OAKTREE | Insights

Performing Credit Quarterly

2Q 2023

FIGHTING THE FED

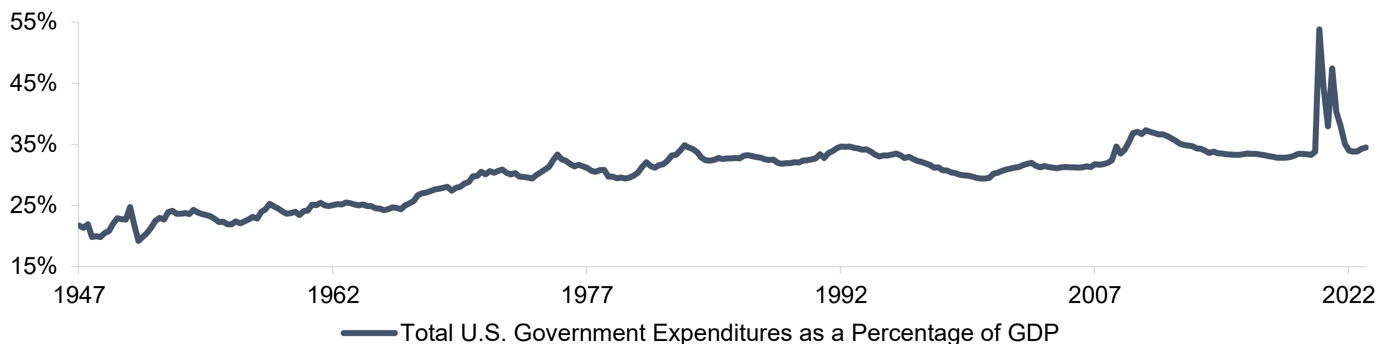
The U.S. economy refuses to follow a single storyline. In the last six months, the gross domestic product has grown, while gross domestic income has contracted; the labor market has added jobs at a robust pace, but average hours worked have declined; and leading indicators have often disagreed with their lagging counterparts. This complexity may be a byproduct of the tug-of-war currently occurring between the U.S. federal government and the Federal Reserve. While they were closely aligned during the pandemic, they've often been working at cross-purposes over the last year, as the former's desire to keep the economy churning has clashed with the latter's interest in throwing sand in the gears. **As a result, the most widely forecast recession in U.S. history, the long-awaited Fed pivot, and the relief the latter could provide to companies and investors all keep getting pushed further into the future.**

Tug-of-War

The Fed is in the midst of the most aggressive interest-rate-hiking cycle in 40 years, having already increased the fed funds rate by 500 basis points. Headline inflation has responded, dropping by 6.1 percentage points in one year to 3.0%. Meanwhile, core inflation (excl. food and energy prices) has been stickier. While it has begun to slow meaningfully in recent months, due to the deceleration in rising shelter prices (which represent over 40% of core inflation), it's still only 1.8 percentage points below its recent peak in September 2022. And at 4.8%, it remains more than double the Fed's 2.0% target.[1]

The persistence of high core inflation speaks to the resilience of the U.S. economy and, relatedly, the aggressive fiscal policy the U.S. government has pursued in recent years. The Biden administration has engaged in one of the largest campaigns of economic stimulus in U.S. history, the impact of which has been compounded by the fact that it followed immediately after the Trump administration's own record-breaking fiscal splurge. (See Figure 1.)

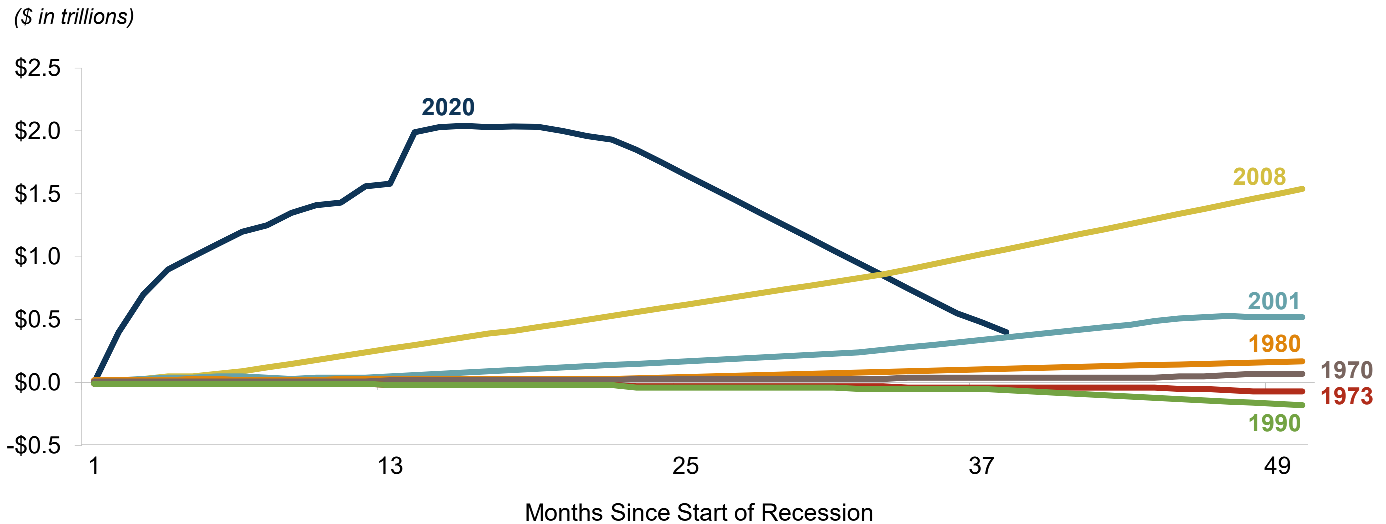
Figure 1: Recent U.S. Fiscal Spending Has Been Unprecedented by Postwar Standards



Source: U.S. Bureau of Economic Analysis, as of January 2023

The Biden administration's first major spending legislation was the $1.9 trillion American Rescue Plan passed in early 2021. In combination with the stimulus released in 2020, the 2021 relief package helped Americans compile over $2 trillion in excess savings during the pandemic – a very different savings pattern from those recorded after recent recessions.[2] (See Figure 2.) This stockpile buoyed economic activity in 2021 and 2022 – and likely also bolstered inflation as supply chains struggled to meet demand. It's unclear exactly how much excess savings remains or how widely distributed it is among income groups. But a research report from the Federal Reserve Board of San Francisco estimates that roughly $500 billion was left as of March 2023, and the authors believe this amount could support economic growth through the end of 2023.[3]

Figure 2: Excess Savings Is Almost Exhausted, but May Support Growth Through Year-End



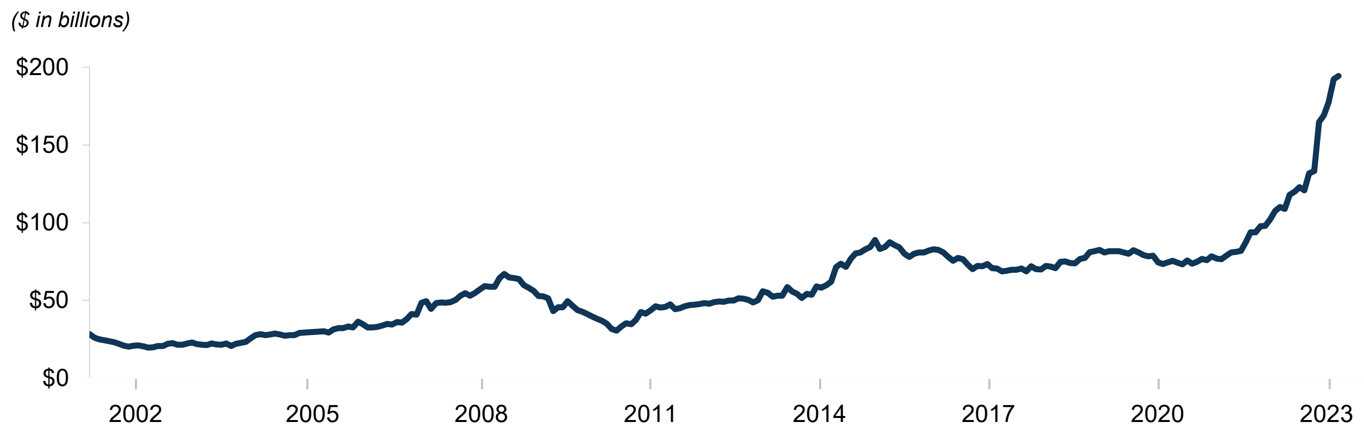
Source: Federal Reserve Bank of San Francisco

Importantly, the Biden administration's spending plans have gone beyond short-term relief. In under three years, the administration has passed the $1 trillion Bipartisan Infrastructure Law; the $280 billion CHIPS and Science Act; and the Inflation Reduction Act, the country's largest-ever investment in renewables and green infrastructure.[4] The latter includes $370 billion in climate-related spending that, despite the legislations's name, is likely to put upward pressure on inflation, at least in the near term.

