VÄRDE

Värde Views: Unprecedented Government Intervention Will Not Prevent Historic Wave of Defaults

A discussion on the limitations of fiscal and monetary stimulus

May 15, 2020

Värde Views: Unprecedented Government Intervention Will Not Prevent Historic Wave of Defaults

Introduction

In the face of the abrupt economic shut-down, governments around the world have responded with a raft of emergency fiscal, monetary and other policy measures in an effort to keep in check the tremendous financial fallout from Covid-19. Intervention has been bigger and deployed faster than expected, but there are limitations on how much the stimulus can ward off. First, much of the stimulus for companies comes in the form of lending facilities, which will solve some liquidity problems, but cannot address the deep fundamental solvency problems. Second, there will be very different outcomes across the globe as many countries, including developed countries, face real constraints on what they can afford to do for their economies.

Brad Bauer and Giuseppe Naglieri, Partners and Deputy Chief Investment Officers at Värde Partners, reflect on the impact of measures to date and why they believe these actions, while necessary, have limitations in their collective ability to prevent a wave of defaults as the credit cycle plays out.

How would you characterize the overall impact of stimulus in the early stages of the crisis?

Brad Bauer

Fiscal and monetary stimulus have certainly helped stabilize markets and deliver assistance to those who need it. The interventions have been extraordinary, demonstrating the lengths some governments are able, and willing, to go to in an effort to head off the devastating impact of the sudden physical and economic disruption. Global corporate credit markets have more than doubled since 2008 to $13.5 trillion, so it stands to reason that the extent of the response needed to stabilize markets would be far greater than we saw during the Global Financial Crisis of 2008-09 (GFC).

There was a clear need to bolster the social safety net as economies began to shut down. Small businesses and individuals are not equipped to deal with a crisis of this scale, and traditional social support systems are not set up for such an extreme environment. In sum total, we believe this financial crisis would be several orders of magnitude worse absent these measures.

Applying intervention of this size and scope is a significant challenge, and even more difficult to implement without creating unintended consequences. Such actions will create winners and losers, while moral hazard has yet to receive the attention it deserves. Policymakers are likely to face a backlash and, with so many policy bullets fired up front, we expect it will become increasingly difficult to maintain public support without insisting on more pain from investors.

"Applying intervention of this size and scope is a significant challenge, and even more difficult to implement without creating **unintended consequences**."

Giuseppe Naglieri

The intensity of the initial shock has been game changing, although there seems to be notable divergence of signals between market and economic data. We have seen markets start to rally on the back of stimulus measures, and data suggesting major economies are beginning to "flatten the curve" as steps to isolate huge swathes of their populations pay off. The outlook, however, remains less sanguine and the International Monetary Fund (IMF) is projecting the global economy will contract by three percent in 2020 and US jobless claims sit at a post-World War II high.

Considering that global credit markets have more than doubled since the GFC, we believe we are in the beginning stages of a major, connected distressed credit cycle exacerbated by the build-up of leverage in the financial system. We are optimistic about the prospect of a medical solution, but we do not believe one will arrive in time to support fully reopening economies in the near-term.

It is important not to get too far ahead in presuming what an end to the crisis will look like. Even as we return to normalcy, we expect a long period of defensive behavior from consumers and corporations as many industries will remain under pressure. Ultimately, we believe the response measures put in place will largely only limit liquidity-driven defaults, and simply delay the inevitable for companies with weaker balance sheets.

How would you compare the levels of intervention across different regions and markets?

Giuseppe Naglieri

When looking at certain regions, countries or even within specific economies, we see wide dispersion in how effective different levels of intervention will be long-term. Measures have varied greatly by country and we see a particular gap in the level of response between developed and emerging markets. As we saw during and following the GFC, we expect this will ultimately be reflected in the time it takes for individual countries to work through their distressed assets. This will likely create a collection of cycles that will play out in different ways over the long term.

