Oaktree | Insights

Performing Credit Quarterly

4Q 2023

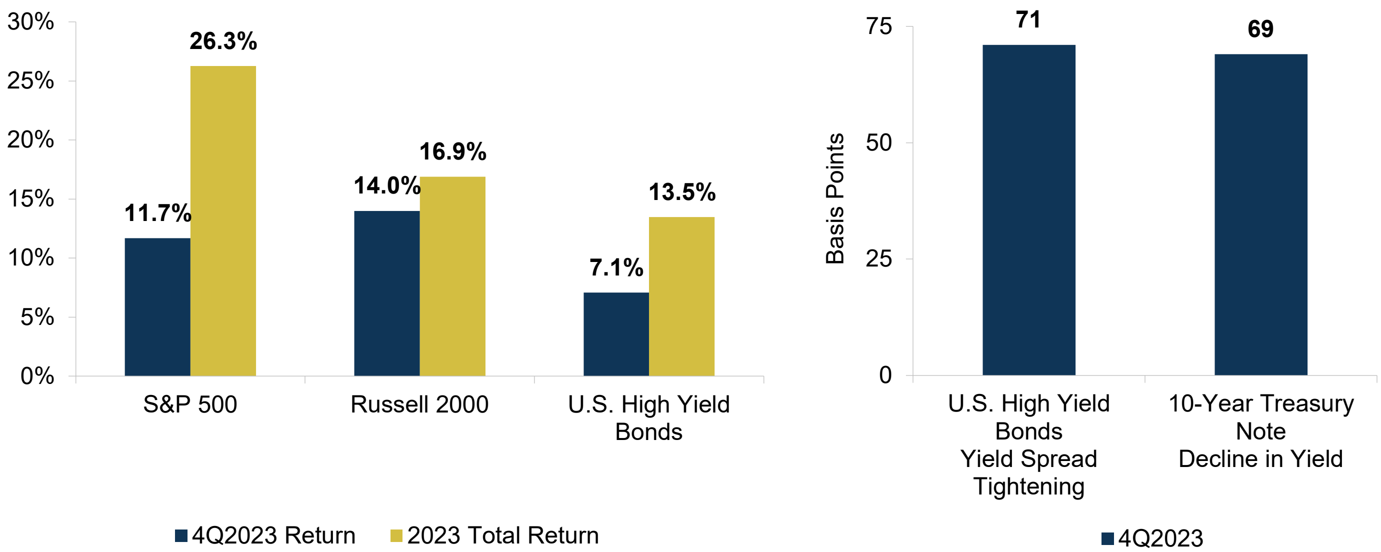
THE GOLDILOCKS TRAP

The prevailing market narrative for the coming year demands a level of optimism that may be bordering on credulousness. The U.S. economy is expected to be neither too hot nor too cold, and the Federal Reserve is projected to begin cutting interest rates meaningfully without there being a recession or other crisis. In other words, everything is expected to be "just right." While this *could* happen, we believe – to quote our co-chairman Howard Marks – that this all "smacks of Goldilocks thinking."

We acknowledge that there are several good reasons for this optimism, namely the rapid decline in U.S. inflation in 2023 and the country's surprisingly resilient economy. However, we still think investors should proceed with caution, given how much Goldilocks thinking appears to be reflected in today's asset prices. **It's notable that we saw rallies in both risk and duration in the fourth quarter:** many equity indices reported double-digit returns, yield spreads in the high yield bond and leveraged loan markets contracted, and Treasury yields fell across the curve.[1] (See Figure 1.)

While we believe Goldilocks thinking is always dangerous, we think it's especially so now, as investors are facing an environment in which multiple long- and short-term market tailwinds are weakening and, in certain instances, turning into headwinds that could create new risks and opportunities in the years ahead.

Figure 1: Fourth-Quarter Rally Reflects Rising Expectations for a Soft Landing



Source: Bloomberg; S&P 500 Index, Russell 2000 Index, ICE BofA US High Yield Constrained Index, Federal Reserve, as of December 31, 2023

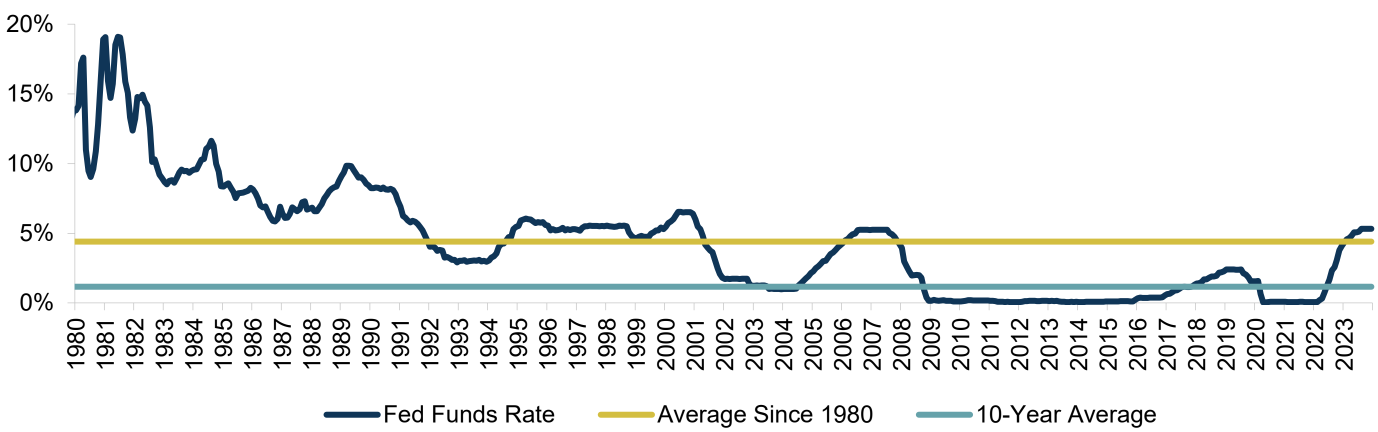
Winds of Change

Over the last few decades, arguably no financial market tailwind was stronger than declining and ultra-low interest rates – as Howard Marks has written about extensively over the last year. As a reminder, not only did the Federal Reserve cut the fed funds rate to zero in late 2008 in response to the Global Financial Crisis, but it kept rates there for almost seven years.[2] (See Figure 2.) This provided a tremendous boost to the economy and markets. As Howard recently noted in his memo *Easy Money*:

Low interest rates made it:

- easy to run a business, with the stimulated economy growing unabated for more than a decade;
- easy for investors to enjoy asset appreciation;
- easy and cheap to lever investments;
- easy and cheap for businesses to obtain financing; and
- easy to avoid default and bankruptcy.

Figure 2: Interest Rates Remain Above the Ten-Year Average but Near the Long-Term Historical Average



Source: The Federal Reserve Bank of St. Louis

While ultra-loose monetary policy is typically expected to generate high inflation, this didn't occur in the post-GFC period largely because little of the trillions that were plowed into the financial system made it into the pockets of consumers. The Fed's quantitative easing and zero interest rate policies helped to spur substantial asset price inflation, but they didn't put much upward pressure on wages or consumer prices. (The inflationary picture was obviously quite different in during the recent crisis because so much of the U.S. government's roughly $5 trillion in stimulus spending was in the form of direct cash payments to individuals or other subsidies that helped households and small businesses.)

