OAKTREE INSIGHTS

MAY 2021

# PERFORMING CREDIT QUARTERLY

## 1Q2021

OAKTREE

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### OVERVIEW

The global economy may have reached an inflection point in the first quarter: the worst of the Covid-19 pandemic is on one side, and an economic recovery generating both optimism and anxiety is on the other. While the pandemic is certainly not over, the accelerating pace of Covid-19 vaccination in countries like the United States and the United Kingdom helped lift global growth expectations during this period, as did the passage of a $1.9 trillion U.S. fiscal stimulus package. Consequently, economists began predicting that U.S. consumers' record-high savings rate and pent-up demand could push the growth of GDP in 2021 well above 5%. But along with this optimism came fears about rising inflation and rate hikes. The upshot was weakness in some parts of the credit markets, strength in others, record-high stock prices, and intra-market equity volatility, as investors tried to reposition their portfolios to keep pace with the latest shifts in this unique recovery story.

Optimism about the U.S. economic outlook seems warranted. In March alone:

- the economy added almost one million new jobs, and the unemployment rate fell to 6%;
- the Conference Board's Consumer Confidence Index hit 109.7 – the highest level since the pandemic began;
- the ISM Manufacturing Purchasing Managers' Index reached 64.7 – the highest recording in 37 years (readings above 50 denote expansion);
- the ISM Services PMI set a record at 63.7; and
- S&P Global Ratings lowered its 2021 speculative-grade default rate forecast to 5.5% – a far cry from the double-digit heights predicted during the heart of the Covid-19 crisis.

Reflecting these improvements as well as higher-than-anticipated economic activity in other regions, the International Monetary Fund raised its 2021 global growth projection to 6.0% at its Spring Meetings held right after quarter-end – an increase of 50 basis points versus its January forecast.

However, in the first quarter, investors also expressed concern that supply-chain disruptions and unprecedented amounts of U.S. fiscal aid could bring on inflation rates higher than the country has seen in decades, which could eventually force the Federal Reserve's rate-hiking hand. The Fed has indicated that it doesn't intend to tighten monetary policy even if the targeted inflation rate rises above 2% as long as the spike is believed to be transitory. Still, investor anxieties about inflation helped push the yield on the 10-year Treasury above 1.7% in March, an increase of around 80 bps over the yield on January 1, as the spread between short- and long-term rates stretched to its widest level in over five years. Meanwhile, Europe's relatively slow vaccine rollout and the spread of potentially more contagious coronavirus variants around the world fueled an entirely different set of fears about backsliding.

This push and pull between hope and fear has created divergence in credit markets. Rising yields made floating-rate debt more attractive than fixed-rate instruments, as the former's coupons rise in tandem with their reference rates. Consequently, U.S. senior loans outperformed high yield bonds, returning 2.0% versus the latter's 0.9%.[1] But U.S. high yield bonds – which saw their yield spreads narrow as economic forecasts grew rosier – performed far better than their investment grade counterparts, which sold off by a full 4.3%.[2] Investment grade bonds' ultra-narrow spreads left little room for compression, and their prices were weighed down by their near-record-long duration (i.e., their sensitivity to changes in interest rates). Rate risk is more subdued in Europe than in the U.S., as benchmark rates remain negative and inflation expectations are more muted; consequently, the region's high yield bonds outperformed those in the U.S. during the quarter, while its senior loans underperformed.

Rising U.S. rates also weighed on emerging markets debt, pushing returns for the asset class to negative 80 bps in the first quarter, though spread compression counterbalanced some of the negative pressure.[3] Higher U.S. rates can make the yield on EM debt relatively less attractive and strengthen the dollar versus local currencies. Long-duration investment grade EM bonds were particularly hard hit, while the impact on high yield and distressed debt – which are less rate sensitive – was minimal. Moving forward, many EM countries may struggle to support their pandemic-battered economies, service higher debt burdens, close fiscal deficits, combat rising inflation, and attract foreign investors. However, the IMF recently raised its 2021 growth expectations for emerging and developing economies to 6.7% from 6.3% in its January forecast; this included a 50-bps bump in its GDP outlook for hard-hit Latin America.