Many less developed economies are limited in their ability to deploy fiscal or monetary interventions. We believe that lack of financial strength, coupled with the fact that many of these countries have outsized exposure to oil and commodities, will lead to deeper and longer lasting periods of impairment. For a point of comparison, the size of stimulus in the US is over 10% of GDP while in Mexico, where there were already strong headwinds of a recession heading into 2020, the level of stimulus is less than two percent of GDP. So, even in what would typically be considered high quality emerging markets, we are seeing a stark inability to apply appropriate intervention to counteract the economic pain.

"Measures have varied greatly by country and **we see a particular gap in the level of response** between developed and emerging markets."

This will also likely lead to regional imbalances where central banks are not able to provide the necessary funding to local governments and agencies. The European Union eventually moved to support the hardest hit member states, many of which already have high debt-to-GDP ratios, allowing access to financial support of up to EUR 800 million in 2020. More broadly, the region faces significant hurdles in its response to the crisis with deeply negative interest rates, an incomplete monetary union and varying fiscal policies. Recent challenges to the European Central Bank's authority in Germany further illustrate the potential for a fractured approach and less support for periphery countries that have been hit harder by the pandemic.

The US has used its position of relative economic strength to move quicker than most to combat the crisis. The Federal Reserve's (the Fed) April 9 announcement of a $2.3 trillion extension of its emergency lending facilities demonstrated its flexibility to expand existing programs where necessary and determination to reassure markets. Details of that program included expanded credit buying of investment grade (IG) and even some high yield (HY) credit, as well as support for municipalities, main street borrowers and certain AAA structured products amongst other things.

Despite some earlier posturing, the US government has now moved to stabilize municipal debt with the Fed announcing on April 27 that it would expand the scope and duration of the Municipal Liquidity Facility to include smaller US cities. The move will likely bolster the financial health of state and local governments, which are facing a drop in revenue while seeking to tackle the impact of Covid-19 in their particular regions.

What makes you believe these measures will fail to prevent a major credit cycle?

Brad Bauer

Some perspective is important here. Consider the roughly $15.5 trillion of non-financial corporate debt in the US where the core focus of the $1.35 trillion component of the Fed's firepower for those borrowers is on IG, recently fallen angels and performing mid-size main street firms. The program does not address general high-yield issuers, let alone impaired credit.

The tremendous appetite for new debt from those covered by the scheme is evident in the pace of new issuance of US IG credit, which is projected to match the volume for all of 2019 by the end of May. We think this will sustain that segment of the market through the worst of the situation, but companies that require restructuring will have fewer options.

A significant factor not reflected in public markets is the tremendous increase in private lending over the past decade. After regulatory requirements on the back of the GFC led to banks reducing lending on riskier assets, private lenders, mostly fund managers, stepped in to fill the void. That market has now ballooned to more than $800 billion.

Saddled with large books of direct loans on relatively highly leveraged companies, many private lenders will struggle through an economic downturn of this magnitude. A lack of meaningful experience in restructurings and asset ownership combined with a limited secondary market for private debt, should result in a significant amount of forced selling at steep discounts and some extraordinary value destruction.

We are also paying close attention to how some early measures meant to provide immediate relief will create unintended consequences in other areas. We expect many lenders and landlords to suffer acutely as a result of both consumer and commercial payment forbearance and, ultimately, defaults. For example, the CARES Act in the US provides relief for consumers and guidance for mortgage servicers on how to address necessary payment forbearance. Servicers are required to advance a portion of missed payments on to bondholders of the underlying mortgages. These become receivables owed to the servicers and could create a significant liquidity need for servicers when they do not have clear access to funding to cover the forbearance to come.

> "**Saddled with large books of direct loans** on relatively highly leveraged companies, many private lenders will struggle through an economic downturn of this magnitude."

While this is a necessary effort to avoid residential foreclosures, there will be a ripple effect. Liquidity problems for servicers can create further pressures throughout the residential mortgage ecosystem, including limitations on the availability of new mortgage credit.