With inflation often running below 2% in the period between 2008-20, the Fed had little incentive to tighten monetary policy meaningfully, especially given that the market reacted negatively almost any time the Fed appeared to be turning even slightly hawkish. Thus, expectations rose that interest rates would remain low perpetually, which left many borrowers vulnerable once this long-term trend reversed. As we stated in *Performing Credit Quarterly 3Q2023*, **"many companies – especially those with outstanding leveraged loans or private debt – borrowed too much … creating capital structures that have become unsustainable now that interest rates have risen by more than 500 basis points."**

Importantly, low interest rates are closely intertwined with many other tailwinds[3] that helped support economic growth and asset prices in recent decades. Let's consider two such trends.

(1) Globalization: Increased international trade and global integration helped to spur economic activity from the 1990s through the mid-2010s. Total international trade rose from roughly 39% of global GDP in 1990 to 56% in 2016,[4] propelled largely by China's booming economy, which grew by an average annual rate of roughly 9% from 1979 to 2019.[5] Importantly, this boost in trade is believed to have reduced U.S. consumer prices by 0.1 to 0.4 percentage points annually between 1997 and 2018,[6] one of multiple factors that enabled the Fed to keep interest rates low for decades.

While experts debate how much globalization is weakening, there's substantial evidence that its dramatic growth stalled in the mid- to late 2010s as anti-trade rhetoric increased. The Covid-19 pandemic then upended international trade and caused companies to reconsider their long supply chains and begin exploring nearshoring opportunities. Meanwhile, tensions between China and the U.S. have continued to rise, populism and economic protectionism have intensified around the globe, and a spate of geopolitical conflicts have reduced the likelihood of greater global economic integration in the coming decade.

(2) Financial deregulation: While the U.S. government tightened financial regulations after the GFC, it began to loosen restrictions in the years leading up to the pandemic – a shift that was enabled, in part, by the low default rates engendered by ultra-loose monetary policy. In 2018, then-President Donald Trump signed a bill into law that eased financial restrictions on regional banks; this included increasing the level of assets banks needed to hold to be subject to the strictest regulatory requirements to $250 billion from $50 billion.[7] Additionally, the Fed began to water down certain regulations beginning in the late 2010s. For example, it weakened the "Volcker rule" (which restricted banks' proprietary trading activities), reduced several liquidity requirements, and essentially eliminated the leveraged lending guidance created in 2013.[8] These actions likely enabled many banks to expand lending, which, in turn, boosted economic activity.

However, bank failures in early 2023 – most notably the collapse of Silicon Valley Bank – have caused regulators to rethink how they should be assessing capital adequacy. If default rates rise and stress on banks' balance sheets continues to grow – a distinct possibility given that banks are still grappling with legacy portfolio issues related to leveraged buyout debt and commercial real estate loans – then the calls for regulators to increase buffers in the financial system will only grow louder. Considering all this, it's reasonable to assume that banks will have less ability to provide capital moving forward – just as more companies are seeking to refinance massive debt burdens taken on in the easy money era.

On top of these longer-term changes, we also expect to see the weakening or reversal of many of the shorter-term tailwinds that kept consumption, and thus economic growth, surprisingly robust last year. Consumption in 2023 was much stronger than anticipated largely because of three key trends:

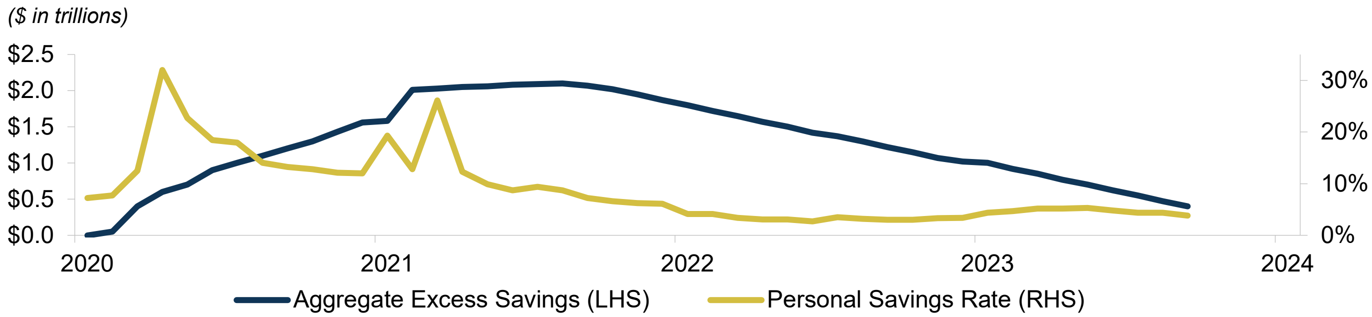
1. The estimated $2 trillion in excess savings that households amassed during the pandemic lasted longer than many models had predicted.[9]

2. Households saved a low percentage of their incomes. The savings rate fell to around 4.0% at year-end after hitting double-digit rates in 2020 and 2021.[10]

3. Consumers were increasingly willing to borrow to deal with the strains of rising prices. Credit card debt eclipsed $1 trillion in 2023, even as the average interest rate on new credit cards climbed to almost 25%.[11]

So what can we expect moving forward? While the unemployment rate remains low and real wage growth has turned positive, consumers now have a reduced stock of savings to draw from to handle higher prices, and it's unclear how much more they'll be willing and able to borrow. (See Figure 3.) **In short, we might finally see the seemingly indefatigable U.S. consumer slow down.**

Figure 3: The Stock of Excess Savings and the Flow of New Savings Have Fallen



Source: Federal Reserve Bank of San Francisco, Federal Reserve Bank of St. Louis

Sticking the Landing

Against this backdrop, we think one of three near-term macroeconomic scenarios is likely:

1. **Soft (or no) landing:** In the most benign scenario, the labor market would remain strong, and the economy would limp through the coming years without falling into a recession. If unemployment were to begin creeping upward, the Fed would have plenty of room to cut rates to stimulate growth. While floating-rate borrowers and fixed-rate borrowers with near-term maturities would obviously benefit if interest rates were to decline gradually and the economy were to avoid recession, many companies with high debt burdens are still likely to struggle unless interest rates fall back near zero.

2. **Hard landing:** If there is an unexpected spike in defaults, a rapid decline in home prices, a sudden change in the employment picture, an unanticipated geopolitical event, or some other shock that's completely off the radar, then the U.S. economy could enter into a serious recession. While these types of extreme events would likely elicit a dramatic response by the Fed – as we saw in both the GFC and the pandemic – officials may not have the ability or the inclination to both cut interest rates to zero and keep them there for a considerable period of time, given the altered inflationary environment and the risks created by the last decade-plus of ultra-loose monetary policy.

3. **Soft-ish landing:** Even if the economy doesn't experience a true hard landing, it could skid on the tarmac for a while. As the impacts of elevated interest rates and multiple years of rapid inflation work through the U.S. economy, we could see mini default cycles in various sectors and asset classes. The most immediately vulnerable, as we noted previously, are (a) floating-rate borrowers, especially those with particularly high leverage levels, and (b) commercial real estate investors, which face almost $3 billion in near-term maturities in the U.S.[12] Risk may then migrate to fixed-rate borrowers with maturities in 2026-28, as these companies may struggle to fill funding gaps if interest rates stay above the ten-year average. Thus, negative forces may weigh on the economy for years – not to the point of creating mass hysteria but also not to the point of provoking massive interest rate cuts.

What Could Go Wrong?

