Distressed Debt—Four Global Themes Beginning to Emerge

Key takeaways

» Over the next several years, we believe that significant segments of the global economy are susceptible to meaningful price dislocations, creating compelling opportunities for the distressed debt strategy (both in liquid hedge funds and in illiquid private debt funds).

» Globally, geopolitical tensions remain high, with most regions of the world affected to some degree. The potential for trade wars between the U.S. and its major trading partners and new conflicts in the Middle East represent heightened risks to the global economy.

What it may mean for investors

» For qualified investors, we favor private debt and distressed credit managers who have distinct competitive advantages, including extensive experience underwriting and scale to successfully capitalize on global distressed opportunities.

Potential market opportunities

With the U.S. economic recovery approaching its 10-year anniversary, many investors are concerned about the inevitable downturn and are interested in whether the downturn may present opportunities. The following are four key global themes that we believe may lead to opportunities for the distressed debt strategy to take advantage of meaningful price dislocations and outsized returns.

Global central bank tightening

Two key central banks, the U.S. Federal Reserve (Fed) and the European Central Bank, have embarked on tighter monetary policies, creating a widening divergence with other central banks. This monetary tightening (and any resulting increases in interest rates) opens the possibility of decelerating economic growth and intensifying pressure on the monetary systems of emerging economies where recovery has not been as robust. Recently, for example, the Indian rupee dropped to an all-time low versus the U.S. dollar. The Indonesian rupiah fell to its weakest level in over 20 years, and the Turkish lira plunged by more than 40% versus the U.S. dollar. The central banks of all three emerging economies have raised interest rates to defend their currencies, but in doing so, may have put the brakes on near-term economic growth prospects.
Elevated debt levels

Globally, economies have not exercised fiscal restraint during the decade since the global financial crisis. As a result of fiscal stimulus and similar measures, debt levels as a percentage of gross domestic product (GDP) are at or near record highs in many major economies and often surpass levels we saw prior to the 2008 financial crisis. Total debt (including household, government, and non-financial corporate) to GDP levels in several major economies—including the U.S., Canada, China, Australia, France, and Italy—generally have been trending higher or are at levels comparable to those prior to 2008.

Chart 1. North American total debt (as percentage of GDP) significantly higher than 2008

Sources: Federal Reserve Statistics Release, “Financial Accounts of the United States,” March 8, 2018 and Bank of Canada, Statistics Canada, Provincial Government Financial Reports (2005-2017). Generally, government debt as a percent of GDP is used by investors to measure a country’s ability to make future payments on its debt, which affects the country’s borrowing costs and government bond yields. A debt-to-GDP ratio of 1.0 (100%) means that a country’s debt is equal to its gross domestic product.

Chart 2. Europe total debt (as percentage of GDP) significantly higher than 2008

In particular, despite steady economic progress in recent years, the European Union (EU) has a total debt-to-GDP ratio of over 200%. Several economies—notably the U.K., France, Spain, Italy, and Ireland—have levels exceeding the average, leaving some households and corporations vulnerable to economic slowdown and potential future higher interest rates.

**Chart 3. European Union has a total debt-to-GDP ratio of over 200%**

Despite a firming economic recovery, the volume of NPLs remains elevated in many European economies, weighing on banking sector profitability and encouraging sales of residential mortgage as well as other loans. In 2017, approximately €24 billion\(^2\) in residential mortgage loans were sold, more than double the €11 billion\(^3\) in 2016, as government sponsored asset management agencies disposed of the mortgages as house prices improved, particularly in the U.K. and Ireland. Several economies—specifically Greece, Italy, Portugal, Ireland, Spain, and Poland—still have material NPL issues.

**Heightened geopolitical tensions**

Global geopolitical tensions are high, with most regions of the world affected; this presents risks to the global economy. Trade disputes between the U.S. and its major trading partners—including China, the EU, and Canada—show no signs of cooling off at the moment. The deteriorating relationship between the EU and Russia since the 2014 Ukraine crisis has resulted in sanctions that have hampered trade and reduced economic cooperation. And as of October 2018, there is still little clarity on the means by which the United Kingdom will leave the EU on March 29, 2019, as the possibility remains of a “no-deal Brexit” that may increase volatility and reduce trade.

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\(^1\) A loan is considered non-performing when more than 90 days have passed without the borrower paying the agreed installments or interest.

\(^2\) Approximately $26.9 billion, at recent exchange rate of 1 Euro = $1.12.

