THE ROUNDUP:

Top Takeaways From Oaktree's Quarterly Letters

2Q2022

The current market turmoil highlights a fundamental truth about investing: It's not supposed to be easy. That's why Oaktree has long emphasized what Howard Marks calls "second-level thinking" – i.e., asking complex questions, eschewing simple answers, and challenging conventional thinking. As Howard has often said, if investors want to be above average, including in bad times, then they need to be willing to think differently. And, importantly, they also need to be right.

In the current edition of *The Roundup*, Oaktree portfolio managers strive to do both. This series compiles thought-provoking ideas that we've shared with clients in the recent quarter.[1] In this installment, Oaktree experts discuss finding value when the tide goes out, the attractiveness of unloved asset classes, and more. As a bonus, we've included excerpts from our recent client conference, at which Oaktree PMs discussed unconventional strategies for taking advantage of some of today's most exciting trends, including the logistics and green energy revolutions.

1

Economic Backdrop: The Tide Turns

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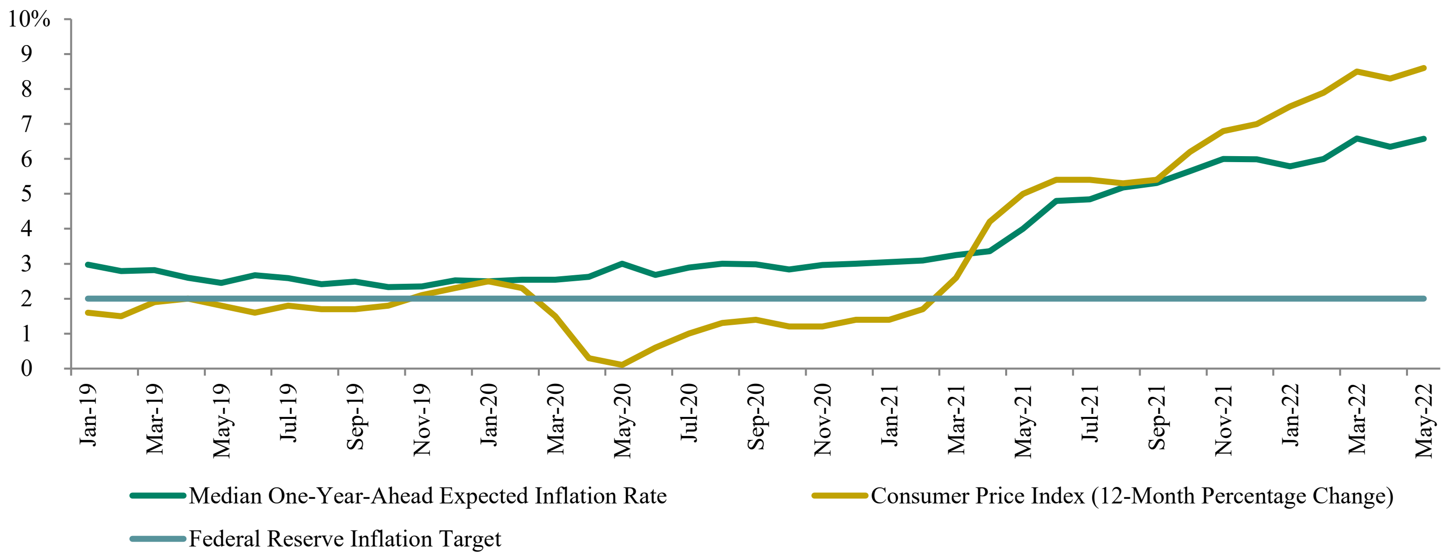
While we aren't macro forecasters, we are able to analyze macro trends by noting their effects on our portfolio companies. That's why we knew that rising inflation was a serious concern long before the Federal Reserve stopped referring to rapid price increases as "transitory." In recent quarters, we've seen many of our companies pass on increased costs to their customers, but we're cognizant that this dynamic may eventually become unsustainable if inflation remains elevated. (See Figure 1.) We're also well aware of the challenge the Fed faces as it seeks to engineer a soft landing – i.e., bring down the rate of inflation without causing a recession.

If the Fed fails to successfully strike this balance, then we think the opportunity set in distressed publicly traded credit will expand, as a rising number of companies will likely require restructuring and other liquidity solutions. U.S. public credit – high yield bonds and leveraged loans – has already grown more attractive in recent months, as markets have weakened.

