Episode 41

Q3 2022 Corporate credit outlook: Quality time

Join Head of Investment Research Rob Hoffman as he outlines his thoughts on areas of opportunity in credit markets for second half of 2022.

[00:00:00] Kara O'Halloran:
Welcome back to FireSide, a podcast from FS Investments. My name is Kara O'Halloran. I'm a director on the investment research team here. And on today's episode, we are diving into one of the harder hit areas of traditional finance this year, corporate credit markets. We'll discuss what's driven the price action, where we think markets go from here, and importantly, how investors should be positioned for a slowing economy and a potential recession. So to walk through all of this, I'm excited to welcome Rob Hoffman, the head of our research team. Rob, thanks for joining.

[00:00:30] Rob Hoffman:
Hello. Hello. Thanks for having me.

[00:00:32] Kara O'Halloran:
Anytime. So last time we checked in on corporate credit a few months ago, things weren't looking great. And in the first quarter, the high yield market was down four and a half percent, which other than the COVID sell off in 2020, was the worst start to a year for the market in history. But over the past few months, things have gone from bad to worse. Through June 30th, the high yield index was down 14%.

[00:00:54] Kara O'Halloran:
We've seen the market recoup some of those losses in July, but it's still been a pretty tough start to the year in high yield. Loans are doing better on a relative basis. They're floating rate coupon, really help them avoid some of those acute price declines. But as we started to see concerns, shift from rising rates to ultimate the ultimate impact on economic growth loans have started to suffer as well. The market was down four and a half percent in the first half of the year. Again, recouping some of those losses in July, but still starting to see those declines with high yield. So I want to start to take a step back and just talk about the credit market as a whole, other than the returns that I just read off. What has really changed over the last three months in your view and what hasn't?

[00:01:40] Rob Hoffman:
Yeah, I mean, it's been, uh, it's been really interesting, I think, to see how the market has changed in moving from the early part of the year, where you were really concerned about duration and rising rates, and then the impact that had on securities that had higher theoretical duration risk. Then that shifted into some growth concerns, and then you sort of got into July where you're almost, I feel like at peak consensus that a recession is coming yet in response to what the Fed is expected to do. Inflation expectations have actually come down as a result.

And so you're seeing a rally in certain risk assets, like it all kind of doesn't make sense to a certain extent, but you really have to look at each one of these periods very specifically.

[00:02:30] Rob Hoffman:
So, I think that's, been one of the big changes that we've seen over the past three months, is more of a recognition of the potential for real credit risk and credit issues, which markets could do better in that type of environment. Less of a concern about duration risk, and rising rates, even though we're in the middle of a big fed rate hike cycle and you're seeing asset classes, I think, respond based on some of these at times competing factors.

[00:03:00] Kara O'Halloran:
Yeah. So I want to dive into that credit risk component a bit, something that we talked about a lot coming into the year and we talked about it again in our, for our second quarter outlook is really kind of the strong fundamentals that the market has. We still have really low default rates. Have we seen fundamentals? You, do you think they still remain supportive? What are you watching?

[00:03:22] Rob Hoffman:
Yeah. I mean, I think the short answer is yes, fundamentals are still generally supportive. One of the drawbacks of some of the data that we get on credit fundamentals is that it comes at a lag because you really have to wait to see how companies report earnings before you can go back and really aggregate all of it. But the data that we have is that companies are generally doing okay. Default rates, as you point out, are still hovering only around one percent, which versus historical averages of call it, three plus percent, is still really low. And, while you're starting to see some weakness and some deterioration in growth rates, you haven't really seen things go negative.

[00:03:59] Rob Hoffman:
When you look at things like distress ratios in the market, they've gone up as a function of prices being down, but you haven't seen major spikes. And so, I think by and large, fundamentals are still conducive to a generally steady, lower type of default rate environ for what we see right now in the market as it relates to credit.

[00:04:20] Kara O'Halloran:
Yeah and we're still seeing those improvements, almost just the momentum of the improvements is moderating a little bit. I actually think interest coverage ratio is an interesting point to make is that they improved to a record high in the first quarter. So, we're concerned about debt service. It's a good metric to watch.

[00:04:37] Rob Hoffman:
Yeah. I mean and look on that last point. It's a good point to point when we talk about credit markets that does include the high yield market, but we also talk about the loan market. The loan market is a floating rate market and certainly one of the drawbacks of higher Fed rate hikes and the implication that has for SOFR and LIBOR is that those companies that have capital structures that are very dependent on floating rates. They are going to be faced with higher interest burdens...

[00:05:02] Kara O'Halloran:
Right.

