Private Markets

May 16, 2024

Global Credit Weekly:

Encouraging (early) signal

BlackRock

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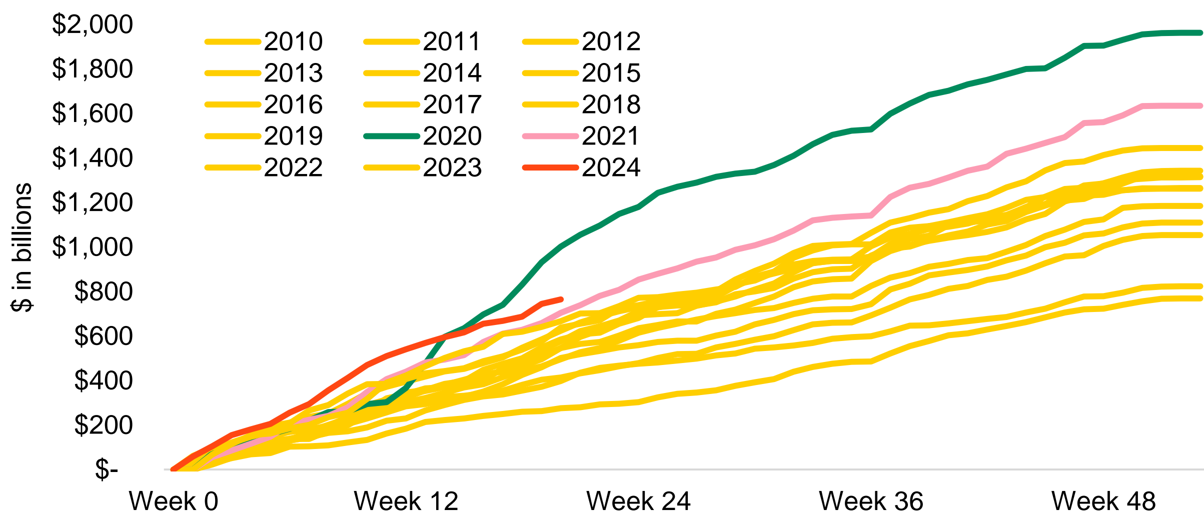
Key takeaways

- After three consecutive months of upside surprises (vs. Bloomberg consensus), the April U.S. CPI data (released May 15th) showed early signs of moving in the preferred direction of the Federal Reserve: lower (Exhibits 2-5). But the "start-stop" nature of the inflation fight (i.e., progress in 2H2023, but a lack of further declines in 1Q2024), suggests a few more months of consistently improving data will be required for the Federal Reserve to begin a rate cutting cycle.
- We continue to expect a shallow rate cutting cycle to begin in 2H2024, with the risks of timing balanced within that timeframe (and highly dependent on the incoming inflation data). But as we have highlighted previously, the *reason* for rate cuts (i.e., improved inflation or weakness in the labor market) is much more important than the *timing*. Similarly, the *reason* behind any *delay* of rate cuts (i.e., stronger than expected growth or a *sustained reacceleration* in inflation) will determine how the corporate credit market responds.
- One of the notable developments in USD corporate credit in recent months has been the robust primary market backdrop (Exhibits 1 and 8). These elevated new issue volumes have (1) occurred despite persistently high interest rates, and (2) been largely well absorbed, based on a variety of metrics. Perhaps most notable for corporate credit investors, however, has been the "bondholder friendly" nature of the supply. For example, 77% of the year-to-date USD HY issuance has been earmarked for debt repayment or refinancing, per Dealogic (Exhibit 9). This ranks as the largest such share in the post-financial crisis era. It also explains why the market has so easily absorbed the supply (as very little "new money" has joined the USD HY universe).
- Finally, given the prevailing expectation for a "high for longer" cost of capital, in this *Global Credit Weekly*, we provide an update on the fundamentals of two alternative asset classes using recently released 1Q2024 data: U.S. private debt, and commercial real estate.

Exhibit 1: The strong pace of USD IG supply continues in 2Q2024
Cumulative USD IG gross issuance by week, 2010 through 2024



Source: BlackRock, Dealogic (ION Analytics). As of May 15, 2024.

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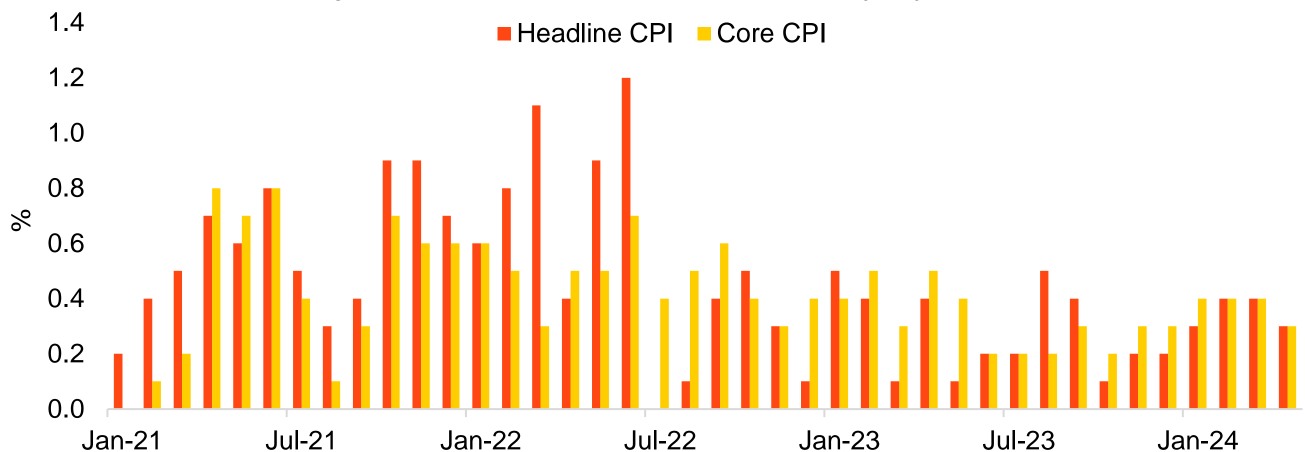
April U.S. CPI: a step in the right direction, but more is likely needed

After three consecutive months of upside surprises (vs. Bloomberg consensus), the April U.S. CPI data (released May 15th) showed early signs of moving in the preferred direction of the Federal Reserve: lower (Exhibits 2-5).

A few categories contributed to the relatively benign core reading. For example, the monthly pace of inflation slowed for health insurance (+0.3%, from +1.2%) and motor vehicle insurance (+1.8%, from +2.6%) vs. the March level. Meanwhile, prices for new and used cars/trucks continued to decline (-0.4% and -1.4%, respectively) in April, alongside airline fares (-0.8%) and household furnishings and supplies (-0.4%). Shelter, which represents 36% of the CPI, remained at +0.4% for April, where it has been for the past few months.

