OAKTREE | Insights

Performing Credit Quarterly

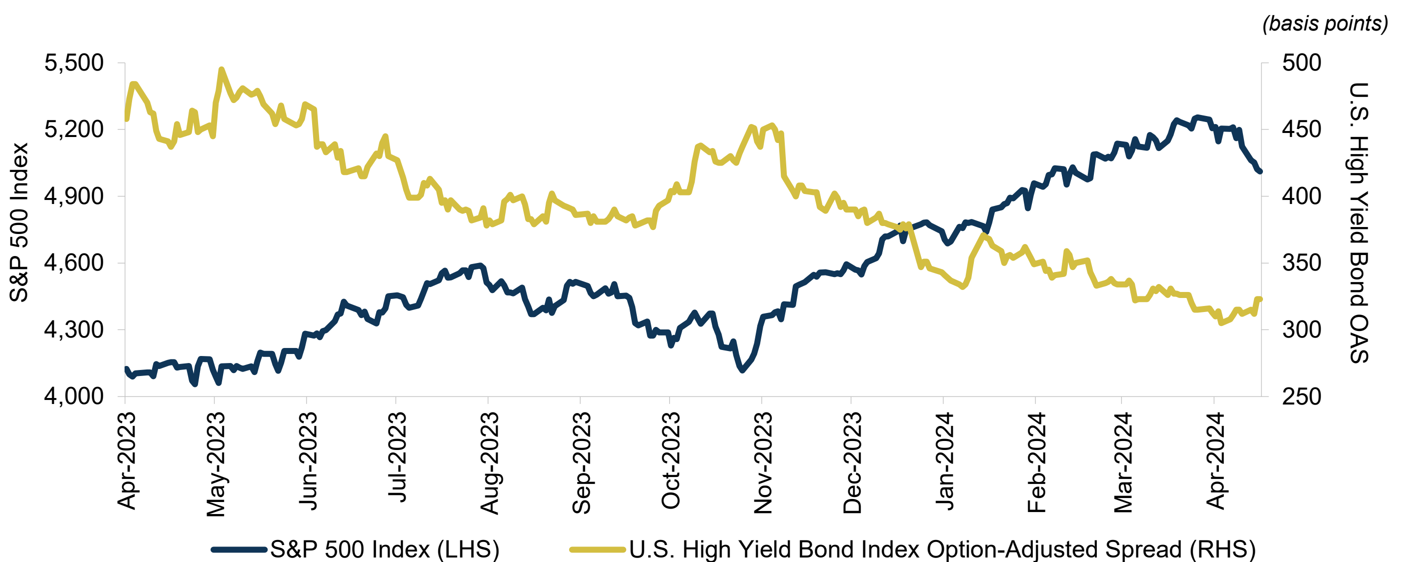
1Q 2024

UNUSUALLY UNCERTAIN

> **"Most of the people I speak with today tell me they're unusually uncertain about what lies ahead in terms of the economy, central bank behavior, fiscal management (or lack thereof), politics, and geopolitics, and what it all means for the markets. It's very healthy that they acknowledge their uncertainty. And it's true that the outlook is as unpredictable as ever, if not more so."**
>
> **– Howard Marks, recent market outlook for clients**

The market rally that began roughly five months ago recently stalled, primarily due to stickier-than-expected inflation and indications that the U.S. may get two or fewer interest rate cuts in 2024, as opposed to the six investors were pricing in earlier in the year – risks we highlighted in January when we noted that "the prevailing market narrative for the coming year demands a level of optimism that may be bordering on credulousness." However, if we zoom out, it's evident that equity and leveraged credit markets aren't anywhere near levels that would denote a significant increase in risk aversion. (See Figure 1.) High yield bond spreads are still hovering around the low end of their normal range, over 35% of U.S. leveraged loans are trading above par, and the S&P 500 Index is up over 20% in the last 12 months.[1] How does one square the robust performance we saw in the five months through March with the uncertainty that our co-chairman Howard Marks is describing above? And should credit investors expect the recent market stumble to turn into a more pronounced decline?

Figure 1: Equity and Leveraged Credit Markets Have Enjoyed a Robust Rally Over the Last Year



Source: S&P Global, ICE BofA, as of April 18, 2024

While multiple forces put upward pressure on securities prices in recent months, we believe supportive technical factors – especially the high level of liquidity in the global financial system – were a major driver. These technical tailwinds are unlikely to dissipate in the next few quarters; however, we think countervailing headwinds could also be strengthening, given the cracks that are emerging in the balance sheets of overleveraged borrowers and overextended consumers. **In this "unusually uncertain" environment, we believe pockets of weakness are likely to continue appearing, even if average economic and corporate fundamentals remain healthy. Thus, there's liable to be greater dispersion between industries, sectors, and issuers in the coming year. In short, we believe it could be a very good time to be an active credit investor.**

Too Much Money Chasing Too Few Bonds and Loans

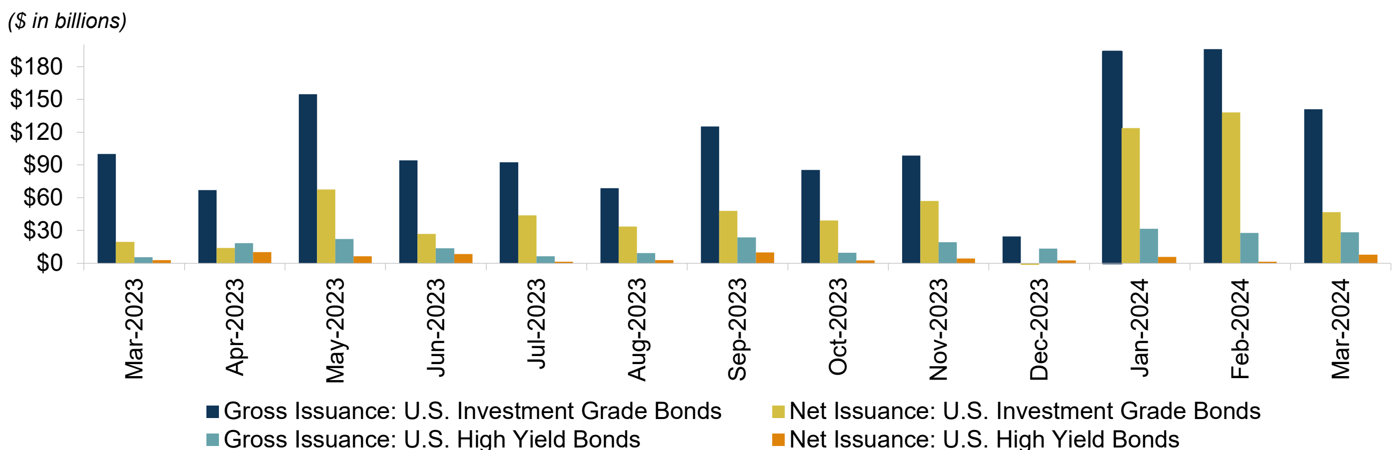
In recent months, leveraged credit markets – both public and private – were buoyed by the high level of liquidity in the financial system, a consequence of the torrent of cash that flooded the economy and investment accounts over the last four years as a result of massive fiscal stimulus and money creation. Interestingly, while the Federal Reserve has been engaging in quantitative tightening (i.e., shrinking its balance sheet) for more than a year, bank reserves have actually increased slightly over this period.[2] This is largely because reverse repo balances, not bank reserves, have been declining. This is notable because in 2022 and early 2023, banks reduced their lending activity in anticipation of a large drawdown in bank reserves. This never materialized, so banks have consequently been ramping up lending in recent quarters. What this all means is that there's been a tremendous amount of capital seeking investment.

