Episode 43

Q4 2022 Corporate credit outlook: At a crossroads

Our research team recaps what's happened in credit this year, and how market volatility could impact key sectors in the coming months.

[00:00:00] Rob Hoffman: Even though you are seeing a big move in rates and a reaction to rising rates across markets, when you look at credit, you're actually seeing the higher quality parts of the market outperform the lowest quality part.

[00:00:20] 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 somehow kicking [00:00:30] off our outlook content for the last quarter of 2022 with an episode focused on credit markets. So we will talk about what's been driving markets through the end of September, whether we think credit markets are fairly valued, and how we think credit is going to cap off what's really been a difficult year. So as always, to walk through all of that with me, I have brought on Rob Hoffman. The head of our research team. Rob, thanks for joining.

[00:00:55] Rob Hoffman: Hey, good morning. Happy to be here.

[00:00:56] Kara O'Halloran: Yeah, it's been a minute since we recorded, so we've been feeling a little rusty, but let's dive in.

[00:01:01] Rob Hoffman: There's nothing happening in markets...

[00:01:02] Kara O'Halloran: Oh, I know exactly. Well...

[00:01:03] Rob Hoffman: It's been a quiet year.

[00:01:05] Kara O'Halloran: So actually, last time we left off in early July top, our last outlook episode, credit was trying to make a rally, which it did for a lot of July and half of August, but exactly to your point where, clearly nothing's going on in markets this year, but if you had closed your eyes and just woken up today, you'd never know that any of that happened. Right. So the high yield market as of yesterday has fully walked back. All of those gains [00:01:30] that we saw from the summer. Year to date is now down almost 15%.

[00:01:34] Rob Hoffman: Yeah.

[00:01:34] Kara O'Halloran: So actually just where we left off at the end of Q2, so a lot of the first half of the year has really been this ping pong match, right?

[00:01:42] Kara O'Halloran: Between interest rate risk and credit risk, or concerns about economic growth with different parts of the market, different credit asset classes, rallying kind of based on whatever that topic du jour was. So, Rob, catch us up a little bit. what, let's look at that ping pong match again, right? Yeah. What has [00:02:00] been really driving markets in the third quarter, and then what do you think is gonna be the main, topic of discussion in the fourth quarter?

[00:02:07] Rob Hoffman: Yeah. Well, I think it's really interesting because in the month of September, and we'll get to this in a moment, but you're seeing something that in some ways is actually quite different than what happened earlier in the year. to start the year rates were going up, everybody was really concerned about duration impact.

[00:02:24] Rob Hoffman: I think it was interesting in the standpoint that, we've written a lot and had a lot of data that historically [00:02:30] showed, high yield in particular as a fixed rate asset class was not particularly duration sensitive, didn't really have correlation to. But I think, things had gotten so low and rates have now gone up, so quickly and so far that it induced a lot of duration sensitivity into the asset class.

[00:02:48] Rob Hoffman: Uhm, but you did see, as you noted, like as you got into July and the market got a little bit less concerned about the rate increase. Maybe things were on pause. People thought, well, maybe the Fed's gonna start [00:03:00] lowering rates early next year. And high yield staged a really strong rally.

[00:03:06] Rob Hoffman: Over the course of the month of July, you saw investor sentiment change where, people started selling floating rate loan funds, started buying fixed rate high yield. A lot of those dynamics changed early on in the third quarter. But you know, as markets peaked in the middle of August, that sentiment started to change again.

[00:03:25] Rob Hoffman: It was probably solidified, early or what, September 13th, I think when the [00:03:30] CPI report came out that inflation is high, it's not gonna magically go back to 2% really quickly. You saw a big increase in rates, a big increase in Fed rate expectations. However, the one thing that I think is different about September, as we sort of near the end of it, when you look at returns by rating, historically when markets were really duration sensitive, the higher duration parts of the market, which is the higher quality part of the market, like BB's [00:04:00] underperformed, and the lower part of quality part of the market did better.

[00:04:04] Rob Hoffman: September, even though you are seeing a big move in rates and a reaction to rising rates across markets, when you look at credit, you're actually seeing the higher quality parts of the market outperform the lowest quality part. And so, I think the one thing that's a little bit different is that the market's a little bit more in tuned to the potential for recession risk next year.