While the dollar figures attached to the above legislation will be allocated over many years, the eye-popping amounts have already sent a clear message: **The U.S. government is strongly committed to (a) boosting U.S. manufacturing; (b) subsidizing investment in the green energy transition; and (c) promoting policies that can help the U.S. gain or maintain an edge in new technologies.**

The private sector has clearly taken note. **Spending on U.S. manufacturing construction in 2023 has nearly doubled year-over-year, and the annual rate is roughly triple the average during the 2010s.**[5] (See Figure 3.) This spike in spending – which may be helping to partially offset the impact of rising interest rates – has likely been driven by the subsidies that the Inflation Reduction Act has provided for electric vehicles and other clean energy technologies. Finally, it's notable that the messaging of the two major U.S. political parties suggests that – even though investment in green technologies might vary depending on who's occupying the White House – the broad shift toward more interventionist economic policy and direct support for U.S. manufacturing and infrastructure will continue regardless.

Figure 3: Manufacturing Construction Spending Has Spiked Under the Biden Adminstration



Source: U.S. Census Bureau, as of May 31, 2023

Higher-for-Longer

What conclusions can investors draw from this tug-of-war? **We believe it's reasonable to assume that the economy will "muddle through" in the coming quarters, meaning it may slow but not enough to enable the Fed to engage in significant interest rate cuts.**

Again, consider the complex economic picture. On the one hand, spending on durable goods has slowed, average hours worked have been trending downward since 2021 (despite a slight increase in June 2023), and consumers are dealing with the aftereffects of a sustained period of negative real wage growth,[6] including rising credit card balances and declining savings.[7] But on the other hand, spending on services is increasing, many employers appear reluctant to lay off workers, and both wage growth and retail sales have recently started to outpace inflation.[8]

As a result, we may see economic activity moderate and corporate earnings weaken in the near term, but not enough to warrant a substantial reduction in interest rates. Although inflation should decline as shelter prices slow over the coming months, returning to the Fed's target may prove challenging. Base effects will be less helpful moving forward, and positive real wage growth could spur faster price increases.[9] Indeed, history suggests that reaching this goal may require the economy to face positive real interest rates for a meaningful period of time. **And even if inflation eventually returns to the target, that doesn't mean interest rates will trend back toward zero.**

Meanwhile, other forces may put upward pressure on interest rates. For one, there's the need to finance high government spending. The Treasury has already issued more than $1 trillion of debt since June, due to the buildup caused by the debt ceiling standoff,[10] and much more is expected to come before year-end. Moving forward, the combination of rising government borrowing and quantitative tightening may mean the upward push on interest rates will often exceed the downward pull, especially given the federal government's shift toward onshoring and industrial policy. Globalization is believed to have played a major role in tamping down inflation – and, by extension, interest rates – in recent decades, so deglobalization could have the opposite effect.

Thus, recession or no recession, we think the probability of higher-for-longer interest rates is far greater than the likelihood of near-term cuts. Therefore, we believe leveraged finance markets are likely to experience higher default rates going forward even if the economy avoids a recession. Capital structures prevalent at companies today were put in place when interest rates were near zero and access to financing was taken for granted. As elevated interest rates make their way through the global financial system – which has racked up over $12 trillion in low-rated debt[11] – the asset bubbles created during the easy money era could deflate painfully, causing a rash of downgrades, distress, and, eventually, defaults.

In short, we believe we've shifted into a higher interest rate regime and that investment returns in the coming years will be closely correlated with the prudence investors displayed in the easy money era and the skill they exhibit when navigating the new one.

Credit Markets: Key Insights for 3Q2023

What trends, risks, or opportunities are Oaktree experts focused on today? Below are key insights that we believe investors should keep in mind when navigating today's markets.

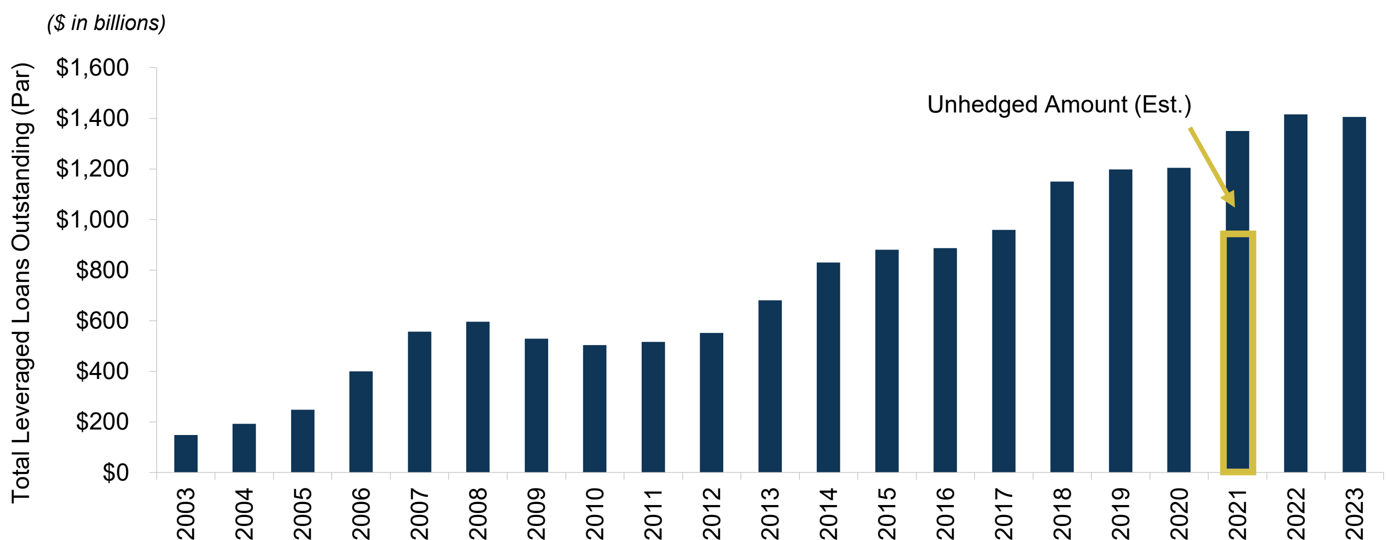
(1) Private equity-owned companies with unhedged floating-rate debt may face increasing stress

In the decade before 2022, many sponsor-backed companies financed leveraged buyouts by borrowing heavily in the broadly syndicated loan and private credit markets – and the majority of this debt had floating rates. Over the last year, reference rates for these loans have jumped by roughly 500 bps.[12] Therefore, these companies are now facing sharply higher borrowing costs, unless they hedged a substantial portion of their interest rate risk.

And most did not: Roughly two-thirds of the $1.4 trillion U.S. leveraged loan market was unhedged at the end of 2021, after which hedging costs skyrocketed. (See Figure 4.) Importantly, many of these borrowers put in place capital structures that may prove unsustainable in a higher-interest-rate environment. The average leveraged loan had a debt-to-EBITDA ratio of 6x at YE2021, and this calculation was often based on aggressive EBITDA adjustments, meaning true leverage was probably often greater.[13]

Thus, even if these highly leveraged borrowers don't have near-term maturities, they may still breach covenants (if their loans had any) or, worse, run into liquidity issues as they seek to service spiking interest costs. As a result, borrowers may increasingly need to request concessions from their lenders or additional equity injections from their owners. This may further limit the capital available for new deals, benefiting those managers not facing legacy portfolio issues.