In today's uncertain environment, we're reminded of a quote from Warren Buffett that Howard included in his memos *It's All Good* (July 2007) and *The Tide Goes Out* (March 2008): "It's only when the tide goes out that you find out who's been swimming naked." This quote underscores our long-held belief that focusing on risk control is especially important during good times, when risk aversion among investors is low and asset prices are high. By remaining cautious when others are fearless, investors make it more likely that (a) they'll be covered when the tide turns and (b) they'll be in a position to take advantage of opportunities created by those with less forethought. During periods like the present, we're mindful that the sharpest asset price declines – and most attractive bargains – often emerge when investors conclude that the tide will never come in again.

Figure 1: Inflation and Expectations of Future Inflation Remain Elevated



Source: U.S. Bureau of Labor Statistics, Federal Reserve Bank of New York

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High Yield Bonds: Silver Linings

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Elevated inflation, tightening monetary policy, and geopolitical uncertainty have recently roiled financial markets, including the high yield bond market. In less than six months, investors have yanked more than $40 billion from U.S. high yield bond mutual funds and exchange-traded funds.[2] With retail investors on a "buyers' strike," new issue activity has slowed considerably from 2021's breakneck pace. Gross issuance has totaled only $71 billion in 2022 to date, compared to more than $293 billion during the same period in 2021.[3]

We believe the broad sell-off has created attractive opportunities for high yield bond investors. In roughly six months, the average yield spread in the asset class has widened by more than 200 basis points to reach nearly 550 bps.[4] (See Figure 2.) With yield spreads at this level, we think investors are well compensated for default risk.

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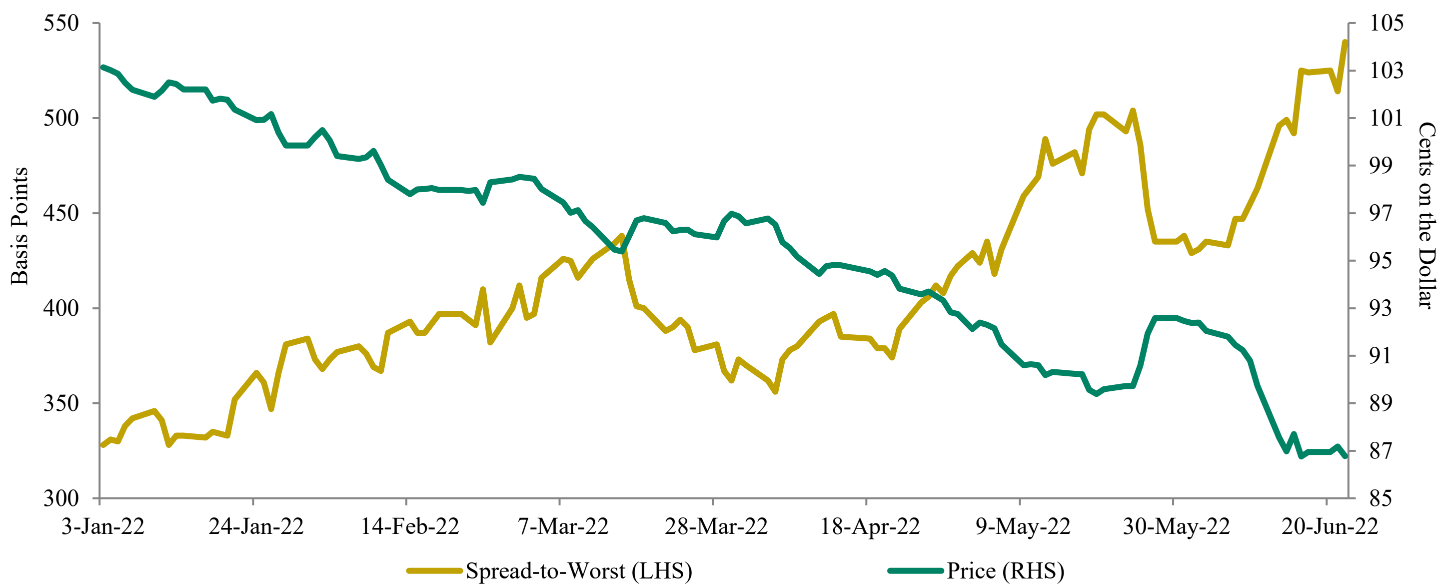
Moreover, the average price in the U.S. high yield bond market has dropped by more than 16 cents on the dollar since year-end and is now hovering near 87 cents.[5] (See Figure 2.) This price decline provides current buyers with the potential to earn meaningful capital appreciation – an opportunity that high yield bond investors haven't enjoyed for some time.

