Learning Insights

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Credit cycle on the turn

"Higher for longer" is a mantra with which observers of the global interest rate regime have been familiar with for some time. As central banks worldwide remain resolved to stay the course of rate rises to counter obstinate inflation, so the effects of 'normalized' rates are beginning to bite in the form of rising levels of corporate defaults.

When credit conditions turn, the high yield (junk) bond market is first to exhibit distress. Moody's expects speculative-grade corporate defaults to rise to 4.6% by the end of the year (the long-term average is 4.1%), and to peak at 5% in April 2024.

The Financial Times, citing Goldman Sachs analysis of data from PitchBook LCD, reported there were 18 debt defaults in the US loan market between January 1 and the end of May 2023, totaling $21 billion. This was greater in number and total value than for the whole of 2021 and 2022 combined. The month of May saw three defaults totaling $7.8 billion — a level not seen since the Covid-19 crisis three years ago. While corporate loan defaults are rising, this is not happening at the same rate as high yield as, while money was cheap, many companies took advantage of low rates to raise cash and push out loan maturities.

Credit cycle enters into late stage

Nonetheless, all told, there are ominous signs that we are entering the latter stages of the credit cycle with an acceleration in defaults likely. The ending of an accommodative monetary policy, and weakening economic growth, threatens the ability of companies to finance increasing debt levels.

The economic cycle from December 2007 until February 2020 in the US was the longest since records began before it crashed against the onset of Covid-19. Nonetheless, the Covid-inspired downturn was brief, as central banks responded with massive monetary stimulus and fiscal bailouts, having the effect of suppressing the credit cycle and limiting the number of defaults. It took only a couple of months for the US economy to begin expanding and the cycle to start again.

Although the current cycle is just two years old, runaway inflation continues to preoccupy the Federal Reserve and other central banks. Meanwhile, a surge in leveraged finance that funded M&A deals from 2021 has pushed global debt to extraordinary levels.

Recent stress in the banking system, and associated slowing in the growth of bank lending, has also brought forward the end of the economic cycle. Combined with higher rates, these tighter financial conditions threaten economic growth, with the tilt toward recession further evidenced by indicators such as housing starts, consumer confidence surveys, business confidence surveys, PMIs (purchasing manager indexes), and the continued inversion of the yield curve.

Interest charges breach loan covenants

The effect of recession on earnings heightens the prospect of default by the weakest borrowers. But the interest rate hiking program also has implications for loan covenants. When interest rates rise, companies may fall below the interest coverage ratios that form part of their covenants when issuing debt (interest coverage ratios measure companies' ability to pay interest on their outstanding debt). While the company may continue trading, the result is a technical default, causing credit rating downgrades and selloffs within bond markets.

Private credit on an upswing

While investment-grade bonds and blue-chip debt issuers carry very limited probability of default, they are not immune from the effects of elevated interest rates. A consequence of this has been growth in private credit. Alternative asset managers, typically private equity firms, have facilitated companies to bypass traditional banks and bond markets in their efforts to raise cash.

And while the booming private credit market has until now been associated with riskier companies, private debt has proved increasingly suitable for blue-chip companies and asset managers alike. Many private equity companies have acquired insurers over the past decade which has led to vast sums of premiums looking for a home. Insurers are required by regulators to invest these premiums in investment-grade rated debt. The circle is completed by private equity operators (insurance company owners) who typically are able to command a slight premium over the yield on traditional investment-grade corporate bonds. For companies, there is the advantage of not having to go to the bond market with the possibility that increased debt might have negative implications for its credit rating.

With "higher for longer" now looking less like a threat than a new reality, and the credit cycle entering into a critical phase, the resourcefulness and financial resilience of companies is set to be tested severely.

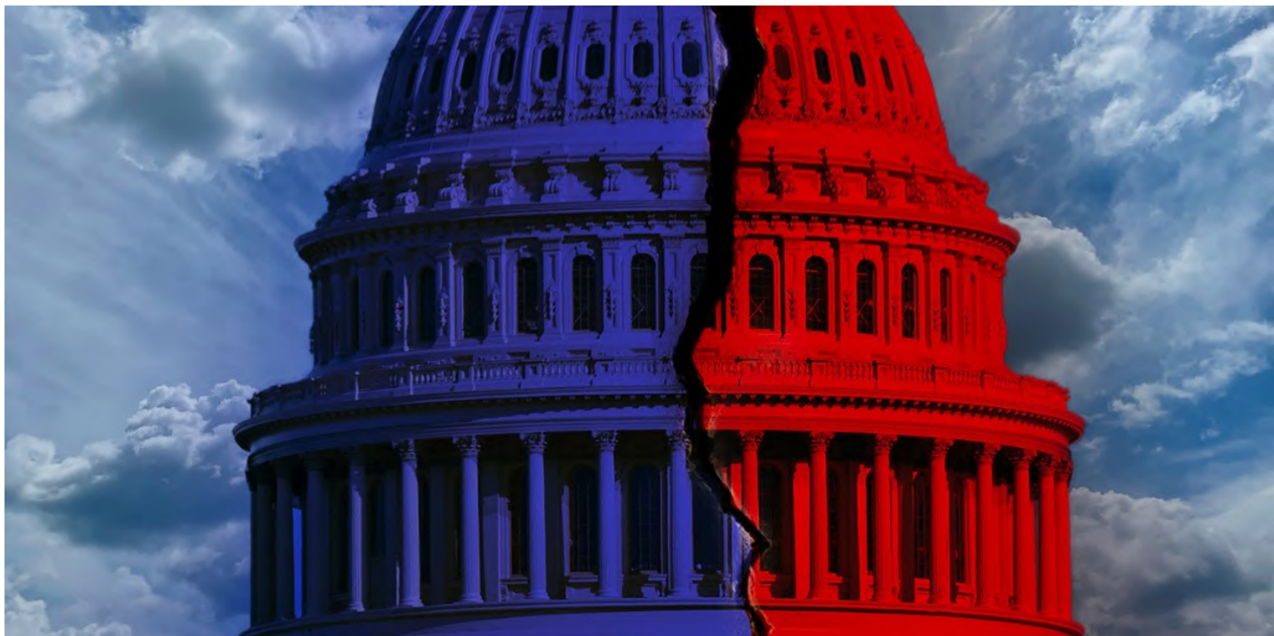
Intuition *Know-How* has a number of tutorials relevant to the content of this article:

