Episode 65

Q3 2023 Research roundtable: Rethink what you know

The Investment Research team offers their outlooks for macro, credit markets, and commercial real estate.

Rob Hoffman (00:05):

Welcome back to FireSide, a podcast from FS Investments. My name is Robert Hoffman, and it is time for an episode of our latest research roundup. I am always excited to be joined by my fellow members on the investment research team, Lara Rhame, our Chief U.S. Economist; and Andrew Korz, our Director in charge of real estate and equities research, among other things. So, welcome to both of you.

Andrew Korz (00:30):

Good to be here, Rob.

Lara Rhame (00:31):

Yeah, thank you.

Rob Hoffman (00:33):

So, we recently published our Q3 outlooks for Macro, Real Estate and Credit Markets. And given the time of year—and we're halfway into July—it's a good opportunity to take stock of where we are and where we see the economy and markets heading over the second half of the year.

I don't know if you two agree with me, but it seems like this year has been a bit difficult to predict. Sentiment entering the year was pretty negative: There were calls for recession that were pretty rampant. Not everyone agreed though, and certainly the timing was a bit mixed depending on who you talked to. And stocks weren't all that cheap when we started the year. Plus let's not forget that the Fed was still raising rates and inflation was by no means under control. It didn't seem like the best setup for markets and yet here we are: The S&P is up nearly 20% on the year..

(01:29):

There's virtually no sign of recession in today's macro data (more on this in a bit), credit markets have been very pro risk and the Fed is still maybe going to increase rates again this month. So, I think it gives us a lot to talk about, both where we are today and where we're going for the rest of the year. So, I think as a good place to start, maybe let's focus on bringing us current, and what happened over the second quarter. So, Lara, let's start with you. Since the macro backdrop is always so critical to setting the stage for markets, if we turn our head and look backwards, so much of the... because so much of the macro data is backwards looking, is it fair to be wearing, you know, some rose-colored glasses? Markets have been pretty surprised by the good economic data that we've had so far. So, what do you think?

Lara Rhame (02:21):

First of all, you're killing me. I was the one, I don't read every economist out there, but I think anybody who's listened to me on this podcast, but our stuff is known that I had never called for recession in the first half of the year. So, audience, I just want to level set that one.

Rob Hoffman (02:39):

I didn't say "your" calls for recession, but there were some calls out there.

Lara Rhame (02:43):

This is my way of saying, when you know you're right, you got to really crow about it because there are enough times when you're wrong and we don't talk about those times. So, the first half of the year, it definitely... I named my Q3 outlook "Sailing into a slowdown" because sailing to me really describes what we're experiencing. Moving along, solid tailwinds, momentum, all of those things really describe our economy in the first half of the year. And, the graph that I have at the first page of my outlook is to me the part, you know, shows what I got right and shows what I got wrong because I was never expecting a recession the first half of the year. I've always been, you know, unfortunately a recession is in my forecast.

(03:30):

I want to dig into that. But the timing has always been later in the year at the earliest. The first half of the year markets were so pessimistic on the economy. And that is what I think I had not appreciated. And when you look at an index of data surprises, it's not that the data are at an 18-month high, it's that the surprises relative to what markets were expecting was at an 18-month high. And that peaked at the end of the second quarter. And if you look at that upward trajectory, those mounting positive data surprises because markets were so dreary that that upside data surprise really enabled a lift of PE valuations. And to exactly, to your point, when you break it down to some of the key categories that the Fed, you know, looks at to gauge the health of the economy today, they are slightly more backward looking. And they're things like real income, real spending, employment is the big one. And then industrial production and manufacturing trade, all of those things are still moving higher. So yes, today really looking good. And I think that optimism, I think that the data relative to the pessimism coming into the start of the year is really what has helped give us valuations where they are today.

Rob Hoffman (05:08):

Yeah, it's just been amazing, the string of data. I mean, just for like the past three weeks and every one of them, it's like, "oh, inflation may be under control". Like no, jobs are still coming in okay, but slowing a little bit, it's almost just like everything that the market almost perfectly wants to see as it relates to somebody's past data. So Andrew, I mean, I think maybe some of that surprise sentiment is partially responsible, but it's hard to argue, probably responsible for all of it, but equity markets, returns have been quite strong. What do you make of that as we look back on what's happened on the S&P supply?

Andrew Korz (05:44):

Yeah, I would say on pace for 40%. Returns this year is pretty strong. I mean, what a first half of the year it was, right? If you're looking for a case study for how challenging it is to actively manage public equities, I think, look no further than in January through June of this year. Coming into the year, I think the consensus was, from the sort of Wall Street intelligentsia, was that earnings expectations were too high. The market likely hadn't bottomed yet because it's very rare for the market to bottom before a recession starts. Tech stocks couldn't handle higher for longer, interest rates, defensives were the only place to be, but they were expensive. So people didn't really know where to look. You know, there was sort of this idea that China was reopening, so maybe the sort of emerging markets trade, you know, was where you should be.