[00:05:03] Rob Hoffman:
...And could start to pressure those interest coverage ratios, so it is something to keep in mind.

But I...where things are right now with where, fundamentally, revenues and cash flow and EBITDA have been, that picture hasn't deteriorated significantly, but it's definitely something to watch going forward.

[00:05:19] Kara O'Halloran:
Yeah. We'll check back in on that. Especially given I think there was only one by the time that data came out, there was only one fed rate hike. So we'll check in on the loan, uh, the loan metrics once we get that Q2 data in. So I wanna turn now to spreads, uh, obviously the valuation measure for these markets, Spreads had kind of maintained. They had spa, they'd stayed pretty, contained basically in the first quarter. And then the second quarter, we did see them, uh, start to widen in earnest, peaking at, I think a little over 600 basis points. With this July rally, we've seen spreads come in they're right around 500 right now, which is actually just about the X recessionary average. So as we start to consider the possibility for a recession and slowing growth, what is your base case directionally for spreads moving forward?

[00:06:06] Rob Hoffman:
Yeah, it's a really difficult question to answer.

[00:06:10] Kara O'Halloran:
Look into your crystal ball.

[00:06:11] Rob Hoffman:
I know. I think that when. I think about all the risk factors that are out there and where things could go, the prevailing feeling that the economy is going to deteriorate more before it gets better. I think that it would be fair to say that spreads probably have a greater chance of going wider before they go tighter. the primary question is, well, how, wide did they go? And as you pointed out, you're, a little bit wide to non recessionary averages by some measures. From a spread basis, the market is pricing in some of that risk of deterioration.

[00:06:48] Rob Hoffman:
It's not quite as attractive as it was a month ago when spreads were 600 plus. And you could start to say that, spreads at trading at their 25th percentile were pricing in quite a bit of risk. now you're only at like a 40th [00:07:00] percentile and, if you really think you're gonna go into a bad, hard recession, spreads probably widen out quite a bit, but you know, that gets to the point. If we go into recession, how bad is it going to be? And if it's only a mild one, what are spreads really saying about where default rates could go? And, if it is mild, there's, I don't think there's a case that you have to make that spreads are gonna blow out from 500 to a thousand or anything like that. But, could you go back to 600, 700, certainly, possibly depending on, where things go and how bad it gets.

[00:07:34] Kara O'Halloran:
Okay. So I wanna now, Rob, I wanna talk about more, more broadly how we think investors should be positioned given what really is a consensus around some sort of impending recession. Again, we don't know what that looks like or when it will happen, but,we called our Q3 outlook quality time. we've seen. We talked a little bit about the oscillations in market leadership that we've seen as we start to get concerns over, as those recession fears [00:08:00] really grow louder, we're seeing higher quality assets outperform. So I wanna walk through what this up in quality allocation or rotation means for credit markets.

[00:08:10] Rob Hoffman:
Yeah.

[00:08:10] Kara O'Halloran:
so across asset classes and within asset classes. So first let's start on the asset class level with bonds versus loans.

[00:08:18] Rob Hoffman:
Yeah. It's a. his, I think the answer is different than it would've been, five, 10 or 20 years ago. When I got into the market, the prevailing wisdom has always been that loans. I are the safer asset class. They're senior they're secured. they have higher recovery rates in the event of default that has changed significantly over the course of really the past decade where, if you look at the loan market by rating, for instance, a significant portion I think the data is like two thirds of the market. It's now single B or below. and that's very different than how it was. And it's put the loan market in a position that by rating it's actually a much lower quality [00:09:00] market than the high yield bond market where the high yield bond market today is actually basically the highest quality it's ever been in history, roughly.

[00:09:08] Rob Hoffman:
And you started to see this. If you look at, recovery rates on defaults over the course of the past 12, Your recovery rate on bonds has actually been higher than your recovery rate on defaulted loans. And that may be for the first time in history that's effectively happened. so, I think one of the areas that goes against what's been, the historical prevailing wisdom is that if you're gonna position higher quality, you would probably position more in bonds versus loans given the dynamic of how these markets have changed.

[00:09:37] Kara O'Halloran:
Yeah. And one of the reasons that, you know, that we talk about that is that we see this really big, this rise in issuance of loan only issuance.

[00:09:45] Rob Hoffman:
Yeah.

[00:09:45] Kara O'Halloran:
Which, these are senior secured products, but if they're, if only loans are in the capital structure, what are they senior to?

[00:09:51] Rob Hoffman:
Yeah. and if you think about that, the entire funding mix of those companies is floating rate and an environment where we're seeing rising interest rates that just exposed them to that, higher debt service.

