Episode 99

FireSide: Q3 Research roundup—Navigating market optimism

[00:00:05] Lara Rhame: Welcome back to FireSide, a podcast from FS Investments. I'm Lara Rhame, Chief U.S. Economist here at FS, and buckle up. It's our quarterly research roundtable. Today, I'm joined by Alan Flannigan, an Associate on our team who's written a lot about private equity, but today we're here to discuss corporate credit markets.

Alan, welcome.

[00:00:25] Alan Flannigan: Yeah, thrilled to be here, Lara. Thank you.

[00:00:28] Lara Rhame: And we're also joined by my podcast partner, Andrew Korz, an Executive Director on our team and my partner in thought leadership. He really focuses on equity markets, commercial real estate, two asset classes, which are pricing in very different outcomes, but we're going to get to all that, I guess.

Because we do this every quarter and it's always one of my favorite episodes, we get to ham and egg after we've spent all this effort putting pen to paper. I guess we did that in the olden days and our Q3 outlooks are out. So it's about highlighting our big themes, our key takeaways, the third quarter.

[00:01:07] Andrew Korz: You know just, not to cut you off, Lara, but I think maybe we should do a little recap first of the first half that was because we were somehow...already at the midpoint of 2024.

[00:01:16] Lara Rhame: I was gonna say, gotta be already at the midpoint. It is incredible. It's alarming. I think it's important to level-set because so much has changed. When I think about the start of this year, growth expectations for the U.S. economy GDP, the consensus estimate was 1.3%. Today, that's risen to 2.4%. We had seven rate cuts priced into markets. Today, we're, like, fiercely debating one or two. I think that amazing swing...that really started...you could argue it started 18 months ago when we were all looking for a recession.

I think that's really fueled so much market optimism. And for me, what has stuck out and has not sort of neatly followed the Goldilocks script, has been that inflation piece, which we've recently gotten. The May CPI numbers looked great, but markets were fast to latch onto that and very fast to forget the fact that we've had five months of data where we've had a lot of upside surprises in inflation, and today inflation is really average.

Let's talk about CPI first. It's really average, like 3.3% since June of last year. Last time I checked, that's far above the Fed's 2% target. Core PCE deflator, arguably what they're really sort of looking at, more like 2.8. But, again, that's really only come down from 3% at the beginning of the year.

All that's to say, inflation is sticky. I would argue it's stuck. But either way, it just has not followed that neat path that the rest of our economy seems to have adhered to the soft landing.

[00:03:06] Andrew Korz: Yeah, it seems like a lot of different parts of the market have gotten ahead of themselves multiple times on the inflation story.

And you've continuously told us, don't take water—even two reports—and run too far with it because there are these different parts of the inflation story where it's kind of whack-a-mole; every time you think you've got something sort of boxed in, something else pops up. So, I think that's a big story in markets right now in terms of what are they pricing for inflation, and what does that ultimately mean for interest rates?

[00:03:34] Lara Rhame: You and I have a very healthy debate going about inflation. We do. By the way, for our listening audience, we spend a lot of time debating. We're often on opposite sides. I always win because that's my...that's what I get to do.

[00:03:46] Andrew Korz: She says that's my bonus.

[00:03:47] Lara Rhame: But I just want everyone to know that Andrew's constantly prodding my outlook with his counter view. No, not at all. That's what makes, that's what makes our research so great. That give and take.

[00:04:02] Andrew Korz: But I think your point on the macro flows well into what's gone on in the equity market over the first half of the year. I mean...

[00:04:09] Lara Rhame: ...'cause record after record. Yeah.

[00:04:11] Andrew Korz: I mean, what an 18 months it's been.

I mean, it was another incredible half for stocks and U.S. stocks specifically. I mean, sitting here in the third week of June, the S&P 500 is up another 15% after being up 20%, 26% in 2023. Just to kind of put that in perspective, how remarkable of a run this has been. That's only happened six times where you've had a year of 25% gains followed by six months of another 15.

