Episode 56

Research roundtable: Q2 2023 outlooks

Join the Investment Research team as they look ahead to Q2 2023

Rob Hoffman (00:04):

Welcome back to FireSide, a podcast from FS Investments. My name is Robert Hoffman and I'm the head of the investment research team here at FS. As the quarter rolls over and we head into Q2 of 2023, we always like to take stock of where we've been and where we think we're going over the course of the next quarter.

Given how fast markets have been changing, I feel like that's a statement we've been making more and more often since the early days of the pandemic. It's worth mentioning that we're recording on April 11 and our written outlooks covering macro, real estate, and credit should all be available on the website, if you want to dive deeper into some of the stats and themes we're going to talk about today. But let's set the stage because a lot has happened in the first quarter. For markets, stocks are up almost 7.5% in the U.S. The Bloomberg Agg is up 4%, high yield and bank loans up 3.5% each.

Seems like a pretty good year for investors, right? So far, straight up, but let's see... Fixed income is up because yields have plunged. The first quarter saw the largest bank failure since the financial crisis. Fixed income volatility has exploded and was higher than the pandemic frenzy in 2020.

It's close to the highs of the financial prices. The Fed, and I know we will talk about this, raised rates in March and may raise again in May. So, there is still a lot of policy uncertainty, but this economy seems to be chugging along with a strong labor market and GDP, that is expected to be around 3% in the first quarter.

There's clearly a lot to dig into today, and for these research roundups as we like to call them, I am joined by my partners and colleagues on the research team, Lara Rhame, our Chief US Economist, and Andrew Korz, our Director of Research [00:02:00] overseeing equities and real estate. Welcome everybody.

Before diving into our forward-looking thoughts, it's probably worth mentioning where we've just been. And to do that, I thought it might be fun to do it in the context of if you were surprised or not surprised by what has transpired to date. So Lara, recap for us what we've seen in the macro economy to start the year, and have you been surprised or not surprised by what's played out so far?

Lara Rhame (02:26):

Yeah, thanks Rob. That's always a lot of pressure going first, you know, <laugh> Okay. I think for the economy it was broadly as I had expected and I think that's good news because I started the year saying that I think the economy's still looking good with a lot of momentum. You mentioned growth in the first quarter and I think we can add on to that this solid labor market. I think if there's a problem with the economy, it continues to be inflation. And I'm going to remind everyone that while CPI peaked at over 9% in the middle of last year, it's still 6% year on year and core CPI is still five and a half percent year on year. So this disinflationary process, it was consensus to say inflation's gonna fall, but it's really taken a lot of time and here's where I

wanna be careful. The surprise, the really truly unexpected event was as you pointed out, the banking failures in the first quarter. And I think when the fed raises rates aggressively, financial events are not uncommon at the tail end of a rate hike cycle. It surprised me that it came from the consumer banking sector. Not in retrospect, hindsight's always 2020, but I think that to me was the surprise.

Rob Hoffman (03:46):

Andrew, real estate, let's see, it's a nice little sleepy market, not a lot going on, right? <laugh> surprised you're not surprised on how the euro started.

Andrew Korz (03:56):

So I would say in general, I'm not surprised by the, I would say the general complexion of what happened in Q1. So we came into the year we called our Q1 outlook, which was written in late December. We called that Mind the Gap and really we were focused on this gap that had formed this, this bid ask spread between property buyers and property sellers. That was really driven by first obviously the, the sort of low interest rate driven frenzy in, the real estate market in sort of late 2020 through early 2022 until the fed kind of put the kibosh on that interest rates went up, financing costs and real estate went up three, 400 basis points. And all of a sudden you have this gap between what buyers wanna buy at and what sellers are willing to sell at. So what you had in Q1 is, is broadly as I expected, transaction volumes were down sort of 40 to 60% depending on the sector that you look at compared to last year.