At Oaktree, we continuously ask ourselves "what could go wrong?" We believe that seeking to construct portfolios with sufficient shock absorbers makes managers less likely to find themselves scrambling to rescue existing assets and more likely to be in a position to take advantage of bargains. In the current environment, we think investing prudently means avoiding falling into the trap of assuming that today's Goldilocks narrative will play out exactly as written. As Howard recently noted:

> I've seen Goldilocks thinking in play a few times over the course of my career, and it rarely holds for long. Something usually fails to operate as hoped, and the economy moves away from perfection. **One important effect of Goldilocks thinking is that it creates high expectations among investors and thus room for potential disappointment (and losses).**

Credit Markets: Key Trends, Risks, and Opportunities to Monitor in 2024

(1) The case for high yield bonds remains very strong

The U.S. high yield bond market experienced a robust rally at the end of 2023, returning 9.2% from mid-October through year-end, due to declining Treasury yields, reduced recession fears, large retail fund inflows, and limited new issuance.[13] However, the asset class remains attractive on a relative basis due to several important factors.

High expected return: The average yield-to-maturity in the asset class is near 8.0% – which is well above the ten-year average – and compelling compared to the roughly 5.0% offered in the investment grade bond market.[14]

High quality: Around half of the asset class is rated BB (the credit rating tier just below investment grade) and only 11% is rated CCC (the lowest tier), compared to 45% and 17%, respectively, a decade ago.[15] For context, only one-quarter of the U.S. leveraged loan market is currently rated BB.[16] This quality advantage partly reflects the increase in the average size of high yield bond issuers in the last decade, as smaller borrowers have increasingly migrated to the leveraged loan and private credit markets. Additionally, leverage ratios in the asset class are fairly healthy compared to the pre-pandemic and long-term averages. (See *PCQ 3Q2023* for more details.)

High average convexity: U.S. high yield bonds still trade at an average price of 92 cents on the dollar, and their average duration is 3.3 years, roughly half the average duration of investment grade bonds.[17] Thus, high yield bonds should benefit meaningfully from the pull to par in the coming years as bonds mature. Additionally, all fixed rate assets, including high yield bonds, should be better positioned than they were in recent years now that the likelihood of near-term interest rate increases has fallen sharply.

(2) Opportunities continue to emerge as a result of weakness in the banking system

The areas where banks were most active in the years before 2022 were typically those where they were the incumbent lenders. However, in recent years, banks have had to contend with multiple challenges, including enormous sums of hung bridge debt, weak commercial real estate books, and uncertainty surrounding potential regulatory changes. Thus, banks have often reduced their lending activities, including in the areas they previously dominated. **This has created the potential for alternative lenders to gain share in new markets that are uncorrelated or only modestly correlated with traditional corporate lending deals.**

For example, private credit investors are increasingly finding attractive opportunities in a wide variety of structured credit transactions, including those involving music royalties, life sciences royalties, equipment finance, trade factoring, lender finance, aircraft finance, shipping finance, and rail cars – just to name a few. Loans through these intermediaries are often generating returns on par with – or even a little above – those seen in corporate direct lending, and, importantly, they typically feature a broad, diversified, global asset base.

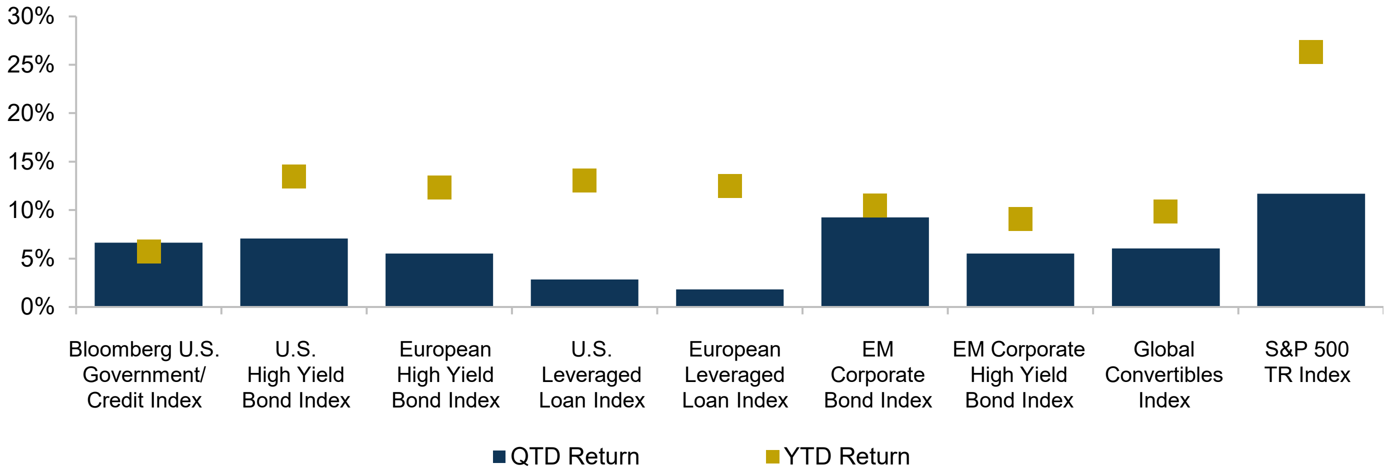
(3) Trends in residential real estate prices should be monitored closely

The dramatic increase in mortgage rates over the last two years has created complex dynamics in the residential real estate market, creating both risk and opportunity. In 2023, existing U.S. home sales declined by roughly one-fifth year-over-year.[18] That's largely because mortgage rates spiked above 7.0%, dampening appetite from buyers.

However, home prices have remained near record-high levels even though willing buyers have become more scarce. Why? Because willing sellers have also become harder to find. Homeowners with 30-year mortgages below 5% – over 80% of the market – have been loath to sell, as that can mean taking on a new mortgage at a rate that is far higher than what they're currently paying.[19]

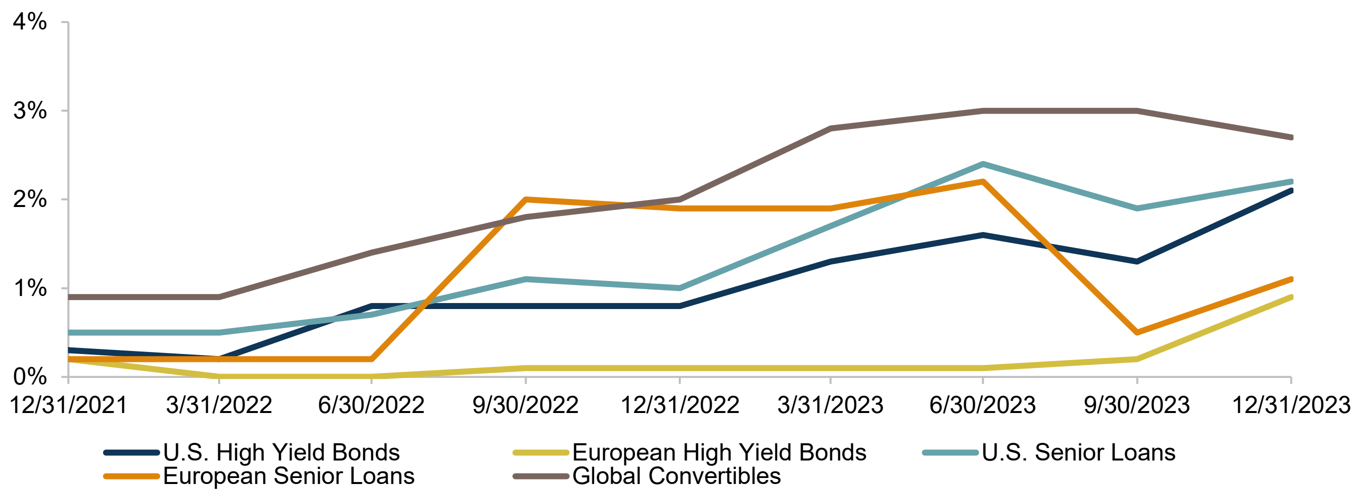
But will this situation last? A significant percentage of home sales are typically driven by life events (e.g., divorce, job changes, etc.). Given that these events will occur no matter what mortgage rates are, we shouldn't expect selling pressure to remain suppressed indefinitely. If we do see a spike in this pressure, you could potentially see a meaningful decline in home prices, due to the current market dynamics. And, importantly, U.S. homeowners typically measure their personal wealth based on the value of their homes and their ability to access that value through lines of credit. **Thus, if vulnerabilities emerge in the residential real estate market, it could have significant knock-on effects on consumer spending and the economy overall.** However, it could also create attractive buying opportunities for prudent real estate investors with capital to deploy.