It's only happened six times in the last 120 years. So, we're sort of in a top fifth percentile equity market rally right now. Which, again, you can expect that once every 20 years, and that's kind of the run we're on right now. Concentration continues to be the story in the equity market.

Yeah. It's gotten much worse this year or better, depending on kind of the lens you're taking, but it's actually gotten again, I think, even more acute—the top six—I'm kind of kicking Tesla out because I don't think they belong with the rest of the Magnificent Seven right now, but the top six have driven two-thirds of that 15% return this year...just remarkable, they account for almost half of the risk contribution, the overall volatility of the index.

So on any given day, you can expect six or seven stocks to drive almost half of whatever the index is doing. So just absolutely remarkable concentration. Um, from a regional perspective, once again, the U.S. is just lapping the field. Emerging markets have been challenged by obviously China, by higher U.S. rates, stronger dollar. Europe can't get out of its way. Japan was good for a while because they're kind of the only one that we're goading inflation to go higher because they've been in deflation for so long. But by and large, you have this environment where earnings have held up, the macro has held up, the AI excitement has only intensified, and that's just a recipe for just a really good U.S. equity market, which is exactly what we've seen over the past six months.

[00:06:09] Lara Rhame: Yeah. Okay. So, swing to optimism for the economy. First-half optimism for equities. Alan, take us through what credit's done in the first half of the year.

[00:06:18] Alan Flannigan: Yeah, well, to start, I think someone forgot to tell credit, [the] calendar turned.

I mean, what you saw toward the end of '23 was this real risk on move where lower-rated securities outperformed and you saw that continue year to date in credit markets. And some of that's come from spread tightening, certainly in loans. Triple C spreads have tightened over 200 basis points to start the year.

But a lot of the return that's being generated is from that income. And so that's where we really see things today is good starting yields, good income returns, price returns may fluctuate throughout the year. And we'll get into it a little bit later, but there are a few pockets of distressed activity that are creeping up, but, you've started out the year with two-and-a-quarter in high yield, four-and-a-quarter in loans, and the market has really processed a lot of the upcoming maturities.

The wave of refinancing that's been happening has been very conducive to market stability. That investor demand that we've seen to start the year, particularly in loans, where CLO markets have opened up and brought in a lot of loans into that structure, it's been very conducive to a stable market and for risk-taking behavior.

And so you see repricing up significantly. Fifty-five percent of loan volume to date has been repricing. When you add in refinancing, it's about 90% of gross issuance to date. So that's really the narrative that's driving the market to start the year.

[00:07:41] Lara Rhame: This is something that's interesting because looking at traditional fixed income, you would look at the 10-year Treasury, where it is today, and think yields are very high compared to where it's been historically. But, you know, we've really had sort of a round trip since the start of the year.

You know, started right around four, crept up to 4.7% yield, down now to about four-and-a-quarter. But the performance year to date is flat. And I think that's where...just that made me think, as you were talking about yields and high yield and leverage loans, that's where, I think, you really see the income still being inadequate coming from traditional fixed income.

You really need to dig deeper into the capital structure to get that better yield.

[00:08:24] Alan Flannigan: Yeah. And like spreads are tight and typically that's a very good proxy for measuring the value of loans and bonds, but right now you've also got to keep in mind base rates are so much higher relative to inflation than they typically are.

So when you think of it from a real yield perspective, you're sitting there in high yield at around 5% and loans, you know, six-ish, call it six-and-a-half. So for many income-oriented investors, that's a very good starting point, particularly fundamentals are solid, which they are in most parts of the market.

[00:08:54] Lara Rhame: Yeah. All right. CRE first half of the year.

[00:08:57] Andrew Korz: Yeah, I think that this continues to be such an interesting part of the market because it is...real estate is uniquely sort of exposed to the higher financing costs. And thus, I think it's a really interesting case study for the cycle. I think first half brought kind of good news and bad news.

