

Late-Cycle Credit Investing: Risks and Opportunities

Artisan Partners Credit Team

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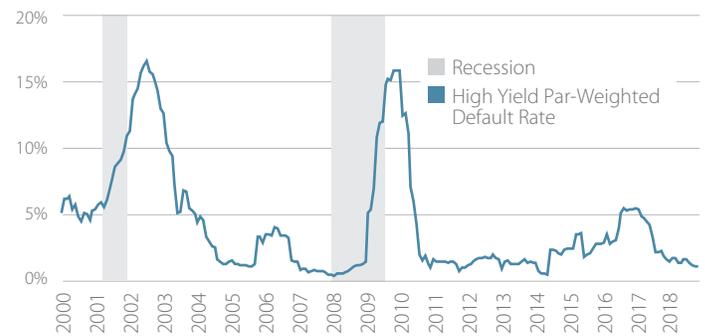
There appears to be growing anxiety among investors that the current credit cycle, now more than 10 years old, is nearing old age and susceptible to a downturn. The implications for high yield credit investors is obvious, as the end of credit cycles tends to coincide with a marked uptick in corporate defaults and asset price corrections.

While we're mindful we're closer to the end of the current cycle than the beginning, we see no near-term catalyst to suggest high yield markets are approaching an inflection point. Broadly speaking, credit fundamentals remain sturdy and the technical environment favorable. Corporate revenue and operating profits are strong on the back of healthy economic growth, and defaults continue falling from 2016 highs—all while leverage and interest coverage ratios remain in check or are improving. Additionally, heavy refinancing activity over the last several years has lowered capital costs and extended the maturity of company obligations, reducing the risk of a near-term "maturity wall." With economic conditions intact and credit fundamentals stable, we expect the current credit cycle to continue and valuations to remain tight over the near term.

We also recognize the current cycle has been longer than most. Yet the excesses that have typically characterized the tops of previous credit cycles have yet to show themselves. For example, nearing the end of the last cycle, aggressive new bond and loan issuance from leveraged buyouts (LBOs), which often accompany credit cycle turns, accounted for more than 42% of new issue proceeds in 2007 and 34% in 2008. Today, LBO issuance remains modest, representing just 19% of year-to-date volume with significant primary market activity focused on refinancing—not leveraging and bondholder-unfriendly transactions (Exhibit 2).

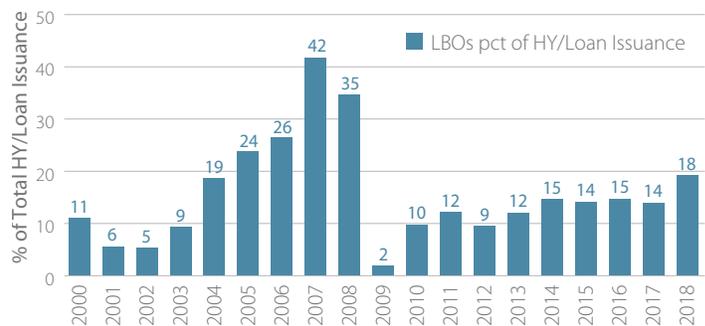
Similarly, today's high yield market skews higher quality (based on credit ratings) and shorter duration relative to the opportunity set that existed pre-financial crisis. The share of lower-rated bonds in the ICE BofAML US High Yield Index—CCC-rated bonds in particular—has shrunk to an 18-year low, while more speculative issuance is just a fraction of new issuance volume today. Bonds coming to market today rated CCC are just 17% of volume year to date through September 2018—much lower than levels seen in 2007, when CCC issuance reached 38% of total volume. Against this backdrop, it's not surprising that high yield defaults have been modest, and the potential for further spread tightening is not unreasonable when examining the structural differences that have developed over the last decade.

Exhibit 1: Corporate Default Rate



Source: ICE BofAML. As of 30 September 2018. Default rate measured by the 12-month par-weighted default rate in the ICE BofAML US High Yield Index.

Exhibit 2: Aggressive New Issuance Remains In-Check



Source: ICE BofAML, S&P/LCD. Use of proceeds for leveraged buyout activity. Values for US dollar-denominated debt only. All data as of year-end except for 2018, which is as of September 30, 2018.

