Episode 50

New year, new views

Research experts Kara O'Halloran and Andrew Korz gather to analyze possible economic scenarios for 2023.

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 the investment research team here. As we enter 2023, a lot of the same macro questions from 2022 remain. So on today's episode, we are gonna walk through how various economic outcomes could impact two of the more interesting areas of the market that we see today, specifically commercial real estate and credit. So to walk through all of that with me, I have brought on my colleague Andrew Kors. Andrew, thanks for joining.

Andrew Korz (00:35):

Hey, Kara, good to be here. And I hear we are celebrating a big landmark today. We have, I think, the half century episode celebration for FS FireSide.

Kara O'Halloran (00:45):

It is the 50th episode. I know, I know. I love celebrating like the halfway to something. I just threw my goddaughter a half birthday party this past weekend. So, but no, we're, we're excited. Any reason to celebrate, right, exactly. And I

Andrew Korz (00:58):

Hear exactly, I hear they're giving you another 50 episodes. I think I,

Kara O'Halloran (01:00):

That's what I, we've been renewed. We've been renewed for the next 50. We're very excited to continue something.

Andrew Korz (01:06):

Right.

Kara O'Halloran (01:07):

Thank you. We're excited to, to bring lots more FireSide this year.

(01:15):

Let's get into it. So coming into this year, it seems that the consensus is that there's not a lot of consensus, right? I mean, I think there's a few things that we all seem to agree about. Inflation has likely peaked, it's heading lower. The probability of a recession has risen quite a bit. But what we haven't really seen consensus on is when will the Fed stop hiking? And then when they do stop hiking, what happens next? If we have a recession, what does that look like? And at the end of the day, what does all of this mean for markets? So in that vein, I kind of wanted to take a different approach from our normal Outlook episodes and walk through kind of a scenario

analysis, right? Almost your classic bull bear based case, but using various economic outcomes than what that's going to mean for commercial real estate and for credit.

(02:05):

Um, we're gonna do actually a little flip the mic and <laugh>, and you're gonna get to a chance. I'm excited for that. I ask me some questions about credit. I know I'm a little nervous. No, I'm only kidding. So our three scenarios that we'll go with are soft landing, hard landing, and stagflation. And just to set the stage about kind of our assumptions for each of those. So soft landing will assume the fed achieves its goals of lowering inflation, but does so without a major impact on economic growth. Jobs data stays strong. We avoid a recession in this scenario. The Fed probably holds rates steady for a while, maybe cuts eventually, but not by a lot. So that's the soft landing scenario. Hard landing is the recession. I think we should go with like mild recession here. I think that's kind of our base case in terms of we have a recession, so the Fed brings inflation down. Obviously the economy contracts, this causes the, the Fed to cut rates. They probably don't elevator down to zero like they have in the past. But I'd say rates come down across the curve. And then stagflation is the tough one. Inflation remains high, and growth is really slow or contracting, the fed probably has to either keep rates high or keep raising rates. Does this sound good? Yeah. Fair assumptions.

Andrew Korz (03:20):

Yep. Totally. Okay. I

Kara O'Halloran (03:21):

Agree. Cool. Okay. So let's start with commercial real estate, but as always, let's set the stage a little bit. So bring us up to speed. What happened in 2022 in the CRE market?

Andrew Korz (03:31):

Yeah, absolutely. So I think going back to my last outlook, what we're still kind of in the midst of here is a recalibration or a response to a fundamental change in the external environment, if you will, primarily slowing growth and higher interest rates. And I think if we can think about it this way and go back to say mid 2021, this is really an upending of one of the best return models in any asset class, right? So if you are a real estate equity investor and you can deploy capital, you can go buy a property at a 6% cap rate, 6% yield, right? You can use 70% leverage with a three and a half percent mortgage rate, and you can assume pretty modest rent growth over the next five years. And then you can assume, hey, you're gonna sell the property at the end of those five years at the same cap rate.