The good news was the animal spirits do seem to be turning a corner, albeit slowly. CMBS issuance, which we've talked about for about two years now, has been really sort of almost nonexistent. It's ticked up recently as spreads have come in on CMBS bonds.

Issuance might be somewhere close to 25 billion in Q2, which is actually pretty normal if you go back to pre-COVID. We're seeing some big acquisitions of publicly traded CRE platforms, made by some major large institutional players. And take privates, which is a good sign that, the quote-unquote smart money, thinks that values might be at an attractive level right now.

And I think underlying all this is a belief that rate volatility, at least, has probably peaked even if rates haven't and investors can kind of narrow the range a bit on where yields are gonna be over the next one to two years. I think the bad news has been that while I would say the vibes have moved higher, the actual dollars have not moved higher started moving yet.

Transaction volume continues to be pretty muted. It's not nothing. It's not like GFC levels [are] low, but it's well below where we would expect, given the market size. Rates are still really high and it's not clear that valuations have corrected enough.

And you're still going to see the steady drumbeat of negative headlines from office, right. You saw the headline that a triple-A CMBS bond that backed an office property in New York City took losses. It's the first time a AAA bond has taken losses since the GFC. Those types of anecdotal stories are just going to continue to creep out about the office sector, which just puts a cloud over the market. At least for some folks.

[00:10:52] Lara Rhame: My normal disclaimer office is like 15% of the total CRE market, much more diverse, heterogeneous. I think we always have to remind listeners of that because it's so easy to get sucked in by the doom loop office-oriented CRE headlines that miss the nuance.

[00:11:10] Andrew Korz: I mean, office has always been kind of like the poster child for commercial real estate. The big glossy New York office building is on its own island right now. And I think, we think, it'll continue to be, but I think ultimately, first half depends on your expectation.

If you're expecting a V-shaped rebound with rates coming to the rescue, it didn't happen. If you're expecting the stuff to hit the fan, that didn't happen either. But if you're expecting what we were expecting, which was continued resilience in the economy, choppy road back to normalcy because interest rates are staying higher for longer. It's kind of what we got.

[00:11:44] Lara Rhame: All right. So why don't you just keep the mic and take us into your Q3 outlook for CRE?

[00:11:51] Andrew Korz: Yeah, no, happy to. You know, we've been talking for a quarter or two now about the next phase of the correction, right? We've kind of been in this correction stance for the better part of two years, really, since the middle of 2022.

And I think we're cautiously optimistic that the second half of the year is where you do start to see signs of this, not only in sentiment—which we've already seen in terms of CMBS trading a

little bit better—in terms of some of the sentiment surveys that you see, come out on a quarterly basis.

So we're optimistic that the second half is where you start to see it actually flow through into real deals taking place. You just kind of think about if you're an investor with capital to deploy, what that backdrop looks like today versus maybe six or 12 months ago. You're sitting here today, cap rates have risen about 100 to 150 basis points. So your starting yield is better. Rates are still high, but I think the shock is starting to wear off a bit for people and they're sort of coming to terms with the fact that rates are probably going to stay here and again, rate volatility has come down, which has been helpful.

And I think the most important thing is that the medium-term outlook for most property sectors from a fundamental standpoint is actually really good, right? So you've got strong demand in most of these sectors. Again, putting office into its own little basket there. But if you think about multifamily, industrial, even retail and hotel, pretty strong structural demand drivers.

And the other side of that, the supply side, new construction…we've talked about this a lot on this podcast. But the Fed raising rates has chopped off what was sort of a rising, what I would call a construction boomlet in 2021/early '22. The Fed has totally chopped that off. So when you look out, let's say an investor has a five-year investment horizon.

You look out two to three years, you're probably looking at a supply deficit in a lot of these markets while demand stays pretty strong. So, I think in the short term, Lara, I think everything about your economic outlook for Q3 would lead me to believe that most property sectors are going to continue to perform pretty well from a fundamental standpoint.

[00:13:57] Lara Rhame: Yeah. All right. I guess I'll just take that one then. Because I think…

[00:14:03] Andrew Korz: …at least I think, I don't want to put words in your mouth.