(06:36):

A lot of that turned out to be wrong. I think Q2 in particular has made investors rethink the popular narratives around the equity market that have been developed over the past fifteen years or so. Real yields across the yield curve right now are higher than they've been in fifteen years. And all the fangs have done is go up 70% year to date. So, I think the idea that low rates are the only potential driver for sort of a tech stock fervor has been proven somewhat wrong for now. Again, I think the longer these rates stay here, the more we're going to learn about this, but clearly the market is assigning some decent probability that artificial intelligence is a paradigm shifter, in the way that the internet was. And I think just kind of as an aside, I think one remarkable thing to me is that Chat GPT came out November 30th of last year.

(07:30):

NVIDIA was flat from November 30th through mid-January. So it took a while for this AI narrative to kind of play its way into the market. But I mean, play its way into it. It did. And we've seen these stocks, you know, NVIDIA's tripled year to date. Now it's, it's remarkable the, the market cap that's been added because of this AI boom. So, here's what I would say. There's nothing to change sentiment like price and that's kind of where we are today. You had a historically narrow market in the first half of the year where I think through June 30th, I think you had something like 14% returns on the S&P. 12% of that 14% was driven by the top ten stocks. That is basically the only time in history we've seen something of that magnitude.

(08:15):

And the market sort of looked at that and said, okay, everything else has sort of been left in the dust outside of this AI tech cohort. If we're going to broaden this rally out, we need confirmation from the economic data. And that's exactly what we've gotten to Laura's point on the upside economic surprise, specifically from the labor market and from the housing market as well. We have seen this rally broaden out, but I think as it broadens out to cyclicals and to value into different parts of the market that economic resilience is really going to come into focus because those are the parts of the market that are most exposed to the economy. So I think, you know thinking more broadly, I think we can be excited about AI and the, and the resilience of the economy to date while also recognizing that, you know, we can't just throw the basic tenets of, of equity investing out the door.

(09:05):

We still need to sort of look at the data, understand what it's telling us and make prudent investing decisions off that. And clearly there are still economic headwinds globally and in the US rates are high. And the longer they stay high, the more companies that rely on debt markets to fund themselves are going to be challenged by that. The market is trading at 20 times earnings today, which is higher than at any time between the.com bubble and the beginning of covid. So, you know, valuations are really high and there's, there's downside risk to the economy. So, I think all of that tells me that, that the forward looking return outlook as challenging as it is to say today, the forward outlook, even if we do skirt a recession is not great.

Rob Hoffman (09:48):

Well, and I appreciate you setting the stage on equities and what's happened. I think there's a very important element of that related to corporate credit markets. Credit doesn't trade with a perfect correlation to equities, especially as we think about sub investment grade credit markets. But it certainly sets the tone. And, the outlook that I used for my credit outlook was "can the good times role" little play on a card song? But, you go back to the beginning of the year and our outlook was one that was a little bit cautious. I think that a lot of the fun fundamental characteristics within credit were reasonably positive. But you did have some of these fears of slowdown and we expected that to sort of play through credit markets, be a little bit more defensive, don't go all the way risk on, but you look at what's happened year to date, especially through now with a high yield markets up five and a half percent loan markets up 7.5%.

(10:50):

CLO markets doing tremendously well. And CCCs, you know, the riskiest part of credit absolutely crushing the broader market and the higher quality parts of the market. This risk on sentiment perhaps taking its cue just from the strength that you've seen in equities has been very pervasive and, and for the most part, very consistent over the course of the first half of the year. Looking back on it. Look, and this has been something we said for a long time, fundamentals are really good within credit companies have been very conservative coming out of the pandemic. So they've maintained low levels of leverage. There hasn't been a lot of debt issuance, interest coverage ratios, despite the fact that interest rates are up quite a bit, really haven't deteriorated all that much, especially for high yield issuers where the majority of their debt is fixed rate versus floating.

(11:45):

We have very strong supply demand characteristics where the market, both high yield and loans are on pace to shrink for the second year in a row. You think about the consistent amount of demand that is out there in a shrinking market, that's a pretty good technical backdrop for pushing prices higher. And when you start to look at some of the other areas that could be more concerning, default rates, lower recoveries, you start to see some little signs of that stuff ticking up, but not anything material to knock the backdrop of the market off when you're looking at 20% equity gains, huge rallies and CCC's credits and elevated yields that I think still have made credit markets pretty attractive through the first half of the year and keep investors coming back when you can make eight and a half percent type yields in high yield, nine to nine and half percent yields in loans, over seven percent yields for the CLO market. Those are pretty attractive numbers and I think it's really driven investors towards credit over the course of the first half of the year and really propelled things higher. If there's one market, Andrew, that has seen weakness and maybe reacted a little bit to some of the negativity that might have been there in the first part of the year and played out with that is the commercial real estate space. So. is it all doom and gloom, you know what, where are we?

