OAKTREE | Insights

Performing Credit Quarterly

3Q 2023

TAILS, YOU LOSE?

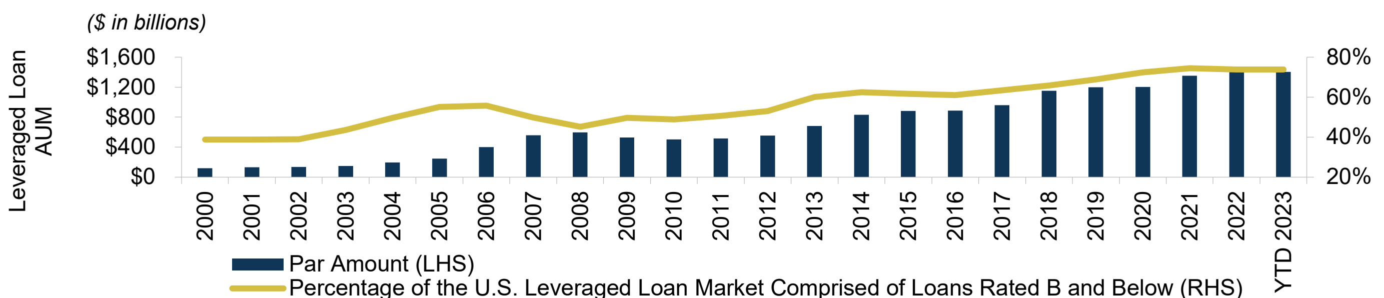
How healthy are today's leveraged credit markets? If you focus on averages, you'd likely conclude that fundamentals are fairly strong despite elevated interest rates and slowing earnings growth. The average debt-to-EBITDA ratio for U.S. leveraged credit was around 4.0x at the end of the second quarter, down from a high of 6.5x in 4Q2020 and just under 5.0x in 4Q2019.[1] While average interest coverage ratios[2] have deteriorated over the last year, the current levels – 5.3x for U.S. high yield bonds and 4.5x for U.S. leveraged loans – aren't sounding alarm bells.[3] However, this environment reminds us of one of our co-chairman Howard Marks's favorite adages, concerning the six-foot-tall man who drowned crossing the stream that was five-feet deep *on average*.

We believe investors in leveraged credit should be focusing less on average risk and more on tail risk: How is the weakest cohort of the borrower universe positioned? Can these companies service their debt if interest rates remain elevated? When do these companies face debt maturities? What might happen to the value of various debt tranches in a restructuring? When one scrutinizes the weak tails of the leveraged credit markets, it becomes clear that many companies – especially those with outstanding leveraged loans or private debt – borrowed too much at a time when interest rates were near zero, creating capital structures that have become unsustainable now that interest rates have risen by more than 500 basis points.

Importantly, the amount of debt represented by these tails is enormous. Not only have the U.S. leveraged loan (aka broadly syndicated loan) and private credit markets grown roughly twofold and sevenfold, respectively, since the Global Financial Crisis,[4] but the percentage of lower-quality debt in these markets has also increased.[5] Loans with credit ratings of B or below represented almost 75% of U.S. leveraged loans at the end of 3Q2023, compared to roughly 35% in 2000.[6] (See Figure 1.) Additionally, our market observations indicate that private debt experienced a similar deterioration in quality in the decades leading up to the recent interest rate spike.

When the weakest segment of the credit markets is both sizable and more vulnerable than usual, investors face elevated risk that (a) defaults will increase more than expected; (b) average recovery rates will be lower than anticipated; and (c) even healthy companies will experience temporary volatility. If this tail risk becomes a tail reality, both performing and distressed credit investors are likely to encounter an expanded set of pitfalls and opportunities.

Figure 1: Leveraged Loan Quality Has Declined as the Market Has Grown



Source: Preqin, Pitchbook LCD, JP Morgan; Credit Suisse Leveraged Loan Index

A Tail of Two Markets

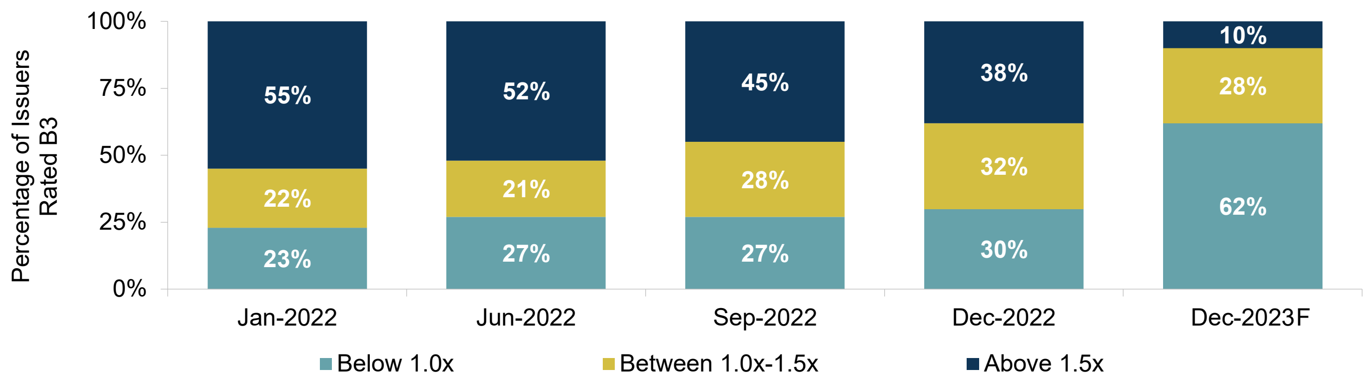
When analyzing the U.S. leveraged credit markets, it's important to first acknowledge the significant difference in quality between high yield bonds and leveraged loans. Almost half of the high yield bond market is now rated BB (the highest rung of below-investment-grade credit), which is near a ten-year peak.[7] While BB-rated debt represented more than 30% of the leveraged loan market ten years ago, that figure has since fallen to just above 20%, and B-rated debt now accounts for approximately 65% of the market.[8] This reduction in quality has only worsened over the last year, as the ratio of downgrades to upgrades in the loan market has risen to nearly two to one.[9] We believe downgrades will almost certainly increase for weaker B-rated loans if borrowers' earnings strength continues to weaken as their interest expense remains elevated. Finally, while broadly syndicated loans have slightly lower average leverage than high yield bonds, that's not the case with private debt. CreditSights estimates that median net leverage among private loans was almost twice that of high yield bonds at the end of 1Q2023.[10]

