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Four for ’24 (Second of a Series)

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1. ***New Normal Rates: The new macro and what this means.***

The US economy continues to roll along. December’s labor report showed 261,000 new jobs, a vigorous uptick from the 173,000 number in November. Market observers took this as a sign that the Fed’s projected three rate cuts for 2024 may be more back-ended. The current QT policy, draining liquidity from the financial system and bank reserves, may also be under review. Even slowing that tightening would improve market volatility and lower Treasury yields.

In June 2006 the Federal funds rate rose to 5.25%, the highest level for the benchmark since early 2001 before the dot.com bubble burst. That ushered in over a decade of generations-low rates, a period that finally ended in March 2022. Because many younger financial professionals began their careers during or after the 2008 downturn, their experience has been limited to near-zero interest rates. That leads to a false sense of confidence in the ability of more leveraged borrowers to withstand significantly higher rates and a potential recession.

Since 1974 the average Fed funds rate was 5.1% – close to where it stands today. For credit managers with decades of investing experience, “higher-for-longer” is familiar. Tighter systemic liquidity is seen as favorable to credit buyers, given tighter structures, lower leverage and higher pricing. It also puts a damper on frothy markets.

While the Fed appears done with rate increases and inflation is moderating, the strength of the economy combined with pent-up financing demand suggests the pace of cuts may not mirror how quickly rates accelerated in 2022-2023. That suggests a less likely return to the “zero-for-longer” world we inhabited before 2022.

It may be a “golden era” for credit investors, but it’s been a challenge for issuers. With interest rates easing, we expect a more forgiving financing environment for private equity sponsors. Considering the depressed levels of M&A during 2023, owners have been slower to achieve realizations for their LPs. With more favorable all-in debt costs, equity returns should start improving, accompanied by a more accelerated deployment of dry powder for 2024.

However, these trends are also tailwinds for portfolio performance. A lower benchmark will bring interest and fixed charge coverages back to more comfortable levels and allow borrowers with payment-in-kind (PIK) instruments to activate cash-pay options.

It’s hard to see beyond the next six months or so, but absent a GFC-level recession we expect the Fed to steer clear of another 2010-2022 era stimulus. Or attempt to wring out every last basis point of inflation to achieve a perfect 2% CPI landing. We could then be in for a more balanced economy with rates closer to old averages.

Instead of a “golden era” in private credit we could arrive at a new normal that benefits both borrowers and investors. Think of it as a “Goldilocks Era” for the asset class.