Anxiety about rising rates certainly wasn't a brake on issuance during the first quarter, and optimism about the global economic recovery was likely an accelerant. Issuance in the U.S. and European high yield bond markets set new quarterly records, with $160 billion and €38 billion priced, respectively.[4] Global convertibles issuance was also elevated versus historical averages at $58 billion despite volatility in parts of the equity market, with the U.S. representing around two-thirds of that total.[5]

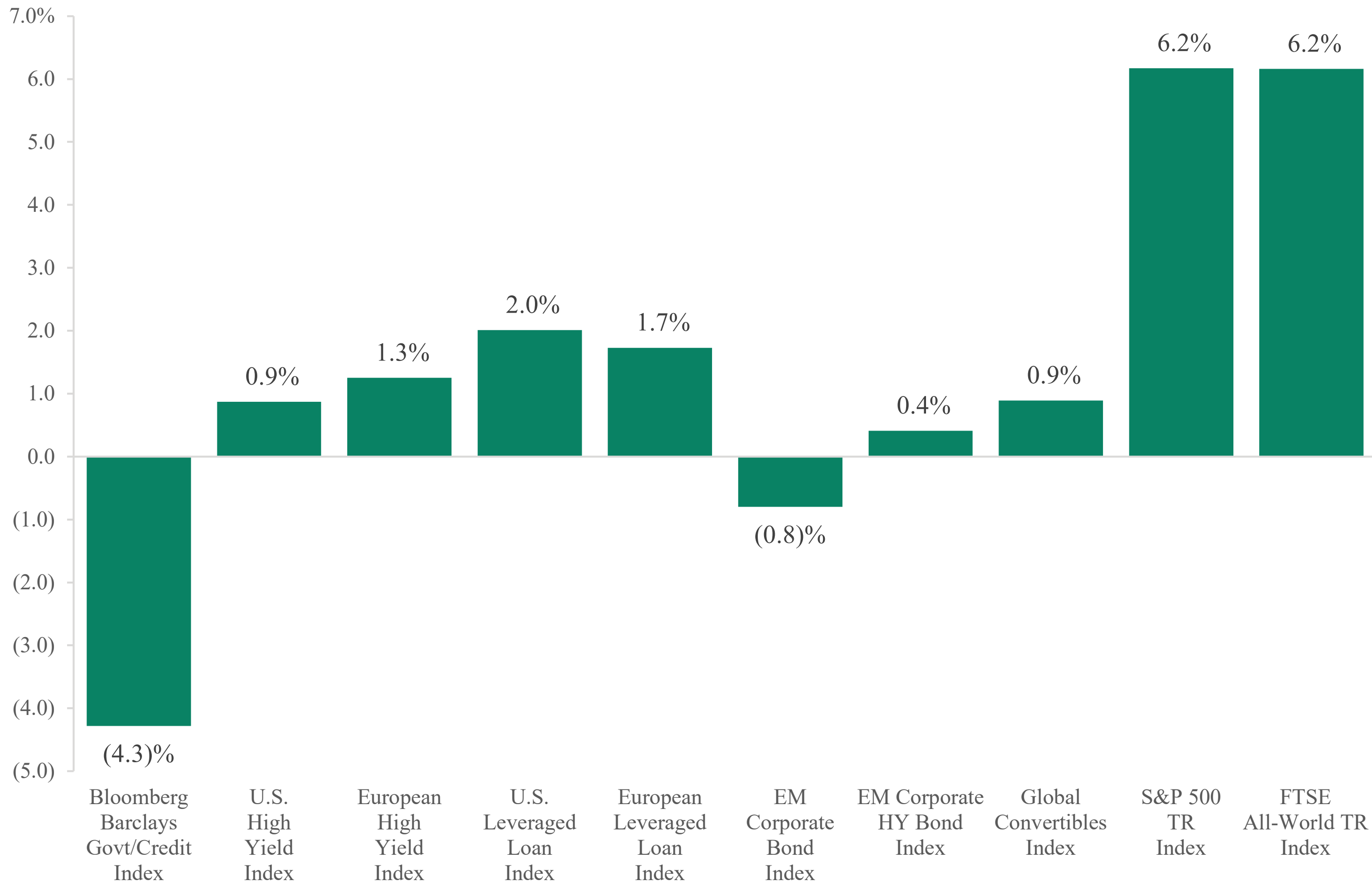
Rising rates likely spurred demand for floating-rate products, which was met with robust supply. U.S. CLO issuance hit $106 billion – another record – and the European CLO market priced €25 billion of debt.[6] Toward the end of the quarter, lower-rated CLO tranches experienced some pricing pressure because of this issuance glut.