[00:04:29] Rob Hoffman: You know what that [00:04:30] would entail? Which part of the markets are better equipped versus others? And even though you're in what would otherwise be, I think a very duration sensitive kind of environment given the really rapid move and rates over the past couple weeks, you're not seeing that flow through in the same way that it has before. So, it's a long way of saying things are still pretty choppy. it's still pretty messy. but you're starting to see the market, maybe react, I think, a little bit more rationally to some of the long term, Positive [00:05:00] fundamentals, but also some of the long-term risks that are out there.

[00:05:02] Kara O'Halloran: Yeah. And so you think in the, if you're thinking about the fourth quarter, it almost seems like we're concerned about, we're concerned about both, right? Of course, we are. But about interest rates and growth or recession fears. But if we're seeing these higher quality assets outperform, we're, are we kind of zooming in on growth or where do you think the market's really gonna be paying attention or are we just kind of along for the ride with the rest of risk assets?

[00:05:26] Rob Hoffman: Yeah. I mean, I think one of the things that we noted and talked about, [00:05:30] is just the really strong underlying fundamentals in credit markets. it's remarkable. I mean, the data always comes out with the lag. So the data we have is through q2, but really significant increases in revenue and cash flow. Really low leverage levels across bonds and loans. and it sets up credit, I think, fundamentally to be quite strong. So as we think about Q4 and a lot of the volatility that we've seen, I do think the [00:06:00] markets are kind of being

whipsawed by equities and this general, risk on, risk off sentiment across markets that is driving things because, it's remarkable.

[00:06:09] Rob Hoffman: High yield is poised, as of now to have its second. Worst year on record. Default rates are barely above 1%. I mean, it's like, it is not a credit risk environment in terms of, this year real time credit risk driving losses. It's been all about rates and all about [00:06:30] expectations, and that's something where equities are, clearly much more impacted. PE ratios and forward expectations of earnings and multiples. Yeah. In a way that credit markets, it's not quite as applicable.

[00:06:41] Kara O'Halloran: Yeah. and I'm gonna get to that, in a minute, but just to drive home how strong these fundamentals are. I mean, I'm looking at a chart rate here. Interest coverage ratios, so that debt service coverage is at the highest level in history. So yeah, the strongest level ever, the leverage levels are back to pre-covid [00:07:00] levels. EBITDA margins, which I think this is something that we had been watching really closely because actually in the first quarter we saw margins, deteriorate a little bit and that, kind of assuming maybe there's some inflation pressures happening.

[00:07:13] Kara O'Halloran: But we saw them grow again in the second quarter. So really that wasn't kind of the start of a broader down trend. So that was something we were watching very closely, and very good to see improvements in the second quarter, but just an exceedingly strong fundamental market. So, let's talk about, I think that brings up the [00:07:30] topic of spreads, right?

[00:07:31] Kara O'Halloran: I think. A lot of people this year have been saying, Oh, spreads haven't widened enough. especially given really this carnage we've seen in equity markets and given that the high yield market is down 15%, I will admit I was in that camp for a while, as Rob, since I sit next to you and we talk about credit a lot.

[00:07:46] Kara O'Halloran: But so as of now, spreads are about 200 basis points wider than where they started the. So I think when we were both like, All right, well, what are spreads gonna do? they really, they hit 600 basis [00:08:00] points. They tightened again, where are they gonna go from here? We kind of took a different approach and almost kind of worked backwards to see whether we found that spreads were adequately compensating investors for these risks that we see out there. So I think it's worth walking through. And I realize this is an audio medium, and this is kind of a math intensive proposition, but walking through a little bit at a high level, what spreads are telling you right now when it comes to kind of what investors, what the risk, what risks are markets pricing in right now, and what does that [00:08:30] compensation for investors look like?

[00:08:31] Rob Hoffman: Yeah, well, to, to your point about not wanting to walk through math in an audio medium, we did publish a report, entitled Decoding Default Risk. what are credit markets telling us? Big kudos to you and a lot of the data that's in there...

[00:08:43] Kara O'Halloran: Always better at plugging our work than I am. So thank you...

