OAKTREE | Insights

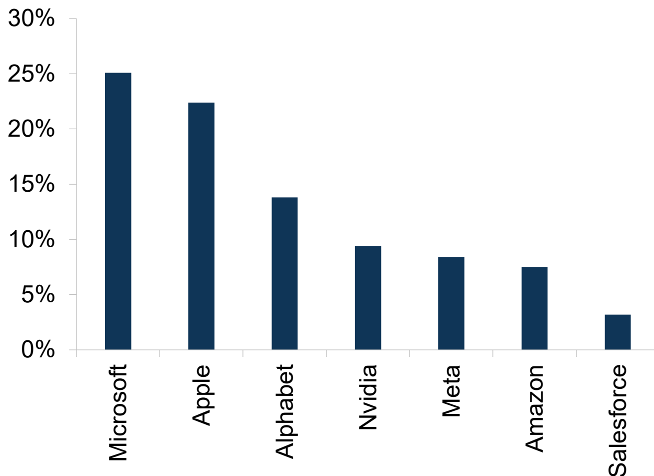
Performing Credit Quarterly

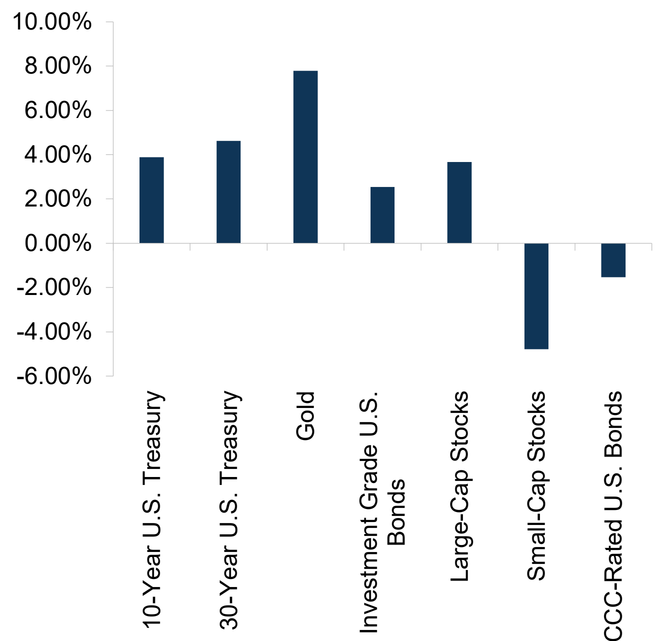
1Q 2023

FLIGHT RISK

In the prior edition of the *Performing Credit Quarterly*, we cautioned investors to be careful what they wished for, as those pricing in significant near-term interest rate cuts would likely only see this "Fed pivot" occur if something truly negative happened first. In mid-March, investors got a preview of how this scenario could play out, when the collapse of Silicon Valley Bank, rescue of Signature Bank, and hasty takeover of Credit Suisse were accompanied by plummeting Treasury yields, widening yield spreads, and falling equity prices. By quarter-end, the crisis appeared to be averted: Fears about deposit flight had eased, the European Central Bank and Federal Reserve had both proceeded with their expected interest rate hikes, and most markets had strengthened. But this rally may be somewhat deceptive, as it was driven by a flight to quality. Seven large companies accounted for roughly 90% of the S&P 500 Index's return in March, and small cap stocks – which are typically perceived to be riskier – recorded significant losses.[1] Meanwhile, investors flooded into investment grade bonds and continued to price in multiple interest rate cuts before year-end. (See Figure 1.[2]) This behavior is far more symptomatic of wariness than relief.

Figure 1: Investors Flocked Toward Quality in March





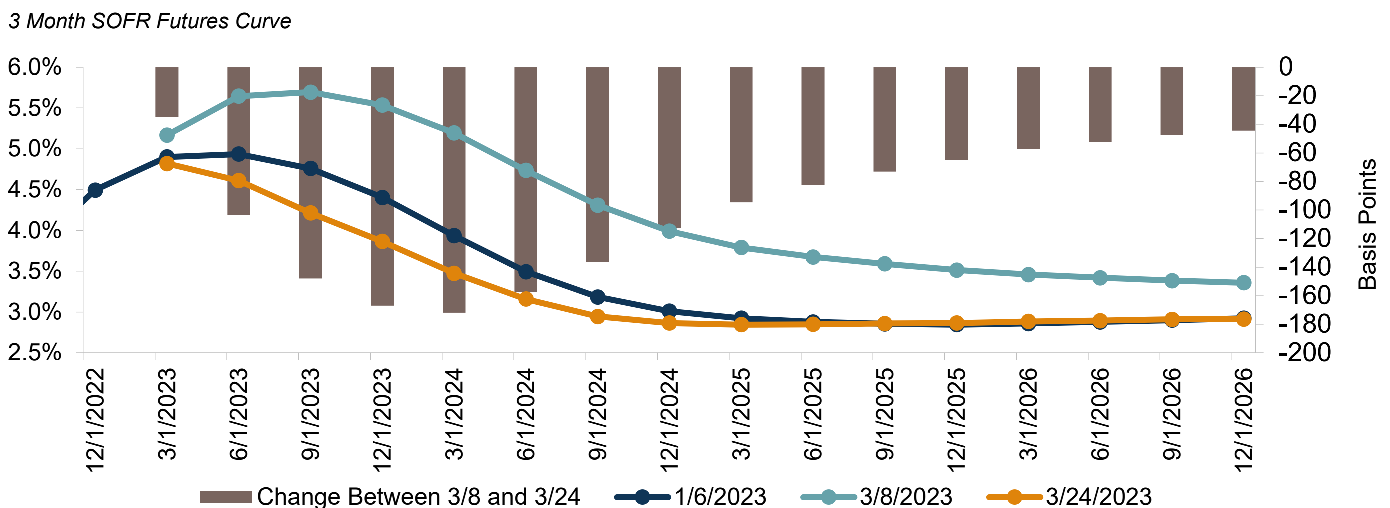
Source: Bloomberg

Do investors have reason to be concerned? While we can't predict the future, we can examine the past. We know that when an era of easy money comes to an abrupt end, simmering risks typically erupt. And over the last year, we've witnessed one of the fastest interest-rate-hiking cycles in decades as well as an attempt to begin reversing the largest program of U.S. dollar creation in history. Thus, we believe SVB's collapse won't be the last major disruption caused by the sudden end of this long period of easy money. This may benefit bargain hunters because credit analysts that are both skilled and disciplined have historically been well positioned to withstand volatility and take advantage of the tremendous buying opportunities that can emerge when other investors take flight.

