Research Roundtable: Q2 2021 Market outlooks

Kara O'Halloran (00:05):

Welcome to Fireside, a podcast from FS Investments. My name is Kara O'Halloran, I am Director on our Investment Research Team. We have the whole gang together today, my whole team is here for our first research round-table episode to discuss our outlooks for the second quarter of 2021. With us is Andrew Korz, another Director on the team. We have Lara Rhame, our Chief US Economist and Rob Hoffman, our fearless leader, the head of our research team. Hi everyone.

Andrew Korz (00:36):

Hello.

Lara Rhame (00:37):

Hey.

Kara O'Halloran (00:37):

How's it going?

Andrew Korz (00:37):

Great.

Lara Rhame (00:40):

It's springtime, happy.

Andrew Korz (00:42):

Yes.

Kara O'Halloran (00:42):

I know. I know. This is fun. This is like a little taste of what it used to be like when we were all back in the office.

Lara Rhame (00:47):

I miss it.

Kara O'Halloran (00:48):

Don't we all? Soon enough. To set the stage a little bit, it is March 26th, so the end of the first quarter is upon us, which means our team has been busy thinking about and writing about what's to come in the next few months. Before we get into all of that though, I thought we could go around and talk a little bit about how things are going so far this year. We have put out outlooks pretty consistently. We each also published a chart book with our top predictions for the year, which means that everything we have forecast and said is on paper, so let's check our work a little bit. I want to know one call that each of you made coming in to 2021 that you are particularly proud of or that we have seen play out. And then something you're kicking yourself about, something you were off on or you didn't specifically call out that you wish you had. Lara, we can start with you.

Lara Rhame (01:39):

I'm really so much more eager to talk about the calls that I'm proud of then what went wrong. But since you put me to task, proud of my conviction of yields were going to move higher in 2021. So far, that's been spot on and I think there is more to come. Kicking myself for, this is a painful one. Last year, my outlook for 2020 included being bullish on the energy sector, which was relatively cheap and a good place for value investors to capture gains but clearly COVID crashed straight into that idea. And when I rewrote the 2021 outlook, I wanted to reframe it, re-run it, but I got cold feet at the end of the day. I wish I had charged through and I am kicking myself for that one for sure.

Kara O'Halloran (02:34):

I feel like we've all done just kind of roll forward our old work. I think it's impressive that you decided to come up with some new things. Rob, how about you in credit markets?

Rob Hoffman (02:48):

Sure. I think looking back at our chart book, which we wrote in early December and published in the middle of December, I think one of the things that we can be most proud in terms of calls was that the senior secure loan market would start to see consistent inflows. That was a market that from October of 2018, really through the end of last year, had $90 billion worth of retail outflows or some astronomically large number.

Rob Hoffman (03:23):

That market had not seen sustained inflows in a really long time. I think a little bit on the backs of the interest rate call, even though loans are really more anchored toward short term rates, felt that if the intermediate to longer term part of the rate curve moved higher, that would cause people to look towards floating rate assets and we've definitely seen that. The loan market has had something like $11 billion worth of inflows now in 2021. This is the first time in three years that this market has really started to see it.

Rob Hoffman (03:57):

And it was definitely something that in early December when we made it, I'm not sure a lot of people were really focused on it and it's happened. In terms of things that we didn't get right, we tried too hard, we were just too accurate. No, I am always well aware that it's extremely difficult to predict. One of the things we talked about loans out-yielding high yield and I think that's one that may end up not being accurate for this year. As rates move up, the high yield bond market, the yield in the market could go up, even though spreads may tighten.

Rob Hoffman (04:40):

I'm sure we'll talk more about that later, but with the loan market, you've seen this really strong demand, which we called but that's inevitably going to push down your yield and because loans are anchored to short-term rates, which we don't really expect to go up, the yield for that market is likely to go lower because of that. I think, it may be one instance where we may not get that one right on the year.

