INVESTMENTS®

Episode 13

Spinal Tapping into interest rates

Kara O'Halloran (00:05):

Welcome back to FireSide, a podcast from FS Investments. My name is Kara O'Halloran. I'm a director on our investment research team here. And today we have a full episode focused on credit markets. We've talked about credit a bit in some of our research roundtable episodes, but we haven't devoted a full show to the topic yet. And when I say credit, I should make it clear, right off the bat, we pretty much mean sub-investment grade, so, high yield bonds and senior secured loans. But specifically today we are myth-busting. So, we're going to go through some of the common misconceptions we've heard about credit over the years, and some of the ones that we're specifically hearing a lot in today's environment, and there is nobody better to do this with than Rob Hoffman, who is the head of our research team here, but in a prior life was a credit trader and portfolio manager. Rob, thanks for joining.

Robert Hoffman (00:52):

Hey, thanks for having me, great to be here.

Kara O'Halloran (00:55):

You're ready to myth-bust a little bit?

Robert Hoffman (00:56):

Yeah, let's do it. Let's do it.

Kara O'Halloran (00:58):

Perfect. So, before we get into it, let's set the stage a little bit, as always. We're recording on August 24th, and man, does it feel like late August right now? And in some ways it's felt a little bit like late August in credit markets all year. We have talked about how high yield bonds and senior secured loans, they've had a good start to the year. They've had pretty stable, predictable returns. We've seen that change a little bit in recent weeks, which we will get to, but Rob, catch us up on what credit markets are doing broadly right now.

Robert Hoffman (01:29):

Yeah. It's interesting. Much of our forecast for the year has been predicated around the income that the markets generate, somewhere around 1.4%. 0.25% for high yield, 1% to 1.1% for loans, combined with a little bit of spread tightening. And really that was our call from the beginning of the year with the idea that markets are a little bit more optimistic, and growth is strong, and people are feeling a little bit better. And when we looked at where spreads were at the beginning of the year, we felt that there was room to tighten. I think that's still largely... What we think about today and looking at the market, that being said, we have seen a little bit of a pause into the third quarter. Spread tightening has turned into a little bit of spread widening, like 15 basis points' worth. So, it's not really anything major-

Kara O'Halloran (02:30):

One of the most major things that's happened this year in credit.

Robert Hoffman (02:33):

I think one of the headlines is, "Spreads are at their widest level since March" or something like that, but you're not talking about very big moves and numbers. And I think that you saw a lot of that spread tightening in Q1, and kind of held that throughout Q2, and now we've seen a little bit of widening into Q3, but it has impacted the numbers. High yields currently negative on the month through the 24th. So, that would be the first negative month since September of last year or something like that. But I don't think anything's really fundamentally changed-

Kara O'Halloran (03:07):

Yeah. And I think drilling down, if you look at where we're seeing the spread widening, it's almost like a mini COVID trade, it's like broadcasting, which is live events and stuff like that. So, kind of things that we would expect given some of the concerns around the Delta variant-

Robert Hoffman (03:20):

Yeah, I think that's right. I mean, we've seen weakness in energy, weakness in gaming and leisure, and very much, to your point, I think it corresponds... I mean, look, equity markets, things are moving pretty quick. So, we had had a few days of sell-off in equity, which kind of makes sense, COVID scare, and what's the Fed going to do. But then yesterday equity market's really strong. Today, markets are strong again, equities could close at all time highs today. So, you see these little periods, these little cycles that are happening within the market. But I think it's consistent. I think there is definitely a moderate feel of apprehension around risk that's come into the market over the past six to eight weeks. And we've kind of seen that impact credit markets as well.

Kara O'Halloran (04:07):

Yeah. All right. So, Rob, you spend a lot of your time actually out talking to advisors predominantly about credit markets. So, we've put together a list of some of the, we'll call them misconceptions that we've heard in our travels about credit. So, now we're going to debunk these myths once and for all. So, the first is one that is very, very popular this year, which is that rising interest rates are a risk to credit. What are your thoughts there?