A Bumpy Ride

Over the last year, we've highlighted the fickle nature of investors' expectations regarding interest rates and the economic outlook. The collapse of SVB on March 10 caused this volatility to reach new heights. (See Figure 2.) On March 15, the ICE Bank of America MOVE Index, which measures volatility in the bond market, reached the highest point since 2008 – eclipsing the level reached in early 2020, when Covid-19 was shutting down the global economy.[3] That was two days after the yield of the 2-year Treasury declined by 61 basis points, the largest one-day drop since 1987.[4] For context, the yield of the 2-year Treasury has only recorded net daily moves of more than 20 bps on 46 occasions since Jan 2000: 15 of those were in 2008, and 10 have already occurred in 2023 – and it's only April.[5]

Figure 2: Interest Rate Expectations Shifted Dramatically Following the SVB Collapse



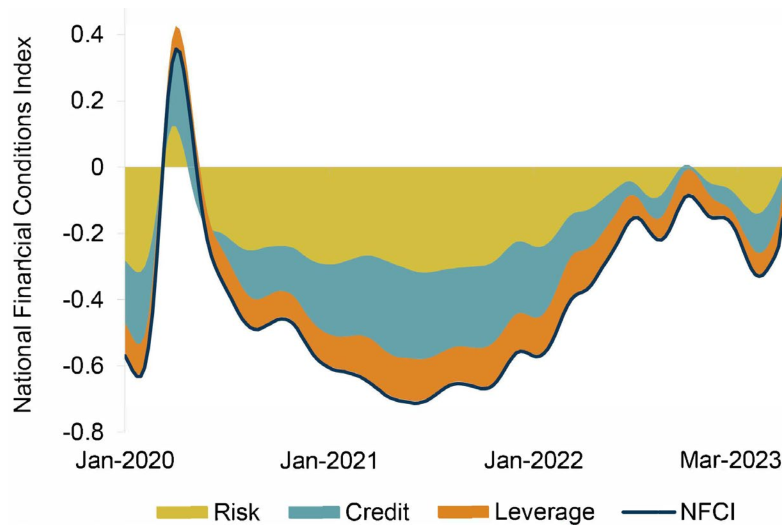
Source: Bloomberg

We expect this volatility to persist – but not because we're anticipating a 2008-style financial crisis. SVB was particularly vulnerable to rising interest rates due to its concentrated depositor base and exceptionally poor risk management, while Credit Suisse had long-standing problems.

But the banking turmoil remains significant because of the impact it could have on credit conditions and investor psychology. It's likely that banks – which were curtailing their lending activity before the crisis – will seek to further reduce risk because of the recent stress as well as weakening economic fundamentals, the potential for further regulatory changes, and legacy issues related to overly aggressive lending in the years before 2022. This would effectively tighten financial conditions, even if the Fed slows the pace of interest rate hikes or pauses them entirely. Financial conditions

actually eased in late 2022 and early 2023 – and still remain looser than the long-term historical average – but they've tightened since the SVB failure and remain substantially tighter than they were at the beginning of 2022. (See Figure 3. A positive figure indicates tighter-than-average financial conditions.)

Figure 3: Financial Conditions Are Tightening



Source: Federal Reserve Bank of Chicago, as of March 31, 2023
Note: The National Financial Conditions Index (NFCI) is calculated weekly based on more than 100 quantitative indicators related to conditions in money markets, public debt and equity markets, the banking system, and non-banking financial firms. See the endnotes for a discussion of the subindices.[6]

Additionally, the risk to small, regional banks may intensify, as individuals and companies wary about the health of smaller banks may continue to seek out larger institutions that are considered safer. Regional U.S. banks are major providers of capital to small businesses and real estate developers, so weakness at regional banks may meaningfully weigh on economic activity, even if it doesn't threaten the health of the global financial system.

To further complicate the situation, the U.S. economy already appears to be weakening, albeit from a fairly robust level. The Atlanta Fed's GDPNow tracker, which incorporates data from the U.S. Census Bureau, the U.S. Bureau of Economic Analysis, and the Institute for Supply Management, is currently anticipating growth of 2.5% in the first quarter, which is in line with the fourth quarter results but below the 3.2% recorded in 3Q2022.[7] We've also recently seen a series of disappointing economic data reports, including the following:

- Private payrolls increased by only 145,000 in March, compared to 261,000 in February.[8]
- Jobless claims figures have topped 200,000 for ten consecutive weeks.[9]
- The number of job openings in February fell below 10 million for the first time in almost two years.[10]
- The ISM Services Purchasing Managers' Index fell to 51.2 in March from 55.1 in the prior month, partly because of a decline in new orders.[11]

In *Performing Credit Quarterly 4Q2022: Bad News Bulls*, we noted that investors appeared to believe that when it came to the economy, bad news was good news because weak economic data made it more likely that the Fed would soon end its interest-rate-hiking cycle. The panic surrounding the SVB collapse appears to have shaken this belief and made investors recalibrate their macroeconomic expectations.

While we aren't predicting that a severe recession or another banking failure are imminent, we think the events of the past quarter have made it highly likely that market volatility will continue and thus that prudent credit investors with available capital will be well positioned. As our co-chairman Howard Marks noted in his most recent memo:

> **When investors think things are flawless, optimism rides high and good buys can be hard to find. But when psychology swings in the direction of hopelessness, it becomes reasonable to believe that bargain hunters and providers of capital will be holding the better cards and will have opportunities for better returns. We consider the meltdown of SVB an early step in that direction.**

Credit Markets: Key Insights for 2Q2023

Where are Oaktree experts finding potential risks, opportunities, and relative value today? Below are key insights that we believe investors should keep in mind when navigating today's markets.

(1) The crisis of confidence in the banking system may expand opportunities in private credit

Banks curtailed their lending significantly in 2022 and are likely to continue doing so following the collapse of SVB, as they await potential regulatory changes and scrutinize their own vulnerabilities, including those related to depreciating commercial real estate portfolios. As we noted in a recent op-ed, we believe private credit funds may have significant – and potentially long-lasting – opportunities to fill the resulting funding gaps, especially those related to large-scale leveraged buyouts.

However, private credit funds that have employed substantial leverage may be experiencing their own financing strains in an environment where floating-rate debt costs have risen and banks have become more risk-averse. These private lenders may also be facing meaningful challenges in their existing portfolios, if they made aggressive loans before 2022, when yield spreads were much narrower and terms were far more borrower-friendly. Ultimately, this will likely benefit those private lenders that (a) have sufficient scale to provide debt financing for large-scale LBOs and (b) aren't facing the types of problems that can result from lax due diligence.

(2) Dislocated markets are creating attractive opportunities for CLO managers – but manager selection is critical

Over the last two decades, managers of collateralized loan obligations (CLOs) have had few opportunities to purchase significant numbers of B- or BB-rated bank loans at meaningful discounts, and these buying windows have typically been short. Today, CLO managers have such an opportunity, as the average loan price is near 93 cents on the dollar and roughly 16% of loans are trading below 90 cents.[12] This means CLO equity investors may be in a position to potentially earn return in both the traditional fashion – i.e., from the difference between the interest earned on the underlying loan portfolio and the interest paid on the CLO debt tranches – and through capital appreciation, as the discounted prices should move back toward par over time, unless the loans default.