Andrew Korz (13:14):

Well, it's certainly getting its time in the limelight here. You know, for better or for worse, I would say Q2 was another slow quarter, in the commercial real estate market, you know, from an activity standpoint, you saw further deceleration in terms of sales volumes. And right now, I think pricing continues to be tough to pin down. The dearth of deals is kind of clear evidence that we probably haven't seen the trough in prices or the trough in prices probably isn't coming in the near future because, if prices had gotten to a point where property buyer was interested in coming in at those levels, we would see activity pick up and we just haven't seen that yet. So I think it's murky water right now on valuations specifically in office. If you look at sort of sales activity today compared to 2019, it's actually only about down about a third for the market as a whole. But in office it's down almost two thirds. So there are very few office properties being transacted. So, when you see, you know, in our research we show the RCA price index that shows office value is only down like six or seven percent. That's not you indicative of what's actually happening in the market.

Lara Rhame (14:22):

As a reminder, what percentage of the CRE market is office?

Andrew Korz (14:24):

It’s somewhere around 15% of the value of the market.

Lara Rhame (14:28):

Because I feel like this is the section that's, this is the sector that's gotten all the headlines and that's important.

Andrew Korz (14:34):

Absolutely, and it is important to talk about because it's always been an important part of the market, but to your point it's a minority. And I think you bring up a good point because fundamentally things have been pretty consistent in other parts of the market. And that's consistent with what you've said about the economy. We've seen moderation to varying degrees. We've seen some moderation multifamily rents, you know, industrial has gone from white hot to maybe like red hot maybe. But look like the fundamentals in most sectors are still pretty good outside of office. So right now, I think we're very much in the middle of a correction still, you're at a place where cap rates need to be higher. Not only because the cost of financing has gone up, but because asset yields in other parts of the market are so attractive relative to cap rates.

(15:23):

So, cap rates are going to continue to have to adjust higher and then financing remains challenging. Again, mortgage rates are high. There's a lot of generalizing about what's going on in terms of the refinancing wave and the ability of borrowers to refinance their debt. I think this is firmly a bifurcated market where there's going to be a lot of stress building in the office market. We saw in Q2 a status came out that 80% of the new distress in the market in Q2 was in the office sector. In all the other sectors where fundamentals are still solid, you have sort of a line of sight to what property values are going to be. I think refinancing is still going to be challenging. You're still going to have borrowers needing to inject new equity and find some creative financing solutions, but I think it's much more manageable in those parts of the market. So, I think we're still in the midst of this interest rate driven correction, but we haven't seen much evidence that there's another shoe to drop per se.

Rob Hoffman (16:16):

Well, let's take that into, into our outlook. Now, if we've shift from backward looking to forward looking. Laura, there's some macro data that tends to be a little forward looking, or at least tends to have some predictive power about where the economy might be headed in the coming quarters. So I guess my question would be, do we wear the same rose colored glasses when driving into this reasonably bright sun that we've had so far? Or do we need to change the shades, put on something a little darker?

Lara Rhame (16:47):

Yeah, this is the problem with looking at really strong employment data and really strong spending data today, because really those are lagging indicators and the forward looking indicators exactly as you said, I think are shaping up to be consistent with what we see before a recession. So I'll just, you know, I won't bury the lead. I think when I look ahead through this business cycle. I am in the camp that expects that we're going to get some kind of recession, although, because the Fed is still probably going to raise rates again in July. We want to start the clock on counting down to that after the last fed rate hike. So, this extended fed rate hike cycle sort of pushed out that timing. But we're talking about the second half of the year, and I want to be clear that I don't think we're going to see a recession start in the second half of the year, but I do not think growth is going to be as strong as it was in the first half of the year.

(17:55):

And this is where I think markets may be a little too sanguine about the implications of avoiding a recession because they're probably not going to be able to avoid a slowdown. Even though a recession's not a foregone conclusion. It's hard to see the economic catalyst for markets to move higher. My favorite or forward looking indicators are things like, initial jobless claims. It

popped above 260, it's come down, but it has been, you know, so that four week average trend is moving higher. The yield curve remains inverted. Even the short term yield curve, which didn't invert until the end of last year, it's not uncommon to have an inverted yield curve for like a year before recession starts. So that to me is still really important. Signal lending standards are still tightening. That is a slow process. It is the classic channel for fed tightening to pass through the banking system to the economy.

(18:57):

And it's working. It takes time, but it's working. We have quarterly data and it is still tightening and really correlates to slower GDP growth within one to three quarters ahead. Finally, corporate profits peaked in the fourth quarter of last year. That is also sort of a four quarter, three to four quarter l lead time to a recession starting. So I think two things really come out of that. Number one, remember the Fed is still raising rates, and that is a policy specifically designed to slow the economy down. That is full stop what they are actually trying to achieve. The second thing is that a risk, you know, I do not have a perfect crystal ball. A recession is not guaranteed by any stretch of the imagination, but I think it would be irresponsible for all of us to look at what these forward indicators are doing and not at least plan for slower growth and acknowledge that the risks of recession are high.

