PALLAS
CAPITAL ADVISORS

# PCA Market Commentary

February 2020

# Big Debt Trends

A near-record bull market has prompted worry among investors about how and when this economic cycle may end. One of history's most prolific investors in the space of macroeconomic forecasting, Ray Dalio, is a disciplined student of the markets who has studied hundreds of cycles across many different countries and interest rate regimes. In his new book titled "Navigating Big Debt Crises," he discusses some of the classic causes, symptoms, ramifications, and conclusions of different debt crises throughout history.

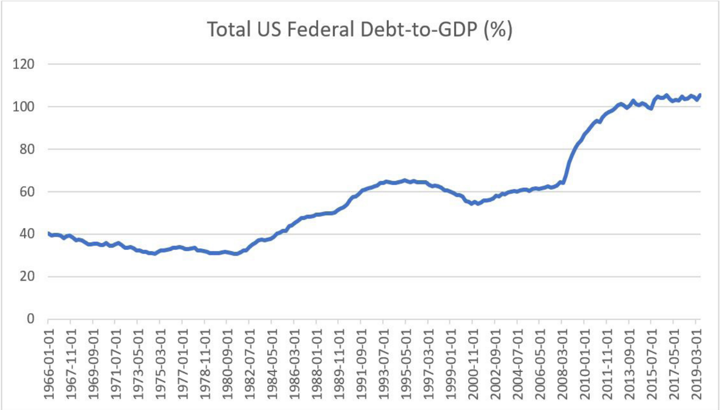
Mr. Dalio has not been shy in voicing his belief the cycle will end sooner, rather than later. In 2018, when the Federal Reserve made its infamous communication "the balance sheet expansion is basically on autopilot," he suggested that there would be a stock market correction within two years, possibly fueled by the bursting of the "debt bubble."

At Pallas, we believe that debt levels on both the private and public side are worrisome. However, we don't see the situation as dire as some of others in the markets. While there are some clear indications of over-leverage due to ample liquidity provided by monetary policy makers, we consider debt levels within the context of global markets.

Ironically, it can be argued that debt levels more concerning to equity investors, than to bond investors. The primary reason being that onerous interest servicing payments could substantially degrade an organization's financial health and pressure returns to equity shareholders, particularly in a rising rate environment. While current corporate debt levels are high, interest rates have come down substantially over the past 30 years, and companies in general have been intelligent about spacing out their debt payments so that the debt service coverage ratio (a measure of cash flows divided by debt service) is still manageable, and even conservative by many metrics.

At the macro level, we tend to agree with the notion that the government debt is more concerning. Past studies on the catalysts for debt crises have noted there is often an intense conflict between the wealthy and poor, especially near the end of a cycle when interest rate reductions have fueled debt and equity expansion. In such a case, one classic go-to option of governments is to raise taxes on the wealthy. Yet the outcome is often ineffective, since there tends to be capital flight from the country with rising tax rates and into countries with low rates. The advent of cryptocurrency increases the ease of such asset transfers.

While we don't view the current US Debt to GDP as dire (roughly in the range of 1.0x debt to GDP), there are a lot of other obligations such as Medicare, and Social Security that don't go into that equation on the debt side. Adding the net present value of those obligations would add roughly $46 Trillion onto the debt (on top of the $22 Tn in direct debt). This would mean that we are no longer in the 1:1 ratio range, but instead at 3:1.




Source: St Louis Fed, Pallas Capital Advisors

Federal receipts right now are around $3.2 Trillion, meaning that if all of today's dollars were dedicated towards paying down debts and obligations, it would take 21.25 years (at the same tax margin) to wipe it completely away. Now, this isn't necessarily a clean calculation, because there's no feasible scenario in which all these "debts" could be simultaneously called at once. It's more likely that programs like social security will diminish, thus easing the burden naturally – and most likely in conjunction with some tax raises. Nonetheless, this type of coverage ratio does raise some red flags.

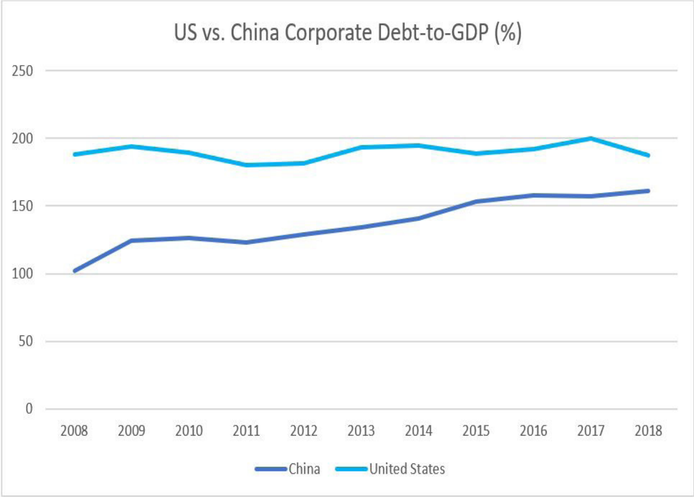
Much of the impact of high leverage comes down to discipline, and the ability of governments to raise taxes, while private corporations engineer a soft landing in an earnings decline. In the private sector, a CEO generally has the latitude to reduce cost, pay down debts, or cut dividends.

In the case of T-Mobile, it could repay its debt from cash flow in 6.67 years. Mobile has a strong moat, with 20% market share in a highly concentrated industry, with strong growth and a competitive advantage in 5G technology due to its native capabilities. Similarly, Darden offers strong free cash flow growth and could repay its debts with only 4.5 years of cash flow. It maintains strong US penetration in restaurants that tend to be fairly recession-resistant, which stabilizes earnings and debt servicing.

In general, we find that US corporate debt since 2008 has been constant at 200% of GDP. In contrast, Chinese nonfinancial corporate debt right now, according to Bloomberg, has grown from 100% in 2008 to 160% in the current economy. While we don't want to downplay the importance of US corporate debt levels, we believe that the globally-based upwards shift provides important context.

Where Pallas is finding the most attractive values today are in the AAA securitized credits. Since the financial crisis, new regulations have curbed risk-taking in the market, and forced financial engineers of these assets to have more skin in the game. Current economic forces are mitigating the downside risk. Tailwinds are found in the form of steadily increasing real estate values and a warmer winter season. A continued uptrend in housing starts will create jobs, spur economic activity, and support additional MBS issuance.  Further, the slowing pace of refinancing translates to a decline of prepayments.

Most of all, AAA securitized credit is the asset class most closely, in our view, tied to the US consumer, which is perhaps the story that supports further elongation of this credit cycle. Providing the consumer remains healthy, housing payments should remain consistently stable.




Source: World Bank, Pallas Capital Advisors