A WORD FROM ANTARES

# Uncertainty yields opportunity

**No recession ... yet; inflation starts to cool**

As we enter the homestretch of 2022, key US macroeconomic indicators have been relatively constructive or at least less troublesome than some had feared. The US real GDP growth of 2.6% in Q3 2022 was higher than consensus expectations and dispelled any notion that the US economy might be in a recession. In September, the Consumer Price Index continued to cool to 7.7% (6.3% core), which was below consensus expectations of 7.9% and down from 8.2% (6.6% core) in August and a peak of 9.0% in June. Labor markets—a sticky source of inflation—remain healthy but have seen some welcome modest cooling with wage growth slowing in Q3 2022 and the unemployment rate rising from 3.5% in September to 3.7% in October.

**Challenges and opportunities ahead**

Markets have celebrated recent economic news with the S&P 500 up about 12% from its early October lows as of this writing; however, the economy is by no means out of the woods, and geopolitical risks continue to loom large. In a world so acclimated to a near-zero interest rate environment, the lagging impact of the fastest pace of interest rate hikes from the Federal Reserve (the Fed) in decades may yield unwelcome surprises. Also, although inflation may have peaked, the Fed still has plenty of work to do with core inflation of more than 6% still well above target. Meanwhile, economic and market stress continues abroad with Europe facing a recession and with the recent UK pension fund fiasco a possible sign of things to come. Clearly, challenges remain. However, with uncertainty and volatility in liquid markets comes opportunity. Although defaults seem likely to rise, 2022 and 2023 could prove to be great vintage years for well-managed direct lenders given double-digit first lien yields, lower leverage, and tighter terms.

**Timothy Lyne**

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## Q&A with Timothy Lyne, CEO of Antares Capital

**How has sponsor-backed private debt been faring in the current environment?**

Direct lending has been faring well in an otherwise down market. Although sponsored middle market loan volume fell 14% YoY in Q3 2022, the direct lending segment's volume was up 1% while the syndicated volume was down 46%, according to Refinitiv LPC. Direct lending was up 16% and syndicated was down 30% YTD. Economic uncertainty that caused a sell-off in the secondary market for broadly syndicated loans forced banks to take billions in write-downs and has constrained their appetite for underwriting. As a result, direct lending's share of the US sponsored middle market surged to 80% in Q3 2022—up from 65% in Q2 2022 and 50% in Q2 2021. Direct lenders have also seen their share of the large corporate segment of the market rise to 23% with $42 billion in volume in Q3 2022, up 12% from Q2 2022. Looking ahead, with more than $40 billion in hung debt still on bank balance sheets, it will likely take some time for syndicated markets to recover—perhaps starting sometime in early 2023.

Meanwhile, direct lending investors are enjoying better pricing and terms, with first lien yields now in the 10%+ zone and with leverage down modestly. It's really a very attractive market, but you need to be highly selective in picking deals, as defaults are expected to rise.

**Are you seeing any signs of stress yet in your portfolio or the middle market more generally?**

Looking at the broader market, about 70% of the companies in the S&P 500 have reported Q3 2022 revenue and earnings-per-share upside surprises thus far; however, earnings growth has decelerated to only about 2%, which is the slowest rate seen since Q3 2020, with the energy sector accounting for the bulk of the growth. Some of the headwinds to S&P 500 earnings stem from the strong impact of the US dollar on company earnings abroad, but this tends to be less of an issue for more domestically focused US middle market companies.

In terms of defaults, the Morningstar LSTA US Leveraged Loan Index default rate of 0.83% in October is up from ultralow levels of less than 0.3% over much of the trailing 12 months, but it is still a low level. The percentage of distressed priced loans (priced below 80), however, has risen to 7% as of October, up from an average of about 3% in Q2 2022.

We continue to see favorable revenue and EBITDA growth across most of our portfolio with a net loss rate of nearly zero YTD as of September 2022. Performance for many industries continues to be favorable, particularly for nondiscretionary and highly defensible industries, such as nonelective healthcare platforms, insurance, business services, and mission-critical software and technologies, which represent our leading areas of exposure. We continue to monitor our portfolio for the impact of key headwinds, including cost inflation/supply chain issues, rising interest rates, and recessionary pressures, and are keeping a close eye on areas of lesser exposure that are more dependent on cyclical end markets and discretionary spending. We remain focused on prudent deployment, selectively investing into noncyclical transactions and relying on our incumbent deal flow where we have conviction and know the credits well.

**What is your current outlook for 2023, and has it changed following recent economic news?**

On the economic front, we still believe a mild recession in 2023 is probably the most likely scenario but a soft landing is still a possibility. Of course, no one has a crystal ball, and a hard landing is also a distinct prospect. For a lender and risk manager, hope is not a strategy, and it is important to stress-test your portfolio and be prepared for any scenario.

On the positive side, as of this writing in mid-November, the Federal Reserve Bank of Atlanta's GDPNow forecast for Q4 2022 is near 4%. This is sharply higher than the "blue chip" consensus forecast of about 0.4%, suggesting Q4 may bring another upside surprise for GDP growth heading into 2023. Also, the Services Purchasing Managers' Index (PMI)—though trending down—remained expansionary in October with the New Orders Index at 56.5%. The Institute for Supply Management's October report says, "The past relationship between the Services PMI and the overall economy indicates that the Services PMI for October (54.4%) corresponds to a 1.5% increase in real gross domestic product (GDP) on an annualized basis." This is an important indicator, as much of our portfolio tends to be services-oriented. (Note: This is in contrast to the Manufacturing PMI, where new orders have started to contract.)

On the deal activity front, US sponsored middle market M&A-related loan volume in Q3 2022 was down 20% YoY and down 10% YTD, reflecting the headwinds of economic uncertainty, an increased mismatch in buyer and seller pricing expectations, and a less favorable financing market. These factors may continue to constrain deal activity in the near term. However, we believe PE deal activity will see a resurgence once inflation is tamed given the levels of PE dry powder and lower, more attractive company valuations.

Finally, on the default front, clearly the outlook depends on whether a recession is in the cards and, if it is, how deep it might be. However, it is worth noting that first lien yields, which have averaged in the 6% to 7% range over most of the last decade, are now more than 10%. A roughly 4% pickup in yield seems highly likely to more than offset any default-related losses after recoveries in all but the most pessimistic of scenarios.