\(^3\) Approximately $12.3 billion at recent exchange rate of 1 Euro = $1.12.
Conclusion

In this environment, we believe that the distressed debt strategy offers the “best of both worlds”—the cash flow potential of debt investments with the upside potential of equities. Distressed debt generally trades at a significant discount to par value (for example, $300 for a $1,000 bond), because the borrower is under financial stress and faces default risk—or from volatility that has lowered the price of both distressed and healthy debt. Qualified investors can participate via an illiquid private debt, drawdown structure that allows the manager to deploy capital opportunistically over a three-to-five year period as market dislocations occur, or they can participate through a distressed credit liquid hedge fund structure that grants access to a seasoned portfolio of global distressed investments.

There are risks involved in investing in this strategy. Distressed securities are primarily debt securities which originate from companies that are in the process of reorganization or liquidation under local bankruptcy law, or companies engaged in other extraordinary transactions such as balance sheet restructurings. Investing in distressed companies is speculative and involves a high degree of risk. The market values of distressed securities may not reflect their true values due to illiquidity related difficulties in the pricing process, inadequate research coverage, among other things. Distressed companies most likely will declare bankruptcy shortly, could currently be in bankruptcy proceedings or are just emerging from bankruptcy. Because of their distressed situation, private debt funds may be illiquid, have low trading volumes, and be subject to substantial interest rate and credit risks. These funds often demand long holding periods to allow for the end of the debt’s term or an exit strategy via the secondary market.
Valuations signal low probability that the bull market will end in 2019

We are nine and a half years into the current bull market (the longest bull market on record), and naturally investors ask the question, “When will the recovery end?” Valuation indicators lead us to believe the end won’t occur within the next year. Let’s sharpen our pencils for a deeper dive into what the key valuation metric to analyze, the price-to-earnings (P/E) ratio, is telling us. The P/E on midterm Election Day was 16.8. That is cheaper (or a lower priced paid for a unit of earnings) compared to the P/E ratio (17.8) on Election Day 2016. This may suggest that, despite the biggest tax reform since 1962 combined with a strong cyclical recovery in the economy, the market is less expensive than it was two years ago. Perhaps investors did not anticipate that positive earnings growth would continue after tax reform and after the record long recovery we've seen.

The average P/E over the last five years is 16.3, which indicates we are in a regular range for this cycle. This compares favorably to 1998, when we were two years before the end of the tech-led bull market, and the P/E was as high as 24.1. History also tells us that valuations 12 months following a midterm election have tended to revert to 16x. So far markets are behaving according to historical norms following midterm elections, and we believe today's market is fairly valued and will rise along with an expected rise in earnings per share (EPS) in 2019. Therefore, based on our analysis, today’s bull market still has room to run.

Key takeaways

» Valuations are not elevated, and we do not expect the current bull market to end before year-end 2020—although price volatility may rise.

» Based on reviewing midterms back to 1990, the S&P 500 Index price tends to rise in the calendar year following the elections, with valuations of around 16x EPS, in the 12 months following midterm elections.

S&P 500 Index 12-month forward P/E indicates “fair value” in today’s market

Sources: FactSet, Bloomberg, Wells Fargo Investment Institute, November, 8 2018. The S&P 500 Index is a market capitalization-weighted index generally considered representative of the US stock market. The P/E ratio is the ratio of a company’s stock price to its EPS. The forward P/E ratio is based on the next projected 12 months of earnings. An index is unmanaged and not available for direct investment.
Guidance on the Treasury’s new five-year TIPS

As trade discussions have heightened in recent months and tariffs are more likely to take shape, investors are concerned with how to protect themselves from the possible inflationary impact on the prices of goods. Treasury Inflation Protection Securities (TIPS) are securities sold by the Treasury Department that are designed to provide protection against inflation. The principal of a TIPS increases with inflation and decreases with deflation. TIPS pay interest at a fixed rate twice a year and adjust in price according to Consumer Price Index (CPI) changes. It’s important to note that there are several ways to measure inflation in the economy, but when investing in TIPS, CPI is the critical measure to monitor.

Additionally, TIPS benefit from an expected change in inflation, so if investors feel that CPI inflation will increase, investors can potentially benefit from an increased price in TIPS. Right now, we feel that TIPS are fairly valued because the path on inflation has been less than clear. Although headline inflation figures had been picking up over the summer, they’ve come down recently in the fall. We believe inflation may pick up; however, we don’t think it will be significant enough to warrant a favorable recommendation. In fact, recently, future inflationary market indicators, such as the Fed’s five-year forward breakeven, have declined slightly, indicating future inflation levels may also decline slightly.

