

# OAKTREE INSIGHTS

FEBRUARY 2021

## PERFORMING CREDIT QUARTERLY 4Q2020



OAKTREE

# PERFORMING CREDIT QUARTERLY 4Q2020

## OVERVIEW

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Vaccine-fueled confidence sustained a credit market rally in the fourth quarter. Comfort around the U.S. general elections and the likelihood of government stimulus under the new administration added to the strength in debt and equity markets globally.

The pace of U.S. high yield bond issuance was “all gas, no brake” during the fourth quarter, with \$96 billion raised, bringing the year’s tally to a record \$457 billion.<sup>1</sup> New issues were met with exceptional demand, which combined with the low-yield environment to push the average new-issue coupon to the lowest in recent history of 6.0%.<sup>2</sup> Even in the U.S. leveraged loan market — which had seen muted issuance activity for much of 2020 after nearly \$200 billion printed in the first quarter — heavy fourth-quarter issuance of \$109 billion boosted the year’s total to nearly \$422 billion.<sup>3</sup> Leveraged finance markets in Europe are running on similar momentum. Such access to capital, which came with central banks’ bolstering of financial markets in response to the crash in March, has led to more-benign debt maturity schedules and lower-than-expected default rates. Defaults are expected to trend down in 2021 given the lower level of distressed debt in the market overall, and the prospect of continued low interest rates could presage another potentially active year of debt financing in 2021.

The pace of financing activity, continued support for higher prices, and persistent demand for risk assets throughout the final quarter of the year defied weak economic fundamentals. Risk-taking was reinforced not by a solid recovery in the economy but primarily by vaccine-related optimism, accommodative central bank policies and hope for additional stimulus. To be sure, we recognize that these are encouraging factors. At the same time, however, the U.S. economy faces elevated unemployment and slowing gains in consumption, among other indications of a stalled recovery, particularly as it confronts the latest surge in Covid cases and related business restrictions. Similarly, economies around the world are experiencing subdued recoveries with muted growth expectations and challenges in public health, central banking and debt management. The backdrop for markets will continue to be dominated by responses to Covid-19, as well as political dynamics that will shape policies at home and relations among nations.

Investing in 2021 will require a major balancing act between managing short-term risks and considering long-run possibilities. In this environment, Oaktree is moving ahead with a defensive bias overall, while also working to benefit from continued progress in the fight against the pandemic and to make tactical moves to take advantage of opportunities arising from dislocations.

## OVERVIEW (CONTINUED)

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Oaktree's Performing Credit strategies have the benefit of a broad yet integrated platform and are able to seek attractive investments while maintaining a value-oriented approach. In our liquid credit strategies, we are mindful that the highest-quality cohorts of those markets are priced at or above their call prices, meaning there could be risk to current prices if companies miss performance estimates or if there is volatility in Treasury yields. We are actively managing our portfolio so that credit quality — not interest rates or duration — is the determining factor in our performance.

We are finding attractive investment opportunities in our illiquid credit strategies, including privately negotiated loans to a variety of borrowers. In 2020, we were active in lending to fast-growing life sciences companies and in rescue lending to businesses in need of liquidity due to coronavirus-related challenges. We think the impact of the virus on the profitability of certain industries will weigh on performance for several years, causing elevated default rates in some sectors. As such, our Performing Credit strategies are looking to identify candidates for highly structured rescue loans, which can be fashioned and delivered by our Opportunistic Credit strategies, which seek to capitalize on individual credits in disrupted or mispriced situations. While the recovery in the markets has reduced the size of this opportunity set and reduced some companies' level of desperation, we still expect to originate potentially attractive rescue loans over the next few years.

In structured credit, we saw CLO prices materially dislocate in early 2020, only to recover nearly the entirety of their declines by year-end. Today, we find that CLOs offer attractive risk-adjusted return potential versus other areas of corporate credit, especially when comparing returns of similarly rated securities. Real estate-related structured credit, which also took a hit in early 2020, was slower than CLOs to rebound, but prices have continued to make steady progress through the end of the year.

