FRIDAY, AUGUST 4, 2023

Well, hello and welcome to this week's Dividend Cafe. I'm filming out in the library at my desert house. I ended up coming out here. I actually wrote the Dividend Cafe from Newport this morning, and now I'm recording from the desert. And I like the fact that there's been a couple hours in between because there's stuff that I wrote very early this morning that has kind of marinated over the last couple hours. And I'm hopeful that you listening to the podcast or watching the video will get some more of that information. This topic is so important to me and I can't really explain why. I don't really particularly invest all that heavy in the credit asset class. We're definitely invested there, but it's by no means a core and foundational position around creating life outcomes the way dividend growth equity would be.

Nevertheless, I think that credit is so important in terms of its macroeconomic, signifying effects. And of course there really are tremendous investment opportunities. And particularly by the way, on the alternative side, when you look at our magnify platform of how we think about investing client capital, the alternatives asset class is much, much larger than what we have invested in straight, long only credit. And in that alternatives bucket, there is a lot that would be considered credit oriented from direct lending to structured credit to various elements of securitized lending to a course private market investing. And so there is plenty of investment allocation and credit within The Bahnsen Group, but yet it isn't. That is driving this two part series of Dividend Cafe. The reason why I'm doing a extra credit Dividend Cafe today is because I don't think that the current moment and the significance that credit has to the economic point of the cycle that we're in it has was fully captured last week.

And so let me kind of pick up where we left off The issue that I talked about last week that defaults have been pretty low in the bond market, both investment grade and high yield. They're higher, but I mean much, much lower than recessionary levels that spreads have been reasonably contained. They're higher, but much, much lower than recessionary levels. Those things are good enough, but it was the issuance point I was making that you haven't seen a lot of new issuance in levered loans. You haven't seen a lot of new issuance in bonds for that matter. And that my point was very likely there were a lot of borrowers who weren't going to borrow at these new higher rate levels and didn't need to because they had extended their maturities. They had locked in better terms, lower borrowing cost at the zero rate environment in 2020, 2021.

And I stand by that theory and I think it makes a lot of sense, and I stand by the theory that the Fed is well aware of this and taking advantage of a free ride on this side of a maturity wall to try to tighten credit. But I would like to add to that, and there are two charts in Dividend Cafe today that you really ought to look at to make this point. It's not merely a bond market loan market that you see this drop in issuance, but in structured credit, by which I mean residential backed mortgages, not Fannie Freddie, but what we would call non-agency RMBS, residential mortgage-backed securities and the CMBS market commercial mortgage-backed securities. You see a significant drop in new issuance, not a big surprise, a lot less housing activity going on, a lot less credit instruments being packaged and sold off to investors because there's less volume activity.

And then the asset backed market, which is again, securitized, pooled streams of borrowing, but it could be connected to credit card auto loans, student loans, all sorts of different asset-backed instruments. And you see a really significant drop in all of these different elements of loans asset-backed CMBS, RMBS. And yet the second chart shows a really big pickup in in TBill issuance and the percentage of total credit, total debt instruments of our borrowing across the investment universe in treasuries. And there isn't a way to prove that this correlation is causation, but I think it is an incredibly likely byproduct of the credit environment that a lot of the borrowing has moved from the more productive private sector to the less productive governmental sector. And funding government deficits because you're getting a higher yield to do so, is a different, is going to produce a different economic outcome than credit being invested towards some productive economic aim, something that is wealth creating.

And therefore it puts downward pressure on growth expectations in the economy. So if one believes that we just are dealing with a lower issuance of credit because we are right now focusing on higher quality, in theory, that could be a good thing. Like abundance of loan issuance in residential mortgages did not exactly prove to be a good thing in 2004,

2005, 2006, sending out money to bad borrowers is not what I look at as a great indicator of economic health, but I do not believe that we see a contraction in productive credit issuance because we are rechanneling from bad borrowers to good borrowers. I believe money has largely been diverted out of the productive economy into the governmental sector. Now, when we look at the default rates, the yield spreads, all of these different components as to what is kind of happening in credit. It doesn't draw a picture of horrible things happening.
But that default wall, the maturity wall that I think is a default reckoning if credit was still this tight with the amount of loans that will mature in a year and a half, definitely two years, definitely three years. So you're kind of looking out into, let's call it 2025, '26. If credit was still that this tight then oh, it would be, I can't imagine someone reasonable drawing a different conclusion, then it would be a blood bath with rates this much higher, that much money, the pressure put on ebitda. I think there'd be a lot of challenges. But of course there's another possible ending here, which is that credit isn't this tight in a couple years. And so you have to kind of look at this whole global picture that meaning the universal dynamics and determine where these things could go. One of the things I want to do with our time here today is parse out the categories. I'm doing a Dividend Cafe on credit. Last week I largely talked about credit as the bond market, and within the bond market you had high quality bonds and then you had higher yield bonds that are lower quality credit quality, and then the levered loan market bank loans. But there are different terms that get used that I think some Dividend Cafe listeners, viewers, and