Lending channels in commercial real estate and broader consumer credit are experiencing slightly different challenges resulting from otherwise well-intended efforts to work with borrowers on forbearance programs.

Investors need to evaluate government intervention across a number of markets (e.g. consumer credit, residential mortgages and commercial real estate) from a technical perspective as the nuances will create winners and losers.

What does all of this mean for the opportunity set as we move through the cycle?

Giuseppe Naglieri

The vast size of global credit markets today indicates that a large default cycle will likely take distressed credit to its highest absolute level in history. The US IG market was roughly $2.3 trillion in 2008, compared to around $6.7 trillion in 2020, nearly tripling the potential for fallen angels. So far this year, more than $170 billion of bonds have fallen from IG to junk, already more than in 2009 during the GFC.

> "The vast size of global credit markets today indicates that a large default cycle will likely **take distressed credit to its highest absolute level in history**."

Initially, we saw dramatic mispricings affecting even the top quality, blue chip IG names. In our view, some of this has settled, especially in A-rated or better companies, but we continue to see meaningful dislocations further down the quality spectrum within IG. These dislocations are most pronounced in some of the more impacted sectors, along with a lot of irrational pricing and dislocation in HY, making it relatively cheap to hedge downside risk.

Despite significant stress in structured credit, we believe pricing does not consistently or adequately reflect the forthcoming deterioration of fundamentals. Price adjustments will take time, although we expect opportunities to emerge sooner in the traded market than in private markets where motivated selling may take longer.

The opportunity set is also likely to differ greatly across geographies, driven by uneven outcomes around the world. Alongside this, geopolitical tensions are beginning to flare up under the surface, which could complicate the recovery further. Looking at any one region as a single opportunity on its own will not suffice, and the ability to compare relative value across markets and regions should prove an advantage.

In Asia Pacific, for example, the strength of the Australian government's response has minimized the blow to their economy. The Governor of the Reserve Bank of Australia recently noted that Australian banks are well capitalized and would pay reduced dividends. Conversely, the Reserve Bank of India has had to step in to provide priority sector relief to banks that lend to small and medium-sized non-bank financial companies (NBFCs) and microfinance institutions (MFIs) in order to help meet the funding needs of this important non-bank lending sector.

Europe, meanwhile, has a greater proportion of bank lending and smaller companies, when compared to the US. We anticipate European banks will respond more slowly to this crisis – as they did following the GFC – and, therefore, expect it will take the region longer to resolve distressed companies.

The duration and path of the recovery remain very uncertain and the range of potential outcomes from here also remains incredibly wide and investors should remain cautious investing in higher leveraged, lower quality businesses at this stage.

Brad Bauer

We believe we are still in the very early stages of what looks to be a historic distressed cycle, where the opportunity thus far has predominately been in traded credit. More broadly, the market is beginning to understand where the greatest levels of stress exist in the system and where the fundamentals are rapidly breaking down.

At this point, particularly when it comes to private markets for both assets and debt, it is important to be patient. There are no prizes for being first to the dish in situations with a high degree of dependence on the economic path to recovery.

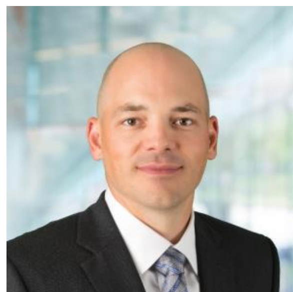
Over the course of the next few months, we expect to see more rescue lending, where the quality of collateral will be critical. We believe motivated sellers of loan portfolios will begin to surface. Lenders and asset owners will likely initially seek to sell performing and sub-performing pools of assets, and eventually move to non-performing loans later as the cycle matures.

> "There are **no prizes for being first to the dish** in situations with a high degree of dependence on the economic path to recovery."

