OAKTREE INSIGHTS

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IS ANYTHING ON SALE? TOP FIVE TAKEAWAYS FROM OAKTREE'S GLOBAL CREDIT PANEL

OAKTREE

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TOP FIVE TAKEAWAYS FROM OAKTREE'S GLOBAL CREDIT PANEL

Prices are increasing on everything from snacks to used trucks, and markups are unlikely to prove transitory in at least one area: the credit markets. Yield spreads in most asset classes have collapsed from their 2020 highs, with even the riskiest category of U.S. high yield bonds offering narrow spreads last seen in 2014[1] when Ebola, not Covid-19, was generating headlines. But this doesn't mean value has disappeared: it has just become harder to find.

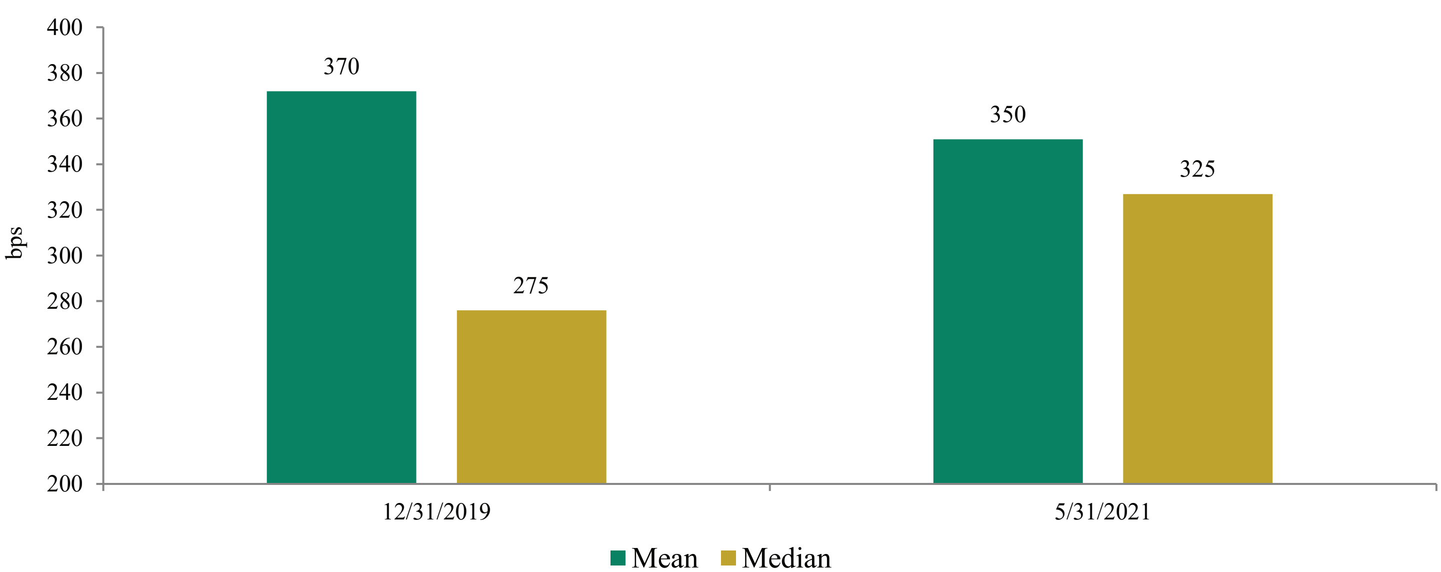
Some of Oaktree's top global credit experts recently sat down to discuss where they're finding value in sub-investment-grade asset classes. They don't provide easy answers, but they do offer some straightforward advice: it's time to dig deeper.