Figure 4: Most of the Leveraged Loan Market Was Unhedged Before the Interest Rate Spike



Source: Market size from Pitchbook LCD; percentage of hedged loans based on Oaktree estimate; both as of June 30, 2023

(2) Residential real estate is well positioned to weather the interest rate storm

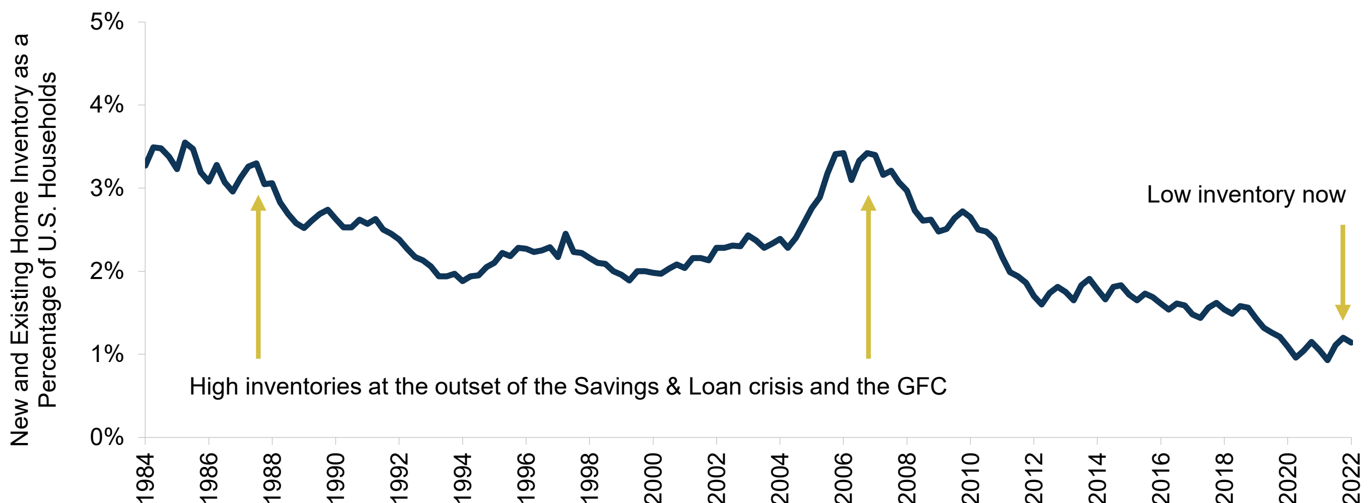
While rising interest rates have negatively impacted the entire real estate market, we believe the U.S. residential market is well positioned to withstand the current downcycle. **First, the supply/demand mismatch in the housing market will likely provide support for prices.** The supply of housing has been limited since construction slowed following the Global Financial Crisis. (See Figure 5.) And the situation has been exacerbated by many homeowners' unwillingness to sell and thereby relinquish their low mortage rates: Over 85% of homeowners in the U.S. have a 30-year mortgage rate below 5%, while the average rate for new mortgages has risen to 6.8%.[14]

Meanwhile, demand for housing remains robust in many markets – so much so that homebuilders typically don't need to carry large inventories of finished homes to attract homebuyers. Maintaining lean inventories has supported developers' bottom lines, which has helped enable many homebuilders to buy down interest rates for borrowers (i.e., pay upfront fees to reduce the mortgage rate for all or part of the borrowing period). **As a result, home prices, sales pace, and homebuilder profits have held up in many markets, even as the cost of a residential mortgage has more than doubled since the end of 2021.**[15]

Additionally, we believe the residential real estate market has become more resilient in the last decade. This is partly because of regulations enacted in the aftermath of the GFC, such as the Dodd-Frank Act, and the declining popularity of financial products that proved problematic during that crisis, like short-reset adjustable-rate mortgages. Moreover, current owners have record-high levels of home equity, and those who took on mortgages in the last decade were subject to much tighter credit standards than those who borrowed before 2007.[16]

Finally, government policymakers – perhaps remembering the economic scarring caused by the GFC – showed a willingness to support homeowners during the pandemic, including with forbearance programs and foreclosure moratoria. They may seek to do so again if they grow concerned about weakness in the housing market. **As a result, we believe residential real estate investors capable of identifying bargains today may be well positioned moving forward, even if interest rates remain elevated.**

Figure 5: Tight Housing Supply Could Support Residential Real Estate Prices



Source: John Burns Research and Consulting, Federal Reserve, Census Bureau; as of 1Q2023

(3) CLO equity investors today should focus on total return potential and track records, not just arbitrage

Media coverage of the CLO market in recent months has increasingly highlighted the shrinking CLO arbitrage and the supposed negative implications for CLO investors. But this conclusion is based on an outdated understanding of the +$1 trillion CLO market and misses the larger story: **the unprecedented increase in total return potential and improved optionality CLO equity investors are seeing today.**

CLO arbitrage refers to the difference between a CLO's financing costs and the income generated by its underlying loan portfolio. In the past, CLO managers typically purchased leveraged loans at or above par, so the potential profit for holders of CLO equity (the unrated notes subordinate to all other CLO debt) was based almost entirely on this arbitrage. **However, today, the loan market is trading at a discount to par, providing CLO equity investors with an additional avenue for profit, as managers can buy discounted loans that should appreciate toward par as they near maturity, unless they suffer losses from defaults.**

Moreover, two options that most CLO equity investors receive have become much more valuable in an environment where loan prices are low and interest rates are elevated. First, after a two-year no-call period, CLO equity holders can exercise their option to liquidate the loan portfolio to capitalize on price increases. Second, they have the option to lower the CLO's cost of debt by refinancing. These options were obviously far less valuable when interest rates were near zero and the loans market was trading above par.

Of course, loans are trading at a discount partly because of rising concerns about credit risk. Many investment banks are predicting that defaults in the loan market will average 3-5% over the next two years with below-average recovery rates.[17] But CLOs are structured with the expectation that the loan market will weaken during the CLO's lifetime: That's why CLOs <u>don't</u> have mark-to-market provisions and <u>do</u> have deleveraging mechanisms that kick in if the performance of the underlying portfolios deteriorates. Additionally, default forecasts for the entire loan market shouldn't be confused with the likelihood of defaults and losses in <u>specific</u> managers' portfolios.

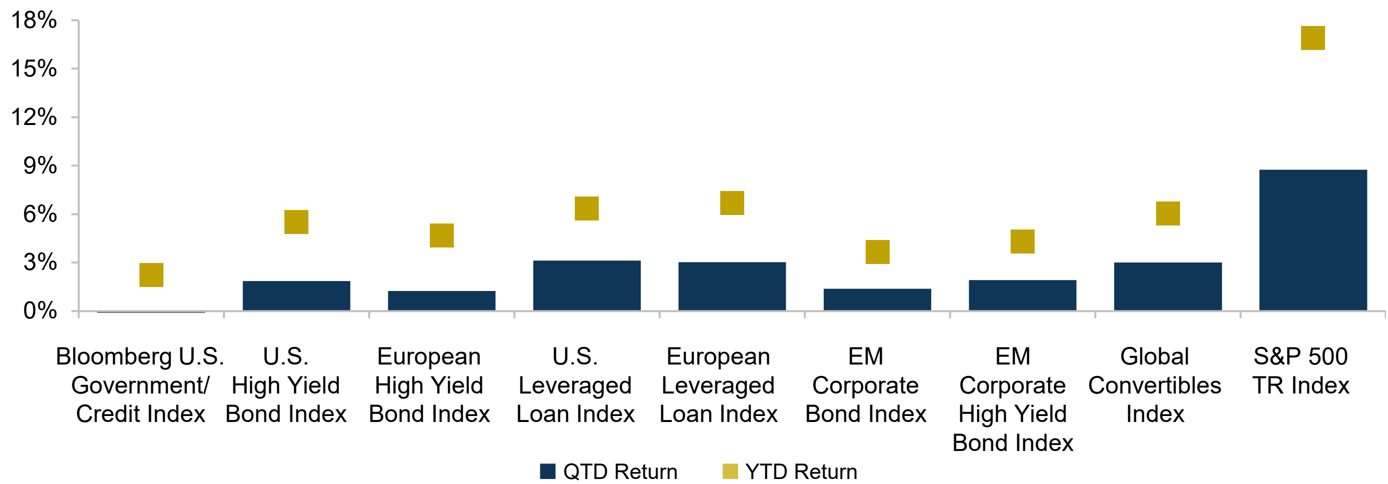
In short, we believe today's market environment is creating a rare total return opportunity for CLO equity investors, but we also think the key to taking advantage is identifying CLO managers with extensive credit expertise and the ability to navigate a complex environment.