Even though CLO equity is in the first-loss position – and thus carries the highest risk in the CLO structure – it shouldn't be confused with a company's equity. Bank loans, the underlying collateral of the CLO, get paid back first when companies default.

Moreover, CLO portfolios are actively managed, so during dislocations, CLO managers can potentially protect the credit quality of their portfolio and generate trading gains that may offset any losses that occur in the underlying assets. Importantly, CLOs offer term financing, meaning that CLOs are, contrary to market myth, never subject to margin calls, redemptions, or forced selling. And most CLOs have a five-year reinvestment period, so managers have time to improve credit quality, generate gains, and reinvest amortizations and prepayments.

All of the above help explain why default rates for CLOs have remained low historically even during periods of market stress, such as the Global Financial Crisis, when loan defaults have increased.[13]

However, as we discuss below, risk has increased in the loan market in the last year as interest rates have risen, so we believe it's more important than ever for investors to identify CLO managers that (a) have deep expertise in the loan market and (b) have historically experienced low default rates in their loan portfolios.

(3) Default rates in the loan market may increase more than those in the high yield bond market over the next year – and recovery rates could be lower

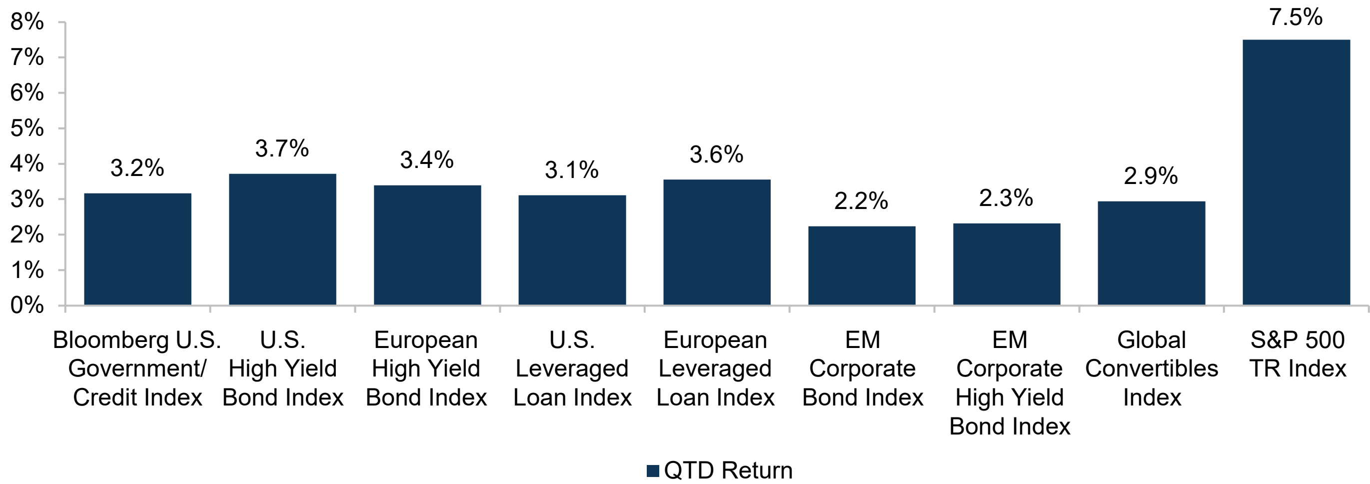
We anticipate that, over the next year, default rates in U.S. leveraged finance markets will only rise into the mid-single digits – well below the recessionary averages[14] – because of the amount of debt that was refinanced (or issued at very low interest rates) following the onset of the Covid-19 pandemic. However, we expect that downgrades and defaults will increase during this period, particularly for borrowers with high leverage or those in cyclical industries.

Importantly, we believe the loan market, which has historically had a lower default rate than the high yield bond market, will record a higher rate during this cycle. Leverage in the U.S. loan market has grown in the recent decade as loans have

become the tool of choice for private equity sponsors financing leveraged buyouts.[15] Moreover, relative to high yield bonds, the loan market has (a) an overweight to lower-rated securities (i.e., single-B and below), (b) higher borrowing costs, and (c) greater exposure to the highly levered software/technology sector.[16]

While we anticipate that recoveries in the high yield bond market during this cycle will be near the historical average of 40%, we expect recoveries in the loan market to be lower than the 65% long-term average.[17] This is due to the covenant-lite nature of most loans and the rising prevalence of loan-only capital structures. (Seniority only matters if you're senior *to* something.) However, we believe that recovery rates are likely to vary significantly by industry. As we noted last quarter, we believe we're in a credit picker's market and that dispersion by sector and issuer is likely to increase moving forward.

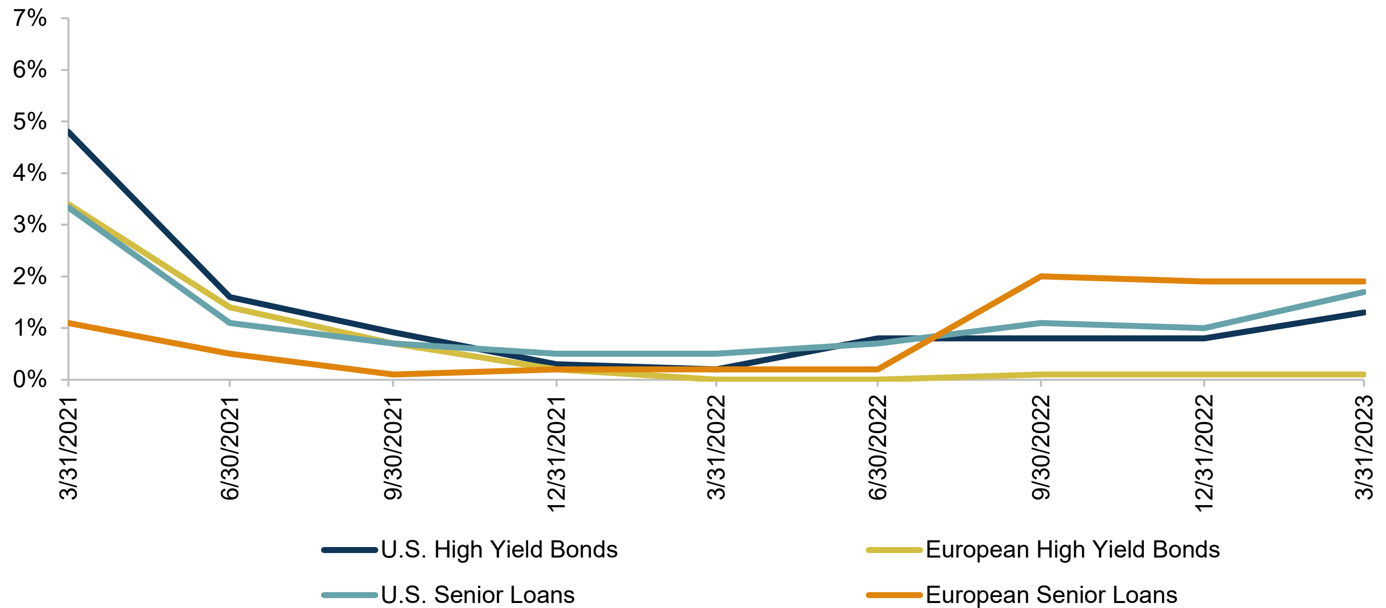
Performance of Select Indices



As of March 31, 2023

Source: Bloomberg Barclays, Credit Suisse, FTSE, ICE BofA, JP Morgan, S&P Global, Thomson Reuters[18]