One asset class that has attracted significant attention has been the U.S. high yield bond market, which saw inflows of nearly $20 billion in the five months through March 31.[3] Investors who eschewed the asset class in 2022 and throughout much of 2023 were likely drawn back in because they can now:

- lock in prospective yields in the high single digits;
- extend duration at a time when additional interest rate hikes are unlikely; and
- create a portfolio of high-quality assets with limited default risk.

While the demand for non-investment grade bonds has increased in recent quarters, the supply of new bonds hasn't grown at the same pace. The high yield bond market actually shrank by roughly $240 billion, or by over 15%, in 2022-23.[4] It's true that the pace of gross issuance picked up considerably in the first quarter, as a substantial number of companies took advantage of the opening in capital markets to address near-term maturities. But net issuance (excluding refinancings) in the period reached only $15 billion, well below the $300 billion seen in the investment grade bond market. (See Figure 2.) Thus, the uptick in supply in the first quarter wasn't enough to offset the spike in demand, particularly from institutional investors. Given these dynamics, it's unsurprising that new issues in the high yield bond market were four to seven times oversubscribed in January.[5]

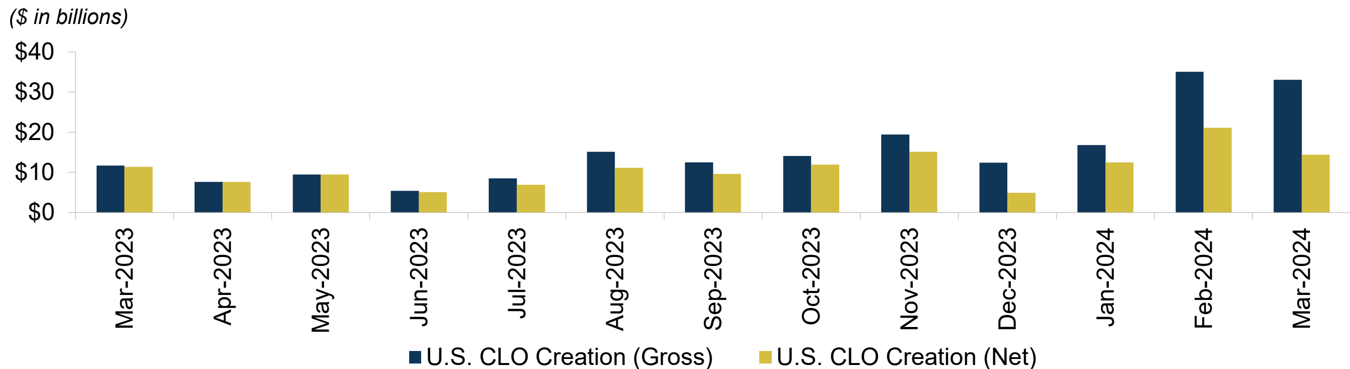
Figure 2: Issuance of Investment Grade Bonds Has Dwarfed Activity in the High Yield Bond Market



Source: JP Morgan, as of March 31, 2024

A similar supply/demand dynamic has been at play in the U.S. leveraged loan market. Demand has been elevated because of the surge in the creation of collateralized loan obligations (CLOs), which hold around 70% of the U.S. leveraged loan market. Over $45 billion of new U.S. CLOs have been created thus far in 2024, roughly 40% more than over the same period in 2023.[6] (See Figure 3.) However, despite the surge in refinancings and repricings in the loan market in recent months, the U.S. syndicated loan market actually shrank by approximately $9 billion in the first quarter and is almost $30 billion smaller than the peak in September 2022.[7]

Figure 3: CLO Issuance Has Increased Meaningfully in Recent Months



Source: JP Morgan, as of March 31, 2024

What does this mean for leveraged credit markets moving forward? **While positive technicals are likely to continue putting upward pressure on loan and bond prices in the near term, we also think that market performance in the next year may be bumpier than it was in the prior 12 months – in part because of multiple emerging risk factors.**

Risk #1: Overleveraged Borrowers

As we noted in *Performing Credit Quarterly 3Q2023*, average fundamentals in the high yield bond and leveraged loan markets remain fairly sound, but tail risk – especially in the public and private loan markets – is continuing to grow as companies struggle with overleveraged capital structures put in place with the expectation that interest rates would remain near zero.

Consider the changes we've seen in the distressed debt universe over the last few years. Oaktree's Global Opportunities group has noted that at year-end 2021, in the universe of companies they monitor, around $30 billion of debt across roughly 40 issuers was trading at prices below 90 cents on the dollar and at yields above 15%. Fast forward to the present, and debt with the aforementioned characteristics now totals more than $150 billion across almost 200 issuers.[8]

Importantly, we've also seen stress pop up in unexpected places. For example, Altice France, the large telecom company, saw the price of its bonds drop to around 70 cents on the dollar in the first quarter and saw its unsecured bonds drop much more.[9] This occurred because Altice unexpectedly announced that creditors would need to accept haircuts on their current instruments, after which the company's credit rating was cut to CCC by S&P Global Ratings and Moody's.[10]

This series of events surprised many investors. While it was well known that Altice had too much leverage, almost no one thought it would take such drastic measures. That's because it didn't fit the profile for the type of company expected to pursue a liability management exercise in the current environment:

- It's a large asset-rich business that was thought to be well collateralized.
- It's a European company, and recent investor concern has primarily been centered on highly leveraged U.S. companies.
- It's not owned by a private equity sponsor. The aggressive use of leverage by sponsors in the 2020-21 period was expected to be the main driver of distress in this cycle.
- Its earnings growth had been weakening, but wasn't slowing at a pace that would typically lead to a potential restructuring.

However, the risk assessment changes when you combine the business's tepid performance with its significant near-term maturities and the current level of interest rates. Altice determined that its financing costs would be unacceptably high at its current leverage level. Thus, management revised that leverage target lower, which meant the company needed to ask for concessions from creditors. This announcement unsettled more than just the Altice investor base. **Both European loan and high yield bond markets experienced volatility in the days following the downgrade of Altice, potentially because investors who had previously thought they were holding safe instruments suddenly had to reevaluate.**

Risk #2: Overextended Consumers

One of the most notable features of the economic landscape over the last year has been the resilience of the U.S. consumer. **However, we're beginning to see cracks emerge in the consumer lending market** – particularly in the non-prime segment, i.e., borrowers with a credit score below "prime" but above "subprime."

Consider the experience of one U.S. consumer loan provider that has seen its loan losses soar in the last two years – a time when U.S. unemployment has been near a 50-year low, real wage growth has turned positive, and retail sales have remained robust.[11]

The story begins in 2018:

- Loans that the company originated in 2018 performed fairly well for the first two years, with losses of roughly 6% per year, but after the two-year mark, the performance went from "good" to "extremely good." Loan losses dropped considerably as consumer spending slowed and Covid-19 stimulus checks began to arrive.
- Loans originated in 2019 exhibited a similar pattern: loss rates were modest until around 2020, when they collapsed.
- Loans originated in 2020 obviously benefited massively from pandemic-related stimulus, meaning losses were meaningfully lower than projected.

Now let's turn to 2021 and 2022. Loans originated in these years were scored using a model trained on the performance of loans originated between 2018 and 2020. **In other words, the model rated borrowers based on the assumption that the stimulus-fueled performance of the pandemic era was the norm.** Very low-credit-quality borrowers were often mischaracterized as moderate-credit-quality. Unsurprisingly, at roughly the 18-month point, the loss rates of loans originated in 2022 were running at more than three times those of loans created in 2019.

