APOLLO

What Does a "Higher for Longer" Rate Environment Mean for Credit Markets?

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On April 16, Federal Reserve Chair Jerome Powell told an audience at Stanford University that "given the strength of the labor market and progress on inflation so far, it's appropriate to allow restrictive policy further time to work." That statement has brought markets around to a view that we at Apollo have been voicing since last year: It's very likely that interest rates will remain elevated for the foreseeable future.

Powell's comments represented a retreat from the Fed's market-moving "pivot" at its December meeting, when it hinted at the possibility of up to three rate cuts in 2024. In the wake of that meeting, easier financial conditions fueled a rally in the stock market and ignited a flurry of activity in the credit markets. Spreads tightened significantly in investment-grade credit, high yield, and leveraged loans. This move brought spread levels materially tighter from the widest levels reached at the start of 2023, particularly in corporate credit. The tightening trend continued into 2024, pushing spreads in high yield to some of the tightest levels seen since the start of the pandemic, and bringing spreads on higher-quality assets close to the tightest levels seen since the global financial crisis.

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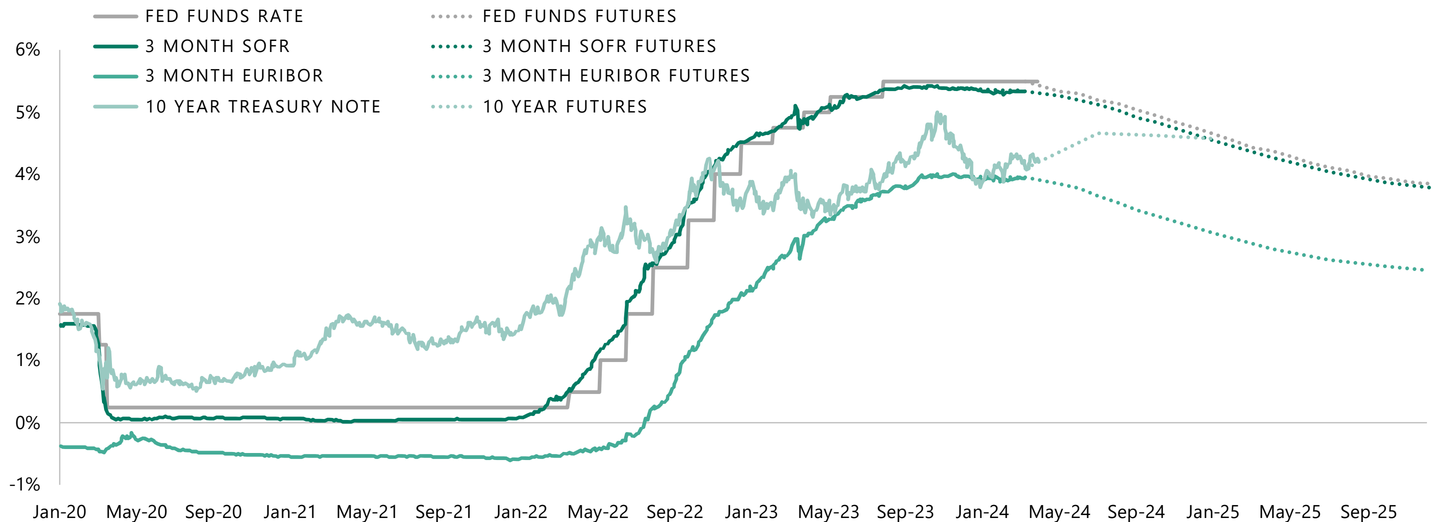
This dramatic spread tightening materially shifted the total return opportunity in public markets from the middle of November 2023, when credit spreads were averaging about 430 basis points in the high yield market, to the end of December, when average high yield spreads were in the high three hundreds. The December Fed pivot also helped push spreads tighter in private markets, but to a lesser extent.

