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Stressed and Distressed Credit in 2023 – An Opportunity Emerges

The year of 2022 is one that most investors would like to forget. The year began with optimism that "easy money" would remain the status quo, but ended with fears as several economic headwinds were mounting on the horizon.

Geopolitical conflict, rising and stubbornly high inflation, and rising interest rates all sapped growth from the global economy and chipped away at investor confidence. This was brought about by the most aggressive monetary tightening cycle on record. Following an era of zero interest rate policies and essentially free cash, 2022 marked an abrupt change of course.

The transition in monetary policy has had broad implications on the global economy and created hurdles in raising capital through the credit markets. Higher interest rates have directly impacted the cost of capital for businesses, which more than doubled for high yield borrowers in 2022. We have begun to see these higher borrowing costs and less accessible credit markets translate into rising distressed exchanges and default rates. We expect the trend of rising levels of stressed and distressed businesses that require financing and potentially restructuring of their debt to continue in 2023.

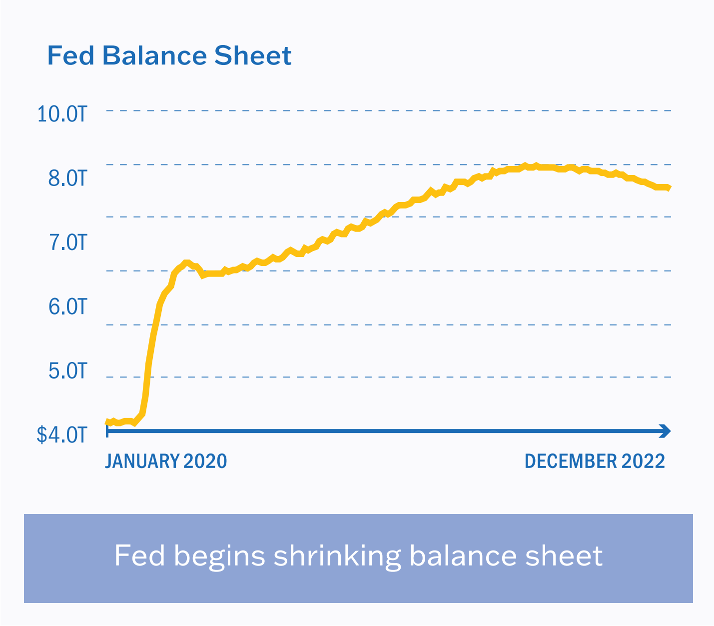
Implications of Higher Rates for the Credit Markets

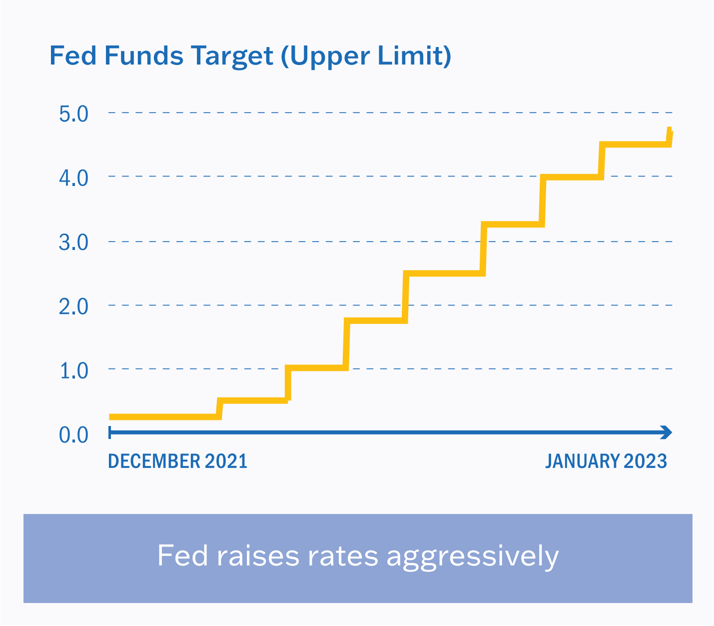
The impact of this regime change in the interest rate backdrop has been wide ranging. Led by the US Federal Reserve, central banks around the world transitioned from quantitative easing to quantitative tightening in 2022. In response to the COVID-19 pandemic, the Fed's balance sheet exploded, growing from about $4.2 trillion in assets in the first quarter of 2020 and peaking at nearly $9 trillion in assets in April 2022. This tidal wave of capital that supported US and global financial systems through the pandemic shock began to unwind in 2022, moving from a tailwind to a headwind.

This dramatic shift in monetary policy had an immediate impact on businesses and their ability to tap the credit markets for funding. High yield issuers raised $116 billion in total debt in 2022, down 78% from $539 billion in 2021[1]. The need for high yield issuers to roll over their debts or add additional debt to their balance sheet did not disappear, but was only delayed. These issuers will find a less hospitable reception and face higher funding costs when they do come back to credit markets for financing.

