OAKTREE INSIGHTS
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ASSESSING RELATIVE VALUE IN CREDIT AMID CORONAVIRUS UNCERTAINTY

OAKTREE

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Coronavirus remains a growing threat to global economies. Financial markets are experiencing extreme turbulence as policymakers and investors grapple with the increasing human cost and uncertainty regarding the scale of the pandemic.

During this time, we believe the important question for us is, "How do we, as credit investors, make sense of these fast-moving developments, and how do we move forward?" The following are edited highlights from a conversation Oaktree's Chief Investment Officer Bruce Karsh had the week of March 9 with our Global Credit portfolio managers.[1]

Bruce Karsh: Much has changed in the past few weeks, certainly in the financial realm. Walk us through the magnitude of some of these changes in the markets.

Wayne Dahl: We've seen a significant selloff in a very brief period. U.S. stocks reached a high as recently as mid-February. But by March 12, when the World Health Organization officially labeled the outbreak a pandemic, we saw the 11-year bull run come to an end, as key indices plunged into what's called "bear territory" (i.e., down 20% or more from the last high) despite policy measures aimed at easing stress. On that day, the Dow Jones Industrial Average dropped 10% — its steepest decline since the crash of October 1987. By March 16, the S&P 500 index, too, had marked its biggest single-day loss since that crash.

As for volatility, here is one statistic to help orient you: If you look at the number of trading days when the S&P 500 index moved by 3% or more, in either direction, there were seven such days in 2017, 2018 and 2019 <u>combined</u>. In contrast, there have been 12 such days so far in 2020 through March 16.

Apart from equities, the decline since February 19 is 13.4% for U.S. high yield bonds and 10.8% for U.S. senior loans.[2] Investment grade corporate bonds have logged a more limited loss, at 4.5%, likely because of the way they benefit from lower interest rates. Oil certainly has collapsed, down 46.1%. Energy prices were already vulnerable due to concerns that the virus would sap global demand, but a rift between Saudi Arabia and Russia sent them tumbling further. We've also seen a steep drop in interest rates, with the 10-year Treasury yield falling to its lowest levels in history. Interest rate volatility has climbed to levels not seen since 2009, according to the Merrill Lynch Option Volatility Estimate Index.

Bruce Karsh: With the understanding that volatility will continue, how are you viewing the credit landscape today? How should a prudent investor behave in the uncertain period ahead?

Armen Panossian: Having an appropriate perspective on the credit environment right now requires an understanding of the nuances of the coronavirus situation. In particular, credit investors should consider the impact of this situation on businesses and industries, and the ensuing risk of principal loss. One should also be attentive to the second- and third-order effects on broader economies, industries and households.

Our current assessment of markets includes a study of how different segments are behaving. Certain areas are trading down because they are directly affected by coronavirus; others are trading down as well, but not by as much. For instance, high yield bonds or senior loans that do not have direct exposure to oil and gas may be down by more moderate amounts, measured in mid-single digits. These securities are also falling on very little volume. Unlike in the Global Financial Crisis (GFC), we aren't seeing much if any forced selling at this time.

So, in this environment, we're watching for potential disruptions and more attractive trading prices. We're looking for situations where good companies – unrelated to either commodity energy or coronavirus risk – are trading lower due to market technical (i.e., supply/demand considerations). Building a diversified portfolio of "baby-out-with-the-bathwater" situations is a priority. I'll add that investment grade credit may also present an opportunity to the extent that the uncertainty around coronavirus creates outflows from retail IG accounts and/or downgrades of BBBs into high yield bond territory.

Thankfully, leading up to this situation, we at Oaktree had positioned our portfolios conservatively, in line with our mantra for many years to "move forward, but with caution." For example, our portfolios have had reduced energy exposure relative to benchmarks, and we haven't held much debt of highly leveraged companies. We believe this has helped position our portfolios favorably as we kept an eye out for opportunity. Still, there are fast-developing technicals in the markets that defy prediction. Market volatility and risks will likely persist for quite some time. I think we're likely to see security prices go lower before they stabilize, and we can't tell what sort of a recovery might be staged: V-shaped or otherwise. In any case, we are actively engaged and watching for opportunities, especially in industries where the virus is not a direct threat to companies' performance. We also want to be sure we're prudent in the way we're deploying capital, because being too early can be as problematic as being too late.

