2020: A Year of Surprises (Part One)

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It's accepted wisdom in the publishing world that magazines sell better with headlines like "The 7 Fastest Ways to Lose Weight," "The 5 Most Awesome Martinis," and "The 10 Hottest Vacation Spots."

Ordinarily a sophisticated finance journal such *The Lead Left* would never stoop to that kind of promotional gimmick. But, in the immortal words of Strother Martin, "this ain't ordinarily."

2020 was a year that redefined surprise, unveiling a sequence of unexpected, yet related, developments. In capital formation these arose from the blend of COVID-19 coursing through the nation and economy, combined with central bank liquidity. In the case of private capital, trends derived from the characteristics of the asset class, simultaneously highlighting its benefits to investors.

With that we kick off our special series: ***"The Five Biggest Private Capital Surprises of 2020."***

Surprise #1: The Market Snap-Back

We begin with the V-shaped recovery that was mirrored in various market moves. The Dow plunged almost 11,000 points in less than six weeks to a relative low of 18,592 at March 23. The realization that COVID-19 was a real threat to the US was hitting home to investors, and the economic outlook looked bleak. No one knew at the time, but public equity valuations had bottomed out. If you panicked and went to cash, you crystalized your downside and lost considerable upside.

The same held true for liquid credit. The S&P LCD leveraged loan index hit a low of 76 in March, a drop of over 20 points in a month, but began its slow trek back towards par. It closed the year at 96. As our *Chart of the Week* highlights, that restoration boosted loan yields to 3.12%, per S&P LCD. Compare that to the index average of 5.5% per year since 1997 – not bad, considering how dire markets looked at the end of 1Q.

The high-yield bond market was a surprise within a surprise. Typically one of the riskiest components of fixed income, junk bonds received special favor last year. When the Fed early in the crisis injected capital into challenged travel and leisure issuers such as Carnival Cruises and AMC – bonds rallied and never looked back. That led to record high volume of $425 billion in 2020.

Private capital, including equity and credit investments, demonstrated a slower recovery befitting an illiquid asset class. The investment pace was driven, not by market technicals, but by the tyranny of dry powder. Uninvested capital burned holes in managers' pockets for five months.

Once owners of performing middle market companies realized their businesses were worth more than pre-COVID valuations, they went to market, compelling a steep ramp-up in deal activity after Labor Day.

So despite how unprecedented and pervasive the pandemic threat turned out to be, with plenty of liquidity in the system (and in GPs) overall markets detached from both the virus and the economy.

Next week: Surprise #2: Non-Correlated Trends – Infections, Markets, and the Economy