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THE ROUNDUP:

Top Takeaways From Oaktree's Quarterly Letters

1Q2022

At Oaktree, we don't prognosticate. We analyze. That's why our portfolio managers pen letters to clients each quarter that dissect the previous period while identifying trends in industries, asset classes, and the economy that are shaping the investment environment. We've created a new *Insights* series in which we share some of the thought-provoking ideas derived from these quarterly letters.[1] The first edition, based on our portfolio managers' year-end letters, features topics ranging from bullish and bearish economic forces to the shifting tides in emerging markets equities. Plus, as a bonus, we've included an excerpt from Howard Marks's 2021 year-end letter to clients.

We've recently been reminded – yet again – how quickly events can change, as the invasion of Ukraine has shocked the world and rattled markets. We won't try to predict the outcome of this crisis – that's certainly beyond our expertise. Our goal is to help investors understand the current investment landscape, so they can better prepare for what lies ahead when the only given is uncertainty. As Howard has long said, "we may never know where we're going, but we had better have a good idea where we are."

1

Positioning in 2022

Howard Marks
Co-Chairman

Over the last few years, it has become my practice to decline to answer standard media questions such as "are you a buyer or a seller?" and "in or out?" First, as I indicated in *Selling Out* last month, there are very few occasions on which it makes sense to try to time the markets and very few people with the skill to do so profitably; it's far more important to be in the markets over the long run. Second, as bottom-up investors, Oaktree's main emphasis is on selection within our markets, not profitably altering our deployment of capital.

Thus, I tell the TV anchors and reporters, if one wants to respond to market conditions, the best way is by deviating when appropriate from one's usual ratio of aggressiveness to defensiveness. And where do I stand in that regard today? Right around normal, or perhaps slightly biased toward defense via increased emphasis on selectivity and downside protection. In short, I think the considerations are too well balanced – although perhaps not perfectly so – to make getting out (or getting too defensive) the right thing to do.

2

Economic Backdrop: Fog of War

Bruce Karsh
Co-Chairman,
Chief Investment Officer

Steve Tesoriere
Co-Portfolio Manager, Value Opportunities

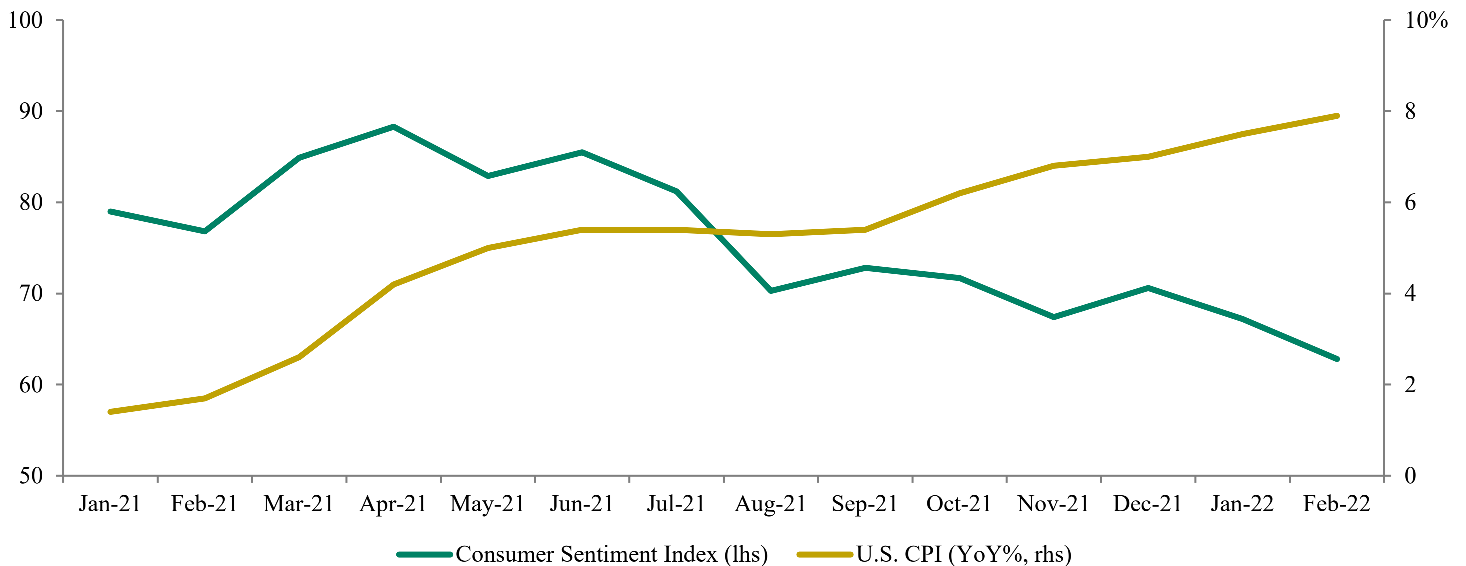
As we entered 2022, we believed a tug-of-war between bullish and bearish economic forces would largely determine the performance of security prices in the year ahead. Consumers entered 2022 with tremendous pent-up demand for services (e.g., travel, leisure, live events, etc.) and far more cash to spend on these services than they had before the pandemic. Offsetting this optimism was rising inflation, which threatened to weigh on consumer spending and push the Federal Reserve to tighten monetary policy aggressively (see Figure 1).

