Private Markets

July 18, 2024

Global Credit Weekly:

Watching for a sustained rebound in sponsor-related M&A

BlackRock.

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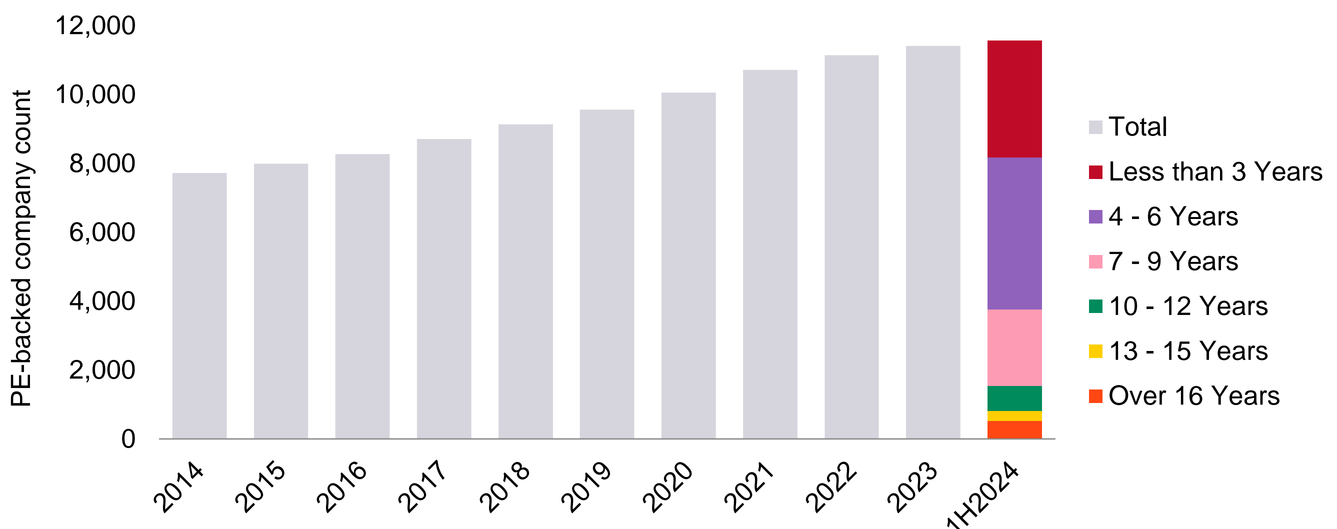
Key takeaways

- This week featured a range of public commentary from Federal Reserve officials, including two members of the leadership: Chair Jerome Powell and New York Federal Reserve President and Vice Chair of the Federal Open Market Committee (FOMC) John Williams. We now expect the first Federal Reserve rate cut in September (vs. our previous expectation for September, *or* at some point in 4Q2024).
- But as we have noted previously (and detail within), we view the *reasons for* and *depth of* the rate cutting cycle as more important for corporate credit investors than the *timing* (start). Recent "Fed speak" reinforces our view that the rate cutting cycle – once it materializes – is likely to be shallow. For corporate credit investors, this means corporate borrowers are unlikely to experience material, near-term interest rate relief – at least barring a sharp downturn in growth. This makes the backdrop for economic activity even more important for credit fundamentals, in our view.
- Away from monetary policy, in this week's *Global Credit Weekly* we take stock of the recent pattern in sponsor-related M&A, which has been more muted relative to strategic transactions. In our view, this is largely a function of the different motivations behind each type of deal-making. A more normalized environment for private equity (PE) exits should allow for additional private debt deployment opportunities, as the private debt industry is a strong financing partner for PE activity. Recent commentary from some large U.S. investment banks has been encouraging on this front (although the recovery in sponsor-related M&A is still likely in its early stages).
- Finally, with the U.S. Presidential election now less than four months away and the Republican National Convention officially underway, incremental details related to platform and policy priorities are beginning to emerge. We revisit areas of focus for corporate credit investors.

Exhibit 1: The median private equity hold time was 5.4 years in 1H2024
U.S. private equity-backed company count, by age bucket



Source: Pitchbook, BlackRock. As of June 30, 2024.

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Watching for additional policy clarity

With the U.S. Presidential election now less than four months away and the Republican National Convention officially underway, incremental details related to platform and policy priorities are beginning to emerge. For example, on July 15th, Ohio Senator J.D. Vance was announced as the candidate for Vice President on the Republican ticket. Additionally, the 2024 Republican Party Platform was released on July 8th alongside the Republican National Convention (which runs from July 15th – 18th). Prediction markets have pointed to a widening lead for former President Trump (Exhibit 2). National general election polls, such as 538, show former President Trump with a +2.0 point lead vs. President Biden, as of July 17th.