Default Rates By Asset Class



Source: Credit Suisse, JP Morgan

Note: Data represents the trailing-12-month default rate; excludes distressed exchanges

High Yield Bonds

Market Conditions: 1Q2023

U.S. High Yield Bonds – Return: 3.7%[19] | LTM Default Rate: 1.3%[20]

- **Fixed-rate assets strengthened in 1Q2023, despite experiencing volatility:** High yield bonds rallied significantly in January, as inflation slowed and recession fears declined. The rally cooled in February, and the asset class weakened in mid-March following the collapse of Silicon Valley Bank. Prices rose toward quarter-end, as fears about the banking system abated.
- **High yield bond spreads were volatile:** While they narrowed by as much as 90 bps during the quarter, they widened by 130 bps following the failure of SVB, before contracting by 60 bps before quarter-end, for a modest quarterly net contraction. They ended the quarter toward the high end of the normal range of 300-500 bps.[21]
- **Yields remain elevated:** While yields declined by nearly 50 bps during the period, they remain well above the ten-year average. (See Figure 4.) Approximately 55% of the asset class had yields above 7% at quarter-end, compared to less than 7% at the beginning of 2022.[22]

European High Yield Bonds – Return: 3.4%[23] | LTM Default Rate: 0.1%[24]

- **The asset class experienced volatility, but ultimately strengthened in 1Q2023:** B-rated bonds outperformed, while there was a notable rally in some sectors that struggled in 2022, such as consumer goods.[25]
- **The spread premium versus U.S. high yield bonds shrank further:** The European asset class's advantage declined to 70 bps at quarter-end from a high of 174 bps in 2022.[26]

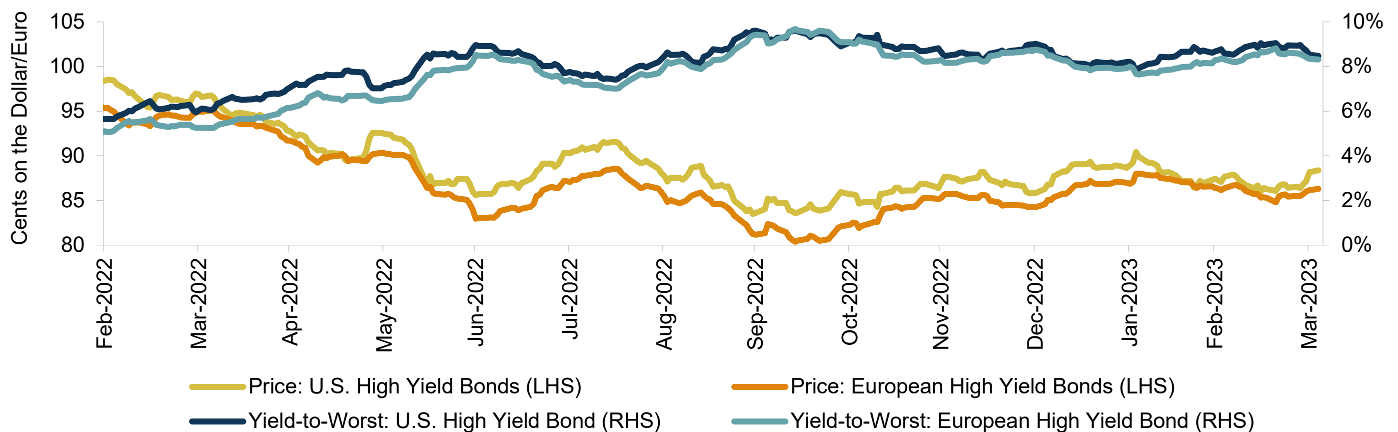
Opportunities

- **The risk of widespread defaults in 2023 remains low:** Issuers' fundamentals are fairly healthy despite the slowdown in economic growth, and near-term maturities are minimal following the wave of refinancings in 2020–21.
- **Quality in the high yield bond market has improved:** The percentage of BB-rated bonds in the U.S. market is near a 10-year high, while the number of CCC-rated credits declined during the decade.[27] Thus, the asset class appears to be better positioned to weather an economic downturn than in the past.

Risks

- **Tightening monetary policy could harm heavily indebted companies:** Low-rated corporate issuers might struggle to roll over debt now that financial conditions have become more restrictive.
- **High inflation could impair issuers' fundamentals:** While inflation has slowed, it remains elevated. Companies may be unable to pass along price increases to customers. Reduced earnings could negatively impact leverage ratios and potentially lead to credit rating downgrades.

Figure 4: High Yield Bonds Are Offering Potentially Attractive Yields and a Low Average Price



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

Senior Loans

Market Conditions: 1Q2023

U.S. Senior Loans – Return: 3.1%[28] | LTM Default Rate: 1.7%[29]

- **U.S. senior loan prices rose in 1Q2023, but markets were volatile:** Performance was supported by increased demand from CLOs and limited new issuance. However, the loan market could weaken moving forward if the economy continues to slow.
- **Retail investors reduced their exposure to the asset class:** Loan mutual funds and ETFs recorded eight consecutive months of outflows through March. Net outflows in 1Q2023 totaled $9.3bn. The U.S. broadly syndicated loan market has experienced consistent outflows and weak issuance over the last three quarters, resulting in the first decrease in outstanding loans since 2008.[30]

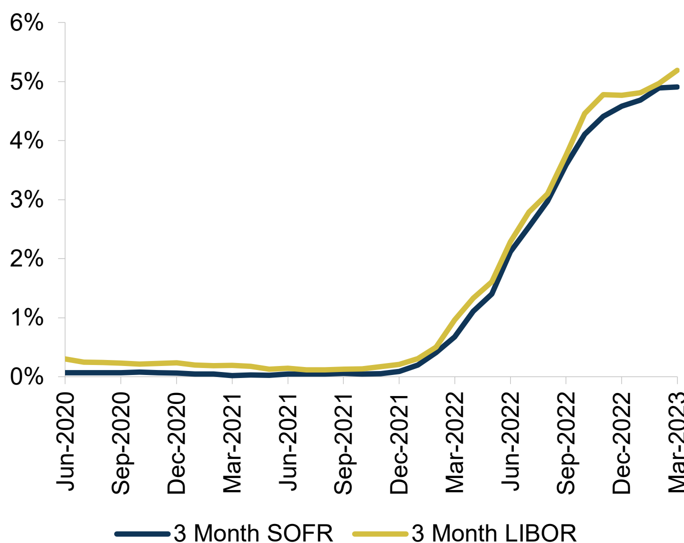
European Senior Loans – Return: 3.6%[31] | LTM Default Rate: 1.9%[32]

- **European loans strengthened, especially the lowest credit rating group:** While volatility increased in March, the riskiest segment of the market still outperformed during the full period: CCC-rated loans returned 5.7% in the quarter.[33]
- **The spread premium versus U.S. loans has disappeared:** Yield spreads of European assets are now narrower than those in the U.S. loan market for the first time since 2Q2022, largely due to moderating concerns about Europe's economy.

