KKR Credit & Markets

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Executive Summary

A lack of confidence has altered the Credit landscape since the U.S. Federal Reserve began aggressively raising interest rates on the back of rising inflation. More than a year into the confidence crisis, we think it is important to take a closer look at the market's fault lines, where the lack of confidence is showing up as indecision, a reluctance to act, a lack of consensus, or some combination of those factors.

The first quarter of 2023 brought some signs of tepid confidence, with an increasing pipeline of M&A processes and leveraged buyouts, but a series of bank runs sent a different message. We have discussed in previous letters how a lack of confidence and leadership has frozen capital markets, and in this letter, we trace the confidence trail through interest rates, the banking system, and financial markets. We also explore how confidence has contributed to a structural shift away from leveraged loans and into high yield and private credit. Finally, we discuss what confidence can look like and what opportunities it can bring.

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Without confidence, capital markets activity freezes. Lenders must have faith that borrowers can repay, a requirement that has been in place for millennia. Borrowers need to believe that their plans will succeed and that the plumbing of the financial system will work in the expected way: Interest rates will be predictable and capital will be available. To fund Credit transactions, investors have to believe they will hit their target returns without wading into a sea of volatility or worse, defaults. For leveraged buyouts that need financing, buyers and sellers must agree on the value of the business or security, which requires certain assumptions about the steady state of the future. In this environment, bid-ask spreads are wide across different markets. In order to narrow them, markets need to thaw and market participants need some level of conviction.

In all of these areas, a lack of confidence has profoundly altered the Credit landscape since the U.S. Federal Reserve began raising interest rates in March 2022 on the back of rising inflation. The reaction to that move was dramatic and long-lasting, even though markets widely expected it, because it marked the end of three decades of low inflation and more than a decade of ultra-low interest rates. The list of direct and indirect consequences now includes failed banks, elusive access to common forms of financing, anemic IPO volume and CLO formation, low high yield bond and leveraged loan issuance, a reluctance to allocate scarce investment capital, and a willingness to pay more for certainty of execution.

After more than a year, uncertainty is still high and confidence is still low. We still do not know exactly how the Fed will navigate conflicting information, or how the growing concern about regional banks and commercial real estate will play out. Without knowing where interest rates and ultimately the economy will land, lenders, borrowers, and investors have increasingly decided to wait and see.

Watching the trend puts us in mind of *Waiting for Godot*, the Samuel Beckett play in which two men sit around a tree, waiting for a man named (no surprise here) Godot. Some strange things happen along the way, but mostly, they wait. Even after someone finally tells them that Godot is not coming, they sit watching until the curtain drops. As market participants wait for something that probably will not come — a return to low interest rates, normalized inflation, and a basic certainty about the shape of the future — those who find the conviction and confidence to get out from under the tree are at a huge advantage, particularly with a hunt for capital in full swing. In this environment, confidence need not manifest as either bravado or exuberance: We continue to believe that investors do not have to reach for risk to achieve attractive returns in this lender's market.

Over the quarter, there were pockets of bravery and signs that the freeze in capital markets may be thawing. We have seen windows of opportunity that allowed for large-scale deals, and private lenders stepping up to the plate to fill in the gaps when public markets were shut. However, the closure of several regional banks in the U.S. and Credit Suisse's forced sale to UBS showed how fragile this confidence can be. The debt ceiling debate in the United States marked another crisis of confidence. We are equally sure that in these volatile times, there will be another.

Key Themes

In this letter, we'll focus on how confidence is playing out in today's markets.

01
Where Is Confidence Lacking?

02
The Confidence Crisis Plays out in Leveraged Credit

03
Finding Confidence in a Timid Market

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Where Is Confidence Lacking?

Exploring the places confidence was absent in the first quarter is a helpful way to understand both the risk and opportunities in the Credit markets.

Inflation, interest rates, and the Fed: Uncertainty about the path for U.S. interest rates tipped off the crisis of confidence in Credit markets, and a year later, it is still hard to predict exactly how the Fed will act. With employment data still robust in the United States, our Global Macro & Asset Allocation (GMAA) team places an extremely low probability on the Fed cutting interest rates significantly (150-175 basis points) in the next 12 months and believes that the market is pricing in too many cuts in the second half of 2023. The team likewise anticipates the headline Consumer Price Index will cool to 3.4% in the fourth quarter of 2023, less than half of the 7.1% in the fourth quarter of 2022. Inflation is likely to prove stickier in Europe than most developed markets, and the region will therefore have to run the tightest monetary policy in developed markets, the GMAA team says.

