Sienna
PRIVATE CREDIT

Alternative assets set to out-perform as inflation, higher rates penalize traditional investments

Equities, long-term bonds suffer worst performance in over a decade, while private credit offers opportunity to ride out higher interest rates

Surging inflation and rising interest rates have turned the world of investing upside down, causing traditional assets to lose value while creating opportunities for some alternative investment classes to shine.

The easy money and low defaults environment that characterized much of the past decade produced almost mechanical gains for traditional stocks and bonds. The S&P 500 Index of leading U.S. stocks almost tripled between 2012 and the start of 2022, with European stock indexes trailing just behind. Even when Covid-related lockdowns shrank economies across the world, stock markets quickly recovered as central banks responded by churning out liquidity. Fixed-rate investment grade bonds returned 5.9% a year as interest rates fell.

Those gains – which many observers warned was a bubble – reversed abruptly in 2022 as rapid economic rebound after the pandemic overwhelmed supply chains and sent inflation to levels not seen some places for 40 years. Then Russia invaded Ukraine, adding further turmoil to energy and agriculture markets. Central Banks started jacking up interest rates. The S&P 500 is now 15% off its high while the tech-heavy Nasdaq Index retreated 30%. Both are on track for their worst years since the financial crisis. Fixed-rate government bonds have taken a beating from higher interest rates, with U.S. and Euro zone bonds down more than 10%[1] from the start of the year. Real estate is being whacked by higher interest rates and continued doubts about the future of hybrid work.

So, which assets are potential winners in this environment, besides the energy and mining companies profiting from booming commodity prices? Infrastructure is poised to benefit from increased spending on sustainable energy. Short-term investment-grade bonds are protected by their short maturity and liquidity. Finally, private credit, or direct lending, is well suited to today's monetary conditions.
Because direct loans are custom fit for borrowers, they tend to carry higher interest rates to begin with than corporate bonds. In addition, private credit investors should be well-positioned to impose floating interest rates, protecting them from rates rise.
With some degree of recession a likely possibility, default rates are bound to increase. Secured private credit is shielded because the most prudent private credit funds use highly covenanted[2] documentation and lend against collateral, whose face value could even rise due to inflation. Finally they are well positioned to negotiate bilaterally ESG clauses to keep a tight rein on the sustainability features of their assets.

Private credit's returns are already increasing thanks to rising interest rates.
The advantages of secured private credit will be even more pronounced should it turn out that policy makers and investors are under-estimating today's recessionary and inflationary risks.

Nicolas Fourt – Chief Risk and Sustainability Officer ; Hugo Thomas - Head of credit analysis. Paris, March 2023

Private debt and bond investments carry risks, such as risk of capital loss, credit risk, liquidity risk, counterparty risk, interest rate risk.
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[1] S&P Eurozone Sovereign bond Index
[2] Includes convenants in their credit documentations