[00:10:02] Kara O'Halloran:
Yeah, absolutely. okay. So within ratings, this should be an easy one. Uh we're thinking double B'S over triple C'S. Am I something I'm missing?

[00:10:10] Rob Hoffman:
Yeah, no, I think that's right. there are a lot of opportunities. I think if you look at the markets, you look at high yield,your average price on a double B is 92 or so, like there's. Some decent upside there,

[00:10:23] Kara O'Halloran:
Especially versus where they were coming into the year.

[00:10:25] Rob Hoffman:
yeah, absolutely. and, your yield opportunities by investing in those, and that's of course, just looking at the index, not to say that if, you take a deeper dive into individual issuers, you may find something that, you think is higher quality based on your credit analysis, but is trading at an even lower price and where the index indicates it.

[00:10:43] Rob Hoffman:
So, we do think that there's a bit of a move up in quality within ratings when you're looking within those asset classes, if you're concerned about recession and rising default rates, those are likely just by their nature, gonna come from the higher risk, lower quality [00:11:00] portions of the market. And those are the ones that are likely to sell off more in the event that you do enter in a recession. I think the one thing to keep in mind is that double B'S, while they didn't historically, they certainly have this year exhibited more duration, sensitivity. But as we've seen, I think in the month of July, as recession, concern grows your concern about duration and interest rate risk falls.

[00:11:25] Rob Hoffman:
And so that also makes I think double B'S a little bit more attractive. Not only is your credit quality better, but if you're now in an environment where you're not as concerned about duration, you would expect double B's to do better. And, that's something that we talked about when we wrote the outlook at the end of June. Low and behold in, in July, they are the best performing asset class by rating. So, you're part of the market by rating. So it's playing out.

[00:11:47] Kara O'Halloran:
Yeah. And one thing, another thing that we haven't brought up yet is the CLO market. and if we, first of all, if we think about kind of on an asset class level, we just view that as yes, there are, it is under, there are loans underlying the market. And we did just talk about some of the risks in the loan market, but CLOs have those explicit investor protections built in and we just view this as really a better way to access the loan market and things have gotten pretty attractive there as well. I mean, you can get triple a or double a or single a rated really high rated CLOs that have very high yields over double the yield of a comparably rated corporate bond, even given the rise and yields that we've seen on the corporate side this year. So...

[00:12:25] Rob Hoffman:
Yeah.

[00:12:25] Kara O'Halloran:
A lot of opportunity. attractive quality allocation of the CLO market as well.

[00:12:30] Rob Hoffman:
Yeah, no, I think that's right. the CLO market, I think is often, uh, maligned given it sounds a lot like CBO or CDO or CMOs,

[00:12:39] Kara O'Halloran:
One letter can make all the difference.

[00:12:41] Rob Hoffman:
Yeah. but CLOs did really well in the financial crisis. And historically from a default and recovery standpoint, they have really low defaults and, have generated really nice returns for investors. That's not to say. Everybody can own them. at portions of the time, the market becomes really illiquid. They're fairly difficult to access, especially as you think [00:13:00] about, single a and below rated on the CLO side, there's not a lot of funds that you're gonna find those types of

holdings, but, for those investors that do have access to the point that you made, the yields are pretty attractive.

[00:13:12] Rob Hoffman:
They've gone up quite a bit. When you think about their default standpoint, which is really low, especially versus comparably rated bonds. I do think there's a case to be made in the CLO space and given some of the market volatility, you can also go up in quality in terms of rating of CLO so that you no longer have to just buy the double B to find attractive returns. You could go into the triple B, the single A's, maybe even the double A's right now, and find mid to higher single digit returns, which can be really attractive for you know what you're trying to do in fixed income.

[00:13:45] Kara O'Halloran:
Right. I wanna emphasize one thing. Cause you brought up the historical performance of CLOs during market downturns. And we have, so now we. The financial crisis where they perform very well, very resilient as well. and then we had the COVID crash. And if I'm [00:14:00] just thinking about it kind of in a vacuum, one of the, attractive features of CLOs is that you get that inherent diversification because they do have diversification rules in terms of industry, across, of, for the collateral pool, it has to be diversified. The CLO, I mean, sorry, the COVID crash was literally everything, everything crashed. So you think like, what is kind of the worst? It wasn't just the housing. I know everything crashed in 08 too, but really driven by certain sectors. So it's not, you had really everything declining together and CLOs still performed very well. And those investor protection mechanisms tripped and, did exactly what they're supposed to do. So,

[00:14:39] Rob Hoffman:
Yeah, exactly.

[00:14:41] Kara O'Halloran: "
Anyway, so we have some comfort there.

[00:14:42] Rob Hoffman:
Yeah.