readers may be interested in. So I'm going to do that very quickly. And then I want to just summarize the whole two weeks of credit talk with a few quick takeaways that will either be useful or not, but I hope they will be for your sake. So bonds, loans, structured credit, direct lending, and private credit. These are five different terms, and I want to make sure we understand the distinction because they're all kind of in a similar vein. They're debt instruments, they're things that are lent out that have a maturity date.

And the profit is to come from a coupon that is being paid interest rate that's being paid on that loan. And yet there are different sort of definitions and particulars that would apply to each, okay, within the credit universe. So bonds the easiest because I think most people understand that they are a security. They're regulated as a security, they generally trade in a marketplace. Investors can buy and sell bonds from one another. Some bonds have more liquidity than others. Treasury bonds are the most liquid instrument on earth. A certain real high yield unrated muni bond on an obscure bridge or private school in Montana might not be very liquid at all. But nevertheless, bonds are securitized. They have ability to create a secondary market. They have a coupon, a debt instrument, and then there's different credit ratings. There's different tax treatment, municipal versus taxable, and they, of course, there's different issuers.

So the bond market could have companies, it could have governments, it could have municipalities. And then there's good rated bonds that we call investment grade and low rated bonds we call high yield. It's a nutshell of the bond market that's been around forever, easy breezy. But then when you talk about the loan market, a bond is a loan, but it's a secure, it's a loan that is backed by the issuer. A loan may not have any asset backing yet. It may, it's just really based on the issuer's credit worthiness, but it's senior, it's issued by a bank. The banks these days often syndicate the loans together, securitize them and sell 'em off to what's called a CLO, A package of the loans. And you're just drawing all these cash flows. And they generally are floating rate. A bond is a fixed rate, and these loans have floating rates. That's a good thing for investors. When rates go higher, it's a bad thing for borrowers. So kind of a depends on what hat you're wearing, how you feel about it. But the loans to banks will have to get paid before even bonds and let alone different instruments down the capital structure.

You look at structured credit as different than the bank loans because bank loans might be backed by a particular issuer but not necessarily with an asset. They may not have a building where a structured credit is going to be backed by an asset. Like residential mortgages is backed by the underlying houses, commercial mortgages backed by the office building or warehouse or self-storage units or what have you involved in that commercial real estate asset. And I mentioned earlier the asset backed where they've kind of securitized around a pool of things that might be backed by aviation actual aircraft or different pools of loans. That's what we call structured credit.

And it's structured around different tranches of risk and reward. And I don't want to get overly complicated, but that's different than lending against cash flows. Now, direct lending is lending against cash flows, but it's a non-bank lender.

And so why would someone go to a non-bank lender for direct lending versus the loan market? Generally they're both going to be floating rate, but the private lender might have less covenants, might have less onerous conditions to underwrite, might be able to go quicker and so forth and so on. There's a number of different factors that could make sense within the direct lending space. But the point is generally there they are lending against cash flows, not again, and they're usually senior secured, but they're not lending against necessarily an underlying asset. And then private credit is a kind of term that gets used a lot. And I would distinguish this between direct lending and private credit is first of all the size. Usually when we talk about the non-bank lenders in direct lending, they're much smaller cashflow. They're lending against cash flows, private credit. They're also probably lending against cash flows, but it's usually larger.

But also they're lending oftentimes on LBOs leverage buyouts. They're providing the debt against which equity position is taken in the purchase of a company or a partial purchase of a company. And this is a very heavy part of economic activity. And private credit has grown exponentially as a mechanism by which a lot of M&A lot of LBOs get funded. They've taken a lot of market share away from the bond market, high yield bonds.

They've taken a lot of market share away from banks and the syndicated loan market. And why would someone perhaps want to go into the private credit world? I think that it's because sometimes they're going to pay more in private credit, yet be able to execute quicker, execute with more privacy. The whole world doesn't necessarily have to see it the way in the bond market. You're going to have more transparency and there's a greater assurance of execution you're going to transact.

And then also, very candidly, there's oftentimes more intangible things just value added. There's intellectual capital from these private lenders, the private credit world that it is could be strategically beneficial for the companies. These private lenders are in the business of doing debt and equity across the landscape of global economic activity, whereas a bank is generally very bureaucratic and much less capable of adding value to the enterprise. The other issue I would say is that when things go bad, generally the bond market just has trust documents and specific legal paperwork for how that's going to go. And the banks have very, very little flexibility even from a regulatory standpoint, whereas private lenders have entrepreneurial freedom to work with someone on a workout. And so there's just more creativity that could come into that process. So private credit is exploded, direct lending's exploded. Structured credit is more asset backed.