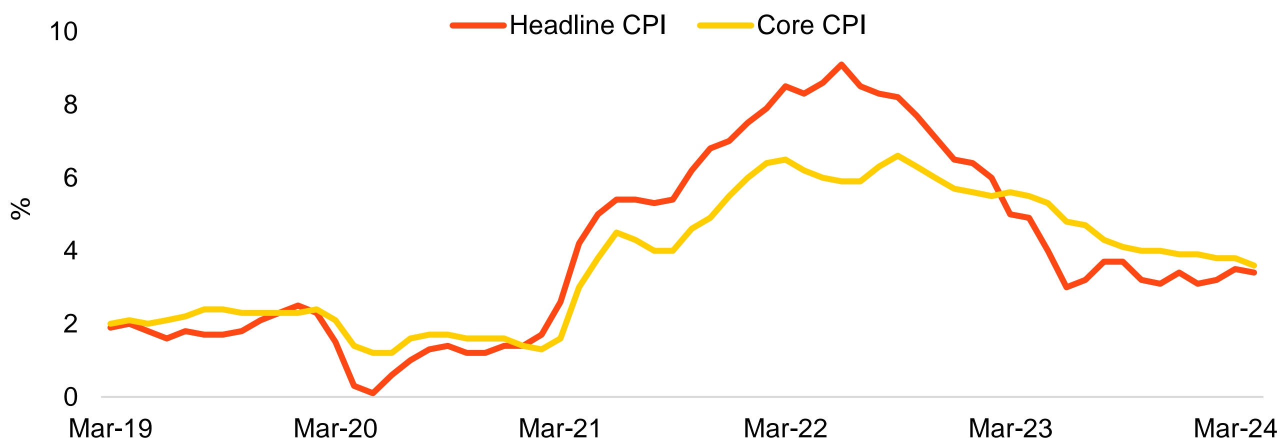
While we view the April data as a welcome step in the right direction, it will likely need to be accompanied by at least a few more months of similar data, in our view, to give the Federal Reserve the confidence to begin a rate cutting cycle. This is because of the "start-stop" nature of the inflation progress, instead of a steady and directionally consistent decline. For example, most of the progress on fighting inflation was captured in 2H2023. By contrast, 1Q2024 featured stronger than anticipated inflation and a lack of further progress. As such, a few months of consistently improving inflation will likely be required, in our view, to give the Federal Reserve confidence that the recent improvement is not a "head fake" (as Chair Powell previously referenced in late 2023).

Exhibit 2: April U.S. CPI was +0.3% for headline and core – a moderation from 1Q2024
Month-over-month % change in headline and core U.S. CPI (seasonally adjusted)



Source: BlackRock, Bureau of Labor Statistics, Bloomberg. Captures data through April 30, 2024.

Exhibit 3: The April year-over-year core CPI reading of +3.6% was the lowest since 2021
Year-over-year % change in headline and core U.S. CPI (not seasonally adjusted)



Source: BlackRock, Bureau of Labor Statistics, Bloomberg. Captures data through April 30, 2024.

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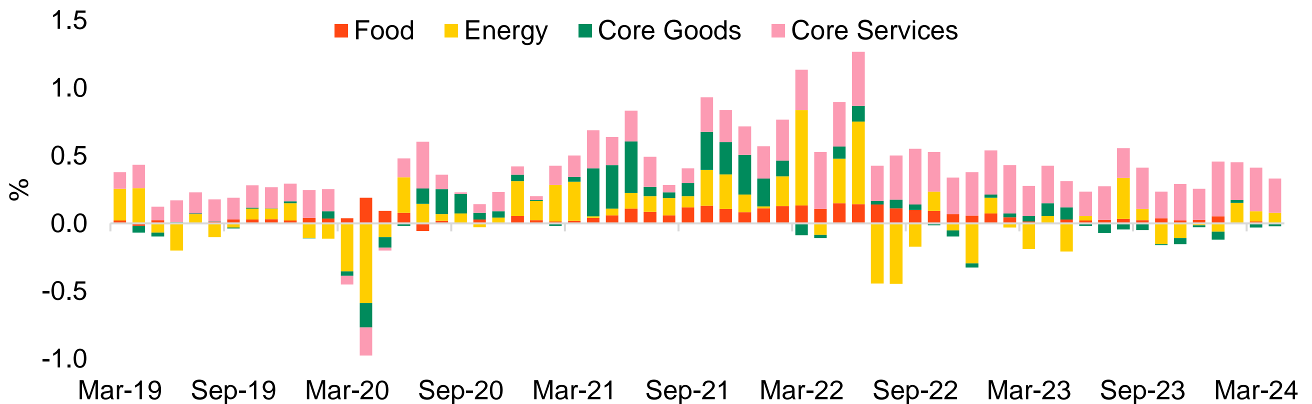
Our base case remains for the first Federal Reserve rate cut to occur at some point in 2H2024. While we had previously been guiding towards the earlier part of that (admittedly wide six-month range), in mid-April we updated our view to reflect more balanced risks re: timing.

More important than the *timing* of the rate cutting cycle, however, is the *reason* for it. Policy normalization in response to improved inflation is a much more supportive backdrop for credit than policy easing in response to a sharp economic downturn – especially for growth-sensitive speculative grade borrowers. By the same token, an extended delay (beyond 2024) for rate cuts because of strength in U.S. economic activity would likely be more easily digested by credit, in our view, vs. a postponement of rate cuts because of a *sustained reacceleration* of inflation. While Chair Powell has recently characterized rate hikes as "unlikely," a *sustained reacceleration* of inflation (*if* it were to materialize, and not our base case) may lend more credence to the possibility. This would be a negative for credit, in our view, given the uncertainty it would introduce vis-à-vis the forward path for U.S. monetary policy.