Our market observations indicate that this situation isn't unique to this one company or to consumer unsecured lending. We've seen a similar dynamic in other areas, such as auto loans, credit cards, and home improvement loans. This is reflected in buying trends in the market for asset-backed securities, structured credit instruments made up of pools of these types of loans. While ABS investors are still comfortable buying investment grade tranches, demand for junior tranches – which are much more sensitive to performance of the underlying loans – has essentially dried up.[12]

The Bottom Line

In *Performing Credit Quarterly 4Q2023*, we noted the high level of optimism being priced into markets. We didn't point this out because we thought the market was set to experience a meltdown; we highlighted it because – as Howard has long said – "no matter how good the fundamental outlook is for something, when investors apply too much optimism in pricing it, it won't be a bargain." Moving forward, we believe credit investors should remain cautious, but also be prepared to take advantage of what could be a period of greater volatility and dispersion. As we've stated frequently in the last year, we believe we're solidly back in a credit picker's market.

Credit Markets: Key Trends, Risks, and Opportunities to Monitor in 2Q2024

(1) High yield bond investors don't need to rely on spread-narrowing to earn a compelling total return

Over the last six months, one question has frequently been raised by those considering investing in non-investment grade credit: "Should I buy if yields are attractive, but spreads aren't?" To answer this question, one must consider both yields and spreads in context.

In the decade preceding 2022, the fed funds rate was often near 0%, average yields in the U.S. high yield bond market were in the 5-6% range, and the average price in the market was frequently at or above par.[13] Thus, leveraged credit investors, for the most part, were focused solely on yield spreads. Investors needed spreads to narrow if they were to earn a total return that could compensate for the risk of buying non-investment grade credit. Fast forward to today, and the yield of the U.S. high yield bond index is near 8%, which is almost 1.5 times the ten-year average and sufficient for many investors, and the index is trading below both par and the average price over the last decade.[14]

One might argue that current yield spreads are insufficient compensation for credit risk. **But when compared to the historical norm, credit spreads in the high yield bond market don't appear to be overly tight.** In 1Q2018, the average spread in the high yield bond market was around 330 bps; it's currently near the same level, and average duration is lower by around one year. And quality in the high yield bond market is stronger than it was in 2018: the percentage of BB-rated issuers (the highest non-investment grade credit rating) remains near the decade-high at 48%.[15] Moreover, investors in the riskiest part of the high yield bond market are demanding normal levels of additional compensation for risk: the current difference between the spread of CCC-rated bonds and BB-rated bonds is roughly 670 bps, which is within a few basis points of the ten-year median.[16]

Finally, it's important to note that the current equity risk premium – i.e., the expected excess return an investor earns for investing in equities versus Treasurys – is the lowest it has been since 2001.[17] (See Figure 4.) If an investor is concerned that credit spreads aren't offering sufficient compensation for risk, then why would they invest in the equity market, where the risk premium is minimal and there is no contractual yield?

In short, we believe the relative value calculus changes dramatically when spread compression is no longer needed to earn an attractive return in leveraged credit.

Figure 4: The Equity Risk Premium Hasn't Been This Unfavorable Since 2001

Source: Bloomberg, as of March 31, 2024[18]

(2) Patience may once again be a significant virtue in credit investment

Patience has historically been rewarded in investing, but over the past decade – when high-quality leveraged credit was usually yielding under 5% – credit investors often struggled to justify self-restraint. Instead, many accepted weak investor protections and stretched for yield by investing in the riskiest parts of the credit markets. Few investors were punished for acting aggressively in an ultra-low interest rate environment, so the price of patience seemed too high for many.

However, this situation has changed dramatically due to the apparent paradigm shift in the interest rate environment. **Today, investors in high-quality non-investment grade portfolios can earn roughly 8% yields as they wait patiently for dislocation to occur, whether that's broad market dislocation or sell-offs impacting specific sectors or regions.**

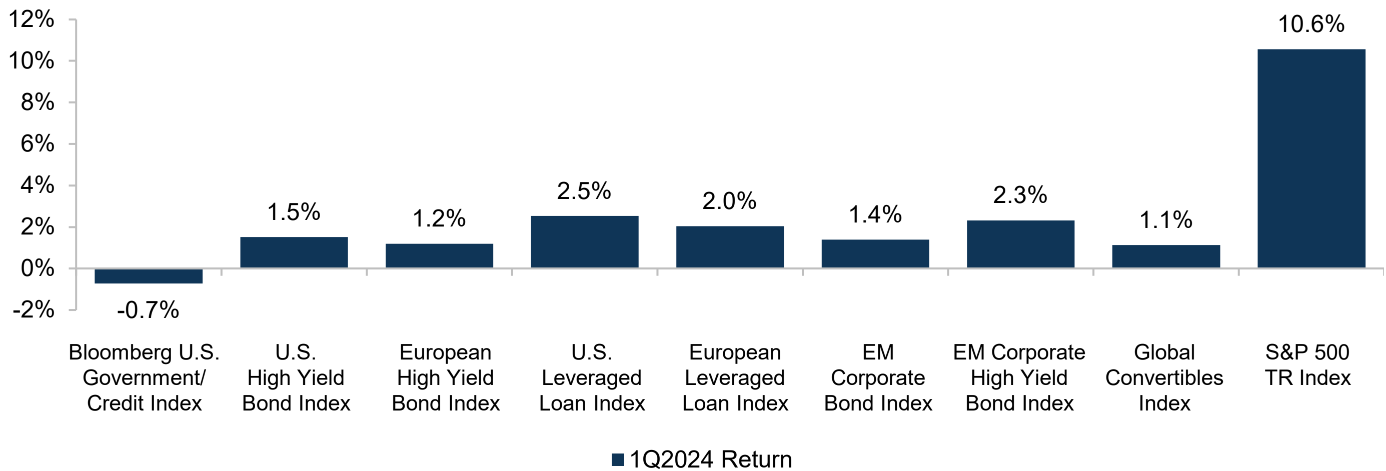
While we aren't expecting to see a widespread crisis in the next year, we think that downside shocks remain more likely than upside surprises. In particular, we believe that we could see a meaningful repricing in many markets if the pace and size of the Federal Reserve's dovish pivot continues to disappoint. If this occurs, investors who've remained patient and prioritized risk control will likely be in a good position to take advantage of market weakness. On the other hand, if the Fed doesn't disappoint and no dislocation occurs, then these same credit investors would be holding a portfolio generating substantial income in an environment with little risk of near-term interest rate increases. In other words, the opportunity cost of patience appears to have declined.

