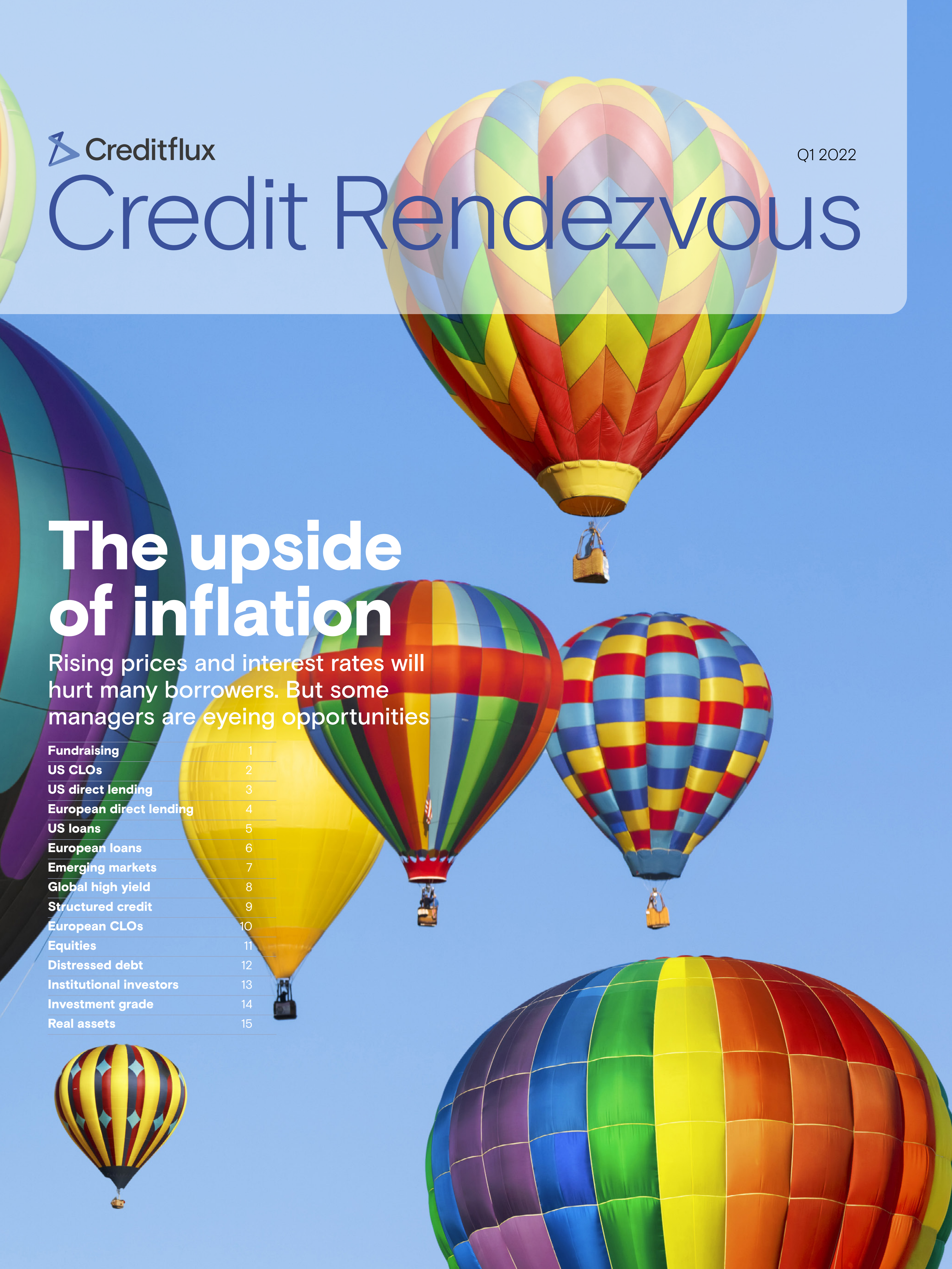


Creditflux
Q1 2022

Credit Rendezvous

The upside of inflation

Rising prices and interest rates will hurt many borrowers. But some managers are eyeing opportunities

Pumped up for floating rate credit

With interest rates expected to rise, funds that invest in floating rate paper are hoping to do well in 2022. But distressed and credit opportunities strategies are also expecting plenty of openings

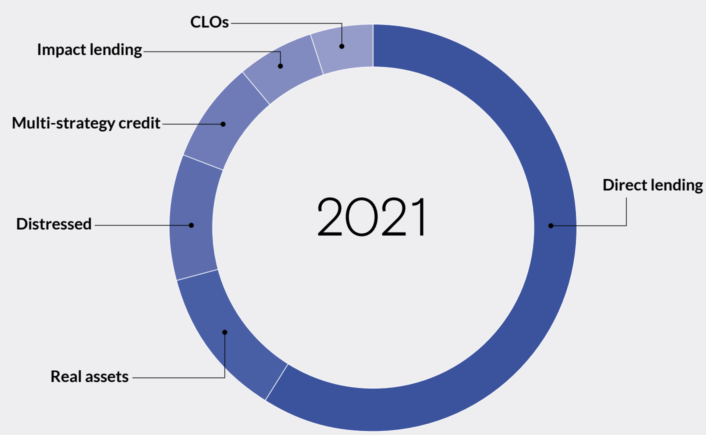
Forget the idea that inflation will be transitory. After a 7% annual rise in prices in the US last year (according to the US consumer price index), the US Federal Reserve is lining up several rate hikes in 2022.

That is expected to draw more investors to floating rate favourites, such as leveraged loans and CLOs. However, floaters have to contend with the transition away from Libor to Sofr this year.

Distressed debt funds have had to wait patiently as pandemic support programmes have done their job. But as fiscal support is withdrawn, opportunities could arise for the likes of Oaktree and Starwood (see below).

Credit funds raised by strategy

Number of funds raised globally Source: Creditflux



59 direct lending funds were raised in 2021, along with 12 real assets funds and 10 distressed funds

Largest funds raised in 2021

Source: Creditflux

Month	Fund	Manager	Strategy	Currency	(m)
Nov-21	Oaktree Opportunities Fund XI	Oaktree	credit opportunities	USD	15,900
Dec-21	Ares Senior Direct Lending Fund II	Ares	direct lending	USD	14,000
Sep-21	HPS Speciality Loan Fund V	HPS	direct lending	USD	11,700
Apr-21	Ares Capital Europe V	Ares	direct lending	EUR	11,000
Sep-21	Starwood Distressed Opportunity Fund XII	Starwood	distressed	USD	9,800
Mar-21	Broad Street Loan Partners IV	Goldman Sachs	direct lending	USD	7,100
Oct-21	Ares Private Credit Solutions Fund II	Ares	direct lending	USD	5,100
Apr-21	Hayfin Direct Lending III	Hayfin	direct lending	EUR	5,000
Aug-21	Strategic Value Special Situations V	SVP	distressed	USD	5,000
Nov-21	Arcmont Senior Loan Fund II	Arcmont	direct lending	EUR	5,000
Apr-21	Whitehorse Liquidity Partners Fund IV	Whitehorse Liquidity	direct lending	USD	4,000
Mar-21	Ares Pathfinder Fund	Ares	direct lending	USD	3,700
Jun-21	CVI Credit Value Fund V	CarVal	distressed	USD	3,600
Jan-21	LCM Partners Credit Opportunities 4	LCM	credit opportunities	EUR	3,400
Jan-21	Blackstone Capital Opportunities Fund IV	Blackstone	direct lending	USD	2,800
Jan-21	Marathon Distressed Credit Fund	Marathon	distressed	USD	2,500
Mar-21	Cerberus Institutional Real Estate Partners V	Cerberus	real assets	USD	2,500
Mar-21	Cerberus Levered Loan Opportunities Fund IV	Cerberus	direct lending	USD	2,400
Feb-21	Apollo Accord Fund IV	Apollo	direct lending	USD	2,340
Oct-21	Vista Credit Partners Fund III	Vista Credit	direct lending	USD	2,300
Oct-21	FP Credit Partners II	Francisco	direct lending	USD	2,200
Jan-21	Kennedy Lewis Capital Partners Master Fund II	Kennedy Lewis	credit opportunities	USD	2,100
Oct-21	Torchlight Debt Fund VII	Torchlight	real assets	USD	2,040
Feb-21	Unknown	Adams Street & American Equity	direct lending	USD	2,000
Jul-21	Owl Rock Opportunistic Fund	Blue Owl	direct lending	USD	2,000
Aug-21	Silver Point Specialty Credit Fund II	Silver Point	direct lending	USD	2,000
Sep-21	HIG Europe Middle Market LBO Fund	HIG	direct lending	EUR	2,000
Oct-21	Texas Debt Capital	CIFC	leveraged loans	USD	2,000
Dec-21	Hayfin Special Opportunities Fund III	Hayfin	distressed	EUR	2,000
Dec-21	Tikehau Direct Lending V	Tikehau	direct lending	EUR	2,000

US CLOs

Reset rush on the cards as equity investors seek to avoid hardwired Sofr spread adjustment

Olga Chernova

Managing partner, Sancus Capital Management

Bullish

CLO equity

Bearish

Loan spreads

Greatest challenge

Settling on the right basis for the Libor to Sofr transition while matching assets and liabilities

As the calendar moves to a new year, CLOs also find themselves in a transition period between Libor and Sofr. But the first deals to fully reference Sofr have come to market, defying the much anticipated pause as the market adjusts to the new rate.