[00:08:47] Rob Hoffman: No, but I, what it, the crux of what it says is that if you look at an environment where spreads or say 500 in a high yield markets, that some portion of that spread is just effectively always there. You're always gonna get some sort of excess spread just for being in credit, to compensate you for the inherent risk of. You then have spread on top of that. And the theory goes that the spread on top of that is default risk. and so when you look at, where markets are currently with credit spreads around 530 basis points, it's effectively giving you about a 4% implied default.

[00:09:27] Kara O'Halloran: And yes, there are ways to massage these numbers [00:09:30] multiple ways, but you know, this is, you go back and you look at some, using these statistics, these implied rates versus actual rates. Do things match up? Do they move the way you would

expect to? the basic answer is yes. and so, meaning that often the market implies a level of defaults. That is relatively in line with, or actually we found exceeds actual defaults.

[00:09:50] Rob Hoffman: Yes.

[00:09:50] Kara O'Halloran: I think that's what you were getting at.

[00:09:52] Rob Hoffman: Yeah, exactly. and so, you look at current default rates around one and a quarter percent, expected default rates, to rise, [00:10:00] but maybe to 2%, and that's consistent with fundamentals that are really strong.

[00:10:05] Rob Hoffman: And you look at a market that you know every day is pricing in greater and greater, default risk. Four plus percent with where spreads are now. And I think you can look at that and say, the market is compensating you for the credit losses and default risk that is likely to be seen, over the course of the next 12 months.

[00:10:26] Rob Hoffman: I think that obviously the volatility that's coming from [00:10:30] equities is something that's difficult. I would like to think that if you take this sort of medium to longer term approach and markets generally compensate you for the underlying credit risk that is there, that with the spread widening that you've seen, markets are kind of appropriately pricing in this expectation for credit loss and default risk.

[00:10:50] Rob Hoffman: And look, we're, you don't necessarily need spreads at a thousand basis points or something like that when the market. It still doesn't really have [00:11:00] any great expectation for rising default rates. Yeah. it's a very interesting dynamic kind of going on, just like the market being down the second most in history with basically no default loss. So it doesn't explain everything, but it's, I think it's, there's a case to be made that it is somewhat appropriate.

[00:11:15] Kara O'Halloran: Yeah. Yeah. And I mean, we're not naive, right? Like we know that in the short-term sentiment is gonna drive spreads. I think we, I toyed with calling our Outlook collateral damage, but I didn't want to because there actually is no collateral [00:11:30] damage in credit markets right now.

[00:11:31] Kara O'Halloran: As we said, fundamentals look really good, but credit's just kind of getting caught up in our view, and a lot of this volatility that we're seeing throughout markets. But so if sentiments driving spreads in the short term, if we have a chop year, fourth quarter, we're not naive that spreads could widen.

[00:11:45] Kara O'Halloran: But if you look at the long term, we do think, know, there is a degree of slow down, priced in and is adequately, compensating investors. And I think. There's a lot of reasons to think that this default cycle could be different than the prior default cycles.

[00:11:59] Rob Hoffman: Yeah,

[00:11:59] Kara O'Halloran: [00:12:00] Right. So we've talked a lot about the market quality. double B'S make up over 50% of the high yield index. Now, the 10 year average default rate for double B bonds is 0.04%. So, as that market continues to improve in quality, that's a large cohort that you just very rarely see defaults.

[00:12:19] Rob Hoffman: Yeah.

[00:12:19] Kara O'Halloran: We talked about fundamentals being exceptionally strong. We just had a default cycle two years ago. Right? Like, we just haven't, Companies have been focused on balance sheet improvement. They just, we haven't [00:12:30] had the time to build up all of those kind of excesses that we've seen

[00:12:33] Rob Hoffman: Yeah.

[00:12:33] Kara O'Halloran: In prior cycles. Yeah. you look at sectors too, right? Energy. Over time has made up, I think, a third of high yield defaults throughout history, and it's the largest part of the high yield market energy in any sort of commodity related sector right now is doing phenomenally.

[00:12:50] Rob Hoffman: Yeah.

[00:12:50] Kara O'Halloran: We know what's going on in, in commodity markets, so, they, their fundamentals look even better than the average for the high-end index.

[00:12:57] Rob Hoffman: Yeah.

[00:12:57] Kara O'Halloran: So, yeah, I think there's a lot of reasons to [00:13:00] think. Even if we do have, an upgrade in defaults and I think, or sorry, not an upgrade, but an uptick in defaults. and I think it's naive to think we wouldn't if we do have a recession or a really slow growth environment, I think there's a lot of reasons to think that the market as a whole is going to experience a level of default.