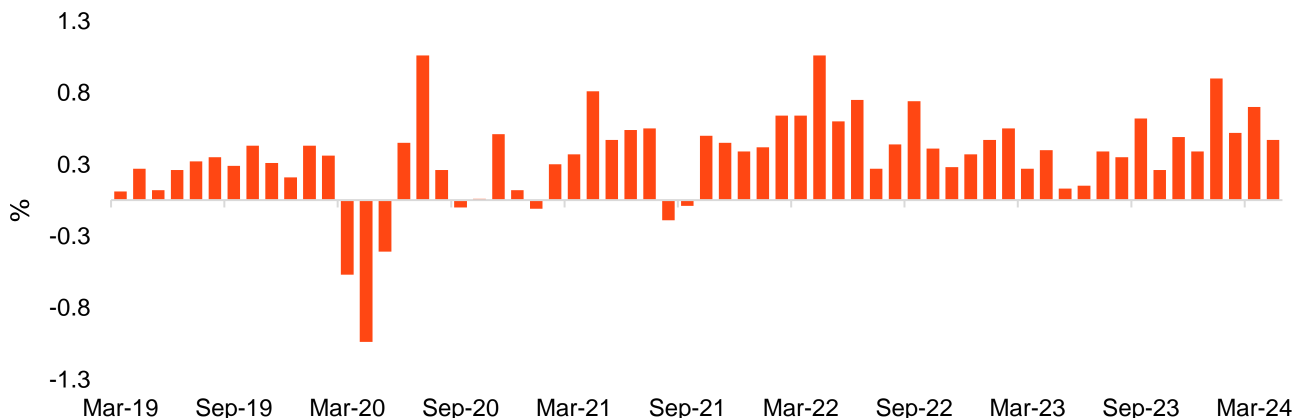
Additionally, we see a high probability for a shallow rate cutting cycle, once it ultimately materializes – a view that is already reflected in market pricing, with just over 60bp of cuts priced through early 2025 (as of May 15th). This means investors should be bracing for a "high for longer" cost of capital environment. Indeed, during his remarks at the Foreign Bankers' Association in Amsterdam on May 14th, Chair Powell reiterated the message from the May 1st FOMC that "it looks like it will take longer" for the FOMC to become confident that inflation is declining to 2% over time. Chair Powell added that "time will have to tell" if the policy rate is "sufficiently restrictive."

Exhibit 4: Core Services is driving the bulk of the inflation
Contributions to month-over-month headline U.S. CPI (seasonally adjusted)



Source: BlackRock, Bureau of Labor Statistics, Bloomberg. Captures data through April 30, 2024.

Exhibit 5: Excluding housing, services inflation moderated in April
Month-over-month change in U.S. CPI services ex-housing ("Supercore" CPI)



Source: BlackRock, Bureau of Labor Statistics, Bloomberg. As of April 30, 2024. Bloomberg estimate of "Supercore" CPI excludes Rent of Primary Residence and Owners Equivalent Rent of Residences from Services ex-Energy Services. Estimate reflects Bloomberg's calculations following consultation with the Bureau of Labor Statistics (BLS) https://www.bls.gov/opub/hom/cpi/calculation.htm.

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USD corporate credit: primary market activity forges ahead

One of the notable developments in USD corporate credit in recent months has been the robust primary market backdrop. These elevated new issue volumes have (1) occurred despite persistently high interest rates, and (2) been largely well absorbed, as evidenced by index-level spreads at the tight end of the historical range (88bp for USD IG and 301bp for USD HY, using the Bloomberg indices as of May 15th).

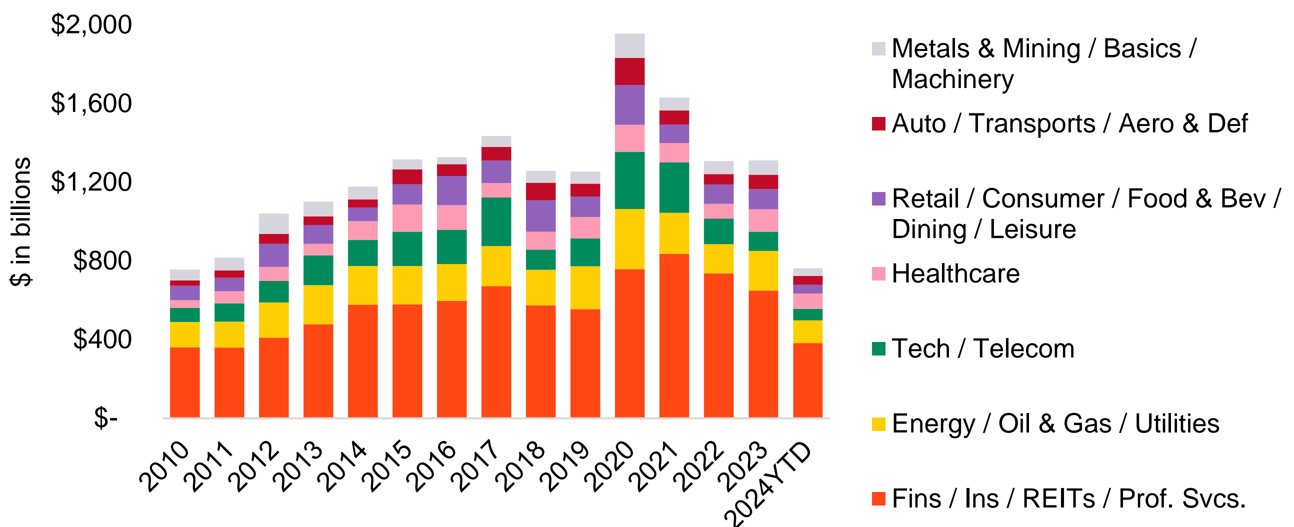
As shown in Exhibit 1, USD IG gross issuance has totaled $764 billion so far this year (as of May 15th) – a pace ahead of most years except for the pandemic-era, record-shattering volumes (as corporates proactively raised liquidity against a backdrop of economic uncertainty and ultra-low interest rates).

Bloomberg data shows that year-to-date USD IG new issue concessions have averaged just 3.2bp – below the 8.5bp average of full-year 2023. Similarly, USD IG order books for new deals so far this year have been, on average, 3.9 times oversubscribed (again using Bloomberg data). This compares to 3.5 times oversubscribed in 2023.

As is typical in the USD IG market, the majority (69%) of this year's issuance has been earmarked for "general corporate purposes." 10% has been issued to fund M&A (2018-2013 average is 9%) and 19% has been issued for debt repayment / refinancing (vs. average of 17%). Exhibits 6 and 7 highlight the broad participation across sectors, and the distribution across tenors.