(3) Investors should focus on long-term trends in interest rates, not short-term changes

We'll conclude with a quote from Howard Marks' recent note to clients:

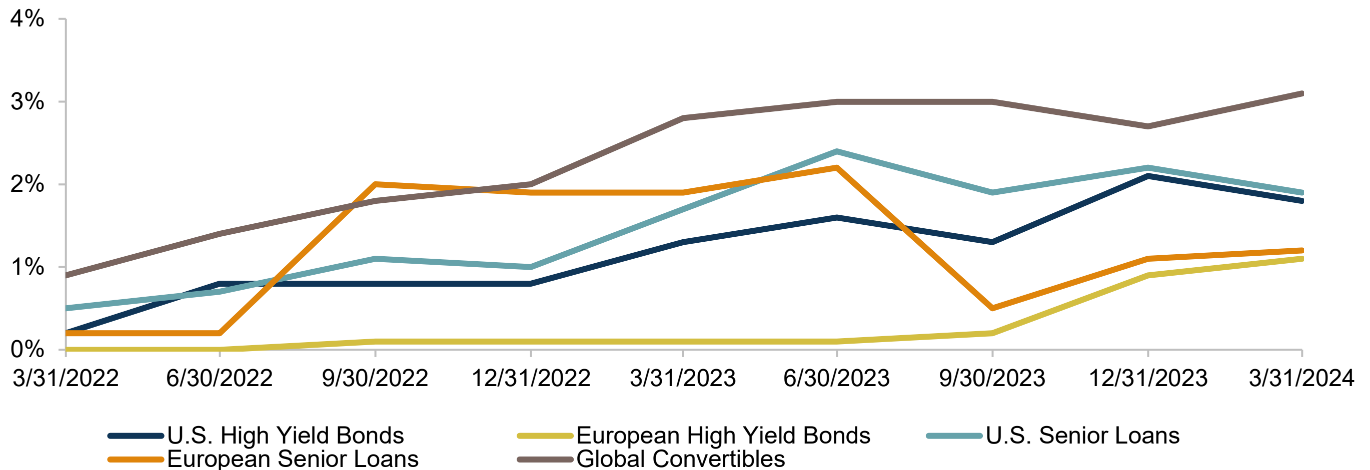
> **This is a good time for me to issue a reminder that the Fed's individual interest rate manipulations are an example of short-term events that lack long-term significance.** These days, everyone wants to know how many rate cuts there will be in 2024 and in what month they'll start. But, as I wrote in November 2022 in *What Really Matters?* (a memo I thought mattered but which garnered relatively little response), the answers to questions about rate cut details aren't meaningful, as any impact is likely to disappear within a few months.
>
> **What does matter in this department is whether rates will stick in the range of 3.0% to 3.5% for the next 5-10 years, as I think, or return to the 0-2% range that prevailed most of the time from 2009 to 2021. If it's the former, it should follow that equity returns will be lower than they were in that halcyon period; leveraged investment strategies will be less advantaged; and returns from credit will be markedly better than they were. That's about all I can say, but it's a lot.**

Performance of Select Indices



As of March 31, 2024
Source: Bloomberg, Credit Suisse, ICE BofA, JP Morgan, S&P Global, Thomson Reuters[19]

Default Rates by Asset Class



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

High Yield Bonds

Market Conditions: 1Q2024

U.S. High Yield Bonds – Return: 1.5%[20] | LTM Default Rate: 1.8%[21]

- **Yield spreads contracted in the first quarter:** While spreads expanded in January, they shrank throughout the remainder of the quarter as investor risk appetite increased. At quarter-end, yield spreads were near the low end of the historically normal range of 300–500 bps.[22]
- **Yields in the asset class were relatively unchanged:** While they increased slightly in 1Q2024 due to the modest rise in Treasury yields, they're still well above the ten-year average. (See Figure 5.) Nearly 40% 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 outperformed:** The riskiest non-investment grade ratings segment returned 3.0% for the period, while BB- and B-rated bonds were up by only 1.1% and 1.5%, respectively. CCC-rated bonds benefited disproportionately from declining recession fears.

European High Yield Bonds – Return: 1.2%[24] | LTM Default Rate: 1.1%[25]

- **The asset class generated a solid return despite pockets of weakness:** Average yield spreads contracted over the period, as the majority of the asset class produced strong results. However, a small subset of weak issuers offset some of these gains.

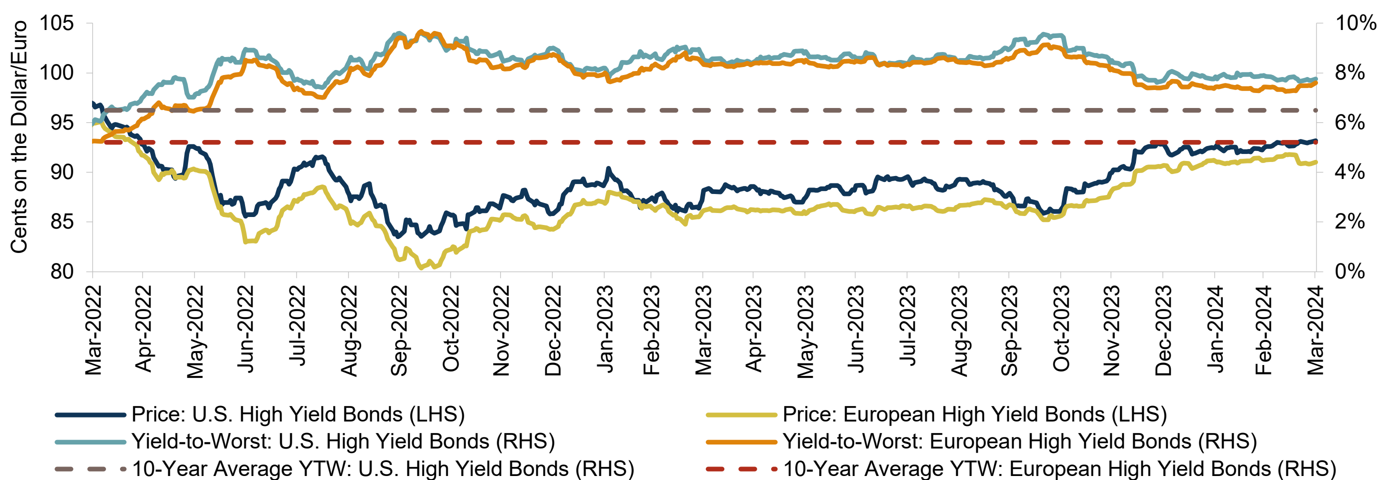
Opportunities

- **Investors may continue to enjoy attractive yields:** Substantial near-term interest rate cuts are currently unlikely, meaning yields in the asset class should stay well above the ten-year average through at least year-end.
- **High yield bonds are trading at a discount to par:** The average price at quarter-end was 93 cents on the dollar and 91 cents on the euro in the U.S. and European markets, respectively. Consequently, investors have the potential to earn capital appreciation while retaining strong call protection.
- **Default risk remains low:** Quality in the asset class is high: the percentage of BB-rated bonds in the U.S. market is near a ten-year high. Additionally, maturities through 2026 have declined considerably in the last year.

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 in the latter half of 2024. Low-rated corporate issuers might struggle to roll over debt if interest rates don't decline significantly.
- **Elevated inflation and high labor costs may impair issuers' fundamentals:** Inflation is proving to be stickier than anticipated, and even though it has slowed, many input costs remain high.

Figure 5: High Yield Bonds Still Offer a Low Average Price and High Average Yield



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: 1Q2024

U.S. Senior Loans – Return: 2.5%[26] | LTM Default Rate: 1.9%

- **U.S. senior loan prices rose in the first quarter:** Performance was supported by positive U.S. economic data and strong buying activity among CLOs.
- **Gross issuance increased in the asset class:** Activity in the loan primary market rose meaningfully during the quarter, though it continues to be dominated by refinancings and repricings. In both January and March, over $100mm came to market, which was well above the pace seen over the same period last year. However, new-money deals (excl. refinancings) remained limited.