The focus areas for corporate credit investors

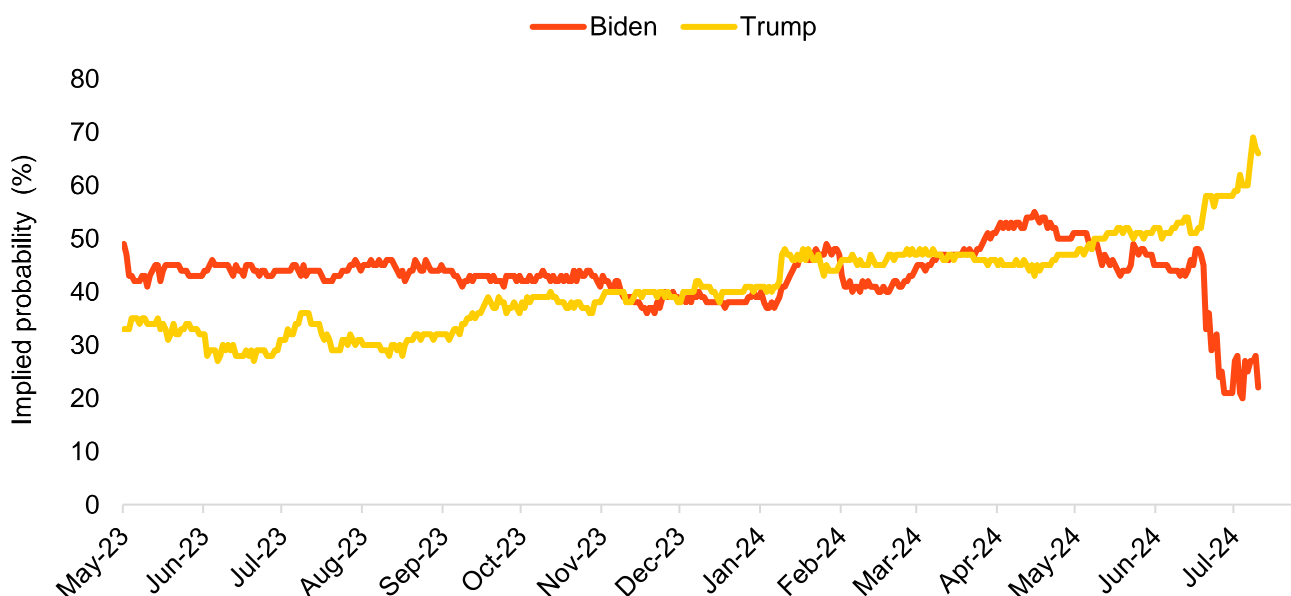
In early May, we highlighted five policy areas we believe are among the most relevant for corporate credit investors to monitor, as the election approaches: (1) taxes, (2) trade and tariffs, (3) fiscal spending, (4) regulation and anti-trust policies, and (5) immigration.

As we outlined recently, we see the most scope for policy change (relative to the status quo) in a Republican sweep scenario – especially in areas such as taxes. For example, a second Trump Administration is expected to prioritize the proposed extension of expiring provisions of the 2017 Tax Cuts and Jobs Act (TJCA) at the end of 2025, which could also include further individual and/or corporate tax cuts. A second Biden Administration's tax extensions would be narrower and would likely seek to incorporate some offsets, with tax increases on corporations and high-income earners. Control of Congress will be key in whether a Trump or Biden administration is able to achieve their fiscal and tax priorities via legislation.

For other potential policy areas, such as those related to trade and tariffs, control of Congress may not be necessary to enact significant change. This is because a president has considerable executive authority to advance U.S. foreign policy, including through the imposition of tariffs on imports deemed to threaten national security. Trump has proposed a 10% across-the-board tariff and a 60% tariff on all Chinese imports. A second Trump administration could also renew pressure on European allies and the transatlantic alliance, including NATO (for example, mandating European countries' increased spending on defense, as a percentage of GDP).

Exhibit 2: Prediction markets have widened since late June

Implied probability of a win in the 2024 U.S. Presidential election, based on quotes available on the PredictIt website



Source: BlackRock, PredictIt (https://www.predictit.org/) Bloomberg. As of July 17, 2024.

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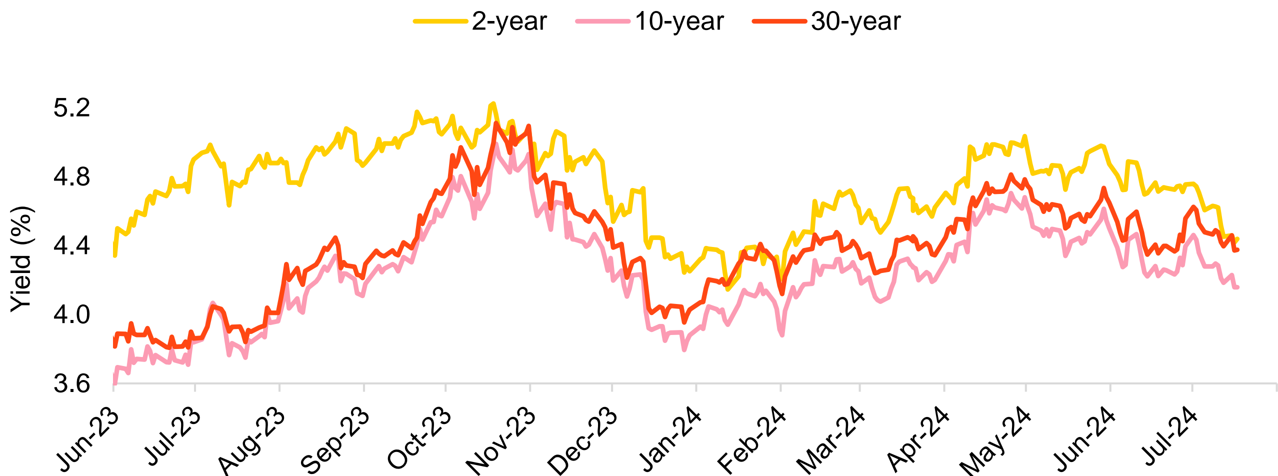
A Biden win is expected to result in similar policies to their current trajectory on trade and foreign policy. This includes a continuation of certain protectionist policies, such as his administration's tariff increases in some sectors as well as industrial policy and use of export controls.

