OAKTREE | Insights

September
2023 Edition

The Roundup

Top Takeaways from Oaktree's Quarterly Letters

We believe we may be in the first act of what could be a long drama unfolding across markets, as companies face the prospect of higher-for-longer borrowing costs and investors adjust to a new environment in which rigorous credit analysis, not inexpensive debt, will likely be the key to generating superior returns. In the current installment of *The Roundup*,[1] Oaktree looks beyond headline numbers and economic noise to identify the trends reshaping opportunity sets today.

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1.

Global Credit: Ahead of the Curve

The U.S. yield curve has exhibited considerable volatility in 2023, reflecting the fickle nature of investors' macroeconomic expectations and the challenge of predicting interest rate moves. Heightened concerns about a recession have given way to the consensus opinion that the U.S. economy is headed for a "soft landing," or slowing inflation without an economic contraction. Hopes for an imminent dovish pivot by the Federal Reserve have therefore faded, and investors increasingly appear willing to hear what Fed Chair Jay Powell has long been saying about the current interest rate environment: We may be here awhile.

In mid-March, investors reacted to the collapse of Silicon Valley Bank by pricing in elevated recession risk and a dovish yield curve that had 3-Month SOFR[2] falling below 4.0% by year-end.[3] That rate is currently near 5.4%, and investors now expect the Fed to keep its policy rate stable until mid-2024 and above 3.5% through 2026.

What does this mean for speculative-grade credit? For U.S. high yield bonds, it's notable that average yields have remained relatively range-bound in recent months, hovering between 8.3% and 9.0%, despite the volatility in the rates market.[4] Yield spreads have compressed as Treasury yields have risen, reflecting the resilience of the underlying U.S. economy. What if we enter a choppier economic environment? Yields in the high yield bond market probably still won't spike, as most events likely to cause significant spread-widening are liable to have downward pressure on interest rate expectations. Next, consider the impact of these interest rate moves on U.S. leveraged loans. Average coupons for these predominantly floating-rate assets have more than doubled since the end of 2021,[5] making loans attractive from an income perspective. However, the rising likelihood of higher-for-longer interest rates has also amplified credit risk broadly in this market, making proper underwriting even more valuable than usual.

In this uncertain environment, we think the ability to dynamically allocate between asset classes is crucial for credit investors. It can potentially enable them to capture attractive yields across markets while strategically adjusting risk exposure. In short, it can potentially help credit investors stay ahead of the curve.

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2.

Opportunistic Credit: Beneath the Surface

On the surface, many companies in the U.S. appear to be weathering the sea change in interest rates surprisingly well. But storm clouds are beginning to emerge as elevated interest rates are making it more challenging for companies to service their floating-rate debt. In the last nine months, the pace of defaults and distressed exchanges in the U.S. has exceeded the levels recorded in recent years.[6] We think distressed opportunities will likely continue to expand – even if the U.S. avoids a near-term recession.

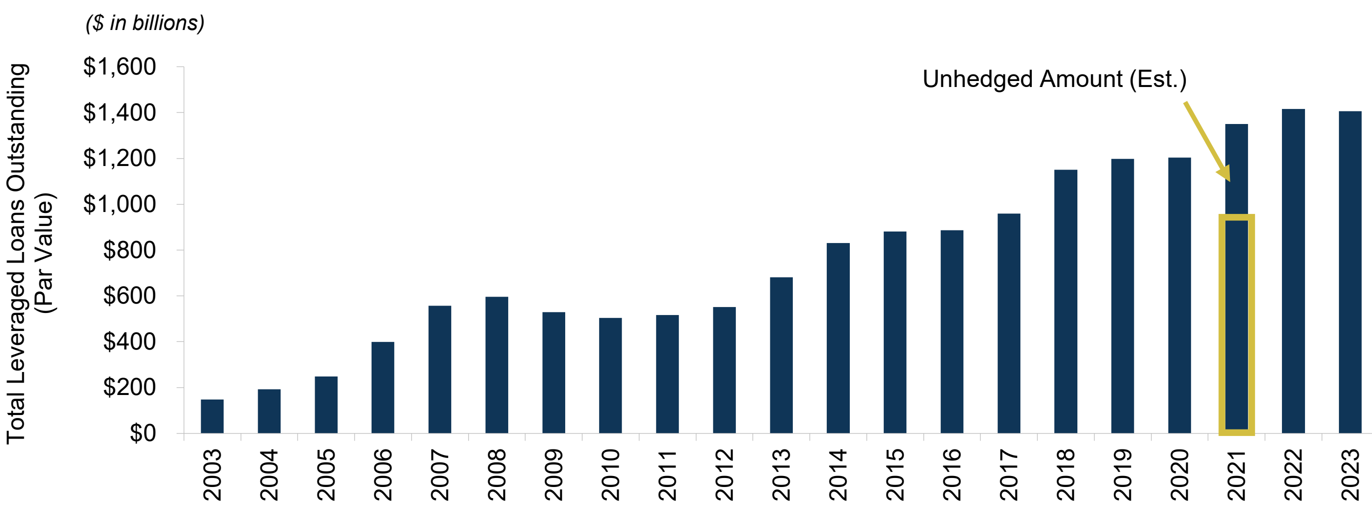
We believe the incidence of distress is likely to be most acute among U.S. leveraged loans and private debt, asset classes that typically feature floating rates. We estimate that the interest rate risk of roughly two-thirds of the U.S. loan market was unhedged as of YE2021.[7] (See Figure 1.) Since then, three-month SOFR (the most common reference rate today) has increased by more than five percentage points.[8] Importantly, changes in loans' reference rates aren't immediately reflected in companies' interest expenses, so firms that failed to hedge have only recently had to start contending with dramatically higher borrowing costs.