Recently, U.S. interest rates have started to reverse course, even as more positive U.S. economic data has been released – a reminder to investors that they should spend more time trying to determine where we are in the current economic cycle and less time trying to predict short-term rate moves.

Moving forward, we're optimistic about the global economic recovery and believe many credit classes may benefit as economies reopen and companies' fundamentals improve. But many questions remain: What will happen if fiscal largesse breaks the decades-long trend of low inflation and low rates? When will the pandemic finally end? And how will businesses, workers, governments and markets react in the post-crisis world? We don't pretend to know the answers to these questions.

Therefore, we believe investing in the coming quarters will require a balanced approach: neither racing into parts of the credit market offering the most protection from rate moves nor eschewing entire regions like Europe or the emerging markets because of their temporary problems. Additionally, we believe that privately negotiated transactions have the potential to generate attractive returns with risk under control, but we also think an investor must be selective, as we've found that too much capital has been chasing too few sponsor-backed leveraged buyout deals recently, causing deterioration in economic and legal terms. When considering both public and private opportunities, we're continuing to focus on fundamental credit underwriting to assess risk, in keeping with Oaktree's philosophy. That way we're prepared whether the next few quarters are defined by hope or by fear.

## PERFORMANCE - 1Q TOTAL RETURN OF SELECT INDICES[7]




*As of March 31, 2021*
*Sources: Bloomberg Barclays, FTSE, Credit Suisse, ICE BofA, JP Morgan, Refinitiv, S&P Global.*

## HIGH YIELD BONDS

### Current Market Conditions

- U.S. high yield bonds returned 0.9% in 1Q2021.[8] They performed far better than investment grade bonds as U.S. Treasury yields rose.
  - Issuance remained robust at over $160 billion for the quarter, with a near- record $64.8 billion in January.[9]
  - High yield bond ETFs and mutual funds recorded their largest weekly outflows in over six months in March.[10]
  - The trailing-12-month default rate of 4.8% remains far lower than forecasts made following the onset of the Covid-19 crisis.[11]
- European high yield bonds, benefitting from lower interest-rate risk, outperformed their U.S. counterparts, returning 1.3%.[12]
  - Yield spreads have continued to tighten, while overall credit quality has improved: BB-rated credits now constitute nearly two-thirds of the market.[13]
  - The market priced €38 billion of bonds, compared to €26 billion in 4Q2020, setting a new quarterly record.[14]
  - The trailing-12-month default rate of 3.4% has remained low compared to analysts' forecasts,[15] as companies were bolstered by unprecedented levels of government and central bank support.

### Outlook

*Opportunities*

- High yield bonds are less sensitive to interest rate moves compared to investment grade bonds and have more room for spread compression.
- Investor demand for high yield bonds is sizeable because rates remain very low in developed markets and investment grade yield spreads are very tight.
- Default expectations may continue to fall as a result of: (1) the faster pace of vaccination and economic reopenings in the U.S., (2) fiscal support in both the U.S and Europe, and (3) increased issuance across both markets.

*Risks*

- Spreads in both regions are near pre-pandemic levels, limiting the margin for error.
- Companies took on significant amounts of debt in 2020, so leverage multiples have increased globally.

*Wildcards*

- Changes in the Fed's current accommodative policy stance could have a significant impact on fixed income prices.
- Europe's slow vaccine rollout could retard economic recovery, potentially eroding companies' fundamentals. However, Europe has recently accelerated the pace of their vaccination campaign.