(19:58):

Because if you look at the last sort of six business cycles, these are the things that have moved in advance of that recession starting. So, this is not to make things so terribly pessimistic. I think again, I've reiterated the view several times. I absolutely expect there to be some kind of a mild recession. We are seeing gathering headwinds because the excess savings from covid that hit household balance sheets just takes a lot of time to work. We're talking about almost $2 trillion excess savings on household balance sheets. It takes a lot of time to work through that, but by the end of the third quarter, we probably will have worked through all of that. So, student loan forbearance is over, that's going to kick in.

(20:48):

These are marginal headwinds, but put together, do slow, the economy down. And I think when I connect that story to markets, it's a deceleration of nominal. It's certainly a de deceleration of real growth. And given that inflation's coming down, it's a pretty significant deceleration in nominal growth, which is of course where you get your top line revenue. So, all of that together to me, paints a picture of a slower 2%. We had 2% growth in the first and second quarter, probably. We haven't gotten a second quarter GDP yet, probably around 2%. I'm looking at 1% for the third quarter, 0.5% for the fourth quarter. That still gives you a, Q4 of 1.4% growth. It's not bad. I'll take it. It's a solid, solid economic performance, but I think it is going to be slower.

Rob Hoffman (21:38):

One of the things that you've said historically that always sticks with me is just, you look at these fed rate hike cycles, six out of the last seven cycles Yeah. Have ended in recession and we're in the midst of the steepest fed rate hike cycle ever or just about. I think it's, to say that all of this is going to happen and you're not going to end up in recession just historically, is more of an outlier call than saying that we are going to get one.

Lara Rhame (22:09):

But yeah I agree with that, Rob. I think that the other problem is that it often feels like the economy's going to be fine until two quarters later in recession. So, the job say like when the unemployment rate moves, it moves fast. It's very hard to, you don't feel it in the moment. And I think that's why this earning season is going to be really important to see what the guidance looks like.

Rob Hoffman (22:35):

Well, fingers crossed, I think it's fair to say none of us want a recession.

Lara Rhame (22:38):

That is absolutely correct. And I think that's something that I really try to carry to my conversations with our clients. Which is that like, we're not in any way rooting for a recession, but again, I think it would be a mistake to look at the gathering forward looking indicators and not recognize that often they at least point to an economic slowdown at the best case scenario.

Rob Hoffman (23:03):

So, Andrew, commercial real estate, you wrote in your outlook that, and I wanted to quote one of your sentences there, "there may not be an I in team, but there is one in defensive"

Andrew Korz (23:17):

Is that corny?

Rob Hoffman (23:18):

I don't know, it stuck out to me. So how do you relate this to what investors should be focused on in terms of your outlook for commercial real estate.

Andrew Korz (23:27):

I appreciate you taking the, the cheesiest line from my outlook and, and repeating it for our audience here. I think, just to kind of continue the thread from my previous thoughts, we look for the correction to continue for the next six months. I do think you'll see more action in the next six months compared to the first six months of this year. Some of it will be good action, some of it will be, you know, maybe an increase in sales activity. Maybe we get better line of sight into where property values will sort of land, and some of it will be negative action. You'll see distress rise, especially in the office sector. We're already seeing delinquency rates there rise. So, I think the first half of the year was mostly about sort of investors going into triage mode and just checking their balance sheets making sure they had a plan going forward for higher interest rates.

(24:21):

The second half of the year, I think you'll see, you know, some more action in capital markets. We wrote in our outlook that as of right now, the correction is mostly about the impact of higher interest rates. Fundamentalists have been, as I mentioned, very solid outside the office sector. So, right now the price declines we're seeing and the slowdown in activity we're seeing is mostly about sort of the friction introduced by higher interest rates. I think the big question for the second half, and really for the next probably year or two, is whether something happens that turns this into something more. And I think the three classic factors that can turn this type of somewhat orderly correction into something more are, number one, a plunging demand from, from occupiers. Number two, a supply glut in terms of the construction market.

(25:12):

And number three, a credit crunch, which is obviously what we saw during the global financial crisis. And right now, to me there it's not clear that there's a high probability of any of these three things happening. So just to briefly tick through them on demand, the consumer, as Laura mentioned, is still pretty robust right now, there's very few signs of slowdown in travel. In retail

you close tons of stores in the 2010s, and now you're seeing net store openings. So of course, there is recession risk. But I would say this is very different from the global financial crisis. Balance sheets are on the consumer side and on the business side in really good shape. And we also sort of have to mention that if there is a recession, you'll probably get at least some relief on the rate side.