Opportunities

- **Elevated interest rates may make loans relatively more attractive to investors:** The spike in reference rates over the last year could make floating-rate loans more compelling than fixed-rate assets. (See Figure 5.)
- **Low issuance could support performance:** Activity in the primary market is expected to remain limited through 2Q2023.[34] The performance of existing loans typically benefits when the supply of new loans shrinks.
- **Loans' core buyer base is stable:** Volatility in loans is usually lower than in other asset classes because (a) CLOs – the primary holders – have limited selling pressure and (b) 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 March 31, 2023

Risks

- **Rising interest rates may be especially burdensome to heavily indebted borrowers:** Borrowers that didn't hedge their interest rate risk – especially those in highly levered sectors like technology – could struggle to service their debt.
- **High inflation could harm companies' fundamentals:** While inflation has moderated, it remains elevated. Borrowers may struggle to pass along cost inflation to customers, which could negatively impact companies' earnings and leverage ratios.
- **Economic growth may slow, increasing the likelihood of downgrades and defaults:** Downgrades in the U.S. exceeded upgrades by $65 billion in the first quarter.[35] Default risk over the medium term has grown, highlighting the importance of disciplined credit selection.
- **Loan quality has declined in recent years:** Issuer-friendly loans may have encouraged imprudent borrowing, which could prove problematic in an economic downturn. Additionally, loan-only borrowers currently account for almost 60% of the market.[36]

Emerging Markets Debt

Market Conditions: 1Q2023

EM Corporate High Yield Bond Return[37] – 1Q2023: 2.3%

- **EM bond performance was boosted by declining interest rate expectations, but negatively impacted by the global flight to quality:** EM debt generated a return of nearly 4% in January,[38] driven by falling Treasury yields, retail fund inflows, and optimism regarding China's reopening. But the asset class started to weaken in February, as high inflation, a worsening growth outlook, and bank stress in developed markets weighed on investors' risk appetite.
- **EM debt funds experienced outflows near quarter-end, and issuance remained subdued:** EM debt funds have recorded modest YTD inflows, as meaningful outflows in March offset a majority of the strong inflows in January. The sluggish pace of bond issuance in 2022 continued through 1Q2023: Issuance in the quarter fell to the lowest level since 2016, and high yield issuers have accounted for less than 20% of the activity.[39] (See Figure 6.)
- **Latin America underperformed other EM regions:** Latin American debt returned only 0.8% in 1Q2023.[40] This was primarily due to stress in the region's largest market, Brazil, where local capital market conditions tightened, a large retailer defaulted, and the number of distressed companies spiked. Additionally, political discontent in Ecuador, Bolivia, and Peru negatively affected investor sentiment.

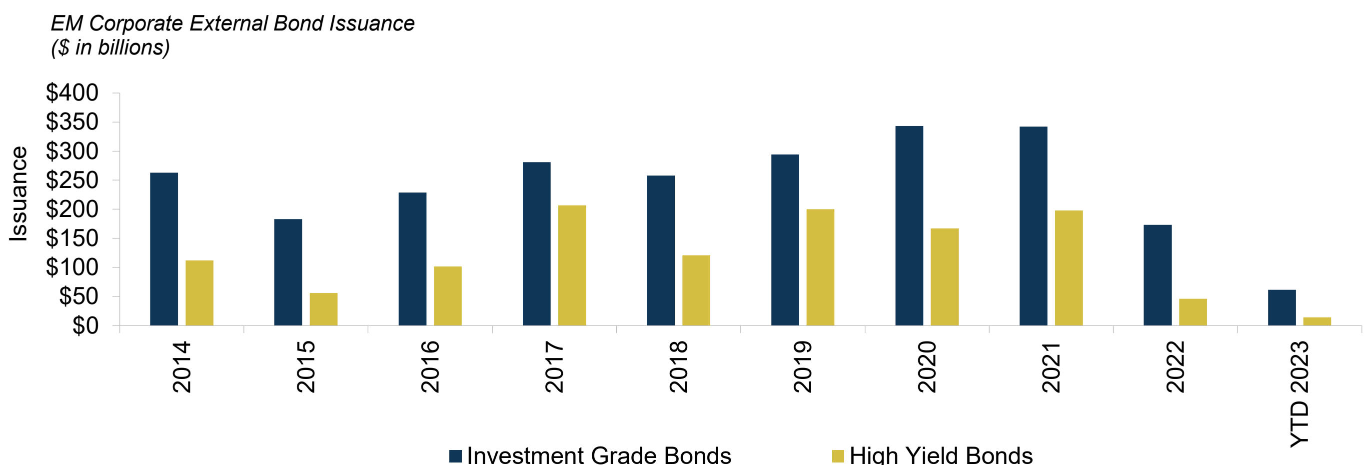
Opportunities

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

Risks

- **Credit investors may underestimate the economic effects of recent monetary policy tightening and the risk of stagflation:** Global growth estimates have repeatedly been revised downward, and capital remains scarce for most EM issuers. If the global economy slows, EM countries may disproportionately feel the negative effects, even if the slowdown causes global central banks to pause their policy tightening.
- **Geopolitical tensions in EM remain elevated:** The war in Ukraine, Sino-U.S. relations, rising populism in Latin America, and macroeconomic instability in Turkey could all erode investor confidence in EM credit.

Figure 6: EM Corporate Debt Issuance Remains Well Below the Pre-Pandemic Average



Source: JP Morgan EM Default Monitor, as of March 31, 2023; data represents gross issuance

Global Convertibles

Market Conditions: 1Q2023

Return: 2.9%[41] | LTM Default Rate: 2.8%[42]

- **The asset class strengthened in 1Q2023 despite market volatility:** The rally in the equity and convertibles markets mostly occurred in January and was primarily driven by (a) expectations that inflation may have peaked, (b) optimism that the pace of interest rate hikes could slow, and (c) China's broad-based economic reopening.
- **Large-cap equities outperformed:** Global equity and credit markets experienced significant volatility following the collapse of Silicon Valley Bank. As a result, large-cap stocks outperformed as investors flocked toward assets deemed to be higher quality and thus safer.
- **Primary market activity was healthy in 1Q2023:** Issuance of convertibles globally totaled $19.7bn across 39 new deals during the period, well above last year's sluggish pace and in line with the pre-pandemic average volume.[43]