(04:22):

That fairly simple sounding operation. You, you can sort of imply like 17 or 18% annualized returns over five years, which over five years, that's, that's two and a half times your investment. So that's an incredible investment model. That's only possible when financing rates are really low. And what we've seen is that over the past year or so is a complete reversal of that. And we've seen that the knock on effects to say the bond market and the equity market, sir, a, is much less liquid. It's heterogeneous. Every property is different in every various location. So it takes time for these macro factors to seep into the market and for market participants to react to that, right? So what we're seeing now is we're seeing a huge gap form between what sellers are willing to sell at and what buyers are willing to transact at. Right?

(05:13):

Buyers see the market and they say financing rates have gone up 250, 300 basis points. You need to bring your selling price down. Sellers say fundamentals are still fine. I don't feel comfortable bringing my price down yet. Right? And what does that lead us to? It has led to

much lower sales volumes. So here's a pretty crazy stat. Over the first half of 2022 sales volumes were 50% higher than the same period in 2021, right? Go to the second half of 2022 actually through November, because we don't December data yet, but volumes were 34% lower than the same period in 2021. So this was a stark change. You kind of have a very clear point where fed policy started impacting activity. You see it in in prices, right? So we used two, two different indexes, one of which is appraisal based, and that's showing significant price declines already to the tune of more than 13%. Whereas a transaction based index, which is based on deals that are actually done, has not fallen nearly as much. That tells me people are selling what they can sell. They're selling high quality trophy institutional grade properties because there's not a ton of liquidity lower down the quality spectrum.

Kara O'Halloran (06:18):

So you're actually, we're actually seeing prices decline. We are seeing prices decline. That's big. I think the last time we talked about the outlook, I think we were seeing like a moderation in price growth Yeah. But not outright declines yet. So that's a big change. Yeah,

Andrew Korz (06:31):

It, it is. And again,

Kara O'Halloran (06:32):

Or I should say for most of the last couple of years, you know, last year, that's what we

Andrew Korz (06:35):

Were saying it is. Yeah. Yeah. And, and we were talking a lot about the persistence or resilience in cap rates, how they hadn't responded quite yet. It again, just takes time. And these prices are falling in a sort of environment of really low liquidity. So what you're seeing is sort of these buyers and sellers circle each other and it's sort of a game of chicken, right? Who sort of blinks first. And I think where we sit today is, look, whether you want to call this a C R E downturn, you wanna call it, you know, a weak spot. The important thing I think to remember is that they come in all different flavors, right? Whether you're talking about the early nineties where you had a supply glut, um, that sort of meta recession and a banking crisis, the SNL crisis, right? That was a painful one.

(07:17):

The early two thousands was more of a fundamental story. You had a relatively mild recession, obviously you had the.com bubble, but that was relatively mild. The gfc obviously you had overleveraging, which led to a availability of credit crisis, which then led to a fundamental downturn. And today, I think it's more of a cost of credit issue as we come into this year. So again, the operative theme, I think, and, and we call it our outlook mind to the gap, because this gap between buyers and sellers is gonna lead to sort of a larger than normal performance gaps, I think, as we go through this year.

Kara O'Halloran (07:48):

Yeah, no, I think that's interesting. I love the way that you put it in your outlook. We talk so much about the Fed having a hammer, not a scalpel, right? So they use this really blunt instrument last year, but it's going to have a really, really disparate effect across asset classes. I think dispersion is just a theme that we're kind of seeing throughout markets for

Andrew Korz (08:06):

2023. Yeah. And and to your point, like cheap money is, is the rising tide that lifts all ships, right? Totally. And when, when capital markets get tighter, you start to seize as Warren Buffet says,

who is swimming naked? So, yep. I think that that that's true in Syria too. You start to see where the weak properties are and where the weak owners are.

Kara O'Halloran (08:25):

Okay, so let's go into our scenarios. Let's start with the <laugh>, which, which we wanna go first. Let's start with the, what I think is probably the worst case scenario, stagflation, like we said in the beginning, inflation remains high. The fed has to remain restrictive and growth slows or outright the economy outright contracts. What happens in c R E Yeah. In this environment also, I think we should be clear that this is probably not our base case economic forecast, so let's just get it out of the way now. But yeah, what would happen theoretically?