(1) 2022 High-Yield Annual Review, J.P. Morgan, January 5, 2023, www.jpmorganmarkets.com

Monetary Policy Shifted in 2022 with Quantitative Tightening & Rate Hikes



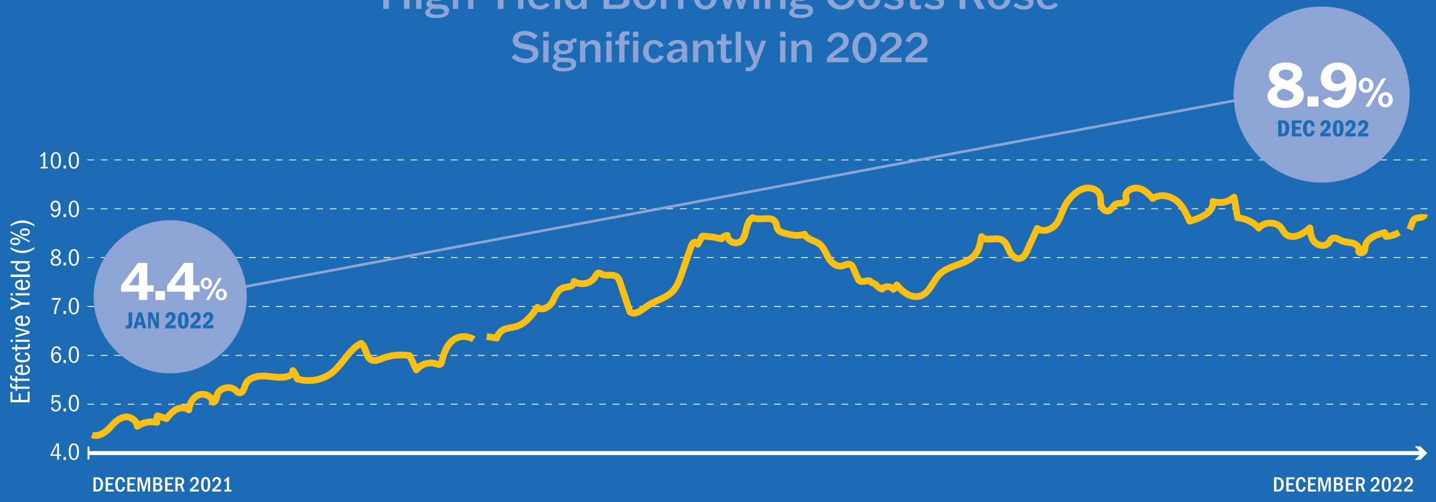


Source: FRED Economic Data, St. Louis Fed

Feeling the Squeeze of Higher Interest Rates

With the Fed beginning to unwind its balance sheet and tighten financial conditions by raising interest rates, the cost of capital has shifted dramatically. As an example, the cost of high yield borrowing more than doubled through the year, **rising from 4.4% at the start of 2022 to 8.9% to finish the year**. Overall corporate borrowing costs spiked to levels not seen since the Great Financial Crisis (GFC).

High Yield Borrowing Costs Rose Significantly in 2022



ICE BofA US High Yield Index Effective Yield, Percent, Daily, Not Seasonally Adjusted
Source: ICE BofA US High Yield Index Effective Yield (BAMLH0A0HYM2EY) | FRED | St. Louis Fed (stlouisfed.org)

Rising Distressed and Defaulted Credits

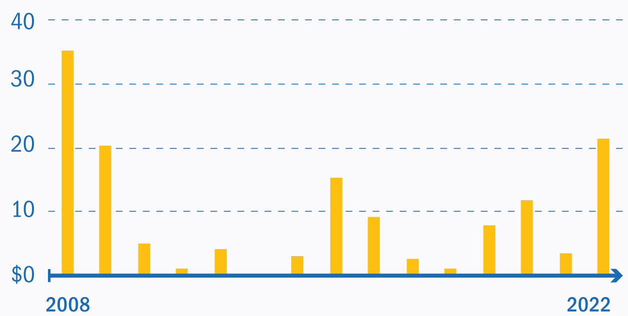
This rising cost of capital has unseated the relative calm of credit markets. It was a wake-up call and has led to a buildup in stresses across credit markets as borrowers will have to face this new market reality. Distressed exchanges – when a company is unable to meet its financial obligations and renegotiates the terms of its debt – **rose by 6x in 2022 to $21.4 billion**[1]. This is the highest level of distressed debt exchanges we have seen since 2009. Companies may look to restructure their debt through this process as an alternative to an outright default and having to enter into bankruptcy proceedings.

Defaults rose **3x** to $26.3 billion in 2022.