(4) Markets may begin to price in refinancing risk among high yield bonds sooner than many investors are expecting

As we've noted multiple times in the last year, we don't expect the high yield bond default rate to spike dramatically in the near term, as maturities in this market don't start to increase meaningfully until roughly 2027 because of the wave of refinancings that occurred in 2020-21. But it's important to remember that a responsible company needing to refinance in 2027 will do so in 2025 or 2026, and the market is forward-looking, so it may begin to price in concerns about rollover risk as early as 2024.

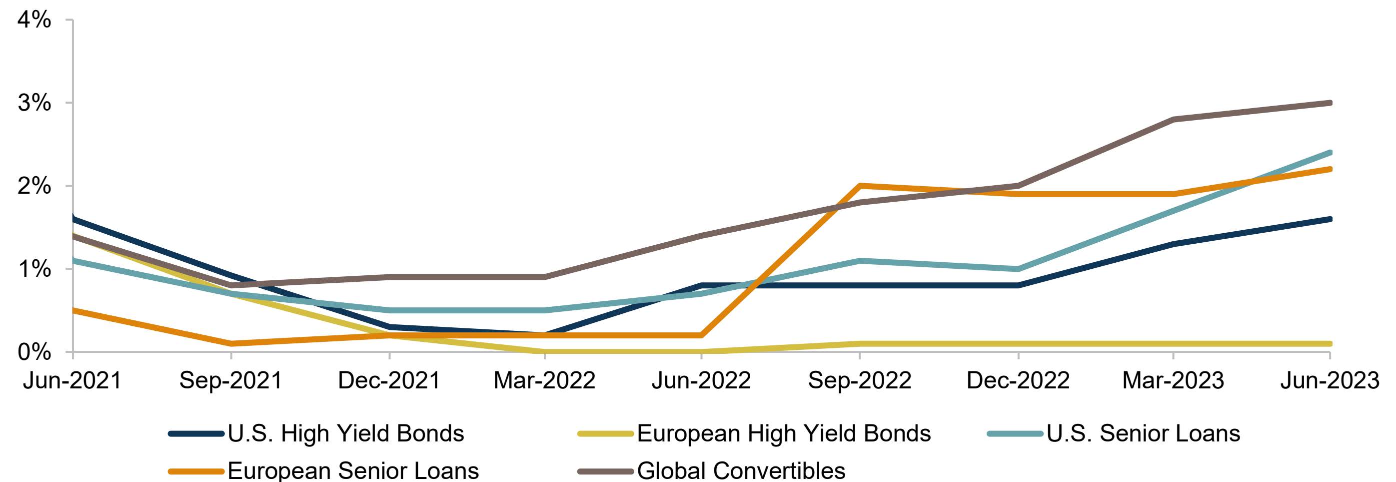
When companies do seek to refinance, they're obviously likely to face much higher borrowing costs. The average high yield bond coupon is currently around 6.0%, with a yield close to 8.5% at current prices – and we see little reason to believe the interest rate environment is going to change significantly in the near term.[18] **While companies that borrowed intelligently and used the money to improve their fundamentals may have little trouble refinancing, those that gorged themselves on cheap debt may find themselves in a challenging position if interest rates remain elevated.** And investors may also find themselves in a tough spot if they fail to recognize that – in market terms – 2027 isn't that far away.

Performance of Select Indices



As of June 30, 2023
Source: Bloomberg, Credit Suisse, FTSE, ICE BofA, JP Morgan, S&P Global, Thomson Reuters[19]

Default Rates by Asset Class



Source: Credit Suisse, JP Morgan
Note: Data represents the trailing-12-month default rate; excludes distressed exchanges

High Yield Bonds

Market Conditions: 2Q2023

U.S. High Yield Bonds – Return: 1.6%[20] | LTM Default Rate: 1.6%[21]

- **High yield bond spreads were volatile in 2Q2023 but ultimately tightened:** The asset class strengthened even as Treasury yields rose. While spreads were relatively unchanged in April, they widened to a three-month high in early May before contracting in June to finish the quarter modestly narrower, toward the middle of the historically normal range of 300-500 bps.[22]
- **Yields in the asset class remain elevated:** They were relatively unchanged over the period, but remain well above the ten-year average. (See Figure 6.) Approximately 60% of high yield bonds had yields above 7% at quarter-end, compared to less than 7% at the beginning of 2022.[23]
- **CCC-rated bonds continue to outperform:** The lowest credit ratings category returned 4.2% for the period, while B- and BB-rated bonds returned 1.8% and 0.8%, respectively.[24] CCCs benefited from their short duration in a rising-interest-rate environment as well as declining recession fears.

European High Yield Bonds – Return: 1.2%[25] | LTM Default Rate: 0.1%[26]

- **The asset class strengthened in 2Q2023:** B-rated bonds continued to outperform, having experienced 70 bps of yield spread compression in 1H2023. Energy and leisure were the best-performing sectors, while real estate and telecoms were the only two sectors to record a negative quarterly return.[27]
- **The spread premium versus U.S. high yield bonds expanded:** The European asset class's advantage increased to 88 bps at quarter-end but is still down from a high of 174 bps in 2022.[28]

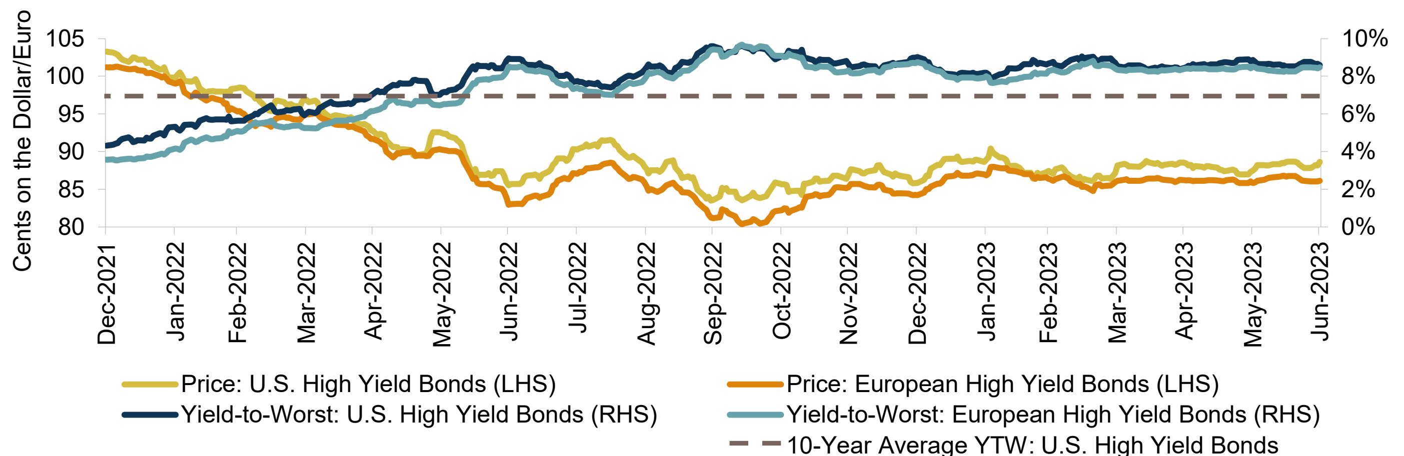
Opportunities

- **The risk of widespread defaults in 2023 remains low:** Issuers' fundamentals are fairly healthy despite the slowdown in economic growth, and near-term maturities are minimal.
- **Quality in the high yield bond market has improved:** The percentage of BB-rated bonds in the U.S. market is near a 10-year high, while the the percentage of CCC-rated credits declined during the decade.[29] Thus, the asset class's ability to weather an economic downturn appears to have improved.

