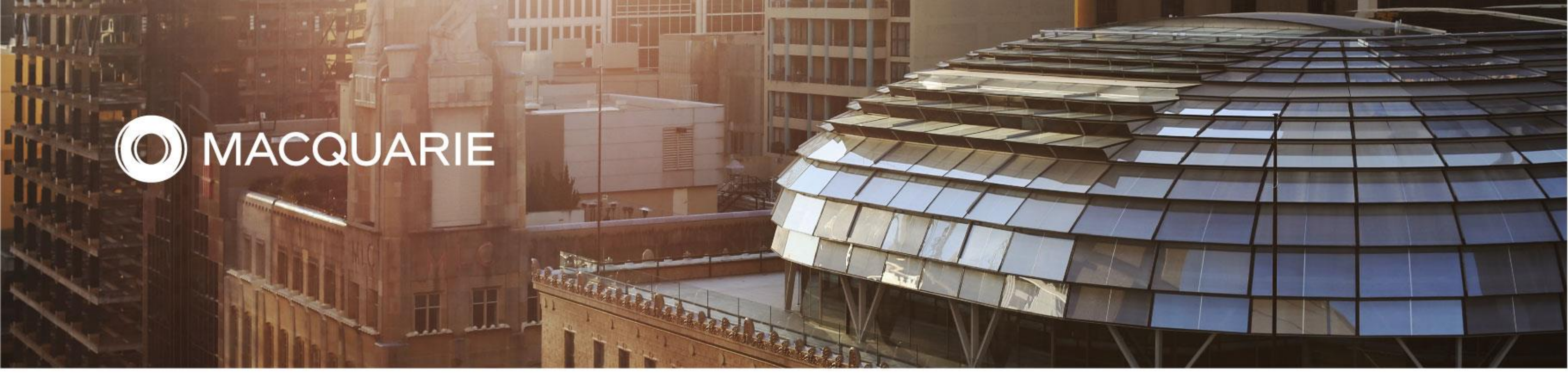


Investment Strategy Update #146

Sense checking portfolio positioning – Part 1: Credit

- Risk assets (equities and credit in particular) have had a strong 1H23. We think the direction (although not necessarily the magnitude) of gains is correct. If the developed world economic downturn was slow in arriving (being pushed back from 1H23 to 2H23), then it is entirely consistent for risk assets to be stronger.

- But, if recession is delayed and not denied, then investors should be cautious about extrapolating current conditions. While equities, credit and other risk proxy assets are at/close to year-to-date highs, it seems prudent to evaluate portfolio holdings to ensure they are consistent with an outlook that is set to deteriorate. Starting with credit, investors should ensure they are positioned appropriately.

- Defaults have already picked up with liquidity conditions continuing to tighten, and unlikely to ease anytime soon. To date, credit stress has emerged as expected and has been limited to the riskiest borrowers across both private and public credit markets. But this is expected to increase with some uncertainty as to how far or fast.

- Expectations are for default rates to rise to ~4% (from less than 2% in 2022) in line with long term averages. However, the nature of the default cycle will depend on the depth and duration of the growth slowdown together with how long borrowing rates remain elevated. Our base case is for a relatively benign credit cycle which means pockets of weakness but no systemic concerns. However, after more than a decade of easy liquidity it is difficult to know where stress may emerge (i.e., the recent US bank failures as an example).

- We are cautious on high yield sectors (particularly loans) and private credit. We see limited risk to overall financial stability from increasing defaults. However, waning risk appetite and ongoing capital scarcity together with limited transparency into the characteristics/creditworthiness of borrowers and uncertainty around asset revaluations makes it difficult to appropriately assess expected returns adequately for the risk.

- We think investors should answer the following questions and/or make the following recommendations for credit exposures:

  1. Lock in mark-to-market gains and trim exposure to the more speculative and illiquid parts of the credit markets back in line with long run targets (~4% for a balanced portfolio).

  2. Ensure that exposures across managers are diversified, we recommend no more than 1.5% - 3.0% to individual managers depending on liquidity and the underlying diversification of the investment vehicle.

  3. Favour liquidity and overweight sovereign bonds that offer attractive risk-adjusted returns and downside protection. Within Investment Grade, we prefer high grade, short-dated investment grade credit that have limited risk from credit spread widening and are more liquid relative to longer dated investment grade bonds.