1. **U.S. High Yield Bonds: Mind the (Average) Gap**
   David Rosenberg, Assistant Portfolio Manager of Global Credit and Co-Portfolio Manager of the U.S. and Global High Yield Bond strategies

I've always believed it's important to dissect averages. The yield spread on the average U.S. high yield bond today is narrower than it was before the pandemic began, yet the U.S. hasn't put the crisis behind it. How can that make sense? Well, if you look at pre-crisis U.S. high yield bonds, you find that a large percentage of the market – representing high- to middle-quality assets – was trading with spreads of roughly 300 basis points, but there was also a sliver of the market – the lowest-quality assets – offering spreads of 2,000 bps and above. So the average was around 370 bps, but almost nothing was actually trading at that level. This upward skew was indicated by the difference between the mean and the median spreads back then: it was roughly 100 bps – a substantial gap (see Figure 1).

If you fast forward to today, there's much less dispersion between the mean and the median – under 30 bps. While the average high yield spread is around 350 bps – below the pre-pandemic mean – the average is now actionable for investors. And the median yield spread, which doesn't often attract much attention, is now substantially higher than it was a year and a half ago. This shift has occurred partly because many bonds that entered 2020 with spreads at distressed levels have since defaulted.

Figure 1: Difference Between Mean and Median U.S. High Yield Bond Spreads



Source: ICE BofA High Yield Master II Constrained Index Spread-to-Worst

At the same time, the U.S. high yield bond market's credit fundamentals have improved despite the pandemic.[2] The percentage of BB-rated bonds (the highest sub-investment-grade rating) in this market has increased both from upgrades, which have meaningfully outpaced downgrades in 2021, and from the early-2020 wave of so-called fallen angels – formerly investment-grade-rated companies that were downgraded.[3] Credit rating[s] agencies also expect the trailing-12-month default rate, which declined by 1.6 percentage points this past April,[4] to continue falling as economies rebound and the most default-heavy months of 2020 fall out of the measurement period.

Despite this improving backdrop, high-quality high yield bonds that were trading with yield spreads of roughly 300 bps at the beginning of 2020 are now offering spreads near 350 bps. So we believe there's still decent value in U.S. high yield bonds.

2. U.S. and European High Yield Bonds: A Tug-of-War Between Vaccination and Duration

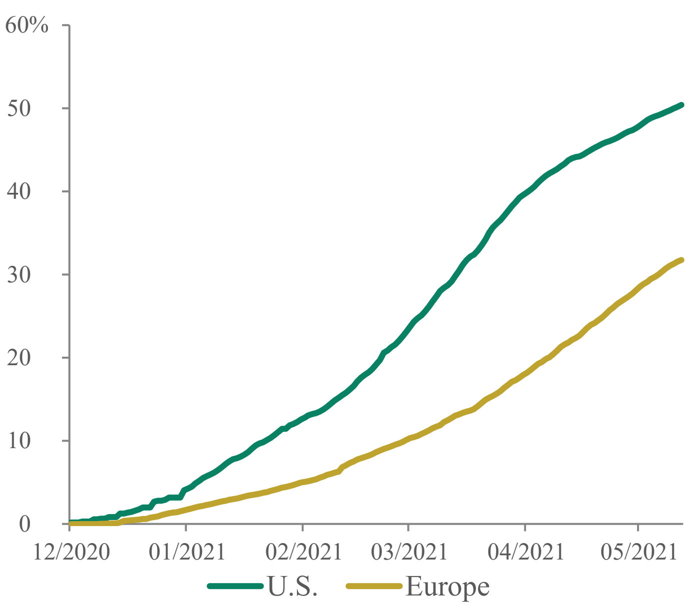
David Rosenberg; Wayne Dahl, Investment Risk Officer; and Madelaine Jones, Portfolio Manager of the European High Yield Bond strategy

When comparing U.S. and European high yield bonds, it's tough to determine which is the better relative bargain. On the one hand, the U.S.'s vaccine rollout has been much more effective than Europe's effort. True, Europe has ramped up the pace of its campaign and is now administering over three million doses of Covid-19 vaccines each day – a level higher than that in the U.S.[5] But the percentage of fully vaccinated Americans remains almost double the European figure,[6] and the gap between the percentage of the population that has received at least one dose in either region remains wide at around 15 percentage points (see Figure 2). This suggests the U.S. economy may continue to reopen and recover more quickly than Europe's, causing U.S. business fundamentals to improve more rapidly. However, Europe's high yield bonds may offer more upside potential compared to those in the U.S. because the former region's lagging economic recovery has more room for improvement.

