Repositioning in nuanced markets

The Greeks reprimanding the Swiss, private equity darlings falling out of favor and ditching the ETF for active fixed income strategy – Welcome to 2023.

Mark Dowding, Chief Investment Officer on the BlueBay Fixed Income Team, recently shared with Institutional Investor his insights into today's credit markets and expectations for 2023.

- Global regulators have acted decisively to contain the damage to troubled banks
- The era of low yields on public debt has fostered a positive environment for private credit and equity
- Private equity has had a great run, but rising rates and potential markdowns are worrying
- Hedge funds look interesting since they can deliver differentiated returns in flat or down markets
- There are many levers for active investors to pull in managing a fixed income portfolio

The first few months of 2023 have been interesting to say the least. Inflation chugs along and the Federal Reserve recently added a ninth consecutive rate hike to bring the federal funds rate range between 4.75%-5%. Its most recent increase came amidst the extraordinary fall of Silicon Valley Bank.

"I think the thing to say is, in terms of SVB, we do sense that we are looking at a pretty isolated incident," says Mark Dowding, Chief Investment Officer on the Blue Bay Fixed Income Team at RBC Global Asset Management. "These regional banks, they benefit, if that's the right word, from a lighter touch on regulation, the fact they report on US GAAP as opposed to IFRS, so they don't need to mark assets to market – they are able to exploit a bit of a regulatory loophole that's been created for them. In the case of SVB, they did so in spectacularly unwise fashion, by effectively turning what was a bank that had really been the darling of the venture capital world into a macro hedge fund by buying a lot of long duration assets, at a time when interest rates were at incredibly low levels."

It didn't take long until contagion spread. The fall of SVB created a risk premium on banks, pushing the spread of credit default swaps at Credit Suisse above 500 basis points. "That acts as a bit of stress to risk managers, to pull risk exposures, terminate CS as a counterparty, and as they do so, that actually worsens the situation. Before you know it, you can be in a bit of a death spiral," says Dowding.

Swiss regulators failed to step in and immediately guarantee deposits, and in turn CDS blew towards one thousand basis points by the end of the week - by which time credit Suisse had become unviable. Typically, when a bank becomes unviable there is an official proclamation of non-viability and then a resolution.

"This time around, the Swiss actually changed their laws over the weekend so that they didn't reach a point of non-viability on Credit Suisse. They said that, because they thought there was a reasonable fear that non-viability would be reached, they preemptively bailed in the junior debt holders anyway. The idea that a government can change the rules of the playing field to suit itself at a whim in that way, is something that was very damaging to what was already very fragile market confidence," Dowding says.

Dowding adds that "Even the Greeks have come out saying 'These Swiss should learn to become a bit more like Greeks these days.' Who could imagine 10 years ago the Greeks would be lecturing the Swiss on how to behave?"

Changing tides on private markets

The past thirty years have been defined by an overall downward push on interest rates and inflation, bringing the discount rate down as well. Easing monetary conditions over the past three decades has fostered a welcoming environment for private credit, which has reached historic highs in recent years.[1] In 2021, private equity-backed buyout transactions reached a global peak just shy of $1 trillion, with deal volumes also reaching a new annual record of 3,460 - representing a 59 percent increase from the year before.

Changing macro conditions now threaten the great private equity expansions.

"I'm particularly worried about private equity largely because they don't mark their assets to market and I think there's a lot of markdowns that need to occur. I also think that a lot of private equity is in a space where it is not necessarily generating profits," said Dowding.

Institutional investors played a significant role in the private equity market boom, but with a redistribution of value and tightened credit markets, asset managers and investors will need to pivot.

"I'd note that within PE, PE is dependent on a lot of cheap money and a lot of leverage. I think they've just been mining a wave where it's been about the multiple expansion plus the fact they've had a lot of leverage at a time of free money. And so, it makes sense that when free money disappears, when rates go up and leverage hurts. This is a business model that could be exposed. So, this is an area that I'd be quite cautious," Dowding added.

Hedge funds, which have taken the backseat to private equity over the past couple of years, might return to favor.

"Hedge funds have kind of been out of vogue, but actually in the last year, hedge funds have been doing pretty well. I do think that you could see more interest in strategies that can deliver non-correlated returns and actually perform well in a flat or a down market," adds Dowding.

As the S&P soared in years past, hedge funds simply could not keep up the pace. This left investors unable to justify a more expensive position for less return. Despite this, hedge funds were successfully able to capture less downside than competing strategies, and 2022 marked the third consecutive year that hedge funds delivered positive alpha.[2]

"For a while there was a bit of a squeeze there, but I do think that hedge funds is an interesting space, but there are other parts of the market where I think there is also value. I believe passionately in active management. One of the things that bugs me a lot, I meet investors who say, 'Oh, we are passive in our fixed income. We are in an ETF.' You invest in core fixed income and you want your core manager to beat the benchmark by 20 or 30 basis points. What a waste of time. Fixed income is an asset class that's rich in opportunity. It really is," Dowding says.

Rethinking fixed income

The S&P 500 is currently selling at a forward price-earnings (P/E) ratio of around 18, suggesting overvaluation and the opportunity for correction. The likelihood of sustained rate hikes and inflation comfortably above target might signal an inefficiency in portfolios saturated with U.S. large-caps and leaves room to rethink fixed income moving further into 2023.[3] [4] [4]

Dowding adds "You have term premia, credit premia, volatility premia, issue premia, volatility premia. If you know what you're doing as a fixed income manager, you should outperform on a serial basis. It's not like equities. Equities is hard to outperform. I'd always make a case for being much more active in your fixed income allocation, much less active in your equity allocation. You see all of these investors who seem to end up in either ETFs or benchmark hugging fixed income strategies and they don't want to take risk in their fixed income for whatever reason, but they're happy to take a load of risk in what they're doing in equity space. It makes not a bit of sense to me," Dowding says.

[1] *https://www.whitecase.com/insight-our-thinking/record-year-private-equity-dealmaking*
[2] *https://www.cib.barclays/our-insights/3-point-perspective/2023-hedge-fund-outlook.html*
[3] *https://insight.factset.com/sp-500-forward-p/e-ratio-falls-below-10-year-average-for-the-first-time-since-q2-2020*
[4] *https://www.morganstanley.com/ideas/investing-in-bonds-vs-stocks-2023*

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