The scope and target of certain trade policies in either administration, especially increased tariffs, could exacerbate inflation pressures. Also important, in our view, is how the proceeds of any tariffs might be used (i.e., to fund tax cuts, or to reduce the deficit). And as we outline later, an overhang of uncertainty is likely to precede any formal policy implementation(s) and will likely be the near-term impact investors will encounter.

Budget deficits are expected to remain large regardless of which party wins the U.S. election. Such ongoing deficits reinforce our expectation for structurally elevated interest rates in this economic cycle (beyond the policy sensitive front-end), as well as the potential that investors may demand additional compensation for holding longer-term U.S. Treasuries.

As shown in Exhibit 3, intermediate and long-end U.S. Treasuries are still below the recent peaks of a few months ago, leaving scope for yields to move higher. If this materializes, and front-end rates decline further (presuming they track gradual Federal Reserve rate cuts), the yield curve should become less inverted, as illustrated in Exhibit 4.

Exhibit 3: We see scope for intermediate and long-end rates to migrate higher
Yield-to-worst of the 2-year, 10-year and 30-year U.S. Treasuries (on-the-run securities, mid levels)



Source: BlackRock, Bloomberg. As of July 17, 2024.

Exhibit 4: The U.S. Treasury yield curve has become less inverted
2s10s U.S. Treasury yield curve (bp): 10-year yield minus 2-year yield

Source: BlackRock, Bloomberg. As of July 17, 2024.

For corporate credit investors, we see three key investment implications:

- First, the aforementioned interest rate backdrop should leave shorter-duration and floating rate products as better positioned vs. longer-duration credit – at least for the near-term (and barring a sharp deterioration in economic activity).
- Second, the interaction with growth will remain critical, especially for speculative rated firms which are navigating a higher cost of capital environment and have thinner financial cushions relative to their investment grade peers. Above trend U.S. growth in 2023 and 1H2024 has been a key ingredient in the resilience of growth-sensitive asset classes such as high-yield bonds and leveraged loans, in our view.
- Third, dispersion is likely to increase as firms may need to navigate a more complicated environment for trade and tariffs. Firm level characteristics such as supply chain resilience, supplier concentration, and geographic exposures may move into the forefront – as was the case during the 2018 trade tensions between the U.S. and China.

On the last point: in the very near-term, markets may encounter heightened uncertainty related to trade and policy – which may weigh on business investment. For example, a Goldman Sachs economic research analysis from July 12th 2024 found that a spike in trade policy uncertainty in 2018-2019 lowered Euro Area industrial production by approximately 2%.

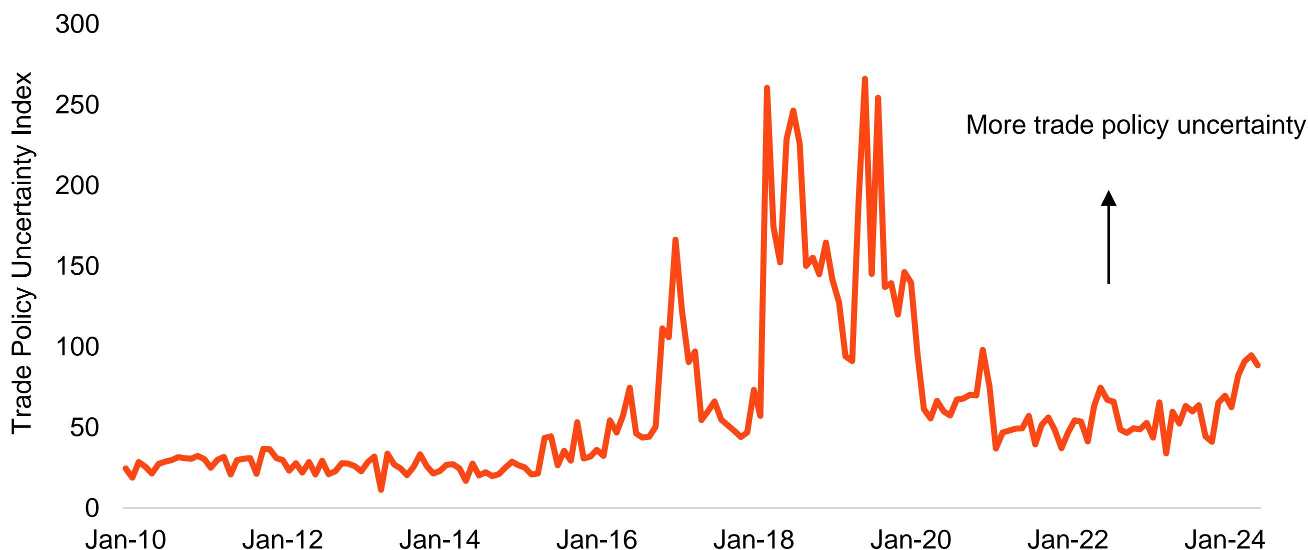
In Exhibit 5, we show a measure of such uncertainty using the Trade Policy Uncertainty Index developed by Federal Reserve economists. In their September 2019 paper, Federal Reserve economists noted that higher trade policy uncertainty has adverse effects on GDP and investment, with these effects estimated to be protracted through time.

This is because uncertainty could (1) lead firms to delay their investment and reduce their hiring, (2) lower consumer confidence and spending, and (3) ultimately curtail economic activity around the world.