Kara O'Halloran (05:04):

All right. Still nine months, we'll see. Andrew [crosstalk 00:05:13]

Andrew Korz (05:13):

Yeah, sure. I think on the good side, one of the calls we made was that CMBS spreads, which we all recall blew out early in sort of the spring of 2020 as COVID really hit. And tight and pretty significantly going into the end of last year but we're still wide of pre-COVID levels. And one of

our calls was specifically to see the triple B portion of the capital stack where it's a little riskier, it's a little more prone to losses, obviously, than the higher rated tranches. So our call was that triple B spreads by the end of '21 could come back into ultimately pre-COVID levels.

Andrew Korz (06:02):

The triple B kind of spread areas, we sort of use it as a market barometer for the broad health of the CRA Market, I think there was concern early in the pandemic that we get a repeat of 07/08 where there was just this broad pullback by CMBS, by banks, by pretty much every type of lender and that sort of led to this huge deleveraging that really kind of decimated the space. That doesn't happen, I think lenders have sort of bridged the gap. I think the market sort of seen the light at the end of the tunnel with the vaccine and an eventual re-opening. Triple B spreads have come in pretty significantly, just since the beginning of this year, we've gone from 481 to 394. So almost 100 basis points of tightening just in three months.

Andrew Korz (06:52):

That's still wide of where we were, I think that could come in further. I think, there's this recognition that there's not going to be this devastation in the market. I think that's become clear. But there's still room to tighten further with hotels and retail still really struggling. So I think we've tightened significantly already, I think there's probably still further ago this year. In terms of mistake, I'm still pretty polish on this call, generally, for the rest of the year. I think, we saw a deal activity in the commercial real estate market really spike in Q4 last year. I thought that might be a springboard for volumes coming into '21, hasn't quite happened through the first two months of the year.

Andrew Korz (07:34):

I think deals always get done at the end of the year, Q1 is generally light. I think initial vaccine excitement, people kind of got excited November, December last year, I think some deals got done on the back of that. And then coming into '21, I think people just want to see the proof in the pudding. They want to make sure that economic growth, there's this pull through to CRA fundamentals. And once that becomes clear, I think we'll see. Transaction volumes really cut a comeback in the second half of the year.

Kara O'Halloran (08:01):

Right. Thanks, everyone. We will certainly check back in on some of our predictions later this year. So we'll see how we're doing in a couple of months. So moving on to the second quarter, I don't know if it's the warm weather, the longer daylight hours, hearing all these people getting vaccinated but for the first time in a while, I personally feel pretty hopeful, which is kind of a foreign feeling after the last year. And we've definitely seen that come through in some of the economic forecasts. So GDP expectations, some of them are now close to 7% growth this year, versus consensus with which was just under 4% only a few months ago. So Lara, can you walk us through a little bit about what's driving this optimistic sentiment and these forecasts and how does this align with your views?

Lara Rhame (08:50):

Yeah. I mean, there's no doubt that tailwind, upon tailwind, upon tailwind, our buildings just create an exceptionally robust year of growth. And to frame out the sort of consensus expectation that we're going to get growth and my expectation that we're going to get growth above 6%, you have to go back to 1984 to get another year of growth, that's that strong. Some of these expectations are for growth around 8%, then you're talking back to 1951. I mean, these are rates of growth that the US just does not see and certainly cannot sustain.

Lara Rhame (09:25):

But this is the impact of $5 trillion of stimulus thrown onto the economy over the last year and with more still to come in March as we know. We have the monetary policy that we've seen draw interest rates to historically low levels. And then to your point, Kara, the progress of vaccines, I think, we cannot forget at its core this sort of like good old American resilience that has really caused consumer confidence and business sentiment to remain rock solid throughout this really unprecedented and rapid recession and this early expansion.

Kara O'Halloran (10:18):

So your Q1 outlook, you said that we were preparing for takeoff. Where are we now? Are we still on the tarmac? Are we close to cruising altitude?

Lara Rhame (10:28):

We are literally just starting to speed up, to take off. We're seeing data so far for the first quarter is kind of a muddle, you had a lot of fiscal stimulus, hitting consumers right in January. But the real, this last package that was just passed, this 1.9 trillion package with hundreds of billions of dollars that are going to be hitting households through the mailbox, again, is going to hit in really at the end of March. So second quarter is expected to be over the course of the year, the strongest quarter for growth. But keep in mind, we had those really terrible snowstorms throughout the Midwest, it's caused some pause and spending activity, construction, all of those areas.