The speed and ease of the transition, and a full pipeline of new Sofr-linked transactions, suggest another busy year for the market is ahead, though commentators expect lower overall volumes than 2021.

Existing CLOs' equity returns could be hit by the transition, with Sofr-linked loans pricing tight of the recommended Alternative Reference Rate Committee (ARRC) adjustment embedded in older CLO documentation, says Chernova.

"For many existing CLOs there is a hardwired ARRC language of 26 basis points written into the documentation, but it looks like the underlying loan market is pricing at least 10 basis points tight of that," says Chernova, who is based in Los Angeles.

"As a result you're going to see a bit of a drag on CLO equity returns on deals that were issued in 2021 and can't be called until 2023. I expect to see a lot of refis and resets at the earliest possible opportunity to get rid of the ARRC language if it's there. The drag on equity returns could be up to four percentage points, which influenced a lot of investors' attitudes to the 2021 vintage."

2021 was a peak year for the CLO market, with $168.9 billion new issues pricing in the US and returns averaging around 30% or more. The performance through two consecutive crises has caught the attention of new investors.

> **If investors can trade out of positions, it makes them more likely to invest**

Chernova is bullish on CLO equity. She says liquidity has increased as the investor base has grown — trading activity doubled last year from 2020 volumes — creating a positive feedback loop.

"If investors see they can trade out of their positions in the secondary market, it makes them more likely to invest," she says.

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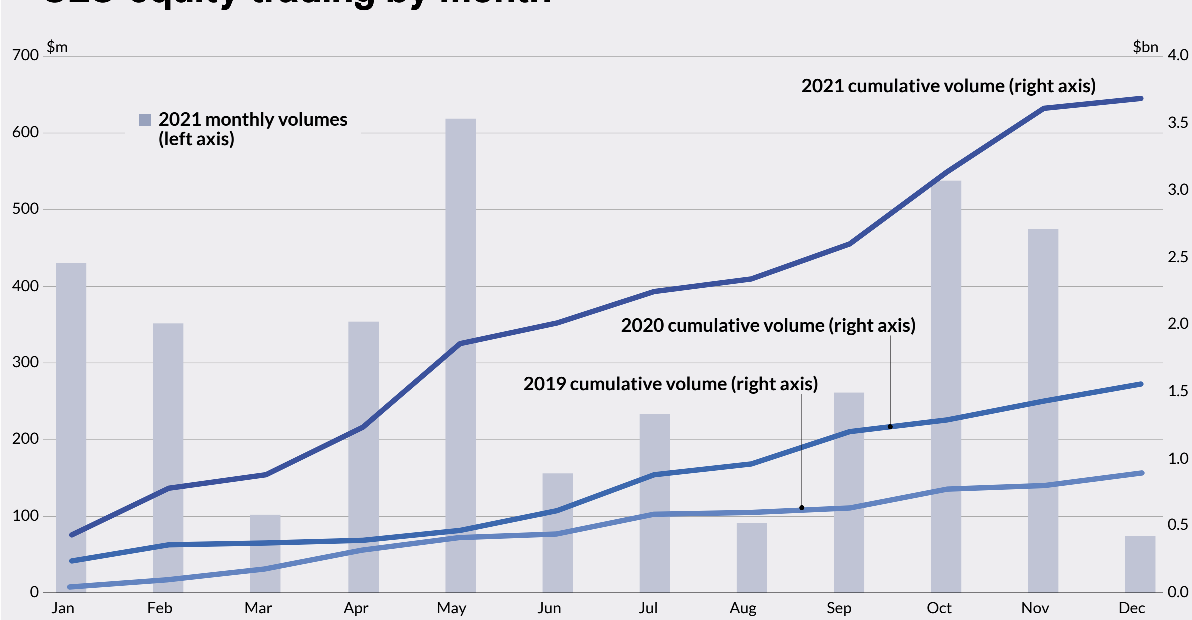
CLO equity trading by month



Source: Sancus

CLO trading growth is strong: by May, 2021 CLO equity trading volumes had surpassed the full-year levels in 2020. Creditflux data shows 25 control US CLO equity positions were available on b-wics last year

US direct lending

2021 is a tough act to follow, but all signs point to another strong year

Dana Carey

Chief investment officer, MidOcean Credit Partners

Bullish

Non-sponsor-oriented companies, due to less competition and high premiums

Bearish

Distressed. Default rates will remain benign so rescue loans will be anaemic

Greatest challenge

Middle of the fairway sponsor-backed direct lending is very competitive, so documentation is aggressive and illiquidity premiums have declined relative to more liquid markets

You've got record levels of corporate cash and private equity dry powder

With the Federal Reserve expected to move on interest rates several times in 2022, direct lending is lining up to be the big beneficiary. This follows a record year in 2021, with $2.5 billion of deal volume, and a 2022 calendar showing a huge amount of M&A activity in the pipeline.

"As we get through the first quarter of 2022, I expect the M&A environment is going to remain extremely active," says Carey, who is based in New York. "You've got record levels of corporate cash and private equity dry powder, which is extremely significant, and loan costs will remain low despite rate increases."

Direct lending deals are likely to continue to grow in size through the year. Carey expects to see more deals that are several billion dollars in size in 2022. But overall volumes are unlikely to match the dizzy heights of 2021.

"2021 was a gangbusters year, and I think issuance volumes this year will be lower, but not significantly so," he says, adding that liquid parts of the market have been volatile during the early days of January, due to rates expectations. "If interest rate volatility continues then banks, lenders and sponsors will be a little more cautious."

Carey believes defaults are likely to remain muted at around 1.5%, but will eventually tick up from their historic lows. With more than $100 billion raised in the direct lending asset class in 2021, the fundraising outlook for Q1 is likely to hold steady in the range of $20-$25 billion.

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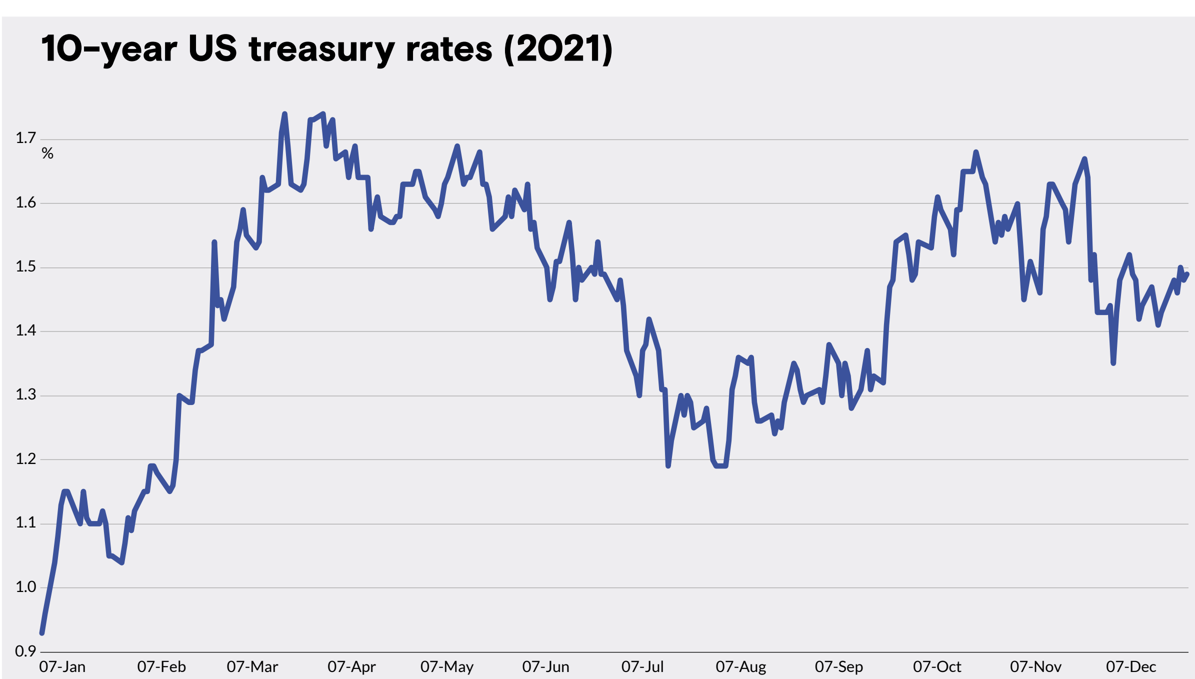
Source: US treasury