A separate September 2019 analysis by the International Monetary Fund also found a link between increases in trade policy uncertainty and significant output declines. These dynamics will be important for corporate credit investors to monitor (in the USD and EUR markets), given the importance of growth in supporting the fundamentals of corporate credit borrowers.

Exhibit 5: Trade policy uncertainty has increased recently, but remains below the peak of 2018-2019

Trade Policy Uncertainty Index developed by Federal Reserve economists



Source: Federal Reserve, Haver Analytics, BlackRock. As of June 30, 2024 (most recent available as of July 17, 2024). The Trade Policy Uncertainty (TPU) Index is based on automated text searches of the electronic archives of seven newspapers: Boston Globe, Chicago Tribune, Guardian, Los Angeles Times, New York Times, Wall Street Journal, and Washington Post. The measure is calculated by counting the monthly frequency of articles discussing trade policy uncertainty (as a share of the total number of news articles) for each newspaper. The index is then normalized to a value of 100 for a one percent article share. Developed by economists Dario Caldara, Matteo Iacoviello, Patrick Molligo, Andrea Prestipino, and Andrea Raffo.

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The first Fed rate cut: September looks more likely vs. 4Q2024

This week featured a range of public commentary from Federal Reserve officials, including two members of the leadership: Chair Jerome Powell and New York Federal Reserve President and Vice Chair of the Federal Open Market Committee (FOMC) John Williams. We now expect the first Federal Reserve rate cut in September (vs. our previous expectation for September, *or* at some point in 4Q2024).

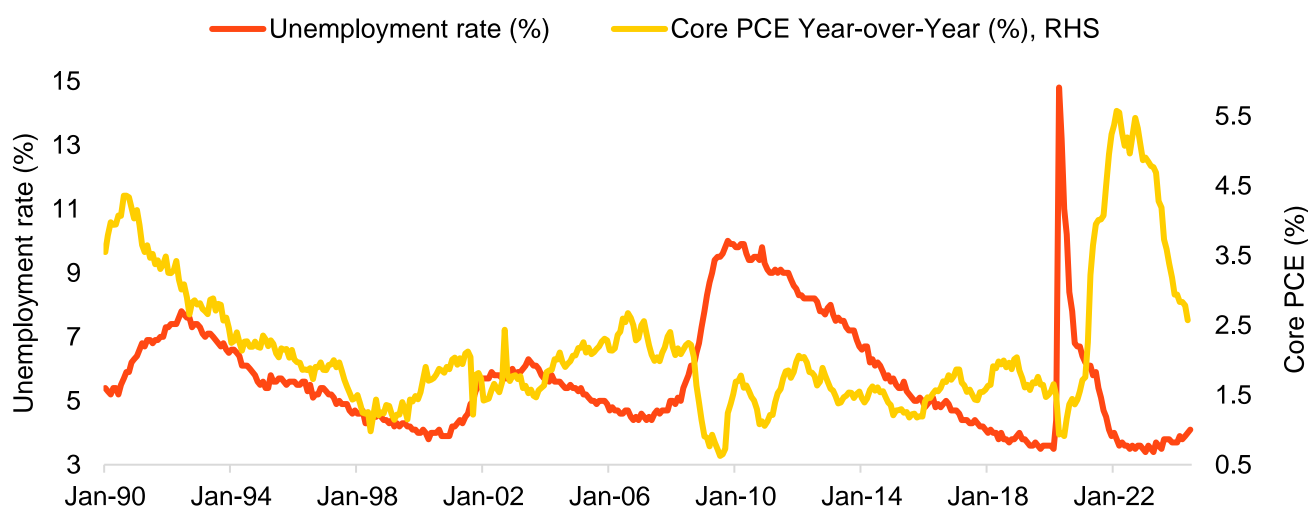
The comments also reinforce our view that the rate cutting cycle – once it materializes – is likely to be shallow. For corporate credit investors, this means corporate borrowers are unlikely to experience material, near-term interest rate relief – at least barring a sharp downturn in growth.

As we have noted previously, we view the *reasons for* and *depth of* the rate cutting cycle as more important for corporate credit investors than the timing (start). A policy normalization cycle in response to a sustained improvement in inflation would likely be a constructive development for corporate credit (even as it would reduce available yields somewhat). By contrast, rate cuts in response to a sharp deterioration in growth would likely be accompanied by spread widening and would be much less supportive for risk appetite, in our view.

Takeaways from recent "Fed speak"

- **A rebalanced labor market leaves risks two-sided.** In an interview at the Economic Club of Washington D.C. on July 15th, Chair Powell emphasized many of the same themes referenced in the past several weeks (June FOMC press conference, ECB Forum in Sintra, U.S. Congressional testimony), including: (1) the two-sided risks facing the Federal Reserve's dual mandate of price stability and maximum employment, given the improved inflation readings and the cooling in the labor market (Exhibit 6); and (2) that an unexpected weakening in the U.S. labor market could warrant a (more swift) policy response to cut rates.
- **Improved inflation data in 2Q provides some additional confidence.** While acknowledging upfront that he would not be sending any signals on the timing of the first rate cut for this cycle, Chair Powell *did* say that the inflation data of 2Q2024 provided some additional confidence that inflation is on a path to sustainably reach 2%. (As of the June 2024 FOMC meeting minutes, officials were still referencing the need for "greater confidence" before reducing rates). In an interview with the Wall Street Journal on July 16th, President Williams said the inflation data over the last three months is "getting us closer to a disinflationary trend that we're looking for," but also noted that he "would like to see more data to gain further confidence inflation is moving sustainably to our 2% goal."