TIPS have special tax consequences, generating phantom income on the “inflation compensation” component of the principal. A holder of TIPS may be required to report this income annually although no income related to “inflation compensation” is received until maturity. TIPS are subject to interest rate risk, especially when real interest rate rise. This may cause the underlying value of the bond in a portfolio to fluctuate more than other fixed income securities.

Key takeaways

» The U.S. Treasury announced last week that it will issue five-year TIPS beginning next October. We believe these shorter dated securities may gain more attention because the current 10-year TIPS have a longer duration (or interest rate sensitivity) that may counter the benefits of increased inflation.

» We believe investors can benefit from the diversification of TIPS to combat future unexpected inflation increases, but we don’t see great opportunities now given their current breakeven levels.
Iran exposes poor oil fundamentals

Oil prices have reversed course over the last five weeks, losing much of their gains for the year. Brent oil is down 16% since its October peak, while West Texas Intermediate (WTI) is down 18%. This price collapse is significant and worth exploring.

So what happened? The short and simple answer is—Iran. Earlier in 2018, President Trump set a November deadline for buyers of Iranian oil to cease and desist. Over the past few months, many buyers of Iranian oil stopped buying, and markets pushed oil prices to four-year highs. In the past five weeks, however, sinking oil prices seemed to suggest that something else may be afoot. It turns out that that was the case. Last week President Trump softened his stance on Iran, allowing key trading partners to continue buying Iranian oil.

While the Iranian storyline sparked the recent oil sell-off, it may very well be a smokescreen, masking the true culprit behind falling oil prices—poor fundamentals. Global supply growth has been outpacing demand growth throughout 2018 (falling green line in chart below). Notice that the price of Brent, the blue line, follows the green line around. They do not sync perfectly, meaning oil prices can ignore their underlying fundamentals at times. Eventually, though, oil prices tend to trend with their underlying fundamentals. Oil’s supply/demand growth balance has been softening throughout 2018, signaling that oil prices would eventually have to soften, too.

Key takeaways

» The U.S. granted waivers that allowed key trading partners to continue buying Iranian oil.

» The Iranian storyline may be masking the true culprit of the recent oil price collapse—poor fundamentals.

Brent oil price versus global oil demand/supply balance

What to make of October 2018 hedge fund performance?

On the surface, October 2018 was a disappointing month for the hedge fund industry. Early estimates indicate that the HFRI Fund Weighted Composite Index was down 2.98%, which wiped out year-to-date gains, resulting in the worst monthly return since September 2011. Equity Hedge, the largest and most popular strategy in the industry, was hardest hit, down 4.25% for the month. The key questions of the moment? How should investors interpret these returns, and has October’s performance changed our views on the opportunity set for hedge funds?

Let’s put the negative into context. Though negative for October, the HFRI Equity Hedge (Total) Index captured less than 40% of the Russell 2000 Index losses (the index measures the performance of the 2,000 smallest companies in the Russel 3000 Index). This comes despite prime brokerage data indicating that crowded “long” hedge fund positions were among the worst performing stocks during the rout, while crowded “shorts” outperformed the market.4 We’ll spend much of our time the next few weeks analyzing whether this is a short-term blip on the radar or a sign of a more difficult environment for Equity Hedge.

While disappointed with Equity Hedge, we are thrilled with how Relative Value and Event Driven held up during the month. Many structured credit managers were actually positive in October, highlighting the low correlation of asset backed securities with the broader macro market.5 Within Event Driven, while the Activist strategy struggled, we saw relatively muted losses from distressed debt managers.6

Key takeaways

» October was a challenging month for the hedge fund industry, especially the Equity Hedge strategy. Though performance was negative, Equity Hedge captured less than 40% of the Russell 2000 losses.

Reversal in popular longs and shorts painful in October

Alternative investments, such as hedge funds, private equity, private debt and private real estate funds are not suitable for all investors and are only open to “accredited” or “qualified” investors within the meaning of U.S. securities laws.

5 The estimated return for the HFRI Relative Value: Fixed Income – Asset Backed Index was +0.59%.
6 The estimated return for the HFRI Event Driven: Distressed/Restructuring Index was -1.18%.

