OAKTREE INSIGHTS

AUGUST 2020

PERFORMING CREDIT QUARTERLY

2Q2020

OAKTREE

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OVERVIEW

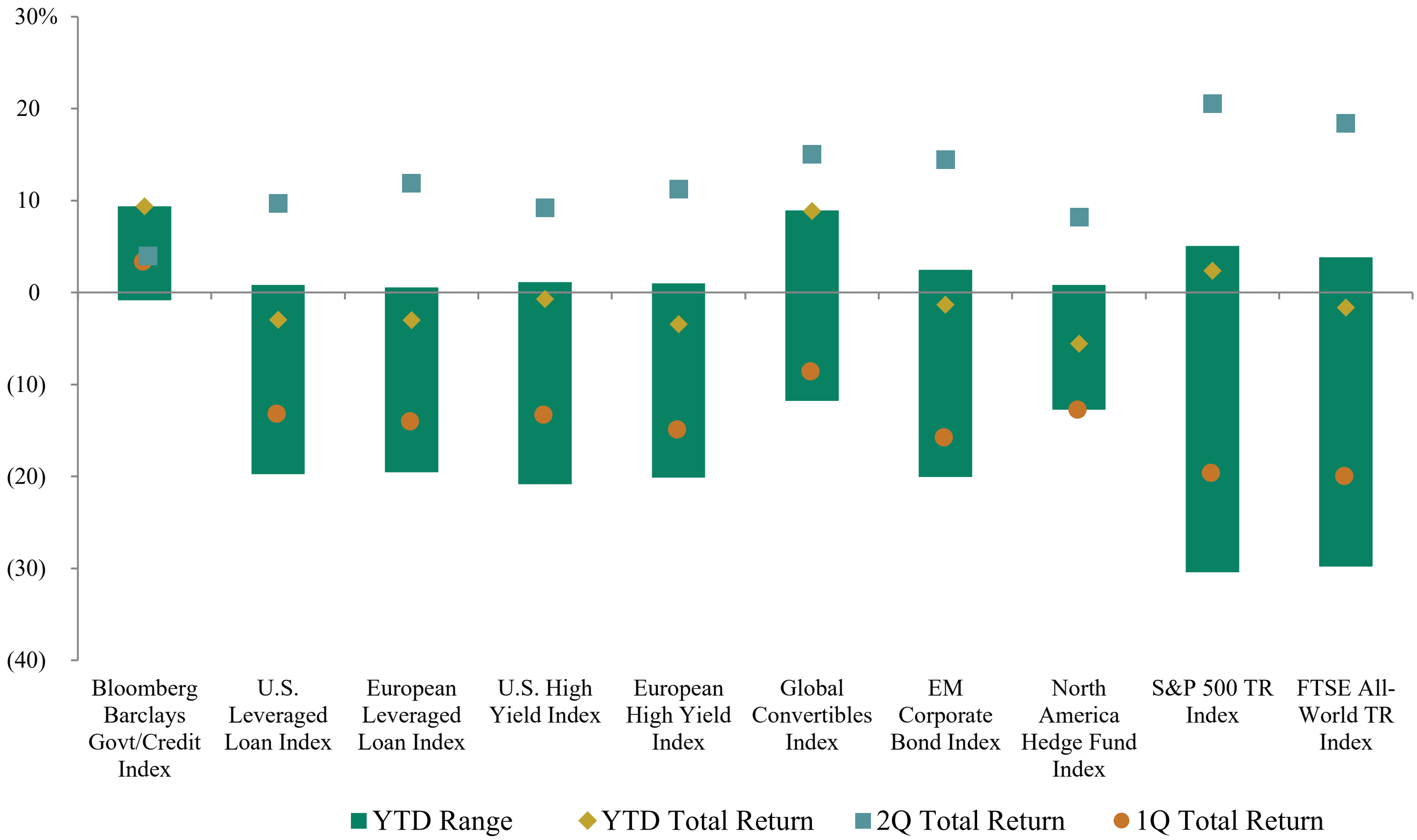
Credit markets strengthened in May and further extended their gains in June, making the second quarter a period of meaningful recovery following the extreme downdraft in March. Spreads tightened across the credit spectrum, with some sectors and asset classes retracing a good portion of the widening we saw in March. Liquidity injected into the markets by central banks has allowed investors to look past the "valley" of lost output during the pandemic, and today's pricing of risk assets indicates an expectation for a quick economic recovery. Additionally, retail investors have helped buoy the equity markets, and there is evidence that U.S. stimulus dollars have been plowed back into the stock market.