Exhibit 6: Progress on inflation, alongside a cooling in the U.S. labor market
U-3 U.S. unemployment rate (monthly, seasonally adjusted) and year-over-year core PCE inflation (seasonally adjusted), RHS



Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Bloomberg, BlackRock. Unemployment rate is as of June 30, 2024 (most recent). Core PCE is as of May 31, 2024 (most recent).

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- **A cut in July appears unlikely.** President Williams added that "we're actually going to learn a lot between July and September," suggesting that a rate cut at the upcoming July 30th – 31st FOMC meeting is unlikely (barring a negative data surprise). Federal Reserve Governor Christopher Waller echoed similar thoughts on timing in prepared remarks to the Kansas City Fed this week, noting "current data are consistent with achieving a soft landing, and I will be looking for data over the next couple months to buttress this view."
- **The degree of restrictiveness will need to be considered.** Chair Powell said the current stance of monetary policy appears to be "restrictive but not severely restrictive," again suggesting (as he has done recently) that the neutral rate has likely risen relative to the period between the 2007-2008 global financial crisis and the 2020 pandemic. President Williams also referenced the degree of restriction currently embedded in monetary policy by saying: "I do think there is a decision ahead of us at some point to decide, not to get out of a restrictive stance of policy, but to lower interest rates in a way that lessens how restrictive policy is."

Risks relative to market pricing: skewed towards slightly fewer cuts, in our view

Markets are currently pricing in slightly more than three (25bp) rate cuts through January 2025 (Exhibit 7). And three-month SOFR futures (a rough proxy for the Federal Funds rate, over a longer period of time) suggest a terminal rate of approximately 3.4% in late 2026 (vs. roughly 3.7% in late 2026, as of a month ago).

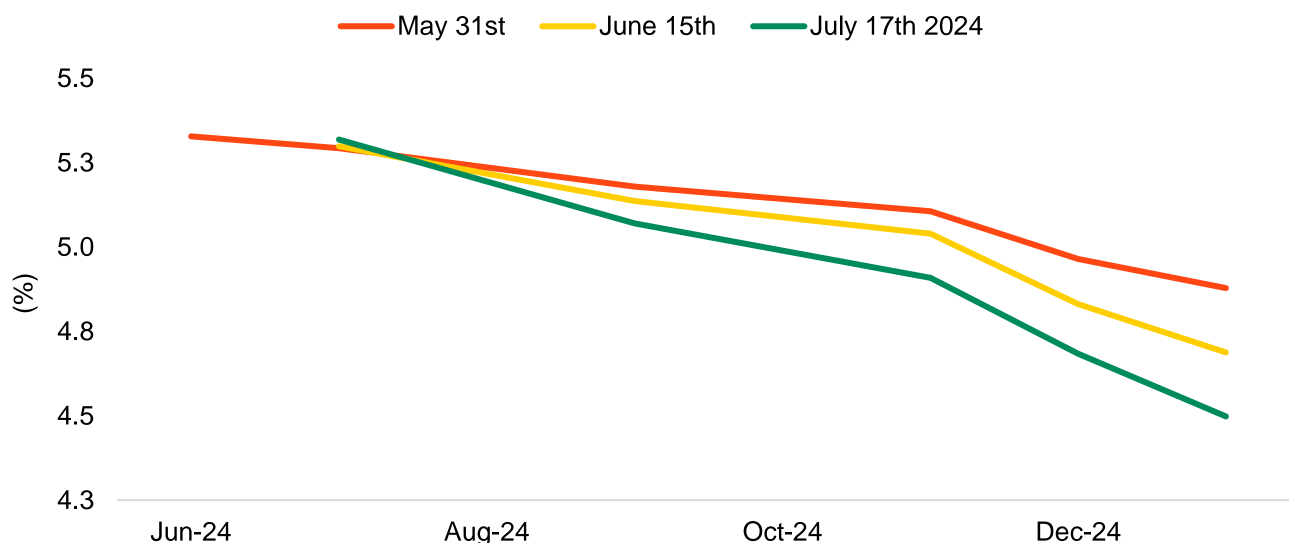
But U.S. real GDP growth – using the Atlanta Fed's GDPNow tracker – places 2Q2024 real GDP at an above-trend pace of +2.7% (as of July 17th). This economic resilience was punctuated with the release of U.S. retail sales (on July 16th), which featured stronger than expected spending in June (vs. consensus estimates) across a range of categories, and upward revisions to the May 2024 figures.

As a result, and assuming the economic momentum slows only moderately from here (i.e., to a pace closer to trend, such as +1.75% to +2%), we struggle to see a strong sense of urgency for the Federal Reserve to embark on a deep rate cutting cycle to ease monetary policy. More likely, in our view, is a path of monetary policy *normalization* (i.e., staying in restrictive territory as President Williams suggests).

We view the risks (relative to market pricing) as skewed towards slightly fewer cuts in 2024 (we expect 1-2) and fewer cuts for the cycle, overall (we see potential for a terminal rate closer to 4%). Of course, a swift downturn in growth or a sharp deterioration in the labor market would likely change the reaction function highlighted above to feature swifter and deeper rate cuts.