Andrew Korz (08:56):

Yeah. In, in the, uh, in the spirit of bringing some positivity to this podcast, <laugh>, I would say this

Kara O'Halloran (09:00):

Is not always my, uh, I'm a credit person. That's not always my, uh, what can go wrong. My mo

Andrew Korz (09:05):

I I would say this is, this is the worst, certainly the worst economic outcome probably. Yeah. And certainly I would say the worst for markets in general. I also think it's the unlikeliest. Yep. Especially given some of the data that we've seen coming in recently. Look, we've talked about c r E as a, as an inflation hedge, and certainly this economic scenario would include inflation remaining elevated. I think the longer it remains elevated, the more of an issue it becomes. You get, you know, the lack of real growth starts to become an issue. You get labor costs rising and becoming entrenched. Um, that's an issue. You get, you know, raw materials or construction costs that start to become an issue. The thing that sort of makes commercial real estate a little bit more resilient, certainly than bonds, I would say, but probably than equities as well in this scenario, is just what we talked about in terms of rents being tied to inflation. Some are specifically tied to inflation via rent escalation in ancy agreements. So, look, this is bad for markets, it's bad for c r e. Real estate's probably one of the better equipped asset classes to deal with this because it's more tied to nominal G D P than it is to real G D P. But this is, this is what the Fed is trying to avoid specifically, and this is what they're scared of.

Kara O'Halloran (10:15):

All right. Let's do, what do you wanna go next?

Andrew Korz (10:18):

Let's, let's go with, let's go with the base case.

Kara O'Halloran (10:21):

All right. Let's do the base case.

Andrew Korz (10:22):

Yeah. Which, which I think our house view here at FS is, is a recession is probably the likeliest scenario or

Kara O'Halloran (10:30):

Likely a mi more mild recession.

Andrew Korz (10:32):

Yeah. Yeah. Okay. Let's go there. In in, in terms of timing. Second half of this year could even take until the first half, the first quarter Yeah.

Kara O'Halloran (10:39):

Of 24, I think. I think we're the probability of a recession has certainly risen this year. Yes,

Andrew Korz (10:44):

Yes. We, I I think you can say that with confidence. Yeah. Again, as you said, there are, again, various flavors of downturns. There's verve, various flavors of recessions as well. We don't see this, as you said, being particularly deep. I think there are sort of two reasons for that. Number one is that we don't necessarily see any systematic financial issues here. Leverage, I think is the sort of tinder that can

Kara O'Halloran (11:07):

Spark the fire.

Andrew Korz (11:08):

Yeah, yeah, yeah. Yeah. I, you know what I'm getting at. But, so we don't see leverage issues necessarily in, certainly in households, but balance sheets for, for corporations are pretty strong too. So we don't see this sort of area of financial contagion that can, that can turn a downturn into a recession that we saw in the global financial crisis. And the second thing would be that, you know, we have decent medium term supports. You have a large Gen Z cohort coming into the workforce. You have automation and AI becoming potentially productivity enhancing tools. You have the capital spending surge that we see coming around automation, around the energy transition. So these things are all supports medium to long term. Make no mistake a recession is not good for real estate. Right. You might see the fed cut, as we've talked about. I think the market's now, now pricing 75 basis points of cuts between June and the end of this year, which certainly disagrees with the fed zone dot plot.

(12:01):

But e even if that's the case you get, if you get a recession, fundamentals weaken and credit spreads probably widen. So that wipes out and any benefit of benchmark rates coming down. So this is not a good scenario, but I think it's important to remember that similar to inequity markets where a recession allows some companies to trim costs, to cut headcount and sort of reset the margin structure. I think it's kind of similar in c R E where a downturn can allow folks to come in, pick up stress and distress properties at relatively large discounts. And that sort of brings the market back up. So this is our base case. I think the, the market given the low leverage levels are, is, is relatively well positioned for this.

Kara O'Halloran (12:43):

All right, so let's, let's close out real estate with a little optimism, the soft landing scenario. So we avoid a recession, jobs stay strong, consumers stay healthy. Rates are still probably higher. Maybe they come down a little bit. What happens then?