This divergence is driven primarily by two key factors: (1) loans became the financing tool of choice for leveraged buyouts (especially those involving highly leveraged healthcare and technology companies) in the years leading up to the interest rate spike in 2022 and (2) loans, unlike bonds, are predominately floating-rate instruments. We estimate that roughly two-thirds of outstanding U.S. leveraged loans were unhedged as of YE2021.[11] As a result, loan-only borrowers, which now represent the majority of the U.S. loan market, have seen a roughly 50% increase in interest expense over the last year, compared to only 21% and 3%, respectively, for bond-and-loan and bond-only issuers.[12]

When honing in on tail risk, the difference in quality between these asset classes becomes even more marked. Tail risk has increased moderately in the high yield bond market over the last year. The percentage of issuers with both interest coverage ratios below 1.5x and cash-to-debt ratios below 10% climbed to a post-GFC high in 2Q2023.[13] But the risk in the public and private loan markets is far more pronounced:

- **Slim interest coverage ratios:** Moody's Investors Services looked at the impact that a federal funds rate of 5.25%-5.50% would have on the interest coverage ratios[14] of more than 300 companies in the U.S and Canada with credit ratings of B3 (the equivalent of B- at other rating agencies). They projected that, when accounting for capital expenditures, the interest coverage ratios of 62% of these companies would fall below one by the end of 2023.[15] (See Figure 2.) This deterioration would primarily be driven by spiking interest costs, though slowing EBITDA growth would likely also play a role.

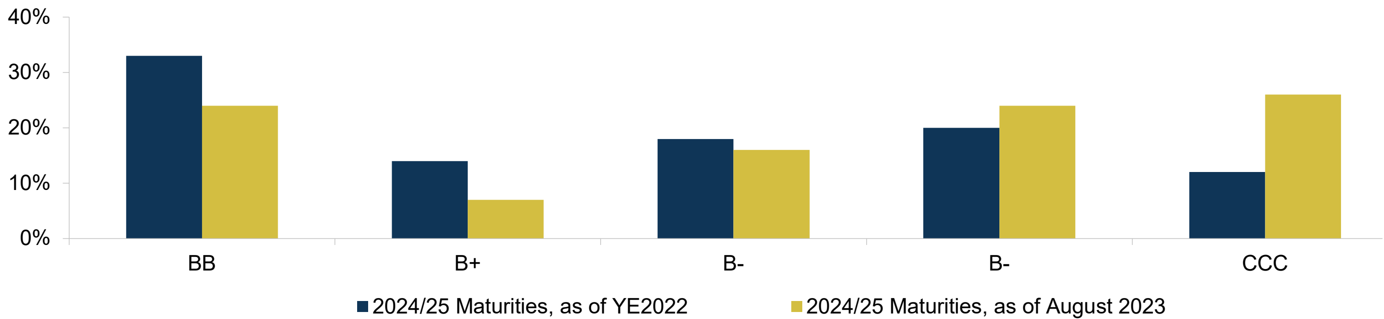
Figure 2: Interest Coverage Ratios in the U.S. Loan Market Could Decline Meaningfully



Source: Moody's Investor Services, as of July 27, 2023, forecasts as of July 2023

- **Worrisome maturity profiles:** While many issuers in both the bond and loan markets were able to refinance debt in recent years and thus extend their maturities, refinancings were less common among lower-rated borrowers. (See Figure 3.) Leveraged loans rated B3 and lower now represent the majority of 2024 maturities.[16] Private loans are facing an even more troubling near-term outlook. Almost 40% of the direct lending market is scheduled to mature by year-end 2025, compared to roughly 15% of broadly syndicated loans, according to Bank of America.[17]

Figure 3: Low-Rated Loans Haven't Materially Improved Their Maturity Profiles



Source: Pitchbook LCD, Bloomberg, Morgan Stanley Research, as of September 15, 2023; issuer rating by S&P Global

Importantly, we believe these overleveraged, interest-rate-sensitive borrowers could find themselves struggling to service their debt whether the Federal Reserve sticks a hard or soft landing. A recession would obviously further impair many vulnerable companies' fundamentals, but so would a sustained period of elevated interest rates, the likely outcome if there isn't a near-term recession. As we wrote in *Performing Credit Quarterly 2Q2023: Fighting the Fed*:

> **… 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.**

Thinking Big

How should credit investors respond in this environment? First, they should recognize that what most distinguishes this environment from those in the past is the sheer size of the global universe of potential dislocated debt. **It has quadrupled since the GFC.**[18] U.S. markets have grown so significantly that even if the annual default rates for U.S. leveraged loans and high yield bonds were to remain below their recessionary averages and only increase to their normal long-term averages for a three-year period, the resulting total would exceed the three-year default volume recorded during either the GFC or the dot-com crash in the early 2000s.[19] **This would both dramatically expand the universe for distressed debt investors and give skilled performing credit managers the opportunity to distinguish themselves through their superior risk control.**

In short, we may increasingly discover which credit investors have been able to – as we like to say at Oaktree – avoid the losers. These investors will likely have fewer problems in their legacy portfolios and thus be in a good position to take advantage of the bargain-hunting opportunities that may increase in the coming quarters. Meanwhile, less prudent investors may – like that six-foot-tall man – find themselves struggling to deal with an unexpectedly sharp drop.

Credit Markets: Key Insights for 4Q2023

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) Limiting duration and taking credit risk has benefited investors in 2023 and may continue to do so – if it's smart credit risk

In the first three quarters of 2023, credit spreads have narrowed, while Treasury yields continued to rise. Thus, debt investors who kept duration short by accepting some credit risk typically outperformed those who bet on an imminent recession by meaningfully increasing their sensitivity to interest rate increases. (Oaktree discussed this dynamic in a recent podcast.) Consider that U.S. investment grade bonds lost 1.2% in the first three quarters of the year, while U.S. high yield bonds and leveraged loans – which both have much shorter duration than IG debt – returned roughly 6.0% and 10.0%, respectively.[20] Clearly, most investors have been better off if they've avoided making large bets on macroeconomic forecasts and instead simply taken advantage of the high yields on offer.

However, in a highly uncertain environment in which companies' ability to service or refinance their debt is likely to become more challenging, it's essential that investors engage in rigorous bottom-up analysis and risk control. By doing so, they can potentially reduce the likelihood that they'll surrender return through defaults and be better able to build a portfolio that can perform well regardless of the twists and turns of the economic cycle.

(2) Technical factors are increasingly benefiting the high yield bond market

We've long noted that technical factors (i.e., factors unrelated to issuers' fundamentals) have helped support prices in the leveraged loan market, but we're now seeing a similar trend in the high yield bond market. While demand for the latter has been negatively impacted by the spike in interest rates since YE2021, supply has also been declining over this period. In the last two years, the par value of outstanding high yield bonds fell from $1.6 trillion to $1.2 trillion in the U.S. and from $692 billion to $490 billion in Europe.[21]

This contraction partly reflects the aforementioned increase in interest rates, as rising yields have caused many companies to refinance existing debt via alternative instruments (e.g., convertible bonds) or avoid issuing new debt. Additionally, in the last year, fallen angels (i.e., bonds downgraded from investment grade to below-investment grade) have been outpaced by bonds whose credit ratings have moved in the opposite direction. Finally, many of the weakest companies defaulted during the pandemic and have been unable to reissue. While interest rate volatility could weigh on all fixed-rate assets in the coming months, we believe positive technicals, moderate duration, and high quality will continue to provide counterbalancing support for the high yield bond market.