[00:13:17] Rob Hoffman: Yeah.

[00:13:17] Kara O'Halloran: Lower than we've seen in the past.

[00:13:19] Rob Hoffman: Well, and one of the other things that I think you pointed out, as we were putting together the outlook was this chart, looking at high yield spreads, Related to equity volatility.

[00:13:27] Kara O'Halloran: Cause I think that could be one of the other things to say, well, equity [00:13:30] volatility is so high, shouldn't spreads be even wider. Just compensating you for that, general ball and risk off sentiment that's in the market. But I think, and you can comment that the data shows that. That's actually not the case. Like spreads are elevated and they're elevated cuz there is an increase in equity volatility, but it's actually consistent with sort of what you would expect.

[00:13:49] Kara O'Halloran: Yeah, totally. So actually in the beginning of this year, spreads had kind of underperformed their typical relationship with, with the VIX is what we're referencing.

[00:13:58] Kara O'Halloran: But, since we really saw, [00:14:00] and that was really when it was like the interest. the interest rate driven declines, and we didn't see a lot of spread widening then, but we have seen, I mean, 200 basis points of spread widening is not insignificant. and since that time, since kind of the end of q1, we really have seen the relationship we would expect between high yield spreads and implied equity vault.

[00:14:17] Kara O'Halloran: Again, I won't continue to reference a chart that no one listening can see. but it is in our quarterly outlook. That, that brings another question I have if we're thinking about, the topic of credit versus equities, [00:14:30] right? And you started to allude to it a little bit, but if we think about right, it's the end of September.

[00:14:34] Kara O'Halloran: We've had nine months of just a lot of pain throughout markets. and so it's clear that things look more attractive from a peer evaluation perspective. The obvious caveat here being that things are still extremely uncertain, so we're in no way calling a, a market bottom or anything like that.

[00:14:50] Kara O'Halloran: I think nobody, wants to make a call like that right now. But, if somebody is considering starting to leg into some sort of allocation, and whether that's [00:15:00] credit or equities, which as we know is kind of the common cross asset comparison, what would you say to somebody, know, deciding between the two asset classes?

[00:15:08] Rob Hoffman: I mean, in a risk off environment, which we have been in recently, credit markets historically exhibit less volatility to the downside, versus equities. And I think that when you also factor in that a lot of this risk off is coming from rising rates, that is also [00:15:30] particularly beneficial to floating rate asset classes, like loans.

[00:15:32] Rob Hoffman: So I. A lot of times we talk about high yield cuz there's tons of data and it's really interesting. But the loan market's really big also. it's something that we're active in, and it's worth mentioning as well. But markets peak in this quarter around, mid-August, from that peak to now equities are down 15% high yield's only down, seven and a half.

[00:15:50] Rob Hoffman: And loans are only down two and a quarter. Like, credit historically in these types of environments does better. Especially to me, when you think about the fundamental backdrop where [00:16:00] defaults are really low, credit losses are really low, markets are very much trading on sentiment, some rate concerns, the potential for recession, and I just think this long-term kind of math involved in, what are the PE ratios for equities?

[00:16:16] Rob Hoffman: What are earnings? Where forward earnings going to actually be? What sort of discount rate do you. that to me can induce so much potential volatility and equities that fundamentally doesn't really impact credit. [00:16:30] Like how's the revenues, how the cash flows, they making their interest payments? Are they gonna default on their debt?

[00:16:35] Rob Hoffman: Like when all of that is still so good? And not to say that it can't get a little bit worse, but you're starting from a very good point. I think that continues to. bolster, plus you add in the income that you're earning in both of these markets where, yields for both markets are now in excess of nine and a half, even 10% plus.

[00:16:54] Rob Hoffman: Like, that's a really nice income component that's coming into a credit allocation, helping [00:17:00] to bolster it against some of the volatility going on with equity markets. So, it's not you're not immune by any means, but I think you do have, reasonable downside protection. You will get upside participation, if this, whatever happens and the water's clear and equities start ripping again and people get euphoric, you're gonna have some spread tightening across these markets and you're gonna see upside price appreciation upon, in addition to just that income. That can allow you to have some really nice returns and credit as [00:17:30] well.