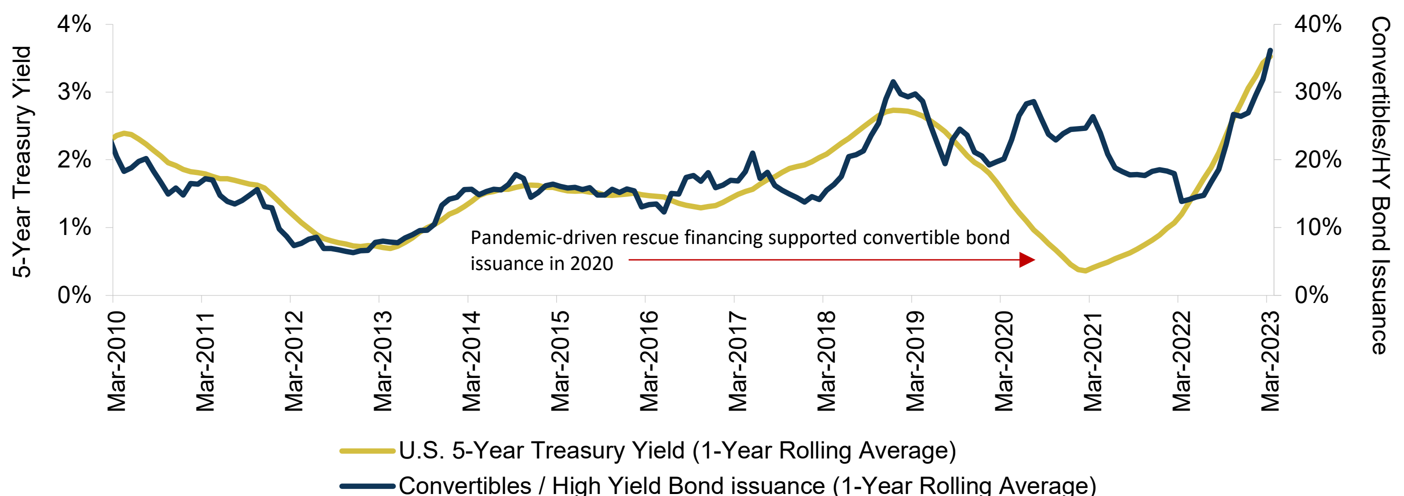
Opportunities

- **The convertibles universe remains broad and diverse:** Many of the new deals in 2023 have come from historically underrepresented convertible bond sectors (such as energy, materials, and utilities), investment-grade-rated issuers, and large-cap companies. The terms of these new securities have become increasingly investor-friendly: On a trailing-12-month basis, the average coupon for a new global convertible is 3.7%, compared to the low of 1.4% in 2021.[44]
- **Issuers may increasingly turn to the convertible bond market in the coming year:** Since the Global Financial Crisis, issuance of high yield bonds has dramatically outpaced activity in the convertibles market. However, higher borrowing costs in the traditional bond market may now encourage issuers to turn to convertibles. (See Figure 7.) As more borrowers migrate toward this market, the quality of new issuance should improve, potentially enhancing the average risk/return profile in convertibles.

Risks

- **Numerous trends threaten to slow global economic growth and weigh on equity prices:** These include lack of confidence in the banking sector, tightening credit conditions, negative consumer sentiment, high inflation, hawkish monetary policy in developed markets, and elevated geopolitical risk.

Figure 7: Convertible Bond Issuance Typically Increases Relative to High Yield Bond Issuance When Borrowing Costs Rise



Source: BofA Global Research, Bloomberg, as of March 31, 2023; data represents gross issuance

Structured Credit

Market Conditions: 1Q2023

Corporate – BB-Rated CLO Return: 3.6%[45] | BBB-Rated CLO Return: 2.3%[46]

- **Broad market volatility negatively impacted the CLO market:** The asset class weakened in March as investors' risk appetite declined following the collapse of Silicon Valley Bank.[47]
- **Primary market activity remained muted:** Issuance of collateralized loan obligations in the U.S. totaled $33.9bn in the period, compared to $51.3bn in 1Q2022. Issuance in Europe totaled only €6.3bn during the quarter versus €15.4bn in 1Q2022.[48]

Real Estate – BBB-Rated CMBS Return: -5.4%[49]

- **Primary market activity has continued to slow:** Issuance of commercial mortgage-backed securities in the first quarter totaled $6.3bn, compared to $44bn in 1Q2022. Issuance in the period represents the lowest first-quarter total since 1Q2012.[50]
- **Yield spreads have continued to widen:** Commercial and residential real-estate-backed securities continue to face many headwinds, including rising interest rates, higher cap rates, declining transaction volumes, falling asset values, and reduced bank lending. In addition, the asset class is grappling with potential fundamental shifts in demand in certain sectors, such as office.

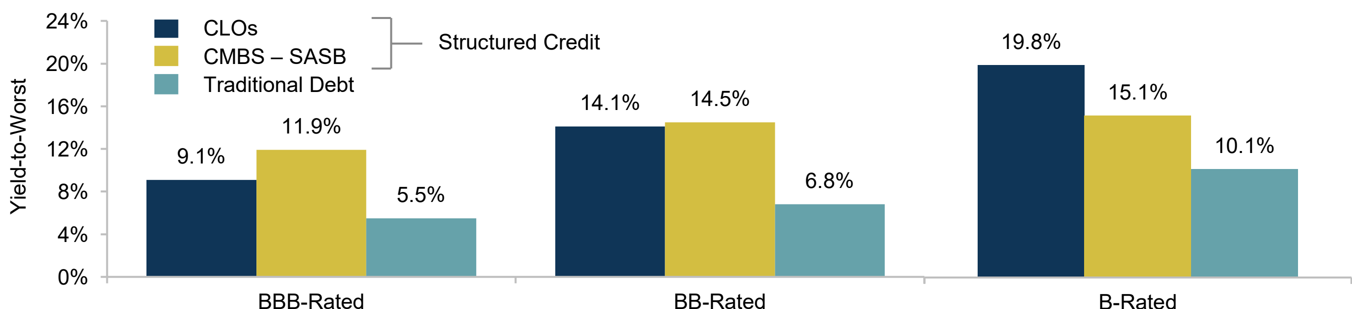
Opportunities

- **BB-rated CLO debt tranches have many sources of potential value:** They have attractive structural and credit enhancements as well as low sensitivity to interest rate increases. Structured credit continues to offer higher average yields than traditional credit asset classes. (See Figure 8.) Weakness in the CLO market could create attractive buying opportunities.
- **Volatile markets could create compelling opportunities for CLO managers:** They can potentially buy B- or BB-rated loans at significant discounts.
- **Weakness in real-estate-backed securities could create compelling opportunities for disciplined investors:** We think firms with available capital and limited problems in their existing portfolios will be well positioned to take advantage of these opportunities. But in this challenging environment, it will be especially important to (a) maintain disciplined credit analysis and (b) remain senior in the capital structure.

Risks

- **CLOs have historically performed poorly during bouts of equity market weakness:** Performance could continue to be negatively affected by anxieties about the economic outlook and the health of the loan market.
- **Primary market activity in real-estate-backed securities may remain limited due to widening yield spreads:** Uncertainty surrounding the trajectories for interest rates and inflation as well as concerns about the health of the banking system will likely limit transaction volumes in the near term.