We've noted similar trends in the European high yield bond market. Since January 1, the average yield spread has widened by more than 250 bps,[6] and gross issuance has totaled only €14 billion, compared to €63 billion in the same period in 2021.[7] However, we believe tail risks in Europe are more significant than those in the U.S., due to the former's energy security concerns and proximity to the war in Ukraine.

We expect that activity in the primary markets for high yield bonds may remain muted through year-end. But we believe investors can capitalize on this situation by (a) acting as liquidity providers to issuers struggling to raise capital and (b) negotiating terms that are more favorable to bondholders. We think it's in choppy markets that skill in structuring deals and deep knowledge of covenants can add the most value.

While rising interest rates and slowing economic growth may continue to weigh on high yield bond prices in the short term, we believe long-term investors may find attractive value in the asset class during this tumultuous period.

Figure 2: U.S. High Yield Bond Prices Have Fallen, and Yield Spreads Have Widened



Source: ICE BofA U.S. High Yield Constrained Index, as of June 22, 2022

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Senior Loans: Double-Edged Sword

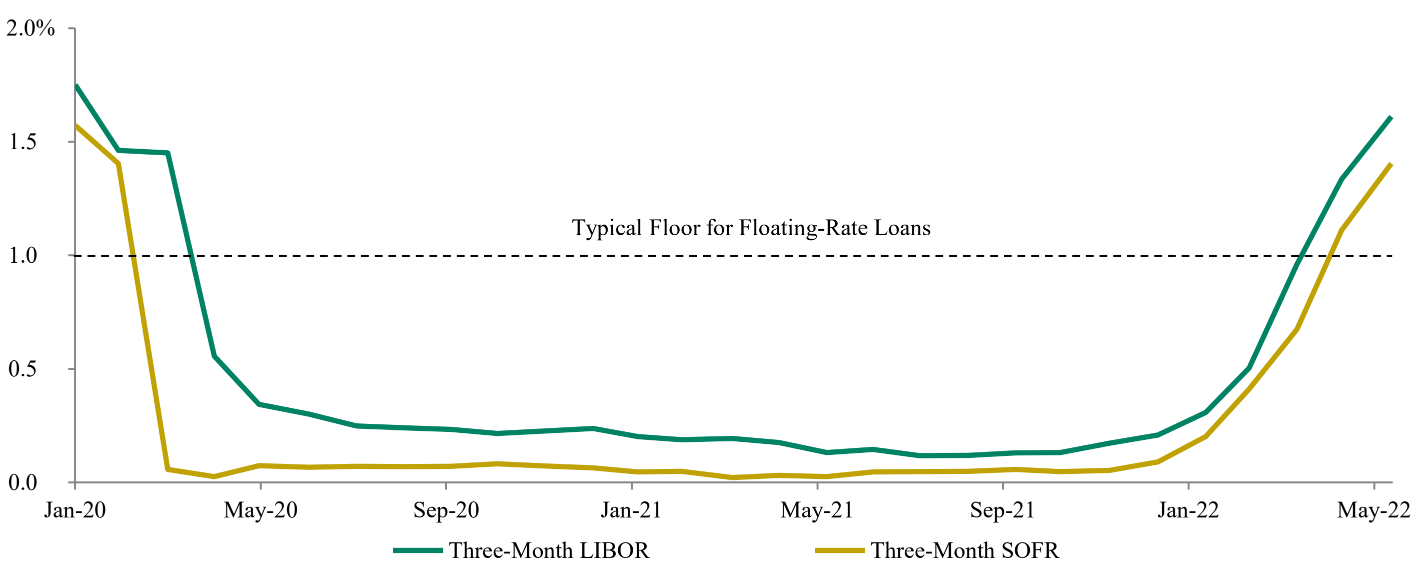
Loan prices have fallen by 3.2% in the first half of 2022, but the asset class has meaningfully outperformed both investment grade and high yield bonds, primarily due to loans' floating rates, which are attractive in a rising-interest-rate environment.[8] We expect this outperformance to persist in the near term, given the Federal Reserve's indications that it will continue to aggressively hike interest rates.