(04:50):

And compared to pre covid, you had prices falling, property values declining at, call it a 2% per month kind of pace, yet cap rates finally responding to higher financing costs. They're only up about 50 basis points from their lows, but they are responding and, we expect them to continue to rise. So I think from a transaction volume, property price sort of market mood perspective things whereas we expected, I think if there's a surprise, it's to your point rob. A market that is somewhat generally slow moving and relatively unexciting, especially relative to called the equity markets. The narrative seems to have really kind of gained steam around real estate and if, there's ever a period where real estate really hits the mainstream news, it seems to be in a negative way and, in a way where people are concerned about some sort of bust.

(05:45):

And I think we've kind of hit that and I'm a little bit surprised about the ferocity with which the media has picked up this narrative around commercial real estate. And I hope we can use this discussion today to sort of add some nuance to that conversation. And I think a lot of that is around the capital markets around the commercial real estate lending markets. And I'm interested to ask Rob, I think we see some interesting things happening in, in the real estate lending market. I'm, I'm curious what you are seeing on the corporate side and if it sort of lightens up with what we're seeing on the real estate side.

Rob Hoffman (06:18):

Yeah, I, I agree. I think I was also not particularly surprised about what played out in corporate credit markets over the course of the first quarter as a reminder, loans were up about three and a quarter percent high yield ended up a little bit under 4%, 4%. So three call it three seventy five or so. Look, 2022 was a bad year for credit. High yield market was down a lot. Loan market was down, both markets were down the second most in their history and credit markets have never had two years in a row of negative returns. I'm sure it's gonna happen one day, but it hasn't happened yet. And so as you roll into this year, I think it created a natural bias that credit markets wanted to move higher, especially when, as we've talked about ad nauseum, but the picture hasn't changed. Fundamentals are still really good for companies and Q4 earnings are really strong.

(07:16):

Leverage is still generally moving lower for companies. Interest coverage despite higher rates is still really good and improving in some regards. You put onto that a backdrop where rates fell, which is marginally positive, especially for a market like high yield equities while they experience some volatility ended up quite a bit and credit markets followed suit. And I don't think that picture is particularly surprising given that type of backdrop. And it sets the stage I think for markets to continue to perform. Especially when we think about one of the key differences for starting this year versus starting last year, is that your overall level of starting yield is like 450 basis points higher than it was to start the year 12 months ago. And that puts a really nice floor of income into the credit markets and I think set the stage for what played out over the course of the first quarter. Let's move on to some forward looking thoughts. As I mentioned, we've all recently written our outlooks for the second quarter. Laura, you want to set the stage for us with your macro outlook?

Lara Rhame (08:27):

Yeah, absolutely. I mean I think, I think everything we've talked about lay lays the foundation for, for the major theme which was, which was tipping point. I feel like it's something that we've been talking about. You hear it in the CRE market in credit markets concerns about corporate balance sheets. And for the macro lens I think it really often is framed as recession risk. And for 2023, this is the storm cloud that has been really like threatening to ruin the picnic. You know that we've seen this whole year and I have on this podcast multiple times, said, listen, we typically historically get a recession about six months after the fed stops raising rates. That puts my timing sort of end of 2023, maybe even beginning of Q4. But when I look now look ahead to Q2 the, I think banking events and Powell I think phrased it well saying that this potential tightening of lending standards really is, could be the equivalent of one rate hike, sort of brings forward some of that timing. And certainly for I think markets for investors, it creates I think a more active narrative around whether we are starting to see further erosion in the foundation of macro growth.

(09:55):

So, one of the things that I wrote in the quarterly is our watch list for our top three things that we are looking at when it comes to recession. Because remember our economy wants to grow and I think we have just constantly been surprised by the positive momentum in our economy. It takes a lot to knock us into a contraction and more than anything these dominoes have kind of lined up. I talk about fragile consumer confidence and I think bank lending standards are part of that, but the labor market is still really strong right now.

Rob Hoffman (10:37):

Maybe expound a little bit more on that. I mean the headlines seem to be filled with layoff, layoff, layoff. Yeah, a lot of it may just be in the tech sector, but what's really the picture?