After a series of surprisingly strong economic data releases in 2024, Powell’s April comments drove home the risk that inflation may remain stubbornly above the Fed’s 2% target for a while. It remains our expectation that the Fed will have to keep interest rates elevated for an extended period of time (**Exhibit 1**). In this paper, we discuss what a “higher-for-longer” rate scenario might mean for credit markets. Specifically, we posit that the current environment represents an attractive point of entry into floating rate credit in general, and private credit in particular.

Exhibit 1: Markets coming to terms with possibility that rates could remain higher for longer



Data as of March 27, 2024.

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There can be no assurance that historical trends will continue.

Source: Bloomberg

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With base rates high, yields in credit markets remain attractive

We believe that one of the unique elements of today's marketplace is that, even at elevated valuations, there are large amounts of capital being deployed in the credit markets because market participants still find yields attractive.

Despite tighter spreads and increased prices, the opportunity in credit markets remains quite attractive due to the fact that high base rates are keeping yields well above their historic average (**Exhibit 2**).

Today, we see the opportunity in floating rate credit in general, and private credit in particular, as notably attractive due to yields that were comparable to historical returns seen on public equities, as of this writing. We believe this opportunity will remain in place because the underlying trends of high prices and high base rates appear likely to persist for the remainder of 2024 and beyond.

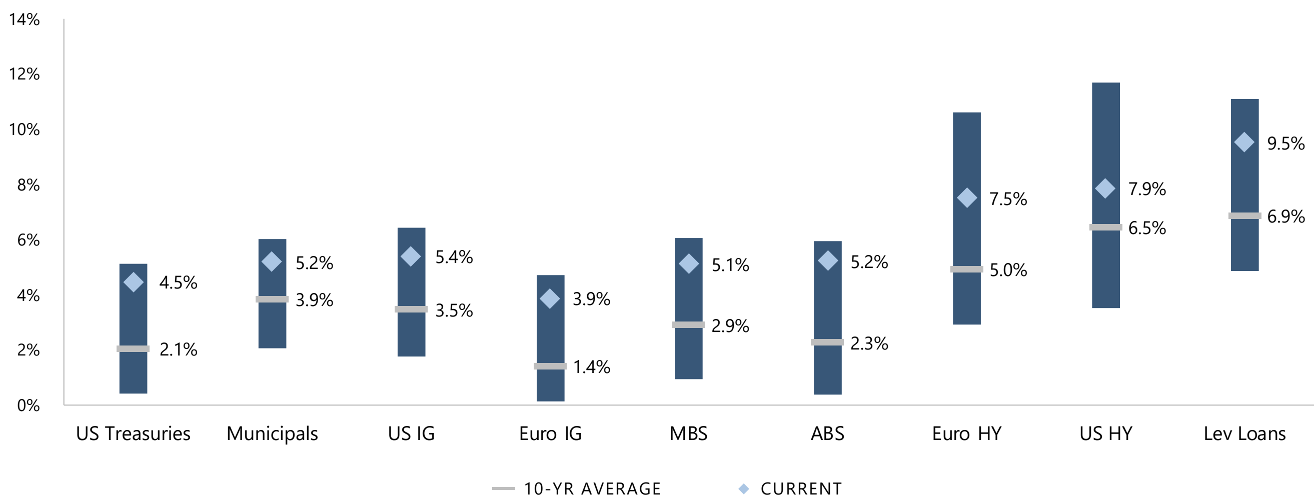
Supply imbalance helps keep prices high

While much of the spread tightening experienced over the past 12 to 18 months can be attributed to a benign economic outlook, a supply/demand imbalance in credit markets also played a role.

For most of 2022 and 2023, elevated interest rates and high borrowing costs kept corporate issuers on the sidelines. Since the December Fed meeting, companies have rushed to take advantage of easier conditions to refinance and extend maturities on bond deals due to mature in the next two to three years. The effects of Powell's April statements will likely dampen that enthusiasm and slow the pace of new issues.

