Brian Carney: Well, right now the opportunity is in protecting capital. And we talk a lot about investors don't expect to lose money in fixed income. And in order not to lose money in fixed income, you have to plan in advance.

Acknowledge bad things will happen. Something bad will happen in the future and that's going to recalibrate financial markets, including credit markets. And you can't start mitigating risk when whatever that event happens, you have to plan in advance and take steps to mitigate that.

What are the steps that we take in the global credit strategy? We are concerned, as we talked about, longer-term yields, credit quality of the United States. So, as we look at individual situations, we're typically buying very short-duration securities. We also don't think, for the most part, investors are being compensated for the risk of owning lower-quality credit. So by and large, our investigations are leading us to much higher quality corporate securities.

So, short-duration, high-quality, even though we think the entirety of the market is expensive, there are a few very special situations that pop up regardless of where you are in the market cycle. We have a few very special situations, lower-quality credit, but for the most part, it's protect capital, high-quality, short-duration, wait for the opportunities that inevitably will come when we have a market correction.

[16:20] Kevin Minas: Maybe just a last question. Defensively positioned, that creates, for lack of a better term and just to connect it to what you said previously, dry powder. So to speak, in a different context, but basically capital to redeploy when there is that market jitter or market event, maybe even full crisis. What are some of those specific triggers that you would be looking for?

Because it's obviously difficult, if not impossible, to call a specific crisis or a part of your preparation, you must be looking for signs. What are those guideposts that you're looking for? Any themes in terms of maybe an inventory list that the team has put together?

[16:55] Brian Carney: So in terms of triggers, we've talked about some of them. Random events to the optimists, tremors to the pessimists, like me. We would expect in the early days of a brewing crisis to see some levered liquidations, hedge funds, other levered vehicles where a prime broker or another lender has said, we're no longer comfortable holding that risk.

You see very dramatic liquidations of levered vehicles. You may see issuer drawdowns. So, companies that are starting to wonder about where we are in the economic cycle, financial market cycle, drawing down on their bank lines, raising cash, and then ultimately, likely more defaults as lenders pare back on risk-taking.

Ultimately, that means companies that are over-levered or who have questionable business models ultimately wind up in default. There are a number of potential triggers and you never know which one is going to be the match that lights the whole thing up. You have to be cognizant of them all. But if you've toggled your portfolio to be defensive when you're not compensated for risk, that allows you to take advantage of the tremendous opportunity for capital appreciation that credit market dislocations provide.

So, as we think about what are some of the names and companies that we might toggle into, we tend to be focused on fallen angels. Companies that are low investment grade might have some challenges, may end up

being downgraded to the high-yield category, issuers with double B credit profiles, issuers that have bigger stocks of debt outstanding that might be when the levered vehicles are unwinding and have to sell. They're going to sell the most liquid securities that they have that might present a unique pricing opportunity for an opportunistic investor to take advantage of. We're looking at a whole bunch of different types of names. No specific sector stands out. No specific geography stands out.

Investigate a lot, have a list and be ready. Because if you go back to the last crisis we had, which was COVID, the timeframe you had to act between when the financial markets started to be in crisis to when the Federal Reserve stepped in on March 23rd, it was measured in days and weeks. You didn't have a lot of time to take advantage of those spectacular opportunities that were born out of something which, unfortunately, was quite tragic. But you got to be prepared and positioned appropriately to take advantage. And that's what we're focused on.

[19:28] Kevin Minas: That's a good place to leave it and a good reminder, actually. It's not just about being prepared and defensive now, but it's also these things can sometimes happen quickly and you've got to be ready to move. So, you need that capital to be defensively positioned, but also it has to actually be there, so that you can pull the trigger when that market event happens.

You can't in the middle of the crisis, or it's harder at least in the middle of the crisis, to actually shift into a strategy like this. There tends to be friction. There tends to be a bit of a delay. And by the time all that happens and you're actually in this type of strategy, the market might've already moved. That's a good reminder as well.

Brian, thanks again for joining today. I always learn lots when we have these conversations and hope to do it again soon.

[20:08] Brian Carney: Excellent. Thanks, Kevin. Appreciate your time.

[20:11] Kevin Minas: Hey, everyone. Kevin here again. To subscribe to the Art of Boring podcast, go to mawer.com.

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