Lara Rhame (10:48):

Maybe one of the other key takeaways of this podcast is that bad news sell because <laugh>, I think we see it in all of our sectors, right? Yeah. This idea that we have really scary headlines and I think we feel that vibrating through the uncertainty and the higher volatility in the markets. But at the macro level, when I talk about the labor market, I think it's gone from a rolling boil to a simmer. It is not cool, it is not cold. We right now kick off second quarter with the unplanned rate at three and a half percent. We added a million jobs in the first quarter. Tech layoffs have gotten a lot of attention and I don't wanna downplay the pain of layoffs and it's scary, but this I think is a sector that has historically really been bulletproof to business cycles. I think that's why it's gotten a lot of attention.

(11:34):

If you look at the layoff data tech accounts for about half of those layoffs. So, the rest of the economy continues to do well and initial claims that sort of that weekly indicator it's moved up but it's really what I call the canary in the coal mine for the job market and it's still looking pretty good. And this is really important, right? We don't get a recession without layoffs. They're really a coincident indicator of recession. So looking ahead to the coming quarter strong growth, watch list for inflation, this idea of tipping point, and then I think interest rates is where I will close out because we started in one month, we had the two year go from over 5% down to 3 75, it's now around 4%. We had the 10 year go from over 4% down to three and a quarter. It's now three and a half percent. This volatility is really significant and to me is going to be a dominant theme of the second quarter.

Rob Hoffman (12:34):

I wanna ask one, one more question to you Laura to expand a little bit more cuz you've touched on it. What is your outlook for inflation? Because I feel like the, the headline narrative is sometimes it's under control and doing what it's supposed to do, sometimes it's not.

Lara Rhame (12:49):

Yeah, I still am that. Yeah, I, it's funny how we, inflation was such a focus last year and we have so much else to focus on now, but it still is this drumbeat that is eroding investor returns and I think is going to continue to really impact the trajectory of the Fed. My year end outlook is for inflation to still be 4% at the end of the year in the second quarter in just given year over year dynamics, it will probably come down a little bit faster. But we see things like durable goods, like used car prices, that we have taken for granted that they're going to fall, they've started to creep back up again. It is going to be very difficult to put the genie back in the bottle at 2%. I think that's going to be a challenge for the policymakers in the second quarter. Certainly.

Rob Hoffman (13:41):

Andrew, before turning to real estate, I do want to ask you a question on equities. Laura just went through, there's a lot of macro uncertainties, US equity market PE ratios or what, pushing almost 19 times at this point. Yep. You've written a lot of pieces on equities both domestic and international. What do you think as a, as a preview here for, for equity markets.

Andrew Korz (14:03):

I think it's interesting coming off what Laura just said, um, about recession risks and, what the bond market is pricing the equity market, you could certainly argue is not pricing a very high probability of a recession right now.

Lara Rhame (14:17):

Yeah, we've had a yield curve inversion for months now. Right. Clear alarm bell of recession, but inequities

Andrew Korz (14:23):

Not so much. Yeah. And there are some things that I'll kind of speak to under the surface that may be show that investors are getting a bit skittish, but we're heading into earning season here. This is gonna be a really important earning season I think. I think the results for Q1 should be okay. I mean we're, you know, tell me if I'm wrong here Laura, but Q1 nominal GDP is probably gonna run somewhere around five to 6% annualized, right? Which is pretty strong and it's gonna keep corporate revenues growing at a decent clip. Margins are another story. Margins are gonna continue to get a hit because you have inflation coming down slowly, but it's coming down. Labor costs are still an issue. Some input costs are still an issue. Certainly, some companies are getting hit by interest costs.