(3) In private credit, risk is concentrated in legacy portfolios, not recent deals

When assessing risk in private credit, it's important to recognize that quality varies meaningfully by vintage. Private credit deals completed in the last year have typically had fairly strong fundamentals: Senior leverage has been only 3.5x on average; the average equity contribution from sponsors has grown to roughly 60%; and the average yield spread has widened by 100-150 bps since YE2021.[22]

Risk is therefore concentrated in deals put in place before 2022 – when base rates were near zero, earnings estimates were optimistic, and investor protections were typically nonexistent. Specifically, we believe the weakest 20 to 30% of private credit portfolios have a meaningful risk of experiencing defaults or write-downs in the near term. Indications of rising stress are already present, as publicly traded business development companies (BDCs), which hold private debt, have begun to announce that some of their underlying borrowers are having to amend loan terms or engage in other actions associated with credit deterioration.

We believe private creditors are less likely to face these legacy portfolio issues if they limited their participation in LBOs during the boom period and instead focused on non-sponsor-backed deals with companies that needed capital for less speculative activities, like strategic growth initiatives. Private creditors that refrained from reaching for yield when interest rates were near zero may now be well positioned to secure both high yields and downside protection.

(4) The opportunity in CLO equity has historically been superior in dislocated markets

Many investors say "you make money on your buy" and, historically, this has been the case for those investing in CLO equity. We conducted back-testing using an approximation of an average new CLO portfolio, which indicated that the strongest performance for equity investors is likely to occur during periods in which a majority of loans are trading below par.[23]

Even though it may be more expensive to finance a CLO in a dislocated market, once the market strengthens, managers can typically refinance their liabilities at much narrower yield spreads. Managers obviously don't have a similar opportunity to reprice their assets once markets recover.

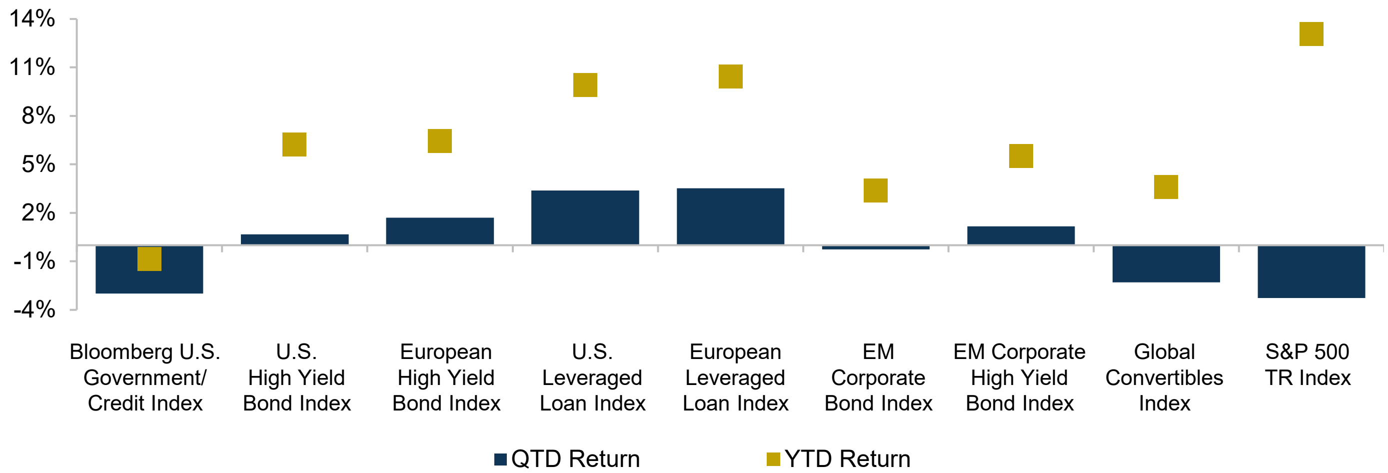
If CLO managers have done their credit work and sought to limit the risk of default and, more importantly, the risk of loss, then the discounted portfolio should recover to par over time. And because of the leverage inherent in CLO equity, that movement back to par has the potential to generate a very attractive total return. But, of course, such performance is only possible if managers avoid (or limit) defaults and losses, which is why we believe credit expertise, experience over multiple cycles, and risk control are essential for successful CLO managers.

(5) The risk/return calculus for credit versus equity investment may be shifting

We'll give Howard the last word, with an excerpt from his recent memo *Further Thoughts on Sea Change*:

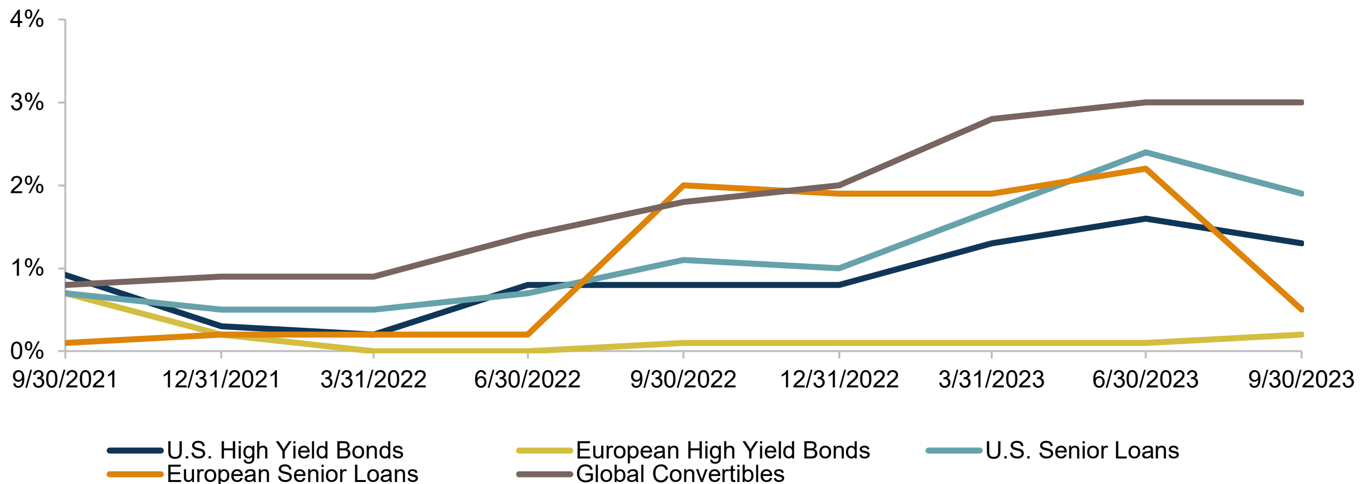
- **Will asset ownership be as profitable in the years ahead as in the 2009-21 period? Will leverage add as much to returns if interest rates don't decline over time or if the cost of borrowing isn't much below the expected rate of return on the assets purchased? Whatever the intrinsic merits of asset ownership and levered investment, one would think the benefits will be reduced in the years ahead.** And merely riding positive trends by buying and levering may no longer be sufficient to produce success. In the new environment, earning exceptional returns will likely once again require skill in making bargain purchases and, in control strategies, adding value to the assets owned.**… Lending, credit, or fixed income investing should be correspondingly better off.**