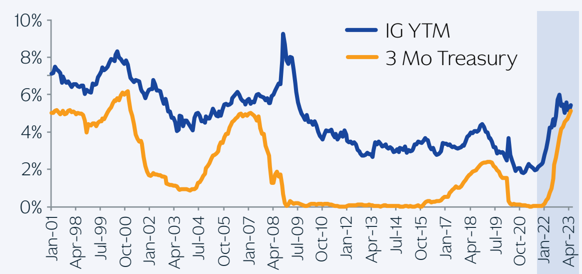
The range of signals that central banks (and the investors trying to predict what those central banks will do) have to consider is wide, particularly in the United States: Employment trends are strong, but confidence in the banking sector and in commercial real estate is faltering. Sharply divided U.S. politicians trying to find a way to avoid defaulting on the nation's debt pushed up yields on short-duration Treasuries in late May, for example (*Exhibit 1*). Not knowing the future path of interest rates is a damper on activity in capital markets and on investors' allocation decisions. However, higher baseline interest rates means that investors are essentially getting paid to wait, which contributes to the broader freeze we have been seeing in market activity.

The banking system: A bank run is a classic failure of confidence. The speed at which depositors began pulling their money out of Silicon Valley Bank when it tried to raise more funds to cover paper losses in long-dated government bonds showed just how little depositors trusted the bank's reassurances that it was financially sound. (The failure also showed that a modern bank run can happen extremely fast in a world of digital banking.) The closures of Silicon Valley Bank, Signature Bank, First Republic, and Credit Suisse have weighed heavily on the shares of U.S. regional banks (*Exhibit 2*), even those that are not seeing significant deposit outflows. Further eroding confidence in the banks is the fact that investors are *generally* pulling their money out of bank deposits in favor of the higher returns available in money market funds (*Exhibit 3*).

EXHIBIT 1

Short-Dated Treasuries Reflect Debt Ceiling Concerns

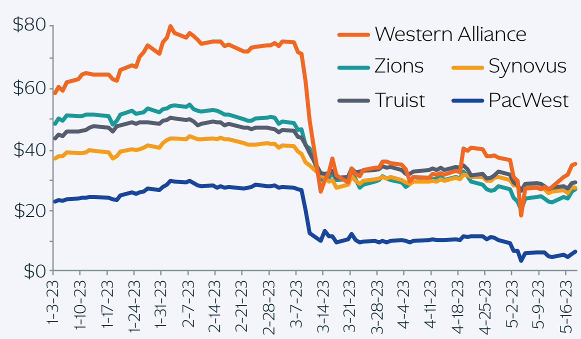
3m Treasuries yielding just as much as IG Corporates



Source: ICE Data Indices and Board of Governors of the Federal Reserve System as of May 29, 2023.

EXHIBIT 2

Shares of US Regional Banks Have Fallen Rapidly



Source: Yahoo Finance as of May 16, 2023.

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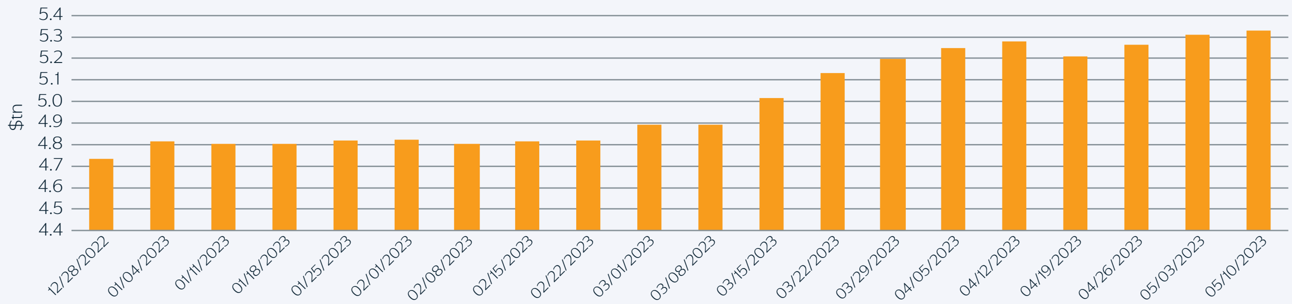
EXHIBIT 3

