The Evolving Loan Market – Key Takeaways from ELFA and S&P Global Market Intelligence Event

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Executive Summary

- ELFA and S&P Global Market Intelligence co-hosted an ELFA Seminar Series event "The Evolving Loan Market" covering the economic outlook for EMEA, and a panel discussion on the evolving loan market, featuring discussions on technology, private credit and more.
- During the market update, we learned that a soft landing is the most likely economic outlook scenario for the larger economies provided the labour market remains resilient and there are no further shocks. Stagflation in Europe is likely to continue over the next two quarters after which the benefits of monetary policy should become evident. However, the outlook is dependent on central banks' actions in terms of interest rates and there being no market shocks.
- Participants agreed that private credit and broadly syndicated loans can work together and co-exist.
- Panellists asserted that the adoption of technology is paramount to increasing efficiency and consistency in the market.
- Overall, participants are optimistic about 2024, but agree that it is difficult to project beyond next year.

EMEA Economic Outlook – Soft landing for the larger economies is the baseline scenario

Sylvain Broyer, Chief EMEA Economist, S&P Global Ratings, explained that there is broad consensus on a soft landing prediction amid high interest rates. The main argument for a soft landing is that it is expected that inflation will ease and price stability will be achieved everywhere in the developed world by mid-2025. Consumer spending should benefit from rising wages and disinflation. Public investment is also increasing. It is expected that central banks will not start cutting rates before mid-late next year. Interest rates will turn positive in real terms. Post-pandemic tailwinds (labour, manufacturing, production) are fading.

It is therefore unlikely that there will be any growth in the larger economies before the second half of next year. Europe, UK and the US are on similar trajectories, but monetary policy tightening works better in Europe. The UK, the US and China are slowing but later than European economies. The medium term is brighter than the short term.

The following economic drivers were identified for the soft landing baseline scenario.

Drivers

The resilience of the labour market: The labour market is tight and wage growth is flattening. Wage growth was 7 per cent in the UK and 4 per cent in the EU. Therefore, real disposable incomes are starting to increase, and this should continue normally in the midterm if there is no further tightening of monetary policy. This is also assuming that the labour market does not collapse, which is the main risk for 2024. The number of job openings is receding. However, there remains a historic situation in the labour market with the level of unemployment at a multi-decade low while the number of job openings is still at multi-decade high.

Inflation: The main drivers of inflation are energy and food. Core inflation looks to have peaked. It peaked later in the UK because of the tighter labour market. The 2 per cent inflation target is viable and is unlikely to be achievable before mid-2025 provided there are no further crises and monetary policy works as expected.

The supply side: The production cycle is turning. Energy intensive production has not yet returned to Europe. EU (European Union) production has peaked. Inventories have normalised post-pandemic. The order backlog is shrinking, especially in Germany. While commodity prices have retracted from record levels, they remain high. The energy intensive sectors are still suffering from the energy price shock and have lost 15 per cent production since the war [in Ukraine]. So far, there is no reason for production to return to Europe having gone offshore. The energy price shock is turning into a structural issue for Europe.

The demand side: Rising interest rates are considerably dampening house prices. Housing prices are correcting themselves, coming from a high level. This is happening quite rapidly in some countries such as Sweden and Germany, where the share of variable rate mortgages was higher than in the past so markets have proved less resilient to higher interest rates. The Spanish housing market has been more resilient. There is also a growing preference for saving rather than spending and there has been an almost unprecedented shift from ordinary deposits to term deposits. The credit impulse has been negative in Europe. Disinflation is easing income constraints and purchasing power is stabilising. Tourism is on track for the first normal season in four years, which will translate to 0.3 per cent in GDP growth. Consumer confidence is recovering from record lows.

Public policy: Public policy will support demand at a time when monetary policy restrains it. There is a lot of money available in Europe, €500 billion, as NextGenerationEU slowly takes off. Public investment is on the rise for the first time in a decade. Transport and utilities make up the bulk of public investment.

