OAKTREE INSIGHTS

NOVEMBER 2020

PERFORMING CREDIT QUARTERLY

3Q2020

OAKTREE

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OVERVIEW

Credit and equity markets continued to gain in the third quarter. Most of the 3Q gains came in the first two months of the period, fueled by improving economic data and consumer sentiment; hope for progress on a Covid-19 vaccine; and ongoing government stimulus measures. Policymakers' apparent readiness to provide further support was another strong tailwind for the markets. Equity valuations remained lofty, especially in the tech sector, and yield spreads offered by high yield bonds and senior loans continued to tighten from the wide levels of March.

However, September proved rocky for risk assets, as a confluence of concerns — regarding a renewed wave of Covid infections, a standstill in Washington on additional fiscal stimulus and the U.S. elections — weighed on investors. September's turbulence interrupted what had been a resounding recovery from the depths of the selloff in the spring, and markets now look to have entered a sideways period. The economy, too, grinds ahead but is facing headwinds.

Given this backdrop, we are approaching the fourth quarter defensively. We attribute the recent rally in risk assets not to fundamental improvement in the economy and markets, but rather to very low interest rates — a factor that causes investors to accept lower prospective returns and encourages risk taking. To borrow from our Co-Chairman Howard Marks, "When uncertainty is high, asset prices should be low, creating high prospective returns that are compensatory. But because the Fed has set rates so low, returns are just the opposite. Thus the odds aren't on the investor's side, and the market is vulnerable to negative surprises." Looking to 4Q, we see ample possibility for negative surprises, particularly regarding Covid-related developments, elections and Brexit.

Our Performing Credit businesses invest in large markets with diversified issuer bases, and we have the ability to skew our portfolios toward more-stable and lower-risk sectors — which today mean those that are unaffected or even positively impacted by Covid. In this regard, we are finding interesting opportunities in the convertible bonds of life sciences and technology companies, which are helping to provide healthcare solutions and cater to the "stay at home" economy. In addition, we're seeing direct lending opportunities in support of leveraged buyouts of businesses that are proving resilient in the face of Covid. We are also lending to businesses that are not easily underwritten via traditional cash flow-based methodologies. Finally, we're monitoring the rescue lending landscape, an area in which we were quite active during 2Q. The opportunity set is less attractive today, but we're tracking a variety of potential deals that we expect to materialize over the next several months.

We believe the economic strain produced by Covid-19 will be felt for several more quarters, if not years. Elevated unemployment and muted GDP growth are likely to persist in the global economy. More than ever, it is important to be wary of market exuberance and to avoid chasing risky investment opportunities to tighter levels or weaker legal protections. We remain focused on protecting the downside in our investments and seeking appropriate compensation for risks taken.

PERFORMANCE OF SELECT INDICES[1]

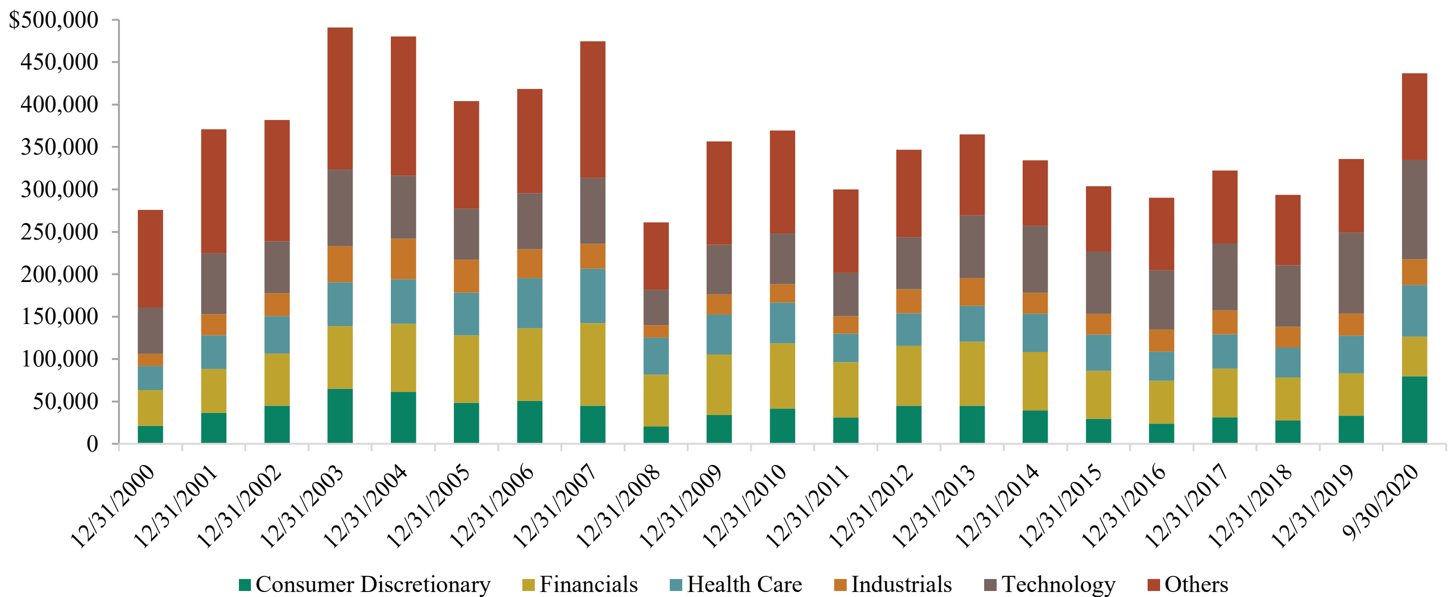
20%
10
0
(10)
(20)
(30)
(40)