There were two routs in US treasury rates. The one in September came as expectations rose that the Fed would taper its purchasing programme and the central bank's messaging turned hawkish

European direct lending

Direct lenders eye venture capital deals as market expands

Robert Wartchow

Portfolio manager, Pemberton

Bullish

Robust M&A volumes

Bearish

Navigating the impacts of inflation and the coronavirus

Greatest challenge

Factoring covid pressures into new investment decisions

Cécile Mayer-Lévi

Head of private debt, Tikehau

Bullish

Diversification of deal types with more complex deals, strong fundraising, ESG covenants

Bearish

Leverage multiples in some deals

Greatest challenge

Inflation fears and disruption in supply chains

2022 could be a bumper year for European direct lending with market participants anticipating an increase in volumes driven by M&A and refinancings.

"We expect continued robust M&A volumes in Q1, as the level of private equity dry powder, the ability to track financial performance through covid and the industrial logic of sector consolidation in Europe remain strong forces in the market," says Wartchow. Within that context, he says Pemberton will focus on strong cash-flow generative businesses with leading market positions and experienced proven shareholders.

Mayer-Lévi says Tikehau has seen a greater diversification of transactions in 2021. There are two deal types: plain vanilla unitranches with strong competition, pressure on pricing, leverage and documentation terms; and bespoke deals where pricing isn't the only criteria.

She says Tikehau has been increasingly involved in the complex, technical transactions, including companies just out of a first round of venture funding.

"We are seeing companies where the management team or shareholders rely on private debt solutions to limit dilution, especially for roll-out strategies," she says, referring to the venture debt transactions. "These transactions, however, have different covenant metrics. The deals are focused on gross debt rather than relying on cash-flow generation, and the companies aren't necessarily profitable already but there is more upside potential."

For plain vanilla direct lending deals, B2B (particularly consulting and software transactions) has also risen. These are companies that were listed and decided to go private backed by large shareholders/founders or private equity, but with financing by private debt funds.

Navigating the impacts of inflation, the pandemic and supply chain disruption — so often crucial factors in the past 12 months — will again be critical. Wartchow says that having the ability to originate new opportunities and monitor investments locally is key to mitigating these risks, as it allows for real-time feedback and deeper market colour than sourcing remotely. Mayer-Lévi says the key is to focus on due diligence and ensure leverage is in line with the profitability of companies.

The performance of many companies in Europe has not normalised from the impact of covid-19 (both positively and negatively) and Wartchow says he does not expect the pressures created by the pandemic to ease in the short term.

There have also been limited restructurings. While some potential liquidity issues arose after state-backed loan support ended, Mayer-Lévi says many portfolio companies that relied on those loans have materially paid them back amid strong private equity support.

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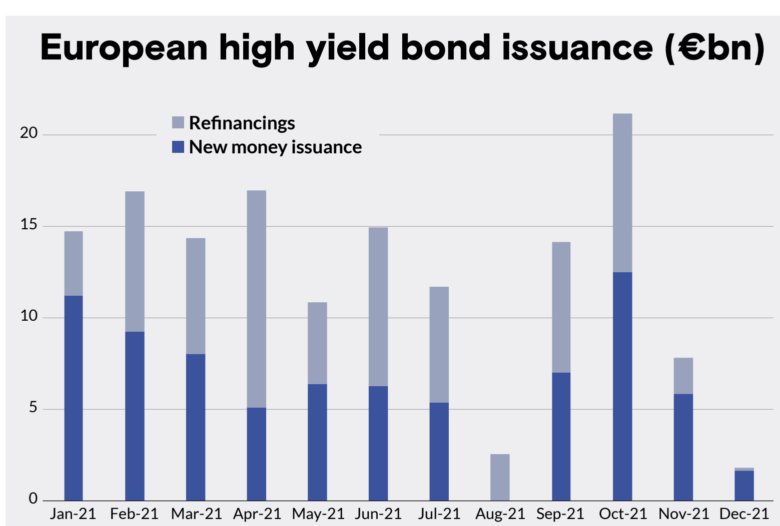
These companies aren't necessarily profitable, but there is upside potential

Source: Debtwire Par



Most of the deals last year came from the industrials and chemicals sector (14% market share), where the weighted average yield to maturity was 3.66%, according to Debtwire Par

US loans

Retail inflows could drive repricing spike as loans make swift adaptation to Sofr

Maegan Gallagher

Head of trading and capital markets, Octagon Credit Investors

Bullish

Credit fundamentals of loans

Bearish

Repricing risk

Greatest challenge

Inflation

We're expecting rates to increase throughout the year, which makes floating rate products attractive

The leveraged loan market hasn't waited for investors to acclimatise to Sofr. New issue activity has had a strong start to 2022 and the M&A pipeline is strong.

"The market is very busy with primary deals and we're seeing a lot of good quality deals, too," says Gallagher. "We're expecting rates to increase throughout the year, which makes floating rate products attractive, so we see more money flowing into the asset class."

Investors pivoting from bonds to loans carries its own risks, with refinancing activity expected to peak as the year progresses. Gallagher says she is keeping an eye on retail inflows, which are at their highest since 2013.

"We just saw a $1.8 billion weekly inflow into the loan asset class," says Gallagher, who is based in New York. "I'm concerned that if new issue loan supply cannot keep up with demand, we will see more loan repricing."

The Sofr switch follows years of industry preparation. Market sentiment regarding the change is positive, with investors familiarising themselves with the new base rate from an operating and trading perspective. But price discovery continues to take place and there is a lack of uniformity across the loan universe.

"The various banks are issuing Sofr-based loans differently. Some are Sofr-based plus a spread and a floor, some launch with a credit spread adjustment, and some issuance is still in Libor, though that will go to zero over time," says Gallagher.

"The majority of our underlying assets are still Libor-based, and the economics of the loans may change when they switch to Sofr. That's something we are factoring in when making investment decisions."

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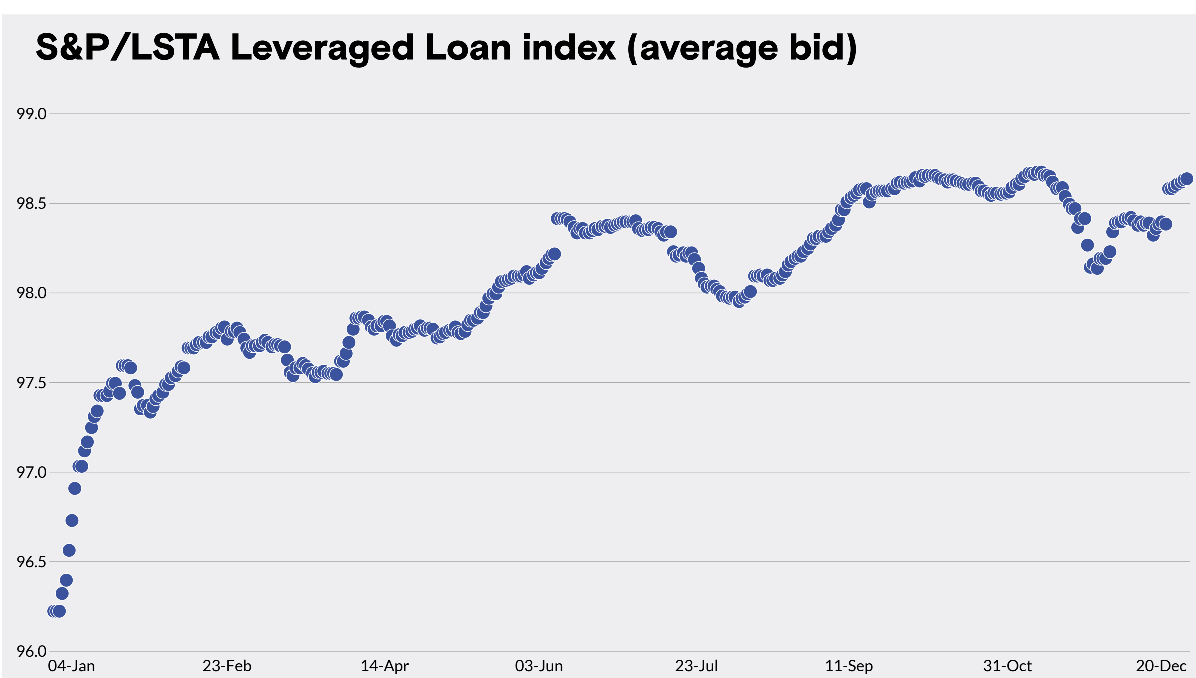
Source: S&P/LSTA