Andrew Korz (12:58):

Yeah. Yeah. So I would say, again, this is the best case, but I, but it doesn't necessarily mean that we're going back to the, the good old days of the return, uh, the return backdrop that we saw in 2021. I don't think we're going back to a world where, where commercial mortgage rates are 3.5%, which is where the 10-year treasury is right now. Right. <laugh>, this is a world where if real growth remains persistent, that likely means that the labor market remains strong and the Fed is not gonna feel comfortable cutting rates meaningfully. I don't think so this is a world where interest rates remain high, and actually it could make the correction prices take longer, right? Because if you get a recession, you start to get property owners who get into distress, hand over the keys to the lender, or they say, I'm gonna go into the market and sell this, and you get this correction prices quicker because market participants are forced to

Kara O'Halloran (13:48):

Do it. Yeah. Enforce

Andrew Korz (13:49):

It. Yeah. In this type of scenario, when rates stay high and the economy sort of, you know, slogs along maybe a below trend, that could mean that this property value correction takes longer. And in that scenario, you know, we, we've talked a lot about the attractiveness of equity versus debt in the commercial real estate market. And in this case, I think, again, you probably have a prolonged period of low to zero growth in property values where income to the asset class remains fairly strong. So I think this is a scenario where you probably wanna be on the debt side more so than the equity side. Okay.

Kara O'Halloran (14:23):

Okay. That was very helpful, Andrew. So let's zoom in a little bit on just the first quarter. You know, what are you gonna be watching in c r e very closely?

Andrew Korz (14:31):

Yeah, so the first quarter is generally the weakest in terms of transaction volume. So I don't expect to see a lot of this, you know, robust price discovery start to occur necessarily until maybe March and beyond. I would expect to see property values continue to face pressure because we don't see interest rates coming down meaningfully. We think the fed means what they say. Hopefully the data starts to cooperate. But I think you are gonna start to see some of these loan maturities coming up where property owners need to make decisions. Do they wanna refinance at this higher or are they able to refinance at this higher rate? Do they want to go sell? So I think we're gonna start to see how property owners deal with these loan maturities that are coming, and we're gonna start to see if there's gonna be meaningful distress where folks who have been waiting on the sidelines for this distress to come, whether that indeed is going to come. And it's probably gonna be in weaker areas of the market like office and maybe some parts of retail.

Kara O'Halloran (15:24):

All right, Andrew. Uh, thank you for that. I'm, I guess I'm in the hot seat now, <laugh>. Yeah,

Andrew Korz (15:30):

Let's, let's do, we have like some sort of sound effect where we can flip the mic?

Kara O'Halloran (15:34):

Yeah. Okay. We'll, we'll add that in. All right. We'll add that

Andrew Korz (15:36):

In <laugh>. Okay. So

Kara O'Halloran (15:37):

I forget how you guys all feel now,

Andrew Korz (15:39):

<laugh>. So this is my, my, my hosting debut. This is exciting. I love it. I'd like to, uh, welcome Kara O'Halloran <laugh>, a a, a director and a a credit markets expert. Welcome to the podcast. Is this your

Kara O'Halloran (15:51):

First time? Thank you. Uh, first time. Yeah. Longtime listener. First time caller. Yeah. <laugh>, that's,

Andrew Korz (15:55):

That's, that's exciting. So let's, in, in sort of using the same structure that, that we used for, for the c r E market, let's first talk about where we come into 2023. And again, just because we flip the calendar doesn't necessarily mean that, you know, much has changed. Totally. But I think it's a good, it's a good opportunity to sort of reset your expectations, you know, talk about the coming 12 months. So credit is coming off a bit of a tough year. High yield bonds were down about 11% loans down just a bit because of the floating rate nature. And, you know, as a, uh, novice to the market, if you will, this is sort of how it looks to me. On one hand, you have spreads that are probably not pricing in a recession, right? Where it's spread levels that are near 2019 levels, which at that point we were dealing with the trade war, but like, it wasn't a recessionary environment. On the other hand, you have an 8% starting yield in the high yield market, right? Which allows you a lot of cushion. So how do you see the market, what are we positioned for now and what's your return outlook Yeah. For the next 12 months?