European Senior Loans – Return: 2.0%[27] | LTM Default Rate: 1.2%

- **European loans generated a solid return in 1Q2024:** Returns were driven by rising demand from CLOs and strong coupon income.
- **Primary market activity picked up following a slow 2023:** The gross supply of loans exceeded €29bn in 1Q2024, following €16bn in 4Q2023. However, refinancings constituted the vast majority of this volume.

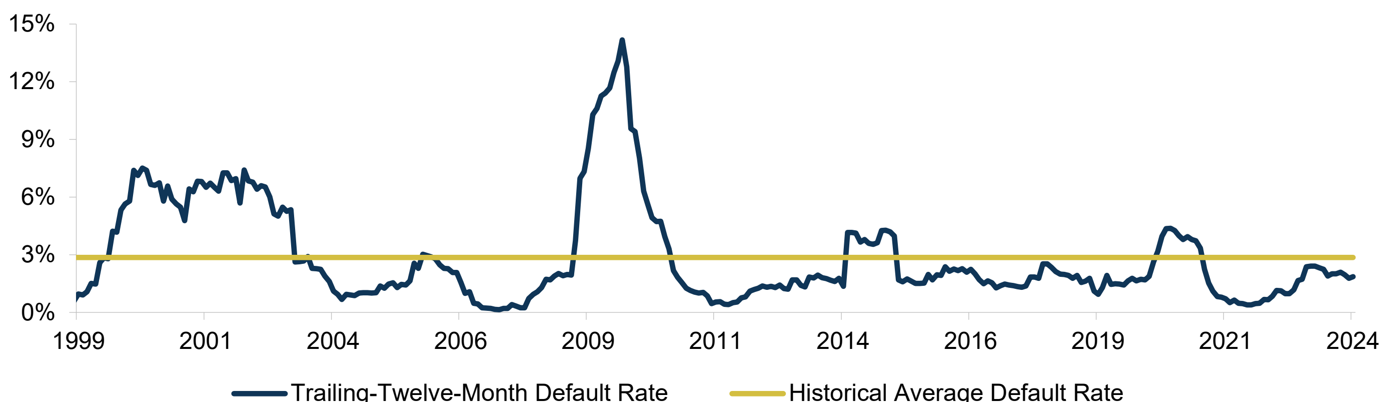
Opportunities

- **High coupons may continue to attract investors:** Floating-rate loans will likely remain compelling through year-end, unless there is a significant decrease in reference rates.
- **The default outlook appears manageable:** Default rates in the U.S. and European loan markets are expected to rise in 2024 and will likely exceed those in both region's high yield bond markets. But default rates are expected to remain below their recessionary averages, even if these economies begin to contract. (See Figure 6.) This is largely due to the limited number of maturities in 2024 and 2025 and the availability of other sources of capital, such as rescue financings.
- **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.

Risks

- **Borrower fundamentals could be worse than they currently appear:** Investors' belief that risk in the loan market was concentrated in specific regions and issuer types was shaken after Altice France, the large telecom company, was downgraded to CCC on March 28. (See pp. 3 for more details.) This surprising announcement raised concerns about other issuers with substantial leverage, muted growth prospects, and near-term maturities.
- **Recovery rates may remain well below the historical average:** The increased prevalence of loan-only capital structures has caused average recovery rates in the asset class to decline to 42%.[28] We anticipate that this trend will continue through this default cycle.
- **Declining interest rates could reduce appetite for floating-rate assets:** Although interest rates are still above their ten-year average, many market participants expect cuts in 2024, which could have a negative impact on demand for floating-rate assets.

Figure 6: Default Rates Remain Below the Historical Average



Source: J.P. Morgan, as of March 31, 2024[29]

Investment Grade Credit

Market Conditions: 1Q2024

Return: -0.1%[30]

- **Investment grade debt weakened in 1Q2024 due to the increase in Treasury yields:** Strong U.S. economic activity and higher-than-expected inflation reduced expectations for interest rate cuts in 2024.
- **Lower-quality credit outperformed:** BBB-rated bonds – the lowest investment grade tier – outperformed the highest-rated segment by over 130 bps in 1Q2024. This was largely driven by increasing risk appetite and the shorter average duration of the lower-rated segment.
- **Issuance reached a record high in the period:** Gross issuance of investment grade bonds in the quarter totaled $544bn, the highest quarterly issuance since 2Q2020.[31] This robust activity reflects reduced investor fears about near-term interest rate hikes, the attractive yields available in the asset class, and the excess liquidity in the financial system.

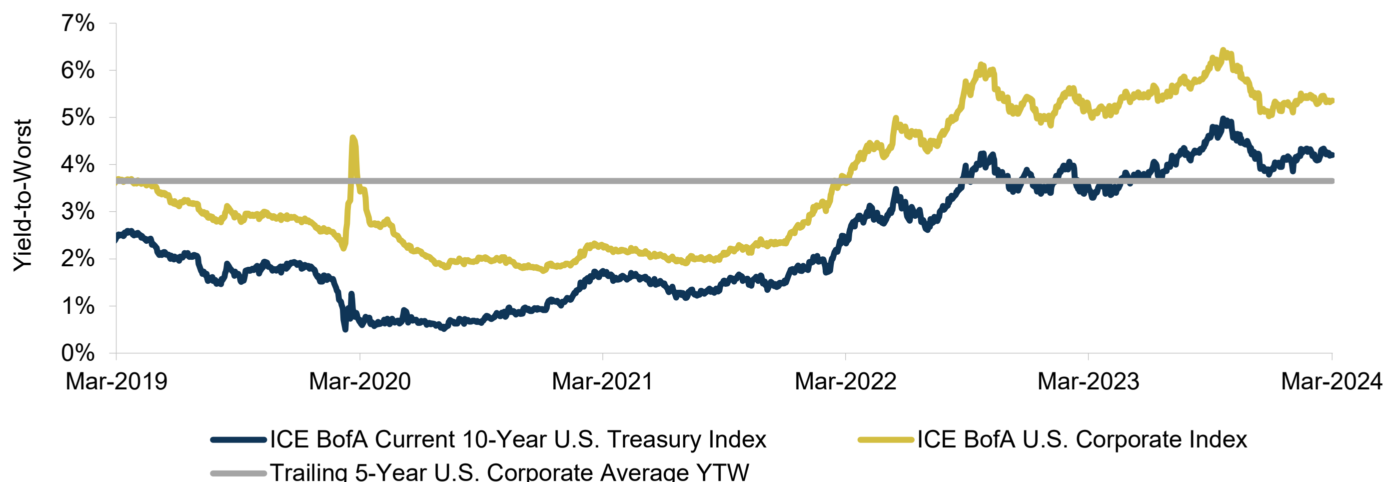
Opportunities

- **Investment grade corporate debt yields remain elevated:** Yields in the asset class ended the quarter at 5.4%, which is well above the five-year average. (See Figure 7.)
- **Investment grade debt may benefit if economic activity slows:** Investment grade debt could outperform high yield bonds in 2024 if slowing growth results in widening yield spreads and declining interest rates.

Risks

- **All fixed-rate asset classes could suffer if interest rates stay elevated longer than investors are currently anticipating:** We've already seen increased volatility in fixed-rate asset classes in April 2024, as investors have reduced their expectations for near-term interest rate cuts. The futures market was still pricing in roughly two interest rate cuts in 2024, as of mid-April.[32]
- **If interest rates decline meaningfully in 2024, demand for low-yielding fixed income securities could decline:** While investment grade credit should benefit more from interest rate cuts than high yield bonds, given the former's longer duration, a declining interest rate environment could reduce demand for higher-rated debt. If base rates fall but default rates stay low, investors needing to earn a specific yield may migrate toward higher-yielding, higher-risk asset classes.