Especially given the strong appreciation in both debt and equity markets in 2Q, we see reason to be cautious. Certain countries and U.S. states that reopened are seeing alarming increases in Covid-19 cases, with some regions reverting to lockdown measures. The fits and starts we've seen in some economies have caused companies to file for bankruptcy, with serious consideration given to permanently winding down operations. We expect numerous industries to experience several years of stress and distress as businesses reassess all aspects of their costs, including how they use real estate, whom they employ and where, and how they distribute their products. Although the impact of retail buying has been a meaningful positive for asset prices, it is easy to envision a panic scenario in which these investors are shaken by bad news around economic performance and therefore choose to quickly exit the markets. The momentum such panic can bring would likely lead to significant outflows from retail mutual funds and ETF accounts. Independent of the pandemic, the U.S. election presents additional uncertainty around fiscal and monetary policy as we approach November.

Apart from the U.S. government's seemingly limitless support of financial markets, we are seeing progress in vaccine development, as well as improved testing for Covid-19 antigens and antibodies. These measures will help remote workers get back to the office sooner; however, we believe it will be at least six to 12 months before a viable vaccine becomes approved for administration.

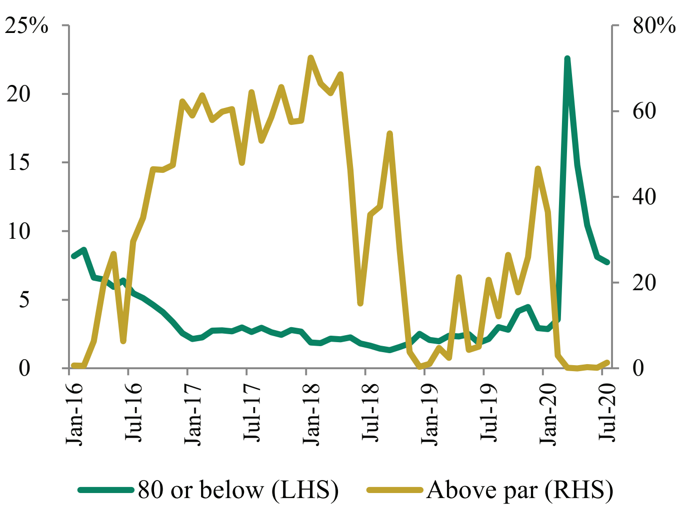
Looking ahead, we anticipate further volatility in the markets, and our focus remains on constructing credit portfolios that are higher in quality and more conservatively positioned than usual. We are mindful of protecting capital and, where possible, reserving dry powder to be able to go on the offense quickly if buying opportunities present themselves. In the public markets, we continue to rotate out of names and sectors that have outperformed expectations and could be challenged if the recovery slows. In private investments, we are tracking a few themes, including life sciences investments targeting life-changing treatments that may continue to have case growth regardless of economic activity; businesses facing pent-up demand that should benefit from a catch-up as the economy recovers; and businesses benefitting from Covid-19, although we do not expect to see discounted valuations in this area unless yield spreads move dramatically wider.