Investors' concerns about higher interest rates also play a key role in this comparison. The U.S. yield curve steepened much more quickly in the first quarter of 2021 than many economists and financial analysts anticipated. While U.S. interest rates have oscillated since then and come down recently, the yield on the U.S. 10-year Treasury remains roughly 55 bps higher than it was at the end of 2020.[7] Consequently, many investors have sought to shorten their portfolios' duration (i.e., reduce the sensitivity to interest rate increases).

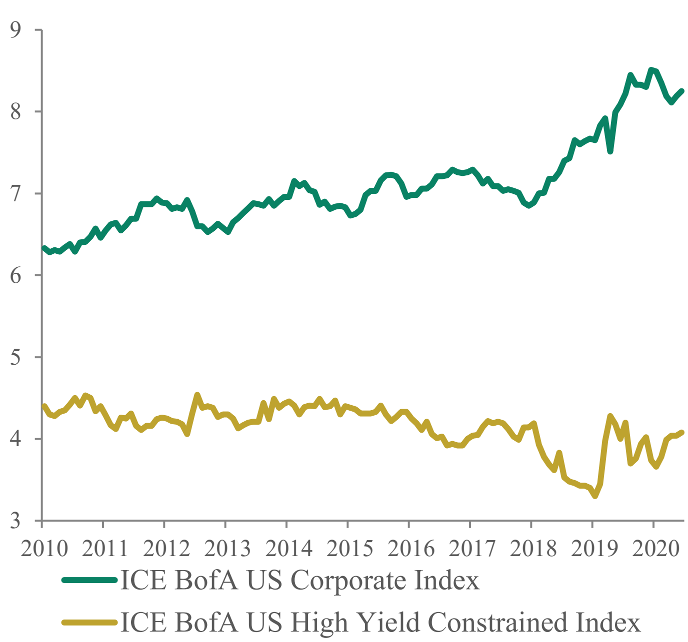
This has benefitted U.S. high yield bonds by making them more attractive than investment grade bonds to those concerned about duration. High yield bonds obviously have interest rate risk – as do all fixed-rate assets – but duration in U.S. high yield bonds shortened during 2020 and now hovers around four.[8] Compare that to U.S. investment grade bonds, where duration extended beyond eight in 2020 – the longest it has ever been (see Figure 3).

Figure 2: U.S. and Europe – Percentage of the Population That Has Received a Covid-19 Vaccine Dose



Source: Our World in Data, a University of Oxford Database

Figure 3: Duration in U.S. High Yield and U.S. Investment Grade Bonds



Sources: ICE BofA, JP Morgan, Credit Suisse

But European high yield bonds may benefit even more than their U.S. counterparts in this environment because investors' desire to shorten duration derives from worries about rising U.S. interest rates. Few investors express serious concern about interest rates rising significantly in Europe, where benchmark rates remain negative and fears about higher inflation are more muted.

Investors must also consider the difference between these markets' respective sizes. The European high yield bond market is much smaller than that of the U.S., meaning the former is less liquid and offers a dramatically reduced opportunity set. For example, U.S. high yield bond issuance in the first four months of 2021 was around $200 billion – over three times the level in Europe.[9] But investors able to handle illiquidity may be able to capitalize on inefficiencies in this smaller market.