Lara Rhame (11:17):

So I think the second quarter, we're going to see the big surge in growth and that's expected to carry through in the second half of the year with increased services spendings. I will be the first one to jump back onto an airplane. We've already got our tickets purchased, we are going to be out there doing our part to support the service side of the economy.

Kara O'Halloran (11:39):

Yeah, Robert, I think you'll be getting a lot of PTO requests from your team there up.

Rob Hoffman (11:47):

We have not yet bought any tickets yet. As it relates to the Grossberg to come, we still have yet to open up the checkbook but it will come to it.

Kara O'Halloran (11:58):

Well, someone has to hold down afford at the office while we're all off [inaudible 00:12:01]

Lara Rhame (12:02):

Fourth of July is mine.

Kara O'Halloran (12:06):

So, Rob, how about in credit, so we see spreads in both high yield and loans pretty much back to where they were pre-pandemic, but pre-pandemic we were talking about how spreads were tight. But we have this optimism as Laura talked about a really strong growth forecast, default rates are trending down, fundamentals are improving. What do you think all this optimism means for credit markets?

Rob Hoffman (12:29):

Yeah. I mean, I think to me, one of the things that's most interesting about where we are today versus a year ago pre-pandemic is that, and we've written about this, things look really similar if you just look at the headline numbers. I do think though, sentiment is a lot different. Pre-pandemic, while things were tight, everyone was sort of positioning for and talking about this is

bound to end at some point, we're late cycle, it's late cycle dynamics. The expansion was the longest in history, it was long in the tooth. And we had to refer to these phrases like, "Well, expansions don't just die of old age, something has to happen."

Rob Hoffman (13:16):

And something did happen, which no one predicted and something we haven't seen since my grandmother, who's 103 happened to witness basically when she was born, which was a pandemic. But what's different about today is that, while again, a lot of those headline numbers like spreads are the same, now we really feel like we're at the beginning of a new expansion. And you no longer have people talking about late cycle dynamics and how we have low population growth and low productivity growth. So GDP is kind of capped at 2%. We just as Lara just said, seven, 8% GDP, I think a lot of us were on a call with an economist a week ago who said, "Things could go to 10 to 15% if it really gets strong."

Rob Hoffman (14:05):

That's a different starting point from where we are. And so I do think, spreads have still not quite hit post financial crisis tights which were level seen in 2018. And I think it gives us a real possibility that that could happen and spreads could even go tighter than that. I mean, if we really see this positive sentiment come in, everything else continues to take hold. I think from where we sit right now, it's really hard to see what sort of negative news setting aside the obvious like the pandemic, what other sort of negative news really gets in the way of this budding expansion, which creates a very good fundamental environment for credit and for lending? And I think gives markets some room to run, even though spreads are at a relatively tight level.

Kara O'Halloran (14:58):

Yeah, and I think also the technical side of things with interest rates being as low as they are elsewhere in markets, just people need income. So I think that'll definitely help things as well.

Rob Hoffman (15:09):

Yeah, absolutely. Well, and people need income and people want assets that aren't going to go down when interest rates go up. And that's, I'm sure we'll talk more about it. But that's another great attribute of below investment grade credit that you're not going to get in the hybrid markets.

Kara O'Halloran (15:27):

Yes, we will get to all of that very shortly. And so, Andrew, turning to you in the real estate markets, I think this is a really this optimistic feeling is I'm curious your thoughts here, given how much our lives have changed over the last year. So we have all been out of the office for over a year, I am certainly shopping a lot less in person than I was, that's all switched to online, plenty of packages coming to my door every day. But yet we saw property values rise in 2020, even given some of these weakening fundamentals. So maybe you can talk a little bit about that. And then also how this optimistic sentiment pervades real estate markets, is there another shoe to drop? what's going on there?

