Where We Are (Second of a Series)

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How challenging has it been to predict the next recession? An inverted Treasury yield curve, a reliable forecaster of the past eight consecutive downturns, has been signaling recession for almost two years. So far, the economy has failed to cooperate. While growth is slowing, and inflation along with it, expectations are broad of a solid GDP number around 2.4% for 2024.

We mention this not to puncture any specific indicator, but to underline how challenged investors are today to get a clear economic or market outlook. Even within the commonly accepted context of a Fed seeking a rate cut at the next opportunity, the macro narrative is still evolving. An unexpected jump in CPI or labor gains could put a hike back on the table.

As we've seen in the post-Covid era, markets are whip-sawed by good and bad inflation data; bullish today, bearish tomorrow. That creates havoc with liquid asset prices, with 2022 a grim reminder for adherents of the 60/40 model. Alternatives such as private capital have proven to be constructive in building diversified portfolios more resistant to headline volatility risk.

With a "worst is over" mindset at the beginning of 2024, CLO equity investors found the arbitrage between cheaper liabilities and higher loan yields worked well enough to support new vehicle investments. BSL activity jumped in the 1Q, though much of that was, and continues to be, deployed to refinance higher cost deals, including those in direct lending hands.

While this story has been cast as a dramatic recapture of lost market share, it simply reflects a natural pendulum swing between publics and privates. When the economics of CLOs, 60-70% of BSL buyers, works, the large cap market works. It can just as easily shut down.

It's been clear now for at least a decade, and particularly since 2020, that private credit operates on an independent wavelength. Armed with long-term capital provided by institutional investors, direct lenders can operate in any economic or market environment. This makes the asset class especially well-suited for periods of uncertainty or volatility.

Of course, all asset strategies must swim in the same ocean and breathe the same air. Buyout markets have been hampered by slower M&A activity. The bid/ask spread for buyers and sellers remains wide. Thanks to the higher cost of debt financing, today's purchase price multiples lag those of earlier vintages for some businesses. Un-exited companies valued at $3 trillion globally, a number that has doubled over past five years, await better conditions.

Deal flow in leverage finance has accordingly been skewed towards refinancings. Per LSEG LPC, of the $500 billion in broadly syndicated loan volume year to date, barely $30 billion are new LBOs! The middle market is faring somewhat better, though top managers report the number of investment bank books circulating outweighs auctions launched.

Next week we look at how private equity firms, in partnership with their credit relationships, are working to get some realizations to their investors.