Notably, the dramatic increase in short-term interest rates has caused the projected income from loans to exceed the yield on high yield bonds. SOFR[9] (the primary reference rate for new loans) increased from 0.09% at year-end to 1.40% at the end of May, and three-month LIBOR (the primary reference rate for loans created before January 1) jumped from 0.21% to 1.61% during the same period.[10] While most floating-rate loans have reference rate floors, the average floor has been surpassed in recent months, meaning many loan investors' coupons are rising. (See Figure 3.)

However, this also means that borrowers are facing rising interest expenses. If interest rates continue to increase – and remain high for a significant period of time – borrowers with floating-rate loans outstanding may begin to face liquidity challenges. While some borrowers were prudent during the pandemic and bolstered their balance sheets, others took on high levels of debt based on the expectation that their interest costs would remain ultra-low. Borrowers in the technology sector may be especially vulnerable due to their high average leverage.

Currently, the default environment remains benign. The trailing-12-month default rate for U.S. loans is 0.9%, well below the long-term historical average.[11] But defaults have increased modestly since March 31.[12] Moving forward, we believe credit selection – which is always important – will become even more so, as borrowers face tighter financing conditions and slower economic growth.

Figure 3: Reference Rates Have Surpassed the Average Floating-Rate Loan Floor



Source: Bloomberg, as of May 31, 2022

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Debt

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Emerging Markets Debt: Tightening the Screws

Emerging markets debt has had a rocky start to 2022: EM corporate bonds have fallen by 13.6% since January 1 and are on pace for their worst performance since 2008.[13] While Russia's invasion of Ukraine was the primary cause of disruption in this market earlier in the year, weakness in the asset class is now largely being driven by the tightening monetary policy of developed market central banks. In fact, more than half of the aforementioned year-to-date loss is directly attributable to rising U.S. Treasury yields.[14] The yield spreads on EM corporate bonds are only slightly wider than the ten-year average.[15] (See Figure 4.)

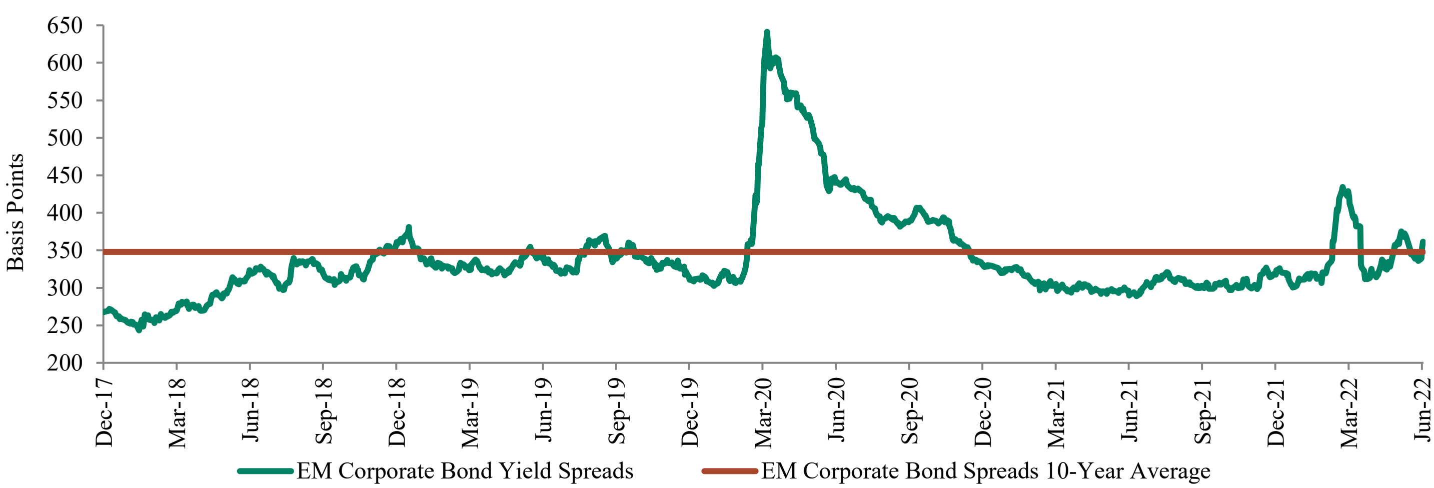
Looking forward, we believe that risk premia in EM debt may increase. Most EM economies are unprepared to handle even a brief period of tight global financial conditions, let alone an extended period or any unforeseen obstacles.