Performance of Select Indices



As of December 31, 2023
Source: Bloomberg, Credit Suisse, ICE BofA, JP Morgan, S&P Global, Thomson Reuters[20]

Default Rates by Asset Class



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

High Yield Bonds

Market Conditions: 4Q2023

U.S. High Yield Bonds – Return: 7.1%[21] | LTM Default Rate: 2.1%[22]

- **Yield spreads contracted over the period:** While spreads expanded in October, they shrank throughout the remainder of the quarter as recession fears faded and investor risk appetite increased. At year-end, yield spreads were near the low end of the historically normal range of 300–500 bps.[23]
- **Yields in the asset class declined but remain elevated:** While the average yield decreased over the period due to the drop in Treasury yields, it is still well above the ten-year average. (See Figure 4.) Nearly 40% of high yield bonds (by market value) had yields above 7% at year-end, compared to less than 7% at the beginning of 2022.[24]
- **BB-rated bonds outperformed:** The highest below-investment grade ratings segment returned 7.4% for the period, while B- and CCC-rated bonds returned 6.8% and 6.7%, respectively. CCC-rated bonds outperformed in 2023 overall, returning 19.8% compared to 11.5% and 14% for BB- and B-rated bonds, largely due to CCCs short duration and large coupons.[25]

European High Yield Bonds – Return: 5.5%[26] | LTM Default Rate: 0.9%[27]

- **The asset class had a robust rally:** Heightened expectations of near-term interest rate cuts caused European government bond yields to decline. This disproportionately benefited BB-rated bonds, the longest-duration assets in the high yield bond market.
- **European high yield bonds remain attractive despite the recent rally:** While the average price in the market rose meaningfully over the period, it ended the year at 91 cents on the dollar, meaning investors still have the opportunity for capital appreciation.[28]

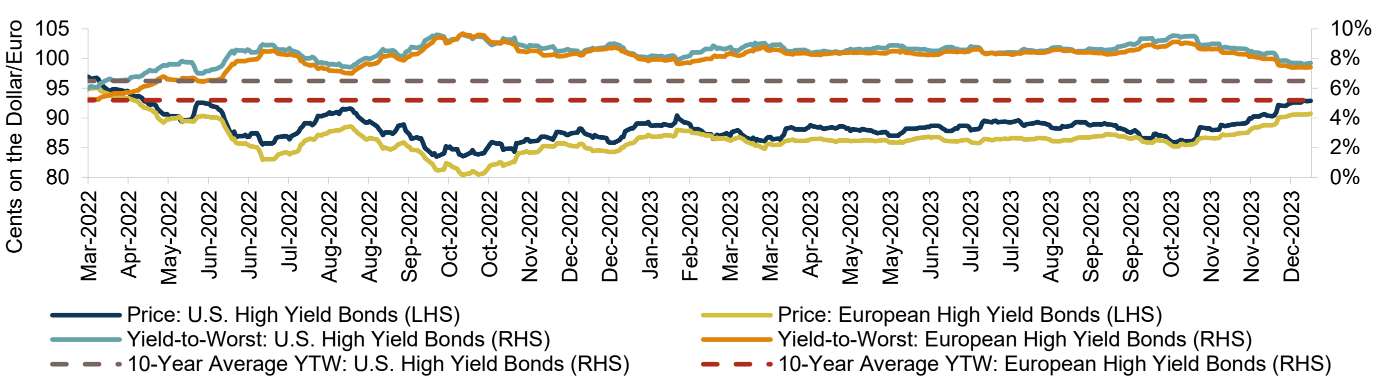
Opportunities

- **Investors may continue to enjoy attractive yields:** Significant near-term interest rate cuts are now unlikely, meaning yields in the asset class should stay well above the ten-year average through at least year-end.
- **High yield bonds are trading at a meaningful discount to par in the U.S. and Europe:** Investors have the potential to earn meaningful capital appreciation while retaining strong call protection.
- **The near-term default environment is benign:** Issuers' fundamentals are fairly healthy, while near-term maturities are limited.
- **Quality in the asset class is strong:** The percentage of BB-rated bonds in the U.S. market is near a ten-year high.

Risks

- **Concerns about medium-term maturities may soon be reflected in bond prices:** Companies needing to refinance in 2027 will likely do so in 2025 or 2026, and the market may begin to price in concerns about rollover risk as early as 2024. Low-rated corporate issuers might struggle to roll over debt if interest rates don't decline significantly.
- **Elevated inflation and high labor costs may impair issuers' fundamentals:** While inflation has slowed, labor costs in many industries remain high, as do many other input costs. Companies may be unable to pass along these cost increases to customers.

Figure 4: High Yield Bonds Still Offer a Low Average Price and Attractive Average Yield



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

Senior Loans

Market Conditions: 4Q2023

U.S. Senior Loans – Return: 2.5%[29] | LTM Default Rate: 2.2%

- **U.S. senior loan prices rose in 4Q2023, while interest rates declined:** Performance was supported by reduced recession fears, moderating inflation, and strong buying activity among CLOs.
- **Gross issuance increased:** Activity in the loan primary market rose meaningfully during the quarter, though it was dominated by refinancings and repricings. In December alone, issuance rose by 88% month-over-month; however, new-money deals (excl. refinancings) remained limited.

European Senior Loans – Return: 1.8%[30] | LTM Default Rate: 1.1%

- **European loans generated a solid return in 4Q2023 to end a volatile year:** Strong appetite from CLOs boosted performance in the period and throughout the year, resulting in a full-year return of 12.5%.
- **Primary market activity picked up during the period:** New supply of loans exceeded €16bn in 4Q2023, compared to roughly €11bn in the prior period, bringing the full-year total to €47bn.

