APOLLO

A case for credit: Opportunity reaches historic entry point as yields surge

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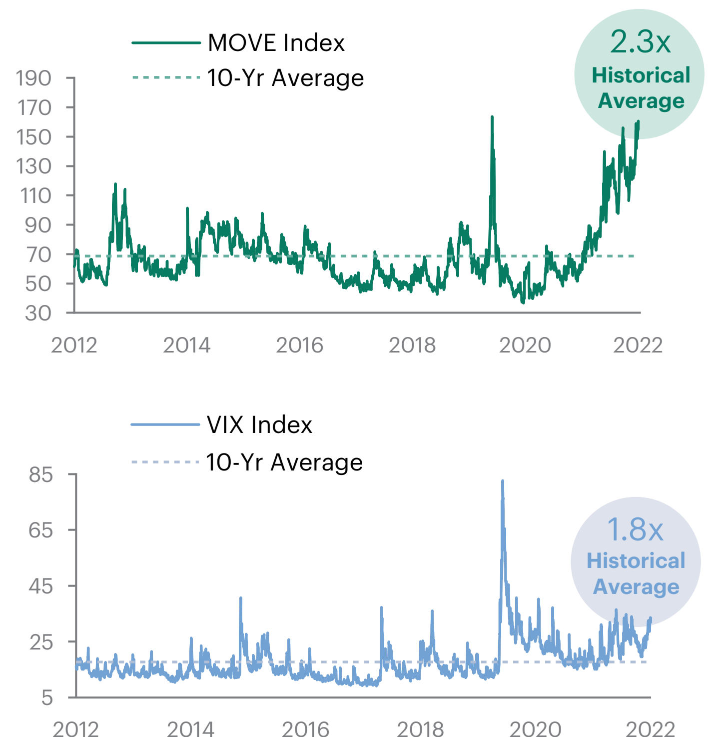
December 2022

After almost 15 years of persistently low (and sometimes even negative) interest rates, yield has finally returned to fixed-income markets. As 2023 approaches, we believe rising volatility—an offshoot of heightened geopolitical turbulence and tightening liquidity conditions—has created a historic entry point to investing in credit. With interest rates at their highest levels since the 2008 Great Financial Crisis (GFC), investors can deploy capital at attractive yields across a wide spectrum of credit investments, from direct lending to dislocated debt.

As the Federal Reserve continues to tighten monetary conditions—both through rate hikes and quantitative tightening (QT)—price volatility has been on the rise across asset classes, including foreign exchange and equities. However, volatility in interest rates, and by extension bond and loan markets, has been particularly eye-catching during this cycle. As shown in **Exhibit 1**, as of October 2022, the Merrill Lynch Option Volatility Estimate (MOVE) Index, an interest-rate volatility barometer, stood at 2.3 times above its 10-year historical average. Comparatively, the Cboe VIX Index, a gauge of equity volatility, was at 1.8 times its historical average during the same period.

Exhibit 1: Volatility in the interest rate market has reached historically high levels



Source: Bloomberg, Apollo Analysts. Data as of October 2022.