Investors Have Turned to Money Market Funds in Recent Months

Money Markets Total Net Assets



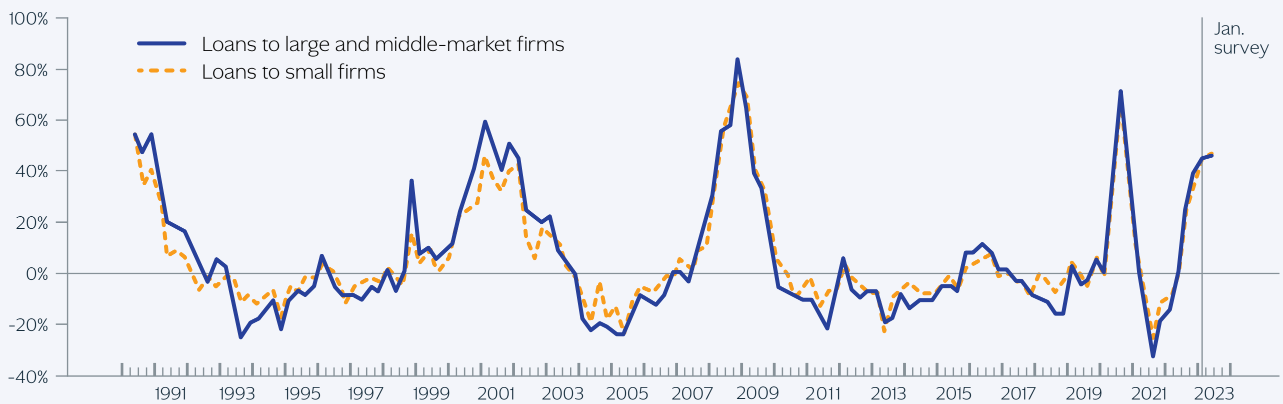
Source: Investment Company Institute as at May 18, 2023.

U.S. regulators have reportedly been questioning banks about their exposure to both interest rate risks and commercial real estate ahead of a widely expected move to tighten capital requirements and increase regulation of other aspects of bank operations. Our Real Estate team has been closely monitoring banks' commercial real estate exposure and believes the focus is likely to hone in on the relatively small exposure to office loans. Data shows that U.S. banks have been tightening lending conditions since late 2021 (*Exhibit 4*), and we expect that trend to continue as pressure on bank share prices and regulatory scrutiny continues. In the April 2023 Federal Reserve survey on lending conditions, most banks said they were increasing the cost of credit lines (63%), widening loan spreads (62%), and charging higher premiums for riskier loans (63%) for large and medium-sized firms. As a source of capital, bank lending is becoming more elusive for many borrowers.

EXHIBIT 4

Lending Standards Have Tightened Meaningfully

Net Percent of Domestic Respondents Tightening Standards for Commercial and Industrial Loans



Source: US Federal Reserve as of May 8, 2023.

As banks come under more pressure, we have seen them taking proactive steps to increase liquidity buffers, including deleveraging, selling assets, and financing portfolios of assets. We see this as a major opportunity for Asset Based Finance (ABF) strategies, which have already experienced significant growth since the Global Financial Crisis as banks have circumscribed lending. (For more on this phenomenon, see the detailed white paper from our ABF team, "Asset-Based Finance: A Fast-Growing Frontier in Private Markets.") We have seen deal flow in our ABF strategies growing as companies look for more creative solutions to their financing needs, and we expect the trend to continue as banks remain under pressure. For investors, ABF strategies can provide returns that are generally uncorrelated to either the broader markets or to corporate credit. Likewise, KKR's Real Estate Credit team sees the pullback by banks as a key catalyst for the outsized risk-return available in real estate credit. The combination of the lack of commercial real estate debt capital combined with current market turmoil and an environment with a lack of confidence and conviction is creating a uniquely attractive environment for non-bank lenders, characterized by higher base rates, wider spreads, low loan-to-value ratios (LTVs), and more lender- friendly covenants and structures in many commercial real estate loans.