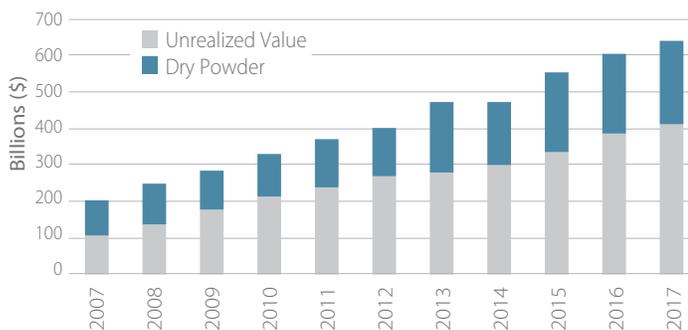
Tail Risks Are Building

We are not complacent about the potential for inflection—the risk of mean reversion is indeed growing as the current cycle wears on. An erosion of underwriting standards in the leveraged loan market is of growing concern. Issuance has been exceedingly strong over the last two years, pushing the total value of the market past \$1 trillion, as concerns of rising rates have led to sharp increases in demand for the low duration and relatively higher yield offered by leveraged loans. This demand has incentivized borrowers to issue leveraged loans rather than high yield bonds, resulting in an increasing number of top-heavy and loan-only capital structures. Historically, loans have been prized for their senior status in the capital structure, but senior status means little when there are fewer subordinated lenders to shield from losses in the event of default. More concerning: Borrowers have steadily weakened the quality of loan covenants—protections that benefit lenders by limiting the amount of debt a company can borrow—leading to deteriorating credit quality of new issuance (Exhibit 4). With weaker covenants and fewer subordinated lenders, loan holders are expected to experience materially lower recoveries and heavier losses in the event of default compared to previous cycles.

Similarly, the BBB-rated credit market has ballooned in size over the last decade to \$2.5 trillion, surpassing the combined size of the US leveraged loan and high yield bond markets. The continued search for yield has led investors with investment-grade mandates to flock toward the bottom rung of the investment-grade credit spectrum. Corporations have had no problem meeting this demand, using record-low funding levels to pile on leverage for purposes like share buybacks and M&A. Today, many BBB constituents have credit profiles and leverage levels more similar to their high yield peers and are at a growing risk of losing their investment-grade status (Exhibit 5). Should a flood of “fallen angels” occur, the risk of significant repricing in both the investment-grade and high yield markets is high.

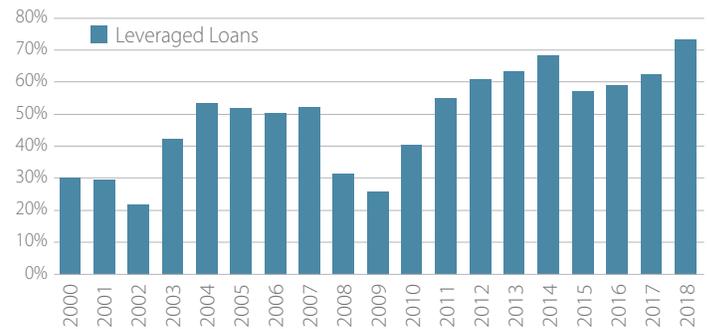
Finally, another byproduct of almost a decade of low interest rates is the explosive growth of private credit—considered a small, niche market prior to the Great Financial Crisis. According to alternative asset database Preqin, the assets under management of private credit funds have increased more than threefold over the last decade as investors looking for yield have moved to fill the void created by the gradual pullback in traditional middle-market bank lending. Private credit assets stand at more than \$650 billion today, of which \$250 billion has yet to be deployed (Exhibit 3). Questions remain about private credit’s ability to perform in less favorable environments than the one seen over the last decade. Credit standards have fallen, and the attractive rates of return that characterized the asset class have eroded over the last several years as private credit managers, armed with large pools of dry powder, have been left chasing fewer deals at increasingly less attractive terms. Given the relatively higher risk and illiquid profile of private credit, it’s possible these excesses could have pronounced capital markets implications if conditions were to sour.

Exhibit 3: Private Debt Assets Under Management



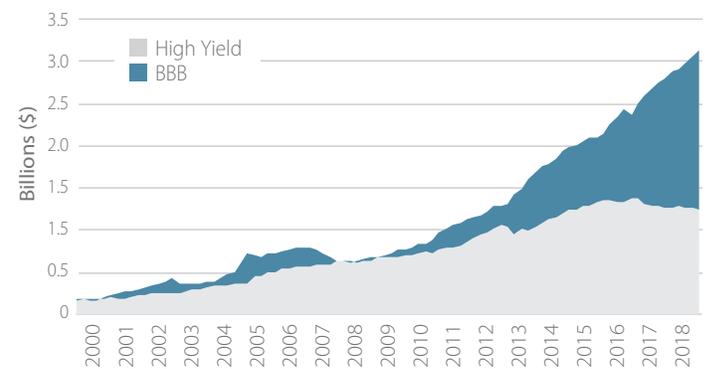
Source: 2017 Preqin Global Private Debt Report. Dry powder represents uncalled capital commitments.

