Aegon Asset Management’s head of distressed debt, Rishi Goel, and head of restructuring, James Rich, discuss their views on economic and credit cycles as well as developing risks and current investment opportunities within distressed debt.

1) Do you think the economic expansion is nearing the end?

Steady economic growth, solid corporate fundamentals and favorable lending conditions have prolonged the economic expansion and current credit cycle. Although this expansion is already one of the longest in modern history, we don’t believe that the length of an expansion has the predictive power to indicate the next turning point. Rather, we believe the timing of the next cycle depends on the balance between the effects of fiscal stimulus, most notably from the US tax reform and the Jobs Act of 2017, and increasingly tighter monetary policy.

In addition, the newest threat is the ongoing global trade war saga, most importantly between the US and China. We also acknowledge that monetary policy can be difficult to predict, and the Federal Reserve has a history of making policy mistakes. Nonetheless, we believe the fiscal tailwinds could more than offset the monetary and trade headwinds for the foreseeable future, indicating the end of this expansion is not just around the corner.

2) Where are you finding opportunities today?

Secular challenges in the retail sector stemming from shifting consumer spending habits and the rise of e-commerce have given way to a rise in retail bankruptcies. Against this backdrop, we’re carefully picking through the retail ruins to source opportunities, although we are cautious on the sector’s outlook.

Aside from retail, the energy sector was under tremendous pressure beginning in late 2014, but those pressures have eased materially since mid-2017 with the recovery in oil prices. Nevertheless, many issuers’ balance sheets rely on $100 per barrel oil prices, and oil at $70 and barrel is not sustainable for many producers’ balance sheets over the long term. This uncertainty creates opportunity as certain oil-related issuers’ securities have traded lower recently, below our perceived fair value.

In addition, the wirelines, hospital, grocers and pharmaceuticals sectors face several secular headwinds that we’re constantly evaluating. Lastly, we’ve found attractive cross-asset opportunities, particularly in emerging market debt, closed-end funds and structured products.

3) Discuss your views on the next default cycle and potential key catalysts.

US high yield default rates currently hover around 3%, well below the historical average of 4-5% (Exhibit 1). For defaults to pick up materially from here, one of two catalysts needs to occur. Either the economy enters a recession or an exogenous shock occurs that’s strong enough to effect one or more large sectors, such as the shock to energy and commodities sectors in 2014-2016 due to the decline in oil prices.

On the first catalyst, we do not expect a recession in the short term. The second catalyst, exogenous shocks, can be much more difficult to predict. Aside from the well-publicized secular shifts in retail, telecom and healthcare, we haven’t identified any other potential exogenous shocks that could cause a material increase in defaults.

As a result, in the near term we expect default rates to remain relatively contained, and below historical averages.

Exhibit 1: Default rates remain below historical average

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4) Given your outlook on defaults, what do you make of the elevated distressed debt drawdown fund flows this year?

According to Preqin, managers raised $15.4 billion in distressed debt private drawdown funds during the first half of 2018, compared to just $6 billion during the same period last year. Similar to a traditional private equity fund, the capital allocated to distressed debt drawdown funds is committed, but not invested, until the economy turns, defaults increase, or distressed opportunities arise. While distressed drawdown structures can provide the opportunity to deploy capital quickly when opportunities arise, these structures typically sit idle as managers wait for the next market turning point. In our view, these structures may miss the opportunity to generate attractive returns while waiting for an uptick in distressed opportunities.

Exhibit 2: Distressed debt fundraising outpaces other private fund types
Year-to-date fundraising as of June 30, 2018

The percent of bonds trading at distressed levels—defined as spreads greater than 1,000 basis points over US Treasuries—is near all-time lows at 3.7% in developed markets according to BofAML as of Q2 2018, but we believe there is increasing divergence between how the markets are pricing different issuers and sectors. As a result, we believe we could see an 8-10% return this year in certain issuers and sectors that aren’t truly distressed, but are coping with fundamental challenges that can result in mispriced securities and potential investment opportunities. Additionally, we are focused on maintaining sufficient allocations to liquid securities so that when the cycle turns, we can rotate and work to quickly deploy capital.

5) What key risks are you monitoring?

While broad market tailwinds, such as rising rates and an improving consumer, are generally supportive of the leveraged loan market, we are growing increasingly concerned about mounting leverage and other increasing market risks. Demand for bank loans from CLOs and, to a lesser extent retail investors, is currently outstripping loan supply. According to JP Morgan, the leveraged loan market has grown from about $900 billion in 2015 to $1.15 trillion today, an increase of about 10% annually. As with any rapidly growing asset class, we remain skeptical on the ability of upward momentum to continue.

Exhibit 3: Bank loan market surpassed $1 trillion in 2018
As of June 30, 2018

Issuers are increasingly taking advantage of this supply/demand imbalance to provide their companies—and their equity holders—greater flexibility, often to the detriment of creditors. This has resulted in a persistent decline in the quality of creditor protections provided in loan documents overall. Aggressive underwriting standards and weakening credit profiles pose real concerns about future defaults and subsequent recoveries. Read more about our views on navigating risks in the bank loans market.

For the time being, 3-month LIBOR has increased by more than 100 basis points in the past year, which can provide investors additional compensation for these in risks. However, even with the higher coupons, we’re finding fewer attractive opportunities in the loan market than we did just a few months ago. Despite the looming concerns, we maintain a constructive view on bank loans and see compelling idiosyncratic investment opportunities.
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