Figure 8: Structured Credit Offers Higher Yields Than Most Traditional Debt



Source: Bloomberg Index Services, ICE Index Platform, Credit Suisse, JP Morgan, as March 31, 2023

Private Credit

Market Conditions: 1Q2023

- **The volume and quality of sponsor-backed deals varies considerably by size:** In 2022, yield spreads for large-cap LBO financings (i.e., EBITDA ≥ $50mm) increased by 100-150 bps, leverage levels fell, and sponsors' equity percentages increased, lowering LTV ratios.[51] While private equity dry powder is at an all-time high, the syndicated loan market has slowed significantly. Banks, which have traditionally provided most of the debt financing for large-cap deals, continue to decrease their lending activities. Many established large private lending funds have also reduced loan sizes on average, potentially due to concerns about slowing economic growth, sluggish fundraising, and existing portfolio issues.
- **Private deal volume in Europe declined as markets faced many headwinds:** The region continues to be beset by high inflation, economic uncertainty, and geopolitical risk. Deals are taking longer to complete, as eroding macroeconomic conditions are extending due diligence timelines. Small banks, which underwrite a significant proportion of deals in Europe, may curtail their lending, following the recent turmoil in the banking system.

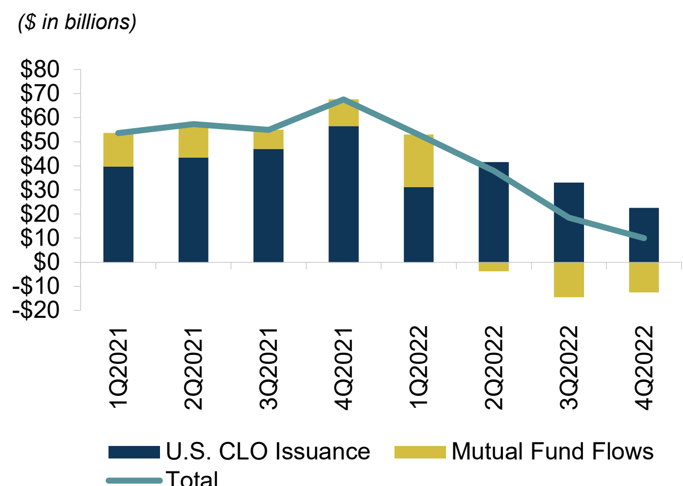
Opportunities

- **Private lenders could continue to gain market share in large-cap financings:** Banks may not be in a position to consistently provide funding in this market for a significant period of time. In 2022, many banks suffered meaningful losses on LBO debt commitments. High borrowing costs and slowing economic activity may weaken their loan portfolios. And recent bank failures may reduce risk appetite and result in stricter regulatory scrutiny. Also, the syndicated market has become less reliable: In 2023, CLO formation has been uneven, and retail funds have experienced meaningful outflows. (See Figure 9.)
- **Rescue lending opportunities are likely to grow:** The opportunity set could expand, especially if the recent stress in the banking system leads to further credit-tightening and weaker economic activity.
- **Opportunities in the non-sponsored market (NSM) remain attractive:** Yield spreads in the NSM widened by as much as 200 bps in 2022, more than the 100-150 bps observed in the sponsor-backed market.[52]
- **European banks may continue to lose market share to private lenders:** We anticipate that the shift toward private financing will continue over the long term, particularly now that regulators are likely to monitor regional banks more closely.

Risks

- **U.S. recession risk is increasing:** The labor market appears to be weakening. If the U.S. economy contracts, private equity sponsors may not inject capital into struggling companies as they did in 2020–21.
- **Credit fundamentals in several sectors are deteriorating:** Consumer-facing companies are especially vulnerable, as it has become challenging to pass through price increases to customers. Cyclical industries may experience significant margin erosion. And concerns continue to grow about commercial real estate valuations.
- **Tight monetary policy could negatively impact the lending environment:** Higher interest rates may discourage new borrowing and make it challenging for current borrowers to roll over their debt. This situation could make defaults more likely.

Figure 9: Traditional Sources of Demand for Large LBO Loans Have Become Less Reliable



Source: LCD Pitchbook, as of December 31, 2022; data represents gross CLO issuance and net mutual fund flows

Investment Grade Credit

Market Conditions: 1Q2023

Return: 2.8%[53]

- **The asset class strengthened in 1Q2023, largely due to slowing inflation and optimism that the Federal Reserve's interest-rate-hiking cycle is coming to a close:** U.S. Treasury yields declined during the period.[54] While the Fed continued to increase interest rates, these hikes were well telegraphed, and Fed Chair Jay Powell also indicated that the pace of tightening may slow.
- **Yield spreads widened during the period:** Fears of a looming recession exacerbated by the stress in the banking sector caused modest spread-widening. The average yield spread in U.S. investment grade credit increased slightly, ending the quarter at 138 bps.[55]
- **Higher-quality credits have been resilient:** Fundamentals in the investment grade corporate bond market remain strong, despite the economic headwinds.[56] At quarter-end, the A-rated segment of the corporate bond index returned 3.3%, with a yield-to-maturity of roughly 5.0%.[57]

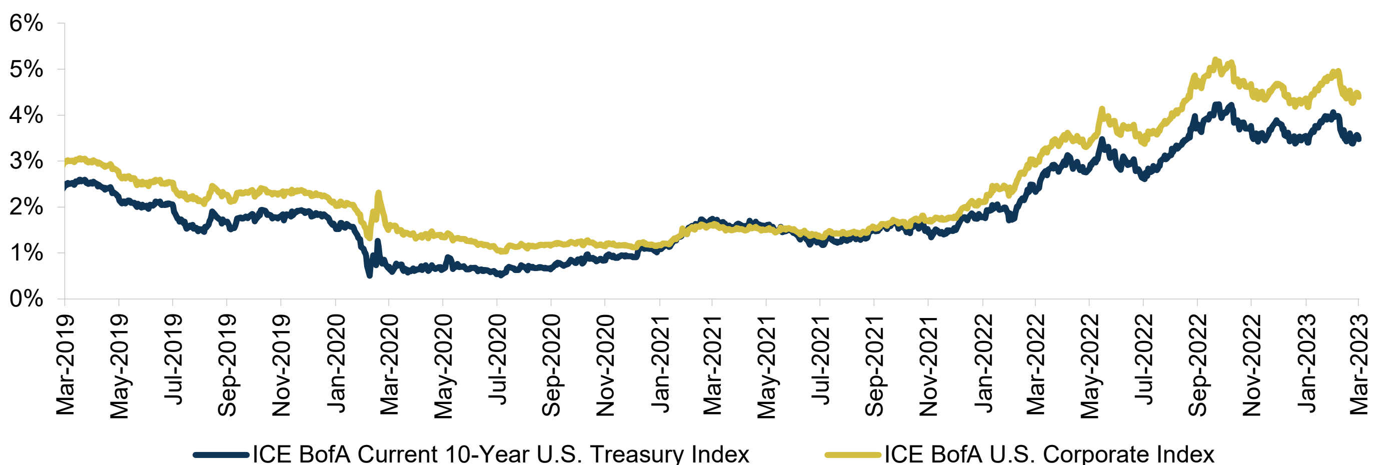
Opportunities

- **Investment grade corporate debt yields have remained elevated in 2023:** While yields declined slightly during the quarter (by roughly 30 bps), yields in the asset class ended the quarter at 4.4%, well above the 5-year average.[58] (See Figure 10.)
- **Rising recession risk may make investment grade debt attractive on a relative basis:** Investment grade debt is likely to outperform high yield bonds if widening yield spreads – as opposed to rising Treasury yields – prove to be the primary driver of performance in credit markets in 2023 and 2024.
- **Defensive sectors could potentially offer compelling value if the economy deteriorates:** Sectors such as consumer staples typically outperform more growth-oriented sectors during economic downturns.