Figure 7: Investment Grade Bond Yields Remain Well Above the Five-Year Average



Source: Bloomberg

Emerging Markets Debt

Market Conditions: 1Q2024

EM Corporate High Yield Bond Return[33] – Return: 4.2%

- **EM high yield corporate debt extended its rally:** The robust quarterly performance resulted from narrowing yield spreads, which reached the tightest levels in six years, and strong gains among lower-rated EM corporate bonds. (See Figure 8.)
- **EM issuance rebounded, even as the asset class experienced steady outflows from retail funds:** Blue-chip issuers in Latin America and the Middle East led the recovery in primary market activity, partly because they were clearing backlog from 2023. However, the pace of issuance remains well below the norm seen before the global rate-tightening cycle began. Retail fund outflows from the asset class totaled nearly $6bn in 1Q2024, similar to the average quarterly outflows recorded in 2023.[34]
- **Volatility in the EM debt market has been muted despite geopolitical tensions:** The ongoing conflicts in Russia/Ukraine and the Middle East generated little market volatility in the period. In fact, the asset class recorded its fewest days of negative performance in any quarter since 4Q2020. The active election calendar in EM countries is also likely to produce less volatility than originally expected: Taiwan's election passed uneventfully, Argentina's new president has garnered market support, and the incumbent parties in India and Mexico maintain strong leads in the polls.

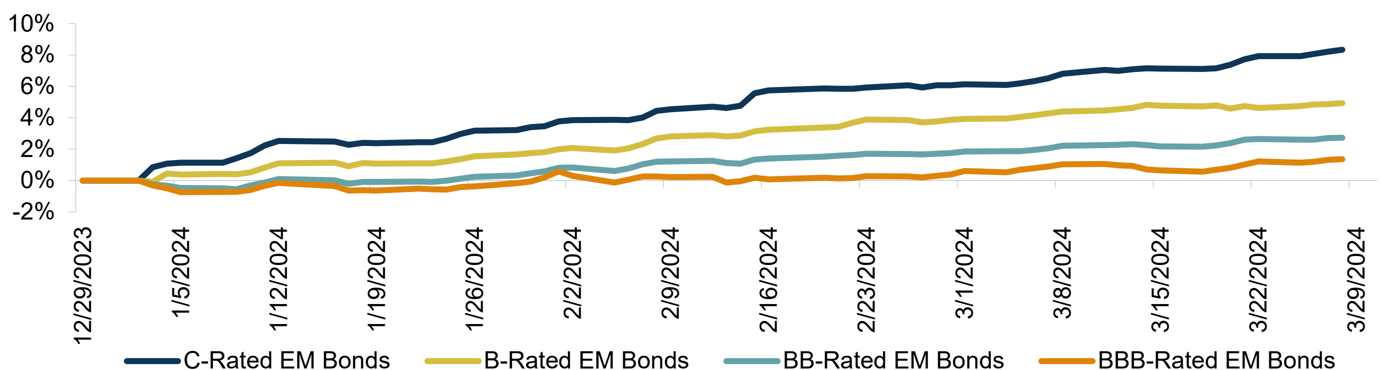
Opportunities

- **EM debt investors have bargaining power:** Nearly 14% of EM corporate bonds mature within one year, a record-high level.[35] Meanwhile, financing options for EM borrowers are limited, meaning EM credit investors will likely have the opportunity to earn high yields while receiving enhanced investor protections in the primary market and in liability management transactions.
- **Attractive investment opportunities remain, despite the recent rally:** The asset class offers an elevated 8.6% prospective yield, and the average price remains low at 92 cents on the dollar.[36] Moreover, average yield spreads in EM high yield debt are over 90 bps wider than those of their U.S. counterparts, which is above the historical average.[37]
- **The EM default outlook is manageable:** The EM default rate in 2024 is expected to be near the historical average of 4%, compared to 7% in 2023.[38] This forecast reflects EM issuers' resilient fundamentals and the fact that over 80% of China's property developers with high yield credit ratings have already defaulted.[39]

Risks

- **EM industries and export-based economies are exposed to decelerating economic activity:** Tighter financial conditions have reduced expectations for near-term global growth. If global demand for commodities declines, many EM company and country fundamentals could be negatively impacted.
- **Geopolitical tensions may have negative long-term effects on EM debt capital flows:** While geopolitical risk hasn't weighed on EM debt performance in recent quarters, investor confidence in EM credit could decline if ongoing conflicts escalate or if China/U.S. relations worsen.

Figure 8: Low-Rated EM Corporate Debt Is Outperforming in 2024



Source: JP Morgan Corporate Broad CEMBI Broad Diversified, as of March 28, 2024

Global Convertibles

Market Conditions: 1Q2024

Return: 1.1%[40] | LTM Default Rate: 3.1%[41]

- **Despite rising equity prices, global convertibles' performance lagged in 1Q2024:** Resilient economic data and positive earnings results boosted global equity markets in the period, even as investors reduced the number of interest rate cuts expected for 2024. However, the convertibles index underperformed, largely due to weakness in the U.S., which has significant exposure to high-multiple companies, which performed poorly during the quarter.
- **Primary market activity remained strong:** In 1Q2024, new issuance of global convertibles totaled $25.2bn across 45 new deals. Although most of this issuance was concentrated in the U.S., the new deals were well diversified by sector.

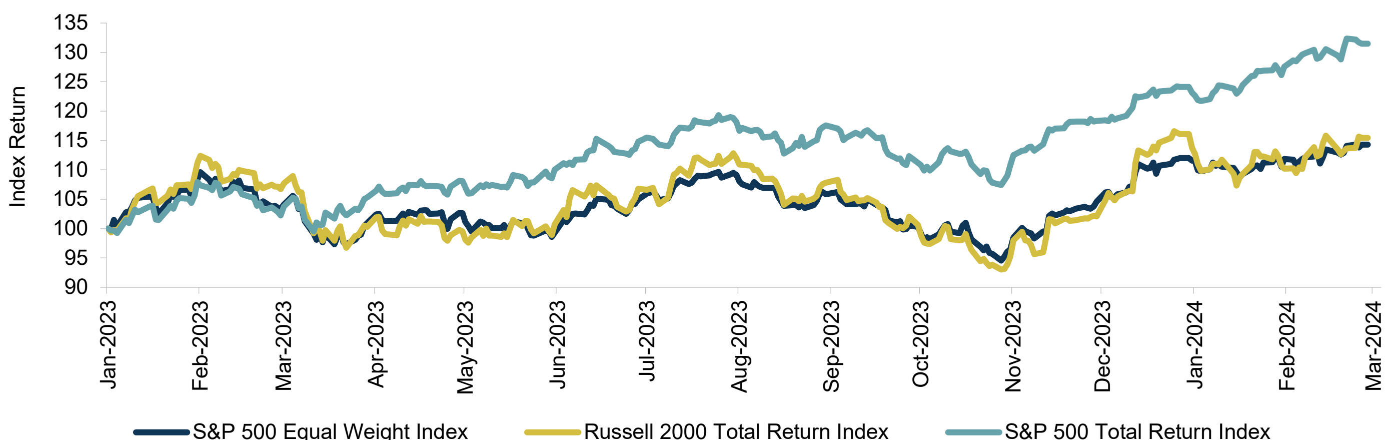
Opportunities

- **Convertibles continue to offer attractive yields and enhanced protections:** The average coupon for a new global convertible is 2.4%, compared to the low of 1.0% in 2021. Additionally, newly issued convertibles feature more investor-friendly terms than those offered in prior years.
- **The size and quality of the convertible bond market has improved:** In an elevated interest rate environment, companies seeking new capital or those looking to refinance straight debt have increasingly turned to the convertibles market, where coupons are lower. Issuance in the asset class rose to $79bn in 2023, double the amount in the prior year. Over 25% of this volume had investment grade credit ratings, and over 70% was from companies with large market caps.[42]
- **Underlying equity valuations are attractive:** The Russell 2000 Index, which is closely correlated with convertibles, currently trades at a meaningful discount to the S&P 500 Index. (See Figure 9.) The valuations of the underlying equities appear especially reasonable when considering the growth prospects of the underlying companies.

