OAKTREE INSIGHTS

OAKTREE

THE ROUNDUP:

Top Takeaways From Oaktree's Quarterly Letters

3Q2022

Oaktree has long stressed the importance of understanding market cycles. Being able to identify where we stand in a cycle – and the likelihood of a turn – is critical if investors wish to adjust their risk postures appropriately and "tilt the odds in their favor," as Howard Marks has written. In order to assess the current environment accurately, we believe it's essential to look closely at the trends that have shaped – and continue to shape – various asset classes.

In the current installment of *The Roundup*,[1] Oaktree portfolio managers explore the noteworthy trends they've observed over the last few months, a period in which volatility has been the only constant. They discuss the widening opportunity set in distressed credit, bright spots in commercial real estate, the potential inflation protection offered by transportation infrastructure, and more. Plus, as a bonus, we've included an unreleased excerpt from Howard's recent interview about assessing risk posture.

Howard Marks
Co-Chairman

1

Risk Posture: It Depends

Determining the appropriate risk posture for a given point in time is more complex than most people think. There can't be a right answer for everyone. There can't be a right answer for every asset class. If pundits say "Buy," you should ask, "Buy what?" And at the time that you're supposed to buy, is there anything you should sell (or anything you should buy if it's time to sell)? Doesn't it depend on individual risk tolerance? Doesn't it depend on how people are positioned at the time? If someone's portfolio is very liquid and a commentator concludes that it's not a good time to own assets because the macro outlook is poor, might the investor already be in the right position for the future? Blanket advice to buy (or sell) isn't very useful.

We know what <u>has</u> happened in the macro environment and what <u>is</u> happening today. We know what most people think will happen in the macro environment moving forward, and we know where security prices are today. What we don't know is how much of what we think will happen in the macro (or what others think will happen) is reflected in today's prices. Since future conditions (as opposed to present conditions) may already be incorporated in prices, a poor macro outlook isn't necessarily synonymous with prices declining, and a good macro outlook needn't be synonymous with prices rising. Investors should be wary of sweeping generalizations about whether it's time to buy or sell.

Bruce Karsh
Co-Chairman,
Chief Investment Officer

Robert O'Leary
Global Co-Portfolio Manager, Global Opportunities

Pedro Urquidi
Global Co-Portfolio Manager, Global Opportunities

2

Distressed Credit: Expansion of the Universe

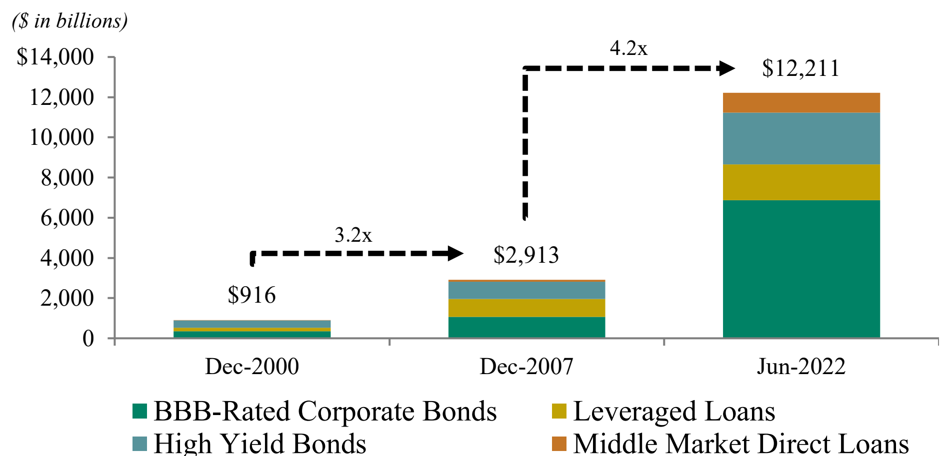
In 2022, rising interest rates and weakening global economic conditions have caused the distressed liquid credit universe to expand meaningfully for the first time since the early months of the pandemic. The combined amount of U.S. high yield bonds and leveraged loans trading at distressed levels reached a two-year high of $140 billion in June, up from $33 billion at the end of 2021.[2] While this total declined during the mid-summer market rally, the figure climbed back to $125 billion at the end of August.[3]

Looking forward, we believe the opportunity set in distressed liquid credit could be substantial in a significant dislocation because of the massive growth in corporate debt since the Global Financial Crisis. The total amount of high yield bonds, BBB-rated bonds, leveraged loans, and middle-market direct loans outstanding globally has risen to $12.2 trillion, more than four times the level in December 2007. (See Figure 1.) While the threat of excessive corporate leverage is most acute in the U.S., the supply of below-investment-grade debt has reached near-record highs in Western Europe, China, and India.