First, many EM countries face negative consequences from Russia's invasion of Ukraine, including energy and food insecurity, the balkanization of the global economy, and rising geopolitical tensions. While Russia's isolation from the West may benefit some constituencies, such as Latin American commodity exporters, most EM nations face the prospect of elevated inflation and slowing growth.

Second, the hawkish pivot of developed market central banks has squashed EM governments' hopes of correcting fiscal imbalances created by pandemic-era stimulus measures. Rising interest rates (a) make EM government debt more expensive to service; (b) may widen EM countries' current account deficits; and (c) will likely make it more challenging for countries to use economic growth to improve their public and private sectors' overstretched finances.

While we remain cautious, we believe the current environment may create opportunities for investors employing an active, bottom-up approach, especially those with the flexibility to deploy capital during a crisis and the ability to rigorously analyze credit quality.

Figure 4: EM Corporate Bond Yield Spreads Remain Near Their Long-Term Average



Source: JP Morgan CEMBI Broad Diversified Index

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Infrastructure: Life Moves Pretty Fast

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We're living through a period of massive change in the way goods are transported around the world. Consumers are increasingly demanding next-day – or even same-day – delivery. At the same time, the pandemic has highlighted the dangers of long supply chains and overreliance on a limited number of trading partners.

One major manifestation of these problems during the pandemic has been the significant increase in dwell time (i.e., the amount of time a ship spends at a port). Ships have been forced to wait many days at U.S. ports, and this has limited companies' ability to meet consumers' demand for rapid deliveries. For example, at California's San Pedro Bay, the percentage of ships with dwell times greater than five days rose from under 5% in December 2019 to almost 50% at the end of 2021.[16] This congestion and the consequent shipping delays have highlighted what can happen when security and redundancy are insufficient in supply chains.

As the world shifts into the post-pandemic era, we believe we're going to see a series of evolutions in the global supply chain. And we believe these changes will enable capital providers to invest in and partner with businesses to create new infrastructure for the next generation of global trade.

First-order thinking may tell you to respond to this transportation revolution by buying the securities of well-known logistics companies. While such securities may perform well when the economy is booming, our experience in transportation has taught us that businesses in this sector are critical but also cyclical. Over the long term, earnings trends in the sector are almost always up and to the right, as a function of population growth and economic expansion. But in the short term, there's typically significant volatility in the industry's financial performance.

Investors may therefore prefer to target hard-to-replicate transportation infrastructure assets that (a) are well positioned to benefit from the aforementioned trends and (b) are capable of providing insulation when the business cycle enters a challenging period. Such investments can potentially offer significant downside protection – because an investor will own real assets in an industry in which barriers to entry are high and long-term contracts are the norm – but also upside potential, especially if the investor is able to employ operational expertise to improve an asset's performance.

To keep up with a rapidly changing industry, the second-order thinker knows it's often better to avoid following the herd and instead take the road less traveled.