Kara O'Halloran (16:55):

Well, first I must commend you as a first time host. You are definitely taking a page out of every podcast host's book and asking really, really long questions. <laugh>, so excellent work I've learned from the best you've learned. Yeah. <laugh>, <laugh>, and yes. So I think that's a, a great question. I think, let's take a step back and talk about 2022 as a whole, right? Because credit was obviously not spared from that volatility that we saw in markets. Loans did fare better, reasonably better, just kind of owing to that floating rate coupon. But at the end of the day, we definitely saw a preference for quality, higher quality assets outperformed lower quality in each market. And really, we kind of saw this ping pong match for a lot of the year about concerns over interest rates and concerns over growth. And then that caused these really sharp oscillations in market leadership.

(17:44):

So periods that we were concerned about rising rates, loans outperformed. When we got got concerned about recession, we saw bonds outperform because loans are by ratings, composition by kind of structure. Loans are, in our view a much lower quality market. But where does that leave us, you know, ending 2022, you mentioned spreads and I think a lot of people like in markets are saying, Hey, you know, spreads didn't widen that much last year. And that's a great point. I think if you think about, or look at credit fundamentals, it kind of starts to tell that story a little bit. So 2022, we actually saw fundamentals continue to improve throughout the year. So leverage is at its lowest level in about a decade. Interest coverage stats are at record

highs, we're seeing double digit year over year revenue and EBITDA growth. So for, and for the most part, margins are holding up pretty nicely.

(18:37):

Defaults did tick up last year. They're about the end of the year, about 1.5% trailing 12 month rates in both markets. That's still half of long-term averages. So, you know, if, if you had just told me that in a vacuum, I would've said, oh yeah, credit probably had a decent year. But that tells you that sentiment matters, right? Credit does trade alongside markets and that sentiment is gonna matter, but I think that's also why spreads maintain or stayed relatively well contained. I think if you look at what so spreads are in about the 40th percentile coming into the year versus coming into 2022, making sure I get my years right, they were closer to the 90th. So we have seen some spread widening. I think if you look at kind of what markets are pricing in right now, in terms of like a default rate, right now it's between three and a half 4% in bonds, which is actually higher than our base case forecast. And then loans are pricing in a much higher degree of default. So about 8% that's significantly above our base case forecast. So I think it's right to say that credit probably hasn't priced in like a massive recession, but I think it has priced in some degree of a slowdown. I think the most likely path for spreads is wider to some degree. But to your point, there's that really, really nice income cushion that we didn't have at the start of 2022 to offset some of those price declines if we do see that spread widening.

Andrew Korz (20:04):

Yeah, that, uh, that's a great overview. And uh, the, the way I always like to think about pricing is it's like it's assigning a probability to, to different outcomes and then it's, it's saying, okay, what's the, what's the outcome in that scenario? Right? So with that, let's kind of jump to the different economic situations that we discussed earlier. So we can go in the same order. So let's, let's talk about the, the stagflation scenario.

Kara O'Halloran (20:27):

Yeah. This is, as you said in the series section, probably the worst outcome and also the least likely. I think I view this as maybe a slightly better version of 2022, which like, isn't that great. We've already seen probably the bulk of that, like really acute interest rate rise and that caused a lot of, of duration driven price declines in high yield, though we probably see fewer of those. And I think actually in this scenario, bonds probably outperform loans. So we saw, obviously loans outperform bonds by a decent amount last year because, you know, loans benefited from that floating rate last year as we saw those really, really acute interest rate height or ri you know, rising interest rates. But now that debt service has just increased for loan issuers. So now loan issuers are forced to pay that higher debt service cost. And so I think that there just adds pressure to, to loan issuers. It's already

Andrew Korz (21:19):

A lower quality

Kara O'Halloran (21:19):

Market. Exactly. Yeah, exactly. I think this is when we really get the test of the loan only structure. So a lot of the loan market, they have these senior secured loans, what are they senior to? Nothing. You know, these, these companies are issuing the

Andrew Korz (21:32):

Equity

Kara O'Halloran (21:32):