Performance of Select Indices



As of September 30, 2023
Source: Bloomberg, Credit Suisse, FTSE, ICE BofA, JP Morgan, S&P Global, Thomson Reuters[24]

Default Rates by Asset Class



Source: JP Morgan for high yield bonds; Credit Suisse for loans through 2Q2023, UBS for 3Q2023; Bank of America for Global Convertibles
Note: Data represents the trailing-12-month default rate; excludes distressed exchanges

High Yield Bonds

Market Conditions: 3Q2023

U.S. High Yield Bonds – Return: 0.5%[25] | LTM Default Rate: 1.3%[26]

- **Yield spreads were relatively unchanged over the quarter:** While spreads compressed in July, they widened throughout the remainder of the quarter, remaining in the middle of the historically normal range of 300–500 bps.[27]
- **Yields in the asset class increased slightly:** They rose over the period along with interest rates and remain well above the ten-year average. (See Figure 4.) Approximately 85% of high yield bonds (by market value) had yields above 7% at quarter-end, compared to less than 7% at the beginning of 2022.
- **CCC-rated bonds continue to outperform:** The lowest credit ratings category returned 2.6% for the period, while B- and BB-rated bonds returned 1.0% and -0.3%, respectively. CCCs have benefited from their short duration as interest rates have risen.

European High Yield Bonds – Return: 1.7%[28] | LTM Default Rate: 0.2%[29]

- **The asset class strengthened in 3Q2023 despite rising interest rates:** European high yield bonds benefited from their relatively short average duration and the offsetting impact of tightening credit spreads.
- **Every sector recorded a positive return, but there was significant dispersion among sectors:** Energy and retail recorded the strongest performance, while real estate lagged for the fourth consecutive quarter, as property valuations remained under pressure in a rising-interest-rate environment.

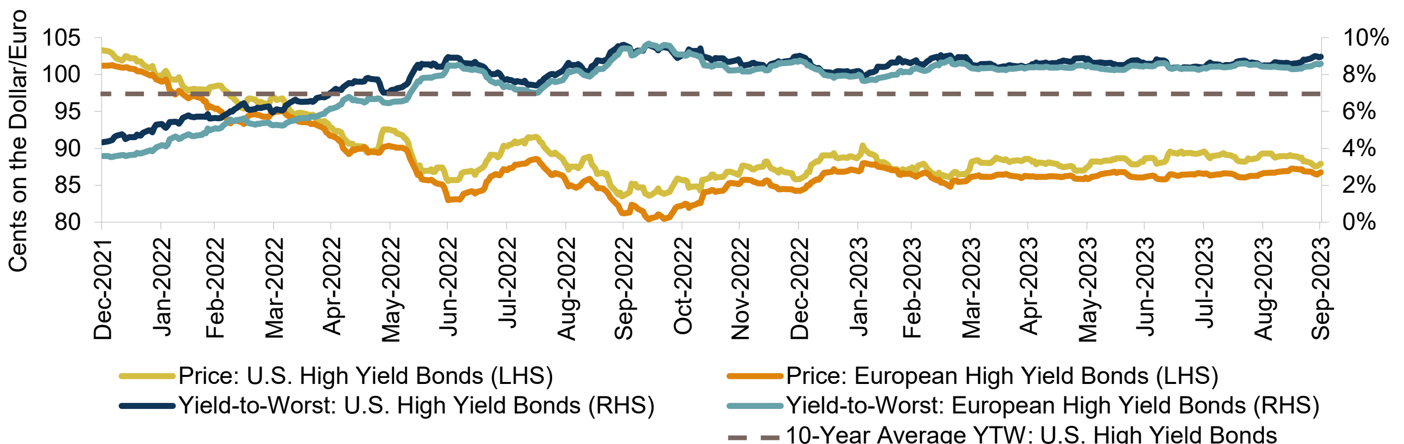
Opportunities

- **High yield bonds are trading at a steep discount to par:** Investors have the potential to earn meaningful capital appreciation while retaining strong call protection.
- **The risk of widespread defaults remains low in the near term:** Issuers' fundamentals are fairly healthy, and there are few significant maturities in 2023 and 2024.
- **Quality in the high yield bond market has improved:** The percentage of BB-rated bonds in the U.S. market is near a ten-year high, while the percentage of CCC-rated credits declined during the decade. Thus, the asset class's ability to weather an economic downturn appears to have improved.

Risks

- **Concerns about medium-term maturities may soon be reflected in bond prices:** Companies needing to refinance in 2027 will likely do so in 2025 or 2026, and the market may begin to price in concerns about rollover risk as early as 2024. Low-rated corporate issuers might struggle to roll over debt if financial conditions remain restrictive.
- **High inflation may impair issuers' fundamentals:** While inflation has slowed, it remains elevated. Companies may be unable to pass along price increases to customers. Weaker earnings could negatively impact leverage ratios and potentially lead to credit rating downgrades.

Figure 4: High Yield Bonds Are Offering 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: 3Q2023

U.S. Senior Loans – Return: 3.4%[30] | LTM Default Rate: 1.9%

- **U.S. senior loan prices rose in 3Q2023 along with interest rates:** Performance was supported by rising interest rates as well as inflows from retail funds, healthy demand from CLOs, and reduced recession fears.
- **The asset class gained favor with retail investors:** Loan mutual funds and ETFs experienced quarterly inflows after 15 consecutive months of outflows through July. Net inflows in 3Q2023 totaled $900 million. The reversal in flows likely reflected declining recession fears and the recent outperformance of loans versus other fixed-rate asset classes. However, fund flows remain negative for the year to date.