Sources: Credit Suisse, Wells Fargo Investment Institute, November 2018. The Credit Suisse U.S. Top 50 Popular Longs and Top 50 Popular Shorts Indices are constructed based on the activity of those hedge fund prime brokers that routinely use Credit Suisse for its trading and other brokerage services. Credit Suisse aggregates the long and short sales of these hedge fund managers daily to determine their 50 most popular long and short positions.
Risk Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

Alternative investments, such as hedge funds, private equity/private debt and private real estate funds, are speculative and involve a high degree of risk that is suitable only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. They entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds. Hedge fund, private equity, private debt and private real estate fund investing involves other material risks including capital loss and the loss of the entire amount invested. A fund’s offering documents should be carefully reviewed prior to investing.

Hedge fund strategies, such as Equity Hedge, Event Driven, Macro and Relative Value, may expose investors to the risks associated with the use of short selling, leverage, derivatives and arbitrage methodologies. Short sales involve leverage and theoretically unlimited loss potential since the market price of securities sold short may continuously increase. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. Derivatives generally have implied leverage which can magnify volatility and may entail other risks such as market, interest rate, credit, counterparty and management risks. Arbitrage strategies expose a fund to the risk that the anticipated arbitrage opportunities will not develop as anticipated, resulting in potentially reduced returns or losses to the fund.

Alternative investments carry specific investor qualifications which can include high income and net-worth requirements as well as relatively high investment minimums. They are complex investment vehicles which generally have high costs and substantial risks. The high expenses often associated with these investments must be offset by trading profits and other income. They tend to be more volatile than other types of investments and present an increased risk of investment loss. There may also be a lack of transparency as to the underlying assets. Other risks may apply as well, depending on the specific investment product. Investors should carefully review the prospectus, private placement memorandum or other offering documents for complete information regarding terms, including all applicable fees, as well as risks and other factors that should be considered before investing.

Index/Strategy Definitions

Credit Suisse US Top 50 Popular Longs Index: Performance of the Top 50 U.S. Longs. List is created daily based on stocks being widely held and their market value on our platform. Performance for the index is calculated on a weighted basis.

Credit Suisse US Top 50 Popular Shorts Index: Performance of the Top 50 U.S. Shorts. List is created daily based on stocks being widely held and their market value on our platform. Performance for the index is calculated on a weighted basis.

HFRI Equity Hedge (Total) Index—Investment Managers who maintain positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations and valuation ranges of typical portfolios. EH managers would typically maintain at least 50% exposure to, and may in some cases be entirely invested in, equities, both long and short.

HFRI Relative Value: Fixed Income-Asset Backed Index—Fixed Income Asset Backed includes strategies in which the investment thesis is predicated on realization of a spread between related instruments in which one or multiple components of the spread is a fixed income instrument backed physical collateral or other financial obligations (loans, credit cards) other than those of a specific corporation. Strategies employ an investment process designed to isolate attractive opportunities between a variety of fixed income instruments specifically securitized by collateral commitments which frequently include loans, pools and portfolios of loans, receivables, real estate, machinery or other tangible financial commitments. Investment thesis may be predicated on an attractive spread given the nature and quality of the collateral, the liquidity characteristics of the underlying instruments and on issuance and trends in collateralized fixed income instruments, broadly speaking. In many cases, investment managers hedge, limit or offset
interest rate exposure in the interest of isolating the risk of the position to strictly the yield disparity of the instrument relative to the lower risk instruments.

HFRI Event Driven: Distressed Restructuring Index—Distressed/Restructuring strategies which employ an investment process focused on corporate fixed income instruments, primarily on corporate credit instruments of companies trading at significant discounts to their value at issuance or obliged (par value) at maturity as a result of either formal bankruptcy proceeding or financial market perception of near term proceedings. Managers are typically actively involved with the management of these companies, frequently involved on creditors’ committees in negotiating the exchange of securities for alternative obligations, either swaps of debt, equity or hybrid securities. Managers employ fundamental credit processes focused on valuation and asset coverage of securities of distressed firms; in most cases portfolio exposures are concentrated in instruments which are publicly traded, in some cases actively and in others under reduced liquidity but in general for which a reasonable public market exists. In contrast to Special Situations, Distressed Strategies employ primarily debt (greater than 60%) but also may maintain related equity exposure.

HFRI Fund Weighted Composite Index is a global, equal-weighted index of over 2,000 single-manager funds that report to HFR Database. Constituent funds report monthly net of all fees performance in US dollars and have a minimum of $50 Million under management or a twelve (12) month track record of active performance. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds.

An index is unmanaged and not available for direct investment.

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