Exhibit 6: A wide range of sectors have driven the robust USD IG new issue volumes

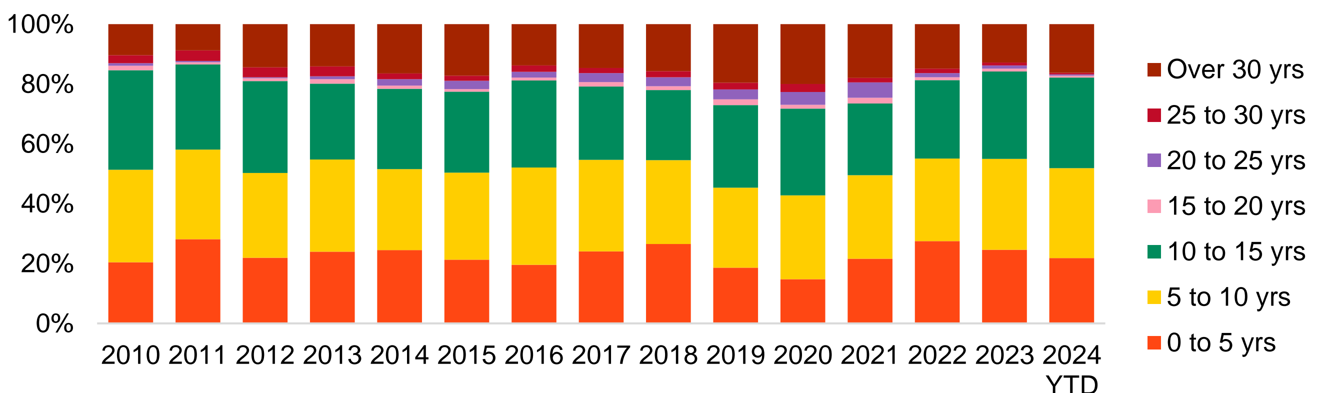
USD IG gross issuance by sector, as captured by the Dealogic "deal industry group"



Source: BlackRock, Dealogic (ION Analytics). As of May 15, 2024. Excludes Holding Companies, Closed End Funds, and Government.

Exhibit 7: Year-to-date supply has featured a very slight decline in front end issuance

USD IG gross issuance by tenor, as captured by Dealogic "years to maturity" at issuance



Source: BlackRock, Dealogic (ION Analytics). As of May 15, 2024.

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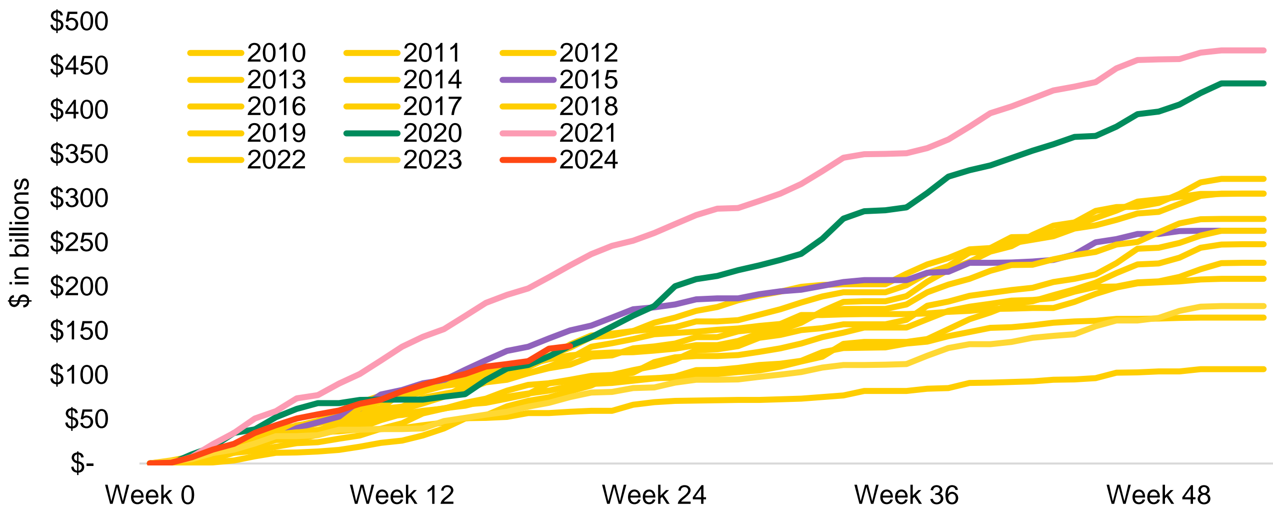
In the USD HY market, a similar (albeit less pronounced) trend exists. $133 billion of gross issuance has priced so far this year, leaving 2024 as one of the most active years (behind 2021 and 2015; Exhibit 8). Perhaps most notable for corporate credit investors, however, has been the "bondholder friendly" nature of the supply. 77% of the year-to-date issuance has been earmarked for debt repayment or refinancing, per Dealogic (Exhibit 9). This ranks as the largest such share in the post-financial crisis era. It also explains why the market has so easily absorbed the supply (as very little "new money" has joined the USD HY universe).

USD HY corporates' focus on addressing upcoming maturities is a prudent and expected step, in our view – especially given their general reluctance to allow debt maturities to become current (i.e., due within 12 months) because of "going concern" accounting considerations. So far this year – and unlike 2H2023 – the syndicated (public) debt markets have remained open to lower rated borrowers (B-/CCC+/CCC/CCC-). This will be important to monitor, going forward, as a less-receptive capital markets environment could provide upside risk to the relatively sanguine default expectation that we highlighted in our *2Q2024 Global Credit Outlook*.

Exhibit 8: 2024 has also been active for USD HY supply

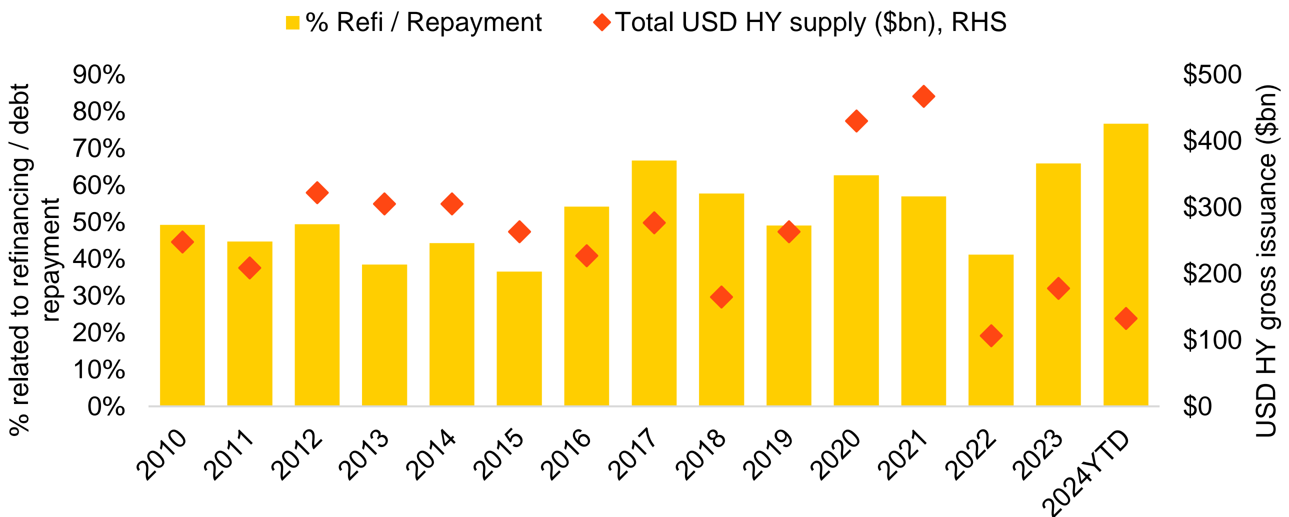
Cumulative USD HY gross issuance by week, 2010 through 2024



Source: BlackRock, Dealogic (ION Analytics). As of May 15, 2024.