[00:14:42] Kara O'Halloran:
Hopefully moving forward.

[00:14:44] Rob Hoffman:
Yeah.

[00:14:44] Kara O'Halloran:
So let's talk about sectors, obviously coming into the year, we were very concerned about Inflation creates winners and losers. You're looking for the suppliers, not the buyers, but now we're also weighing who can weather a slow down in economic growth. Some of these rising, rising interest rates as [00:15:00] well. so what are you watching on a sector basis?

[00:15:03] Rob Hoffman:
Yeah, I'm I mean, I think it's. I think you, you make the right point. when you look at certainly some of the sectors that have done the best this year, uh, oil and gas and energy across markets, which have historically been a pretty big part of the high yield market. much less so today than it was, pre 2014 and the last time

[00:15:22] Kara O'Halloran:
they're still the largest...

[00:15:23] Rob Hoffman:
Yeah.

[00:15:23] Kara O'Halloran:
...still the largest sector though. Just smaller waiting

[00:15:25] Rob Hoffman:
yeah. but you know, that's a sector that's done really well. and I think given the commodity environment is one that, that probably, continues to do. Okay. I think you do have to be a little bit more concerned, whether it's economically, sensitive and cyclical sectors. Or, ones where maybe there's been lower quality issuance. Like if you look at, electronics and some electronic services companies have been, I think, tremendous issuers in the loan market, back when I was at PM, healthcare was always the leading sector. Uh, today I think healthcare is number two in the loan market and, electronics is number one at [00:16:00] like 15% of the market. And so whether it's cyclical, sensitivity and, categories. Home furnishings or housings, areas where you're exposed there or sectors where you've just had lower quality issuance and companies that are just not as well prepared to, handle, uh, recession or slow down in growth. those are some of the areas where you should probably be concerned.

[00:16:23] Kara O'Halloran:
Yeah. And one, another thing that we called out in the outlook is some of those companies that are. As we keep, as we see the fed, continuing to hike, some of the companies that are exposed to, they're relying on credit extension to their customers. Yeah. autos have not, historically yes. Relying on credit extension. I'm not too concerned about the auto industry right now. still seeing high demand there, but things like that, retail housing, all of that.

[00:16:46] Kara O'Halloran:
Okay. So let's. Let's wrap it up. so we've talked about, some of the risks facing the market, some of the stuff that has happened this year that has, have, has caused this pain. and it's been a tough start to the year. Really? There's no, no two ways around that. So what would you say to an investor considering a credit allocation now?

[00:17:05] Rob Hoffman:
Yeah, I mean, I think in the, broad in the way that I think about it in the broad context of portfolio construction, this is a sector and these are asset classes that people should own in their portfolios. it's different when you think about, and talk to institutional investors. In most cases, it's second nature that they're gonna have some type of allocation to credit, and that's not just, private originated credit, which has been a really popular part of the marketplace, but also, liquid credit exposures, oftentimes in, institutional, multi-strategy funds that have allocations to bonds and loans and CLOs and things like that within them. that's a very common allocation institutionally. For individual investors, you tend to see it a little bit less frequently. I, we hear consistently from advisors that allocations to credit are more tactical, I'm waiting for the market to tank and then I'm gonna buy it. When, and [00:18:00] we've written about this and put out some data when you look at, long term sharp ratios and things like that. For credit markets. it definitely warrants an allocation and a portion. within people's portfolios, it doesn't mean it does well in every environment, but you know, nothing does. And so, I think when you look at the ability to invest in markets that have, high single digit yields in an environment where it's still somewhat difficult to find income, if you're a little bit less concerned about Rising rates

on the long-term side, and the duration, the negative duration impact that has to fixed income, credit markets like high yield and loans are pretty well positioned in that regard. And the markets are pricing in some degree of rising defaults and recession risk already. And, if we do end up with a mild recession and, mid-single digit default rates. That doesn't necessarily mean that these markets are going to take a huge another leg down. And in the context of, credit versus equities, you could get pretty decent performance, I think in credit and how it looks in a variety of environments.

[00:19:07] Rob Hoffman:
So, I think it makes sense in the broader context of portfolio diversification. And I think there's a case to be made that, there are some attractive reasons to want to own credit, uh, within portfolios today.

[00:19:18] Kara O'Halloran:
All right. That's a perfect place to end there, I think. So to access the full Q3 2022 corporate credit outlook, as well as the rest of our Q3 outlook content, you can head to fsinvestments.com.

[00:19:33] Kara O'Halloran:
Rob, thanks as always for joining.

[00:19:35] Rob Hoffman:
Sure. Glad to be here.