(15:04):

So I think Q1 will be interesting, not necessarily from the results perspective, but from an outlook perspective. What are companies seeing on the demand side? I mean that's really what investors are gonna be focused on. I think analysts are not pricing in a recession. As I said, the sort of consensus is an expectation that earnings compared to last year are gonna be roughly flat this year, mostly because margins are gonna compress. And then they're expecting 12% earnings growth next year. So what's really priced into the market right now is a blip and then a soft landing really. So our argument has been that the risks to the fundamental side are certainly skewed to the negative end. Generally in a more mild recession you get earnings falling between 10 and 20%. Again, that's not priced in right now. And on top of that, Rob, as you mentioned, you have PE ratios that are based on those somewhat argue rosy earnings expectations above 18 times. Which I've said this step before, but if you put that in the context of the period from right after the dot com bust to 2019, it would be in the 97th percentile.

(16:11):

So valuations are really high. That's high, right? 97 tile, I would say that's high. Yeah, that's out of a hundred <laugh> <laugh>. Yeah. So I think you look at the market right now, it was a, the s and p 500 was up over 7% in Q1. It was very narrow, it was Nvidia, it was Apple, it was Microsoft, it was the big stable tech names that investors just, you know, they see some, some bad headlines as we talked about. They see some, some negative news and they just pile into these names that they know and trust. Right.

Lara Rhame (16:39):

It's scary that that's the flight to quality though.

Andrew Korz (16:41):

Right, and I think as we've seen, as we've talked about some of these names under the hood, there's some more questions from a fundamental standpoint than there maybe have been in the past five, 10 years. So I think I look at the market right now given valuations and given the issues on the fundamental side, you probably wanna get more defensive. We think you probably wanna get more international because as the Fed sort of at least stops hiking at some point this year, the dollar comes under a little bit more pressure. Economic growth in Asia is a little bit better. I think there's room internationally for some more outperformance there. So that's sort of our view in equity markets.

Lara Rhame (17:17):

Yeah. When this question of corporate balance sheets. This question of market sort of vulnerability and, and pricing. To me, when you say equities are at such high valuations right now, I think makes me, Rob, turn to one of your like biggest points about credit, which is valuations and entry points.

Rob Hoffman (17:43):

Yeah. I mean look, I titled our outlook for credit markets in the second as deja vu, although it's deja vu with a question mark. So I really think of it as like deja vu <laugh>. But you know, the reason is that, and we've been saying this very consistently for a while now. Which is the fundamentals that underpin credit markets continue to be very strong and that hasn't changed through the fourth quarter. If nominal GDP is expected to be five, 6% in the first quarter, you're probably not gonna see a big deterioration in company's earnings or leverage profiles or interest coverage profiles in that environment. And that creates a very stable base for what's going on within credit markets. And it's also sort of similar to how the first half of last year played out in regards that early on in Q1 when people wanted some risk taking, triple Cs

outperformed double Bs when people got a little bit scared in the middle part of March, suddenly double Bs took over for Triple Cs.

(18:51):

But you know, that's very accustomed to what this market has done over the course of the past couple years and it's been moving higher. So, I think in terms of outlook for the second quarter, you've got elevated yields. You have elevated spreads as a function of some of this volatility that occurred in March. That is definitely something that we identified that we're watching closely over the course of the second quarter. When we take spreads and we think about what does that mean for implied default rates in the marketplace? It puts implied defaults for high yield at close to 4%, but we're currently running two or slightly sub two. Some expectations are maybe you get to three by the end of this year, maybe you get to four by the end of next year. But the market is definitely pricing in some cushion. And if you think about the loan market, you're implied default rates are even higher than that and again are generally a couple percentage points higher than what most market expectations are for default rates even by the end of next year.