You have the bank loan market, and then you have the bond market. And these are all different elements of credit they have to do with how debt gets issued to fund some economic activity. So with that kind of overview, my takeaways of these last two weeks, I'm going to do this kind of quickly and I got to make this a little larger for me to see it. They're all listed at dividendcafe.com, but there's eight takeaways. I know it seems like a lot, but I'm going to do 'em quickly. Just kind of summary statements. First and foremost, credit is tightening right now. Credit is tightening, but just simply not at a point where we're seeing real high defaults or overly restrictive access or overly expensive cost of capital that could get to that point of real economic attraction. Not yet credit's tightening, but it is not become this shutdown of credit.

But number two, there is a maturity wall in about two to three years where a lot more new credit will be needed from just different maturities of current loans and bonds. And if credit remains as tight as it is now, you would have a significant avalanche of defaults and problems. Number three, those problems in number two would not merely be for the borrowers and for the lenders because have a ton of defaults, but also for the economy at large. If that were to happen, it would have a big impact on jobs, wages, profits, and overall and counterparty activity. It would lead to an impact to those on the other side of different transactions, vendors, suppliers, things like that. Number four, I find it unlikely that credit will be allowed to stay tight through that election year of next year and through the maturity wall that lives on the other side of the election year.

That's not to say it can't or it won't. It's not even to say it shouldn't, although I do think it shouldn't, but I find it unlikely. Number five, demand for corporate loans, for bank loans for other credit activity is dropping quickly. Right now, we see a significant drawdown in the level of issuance. So defaults and distress may be low, but new issuance is way down. Number six, private credit. That kind of last category, the five silos I went through has been the big winner for some time. I believe it will continue to be from out of bank failures, out of just the avalanche of change post Dodd-Frank, post GFC, the capacity of some of the large private equity sponsors to arm themselves of credit capabilities. I think we're living in very different world in non-bank lending and private credit's been the big winner.

We'll continue gaining market share from both the bond market and the loan market. Number seven, from an investment standpoint, what we do professionally and what those of you listening want to understand, not just for economic relevance but for portfolio relevance. I really think all of the above kind of approach is the best thing to think about in terms of the menu of what might go into one's portfolio, that there could be tactical opportunities and loans and you could have structured credit that becomes less attractive and vice versa at different points the way yield spreads move, the way defaults move and so forth. There is a really big benefit to us constantly vetting right managers in each of these asset classes because it is not a sort of pick one versus the other and stick there. You want to have all on your menu for a variety of

reasons in terms of optimizing the portfolio risk and reward and capturing opportunities as they become available.
And then finally, number eight, declining credit conditions are here. We already know that. But what is not known is how much they decline from here. A few notches lower into 2024, and a soft landing will not happen. If credit worsens much, you will end up getting a harder landing recession. And if credit has already sort of bottomed and there's a kind of pickup in credit conditions, credit quality, a tightening of credit spreads, then that stabilization recovery in credit almost certainly means you will not see a recession at all, let alone a soft landing from one. So I'm not here to make a prediction of what will happen to credit. I'm merely telling you that credit goes, I think the economy will go, and that there is right now this sort of middle ground of weakening credit conditions that are not horrid, that could become horrid or they could become stronger.

And if you find that unhelpful, I don't blame you, but that is the way of the land and it's not really understood the way I think it ought to be by many who are talking about the recession. They could just continue to obsess with the jobs number when in reality the jobs number is sort of a byproduct of the fact that credit's hanging in there and that if you have a wave of defaults, that job number's going to change very quickly. So if we're trying to get to cause and effect chicken and egg, all these cliches, just trust me, credit is a really good place to start in the kind of domino of how things will go as opposed to trying to pick it up in the middle of the chain and guess where things are going. So that's my take on the economy as seen through the lens of credit.

I appreciate you bearing with me these two weeks. I hope it's been informative. I love your feedback on it. If there's still questions, if you found it to be totally boring and dry, then go ahead and just delete those emails. But if you did think there's something beneficial here and you want to unpack more, I'm very happy to answer questions. And with that said, I do hope you'll have a wonderful weekend. I'll be, if I'm back to New York City on Sunday, I'll be there all next week and I will next week be doing a Dividend Cafe that is, let's just say at the heart of what we do at the Bahnsen Group. Thanks for listening. Thanks for watching. And thanks for reading the Dividend Cafe.

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