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First quarter 2021

2021 predictions for private markets

One of the many lessons of 2020 was that the world of COVID-19 inhabited a parallel but different universe than the global markets. It certainly impacted everything that involves the economy and capital flows. Nevertheless, once central banks flooded liquidity into the system, investors were able to look beyond the pandemic to a post-vaccine world. And they liked what they saw.

To get a sense for what lies ahead in the coming year, we divided our forecast into three categories: what's in store for the economy, how will this affect capital markets and what does this mean for private credit specifically?

INJECTIONS AND PROJECTIONS

Last March many would have thought that with at least three major pharmas rolling out their vaccines, nine months later the crisis would be winding down. Unfortunately, a combination of underestimated virus contagion and overestimated vaccine distribution makes it look like 2021, at least through the first half, will be a continuation of 2020.

Suggesting that the U.S. economy will bump along for a while. Economists, including Nuveen's own Brian Nick, expect an up year relative to 2020. Once vaccines and the $1.9 trillion rescue package fully take hold, not to mention some political stability, the recovery will indeed be a "bright light" at the end of a "dark tunnel."

Will pent-up consumerism, as Fed chair Jerome Powell suggests, drive growth as we emerge from hiding later in the year? It's all about confidence. If unemployment ratchets down and consumers don't worry about other shoes dropping, a 4% GDP seems achievable.

MARK-TO-MARKETS

For the broadly syndicated loan (BSL) market, the balance of 2020 was one of restoration. Secondary prices came back from the depths of last March's "sell-off to par-ish by year-end" approach. Financings and re-pricings for a wide range of industries came to market.

At the same time, the supply/demand dynamics for liquid loans swung around in favor of institutional investors. Collateralized loan obligation (CLO) managers, representing some two-thirds of overall large loan appetite, found asset spreads wider than historic measures. Structures were also tighter with issuers representing the stronger, less COVID-19-sensitive sectors.

Concurrent with a general sense of economic recovery for the year ahead, retail money began to flow back into the asset class. Since January 1, over $4 billion has returned to funds, compared to over $30 billion of outflows for all of 2020.[1]

CORRELATION NATION

One of last year's surprises was how detached capital markets became with the course of COVID-19 and the economy. We predict this trend will continue; in particular, private credit will move more in concert with the amount of dry powder raised for the asset class than any headlines or general market moves.

At the margin extremes in BSL technicals, such as big swings in fund flows can sway direct lending terms. As a relative value matter, if liquid loan yields widen dramatically, illiquid loan yields should follow, directionally if not in lock-step.

High-yield bonds enjoyed their best year ever in 2020, thanks to Fed support early on. Bizarrely, as the world was stuck at home, one of the highest risk credit assets was thriving. Single-B rated new issues are yielding about 6%. For private credit investors who are secured and earning at least 100bps north of that, relative value is favorable and expected to remain so.

TERMS FOR PRIVATE CREDIT

Manager selection aligned with sponsor expertise could provide better outcomes

With supply/demand in private credit driven by dry powder, won't 2021 be a continuation of the frothy market we saw at the end of 2019 (and early 2020)? Hard to recall a time over the past four decades when direct lending wasn't competitive.

But several post-COVID-19 trends favor certain managers. First, businesses less impacted by the virus are earning purchase price multiples above pre-COVID-19 levels. Second, volatility as measured by the VIX peaked above 69 last April. While it's down from there to the mid-20s, it's still 10 points higher than 2018 and 2019. That should provide some yield support on the upside.

Private equity fundraising fell sharply in the U.S. last year to $231 billion from $375 billion in 2019 according to Pitchbook. Nevertheless, dry powder remains over $500 billion. That's sufficient to drive new buyout activity and greatly outweighs the $100 billion or so of private credit capacity.

As economic conditions strengthen, will bull loan market features such as middle market covenant-lite return? It's inevitable that competition among direct lenders will drive weaker investor terms. But residual pandemic drag on some portfolio companies may prompt risk managers to keep the foam off the latte.

THE TAKEAWAY

For patient investors with a long-term time horizon, we believe middle market debt offers a compelling relative value proposition

With a recovery underway, are we in a new business cycle? Or was 2Q 2020 just a bump in a decade-long expansion? The former, we think. COVID-19's influence over commercial activity and consumer behavior will last for many years. But our experience over the past twelve months suggests the Fed will do whatever it takes to keep things rolling along.

Inevitably the economy, capital markets and private credit are intertwined. Hard for large moves in one not to impact the others. But improved vaccine distribution should lead to a tipping point for reopening of commercial activity. That will lead to further value restoration in the capital markets. And ultimately, enhanced valuations should energize the M&A market — the lifeblood of private equity and private credit investing.

All good news. As one financial columnist put it succinctly, "A stronger economy...and higher interest rates. It's called a recovery."

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1 S&P Leveraged Commentary & Data (LCD) Q1 2021

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