- As the default cycle progresses, we expect there to be opportunities across all credit sectors to make outsized gains - from distressed/stressed debt to dislocation in credit markets to performing and high yield loans. But allocations to these investments should be consistent with overall portfolio credit exposures and account for the risks to underlying assumptions.

Credit conditions are deteriorating:

Repayment stress and default rates have started to pick up on the back of the rapid tightening in lending conditions together with increasing interest rates as well as deteriorating corporate balance sheets and slowing economic growth.

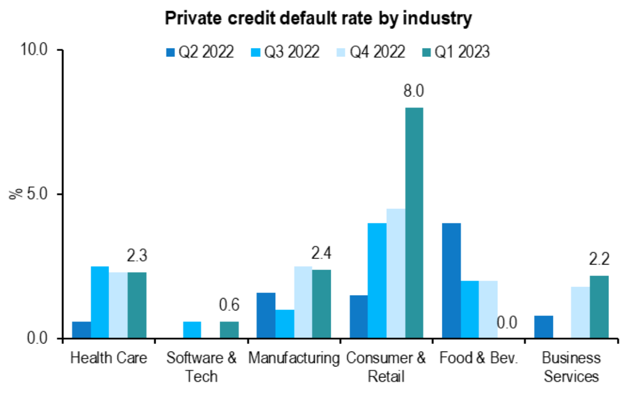
Lending standards have tightened rapidly

Source: Federal Reserve, MWM Research, July 2023

So far, credit stress/defaults have been well contained and concentrated in the more speculative areas of the credit market including:

- The bank loan market which tends to be of lower quality relative to the high yield bond market.
- Defaults have increased in the private credit markets, which are predominantly used as financing for PE sponsored leverage buyouts. In particular, the consumer sector (8% in 1Q23 up from ~1.5% 2Q22), with some signs that it is beginning to widen from consumer sectors to business services and software/technology.

Defaults are increasing within private credit



Source: KKR, JP Morgan Default Monitor, June 2023

Elevated default uncertainty requires caution:

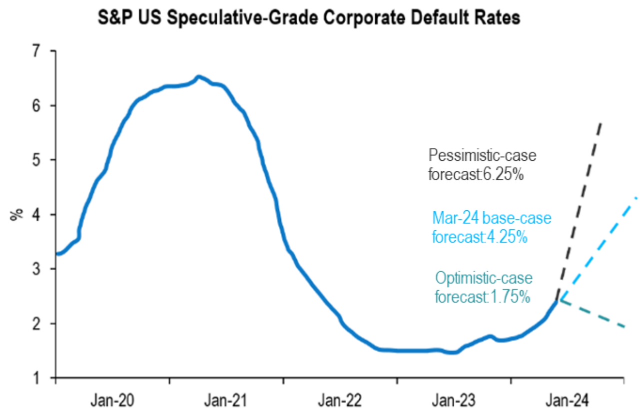
The outlook for credit defaults is consistent with the broader view that the tightening cycle will drive a short and shallow recession with only moderate flow on impacts to credit markets. This is also our base case, but just as central banks are treading a fine line in their attempt to bring inflation down without a hard economic landing, the potential for larger than expected spread widening and higher defaults is also non-trivial.

The base case scenario according to Moody's and S&P (credit rating agencies) is for default rates to increase throughout 2H23 back towards long run averages (~4%) assuming a short, shallow recession. However, the longer rates are held at restrictive levels, the greater the potential for negative surprises surrounding the default outlook, and this is contingent on the pace of decline in "core" inflation. This outlook carries significant tail risk which is not embedded in pricing of risk assets – credit included.

As a result, we think investors should approach credit with some degree of caution and consider the potential that a "best" case scenario may not eventuate. We think credit allocations should be stress tested against the following risks:

1. **A deeper than anticipated default cycle given higher for longer rates.** Once defaults start, the risk of knock-on effects increases whereby defaults begin in one sector but spread out to companies up and down the value chain (the weak infect the strong). This creates a vicious cycle where lenders grow increasingly cautious and further restrict capital, in turn increasing defaults further. Should the downturn prove deeper and/or longer than anticipated, it seems likely that elevated interest payments will see more companies facing financial difficulties and/or defaulting on the financial obligations.