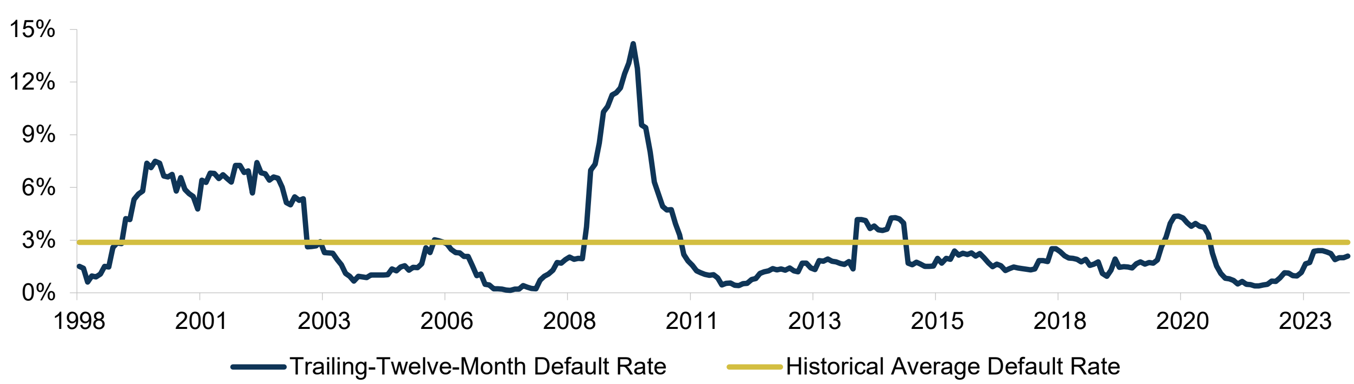
Opportunities

- **High coupons may continue to attract investors:** The spike in reference rates since YE2021 will likely continue to make floating-rate loans compelling.
- **The default outlook appears manageable:** Default rates in the U.S. and European loan markets are expected to rise in 2024 and will likely exceed those in the respective high yield bond markets. But default rates are still likely to remain below their recessionary averages, even if these economies begin to contract. (See Figure 5.) This is largely due to the limited number of maturities and, particularly in Europe, the average strength of issuers' balance sheets.
- **Loans may experience less volatility than many other asset classes because of loans' stable buyer base:** CLOs – the primary holders of leveraged loans – have limited selling pressure, and the asset class tends to attract long-term institutional investors due to the lengthy cash settlement period.

Risks

- **Declining interest rates could reduce appetite for floating-rate assets:** Although interest rates are still above their ten-year average, many market participants expect cuts in 2024, which could have a negative impact on demand for floating-rate assets.
- **Elevated interest rates may be burdensome to heavily indebted borrowers:** Companies that didn't hedge their interest rate risk – especially those in highly leveraged sectors – may experience meaningful deterioration in their interest coverage ratios.
- **Recovery rates may be lower than expected:** The increased prevalence of loan-only capital structures has already caused average recovery rates in the asset class to decline to an all-time low near 38%.[31] We anticipate that this trend will continue through this default cycle.
- **CLOs' buying activity could decline:** CLO creation was erratic during 2023 and isn't expected to rise meaningfully in 2024.

Figure 5: Default Activity in the Loan Market Remains Below the Historical Average



Source: J.P. Morgan, as of December 31, 2023[32]

Investment Grade Credit

Market Conditions: 4Q2023

Return: 8.5%[33]

- **Investment grade debt had a strong rally in 4Q2023 due to the sharp decline in Treasury yields:** Moderating inflation and increased expectations for near-term interest rate cuts put downward pressure on Treasury yields.
- **Lower-quality credit outperformed:** BBB-rated bonds outperformed the AAA-rated segment by over 400 bps in 4Q2023 and by over 500 bps for the full year. Reduced recession fears caused yield spreads to shrink, which disproportionately benefited the lower-rated end of the market.

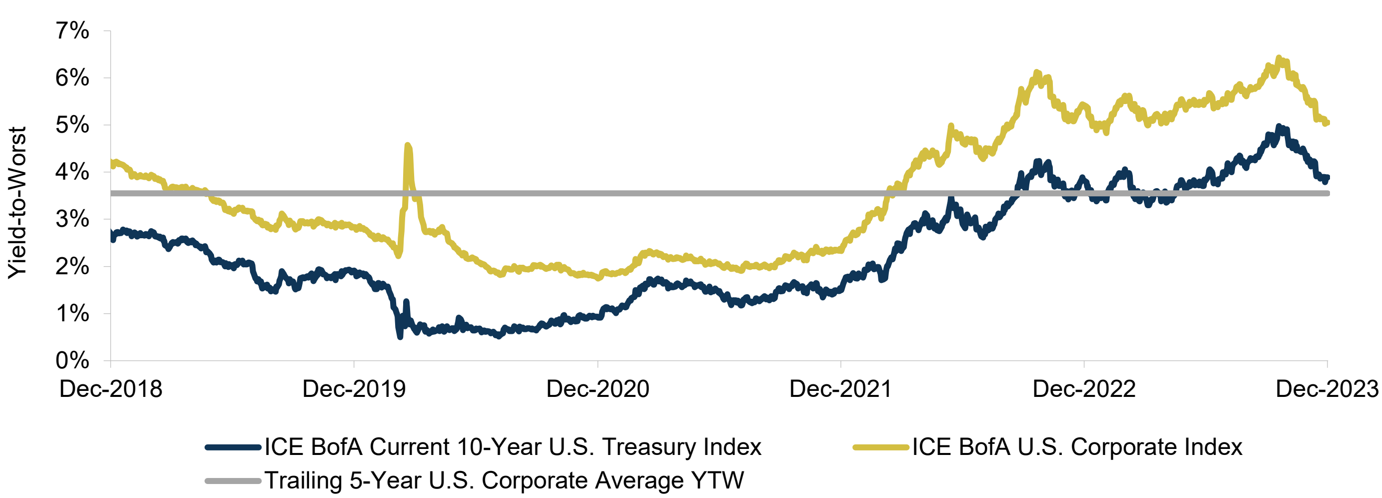
Opportunities

- **Investment grade corporate debt yields remain elevated despite the year-end rally:** Yields in the asset class ended the quarter at 5.0%, still above the five-year average. (See Figure 6.)
- **Investment grade debt may benefit if economic activity slows:** Investment grade debt could outperform high yield bonds in 2024 if slowing growth results in widening yield spreads and declining interest rates.

Risks

- **If interest rates decline in 2024, demand for asset classes with greater credit risk may increase:** While investment grade credit should benefit more from interest rate cuts than high yield bonds, given the former's longer duration, a declining interest rate environment could reduce demand for low-yielding debt. If base rates fall but default rates stay low, investors needing to earn a specific yield may migrate toward higher-yielding, higher-risk asset classes.
- **All fixed-rate asset classes could suffer if interest rates stay elevated longer than investors are currently anticipating:** The futures market is pricing in a high probability of multiple interest rate cuts in 2024, which may be overly optimistic.[34] If interest rates don't decline as expected, fixed-rate assets could experience increased volatility.

Figure 6: Investment Grade Bond Yields Remain Above the Long-Term Average Despite the Rally in 4Q2023



Source: Bloomberg

Emerging Markets Debt

Market Conditions: 4Q2023

EM Corporate High Yield Bond Return[35] – 4Q2023: 5.4%

- **EM high yield corporate debt rallied near year-end:** The strong performance, which resulted in a YTD gain of 11.2%, was primarily driven by declining global interest rate expectations and strong performance among many large EM economies. (See Figure 7.) EM bonds maturing in five years or longer, which constitute over 40% of the EM corporate high yield bond index, were the top performers.[36] Additionally, rising investor confidence caused EM yield spreads to narrow, leaving them slightly above the 18-month low seen in early 2023.[37]
- **Geopolitical risk rose in 2023, but had a limited impact on bond prices:** The onset of the Israel/Hamas war heightened tensions in the emerging markets, even as concerns remained about the Russia/Ukraine War and strained U.S./China relations. But EM asset prices weren't impacted significantly by this turbulence. For example, Ukrainian corporate bonds were EM's top performers in 2023, and Israeli corporate bond prices were down only modestly for the year.
- **The asset class experienced substantial retail fund outflows in 2023:** Outflows were consistent throughout the year, totaling $25bn. However, this is lower than the record-high total in 2022.[38]
- **EM borrowers' balance sheets fared well despite two years of tightening global financial conditions:** Net leverage in the asset class has risen slightly but is still below pre-pandemic levels. This stability reflects the steady economic activity in various EM regions, especially in Latin America and India.