[00:14:06] Lara Rhame: Well, and this is the nuance of the Q3 outlook, which is that I do think the economy is going to slow somewhat, but from a really strong pace of growth. And we look at Q1, the headline was 1.3, but if we take out a massive inventory drawdown, that sort of final demand piece, which I feel is a better reflection of the domestic U.S. economy was 2.5%. And our economy just does not sustain growth of 2.5% for very long, very well.

And so a slowing to more like 2% to me, it doesn't sound like it's an exciting forecast, but that's good. That's good for all of our asset classes. And I think more importantly, is welcome news because the reality is that's something that we can actually maintain for some time. I don't expect a rate cut in the third quarter.

I know that's off consensus. Markets have kind of one price third quarter, one price fourth quarter. But to me, I think the election calendar starts to really narrow the Fed's options. I don't think they're going to cut in July, and I don't think they want to cut the September before the election; give it…especially if markets remain near these very stratospheric valuations.

To me, a November or December opportunity presents itself as much more convenient for the Fed. So, I think the piece of the Fed forecast that I feel the most strongly about is that I have high conviction it will be surgical rate cuts. And Andrew, always trademark you on that because you're the one who came up with it and I've taken it and run with it.

But the idea that the Fed will ease once a quarter on some kind of autopilot next year is not realistic to me. I think it's going to be much more a nip and a tuck and a careful sort of data dependent cycle. If we can even call it that because I don't think it's going to be as deep of a rate cut trajectory as markets are currently pricing in. And then finally, I continue to think, and this is where I'm really going to put myself out on a limb, that the 10-year is going to retest 5%. Sometime, if not Q3, sometime by the end of the year…

[00:16:32] Andrew Korz: …the curve is still pretty significantly inverted. I mean, at some point it has to un-invert and part of that is likely higher, you know, higher long-term rates, right?

[00:16:42] Lara Rhame: Yeah, we're either going to have a recession, which is going to get the Fed to really cut rates fast and deeply, or we're going to have some kind of normalization of the yield curve.

And one of the areas that I focus on a lot in the Outlook are our debt and deficit dynamics. Those aren't looking better anytime soon. This is not a premium. This is not the podcast where we're going to dive into the election. But if you look at right now, both party candidates, both of their economic proposals and campaign rhetoric does not equal policy, but both of them are inflationary.

So, it just ties with my broader view that inflation is going to end the year at 3%. To me, that's above consensus and is higher interest rates all around. So, when you add it up, I look at a forecast where the economy remains healthy, growth remains solid, albeit slower than we started the year. And I think when you look at the inflation numbers, it's going to be high enough. So the Fed can cut rates, but they can't go on some sort of easy autopilot.

What does that mean for credit?

[00:17:59] Alan Flannigan: Well, the setup you just described means credit can kind of continue doing what it's been doing, which is to pay an attractive level of income, given where yields are. And defaults would remain relatively contained in that scenario. But where we kind of get into our outlook this quarter, which is being selective in selection and that this really is becoming a credit-picker's market, is because we see some segmentation between high yield and loans, particularly when you look at the fundamentals.

So, if you look at just the income statement, both credit universes look fairly similar, revenues and growth have slowed a bit over the near term, revenues down quarter over quarter, but still up year over year, kind of in line with that slow, moderating pace of economic growth that you described.

But where the segmentation occurs is when you look at the balance sheet. And that's where we start to see a few more problems creeping up. Again, not significant, not market wide.

In Q1, our outlook was buy the bushel, but beware of bad apples. And a lot of that still applies today. The market as a whole is pretty sound, but where things creep up is when you look at loans and there's a full turn of leverage higher in loans. There's a full turn lower in terms of interest coverage.

And then when you parse the data further and look at things like public versus private loan borrowers and the size of loan borrowers, and there are a significant cohort of smaller private loan-only borrowers who are having some problems. And so you are seeing default rates in the loan market tick up a bit.