(19:58):

So you've got elevated yields, you have elevated spreads, you have pretty good fundamentals, you have a much higher starting yield that is generating, call it 1.6% of income per quarter for high yield, 2.1% of income return for loans per quarter. That's a lot more than you were getting a year ago. And I think it creates a really interesting picture for the second quarter, especially if some of the scariness risk environment subsides a little bit. It could especially set the stage for some price appreciation to build on top of that income and may set the second quarter up to be a pretty decent quarter for credit. So

Lara Rhame (20:43):

I think people forget that with inflation where it is, these are the only sectors that are giving you a positive real return on income. Yeah. You know everybody got really excited when the two year crested 5%. If you were lucky enough to buy a two year treasury on like the three days that it was above 5% <laugh>. Congratulations, Cuz that window snap shut and now where it is today, you're still looking at a really pretty significant negative real return. Where inflation is. And I think that's the, the insidious nature of inflation, I think speaks to the positive. Yeah. The opportunity.

Rob Hoffman (21:23):

Yeah. No, and I think that's spot on and following Andrew's comments on equities, I do think one of the things that if you look at yields and spreads and credit markets, while they are also not pricing in recession When you think about where they are on a percentile basis versus history, they are much more attractive than how the equity markets look on a PE ratio basis. And so I think from that standpoint, you know, that underpinned one of our calls, that if things start to get a little bit choppy, an expectation that credit markets could outperform equities. And I still think that's true in the event the market really wants to start to get negative because you're starting from a better base in credit, I think relatively speaking, than where you might be starting in terms of equities. So, Andrew, real estate,

Andrew Korz (22:15):

Let me just do a quick rundown <laugh> of our Q2 outlook on real estate. So I think like the ultimate question here is how do you draw buyers back in? How do you get sales going again? Right? You have this, this gap that I mentioned between buyers and sellers and really the best way or the most likely way that we see of that happening absent some miraculous decline in inflation and interest rates is by property values continue to fall. And that's how you draw buyers back in. I think it's important to remember that we had these incredible property value

increases between the end of 2019 and mid 2022. We've really only since then clawed back between 20 and 40% of them. So property values are still pretty elevated. The green street, um, property index, which is based on appraisal values, right?

(23:05):

So it's a bit more forward looking that's down 15 or 16% from its peak. So we would expect sort of values implied by transactions to sort of follow the lead of appraisals and continue to fall in the second quarter. But I think we're gonna see in the second quarter a pretty similar dynamic that we saw in the first quarter where transaction volume stays, stays muted, property values continue to fall, and I think it's just gonna take time, right? Like this is a slow moving market, it's illiquid, every property's different. There are buyers on the sidelines with capital ready to deploy that into the market. But I think it's just gonna take time before the economics of doing a deal. In a world where mortgage rates are six and a half, 7%, you can only get 50 or 55% LTVs on deals.

(23:48):

It's just gonna take time for the market to adjust to that new equilibrium. My second point would be the fundamentals outside of office are pretty good. Like multifamily rents are 26% higher than they were before covid, even though growth has fallen, rent growth has sort of moderated, like we've reached a new higher plateau here. Industrial rents are 37% higher than they were pre covid. These sectors are durable and they have secular drivers, right? And then they're on the retail and hotel side, the consumers still pretty good. People still wanna travel. We're coming up on the summer season like people are gonna wanna go out on vacation. So fundamentals, if you carve out office, which you can't just carve out office and we can talk about that another time, but fundamentals in the majority of the market are really good. So I think overall this is gonna take some time. There's real estate is not like the equity markets, it's not like the credit markets. It develops slowly we see these trends happening, but it just takes time for property values to correct and for cap rates to get to a level where they become attractive.

Lara Rhame (24:51):

And yet I was holding my breath because I feel like to your point about the negative headlines, there's been, we all have PTSD from the financial crisis and everything that you've said makes it seem like the fundamentals are still completely different from that episode where you just saw a much more extreme shift in values and the market dynamics.

Andrew Korz (25:15):

Yeah. And I think this right now is.

Lara Rhame (25:17):

I say that with relief <laugh>,

Andrew Korz (25:19):

Well as of now this there's interest

Lara Rhame (25:21):

Rate sensitivity. Yes.

Andrew Korz (25:22):

But yes, absolutely and that's it. This is a cost of credit shock right now. Not a fun, a fundamental one. Great. That's how I would put it.