Bloomberg Barclays Govt/Credit Index
U.S. Leveraged Loan Index
European Leveraged Loan Index
U.S. High Yield Index
European High Yield Index
Global Convertibles Index
EM Corporate HY Bond Index
North America Hedge Fund Index
S&P 500 TR Index
FTSE All-World TR Index

YTD Range
YTD Total Return
3Q Total Return

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

TOTAL MARKET VALUE OF GLOBAL CONVERTIBLE SECURITIES MARKET BY SECTOR



As of September 30, 2020
Source: ICE Bank of America - Merrill Lynch Convertible Research.

HIGH YIELD BONDS

Current Market Conditions

- U.S. high yield bonds gained 4.9% for the third quarter. Strong returns in the first two months of 3Q were partially offset in September, when rising Covid cases, a stalemate over fiscal stimulus and a glut of supply sent prices down.[2]
- U.S. issuance for the quarter totaled $126 billion, the second-highest quarterly tally on record, just behind the $140.5 billion printed in 2Q.[3]
- As of quarter-end, the rolling-12-month default rate stood at 4.5%. This compares with 2.4% at the end of 3Q2019.
- European high yield bonds also started the quarter strong but saw a halt to the rally in September. The asset class returned 2.6% in 3Q.[4]
- The default rate in the European high yield bond market was 2.9% as of September 30, the highest level since 2012 and up from 1.0% a year earlier.
- Issuance in Europe totaled €21.6 billion in 3Q, with a strong July and September offsetting a quiet August.
- The European high yield bond market has faced a lack of supply relative to its investment grade and U.S. counterparts. With governments quick to provide liquidity and fewer fallen angels than initially anticipated, there is little to suggest demand will be satisfied in the near term.

Outlook

Opportunities

- Despite recent tightening, yield spreads remain significant and wider than historical levels, representing good value.
- We're keeping a defensive tilt in our portfolios, with a focus on higher-quality bonds, rather than stretching for yield.
- We expect supportive technicals to continue in Europe.
- The dispersion in the pace of recovery by sector creates opportunity for skilled managers to identify deeply discounted bonds that have the potential to recover.

Risks

- Though we are focused on keeping our own default rate lower than that of the market, these investments aren't immune to credit problems, especially with many industries experiencing stress and Covid cases rising again in the U.S. and Europe.

Wildcards

- With the U.S. election and Brexit ahead, market volatility is all but guaranteed. The uncertainty around the severity of the next bout of turbulence means disciplined credit research will be central to building a portfolio with optimal yield and less default risk than the bond universe.