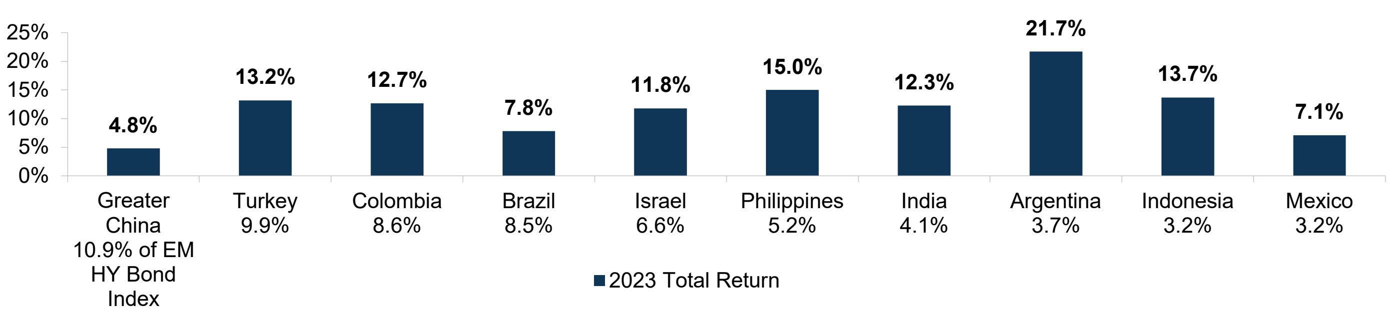
Opportunities

- **Prices remain attractive despite the recent rally:** The average price in the asset class is low at 90 cents on the dollar,[39] and average EM yield spreads are over 100 bps wider than those of their U.S. counterparts, which is greater than the historical average.[40] Additionally, financing options for EM borrowers are limited, meaning EM-dedicated credit investors will likely have the opportunity to earn high yields while receiving enhanced investor protections.
- **The EM default outlook is manageable:** The EM default rate in 2024 is expected to be near the historical average of 4%, compared to 7% in 2023.[41] This forecast largely reflects the resilience of EM issuers' fundamentals and the fact that over 80% of China's property developers with high yield credit ratings have already defaulted.[42]
- **Primary market activity may increase in 2024:** Total issuance in 2023 was only slightly above the ten-year low recorded in 2022. The recent rally in bond markets may cause issuance to accelerate, as indicated by the strong activity thus far in January 2024.[43]

Risks

- **EM industries and export-based economies are exposed to decelerating economic activity:** Tightening financial conditions have reduced expectations for near-term global growth, evidenced by the fact that commodity indices fell to a two-year low in 4Q2023. Additional weakness in global demand may begin to affect EM company and country fundamentals.
- **Geopolitical tensions may have negative long-term effects on EM debt capital flows:** The wars in Ukraine and the Middle East, complicated China/U.S. relations, and unpredictable presidential elections in many countries could all erode investor confidence in EM credit.

Figure 7: The Ten Largest Constituents of the EM High Yield Corporate Debt Index Recorded Healthy 2023 Returns



Source: JP Morgan Corporate Broad CEMBI High Yield Plus Index, as of December 29, 2023
Note: Greater China includes China, Hong Kong, and Macau. Mainland China's total return in 2023 was -23.6%.

Global Convertibles

Market Conditions: 4Q2023

Return: 6.0%[44] | LTM Default Rate: 2.7%[45]

- **Rising equity prices boosted global convertibles' performance in 4Q2023:** Global equity markets strengthened during the period, primarily due to rising expectations for a soft landing in the U.S. and optimism that central banks may begin to cut interest rates meaningfully in 2024. Importantly, the equity market rally broadened to include small-cap stocks, which benefited convertible bonds.
- **Growth equities outperformed in 4Q2023, while energy stocks lagged:** Reduced fears about higher-for-longer interest rates boosted growth-oriented equities, most notably unprofitable technology companies, biotech firms, cryptocurrency-related businesses, and potential "AI winners." On the other hand, many energy companies' stocks were negatively impacted by expectations of weaker demand for oil.
- **Primary market activity remained healthy:** In 4Q2023, new issuance of global convertibles totaled $18.2bn across 32 new deals, bringing issuance to $79.4bn at year-end. This exceeded the sluggish pace seen through most of 2022 and is in line with the pre-pandemic average volume.

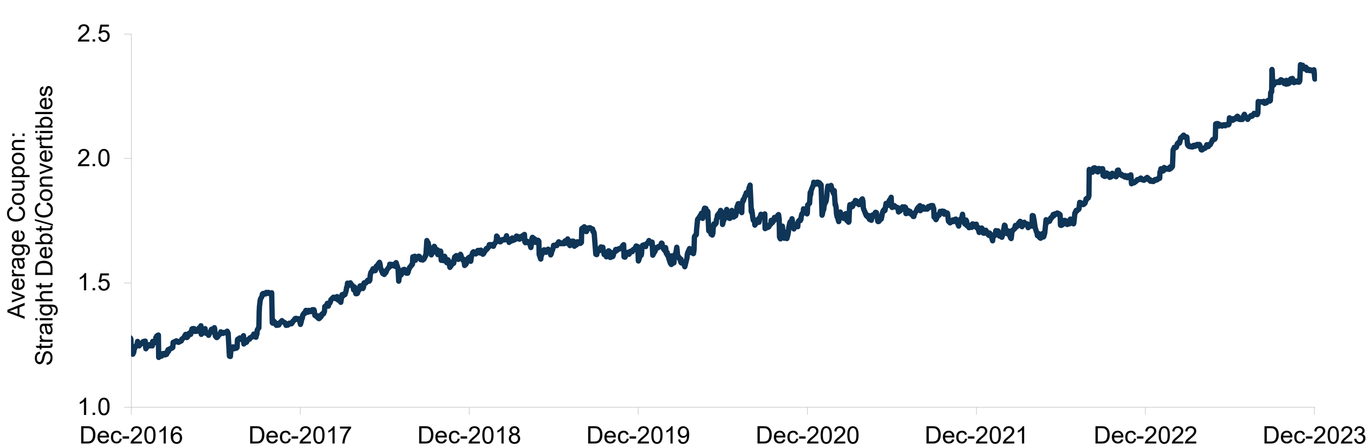
Opportunities

- **Convertibles continue to offer attractive yields and enhanced protections:** The average coupon for a new global convertible is 2.8%, compared to the low of 1.4% in 2021. Newly issued convertibles also feature more investor-friendly terms than those issued in prior years.
- **Borrowers may increasingly turn to the convertibles market in the coming year:** Since the GFC, issuance of high yield bonds has dramatically outpaced activity in the convertibles market. However, convertibles now offer average coupons that are more than 2.3 percentage points lower than those of straight debt. (See Figure 8.) Thus, companies needing to refinance in 2024-26 may seek to do so at a lower cost in the convertibles market.
- **The convertibles universe is broad and diverse:** Many of the new deals in 2023 came from historically underrepresented sectors (e.g., utilities and financials), investment-grade-rated issuers, and large-cap companies.

Risks

- **Company fundamentals appear to be weakening:** Third quarter earnings reports, and particularly 4Q2023 guidance, revealed growing cracks in the fundamentals of borrowers, especially companies with products/services that have a high sticker price, a loan component, or a large cash-pay element. While most issuers are continuing to cut costs and reduce capex, many are also struggling with high labor costs.
- **Numerous trends threaten to slow global economic growth and weigh on equity prices:** These include the lagged impact of several years of rapid price increases and elevated interest rates as well as concerns about slowing consumption and heightened geopolitical risk.