Bruce Karsh: How about Europe? What's been the impact there so far? Share with us how the situation has impacted European high yield bonds and senior loans.

"We're looking for situations where good companies are trading lower due to market technicals."
– Armen Panossian,
Head of Performing Credit
Portfolio Manager
Strategic Credit

Madelaine Jones: It probably didn't help that in January investors were extremely relaxed about the environment in Europe, pleased that there had been a resolution to the trade war and Brexit. So yield spreads were at modest levels before their swing dramatically higher when the virus's effects started to become more severe. We're now seeing spread levels in European credit not seen since 2012.

The market's assessment of virus-related risks has evolved over the past few weeks, from the issue initially being mostly about China to something much more comprehensive. Europe is an export-led market. Germany in particular counts on global supply chains and the free flow of trade, especially for exports to China in the auto, chemicals, commodity and industrials sectors. So really, the first ramifications were seen in those cyclical sectors having to do with German exports and Chinese demand. Now, as we all know, the virus has spread across Europe and is having a much broader and harsher impact on markets; public events, hotels, travel, leisure — all of these segments of the market are being scrutinized.

As for the asset classes specifically, we've seen a sharp reaction, particularly in high yield bonds. But eventually the market has come to a point of trying to sift through information and be more rational about separating out the very exposed parts of the markets and the less exposed. So there's a delineation of risk in European high yield bonds. Similar to the U.S., there's not a lot of forced selling on the part of ETFs, certainly not in the loan market. But regardless, we are seeing parts of that market repricing as well.

In terms of sectors, energy has certainly taken a beating. European credit generally has very little exposure to this area, about 4% for high yield bonds and essentially none for loans. So the risk vis-à-vis the oil crash, lower global fuel demand and related volatility in that sector is relatively low. There is instead a clustering of risk around the cyclicals and the travel and leisure companies.

Bruce Karsh: Let's briefly turn to defaults and recoveries. What's the outlook for default rates?

Brendan Beer: With growing uncertainty over coronavirus's economic implications, we may be starting to see a cyclical pattern when it comes to defaults. Credit problems in the recent past have been mostly idiosyncratic, involving companies that had significant exposure to, for example, litigation in the pharmaceutical space, balance billing regulation for healthcare services, failed asset sales, increasing irrelevance of certain types of retail stores, etc. Some of these businesses that did default ended up having very low recovery rates for first lien lenders, but in any case the legacy issues were borrower-specific.

What you're seeing now are companies returning rapidly to a cyclical narrative. Businesses that are overleveraged, can't make payroll, can't pay their leases, can't service their debts — these companies may have to restructure. Default rates remained remarkably low for ten years as companies borrowed and reborrowed, thanks to easy and cheap credit, but we're now seeing cyclical default expectations pulled forward.

We might also see companies that are otherwise doing fine but just can't make it through this extraordinary period dominated by the real and perceived effects of coronavirus. These companies might need to restructure, but in those cases we can probably expect healthy recovery rates.

Bruce Karsh: **Real estate debt has been relatively calm. But how are things looking underneath the surface? Have there been problems brewing?**

Justin Guichard: Being relatively calm is what we'd generally expect real estate debt to do, given the defensive characteristics of the asset class such as low volatility and limited correlation with other asset classes, with an attractive income component. But even within real estate debt, some sectors such as retail and hospitality are judged to be more vulnerable in this environment.

We've been conservatively positioned coming into this period, with negligible exposure to retail and relatively low exposure to hospitality. That's because we simply didn't find the risk premium associated with those areas to be attractive. The further we moved away from the GFC, the less the memory of the dramatic volatility from the crisis resonated with investors. So risk premiums compressed to a point where we didn't see much value.

Now we are out looking for opportunities in areas that we think will hold up well in these challenging times. The good news is that many companies in our portfolios are ones we've been tracking since the GFC, so we can look back at how they performed then. This historical perspective is quite valuable as we assess how they will perform in the current scenario.

