OAKTREE INSIGHTS

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RISING RISKS CALL FOR A TACTICAL APPROACH TO GLOBAL CREDIT INVESTING

OAKTREE

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RISING RISKS CALL FOR A TACTICAL APPROACH TO GLOBAL CREDIT INVESTING

This is the first of what will be a regular Insights series from Oaktree's Global Credit Investment Committee. Our team is looking forward to engaging with our readers on a variety of topics relevant to global credit investing.

KEY POINTS

- Oaktree does not focus on making macroeconomic projections, but we do believe that observing the present market conditions and considering possible outcomes can help investors reach sound decisions.
- The global financial markets appear to be telling conflicting stories, with certain bullish developments not quite lining up with the growing set of risks across asset classes.
- Key risks to the global economy today include weakening of production growth and expansion of lower-quality debt.
- While we cannot predict the future, it is worth considering the various economic scenarios that might unfold. We discuss three with an eye toward better assessing where we are in the cycle and positioning portfolios for possible outcomes that lie ahead.

A BOTTOM-UP VALUE APPROACH

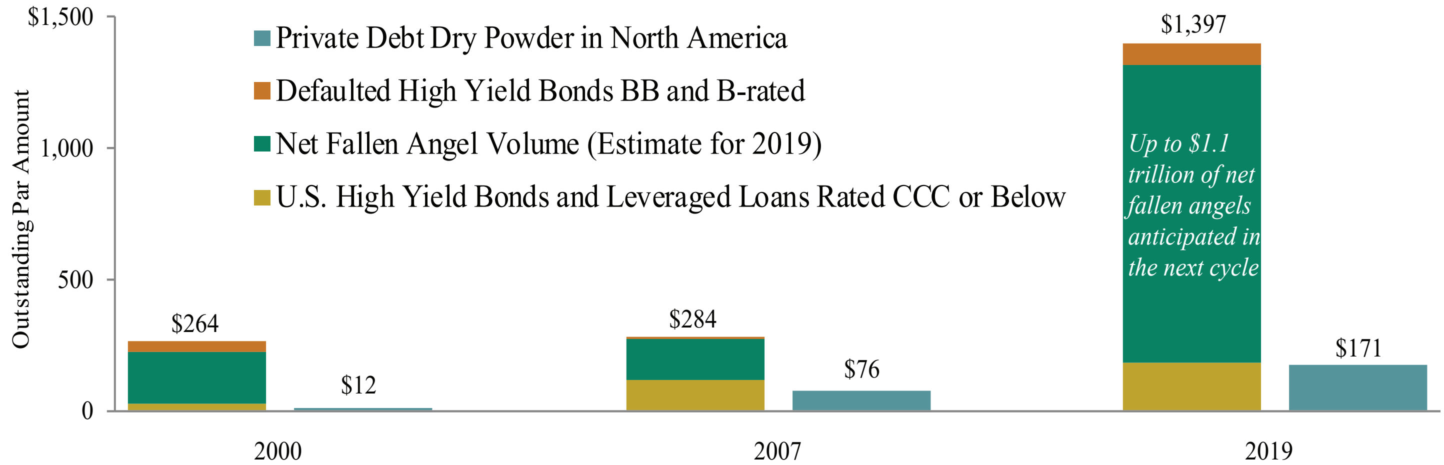
Oaktree has long maintained its investing philosophy of engaging in a bottom-up process rather than predicting what's in store for the economy. We continue to stand by that discipline and aren't very much interested in making macroeconomic forecasts. We do not employ economists at Oaktree, nor do we have a "house" view on the outlook for interest rates. But we also think that it is essential to have a good sense for where we stand in the present in cyclical terms and what that implies for our actions, especially when it comes to investing in global credit instruments across multiple sectors and assessing relative value. With this paper we aim to "take the market's temperature." Is there reckless confidence? Is there too much money chasing too few deals? Are different parts of the global financial markets telling different stories? We observe these questions and consider a few scenarios that might unfold in an effort to gain insight into where we are in the cycle and to properly determine the risk posture for our portfolios.