Exhibit 7: Market pricing now implies roughly 83bp of rate cuts through January 2025

The U.S. monetary policy rate implied by Fed Funds Futures, through early 2025



Source: BlackRock, Bloomberg, As of May 31, 2024, June 15, 2024, and July 17, 2024.

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Watching for a sustained rebound in sponsor-related M&A

A few weeks ago, we took stock of the trends surrounding strategic M&A (i.e., transactions involving corporations). While strategic M&A moderated in 2Q2024 relative to the 1Q2024 pace, it has nonetheless rebounded from the muted levels of 2022 and 1H2023. Sponsor-related M&A volumes (i.e., transactions involving a financial sponsor such as a private equity firm), on the other hand, have not yet experienced a similar, sustained rebound (Exhibit 8). That said, 2Q2024 volumes do show some increased activity.

We attribute the disconnect to the different motivations behind each type of transaction. Strategic M&A is often driven by CEO confidence and the need to expand, diversify, or simplify a corporation's business model – often permanently. While financing plays a role in the attractiveness (and sometimes feasibility) of such deals, it is *not* usually the primary catalyst to do a deal. Rather, enhancing market positioning, obtaining competitive advantages, and capturing longer-term opportunities for growth tend to be the key drivers.

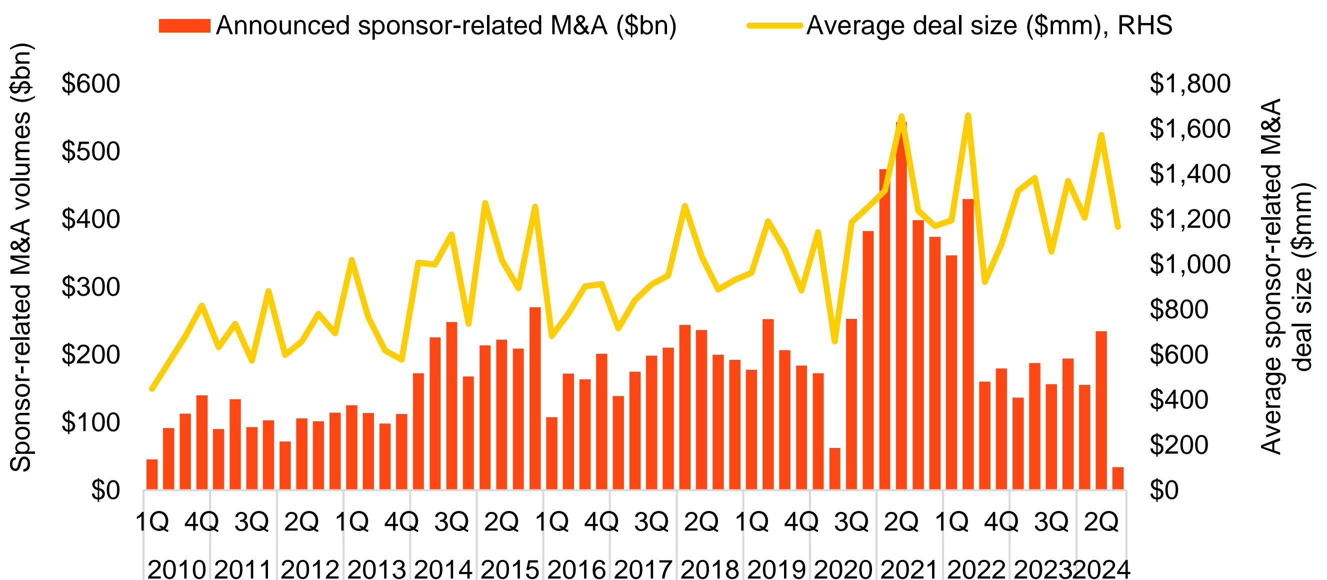
Sponsor-related transactions, on the other hand, often rely heavily on debt financing and are more transactional in nature. Generally, the objective is to acquire, improve, and exit a business, for a financial return. As a result, debt financing costs feature more prominently, and buyer-seller valuation misalignments can present a greater obstacle to deal finalization.

Given the swift change in the interest rate regime since early 2022 (underscoring the importance of vintage diversification), it is perhaps not surprising that sponsor-related transaction volumes remain slower to rebound. As financial sponsors wait for a more favorable exit environment, hold times for private equity (PE) investments have extended.

This has weighed on some PE general partners' ability to return capital to investors. A more normalized environment for PE exits should allow for additional private debt deployment opportunities, as the private debt industry is a strong financing partner for PE activity.

On this point, recent data has been somewhat encouraging. Our review of 2Q2024 earnings call transcripts from some large U.S. investment banks points to increasing M&A dialogue (including for sponsor related activity) and building backlogs. That said, this recovery was generally characterized as being in its early stages, with an expectation that it would play out over the next few quarters.

Exhibit 8: Watching for signs of a sustained rebound in sponsor-related M&A volumes
Sponsor-related announced M&A volumes, for North American and European acquirers. Captures deals valued at $100 million or more, at announcement. Excludes canceled and withdrawn deals.



Source: Dealogic (ION Analytics), BlackRock. As of July 17, 2024. A transaction is classified by Dealogic as sponsor-related if it involves a financial sponsor as buyer or seller.

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To frame the current backdrop, Pitchbook estimates a $266 billion exit deficit as of 1H2024, down nearly 50% from peak values in 2022, but still elevated by historical standards (Exhibit 9). In 2Q2024, the exit/investment ratio for PE in the U.S. fell to 0.36x, a new record low, according to Pitchbook.