Conflicting signals in financial markets: Risk assets whip-sawed in the first quarter as the January risk rally gave way first to rekindled inflation fears and then the string of banking collapses. Analysts have little conviction on the path forward. At the end of the fourth quarter of 2022, analysts polled by Bloomberg estimated that S&P 500 total returns in 2023 could range from -10% to 10%, illustrating the lack of consensus across the market. To add to the confusion, bond markets and stock markets are sending opposite messages. Bonds say recession, while stocks say soft landing, our KKR Capital Markets team noted recently.

CCC-rated assets offer a window into the Credit market's swings, particularly the whipsaw shift to risk-off that took place in March. Despite being the best-performing U.S. leveraged credit asset in the quarter, CCCs markedly underperformed other fixed income assets in the month of March, which for the most part remained flat (*Exhibit 5*). Leveraged loans also continued repricing, with spreads moving higher for the fourth quarter in a row.

EXHIBIT 5

Triple-C Absorbed Market Fears in March

Asset Class	MTD	YTD
US HY	1.1%	3.7%
US BB	1.9%	3.4%
US B	0.9%	3.8%
US CCC	-1.5%	4.8%
Euro HY	-0.4%	2.7%
Euro BB	0.0%	2.4%
Euro B	-0.2%	3.5%
Euro CCC	-5.3%	1.1%
US Loans	0.0%	3.2%
US BB	0.0%	2.1%
US B	0.1%	3.8%
US CCC	-2.0%	3.9%
Euro Loans	-0.1%	3.9%
Euro BB	0.1%	3.0%
Euro B	-0.2%	3.9%
Euro CCC	-1.5%	3.4%

Source: ELLI, LSTA, and Morningstar/LCD as of March 31, 2023.

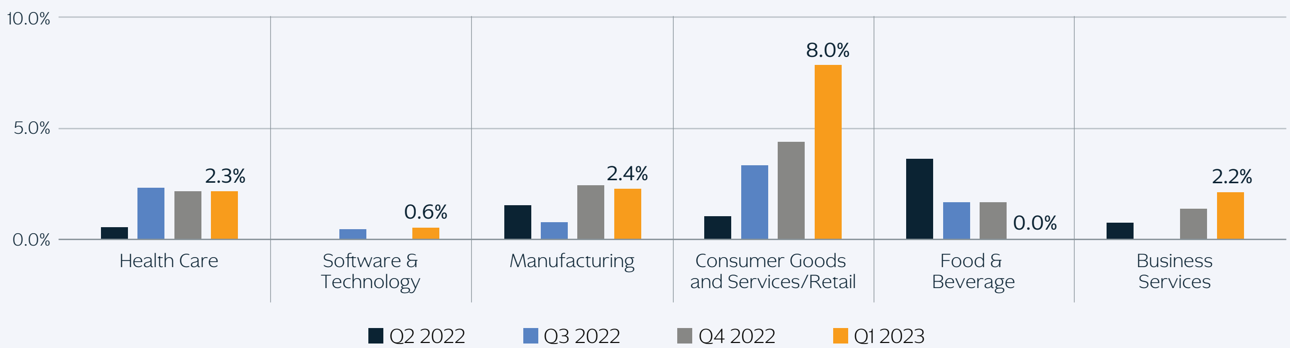
There is also significant sector dispersion in financial markets, with troubled credits concentrated in consumer sectors. Marketwide data suggests that private credit defaults concentrated in the consumer goods and services and retail sectors (*Exhibit 6*). Our concerns within our own portfolios are not evenly spread, either. In our European Leveraged Credit portfolio, for example, the names we are most concerned about are concentrated into just a few sectors, particularly Consumer Staples and Consumer Discretionary. In markets that lack leadership, pockets of trouble and systemic trouble can be easy to conflate.

Perhaps most importantly, many traditional sources of funding remained either scarce or utterly unavailable. M&A was down significantly in the first quarter of 2023 compared to the first quarter of 2022. IPO activity was also muted. As our colleague on the KKR Credit & Markets team, George Mueller, detailed in a recent piece, we were heartened to see that some large cap leveraged buyouts were able to take place in syndicated markets, but only a very few and only with relatively high credit ratings. Large equity checks filled in the gap in funding, so we do not expect this to become the norm. These green shoots are vital for confidence to grow, though.

EXHIBIT 6

Private Credit Defaults Are Concentrated in Consumer Sectors

Default Rate by Industry



Source: Proskauer, JPM Default Monitor as of March 31, 2023.