Attractive opportunities could emerge in many types of corporate credit. For example, we believe banks are already saddled with a significant number of bridge loans (i.e., bonds and loans related to recent mergers & acquisitions) that they've been unable to sell in the syndicated market. We estimate that the total amount of these "hung bridges" was roughly $70 billion in the U.S. at the end of August, with meaningful volume in Europe as well.[4] If credit conditions worsen, banks wishing to reduce risk may be willing to sell these securities at discounted prices.

In 2020, opportunities in distressed liquid credit were mostly short-lived, due to the record-high monetary and fiscal stimulus supplied globally. But times have changed. Governments will likely struggle to provide such extensive support as long as inflation is running at multi-decade highs and debt-to-GDP levels remain elevated. Thus, we believe the current expansion of the distressed credit universe could prove to be more long-lasting.

Figure 1: Low-Rated Global Corporate Debt Has Ballooned



Source: Bloomberg Barclays, Credit Suisse, ICE BofA, Preqin, Cliffwater as of June 30, 2022. Data for Middle-Market Direct Loans from Refinitiv as of November 2021.

3

Senior Loans: Tug-of-War

Ronald Kaplan
Portfolio Manager,
U.S. Senior Loans

Madelaine Jones
Portfolio Manager,
European Senior
Loans

The loan market was resilient in the first eight months of the year: U.S. loans returned -1.2%, while U.S. high yield bond prices fell by 11.0%.[5] This outperformance is mostly due to high yield bonds' higher sensitivity to interest rate increases as well as favorable supply/demand dynamics in the loan market. Moving forward, it's unclear whether negative economic trends will upset this balance.

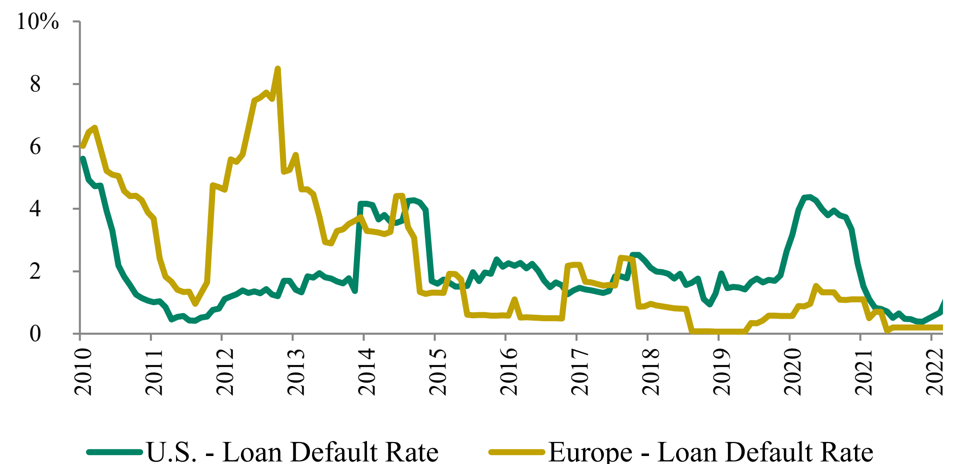
The supply of new loans in 2022 has been limited. Gross issuance through August declined by approximately 68% compared to the first eight months of 2021.[6] Meanwhile, demand for floating-rate assets has been high throughout most of 2022, as investors have sought protection from rising interest rates. Due to the increase in Treasury yields in 2022, the average projected income from U.S. loans now exceeds the average yield in the U.S. high yield bond market.[7]

In Europe, similar forces have caused loans to significantly outperform high yield bonds: The asset classes posted returns of -2.7% and -12.7%, respectively, in the year through August.[8] But European loans lagged behind their U.S. counterparts, partly because of investor concerns about Europe's energy crisis and other tail risks.