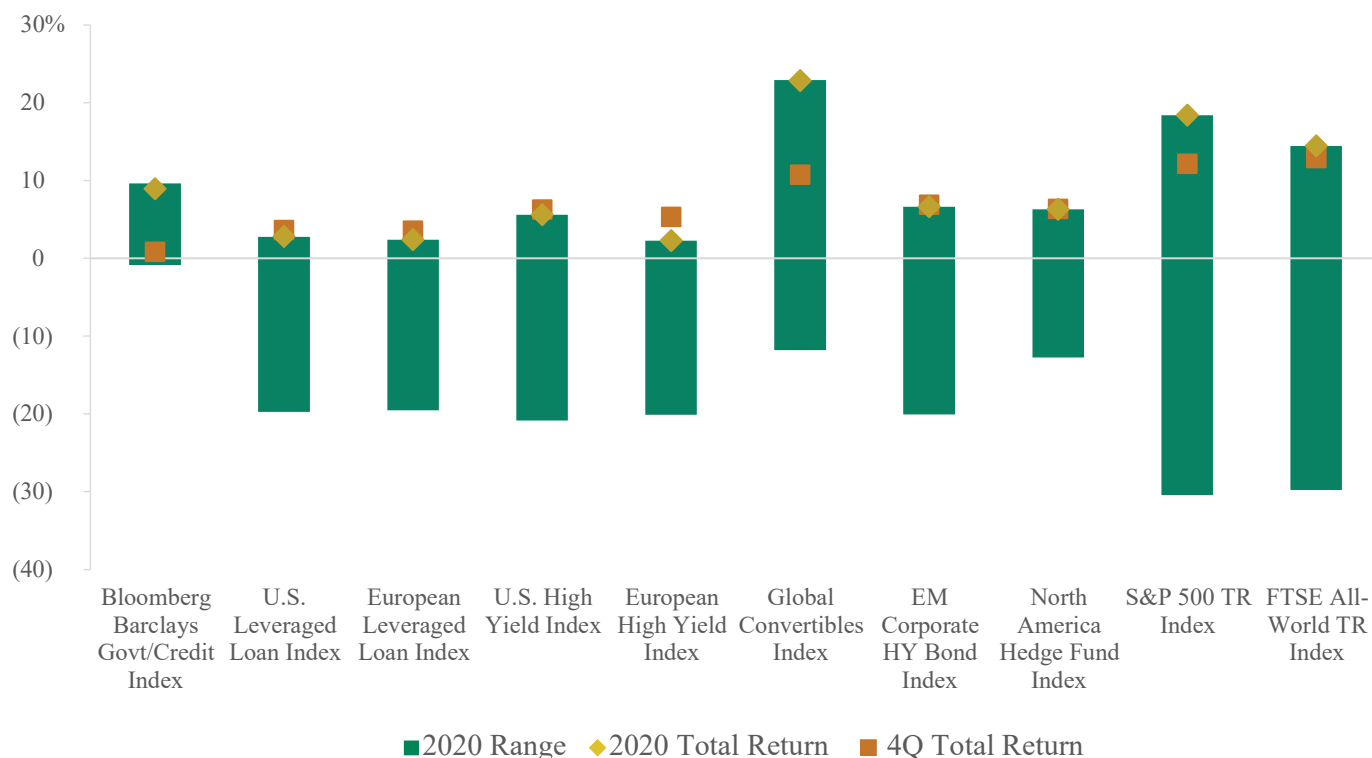
Finally, in emerging markets debt, we believe that security prices have appreciated to levels where in general they are unattractive relative to U.S. or European high yield debt. However, we believe EM debt is a credit picker's market, and we are finding corporate debt opportunities in select industries and geographies that offer attractive prices, yields and recovery stories. We believe Oaktree's bottom-up approach works well in identifying mispriced EM debt investments.