PERFORMANCE OF SELECT INDICES[1]

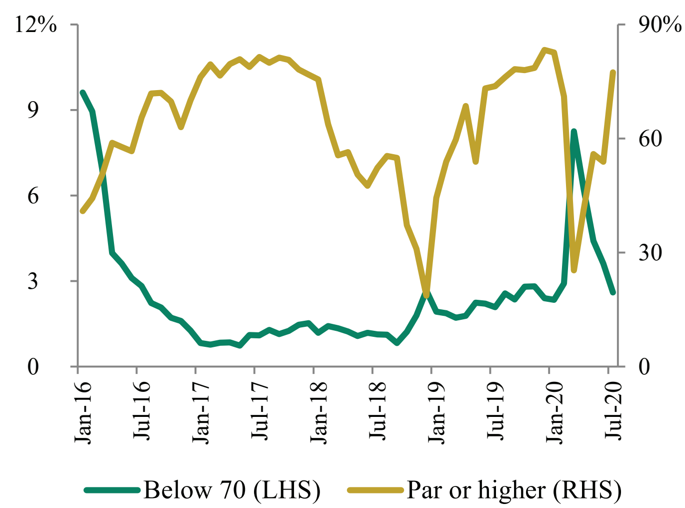


Note: Year-to-date data as of July 31, 2020, with the exception of the hedge fund index performance, which is as of June 30, 2020.
Source: FTSE, Bloomberg Barclays, Bloomberg, Credit Suisse, ICE BofA Merrill Lynch, J.P. Morgan, Refinitiv, HFR.

LEVERAGED LOAN PRICES



HIGH YIELD BOND PRICES



Source: Credit Suisse, ICE BofA Merrill Lynch

HIGH YIELD BONDS

Current Market Conditions

- In a roaring recovery from 1Q, U.S. high yield bonds gained 9.2% in 2Q.[2] Strong performance by CCC-rated bonds helped fuel the rally.
- In addition to sharing in the broad rally in risk assets, high yield bonds also got a boost from the Fed when it extended its bond-buying facility to include fallen angels and high yield bond ETFs.
- This support spurred new issuance in the U.S. New issues in 2Q totaled $139 billion, making it the most active quarter in history.
- In Europe, the high yield bond market recorded its best quarterly performance since the aftermath of the Global Financial Crisis, with the index rising 11.2% in 2Q.[3] Sustained government stimulus and the gradual reopening of economies tempered default expectations. Similarly to the U.S., CCCs were the top performers.
- Issuance in Europe totaled €17.8 billion in 2Q, the lowest since 1Q2019.

Outlook

Opportunities

- Issuers aren't as desperate today as they were in March. Still, the quality of new issuance has been high. Most new deals are aimed at bolstering liquidity or refinancing near-term maturities. The terms of such offerings tend to be more creditor-friendly than those issued to finance LBOs.
- The influx of fallen angels has broadened our opportunity set.
- European high yield bond spreads remain above historical averages, which we believe provides fair compensation for heightened credit risk.

Risks

- The high yield bond asset class is no longer a screaming bargain. With the average price in the mid-90s as of June 30, versus in the mid-80s on March 31, there's less potential for capital appreciation.

Wildcards

- While we seek to keep our default rate low relative to the market, we also recognize that our investments won't be immune to all credit problems in these challenging times.

SENIOR LOANS

Current Market Conditions

- U.S. senior loans rose 9.7% in 2Q in one of the strongest rallies in a decade.[4]
- New CLO formation picked up in the quarter, driving institutional demand for loans.
- Defaults totaled $76 billion across bonds and loans, the second-highest quarterly total on record. The trailing-12-month default rate hit 3.96%. The recovery rate, as of June 30, was at a record low of 47.3%.
- European senior loans had their best quarter since the aftermath of the GFC, gaining 11.9%.[5] As in the U.S., lower-rated loans outperformed.
- Despite rising defaults elsewhere, the European market saw none in 2Q. The trailing-12-month default rate was 0.6%.
- European senior loan issuance totaled €11.8 billion in 2Q, the lowest since 2015.
- The European market saw modest CLO issuance. Demanded yields of CLO liabilities continued to decline, which could encourage issuance in the second half of 2020.