Rob Hoffman (25:28):

I mean would you rather be a buyer or a lender in the market.

Andrew Korz (25:33):

Oh, you'd rather be a lender a thousand times over. Yeah, I mean it was a great time to be a buyer for 12 years there, right? <laugh> where you could basically just utilize the incredibly cheap cost of debt. Cap rates were 6%. You could finance yourself at three and a half and you could lever up that spread and make yourself a really nice return for the better part of 12 years. And we saw the incredible capital appreciation over that time. Our view is that's probably ending now. It's gonna be a yield market where income is king. Borrowers are gonna have, or property owners are gonna have to get in there and kind of drive higher rent growth. They're not gonna be able to rely on cheap debt. And I think that's Q2, like we're just getting started there.

Rob Hoffman (26:18):

Well, I do want to take an opportunity to focus on one big new thing that came out of the first quarter. And for this, let's talk about the bank officer survey in a tightening and lending standards by the banks. Laura and I both included this as something to think about and watch in our written outlooks. So Laura, let me, kick it to you to, to get your view.

Lara Rhame (26:40):

Yeah, I think it's really pretty simple and I would agree with you. To me this was absolutely one of the critical events of the first quarter. And I think it's really going to drive and alter the trajectory of the economy over the coming quarters. And I think adds to this tipping point theme <laugh> for the second quarter. Because while the banking system is broadly sound, it's hard to imagine, it's inconceivable that we would come out of these regional bank failures with lending standards easier. They're only going to get tighter. And it remains to be seen how that process evolves. But that will also act on an additional break to growth, to leverage in our financial system and to the grit that clogs the wheels of the economy at the later stages of a tightening cycle. So we know that fed rate hikes impact interest rate sensitive sectors of the economy and can change how businesses and consumers spend.

(27:45):

And to be clear, bank lending was extremely easy during the pandemic that was fueled by specific policies like the PPP lending and other very, very low interest rates that caused lending standards to really ease significantly. So, we had begun the process of normalizing that had already, I think largely taken place, but now the pendulum is probably going to swing towards tightening lending standards. So, our economy really naturally grows. And I have always said that even if we avoid a recession, we're probably not in for a particularly strong year of growth despite how good the first quarter's looking. But going forward, we need to really pay attention to how this process evolves and how it impacts consumers. At the end of the day, 70% of our economy is consumption and whether people have jobs and how they feel comfortable spending is going to drive our business cycle.

Rob Hoffman (28:42):

Hmm. Andrew, what about you? Do banks and lending standards matter to real estate?

Andrew Korz (28:48):

I would say they, if you've read Bloomberg or the Wall Street Journal recently, I think you might be running for the hills. But no I want to give a few stats that I think are important to the level set, how important regional banking is to the commercial real estate sector. So banks hold between 50 and 60% of CRE loans in aggregate, depending on your source. Regional banks are about three fourths of that bank lending, right? So small and mid-size banks hold roughly 35% of the CRE lending market, but they are responsible for about half of the loan growth over the past decade or so. Now, a lot of that was carved out from the CMBS market, which has been a lot smaller post global financial crisis than it was pre ‘08.

(29:33):

But look, I think it's important to recognize that regional banks are a really important lender in the market, especially for smaller properties and smaller loans in secondary and tertiary cities. So to Laura's point, I think it would be naive to not expect some deterioration or tightening in lending standards going forward, especially for some of these banks that are seeing their interest margins compressed and deposit outflows. But I think it's really important to sort of level set and understand where the CRE market comes into this sort of correction, right? So if we look back to pre 2008, almost the entire commercial real estate lending market was comprised of banks and CMBS. That was about it. Those were the two sources of capital. There was really nothing else. So if those two lenders stepped back as they did during ‘08, in the end, in the aftermath, there was really nobody else to sort of pick up the mantle.