Figure 8: The Difference Between the Coupons of Straight Debt and Convertible Bonds Has Expanded



Source: BofA Global Research; represents coupons for convertible bonds and straight debt in the secondary market

Structured Credit

Market Conditions: 4Q2023

Corporate – BB-Rated CLO Return: 7.3%[46] | BBB-Rated CLO Return: 4.7%[47]

- **Collateralized Loan Obligations strengthened in 4Q2023:** The asset class benefited as concern about a U.S. recession decreased and demand for CLOs outpaced supply growth.
- **Activity in the primary market rose moderately:** Issuance of CLOs in the U.S. totaled over $30bn in the period, up from $27bn in 3Q2023 and $22bn in 2Q2023. Issuance in Europe totaled €8.1bn compared to €7.5bn in 3Q2023.[48] Despite the recent increase, 2023 issuance was below 2021 and 2022 levels.
- **BB-rated CLOs outperformed during the quarter:** This tranche's relatively high average yields helped it attract a wider buyer base than BBB-rated CLOs.

Real Estate – BBB-Rated CMBS Return: 4.3%[49]

- **Primary market activity decelerated meaningfully in 2023:** Issuance of commercial mortgage-backed securities decreased by 54% in 2023, with just $47bn of private label CMBS issued, compared to $101bn in 2022.
- **Performance in the CRE market varied meaningfully by sector:** Green Street's Commercial Property Price Index, which tracks the pricing of institutional-quality commercial real estate, declined by 6.2% quarter-over-quarter, and by 9.5% year-over-year.[50] The index for the office subsector decreased by 5.8% QoQ and by 25.1% YoY.[51] Importantly, we've seen greater resilience in subsectors such as residential housing, data centers, and industrial properties, which are all benefiting from more favorable supply/demand dynamics than the office subsector.

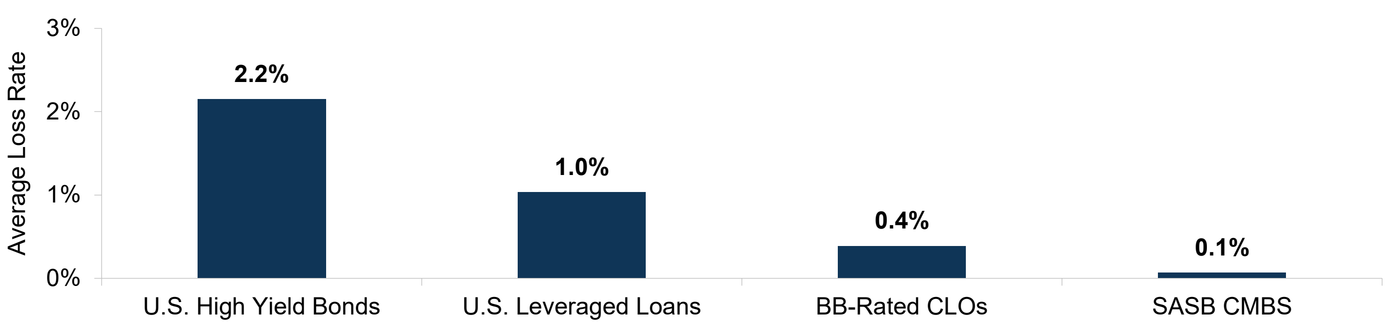
Opportunities

- **Corporate structured credit offers higher average yields than traditional credit asset classes:** CLOs have attractive yields as well as strong structural enhancements, evidenced by their lower long-term loss rates. (See Figure 9.)
- **Volatile markets could create compelling opportunities:** CLO managers can still buy loans at a discount to par, meaning managers can potentially benefit from both the CLO arbitrage and capital appreciation.
- **Weakness in the CMBS market could create compelling opportunities for disciplined investors:** Investors with available capital and limited problems in their existing portfolios may be well positioned to take advantage of these opportunities. But in this challenging environment, it will be especially important to (a) conduct disciplined credit analysis and (b) remain senior in the capital structure.

Risks

- **CLOs have historically experienced increased volatility during bouts of equity market weakness:** Performance could be negatively affected if investors' risk appetite declines or if the loan market experiences a large wave of downgrades and/or defaults. The ongoing equity rally might stall if interest rates aren't cut as quickly as investors currently anticipate.
- **Activity in the CMBS primary market will likely remain muted:** Uncertainty surrounding the outlook for interest rates, inflation, and financing costs may limit transaction volumes in the near term.
- **Weakness in the office sector may persist:** The sector continues to face multiple headwinds. The performance of this sector will likely weigh on real estate structured credit indices throughout 2024.

Figure 9: Structured Credit Features Lower Loss Rates than Traditional Credit



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

Private Credit

Market Conditions: 4Q2023

- **Private credit was resilient in 2023, but it's likely to weaken in the near term:** Performance was supported by robust U.S. economic growth and proactive actions taken by private equity sponsors and lenders to temporarily address liquidity problems facing vulnerable borrowers.[52] But companies are now beginning to feel the full impact of recent interest rate increases, so performance may deteriorate moving forward.
- **Private credit deal terms remain relatively lender-friendly:** While yield spreads compressed modestly during the quarter, they're still wider than the historical average, and covenants continue to be more restrictive than in recent years.[53] Additionally, average loan-to-value ratios in new deals are well below the pre-2022 average, as sponsors have been under pressure to contribute higher percentages of equity capital due to portfolio companies' elevated interest burdens.[54]
- **Deal volume in European private credit has rebounded, but is muted compared to 2020-21 levels:** The region continues to be beset by high prices, economic uncertainty, and geopolitical risk. While private credit activity has increased following several quarters of declining volumes, deals are still taking longer to complete, as weak macroeconomic conditions are extending due diligence timelines.
- **Refinancing activity picked up in the final quarter of 2023:** While buyout activity in 2023 was much lower than in previous years, refinancings increased meaningfully. Many companies that would have normally sought to refinance in the syndicated loan market have instead turned to private credit. Companies involved in these refinancings are often reducing their leverage with injections of new equity from their sponsors.

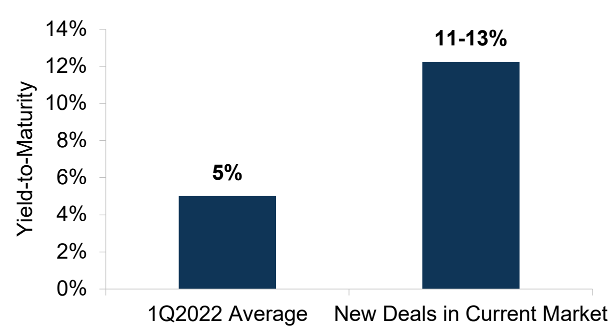
Opportunities

- **Demand for private debt financing appears to be increasing:** Sponsor-backed M&A activity has risen since the end of August.[55] Moreover, demand for refinancings is likely to grow significantly in the coming years, as an estimated 40% of the direct lending market is maturing in 2024-25.[56]
- **Private lenders could continue to gain market share in large-cap financings:** Bank lending in this market may remain inconsistent and limited, due to (a) the meaningful losses banks suffered in recent years on hung bridge debt; (b) the tighter capital restrictions resulting from the Basel III regulatory framework;[57] and (c) the reduced reliability of syndicated markets.
- **Yields available to large private lenders are very attractive:** Many large buyout deals that would previously have been completed in the syndicated markets are moving to the private market. Reduced competition to finance these deals has helped push large LBO loan yields to 11-13%. (See Figure 10.)
- **Attractive direct lending opportunities are emerging in areas that require specialized expertise, such as life sciences:** Biotech companies, which have historically favored equity issuance, have increasingly been turning to the direct lending to avoid diluting their equity by issuing at depressed valuations.