Ultimately, when one weighs the advantages and disadvantages, it's challenging to pick an obvious winner. (Of course, one of the hallmarks of a functioning market is that it eliminates obvious under- and over-pricing.) Also, no one can accurately predict exactly how the inflation and interest rate stories will play out. For instance, U.S. Treasury yields have recently declined despite the Consumer Price Index rising by 5% in the 12 months through May – the highest level in over a decade.[10] So finding value comes down – as it always does – to locating idiosyncratic opportunities in either market and doing bottom-up analysis to find solid credits.

3. CLOs: BB-uried Value

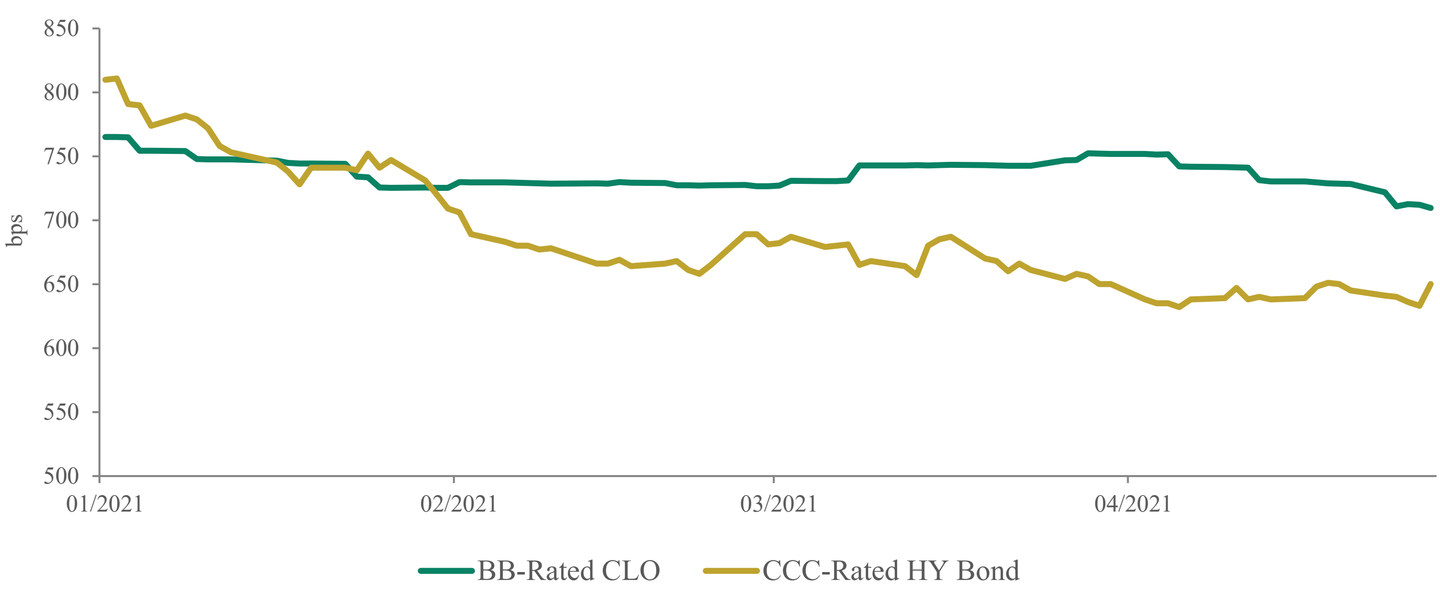
Armen Panossian, Head of Performing Credit

With investors worried about rising inflation and interest rates, it's unsurprising that many are attracted to asset classes characterized by floating interest rates, such as senior loans and collateralized loan obligations (CLOs). Demand for the latter was met by record-breaking issuance in the first quarter of 2021 as U.S. issuance hit $106 billion.[11]

Finding value in CLOs requires a deeper dive into this issuance story. Banks and insurance companies have been eager to buy investment grade CLO debt tranches, which normally represent over 80% of the CLO structure. But once you drop below the investment grade level into BB-rated tranches, the pool of potential buyers shrinks considerably. So what does a CLO manager do when she sees significant demand for AAA- and AA-rated tranches and wants to finish investing her current CLO and create another, but there isn't much appetite for lower-rated tranches? Logically, she offers a small amount of extra yield on the BB-rated piece. This decision doesn't significantly change the economics of the CLO, as this tranche represents only a small percentage of the CLO's liabilities, but it enables her to get the deal done.