Russia's invasion of Ukraine muddies this picture. The war has the potential to be highly inflationary, with effects across many commodities. The conflict may also mute consumer spending in Europe while straining supply chains. And the global food system could be heavily disrupted, as Russia and Ukraine together supply roughly one-quarter of the world's wheat and the former is a major exporter of fertilizer.[2]

We obviously don't know how long this conflict will last. If the war were to end quickly, then the bullish/bearish forces described in the first paragraph might once again become the driving force in securities markets. However, a lengthy war – in addition to being a humanitarian catastrophe – could lead to stagflation in major economies and even a global recession.

In a period of increasing inflation, rising interest rates, and geopolitical tumult, investors may prefer to (a) hold a large portion of their assets in floating-rate debt; (b) focus on high-quality companies with hard assets and strong pricing power; and/or (c) target businesses that are positioned to benefit if commodity prices or interest rates rise but not suffer proportionally if both fall.

Figure 1: U.S. Consumer Sentiment Falls While the Inflation Rate Rises



Source: University of Michigan Consumer Sentiment Index; U.S. Bureau of Labor Statistics, Consumer Price Index

3

High Yield Bonds:
Beware Strategists Bearing Forecasts

Sheldon Stone
Head of High Yield Bond Business

David Rosenberg
Co-Portfolio Manager, U.S. and Global High Yield Bonds

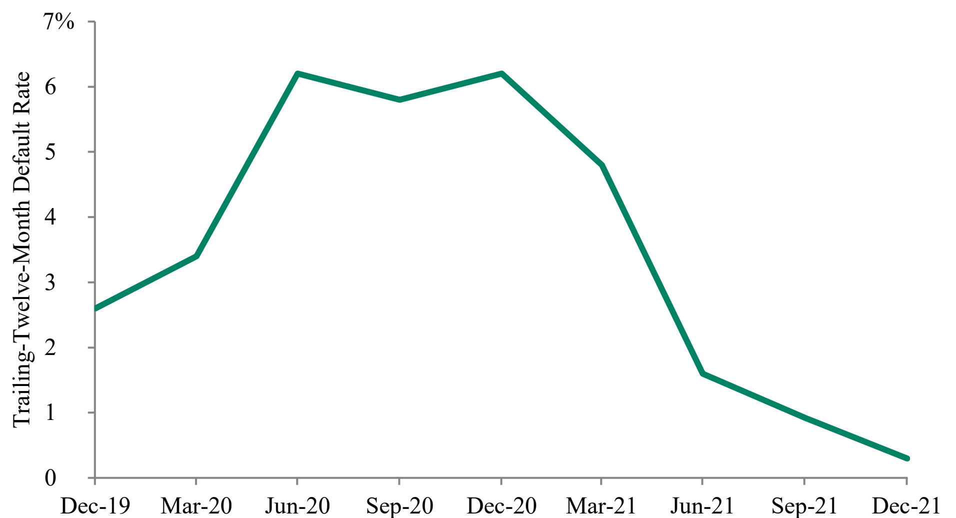
Alap Shah
Co-Portfolio Manager, U.S. High Yield Bonds

Strategists were much too pessimistic about the credit environment for the second consecutive year, underscoring – once again – why we don't rely on macro forecasts in our investment process. Strategists overestimated defaults by roughly 500 bps in 2020, failing to consider the limited number of maturities coming due and the enormous impact fiscal and monetary support would have on the financial markets.[3] They again meaningfully overestimated the default rate in 2021, which dropped to 0.3% at year-end (see Figure 2).[4] Who could have predicted that the U.S. high yield bond market would experience just one default in the second half of 2021?[5]

Although we recognize that we don't have a crystal ball, we think it's unlikely that the asset class will generate much capital appreciation during 2022, given that the average bond price was hovering above par at year-end.[6] However, we believe high yield bonds remain attractive relative to their investment grade counterparts because of the former's higher coupon and lower interest rate sensitivity (i.e., their duration). If history is any guide, high yield bonds – thanks to their shorter duration – could trounce investment grade securities in a period of rising interest rates.