(25:55):

So I think a mild recession is much different than something like what we saw in the GFC on the supply side the biggest concerns are on multifamily and industrial, the in favor sectors that sort of garnered the most attention from developers. And people point out that we have as many or more units under construction more than any time since the 1970s. Well, we have almost doubled the demand for housing units today than we did in the 1970s. So I think this is sort of the market the logical market response t record low vacancy rates in apartments and record high rent growth. You're seeing supply come on, it's softening the market, but I think that those things tend to balance out. You're seeing permits for new apartments come down as we speak.

(26:37):

So I think the demand for multifamily, the demographic trends within, are still strong from a demand standpoint. In certain metros, you've built a lot of apartments, but I think in a lot of cases that's the logical response to increase demand. And then finally, on the possibility of sort of a credit crunch, there's a lot of talk about properties being on unable to refi having to turn the keys over to lenders who have to sort of own that property, and that sort of saps their ability to go out and lend. We just don't see that at a systemic level right now. Leverage coming in was low. Even if we assume the most sort of draconian price declines, most borrowers are still going to have equity in their deals. And worst case scenario is sort of borrowers get wiped out of their equity.

(27:22):

They say, here's the keys, I don't care anymore. This investment's a zero for me. And then that's how you sort of get to this credit crunch scenario. We don't see that right now. Borrowers still have equity in deals that's going to make them continue to sort of inject fresh equity to sort of extend the horizon on those investments and hopefully improve their ability to make a profitable exit. So I think we don't quite see a high probability of any of these three things, but of course, we need to be on the lookout for them.

Rob Hoffman (27:51):

And before chiming in on credit, one very quick question on equities, because the comment was made earlier that, you know equity markets have obviously been very strong year to date. Is it fair to say that we don't necessarily see immediate signs that they need to weaken, but the ability of equity markets to go higher from where we are today is much more difficult given the starting point?

Andrew Korz (28:17):

Yes, I think that's totally fair. I mean I think we've seen plenty of times in the past that these types of specifically technology driven kind of, I won't call it a bubble, you got to call it a fervor. They can last a while. But I think again, we need to step back and look at what the market is pricing. Consumer discretionary is very expensive compared to consumer staples. Industrials are very expensive compared to utilities. These are signs that the market is pricing in a really sanguine economic outlook. And then on the valuation side, again, if you go back 150 years, apparently this is a history class, we're in the 95th percentile from a valuation standpoint going back to the 1880s. And when you look at the average two year return from it, assuming you have a top decile valuation, you're only positive, above zero over the, the sort of succeeding two years in a third of those cases. So, in normal times it's close to 60%, S&P 500 is positive

over a two year period. So the return expectations should just be low from here, given that. So I think given that, and given the fact that you can get equity-like returns in other parts of the market, I just think it probably pays to be cautious giving what the equity market is pricing today.

Rob Hoffman (29:40):

Well, I'm glad you, you commented on the percentile for where equity markets are, because that is a stat that we've looked at a lot, historically in terms of providing a little bit of a cue where credit markets are. And one of the things I find interesting is pre covid, if I remember correctly, a lot of the times when we talked about credit markets, it was, you know, spreads are okay, spreads have been tighter than where they were. Spreads are 325, and that's not where we are right now, but like spreads at 325, they could certainly go to 250. But the issue is that the absolute level of yield in the market was so low that I think you had a lot of skeptics saying, just why should I accept that level of yield? I get that spreads could go even lower, especially when defaults are so low.

(30:31):

But why should I buy a market when the yield is so low? Today, I feel like it's almost the exact opposite. There has been some recent strength, and certainly over the course of this first eighteen trading days of July or eighteen days of July, credit markets have gotten pretty strong. And if you just look at things on a spread basis, and you look at this historical percentile ranking, the high yield market is now kind of fifty to sixty percent. The market's higher quality today than it's been historically. So that helps that number a little bit. But let's say you're about average in terms of historical spread on a percentile basis. The loan market's a little bit better. But the loan market's also lower risk, or I'm sorry, higher risk than it tends to be right now.

(31:20):

CLO market looks pretty attractive even on a spread basis. But if you look at yields, yields look even better, I think as a function of the higher interest rate environment that we're in right now. You know, the high yield market on a yield basis percentile is still like thirty-five, forty percent. The loan market, the CLO market are like ten percent maybe fifteen percent, meaning that yields are less attractive eighty-five to ninety percent of the time than how they are right now. And I think that sets up a really interesting case for credit and is one of the reasons why we've been a little bit bullish in general, just generically speaking for markets, is because that yield level is really attractive and behind that you place good fundamentals, which the outlook for that isn't changing, certainly in the immediate outlook. We'll see if we get to the beginning of next year and really start to get signs of slowdown potential recession, that data could start to change.