Exhibit 9: 77% of USD HY supply has been earmarked for debt repayment or refinancing

Cumulative USD HY gross issuance by year, and the share earmarked for debt repayment or refinancing, as captured by the Dealogic "primary use of proceeds"



Source: BlackRock, Dealogic (ION Analytics). As of May 15, 2024.

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Private debt: takeaways from recently released 1Q2024 data

Market participants remain focused on how floating rate borrowers are navigating this "high for longer" cost of capital backdrop. The takeaway from recently released 1Q2024 data highlights some encouraging datapoints on covenant defaults and EBITDA growth, while also underscoring the importance of vintage diversification.

Covenant defaults decline, owing to enhanced flexibility

The covenant default rate for companies included in the Lincoln International Proprietary Private Market Database decreased for the fourth consecutive quarter, to 2.7% in 1Q2024 (Exhibit 10). For context, Lincoln is an independent valuation advisor specializing in illiquid alternative investments. As of 1Q2024, Lincoln's Valuations and Opinions Group Proprietary Private Market Database included approximately 5,000 U.S. operating companies, representing over $185 billion of privately held principal and invested capital (primarily by private equity sponsors).

As we've previously noted, the long-term relationship between a borrower and lender (or a small group of lenders) in the private debt market often allows for flexibility to address financial stress more proactively and efficiently relative to what may take place in the public universe (where many more lenders are typically involved). This flexibility to amend in advance of stress is one factor likely enabling the decline in covenant default rates in our view, despite a higher interest burden on borrowers.

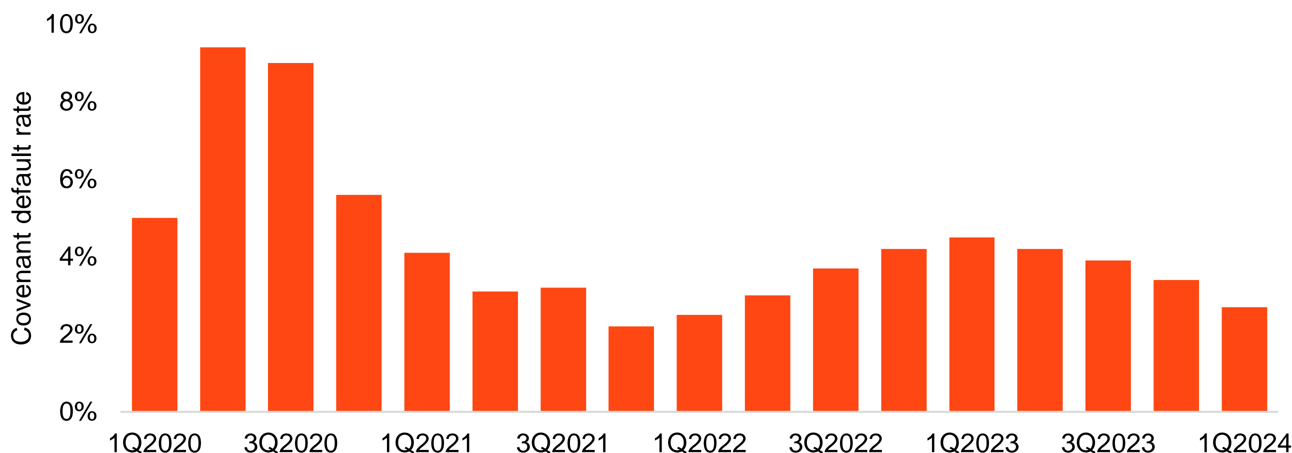
In the last 12 months ending in 1Q2024, more than 730 amendments were completed (involving nearly 16% of portfolio companies valued by Lincoln), down slightly from 740 amendments (involving 18% of portfolio companies) in the full year 2023. Of the amendments completed, 58% included pricing changes, many of which incorporated a paid-in-kind (PIK) interest component.

Over the past four quarters, loans originated in 2021 have represented the largest percentage of amendments, averaging ~31% per quarter, according to Lincoln. We believe the swift rate hiking cycle (which began in March 2022) and the consequential increased interest burden is a large contributor to this skew of amendment activity. In our view, this also illustrates the importance of credit selection and vintage diversification (a topic we explore more on the next page).

Beyond amendments, general fundamental data from 1Q2024 has also been encouraging. 63% of companies tracked by Lincoln reported EBITDA growth (the fourth consecutive quarterly increase). And last 12 months' EBITDA growth of 5.6% was the highest since 2Q2022.

Exhibit 10: Covenant default rates declined for the fourth consecutive quarter in 1Q2024

Aggregate covenant default rate for the U.S. portfolio companies included in the Lincoln International Proprietary Private Market Database



Source: BlackRock, Lincoln International Valuations & Opinions Group Private Markets Proprietary Database. As of 1Q2024. A default is defined as a covenant default and not a monetary default. The analysis was performed based on a size-weighted approach, which considered the total net debt balance for each of the portfolio companies that had a defaulting security in the respective quarter.

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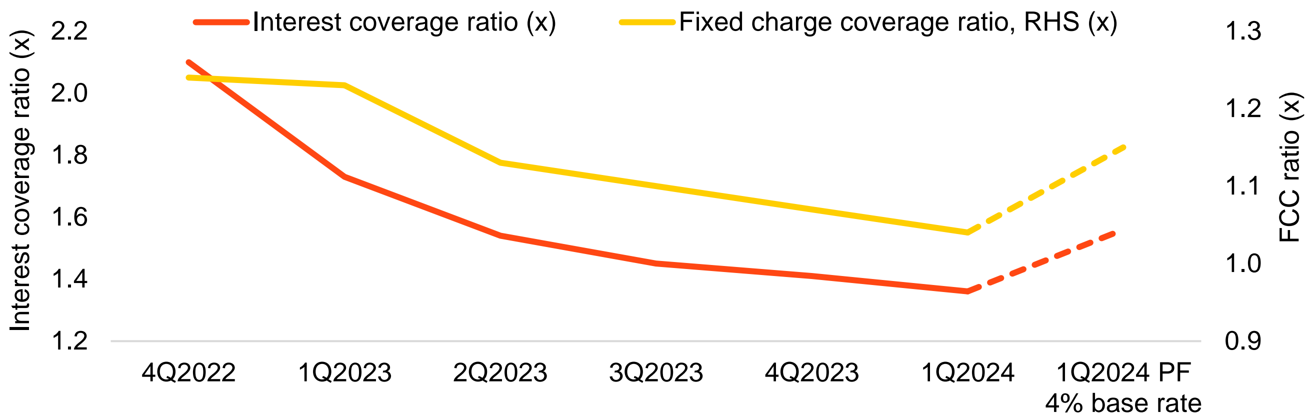
Vintage dispersion persists

The benefit of the flexibility inherent in the long-term relationship between private lenders and borrowers has been especially important for vintages formed in a more benign rate environment (such as 2021).