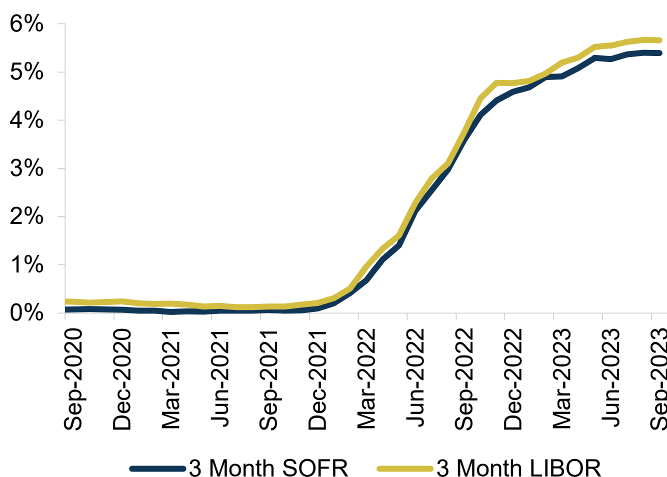
European Senior Loans – Return: 3.5%[31] | LTM Default Rate: 0.5%

- **European loans strengthened over the quarter as government bond yields rose:** The average loan price increased by over two cents. CCC-rated loans recorded the strongest performance, returning 5.6%.
- **New issuance continues to be very attractive:** While primary market activity has been limited, it's 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 since YE2021 could make floating-rate loans more compelling than fixed-rate assets. (See Figure 5.)
- **Low issuance could support performance:** Activity in the primary market increased in August and September but is expected to be fairly limited through year-end.[32] 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 5: Reference Rates for Floating-Rate Loans Have Spiked



Source: Bloomberg, as of September 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 – may experience meaningful deterioration in their interest coverage ratios.
- **CLOs' buying activity could decline:** CLO creation has been erratic during 2023 and isn't expected to accelerate meaningfully before year-end.
- **High inflation could harm companies' fundamentals:** While inflation has moderated, it remains elevated. Companies with outstanding loans may struggle to pass along cost inflation to customers, which could negatively impact their earnings. This could cause leverage to increase and coverage ratios to decline, resulting in further downgrades and liquidity challenges.

Investment Grade Credit

Market Conditions: 3Q2023

Return: -3.1%[33]

- **Investment grade debt was negatively affected by rising U.S. Treasury yields:** Surprisingly robust U.S. economic data, hawkish guidance from the Federal Reserve, and significant amounts of Treasury issuance have put upward pressure on interest rates.
- **Higher-quality credit outperformed:** The AAA-rated segment of the corporate bond index outperformed the BBB-rated segment by almost 90 bps in 3Q2023.

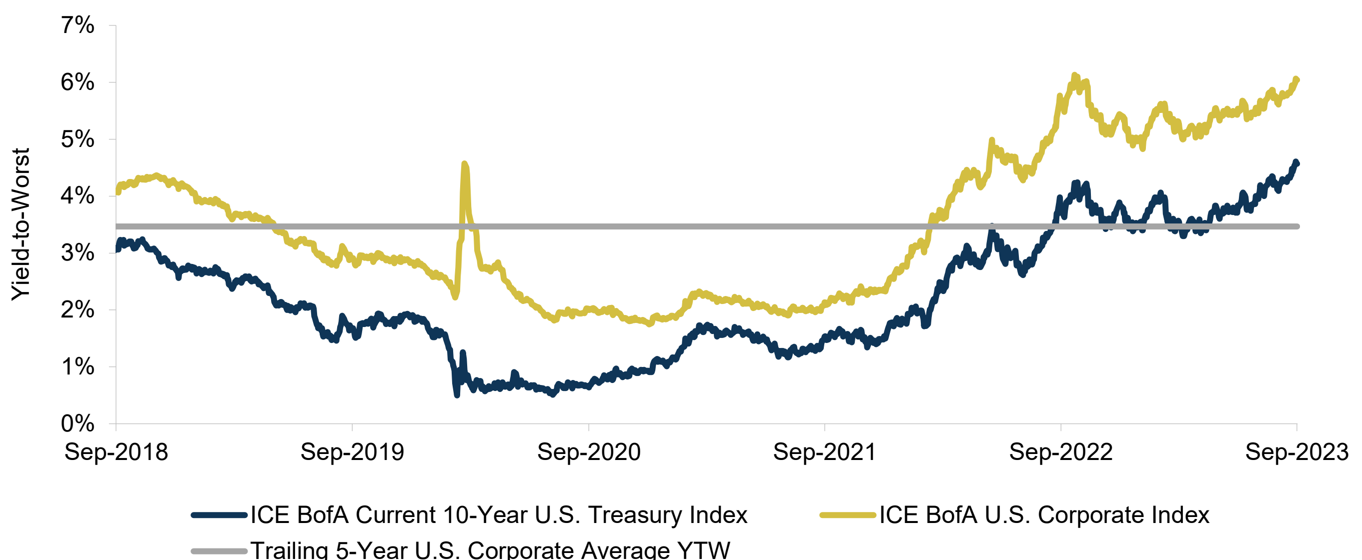
Opportunities

- **Investment grade corporate debt yields have remained elevated in 2023:** Yields in the asset class ended the quarter at 6.0%, well above the five-year average. (See Figure 6.)
- **Investment grade debt may benefit if economic activity slows:** 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 4Q2023 and 2024.

Risks

- **Interest rates may remain elevated longer than investors are currently anticipating:** The futures market is pricing in a high probability of multiple interest rate cuts in 2024, which may be overly optimistic.[34] If the U.S. doesn't experience a meaningful recession or crisis, the Fed would have little incentive to reduce interest rates. Moreover, disinflation could slow, which would further reduce the likelihood of near-term interest rate cuts.
- **A slowdown in economic growth could weigh on corporate earnings:** Issuers' fundamentals remain fairly strong on average, and the U.S. economy has proven to be resilient. But earnings growth is slowing, and margin compression could negatively impact credit metrics, leading to mark-to-market weakness.