<laugh>. Yeah, exactly. Exactly. So many of these companies are issuing only loans. They don't have that mix of that fixed rate, low cost debt that we have in high yield. Where do some other troubles come in? Obviously this would cause a situation where you're having to refi at higher rates. The good news is only 8% of the credit market matures between now and 2024, the end of 2024. You know, issuers really, really took advantage of those rock bottom rates in the last couple of years to term out their structures. So I think that's definitely helpful, you know, kind of buoys the asset class a little bit, but I think dispersion really, really increases, as I said, credit fundamentals are really strong and, and maturities are not facing this near term maturity wall, but you still need to be able to pick the healthiest balance sheets costs obviously become an issue here, so you know, who can withstand the higher costs, continue to pass those on to consumers. But I think one other benefit to credit in this environment is in this no hypothetical scenario, inflation remains high credit is actually one of the few fixed income asset classes with a yield that's currently higher than inflation. So yeah, we've seen yields on kind of core bonds corp, you know, investment grade corporates rise in 2022, it's still not outpacing inflation. So you're still getting a positive real yield in credit in that scenario. But that's, that's kind of the bright side.

Andrew Korz (22:52):

Yeah, it's, it's interesting, right? Like, like an 8% carry is, is pretty significant. I mean, so

Kara O'Halloran (22:58):

Often it's almost double what it, it was started. Yeah, it was

Andrew Korz (23:01):

3.7% in, in, in 2020

Kara O'Halloran (23:03):

Ones. Double what it started a year. Yeah. Yeah.

Andrew Korz (23:05):

And how, how much spread widening would you need to wipe that up?

Kara O'Halloran (23:07):

Yeah, about 200 basis points. Okay. To fully, to fully wipe that out. That's, that's a decent amount of frustration. Yeah, exactly. Exactly.

Andrew Korz (23:14):

So going back to sort of fundamentals, and this will take us to our second scenario, I would imagine a recession, even if it's mild, is probably, if not the worst case, close to the worst case for credit fundamentals. Yep. So how do you view credit now as prepared for a

Kara O'Halloran (23:30):

Recessionary outcome? Yeah, we have talked so much on this podcast about how credit has just the fundamentals have continued to improve over the last couple of years. So I think that they can withstand some degree of slowing growth. I think you get like the mean reversion, but again, back to the mean. So fundamentals are at exceptionally strong levels right now. So they can weather some degree of slowdown. I do think you're probably gonna see defaults and distress pick up. I think that's natural. We're not really calling for this oh eight style or double digit default spike. Probably a kind of mid single digit would be our, our base case. I do think

that there's a couple of reasons to think that a recession could look a little bit different in credit this time. Obviously no two cycles are the same. So I just talked about how fundamentals are really strong.

(24:19):

You know, we we're just coming off of the last recession a few years ago. We haven't really had the time to build up all of those excesses, right. You know, corporations have really been focused on balance sheet repair. So we're going into the most telegraphed recession in history, <laugh> with really strong levels, and then are really strong fundamentals. So, and then I think about market quality. So the high yield market has just become increasingly higher quality over the years versus the loan market. We're seeing this really big divergence. So the loan market has become lower quality over the years. Over 50% of the high yield market right now is made up of double B issuers. Whereas the loan market, it's over 50% is made up of single B and below. So you have really different market qualities. A lot of that is owing to that really large amount of fallen angels that we saw in 2020.

(25:09):

So we saw 230 billion or something fallen angels, you know, so formerly high investment grade rated companies fall into the high yield market. Only about half of those have returned to the investment grade market. So you have, you know, 120 so or so formerly fallen angels that are really trying to like, repair their balance sheets and get re-up upgraded and stuff. But it's just a much higher quality market. We're seeing ratings, upgrades in the high yield market. Outpace, downgrades the loan market. It's the opposite. You're seeing more companies downgraded than upgraded. So I do think market quality comes into play here. I think bonds are well positioned, um, uh, owing to that market quality. I think loans are gonna be really tested in this

Andrew Korz (25:50):

Scenario. Yeah. And, and I would imagine this is where, you know, in terms of how to get access or how, how to, how to play credit in a downturn, like the shape of the downturn really starts to matter. Whereas like, if it's like, is it a manufacturing driven recession? Yeah. Is it a consumer labor market driven recession is, you know, is it, is it housing? Like

Kara O'Halloran (26:13):