Robert Hoffman (04:35):

Yeah, it's a great question. It's one that I've been asked a lot about. And oftentimes when we're talking about credit, people ask about interest rates as being really impactful for... The path of interest rates being important for fixed income markets. You noted at the beginning that we're really talking about sub-investment grade credit, high yield, things rated below investment grade. And what you'll find, I think, when you get into those markets is that returns are really driven more by credit risk and people's willingness to take risk in credit markets. And that tends to overwhelm a lot of these trends that you see in interest rates. And so, I think we've written about this before, but you have a market like high yield, which is a fixed-rate market, but its historical correlation to changes in rates is basically zero.

Robert Hoffman (05:31):

When you look at statistics like empirical duration, which is how is the market actually done looking back historically as rates have moved, the market tends to do better as rates go up. And the reason for that is when rates are rising, it's generally an environment of good growth, and good growth is good for credit, it's good for risk-taking. And that tends to generate positive returns, even though you might have some perception of negative duration risk in a fixed-rate market. When we look at loans, there's a couple of things that are beneficial, but I think the same overarching message is the same, which is, if rates are going up, generally speaking, risk-taking is in favor, and loan market being sub-investment grade is something that favors allocations to loans. Loans get this additional benefit, which has really helped the market this year, to a certain extent, which is, retail fund flow dollars tend to also follow interest rates.

Robert Hoffman (06:32):

So, when rates go up, the natural inclination is to think that I should be buying a floating rate asset that benefits from rising rates on the rate side. And even if my opinion is that loans don't really benefit all that much from rates going up, it does cause retail investors to want to put more money to work into floating rate funds. And you've seen $30 billion of inflows into floating rate this year. It's $1.5 trillion market, 30 is not that big of a number, but it helps on the margin and I think provides additional support. So, the market moves, to a certain degree, based on rates, but over time I think it evens out, and it's much more impactful in terms of the overall growth cycle and corporate risk cycle than rates just in and of themselves.

Kara O'Halloran (07:25):

Yeah. And I think that over time, language that you just used is especially important. I think for high yield, thinking back to in March when we had some of those interest rates spike late February, early March, and kind of more of just that risk-off sentiment broadly around interest rates spikes will flow into the high yield market. But then after that we do see high yield actually performed pretty well while interest rates are rising.

Robert Hoffman (07:50):

Yeah. And look, you saw interest rates, you look at the 10-year has actually fallen off its highs over the past couple months. That's corresponded with the period of time that high yield has run into a little bit of volatility. But to your point on long-term, you can go back to the taper tantrum where I think it was, what, 2013, markets definitely got negative as rates went up, but they were negative for two or three months. And then they got really strong immediately after that because rates were going up, because growth was good, and everyone came back to the market at that point in time. So, it's not quite as easy, I think, as sometimes you think fixed rate, you think duration sensitivity, you think rising rates equal bad. It's a bit more complex than that, and actually tends to shade more to the opposite, I think.

Kara O'Halloran (08:38):

Right. Right. All right. So, next, let's talk about spreads. Spreads are tight, we all know this. I think anyone talking about credit right now kind of has to contend with this idea that spreads are very tight. And I think some people think, "Okay, well, spreads are tight, so the only place they can go is wider imminently." So, I think the next myth that we want to talk about is that tight spreads mean a sell-off is coming.

Robert Hoffman (09:04):

Yeah. I mean, look, spreads are tight, but I think they're tight for a reason. They're tight because growth is good, risk is low, default rates are low, and that's why we find ourselves where we are in the market right now. And that type of situation can persist for quite a while. Just because GDP growth is good doesn't mean next quarter GDP growth is going to be bad. And I think we have analogs to periods of time like today, not to say that the period leading into the financial crisis was just like right now, but you had this period of time from 2004 into the middle of 2007, a three-and-a-half-year period of time where the average spread environment was basically at or tighter than where we are now for a really long period of time, and returns weren't bad.