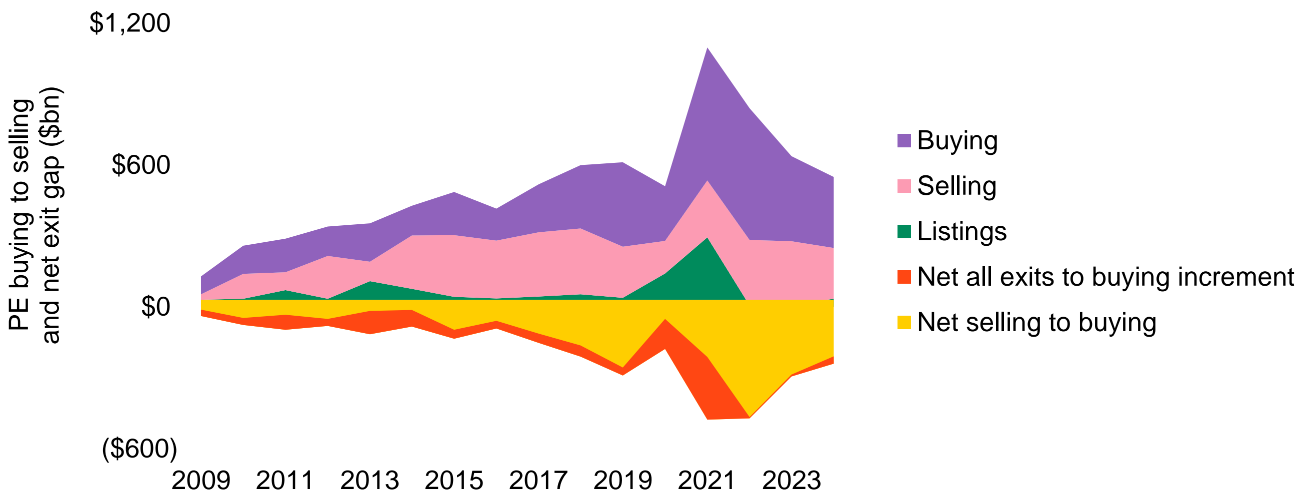
Lower PE exit volume has also influenced median hold times for PE-backed companies globally, as sponsors wait for better exit conditions. Indeed, median cumulative exit hold times reached 5.4 years in 2023 and 1H2024, up from an average of 5.2 years from 2018-2022 (Exhibit 10). The annual hold times highlight a more significant contrast.

Still, the universe of U.S. PE-backed companies remains relatively diversified across age buckets, with 4-6 years and less than 3 years representing the two largest segments at 38% and 29%, respectively (Exhibit 1).

And while a large PE exit deficit may reduce GP's ability to return capital to investors, U.S. PE dry powder to make new investments remains robust, totaling $965 billion as of 3Q2023, according to Pitchbook.

Exhibit 9: PE investments have outpaced exits in recent years

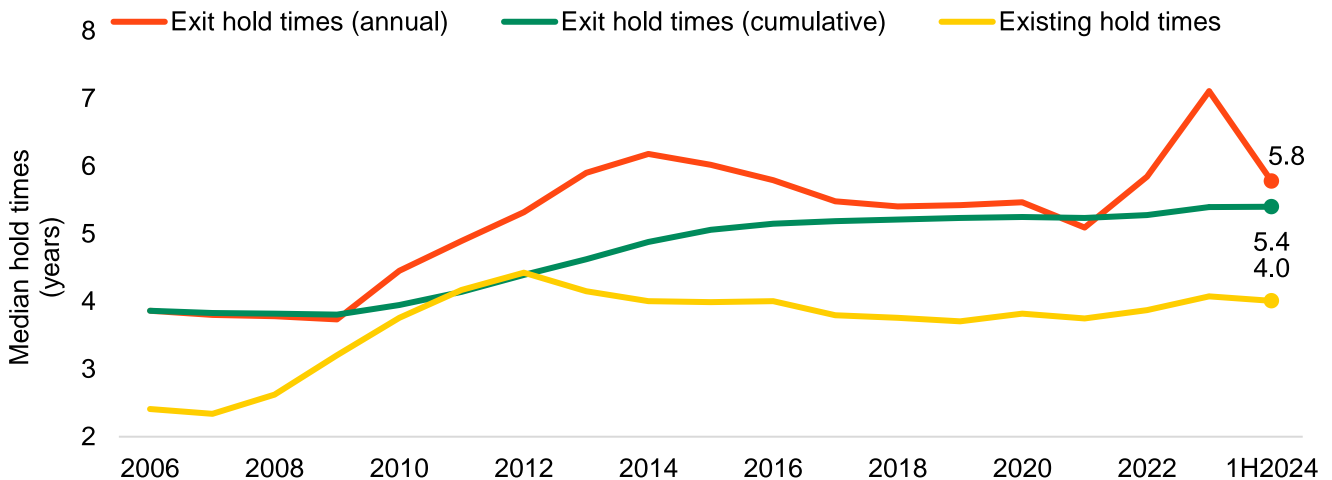
U.S. PE buying to selling and the net exit gap



Source: Pitchbook, BlackRock. As of June 30, 2024. Listing and selling represent selling activity, buying represents buying activity. Both buying and selling activity is illustrated above the zero. Net selling to buying and net all exits to buying increment represent the total net exit gap, which is illustrated below zero.

