FRIDAY, JULY 28, 2023

Well, hello and welcome to the Dividend Cafe. I am recording back from the Newport Studio, better in New York all week. Flew back late last night, had a very adventurous morning, and we are now recording Dividend Cafe. There's, I'm actually recording a tiny bit before the market closes, but we're up today. It's been a wonderful earning season. You'll hear much more about all that, the update on inflation data, the update on the market and so forth in a very robust extended Monday DC Today, the Dividend Cafe. Today I want to talk about credit markets, and I always feel that when I talk about bonds, when I talk about debt, when I talk about the credit world, that people tune out a little bit relative to when I talk about the fun stuff, equity, stocks, dividends. I get it because I think stocks are much more fun than bonds.

I get it because stocks are a higher return asset class than bonds, and I get it because there's more upside with something like equities, a stock you could buy at 30 and hope it goes to some number that doesn't theoretically have a ceiling where bonds, you generally are buying at a number around a hundred, and you're hoping to get back a number at a hundred with a coupon, with a interest rate that is attached to that. Along the way, it's what we call par value. And that a hundred dollars par that is around usually what people pay for a bond and a hundred dollars par value, what it matures at similar to like a CD at a bank. Bonds work in the world of par value getting back a face value of a certain amount of debt, and there's something less exciting about that than there is this sort of infinite upside that the ownership of free enterprise involves.

So from an investor standpoint, I get it from a macroeconomic standpoint, I never really have, the bond world is significantly bigger than the stock world, and for that matter, the overall world of credit of extending capital that has to be paid back. So for one person, it's debt, for the other person, it's credit that is connected to how we finance wars, how we finance governments, how we finance city and local and state projects from bridges to dams, to tunnels to schools. Even in the corporate world in the actual for-profit world, the private sector, there is such a significant amount of debt issuance, startup businesses, loans, borrowing to build factories, borrowing for working capital, borrowing to build hotels and in warehouses and all apartment buildings, all of the aspects of commercial real estate that are such a significant aspect of our lives. So there is a sense in which the credit world is large and very important, and yet there's also a sense which the stock world's a little more exciting.

I get all of it, but the basic thing I want to talk about today is why credit is so important to what's going on right now. And there is a kind of fundamental or universal truth that I don't think it's explained very clearly. I don't think it gets talked about a lot. And this is kind of my passion with Dividend Cafe is to take things that I think are universally important and do my best to present them in a way that is understandable, digestible. I talk about credit as being both a chicken and an egg, a cause and an effect that it is reflecting economic reality and creating economic reality all at once. And so the way I kind of want to explain this today is what it means when we talk

about concerns with credit and how that could impact the economy, how it could impact our wellbeing as investors, how it could impact the overall health of an economy, jobs, wages, profits, all of those things.

And I think that the most obvious sense, particularly when we're talking about a period where interest rates have gone so dramatically high in such a dramatically quick period of time, is the cost of capital a higher cost to borrowing can lead to less borrowing, it can lead to less profitable projects. It can lead to more defaults when the cost of capital is overly burdensome. And so a higher cost of capital is the easiest to explain because it's just math. Whatever you could borrow at 2%, now you're borrowing at 7%. That's a big difference in the cost that is just simply going to service that debt. But that isn't the only thing people mean when they talk about worsening credit or upsetting or distressed credit conditions. It's not merely the cost to capital. The second is this notion of access to capital. When you talk about worsening credit conditions, access to capital can be limited.

And that's happening now in that there are less lenders available for certain commercial real estate projects, but it's tiddlywinks compared to something like 2008 where what we had what we call a credit freeze where literally credit markets just broke down, people put their pencils down, stopped lending, and I'm going to talk about that in a moment. What we mean by that, what the differences between that dramatic level of credit conditions kind of breaking versus credit

tightening where the access to capital gets diminished. Where right now you may not be able to get money easily from a bank, but get it from like if you're a commercial developer, but from a private fund, you may be able to get money if it's for an industrial project but not for a office project. Or you may be able to get it for multifamily but not for industrial. There's different situations out there and it all speaks to diminishing access to capital but not a freeze up.

The conditions around it are a great way where capital be constrained. It may be that in more widely accessible periods for capital, personal guarantees are not needed or covenants and conditions are quite liberal. And it may be that in a tighter period of capital access that all of a sudden they start asking for guarantees or putting more onerous conditions on borrowing besides merely the cost. Tighter credit means more onerous borrowing conditions. Frozen credit means good luck getting money, okay? And we'll talk about that in a moment. But then the third is when we talk about, oh, credit is getting difficult, we have a problem with credit first, higher cost of capital second, tough access to capital third is defaults in borrowing. And now we're not referring to what we were with number one and number two, which were tough conditions for getting new borrowing, but we're referring to tough conditions of borrowing that's already happened.