All told, Oaktree's Performing Credit strategies continue to deploy our expertise in fundamental credit underwriting to assess security-specific risks. We believe, in today's world of uncertainty, it is most prudent to proceed with caution and discipline, and to prioritize the durability, dependability and true worth of an investment as opposed to merely its price.

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# CHARTS

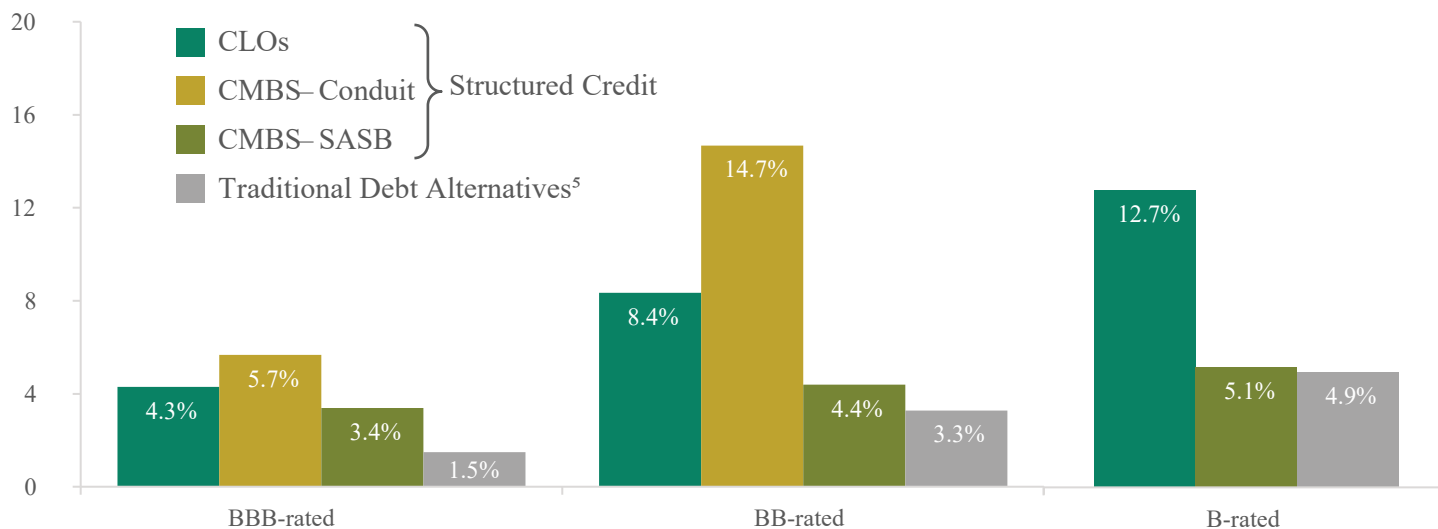
## PERFORMANCE OF SELECT INDICES<sup>4</sup>



As of December 31, 2020, with the exception of the hedge fund index performance, which is as of November, 30, 2020.  
Sources: FTSE, Bloomberg Barclays, Bloomberg, Credit Suisse, ICE BofA Merrill Lynch, J.P. Morgan, Refinitiv, HFR

## STRUCTURED CREDIT OFFERS YIELD PICKUP

(Yield-to-worst)



As of December 31, 2020  
Sources: Bloomberg Barclays Index Services, Cliffwater Direct Lending Index, FTSE Global Markets, Credit Suisse, JP Morgan