[00:17:30] Rob Hoffman: I also think one thing that we haven't talked about a ton is the dollar. And I mean, when I say we haven't talked about it a lot, I mean, on this podcast, because obviously, we're talking about it a lot just throughout markets, it's a very hard to ignore topic right now. But if you think about, who is impacted by a stronger dollar, a lot of the high yield.

[00:17:49] Kara O'Halloran: Market is very US centric. They don't have as much foreign revenue. so they're a little bit more insulated from some of those, those costs, associated.

[00:17:58] Rob Hoffman: Yeah, no, that's exactly [00:18:00] right. I mean, I think if focus on, the s and p 500 and the largest companies that are in there, and you think of the Microsoft and the Apples and, they generate significant foreign revenues that are really impacted by a really strong dollar. as you go to smaller company sizes, and especially as you come into companies that tend to be private, they are naturally much more focused domestically in the US where they, their costs and their revenues are almost entirely domestic. And [00:18:30] the propensity to see that is much higher across credit markets.

[00:18:33] Rob Hoffman: And so, you're right, that certainly one of these major macro risks that is out there that you know, could impact things like s and p forward earning. Which could have an huge impact on equity prices. And equity Volatility is much less of an issue for, domestic US credit markets.

[00:18:50] Kara O'Halloran: Yeah. It's actually an issue for investment grade credit markets.

[00:18:53] Kara O'Halloran: Yeah. that's kind of the, if you think about like the S&P 500 companies, where are they issuing their debt? It's often in the investment grade market. Yeah. So, [00:19:00] that is a headwind facing. Yeah. That market has been hit extremely hard this year, but, yield there. look. Okay now, but they definitely have that headwind.

[00:19:07] Kara O'Halloran: Yeah. okay. So, I want to wrap it up with, a new segment that we're calling the fireside fire drill. So, I'm gonna rapid fire a couple of questions and you get, I just want your gut reaction.

[00:19:17] Rob Hoffman: Okay.

[00:19:17] Kara O'Halloran: You get, one or two words. I don't even want an explanation.

[00:19:17] Rob Hoffman: Oh. All right. That's very hard. But we'll try.

[00:19:23] Kara O'Halloran: Yeah. Well, we'll be fun. Okay, question one. If you had to choose, is it more [00:19:30] likely between now and year end or what is the next big spread move? Are we going to, so keep in mind, spreads are like four hundred twenty, five hundred and twenty five basic points right now. Is it more likely that spreads go to 475 or 650?

[00:19:45] Rob Hoffman: Whew. Wow. It's a tough one. Okay, I'll say higher. Six 50 sounds a little high between now and the end of the, but. Six, I'll say higher. Higher.

[00:19:52] Kara O'Halloran: 600.

[00:19:53] Rob Hoffman: Okay. Higher.

[00:19:54] Kara O'Halloran: All right. what outperforms through year end high yield bonds or equity?

[00:19:58] Rob Hoffman: High yield

[00:19:59] Kara O'Halloran: Does higher or lower rated credit outperform through year end?

[00:20:04] Rob Hoffman: Higher rated.

[00:20:05] Kara O'Halloran: What is a higher default rate at year end bonds or loans?

[00:20:09] Rob Hoffman: Loans.

[00:20:11] Kara O'Halloran: All right. That's all I had...

[00:20:13] Rob Hoffman: That was quick.

[00:20:13] Kara O'Halloran: See, I told you

[00:20:15] Rob Hoffman: We did it.

[00:20:16] Kara O'Halloran: You did a good job. you got one words at the end, one word answers at the end. Do you have a little bit of a caveat...

[00:20:21] Rob Hoffman: I know.

[00:20:21] Kara O'Halloran: In your first one, but I'll allow it. Since it was our first time doing that segment. I think that's a good place to. Stop. I, our, as always, [00:20:30] our credit outlook is available on fs investments.com, along with the rest of our Q4 outlook content. Rob, thanks. thanks for joining and...

[00:20:38] Rob Hoffman: Thank you.

[00:20:38] Kara O'Halloran: We'll be back for 2023 sooner than...

[00:20:42] Rob Hoffman: Yeah.

[00:20:43] Kara O'Halloran: ...pretty soon. All right, thanks. Okay.

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