Exhibit 4: Lower-Rated Leveraged Loan Issuance
Issuance Percentage Rated B or Lower



Source: S&P/LCD. As of 30 September 2018. Issues rated B2 and lower by Moody’s or B and below by Standard & Poor’s.

Exhibit 5: Market Size: High Yield Index and BBB-Rated Bonds



Source: ICE BofAML. As of 30 September 2018. Represented by the face value of bonds outstanding in the ICE BofAML US High Yield Index and in ICE BofAML US Corporate BBB Index.

Certainly, the deterioration of traditional checks and balances means it’s possible the risk to credit investors is much higher than the rock-bottom levels being priced in the market currently. However, there’s little reason to expect this aggressive behavior will result in losses until we see the economic tide turn. And, as we’ve mentioned, we see no meaningful catalysts—absent a major unforeseen global economic shock—that suggest we’ll see material economic weakness soon. Additionally, the cascade of defaults that erupted during the global financial crisis that marked the end of the last cycle is unlikely to occur this time around as the makeup of today’s credit market stands in stark contrast to the makeup of cycles past.

Putting this together, we believe that despite building risks, high yield credit continues to be an attractive asset class at this point in this cycle. Given cyclically tight spread levels, we acknowledge the likelihood of outsized returns is unlikely, but the risk/reward profile still looks favorable when compared to the alternatives—namely, investment grade and emerging market debt. And in the context of risk-adjusted returns, it’s important noting that both leveraged loans

and high yield bonds are historically less volatile and experience less dramatic drawdowns than equities. Past performance is not indicative of future results, but we believe this reinforces our view that not only does high yield credit warrant a permanent allocation in portfolios, it is an attractive asset class on a relative basis versus other investment alternatives in the current market environment.

Navigating Cycles With A Long-Term, Disciplined Approach

As we move forward, we view the market environment as akin to walking a tightrope. Investors must balance the trade-off between positive economic tailwinds that are supportive of credit conditions and growing but manageable market risks. As a manager with a proven track record of navigating different market environments, we believe our portfolio is well

tailored to succeed in this environment, where disciplined underwriting is required and deep credit work is essential. A key tenet of our success is our commitment to margins of safety and an unwavering focus on risk-adjusted return, meaning we won't stretch for yield or lend through enterprise value. At this point in the cycle, we are particularly selective about the businesses in which we invest, preferring multi-cycle models less sensitive to economic swings and with less volatile credit metrics. Additionally, the aggressive issuance seen in the loan market means a thorough understanding of credit agreements is required to ensure our position should a downside scenario occur. It's this discipline that allows us to capitalize on market inefficiencies by way of individual security selection and to build a focused portfolio that we feel can perform well in any environment.

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Fixed income securities carry interest rate risk and credit risk for both the issuer and counterparty and investors may lose principal value. In general, when interest rates rise, fixed income values fall. High income securities (junk bonds) are speculative, experience greater price volatility and have a higher degree of credit and liquidity risk than bonds with a higher credit rating. The portfolio typically invests a significant portion of its assets in lower-rated high income securities (e.g., CCC). Loans carry risks including insolvency of the borrower, lending bank or other intermediary. Loans may be secured, unsecured, or not fully collateralized, trade infrequently, experience delayed settlement, and be subject to resale restrictions. Private placement and restricted securities may not be easily sold due to resale restrictions and are more difficult to value. The portfolio's use of derivative instruments may create additional leverage and involve risks different from, or greater than, the risks associated with investing in more traditional investments. International investments involve special risks, including currency fluctuation, lower liquidity, different accounting methods and economic and political systems, and higher transaction costs. These risks typically are greater in emerging markets. Investors investing in strategies denominated in non-local currency should be aware of the risk of currency exchange fluctuations that may cause a loss of principal. These risks, among others, are further described in Artisan Partners' Form ADV, which is available upon request.

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Leveraged buyout (LBO) is the purchase of a controlling share in a company with debt collateralized by the target's own assets.

Par-weighted default rate measures the volume of defaulted bonds by the average principal volume outstanding for the period under observation.

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