Defaults expected to rise throughout 2H23



Source: S&P Ratings Direct, June 2023

2. **Lower recovery rates** Particularly in senior secured loans given the rise in "covenant-lite" loans (weaker lender protections) together with uncertainty around asset quality and/or valuations within private equity and unlisted real estate. Taken together this implies that the expected recovery in the event of default is highly uncertain but broadly expected to be lower than we have seen in past credit cycles. (Anecdotally, there are reports of recoveries in the 30-40c in the dollar range versus 70c for secured loans).

3. **Limited transparency due to the rise of private (direct) and senior secured loans.** Loans are by their nature confidential, often with bespoke terms

particularly in private credit markets. Unlike bonds, repayment terms can be renegotiated so defaults/distress can take time to emerge. The lack of publicly available information on the nature of the loans as well as the characteristics of the borrowers together with the illiquid nature of the asset class requires some caution is an uncertainty macroeconomic backdrop. While the risk of forced asset sales that causes broad financial instability is limited given most vehicles are unlevered, with limited redemption risk (unlike banks) the impact on the companies they lend to is untested.

Know the risks when reaching for yield:

Throughout 1H23, credit spreads narrowed alongside increases in equity markets, driving strong returns particularly in the riskiest end of the credit market.

Strong total returns provide opportunity to reposition

	6M (%)	1Y (%)	3Y (%)
US IG	1.91	-0.20	-4.08
US HY	5.38	9.06	3.13
US Senior Secured loans	6.74	12.50	5.23
US Private Debt	3.00	6.00	8.60

Source: Bloomberg, Cliffwater, Credit Suisse, June 2023

As downside economic risks increase, we think it is the right time to assess credit exposures. Strong total returns across senior secured loans and high yield provides an opportune time to reposition credit portfolios while also locking in gains.

When all is said and done, success in credit investing is about avoiding credit losses from which it is very difficult to recover. We recommend investors:

1. Right-size allocations across high yield and private credit allocations. Reduce exposures in line with long run targets. We recommend ~4% for a balanced portfolio. Within high yield exposure, prefer bonds to loans given their generally higher credit quality.

2. Ensure manager diversification particularly for riskier segments of the market. In general, we recommend no more than 1.5%-3% to an individual manager within a diversified portfolio depending on liquidity and diversification of the underlying investment vehicle.

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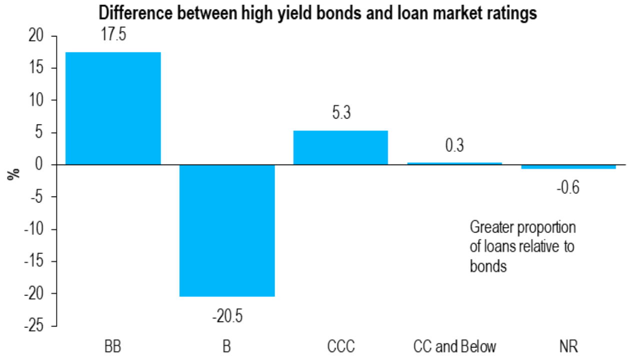
3. Overweight sovereign bonds relative to credit. For a balanced portfolio (35/65) we recommend ~16% in sovereign bonds versus 10% in Investment grade. Sovereign bond yields continue are at the highest levels in over a decade (10Y UST: ~4.05%) with the current yield highly correlated to future expected returns and downside protection in the event of recession/flight to safety.

Bonds relatively higher quality than loans



Source: KKR Credit, June 2023

4. Maintain and/or increase liquidity within fixed income to ensure flexibility. Within investment grade credit, we prefer short-dated highly rated floating rate debt given higher access to liquidity.

As with all credit cycles, there will be an increasing number of opportunities as the default cycle picks up and confidence deteriorates, causing a further pullback in capital. However, in our view, expected returns do not yet compensate adequately for the ongoing uncertainty surrounding the depth and duration of the economic growth slowdown and the corresponding Central Bank reaction function. Additionally, given the opaque nature of private markets and the uncertainty around asset values, forming an assessment of the risk being assumed is inherently more challenging. In time, opportunities will present themselves across all credit sectors – but we are not there yet.

Macquarie WM Investment Strategy Team

The report was finalised on 10 July 2023.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return

Neutral – return within 3% of benchmark return

Underperform – return >3% below benchmark return

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