Central banks: Interest rates may have peaked. It is not expected that the ECB will start cutting rates until mid next year. The ECB will also have to decide on the strength and the speed of the reduction in bank reserves. Since the global financial crisis, the ECB has been providing liquidity to banks in an unlimited way which has created abnormally high levels of reserves by banks at the ECB. The optimal level would be about half of what it currently is, and they will move towards this by the end of 2025. There are a number of options open to the ECB to normalise its balance sheet.

An Evolving Loan Market: Technology, Private Credit & Beyond – Panel discussion

During the panel discussion, Ali Allahbachani, Managing Director, Portfolio Manager, European Leveraged Credit, KKR Credit, Simon Bradford, Director, Head of High Yield Loan Closing, Barings, Sabrina Fox, Chief Executive Officer, ELFA and James Irwin, Executive Director, Loan Platforms, S&P Global Market Intelligence discussed market trends, challenges facing investors, technological adoption and advancements, operational challenges and solutions, and the outlook for the next three to five years. The discussion was moderated by Oliver Maxwell, Executive Director, S&P Global Market Intelligence.

Market trends & challenges facing investors

Volume and liquidity are coming to the market. Covid has had a significant impact on the market in terms of volatility. The primary market is no longer at 2019 high levels. There have been fluctuations in global issuance in the primary market, with 2023 volumes likely to fall just short of 2022. 2020/2021 were strong years for new primary issuance. There was a huge increase in deal issuance in 2021 due to significant refinancings. Amidst this backdrop, the use of trading platforms has increased.

There has been a similar trend regarding volume increases in the secondary market, which have been more impactful on the EU side where there is more of a liquid market than seen previously. The trend is the same in the US, which is ten times the size of the EU market.

Settlement times have fallen significantly from pandemic highs but remain lengthy. Average settlement times in Europe are much longer than in US. During Covid, there was significant disruption and a lag in settlement due to higher volumes and backlog – average settlement time increased from 45 to 64 days. It is now coming down to 47.7 days. Trade entry and allocation times have fallen significantly due to automation.

There is a large disparity between the best and worst settlement times on the buyside, sellside and with agents. Banks used to be under-resourced to deal with increased volumes but are better resourced now. KYC appears to be less of an issue in the market in relation to settlement delays, with institutions finding in house or external utilities to handle volume increases.

Private credit compared to broadly syndicated loans

The price point for private credit has been relatively stable, and private credit offers certainty of execution compared with the broadly syndicated market. It is a growing market that is predicted to double in size to over $2 trillion by 2027.

There seems to be a false narrative that private credit is taking over in the European leveraged finance market, as it is still a much smaller market than broadly syndicated loans. Private credit and broadly syndicated loans can work together and co-exist. Institutional investors and banks are partnering on deals.

M&A is down significantly as the last 18 months has been volatile and underwriting activity has been stop-start. M&A activity needs to increase to fuel deal flow, but it is unlikely that this will get to 2021 levels as early as 2024. Regardless, both markets are needed. The market should see greater avticity and deal flow next year.

Private credit buys to hold but there will be a natural evolution for secondary private market credit. It may not happen now, and the drivers are a grey area. As private credit gets bigger, it will want to move risk. The biggest issue is the cost of doing this.

Tech adoption & advancements

Technology adoptions have played a significant role in the market. It has taken some time to get here. Tools and platforms have become the norm. If all the market is using technology, it will make a significant difference. We are not seeing real time exchange and more technology needs to be used to facilitate speed to the market.

S&P Global has been driving technology adoption. S&P Global's Loan Platforms solutions provide a complete technology process across the lifecycle of a loan. The Loan Platforms suite, which includes tools for secure settlement instructions, trade settlement and custodian services, is making a difference. S&P Global is focusing on consistency in conjunction with the right use of technology in the market as this will improve operational efficiency and liquidity. More information on these solutions is available at https://www.spglobal.com/marketintelligence/en/campaigns/lending-solutions.