Risks

- **Numerous trends threaten to slow global economic growth and weigh on equity prices:** These include the lagged impact of several years of rapid price increases and elevated interest rates as well as concerns about sticky inflation and heightened geopolitical risk.
- **Strength in the equity market may remain concentrated:** The equity rally in 1Q2024 was driven by a small number of companies. As markets have weakened in April, small cap stocks have underperformed.[43]

Figure 9: Small-Cap U.S. Stocks Continue to Underperform



Source: Bloomberg

Structured Credit

Market Conditions: 1Q2024

Corporate – BB-Rated CLO Return: 6.4%[44] | BBB-Rated CLO Return: 3.5%[45]

- **Collateralized Loan Obligations strengthened in 1Q2024:** Declining recession fears and attractive yields fueled investor demand for CLOs in the period. BB-rated CLOs outperformed, primarily due to their relatively high average yields**.**
- **Activity in the primary market rose significantly:** CLO issuance reached a record-high pace in the first quarter, largely due to reduced financing costs and strong investor demand. Issuance of CLOs in the U.S. totaled over $48bn in the period, up from $30bn in 4Q2023 and $27bn in 3Q2023. Issuance in Europe totaled €11bn compared to €8bn in 3Q2023.[46]

Real Estate – BBB-Rated CMBS Return: 11.4%[47]

- **Real estate structured credit enjoyed a strong rebound in 1Q2024:** The asset class benefited from improving investor sentiment, largely due to expectations that interest rates have peaked in this cycle.
- **Performance in the CRE market varied meaningfully by sector:** Green Street's Commercial Property Price Index[48] increased by 0.3% quarter-over-quarter, but decreased by 3.0% year-over-year.[49] The office subsector index decreased by 3.0% QoQ and by 16.5% YoY.[50] Nearly all sectors suffered annual declines, but prices were relatively stable compared to 4Q2023.
- **Primary market activity decelerated meaningfully in 2023 and has remained muted:** Issuance of commercial mortgage-backed securities decreased by 57% over the prior 12 months, with just $45bn of private label CMBS issued, compared to $101bn in 2022.

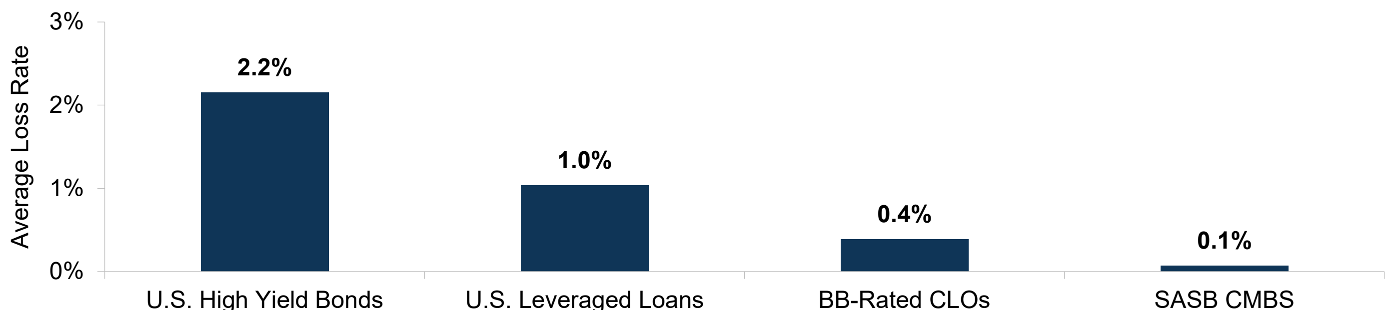
Opportunities

- **Corporate structured credit offers higher average yields than traditional credit asset classes:** CLOs have attractive yields as well as strong structural enhancements, evidenced by their lower long-term loss rates. (See Figure 10.)
- **Volatile markets could create more compelling buying opportunities for CLO investors:** The elevated interest rate environment could create more volatility in the loan market, giving CLO managers the ability to buy loans at a discount to par.
- **Depressed valuations 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:** Equity markets – which have weakened in April 2024 – might suffer additional declines if interest rates aren't cut as quickly as investors currently anticipate. Moreover, performance could be negatively affected if investors' risk appetite declines for other reasons 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 outlook for U.S. interest rates and fundamentals in several real estate sectors 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 throughout 2024.

Figure 10: Structured Credit Has Historically Offered Lower Loss Rates than Traditional Credit



Source: NYU Salomon Center (High Yield Bonds, 1978-2019), J.P. Morgan Research (Leveraged Loans, 1998-2019), Moody's (CLOs, 1993-2018), J.P. Morgan research (SASB CMBS and large loan floaters, 1996-2018). Updated annually.

Private Credit

Market Conditions: 1Q2024

- **Default rates in U.S. private credit remain modest:** The default rate by issuer count in the 12 months through March 20 stands at 2%, or 1.5% and 3.5% for sponsor-owned and non-sponsor-owned borrowers, respectively.[51]
- **Leveraged buyout activity in the U.S. reached its highest level since 2Q2022:** We've seen a pickup in deal flow in recent quarters, which is expected to expand opportunities for providers of private credit. This trend is likely due to (a) the belief that interest rates have likely peaked in this cycle, (b) pressure on GPs to provide LPs with capital distributions, and (c) the fact that many private equity funds' investment periods are nearing their expiration dates.
- **Deal volume and average size have continued to increase in European private credit:** Deal volume in the asset class bounced back in 2023 following the substantial decline seen in 2021. The rebound was largely driven by expectations of interest rate cuts in 2024. Deal size in the European market has also grown, as evidenced by the record-breaking €4.5bn private credit facility recently provided to Adevinta, an online classified ad company.