Risks

- **Tight monetary policy could harm heavily indebted companies:** Low-rated corporate issuers might struggle to roll over debt if financial conditions remain restrictive.
- **High inflation may impair issuers' fundamentals and put upward pressure on interest rates:** While inflation has slowed, it remains elevated. Companies may be unable to pass along price increases to customers. Reduced earnings could negatively impact leverage ratios and potentially lead to credit rating downgrades. And central banks may have to continue raising interest rates if core inflation remains persistently high.

Figure 6: High Yield Bonds Are Offering Potentially Attractive Yields and a Low Average Price



Source: ICE BofA US High Yield Constrained Index and ICE BofA Global High Yield European Issuers Non-Financial Excluding Russia Index

Senior Loans

Market Conditions: 2Q2023

U.S. Senior Loans – Return: 3.1%[30] | LTM Default Rate: 2.4%[31]

- **U.S. senior loan prices rose in 2Q2023, despite accelerating downgrades and weakening fundamentals:** Performance was supported by rising interest rates and limited activity in the loan primary market.
- **Retail investors reduced their exposure to the asset class:** Loan mutual funds and ETFs recorded 14 consecutive months of outflows through June. Net outflows in 2Q2023 totaled $7.6bn. However, the monthly outflow in June was the lowest in 14 months, which may reflect declining recession fears and the recent outperformance of loans versus fixed-rate asset classes.

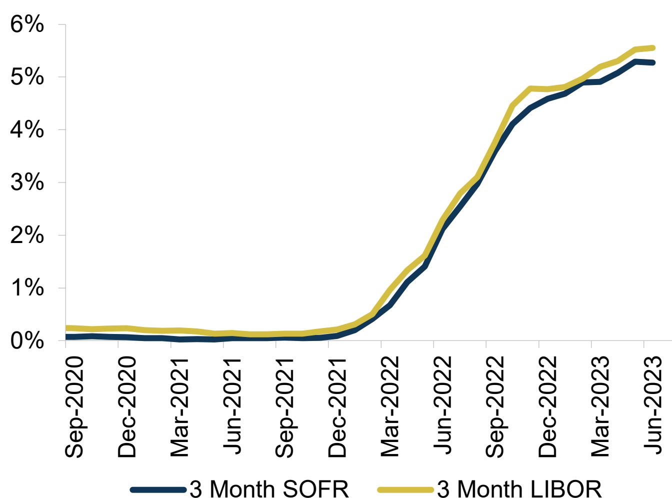
European Senior Loans – Return: 3.0%[32] | LTM Default Rate: 2.2%[33]

- **European loans strengthened over the quarter:** B-rated loans recorded the strongest performance, as their yield spreads compressed by 35 bps.[34]
- **New issuance continues to be very attractive:** While primary market activity has been limited, it is presenting investors with compelling opportunities to purchase quality loans at elevated yields.

Opportunities

- **High coupons may continue to attract investors:** The spike in reference rates over the last year could make floating-rate loans more compelling than fixed-rate assets. (See Figure 7.)
- **Low issuance could support performance:** Activity in the primary market is expected to remain limited through 3Q2023.[35] The performance of existing loans typically benefits when the supply of new loans shrinks.
- **Loans may experience less volatility than many other asset classes because of loans' stable buyer base:** CLOs – the primary holders of leveraged loans – have limited selling pressure, and the asset class tends to attract long-term institutional investors due to the lengthy cash settlement period.

Figure 7: Reference Rates for Floating-Rate Loans Have Spiked



Source: Bloomberg, as of June 30, 2023

Risks

- **Elevated interest rates may be burdensome to heavily indebted borrowers:** Companies that didn't hedge their interest rate risk – especially those in highly leveraged sectors like technology – could struggle to service their debt.
- **Economic growth may slow, increasing the likelihood of downgrades and defaults:** Downgrades in the U.S. exceeded upgrades by $81 billion in 2Q2023.[36] Additionally, defaults have accelerated, and average recovery rates are near 40%, well below the historical average of 64%.[37] The weakness is concentrated among loan-only borrowers.[38]
- **CLOs' buying activity could decline:** CLO creation has been erratic in 1H2023 and isn't expected to accelerate meaningfully before year-end. Moreover, roughly 40% of U.S. CLOs are exiting their investment periods by the end of 2023, meaning demand for new loans will likely decline.[39]
- **High inflation could harm companies' fundamentals:** While inflation has moderated, it remains elevated. Borrowers may struggle to pass along cost inflation to customers, which could negatively impact companies' earnings and leverage ratios, resulting in further downgrades.

Investment Grade Credit

Market Conditions: 2Q2023

Return: -0.3%[40]

- **Prices in the asset class were relatively unchanged in 2Q2023:** Investment grade debt was negatively affected by rising U.S. Treasury yields, but the impact was partially offset by narrowing yield spreads,[41] which averaged 23 bps at quarter-end, down from 138 bps as of March 31.[42]
- **Lower-quality credit outperformed:** The BBB-rated segment of the corporate bond index outperformed the AAA-rated segment by 90 bps in 2Q2023.[43] This was likely due to increased optimism about the U.S. economic outlook, the robust fundamentals in the investment grade corporate bond market, and the shorter duration of lower-rated credit.[44]

Opportunities

- **Investment grade corporate debt yields have remained elevated in 2023:** Yields in the asset class ended the quarter at 5.5%, well above the 5-year average.[45] (See Figure 8.)
- **Concerns about slowing economic activity may make investment grade debt attractive on a relative basis:** Investment grade debt is likely to outperform high yield bonds if widening yield spreads – as opposed to rising Treasury yields – prove to be the primary driver of performance in credit markets in 2H2023 and 2024.

Risks

- **Interest rates may rise higher than investors are currently anticipating:** Sticky inflation might compel the Fed to continue hiking interest rates, and the substantial Treasury issuance expected through year-end may exert upward pressure on Treasury yields.
- **High input costs and slowing economic growth could weigh on corporate earnings:** Issuers' fundamentals remain fairly strong on average, but margin compression could negatively impact credit metrics and lead to credit rating downgrades and mark-to-market weakness.

Figure 8: Investment Grade Bond Yields Remain Elevated Due to the Rise in Treasury Yields

Source: Bloomberg

Emerging Markets Debt

Market Conditions: 2Q2023

EM Corporate High Yield Bond Return[46] – 2Q2023: 1.9% | YTD: 4.3%

- **EM credit indices strengthened in 1H2023, as improving investor sentiment offset stress in specific countries:** EM debt finished 2Q2023 on a high note, as yield spreads in the asset class tightened by over 60 bps in June, driven by declining fears about a global recession.[47] EM credit markets trailed their developed market counterparts modestly in the period,[48] as multiple companies in two core EM countries, China and Brazil, experienced defaults and asset price dislocations.
- **Outflows from EM debt funds continued, and new issuance remained limited:** EM debt retail funds have recorded monthly outflows since February 2023.[49] While YTD EM high yield bond issuance is at its lowest level in over a decade,[50] activity increased modestly in June following a period of relative stability in financial markets. Looking forward, EM debt investors may have additional cash to invest, given that companies' aggregate bond payments have far exceeded new corporate debt fundraising in the year to date (i.e., net financing has been negative).[51] (See Figure 9.)
- **Latin American economies have been surprisingly resilient in 2023, while growth in China has been weaker than expected:** Latin American countries grew by 1.4% QoQ in 1Q2023, despite tight monetary conditions, as two of the region's largest economies, Mexico and Brazil, reported robust growth of 4% YoY.[52] Meanwhile, China experienced lower-than-expected demand for goods and services in 1H2023,[53] as high debt levels, elevated unemployment, and a weak property market weighed on consumption. This, in turn, put downward pressure on global commodity prices, which fell by more than 10% in aggregate over 1H2023, due to declines in the prices of oil, gas, metals, and grains.[54]