Yeah, it's all, I mean, like we said, it's dispersion. Like that's, that's just gonna be such a theme this year. Yeah. I also think it's really important to remember how resilient credit is. So if we do have a recession, this asset class snaps back and it snaps back hard. We've never seen two negative years in a row in either market. If you look at data of, you know, returns after yields are past, you know, whatever percent and 800 basis points spreads, whatever it is, all of these return numbers are phenomenal. Yeah. So it's a really, really resilient asset class. I also like credit over equities in that scenario quite a bit. Obviously you benefit from being higher in the capital structure, but there's also this implicit floor in place. So investors are recovering a lot more of their principle right now in the event of default than they were before. So long-term, long-term recovery rate for bonds, the average is about 40%. The trailing 12 month rate is close to 70%. So if you think about that as kind of the implicit floor, obviously that number's gonna fall a bit during a recession. But you're starting at, you know, a after last year you're starting at these low prices. The average price in the bond index is sub 90. You have that kind of implicit floor in place. I, I like that risk return profile. Um, just kind of hard stop more than equities right now. A lot

Andrew Korz (27:32):

Of convexity there.

Kara O'Halloran (27:33):

Yeah. Yeah, exactly.

Andrew Korz (27:34):

Okay, let's get to our third and final scenario. Yep. The soft landing. Gimme your upside

Kara O'Halloran (27:37):

Case. I think this is the easiest one. There's a lot of upside we just talked about. There's a lot of upside in credit right now. The average price of the high yield index is below 90. As I said, the market is yielding a lot. If you look at forward 12 month returns from starting yields of, we started the year about 9%. The average forward 12 month return is between 12 and 14%. And returns have been positive over 90% of the time. So really nice return profile plus, even if we have a soft landing, there could be some bumps along the way. And you have that yield, as we talked about, to really cushion some of that, that interim volatility. So, you know, I think it, it's soft landing is the easy, best case scenario, obviously, but I think there's still a lot of up upsided in credit right now based on where we started the year and where, where we've seen, you know, the tights that we've seen in spreads before and where they could go. So here's hoping Right.

Andrew Korz (28:30):

<laugh> great. Yeah, I, I, yeah, I, I I I think we're all hoping for that scenario. Certainly. Yeah. Okay. Let's, let's tie this up into a nice little bow. Okay. Give me your, your sort of couple big things for this year.

Kara O'Halloran (28:40):

Yeah, it's a good question. I mean, I think my, what I, what this scenario analysis has told me, and as I was, you know, prepping for this podcast, credit's pretty well positioned to navigate a variety of outcomes. As I keep saying <laugh>, I'm gonna say until I'm blue in the face, fundamentals remain really strong. We just don't have those excesses. Leverage is good. Companies are servicing their debt with ease. But again, it's dispersion. I think you wanna be in credit this year, you just wanna be in the right credit. But I think that that's how I would wrap it up. Okay. How'd I do it my first time on this day?

Andrew Korz (29:13):

That's amazing. I think you might have a future in this thing. I don't know.

Kara O'Halloran (29:16):

<laugh>, you're gonna try to, I thought you did a good job. You wanna be coming for, uh, you're coming from my hosting gig.

Andrew Korz (29:20):

Hey, we're, uh, we're two people of many talents. I think so. Oh, perfect. Um, I, I think that's a great way to wrap up the, the big 50th show. Yeah. How do you think it went?

Kara O'Halloran (29:28):

This was, it was hard being on this side. It was fun though. I liked it. Yeah, I liked it. Absolutely. We, we'll do

Andrew Korz (29:32):

This again. They both have their challenges, both

Kara O'Halloran (29:34):

Sides. Yeah. Yeah. We'll do this again, <laugh>. All right. Well thanks Andrew. Appreciate it.

Andrew Korz (29:37):

Thanks, Kara. Appreciate it.

Kara O'Halloran (29:42):

This episode was recorded at the FS Investments headquarters in Philadelphia's historic Navy Yard. It was produced by Kara O' Halloran. It was edited and engineered by Aaron Sherman. Special thanks to show coordinator Ellie Zhang. If you enjoyed this episode, be sure to like and subscribe wherever you get your podcasts. Thanks for listening.