## SENIOR LOANS

### Current Market Conditions

- U.S. senior loans returned 2.0% in 1Q2021,[16] as the steepening yield curve made floating-rate instruments more attractive.
  - Over $215 billion of loans priced during the quarter – already more than half of the full-year 2020 total – with net issuance, excluding refinancing, of $95 billion.[17]
  - The trailing-12-month default rate fell below 4.0% at quarter-end,[18] though it's still around twice the pre-pandemic rate.
  - Mutual funds and ETFs recorded four consecutive months of inflows totaling over $11 billion.[19]
- European senior loans returned 1.7% in 1Q2021,[20] supported by demand from investors seeking attractive yields and relative protection from rising interest rates.
  - The new issuance market for European senior loans was very active. The market priced €41 billion of loans compared to €11 billion in 4Q2020.[21]
  - The European senior loan market's default rate decreased to 1.1%.[22]

### Outlook

*Opportunities*

- Senior loans offer relatively attractive yields and spreads compared to high yield bonds, along with first lien status, shorter duration, and lower default expectations.
- The robust pipeline of new issue CLOs in the U.S. and Europe should support demand for loans.

*Risks*

- Demand for floating-rate products pushed up loan prices: over 90% of U.S. loans traded at or above 95 at quarter-end.[23]
- Volatility is possible as the market digests higher growth expectations and the potential for higher inflation.

*Wildcards*

- The medium-term impact of the initial delays in Europe's vaccine rollout is unknown.
- It remains unclear how the Fed would react to a bout of higher inflation, though senior loans should benefit from the expectation of rate increases.

## EMERGING MARKETS DEBT

### Current Market Conditions

- The broad EM credit index returned (0.8%)[24] in 1Q2021, while the EM high yield bond index returned 0.4%.[25]
- The rapid steepening of the U.S. yield curve pushed down the price of long-duration EM bonds, investment grade EM corporate bonds, local-market bonds, and EM currencies.
- However, rising U.S. interest rates had a very limited impact on the prices of EM high yield bonds or distressed credit, and the impact was partly offset by spread compression.
- The additional yield EM debt offers over developed markets debt may not fully compensate investors for credit risk in many countries, as the pandemic has increased debt burdens and lowered economic output.

### Outlook

*Opportunities*

- Issuers in utilities and other essential industries with inelastic demand profiles and strong balance sheets may be able to withstand sovereign credit-related risk or prolonged economic weakness in their respective countries.

*Risks*

- Many EM countries benefitted from low interest rates and inflation in 2020, but these trends may reverse, which would be particularly worrisome for countries that want/need to offer more fiscal support.

*Wildcards*

- The vaccine rollout could remain slow and uneven in many EM countries, though lockdowns are unlikely in most regions.
- Commodity prices could increase as global economic activity picks up. This could have a mixed impact on EM economies, with some benefitting while others struggle with inflationary pressures.

## PRIVATE CREDIT

### Current Market Conditions

- In the U.S., businesses are benefitting as states reopen and fiscal stimulus bolsters spending, but companies in industries most strongly impacted by the pandemic may require more financing solutions as forbearance ends.
- Leveraged buyout activity is back to healthy levels less than a year after Covid-19 shocked the market, creating new financing opportunities.
- In Europe, banks' credit standards have become more stringent, and non-performing loans are rising on banks' balance sheets.
- Demand for exposure to direct lending remains high and is continuing to grow in many major European markets, including Germany and the Netherlands.

### Outlook

*Opportunities*

- Private equity sponsors have high levels of dry powder available to drive deal flow.
- The need for refinancing should increase because certain direct lenders are experiencing stress and U.S. middle-market companies face a large maturity wall, as around $550 billion of debt comes due in the next few years.[26]
- Smaller European companies with pressing Covid-19-induced liquidity needs may be unable to easily access credit because banks dispensed so much capital in 2020.
- Divergence in performance between industries could grow, as the accelerating speed of vaccine rollouts in Europe will allow some sectors to recover sooner than others.