The outlook is murky in both markets. Default rates are very low and unlikely to reach recessionary averages over the next year, due to the limited number of upcoming maturities. (See Figure 2.) However, default rates are beginning to increase modestly, and companies with floating interest rates may struggle to service their debt if key policy rates remain higher for longer. Heavily leveraged borrowers in cyclical industries are particularly vulnerable, as they may be adversely impacted by both elevated interest rates and a slowing economy. In Europe, borrowers with significant exposure to energy prices could be in a precarious position.

So which force will drive loan performance moving forward: rising interest rates, which should continue to make floating-rate loans more attractive than fixed-rate alternatives, or slowing economic growth, which could weaken company fundamentals and cause the yield spreads of loans to continue widening? That is the question that loan market participants will grapple with in the coming months.

Figure 2: Loan Default Rates Remain Low in the U.S. and Europe



Source: JP Morgan, as of August 31, 2022

4

Julio Herrera
Portfolio Manager,
Emerging Markets
Debt

Emerging Markets Debt: Past Isn't Always Prologue

Emerging markets corporate high yield bonds are on track for their worst performance since 2008.[9] Consequently, investors are reevaluating trends that underpinned investment in emerging markets over the last two decades.

Until 2020, many EM countries enjoyed (a) declining interest rates, which often approached the levels seen in developed markets; (b) robust economic growth; (c) strong capital inflows; and (d) the benefits of globalization. These trends enabled EM countries and companies to accumulate substantial amounts of debt. However, many of these trends now appear to be weakening or reversing entirely.

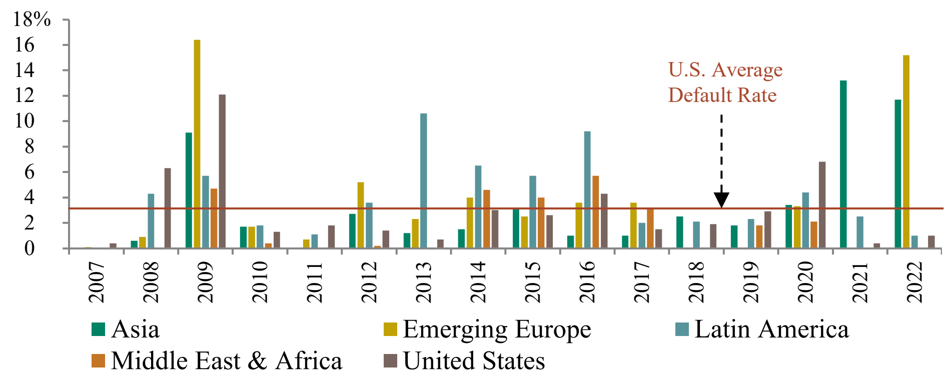
To assess this potential paradigm shift, market participants have frequently looked to the history books. In two of the most notable EM credit dislocations (in 1994 and 1998), the yield spreads of EM bonds expanded beyond 1,400 basis points, far wider than the 600 bps that the EM corporate bond index currently offers.[10] While yield spreads may widen further, we think the floor for valuations across EM debt may be higher than in the past because most EM countries have become more resilient since the 1990s.

Today, the term "emerging markets" refers to countries that (a) drive 40% of global exports;[11] (b) currently generate over half of global GDP and have been responsible for two-thirds of global GDP growth in the last decade;[12] (c) mostly have flexible exchange rates (not the fixed pegs that were common in the past); (d) have central banks that are willing to hike interest rates aggressively when necessary (with the notable exception of Turkey); and (e) typically have access to large domestic capital pools as well as the $4 trillion EM bond market.[13]

Also, in the past, a crisis in one EM economy often quickly spread to other countries, but we think contagion is less likely now because of the developments noted above. Importantly, while default rates have recently spiked in Asia (primarily in China) and Eastern Europe (primarily in Russia and Ukraine), they remain relatively low in other regions. (See Figure 3.)

We remain cautious about the near-term outlook for the asset class, as the combination of massive debt burdens in EM countries and tightening global financial conditions is dangerous. But we believe simply extrapolating from the past is a clear example of the type of first-level thinking we seek to avoid.

