DISTRESSED CREDIT

AN OPPORTUNITY DURING DISAPPOINTING GLOBAL GROWTH

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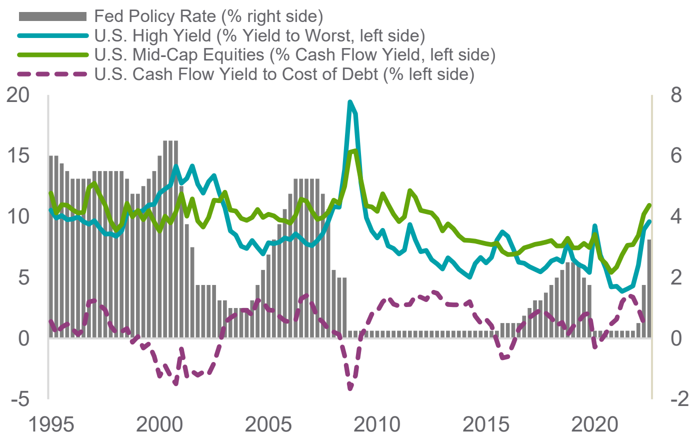
Northern Trust Asset Management
Global Family Office

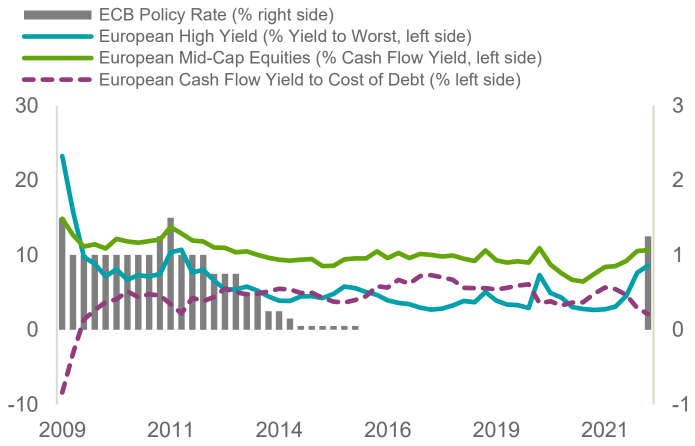
Tighter financial conditions from the global rate hiking cycle have put company business models and balance sheets to the test. At the index level, the high yield asset class looks compelling given solid fundamentals and attractive valuations. But within the asset class, some issuance will become distressed or even default. That is the arena of distressed credit hedge funds, who look to separate the salvageable from the truly insolvent. Capital that can handle the illiquidity and idiosyncrasies of these investment strategies could be rewarded handsomely.

The Federal Reserve (Fed), the European Central Bank (ECB) and other central banks' resolve to tamp down inflation has rapidly driven the cost of debt (yield to worst) higher for U.S. and European mid-cap companies. During past periods of central bank rate hikes, the cost of debt eventually exceeded the cash flows that serviced it for a meaningful number of businesses, with those that had lower credit ratings especially vulnerable to this debt servicing shortfall. The weakest bonds would fall to distressed prices until a missed interest payment or the inability to pay back principal led to a default. Exhibit 1 shows the path of both the Fed and ECB policy rates alongside yields for both U.S. and Europe high yield and equity cash flows as far back as we have it. As the blue lines move closer to the green lines – in part driven by the higher interest rate environment – risks (and opportunities) grow.

EXHIBIT 1: DEBT COSTS INCREASING DUE TO HAWKISH POLICY

Rising rates have reduced the ability of companies to service their debt.





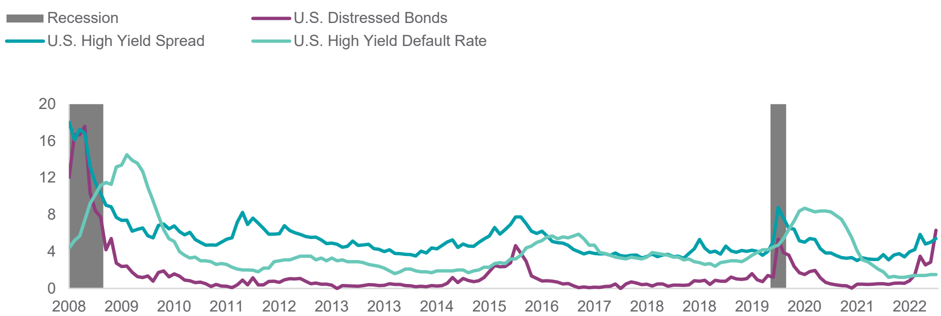
Source: Northern Trust Asset Management, Bloomberg, ICE, S&P, MSCI. Quarterly data through 9/30/2022. Cash flow yield is proxied by EBITDA/EV. Past performance does not guarantee future results. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index.

During these distress periods, traditional fixed income investors often sell out of distressed securities due to investment guideline constraints or a lack of workout capabilities. Distressed hedge funds often step in, at potentially very attractive prices, to participate in the transformation of the company back to a going concern or into liquidation. This has enabled distressed credit to be one of the best performing hedge fund strategies over the past 30 years, with performance becoming especially attractive during periods where defaults reached 5%. While potentially lucrative in both the U.S. and Europe, investors looking to take advantage should use discretion when deciding to tilt to distressed hedge fund strategies.

Widening credit spreads is a commonly cited leading indicator for a distress cycle, but it alone may not portend defaults. There have been moments where spreads have widened to levels that suggested a default cycle, but ultimately led to a period of below-average default rates (for instance, 2011; see Exhibit 2 below). Incorporating other signals such as the percentage of distressed bonds (those trading at $70 or less) suggests a more reliable composite signal. Looking back at the last three instances where default rates peaked above 5%, credit spreads and the percentage of distress-priced high yield bonds both accelerated higher before peaking roughly 6 to 12 months prior. Two of these distressed cycles occurred during a recession where distressed bond levels exceeded 5%. Today, spreads and distressed bonds percentages have noticeably moved higher above 5%. Investors may find that the next distressed cycle is unfolding. One caveat, the historic increase in rates has pushed a portion of long duration bonds that have relatively strong credit fundamentals to trade below $70.