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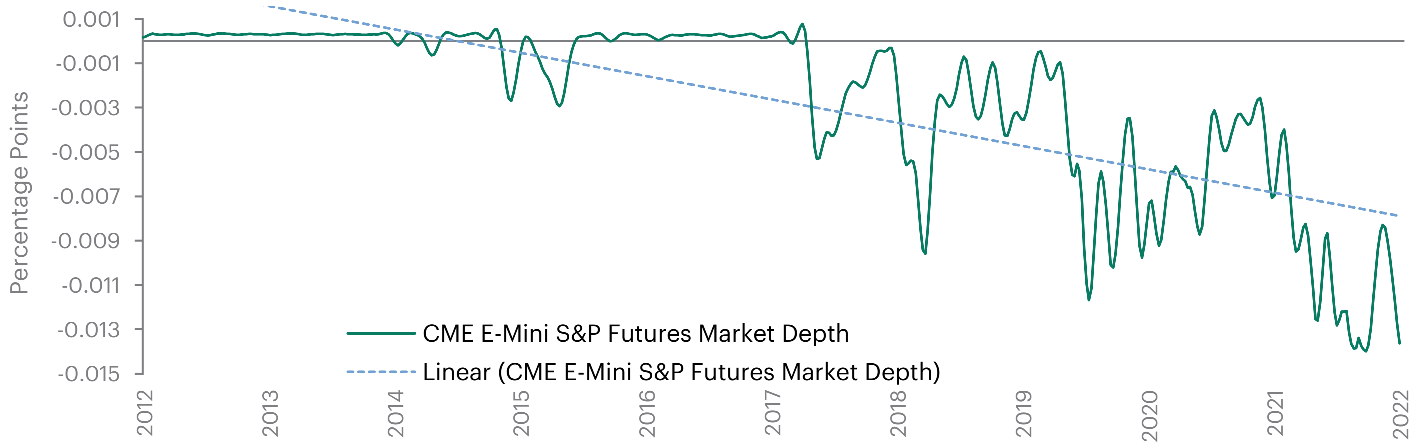
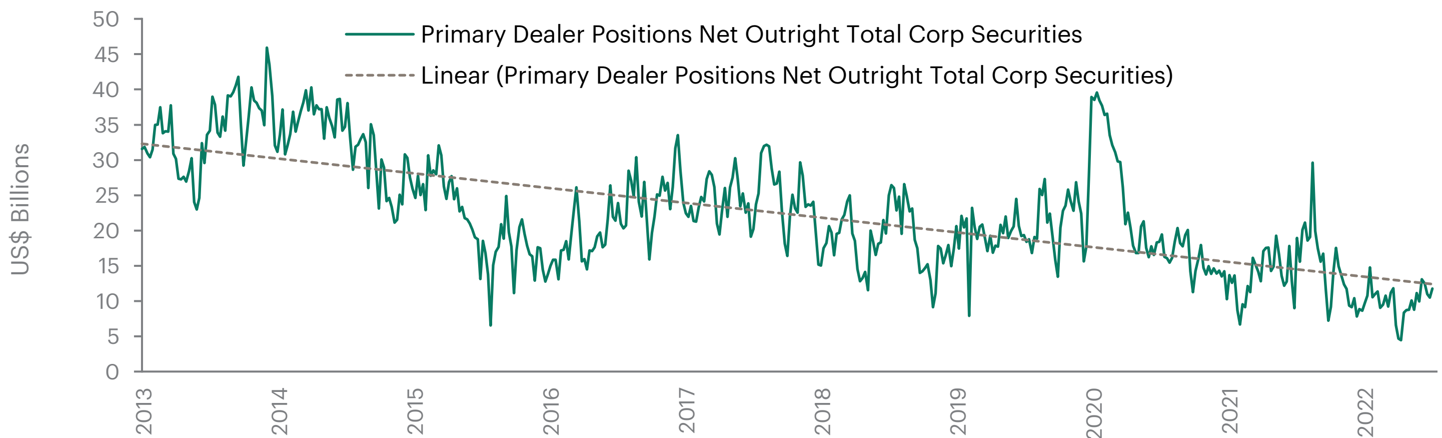
Tightening monetary policy (in response to elevated inflation) is not the sole explanation for the heightened volatility across markets this year. The ongoing war in Ukraine, which is entering its ninth month, has destabilized Europe, and souring US-China relations are threatening to turn back the clock on globalization. Policy mistakes, such as the proposed UK mini-budget and the ensuing sell-off in European credit markets, have also contributed to market instability. Unsurprisingly, liquidity conditions in both equity and fixed-income markets have deteriorated (**Exhibit 2**).

Exhibit 2: Deteriorating liquidity conditions have worsened market dislocations

LIQUIDITY IS WORSENING IN BOTH EQUITY…



…AND BOND MARKETS



Source: Bloomberg, Apollo Analysts. Upper chart reflects weekly data from October 5, 2012 through October 7, 2022. Shown in percentage points. Bottom chart reflects weekly primary dealer transactions in US corporate securities from April 3, 2013 through October 5, 2022.