CAUSE FOR CAUTION

Years of global economic growth and system-wide liquidity, supported by accommodative central bank policies, have rendered many investors more or less complacent. Positive investor sentiment isn't inherently unwise, but at some point we have to consider its relationship to economic realities in making investment decisions. The fact is that there are mounting risks in global financial markets that are contributing to a softening macroeconomic backdrop. At a high level, the International Monetary Fund (IMF) and Organization for Economic Cooperation and Development (OECD) have lowered their global economic growth estimates in recent months. The IMF in its July 2019 World Economic Outlook report projected this year's growth at 3.2%, down from the 3.9% it estimated a year prior. The OECD in May revised its estimate of 2019 growth from 3.5%[1] to 3.2%, adding that "global momentum has weakened markedly and growth is set to remain subpar."

Perhaps one of the more highly publicized risks to global economies today is the ongoing trade war between the United States and China, which has implications for various industries around the world. A growing list of products targeted for retaliatory tariffs – particularly with the latest move by Trump to tax essentially all Chinese imports – has begun to expose consumers and businesses to disruptions in trade and business investments. Many investors have turned to safer assets, evidenced by a surge in gold prices in June and an ongoing global fixed-income rally that has seen government bond yields tumble and the amount of negative-yielding debt around the world pass the $13 trillion mark in June for the first time.[2] Still, the trade war presents potential for further economic fallout, with uncertainty around the scope of its impact.

Figure 1: Inventory of Low-Quality Debt Has Grown Much Faster Than Dry Powder Since the Previous Cycle ($ in billions)



Source: See Endnote 3.

Affected in part by the trade conflict, the global manufacturing sector continues to see weakness. Following lackluster readings in prior months, the IHS Markit U.S. Manufacturing Purchasing Managers' Index (PMI) fell to 50.4 in July, the lowest reading since September 2009. Levels below 50 indicate contraction. Manufacturers cited concerns around a downturn in the automotive sector and heightened global economic uncertainty. PMI readings for the Eurozone fell to the lowest level in more than six years, hitting 46.5 in July. Reflected in this figure is a disappointing month for Germany's manufacturing sector, which experienced one of its steepest contractions since 2009, dropping to 43.2 amid a significant decrease in output. The July figure for the United Kingdom came in at 48, unchanged from a month prior, after dropping below 50 in May for the first time since July 2016, just after the Brexit vote. Uncertainty grows for UK economic projections with no clear resolution for Brexit, and this is expected to continue to weigh on businesses and consumers, dampening confidence and the performance of risk assets.

Also part of today's economic reality is that corporate debt has been building at a fast clip even as concern rises about declining credit quality, creating greater expected risk in credit markets and making debt instruments more vulnerable to financial stress and potential rating downgrades. Figure 1 illustrates the pace at which the inventory of low-quality debt has grown since the last cycle compared with the pace of growth for dry powder dedicated to private debt. The massive growth in recent years in the number of BBB-rated bonds – those bearing the lowest rating within the investment grade category – has led to a pool of about $1 trillion of debt securities today that could be downgraded into the high yield category. Any number of factors indicating souring of market conditions could trigger the next round of downgrades, which then could lead to a disorderly pricing adjustment as many institutional investors have mandates that preclude high yield holdings.

DEPENDS WHERE YOU LOOK

Still, it seems bulls aren't quite finished yet, even as these accounts suggest markets are increasingly vulnerable and characterized by excess.

For one thing, the U.S. stock market has continued to climb this year, hitting a series of new highs and posting double-digit gains amid muted volatility.[4] Much of this cheer was due to the prospect that the Federal Reserve might lower interest rates to help sustain the economic expansion. In July the Fed delivered what the market wanted, lowering rates by 25 basis points, but investors sent stocks lower on the announcement, disappointed that the rate reduction – the first since 2008 – came with no promises of further cuts. The market's preoccupation with interest rates has been notable for some time, as it caused investors to read bad news as good news and vice versa over the past few months. For instance, equity investors absorbed lackluster private-sector jobs data from May as a win based on the expectation that the disappointing numbers might convince the Fed to cut rates. Investors then drove stock prices down on a stronger-than-expected June jobs report. Separately, indices representing global stock markets also have had solid performance so far this year, with double-digit gains for the MSCI World and MSCI EAFE indices.[5]

Perhaps in line with such stock market gains, U.S. consumer sentiment has been relatively high throughout the last couple of years, on par with levels seen in 2004.