*Risks*

- Uncertainty about growth, inflation and interest rates makes it challenging to gauge how borrowers will perform over the medium or long term, particularly in industries most heavily affected by the pandemic.
- While the pace of vaccination in the UK has been swift and is accelerating in the EU after a sluggish start, risk remains that supply issues could cause it to slow in both areas.

*Wildcards*

- It's unclear how durable consumer and business behavioral shifts (e.g., work-from-home, ecommerce or aversion to travel) will be after the pandemic ends and how industries will respond.
- The president of the European Commission recently indicated that vaccinated U.S. travelers will be welcome in Europe this summer, which could potentially providing aid tourism-reliant economies.

## CONVERTIBLES

### Current Market Conditions

- The global convertible bond index earned 0.9% in the first quarter, though performance varied by region, with European convertibles' performance lagging year-to-date due to extended Covid-19 lockdowns.[27]
- Despite strong equity market performance, global convertible bonds generated only a marginal gain. The record pace of new issuance in the first quarter – a continuation of the surge seen in 2020 – led to near-term market indigestion, which caused convertible valuations to "cheapen" meaningfully in March (i.e., the fall in convertible prices was steeper than what would have been expected on the basis of their theoretical sensitivity to the changes in their underlying stocks).
- On the supply front, a record $58 billion of new issues were priced in the first quarter globally. This included around $40 billion in the U.S. [28]

### Outlook

*Opportunities*

- Some sectors that thrived during the pandemic are now experiencing weakness; however, rigorous case-by-case analysis may identify companies in these sectors with solid fundamentals whose convertibles can be purchased at bargain prices.
- Regions outside the U.S. may offer more attractive valuations and upside potential because so much of the U.S. economic reopening has already been priced into convertibles' valuations.

*Risks*

- Terms for new issues have become less attractive, particularly in the U.S., with some deals offering 0% coupons and conversion premiums over 60%.
- The secondary market has struggled to absorb the high level of new issuance.
- Convertibles for many growth-oriented companies appear to be richly priced and highly vulnerable if risk assets reprice.

*Wildcards*

- Predicting the trajectory and duration of the pandemic in various regions remains challenging given divergence in vaccine rollouts and reopenings.
- While equity market performance has remained strong overall in many regions, the steepening U.S. yield curve could continue to negatively impact high-growth companies' equity prices.

## STRUCTURED CREDIT

### Current Market Conditions

- An index representing a mix of CLOs and CMBS returned 4.3% in the quarter,[29] as optimism about vaccine rollouts and worries about rising rates made these investments more attractive.

**Corporate**

- CLOs continue to offer significant yield pickup over similarly rated bonds.
- Most senior tranches are at or near pre-pandemic spread levels.
- Default expectations for senior loans are declining as well as concerns about CLO tranche downgrades and defaults. This is increasing demand for CLOs from top-rated managers.
- Around two-thirds of respondents to a recent JP Morgan survey said they plan to add CLOs to their portfolios in the next six months.
- CLO issuance for the quarter, including refinancings and resets, came to a record $106 billion in the U.S. across 236 deals and €25 billion across 70 deals in Europe.[30]

**Real Estate**

- Debt backed by commercial real estate (CRE) benefitted from optimism about vaccination and reopenings.
- Despite the recovery in CRE, the prices of indices are still well below February 2020 highs.
- Delinquencies over 30 days in CMBS have continued to decline to well below June 2020 highs.

### Outlook

*Opportunities*

- Lower-rated CLO tranches with attractive structural and credit enhancements are less sensitive to changes in interest rates and may provide downside protection while still offering relatively attractive yields.
- European CMBS currently offer a significant spread pickup versus similarly rated U.S. CMBS.

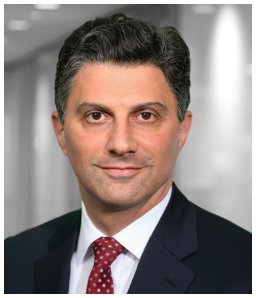
*Risks*

- Europe's initially sluggish vaccine rollout and extended lockdowns may have negatively affected businesses' fundamentals.

