

Credit markets too bearish: Ares

Jonathan Shapiro

Global credit markets are pricing in “an abnormally high” level of defaults over the next two years, which is creating compelling return opportunities for investors in loans and bonds.

That’s the view of portfolio managers at Los Angeles-headquartered mega-fund Ares Capital Management, which is seeking to capitalise on the dramatic price moves in public debt markets.

Ares co-head of global liquid credit, Boris Okuliar, said his team analysed the credit risk of loans and bonds to determine whether the default likelihood was implied by their price.

“Right now, it’s pricing in massive defaults, which we just don’t agree is going to be the case,” said the London-based portfolio manager, who was in Australia meeting clients last week.

Mr Okuliar explains that some risky corporate bonds have fallen in price by about 20 per cent, largely because base interest rates have risen sharply, increasing the relative cost of holding these securities.

But as long as the borrower was solvent, the full par value would be repaid at maturity, which meant over time the discount would narrow, creating price gains.

Ares Management is listed in the US and has a \$US19 billion (\$27.4 billion) market capitalisation. It manages \$US325 billion of assets, of which almost \$US200 billion is in corporate bonds and loans in both private and public markets.

Credit markets are often regarded as the “canary in the coal mine” as lenders attempt to get ahead of any looming risks. But the view of Ares is that measures of the credit market aren’t reflective of the underlying health of borrowers.

Ares Management partner of global



Ares Management’s Samantha Milner and Boris Okuliar at the firm’s Sydney office. PHOTO: JAMES BRICKWOOD, AFR

liquid credit Samantha Milner said the credit spreads could widen further, but that was not the firm’s base case.

She said that when spreads on high-yield bonds reached about 6 per cent over the risk-free rate, that tended to lead to attractive returns from a 12- to 24-month period.

“It’s always hard to buy at the bottom, but it does bode well for future returns,” she said.

The sell-off was “sentiment-driven. But that being said, there are yellow blinking lights in terms of rising energy costs and inflation that does impact the consumer.”

The spread hit 6 per cent recently but has since fallen back to about 5.5 per cent. These are levels rarely seen over the past decade and imply a wave of defaults. The overall interest rate in the high-yield bond market is about 9 per cent.

Ms Milner said despite rising interest rates and higher inflation, borrowers were relatively healthy as leverage had not built up in the financial system.

“Consumer balance sheets are pretty solid. More importantly, corporate balance sheets are solid.

“Over the two years, companies have pushed out maturities given the liquidity that’s been available. It’s a small percentage of companies that have debt coming due in the next two to three years.”

To be precise, only 8 per cent of US high-yield bonds are due to mature by 2024, with the bulk of repayments due in 2029 in the US, and 2026 in Europe.

Corporate defaults, she said, were likely to increase, but only from their historic lows. “We do think we will see reversion to the mean because we are at such extreme levels.”

The long-term historic default levels

for high-yield bonds are about 3 per cent, and 4 per cent for leveraged loans.

Mr Okuliar said the firm’s analysis showed that companies that had borrowed money could service their debt – and by its measure borrowers in Europe and the US had \$3.70 of cash flow to cover each dollar of interest.

In general, companies had managed to pass on rising input costs with minimal disruption and, coupled with strong cash balances, could comfortably service their debt.

There had, he said, been a “bit of deterioration” in certain companies exposed to commodity and food costs.

Chemical companies were being hurt by rising petroleum prices. But companies had generally extended the term of their debt at low rates and had conservative amounts of leverage.

“Their ability to weather a storm is reasonable,” he said.