The US loan index had a slight blip in late November as the omicron variant of covid-19 emerged. But it bounced back to end 2021 on a high

European loans

Self-certified 2021 ESG ratchet agreements will hurt lenders

Jeremy Ghose
Chief executive officer, Investcorp Credit Management

Bullish

Strong loan issuance helped by hungover deals from Q4 2021. Strong CLO issuance

Bearish

Potential volatility driven by global inflationary pressures

Greatest challenge

ESG margin ratchets. Pressure on returns from deals launched over the past 18 months

New European loan issuance forecasts for the first quarter of 2022 are strong. Several large deals — including Ceramtec and Morrisons — were held over from the prior quarter due to the volatility caused by the omicron variant of the coronavirus. Market participants anticipate similar if not higher issuance levels than Q1 2021 (about €35 billion).

Default rates in Q1 are also projected to remain low. Credit Suisse's 2022 forecast is 1% in European high yield and 0.8% in loans. Loss rates are forecast to be even lower, at 0.6% and 0.3% respectively, with defaults likely to driven by borrower-specific issues.

But ESG margin ratchet loans launched over the past 18 months could put pressure on loan returns, says Ghose.

Margin ratchets are typically self-certified by borrowers, allowing them to use material forward-looking ebitda adjustments. In addition, newer ESG ratchets allow borrowers to reduce the cost of borrowing by self-certified ESG targets.

"Increasingly, we are seeing borrowers able to achieve one or two step-downs on their margin ratchets almost as soon as the typical six-month ratchet holiday expires, with no substantial improvement in credit quality (such as reduction in leverage)," he says. "This is totally against the spirit of a margin ratchet — which is supposed to reward a borrower for real improvement in credit quality."

Ghose says this is causing issues. There is a disparity between the 'headline margin' (4%) lenders are expecting to earn on an investment and the actual first year reality, which is much lower, especially when funding delays are taken into account. Ratchets also affect demand for assets in the secondary market, which can move substantially as soon as the ratchet kicks in.

Ratchets are supposed to reward a borrower for improved credit quality

The concern for Q1 is that the market starts to see the full impact of margin ratchets agreed during the second half of last year, while new ratchets become even more aggressive as borrowers get their way.

In addition, there could be volatility in store across credit given global inflation pressures, potential Chinese and wider global supply issues, and rate rises in the US.

Although the more technical nature of the European loan market, which is driven by CLOs, tends to insulate European loans somewhat from wider market volatility, Ghose says there is risk of contagion from European high yield volatility.

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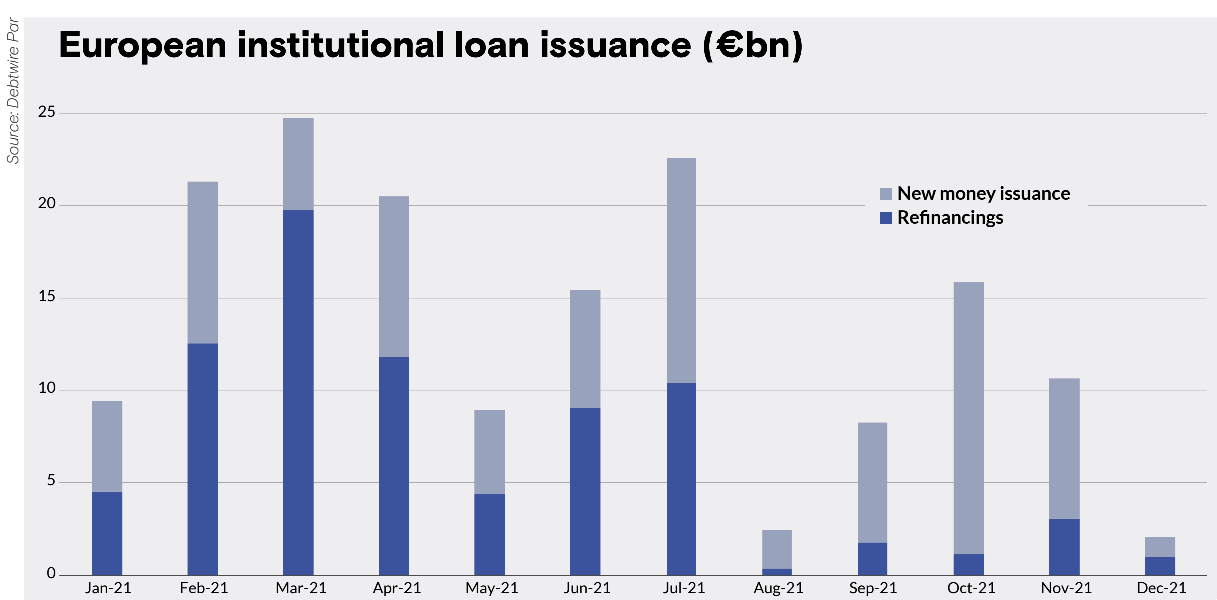

In a record year for loan issuance, refi volumes tailed off in Q4 as the average spread on first lien loan issuance rose to 403bp over Euribor

Emerging markets

Geopolitical risks threaten volatility, but inflation appears to be priced in

Jennifer James

Portfolio manager,
Janus Henderson

Bullish

There is room for outperformance once the US Fed's tightening policy comes into effect. Also, there are opportunities in China in H2 if they loosen their zero-covid approach

Bearish

Inflation — this can lead to unusual political outcomes (and therefore instability) as policy makers put less emphasis on fiscal consolidation

Greatest challenge

Volatility can test an investor's stamina

Illya Zyskind

Portfolio manager,
BlueBay Asset Management

Bullish

Covid vaccination rates are increasing in emerging market countries

Bearish

Higher inflation will put a brake on how positive the picture could be in 2022. Elections will be a risk

Greatest challenge

Managing around political and geo-political election themes. Covid disruption has taken a backseat

The spectre of inflation is enough to put a dampener on prospects for emerging market debt, but market participants are quietly optimistic that this could be put to one side, so that 2022 is a reasonably strong year. This theory is built on the premise that a lot of the risks associated with inflation have already been priced in.

"Geopolitical events have the potential to disrupt markets and cause volatility, but the interest rates outlook has been managed and communicated well," says Zyskind. "As with all cycles, any tapering inherently is not brilliant for emerging market growth but, right now, it is not having as much of a detrimental effect as it had previously."

"Usually when we have lift off from the Fed, emerging market debt suffers, but it could be different this time," says James.

She reasons that there have been signs of volatility and interest rate hikes have been widely forecast. As a result, many companies have front-loaded issuance in the early part of this year. There was roughly $530 billion of hard-currency emerging market corporate debt issuance in 2021.

There are early signs of greater volatility in 2022. James points to the JP Morgan emerging market corporate credit indices, which were trading at 240-295 basis points in early January. "I think we will be tighter by the end of the year, but it will not be a straight line," she says.

Amid any credit volatility there will be winners and losers. James gives the example of the weakness of the Turkish lira. "Most companies in Turkey are exporters so a persistently weak lira can be good for them."

She also cites how, amid the shortage of toilet paper in the UK in early 2020, a lot of pulp came from Brazil.

On the political front, the focus in the early stages of 2022 has been on the tension between Russia and Ukraine. Russia CDS has jumped from 120.24bp on 4 January to 199.37bp on 18 January — taking it back to where it was in March 2020 — as fears of an invasion of Ukraine mount.

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> **Usually when we have lift off from the Fed, emerging market debt suffers. But it could be different this time**

199.4bp

Russian CDS jumped 80bp in two weeks. On 18 January it finished back where it was in March 2020

Global high yield

Inflationary pressures make it important for investors to broaden scope to loans and CLOs

Chris Barris

Deputy chief investment officer of liquid credit, Alcentra

Bullish

Fundamentals underpinning high yield are in good shape

Bearish

Higher than anticipated inflation leading to broader reductions in fixed income flows and returns

Greatest challenge

Volatility in emerging market high yield

New issue volume should remain positive, as the overall cost of debt is still compelling

The emergence of the omicron variant of the coronavirus and higher interest rates have not eroded the strong fundamentals underlying most of high yield, according to Barris. But a handful of sectors are still restricted owing to covid.