Outlook

Opportunities

- We expect loans to remain particularly attractive, as their secured status can add resilience to portfolios in an environment of greater defaults.
- In the U.S., technicals seem likely to support the loan market given limited indicated new issue supply, heightened CLO activity and slowing retail outflows.
- European loan spreads are attractive even with the recent rally. Average prices still allow for potential principal gains.

Risks

- Defaults have yet to materialize in European credit markets.[6] Prioritizing default avoidance while seeking to participate in attractively priced loans will be crucial.

Wildcards

- In addition to deteriorating issuer fundamentals, muddying the waters are many unknowns regarding the virus and the lack of clarity into true earnings disruption.

EMERGING MARKETS DEBT

Current Market Conditions

- In 2Q, investor sentiment flipped from panic selling to panic buying, as investors looked beyond the rising Covid-19 cases and deaths globally, supply-chain disruptions, and the dramatic plunge in corporate earnings and global GDP.
- Helping shift the market sentiment in EM were liquidity injections and reflationary policy responses by developed market governments, which included debt-purchase programs expanded to include corporate bonds and ETFs.
- Such developments caused prices of higher-grade EM credits to soar and their credit spreads to collapse.
- The biggest problem in this phase of the economic cycle is liquidity, not solvency, for investors and issuers alike.
- A restart in mobility and industrial activity in the northern hemisphere helped boost commodity prices, particularly in energy, petrochemicals and metals.
- Private sector financing and debt restructuring remain key issues for emerging economies.

Outlook

Opportunities

- We remain focused on finding mispriced assets. A lack of patient capital in EM, reflected in bouts of indiscriminate selling during crises, may lead to opportunities.
- Underpinning our positive near-term outlook is our focus on idiosyncratic performance drivers, rather than on fiscal or monetary policy.

Risks

- A slowdown in global growth and trade may cut into EM government finances.
- Any debt restructuring process can include confrontational aspects and runs the risk of delays.

Wildcards

- Many EM nations entered the Covid crisis in poor shape, with stagnating economies, high debt levels and stressed public health systems. The full extent of the damage from the pandemic and global recession, including on budgets and ratings downgrades, remains uncertain.

PRIVATE CREDIT

Current Market Conditions

- Stimulus measures and a recovery in financial markets have reduced the imminent capital needs of many companies.
- Most middle-market companies have been impacted by Covid-19, making valuation more challenging.
- Many borrowers are seeking new loans to fund small add-ons, increase liquidity or capitalize on strong Covid-related growth potential.
- The pronounced snapback in the U.S. equity and leveraged finance markets might suggest a stronger economy, but we're not yet seeing meaningful improvement in revenue or profitability among middle-market companies.
- In a shifting landscape, lenders appear poised to recapture some of the covenant protections they forfeited over the last 3-5 years.
- Traditional debt markets remain dislocated or distressed in Europe, and European banks continue to avoid most lending, except for investment-grade borrowers.

Outlook

Opportunities

- We believe compelling private investment opportunities may be even more plentiful in 2H2020. Lenders with dry powder may find an improved environment for lending.
- Still, our focus today is on maintaining a conservative approach. We're emphasizing themes that we believe will be more resilient in a potential downturn.
- While many lenders in Europe focus on lending to financial sponsors, demand exists for flexible financing in many other parts of the market.

Risks

- Company fundamentals remain at risk. Temporary payroll cuts may become permanent, prolonging elevated unemployment rates and impacting consumer spending.

Wildcards

- The U.S. presidential election in November adds even more uncertainty to investors' growing list of concerns.

CONVERTIBLES

Current Market Conditions

- The global convertible bond index rose 15.0% in 2Q.[7] Gains were driven by global equities, which recovered more than half of their losses from 1Q as governments continued to roll out stimulus programs of unprecedented scale.
- By region, the U.S. stock market was the best performer. By sector, consumer discretionary and information technology were top performers, supported by a rebound in the global economy and the growing work-from-home trend.
- In the U.S., new issuance of convertible bonds soared to record levels in 2Q, with 95 issuers raising $57.6 billion. The pandemic spurred demand for capital from companies in need of either rescue financing (mostly travel-related issuers) or growth capital (those benefiting from the work- or shop-from-home trends).
- Deal flow also picked up outside the U.S., with $16.1 billion coming to market across 31 deals. By geography, issuance was largely split between Europe and Asia ex-Japan.