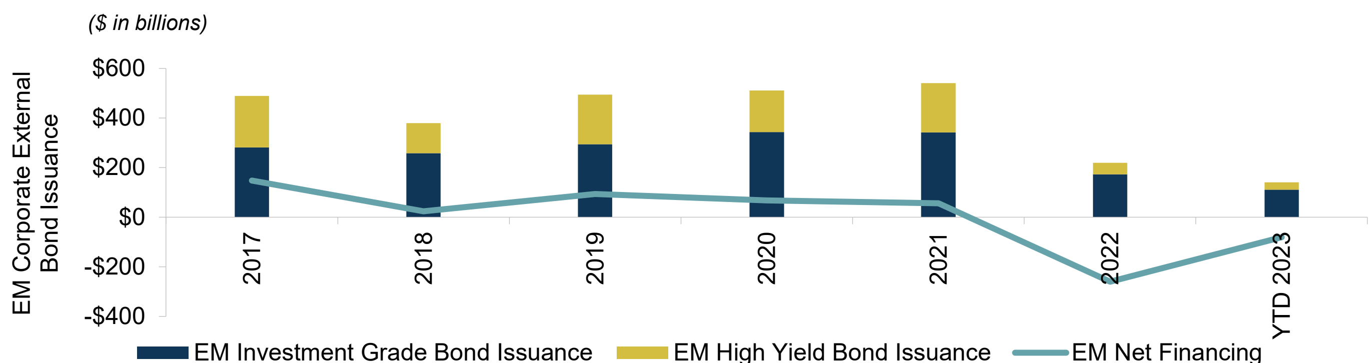
Opportunities

- **Weak capital flows and market volatility may create compelling EM price dislocations:** Volatility in the U.S. Treasury market has been elevated, and EM bond funds continue to face outflows. In this environment, EM credit may experience broad sell-offs, potentially creating opportunities for investors to purchase the debt of fundamentally sound issuers at dislocated prices.
- **Active management could be beneficial in this challenging environment:** Extensive credit analysis may enable investors to identify securities that offer attractive risk-adjusted return potential. Companies that can generate consistent cash flow may be well positioned in an environment where access to U.S. dollar financing is limited.

Risks

- **EM debt investors are potentially being inadequately compensated for risk:** Yield spreads of EM debt are only slightly wider than the historical average despite tight capital markets,[55] slowing economic growth, and elevated default rates. While default rates vary significantly between EM countries, the aggregate rate in 2022 was 14%, well above the long-term average, and the rate in 2023 is forecast to remain high at 6%.[56] Moreover, the recent decline in commodity prices to levels present before the invasion of Ukraine could put additional strain on the balance sheets of many large issuers in net-commodity-exporting countries.
- **Geopolitical tensions in EM remain elevated:** The war in Ukraine, Sino-U.S. relations, elections in Latin America, and macroeconomic instability in Turkey could all erode investor confidence in EM credit.

Figure 9: Net Financing Has Been Negative in EM Corporate Debt Since 2022



Source: JP Morgan, as of July 5, 2023

Global Convertibles

Market Conditions: 2Q2023

Return: 3.0%[57] | LTM Default Rate: 3.0%[58]

- **The asset class was boosted by the strong performance of global equity markets in 2Q2023:** The rally among convertible bond issuers mostly occurred in June and was primarily driven by (a) reduced recession concerns and (b) strength in the information technology and travel & leisure sectors.
- **Convertibles meaningfully underperformed equities:** Global convertibles haven't enjoyed the full benefit of the 1H2023 equity market rally for several reasons. First, the convertible bond universe has limited exposure to the large- and mega-cap companies responsible for the broad market rally. Instead, the asset class's performance is more closely correlated with that of the small-cap Russell 2000 Index, which underperformed the S&P 500 Index. Next, a convertible bond's delta (i.e., its sensitivity in equity price changes) declines as equity prices fall, so average deltas in today's convertibles market are low relative to history due to last year's equity market sell-off.
- **Technology stocks outperformed:** This sector was buoyed by the positive outlook for artificial intelligence. The U.S. is home to many AI-related companies, so the country's equity markets outperformed those in many other regions.
- **Primary market activity maintained a healthy pace:** New issuance of global convertibles totaled $19.5bn across 41 new deals during the period, well above last year's sluggish pace and in line with the pre-pandemic average volume.[59]
- **Convertible retail funds experienced significant outflows:** Concerns about the durability and narrow breadth of the equity market rally negatively impacted sentiment about the asset class throughout much of 2Q2023. However, the rally in convertibles at quarter-end could encourage inflows moving forward.

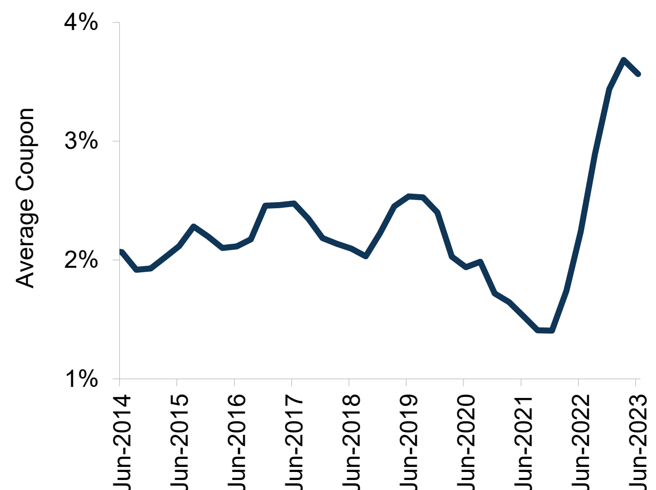
Opportunities

- **The convertibles universe is broad and diverse:** Many of the new deals in 2023 have come from historically underrepresented sectors (such as utilities and financials), investment-grade-rated issuers, and large-cap companies.
- **Convertibles are offering attractive yields and enhanced protections:** The average coupon for a new global convertible is 3.6%, compared to the low of 1.4% in 2021.[60] (See Figure 10.) Newly issued convertibles also feature more investor-friendly terms.
- **Issuers may turn more to the convertibles market in the coming year:** Since the Global Financial Crisis, issuance of high yield bonds has dramatically outpaced activity in the convertibles market. However, higher borrowing costs in traditional debt markets may encourage issuers to turn to convertibles. This trend could improve the quality of new convertibles issuance, potentially enhancing the average risk/return profile.

Risks

- **Numerous trends threaten to slow global economic growth and weigh on equity prices:** These include elevated inflation, tightening global monetary policy, concerns about slowing consumption, and geopolitical risk. Moreover, while the equity market rally broadened in June, performance has been supported by a few companies for most of 2023. Historically, such narrow breadth has often preceded bouts of market volatility.