"Earnings are positive, leverage is reasonable, defaults low, and speculative borrowings less prevalent at this stage of cycle," he says. "Within fixed income, high yield still offers spread cushion and duration advantages."

European high yield new issuance hit a record high of €127 billion in 2021, while default rates decreased to a historical year-end low of 0.7%.

"New issue volume should remain positive, as overall cost of debt is still compelling in a historical context, including liquidity for M&A financings and opportunistic refinancings," says Barris. He adds that defaults should be minimal in the near term, though an aggressive rate trajectory may pause market access for some issuers later this year.

Given the tighter spreads, relative performance will be driven by security selection, focus on duration exposure, and flexibility to identify opportunities across a wide leveraged finance opportunity set, including loans and CLOs.

Market participants anticipate spreads will be range-bound around current levels given fundamental underpinnings, resulting in some sensitivity to rate movements.

Inflationary pressures, however, will be a challenge. "While developed market high yield will remain sensitive to inflationary pressures and central bank decisions, volatility in emerging market high yield, particularly Chinese real estate, will remain elevated," says Barris. Chinese real estate faces an exceptional maturity wall and the Chinese government may have to change the local regulatory environment to stave off widespread bankruptcies.

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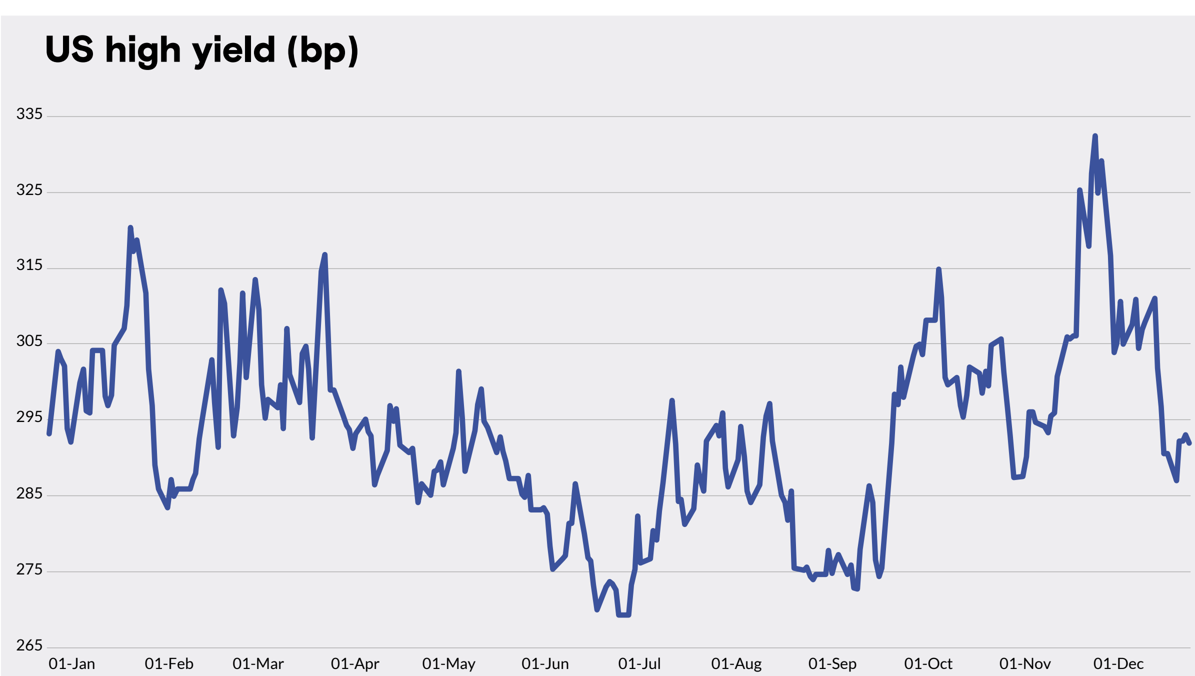
Source: CDX NA HY from IHS Markit



Omicron scares caused spreads to jump out to 332bp on 1 December, but when it became clear the variant was not as threatening as other strains, CDX HY jagged back to 287bp. This marked the sharpest move in the indices all year

Structured credit

100bp of free spread pick-up is in store if the Fed raises interest rates three or four times

TJ Durkin

Co-head of structured credit, Angelo Gordon

Bullish

Newly-originated mortgage credit

Bearish

Mainstream products like autos, where spreads are tight and we expect delinquencies to start climbing in 2022

Greatest challenge

Interest rates, and the expectation that the Fed could affect fixed income flows

Almost all structured credit products had a record 2021, but primary activity has been slow to materialise in the early days of the new year. One major CMBS conference was delayed due to covid and that has been a factor in delaying the pipeline calendar.

Despite the slow start, the mood in the structured credit markets is firm and constructive, says Durkin, who anticipates the ABS and RMBS markets could see similar volumes to 2021, while CMBS and CLO volumes tick down slightly.

"Across the market, we've been seeing people look to get exposure to assets that have good inflation protection, and many structured products are floating rate by default," says New York-based Durkin. "If the Fed is going to raise rates three or four times, there's 100 basis points of potential free yield pickup."

Consumer ABS products have been the big beneficiaries of covid policies. Consumers in receipt of stimulus checks and those who were able to increase savings through the pandemic have ensured delinquencies in residential mortgages remain at post-2008 financial crisis lows.

In addition, according to Durkin, wage inflation has outpaced the inflation in household expenses, such as gasoline and groceries, another credit positive for consumer ABS products. Despite this, he expects to see a small increase in defaults as the year progresses, but emphasises that this reflects a return to market normality rather than a major risk to creditors. "Eventually we're going to get back toward normal levels of delinquencies in consumer products," he says.

Refinancing is likely to start rising through the year. Legacy RMBS transactions will continue to get called, and deals that were issued in the immediate aftermath of the first covid outbreak with high credit spreads will come up to their optional refi dates.

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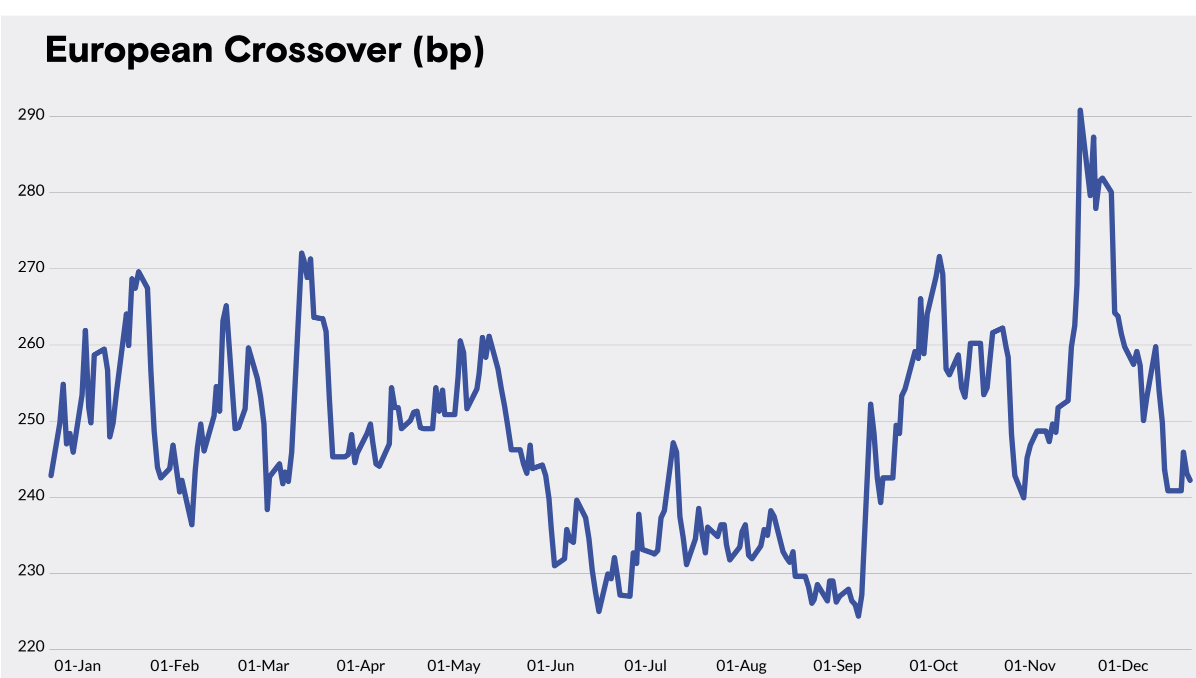
Eventually we will get back toward normal levels of delinquencies in consumer products



Source: iTraxx Xover from IHS Markit

Crossover ended 2021 precisely where it started: 242bp. That left it about 15bp off its tight print on 16 September

European CLOs

Volumes will remain elevated as demand for floating rate paper picks up

Filippo Sampietro
Partner at Serone Capital Management

Bullish

Junior mezz and equity tranches in Europe

Bearish

Senior ABS currently being sold to ECB. If the largest buyer is removed, they can widen

Greatest challenge

How unwinding of QE will affect the CLO market

QE unwinding could create volatility and periods where the market goes risk off

Europe's CLO market hit post-global financial crisis records in 2021. The year's €38.5 billion new issuance surpassed €22.8 billion in 2020 and €29.8 billion in 2019. Market participants are bullish on new CLO issuance volumes for 2022.

