



MONTHLY ISSUE **#118** | 1st November 2024

Navigating private credit's new era

EDITORIAL VIEW

- Private credit tops this decade's private asset performance rankings...
- ... thanks to a backdrop of higher rates and reduced banking/bond market lending activity
- As the cycle shifts, smaller, nimble funds serving dislocated segments should continue to thrive

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- Macro backdrop: too Goldilocks to be true?
- Equity markets: Catch me if you can
- A long list of scary movie scripts that will likely remain in the drawer

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Navigating private credit's new era

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In early 2023, Blackstone's Jon Gray claimed private credit was in a "golden moment". Others soon started talking of a "golden age", and by year end Blackstone execs were bopping to the Christmas song "It's the Alternatives Era". The thesis is simple: high interest rates and reduced competition from traditional lenders have boosted returns on private credit, making it this decade's top performing private asset class, with a 15.8% IRR.

The maturing phase of a golden age can be very exciting. Better credit vintages often originate when rates are high and exit as they come down. Central banks have admittedly begun to loosen policy, but the decline in rates will be gradual, and private credit deals terms can take months to adjust. There is thus still time to take advantage of the rate backdrop, although selectivity will be increasingly crucial. In particular, we see an evolving divergence between the large cap "dinosaurs", forced into commoditised segments in order to continue to grow, and smaller, specialised firms (the "birds"), better adapted to thrive in changing conditions. Put differently, can the giants continue to beat the market now that they are becoming the market? According to Pitchbook, in H1 2024, 88% of private credit fundraising went to funds exceeding USD 1 billion in assets.

The key features of those still basking in the golden age are a "swiftness" in asset deployment, a "nimbleness" to swoop on pockets of dislocation, and an "ability to fly" by structuring upside exposure that benefits from monetary easing.

Within private markets, faster deployment generally makes for more efficient fund structures, with lesser undrawn commitments. Also, given the time-limited opportunity to benefit from high base rates, swiftness is of course all the more relevant today.

To be sure not to miss out, another trick is to invest in already well-deployed funds, full of deals originated in ideal conditions.

Private credit thrived amid reduced banking and bond market activity. As the cycle shifts, our preference goes to segments that have never been well served and where dislocations have emerged – such as asset-backed lending, credit secondaries and technology-sector lending (the 2023 collapse of Silicon Valley Bank having left an unfilled market gap).

Private credit is often viewed as a capped return strategy. With bespoke structuring, however, it is possible to gain upside exposure above contractual minimums, and even take advantage of falling rates. One option is to shift from floating to fixed coupons, particularly in smaller deals where borrowers tend to focus on their initial quarterly payments. Pre-payment penalties can also help boost the IRR, with borrowers more likely to refinance early in a context of falling rates and spreads. And equity warrants can make for an interesting addition to contractual interest. If loans are refinanced early, they will be crystallised faster. Odds of their value moving up are also greater when rates are falling, especially in rate-sensitive segments such as asset-backed deals.

What follows a golden age? The term originates from Greek mythology, where the progression is to a silver and then bronze age. But those who know their Hesiod from their Ovid will remember that all these stages led up to a "heroic age", where the famous stuff of legend happened. Perhaps this is the better analogy. Life will not be uniformly easy for everyone, but the greatest has yet to come. Just make sure to carefully pick your hero strategies.

Written by Reji Vettasseri, Lead Portfolio Manager for Private Market Solutions

GRAPH OF THE MONTH

3 Yr Horizon IRR for Private Markets Asset Classes (2020-23)



Source: Preqin

GLOBAL STRATEGY

Keep calm & carry on

- Macro backdrop: too Goldilocks to be true?
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Since the US Fed's mid-September jumbo rate cut, investors have enjoyed a perfect macro backdrop, made of reassuring US economic indicators, comforting inflation data (especially in Europe) and, cherry on the cake, a surprisingly strong US labour market report – which definitively assuaged fears of an imminent recession. Add to that a global monetary easing cycle now well underway, China's revived stimulus and geopolitical risks taking a backseat, and you will get to hear what Goldilocks music really sounds like.