## HIGH YIELD BONDS

### Current Market Conditions

- Amid a broad rally in credit markets, U.S. high yield bonds earned positive results in all three months of the fourth quarter, returning 6.3% in 4Q and 5.6% for the year.<sup>6</sup>
- Issuance set new records, with \$96 billion for the quarter and \$457 billion for the year.
- The trailing-12-month default rate for the U.S. high yield bond market was 5.1% as of Dec. 31, up from 2.1% a year prior but significantly lower than estimated in early 2020.
- With a strong 4Q return of 5.3%, European high yield bonds made their way comfortably into positive territory for the year, gaining 2.3%.<sup>7</sup>
- New-issue supply in Europe reached €26 billion in 4Q, for a 2020 total of €85 billion, a level only bested by 2017.
- The trailing-12-month default rate in the European high yield bond market rose to 3.3%. Though higher than the 1.0% marked a year earlier, the rate remained lower than anticipated.
- “Stay-at-home” sectors were the clear winners of 2020, but Covid-sensitive sectors in Europe performed particularly well in 4Q, thanks to vaccine-related optimism for hard-hit industries such as leisure, retail and transportation.



### Outlook

#### Opportunities

- In a world of negative interest rates and dwindling dividends from equity markets, high yield bonds continue to offer an attractive relative-value proposition.
- Strong demand for U.S. and European high yield bonds has helped companies strengthen liquidity buffers and push out debt maturities.



#### Risks

- Default rates, while lower than expected, have inched up over the year. The fact that defaults are largely concentrated in a few struggling sectors reinforces the importance of an active approach to portfolio construction.



#### Wildcards

- Expansive monetary and fiscal policy might lead to higher inflation.
- If interest rates move up in line, all fixed income instruments will feel it. However, high yield bonds should generally fare better than traditional fixed income in such an environment, thanks to their shorter duration.

## SENIOR LOANS

### Current Market Conditions

- U.S. senior loans returned 3.6% in 4Q as anticipation of a cyclical recovery in 2021 outweighed the rise in Covid-19 cases worldwide.<sup>8</sup> The asset class was up 2.8% for the year.
- New issues totaled \$109 billion for the quarter, bringing the year's total to \$422 billion, up 8% year over year.
- The U.S. senior loan market's default rate was 4.0% at the end of the year, versus 1.6% at the end of 2019.
- December saw the first monthly inflow into U.S. retail loan funds in 26 months. This indicates yield-sensitive investors are turning to loans over other credit asset classes as a tool for managing duration risk.
- European senior loans returned 3.5% in 4Q and 2.4% for the year, helped along by welcome news of vaccines, a settled U.S. election and eventual Brexit progress.<sup>9</sup>
- New issuance in Europe was muted, with €11 billion. The full-year total of €65 billion was down 20% from 2019.
- The European senior loan market's default rate was 1.2% as of year-end, up from 0% a year earlier.
- The European CLO market continues to recover, with new warehouses opening. The dearth of new-loan supply added to the positive technicals during the quarter.



### Outlook

#### Opportunities

- Despite recent price gains, we still see potential upside in U.S. and European senior loans, given that their yield spreads are wider than the historical averages and that they benefit from lower volatility and, generally, a first-lien position on assets.
- The economics for CLO equity remain attractive, as interest income still meaningfully exceeds debt costs.



#### Risks

- Company earnings will not recover overnight, leverage has increased, and the continuation of stimulus measures remains a lurking question.



#### Wildcards

- The global economic outlook remains uncertain. This asset class, however, doesn't require a booming economy — just the creditworthiness of companies — to deliver income. The key will be to “avoid the losers.”
- Should increasing inflation take rates higher, senior loans' floating interest rates will allow investors to keep pace.

## EMERGING MARKETS DEBT

### Current Market Conditions

- Emerging markets debt wrapped up 2020 with a strong 4Q. The broad EM credit index rose 5.5% in the quarter, for a full-year gain of 5.9%. The EM high yield bond index was up 6.9% in 4Q, returning 6.6% for the year.<sup>10</sup>
- Recent investor optimism has been fueled by expectations of a global post-pandemic economic recovery; the strengthening of many EM currencies against the U.S. dollar; and rising commodity prices fueled by strong demand from developed economies. For the moment, markets also perceive geopolitical risks as diminished under a Biden presidency, expecting stronger global trade ties, which could further support a global economic recovery.
- As a result of recent price gains, the yield spread premium of EM debt over developed markets debt may not fully compensate investors for credit risk in many countries where debt is rising.
- For now, the EM corporate sector should continue to benefit from the unprecedented monetary and fiscal support that both developed and emerging markets governments have employed to bolster an overall economic recovery.