Analysts have predicted primary issuance for the year will be between €30 billion and €37 billion, with 60-plus European CLO warehouses being readied, strong projections for European loan primary issuance and huge amounts of private equity dry powder.

Sampietro says: "If you have an asset class that has experienced very low to no losses through the pandemic, emerging seemingly unscathed, and it is a floating rate product in Europe with rates floored at zero, it's likely investors are going to allocate more to the asset class in the near term."

He is constructive on junior mezzanine and equity tranches in European CLOs. "The past 12 months' trailing default rate has been incredibly low and most CLO managers have been able to build par," he says. Europe's trailing 12-month loan default rate was 0.63% in December, down from 0.75% at the end of November, while loans trading below 80 dropped from 0.9% to 0.63%, according to the S&P European Leveraged Loan Index.

CLO equity should outperform, with low default rates, limited downgrades, and rising market volatility, but performance will be a function of loans. If loan market demand picks up, triple As will also need to move, otherwise equity will become expensive and CLO supply will slow.

Sampietro warns that if QE gets unwound and rates start to shift, that could drive market sentiment.

"CLOs are floating rate products, so they'll do better in a rising rates environment, particularly in the US where rates are already positive. If rates go up, US CLO equity cashflows benefit and if US CLO equity benefits, then European CLO demand is likely to remain healthy," he says.

"But QE unwinding could create volatility and periods where the market goes risk off. In that case the CLO market will not be completely insulated and could provide an attractive point to add risk."

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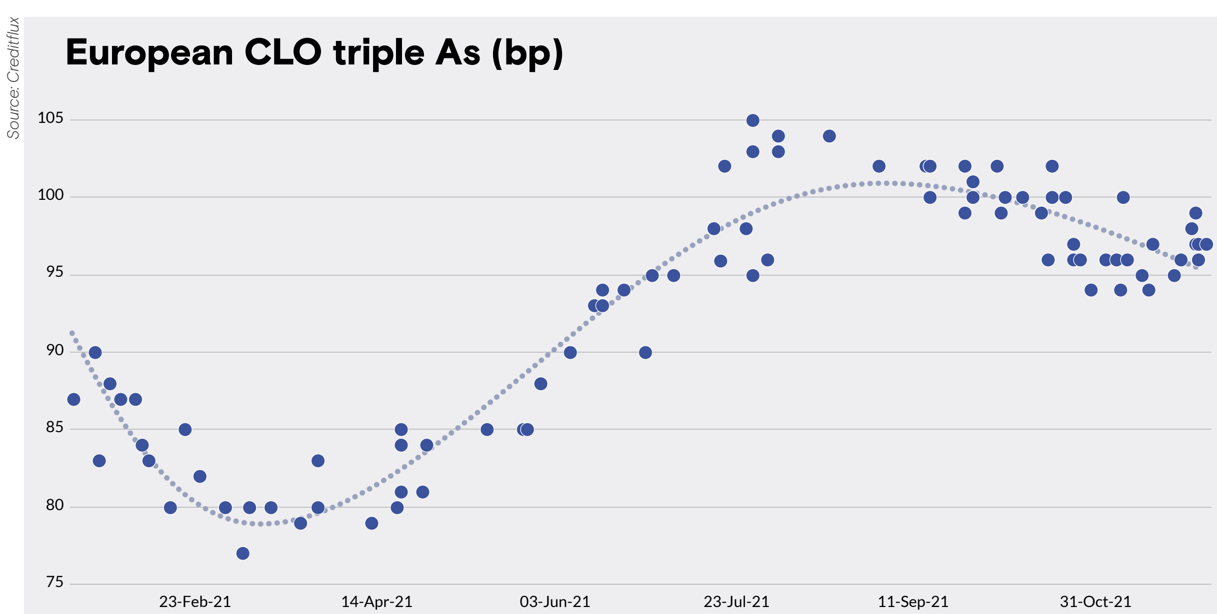
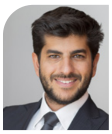


Senior CLO spreads finished about 4bp off where they started 2021 and some 26bp away from the high 70bp prints in early March. But there were signs of a slow rally in November and December

Equities

European equities should outperfom credit with 'green deal' companies starring



Roland Kaloyan

Head of European equity strategy, Societe Generale

Bullish

Beneficiaries of EU Green Deal and cyclical sectors, with overweights in industrials, construction and materials, IT, utilities and financials (except real estate)

Bearish

Defensive sectors, plus consumer discretionary, staples, energy, telecoms and real estate

Greatest challenge

New covid-19 waves, a Chinese slowdown, French elections and the first Fed rate hike in four years

European balance sheets are sound and full of cash

After a strong performance in 2021, European and US equity markets appear to be entering 2022 on a firmer footing than credit, despite facing some of the same challenges. Partly this results from the tightness of credit spreads at the start of the year, as well an outlook of solid corporate earnings growth, M&A and shareholder-friendly actions.

"The bull has plenty to feed on," says Kaloyan. SocGen is especially upbeat on European stocks, with an end-of-year target for the Stoxx Europe 600 index at 520 points, up 6.6% on the year.

"The European cycle still has legs. Cost inflation may peak soon and ECB policy should desynchronise from the Fed's. European equities are trading back at historical lows relative to US equities, and their current valuation may absorb higher bond yields."

The EU Green Deal is also likely to gain momentum this year, with the EU recovery fund warming up and an increase in energy transition spending. SocGen has created the SG European Green Deal index, whose basket is composed of European companies that would benefit from the European Commission's green deal strategy. The bank projects company earnings in this to grow by 19% in 2022.

Otherwise, SocGen favours a portfolio geared to the economic recovery, and notes cyclical sector stocks are trading once again at a discount compared to defensive sectors.

"Within cyclicals, our preference is for companies tilted to corporate and government spending — such as industrials, construction and materials, and IT — over those geared to consumer-related sectors like consumer discretionary and staples," says Kaloyan.

SocGen's allocation also factors in energy transition and digitalisation, preferring utilities and IT to energy and telcos. These themes are likely to push companies into a new investment cycle that will increase capital expenditure.

"European balance sheets are sound and full of cash," says Kaloyan. "Rising free cash-flow should push companies to spend and/or return cash to shareholders."

M&A activity was close to a 14-year high in 2021. To return cash to shareholders, companies may favour buybacks over dividends, as the former offer more flexibility.

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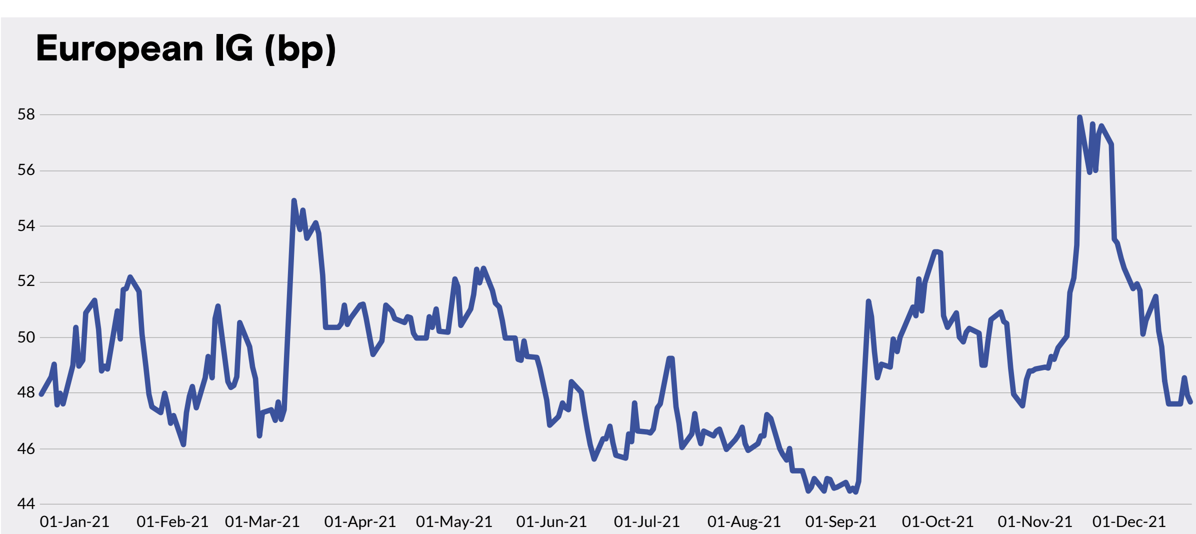