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Power: Think Bigger

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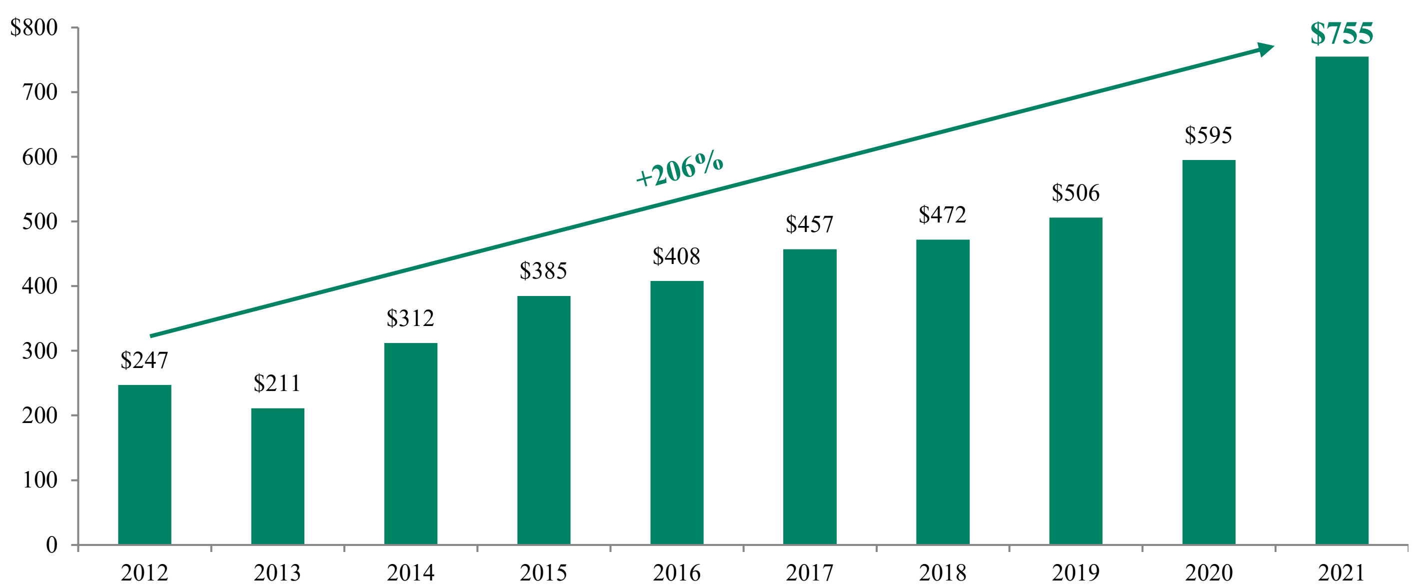
The green energy revolution is creating massive investment opportunities: Nearly $800 billion is currently being spent annually on the global energy transition, according to a BloombergNEF estimate. (See Figure 5.) And we believe the actual figure may be far higher. But investors are mostly focused on a narrow sliver of the vast energy ecosystem: primarily utility-scale systems, solar and wind power, electric vehicles, and grid battery storage.

There's good reason to be excited about these areas, as their growth has been phenomenal in recent years. But the energy transition encompasses much more than solar panels, wind turbines, and EVs. The entire power grid needs to be updated and reimagined in many ways – some obvious and some that take more expertise to appreciate.

For example, substation equipment will need to be upgraded to handle renewable capacity additions. Tens of thousands of miles of overhead conductors will need to be replaced, and new lines will need to be built. And new distribution equipment, such as transformers, will need to be installed and serviced. In short, we believe investors should focus on the entire electric power value chain – from generation through consumption.

It's impossible to predict which companies – or even which forms of power – will become dominant in the new energy regime. But it's a safe bet that the amount of investment needed to support all aspects of this momentous shift will be massive. By looking beyond the most crowded investment areas, investors may be able to identify opportunities in which upside potential isn't tied to the success of any particular technology but is instead rooted in the momentum of the global energy transition itself.

Figure 5: Investment in the Global Energy Transition Is Booming



Source: BloombergNEF 2022[17]

Endnotes

1 The content is derived from 1Q2022 letters sent to clients in 2Q2022 or presentations from the Oaktree 2022 client conference; the text has been edited for space, updated, and expanded upon where appropriate.

2 JP Morgan, as of June 24, 2022.

3 Ibid.

4 ICE BofA U.S. High Yield Constrained Index, as of June 22, 2022.

5 Ibid.

6 ICE BofA Global High Yield European Issuers Non-Financial Excluding Russia Index, as of June 24, 2022.

7 LCD European Weekly Monitor, as of June 10, 2022.

8 Credit Suisse Leveraged Loan Index, as of June 24, 2022.

9 Secured Overnight Financing Rate.

10 Bloomberg, as of June 15, 2022.

11 JP Morgan, as of May 31, 2022.

12 Ibid.

13 JP Morgan CEMBI Broad Diversified Index, as of June 23, 2022.

14 Ibid.

15 Ibid.

16 Pacific Merchant Shipping Association.

17 Includes investment in renewables, storage; charging infrastructure; hydrogen production; nuclear power; recycling and carbon capture & storage projects; and end-user purchases of low carbon energy devices, such as small-scale solar systems, heat pumps and zero-emission vehicles.

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