Many of these borrowers are likely ill-equipped to handle elevated interest rates. Quality in the loan market has declined significantly over the last decade: Loans with credit ratings of B or below represented 30% of speculative-grade debt outstanding[9] in 2000, but this figure rose to 60% by YE2022.[10] (While the private credit market isn't rated by agencies, we suspect its credit quality has diminished similarly.) Moreover, much of this debt was issued based on aggressive earnings assumptions (e.g., growth, synergies, cost cuts, etc.) that haven't materialized, meaning many of these companies are more highly leveraged than they appear on paper.

These vulnerabilities are likely to push up default rates over the next few years. Consider a study by the credit rating agency Moody's that analyzed the impact a federal funds rate of 5.25%-5.50% would have on the interest coverage ratios[11] of more than 300 corporate issuers in the U.S. and Canada with credit ratings of B3 (the equivalent of B- at other rating agencies). Moody's projected that, in this scenario, the interest coverage ratios of 62% of these companies would fall below one by the end of 2024.[12] (See Figure 2.) In other words, these companies will owe more in interest than they'll be generating – a dynamic that will obviously lead to defaults if uncorrected.

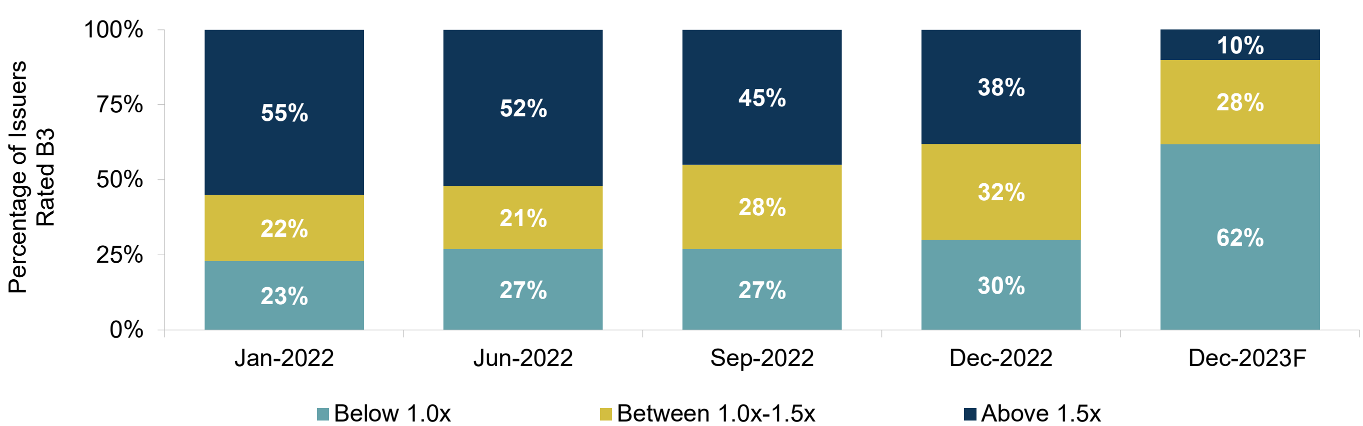
To be clear, we're not outlining a doomsday scenario, as current economic trends are too complex to support such a call. But we do think investors should look more deeply at vulnerabilities that are likely to disrupt the relative calm in credit markets and create opportunities for skilled investors in the years ahead.