Source: iTraxx Main from IHS Markit

The November rout in IG was the first sharp case of widening in 2021 not brought on by an index roll. Single names widened in line with the index, suggesting macro traders were positioning short

Distressed debt

Abundant opportunities in the mid market and inflation is bringing some benefits

Lorna Robertson

Head of funds, Connection Capital

Bullish

Distressed opportunities should grow as fiscal support is withdrawn and other exogenous macro risks come to the fore

Bearish

Higher inflation, rising rates, supply chain bottlenecks, fuel prices, all adding pressure to a system that is already over-stressed following two years of pandemic restrictions

Greatest challenge

Timing the cycle and not overpaying for assets. Large funds may struggle to deploy capital in attractively priced assets in the large cap space

Julien Raffelsbauer

Portfolio manager, Lakemore Partners

Bullish

Telecommunications, certain names in healthcare and energy — if management teams can put in place a clear ESG strategy

Bearish

Consumer discretionary/retail as inflation dents purchasing power. Packaging (particularly plastic and glass). Over-levered travel companies

Greatest challenge

Most companies that are still in a distressed position will have exhausted rescue options allowed by their credit agreements, as well as goodwill they still had with lenders

We will consider businesses which can benefit from high energy prices

You might think inflation is a problem for distressed companies after two years of pandemic restrictions. But Raffelsbauer sees an upside. “Inflation has allowed most companies to get back some pricing power. We see that in gross margin improvement for the major equity indices for 2021, but as well for expectations in 2022 and 2023,” he says.

He adds that the US Federal Reserve has raised rates in a telegraphed way, allowing corporations to plan how to pay for their capital structures.

Robertson thinks small companies may struggle to find suitable sources of financing as fiscal support is withdrawn. As a result, investors may find abundant opportunities in the middle market.

“Good companies with bad balance sheets will make a ready supply of attractive assets at discounted levels,” she says. “With the correct support and funding structures, these assets could eventually produce vintage returns in a distressed and special situations portfolio.”

Small funds could stand to benefit most from these opportunities to create bespoke financing agreements. By contrast, large funds face competition in public markets.

Robertson says: “Private credit has emerged from the pandemic in good shape and the arbitrage between the private and public markets continues, with investors being rewarded for illiquidity and complexity.”

Raffelsbauer is bullish on several sectors, but he concedes that one of his most controversial picks is in energy. “With energy prices at record levels and reduced investment in the space restraining supply, we will definitely consider businesses which can benefit from high energy prices, especially if their management teams can put in place a clear ESG strategy,” he says. “We feel those that don’t will see a decline in the medium term value of their assets.”

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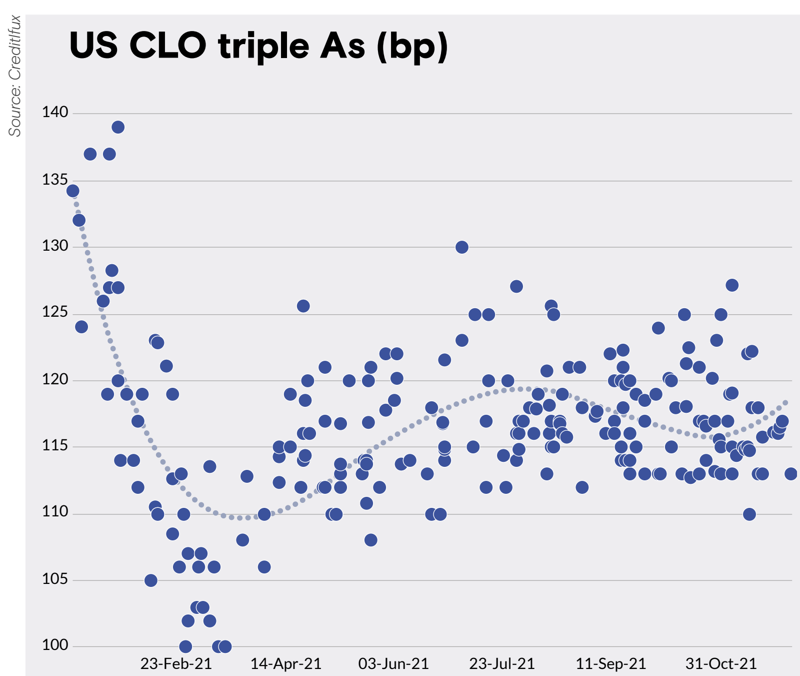

The unusual sense of harmony in the US primary market extended into a ninth month as CLO senior spreads were entrenched in a 110-125bp range

Institutional investors

Shifting risk factors give firms opportunities to differentiate themselves

Rhys Marsh

Portfolio manager, private credit at Lombard Odier IM

Bullish

Climate transition disruptors and enablers, structured capital solutions for ESG improvement, undercapitalised sectors

Bearish

Sectors misaligned with climate transition. Investments where tech, performance and merchant-based risks cannot be alleviated. Businesses with blind spots on oversight and internal controls

Greatest challenge

Standardisation of approaches and best practice across industries. Sidelining of managers that fall short as institutionalisation of ESG investing increases

There is little doubt that 2022 begins with a tougher outlook for credit than recent years. The focal point is inflation, and with it the prospect of central bank rate hikes and asset purchase tapering. But there are also persistent supply chain issues and high energy costs that threaten to drag on growth as economies pay for support during the covid-19 pandemic.

A full risk-off rout looks unlikely, so these factors give institutional investors opportunities to differentiate themselves, especially in the realm of private credit. But by the same token there are pitfalls, which could be more painful if they prove to be lasting rather than sudden. Some sectors are still vulnerable to covid-19 restrictions, particularly in countries with low vaccination rates, while others, such as auto parts and utilities, may struggle to pass on higher costs.

ESG looks odds on to be an even bigger differentiator than it was in 2021. It will have the potential to install new leading names and rattle incumbents. According to Marsh, this year's best investments will include "disruptors and enablers of the climate transition, particularly those operating with a distributed footprint". Sectors misaligned with this shift could suffer.

Companies that simply "chase the money" will also struggle, notes Marsh. "As institutionalisation of ESG investing increases, managers without authentic commitment and processes may be sidelined as regulation increases," he says. Another challenge will be aligning measurement approaches and best practices, particularly across industries.

Good use could be made of structured capital solutions where they enable the delivery of goods and services to enterprises seeking greater alignment with ESG and impact goals, adds Marsh.

Conversely, other businesses could pay the price of having cultures lacking transparency or adequate oversight. The Ozy Media scandal and the Amplify Energy oil spill in Q4 2021 illustrate the potential liabilities such lack of internal controls can create.

These, however, should be distinguished from inefficient, fragmented sectors that merely suffer from a void of capital financing. Marsh sees these as another area to be bullish about in 2022, as they are "situations requiring authentic investor stewardship and engagement".