A pickup in mergers & acquisitions (M&A) activity in the wake of the December Fed pivot also helped alleviate some of the supply/demand imbalance and counteract tightening pressure on spreads to some extent. However, we believe that effect will be limited in the months ahead. High costs of debt capital will remain a significant impediment to M&A, making it difficult for sponsors and companies alike to achieve an attractive return on equity on transactions. In addition, the start of the US presidential election season could add volatility and uncertainty into the mix, prompting some market participants to put off M&A deals. As a result, any spread widening from a short-term pick-up in M&A will likely be modest. With demand in credit markets continuing to outstrip supply, we expect spreads to remain tight.

Exhibit 2: Yields are attractive across the board, even if valuations appear rich



Data as of February 28,2024.

All sectors shown are yield-to-worst except for Municipals, which are based on the tax-equivalent yield-to-worst, and Leveraged Loans, which are based on YTM. Dark blue bar represents min/max yield-to-worst over trailing ten-year period ending February 28, 2024. Orange triangle represents current YTW as of February 28, 2024. U.S. Treasuries represented by Bloomberg US Treasury Index (LUATYW). Municipals represented by Bloomberg US Municipal Index (BTXMYW). U.S. IG represented by Bloomberg US Corporate Bond Index (LUACTRUU). Euro IG represented by Bloomberg Euro Aggregate Corporate Index (LECPYW). MBS represented by Bloomberg US MBS Index (LUMSYW). ABS represented by Bloomberg US Agg ABS Index (LUABYW). Euro HY represented by Bloomberg Pan-European High Yield Index (LP01YW). US HY represented by Bloomberg US Corporate High Yield Index (LF98YW). Lev Loans represented by Credit Suisse Leveraged Loan Index (CSLLLTOZ).

Source: Bloomberg

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Secular trends helping keep base rates elevated

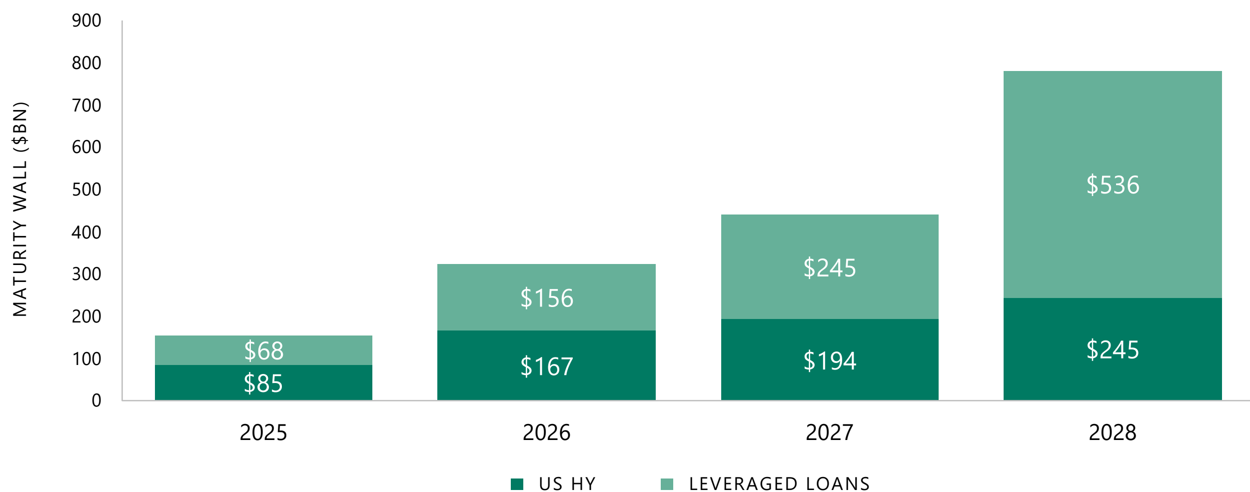
Throughout 2023 we remained convinced that inflation was proving sticky well above the Fed's 2% target rate, and that, as a result, rates would have to remain higher for longer. However, the Fed's battle against inflation is not the only factor working to keep interest rates high. At Apollo, we are watching several long-term trends that aren't necessarily well understood by markets, and don't get as much attention as they should in the financial press. High levels of US Treasury issuance, de-globalization, energy transition, a high US fiscal deficit, and an increase in government defense spending can all produce upward pressure on rates. These macro forces appear to be contributing to higher rates at a more secular, long-term level.