Figure 6: Investment Grade Bond Yields Remain Elevated Due to Rising Treasury Yields



Source: Bloomberg

Emerging Markets Debt

Market Conditions: 3Q2023

EM Corporate High Yield Bond Return[35] – 3Q2023: 1.2% | YTD: 5.5%

- **EM high yield bonds recorded a positive quarterly return, driven by the performance of debt with shorter tenors:** Policy rates in many developed markets rose during the quarter, which weighed heavily on long-duration securities. EM high yield bonds maturing in seven years or more posted a small loss, while those maturing in less than seven years (the majority of the market) recorded a positive return.[36] (See Figure 7.)
- **EM debt default rates remain low in most regions:** EM default rates in the first three quarters of 2023 were in line with those in global high yield bond markets, when excluding China's troubled property sector.[37] While the expansive Brazilian market has experienced an increase in corporate distress this year, most risks related to specific countries remained under control through September, as evidenced by the fact that there has been only one sovereign default this year.
- **Outflows from EM debt retail funds accelerated during the quarter, while primary market activity rebounded modestly in September:** Cumulative YTD outflows are significant but still smaller than the record-high total in 2022.[38] Similarly, total issuance in 2023 is expected to be slightly above the ten-year low recorded in 2022. However, interest rate volatility may cause issuance to slow into year-end, and EM companies' aggregate bond payments in 2023 continue to far exceed new corporate debt fundraising.[39]
- **Latin American economies remained resilient:** The region enjoyed solid economic growth, led by Brazil and Mexico, despite tight global financial conditions. Central banks in this region are expected to reduce interest rates in 2H2023 by nearly 100 bps, on average, from the current double-digit levels.
- **In China, new government policies helped moderate pessimism about the country's growth outlook:** Industrial activity and consumer demand stabilized, as policymakers seeking to achieve the country's 5% growth target announced policies designed to stimulate economic growth, boost the property sector, and shore up the currency.

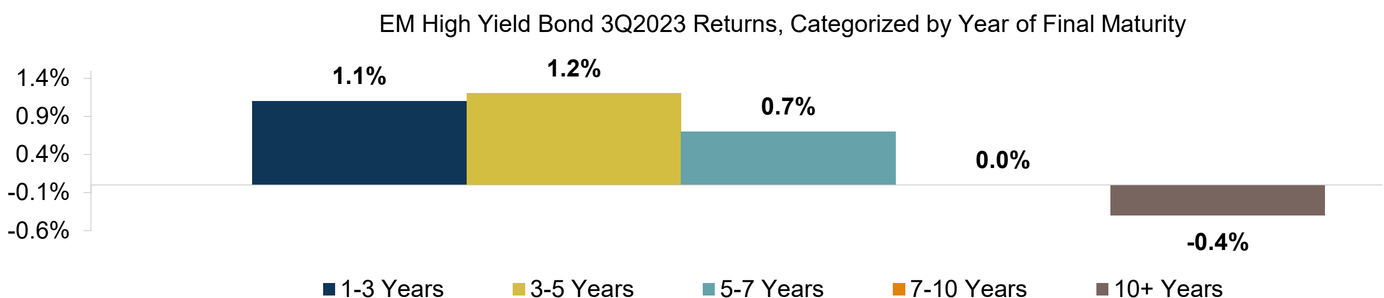
Opportunities

- **Opportunities for EM investors have improved due to the prolonged period of tight monetary policy globally:** Rising yields in U.S. and European debt markets have caused many cross-over investors to exit EM debt markets. Consequently, EM-dedicated investors with capital to deploy can now typically enjoy enhanced investor protections and high yields.
- **The yield spread differential between EM and U.S. high yield bonds now exceeds the long-term average:** The average yield spreads in EM high yield bond indices are 100 bps wider than those of their U.S. counterparts, even though the former market features companies with lower leverage and more defensive business models on average.[40]

Risks

- **EM debt investors are potentially being inadequately compensated for risk, despite the increase in yields:** Yield spreads in EM debt are only slightly wider than the historical average despite tight capital markets,[41] slowing economic growth, and elevated default rates.
- **Geopolitical tensions in EM remain elevated:** The war in Ukraine, complicated China-U.S. relations, elections in Latin America, and instability in the Middle East could all erode investor confidence in EM credit.

Figure 7: Performance in EM Debt Varied Significantly by Tenor in 3Q2023



Source: JP Morgan Corporate Broad CEMBI High Yield Plus Index, as of September 30, 2023

Global Convertibles

Market Conditions: 3Q2023

Return: -2.3%[42] | LTM Default Rate: 3.0%[43]

- **Declining equity prices weighed on global convertibles' performance in 3Q2023:** Most global equity markets weakened during the period, which caused convertible bond prices to fall. This trend was driven by expectations that the Federal Reserve will keep interest rates higher for longer and the attendant spike in U.S. Treasury yields to levels not seen since 2007. In addition, economic weakness in China put further pressure on convertibles in Asia and Europe.
- **Energy stocks outperformed, while high-multiple equities lagged:** Many energy companies' stocks rallied as production cuts by OPEC+ and resilient global demand drove oil prices higher. On the other hand, rising Treasury yields negatively impacted the performance of growth-oriented and high-multiple equities.
- **Primary market activity remained fairly strong:** In 3Q2023, new issuance of global convertibles totaled $21.5bn across 37 new deals. This exceeded the sluggish pace seen through most of 2022 and was in line with the pre-pandemic quarterly average.

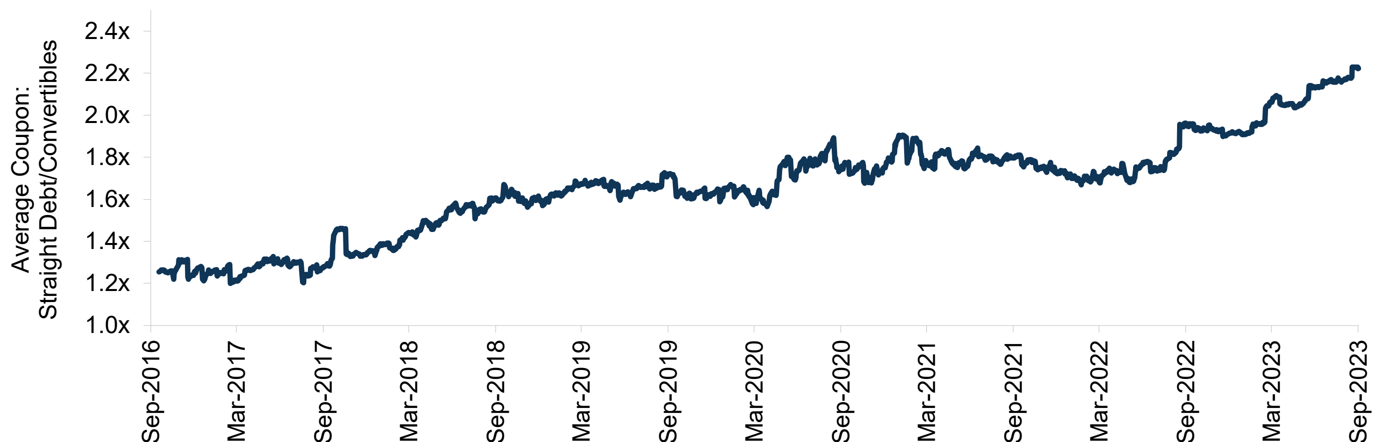
Opportunities

- **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, expectations that interest rates will remain higher for longer may encourage issuers to turn to convertibles, which currently offer average coupons that are more than 2.2 percentage points lower than those of straight debt. (See Figure 8.)
- **Convertibles are offering attractive yields and enhanced protections:** The average coupon for a new global convertible is 3.1%, compared to the low of 1.4% in 2021. Newly issued convertibles also feature more investor-friendly terms.
- **The convertibles universe is broad and diverse:** Many of the new deals in 2023 have come from historically underrepresented sectors (e.g., utilities and financials), investment-grade-rated issuers, and large-cap companies.