- Bond Markets – An Introduction
- Bond Markets – Issuing
- High Yield Debt
- Credit Risk – An Introduction
- Credit Analysis – An Introduction
- Credit Analysis – Cash Flow Analysis
- Private Equity – An Introduction
- Private Equity – Investing
- Private Debt
- Monetary Policy Analysis
- Fiscal Policy Analysis

ESG backlash gathers pace

The recent statement by the CEO of one of the world's largest asset managers that henceforth he would stop using the 'weaponized' term 'ESG' is clearly a consequence of a backlash against ESG investing that has been building for years.

The issue of environmental, social, and governance (ESG) factors may or may not be weaponized, but it has certainly been highly politicized, notably in the United States where Republican politicians tend to view ESG as a cover for promotion of an economically liberal agenda, while Democrats look to defend the sustainable investing movement. The outcome of ESG being dragged into the 'culture war' has seen "Red" states propose and enact "anti-boycott" bills that prohibit state business with firms (asset managers) that divest from specified industries (industries likely to transgress against ESG such as fossil fuels). "Blue" states, meanwhile, are of a mind to mandate divestments from such industries.



Anti-ESG lobby focuses on investment returns

Leaving aside political or 'culture' considerations, a core aspect of the 'anti-ESG' backlash has focused on the implications of ESG for investor returns. Anti-ESG proponents point to the limiting nature of ESG investing, with its tendency to exclude companies from its investment universe that offend ESG principles – an approach they contend has negative implications for returns (indeed, Morningstar has identified some 27 'anti-ESG' funds which "take the opposite tack" to sustainable investing). This notion was boosted significantly by the Ukraine war that saw sectors such as defense and energy enjoy spectacular profits with investment returns that would have been entirely missed by ESG-observant investment vehicles.

ESG supporters highlight risks

Supporters of ESG, on the other hand, contend that ESG integration in investment decisions is the only option to fulfil their fiduciary duty and to ensure long-term, sustainable value creation. They point to the numerous risks attendant in ignoring ESG factors.

Environmental risk posed by exposure to issuers that may potentially be causing, or affected by, environmental degradation and/or depletion of natural resources.

Climate transition risk arising from exposure to issuers that may potentially be negatively affected by the transition to a low-carbon economy due to their involvement in exploration, production, processing, trading, and sale of fossil fuels.

Climate physical risk from the exposure to issuers that may potentially be negatively affected by the physical impacts of climate change.

Social risk from association with issuers that may potentially be negatively affected by social factors such as poor labor standards, human rights violations, damages to public health, data privacy breaches, or increased inequalities.

Governance risk arising from investments that may be negatively affected by weak governance structures.

Sustainable funds growth slows

The evidence of (and effect of) anti-ESG sentiment can be seen in the stark difference in ESG fund volume and flows between the US and Europe.

Morningstar's Global Sustainable Fund Flows report for Q1 2023 showed that global sustainable funds attracted USD 29 billion of net new money in the first quarter of 2023. This figure was down from nearly USD 38 billion in the previous quarter on account of macroeconomic pressures, including rising interest rates, inflation, and a looming recession that continued to weigh on investor sentiment. Morningstar noted that ESG product development "cooled down" and that "Europe saw a significant reduction of new sustainable fund launches, amid regulatory uncertainty and fears of greenwashing accusations."

Meanwhile, sustainable funds in the United States experienced their third quarter of outflows in a year. Nonetheless, despite lower inflows (but helped by higher valuations) global sustainable fund assets continued their recovery to reach USD 2.74 trillion at the end of March. Notably, however, some 84% of that total was attributable to European-domiciled funds and their US equivalents accounted for just 11%.

ESG supporters promote active engagement

The geographical and ideological divide on the subject of ESG is becoming stark. But sustainable investing practice need not mean exclusion of ’problematic‘ companies. Most asset managers that expound ESG principles prefer an active engagement approach with such companies. This involves dialogue with company management in support of the pursuit of sustainable business practices that the asset manager believes more likely to generate long-term value. This approach will normally be coordinated with voting practices consistent with the same end.

The argument is that excluding “bad” players does not deliver financial, environmental, or social return. In fact, in the words of one asset manager, “Selling a polluter with transition potential to another buyer does not reduce emissions released into the environment. It’s like throwing your garbage onto the neighbor’s lawn. There will always be speculators willing to take on additional risk for greater potential return in the short term. This is why numerous studies have shown that engagement is more effective than exclusion at changing corporate behavior.”

Ironically, given the severe divide between pro- and anti-ESG investment camps, neither party would necessarily disagree with this statement in principle; nonetheless, that should not be to disguise the profound implications of the ESG backlash both for investment funds flows and asset management industry politics.

Intuition *Know-How* has a number of tutorials relevant to the content of this article:

- ESG – Primer
- ESG – An Introduction
- ESG Factors
- Climate Risk – An Introduction
- Sustainable & Responsible Investing – An Introduction
- Sustainable & Responsible Investing – Strategies
- Impact Investing
- ESG Reporting

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