The upshot is that an investor may be able to earn roughly the same yield spread on a BB-rated CLO tranche – where, remember, the spread has widened because of a technical matter – as on a CCC-rated bond, where even a small hiccup in the economy could challenge the bond issuer's highly levered balance sheet (see Figure 4).

Figure 4: Yield Spreads for BB-Rated CLOs and CCC-Rated High Yield Bonds



Sources: JP Morgan, ICE BofA CCC & Lower US HY Index Option Adjusted Spread

CLOs have another advantage: they're backed by a diversified underlying portfolio. A CCC-rated bond is exposed to a single company's risk, while CLO portfolios typically represent hundreds of issuers. And losses stemming from this large and varied group are initially absorbed by the CLO's equity tranche. So a correlated default event would need to occur in several industries to eat through a CLO's credit support and endanger the debt tranches.

And CLOs benefit from having a self-correction mechanism whereby the CLO starts to delever if a certain percentage of the underlying loans default or are downgraded. So a holder of the BB-rated tranche would need to see a significant loss before his investment would begin to be imperiled. Yet, again, that investor is, in many cases, being offered roughly the same spread for the BB-rated tranche as he would receive for one single company's CCC-rated bond.

4. Emerging Markets Debt: Cash Flow Is King

Julio Herrera, Portfolio Manager of the Emerging Markets Debt Total Return strategy, and Armen Panossian

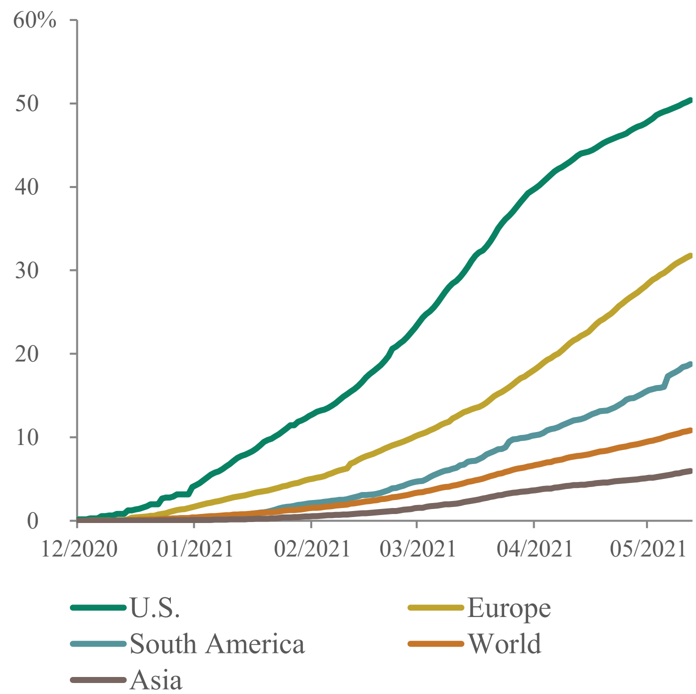
Emerging markets debt is often spoken of as though it were a monolithic asset class. But EM includes countries representing a majority of the world's population, so there's significant diversity among countries and issuers. As such, finding value usually requires a focused strategy that zeros in on specific geographies, industries, sectors and idiosyncratic situations, not an index-driven approach. And in our opinion, this strategy should focus on businesses' ability to generate cash.

