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Where We Are (First of a Series)

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A friend of long-standing and keen observer of capital markets for almost a half-century tells us: “When a rising Dow hits 10,000 increments, investors feel good, even though optimism may not be justified.”

And so we find ourselves mid-second quarter of 2024 with the Dow having reached 40,000, a destination that was Shangri-La not long ago. Like that mythical city somewhere in the Tibetan mountains, no one expected to find it in the real world. Yet barely four years from its Covid-era low of 19,173 here we are.

What does this really mean for investors? As our friend Van Hesser points out in a recent podcast, it’s one of several recent bullish indicators. The US economy is motoring along nicely with expected 2.4% GDP growth this year; a Goldilocks “not-too-warm” keeping things going without igniting inflation. Unemployment is on an unprecedented streak below 4%.

Consumer sentiment surveys are stubbornly bearish. Housing costs and mortgage rates remain elevated. Food and energy prices are challenging for middle- and working-class budgets. And certain industries such as healthcare are falling behind growthier tech and software sectors.

As we’ve discussed in previous weeks, the capital markets are similarly bilateral. The broadly syndicated market awoke in January with fresh CLO dollars and retail loan fund cash to put to work. Yet while global M&A is on its best upward trajectory in two years, new deal activity has not reached many sponsor-backed businesses. Of the $400 billion in institutional loan activity year-to-date, only about 10% is buyout related.

It has been noted that refinancings in the liquid market have targeted upper-middle market loans held by direct lenders. The effect has been both to improve the financing structures of those borrowers and to create spread compression across private credit for new issuance. Nevertheless, the traditional middle market – companies between $20 and $75 million Ebitda – retains much of its benefits for investors.

It should not be lost on anyone that regardless of a record level of repricings, borrowing costs remain quite high. The average all-in yield for first-lien loans, according to KBRA DLD, is 11%. Even accounting for some spread tightening over the past twelve months, that still limits the amount of leverage private equity firms can put on their portfolio companies.

Some credit managers, in more desperate bids to put idle cash to work, are offering aggressive terms to smaller businesses. Large cap features such as PIK-toggle and cov-lite provide cushions in balance sheets when pro forma interest or fixed charge coverage ratios sink below 1:1.

Over the next several weeks, we’ll revisit private credit market trends for both issuers and investors in the context of where rates and the economy look likely to be heading.