(32:22):

But right now, certainly as we think about Q2 earnings and probably the outlook for Q3, the economy doesn't turn on a dime. It takes a little bit, maybe a quarter, but it takes a little bit slower. Fundamentals are reasonably good, that strong supply demand dynamic, for now is holding. Although now that the markets are strong, you are starting to see an increase in supply, really just over the course of the past couple weeks, we'll see if that's enough to really tilt that statistic. And, look, you are starting to see a little bit more breadth in equity markets, which could spell good things for credit markets. I think, Andrew, one of the stats you had had pulled for me is that if you looked at just the, what was it, the top two industries that have done so well in the S&P comprised like 28% of the index.

(33:13):

But if you looked at the relative weight of, was it tech and software or something like that within credit markets, it was like mid-single digits. And so when you think about what has propelled

equity markets, so high credit markets have fairly small exposure to really the tech AI drive that has driven the S&P. But as you start to see things broaden out, and if that trend continues down into mid-caps for instance, or just other sectors within equities, that could also pretend really good things for credit markets. So we wrote about somewhat of a favorable outlook in the Outlook, which was done about a month ago. And now we've rolled in July and credit markets have really propelled higher, things are up one to one and a quarter percent just month to date.

(34:01):

The last thing I'll touch on as it relates to yields, one of the calls that we certainly got wrong on the year was so far was the outlook for double Bs to outperform triple Cs, um, because we thought the market would be a little bit more defensive, but on the yield side, we did make this call that we thought CLO single As could outperform high yield double Bs. So, think about that. You can move up two notches and outperform something two notches lower where we sit right now, CLO single As are actually outperforming the entirety of the high yield market, which is pretty remarkable. And I think is another one of these indications of where there are still some really attractive yields that can power returns in the forward outlook, and that could set up credit markets to really maintain some of their strength and reasonably decent returns, I think from here towards certainly over the course of the third quarter and into the end of year.

Andrew Korz (35:01):

Just to tack on that, that was sort of my point around, investing in equities here at about twenty times. And I'll reiterate a slightly different version of the stat that I just gave. When valuations are in the top decile, the four two year return on average on equities is negative 7.5%. So if you're thinking about it over a two year timeframe and you're talking about high yield or CLO yields somewhere in the eight, nine, you know, ten percent range, that's probably a decent return expectation over a two year period. You never know. But of course, that's probably a decent baseline that's equity like returns when equities are super expensive. So, I think if you're thinking about it over a sort of medium term timeframe, the market seems pretty lopsided right now.

Rob Hoffman (35:46):

So, I want to toss out a question and focus a little bit on interest rates for a moment. One of the things that's been very beneficial for investors over the past three decades or so, is this progressive line down in interest rates in what it has meant for portfolio construction. What it has meant that anytime equity markets really got weak, you could count on the fed slashing rates, the boost in fixed income that offset that. Are we, and maybe Laura, I'll address this to you. Are we entering a time where rates could be range bound? And just being range bound instead of being consistently falling is a pretty material difference than where we've been historically? What do you make of that and what it can mean for markets?

Lara Rhame (36:35):

I think this came about because the fact that in 2021, the tide was going up. The fed was, the rates were really low and this rising tide of liquidity just caused everything to go up. And 2022 was the year of tightening and the tide really went down. And so now that we're sort of winding down the Fed, how do we think about the rates outlook? What is it? Are we still talking about the Fed? Does it matter or not? And I think to connect the second quarter outlook to this longer term theme. In the second half of the year as the Fed is really winding down their nominal sort of rate hike cycle. Now, their goal is to really make sure that long-term interest rates stay kind of where they are. And really it's been a sideways year.

(37:27):

We started the year with the ten year treasury at 387. Today it's 375. So, we've gone above four a couple times, we've hit 350, but we've really, been treading water, I would say. And I think that continues in the second half of the year because the minute that the Fed allows rate cuts to get

priced into the forward curve, immediately what happens? Housing, the smoldering desire for housing just reignites. Markets off on a tear. And I think that is something that they really want to control. And so I think that is going to be the, the bulk of their work that they would see as their job for the second half of the year. And I connected that in my outlook to the fact that we've had 40 years of this downward channel of interest rates. Where if you could just manage through, and there were for sure periods of volatility, but if you could manage through that volatility on the other side, you got a really nice price gain.

(38:42):

And I look at the year so far, and all we've done is talk about equities and how they're up 20%. And the reality is, on the fixed income side, it was down 13% last year. You're up 2% today. That is the problem when you don't get any price gain, you're kind of stuck with this yield and hey inflation, yeah, it's come down, but it's still 3%. The core inflation is still 4.8. 2% really isn't going to cut it. Going forward, I think that there are huge ramifications to the fact that we're facing, I'm going to make a bold statement, a decade where rates are not going to be continuing this downward channel. They're going to be sideways probably with bouts of sort of two-way risk. It's the reintroduction of two-way risk in interest rates and rates can go up from here. Certainly with a fed funds rate persistently at 5.3%, it wouldn't shock me if we had a 10 year at 4.5% at some point or even higher, a flatter yield curve. And they can go down, unfortunately in this instance, and Andrew alluded to this earlier, they probably go down because we're having a really rough patch in the economy and that's not great.