Both the average interest coverage ratio and the average fixed charge coverage (FCC) ratio for portfolio companies tracked by Lincoln have declined for the last six quarters (Exhibit 11). Elevated base rates (and therefore, elevated interest expense) ultimately limit cash available to borrowers to reinvest in growth or repay existing debt. Exhibit 11 also illustrates Lincoln's analysis of how a decline in rates to 4.0% would influence current coverage metrics.

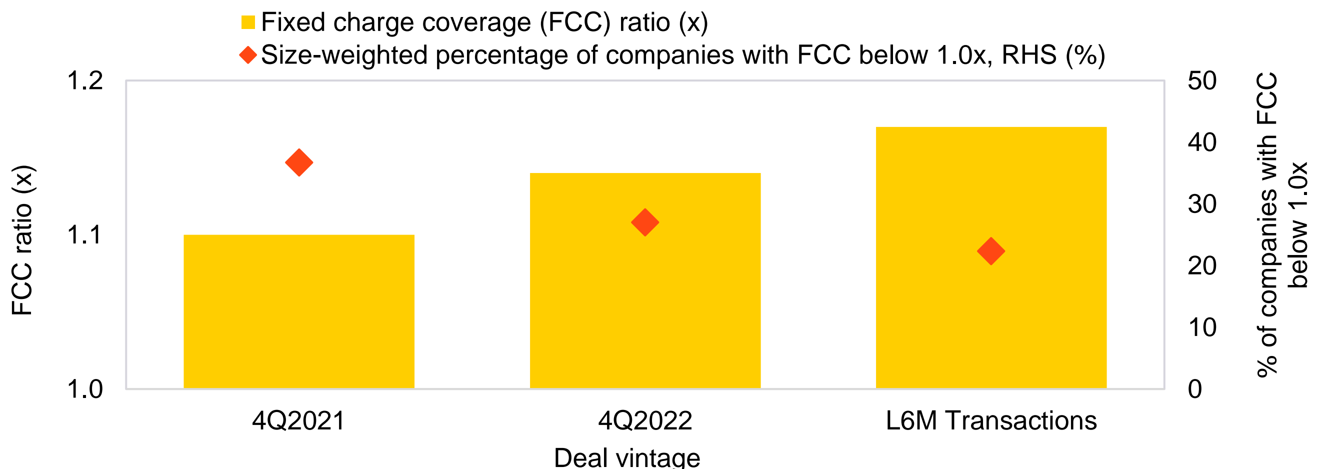
Further, Exhibit 12 demonstrates how the FCC ratio of companies in the Lincoln Database varies by vintage. For example, the average FCC ratio for deals done in 4Q2021 – prior to the start of the Federal Reserve's rate hiking cycle – is 1.10x. And 36.8% of these deals have a FCC ratio below 1.0x. By contrast, the average FCC ratio for deals done in the last six months (L6M) is 1.17x. And 22.4% of these deals have a FCC ratio below 1.0x.

Exhibit 11: Quantifying potential interest rate relief for private debt borrowers
Size-weighted actual and pro-forma (using a 4.0% base rate) interest coverage ratio for the portfolio companies in the Lincoln International Proprietary Private Market Database



Source: BlackRock, Lincoln International Valuations and Opinions Group Proprietary Private Market Database. Captures data through 1Q2024. Interest Coverage Ratio = LTM EBITDA / Interest. LTM = last twelve months. Fixed Charge Coverage Ratio = (LTM EBITDA – Taxes - Capex) / (LTM Interest Expense + (1% * Total Debt)).

Exhibit 12: Fundamental dispersion is evident across interest rate regimes
Fixed charge coverage ratios, by deal vintage, for the operating companies in the Lincoln International Proprietary Private Market Database



Source: BlackRock, Lincoln International Valuations & Opinions Group Private Market Proprietary Database. Captures data as of 1Q2024. Calculations: Fixed Charge Coverage Ratio = (LTM EBITDA – Taxes - Capex) / (LTM Interest Expense + (1% * Total Debt)).

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Commercial real estate data: watching for early signs of a trough

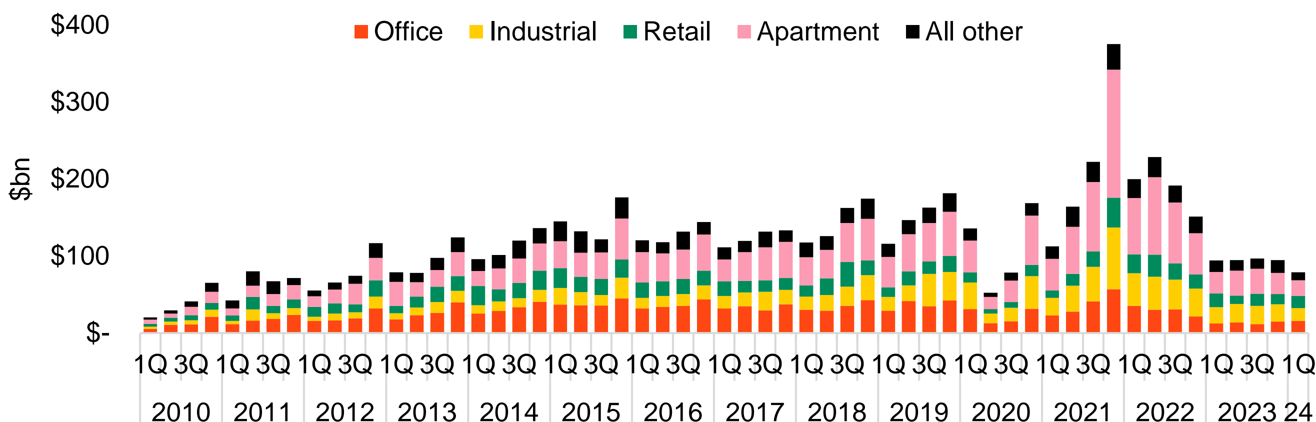
Commercial real estate (CRE) has been characterized by an enduring (yet nuanced) decline in transaction volumes and headwinds to asset valuations, amid an elevated rate environment, according to data compiled by Real Capital Analytics (RCA). However, there are early indications that the magnitude of such pressures could be moderating.