Robert Hoffman (09:59):

You're generating your coupon, you're making income. When you look at the relative level of interest rates in the market today, I think the income that these markets generate, because they're sub-investment grade, is relatively competitive. But I think markets follow this general trend of growth and credit cycles, and they can take a while. You look at a market like high yield over its what, 25-, 30-year history, it's got six years with negative return or something. That's a lot of space in between those negative years that you're getting persistent positive returns. And I think that could be an environment we find ourselves in now where growth is expected to remain reasonably strong. And there could be some blips in terms of how strong it really is, but most people I think are not forecasting or calling for recessions anytime soon, and expect growth to remain reasonably strong through the end of next year. And to me, that's the best gauge for what would drive credit markets and, ultimately, spreads.

Kara O'Halloran (11:06):

And to your point about spreads are tight and they're tight for a reason, and the high yield market is a higher quality than ever before. If you look at just based on ratings breakdown, so that the largest proportion of BB-rated issues, basically in its history, which obviously carry a lower spread, and so, it's kind of made the entire market higher quality, and kind of merits those tighter spreads.

Robert Hoffman (11:29):

Yeah. I mean, I think that's been the basis of one of our calls that we expected spreads to be able to go tighter this year, which is, if you look at the all-time tights for high yield spreads at 250 basis points, today we're 100 basis points wider than that. But, to your point, the quality of the high yield market is higher quality than it was when spreads hit those previous lows. That's not the same for the loan market and it's actually the opposite in the loan market. To say that when spreads were at 400 or 450 that they couldn't go tighter, especially to your point that the change in composition of the market, we really felt that they could. And I think it's still a basis to say they could go tighter from where they are right now, which means there could be some reasonable upside depending on the path that markets go.

Kara O'Halloran (12:16):

Yep. And that's a perfect segue into the next myth that we want to talk about, which is that as an asset class, loans are less risky than high yield bonds because of their seniority in the capital structure and the fact that they are senior secured. We just talked about some of the dynamics in the loan market. So, what are your thoughts there?

Robert Hoffman (12:37):

Yeah, I mean, it's been amazing. When I came into the loan market 20, 21 years ago, it was a much different market at that time. And it's evolved like everything and it's changed, and it's not just a rising prevalence of covenant-lite loans, and some of these things that has changed the loan market, but the types of companies that access the loan market, the size of companies. In particular, one of the things that the market really talks about is companies that are loan-only issuers versus companies that are issuing both bonds and loans. It has really changed the composition of the loan market, and you see a lot less higher-quality BB-type loan issuance, and you've seen a lot more single B loan issuance in the loan market.

Robert Hoffman (13:32):

And one year doesn't make a trend, but we've now had 10 years of this, and it really has changed the composition of the loan market quite a bit. And you see single B, in particular, far overwhelming BB issuance and the overall composition in loans, and it's made it a very stark difference versus the high yield market. So that, yeah, the loan market today, from a ratings-composition standpoint, seems to be riskier than high yield, at least just looking at ratings. And it certainly has a much lower rating component than it did a decade-plus ago when the loan market looked a lot different.

Kara O'Halloran (14:14):

And on that point, the point you made about some of the issuance trends with the cov-lite and the loan-only structures, something that we talked about pre-COVID was, the loan-only structure in and of itself is not necessarily risky, it's what happens when things go wrong, if you're thinking about not having the bonds subordinated to you to take that first loss. And we saw this last year, the recovery rates on loan-only issuers was about 43% versus historically companies that had both bonds and loans in their structure had a recovery rate of 59%. So, pretty big delta there. I shouldn't use the word delta these days, trying to be better about that.

Robert Hoffman (14:51):

Yeah, no, it's a great point. I mean, the market's talked a long time about, "Will these trends impact recovery rates in the event of default?" And I think the answer is that it has, and it's spot on what you mentioned. I mean, I think it's a great indication. We haven't seen these long, pronounced waves of defaults to really see the long-term magnitude. You look back at the financial crisis, covenant-lite loans perform better because at that time it was really only the better loans in the market that could earn a covenant-lite status. But today basically everything's covenant-lite-

Kara O'Halloran (15:30):

91% Of loans issued this year. I just looked up that stat.

