#### Episode 21

**Corporate credit: 5 for ‘22**We continue our outlooks for 2022 and talk corporate credit markets with Head of Investment Research, Rob Hoffman.

Kara O’Halloran (00:06):

Welcome back to Fireside a podcast from FS Investments. My name's Kara O’Halloran and I'm a Director on our Investment Research team here and on today's episode we are continuing with our 2022 outlook content this time focused on credit markets. I have brought in Rob Hoffman, the Head of our Research team and our resident credit expert to talk about the five big things that we are watching in credit next year. Rob, welcome. Thanks for joining.

Rob Hoffman (00:31):

Yeah, thanks for having me great to be here.

Kara O’Halloran (00:32):

Yeah, of course. so I would say I want to dive right in but as a podcast host, I think I'm legally obligated to have a really long meandering question. So thinking about 2021, I felt like a broken record at times talking about credit markets, which I don't think is a bad thing coming into the year we basically called for spreads to tighten to post global financial crisis levels, which they did in high yield and they came close in loans. They've come off of those tights a little bit in recent weeks but still sitting at pretty tight levels, we thought default rates would fall, they have, they're below 1% in both markets. We thought fundamentals would continue to improve and they did, so basically my question is, how did we get all this so right? No, I'm kidding. But no, so I want to talk about 2022, as I said, "Spreads are tight". Where do you think they can go from here?

Rob Hoffman (01:24):

Yeah, look the past couple weeks, few weeks have brought us this... Almost the first bout of real volatility that we saw in the year and one of the things that was really interesting is, I think the equity markets saw more volatility than high-yield and credit. If you look at small cap stocks and how they performed vis-à-vis high-yield, high-yield held in really well and I think a core part of that and really what was one of the core parts of our calls for 2021 was just a strong, AKA low default environment and a strong fundamental environment for credit that really helps anchor high-yield bonds and loans from an index perspective. I think as we look into 2022, to expect a low default rate to continue, high-yield spreads average below 350, loans, which are maybe just a hair over 400 right now could very easily average below 400.

Rob Hoffman (02:25):

I think those are conditions that are fairly consistent with strong, low default rate environments. We have examples of this in history, December of 94 to July of 98, December of '03 three to June of '07. These are each three and a half year long periods of time with default rates that are sub 2% let alone the environment we're in now where we're sub 1% where default rate or spread levels can very much average, these levels that we just talked about for almost the duration of those periods of time. So not that we may not get a little bout of volatility here or there in 2022. Sure enough we definitely will but I think as we think about the year as a whole, if we expect these favorable credit conditions to continue, I think spread levels are going to stay fairly low, fairly tight, because what's going to push them wider? What's going to change that real fundamental backdrop?

Kara O’Halloran (03:25):

Yeah. I think thinking about the things that we talked about, I just talked about the macro outlook and we're talking about inflation and the Fed tightening and these are things that we really don't see having major, major impacts on credit as a whole. There's a lot of data pointing to, well, first of all, Laura has myth busted that the fact that when the Fed raises rates that long term interest rates rise as well, they actually tend to stay flat. So I think some of these things that a lot of people are pointing to that could jeopardize credit markets, maybe they cause like you said some inner volatility, but still see a really, really strong backdrop. So let's talk about bonds versus loans. Right?

Kara O’Halloran (04:06):

I think that we did just say that as the Fed raises rates, we don't necessarily expect long-term interest rates to rise. However, we do still see demand for floating rate products. We saw a really strong CLO engine this year buoying the loan asset class. What are your thoughts on a relative basis, bonds versus loans next year?

Rob Hoffman (04:29):

Yeah. It's interesting, if you look back in history and some of the data that you help pull, there's only been one other instance when both markets are positive that loans outperformed high yield. And I think even if you include where one of those markets might have been negative, which was 2018 in loans outperformed, there's only two total instances, in a lot of the available data when loans have ever outperformed high yield. So generally speaking, you would call for yield to outperform loans. The interest rate question is interesting because it definitely has the potential to impact high yield more. You look at 2021, five year rates, which is a proxy for the duration of the high yield market. We're definitely up more than 10 year rates. And if that type of thing were to continue into next year, that's a potential negative for high yield.

Rob Hoffman (05:27):

I think the other thing is looking at retail flows, which absent what goes on with interest rates, retail investors definitely seem to follow the narrative of what's going on with rates, whether rates actually do that or not. And so if we come into 2022 and we've seen some of that this year and it's still... The tapering is going to wind down and the Fed's going to raise rates a couple times, I think you continue to see strong retail inflows into loans and high yield, even though... Because it's a fixed rate market tends to get outflows. Even if, I would argue maybe on another podcast that maybe it shouldn't, but... So I think it might create an environment next year where both markets, we would expect to be positive given the positive fundamentals that we just talked about.