Distressed exchanges are typically a leading indicator of defaults, and we expect this cycle to play out in a similar fashion. Right on cue, we also saw a rise in default rates in 2022. Seventeen companies, with a total face value of **$26.3 billion of debt, defaulted during 2022**[1]. The 3x growth in the value of defaults in 2022 comes off of all-time lows in 2021, rising to 1.6% of the total dollar value of the levered credit markets[1]. 1.6% is still far below the median default rate of high yield (HY), which is 3.6%. For 2023, the market consensus[2] is forecasting default rates to reach approximately 3% to -3.5% and rising to 4% in 2024 at the broad market level. With default rates edging higher from cycle lows, this should accelerate into 2023 and 2024 as the accumulated stresses from 2022 take hold.

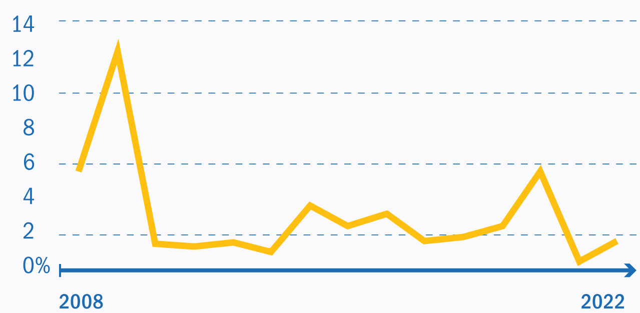
Distressed Exchanges & Default Rates Rising in 2022[3]

Distressed Exchanges (Billions $)



Financial stresses build with rise in distressed exchanges

Default Rates Rising ($ value of defaulted bonds)



Default rates beginning to climb

(1) 2022 High-Yield Annual Review, J.P. Morgan, January 5, 2023, www.jpmorganmarkets.com.
(2) CreditSights, Special Situations 2023 Outlook.
(3) J.P. Morgan.

Some interesting data:

- US high yield bonds returned -11.2% in 2022, ending the year with 8.6% yield to worst (YTW)
- By the end of 2022, there were 157 bonds with YTW greater than 15% and 277 bonds with YTW greater than 10%
- Looking at credit ratings, the average YTW of B-rated bonds was around 8.8% and non-defaulted CCC-rated bonds was YTW ~16%
- According to CreditSights[2], CCC bonds returned -14.2% and distressed bonds returned -25.2% in 2022

Cycle Favours Stressed and Distressed Credit

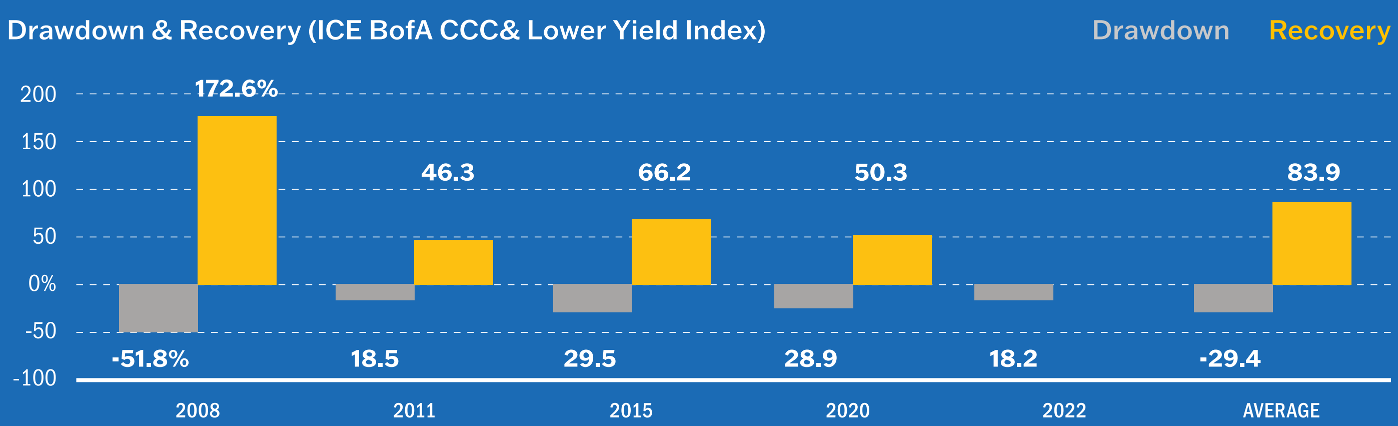
These signs of stress have become more evident as investors begin to sniff out rising defaults. In 2022, CCC-rated and distressed securities returned -14.2% and -25.3% respectively, with broad-based weakness[2]. As default rates continue to rise, the lowest rated and already stressed issuers will continue to face headwinds.

