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PERMIRA CREDIT MARKET UPDATE Q2 2024

In partnership with Capital Economics

Please note that the views described herein represent those of Permira Credit and Capital Economics as at Q2 2024.

- Slower economic growth and lower inflation has prompted the ECB to cut rates, and similar conditions in the UK mean that the Bank of England could follow suit in August. Economic growth is set to remain subdued across Europe over the next few years as fiscal tightening remains a headwind to growth.
- The global elections in 2024 are unlikely to alter the overall outlook for economic growth as fiscal constraints will limit the ability for governments to increase spending. The US election will, however, be particularly important due to its potential impact on global trade and geopolitics.
- Private credit market activity in the second quarter of 2024 was more muted than expected, while more liquid credit markets experienced a resurgence. But activity in both private and liquid credit is still higher than last year and a pick-up in deals is expected in H2 2024 as election outcomes become clearer across Europe.

Economic outlook

Raft of rate cuts across Europe this year

The surge in energy prices throughout 2022 has largely reversed and global inflation has fallen sharply. Meaningful recessions have been avoided, but GDP growth has been below potential in most developed economies, paving the way for interest rate cuts.

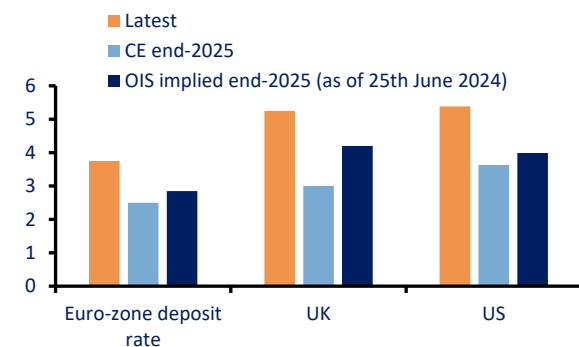
Contrary to earlier views that the US would lead the monetary policy loosening cycle among advanced economies, Switzerland and Sweden cut first in March and May, followed by the euro-zone in June.

Even though the recession in the euro-zone was mild, real GDP has risen by just 3.4% since the final quarter of 2019. The economy has hardly grown and is not overheating in the way that others, such as the US, are. With growth weak and inflationary pressures easing, the European Central Bank (ECB) cut the deposit rate from 4.00% to 3.75% at its meeting in early June.

The ECB will move cautiously going forward and will likely wait until September to cut rates again,

as underlying price pressures are proving slightly stickier than expected. The economy is expected to grow only slowly in the coming quarters and the labour market should soften as a result, helping to bring inflation down. Headline inflation should ease to around 2.0% by September, enabling rates to be cut two more times this year to 3.25% by end-2024 and to 2.50% by end-2025. (See Chart 1.)

Chart 1: Policy Rate and Market Expectations (%)



Sources: Capital Economics, Refinitiv and Bloomberg

On the basis of GDP growth since the pandemic, the UK economy appears in need of support, but its stubborn services inflation outturns have prevented monetary policy loosening so far.

Headline inflation should fall further than the Bank of England expects, from 2.0% in May and to around 1.5% later this year. Spare capacity from the previous weakness in the economy will limit companies' ability to raise prices, and energy and food price inflation should fall further. Interest rates could begin to be cut in August from 5.25%, down to 3.00% by end-2025; further than is currently priced into markets.

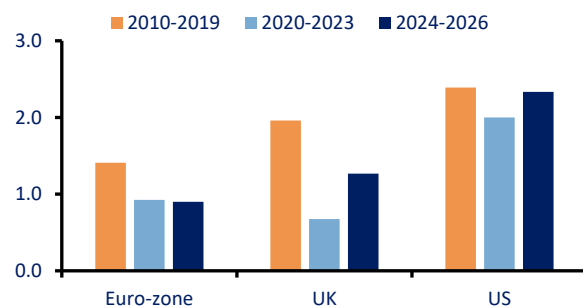
The big difference between the US and Europe has been the relative resilience of the US economy, especially household spending. This explains why rate cuts are likely to start later across the Atlantic, most likely in September.

Fiscal tightening a headwind for growth

Economic growth across Europe will be soft over the coming years and will underperform the US. (See Chart 2.) The boost from rate cuts in the euro-zone will feed through only gradually and governments will tighten fiscal policy further to meet new EU fiscal rules. Real GDP could grow by just 0.7% this year, picking up to a soft 1.2% next year.

Meanwhile, the current fiscal constraints in the UK mean that the new Labour government will find it difficult to boost economic growth. But with inflation set to ease more than most expect and rates to be cut further, real GDP could grow by a healthy 1.5% in 2025 and 2026.

Chart 2: GDP growth (y/y%)



Sources: Capital Economics and Refinitiv

In-depth: Do elections matter for the economy?

Economic impact of elections is often overstated

Major elections have already been held in 2024 across India, Mexico, Russia, Taiwan, Indonesia, Pakistan, South Africa, and most recently in France and the UK. The US election in November will cap off this busy election year.