Rob Hoffman (06:23):

But I think it could be a year that loans outperform high yield with both markets being up, which would be pretty rare. But given retail demand, given really strong CLO creation, which creates retail or which creates loan demand, it might bring together another one of these environments that sets up loans to outperform high yield. I don't think by very much, it's not like it's going to be by hundreds and hundreds of basis points, but in these markets every little bit can count to a certain extent.

Kara O’Halloran (06:56):

Yeah, sure does. One of the other themes this year was really just this domination by lower rated assets. I think CCCs in both markets outperformed, BBs by almost double in 2021. So can that continue in 2022? What is your outlook there?

Rob Hoffman (07:14):

Yeah, I think that in general, if you think about credit markets and sub investment grade credit markets where your primary ratings categories are BB, B and CCC. And if you look at a market like high yield, that is a fixed rate market, theoretically, BBs are going to have your lowest spread versus your other rating or rating profiles because it's theoretically the lowest risk. It is going to have the most duration or interest rate sensitivity. So from that standpoint, you would expect in a positive environment where rates are trending up, that BBs are likely to underperform the other ratings categories by a little bit, at the same time, as you continue to have strong fundamentals and recovery people stretch for risk into the CCC space and you would expect CCCs to probably do better.

Rob Hoffman (08:15):

I think one of the limiting factors though, is that you have seen a lot of this tightening in CCC spreads vis-à-vis BBs and vis-à-vis the index. And you are probably not likely to get the same amount of outperformance. I think now if BBs are up two and a half percent on the year, CCCs are up eight and a half or something like that. That relative degree of outperformance is likely to close next year. There's just... I don't think there's that much more juice to squeeze.

Kara O’Halloran (08:44):

Right. It's kind of just a sign of how quickly this cycle has moved. I think we looked at a couple of other time periods and took a look at the differential between BBB spreads or CCC spreads, excuse me, and BB spreads. And just that ratio really came down, that differential came down really quickly, this cycle, as opposed to others. So what might have been a lingering opportunity in cycles past has really come in quickly.

Rob Hoffman (09:11):

Yeah. And look, I think, we might feel better about CCCs and Bs versus BBs from a broad outlook perspective by no means would I recommend going full steam ahead into CCCs just buying whatever's in the index and just hoping that that's going to work out great, because there is a lot more volatility, a lot more risk as you head down into the CCC's base. Overall spreads are relatively tight. And so I think that favors taking a real idiosyncratic view to all of these credit stories, to the extent that you can pick names that you really like, that could outperform. I do think it's more of a credit pickers environment next year.

Rob Hoffman (09:58):

The broad beta rallies that we've seen coming out of the pandemic, it's going to get harder and harder to generate returns with that type of strategy. And so I think, you definitely got to be careful as you go down the credit spectrum and really want to understand the fundamentals of those companies and which ones are deployed to perform and which ones have low ratings and low prices for a reason so.

Kara O’Halloran (10:22):

So staying on the ratings topic, rising stars were a big topic this year, especially after we had so many fallen angels in 2020, a lot of people expected the reverse of that trade. So bonds being upgraded from high yield to investment grade. That did materialize in a major way this year. So pushes out the forecast a little bit. So what are you thinking when it comes to rising stars in 2022?

Rob Hoffman (10:50):

Yeah. The rating agencies, I think are always quick to downgrade and sometimes a little bit slow to upgrade as you pointed out, if the market was calling for $250 billion worth of potential rising stars, it was probably optimistic to think that all of that would happen in 2021, but nonetheless there were what, 40, $50 billion worth of rising stars this year. And if you look at broadly speaking, not just upgrades from high yield to investment grade, but just overall upgrades within sub investment grade markets, upgrades have far outnumbered downgrades this year.

Kara O’Halloran (11:34):

Yeah. What gave the rating agencies a little credit, they weren't just hanging out this year. They were busy just not into a market.

Rob Hoffman (11:40):

Exactly. But I do think it sets the stage for next year in terms of looking at what it is that they could do, a couple of $100 billion worth of rising star upgrades is a big potential. And that's a very big number. It has some meaningful impacts to the market but I think it's a real possibility if credit conditions stay the way that they are.

