SOLVING
FOR 2020

NEUBERGER | BERMAN

ASHOK BHATIA
DEPUTY CIO—FIXED INCOME

DAVID LYON
CO-HEAD OF THE PRIVATE CREDIT BUSINESS

KEY POINTS

- Ashok put the bull case: stable growth and interest rates, and a recent decline in corporate leverage
- David put the bear case: he focused on deteriorating credit quality and covenants in loans
- Both agreed that they do not see any immediate threats, but potentially serious issues in some parts of the market may cause volatility before the year is out
- The *Solving for 2020* audience poll revealed similar views

CONFERENCE SUMMARY

BULL VERSUS BEAR 2020: WEIGHING THE UPSIDE AND DOWNSIDE IN PUBLIC & PRIVATE CREDIT

"We do not see any obvious threats to the current stable environment in 2020, but there are issues in some parts of the market that may cause volatility before the year is out."

Given the complexity that investment views tend to accrue as we get late into the cycle, especially in a market such as credit that has changed so much over the past decade, we decided to simplify our outlook by offering straightforward bull and bear cases for 2020. Ashok Bhatia argued the bull case and David Lyon played the bear.

Ashok Bhatia

Ashok characterized the bull case as the same argument that the Fixed Income team would have made 12 months ago, or even 24 months ago.

Slow but positive global GDP growth can cover up a lot of debt issuers' problems for a long time, he said. There will be isolated challenges and defaults—we are certainly cautious about lower-rated energy and the auto sector—but widespread sell-offs in credit tend to be grounded either in systemic financial problems or in debt-funded mal-investment, and neither is evident today. Financial sector leverage remains relatively low and corporate investment in capital-intensive assets (factories and autos, for example) is also low relative to investment in capital-light assets (such as technology), which are much more likely to be internally-financed.

Ashok explained that this is partly a result of corporate management recognizing that this cycle is growing old. That caution is reflected in the fact that corporate leverage has already peaked and begun to decrease, even in places like BBB rated investment grade, where issuance has ballooned over recent years: after hitting 3.9 to 4.2-times EBITDA, it is now down to 3.5 to 3.7-times, according to JPMorgan. Moreover, because interest rates have been so low for so long, that leverage comes with much better interest-coverage ratios and longer maturities than it typically would have done in the past.

David Lyon

David zeroed-in on leveraged loans for his bearish case. He observed that the credit quality of the S&P/LSTA U.S. Leveraged Loan 100 Index has deteriorated. B rated, mainly private-equity sponsored issuers have gone from 37% of that index two years ago to 50% today. According to our estimates, those issuers are nominally leveraged 6.5-times EBITDA but, as David argued, once you strip out all of the questionable adjustments made to reported earnings, that looks more like 13-times. And for underwriting that, you get less than 6% yield.

David also highlighted the growth in the size of the loan market, as well as the growth of collateralized loan obligations (CLOs) as buyers of loans, and the weakening of covenant standards. That, together with asset-price inflation in a low-rate environment, is likely to lower recovery rates. We are already seeing that, with the default rate still at a modest 2% per year. David warned that portfolio risk models, calibrated for high-yield recoveries of 40 cents on the dollar and loan recoveries of 60c, may not prepare investors for a scenario in which defaults are rising and recovery rates are more like 25c and 45c.

David emphasized that this was not just a challenge in loan markets. The current extreme bifurcation of credit markets means that high-quality issuers trade at very tight spreads partly because of credit deterioration elsewhere.

Concluding Remarks

Ashok and David were not really in disagreement over credit fundamentals, but rather over the timeframes they were using. When they asked what might be the catalyst for a turn in the current stable growth and interest rate environment, they both agreed that there was nothing clear and obvious to point to. As David put it, he made the bearish case with total conviction but conceded that one cannot invest bearishly until one is sure that appetite for risk is about to dry up. Both he and David agreed that, while they do not see any obvious threats to a stable environment in 2020, they both recognize potentially serious issues in some parts of the credit markets that may cause volatility before the year is out.

When we polled our audience, most anticipated a positive, single-digit total return to U.S. high yield this year, but they also picked out leveraged loans, CLOs and CCC bonds as their main causes for concern. That was in line with a more cautious outlook for risk and an up-in-quality bias in the credit market.

This document is addressed to professional clients only.
United Kingdom: This document is a financial promotion and is issued by Neuberger Berman Europe Limited, which is authorised and regulated by the Financial Conduct Authority and is registered in England and Wales, at Lansdowne House, 57 Berkeley Square, London, W1J 6ER.
European Economic Area (EEA): This is a marketing document and is issued by Neuberger Berman Asset Management Ireland Limited, which is regulated by the Central Bank Ireland and is registered in Ireland, at MFD Secretaries Limited, 32 Molesworth Street, Dublin 2.
Switzerland: For qualified investors use only. This document is provided to you by Neuberger Berman Europe Limited.
Neuberger Berman Europe Limited is also a registered investment adviser with the Securities and Exchange Commission in the US, and the Dubai branch is regulated by the Dubai Financial Services Authority in the Dubai International Financial Centre. Neuberger Berman Europe Limited is an authorised financial services provider with the South African Financial Sector Conduct Authority, FSP number 45020.
This document is presented solely for information purposes and nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security.
We do not represent that this information, including any third party information, is complete and it should not be relied upon as such.
It should not be assumed that any investments in securities, companies, sectors or markets identified and described were or will be profitable.
Any views or opinions expressed may not reflect those of the firm as a whole.
All information is current as of the date of this material and is subject to change without notice.
Indices are unmanaged and not available for direct investment.
An investment in this product involves risks, with the potential for above average risk, and is only suitable for people who are in a position to take such risks.
Past performance is not a reliable indicator of current or future results. The value of investments may go down as well as up and investors may not get back any of the amount invested. The performance data does not take account of the commissions and costs incurred on the issue and redemption of units.
The value of investments designated in another currency may rise and fall due to exchange rate fluctuations in respect of the relevant currencies. Adverse movements in currency exchange rates can result in a decrease in return and a loss of capital.
Tax treatment depends on the individual circumstances of each investor and may be subject to change, investors are therefore recommended to seek independent tax advice.
No part of this document may be reproduced in any manner without prior written permission of Neuberger Berman Europe Limited.
The "Neuberger Berman" name and logo are registered service marks of Neuberger Berman Group LLC.
© 2020 Neuberger Berman Group LLC. All rights reserved.

NEUBERGER | BERMAN

Neuberger Berman
Lansdowne House
57 Berkeley Square
London W1J 6ER
United Kingdom
www.nb.com

425657 02/20© 2020 Neuberger Berman Group LLC. All rights reserved