Outlook

Opportunities

- Pricing on new deals has improved due to the uncertainty created by Covid-19.
- We remain focused on seeking high-quality businesses with upside potential. We continue to believe that the defensive nature of convertible bonds, coupled with the potential for future upside participation, makes this asset class a compelling opportunity today.

Risks

- The potential for another wave of Covid-19 poses a risk to equity valuations, with some regions already experiencing a resurgence of cases that may extend the path to recovery.

Wildcards

- High correlation with equity markets overall remains both a key risk and an opportunity amid Covid-related uncertainty.

STRUCTURED CREDIT

Current Market Conditions

- Structured credit was slower than other credit asset classes (e.g., high yield bonds and senior loans) to benefit from pandemic-related policies, but we've seen the return of demand for structured credit opportunities.
- Corporate CLO prices improved, as a rally that was once limited to higher-rated tranches began to reach other tranches broadly. BBB-rated CLOs, which had dipped to prices in the mid-60s, rose to the low-90s by the end of 2Q. BBs recovered from the low-50s to the low-80s.
- Both the primary and secondary CLO markets are seeing higher demand. New issues have higher-quality collateral and better-enhanced debt tranches than pre-Covid issues. Prices of secondary CLO debt tranches improved, driven by new opportunistic capital.
- Real estate-related structured credit lagged corporate credit as prices remained under pressure. Assets have recovered unevenly by industry, presenting total return opportunity for select conservatively underwritten investments.

Outlook

Opportunities

- Despite the bounce off of the lows, opportunities remain in CLOs, particularly given the structural protections offered by certain BBB and BB tranches.
- We are focused on seeking “loss-remote” positions that can provide downside protection.
- We believe it’s key to be cautious yet ready to transact, so as to quickly capture potential opportunities as they arise.

Risks

- Commercial properties (particularly in the already-challenged retail and hospitality sectors) are still facing headwinds from global quarantine measures and changes in consumer behavior.

Wildcards

- We are mindful of the positive impact of stimulus programs on consumer credit, as well as multifamily and industrial rent collections, and the challenges that would occur if government support programs are not continued.

ABOUT THE AUTHORS

ARMEN PANOSSIAN

Head of Performing Credit and Portfolio Manager

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 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.

DANIELLE POLI

Managing Director, Multi-Strategy Credit Product Specialist and Head of Product Specialist Group

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 $40.6 billion in AUM and approximately 190 investment professionals.[8]

END NOTES

[1] The ten indices used in the graph are the following, from left to right: Bloomberg Barclays Government/Credit Index; Credit Suisse Leveraged Loan Index; Credit Suisse Western European Leveraged Loan Index (EUR hedged); FTSE High-Yield Cash-Pay Capped Index; ICE BofA Global Non-Financial HY European Issuers ex-Russia (EUR Hedged); Thomson Reuters Global Focus Convertible Index (USD Hedged); J.P. Morgan Corporate Broad CEMBI Diversified High Yield Index (Local); HFRX North America Hedge Fund Index; S&P 500 Total Return Index; and FTSE All-World Total Return Index (Local). The HFRX index data is as of June 30, 2020, as July data was not available at the time of print.

[2] FTSE High-Yield Cash-Pay Capped Index

[3] ICE BofA Global Non-Financial HY European Issuers ex-Russia (EUR Hedged)

[4] Credit Suisse Leveraged Loan Index

[5] Credit Suisse Western European Leveraged Loan Index (EUR Hedged)

[6] As of July 27, Fitch Ratings pegged the European loan default-rate forecast for FY 2020 at 3.8%.

[7] Thomson Reuters Global Focus Convertible Index (USD Hedged)

[8] The AUM figure is as of June 30, 2020, 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.

NOTES AND DISCLAIMERS