The Confidence Crisis Plays out in Leveraged Credit

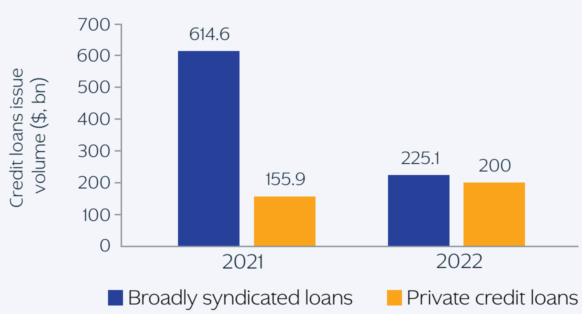
Loan activity picked up a bit in the first quarter of 2023. U.S. institutional loan issuance inched up, but still lagged 2021 and pre-COVID issuance. Some 77 CLOs worth $33.6 billion priced in the first quarter. We expect CLO creation to be slow in the coming months, as banks are no longer buying AAA-rated tranches of CLOs. Without new CLOs, which represent some 70% of institutional demand for loans,[1] leveraged loan issuance becomes challenged. We believe that in order to unleash CLO formation, either banks need to start buying assets again or spreads need to widen. We think new loans need updated capital structures paying spreads of SOFR-plus 450 basis points (bps), which is far higher than the SOFR-plus 300-350 bps that was typical in the deal frenzy of 2021.

The gum in the CLO gears explains why private credit has continued to grow in importance as a competitor for leveraged loan deals. Private debt loan issuance nearly matched institutional broadly syndicated loans in 2022 (47% private), which is a radical departure from 2021, when private loans made up just 20% of net issuance (*Exhibit 7*).

Ratings downgrades continued to increase in the first quarter as well, particularly at the lower end of the ratings spectrum and in credits with higher leverage and lower interest coverage — companies with capital structures that are not fit for purpose in today's environment. Technical factors also posed difficulties for B3/B- loans, as CLOs had to shed lower-rated loans to manage their weighted average rating factors (WARF), which are essentially aggregated ratings that take into account the individual ratings of the underlying loans. For the same reason, however, technical factors were a positive for high-single B and BB loans. Indeed, as we tracked the large leveraged buyouts that came to syndicated markets this year, we noticed that these higher ratings are more or less a requirement for the deal to land.

EXHIBIT 7

Private Loans Seem to Be Taking Market Share



Source: PitchBook as at April 11, 2023.

As for high yield bonds, issuance was relatively strong at $44.6 billion,[2] which reinforced our conviction that a shift in borrower preferences is underway. Leveraged credit borrowers have been shifting from leveraged loans to high yield bonds, or sometimes out of leveraged credit altogether and into private credit.

As we continue to track this evolution, we think it is helpful to delve deeper into the ways in which a "typical" high yield bond does not look like a "typical" loan and how those distinctions are playing into borrowers' decisions.

The global[3] sub-investment grade high yield bond market is larger than the equivalent loan market (roughly $1.8 trillion vs. $1.6 trillion). Corporate issuers tend to flock to high yield, while private equity firms have traditionally used leveraged loans for large cap leveraged buyouts. (Our Leveraged Credit team has noted that there has been a migration from leveraged loans to high yield and private debt.) High yield bonds often have call protection; they are registered securities, which creates a reporting responsibility; and it is not possible to amend the terms of the debt. Loans, however, are bilateral agreements, it is possible to amend their terms, and in general, are more flexible instruments for private equity sponsors. Importantly, however, high yield bonds have fixed interest rates and loans tend to have floating interest rates.

The trend started to turn last year, however. For example, in Europe, high yield bonds financed a larger proportion of leveraged buyouts in 2022 than at any time since the Global Financial Crisis, albeit on lower volume. We think this is because sluggish CLO creation has made loans harder to price in the market. CLOs are the main buyers of leveraged loans, and they are structurally constrained from taking on a great deal of risk.