And of course the more defaults happening in terms of monies that have already been run out, the harder it will be to get new borrowings because lenders are less likely to lend money out or

more likely to tighten conditions for lending money out when they have past borrowings not paying them back. It's just very common sense domino effect. Okay, again, what causes some the cost cap go higher. When a lender feels that there is a concern about getting paid back, they have a higher risk premium. That's one great example. So if you have a slowing economy, then you get a lender that wants to charge higher cost to lend money out, but if they have a higher cost to lend money out, you're going to have a higher default rate. If you have a higher default rate, you're going to have less access to credit.

If you have less access to credit, there's less productive projects going on. So in this sense, credit is all at once reflecting the tighter conditions, higher cost of capital, more limited access, and it's creating some of these conditions. And I hope this makes sense. I don't think it's overly complicated, but I want you to grasp the real potency of credit as both a signifier and a creator. Now, I do want to make this distinction just as I did by the way, in past discussions we've had about housing between a period of a housing collapse versus a period where housing slows or were prices correct, a bit more normalized period of distress versus something where it's really quite historically rare. Credit markets froze in 2008. What I mean by that is generally speaking, the default reality is that there is a lender and a borrower in the economy and at the right price a deal gets done.

And the reason for that is just simple self-interest and human rationality that if I'm a lender, there is a price at which it makes me money to lend money to you. And if you're a borrower, there's a price at which it makes you money to borrow money from me. And finding that money, that point, that clearing price, those clearing conditions that enable a transaction to happen that can move. But there is a level, and during a period of 2008, there wasn't really a level for good projects and obviously bad projects, low cost of capital, obviously not going to happen, even high cost of capital, very difficult to happen. You could say, well, yeah, residential housing was blown up, but maybe for another kind of asset. But anything that required borrowed money for the most part froze because there was a total breakdown in systemic confidence of being able to get paid back and that institutions couldn't trust each other.

This has to do with the complexity and the interconnectedness of markets. A lot of lending institutions hedge their risk by doing swaps and derivatives, which are a ways to kind of protect some portion of their risk. And there's a counterparty in that. And with all of a sudden, you don't know if your counterparty is going to be solvent. You may have more risk than you think you did because you think you hedge some of it, but your hedge partner may not be able to pay you. But then if you have more risk than you thought you did, that means you become a bad counterparty to someone who's relying on you for their swaps of derivatives and hedging and ability to pay back. And when all of a sudden all these financial institutions can't trust one another, they have to put pencils down and

cannot lend out good or bad projects until things kind of normalize reify.

That was the sort of post-crisis period is how did they reflate credit conditions? And effectively that happened. And one of the innovations that came out of it was I think very positive. There's a whole lot of negatives I think came out of it, including distorting markets with a ridiculously low cost of capital for many years. But one of the things was a kind of new industry almost, or certainly a boost to an industry of non-bank lending. And I've written a whole different cafe about this about maybe three or four months ago now with non-bank lenders private credit that really took off post-crisis where there's a lot more entrepreneurial dynamics and corporate savvy than just happens from traditional or commercial bank lending. But back to kind of where I want to make our point right now about the conditions we're in. Now, the question before us is not if we're in a full blown credit crisis, just certainly not, it's no one believes credit markets are frozen.

And again, you could say a pocket or a sector or a particular category, a lender has kind of taken themselves out. Regional banks lending to a new industrial project is an example. There's definitely tightening of credit by way of access. There's definitely tightening of credit by way of a higher cost of capital. But in terms of the overall state of credit markets, we first of all could look to the bond market. Now, again, these are bigger borrowers. They're often publicly traded companies. They could be low credit rating or high credit rating, but they're large

enough to be borrowing in a securitized vehicle known as a bond, and defaults remain incredibly low. And there's a chart at the dividendcafe.com reflecting that both for high yield junkier bond credits and investment grade, higher quality defaults remain very, very low. They've ticked up though they're, they've ticked up from where they were, but they remain very, very low. Now you could say, okay, well wait a second. Cost of credits and gone up or interest rates to skyrocket up for 18 months. There's all this talk of recession, corporate profits have a decelerate. Isn't there a sense in which you know would expect some higher bond defaults, but maybe just the reason is that many companies were smart enough at the lowest cost of capital in world history out of 2020 into 2021 to refinance debt, to borrow down what they expected to meet liquidity needs for a few years out. And that there isn't a huge need to tap the bond market and that there aren't a lot of bonds maturing with extensions and refinancings that took place. This appears to me to be a story clear as could be in the bond market. But I also want to point out in a moment throughout most of credit markets, and I'll get there in a second, what about defaults in the levered loan market?

