by Sergio Grasso

After summer: still warm, or getting a cold shower?

Investors came back to their desks and credit committees after the summer break to find a credit market that has turned marginally wider, with interest rates remaining elevated ahead of the Fed's upcoming decision (and the Treasury buyback "event study") and a complex geopolitical backdrop putting renewed pressure on commodity prices. Taken together, these factors could provide the catalyst for the next bout of volatility across credit markets.

I wrote "volatility" rather than a "systemic credit event".

The widening in hyperscaler credits has already become largely accepted- and digested- by the market. At this stage, however, those issuers appear relatively insensitive to funding costs, and this does not seem to be constraining their appetite for primary issuance. The situation is different for high-yield borrowers, where the cost of debt is much more relevant and where investors are increasingly differentiating-but not enough in my opinion-between sectors and individual credit profiles.

In September we have already seen HY European issuers offer yield concessions and pay a premium relative to their existing credit curves to ensure smooth execution for their bonds in primary market. I expected the move in rates to spill over into credit as well. It happened. The key question now is whether this trend will also be reflected in the leveraged loan market. Much will depend on the CLO machine: the availability of new paper to support additional issuance of new CLOs and the scarcity of suitable collateral to replace troubled and non-performing assets within existing portfolios. Taking those assumptions into account, a more disciplined approach from CLO and loan portfolio managers would arguably be to demand an additional 25–35 bps of margin on new loan financings. The market should soon provide an important test of this thesis. The recent leverage loan of French nursing-home operator Domidep, which priced aggressively and inside initial price thoughts, could prove instructive. Was it simply another example of the continuing compression in spread margins and risk premia, or an exception justified by the borrower's relatively strong credit characteristics?

The answer matters because the broader market environment arguably warrants greater compensation for credit risk. Higher nominal interest rates are increasingly being viewed not as an anomaly, but as a return towards more historically normal market conditions—particularly compared with the unusually low-rate environment that prevailed following the Global Financial Crisis; this was the opinion expressed by WSJ in the summer. I share this view. If this "normalization" is taking place in interest rates, a similar adjustment should eventually occur in credit: investors should demand a more appropriate risk premium for leverage, refinancing risk and weaker corporate names with poor fundamentals. In my perspective, the focus should therefore move away from the market's capacity to absorb liquidity and money supply (the central message from the recent London credit conferences), and towards the underlying ability of borrowers to service and refinance their debt. This, ultimately, is what credit investing is all about.

The risk landscape has become significantly more complex. Higher-for-longer interest rates, persistent inflation risks, geopolitical uncertainty and commodity-price volatility are interacting with structural problems of weak cyclical sectors and the new challenges such as the potential disruption or replacement of certain business models by AI. Ultimately in the credit space, the critical issue is not simply the absolute level of rates, but whether corporate capital structures remain sustainable with lower EV/Ebitda multiples in a more demanding financing environment. Companies carrying excessive leverage may find it increasingly difficult to service their debt, refinance or roll existing liabilities, or preserve sufficient financial flexibility to pursue value-creating M&A. Private equity sponsors, increasingly grappling with non-performing investments, may have limited capacity to provide further support to companies being squeezed by weaker operating KPIs and lower valuations. We are seeing this increasingly often across the market (I will return on this point in the future: are credit investors actually better positioned to manage a business once they get the keys?).

This is where credit selection and credit discipline should become increasingly important. In an environment of structurally higher rates (against expectations of the start of the year), restrictive monetary policies (without forward guidance but not anymore accommodative) and greater macroeconomic uncertainty (which is not an immaterial factor), credit investors should be increasingly reluctant to accept compressed and tight spreads simply because liquidity and inflows remain abundant—a point that has been central to my thesis for several years for explaining both the compression and its persistence. The next phase of the credit cycle may therefore be defined less by a dramatic increase in headline default rates and more by a fundamental reassessment of the risk premium required to invest in the credit world in a different economic and financing environment.

Importantly, the traditional default statistics may not fully capture this deterioration. Restructurings, liability management exercises and evolving rating-agency methodologies can all influence the timing and classification of defaults, potentially masking underlying credit stress. A more meaningful set of indicators may therefore be the persistent underperformance of long credit funds (even against benchmarks), the expansion of watch and monitoring credit lists, the increasing dispersion in numbers across CLO equity performances (I have written extensively about this, and I find it difficult to justify a situation in which more than 40% of the European vehicles are generating an IRR for the subordinated tranche below 9%), the accumulated unrealized mark-to-market losses on institutional investors' balance sheets, the increased percentage of PIK usage with borrowers with negative cash flows, and the growing tensions surrounding the NAV, the asset valuation and available liquidity of parts of the private credit market. These signals-I mentioned only a few- may provide a more timely indication that credit risk should be repriced, even if headline default rates remain relatively benign and distress ratios stay below their medium- to long-term historical averages.

Across the broader HY credit market, I see several credits that warrant consideration as "short opportunities", particularly where fundamentals are deteriorating, the forward outlook is challenging, and investor positioning has become increasingly concentrated in certain trades or credit ideas. The resilience of "financial engineering and accounting gimmickry" is ultimately finite. "They tell us that things are working well" at the micro level and that earnings are resilient, yet the European high-yield market has provided ample evidence to the contrary over the past two years. Ask distressed financial advisers and lawyers.