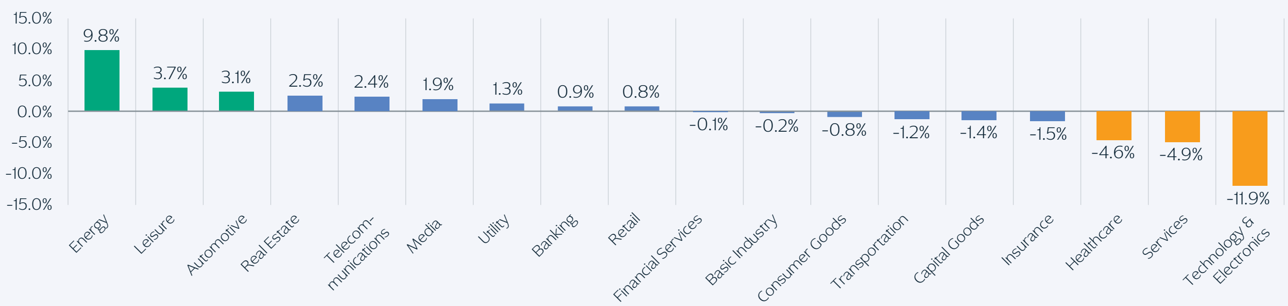
Traditionally, however, the different issuer bases have resulted in different sector distributions. High yield bonds are overweight energy, leisure, and automotive. The sectors they are underweight — healthcare, services, and technology — all have predictable, recurring cash flows, which are attractive to private equity buyers (*Exhibit 8*).

The two asset classes also tend to have different credit ratings (*Exhibit 9*). Syndicated high yield bonds split evenly between BB and B, while B ratings comprise two-thirds of the loan market, a result of their status as the favored instruments of large cap leveraged buyouts. The proportion of high yield bonds that are secured has also increased significantly over time (*Exhibit 10*).

Finally, bonds and loans have different buyer bases. Some 40% of high yield bonds are in mutual funds and income funds, which tend to have more fluid, pro-cyclical flows, meaning that investors are more likely than an institutional base to sell on negative news or buy on positive trends. Only 8% of leveraged loans are in mutual funds. Loans have a stickier investor base, including CLOs, insurance companies, and banks, which own 82% of outstanding loans.

EXHIBIT 8

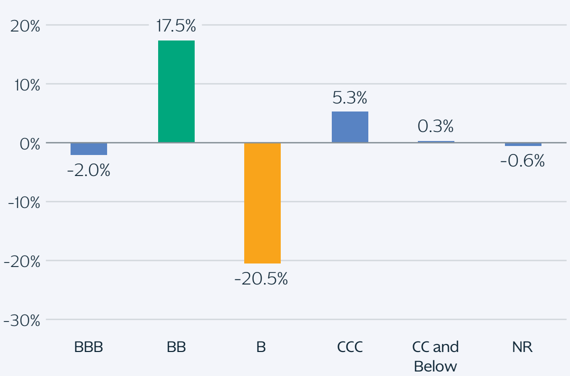
HYB to Loan Market Sector Weighting Difference



Source: KKR Credit, ICE BofA, Morningstar LSTA as at 31 March 2023.

EXHIBIT 9

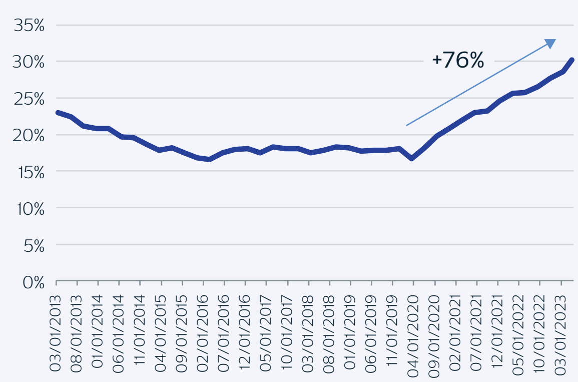
HYB to Loan Market Rating Weighting Difference



Source: KKR Credit, ICE BofA, Morningstar LSTA as at March 31, 2023.

EXHIBIT 10

The Proportion of Secured Bonds in the US High Yield Market Has Increased



Source: BAML ICE HY Index as of May 31, 2023.

How Does Confidence Build in a Timid Market?

We have detailed how a lack of confidence is shaping Credit markets, but it is equally worthwhile to consider what investing with confidence could and should look like. We have been encouraged to see some increased M&A activity and believe if the trend continues, confidence will build, and the demand for private credit, both junior and senior, will increase considerably. The current structure of the investment landscape discourages risk-taking. Investors' portfolios are more siloed today than they once were, focusing narrowly on segments of the market rather than viewing the entire Credit landscape as a source of possible opportunities.