CRE transaction volumes continue to fall, but at a lesser pace

CRE transaction volumes continued their decline in 1Q2024, falling 16% year-over-year (YoY) and marking the seventh straight quarter of YoY declines, according to data by RCA. However, when compared to the average YoY decrease over the preceding six quarters (3Q2022 – 4Q2023) of 45%, the 16% figure shows some early indications of potential stabilization (Exhibit 13).

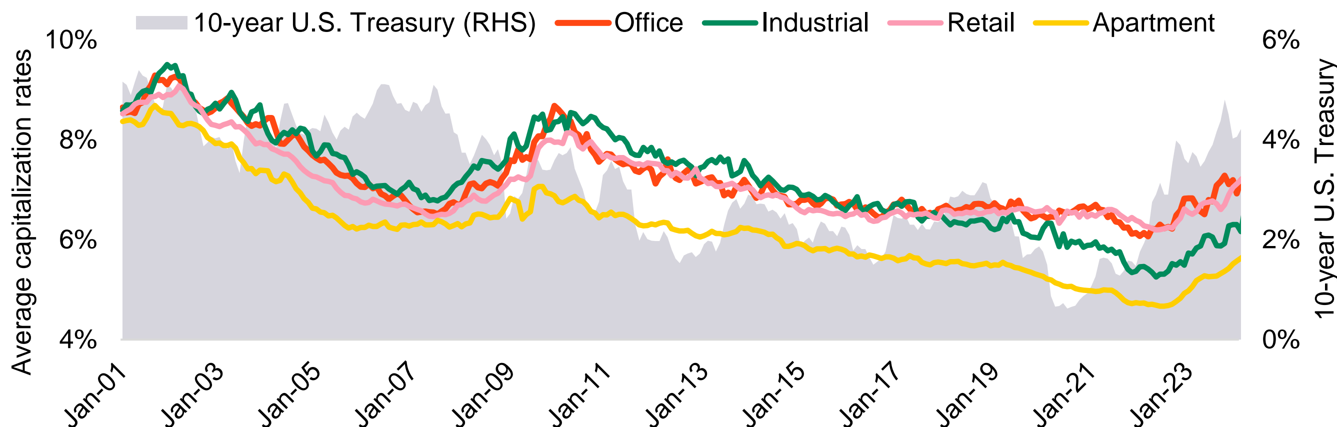
Clarity on the interest rate environment is key to the "price discovery" process required to catalyze a sustained rebound in transaction volumes, in our view. As of 1Q2024, capitalization rates ("cap rates"; defined as a property's annual net operating income divided by its asset value) have moved higher alongside the U.S. Treasury – but a gap still remains (Exhibit 14).

Exhibit 13: Transaction volume remains depressed, but may be troughing
U.S. commercial real estate (CRE) quarterly transaction volumes, by property type



Source: BlackRock, Real Capital Analytics. Captures data through the end of 1Q2024. "All other" includes: Hotels, Development Sites, and Seniors Housing & Care.

Exhibit 14: Capitalization rates have increased, tracking the U.S. Treasury
Average capitalization rates (%, three-month rolling), defined as a property's annual net operating income divided by its asset value



Source: BlackRock, Real Capital Analytics. Captures data through March 31, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.**

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CRE asset prices are nuanced, both *between* and *within* CRE categories

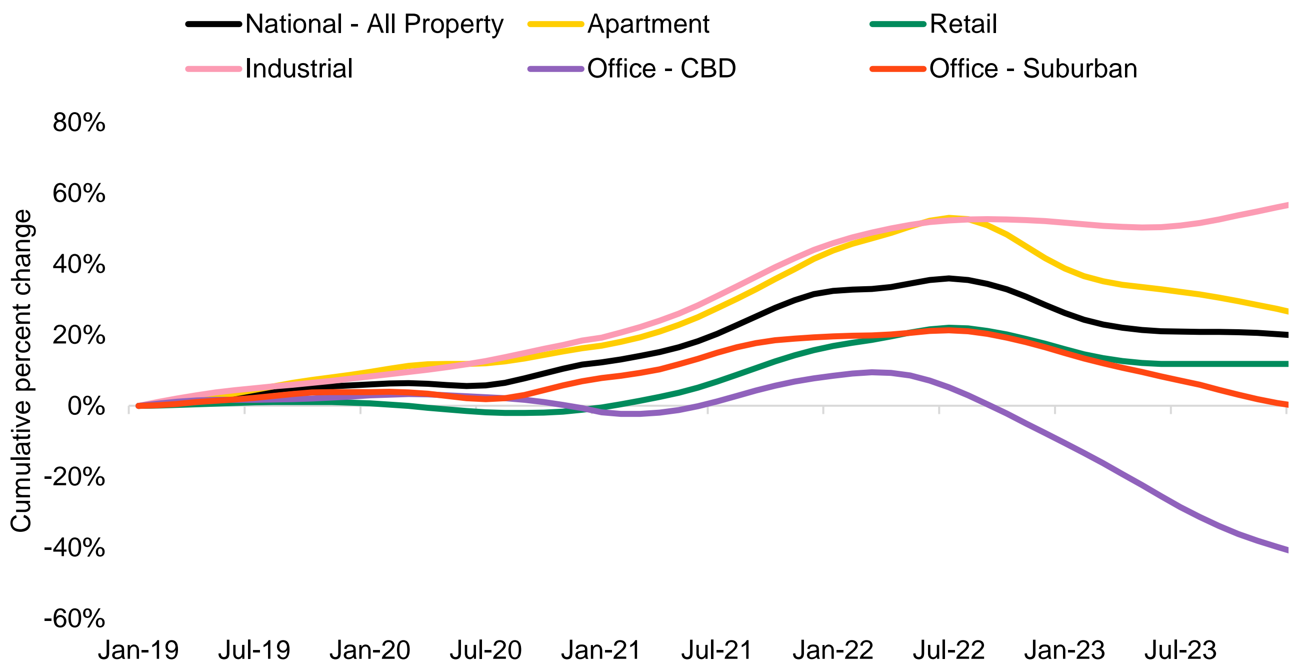
Asset pricing, according to the RCA Commercial Property Price Indices (CPPI), have shown a similar trend of moderating declines in recent quarters. The RCA CPPI National All-Property Index fell 3% from one year prior in 1Q2024, a considerable improvement from the largest decline in the recent series, of -10.7% YoY in 2Q2023.

However, Exhibit 15 illustrates the nuance both *between* and *within* CRE categories. Prices fell YoY across many CRE categories, as of March 31, 2024. But industrial properties were the exception, where prices *grew* by 5.7%. While the industrial sector has been subject to higher mortgage costs that ultimately limit asset value (a headwind most CRE property types are facing), industrial property income has outpaced the growing cost of capital, allowing price growth to continue.