The July reading of the monthly Index of Consumer Sentiment by the University of Michigan inched up slightly to 98.4 from June's 98.2, remaining close to the eight-month high reached in May of 100.

It is also worth noting that the latest rounds of initial public offerings of technology and consumer companies have been embraced by an enthusiastic investor base who bid up even money-losing enterprises to double- or triple-digit gains following their IPOs. Public debuts of ride-hailing companies Uber Technologies and Lyft have somewhat disappointed, but plenty of other companies have enjoyed notable post-IPO stock gains, including Zoom Video Communications, Beyond Meat and CrowdStrike Holdings. Market data shows 62 IPOs raised $25 billion in the second quarter, the most activity in several years.[6]

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Bullishness can be seen in lower-rated debt as well. High yield bonds started the year with a stellar January on a dovish pivot by the Fed and continued with additional gains bringing them to a first-half return of nearly 10%. New issuance of high yield bonds also has been strong, with about $28.5 billion raised in June, the heaviest monthly activity since January 2018. This brought the first-half gross volume to $140.5 billion, up 11% from the same period last year.

WHAT NEXT? A RANGE OF SCENARIOS

Between still-buoyant sentiments and mounting challenges to financial markets, a key question for investors is "What should we expect going forward?" When it comes to market conditions, predicting is not Oaktree's game, but preparing is. **Having a sense for where we are in a market cycle and what that implies for the future is different from predicting the timing and extent of the next cyclical turn.** With that in mind, we detail below some of the scenarios that might unfold. Importantly, this is only meant to be indicative of the range of possible outcomes, of which any could happen. We understand that an up-cycle sometimes corrects under its own weight and sometimes is affected by external events. In any case, we think considering these and other scenarios is a necessary effort.

1) **U.S.-China trade talks resolve, rates are kept steady or decline, recession is kept at bay:** Here we contemplate a few different cases that could send interest rates into different directions in the near and medium term. A resolution of trade talks or a clear indication of progress toward that end could set the stage for perhaps the most benign scenario for the near term and could help extend what has already been the longest winning streak in history for the U.S. economy and stock market. Trade talks seemed to be moving in the right direction in some instances over the past couple of months, including a truce between Trump and Xi at the G-20 summit in June, which held back new tariffs, and a meeting of negotiators in July. To be sure, no concrete progress was made during those meetings, and, more recently, Trump extended tariffs to another $300 billion in Chinese imports, rattling markets with the announcement. Still, if the U.S. and China eventually come to a constructive deal, an uptick in economic data should reduce the need for additional interest rate cuts. It is also quite possible that a trade deal with China will be delayed by several months, affording time – and cover – for the Fed to continue on its path of lowering rates throughout this year. If rates are lowered *and* there is a trade deal with China, this may provide a shot in the arm for the U.S. economy, giving further lift to an already strong market. Typically, such a scenario would initially support long-duration assets and help real assets and fixed-rate products – such as real estate debt and high yield bonds – do well. In today's environment, though, it may also benefit investors to consider floating-rate products in a contrarian approach, as loans are largely trading below par and the yield premium of unsecured high yield bonds relative to senior secured loans is close to the slimmest it has ever been. Moreover, a turbo-charged U.S. economy could eventually lead to an uptick in inflation, a future scenario in which the Fed may consider increasing rates, meaning floating-rate products would benefit.

2) **Trade war escalates, leads to potential inflation and global economic slowdown in earnest:** Trump intensified pressure on China when he announced in August the U.S. would impose a 10% tariff on an additional $300 billion worth of Chinese imports. We have not seen retaliatory moves by China as of this writing, but reports say it is becoming more likely

the two countries will be locked in a prolonged dispute. This could further hamper global trade activity and add pressure to supply chains, potentially worsening the global growth outlook and creating room for declines across asset classes. In such an environment, the idea would be to preserve capital while most asset classes likely demonstrate relatively high correlation. Investors would do well to de-risk and seek higher-quality securities, including by moving up in the capital structure of companies. Investments in senior loans, for instance, may provide seniority and more protection than other debt products, as loans may be less correlated with the market and thus not dislocate as much in times of stress.