Expanding opportunity set in private credit

In an environment of tight spreads and elevated base rates, opportunities in floating rate and private credit remain attractive. Going forward, the opportunity set in private credit will be enlarged by the much-discussed "maturity wall." As shown in **Exhibit 3**, about $1.6 trillion of US high yield and leveraged loan volume is scheduled to come due between 2025 and 2028. The approach of this maturity wall will create chances to lend to companies at attractive rates of return while also de-risking the investment by injecting new capital into the business, enhancing lender protections, and making sure the capital structure makes sense for the prevailing cost of debt. If done correctly, this will benefit the company, the lender, and bondholders.

Exhibit 3: $1.6 trillion maturity wall will create opportunities for private lenders

Companies are expected to roll over debt in coming years



Data as of February, 2024.

Leveraged Loans data excludes defaulted facilities and is based on par amount outstanding. High Yield data based on February 2024 universe of ICE BofA US High Yield Index (H0A0) and ICE BofA 0-1 Year US High Yield Index (H544) and is based on face value.

Sources: Bloomberg, Pitchbook LCD

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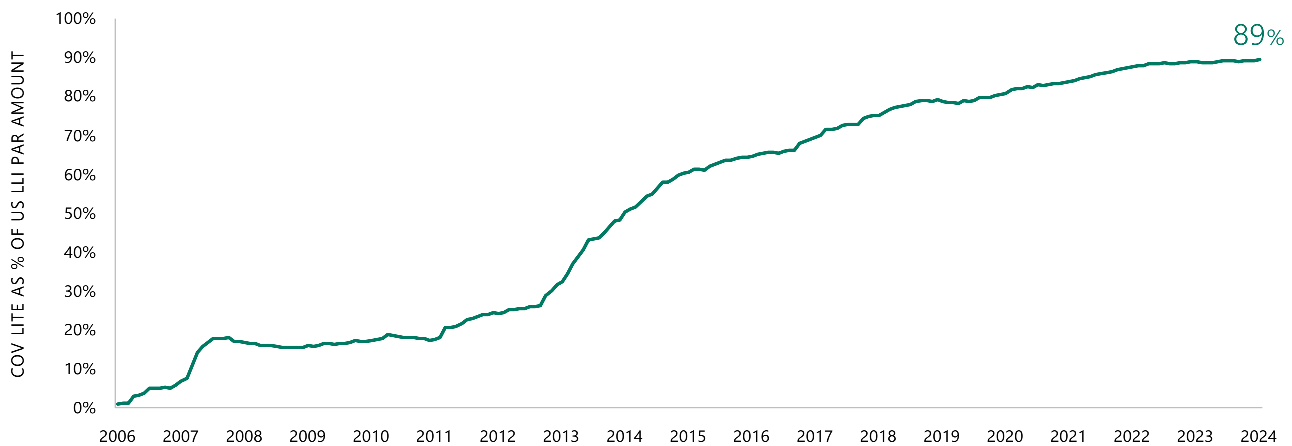
A disciplined approach

Although we remain optimistic about opportunities in private credit, given market uncertainty, we at Apollo are paying close attention to fund structures, lender protection, and leverage levels. Thanks in large part to the supply/demand imbalance discussed earlier, "covenant-lite" transactions now make up the bulk of the US leveraged loan market (**Exhibit 4**).

Lenders who compromise on loan structure and protections will be at increased risk to a rise in defaults. Throughout this current period of elevated rates, highly leveraged companies with lower coverage ratios have found themselves under pressure. This pressure has pushed up default rates from the lows set at the end of 2022. Currently, the default rate in the US loan market is just above the historic average of about 3%. Default rates in high yield, which have been subdued, are climbing toward historical averages (**Exhibit 5**). We believe default rates in private credit markets are slightly higher than those in the publicly syndicated market due to the preponderance of floating rate debt in private markets.