Robert Hoffman (15:32):

Yeah, you sort of lower quality or lower rated issuance in the single B area. And I think you are starting to see some of those signs, and I think it makes some people adjust, longer term what are they thinking, in terms of what should their recovery rate assumptions and things be like for loans given how these metrics have evolved.

Kara O'Halloran (15:53):

All right. So, moving on. The next myth we're going to talk about, you only make money when spreads across the market tighten.

Robert Hoffman (16:02):

Yeah, look. Tightening spreads is definitely a driver of return, without a doubt. I think, especially-

Kara O'Halloran (16:10):

I should say broadly across the market.

Robert Hoffman (16:13):

Yeah. You know, especially if you're thinking about investing in a passive index exposure to the market, you're basically going to live or die by the path that spreads take. I think there's a lot of other ways to make money in the market. I've talked before about this idea of almost like getting paid for complexity, and on top of getting compensated for interest rate risk or basic credit risk, the market, especially in the sub-investment grade market where things happen to companies, and that results in complexity and analyzing credit, and I think you can earn a premium for that complexity as well. So, I know we have a variety of examples, but companies getting upgraded or downgraded, companies going through M&A activity, positions that are inherently illiquid, all these types of things can result in complexity, I think, that can result in the ability to make money, absent just a broad trend in what you see going on in terms of spread.

Kara O'Halloran (17:21):

So, more specifically, what are some things you're seeing right now in the market?

Robert Hoffman (17:23):

Yeah. Look, last year we talked a lot about fallen angels. There were $220 billion of fallen angels or something, annual record. This year, we're now talking about rising stars, which is companies that can get upgraded from high yield into investment grade. And there's some stats that as many as, I think, $280 billion of rising stars could occur between now and the end of next year. You look at a situation like that, that type of event, a lot of the spread tightening that might occur on the upgrade actually happens before the upgrade. So, if you're taking a look at what might be a likely rising star candidate, the ability to get involved in some of those names, a quarter or two before that likely event occurs might afford you the ability to capture a tightening spread for that individual company before that event happens.

Robert Hoffman (18:25):

And the reason that's impactful is that if you do look at where investment grade spreads are relative to higher-quality high yield, there's still an extra 100 basis points of pickup or so in spread tightening that you can gain by going to investment grade. So, there's situations like that. We certainly see a record amount of issuance in the markets or record amount of refinancing. If you can pick up an extra point or two on a refinancing, that can be really impactful in this kind of environment. And then, something else that we've talked about and written about, is that if you actually look at indexes of newly issued companies, they tend to actually perform better. And they perform quite well as almost an investment strategy of investing in new issues, to a certain extent.

Robert Hoffman (19:15):

And so, we see a variety of these types of events that I think can occur within the context of a relatively strong market, that if you can make an extra 100 or 200 basis points on some of those in an environment where the market's just giving you income, which is only a 5% or 6% annualized return, that's suddenly really impactful. And I think in the context of markets and just the paltry level of returns when interest rates are as low as they are, those types of incremental strategies can really generate some nice returns for investors.

Kara O'Halloran (19:50):

Yeah, definitely. And we just put out a piece on all of the opportunities that we're seeing in event-driven, which, at its core, we really view event-driven as just identifying mispriced or kind of misunderstood opportunities. So, talking more about today's environment and you just referenced the record amount of debt that we've seen issued, I think one of the misconceptions there is that all of this record debt is cause for concern, that companies are very over-levered. So, what are your thoughts there?

Robert Hoffman (20:23):

There is definitely an environment of risk taking in the market. And so, given that rates are low and money is sort of easy to come by, I think it's not surprising to see that a lot of companies are tapping the market. As we look at a variety of trends in terms of the ratings quality of the companies that are issuing in the high yield market, for instance, it's not a deterioration as it relates to the overall market. You're still seeing fairly healthy issuance of BB-rated companies and things like that. So that, as we talked before about that overall ratings mix of the market, you're not seeing this record issuance greatly tilt a lot of those statistics. One of the other things that we've seen, I mean, if you look at leverage levels in the market, they are much higher than where they were when I was analyzing companies 15-plus years ago.