3) **Trade war resolves, but U.S. technological competitiveness weakens against China's over the long term:** This is probably a notion less widely considered by market participants, but an important one still. At the core of the U.S.-China trade negotiations is the theme of technology and each country's fight for dominance in that sector. We believe it is fair to say that China is taking a significantly longer-term view in developing a technology ecosystem than is the U.S. In our view, China has the luxury of being able to think long term and invest aggressively, especially with massive government support for education. The U.S. could rely on capitalistic forces to help advance its own technology landscape, but it may be disadvantaged considering the impact election cycles can have on policy and investment direction, as well as mounting student debt that may hinder development of talent. Placing restrictions on Chinese technology companies may only spur domestic innovations in China as it seeks to lessen its dependence on the U.S. Chinese companies could increasingly source components locally or from its supporting bloc of countries. This scenario sees negative effects on the global technology sector over the long term vis-à-vis supply chains and a potential divide in future technological developments, including, for instance, a fracturing of global standardization of 5G networks.

   We can't predict whether or how this scenario may pan out, and neither can we tell the potential consequences of such a state many years into the future. Still, Oaktree's Global Credit team is cognizant of this potential and is keeping close watch on developments, as well as constructing our portfolios in a conservative manner to reflect our belief that the market may face significant headwinds in coming years. Today, we believe the markets are anticipating a favorable outcome regarding steady or declining interest rates and a resolution of the trade war. But given the different scenarios that could unfold, we believe it is prudent to protect against downside risk and move forward with caution.

A TACTICAL APPROACH IS WARRANTED

Those scenarios go to show that there is a significant level of uncertainty in the financial world today. We saw in the fourth quarter of 2018 how fickle markets and investor sentiment can be. The pronounced selloff in equities during that period may seem like old news now, but it was a reminder nonetheless that we are no longer in "just right" conditions for stable economic growth. Investors should be wary that supercharged risk-taking in the face of growing evidence of a broad economic slowdown – which is visible today – could threaten financial stability and lead to a correction or a collapse, marked by intensifying selling pressure and falling asset prices.

We can't pinpoint the timing or extent of the next market turn, and we believe that against the current backdrop an investor's approach to global credit investments – especially those that are liquid – should be grounded in careful and dispassionate fundamental analysis and relative-value comparison of individual assets. A flexible but selective bottom-up approach can provide opportunity to capture significant returns or allow for a move in time to avoid a loss. Such an approach becomes even more crucial in today's market, one in which the ability to make tactical asset-allocation decisions – i.e., being able to adjust exposures to asset class, geography or credit quality – can have an outsized benefit as investors aim to best navigate the changing environment and capture opportunities.

Endnotes

1 Estimate of 2019 economic growth from November 2018.

2 Bloomberg.

3 U.S. High Yield Bonds and Leveraged Loans rated CCC and below are based on the constituents of the Credit Suisse High Yield and Leveraged Loan Indices and excludes defaults. Net Fallen Angel volume is based on Morgan Stanley's statistics for Fallen Angels during previous credit cycles as of October 5, 2018. While the CCC and below data represents the outstanding par amount as of December 31, 2000, December 31, 2007 and March 31, 2019, the Fallen Angel volume represents the

par amount for a range of time: 1Q 2000 – 3Q 2003, 3Q 2007 – 4Q 2009 and an estimate for the next cycle's "Implied" Fallen Angel volume, calculated by multiplying the proportion of fallen angels seen in the previous two cycles as a percentage of the BBB index, times the current BBB index par. Defaulted High Yield Bonds BB- and B-rated data is based on J.P. Morgan's statistics for outstanding par amounts as of December 31, 2000, December 31, 2007 and December 31, 2017, multiplied by default rates by rating as seen in 2001, 2008 and 2001, respectively. Private Debt Dry Powder data is from Preqin.

[4] As of July 31, 2019. S&P 500 Index + 20.2%; VIX -9.30.

[5] As of July 31, 2019. MSCI World + 17.6%; MSCI EAFE + 12.6%.

[6] Renaissance Capital.

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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. He is a member of the State Bar of California.

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