Figure 10: Coupons for Newly Issued Convertibles Have Spiked



Source: BofA Global Research; trailing-12-month average coupon for global convertibles[61]

Structured Credit

Market Conditions: 2Q2023

Corporate – BB-Rated CLO Return: 4.7%[62] | BBB-Rated CLO Return: 3.8%[63]

- **Collateralized Loan Obligations strengthened in 2Q2023:** The asset class benefited as CLO creation slowed, especially in Europe, and concern about the U.S. regional banking crisis decreased.
- **Primary market activity remained muted:** Issuance of CLOs in the U.S. totaled $21.3bn in the period, down from $33.9bn in 1Q2023. Issuance in Europe totaled only €5.0bn during the quarter versus €6.7bn in 1Q2023.[64]

Real Estate – BBB-Rated CMBS Return: -2.7%[65]

- **Primary market activity continued to decelerate:** Issuance of commercial mortgage-backed securities has decreased by 77% in the year to date, with just $16bn of private label CMBS issued in the last six months, compared to $72bn in the same period last year.[66] However, issuance of conduit CMBS experienced a modest increase toward quarter-end.
- **Performance varied meaningfully by sector:** All sectors were negatively impacted by rising interest rates, higher capitalization rates, declining transaction volumes, and reduced bank lending. However, debt secured by residential assets has benefited from the ongoing supply/demand imbalance in the housing market. In commercial real estate, the office sector continued to face additional headwinds, but yield spreads in the industrial and multifamily sectors tightened due to supportive dynamics in these markets.[67]

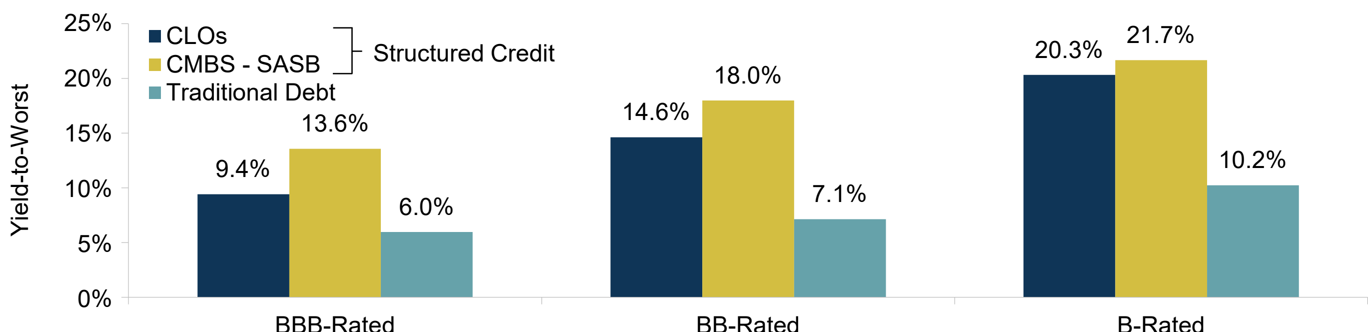
Opportunities

- **Corporate structured credit offers higher average yields than traditional credit asset classes:** CLOs have attractive yields as well as strong structural enhancements. (See Figure 11.)
- **Volatile markets could create compelling opportunities for CLO managers:** They can now often buy B- or BB-rated loans at significant discounts, meaning managers can potentially benefit from both CLO arbitrage and capital appreciation.
- **Weakness in the CMBS market could create compelling opportunities for disciplined investors:** We think firms with available capital and limited problems in their existing portfolios will be well positioned to take advantage of these opportunities. But in this challenging environment, it will be especially important to (a) conduct disciplined credit analysis and (b) remain senior in the capital structure.

Risks

- **CLOs have historically performed poorly during bouts of equity market weakness:** Performance could be negatively affected by anxieties about the economic outlook and the health of the loan market.
- **Activity in the CMBS primary market may remain muted:** Uncertainty surrounding the trajectories for interest rates, inflation, and the cost of financing may limit transaction volumes in the near term. Weakness in the office sector will also likely weigh down real estate structured credit indices.

Figure 11: Structured Credit Offers Higher Yields Than Most Traditional Debt



Source: Bloomberg Index Services, ICE Index Platform, Credit Suisse, JP Morgan, as June 30, 2023

Private Credit

Market Conditions: 2Q2023

- **The volume of sponsor-backed deals has declined as debt financing has become more expensive:** Banks, which have traditionally provided most of the debt financing for large-cap deals, continue to limit their lending activities, and new issuance in the loan market remains muted. Additionally, many large private lending funds have reduced average loan sizes, potentially due to concerns about slowing economic growth, sluggish fundraising, and existing portfolio issues. As a result, since early 2022, yield spreads for large-cap LBO financings (i.e., EBITDA ≥ $50mm) have increased by 100-150 bps, leverage levels have fallen, and sponsors' equity percentages have increased, lowering LTV ratios.[68]
- **Private deal volume in Europe has continued to decline as markets face many headwinds:** The region continues to be beset by high inflation, economic uncertainty, and geopolitical risk. Deals are taking longer to complete, as weak macroeconomic conditions are extending due diligence timelines. And small banks, which underwrite a significant proportion of deals in Europe, are curtailing their lending.

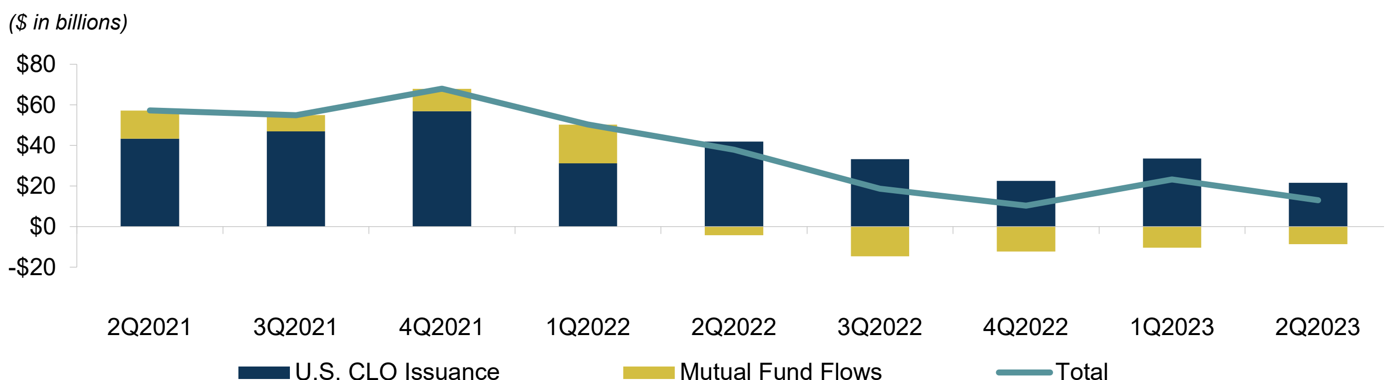
Opportunities

- **Private lenders could continue to gain market share in large-cap financings:** Bank lending in this market may remain inconsistent and limited for multiple reasons:
  (1) In 2022, many banks suffered meaningful losses on LBO debt commitments.
  (2) In 1H2023, the six largest U.S. banks wrote off $5bn of defaulted loans and set aside an additional $7.6bn to cover future defaults.[69]
  (3) Banks are potentially facing the biggest regulatory overhaul since 2008 following the banking turmoil in early 2023.
  (4) The syndicated market has become less reliable. In 2023, CLO formation has been uneven, and loan retail funds have experienced meaningful outflows. (See Figure 12.)
- **Opportunities in the non-sponsored market remain attractive:** Yield spreads in this market have widened by as much as 200 bps since the beginning of 2022, more than the 100-150 bps observed in the sponsor-backed market.[70]
- **European banks may continue to lose market share to private lenders:** The challenging macroeconomic backdrop could cause banks to continue curtailing lending.

Risks

- **Monetary policy could continue to tighten, negatively impacting the lending environment:** Central banks have signaled that they intend to keep interest rates higher for longer to combat persistently high inflation. Elevated interest rates may discourage new borrowing and make it challenging for current borrowers to roll over their debt, especially highly leveraged sponsor-backed companies.
- **Fears about a near-term U.S. recession moderated, but the economic outlook remains uncertain:** The labor market has been resilient, and spending on services is increasing. But high borrowing costs may curb growth, and even though inflation has decelerated, it remains elevated. Moving forward, private equity sponsors may not inject capital into struggling companies as they did in 2020–21.
- **Credit fundamentals in several sectors are deteriorating:** Consumer-facing companies are especially vulnerable, as it has become challenging to pass through price increases to customers.