Figure 1: Much of the Loan Market Was Likely Unhedged Before the Interest Rate Spike



Source: Market size from Pitchbook LCD; percentage of hedged loans based on Oaktree estimate; both as of June 30, 2023

Figure 2: Rising Interest Rates Are Eroding Interest Coverage Ratios in the U.S. Loan Market



Source: Moody's Investor Services; ratings as of April 2023; forecasts as of July 2023

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3.

European Liquid Credit: Quality Control

European credit markets have recovered much of the ground lost in 2022, and we remain confident in the relative strength of the regions' corporate balance sheets – especially compared to those in the U.S.

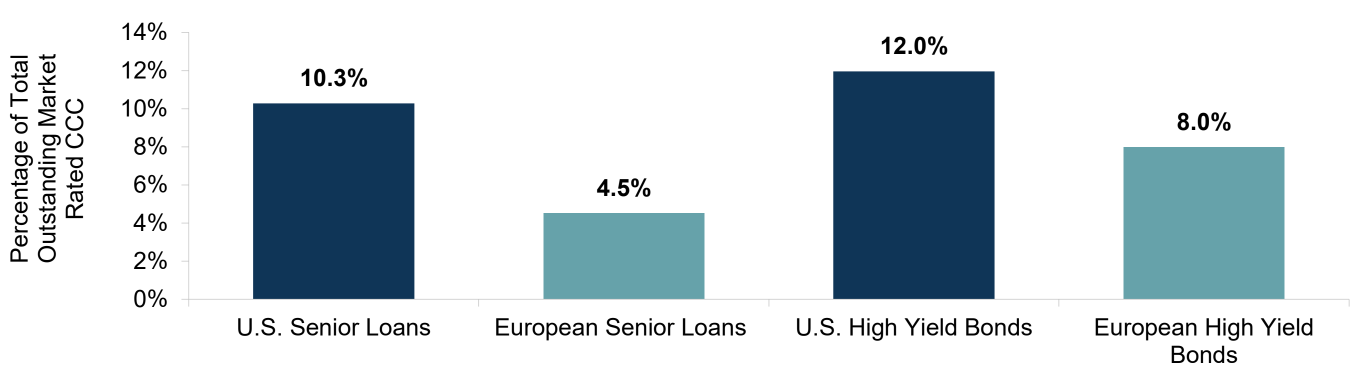
In the year to date, European markets have benefited from the surprising resilience of its consumers, reduced fears of an escalating conflict in Ukraine, and muted energy supply concerns versus those in 2022. Rising confidence in European markets has enabled most companies with impending maturities to refinance their debt. Only the most vulnerable companies have truly struggled to access financing. Thus, the trigger for defaults in Europe in the next two years is unlikely to be maturities, but instead insufficient cash due to rising borrowing costs and shrinking margins.

But we expect that only a limited number of European companies will run into a cash crunch. That's because most European companies didn't expand aggressively or pile on excessive leverage in recent years – unlike what we saw in the U.S. leveraged loan and private debt markets. On the contrary, European borrowers were more apt to be biased toward conservativism. For example, many extended debt maturities, increased cash on their balance sheets, and delayed significant capital expenditures and dividend payments.

As a result, quality in European below-investment grade markets is higher than in the corresponding U.S. asset classes, as we discussed in a recent podcast. This quality difference is readily apparent when comparing the prevalence of CCC-rated debt (the lowest credit rating): CCCs comprise almost 11% of the U.S. leveraged loan market, but less than 5% of the European market, and trends in the regions' respective high yield bond markets are similar.[13] (See Figure 3.)

Now, it's true that the near-term economic outlook for Europe has dimmed in recent months. Weakness in China and rising interest rates have weighed on growth, especially in Germany, Europe's largest economy, which has stagnated for multiple quarters. However, the quality advantage in European markets has left many of the region's borrowers with significant cushion, which should prove extremely valuable if interest rates and geopolitical tensions remain elevated and drivers of growth become more elusive.