Thanks to this supportive soft-landing backdrop, alongside resilient corporate earnings (consensus puts 2025 EPS growth at +13%) and further institutional & retail inflows as of late, global equity markets have extended their rally to new all-time highs. Admittedly, investor positioning has become somewhat more positive as a result, though largely driven by China-related FOMO. And major markets are expensive by most valuation standards, but that is nothing new (as in the credit market) and has not stopped this year's up leg. In fact, elevated current equity index multiples conceal a much more complex reality, with segments such as the Eurozone and small-caps still offering pockets of value beyond the Mag7 titans.

What could go wrong from here? Many things could be the short answer, especially as we are entering November through the Halloween backdoor, with investors having already enjoyed many treats this year, certainly more than they had expected. Meanwhile, the list of risks has grown to now include geopolitical crises, US presidential election-related turmoil, macro deterioration and other factors than we can imagine – or not (unknown unknowns). In particular, the upcoming US election will bring about a noisier backdrop for the Fed to carry out its near-term easing plans.

While investors may be guesstimating – in vain – the outcome of this election, we actually think it is time... to stay put. And perhaps just add some hedges to mitigate the volatility associated with these latent risks. Indeed, while significant market noise/volatility lies ahead, we view the odds of getting the outcome right

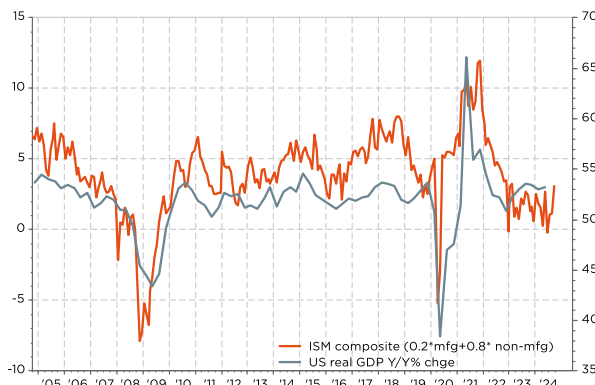
and, more importantly, then taking the “good” investment decision with a perfect timing, as very low. That said, macro and micro fundamentals remain healthy and should continue to provide support for risky assets in the aftermath of the event. We thus remain cautiously optimistic on the trajectory and continue to favour an all-terrain approach to portfolio construction together with a well-balanced diversified asset and sector allocation, tilted towards high-quality plays in equities, credit carry and high-quality duration convexity in bonds, while keeping a meaningful allocation to gold combined with USD and CHF exposure as risk diversifiers.

As regards equity markets, we remain constructive but cannot exclude further bouts of volatility (final destination of policy rates, nature of landing, geopolitics, inflation trajectory or market rotations among others), driving some price consolidation and suggesting somewhat more muted near-term returns. We maintain our (structural) preference for US equities, carefully balancing our (actively managed) small/mid-cap allocation with somewhat less growthier mega-caps, which should benefit from lower rates and cost pressures. Elsewhere, we already downgraded our eurozone stance (to slight underweight) last summer, as economic growth again peters out amid Germany's struggles, and continue to prefer other European markets – notably the UK and Switzerland.

Moving to bonds, we retain a cautiously neutral stance, with a preference for credit at the short end and belly of the curve vs. long-term sovereign debt, through a “buy-and-hold” carry strategy, while retaining a selective approach in the high yield/emerging market segment. Finally, we continue to favour diversification through gold (rather than via bond duration), as it stands to benefit not only from the Fed's anticipated easing cycle but also its better safe haven status than that of sovereign bonds in the event of post-electoral US turmoil, additional budgetary slippage concerns, or a no-landing scenario.

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Resilient US growth



Gold-cash mix vs. UST 7-10y total return: relative performance



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External sources include: LSEG Datastream, Bloomberg, FactSet.

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