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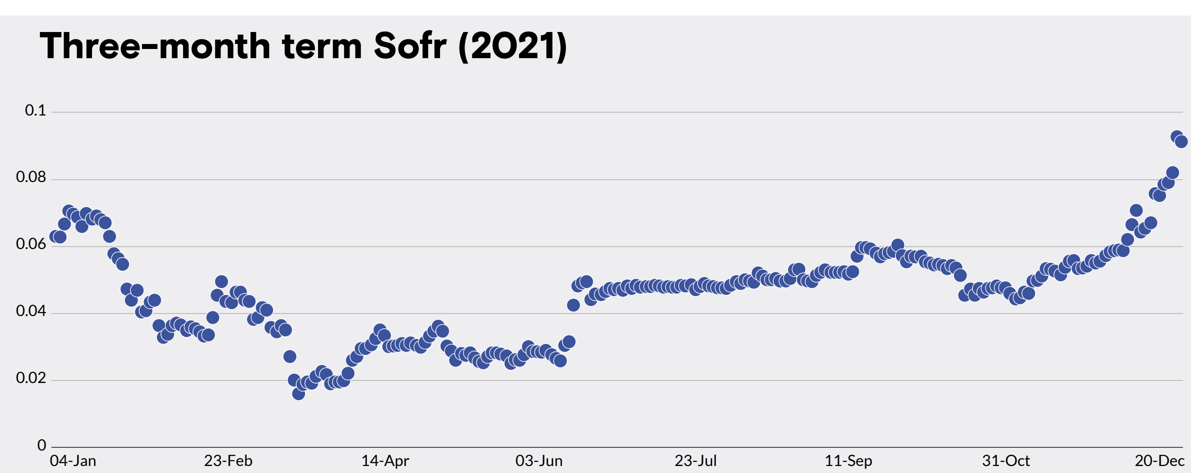
Managers without authentic ESG commitment and processes may be sidelined

Source: CME Group



A few weeks before CLOs and loans were forced to switch away from Libor, the favoured replacement — three-month Sofr — widened sharply from under 5bp to 9bp. In January, it has headed further north to 17bp as investors price in a rate hike

Investment grade

Still some juice left in the rising star trade, but China's growth may slow

Jon Mawby

Head of investment grade credit, Pictet Asset Management

Bullish

Rising stars, some convertibles and shorter-duration credit

Bearish

Less margin for error in some areas. Slow growth in China could cause a global shock

Greatest challenge

If inflation spikes higher in Europe, central banks may take an outsized response

We like rising stars, as wider spreads mean we get implicit protection from credit widening

Investment grade volumes reached $1.7 trillion in 2021, the second-highest total on record after 2020's $2.1 trillion. But there was a notable slowing in the fourth quarter as the US Federal Reserve accelerated its tapering programme and signalled its intention to raise interest rates.

Margins are tight. The Ice BofA US Corporate Index Option Adjusted Spread was at 98 basis points, which leaves little room for error, but there are pockets of value.

Mawby says he is positioning for rising stars, but these are not necessarily companies that were downgraded en masse in early 2020 when the coronavirus outbreak began.

"There are some companies, like Netflix, that have grown stronger through the pandemic, and there are others that have improved their ESG profile and therefore their credit standing," he says.

"We like rising stars, as the wider spreads mean we get implicit capital protection from credit widening, added to the fact the investor base will broaden for these credits if they can climb to investment grade."

Market participants estimate there will be $70 billion of credits promoted to investment grade in the US this year.

Mawby says investors need to pay attention to China, where growth may be slower. "The third term is [China's president] Jinping's legacy. He does not care about near-term growth and has set about restructuring by taking away powers from tech and property oligarchs in a bid to secure society in China. This could lead to a global growth shock like in 2016."

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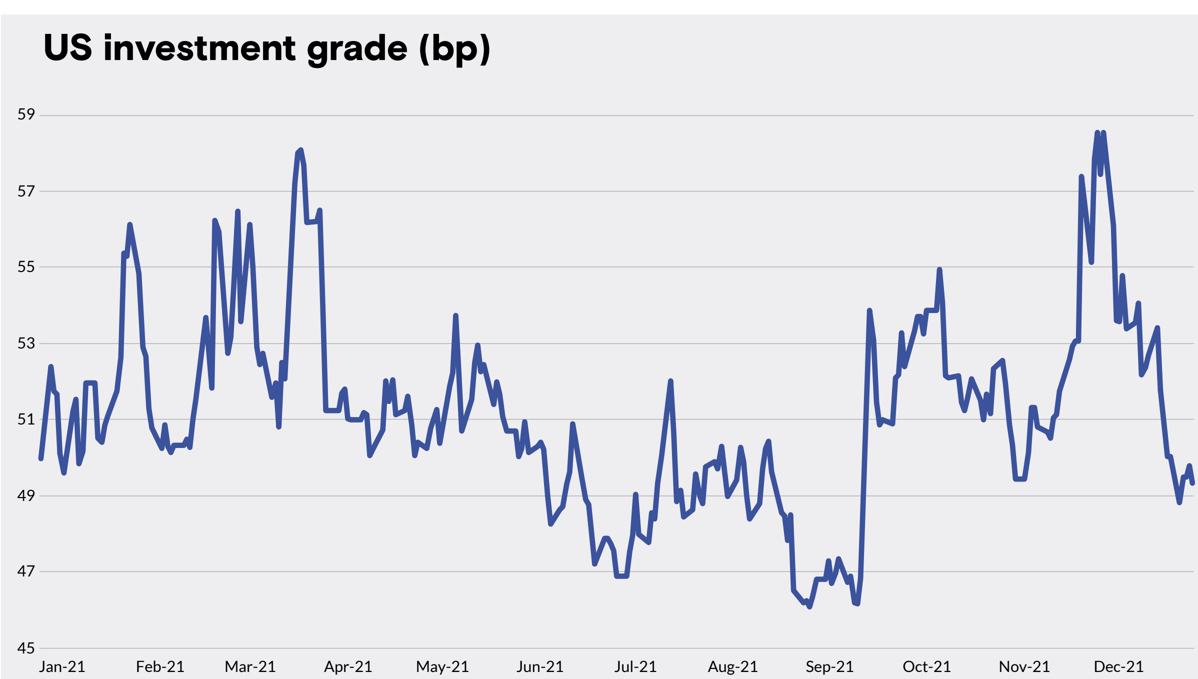


Source: CDX NA IG from IHS Markit

US IG spreads ended the year under 50bp, but it did not look as though the picture would be as rosy earlier in December when omicron drove spreads towards 60bp

Real assets

UN conference points to greater emphasis on ESG and renewable energy

Emma Haight

Partner,
AMP Capital

Bullish

Increasing acceptance that society's needs and goals can only be supported long term if we focus on and work towards a more circular economy, through renewable energy and ESG

Bearish

We tread carefully around fossil fuel assets that might have stranded asset risk

Greatest challenge

Finding deals where you can gain a first mover advantage

A record $450.7 billion of infrastructure loans were issued globally in 2021, according to data from *Inframation*. This toppled 2020's record of $379.26 billion.

Renewables was the second-most popular sector, contributing $112.61 billion (25%), just behind energy at $126.03 billion (28%). But London-based Haight says that the United Nations Climate Change Conference in Glasgow in October has sharpened the focus on renewable energy and fibre-optics (plus other forms of telecommunication).

She sees a bright year ahead. "There are lots of funds being raised, and infrastructure — physical and digital — is as essential as it has ever been," she says.

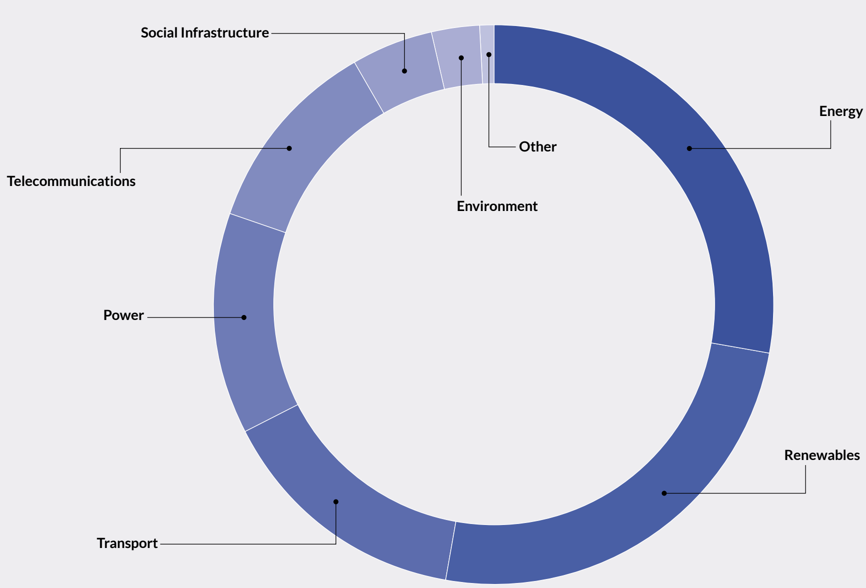
However, Haight cautions that the longer-term picture is not as clear in the US. The potential for Donald Trump to be re-elected as president in three years could result in a sharp shift away from the current administration's positive sustainable energy policies.

As for inflation and the accompanying interest rate hikes, there are reasons to be optimistic.

"Interest rate increases should be slightly positive for floating rate loans," says Haight. "They should not have much of an impact on specific projects as they tend to be interest rate-hedged.

> **There are lots of funds being raised. Physical and digital infrastructure remains essential**

Infrastructure loans by sector (2021)



Source: Infralogic

The energy sector was the most popular last year, but telecoms could be in line for growth in 2022

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