*Wildcards*

- A rising-rate environment can be beneficial for structured credit products such as CLOs, given their floating-rate structure and shorter duration; however, investors have already crowded into this area, pushing up prices, and the short-term interest rate trajectory is unknown.
- The pandemic's long-term effects on CRE are unknowable.

# ABOUT THE AUTHORS



### ARMEN PANOSSIAN
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Mr. Panossian is a managing director and Oaktree's Head of Performing Credit, as well as portfolio manager for Oaktree's Strategic Credit strategy. His responsibilities include oversight of the firm's performing credit activities including the senior loan, high yield bond, convertibles, structured credit, emerging markets debt, mezzanine and direct-lending strategies. Mr. Panossian also serves as co-portfolio manager for Strategic Credit's Life Sciences Direct 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 Distressed Debt investment team. 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 the product specialist for Oaktree's multi-strategy credit business, as well as a member of Oaktree's Global Credit Investment Committee. She also oversees the firm's Product Specialist Group and its three core, closely related activities: product investor relations, product marketing, and product development support. Prior to joining Oaktree in 2014, Ms. Poli worked at PAAMCO, where she was a senior analyst helping manage fund of hedge fund portfolios for institutional investors. Ms. Poli received a B.S. degree from USC's Marshall School of Business, and an M.B.A. from UCLA's Anderson School of Management, where she was recipient of the Laurence and Lori Fink Investment Management Fellowship. Ms. Poli is a CAIA charterholder.

# ABOUT 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 $46.7 billion in AUM and approximately 190 investment professionals.[31]

## END NOTES

[1] Credit Suisse Leveraged Loan Index; FTSE High Yield Cash-Pay Capped Index

[2] Bloomberg Barclays U.S. Government/Credit Index

[3] JP Morgan CEMBI Broad Diversified Index

[4] JP Morgan High Yield Bond and Senior Loan Report

[5] Bank of America

[6] JP Morgan

[7] The indices used in the graph are: Bloomberg Barclays Government/Credit Index, FTSE High-Yield Cash-Pay Capped Index, ICE BofA Global Non-Financial HY European Issuers ex-Russia Index (EUR Hedged), Credit Suisse Leveraged Loan Index, Credit Suisse Western European Leveraged Loan Index (EUR hedged), JP Morgan CEMBI Broad Diversified Index, JP Morgan Corporate Broad CEMBI Diversified High Yield Index (Local), Thomson Reuters Global Focus Convertible Index (USD Hedged), S&P 500 Total Return Index, and FTSE All-World Total Return Index (Local).

[8] FTSE High Yield Cash-Pay Capped Index

[9] JP Morgan High Yield Bond and Senior Loan Report

[10] JP Morgan High Yield Bond and Senior Loan Report

[11] JP Morgan Default Monitor

[12] ICE BofA Global Non-Financial High Yield European Issuer Excl. Russia Index

[13] Based on the ICE BofA Global Non-Financial High Yield European Issuer Excl. Russia Index

[14] S&P Global Leveraged Commentary & Data

[15] JP Morgan Default Monitor

[16] JP Morgan High Yield Bond and Senior Loan Report

[17] S&P Global Leveraged Commentary & Data

[18] JP Morgan Default Monitor

[19] JP Morgan High Yield Bond and Senior Loan Report

[20] Credit Suisse Western European Leveraged Loan Index

[21] S&P Global Leveraged Commentary & Data

[22] Credit Suisse

[23] Credit Suisse Leveraged Loan Index

[24] JP Morgan CEMBI Broad Diversified Index

[25] JP Morgan Corporate Broad CEMBI Diversified High Yield Index

[26] Refinitiv

[27] Thomson Reuters Global Focus Convertible Index

[28] Bank of America

[29] Blended Structured Credit Index: 50% JP Morgan CLO BB Post-Crisis Index, 50% Barclays US CMBS 2.0 Baa Index

[30] JP Morgan

[31] The AUM figure is as of March 31, 2021 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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