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.

Figure 8: The Difference Between the Coupons of Straight Debt and Convertible Bonds Is the Largest Since 2016



Source: BofA Global Research; represents secondary market convertible bond coupons and secondary market straight debt coupons

Structured Credit

Market Conditions: 3Q2023

Corporate – BB-Rated CLO Return: 7.0%[44] | BBB-Rated CLO Return: 5.8%[45]

- **Collateralized Loan Obligations strengthened in 3Q2023:** The asset class benefited as concern about a U.S. recession decreased and demand for CLOs outpaced supply growth.
- **Activity in the primary market rose moderately:** Issuance of CLOs in the U.S. totaled nearly $30bn in the period, up from $22bn in 2Q2023. Issuance in Europe totaled €7.5bn, compared to €5.4bn in 2Q2023.[46] Despite the recent increase, YTD issuance remains below levels in the first nine months of 2021 and 2022.

Real Estate – BBB-Rated CMBS Return: -2.2%[47]

- **Primary market activity has continued to decelerate:** Issuance of commercial mortgage-backed securities has decreased by 66% in the year to date, with just $31bn of private label CMBS issued in the last nine months, compared to $92bn in the same period last year.
- **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.

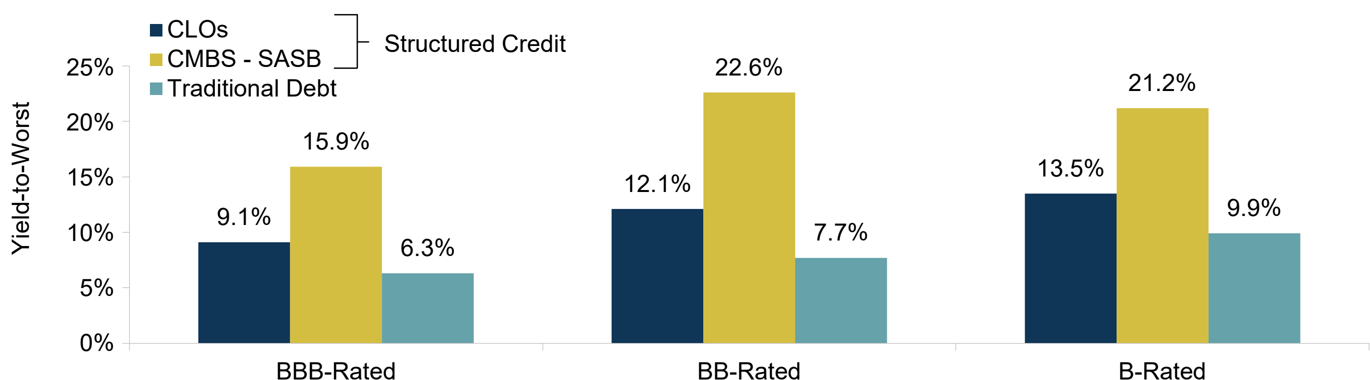
Opportunities

- **Corporate structured credit offers higher average yields than traditional credit asset classes:** CLOs have attractive yields as well as strong structural enhancements. (See Figure 9.)
- **Volatile markets could create compelling opportunities:** CLO managers can now often buy B- or BB-rated loans at discounts to par, meaning managers can potentially benefit from both the CLO arbitrage and capital appreciation.
- **Weakness in the CMBS market could create compelling opportunities for disciplined investors:** Investors with available capital and limited problems in their existing portfolios may 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 experienced increased volatility during bouts of equity market weakness:** Performance could be negatively affected if investors' risk appetite declines or if the loan market experiences a large wave of downgrades and/or defaults.
- **Activity in the CMBS primary market will likely 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 may persist:** The sector continues to face multiple headwinds. The performance of this sector will likely weigh on real estate structured credit indices.

Figure 9: Structured Credit Offers Higher Yields Than Most Traditional Debt



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

Private Credit

Market Conditions: 3Q2023

- **Private credit has been resilient in 3Q2023, but it's likely to weaken in the near term:** Strong YTD performance has been supported by robust U.S. economic growth and proactive actions taken by sponsors and lenders to stave off liquidity problems among vulnerable borrowers.[48] But companies haven't yet felt the full impact of rate increases, so performance may deteriorate moving forward.
- **Average private credit terms remain relatively lender-friendly:** While yield spreads compressed modestly during the quarter, they remain wider than the historical average, and covenants continue to be more restrictive than in recent years.[49] Additionally, average loan-to-value ratios have decreased for new deals, as private equity sponsors have been under pressure to contribute higher percentages of equity capital due to portfolio companies' elevated interest burdens.[50]
- **Private deal volume in Europe remains muted:** 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.

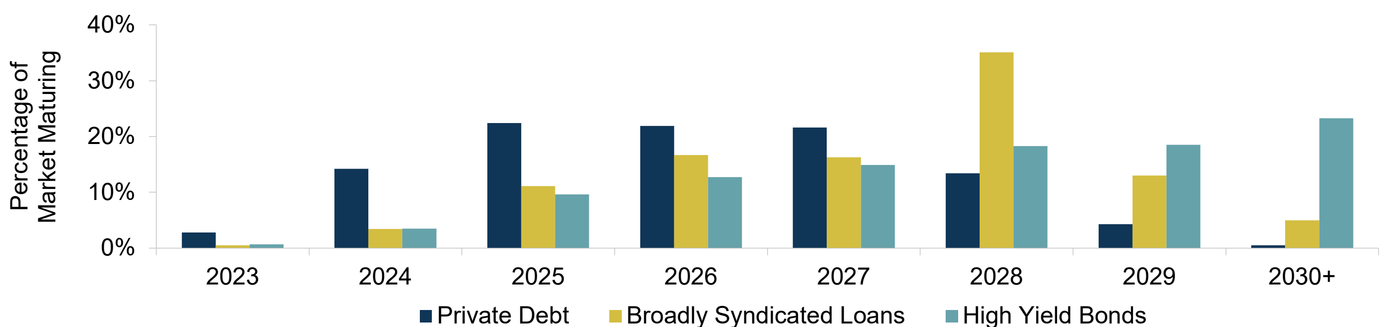
Opportunities

- **Demand for private debt financing appears to be increasing:** Sponsor-backed M&A activity has risen since Labor Day.[51] Moreover, demand for refinancings is likely to grow significantly in the coming years, as an estimated 40% of the direct lending market is maturing in 2024-25.[52] Only about 15% of both the high yield bond and leveraged loan markets are expected to mature in 2024-25. (See Figure 10.)
- **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 $5.0bn of defaulted loans and set aside an additional $7.6bn to cover future defaults.[53]
  (3) The syndicated market has become less reliable. In YTD 2023, CLO formation has been uneven, and loan retail funds have experienced meaningful outflows.
- **European banks may continue to lose market share to private lenders:** The challenging macroeconomic backdrop could cause banks to continue curtailing lending. Moreover, we're increasingly seeing European banks partnering with direct lenders on new deals.

