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Private Credit and Business Cycles (Last of a Series)

THE LEAD | May 19, 2016

The question of where we are in the business cycle may ultimately be answered only in hindsight. Similarly what triggers the next cycle will likely different than what set off previous downturns. Subprime mortgages, tech, or sovereign defaults will probably not be culprits, though fallen energy credits could certainly qualify.

Given the mature recovery, credit investors are understandably focused keenly on which part of the capital stack prospective managers play in. Yet unlike the corresponding end stage of the last cycle, rates remain at rock-bottom. It’s hard to remember now, but Libor in September 2007 was 5.5%. Today it stands at 0.44%.

Growth has also been severely challenged. First quarter US GDP barely registered at an anemic 0.5%. Even Italy – that engine of European capitalism – did better at 0.7%. Given how weak global economies are, it’s hard to imagine a precipitous downturn. Tough to crash your plane when you’re flying one foot above the ground.

Chris Godfrey at CEPRES highlights the connection between capital availability and cycle timing. “Our analysis is that the biggest determining factor of future returns is volume of capital in the market. It’s a direct correlation. If we see significantly increased capital, then future value in that segment deteriorates.”

That view argues against public credit where “hot money” predominates. Both high yield and large cap loans have seen outflows from retail funds this year, as investors toggle between “liquid” alternatives. The Fed’s inaction on rates heightens this activity.

In contrast, Godfrey says, there’s increasing interest in private credit. “It’s been recognized as a real asset class that should be part of every investor’s portfolio. So it’s a good time to invest in private debt if you believe the public markets may be overheating.”

How about default rates? “Recovery rates have been higher over the last few years. And there’s been less mezz flow, so quality has improved. It’s fair for investors to ask themselves, would I have been better off in high-yield? Probably not, but timing is key.”

We’ve worked for years educating investors on private credit. What strikes Chris Godfrey is how long it’s taken for interest in the asset class to take off. “It’s quite a complex market,” he told us. “Investors are still not clear on where private debt fits. This has historically restricted deployment of capital that could potentially come into the market going forward.”

That’s a heartening perspective, given how much chatter there’s been about new debt funds being formed.

“We believe we’re still at the early part of the growth curve,” Godfrey concludes. “There’s plenty of room for private debt. It’s taken a long time, but sophisticated investors are finally putting dollars to work there.”