SENIOR LOANS

Current Market Conditions

- U.S. senior loans rose 4.1% in 3Q, thanks in part to a favorable technical backdrop driven by strong CLO formation. The lower-quality segment rallied the most.[5]
- U.S. loan issuance totaled $67.8 billion, up from 2Q but well below historical norms. CLO issuance totaled $26.5 billion, with an assist from September's $12 billion, the highest monthly figure since February.
- The trailing-12-month default rate for the U.S. market hit 4.2% at quarter-end, versus 1.4% a year earlier.
- European senior loans earned 2.8% in 3Q.[6] After 1Q's plunge in prices, steady positive returns have brought the market to within touching distance of its pre-Covid levels.
- European senior loan issuance was €16.4 billion in 3Q, up from €11.1 billion in 2Q.
- The default rate in the European senior loan market was 1.1% as of September 30. This compares with a 0% default rate a year earlier.
- The European CLO market is slowly returning to life, with warehouse clear-out adding some supply.

Outlook

Opportunities

- Despite the recent rally, upside remains in U.S. and European senior loans, which offer relatively attractive yields. Protective traits inherent in senior loans, such as first lien security, can help fortify a portfolio against volatility.
- We believe now is the time to be cautiously positioned but attentive to the opportunities presented by volatility.

Risks

- With a heavier debt load and business activity levels far from normal, companies are generally in a worse credit position.

Wildcards

- An economic recovery will eventually drive interest rates higher from current historical lows. Senior loans will be well positioned to benefit due to their floating-rate nature. At the same time, rates are expected to stay low for a while, and any change will be subject to the pace of the economic recovery.

EMERGING MARKETS DEBT

Current Market Conditions

- The broad EM credit index rose 2.3% in 3Q, and the EM high yield bond index gained 2.9%.[7] Performance was subdued compared with the sharp gains in 2Q, partially due to a modest sell-off in the final weeks of the quarter.
- Finding value is difficult in today's EM credit markets, as investors continue to chase yield irrespective of credit quality. Although the yield spread on the EM bond index is at the ten-year average, this spread is over ultra-accommodative interest rates, providing little, if any, margin of safety. In our opinion, 3Q's record issuance of U.S. dollar-denominated EM debt will prove abundantly rewarding to issuers and a disappointment to investors.
- Gains in EM debt over recent months owe to various factors, including improving investor sentiment, growing global demand and supportive financial conditions.
- Still, the speed of economic recovery varies widely across EM countries, influenced by pandemic- and policy-related developments, and by recoveries in major trading partners.
- Most EM currencies appreciated in 3Q, but the more challenged countries (e.g., Russia and Turkey) saw their currencies deteriorate further against the USD.

Outlook

Opportunities

- We believe EM debt selectively offers modest relative value over developed market debt; hence, our investment posture remains defensive.
- We're focused on essential industries (e.g., utilities) and businesses that have strong balance sheets, which should help them withstand volatility. We are avoiding debt with near-term maturities.

Risks

- Economic activity and outlook have recently improved in certain emerging markets, but weakness may persist in EM corporate profitability and liquidity.
- 3Q has seen a rise in geopolitical risks in some markets, notably Russia and Turkey.

Wildcards

- The capacity of many EM countries to rein in the virus's spread remains a concern. A renewed surge in cases could disrupt economic recoveries, with little room for policy support. Lockdowns in advanced economies could lead to another bout of shrinkage in global demand and trade.

PRIVATE CREDIT

Current Market Conditions

- Market trends continue to move in favor of mezzanine lenders; we're seeing higher cash coupons than in quarters past and record levels of equity contributions in LBOs.
- M&A and LBO activity has picked up. U.S. direct lenders are finding limited competition from unitranche providers and struggling BDCs as they work through troubled portfolios.
- In Europe, we're observing an unprecedented need for new liquidity across sectors.
- European banks have been a key conduit for liquidity during the current economic slowdown, significantly expanding their balance sheets. The increased debt load and continued economic challenges could lead to an even greater need for liquidity to allow businesses to deleverage.
- Unlike in the European sponsor-lending market, there has not been a marked dilution in returns for lending to middle-market non-sponsor counterparts.

Outlook

Opportunities

- Growing conservatism among senior and unitranche lenders could drive borrowers to seek second lien and mezzanine financing.
- In Europe, where banks are less likely to sell off debt and operational restructuring is very costly, we believe providing liquidity to dislocated companies will be a more-attractive distress opportunity than buying secondary debt.
- We're focused on lending to high-quality companies temporarily unable to access conventional debt financing.