Producing consistent cash flow is important in most markets, but it's especially significant in EM debt because credit risk and political risk are often high while liquidity in local markets is frequently low. So even though risk varies by region and country, the danger that credit markets will freeze is usually greater for EM companies compared to their developed market counterparts. But businesses with significant market share in industries where demand is fairly inelastic may be able to generate cash even during a sovereign- or industry-related crisis. That's a huge advantage because usually the company can then meet its debt service obligations without having to wait for credit markets to thaw. At the same time, such market dislocations can create buying opportunities for value-oriented investors.

The margin of safety that steady cash generation provides is particularly important in the current environment. The Covid-19 crisis is far from over in much of the world, with vaccination rates quite low in many emerging and developing economies (see Figure 5).

Also, many EM countries have dramatically increased their debt burdens to combat the pandemic: the debt-to-GDP ratio for EM countries increased around eight percentage points between 4Q2019 and 1Q2021, hitting 60%.[12] While governments in DM countries may express little concern about servicing their ballooning debt piles because of historically low interest rates, EM countries may struggle to support economic growth and restore fiscal stability. With so much uncertainty, the risk remains that credit markets could tighten at the worst moment for EM businesses, potentially giving large-scale companies with steady cash flow a significant advantage.

Figure 5: Percentage of the Population That Has Received a Covid-19 Vaccine Dose by Country/Region



Source: Our World in Data, a University of Oxford Database

5. Real Estate Debt: The Market-Wide Sale Is Over

Justin Guichard, Co-Portfolio Manager of the Real Estate Debt and Structured Credit strategies

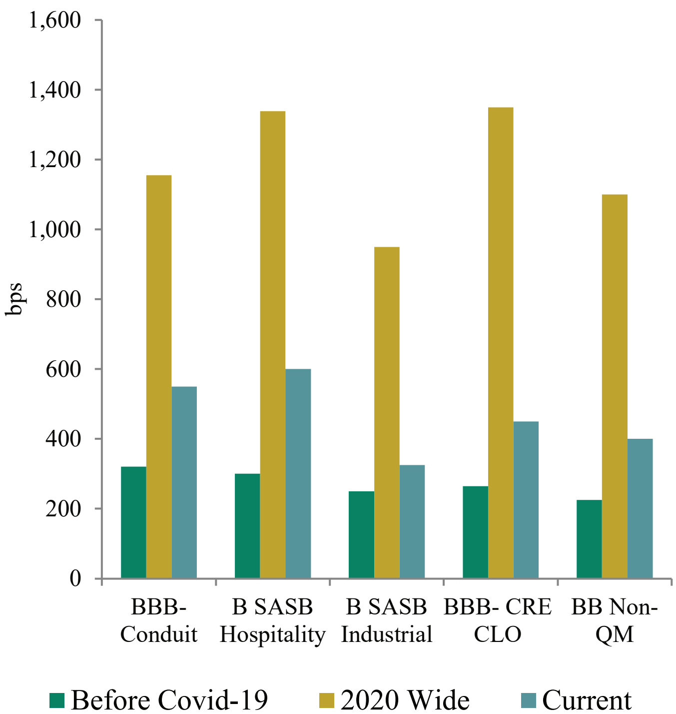
Real estate structured credit has enjoyed a strong 2021 thus far – flipping the script from early 2020. But even though the entire real estate debt market is no longer on sale, commercial mortgage-backed securities (CMBS) may still offer attractive yields compared to many corporate credits. But investors must be highly selective.

Commercial real estate suffered significantly during the pandemic, but this was hardly a repeat of 2009. U.S. real estate came into the pandemic with lower loan-to-value (LTV) ratios and stronger investor protections than when the country entered the Global Financial Crisis (GFC) of

2007–08, due in large part to government regulations that mandated more responsible lending practices.

Currently, the LTV ratios for CMBS – both single asset/single borrower (i.e., the securitization of a loan to one borrower, typically backed by one large property or a portfolio of similar properties) and conduit (i.e., the securitization of large, diversified pools of commercial real estate loans) – are currently near 20-year lows.[13] So the likelihood of default and loss given default are both fairly low, yet yield spreads for most types of real estate structured credit haven't shrunk to pre-pandemic levels (see Figure 6).