Andrew Korz (16:08):

Sure. No, it's an interesting question. I think it's a complicated one. But at its core, real estate is a very economically sensitive sector, right? The more money people have, the more they're going to go out and spend shopping or stay in hotels, the better business activity there is, is going to create demand for industrials and warehouses. Employment drives sort of office demand. So generally speaking, I think, undoubtedly a better economy is unambiguously good for the real

estate market. Right? I think, this downturn was obviously very complicated, we need to acknowledge the fact that in so many ways, it's driven just divergences in so many areas of life and the real estate market is certainly one of those.

Andrew Korz (16:58):

The boom in e-commerce has really just created the surge of demand for warehouses and distribution centers, last mile facilities and there's sort of this underlying demand for apartments that's still kind of there. And then you have retail and hotel, which have just been decimated by the restrictions put in place and just generally people not wanting to risk going out and sort of being in the presence of other people. So I think in the short term, it's pretty clear that economic growth is just going to be really strong this year, people have a ton of money to go out and spend, people are itching to travel. I absolutely second what Lara said earlier.

Andrew Korz (17:46):

I think in the short term, you're going to see a really strong improvement in fundamentals specifically in retail and hotel. Longer term, whether there's another shoe to drop, I think it depends on how you look at it. For the market as a whole, I think we've seen the worst of this, I think the spring and summer last year was really worrisome for a lot of people. And like I mentioned, I think lenders were a lot more available during this downturn and that kind of got us through to where we are now. And I think we've probably seen the worst of it. On the other end of that, will certain properties and sectors and geographies feel some more pain going forward? Yeah, of course.

Andrew Korz (18:28):

What I want to be the owner of a San Francisco office building or a high end New York apartment building right now? Probably not.But I think there's always going to be divergences. Is there another shoe to drop? Maybe there's a sock to drop or a build a bear shoe. But for the market as a whole, I don't think there's going to be this big wave of distress that we see come over the next year or two.

Kara O'Halloran (18:57):

Alright, so we might see $1 shoe drop. So switching gears a little bit, we've alluded a little bit to interest rates, which also brings up the topic of inflation a little bit, certainly a hot topic with really wide ranging impacts. Lara and I chatted about interest rates on a podcast a few weeks ago, but still definitely top of mind. I think inflation is very much part of the conversation again, for the first time in a while. I think the expectation is for a pickup in inflation in Q2, at least temporarily. But Laura, walk us through some of your thoughts about inflation right now, in the short term, more long term.

Lara Rhame (19:37):

Yeah, sure. Inflation remember sits at the intersection of the economy, interest rates, Fed policy and financial markets. So exactly as you said, second quarter because of just the deflationary pulse that we experienced exactly in the coming sort of March, April, May of last year, those base effects will wind out of the data and we'll see a jump in Q2. It could be as high as 3%, which would be not the highest inflation in a decade, but that is largely expected to be transitory. We're still going to be muddling through a sort of conflicting and contrasting impulses stemming from the pandemic, we've seen some supply side driven increases in commodity prices and input prices. But we've also seen really large parts of the consumer price index like owners equivalent rent, that's how we try to capture the cost of shelter or apartments or houses in the consumer price index.

Lara Rhame (20:45):

And that's been trending lower. So you have these sort of conflicting pieces, which could make inflationary signals a little bit tough to decipher beyond this expected Q2 jump. I will say that when it comes to the Fed, they're really not focused, I think, on the actual headline, inflation numbers over the next year, they're going to be focused on employment. And they're going to be eager to just be very patient and manage expectations away from them doing anything to slow the economy or disrupt the economic recovery.

Lara Rhame (21:26):

But as far as interest rates go, these conflicting or at times sort of dramatic shifts in inflation, could cause volatility. We've already seen interest rates rising, that is my expectation that it continues. And to the extent that we're getting one or two months where inflation could kind of overshoot expectations or do something unexpected, I think that's something that will continue to draw attention to the Treasury Market and will continue to cause the sands to shift under broader financial markets.

Kara O'Halloran (22:01):

So, Andrew, real estate is probably well positioned for a pickup in inflation, especially if landlords are able to pass along some of these price increases to tenants. So maybe you could talk a little bit about your thoughts on inflation in that market?