Rob Hoffman (39:58):

Certainly, that's not what's priced into markets right now.

Lara Rhame (40:00):

Well put. This to me a world where interest rates are higher, just is going to, and it's going to take time. It's going to take a retraining of markets, but I think that allocation of risk has really changed over the past twelve years when interest rates were virtually zero for all intents and purposes. And as that behavior changes I think we're going to see it in ways that we don't expect. And I think we're going to have to start really reexamining some of these valuations. Not today, we've got AI, I am not proposing that this is a month by month story, but I think, you know, just looking ahead at long-term returns, it is a different portfolio construction process when interest rates are between three and five percent.

Rob Hoffman (40:54):

But is it fair to say that's probably not all negative? I just got done talking about credit markets, the fact that we're in a higher interest rate regime and potentially one that could be higher for longer actually could help fuel returns in markets that are heavily income based. So that, Andrew probably a similar story in some areas of real estate as well. That look it changes some of the classic 60, 40 traditional investment allocations that have worked really well for a long time for investors, but there are probably areas of the market that could benefit from an asymmetric outlook on rates, the potential for even higher rates and or just sustained higher rates without necessarily dropping down every time the market sells.

Lara Rhame (41:37):

Well, and let's face it, it's probably also allowed some companies that maybe to behave less responsibly than they otherwise could have if rates were higher. I think there will be some rationalizing there, and I think it absolutely could be healthy.

Andrew Korz (41:53):

I mean, there's more competition for capital for more areas of the market. And certainly if you want to see sort of a good case study of investors going through the five stages of grief in coming to this realization. I think maybe real estate investors are right now in like the bargaining stage, maybe, I'm not sure. But, real estate is very sensitive to interest rates. The average deal is sort of financed with 60 or 65 percent debt and 35 or 40 percent equity. So, where interest rates go is a really pivotal input into sort of the investment backdrop. I think early on in 2022, investors were skeptical, obviously the Fed had signaled that they were going to raise rates. We had this first 75 basis point hike in, what was it, May of last year, April, maybe.

(42:41):

I think investors were still skeptical. You were still doing deals at these sky high evaluations. And I think, you know, frankly, a lot of those investors are kicking themselves right now. I would say since then, call it the second half of last year and the first half of this year, you're seeing this slow recognition that there is this two way risk to interest rates and that rates aren't just going to kind of hit this, this upper bound and ping back down the way they have for the past three or four decades. I think this is a completely different calculus for investors than we've come to be used to over the past, especially 10 or 15 years. If you just look at property prices rose from the trough and prices post GFC in June of 2010 through the end of last year, prices rose 155%, that's not even including income, that's not total return, that's just the value of the average property.

(43:40):

About two thirds of that came from valuations, cap rate compression only about a third came from the growth in, in net operating income. It's a pretty remarkable run. Why were investors willing to accept lower and lower yields that drove higher and higher property valuations? There were obviously multiple reasons, but the biggest was that they knew that at the first site of fundamental trouble, the Fed would come in and save the day and they were proven largely right. That is, I think Laura would agree that's not the case today.

Lara Rhame (44:15):

Yeah. I mean, inflation's come down but it hasn't come down anywhere near enough. And it certainly hasn't come down to a place where the Fed is going to be comfortable,

Andrew Korz (44:26):

Right.

Lara Rhame (44:26):

Just opening the dam and allowing the release of the zero interest rates, the liquidity zirp, all the stuff that feels so good.

Andrew Korz (44:36):

I think sort of another way to say two-way risk on interest rates is that there's a much more even tradeoff between economic growth and demand in the economy and monetary policy. To get a significant cut in interest rates, you're going to need a significant drop-off in economic activity. Whereas maybe in, call it, in 2019, the first site of trouble, the Fed started cutting rates again,

Lara Rhame (45:03):

Right, the first site of market volatility. It was enough.

Andrew Korz (45:05):

Yeah, exactly. I think what does this mean for the market? I think it means even as property values fall and cap rates rise to levels that are kind of more commensurate with where interest rates are today. We should not expect that property appreciation of this magnitude is just going to kind of roar back once, once we get to that equilibrium. Investors are going to remember this period, they're going to remember the number of times that we priced rate cuts into the market and they didn't come. And I think people are coming to the recognition that the economy of today is different than the economy of 2019. So I think the bottom line is, from an investing standpoint that ultra-low interest rates since, the global financial crisis, subsidized property owners and subsidized property price appreciation at the expense of lenders for a long time. And I think that is changing as we speak, and that is really the crux of the reason that we're so excited about commercial real estate debt markets today.

Rob Hoffman (46:09):

Awesome. Well, let’s take us into the end here. I think we can't do that without focusing on at least the one big thing. So, Laura, what's your one big thing as you think about macro between now and the end of the year?