Kara O’Halloran (12:05):

Yeah. And something we've talked about is just the fact that rising stars, their spreads do tend to tighten in advance of the upgrade. There are a lot of rising star candidates to your point. And even assuming that markets have priced in maybe a little bit, but there still could be some potential spread tightening, which back to our earlier point, every little bit helps in markets like this.

Rob Hoffman (12:24):

Yeah, no, definitely. I think it could be a core theme as you think about some event driven opportunities for investors next year, as you said, every little bit's going to count when you're in a tighter spread environment like you are now. And you look at some of the potential rising star candidates, maybe trading 50 to 75 basis points wide to the BBB index. But look that could be two to four points, a price appreciation. And if your overall return outlook is four and a half, five percent, five and a half, to get an extra two to three percent from price appreciation on a name getting upgraded to investment grade, that's a lot of return in the context of what's out there in the marketplace.

Kara O’Halloran (13:08):

It's almost half [inaudible 00:13:08] annual return.

Rob Hoffman (13:09):

Yeah. So, it's a big deal. And I think something that... Again, you got to go line by line. You got to find the names that you really like and the ones that are likely to get upgraded that still have some of that upside [crosstalk 00:13:22]

Kara O’Halloran (13:23):

Given what we just talked about, everyone thinking that so many rising stars are going to happen in 2021 and that getting pushed, just having the time horizon to wait that out but-

Rob Hoffman (13:32):

Yeah, no, exactly.

Kara O’Halloran (13:33):

So I want to bring it back to spreads again, we've talked about it a bunch, things are tight. What is the best opportunity you see in credit right now?

Rob Hoffman (13:40):

One of the things that we really like are CLOs, for those who don't know collateralized loan obligations, securitizations of pools, of floating rate loans. When you think about our outlook for credit markets, fundamentals are really good. Default rates are really low so that when you look at the composition of what is in a CLO, we feel pretty good about the overall quality outlook for loans. One of the things that's really interesting when you look at CLOs and where they are trading vis-à-vis corporate bonds. You look across markets, the expectation is that spreads today are tight and tighter than historical averages. However, when you look at CLOs and where CLO liabilities, rated liabilities, so AAA, AA, A, BBB, BB, and you start to look at some of these areas of CLOs and how they're trading. In some cases, they are not trading tight and they might even be trading wide of historical average in an environment where default rates are sub one percent and every other credit market is trading with tight spreads.

Kara O’Halloran (14:54):

And one thing I'd add to that point is that CLOs reach, it was a major milestone this year. They're a trillion in market cap. We look at that as really cementing them as a mainstream credit allocation. And so I think if we think about CLOs are going to trade wide to corporates, I think that's just a fact, but I think that there's an argument to be made that they should be trading... They could take trade tighter to corporates than they have in the past, which could resolve in some significant spread type in a relative basis.

Rob Hoffman (15:24):

Yeah. And look, and even if you just look at the yield of BBB CLOs, which is a investment grade rated instrument, and compare that to BB corporate bonds, which is a sub investment grade, you can earn a higher yield in a floating rate, investment grade rated instrument versus a fixed rate sub investment grade rated instrument. That's a really interesting dynamic. And if you look at the long term default loss history of CLOs, it's really, really good. And in some cases it looks better than comparably rated bonds.

Rob Hoffman (15:59):

So maybe CLOs have a little bit of a stigma being a securitization, they trade with this excess risk premium but when you actually look at the historical risk profile, certainly for CLOs, we're not going to spend time talking about mortgages that's a whole another thing but for corporate loans, they have a great return profile, a great history of performing through periods of volatility and elevated yields. And we think it's a really attractive opportunity. It's harder to access, that might be one of the things that causes the opportunity to persist. It's not very easy to go buy an ETF or an index tracking product to gain access, especially to the BB or BBB part of the CLO market. It's a lot more difficult. You got to look at some more specialized managers, but it is an area of the market that we think-

Kara O’Halloran (16:50):

Well, it is more complex too.

Rob Hoffman (16:57):

Yeah.

Kara O’Halloran (16:58):

It's a lot that goes into [crosstalk 00:16:58].

Rob Hoffman (16:58):

Absolutely. But we think it is a part of the market that looks pretty attractive.

Kara O’Halloran (16:58):

100%, yeah. All right, Rob, we're going to have to leave it there. Thank you so much for joining our file for 2022 credit outlook will be available on fsinvestments.com along with the rest of our 2022 year ahead content. And we'll bring you back next year to talk credit again.

Rob Hoffman (17:13):

Can't wait. Sounds good.

Kara O’Halloran (17:14):

Thanks.

Rob Hoffman (17:14):

Take care.

Kara O’Halloran (17:21):

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