Andrew Korz (22:16):

So yeah, I mean, when people consider rising inflation and sort of where you want to be in markets in those periods, people generally think of real assets whether it be real estate, whether it be commodities. And I think the same is true here, in a rising inflation environment, the idea is the property owners are seeing rising costs and they're able to raise rents, whether it be in an office building, on an apartment building, on a retail building, they're able to raise the rents on the tenants to sort of offset the negative impacts of inflation. And I think, if we do see a sort of longer term uptick in inflation, it'll probably be driven by demand pull inflation which in that case, we would fully expect real estate landlords to be able to increase the prices that they charge and sort of the rents that they charge.

Andrew Korz (23:19):

I think from a broad interest rate standpoint, a lot of people are worried about the impacts on commercial real estate pricing, with sort of cap rates which is sort of how we look at... It's basically the yield on a property, right? People are sort of concerned that interest rates go up, cap rates should go up, which would hypothetically be a negative for property values. I'm not so sure. During the COVID crisis, as rates plummeted, we saw cap rates barely budged. They moved a little bit up for hotels, they moved a little bit down for industrial buildings but buy and large, they were kind of flat, which means that investors were demanding a higher risk premium for buying a real estate building. And that makes perfect sense, right? There was more risk out there, investors were sort of demanding an extra risk premium to invest in commercial real estate.

Andrew Korz (24:16):

As rates go up, it sort of implies the economy is getting better and real estate fundamentals are stronger. So you'd sort of expect that spread to come in a little bit. Right? So I think there's plenty of room for, I shouldn't say plenty of room, there's some room for rates to go up further without cap rates feeling that heat. So I think, by and large, I'm not super concerned with the current state of inflation or interest rates now. If inflation were to go to the moon and interest

rates go to 5%, that's a different story. But right now based on our projections, I think people might be over-hyping the impact to cap rates and to CRA pricing as a whole.

Kara O'Halloran (24:54):

I think if inflation goes to 5%, we'll be recording an emergency podcast. They'll be plenty of impacts to talk about there.

Rob Hoffman (25:03):

Andrew, one question. I wanted to ask that following up on Kara's comment, I think and correct me if I'm wrong, and I'm sure I may misremember this, but It might have even been a couple years ago, you helped write a piece about interest rates and cap rates, and talked about really the importance of real rates and the impact on cap rates. And I think one of the things that we're seeing in this cycle is, especially really just over the past few months, we've actually seen moves in real rates go higher. Is that something that could be more impactful? Is that something rather than just headline like Treasury rates going up but if inflation expectations are going up along with it, then real rates are on change but if we see real rates really move up, that that's something to pay more attention to as it relates to cap rates?

Andrew Korz (25:59):

Yeah, and I think that's definitely right. And like I said, real estate is theoretically thought of as a good inflation hedge. Like I said, property owners can sort of pass along some of that extra inflation costs on to their tenants. Yeah, I think that's right. And we have seen real rates kind of start to creep up but let's be clear, they're still at negative 50 basis points at the 10 year point. That's not a level where I think you'd start to get concerned. I think the Fed is very intentional with not letting financial conditions tighten until they see a really robust recovery and employment. And I think until that point, real rates are kind of going to be mired in this negative 50 to zero areas which... Yeah, I mean we certainly think of cap rates as real interest rates plus sort of real estate risk premium. Yeah, I mean unless we start to see a big uptick in real rates, which I don't see over the next few years at least, I think that's pretty bullish for commercial real estate pricing.

Kara O'Halloran (27:16):

So Rob, switching now to credit, we typically see when rates rise, we see a lot of inflows into senior secured loans like we've talked about already. But we've also done a lot of work on this and found that high yield bonds actually performed pretty well following periods of rising rates. So maybe you can talk a little bit about the relationship there, what's driving that dynamic? How do we see inflation fears as well play out in the high yield bond market?

Rob Hoffman (27:46):

Yeah, I mean the move in rates, I think, as it relates to credit markets and we talk about high yield senior secured loans, even CLOs, collateralized loan obligations, it has a really interesting impact on the market that's not always intuitive. When you talk about high yield, in particular, it's a fixed rate asset class. And so the general convention is fixed rate asset classes have duration risk. And if rates go up for whatever reason, it's a negative for the asset class. What we sometimes forget about is that when you're in these asset classes and you're getting paid a lot of excess spread over the risk free rate over the Treasury rate, that excess spread can theoretically and it has in a lot of cases, fully absorb the change in that base risk free rate.