Lara Rhame (46:26):

The indicator that I continue to just watch the most is that weekly initial claims number. And I don't want to sound boring with that. I think at the beginning of the year, we hold our Market Madness podcast, which is always such a fan favorite. I think the winner in the bracket was whether or not tech layoffs would spread to the rest of the economy. We are still seeing layoff announcements higher than they were before Covid. And they are spreading across, a little bit more, not just in technology

Andrew Korz (47:00):

Tech's hiring again, right?

Lara Rhame (47:01):

Yeah, now everything's AI. And again, I think the irony is all the talk of AI disenfranchising coders, in fact, they're actually having to hire a lot of coders to code the code, disenfranchise themselves.

Andrew Korz (47:12):

Prompting engineers.

Lara Rhame (47:13):

There you go. This has been a recurring theme. I don't mean to be boring, but I think to me, that continues to be when the job losses show up, that is the recession, and when initial claims start moving significantly higher, that is usually a very strong indicator that we're going to see job losses. So, 250 had been one of my thresholds. We hit above that for two weeks. Now we're back down. Let's see, 250 is still a big threshold for me. And should we move higher above 300, above three 30, my expectation that a recession would start, you know, in the next quarter would really sharpen.

Rob Hoffman (47:57):

Well, in credit markets, I want to take the, the question of if triple Cs can continue to significantly outperform double Bs in the rest of the market. And if you looked at returns

through June 30th, triple Cs had outperformed significantly couple hundred basis points or so across both bonds and loans. If you look at just returns through July, that trend has only grown stronger. Triple C is continuing to outperform the rest of the market. And I think now what you're starting to see is the market embrace a little bit this risk on attitude. You're starting to see new issuance grow, which has been at a really low level for the past 18 months. The market has an issue, there's a maturity wall starting to really come in 2025. And so I think that if we continue to see triple Cs outperforming the rest of the market, it's just an indication that things will continue to be open for business.

(48:59):

I think you'll see companies starting to issue debt at a volume that they haven't been able to issue. It probably portends that spreads overall can continue to go tighter, which will drive additional capital appreciation for investors across the rating spectrum and credit markets. And I think that would really fuel a continued ability for markets to generate pretty attractive returns and potentially be able to put a bow on 2023 as being a great year for investing in credit markets. If that dynamic changes and you start to see the higher quality stuff outperform, that could really be a sign of, wait a second, get defensive, broader storm clouds on the horizon, markets could close off again. I think it could really signal that kind of shift in sentiment. So certainly one of the things that we'll be watching is propensity for triple Cs to continue to outperform double BS and higher quality parts of the market. So Andrew, take us out real estate. What do you think?

Andrew Korz (50:00):

So, the, the one thing that I'm watching is the activity and the outlook from lenders over the last six months of this year. So I think this is where you're going to see early signs of where risk appetite is going. I think lenders are always worried about the downside. So you can sort of surmise a lot about what's going to be coming by looking at what lenders are doing. I think right now lenders are cautious. LTVs new deals are low. That means in some cases there's going to be sort of a proceed shortfall on refinancings. And in those cases, as I sort of mentioned, the borrower's going to have to either pony up more equity in the deal to make it happen, or they're going to have to find other creative sources of financing to make these deals work.

(50:44):

And that just makes deals challenging. It just makes it difficult and it kind of gums up the works. So, that's kind of where we are right now. The lending market is less competitive than it's been. Spreads are wide because of that. I think it's interesting you kind of look at the market today, and it really is sort of the mirror image of what it was for much of the last decade. You've got tons of private equity capital sitting on the sidelines waiting for this new equilibrium form and for the ability to sort of put capital to work again. So there's a lot of potential supply of equity capital, but the demand for equity capital just isn't there because again, the economics of doing a deal today just aren't great. And then you kind of take it to the debt side and you've got sort of the opposite.

(51:31):

You've got this big demand for capital coming from, you know we've all heard about the refinancing wall that's coming. There's a lot of demand for capital there. But the supply side is constrained because again, banks are reticent to lend right now public investors are spooked by the office sector. So CMBS, the CMBS market is really hamstrung. And as we've talked about, there are plenty of other players but for them, this means they can be patient. They can demand wider spreads, they can demand more attractive terms and the market can come to them. They don't really need to come to the market. So, I think ultimately lenders are in control of this market, right now. And their outlook for the economy and for CRE fundamentals and for interest rates are going to be really crucial as to what happens over the next six to twelve months. And for that reason, that's really what I'm going to be watching.

Rob Hoffman (52:24):

Great. Well that's a wrap, Lara, Andrew, thank you very much as always, and we look forward to doing it again soon.

Lara Rhame (52:32):

Going to be an interesting quarter.

Andrew Korz (52:33):

Yeah. See you in three months.

Lara Rhame (52:41):

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 podcasts. Thanks for listening.