However, it is precisely because we are in a new macro-economic regime that it's important for Credit managers to keep tabs on shifts in relative value across the whole market, without getting tangled up in internal politics and organizational silos. Identifying the opportunities in a market that is changing in fundamental ways is the first step, and having flexible pools of capital available with both breadth and depth is a critical second step. With so many avenues to traditional financing blocked, lenders with ready capital can find attractive opportunities and build long-lasting relationships by acting as proactive problem-solvers for good businesses.

When the market capitulates, we think things will restart very quickly — the analogy we continue to see as apt is that of a tinderbox suddenly sparking. There are two ways we might get to this point. The first is that investors start to deconstruct their silos, opening themselves up to take advantage of opportunities as they present themselves rather than limiting themselves to buckets with space to fill. This opens the possibility of confidence building opportu-nistically in one sector of the market and potentially having a halo effect elsewhere. As we reviewed at the beginning, we have seen doubt spread through the interconnected channels of the credit system, but confidence can spread through the same network. The other potential avenue for confidence to build is for the market to reach a greater consensus on the path forward from a macro perspective. When market participants have more conviction about the basic assumptions they can make about the future, confidence in particular sectors has more opportunity to take root. Given that allocators tend to have pre-defined buckets for asset classes for multi-year deployment targets, we think that the second path around market conviction is more likely in the short term.

As we talk about confidence, it is worth remembering that there are problems flexibility cannot solve. Confidence is not appropriate *everywhere*. We continue to urge our investors to keep it simple and remember that attractive returns are available without traveling too far out on the risk spectrum.

Bob and Carl Struggle to Choose

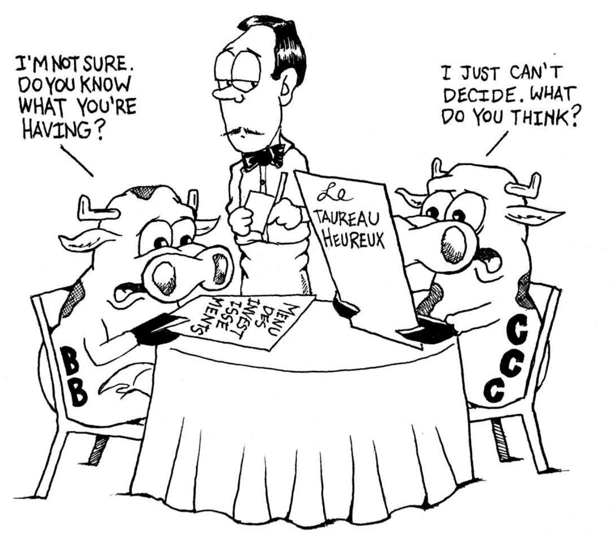


Illustration by: Jerry Capria, KKR Credit.

Conclusion

When will markets stop waiting for Godot? We are carefully watching flows of capital for the answer. We have been encouraged to see some high quality leveraged buyouts and believe that if the trend continues, demand for private junior debt will increase considerably and confidence may take hold. Flickers of confidence have faltered easily of late, and we believe in the possibility of a mirror effect. On the way up, a spark may ignite the tinderbox of confidence and activity more quickly than people expect.

The fact is, markets cannot stay still forever. Borrowers will need at least to find solutions for refinancing debt that is coming due, and private equity investors will have to put their dry powder to work in the markets. We believe, too, that investors are starting to realize the strength of the opportunity in certain corners of private credit, including the collateral-based cash flows of asset-based finance and the high income levels available for lending directly to high quality companies.

Tighter lending conditions and a slow, grinding thaw in markets mean that the hunt for capital is still on across corporate credit and increasingly in real estate and real estate credit. That the need for capital exceeds supply is one area of broad consensus, in our view. But market participants should also get comfortable with the idea that eventually, more people will get tired of waiting under the tree, forget about Godot, and look to seize the opportunities that are available in this unique environment. Be ready, be nimble, be careful, and be confident.

Christopher A. Sheldon

1. Figure represents institutional buying only.
2. Source: Refinitiv Lipper https://lipperalpha.refinitiv.com/2023/04/high-yield-corporate-debt-funds-attract-in-flows-as-high-yield-bond-issuance-increases/#:˜:text=In20Q12020232C20we20saw,quarter20gain20since20Q1202021.
3. US and Europe.

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