Exhibit 4: Underwriting standards have become increasingly lax

Deterioration in credit documents

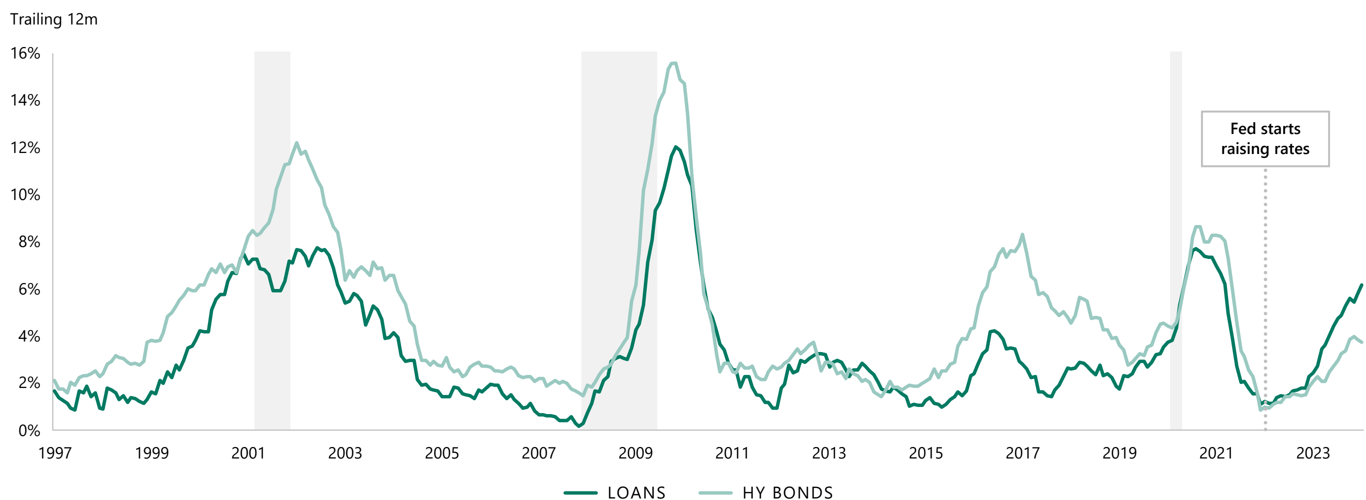


Data as of 2024.

Source: Pitchbook LCD, Barclays Research

Exhibit 5: Default rates have climbed since the Fed started raising rates

US speculative grade default rates



Data as of January 31, 2024.

Sources: Moody's Analytics, Apollo Chief Economist

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In both public and private credit markets, the December Fed pivot triggered a reversal to the long-term trend of deteriorating coverage ratios. The uptick in coverage ratios in December 2023 (**Exhibit 6**) helped alleviate at least some pressure on vulnerable companies. However, if, as it now appears, rates do remain higher for longer, it's possible that coverage ratios could return to the downward course initiated when the Fed started raising rates in 2022, placing more companies at risk of default.

When default rates climb, we believe that the best protected investments are high up in the capital structure, with significant amounts of equity support. Given today's conditions, vintage will also be an incredibly important market consideration. Rising default rates will impact credit that was underwritten before 2022 to a much greater degree than structures put in place since the rise in interest rates. Market participants buying into structures created and deployed over the last two years are acquiring portfolios that have better lender protections and much lower loan-to-value ratios. Given this discrepancy, we believe that it will be important to remain disciplined when deploying capital at this time.