Figure 3: European Credit Markets Have Less Exposure to CCC-Rated Debt



Source: Credit Suisse Leveraged Loan Index, Credit Suisse Western European Leveraged Loan Index, ICE BofA US High Yield Index, and ICE BofA Global High Yield European Issuers Non-Financial Excluding Russia Index, all as of August 31, 2023

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4.

Real Estate Income: Pulling Ahead

We may increasingly see geographic bifurcation in U.S. industrial real estate – a sector that has enjoyed historically low vacancy levels over the last year despite the challenging macroeconomic environment.[14] While the sector is currently performing well nationally, we expect that favorable supply/demand dynamics in coastal markets will help them pull ahead of their inland counterparts in the coming years.

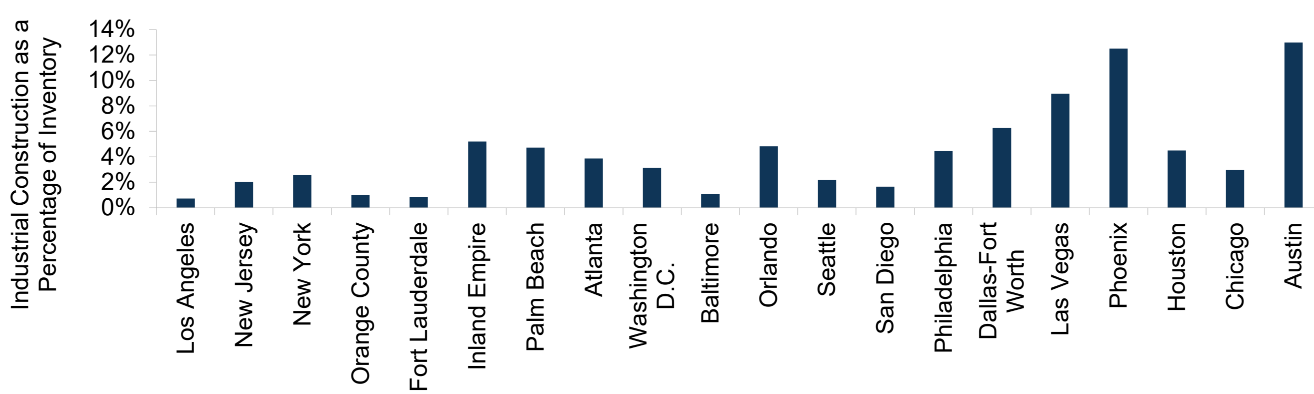
First, demand for industrial properties in coastal markets will likely be supported by high population density. While roughly one-third of the U.S. population lives in coastal counties, these areas represent less than one-tenth of total land in the contiguous United States.[15] If demand for goods softens nationally, markets with greater density will likely suffer less than those that are more sparsely populated.

Meanwhile, the ongoing shift toward online commerce is apt to keep shipping volumes at U.S. ports elevated for the foreseeable future. As waterborne trade has grown in recent decades, ports in U.S. coastal regions – particularly the Ports of Los Angeles and Long Beach – have had to handle skyrocketing volumes of goods, creating tremendous need for warehouses. While shipping volumes in 2023 have declined from the record-high levels recorded in recent years,[16] this mostly reflects short-term issues, like destocking, not changes in long-term trends.

Next, the supply of industrial properties in coastal markets is thin and likely to remain so, especially near Los Angeles, New York, and New Jersey, where land available for industrial construction is limited and anti-growth regulations are further hampering development. Currently, industrial construction represents less than 3% of the total inventory in Los Angeles, New York, and New Jersey, compared to 12% in Phoenix and Austin.[17] The recent increases in interest rates and construction costs (i.e., land, labor, and materials) will also likely check supply growth in these expensive coastal markets.

As a result of the above, we believe industrial sector rent growth in these markets will likely remain strong moving forward and outpace the gains recorded in the rest of the country.

Figure 4: Limited Supply of New Industrial Properties May Support Rent Growth in Coastal Markets



Source: GreenStreet, as of June 30, 2023

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5.

Power Opportunities: Turbocharged

Massive government spending programs passed in recent years could provide a once-in-a-generation boost to energy- and infrastructure-related investments over the next decade, expanding an opportunity set that has been growing for decades.