Figure 3: EM Default Rates Now Vary Significantly Between Regions



Source: JP Morgan CEMBI Broad Diversified, as of July 18, 2022

5

Real Estate: Give Me Shelter

John Brady
Head of Global Real Estate

Mark Jacobs
Co-Portfolio Manager, Real Estate Income

Commercial real estate has faced multiple headwinds in 2022: Cap rates have risen, work-from-home trends have weighed on valuations in the office sector, and appetite for CRE structured credit products has declined. But the multifamily and industrial real estate sectors – the outperformers in 2021 – have remained resilient.

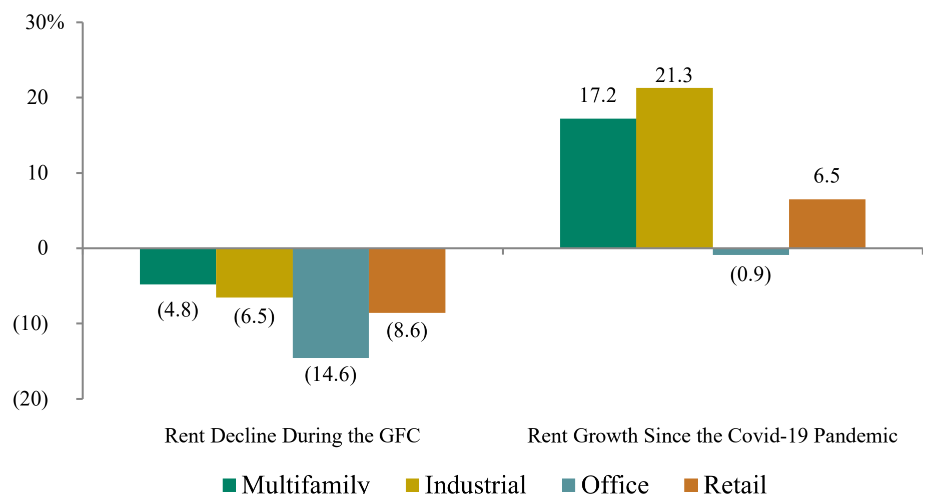
Multifamily has historically held up well during economic downturns. (See Figure 4.) This is primarily due to the asset class's short average lease terms (typically one year) and relatively low annual capital requirements as well as the availability of debt financing from the federally backed agencies Freddie Mac and Fannie Mae. Importantly, short average lease terms also benefit multifamily properties during periods of high inflation because property owners can quickly adjust rental rates.

While we don't expect growth in multifamily rents to continue to increase at the rapid pace recorded in the last 12 months, we believe the rate will remain fairly high over the short to medium term, as the supply of housing in much of the U.S. is insufficient to meet the demand. Moreover, we think the U.S. housing shortage could be exacerbated if anticipated increases in land, labor, and materials costs constrain new construction.

We also remain bullish on industrial real estate, which has benefited from the rise in e-commerce and the limited supply of industrial-zoned land in prime locations. While industrial real estate with long-term leases may be negatively impacted by rising inflation and elevated interest rates, properties with fairly short lease terms and/or unleased areas may be able to increase rents to keep pace with inflation. These properties might therefore be able to partially offset the downward pressure on valuations caused by higher interest rates.

Even if commercial real estate continues to encounter headwinds in the coming year, we believe these sectors could provide a shelter from the storm.

Figure 4: Rent Growth in Multifamily and Industrial Properties Has Been Resilient



Source: CoStar, GFC decline defined as peak to trough of asset type between 2008 and 2012. Covid-19 fluctuation defined as 1Q 2020 to 1Q 2022.

6

Middle-Market Direct Lending: Reality Check

Raj Makam
Portfolio Manager,
Private Debt

Bill Casperson
Co-Portfolio
Manager, Private
Debt

Middle-market loan prices are finally adjusting to the new economic reality. Yields of broadly syndicated loans and high yield bonds began to rise in the first quarter along with interest rates, but until mid-June, middle-market debt pricing had barely budged in 2022.[14] This was partly because the slowdown in leverage buyout activity kept the supply of new loans relatively low.