Rob Hoffman (28:46):

And so yeah, I mean, the work that you help put together for us, Kara, about empirical duration which basically says, "Okay, let's take a market like high yield and let's look at its whole history.

And let's figure out what actually happened to the market in periods of rising rates?" And surprise, surprise, the market does well in periods of rising rates. So, that duration number was actually negative. So that even though high yield has a stated duration number of like four, four and a half, something in that number, the empirical duration number was negative... Correct me if I'm wrong Kara, one and a half maybe or point five negative one and a half. And I think what ultimately happens is if you get a period in which we may be in now, where rates are going up because fundamentals are doing really well, the economy is doing better, that creates a really good environment for companies.

Rob Hoffman (29:45):

And so the credit spread, that premium you're getting paid over base rates shrinks, as it we're in a lower risk environment. And so you don't need to get paid as much for risk because risk is really low. So it creates a little bit of diverging dynamics, I think if you look one quarter into this year, the return for high yield is actually a little bit below what we would have maybe thought for the quarter, you've had some price depreciation so that you haven't earned just your full coupon, your full income because what does happen is when rates go up, everybody tends to freak out a little bit, equities go down, high yield which has correlation with equities, it goes down along with it, the markets kind of trade off.

Rob Hoffman (30:32):

But what we have seen and again, we also wrote about this, that if you can start to look three, six, nine months out, that tends to correct itself, then you go back to trading on fundamentals and in an environment where fundamentals are important in the market as well. As I said it also then impacts other markets differently. And we look at a market like loans, loans are floating rate. So just a pure move on interest rates on treasuries, for instance, doesn't really impact the loan market directly because it's a asset class with the duration of basically zero.

Rob Hoffman (31:08):

And again, you have this credit risk spread where if you're in an environment of really good GDP growth and really good corporate underlying fundamentals, then that risk premium should shrink which helps induce even more price appreciation for loans, which is great for the market. You also get this other benefit, which is retail investors into a floating rate loan products tend to follow interest rates, and they tend to follow Treasury rates, which I think arguably, they shouldn't really do because loans are priced off Libor but at some point in the future, are probably priced off so far.

Rob Hoffman (31:49):

The Libor hasn't moved, really short term, one month, three month rates are still anchored at zero. But yet investors start to look for, "Okay, well, rates are going up, I don't want duration risk. I still want income, let me go buy an asset class that has income but doesn't have duration risk." And an asset class like loans fits into that very well. So, I think it's a really interesting environment in these periods of rising rates and the impact it has on credit because it's not always very intuitive why they work the way they do.

Rob Hoffman (32:24):

And I think they can be a really nice place especially, Kara, as you pointed out earlier, you compare that to investment grade markets whether it's investment grade corporates or the Barclays AG which has a lot of sovereign investment grade exposure, their duration risk is a real issue, that if you don't have that credit premium and so you run into these periods of rising rates and it can have a very negative impact on price and I think we've seen that with the Barclays AG year to date being down over 3% in some periods, that it can be a major negative

on some of those asset classes. So it's a really interesting phenomenon, I think, as a relates to credit.

Kara O'Halloran (33:08):

And Rob, I think stepping back from that, something that we're going to have to watch really closely over the coming quarter, is how fast rising rates are happening. I think, exactly to your point about credit markets and their reaction, rising rates in and of themselves may not be problematic but any kind of disorder or even rising rates, I think that start to cause other mechanical problems with getting some of these deals done. I think we flirted with that in the first quarter. And I think that's going to be something everyone's watching really closely. So, I think rising rates are a really healthy expression of these extraordinarily optimistic growth outlooks and growth forecasts. But the speed matters.