Asset valuations for the office sector tell a different story. The well-telegraphed structural headwinds related to office utilization have kept asset valuations under stress, with prices across office assets declining 16.6% YoY as of 1Q2024 according to RCA CPPI. However, dispersion continues within office assets, too. Central business district (CBD) offices remain under more valuation pressure than suburban offices, with asset values declining 33.2% YoY, versus only 11.4% YoY for suburban offices in 1Q2024, according to RCA CPPI data.

Exhibit 15: CRE asset valuations remain very nuanced

Cumulative percent change in the level of the Real Capital Analytics Commercial Property Price Indices, since January 2019



Source: BlackRock, Real Capital Analytics. As of March 31, 2024. The figures shown relate to past performance. **Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

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A decline in potentially distressed CRE also sends a positive signal

Additionally, the small (but notable) contraction in potentially distressed CRE in 1Q2024 suggests the market may be taking a positive turn, despite growth in distressed volume over the same period.

As illustrated by Exhibit 16, the amount of outstanding potential distress decreased across all CRE property types except “others” in 1Q2024, in aggregate declining by 12% quarter-over-quarter.

Outstanding distressed volume, on the other hand, grew on net by $2.7 billion in 1Q2024, increasing the cumulative total distress outstanding to $88.6 billion, per RCA (Exhibit 17). However, this net addition in outstanding distress marked a third consecutive quarter of declining net additions and is 59% lower than the net additions of one year ago, according to RCA. Consistent with large declines in office asset values, office assets remain under stress, representing 43% of total outstanding distressed value in 1Q2024.

While we broadly expect CRE distress to be a longer-term trend, especially as macroeconomic factors like an elevated rate environment and muted transaction volumes persist in the near-term, we believe a shrinking pipeline of potentially distressed CRE could signal a potential trough – at least in some corners of the market.

Exhibit 16: Potentially distressed CRE declined across all categories except “others”
Pipeline of potentially distressed CRE by category, at quarter end

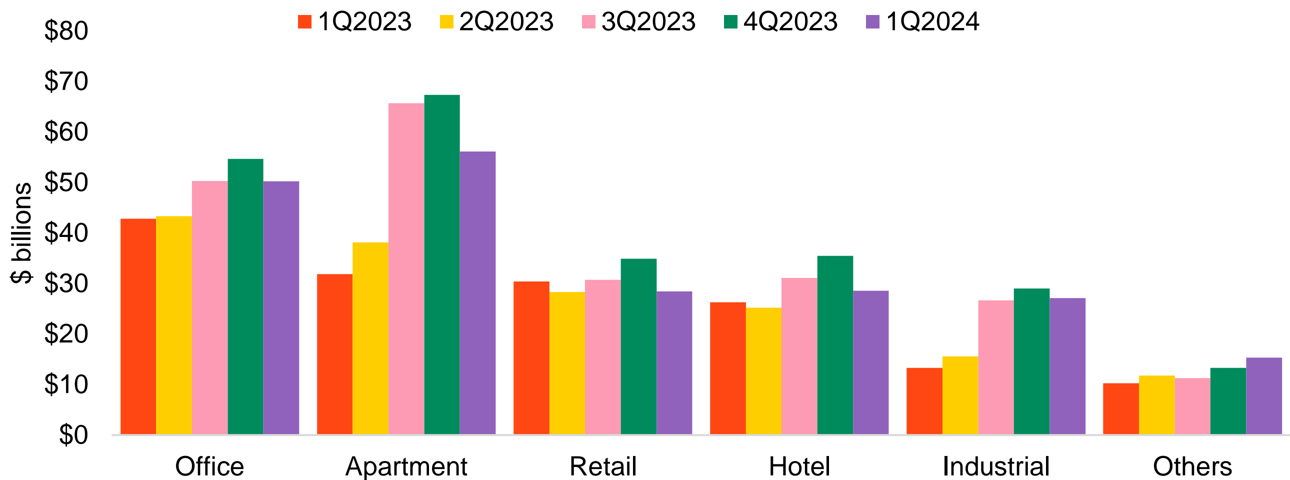
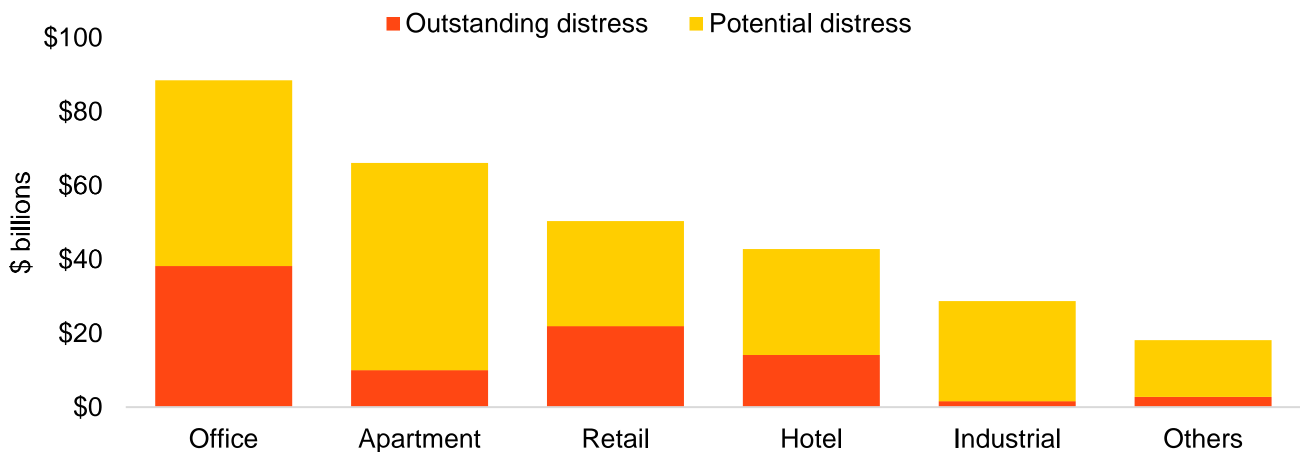


Exhibit 17: Office represents the largest share of outstanding distressed
Balance of distressed CRE by property type



For both charts: Source: BlackRock, Real Capital Analytics. "Others" includes categories such as self storage and manufactured housing. As of March 31, 2024. “Outstanding distress” indicates direct knowledge of property-level distress (via announcements of bankruptcy, default, foreclosure, and other publicly reported issues). “Potential distress” indicates possible future property-level financial trouble due to events such as delinquent loan payments, forbearance and slow lease up/sell out, among others. This also includes CMBS loans placed on master servicer watchlists.

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