In 2021, congress passed the Infrastructure Investment and Jobs Act,[18] which authorized the government to spend $65 billion on electric grid updates; $15 billion on electric vehicle adoption, including the construction of charging stations; $65 billion on improving broadband access; and $55 billion on drinking water and wastewater system improvements.[19] Roughly one year later, we saw the passage of the Inflation Reduction Act, which authorized roughly $385 billion[20] in spending for climate- and energy-related programs, including more than $60 billion for clean energy manufacturing in the U.S. and another $30 billion for other projects related to the clean energy transition.

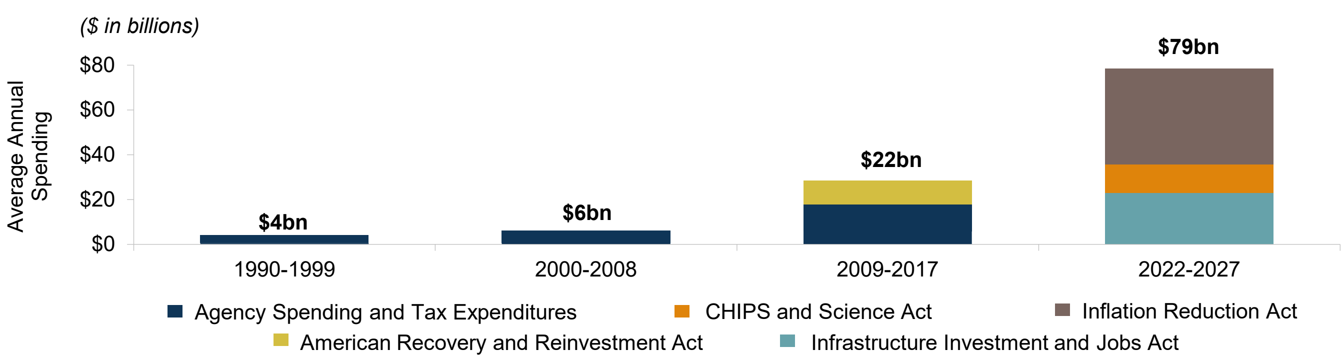
It's unknown exactly where, when, and how all of this spending – be it through grants, loans, or tax credits – will be distributed. But it's reasonable to assume that these outlays will benefit companies in a wide range of subsectors – from those supplying critical components needed for energy and infrastructure projects to those offering installation, maintenance, and expansion services.

We've long believed that both the U.S. government and private sector were likely to increase their investment in the nation's infrastructure to improve the reliability of energy delivery and accelerate the transition toward renewables – and we've invested accordingly. Now, we expect that these long-term trends will not only continue but also accelerate.

However, we also believe that prudent investors shouldn't base their underwriting solely on government legislation. Our decades of experience have taught us that actual government spending doesn't always match what's in the text of a law, bureaucratic logjams are common, and priorities (and policies) can change when new administrations come into power.

Thus, we think investors should target energy- and infrastructure-related projects that have strong fundamentals and growth outlooks absent government spending. That way, this spending doesn't represent a risk but rather a source of possible upside, creating an attractive risk/reward profile. Investors following this plan may face limited risk of downdrafts moving forward and enjoy some of the strongest tailwinds we've seen in decades.

Figure 5: U.S. Federal Spending on Clean Energy Projects Has Skyrocketed



Source: Rocky Mountain Institute; average annual spending is adjusted for inflation; data wasn't available from 2018-21; 2022-27 total excludes projected agency spending

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6.

Emerging Markets Equities: Peak Fear

While media reports about China's economic slowdown have become dire, we're optimistic regarding the opportunities currently available in the country, precisely because of the impact this negative sentiment is having on equity valuations.

China's government hasn't provided large fiscal or monetary stimulus despite sluggish growth. It has instead opted for targeted measures, such as modest interest rate cuts, reduced restrictions on property buying, and policies to help lower local government debt. Thus, many investors aren't optimistic that China will hit its 5% GDP growth target for 2023.