In our view, one of the keys to success in 2022 will be avoiding pitfalls and keeping duration in check during what could be a challenging period for the more interest-rate-sensitive bonds in our universe.

Figure 2: The U.S. High Yield Default Rate Has Plummeted



Source: JP Morgan

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Emerging Markets Equities: Incredible Shrinking Growth Factor

Frank Carroll
Portfolio Manager, Emerging Markets Equities

Janet Wang
Co-Portfolio Manager, Emerging Markets Equities

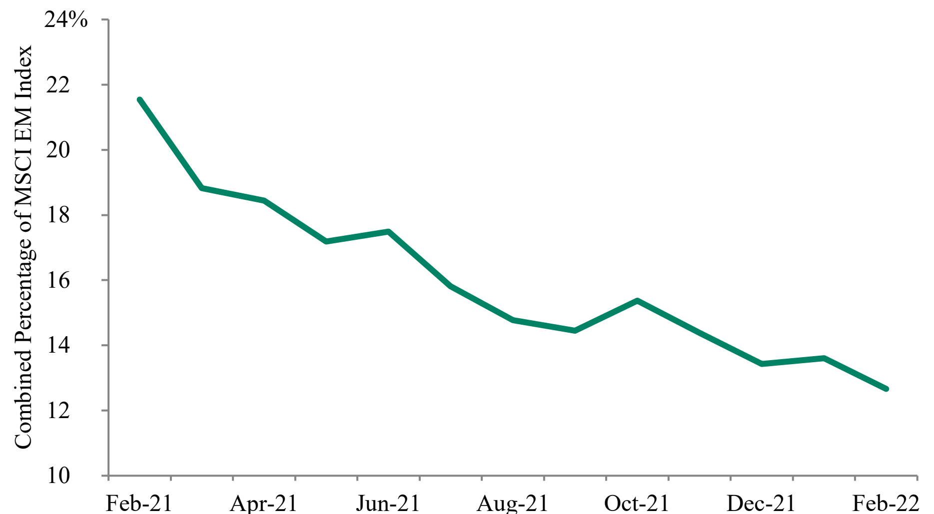
Emerging markets equities started off strong in 2021, but performance declined in the second half of the year. Despite the resurgence of Covid-19, we still witnessed meaningful and persistent inflation in many industries, including energy, shipping and materials. We currently don't see any signs that inflation will subside. The conflict in Ukraine has increased the likelihood that elevated global inflation will persist.

In this environment, investors may be attracted to EM commodity companies with value characteristics, including (a) pricing power in an inflationary environment, (b) strong balance sheets, (c) disciplined capital allocation, and (d) increasing dividend payouts.

One of the most notable trends in EM equities in 2021 was the weakening of the growth factor. At the end of 2020, we believed that the failure of Chinese digital payments company Ant Group's IPO signaled the beginning of the end for the growth factor's outperformance in our market.

Large internet/technology companies began to fall out of favor in 2021, and the tech sector's weighting in EM equities indices (which was high in late 2020) fell throughout 2021 and early 2022. Chinese tech giants Tencent and Alibaba, which each represented more than 5% of the EM equities index at the beginning of 2021, now represent just over 4% and less than 3%, respectively.[7] Consequently, the EM equities index became significantly less concentrated throughout 2021 (see Figure 3). In February 2021, the top ten internet/tech names represented almost 22% of the benchmark, versus just under 13% as of February 2022. Despite this shift, we continue to believe that investors haven't fully rotated into value.

Figure 3: Index Weighting of Top Ten EM Internet/Tech Companies Has Declined



Source: MSCI Emerging Markets Index

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Real Estate: A Tale of (More Than) Two Markets