Risks

- **More borrowers are likely to feel the negative impact of higher interest rates:** We expect a greater number of companies to face liquidity challenges in the coming quarters, especially borrowers with unitranche floating-rate debt structures put in place in 2021 and earlier.
- **Monetary policy could remain tight, negatively impacting the lending environment:** Central banks have signaled that they intend to keep interest rates higher for longer to combat persistently high inflation. This 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 have 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.

Figure 10: Private Debt Faces a More Imposing Near-Term Maturity Wall than BSLs and High Yield Bonds



Source: BofA Global Research, ICE, DLD, as of June 30, 2023[54]

About the Authors

Armen Panossian

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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 $71.4 billion in AUM and approximately 190 investment professionals.[55]

Endnotes

1. JP Morgan, *2Q2023 Leveraged Loan Credit Fundamentals*. September 25, 2023.
2. Interest coverage ratio defined as EBITDA/interest expense.
3. JP Morgan, *2Q2023 Leveraged Loan Credit Fundamentals*. September 25, 2023.
4. References to GFC are based on data as of December 2007.
5. Preqin and Pitchbook LCD, as of March 30, 2023.
6. Credit Suisse Leveraged Loan Index.
7. ICE BofA US High Yield Constrained Index, as of September 30, 2023.
8. Credit Suisse Leveraged Loan Index, as of September 30, 2023.
9. JP Morgan, as of September 29, 2023. The downgrade-to-upgrade ratio is 1.65:1 on a dollar basis.
10. CreditSights. *US HY Vs Lev Loan Fundamentals Comparison (1Q23)*. July 17, 2023.
11. Percentage based on loan volume at par value, as of September 30, 2023.
12. JP Morgan, *2Q2023 Leveraged Loan Credit Fundamentals*. September 25, 2023.
13. Morgan Stanley, *2Q23 Fundamentals – A Faster Descent*. September 29, 2023.
14. Interest Coverage ratio defined as (EBITDA – capex) / LTM interest expense.
15. Moody's Investors Services, as of July 27, 2023. Data as of December 31, 2022.
16. Morgan Stanley, *Climbing a Wall of Worry*. September 15, 2023.
17. BofA Global Research. *Private Debt: Opportunities and challenges in a new rates regime*. October 2, 2023.
18. Universe of potential distressed credit includes debt related BBB and below and private credit. Bloomberg Barclays, Credit Suisse, ICE BofA, Preqin, as of June 30, 2023. For Middle Market / Direct Loans data from Preqin as of December 2022.
19. JP Morgan and Oaktree analysis.
20. Bloomberg US Aggregate Bond Index, ICE BofA US High Yield Constrained Index, Credit Suisse Leveraged Loan Index, as of September 30, 2023.
21. ICE BofA US High Yield Constrained Index, ICE BofA Global High Yield European Issuers Index; statistics comparing December 31, 2021 and September 30, 2023.
22. Refinitiv LPC's Private Deals Analysis, Refinitiv, and Oaktree market observations, as of June 30, 2023.
23. In this analysis, Oaktree excluded the worst-performing loans (i.e., those with prices below 90 cents on the dollar) when creating an approximate average new CLO portfolio, as CLOs are restricted from buying the riskiest loans. Dislocations were defined as periods in which the loan portfolio was trading below particular price thresholds (i.e., below 99 cents on the dollar). We calculated hypothetical equity returns for two sets of CLO liability structures: (a) one with a weighted-average cost of debt of the reference rate plus 150 bps, representative of "par loan" markets, and (b) one with a weighted-average cost of debt of the reference rate plus 225 bps, representative of "dislocated" markets.
24. 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).
25. ICE BofA US High Yield Constrained Index for all references to U.S. High Yield Bonds, unless otherwise specified.
26. JP Morgan for all U.S. default rates, unless otherwise specified.
27. The normal range refers to the average range over the last 25 years.
28. ICE BofA Global Non-Financial High Yield European Issuer, Excluding Russia Index (EUR hedged) for all references to European High Yield Bonds, unless otherwise specified.
29. UBS for all European default rates, unless otherwise specified.
30. Credit Suisse Leveraged Loan Index for all data in the U.S. Senior Loans section, unless otherwise specified.
31. Credit Suisse Western Europe Leveraged Loan Index (EUR Hedged) for all data in the European Senior Loans section, unless otherwise specified.
32. JP Morgan for all issuance data, unless otherwise specified.
33. Bloomberg US Corporate Index for all data in this section, unless otherwise specified.

Endnotes

34. As of September 30, 2023.
35. JP Morgan Corporate Broad CEMBI Diversified High Yield Index for all data in this section unless otherwise specified. The emerging markets debt section focuses on dollar-denominated debt issued by companies in emerging market countries.
36. JP Morgan Corporate Broad CEMBI High Yield Plus Index.
37. JP Morgan for default, issuance, and retail fund flow data.
38. Data as of September 30, 2023.
39. JP Morgan, Oaktree Capital Management, as of September 30, 2023.
40. JP Morgan Corporate Broad CEMBI Diversified High Yield Index compared to JPM U.S. High Yield Index.
41. JP Morgan, Oaktree Capital Management, as of September 30, 2023.
42. Refinitiv Global Focus Convertible Index, for all performance data, unless otherwise indicated.
43. Bank of America for all default and issuance data in this section, unless otherwise specified.
44. JP Morgan CLOIE BB Index.
45. JP Morgan CLOIE BBB Index.
46. JP Morgan for all data in this section, unless otherwise specified.
47. Bloomberg US CMBS 2.0 Baa Index Total Return Index Unhedged Index.
48. BofA Global Research. *Private Debt: Opportunities and challenges in a new rates regime*. October 2, 2023.
49. Oaktree observations in the market, as of September 30, 2023.
50. Refinitiv.
51. Based on Oaktree observations in the market, as of October 13, 2023.
52. BofA Global Research. *Private Debt: Opportunities and challenges in a new rates regime*. October 2, 2023.
53. Bloomberg, *Financial Times*.
54. BofA Global Research. *Private Debt: Opportunities and challenges in a new rates regime*. October 2, 2023.
55. The AUM figure is as of June 30, 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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