Bank loans, they're the senior debt instrument. In the capital structure, they have to be paid back first, but they float. The rates float. See, for a bond you can lock in a rate. So even if interest rates go higher, your bond is fixed at a coupon. But when you're borrowing from a bank, they protect their interest rate risk by making your cost to borrowing float as well. I'm not referring to residential mortgages right now where you have

fixed rate, but most corporate borrowings are first of all from smaller companies than tap the bond market and there's a higher credit risk, but then they face the real life pressure of A, seeing their cost of borrowing go higher as interest rates go higher. But B, have covenants they have to meet so that even if they aren't faithful to pay their payment, if their borrowing costs go up and their profits go down so that the ratio of debt to earnings might violate a covenant or a condition of the loan, the bank can call the loan.

And the analogy I use and Dividend Cafe this week is, imagine if you owned a home and you're making your payment, but you've lost your job and the bank says, we got to call the loan, we're going to take your house back. And you go, well, I'm making my payment. And they go, yeah, we think you gotten riskier than you were when we gave you the loan. We're taking it back. It would be unfathomable, first of all, that a bank would do that for a faithful payer, but it'd be unfathomable for the borrower to think that ever could happen. But that's how trillions of dollars of levered loans work in our marketplace. The senior secured loan world has covenants that even for performing loans can result in the loan being in a default. We really don't see defaults even back up to average levels yet. Now, again, they have ticked higher and there's a chart to this effect in Dividend Cafe, but they've ticked higher, it's still a very benign rate and it's still below average. And even if it were average, we wouldn't call it a problem because that's what the word average means, okay? And it's still below average at that. And so you have this situation where I think the biggest

problem is not a default rate rage. It is that, and even when you look at low issuance, there's no question there's not a lot of new bonds being issued. There's not a lot of people tapping the levered loan market. A lot of levered loans are used to fund buyouts, to fund mergers and acquisitions. There's less of that corporate activity that's been going on that shows signs that maybe starting to pick up, so maybe the loans will follow, but I think it has to do with the fact that companies entered this tightening period with fairly healthy balance sheets, fairly healthy borrowing decisions made prior to the tightening period, and that the Fed has gotten a free ride in this tightening cycle with the fact that there weren't going to be a lot of loans maturing and there a lot of, there was already a reflation that had taken place P prior to the tightening cycle.

Consider this stat, 27 billion of levered loans mature into the first part of 2024, but it's 140 billion, okay? Five to six times more maturing the year after. So there's a lot of loans maturing in two to three years, but there's not a lot of loans Turing in the next two to three quarters, and I believe the Fed knows that, I believe I know that I believe now you know that I certainly believe the market knows that that's how you get a tightening cycle talk of recession, slowing economic conditions in a lot of categories, and a loan market up 6.5% year to date, closer to 7% right? Now you have that because many just simply say, look, there hasn't been the default levels and distress conditions that you would normally have from this kind of radical fed tightening. So in conclusion, I don't think all things are rosy.

I think some metrics have moved a bit tighter, but overall, the cost of borrowing is not normally high unless you're comparing it to zero interest rate, period. This is true in high yield. This is true in investment grade, high quality corporate bonds. It's true in levered loans. The spreads have not widened dramatically. The defaults are actually quite low. All of these things can change, and perhaps the Fed keeps going until they make one of these things change. Or perhaps the Fed is known that they could tighten in a period where there wasn't a lot of liquidity credit need, that there wasn't going to be a lot of maturing debt bonds that had to be, or debt loans that had to be rolled over, and that they intend to see things much more normalized before that part of the cycle resurfaces. I think it's a very, very useful working theory, not provable beyond a shadow of a doubt, but certainly credible, and I believe that those who pay attention to the credit markets up and down the debt totem pole, meaning from securitized loans around real estate, your loans that back mergers and acquisitions, your loans that are securitized as a collection of loans in commercial real estate, residential real estate, small business loans, there's all these different categories of credit.

I think paying attention to that stuff, even for one, not invested in it, will give 'em a better understanding of the economy and a better understanding of the stock market. And of course, there are really great investment opportunities themselves within credit. So we view credit as an educational tool to the entire thing we're doing when we asset to allocate a client and we

view it as a tool we may very well use when we're asset allocating a client. This is the world we're living in now. There's more weeds I could get into on this. There were a hundred other pages of charts and material I thought about including and I thought better of it. So maybe in a few weeks we'll have another kind of revisit of this issue. I'm going to leave it there for now. I don't want to overload you. I do hope this was a good high level summary of a topic that's near and dear to my heart. I welcome your questions on it, and I will continue to do my part to manage, oversee, and understand credit conditions because I want to do my part to manage all the things that matter in our economy. To that end, we work at the Bahnsen Group. Thanks for watching. Thanks for listening. Thanks for reading the Dividend Cafe.

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