With few major structural reforms planned so far, the elections are unlikely to bring significant changes to the economic outlook. A combination of high interest rates and huge government spending since the pandemic has pushed up interest repayments on government debt. As a result, governments face significant fiscal constraints.

Changes to fiscal policy will therefore have to be distributional, rather than have a notable impact on fiscal stance and the overall economy. The new Labour government in the UK, for example, could shift the composition of government spending and tax cuts. This may only have a relatively small impact on the economic outlook, though. Labour's manifesto envisages public spending in 2028/29 being £9.5bn higher than previous plans and taxes being £8.6bn higher. Typically, £1 more of public spending would add more to GDP than £1 more in taxes takes away. This may mean by 2028/29 GDP is a bit higher than otherwise, although perhaps by only 0.1-0.2% and even that is not a given.

In the past, elections have only tended to have significant effects if governments have embarked on large structural reforms, interfered with monetary policy or changed their geopolitical stance. The 1979 UK election of Thatcher saw a major privatization drive and labour market reforms. Two years later, the economy was in recession and the unemployment rate hit a 50-year high of 11.8%.

Elsewhere, the mass nationalization of industries and socialist policies after the 1970 Chile election was met with an economic crisis. On a more positive note, Brazil's 1994 election ensured adherence to a new monetary policy mandate, helping to end hyperinflation.

Looking at the outcome of the recent UK election, Rachel Reeves in her first major speech as the new Chancellor reiterated Labour's intention of changing planning rules. This may provide a boost to homebuilding. In addition, Labour seems more willing to boost green and public investment. All of this could potentially help boost supply and raise the economy's medium-term growth rate.

Biggest risk is around trade and geopolitics

The area where this year's elections could be most important is trade and geopolitics. Against a backdrop of global fracturing and given the prevalence of "populist" or "protectionist" candidates, this channel could be more important than it has been historically. The US election will be a major event in this sense.

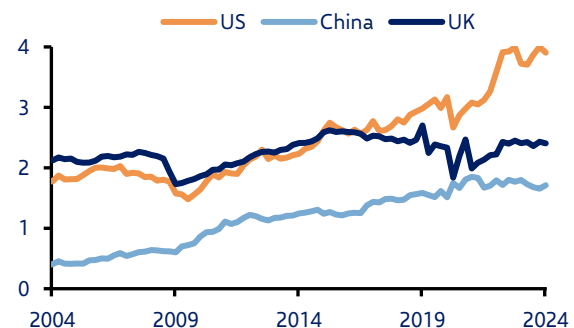
The 2016 election of Donald Trump led to protectionist policies and "trade wars" with China. Trump's first set of tariffs went into effect in 2018 and by the end of 2019, nominal imports from China had already fallen by 16%. These "trade wars" kickstarted a wider escalation of geopolitical tensions with China, which remains a major issue today and will shape the world economy over coming decades.

Regardless of which way the US election goes, it is unlikely that it will yield a major change in US-China relations or trade between the two countries. The current Biden administration didn't roll back any of Trump's original tariffs on China. But if Trump were to be elected, there could be wider implications for trade. If he wins, Trump has said he would introduce a universal 10% tariff on all imports and tariffs of up to 60% on imports from China. This is a concern for

Europe as the US is the euro-zone's largest export market by far. (See Chart 3.)

How much euro-zone export volumes would fall as a result would depend on whether the tariff caused the US dollar to appreciate, the extent to which exporters absorbed some of the tariff cost through lower margins, and the elasticity of demand for exports. So there is a lot of uncertainty. But in all, these proposed tariffs would likely result in a hit to the euro-zone economy of up to half a percent of GDP over a year or two. And the damage would be bigger if this triggered a transatlantic or EU-China trade war. Yet this more damaging scenario appears less likely to occur, as European policymakers would probably take great pains to avoid a major transatlantic trade war.

Chart 3: Euro-zone goods exports by destination as a share of GDP (%)



Sources: Capital Economics and Refinitiv

Elections can trigger notable market reactions

Even if many of these elections don't significantly alter the economic outlook, there could still be major market reactions, at least initially.

French equities rose sharply in the month leading up to the 2017 election when a Macron victory looked likely, most likely due to the lower risk of geopolitical tensions and unsustainable debt compared to a Presidency under Le Pen. Financial moves had unwound within a few months. More recently, the spread on French

government bond yields widened sharply after Macron called a snap election in June, a response to concerns that the far-right party may pursue looser fiscal policies if it won the elections.

In the end, the 2024 French election delivered a surprising result in which the far-right National Rally (RN) did worse than anticipated, whilst the left-wing New Popular Front (NFP) and President Macron's centrist Ensemble group both did better than expected. Despite the surprising result, there was not much of a reaction in financial markets, because whilst investors welcomed the defeat of the RN, they may be worried that the left-wing NFP could form part of the next government and push for more public spending. In any case, it seems that the path towards the reduction of France's deficit is going to be harder. And political uncertainty remains high. The upshot is that the spread between 10-year French OATs and German Bunds is still higher than it was before the election was called - but lower than the highs reached in the immediate aftermath of Macron calling the election.