Exhibit 10: Muted PE exit activity led to longer hold times in 2023, before shortening somewhat in 1H2024

Median global PE company hold times, in years



Source: Pitchbook, BlackRock. As of June 30, 2024.

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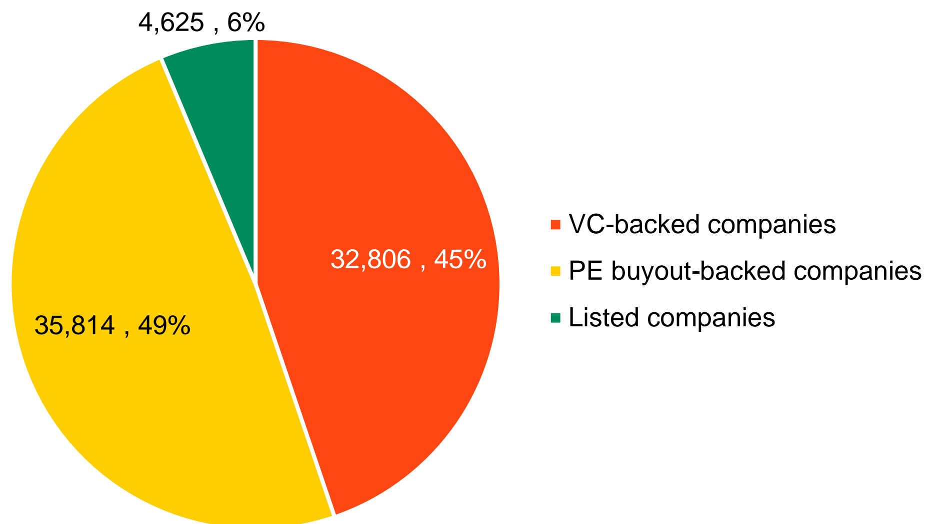
Fewer public companies may create more financing opportunities for private debt

Fewer U.S. companies are choosing to issue public equity, potentially expanding the addressable market for private debt (a theme we explored in the 3Q2024 Global Credit Outlook). There are currently 4,625 publicly listed companies in the U.S. (excluding foreign firms), versus over 68,000 firms backed by PE buyouts or venture capital (VC), according to Preqin (Exhibit 11).

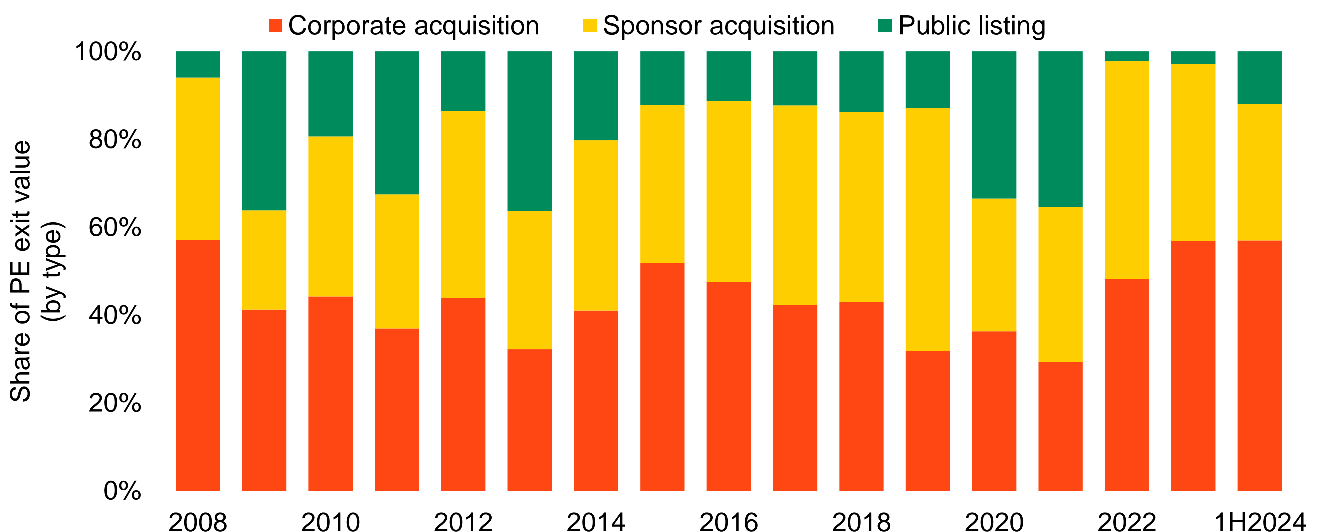
This trend is also evident in PE exits, which increasingly favor corporate or sponsor acquisitions over public equity listings, in part due to a perceived unfavorable IPO environment, and depressed equity market valuations in certain industries (especially outside of some sectors such as mega-cap technology). In 1H2024, public listings accounted for just 12% of U.S. PE exits, by value (Exhibit 12). With companies staying private for longer and corporate or sponsor acquisitions representing the majority of PE exit value, private debt is positioned to grow as a key financing partner, in our view.

Exhibit 11: There are over 68,000 PE/VC-backed companies in the U.S.
Number (and share) of listed and PE/VC-backed companies



Sources: Preqin, BlackRock. As of March 31, 2024. Listed companies exclude foreign-based companies listed in U.S. exchanges. Listed companies may overlap with PE/VC-backed list due to unsold stakes.

Exhibit 12: Corporate and sponsor acquisitions represented 88% of PE exits in 1H2024
Share of U.S. PE exit value by type



Source: Pitchbook, BlackRock. As of June 30, 2024.

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