John C. Brady
Head of Global Real Estate

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

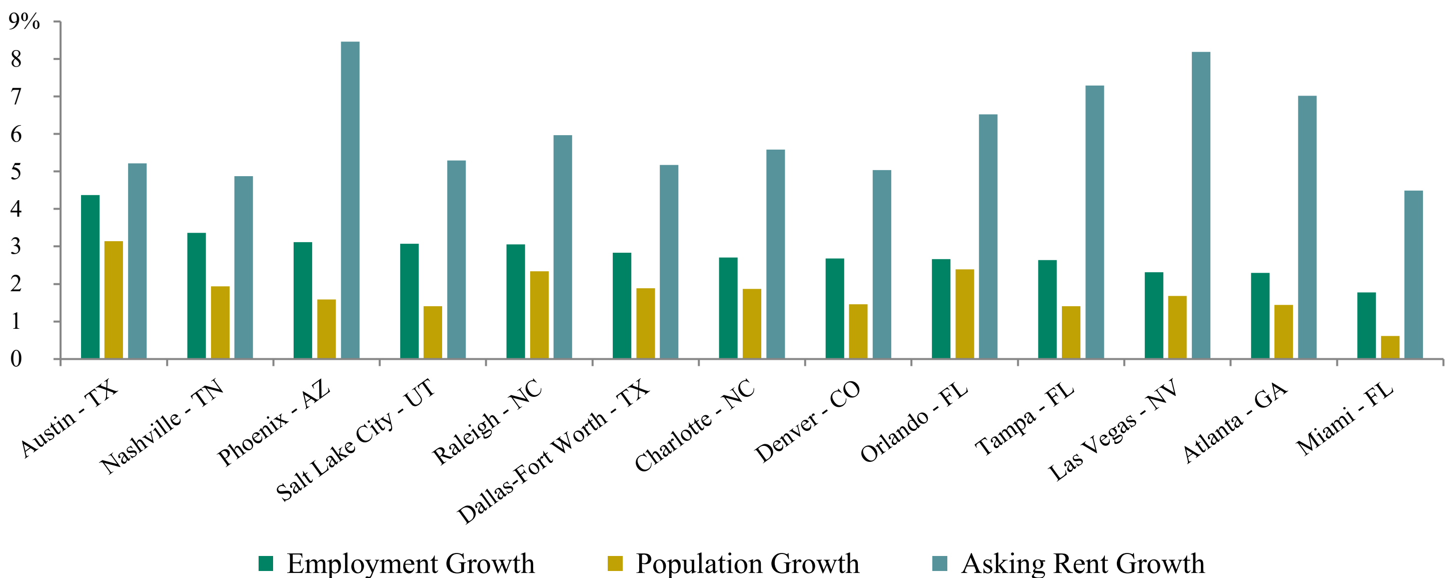
Mark Jacobs
Co-Portfolio Manager, Real Estate Income

Fundamentals in the commercial real estate (CRE) market as a whole are fairly healthy. Green Street's Commercial Property Price Index, which is a good measure of CRE values in the U.S., increased by 24% in 2021 and ended the year 14% higher than it was prior to the pandemic. However, performance varied significantly between property types. The multifamily segment of the index rose by 29% year-over-year in 2021, as the sector enjoyed healthy cash flows and strong asset sales in the period. This outweighed the less impressive performance of property types such as retail, hospitality and office.

Importantly, prices in these underperforming sectors still rose in 2021. This was particularly the case in hospitality; this segment of the index generated a 14% year-over-year gain in 2021, benefiting from the increase in domestic travel during the summer. While the office sector has been weak, long lease terms have helped landlords service their debt even as demand for office space has fallen. Additionally, there are signs of recovery in the office market, as vaccination rates have increased and corporations have initiated return-to-office plans.

We've long emphasized the ongoing strength of multifamily properties in U.S. high-growth markets – those with fast rates of population and job growth (see Figure 4). An imbalance of demand over supply existed in high-growth markets before the pandemic – as construction didn't keep pace with migration patterns – and this imbalance is even more pronounced today. The multifamily sector thus has solid fundamentals, which have generated robust growth in rental rates and property appreciation. We expect this imbalance to continue in 2022 and believe it may persist for many years to come.

Figure 4: Rents Are Rising Rapidly in Many High-Growth Markets



Source: CoStar and Oxford Economics, Annual Average Growth from 2011–2021

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Special Situations: A Rising Storm?