Wayne Dahl: I would add that this is all part of a relative value decision that we're trying to make in the context of a multi-strategy credit portfolio. It's important for us to try to generate low-volatility income. The yield available from real estate debt might seem low on an absolute basis, but the relative lack of volatility associated with the asset class has the potential to pay off at a time like this. We've discussed in detail with our investors our view that traded real estate debt has tremendous value as a protective force.

Bruce Karsh: **Speaking of relative value, in terms of both "sector" and "asset class," what areas do you think look more vulnerable or more attractive than others?**

Armen Panossian: Travel and leisure, and certainly oil and gas, look to be most vulnerable today, and related securities might take years to recover. More specifically, I'm concerned, given what's been going on with Saudi Arabia, OPEC and Russia, about the longer-term impact on the oil and gas complex in the U.S. We may see a re-evaluation of whether the domestic U.S. oil and gas industry is competitive globally. In the meantime, capital is unavailable to the U.S. energy industry. As this situation works itself out, we may see interesting infrastructure assets that trade down in sympathy with the broader industry despite having value independent of oil and gas production in the U.S. When negatives are overrated, that can create enhanced relative value for those who will buy.

Madelaine Jones: From the European credit side, small companies that have liquidity issues or have sponsors that cannot ride out this temporary supply/demand situation are what we view as particularly vulnerable.

Wayne Dahl: As for relative value across asset classes, I'm considering factors such as (a) yields, which have increased in liquid credit, and (b) interest rates, which are falling and can impact coupon rates for floating-rate assets. It's also notable that certain tranches of collateralized loan obligations (CLOs) would need default rates to exceed 20% today in order to lead to a dollar loss in principal. So given these circumstances, I'd say CLOs are relatively attractive. I also see relative value in real estate debt given its defensive nature, low volatility and low correlation to broader markets.

Bruce Karsh: I continue to like real estate debt for the same reasons. There's been a bubble in corporate debt, I think, and much less so in real estate, where the underlying debt is supported by a reasonable balance between supply and demand.

Oaktree continues to place great importance on downside protection, bottom-up security selection, and relative value assessment. We're actively evaluating potential dislocations as situations evolve to ensure our Global Credit portfolio is well positioned to capture opportunity while withstanding volatility. As Sergeant Phil Esterhaus would say on "Hill Street Blues" — my favorite TV show — "Let's be careful out there."

ABOUT THE AUTHORS

BRUCE KARSH
Co-Chairman and Chief Investment Officer

Mr. Karsh is Oaktree's Co-Chairman and one of the firm's co-founders. He also is Chief Investment Officer and serves as portfolio manager for Oaktree's Distressed Opportunities, Value Opportunities and Multi-Strategy Credit strategies. Prior to co-founding Oaktree, Mr. Karsh was a managing director of TCW Asset Management Company, and the portfolio manager of the Special Credits Funds from 1988 until 1995. Prior to joining TCW, Mr. Karsh worked as Assistant to the Chairman of SunAmerica, Inc. Prior to that, he was an attorney with the law firm of O'Melveny & Myers. Before working at O'Melveny & Myers, Mr. Karsh clerked for the Honorable Anthony M. Kennedy, then of the U.S. Court of Appeals for the Ninth Circuit and retired Associate Justice of the U.S. Supreme Court. Mr. Karsh holds an A.B. degree in economics summa cum laude from Duke University, where he was elected to Phi Beta Kappa. He went on to earn a J.D. from the University of Virginia School of Law, where he served as Notes Editor of the Virginia Law Review and was a member of the Order of the Coif. Mr. Karsh serves on the boards of a number of privately held companies. He is a member of the investment committee of the Broad Foundations. Mr. Karsh is Trustee Emeritus of Duke University, having served as Trustee from 2003 to 2015, and as Chairman of the Board of DUMAC, LLC, the entity that managed Duke's endowment, from 2005 to 2014.

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ENDNOTES

[1] Unless otherwise noted, index data have been updated as of March 16.

[2] February 19 marked the latest record high for the S&P 500 index.

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