Risks

- Fund-level leverage will continue to "tighten the screws" on the more-aggressive direct lenders.

Wildcards

- Today's market pricing could easily be disrupted. Meanwhile, business fundamentals remain at risk, particularly in Europe as a second wave of the virus brings new constraints on doing business.

CONVERTIBLES

Current Market Conditions

- The global convertible bond index earned 5.5% in 3Q, supported by strong underlying returns on equities.[8]
- At the sector level, consumer discretionary and information technology stocks generated the largest gains, while those in the energy sector experienced losses.
- Notably, "quarantine" stocks (those benefitting from the pandemic, such as remote-learning and telemedicine companies) sharply outperformed "recovery" stocks (those that won't benefit until economies reopen, such as travel companies).
- In the U.S., 47 issuers raised $22 billion in new convertible bonds in 3Q. This lifted the year-to-date figure to over $105 billion, more than twice the amount raised in the comparable period in 2019.
- Outside the U.S., the convertibles market saw $12.9 billion of new issuance come to market across 27 deals. Issuance activity was busiest in Europe, followed by Asia ex-Japan.
- Similar to in 2Q, sectors with the highest issuance volume were information technology and consumer discretionary.

Outlook

Opportunities

- We believe today's uncertain environment bodes well for our balanced convertible strategy, which has defensive characteristics coupled with the potential for equity upside.
- Pricing on new deals has improved, and the healthy new issuance calendar continues to be a good source of opportunities.

Risks

- A resurgence of Covid-19 cases in the U.S. and Europe, as well as new restrictions in certain regions, poses a risk to equity valuations.

Wildcards

- Market volatility remains above normal, and many crosscurrents — economic and political — are present.
- Convertible bonds' high correlation with equities remains both a risk and an opportunity amid Covid-related uncertainty.

STRUCTURED CREDIT

Current Market Conditions

- Structured credit maintained its upward trend in the third quarter, driven by a lift in investor sentiment and modest improvement in economic data.
- Higher-quality CLOs (rated A and higher) saw spreads retrace to their pre-Covid levels. In contrast, spreads for BBB- and BB-rated CLOs have moved sideways since June.
- Following the usual lull in late summer, new CLO issuance picked up in September, totaling $13.1 billion for the month across the U.S. and Europe, the highest monthly tally in 2020.
- Debt backed by corporate real estate assets recovered in 3Q. BBB- CMBS spreads ended the quarter at 550 bps, 125 bps tighter than a quarter earlier.
- The recovery in commercial real estate debt can be attributed to (a) fewer-than-expected delinquencies, (b) favorable supply/demand technicals as flows into real estate structured credit are met with reduced issuance, and (c) increased optimism for direct government intervention to support the commercial real estate market.

Outlook

Opportunities

- We believe we are in a credit picker's market, where credit differentiation is key and managers will be rewarded for identifying winners created during this pandemic.
- We continue to invest higher in the capital structure, prioritizing positions that we perceive to be loss-remote while offering attractive return potential.
- Our U.S and European CLO activity is focused on cleaner new issues rated BBB and BB. This reflects a shift in our pipeline away from the deeply discounted BBB and BB CLOs that were available earlier in the year.

Risks

- The hospitality and retail sectors continue to face challenges. We remain concerned about consumer credit.

Wildcards

- We're watching for further government support. The HOPE Act, for instance, would establish a preferred-equity facility for CMBS borrowers. Such a development would ultimately prove positive for real estate structured credit.

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.

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Managing Director, Multi-Strategy Credit Product Specialist and Head of the 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 $43.2 billion in AUM and approximately 190 investment professionals.[9]

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 August 31, 2020, as September data was not available at the time of print.

[2] FTSE HY Cash-Pay Capped Index

[3] S&P Global Market Intelligence

[4] ICE BofAML HY European Issuers Constrained Index ex. Russia and Financials (Euro Hedged)

[5] Credit Suisse Leveraged Loan Index

[6] CS Western European Leveraged Loan Index (Euro hedged)

[7] J.P. Morgan Emerging Markets Bond Index Global, J.P. Morgan Corporate Broad CEMBI Diversified High Yield Index Level (LOC)

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

[9] The AUM figure is as of September 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.

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