Rob Hoffman (34:04):

Yeah, definitely. I mean, so much if our general view is that fundamentals are really good, GDP is really good, so much of the path, I think, for a market like credit is just then sentiment. Does that positivity about the underlying fundamentals in the economy flow to sentiment for the market and I think if you get these really quick, rapid rises in rates, equities are bound to crash. It's just like a change in environment. And that crash may not be permanent but it persists. And everybody it's the classic risk off trade. And the reality is asset classes like high yield or loans because they are sub-investment grade asset classes, they tend to move with risk. And if you get a big risk off trade, those asset classes tend to correspondingly go down at that period of time. So yeah, I think that's exactly right.

Kara O'Halloran (34:59):

So this has been a great conversation, we have covered a lot of broad topics about markets. But I want to know really quickly, kind of your elevator pitch on Q2, we can start with Lara, your outlook?

Lara Rhame (35:12):

It's always hard to go first, it's like ordering at a restaurant.

Kara O'Halloran (35:17):

You're a macro economist [crosstalk 00:35:23].

Lara Rhame (35:27):

I think Q2, we really need to see the policy pivot away from stimulus checks in the mailbox towards policies which incentivize business investment spending, which incentivize hiring to close the uneven gaps that have emerged in the labor market picture. At the end of the day, we know where there's going to surge in Q2 but keeping that sustainable through the remainder of 2021 and into 2022, is I think, where the focus quickly shifts after what is going to be arguably really positive numbers and data coming out of the next quarter, the coming quarter.

Kara O'Halloran (36:13):

Andrew, real estate?

Andrew Korz (36:16):

Yeah, sure. I mean, I think for Q2, let's just fast forward three months, I think sitting here June 30, we could be in a very different and much better place from a vaccination standpoint. I think the commercial real estate market is like if equity markets are a Mazda Miata, they trade millions of times a day, the commercial real estate market is like an oil tanker, right? It takes a long time for deals to get done. And it takes a long time for positive sentiment to kind of pull through to

the market. So I think we'll continue to see an improvement in deal activity and volumes but we may not see this robust surge that I think we might ultimately get by the end of the year.

Andrew Korz (37:04):

But I'll be watching traveling numbers, are people really going to get out there and start to travel towards the end of Q2. I'm always watching office announcements, will they or won't they come back to the office? Are they going to go flex? Are they going to go full time? Virtual? And we could do a whole episode on that but there's so much to figure out there. And anybody who tells you they know what's going to happen is not telling the truth. So I think a lot of that kind of stuff, we're going to get better clarity on throughout Q2.

Kara O'Halloran (37:38):

I really hope the real estate market is not the boat that is stuck in the Suez Canal right now. [crosstalk 00:37:47] more credit to wrap us up. Rob, wrap us up with credit. [crosstalk 00:37:56]

Rob Hoffman (37:56):

I think credit markets, it's an acknowledgement that spreads are tight. I think we look for income based returns over the course of Q2. Look, it's anywhere from one to one and a half percent for high yield loans. In the context of what's going on in the rest of fixed income, I think that can be really attractive. Asset classes that have a general degree of resiliency against rising rates, they have the potential for spreads to tighten. I do think it's possible, I don't know when spreads are going to tighten but it's still our call that they could tighten further at some point this year. And I think that gives the markets the potential on the credit side to generate returns that are in excess of just their income based return.

Rob Hoffman (38:46):

But at a minimum, I think that provides a very nice baseline assuming this narrative of improving economic outlook. Potentially rising but a steady path for interest rates, I think that can set up very well and can make credit look like a pretty attractive option within portfolios which can ultimately drive demand and support the return. So, we'll see what happens, we'll see if something derails that. If some big news events comes out which inevitably happens at some point during the year, but for now it looks pretty good. And I think markets could be supportive with that.

Kara O'Halloran (39:29):

Great, well, thank you all for joining today. We will have all of our Q2 outlooks out in the next few weeks, always on fsinvestments.com. And we'll be back in a couple of months to see how right we were. Thanks, everyone.

Andrew Korz (39:43):

Thanks.

Lara Rhame (39:44):

That was great. Thanks, Kara.

Rob Hoffman (39:44):

Thanks a lot, Kara.

Speaker 5 (39:51):

This podcast is brought to you by FS Investments. If you found this helpful, subscribe to get new episodes as soon as they're available.