Figure 6: Yield Spreads Across Real Estate Structured Credit[14]



Sources: ICE BofA Securities, JP Morgan

Additionally, real estate as a whole may benefit from current conditions because it has traditionally been considered an inflation hedge. Investors frequently flock to this asset class when inflation heats up because such environments often feature rising rents and therefore high property-level cash flows. And accelerating price increases are more likely now than they were in the aftermath of the GFC, as the U.S. fiscal and monetary responses have been much more aggressive this time around.

Still, some commercial real estate sectors appear to be richly valued. For example, appetite for hospitality-related debt is robust, which isn't surprising given the accelerating pace of economic reopenings, particularly in the U.S. Yet we question whether business-centric hospitality (i.e., hotels catering to business travelers or conferences) will recover as quickly as many analysts expect, or if the prospective return currently offered compensates for the risk that they won't.

The bottom line is that real estate structured credit has much to recommend it. But as uncertainty about the post-pandemic environment and corporations' work-from-home policies recedes, investors in real estate structured credit may have to look harder to find bargains.

FINAL THOUGHTS

Our co-founder Howard Marks likes to say, "In investing, it's not about buying good things but buying things well." While "buying things well" is always tougher than it sounds, this is especially true today. Governments and central banks are deploying significant resources to keep economies moving. But it's difficult to know the long-term implications of so much stimulus or what will happen once this support decreases. Also, many investors appear to be pricing in a straight line from here to herd immunity. Having spent decades in this business, we know few things progress in a straight line.

To navigate this environment, we believe it's vitally important for investors to consider investment options across asset classes so that they can potentially enhance yield, lower volatility and manage duration. Opportunistic investors can capitalize on mispricings in a seemingly rich market, but the prudent investor must only buy when there's the potential for attractive return with a reasonable margin of safety. If the last year taught investors anything, it's that market trends can reverse quickly, and no one knows what's going to happen next. So the most successful post-crisis bargain hunters may turn out to be those who possess humility, flexibility and the patience to keep digging.

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Ms. Jones joined Oaktree's London office in 2003 and serves as portfolio manager for the European High Yield Bond and European Senior Loan strategies, and co-portfolio manager for the Global High Yield Bond strategy. She is also the head of the firm's EMEA Diversity & Inclusion Committee. Before joining Oaktree, Ms. Jones spent more than three years at Deutsche Bank AG in London as a senior associate in the Leveraged Debt Origination Group specializing in loan, mezzanine and high yield bond financings to support European leveraged buyouts. Prior thereto, she spent two years in the Acquisition Finance Group at Natwest Group plc. Ms. Jones received a B.A. degree in economics from the University of Durham, England. She is a CFA charterholder.

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END NOTES

[1] ICE BofA CCC & Lower US High Yield Index Option-Adjusted Spread; as of May 31, 2021

[2] ICE BofA; JPMorgan; Credit Suisse

[3] ICE BofA; JPMorgan; Credit Suisse

[4] JPM Default Monitor

[5] Centers for Disease Control and Prevention; European Centre for Disease Prevention and Control; as of May 31, 2021

[6] Our World in Data, a University of Oxford database; as of May 31, 2021

[7] U.S Department of Treasury; as of June 15, 2021

[8] ICE BofA US High Yield Constrained Index; as of May 31, 2021

[9] Leveraged Commentary & Data, S&P Global Market Intelligence

[10] U.S. Bureau of Labor Statistics, the non-seasonally adjusted Consumer Price Index for All Urban Consumers

[11] JP Morgan, includes refinancings and resets

[12] Institute of International Finance

[13] Morgan Stanley

[14] BBB-, BB and B refer to credit ratings; Non-QM refers to non-qualified mortgage securitizations

NOTES AND DISCLAIMERS