### Outlook

#### *Opportunities*

- Our focus is on issuers in utilities and other essential industries that have inelastic demand profiles and strong balance sheets, which we believe should be able to withstand sovereign credit-related risk.



#### *Risks*

- We believe the current vaccine rollout may go a long way in normalizing the global economy, but acceptance issues, logistical hurdles and effectiveness remain important risks.
- New bouts of frozen credit markets and a double-dip global recession remain realistic risks in the case of a worsening Covid picture and stricter lockdowns.



#### *Wildcards*

- Concerns are building about higher interest rates and the normalization of policy support, though central banks are mindful not to taper too early.
- EM debt is not a homogenous asset class. Dispersion may be significant, with different countries experiencing varying speeds of economic recovery and degrees of debt pressures.

## PRIVATE CREDIT

### Current Market Conditions

- Many businesses in the U.S. and Europe have muddled through the challenges of the pandemic thanks to emergency liquidity from governments and temporary waivers from lenders. But matters are likely to come to a head for many borrowers that may need structural solutions to debt management.
- In the U.S., we observed some direct lenders showing signs of strain, particularly yield-chasing lenders that invested in riskier parts of capital structures and effectively took mezzanine risk while calling the debt “senior.” Coming into 2021, this trend has faded but will bear watching.
- In Europe, credit standards are becoming more stringent and non-performing loans are on the rise, with further tightening expected. This may worsen credit availability but bodes well for direct lenders to find gaps left by banks.
- We observe a trend of capital consolidation, in which allocations tend to favor larger-scale funds at the expense of new or smaller funds.
- Demand from limited partners is high, with direct lending continuing to grow in many major European markets, including Germany and the Netherlands.



### Outlook

#### *Opportunities*

- Demand for private debt remains strong as companies refinance legacy debt. Increases in M&A and LBO activity signal a strong deal pipeline in 2021.
- In Europe, there is a massive pool of capital in the market looking for yield. The relative inefficiency of the European market could create opportunities.



#### *Risks*

- Covid will likely continue to be a key driver of credit risk.
- Gauging how borrowers will perform over the longer term continues to require complex assessments amid the uncertainty of the pandemic.



#### *Wildcards*

- The uneven impact of the pandemic and pace of recovery across sectors could lead to an unbalanced supply-and-demand dynamic, possibly causing lenders and sponsors to converge toward the same pool of deals.
- Any volatility or disruption in third-party leverage could result in substantial investment opportunities.

## CONVERTIBLES

### Current Market Conditions

- The global convertible bond index earned 10.7% in the fourth quarter, supported by strong underlying returns on equities.<sup>11</sup> For the year, the index returned 22.8%.
- Equities in all regions and sectors generated positive returns and, in a reversal from prior quarters, value stocks led the rally. Markets were largely sustained by vaccine-related news and continued policy support, which allowed investors to look past the near-term increase in virus cases and lockdowns.
- In the U.S., new issuance continued the strong pace of the first half of the year, with \$21 billion raised by 32 issuers in 4Q. This lifted the year's total to \$118 billion — twice the amount for 2019 and the highest since 2007.
- New issuance, combined with price appreciation, pushed the U.S. convertible bond market's total value to \$350 billion as of year-end, a 65% year-over-year increase.
- Outside the U.S., the convertibles market saw a healthy \$15 billion of new issuance across 29 deals in 4Q. The majority of the issuance was concentrated in Europe, followed closely by Asia ex-Japan.



### Outlook

#### Opportunities

- We are constructive on the prospects for convertible bonds and believe that our portfolio offers a conservative way of gaining equity market exposure to both the growth-oriented names benefitting from the pandemic and companies poised to thrive as economies reopen.