(30:32):

That is completely different today, right? We have a much deeper pool of capital available to the real estate markets today. You have many more, not only many more lenders in the market, but many different types of lenders. You have debt funds which have over 70 billion of dry powder to go deployed today. You have mortgage rates, you have insurance companies, a lot of diversity and a lot of lenders who don't have the same issues in the liability side of the balance sheet as some of these banks and now the CMBS market does. And I think part of that is actually due to the ultra low interest rates from the 2010s, which brought in a lot of capital into the CRE debt markets as people sort of looked for places where they could get yield in a world where there was not much of it to be had.

(31:12):

And the second thing is the market is just much healthier going into this correction than it was going into the global financial crisis, right? So the underwriting standards have been night and day going into this year leverage is 10 to 15% lower than it was debt service coverage ratios are much better. And the other thing that I think people don't quite understand is that we had a really long expansion and a really long run of growth in property values, right? So if you had a loan a typical CRE loan is five or 10 years generally. So, if you have a loan that was originated in 2013 and it's coming up for refinancing this year that property may have doubled in value since that point. So yes, we should watch and be concerned about some of the issues in regional banks, especially in the markets where they are big players, but they are many more lenders out there.

(32:03):

And we come into this correction with a decade really of very kind of safe underwriting standards. So I think this is gonna be something to watch, but it's not a, a crisis in building as I think sometimes the media is sort of portraying. So with that in mind, Rob, I'm interested if you're seeing I guess some similar things. Obviously regional banks are probably pretty big players in the small business lending market. So I'm curious on the corporate side kind of what you think are the impacts of this?

Rob Hoffman (32:32):

Yeah, I think there are two primary considerations as it relates to corporate credit markets. The first being, one of the things that Laura pointed out and included in the graph is not just what are the officers of the bank saying about their lending standards, but the correlation of that statistic to growth. And when we think about corporate credit, this is generally a sub investment grade market that we're talking about with high yield and loans. Ultimately the path and trajectory of the economy is a major driver of corporate fundamentals and what will happen to companies and to the extent banks step on the brakes and that causes growth to decline that will find its way and flow into credit markets in a negative way. And so I think it's important from that standpoint. On the other hand, we also have the role that banks play within corporate credit markets.

(33:27):

And look, this has definitely changed over the course of the past decade plus, whereas today of high yield and loans are each about one and a half trillion markets. The quote unquote private credit market is now also like one to one and a half trillion dollars. And so private markets have done a very good job, I think, of filling in the role that banks sort of used to play pre-financial crisis when they could really commit balance sheet to these markets and hold loans or hold bonds. That being said, these are big traded markets. The banks play the role of key trading counterparties for everybody who wants to really transact in liquid tradable credit banks are trying to make their entries into finding ways to trade private credit. When we think about upcoming maturities in the market, there's not a lot in 23, 24 is not that significant, but there is a maturity wall in corporate credit that starts to build in 2025 and the private credit markets are not going to be able to bail out all of that refinancing that needs to happen.

(34:42):

And I do think you're gonna need the banks there at that point to lead deals. Not necessarily to take down the deals because they're gonna syndicate them, but to lead and arrange and facilitate that type of capital creation that needs to happen to try to meet this maturity wall that's coming. So that it ends up not being a big deal. Because if you don't address a maturity wall, which, you know, look historically, they tend to get addressed, but I don't want to think about what would happen if you're running up on a big maturity wall and the market is closed and you can't address it. That could pose some really big problems for credit. So I do think it's worth watching in that regard.

Lara Rhame (35:19):

So it sounds like we don't have to worry until 2025.

Rob Hoffman (35:21):

For some of it. Yeah.

Lara Rhame (35:22):

Okay. <laugh>. Yeah, <laugh>. Let's get through the second quarter for this. Yeah, right, exactly. I'll just go on vacation till then. Yeah, <laugh> <laugh>. Well I think this is the, the big question though, right? Like what maybe we should go around and say like what, in three months we're going to be talking about, like that's the true forward looking, right? Or <laugh>. Yeah, <laugh> <laugh> you will be graded. This is a graded assignment. <laugh>. What are we expecting? Like sort of what in three months from now when we write our Q3 outlooks. What are we gonna be talking about that Yeah. Is worth going for?