Robert Hoffman (21:20):

But when you think about the interest rate environment we're in, companies can support those debt burdens. The interest expense for borrowing is much lower than what it was before, and I think that can allow companies to borrow a little bit of excess debt. Their interest coverage ratios are not deteriorating, and then we're in a fairly strong growth environment. So, through the pandemic, we did see overall leverage levels deteriorate or go higher for companies, but that has predictably, I think, started to reverse, as GDP growth is strong and companies are now reporting strong EBITDA on revenue growth trends, that will help naturally bring some of those leverage numbers in line, and could help even further improve interest coverage statistics for companies. So, I think it bears watching. You don't want to see these numbers really blow out and get super high, right at the narrative about the end of the cycle starts to get really loud again, because that's where you could have some risk if the cycle turns, and companies are caught with a lot of leverage.

Robert Hoffman (22:28):

But I think right now, it's not really setting off alarm bells for me. I think it looks pretty manageable. You see default rates that are extremely low. So, default rates were a little bit of a lagging indicator. Distress ratios in the market are extremely low. There's not a lot of things that are signaling risk about this heightened level of issuance that we see going on in the market right now.

Kara O'Halloran (22:52):

Yeah. And then also looking kind of at the technical side of things. So, looking at supply and demand statistics, even though we've seen this really strong issuance, there's been demand to support it. So, technicals in the market are much, much more balanced this year than they were last year, when there was just tons of excess supply in both high yield and loans. And we're seeing things like the fact that a lot of the debt is being used to refinance existing debt, and then fewer fallen angels this year, and then rising stars, which take high yield bonds out of the high yield market. So, really just all of these things are keeping technicals a lot more balanced to support the market.

Robert Hoffman (23:29):

Yeah, no, I think that's right.

Kara O'Halloran (23:31):

All right. Let's wrap it up. I have one more question, one more myth, I should say. So, which is that spreads are too tight right now to warrant an investment and that I should just wait until spreads widen to consider entering the credit markets.

Robert Hoffman (23:47):

Yeah. I mean, going back to I think the question about a sell-off being eminent, you could end up waiting a long time. I think it's something that we've seen in this market over many, many years. The cycles don't tend to turn quick. Prior to the pandemic, a lot of people were saying, "This is the end of the cycle. It's late cycle. Something's bound to happen. We're overdue for a recession." And while no one could predict, obviously, the pandemic and the recession that ensued, it happened. One of the things that I think is different today is that it sort of hit the reset button on our outlook for the environment that we're in. And it had been, what, a decade since the previous recession.

Robert Hoffman (24:38):

Not to say that it's going to be a decade until the next one, but if we really hit a reset button to a certain extent in the market, we could have a fairly long runway of decent growth and a decent environment for credit, in an environment where we said, "If you can earn 5% to 6% income when 10-year Treasuries are at 1 1/4%, that's pretty competitive if you're trying to find returns in the fixed income portion of a portfolio." And so, I think from that standpoint, especially when you combine on top of that, the ability to potentially capture excess return from upgrades and rising stars, or participating in new issues, other types of complexity that can generate incremental return, I think you have an environment where, on a relative basis, you can still make some pretty nice returns across credit markets. Just because spreads are tight doesn't mean that it's unattractive, and you should stay away and wait for the next sell-off. You really might be waiting a long time and miss out on some nice returns in this portion of a portfolio.

Kara O'Halloran (25:46):

All right. Well, thank you, Rob. I think we've just busted every myth about credit.

Robert Hoffman (25:52):

There'll be more. There'll be more.

Kara O'Halloran (25:53):

I know, I know. We'll do a follow-up at some point, I'm sure. But all right, Rob, well, thank you so much for joining me. And if you want to hear more about those event-driven opportunities we talked about, there is more available on fsinvestments.com and we'll be back soon.

Robert Hoffman (26:12):

Okay. Thank you.

Speaker 3 (26:16):

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