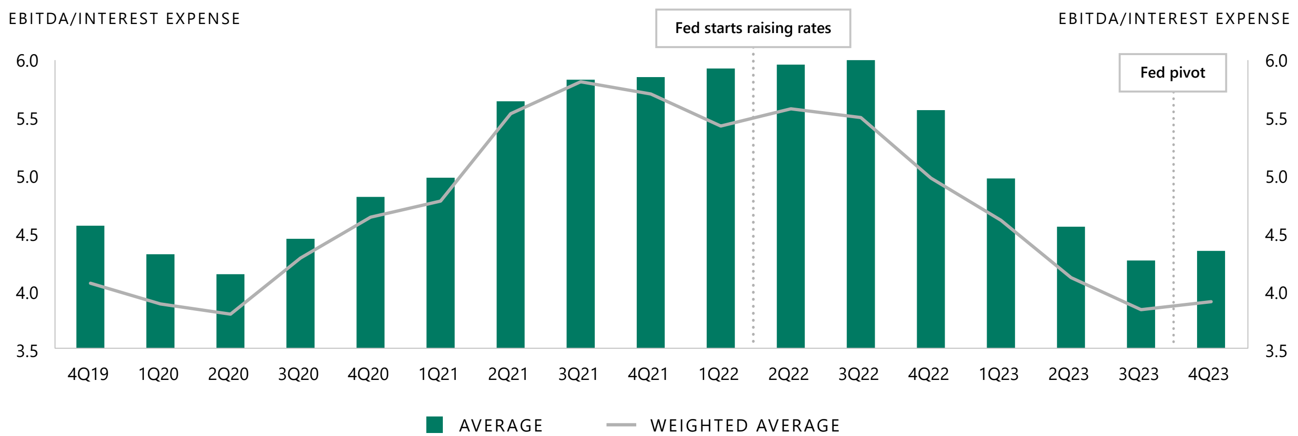
Additional risks: geopolitics and the US-China trade

In addition to the market dynamics discussed to this point in this paper, credit markets face a series of geopolitical risks that call for a conservative market approach, including the ongoing conflict in the Middle East, the war in Ukraine, and the 2024 election cycle, which will witness ballots in 40 countries around the world, accounting for almost half of global GDP.[1]

Although all these risks deserve close monitoring, we believe market participants should also pay attention to the US-China trade relationship. Economic and political tensions between the two countries represent significant risk. However, there is another, lower-profile trend that we believe bears close watching. Trade flows between the US and China now have a considerable influence over both the overall economy and the economic performance of specific industries and companies. With China experiencing an economic downturn, some US companies are seeing a change in their profitability due to a decrease in demand from this large and increasingly important market.[2] We believe this slowly developing trend could have a meaningful impact on companies in certain subsectors.

Exhibit 6: Delay on rate cuts could resume pressure on coverage ratios

Interest cover ratio for leveraged loans



Source: Pitchbook LCD, Apollo Chief Economist

[1] https://www.bloomberg.com/news/newsletters/2023-11-01/2024-is-election-year-in-40-countries-and-podcast-elon-inc-launches-next-week

[2] https://www.reuters.com/world/china/chinas-sagging-economy-looms-over-quarterly-results-around-world-2023-07-20/

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Conclusion

We believe the US Federal Reserve will be forced to keep interest rates at elevated levels for the foreseeable future. Yields from higher base rates should keep credit attractive to market participants, despite spread tightening. The resulting demand will likely outpace limited supply, keeping prices high and spreads tight. Nevertheless, we believe investors will continue to find credit markets attractive due high base rates and relatively high yields. Specifically, we believe the current environment represents an attractive point of entry into floating rate credit in general, and private credit in particular—provided investors remain disciplined when deploying capital.

Solutions that would have been possible only in public markets just five or 10 years ago are migrating to private markets, and we believe the overall opportunity set is now significantly larger in private credit. That opportunity extends beyond simply lending to corporates on a private basis, as opposed to participating in publicly syndicated loans or bond deals. As markets contend with what appears to be a higher-for-longer scenario, private lenders will have an opportunity to engage in a much broader swath of the market, to be providers of liquidity, and to structure and create assets that can play specific, beneficial roles in fixed-income portfolios.

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