Rob Hoffman (35:59):

I'll I'll jump in. Yeah, I mean I, let's see it. As we think about corporate credit, three months from now, I am going to go on record that spreads will be tighter than where they ended the first

quarter. So at the end of the first quarter, high yields a little bit under 500 loans are a little bit under 600 maybe. I'm a credit guy, the sky's always supposed to be gloomy, but I'll maybe I'll put on my optimist hat here. We get through the second quarter, growth is still reasonably strong, at least coming out of the first quarter. Corporate fundamentals are still good. The fed is perhaps closer to the end of the hiking cycle. The market is not yet worried about or pricing in recession and spreads were somewhat wider and attractive on March 31st. And so I think that could set up a scenario whereas we get to three months from now at the end of the second quarter that spreads are tighter and credit markets are generated returns that are in excess of the attractive income that they generate.

Andrew Korz (37:10):

All right, I, so I'm gonna say that cap rates will make their most significant move upward or a significant move up or I don't wanna say most <laugh>. So I think when we're sitting here in late June or early July, I think cap rates will be significantly higher. I think it takes a while for this market to react to higher interest rates. Again, it's slow moving, but eventually look like high yield is yielding what, eight point a half percent right now ish. Cash is yielding 5%. I think people are gonna look at six and a half percent-ish cap rates. And given that rent growth is normalizing to more kind of standard levels, it just doesn't make a ton of sense to buy properties at that valuation when you can get better yields in other parts of the market. So I think we'll slowly see that move upward in Q2.

(38:01):

And I think as you talked about with the refinancing volumes, there is a significant maturity wall in commercial real estate this year. And my view is that the capital markets can handle it like there's enough lending capacity out there to handle that. I think what will show up is that it's going to tell us where true value lies because the lenders are gonna have to underwrite those deals and if they're saying we only wanna do a 55% leverage loan here, that sort of implies a value, right? So I think you're gonna see some, even if it's not via a significant increase in in sales and transactions, you're gonna see some price discovery. And I think that price discovery is gonna show that values are lower and cap rates are higher than maybe some market participants think.

Rob Hoffman (38:48):

Lara, take us out here.

Lara Rhame (38:49):

All right. All right. Well I'm gonna sort of take the spotlight that you put on CRE and widen it out to the entire economy because the fed rate hike cycle was just the dominant title poll of 2022 and it's continued in 2023. I think what continues to surprise people is the fact that interest rate sensitive sectors take time to respond and are maybe responding differently this cycle than they have in the prior cycle. So here's my three months out. I hear a lot of people say, oh, the housing market, I'm waiting for the housing market to take a dive. Nope. We see different dynamics this time around than we did in the prior cycle and in the mid two thousands. I think we're seeing strong demand for housing that is going to limit the downside. Of course, there's interest rate sensitivity there, but I think it's going to be a more modest decline.

(39:46):

And I think for business investment, and this is something that we've written about, but it continues to surprise people how resilient US equipment spending and construction business construction spending has been. And there are secular drivers that are causing businesses, call it de-globalization, call it ESG spending, infrastructure spending. All of these things mean that despite interest rate sensitivity that is present and visible. We are just seeing a more solid midterm story and I think that is going to just continue to be apparent three months from now.

So hopefully that offsets some of the negativity of me talking about a very high probability of recession at some point late in 2023, but not in Q2.

Rob Hoffman (40:33):

Awesome. Well, that takes us to the end of the research roundup in Q2 outlook. So, thank you all for joining us and look forward to talking to you soon. Great. Yeah, it was fun.

(40:49)

This episode was recorded at the FS investments headquarters in Philadelphia's historic Navy Yard. It was produced by the investment research team, 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 podcast. Thanks for listening.