#### Risks

- Given the uncertainty surrounding the path of the pandemic and still-elevated cases, we remain cautious about possible Covid-19 resurgences around the world and about geopolitical tensions. In this environment, we continue to emphasize issuer quality, liquidity, diversification and selling discipline as core tools for risk management.



#### Wildcards

- Pricing on new deals improved in 2020 and has remained attractive amid the volatility and uncertainty created by Covid-19. From where we stand now, however, it appears new-issue pricing has started to revert, highlighting the importance of evaluating each deal on a case-by-case basis.

## STRUCTURED CREDIT

### Current Market Conditions

- Structured credit posted strong returns in 4Q as optimism around Covid vaccines eclipsed concerns of rising cases. An index representing a mix of CLOs and CMBS returned 12.1% in the quarter, pushing the annual return to 1.8%.<sup>12</sup>
- CLO prices rose in line with continued positive momentum for the asset class. Spreads compressed over the quarter, though the year-end ranges for the BBB and BB tranches still exceeded pre-pandemic levels.
- New CLO issuance for the quarter came to about \$32 billion in the U.S. and €7 billion in Europe. Though still short of 2019 levels, 2020 issuance ex-refinancing totaled \$93 billion in the U.S. and €22 billion in Europe.
- Debt backed by corporate real assets continued its recovery after the challenges presented in the first half of the year.
- Within real estate structured credit, the industrial and multi-family sectors continued to perform well, with better occupancy and rental collection rates than the more-challenged retail and hospitality sectors. It's notable that the “extended-stay” segment of the hospitality category has bucked the general adversity facing the sector.



### Outlook

#### Opportunities

- We believe CLOs remain attractive despite their recent spread compression. BB-rated tranches, in particular, still offer a meaningful yield pickup over other areas of corporate credit.
- For our real estate investments, we're paying special attention to sponsor quality, duration of leases and property location.



#### Risks

- A resurgence of Covid cases and quarantine policies will prove stressful. We've begun to see some immediate impacts, including a reversal of what had been positive trends in rent collections and occupancy rates.



#### Wildcards

- Interest rates are likely to remain low for the near term, but talk of Fed tapering has begun. A rising-rate environment can be beneficial for structured credit products such as CLOs, given their floating-rate coupons and lower duration risk.

## 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, CAIA

*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 \$45.9 billion in AUM and approximately 190 investment professionals.<sup>13</sup>



## ENDNOTES

<sup>1</sup> Deutsche Bank, S&P Global

<sup>2</sup> Barclays

<sup>3</sup> J.P. Morgan

<sup>4</sup> The indices used in the graph are: 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).

<sup>5</sup> Data is for illustrative purposes. The indices indicated are unmanaged, and it is not possible to invest directly in an index. "Traditional debt" represents a similarly rated asset class for each rating category and includes the Bloomberg Barclays Investment Grade Corporate Bond Index (BBB), the FTSE High Yield Cash-Pay Capped Index (BB) and the Credit Suisse Leveraged Loan Index (B).

<sup>6</sup> FTSE HY Cash-Pay Capped Index

<sup>7</sup> ICE BofAML HY European Issuers Constrained Index ex. Russia and Financials (Euro Hedged)

<sup>8</sup> Credit Suisse Leveraged Loan Index

<sup>9</sup> Credit Suisse Western European Leveraged Loan Index (Euro hedged)

<sup>10</sup> J.P. Morgan Emerging Markets Bond Index Global, J.P. Morgan Corporate Broad CEMBI Diversified High Yield Index Level (LOC)

<sup>11</sup> Thomson Reuters Global Focus Convertible Index (USD Hedged)

<sup>12</sup> Represents 50% Bloomberg Barclays U.S. CMBS 2.0 Baa Index and 50% J.P. Morgan CLO BB-Post Crisis Index.

<sup>13</sup> The AUM figure is as of December 31, 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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