However, since mid-June, coupons for senior middle-market loans have increased by approximately 50–100 bps.[15] This trend has multiple drivers. First, rising interest rates and slowing economic growth are making direct lenders less willing to offer large loans to individual borrowers. Next, industries such as construction and home remodeling have weakened, so lenders are demanding higher yields when providing financing to borrowers in these sectors. Finally, large banks that provide leverage facilities to direct lenders have started to tighten their credit standards and limit access to these facilities, reducing direct lenders' ability to provide funding to middle-market firms.

In the coming months, we believe opportunities to provide private debt financing with lender-friendly terms will proliferate. Some direct lenders may miss out on these opportunities because they'll be too focused on triaging underperforming assets. But lenders with solid portfolios, limited exposure to cyclical industries, low leverage, and plenty of dry powder may be well positioned to take advantage of this new normal.

7

Transportation Infrastructure: Port in the Storm

Emmett McCann
Co-Portfolio
Manager,
Infrastructure
Investing

Josh Connor
Co-Portfolio
Manager,
Infrastructure
Investing

While no industry is entirely immune to the negative effects of rising inflation, we believe transportation infrastructure assets – such as railways, ports, highways, and transit systems – are better protected against inflation than many other asset types. That's because the contracts that transportation infrastructure assets operate under typically specify that increases in fuel, labor, and other operating costs will be passed through to end customers. For example, in the U.S. maritime sector, a contractual arrangement allows port operators to pass through union pay increases to shipping customers. Similarly, operators in the freight rail sector can recover increases in fuel costs via surcharges embedded in customer contracts.

End customers normally have little choice but to tolerate these pass-throughs due to the essential nature of transportation infrastructure. Accepting higher costs is obviously a better alternative than losing access to a critical asset, like a port or railway, for which there are few, if any, alternatives. These contractual provisions, therefore, enable infrastructure businesses to preserve, or even improve, financial margins during periods of rising inflation.

While no one knows how long the current period of high inflation will last, it's reasonable to assume that elevated input costs will be a recurring phenomenon in the post-pandemic world, as will the need to protect against them.

8

Special Situations: Gathering Speed

Jordon Kruse
Co-Portfolio Manager, Special Situations

Matt Wilson
Co-Portfolio Manager, Special Situations

At the beginning of the year, we wrote that a distressed cycle might be on the horizon. While a full-fledged distressed cycle hasn't yet begun, the leveraged debt markets are as weak as they've been since early 2020. Many businesses, especially those in the middle market, are struggling with economic trends that have had – and could continue to have – negative effects on financial performance. These include slowing consumer demand, labor shortages, supply-chain challenges, and input cost inflation. If these trends persist and interest rates continue to rise, companies that are dependent on floating-rate financing could face liquidity challenges and need to secure new sources of capital.

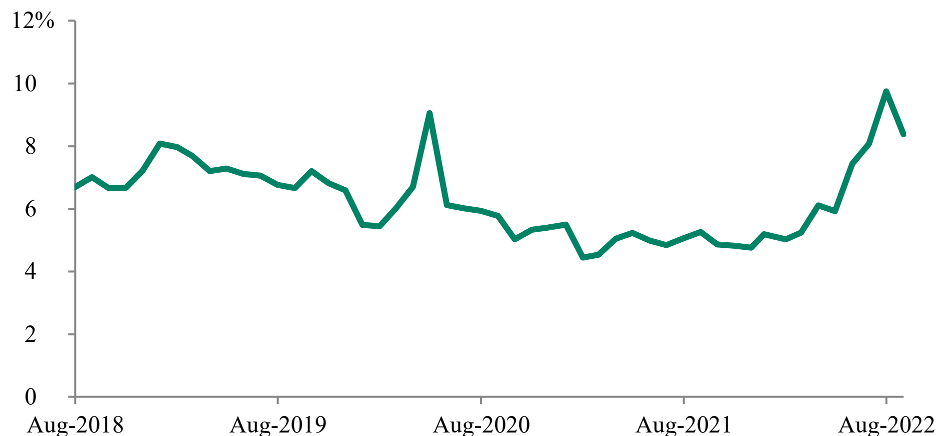
Companies that have recently sought to raise capital from the high yield bond and leveraged loan markets have found that terms have become far more investor-friendly in the last eight months. New B-rated loans were priced at average yields of nearly 10% in July and are currently being offered above 8%, compared to roughly 5% at the beginning of the year.[16] (See Figure 5.)