Risks

- **Inflation may remain well above the 2% target, putting pressure on the Fed to keep interest rates elevated:** Tight monetary policy and weakening economic activity will likely continue to temper inflation, but uncertainty remains about how quickly price increases will slow.
- **High input costs and slowing economic growth could weigh on corporate earnings:** Issuers' fundamentals remain fairly robust on average, but margin compression could negatively impact credit metrics and lead to credit rating downgrades and mark-to-market weakness.

Figure 10: Investment Grade Bond Yields Remain Elevated Due to the Rise in Treasury Yields



Source: Bloomberg

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 co-portfolio manager of the Oaktree Diversified Income strategy. Since joining Oaktree in 2014, Ms. Poli has led the expansion of the firm's multi-asset credit offerings, including its flagship Global Credit strategy for which she is a senior specialist and member of the Investment Committee. In addition, Ms. Poli oversees Oaktree's product management activities globally across Credit, Private Equity, Real Assets and Listed Equities, in her role as Head of the Product Specialist Group. Prior to joining Oaktree, Ms. Poli earned her M.B.A. at the UCLA Anderson School of Management, where she was the recipient of the Laurence and Lori Fink Investment Management Fellowship and an intern at Oaktree in 2013. Prior experience includes four years 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 $65.1 billion in AUM and approximately 190 investment professionals.[59]

Endnotes

1. Bloomberg.
2. Bloomberg; March 2023 MTD performance based on the following: FTSE 10-Year Treasury Benchmark On-the-Run Index, FTSE 30-Year Treasury Benchmark On-the-Run Index, Gold United States Dollar Spot Price, Bloomberg US Aggregate Index, S&P 500 Total Return Index, Russell 2000 Total Return Index, and ICE BofA CCC and Lower US High Yield Constrained Index.
3. Bloomberg.
4. Bloomberg.
5. Bloomberg, as of April 14, 2023.
6. From the Federal Reserve Bank of Chicago, *National Financial Conditions Index Frequently Asked Questions*: "By risk, we mean both the premium placed on risky assets embedded in their returns as well as the volatility of asset prices. By credit, we refer to the willingness to both borrow and lend at prevailing prices. Our measures of leverage provide a reference point for debt relative to equity. Risk measures tend to receive positive weights, while credit and leverage measures tend to receive negative weights, providing the interpretation that 'tight' financial conditions are associated with above-average risk and below-average credit and leverage."
7. Federal Reserve Bank of Atlanta, estimate as of April 14, 2023.
8. ADP, as of April 5, 2023.
9. U.S. Department of Labor, as of April 14, 2023. Data is seasonally adjusted.
10. U.S. Bureau of Labor Statistics, as of April 4, 2023.
11. Institute for Supply Management, as of April 5, 2023.
12. Credit Suisse, as of March 31, 2023.
13. S&P Global Ratings.
14. JP Morgan.
15. Pitchbook LCD, as of 1Q2023.
16. ICE BofA US High Yield Constrained Index; Credit Suisse Leveraged Loan Index; as of April 14, 2023.
17. JP Morgan, as of April 14, 2023.
18. 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).
19. ICE BofA US High Yield Constrained Index.
20. JP Morgan.
21. ICE BofA US High Yield Constrained Index for all data in this bullet point. The normal range refers to the average range over the last 25 years.
22. ICE BofA US High Yield Constrained Index for all data in this bullet point.
23. ICE BofA Global Non-Financial High Yield European Issuer, Excluding Russia Index (EUR hedged).
24. Credit Suisse.
25. ICE BofA Global Non-Financial High Yield European Issuer Excluding Russia Index.
26. ICE BofA US High Yield Constrained Index; ICE BofA Global Non-Financial High Yield European Issuer Excluding Russia Index.
27. ICE BofA US High Yield Constrained Index.
28. Credit Suisse Leveraged Loan Index.
29. JP Morgan.
30. JP Morgan for all statistics in this bullet point.
31. Credit Suisse Western Europe Leveraged Loan Index (EUR hedged).
32. Credit Suisse.
33. Credit Suisse Western Europe Leveraged Loan Index (EUR hedged).
34. JP Morgan.
35. JP Morgan.
36. JP Morgan, percentage of the loan market on a market-weighted basis, as of March 31, 2023.

Endnotes

37. JP Morgan Corporate Broad CEMBI Diversified High Yield Index. The emerging markets debt section focuses on dollar-denominated debt issued by companies in emerging market countries.
38. JP Morgan Corporate Broad CEMBI Diversified High Yield Index.
39. JP Morgan; data refers to gross issuance.
40. JP Morgan Corporate Broad CEMBI Diversified High Yield Index.
41. Refinitiv Global Focus Convertible Index.
42. Bank of America; includes distressed exchanges, missed interest or principle payments, and bankruptcies.
43. Bank of America; data refers to gross issuance.
44. Bank of America, as of March 31, 2023.
45. JP Morgan CLOIE BB Index.
46. JP Morgan CLOIE BBB Index.
47. JP Morgan CLOIE BBB Index, JP Morgan CLOIE BB Index.
48. JP Morgan for all data in this bullet point.
49. Bloomberg US CMBS 2.0 Baa Index Total Return Index Unhedged Index.
50. JP Morgan.
51. Derived from Oaktree estimates, as of March 31, 2023.
52. Derived from Oaktree estimates, as of March 31, 2023.
53. Bloomberg US Corporate Index.
54. U.S. Department of the Treasury.
55. Bloomberg US Agg Total Return Value Unhedged USD Index.
56. Bloomberg US Agg Total Return Value Unhedged USD Index.
57. Bloomberg US Agg Total Return Value Unhedged USD Index.
58. Bloomberg US Agg Total Return Value Unhedged USD Index.
59. The AUM figure is as of December 31, 2023 and excludes Oaktree's proportionate amount of DoubleLine Capital AUM resulting from its 20% minority interest therein. The total number of professionals includes the portfolio managers and research analysts across Oaktree's performing credit strategies.

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