Another example is in Brazil, where the positive market reaction around the election of Bolsonaro in 2018 was largely due to the perception of reduced fiscal risks. One year after the election, equities were up around 30% and 10-year government bond spreads had narrowed by 400 basis points. Gains have been largely reversed since, as fiscal risk returns to the spotlight.

Finally, UK financial markets reacted calmly to Labour's win in the recent general election. This is likely due to the result being unsurprising, but also because both parties were preaching fiscal discipline during the campaign.

In all, market reactions can be large when a "populist" or "protectionist" candidate is a serious contender, or when there is the potential for fiscal credibility to be lost or restored. In

many cases, market moves are eventually largely unwound as the reality of constraints on candidates' proposed policies sinks in.

Implications for credit markets

Opportunities for private credit amidst bank tightening

Following a relatively muted year of activity in 2023, the private credit market made a positive start to 2024. Yet many market participants have reported that Q2 2024 has seen a slight dampening in activity. This is despite several central banks in developed economies either beginning their rate-cutting cycle or considering rate cuts later in the year.

Although fears of a hard landing and deep recessions across the globe have subsided, inflation data out in recent months, such as that seen in the US, continues to provide some warning signs that inflationary pressures have not completely dissipated. Interest rates are still in restrictive territory and uncertainty surrounding the geopolitical backdrop remains.

And while changes in governments worldwide are unlikely to have major or long-lasting impacts on credit markets, the uncertainty surrounding upcoming elections has meant that investors have been taking a more cautious approach.

There are signs that, in a market with a relatively lower volume of transactions, firms are under pressure to deploy and so it is very much a borrower's market. But overall in the private credit market, there is still an expectation that the second half of the year should see an improvement, as rate cuts become more widespread globally and election results are confirmed.

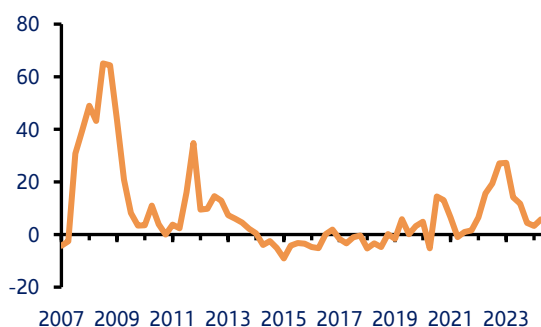
Turning to the lower mid-market range more specifically, the global geopolitical backdrop is mainly affecting the number of lenders rather

than the number of borrowers. Since 2022, banks have pulled back significantly and tightened their credit processes, especially in the lower mid-market, and they are being far more selective on the types of deals they do.

Markets generally expected there to be more distress due to the rapid rise in interest rates, yet this has not materialised. But, the longer rates remain elevated, the more likely companies are to be pushed into challenging territory. As a result, banks have been cautious about wanting to increase the size of their balance sheets in that type of environment.

This tightening is illustrated by data from the European Central Bank’s quarterly ‘Bank Lending Survey’. Banks’ lending standards for businesses in 2023 tightened to levels surpassed only twice in the past fifteen years; during the Global Financial Crisis of 2008 and the onset of the COVID-19 pandemic in 2020. And, although the pace has moderated a touch since, the outlook for lending to firms over the next quarter remains poor. With banks not offering as much, borrowers will tend to go directly to lenders, in turn widening the opportunity set for more opportunistic players in the lower mid-market.

Chart 5: Net percentage of euro-zone banks reporting a tightening of credit standards for companies (%)



Sources: Capital Economics and the European Central Bank

Liquid credit markets are back

Meanwhile in the liquid credit market, there is a different dynamic occurring. This year started strongly after muted issuance over 2022 and 2023, and momentum has continued to gather. Indeed, CLO issuance in Europe and the US in the first five months of the year were the strongest continuous start of any year in the history of the market.

This has been driven by the significant amount of inflows that have been seen across Europe and the US, which in turn has been driven by the buoyant collateralised loan obligation (CLO) market. CLO issuance has been strong, which has fueled robust demand in the liquid credit market and has had a number of additional knock-on effects.

The first of these effects is the strength in demand for primary credit, with lots of primary deals coming to market. Second, there has been a major impact on re-pricings, because whilst there is strong demand and appetite for risk is rising, the level of M&A activity fueling the new issuance is still lower compared to the heights of 2021.

Third, there has been significant tightening in the secondary market, due to CLOs having substantial deals in the primary market. In addition to these impacts, there are signs that investors in general are willing to take risks and are moving down the risk spectrum in order to put their capital to work.

The bottom line is that whilst ongoing geopolitical uncertainty is likely to continue hanging over credit markets in the near-term, demand for credit products is strong and it is expected that overall deal activity should pick up in the second half of 2024. Furthermore, while private credit will remain the key product and market leader, especially across the mid-market space, broadly syndicated loans will gain some market share. There will be cases where these two markets can co-exist in mutually beneficial ways.

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