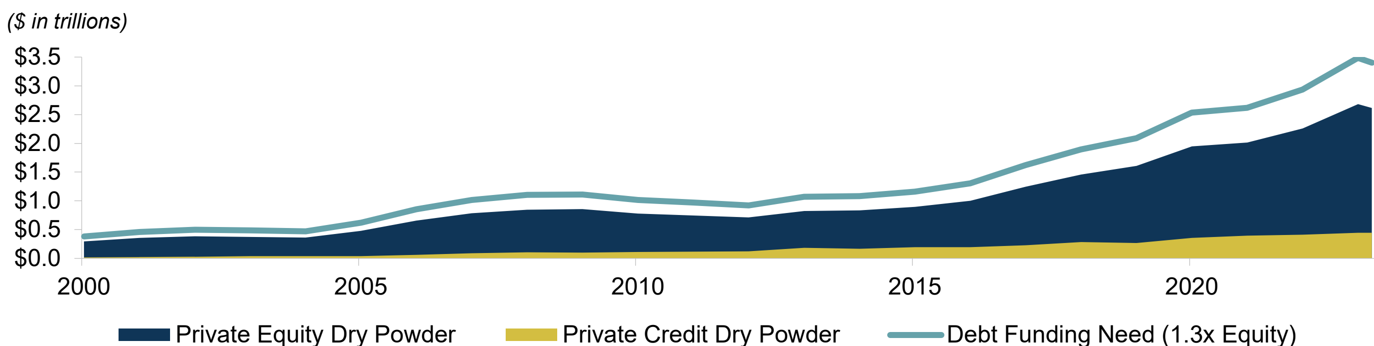
Opportunities

- **Demand for bifurcated structures appears to be growing:** Portfolio companies that require additional capital are increasingly choosing to issue junior debt to avoid repricing their existing senior debt. Companies are increasingly favoring bifurcated structures (which include both senior and junior debt) over unitranche capital solutions because the former can offer more flexibility, including a combination of fixed- and floating-rate debt.
- **LBO debt financing continues to face a significant funding gap:** Private equity funds continue to hold record-high levels of dry powder. (See Figure 11.) As a result, the demand for debt financing has risen meaningfully. The amount of debt funding needed to support the current level of private equity dry powder is estimated to be roughly $2.9tn, assuming a debt-to-equity financing ratio of 1.3x.[52]
- **Increased biotech M&A activity should benefit direct lenders with sector-specific expertise:** The biotech equity market has partially recovered from its downturn in 2022, largely due to more benign U.S. interest rate expectations. This could result in more direct lending opportunities, but investors will be best positioned to take advantage if they have sector-specific experience and expertise.

Risks

- **More borrowers are likely to feel the negative impact of elevated interest rates:** Many companies have seen their interest coverage ratios decline meaningfully over the last two years. While the Federal Reserve is expected to cut interest rates in 2024, these cuts – if they occur – likely won't be large enough to meaningfully reduce the pressure faced by many overleveraged companies. This could ultimately lead to an increase in default rates and the need for rescue financing.
- **Liquidity pressures are causing increased demand for PIK-only structures:** Companies facing higher interest costs and muted earnings growth are increasingly seeking to bolster liquidity by issuing junior debt and preferred equity tranches that are entirely paid in kind. This can help sponsors avoid having to inject additional cash equity. However, we remain skeptical about the long-term efficacy of this strategy, as we believe liquidity concerns won't truly be resolved for companies with unsustainable capital structures unless the fed funds rate falls to approximately 2% in the near to medium term, an outcome we don't consider likely.

Figure 11: Private Equity Dry Powder Has Increased Dramatically



Source: Preqin as of December 31, 2023

About the Authors

Armen Panossian

Co-Chief Executive Officer and Head of Performing Credit

Mr. Panossian serves as co-Chief Executive Officer, primarily focused on overseeing the organization and performance of Oaktree's investment teams. He is also Head of Performing Credit, where his responsibilities include oversight of the firm's liquid and private credit strategies and as a portfolio manager within the Global Private Debt and Global Credit strategies. Mr. Panossian joined Oaktree's Global Opportunities group in 2007. In January 2014, he joined the U.S. Senior Loans team to assume co-portfolio management responsibilities and lead the development of Oaktree's CLO business. He became head of all performing credit in 2019. Mr. Panossian joined Oaktree from Pequot Capital Management, where he worked on their distressed debt strategy. Mr. Panossian holds a B.A. degree in economics with honors and distinction from Stanford University, where he was elected to Phi Beta Kappa; an M.S. degree in health services research from Stanford Medical School; a J.D. degree from Harvard Law School; and an M.B.A. from 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.

Danielle Poli, CAIA

Managing Director and Assistant Portfolio Manager

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 $84.2 billion in AUM and approximately 190 investment professionals.[53]

Endnotes

1. ICE BofA US High Yield Constrained Index, as of April 24, 2024. Credit Suisse Leveraged Loan Index, as of March 31, 2024. Bloomberg, SPX Index, as of April 24, 2024.
2. Board of Governors of the Federal Reserve System (US).
3. JP Morgan.
4. JP Morgan.
5. JP Morgan.
6. JP Morgan, as of March 31, 2024.
7. Credit Suisse Leveraged Loan Index, LevFin Insights.
8. ICE BofA All Maturity US High Yield Index, as of March 31, 2024. Credit Suisse Leveraged Loan Index; as of March 31, 2024.
9. Bloomberg.
10. S&P Global, Moody's.
11. Based on Oaktree discussions with the unnamed company.
12. Based on Oaktree observations in the market, as of March 31, 2024.
13. ICE BofA US High Yield Non-Financial Constrained Index.
14. ICE BofA US High Yield Non-Financial Constrained Index.
15. ICE BofA US High Yield Index, as of March 31, 2024.
16. ICE BofA BB/CCC US High Yield Index (OAS of h0a3 vs h0a1), as of March 31, 2024.
17. Bloomberg. Equity Risk Premium is defined as the S&P Earnings Yield (reciprocal of the P/E ratio) minus the yield on the current 10-Year U.S. Treasury.
18. Equity Risk Premium is defined as the S&P Earnings Yield (reciprocal of the P/E ratio) minus the yield on the current 10-Year U.S. Treasury. It is the excess return that investing in the S&P provides over the 10-Year Treasury.
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.
20. ICE BofA US High Yield Constrained Index for all references to U.S. High Yield Bonds, unless otherwise specified.
21. JP Morgan for all U.S. default rates, unless otherwise specified. This figure excludes distressed exchanges.
22. The normal range refers to the average range over the last 25 years.
23. ICE BofA US High Yield Constrained Index. Percentages are based on the market value of debt.
24. 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.
25. UBS for all European default rates, unless otherwise specified.
26. Credit Suisse Leveraged Loan Index for all data in the U.S. Senior Loans section, unless otherwise specified.
27. Credit Suisse Western Europe Leveraged Loan Index (EUR Hedged) for all data in the European Senior Loans section, unless otherwise specified.
28. JP Morgan, LTM average rate, as of March 31, 2024. Default figures exclude distressed exchanges.
29. TXU was removed from J.P. Morgan's twelve-month default rate calculation in April 2015 resulting in a meaningful decrease in the rate in March 2015.
30. ICE U.S. Corporate Index for all data in this section, unless otherwise specified.
31. BofA Securities IG Syndicate Deal Recap.
32. As of March 31, 2024.
33. 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 high yield debt issued by companies in emerging market countries.
34. JP Morgan, as of March 28, 2024.
35. JP Morgan, as of February 26, 2024.
36. Bloomberg, JP Morgan, as of March 28, 2024.
37. JP Morgan Corporate Broad CEMBI Diversified High Yield Index compared to JPM U.S. High Yield Index.

Endnotes

38. JP Morgan, default rate for Corporate CEMBI High Yield Index, as of February 5, 2024.
39. Bloomberg, JP Morgan, as of March 28, 2024.
40. Refinitiv Global Focus Convertible Index for all performance data, unless otherwise indicated.
41. Bank of America for all default and issuance data in this section, unless otherwise specified.
42. Companies with a market cap of $10 billion or more.
43. Small-cap stocks are represented by the Russell 2000 Index; underperformance as of April 22, 2024.
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. Index tracks the pricing of institutional-quality commercial real estate.
49. Green Street Commercial Property Index, as of December 31, 2023.
50. Green Street Commercial Property Index, as of December 31, 2023.
51. KBRA Direct Lending Deals Default Report, as of March 22, 2023.
52. Preqin as of December 31, 2023.
53. The AUM figure is as of March 31, 2024 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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