Risks

- **More borrowers are likely to feel the negative impact of elevated interest rates:** We expect an increasing number of companies to face liquidity challenges in the coming quarters, especially borrowers with unitranche floating-rate debt taken before 2022. While most companies have been able to manage liquidity problems with short-term solutions, such as tapping revolving credit facilities, pressure will likely mount in the coming months if interest rates stay elevated. Additionally, private equity sponsors may not inject capital into struggling companies to the same extent that they did in 2023.
- **Tighter-than-expected monetary policy could negatively impact the lending environment:** Central banks have signaled that they intend to keep interest rates higher for longer than markets are currently anticipating. This may discourage new deals and make it challenging for current borrowers to roll over their debt, especially highly leveraged sponsor-backed companies.

Figure 10: Large LBO Financings Are Migrating to the Private Market and Offering Higher Yields



Source: Pitchbook LCD, as of December 31, 2023; represents companies with EBITDA > $50 million

About the Authors

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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 portfolio manager within the Global Credit strategy. She is a founding member of the strategy, having helped design its portfolio management processes and having served as a member of the Global Credit Investment Committee since 2017. Ms. Poli has led the expansion of the firm's multi-asset credit offerings, including a product for Brookfield Oaktree Wealth Solutions which she has co-managed since 2021. In addition, Ms. Poli oversaw Oaktree's product management activities globally across Credit, Private Equity, Real Assets and Listed Equities from 2019 to 2023. Prior to joining Oaktree in 2014, Ms. Poli earned her M.B.A. at the UCLA Anderson School of Management, where she received the Laurence and Lori Fink Investment Management Fellowship. Prior thereto, she worked at PAAMCO KKR Prisma (formerly PAAMCO) where Ms. Poli helped manage hedge fund portfolios for institutional clients. Ms. Poli holds a B.S. degree in business administration from the University of Southern California and is a CAIA charterholder.

Oaktree's Performing Credit Platform

Oaktree Capital Management is a leading global alternative investment management firm with expertise in credit strategies. Our Performing Credit platform encompasses a broad array of credit strategy groups that invest in public and private corporate credit instruments across the liquidity spectrum. The Performing Credit platform, headed by Armen Panossian, has $80.3 billion in AUM and approximately 190 investment professionals.[58]

Endnotes

1. Bloomberg; S&P 500 Index, Russell 2000 Index, ICE BofA US High Yield Constrained Index, as of December 31, 2023.
2. The Federal Reserve Bank of St. Louis.
3. Various tailwinds/headwinds also cited by Apollo, Goldman Sachs, Rosenberg Research.
4. Forbes, Kristin. *Has Globalization Changed the Inflation Process?* Bank for International Settlements. June 2019. Total trade refers to imports plus exports.
5. The World Bank.
6. Robert Johnson of the University of Notre Dame and Diego Comin of Dartmouth College. National Bureau of Economic Research. *Offshoring and Inflation*. October 2020.
7. Economic Growth, Regulatory Relief, and Consumer Protection Act. May 24, 2018.
8. The Federal Reserve. *Agencies finalize changes to simplify Volcker Rule*. October 8, 2019; *Federal Reserve Board finalizes rules that tailor its regulations for domestic and foreign banks to more closely match their risk profiles*. October 10, 2019; in 2018, the Federal Reserve Board said the 2013 Leveraged Lending Guidance was "non-binding."
9. Based on the estimates of the Federal Reserve. Excess savings refers to the savings accumulated in excess of what would have been expected based on long-term savings trends.
10. Federal Reserve Bank of St. Louis.
11. Federal Reserve, as of September 30, 2023. Average APR for all new credit cards from Lendingtree.com, as of January 2024
12. Federal Reserve, Trepp Inc., as of September 30, 2023.
13. ICE BofA US High Yield Constrained Index.
14. ICE BofA US High Yield Constrained Index, as of December 31, 2023. ICE BofA US Corporate Index, as of December 31, 2023.
15. ICE BofA US High Yield Constrained Index, as of December 31, 2023.
16. JP Morgan Leveraged Loan Index, BB includes split rated and CCC includes split B-rated.
17. ICE BofA U.S. High Yield Constrained Index and ICE BofA US Corporate Index, as of December 31, 2023.
18. National Association of Realtors, as of December 2023.
19. Federal Housing Finance Agency, as of September 30, 2023.
20. 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.
21. ICE BofA US High Yield Constrained Index for all references to U.S. High Yield Bonds, unless otherwise specified.
22. JP Morgan for all U.S. default rates, unless otherwise specified.
23. The normal range refers to the average range over the last 25 years.
24. ICE BofA US High Yield Constrained Index. Percentages are based on the market value of debt.
25. ICE BofA US High Yield Constrained Index.
26. ICE BofA Global Non-Financial High Yield European Issuer, Excluding Russia Index (EUR hedged) for all references to European High Yield Bonds, unless otherwise specified.
27. UBS for all European default rates, unless otherwise specified.
28. Pitchbook LCD, as of December 31, 2023.
29. Credit Suisse Leveraged Loan Index for all data in the U.S. Senior Loans section, unless otherwise specified.
30. Credit Suisse Western Europe Leveraged Loan Index (EUR Hedged) for all data in the European Senior Loans section, unless otherwise specified.
31. JP Morgan, LTM average rate, as of December 31, 2023.
32. TXU was removed from J.P. Morgan's twelve-month default rate calculation in April 2015 resulting in a meaningful decrease in the rate in March 2015.
33. Bloomberg US Corporate Index for all data in this section, unless otherwise specified.
34. As of September 30, 2023.

Endnotes

35. JP Morgan Corporate Broad CEMBI Diversified High Yield Index for all data in this section unless otherwise specified. The emerging markets debt section focuses on dollar-denominated debt issued by companies in emerging market countries.
36. JP Morgan, as of December 29, 2023.
37. Bloomberg, JP Morgan, as of December 29, 2023.
38. Data as of September 30, 2023.
39. Bloomberg, JP Morgan, as of December 29, 2023.
40. JP Morgan Corporate Broad CEMBI Diversified High Yield Index compared to JPM U.S. High Yield Index.
41. JP Morgan, default rate for Corporate CEMBI High Yield Index, as of December 31, 2023.
42. JP Morgan, as of December 29, 2023.
43. JP Morgan, as of January 12, 2024.
44. Refinitiv Global Focus Convertible Index for all performance data, unless otherwise indicated.
45. Bank of America for all default and issuance data in this section, unless otherwise specified.
46. JP Morgan CLOIE BB Index.
47. JP Morgan CLOIE BBB Index.
48. JP Morgan for all data in this section, unless otherwise specified.
49. Bloomberg US CMBS 2.0 Baa Index Total Return Index Unhedged Index.
50. Green Street Commercial Property Index, as of December 31, 2023.
51. Green Street Commercial Property Index, as of December 31, 2023.
52. BofA Global Research. *Private Debt: Opportunities and challenges in a new rates regime*. October 2, 2023.
53. Oaktree observations in the market, as of September 30, 2023.
54. Refinitiv, as of June 30, 2023.
55. Based on Oaktree observations in the market, as of October 13, 2023.
56. BofA Global Research. *Private Debt: Opportunities and challenges in a new rates regime*. October 2, 2023.
57. Federal Deposit Insurance Corporation, as of July 27, 2023.
58. 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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