Figure 12: Traditional Sources of Demand for Large LBO Loans Have Become Less Reliable



Source: LCD Pitchbook, as of June 30, 2023[71]

About the Authors

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Mr. Panossian is a managing director and Oaktree's Head of Performing Credit, as well as a member of the investment committee for Oaktree's Direct Lending and Global Credit strategies. He also serves as portfolio manager for the Strategic Credit strategy and co-portfolio manager for the Global Credit Plus and Diversified Income strategies. His responsibilities include oversight of the firm's performing credit activities including the senior loan, high yield bond, private credit, convertibles, structured credit and emerging markets debt strategies. Mr. Panossian also serves as co-portfolio manager for Oaktree's Life Sciences Lending platform, which focuses on investment opportunities across the healthcare spectrum from biotechnology and pharmaceuticals to medical devices and healthcare services. Mr. Panossian joined Oaktree in 2007 as a senior member of its Opportunities group. In January 2014, he joined the U.S. Senior Loan team to assume co-portfolio management responsibilities and lead the development of Oaktree's CLO business. Mr. Panossian joined Oaktree from Pequot Capital Management, where he worked on their distressed debt strategy. Mr. Panossian received a B.A. degree in economics with honors and distinction from Stanford University, where he was elected to Phi Beta Kappa. Mr. Panossian then went on to receive an M.S. degree in health services research from Stanford Medical School and J.D. and M.B.A. degrees from Harvard Law School and Harvard Business School. Mr. Panossian serves on the Advisory Board of the Stanford Institute for Economic Policy Research. He is a member of the State Bar of California.

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Ms. Poli is a managing director and portfolio manager within the Global Credit strategy. She is a founding member of the strategy, having helped design its portfolio management processes and having served as a member of the Global Credit Investment Committee since 2017. Ms. Poli has led the expansion of the firm's multi-asset credit offerings, including a product for Brookfield Oaktree Wealth Solutions which she has co-managed since 2021. In addition, Ms. Poli oversaw Oaktree's product management activities globally across Credit, Private Equity, Real Assets and Listed Equities from 2019 to 2023. Prior to joining Oaktree in 2014, Ms. Poli earned her M.B.A. at the UCLA Anderson School of Management, where she received the Laurence and Lori Fink Investment Management Fellowship. Prior thereto, she worked at PAAMCO KKR Prisma (formerly PAAMCO) where Ms. Poli helped manage hedge fund portfolios for institutional clients. Ms. Poli holds a B.S. degree in business administration from the University of Southern California and is a CAIA charterholder.

Oaktree's Performing Credit Platform

Oaktree Capital Management is a leading global alternative investment management firm with expertise in credit strategies. Our Performing Credit platform encompasses a broad array of credit strategy groups that invest in public and private corporate credit instruments across the liquidity spectrum. The Performing Credit platform, headed by Armen Panossian, has $67.8 billion in AUM and approximately 190 investment professionals.[72]

Endnotes

1. U.S. Bureau of Economic Analysis, as of June 29, 2023; U.S. Bureau of Labor Statistics, as of July 14, 2023.
2. Based on the estimates of the Federal Reserve. Excess savings refers to the savings accumulated in excess of what would have been expected based on long-term savings trends.
3. Hamza Abdelrahman and Luiz E. Oliviera. "The Rise and Fall of Pandemic Excess Savings." The Federal Reserve Bank of San Francisco. May 8, 2023.
4. Totals based on spending expectations in legislation.
5. U.S. Census Bureau, as of May 31, 2023; Axios.
6. U.S. Bureau of Labor Statistics, as of June 30, 2023.
7. Federal Reserve Bank of New York, as of 1Q2023.
8. U.S. Bureau of Economic Analysis, as of June 30, 2023; U.S. Bureau of Labor Statistics, as of July 7, 2023, Federal Reserve Bank of San Francisco, as of May 8, 2023.
9. Wage growth as calculated by the Federal Reserve Bank of Atlanta, as of July 8, 2023.
10. U.S. Treasury, as of July 18, 2023.
11. Bloomberg, Credit Suisse, ICE BofA, Preqin, Cliffwater, as of March 31, 2023; For middle-market direct lending data: Preqin, as of June 2022. "Low-rated debt" includes BBB-rated debt as well as below-investment grade debt.
12. U.S. Department of the Treasury.
13. Federal Reserve Bank of New York, as of July 14, 2023.
14. Freddie Mac, as of July 1, 2023.
15. Freddie Mac, as of July 1, 2023.
16. John Burns Research and Consulting, Federal Reserve, Census Bureau; as of 1Q2023.
17. JP Morgan.
18. ICE BofA Master II High Yield Index, as of June 30, 2023
19. The indices used in the graph are Bloomberg Government/Credit Index, Credit Suisse Leveraged Loan Index, Credit Suisse Western European Leveraged Loan Index (EUR hedged), ICE BofA US High Yield Index, ICE BofA Global Non-Financial HY European Issuers ex-Russia Index (EUR Hedged), Refinitiv Global Focus Convertible Index (USD Hedged), JP Morgan CEMBI Broad Diversified Index (Local), JP Morgan Corporate Broad CEMBI Diversified High Yield Index (Local), S&P 500 Total Return Index, and FTSE All-World Total Return Index (Local).
20. ICE BofA US High Yield Constrained Index.
21. JP Morgan.
22. ICE BofA US High Yield Constrained Index for all data in this bullet point. The normal range refers to the average range over the last 25 years.
23. ICE BofA US High Yield Constrained Index for all data in this bullet point.
24. ICE BofA US High Yield Constrained Index.
25. ICE BofA Global Non-Financial High Yield European Issuer, Excluding Russia Index (EUR hedged).
26. Credit Suisse.
27. ICE BofA Global Non-Financial High Yield European Issuer Excluding Russia Index.
28. ICE BofA US High Yield Constrained Index; ICE BofA Global Non-Financial High Yield European Issuer Excluding Russia Index.
29. ICE BofA US High Yield Constrained Index.
30. Credit Suisse Leveraged Loan Index as of June 30, 2023.
31. JP Morgan.
32. Credit Suisse Western Europe Leveraged Loan Index (EUR hedged).
33. Credit Suisse.
34. Credit Suisse Western Europe Leveraged Loan Index (EUR hedged).
35. JP Morgan.
36. JP Morgan.
37. JP Morgan, as of June 30, 2023.
38. JP Morgan, percentage of the loan market on a market-weighted basis, as of June 30, 2023.
39. JP Morgan.
40. Bloomberg US Corporate Index.

Endnotes

41. U.S. Department of the Treasury, Bloomberg US Corporate Index.
42. Bloomberg US Corporate Index.
43. Bloomberg US Corporate Index.
44. Bloomberg US Corporate Index.
45. Bloomberg US Corporate Index.
46. JP Morgan Corporate Broad CEMBI Diversified High Yield Index. The emerging markets debt section focuses on dollar-denominated debt issued by companies in emerging market countries.
47. JP Morgan Corporate Broad CEMBI Diversified High Yield Index.
48. Comparing EM Debt returns to ICE BofA US High Yield Constrained Index.
49. JP Morgan.
50. JP Morgan, as of June 30, 2023.
51. JP Morgan.
52. Goldman Sachs Global Investment Research.
53. National Bureau of Statistics of China.
54. Bloomberg Commodity Index.
55. Oaktree Capital Management, JP Morgan.
56. JP Morgan.
57. Refinitiv Global Focus Convertible Index.
58. Bank of America.
59. Bank of America for all issuance statistics in this bullet.
60. Bank of America; average calculated on a trailing-12-month basis.
61. Excludes mandatory convertibles (bonds which a company must convert into equity on or before a specific date).
62. JP Morgan CLOIE BB Index.
63. JP Morgan CLOIE BBB Index.
64. JP Morgan for all data in this bullet point.
65. Bloomberg US CMBS 2.0 Baa Index Total Return Index Unhedged Index.
66. JP Morgan, as of June 20, 2023.
67. JP Morgan.
68. Derived from Oaktree estimates, as of March 31, 2023.
69. Bloomberg, Financial Times.
70. Derived from Oaktree estimates, as of March 31, 2023.
71. Data represents gross CLO issuance and net mutual fund flows.
72. The AUM figure is as of March 31, 2023 and excludes Oaktree's proportionate amount of DoubleLine Capital AUM resulting from its 20% minority interest therein. The total number of professionals includes the portfolio managers and research analysts across Oaktree's performing credit strategies.

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