EXHIBIT 2: SPREADS AND DISTRESSED CREDITS HINT AT DEFAULTS

Percentage of bonds trading at distressed levels have increased with widening spreads before default.



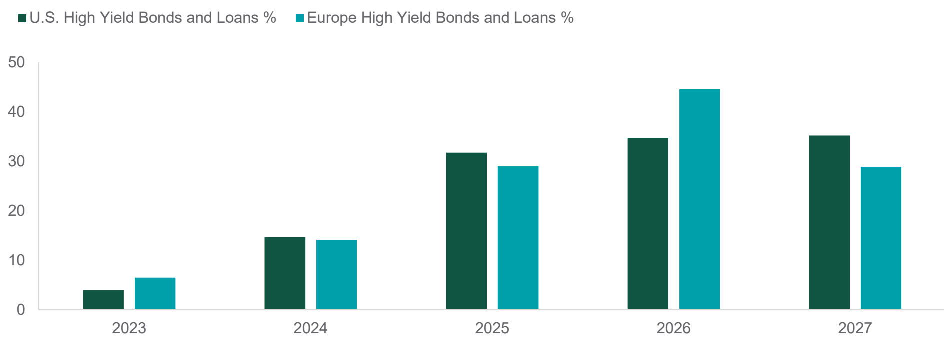
Source: Northern Trust Asset Management, Bloomberg, ICE, JPMorgan. Monthly data through 9/30/2022. Past performance does not guarantee future results. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index.

The opportunities are likely to evolve leading up to and through the end of the distressed cycle and vary by region due to the timing of economic cycles and nuances of local debt markets. Experienced hedge fund managers are positioned to uniquely benefit from the different phases and geographic differences. For example, ahead of a period of increasing defaults, traditional sources of financing tend to dry up as lenders become risk averse while economic growth weakens. Companies will turn to distressed hedge funds as lenders of last resort, leading to potentially lucrative returns for investors. Notably in Europe, companies that have borrowed at floating rates are acutely feeling the effects of ECB rate hikes. Meanwhile, lenders are tightening their belts against a backdrop of high inflation and weaker growth. This allows other investors with lower liquidity needs and higher risk tolerance – such as distressed credit hedge funds – to step in.

It is important to note that distressed opportunities tend to be somewhat divorced from the broader credit markets. The reason a company becomes distressed or ultimately bankrupt can vary (e.g., a company can no longer pay its debts and other liabilities because of miscalculated production costs). An important factor is the market's willingness to lend when a company's debt matures. Lenders avoiding credit risk during a recession can cause even financially-strong companies to find it difficult to borrow. Beginning in 2025, the percentage of debt that needs to be paid back or refinanced every year exceeds 20% (see Exhibit 3) and those issuers may find it difficult to roll over their debt if it coincides with a period of weak growth. This backdrop is attractive for active management where managers that have an edge (e.g., deep relationships, knowledge of local bankruptcy law) can achieve alpha.

EXHIBIT 3: CLIMBING A WALL OF MATURITY

Debt refinancing needs grow notably starting in 2025, which may trigger defaults.

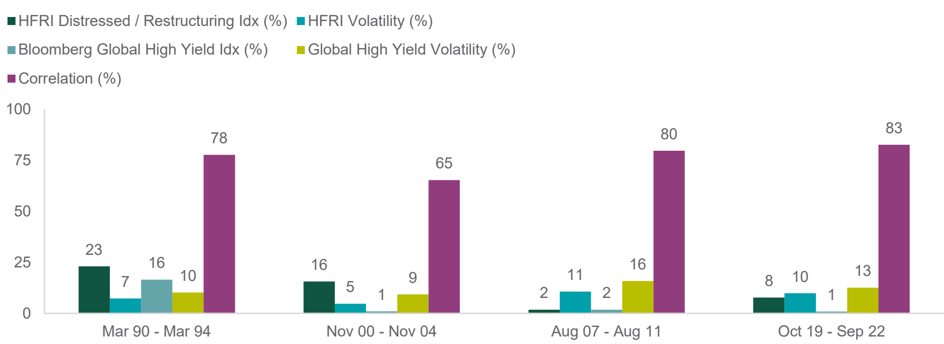


Source: Northern Trust Asset Management, Bloomberg. Monthly data as of 12/1/22.

Investors looking to size distressed strategies in a diversified portfolio should balance the risk-adjusted return opportunity against the ability and willingness to take on illiquidity. Exhibit 4 shows the idiosyncrasies of distressed opportunities, which have allowed the asset class to outperform high yield by an average of 7.1% with less volatility during distressed cycles (defined as the four-year period beginning three months before the recession).

EXHIBIT 4: HIGHER RETURNS AND LOWER RISK WITH A CATCH

Distressed hedge funds have enhanced both return and risk during distressed cycles.



Source: Northern Trust Asset Management, Bloomberg, HFRI. Monthly data through 9/30/2022. Past performance does not guarantee future results. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index.

CONCLUSION: BENEFITTING FROM STRESS

All in all, the opportunity for distressed credit is brewing and looks attractive due to global macroeconomic headwinds. Investors can potentially reap significant benefits from the environment by providing essential liquidity to distressed companies. The optimal path forward for most investors may be a pairing of illiquid and liquid allocations to create a balanced exposure to credit.

For more information, please reach out to Katie Colelli at KAC17@ntrs.com or (312) 444-3070.

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