Matthew C. Wilson
Co-Portfolio Manager, Special Situations

Jordon L. Kruse
Co-Portfolio Manager, Special Situations

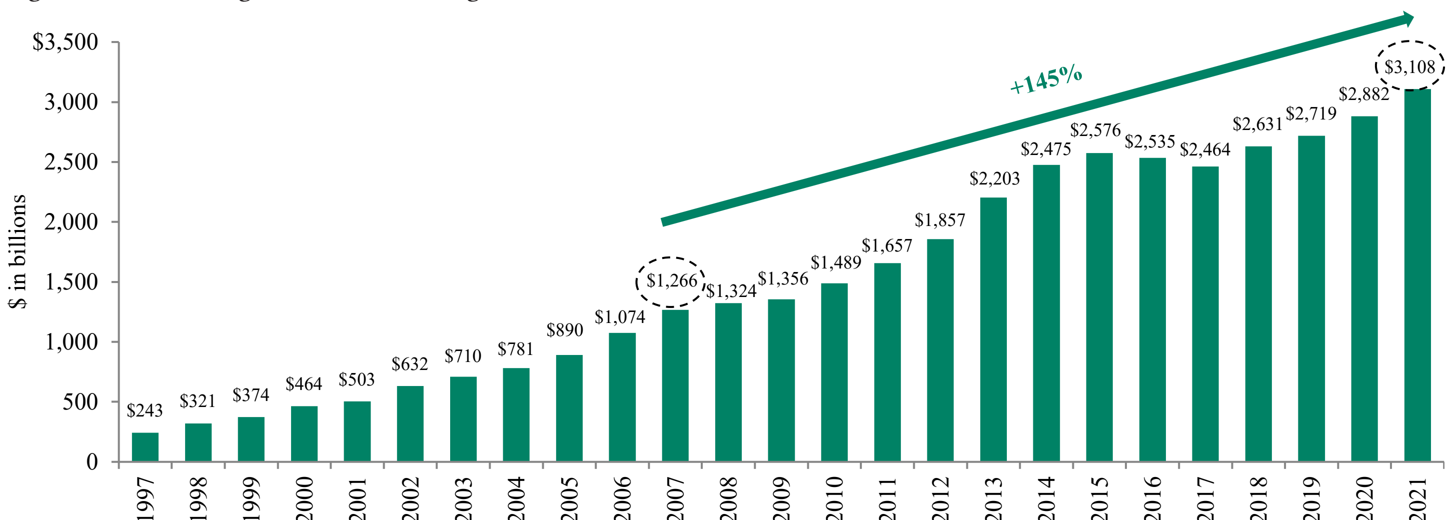
We talk a lot about the broad spectrum of special situations investment. It ranges from healthy businesses that need capital for a specific purpose but can't – or don't want to – access traditional financing markets to financially distressed companies. While deals in the latter category were prevalent during the Covid-19-impacted period of 2020, the opportunity set shifted to the former group in 2021. Healthy businesses were looking to complete capital expenditure programs and strategic acquisitions or provide liquidity to their owners.

Importantly, special situations investment isn't reliant on systemic market distress but rather on situations that continually arise. No matter where we are in the market cycle, investors can usually find healthy companies seeking highly structured solutions to complex problems. And investors can almost always count on locating companies that are suffering from idiosyncratic difficulties, such as a flawed strategy, poor management, a failed acquisition, a rise in input costs, a lost customer, overleverage in a time of weakness, or supply-chain disruptions.

Even though special situations investors don't depend on periods of distress, a new, expanded set of opportunities can arise during market dislocations. As we look forward to the rest of 2022, we don't claim to know what will happen. U.S. equity markets have had an extremely rocky start to the year, even before the war in Ukraine began, perhaps because the implications of labor shortages, supply-chain problems, elevated inflation, and a rising-interest-rate environment finally hit home. And the high yield bond market is down by approximately 4.5% this year.[8]

Does this signal the start of the next distressed cycle? No one knows. What we do know is that a record amount of non-investment-grade debt is outstanding in the U.S. – over $3 trillion at the end of 2021 (see Figure 5). So there are plenty of leveraged companies out there that are only one idiosyncratic event away from being an actionable target for special situations investors. And in an imperfect world, that's something you can count on happening over and over and over again.

Figure 5: U.S. Leveraged Debt Outstanding Has Ballooned



Source: S&P Global Leveraged Commentary & Data

Endnotes

[1] The content is derived from 4Q2021 letters sent to clients in 1Q2022; the text has been edited for space and updated where appropriate.

[2] Observatory of Economic Complexity, as of 2019.

[3] Strategists' 2020 high yield bond default rate forecast is based on an aggregate of estimates from JP Morgan, Credit Suisse, Bank of America, Moody's, Fitch Ratings and S&P Global Ratings. These are the revised 2020 estimates that reflect the projected impact of the Covid-19 pandemic.

[4] The default rate forecast is based on the same aggregate used in endnote 3.

[5] JP Morgan.

[6] FTSE High Yield Cash-Pay Capped Index.

[7] MSCI Emerging Markets Index, as of March 4, 2022

[8] Citi High Yield Cash-Pay Capped Index, as of March 9, 2022.

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