Over longer time periods, the stressed and distressed segments of the market have historically offered attractive returns to investors. These segments of high yield bonds performed as you would expect – the wider spread credits outperformed over a cycle and provided investors a return enhancement element to an overall portfolio mix. We consider B and CCC-rated bonds as a proxy for stressed and distressed issuers. If we focus on CCC-rated bonds, the returns have varied through different periods in the credit cycle. The chart below shows this phenomenon in more detail, including the peak-to-trough drawdown in CCC and lower high yield credits, as well as the subsequent recovery over the ensuing two years off the lows.

Over the last five drawdowns of greater than 10%, the average peak-to-trough decline was 29.4% (this includes the most recent **-18.2% drawdown in 2022**). While these pullbacks are not for the faint of heart, we believe there are opportunities for patient investors with a long-term orientation to capitalize on these market dislocations. In the two years following the troughs in CCC and lower high yield credits, this segment of the high yield market has delivered an outsized return of over 80% to investors. In our opinion, there is an attractive opportunity developing in the areas of stressed and distressed credit, where investors will have an opportunity to deploy capital in credit investments that offer an attractive risk to reward return potential.

Averaged drawdown of **-29.4** in past 5 downturns, **+80%** recovery.

Historical Drawdown & Recovery of CCC Rated High Yield



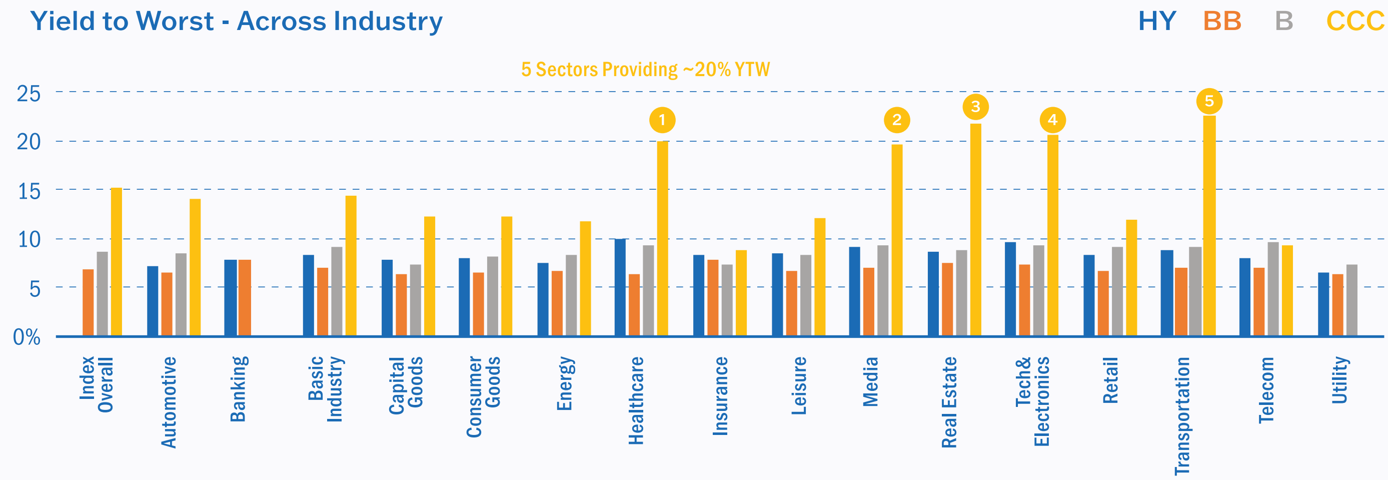
Source: Bloomberg

Strong historical recovery following drawdown in stressed and distressed credit

Broad and Diverse Opportunity Set

Looking at a detailed breakdown by industry, the YTW for most industries are already attractive (with the exception of transportation, insurance and utilities). Industries like healthcare, media, retail and telecommunications are providing ~20% YTW for CCC-rated credits. This is a diverse opportunity set where investors can be selective and identify attractively priced credits in companies that have been overlooked. We believe the opportunity set is not tilted towards one industry or category, but we are seeing double-digit YTW in multiple industries.

Yield to Worst - Across Industry



Source: CreditSights, Special Situations 2023 Outlook

Range of industries offering attractive yields

Emerging Opportunity Set in Stressed and Distressed Credit

Highly levered companies that would have restructured their balance sheet long ago in more normal markets, survived on a flood of cheap credit brought about by central bank intervention and zero interest rate policies. These tides have turned, with more and more companies either looking for distressed exchanges or restructurings, trends that we expect to continue as the lagged impact of interest rates hikes takes hold. We believe that a combination of factors – the withdrawal of stimulus by central banks, the rising and elevated cost of capital for businesses and a slowing growth outlook – are combining to cause a buildup of stress in the credit markets. We are seeing signs of this phenomenon emerging, and expect a growing opportunity set in stressed and distressed credit in 2023.

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