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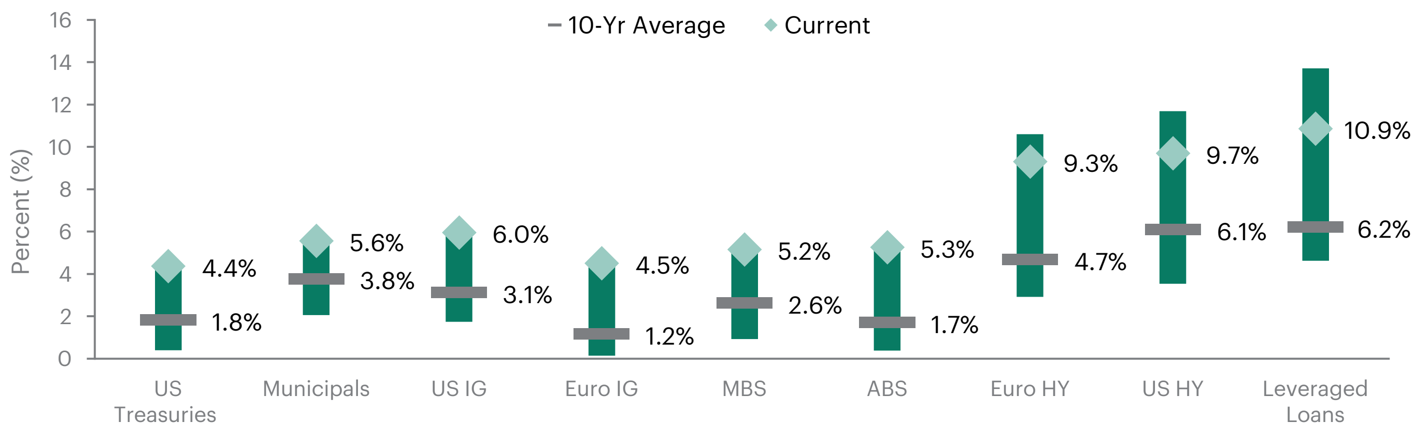
Through a historical lens, we believe today's market environment offers a unique entry point for investors looking to allocate to credit. We expect this opportunity to unfold over the next 12 to 24 months, as the Fed tightens monetary policy, market volatility stays historically elevated, and liquidity remains challenged. In our view, this environment will continue to create periodic forced-selling dynamics that can, in turn, generate attractive opportunities for investors who can act as liquidity providers in times of market stress and distress.

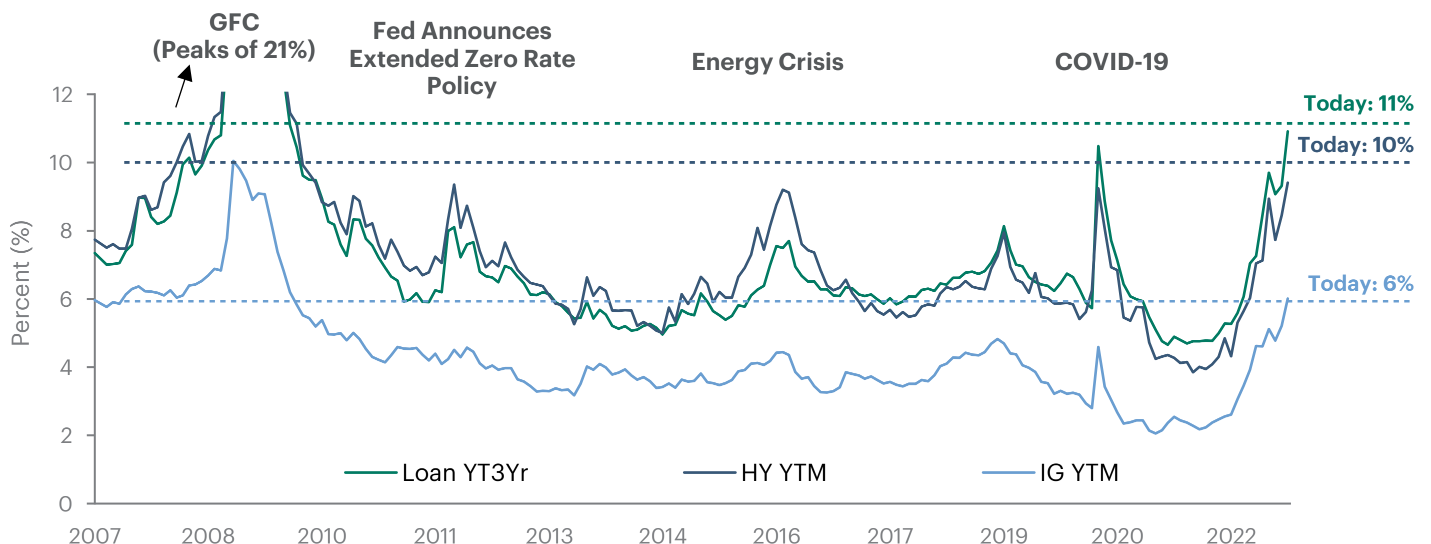
Exhibit 3 captures this point. As seen in the first chart below, yields have surged to historical highs across fixed-income asset classes, with US Treasury and investment grade yields well wide to their 10-year average. Today, US high yield bonds and leveraged loans offer returns that are 300 to 400 basis points above their 10-year average. The second chart below dimensions this opportunity in historical terms, as yields today sit at the loftiest levels in almost 15 years.