Barriers to technology adoption include consistency of use across the market and structural barriers. Standardisation would be beneficial to the market. In this wise, transactions need to become more bond-like. There is a misconception that the technology for the loan market does not exist and there is still a reliance on manual processes and communications in some parts of the market, for example, in direct lending. This may be because direct lending deals are more bespoke. Electronic communications will be a game changer, but all parts of the market will need to be on board. Although such communication issues are not an issue in the high yield market. Changing mindsets to appreciate the enhancement technology adoption can make to loan processes and decision making has been a challenge to technology adoption.

ELFA's role is to support members by providing best practice guides on behaviours that allow transactions to take place seamlessly, and to assist members with understanding the evolution and adoption of technology. While Covid helped with the adoption of technology as it increased the dependency on technology, there is more that needs to be done. To this end, ELFA has been thinking about AI and is creating an AI Committee to look further into how AI and technology can effectively support members in their decision making and transaction settlement. Technology will not replace members' staff roles but will add value to what members' staff do.

Operations challenges & solutions

Settlement times is an operational focus in the loan market. The Loan Market Association is working on settlement delays. Generally speaking, things are moving in the right direction regarding settlement and there should be a cautious approach regarding naming names.

Technology is key to driving down settlement time. For example, auto-allocation tools can be used for allocating a trade across multiple funds within an asset manager. Also, real time data is key as it helps automation flow seamlessly and helps analyse performance. Technology cannot add value without the data. Technology also offers risk reduction benefits, increased security and accuracy.

There is a feeling that the technology is evolving and is there, but the markets are not evolving with it. There is a reticence amongst market participants to change ways of working. Commercial drivers are also slowing adoption.

Best practices should focus on efficiency, transparency, and engagement. The focus should be on how behaviours can be changed to see technology as a process enhancer rather than a process inhibitor.

Next 3-5 year outlook

Panellists were optimistic for 2024 but agree that thinking beyond 2024 is difficult. There is the need to stay on top of trends and keep people talking.

Looking ahead to 2024 and beyond, the market will present both challenges and opportunities. While there will be a pickup in activity and more transactions than in 2023, the pace of market activity is not expected to surge to the extent seen in prior years. Additionally, market transparency is expected to continue to increase, particularly due to the increase in innovation from data providers.

Consistency will improve the market, and the existing platforms will have taken their offerings to another level. There will be real time data for real time decisions.

Regulators are looking at the loan market, and ESG has changed everything as a regulated activity.

Conclusion

The loan market continues to evolve. The market is picking up and there is space for both private credit and broadly syndicated loans in the market. Operational inefficiencies exist in the market and the adoption of technology solutions will go a long way in resolving many, if not all, of these inefficiencies. Consistency and standardisation are key to eliminating market inefficiencies.

About ELFA:
ELFA is a professional trade association comprised of European leveraged finance investors from over 60 institutional fixed income managers, including investment advisors, insurance companies, and pension funds. ELFA seeks to support the growth and resilience of the leveraged finance market while acting as the voice of its investor community by promoting transparency and facilitating engagement among European leveraged finance market participants. For more information please visit ELFA's website: www.elfainvestors.com.

About S&P Global Market Intelligence:
S&P Global Market Intelligence is a division of S&P Global (NYSE: SPGI). S&P Global is the world's foremost provider of credit ratings, benchmarks, analytics and workflow solutions in the global capital, commodity and automotive markets. With every one of our offerings, we help many of the world's leading organizations navigate the economic landscape so they can plan for tomorrow, today. For more information, visit www.spglobal.com/marketintelligence.

European Leveraged Finance Association
35 Ballards Lane, London N3 1XW
T +44 (0)7921 384457
E support@elfainvestors.com

European Leveraged Finance Association