Finally, we anticipate a large number of restructuring opportunities where it is essential to have a detailed understanding of the underlying assets and business operations in order to maximize value. The activity of restructuring the liabilities of a company, in and of itself, is not a high value-add strategy like it might have once been. Asset owning and value creation experience will play a bigger role.

As a wave of impairments approaches, the investment focus will likely shift to a credit selection exercise, focused on strong businesses and high quality collateral. It is a period of time when one would do well to take a step back, and a deep breath. Ultimately, we can expect this opportunity to endure over many years.

About the Authors



Brad Bauer

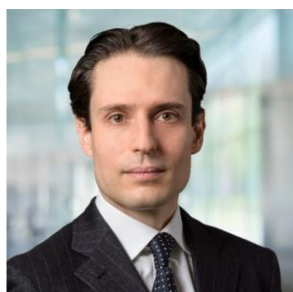
Partner and Deputy Chief Investment Officer

Brad Bauer is a Partner and Deputy Chief Investment Officer. In addition, he serves as Global Head of Private Debt, Transportation and Energy. He is a member of the firm's Investment Committee. Based in London, he joined the firm in 2007.

Brad has held numerous leadership positions throughout his time at Värde, including oversight of all non-investing functions. Prior to that, he was involved in managing the firm's Corporate and Traded Credit team. Brad's experience spans an array of industries and spectrum of credit markets.

Prior to joining Värde, Brad held senior investing and portfolio management roles focused on distressed debt and credit trading at both Deephaven Capital Management and Ameriprise Financial, Inc. Prior to Ameriprise, he worked for U.S. Bancorp Piper Jaffray in the Middle-Market Mergers and Acquisitions group.

Brad received a B.S. in Finance from Iowa State University, where he also competed on the varsity golf team. He earned his Chartered Financial Analyst (CFA) designation.



Giuseppe Naglieri

Partner and Deputy Chief Investment Officer

Giuseppe Naglieri is a Partner and Deputy Chief Investment Officer. In addition, he serves as Global Co-Head of Corporate and Traded Credit and a portfolio manager of the firm's global liquid investments. He is a member of the firm's Investment Committee. Based in Minneapolis, he joined the firm in 2009.

Prior to joining Värde, Giuseppe worked for Goldman Sachs as an Associate in Fundamental Strategies. Prior to Goldman Sachs, he worked at JP Morgan in Investment Banking, focusing on telecom, media and technology.

Giuseppe graduated from Bocconi University with a B.A. in Business and Finance.

About Värde Partners

Värde Partners is a leading global alternative investment firm with roots in credit and distressed. Founded in 1993, the firm has invested more than $68 billion since inception and manages over $14 billion on behalf of a global investor base. The firm's investments span corporate and traded credit, real estate and mortgages, private equity and direct lending. Värde employs more than 300 professionals across 13 offices worldwide. For more information, please visit www.varde.com.

Disclaimers

This material expresses the views of the authors as of the date indicated and such views are subject to change without notice. Värde Partners has no duty or obligation to update the information herein. The information contained in this material should not be considered a recommendation or an offer to sell, or solicitation to purchase, any security or investment. Actual events or results may differ materially from the views and forward-looking statements included in this material.

Certain information contained herein is based on or derived from independent third-party sources, and Värde Partners cannot guarantee the accuracy of such information. Recipients should not rely on any information in this material. This material contains commercial information and intellectual property of Värde. This material, including the information contained herein, may not be copied, reproduced, republished or posted in whole or in part without the prior written consent of Värde Partners.

Regional Headquarters

London

2 St James's Market
London SW1Y 4AH
United Kingdom
+44 (0)20-7808-3370

Minneapolis

901 Marquette Avenue South
Suite 3300
Minneapolis, MN 55402
United States
+1 952-893-1554

New York

510 Madison Avenue
12th Floor
New York, NY 10022
United States
+1 212-321-3780

Singapore

6 Battery Road, #21-01
Singapore 049909
Singapore
+65 6579-0800