Exhibit 3: As yields surge, we see a historic entry point for investing in credit

YIELDS ACROSS FIXED-INCOME SECTORS REACH DECADE HIGHS



YIELDS AT THE HIGHEST SINCE THE GREAT FINANCIAL CRISIS



Source: Bloomberg, J.P. Morgan, Apollo Analysts. (Upper Chart) Based on daily yield-to-worst data from October 12, 2012 through October 14, 2022. Municipals based on tax-equivalent yield-to-worst and leveraged loans ("leveraged loans") based yield to 3 years. (Bottom Chart) Reflects daily data from January 2, 2007 through September 30, 2022. Represents the views and opinions of Apollo Analysts. Loan YT3Yr refers to the JLY3LLI, HY YTM refers to H0A0 Index and IG YTM refers to C0A4 Index.

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However, to fully capitalize on this opportunity, investors must successfully navigate a variety of pitfalls including a potential global recession, future monetary and fiscal policy missteps, and heightened geopolitical risk. That is why we believe a sharp focus on pricing and underwriting discipline when selecting potential investment options is key. In this context, we have detected two key underlying trends shaping the most attractive opportunities we see in the credit space today. They are:

1. Capitalizing on challenged syndicated loan markets

Syndicated markets continued to show signs of stress in the second half of 2022. Legacy bank commitments remain high as the market struggles to absorb the remaining pipeline of deals and investors demand significant concessions to complete transactions. This difficulty syndicating new leveraged loans has constrained access to capital, creating two main opportunities for credit investors: a) partnering with banks on offtake solutions for their financing backlog at attractive prices and terms, and b) providing private credit on new deals where banks have pulled back.

As of September 30, 2022, for example, year-on-year issuance in the US high yield market plummeted 78%, while leveraged loans issuance dropped 69%. This compared to a more modest—yet still significant—drop of 7% in US investment grade issuance volume. In the meantime, a looming maturity wall is fast approaching. Following a strong issuance year in 2021, the need for refinancing in the US leverage loan market is expected to grow from $12 billion in 2023 to $105 billion in 2024, $207 billion in 2025 and $242 billion in 2026.[1]

Additionally, the opportunity to provide private capital at attractive rates has expanded as excess spreads in the space have continued to rise throughout the second half of 2022, as we had predicted in a previous article. Typical direct deals are now pricing at SOFR + 650 with 2.0-3.0-point original discount (OID) versus SOFR + 500 with a 1.5-point OID in 2021. Coupled with higher short-term interest rates, all-in yields on direct deals now average 11% vs. 7% last year. We expect spreads to widen further, reaching SOFR + 650-750 basis points with yields between 12% and 14% in 2023.[2]

2. Capitalizing on dislocation

Tightening monetary conditions and ill-fated policies have also generated dislocations across capital markets. Take, for example, the failed attempt to implement a deficit-funded stimulus plan in the UK in September. The announcement kickstarted a wave of forced selling by pension plans facing margin calls related to their liability-driven investment (LDI) programs. The UK LDI contagion spread globally across equity and fixed-income markets.

Against this backdrop, AA- and A-rated senior tranches of collateralized loan obligations came into forced selling pressure, creating an opportunity for investors able to provide credit to step in and purchase high-quality paper at steep discounts. With the Fed and other global central banks at risk of upsetting market stability in their quest to rein in inflation, we believe the opportunity remains strong for investors who are ready to deploy when things break down.

All in all, as we advance into 2023, we believe that the current market environment has created a unique entry point for credit investors. Dislocated public and syndicated markets can open a window of opportunity for investors to benefit from discounted investments in the primary and secondary public markets and provide private capital alternatives for businesses that need to access the debt markets.

1. Source: Morningstar and Bloomberg, as of September 2022.
2. Source: Apollo analysts, as of October 2022.

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Robert Bittencourt is Partner and Head of Investment Strategy for Apollo's Credit Platform. Prior to joining Apollo in 2006, he was previously with GSC Group (formerly known as Greenwich Street Capital), where he focused on distressed-for-control assets. Prior to that time, Mr. Bittencourt was a member of the Restructuring group at Lehman Brothers. Mr. Bittencourt graduated cum laude from Harvard University with a BA in Economics.

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APO-IU206950(1122)