If stressed companies struggle to access funding through the capital markets, special situations investors may be well positioned to provide alternative solutions, such as structured equity rescue financings. These capital solutions, which typically combine a fixed-income component with a warrant package or equity conversion feature, can help businesses avoid restructurings or solve other problems. In turn, special situations investors often gain control or significant influence over a company, putting them in a position to add substantial value.

We believe that investors may also increasingly have opportunities to purchase distressed debt in the secondary market if companies struggle to roll over their debt as economic conditions decline. In fact, we've had conversations with several bankruptcy lawyers and restructuring advisors who've indicated that a substantial number of restructurings may be coming down the pike in the next six months.

While special situations investors aren't reliant on distressed cycles to generate deal flow, disciplined investors with significant structuring expertise may be well situated to take advantage of these opportunities when they arise.

Figure 5: Yields on Newly Issued Loans Have Risen Sharply in 2022



Source: Leveraged Commentary & Data, as of August 31, 2022

Endnotes

[1] The content is derived from or inspired by ideas in 2Q2022 letters or other materials sent to clients in 3Q2022; the text has been edited for space, updated, and expanded upon where appropriate.

[2] JP Morgan. Bonds trading below 70 cents on the dollar and leveraged loans trading below 80 cents on the dollar are both classified as distressed.

[3] Ibid.

[4] Derived from Oaktree estimates, as of August 31, 2022.

[5] Credit Suisse Leveraged Loan Index; ICE BofA High Yield Index.

[6] U.S. data from JP Morgan; include refinancings and resets.

[7] Based on the realization of the forward curve, as of August 31, 2022.

[8] Credit Suisse European Leveraged Loan Index (EUR Hedged). ICE BofA Global Non-Financial High Yield European Issuers, Excluding Russia (EUR Hedged).

[9] JP Morgan CEMBI Broad Diversified High Yield.

[10] Ibid.

[11] United Nations Conference on Trade and Development. March 2022.

[12] World Economics. 2021.

[13] JPM Emerging Markets Corporate Strategy Presentation. June 2022.

[14] Derived from Oaktree estimates based on deals seen in the market, as of August 31, 2022.

[15] Ibid.

[16] Leveraged Commentary & Data, as of August 31, 2022.

Notes and Disclaimers

This document and the information contained herein are for educational and informational purposes only and do not constitute, and should not be construed as, an offer to sell, or a solicitation of an offer to buy, any securities or related financial instruments. Responses to any inquiry that may involve the rendering of personalized investment advice or effecting or attempting to effect transactions in securities will not be made absent compliance with applicable laws or regulations (including broker dealer, investment adviser or applicable agent or representative registration requirements), or applicable exemptions or exclusions therefrom.

This document, including the information contained herein may not be copied, reproduced, republished, posted, transmitted, distributed, disseminated or disclosed, in whole or in part, to any other person in any way without the prior written consent of Oaktree Capital Management, L.P. (together with its affiliates, "Oaktree"). By accepting this document, you agree that you will comply with these restrictions and acknowledge that your compliance is a material inducement to Oaktree providing this document to you.

This document contains information and views as of the date indicated and such information and views are subject to change without notice. Oaktree has no duty or obligation to update the information contained herein. Further, Oaktree makes no representation, and it should not be assumed, that past investment performance is an indication of future results. Moreover, wherever there is the potential for profit there is also the possibility of loss.

Certain information contained herein concerning economic trends and performance is based on or derived from information provided by independent third-party sources. Oaktree believes that such information is accurate and that the sources from which it has been obtained are reliable; however, it cannot guarantee the accuracy of such information and has not independently verified the accuracy or completeness of such information or the assumptions on which such information is based. Moreover, independent third-party sources cited in these materials are not making any representations or warranties regarding any information attributed to them and shall have no liability in connection with the use of such information in these materials.

© 2022 Oaktree Capital Management, L.P.