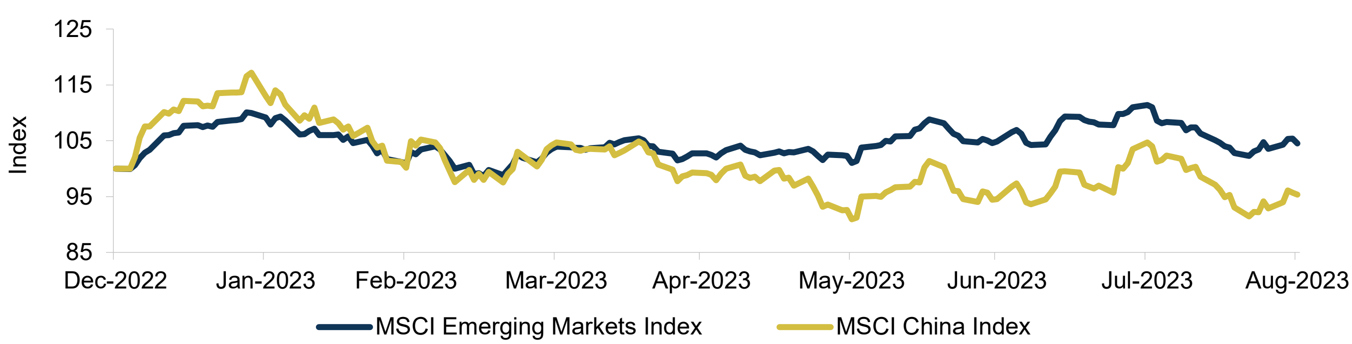
Against this backdrop, Chinese equity markets fell by 4.7% in the first eight months of the year, while the MSCI Emerging Markets Index rose by 4.6%.[21] (See Figure 6.) As a result, several major Chinese technology companies have essentially become value stocks, trading at price-to-earnings multiples in the single digits.[22]

However, China's economy has recently shown some signs of stabilization, and the government still has many policy levers to pull. And, importantly, so much negativity is baked into today's equity prices that any upside surprise – even if it's modest – is likely to drive the market significantly higher. As a result, we believe the risk/reward profile in Chinese equity markets today is very favorable.

Consider what we saw occur in Brazil earlier in the year. Investor sentiment surrounding the country declined dramatically at the end of 1Q2023, largely due to concerns about the policies of President Luiz Inácio Lula da Silva. In response, many investors sold their Brazilian holdings indiscriminately. However, in the following months, the Brazilian government demonstrated healthy checks and balances, and investors started to gain more confidence in the country's outlook, given better-than-expected economic performance. As a result, Brazil was one of the top-performing markets in the second quarter.[23]

What was reported about Brazil was often alarming, but the end result turned out to be much more benign. We believe the same could be true in China. Our many decades working in emerging markets have taught us that investors should watch what governments and companies do, as opposed to what others say.

Figure 6: Chinese Equities Are Underperforming the Broad EM Equity Index



Source: MSCI, as of August 31, 2023, performance since year-end 2022

Endnotes

1. The content is derived from or inspired by ideas in 2Q2023 letters or other materials sent to clients in 3Q2023; the text has been edited for space, updated, and expanded upon where appropriate.
2. Secured Overnight Financing Rate.
3. For all references to interest rates in this section, unless otherwise specified: 3-Month SOFR Futures Curve; Bloomberg, as of September 12, 2023.
4. Yield-to-Worst; ICE BofA Merrill Lynch US High Yield Index, as of August 31, 2023.
5. Credit Suisse Leveraged Loan Index, as of August 31, 2023.
6. JP Morgan, as of September 14, 2023.
7. Market size from Pitchbook LCD; percentage of hedged loans based on Oaktree estimate; both as of June 30, 2023.
8. Pitchbook LCD, as of June 30, 2023.
9. Debt with a credit rating of BB+ and below.
10. S&P Global Ratings Credit Research & Insights, S&P Global Market Intelligence's CreditPro.
11. Interest Coverage ratio defined as (EBITDA – capex) / LTM interest expense.
12. Moody's Investors Services, as of July 27, 2023. Data as of December 31, 2022.
13. Credit Suisse, ICE, as of August 31, 2023.
14. Costar, as of June 30, 2023.
15. U.S. Census Bureau, as of 2017.
16. Port of Los Angeles, as of June 30, 2023.
17. GreenStreet, as of June 30, 2023.
18. Commonly referred to as the "Bipartisan Infrastructure Law."
19. The White House.
20. The White House; the figure includes the impact of spending and tax credits.
21. MSCI China Index, as of August 31, 2023.
22. Bloomberg, as of June 30, 2023.
23. MSCI Brazil Index, as of June 30, 2023.

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