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Private Credit Helps Investors Get Defensive as Federal Stimulus Fades

Now's the time for risk-seeking institutional investors to safeguard themselves in a frothy market against potential volatility. Even as many have thrived riding the bull market in stocks, private equity and some hedge funds, opportunities within private credit could provide the timely downside protection and sustainable returns they'll need as federal support fades and inflationary pressures rise.

A receding tide of liquidity

Federal spigots have provided an estimated $12.3 trillion in monetary and fiscal stimulus from February 2020 through March 2021, according to Cornerstone Macro Research data and the Wall Street Journal. This has driven down corporate defaults and supported struggling businesses, many of which have taken on enormous amounts of debt.

At the same time, federal largess has reinforced consumers' savings accounts, positioning many to weather the pandemic and emerge ready to spend. Along the way, the stimulus bolstered business confidence substantially and boosted asset prices, helping many institutional investors flourish.

On the flipside, low interest rates have pushed yields on the most speculative company bonds to rock bottom. This has pressured institutional investors to take on more risk, whether through public equities, private equity or high yield corporate bonds.

The ripple effects of federal spending and central banks' unprecedented responses to the pandemic's impact on economies have prompted some investors to pay closer attention to troubling developments on the horizon. Investors have noticed how sponsors have been paying dangerously high multiples for anything regarded as pandemic- or recession-resilient. As public equity valuations continue to top up, private valuations for businesses are shadowing their upward trajectory. Some asset allocators also worry that the combination of waning federal support, rising interest rates and inflationary pressures will likely strain many companies' ability to service debt and grow.

Federal stimulus will fade eventually, which we expect would steer the markets back in line with the real economy. Reduced federal stimulus will lead to a return to more "normal" conditions, likely exposing those who'd been propped up by Uncle Sam.

Rethinking private credit inclusion in a diversified portfolio

To prepare for these challenges, institutional investors may want to take another look at credit strategies that offer sustainable, risk-adjusted returns. Fewer investors feel they're properly compensated for the risk they're taking and may soon conclude that riskier investments with double-digit returns shouldn't replace their otherwise prudent investment objectives, given the uncertainty and likely volatility on the horizon.

These investors may appreciate the many defensive qualities that investments in private credit offer, particularly non-sponsored and asset-heavy direct lending strategies. For one, many private credit structures are floating-rate loans that reward investors with the yield float when interest rates rise, providing a degree of inflation protection.

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But equally important, private credit strategies across all sectors of the economy promise investors diversification. And those strategies focused on asset-heavy lending—inventory, receivables and PP&E—show little correlation to public equity and sponsored markets.

Finally, senior-secured lending tends to offer additional protections. Lenders in this space have greater control over lending terms—so, typically fewer borrowers get into trouble. Often, these lenders require more restrictive covenants from borrowers and limit leverage ratios to half that of sponsored companies. The conservative measures that many of these lenders take put them in a better position to recover funds if the borrower defaults.

Direct lending can provide investors with stable, long-term risk-adjusted returns in the high single digits and substantial current yield. But not all lenders are created equal. Investors need to place bets on true credit experts with extensive sector knowledge to originate and underwrite differentiated opportunities.

Investing in a sustainable recovery

Beyond consistency, diversification and protection, private credit can have a positive economic impact. Some direct lenders support small- and medium-sized enterprises (SMEs) which typically have been less efficient for banks' balance sheets. This lending can enable SMEs to power a more sustainable post-pandemic economic recovery and helps drive lasting growth in family-owned businesses. Another private credit strategy, receivables financing, can alleviate the strains on stretched supply chains.

Institutional investments in private credit keep money circulating through the system, play a vital role in the kind of debt capital distribution that supports local businesses, and can help create and sustain jobs.

Too much money in the financial markets has driven up asset valuations, largely distorting the functional relationship between returns and risk in the process. Many investors still predict that a more normal default cycle remains a few years off, but also anticipate significant volatility along the way. When the next default cycle does materialize, however, expect those who've invested in highly levered businesses in their search for yield to feel the most pain. In this environment, portfolio diversification and defensibility are crucial.

As yield is a function of risk in the real economy, investors can find healthier returns by assessing risk more realistically. They can look at senior-secured loans to the vast middle market underwritten with conservative leverage ratios and strict covenants.

Investors today have based their bullish sentiment largely on the federal government's efforts to support the economy's recovery. Private credit investments offer investors desirable returns with a healthy amount of risk, all while supporting SMEs, the dominant engine of employment and the economy, helping to forge a more sustainable recovery.

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