And something that we may touch on later, which is the amount of distressed exchanges that are happening in that market is really significant as well. And that's a step that can happen for a borrower before they reach the point of bankruptcy or default, and that can eat away at recovery rates for lenders as well. And that is something that increasingly lenders are starting to need to take into consideration at the outset of that loan.

[00:19:55] Lara Rhame: So when you say default rates are ticking up, is that from like very historic lows? Put that in a historic perspective for us.

[00:20:03] Alan Flannigan: Yeah. It is very historic lows. So the long-term 25-year average for high yield is 3.4%. Currently today, it's around 2.1%. In loans, historically 3%. It's up to about 3.3% on a par weighted basis. So ticking up a little bit, but again, that's driven primarily by these smaller loan-only private borrowers. Or you have coverage metrics that are cash flow 1.8 or so relative a market of three.

[00:20:31] Lara Rhame: So you're getting your money back.

[00:20:32] Alan Flannigan: You're getting your money back, but you're taking a little bit more risk. And I think this is why we call it a credit-pickers market because there are plenty of opportunities. But that flexibility to go across bonds, loans, CLOs, maybe even some ABF if it's within the investment mandate of the fund, that's how you're going to go out well in this market. Having that flexibility, doing fundamental analysis of each individual credit and, if necessary, having some workout and distress capabilities.

[00:20:59] Lara Rhame: Yeah. Okay. Some of that sounds like Q3 and some of that just sounds like smart investing 101.

[00:21:05] Alan Flannigan: It always applies.

[00:21:05] Lara Rhame: Yeah, it does.

So Andrew, before we get your outlook for equities, I wanted to introduce one of the things that we like to...sort of a thread that we like to pull every single quarter in these podcasts, which is a big idea that really we can relate to all of our markets. And to me, it is this idea that maximum optimism is priced in, you know, the swing over 18 months. We talked about the last six months, but I would argue it really started even before that, when we had aggressive concerns about recession and we kept rolling that forward every six months.

And now that's really peeled away from the outlook and we're left with, on a scale of 1 to 10, optimism's at an 11. And this is something I try to hammer home to a lot of investors I talk to. If you're expecting a rainy day, and you get a sunny day, it's a wonderful surprise. If you're expecting a sunny day, and you get a sunny day, it's still nice, but it's not quite the happy frolic that it would have been if you were hunkering down for a week of rain.

And so when we look at markets today, I think we are expecting sunny days as far as the forecast can see. And I think that's something that I think of in particular with equity markets.

[00:22:31] Andrew Korz: Yeah, we've seen it in the macro data, right? In 2023, you had record levels of upside surprises on the economic data. Yes. Right. It was, it was remarkable how consistent that occurred.

[00:22:40] Lara Rhame: And that has stopped by the way.

[00:22:42] Andrew Korz: It has stopped.

[00:22:42] Lara Rhame: Now the surprise indexes are like negative territory. Yeah. Yeah. We're very choppy.

[00:22:47] Andrew Korz: So far it hasn't, markets haven't really really cared. We'll see. But no, I think you're right.

Equities is really where, sort of ground zero for this dynamic. And I think the theme that I've been going with is that higher earnings growth for longer has fully counteracted the idea of higher interest rates for longer. Love it. So, I mean, higher interest rates are in a vacuum, not a positive for stocks necessarily.

Of course, what comes along with those higher interest rates really matters. And what's come along with the higher interest rates in this cycle has been higher earnings growth and specifically expectations for medium- to long-term higher earnings growth. So if you think about…2023/end of 2022 and last year were sort of a blip, for earnings in the S&P 500.

As company margins kind of compressed, this year, markets are expecting 10% earnings growth; next year 14%. That's really strong. It's not unheard of, but it's really strong, right? And I think, given that outlook for sort of good earnings growth as far as the eye can see, ultimately that's allowed markets to sort of take this, I would say, asymmetric skew on risk, right?

When rates go down, markets go bonkers, mega caps lead, but beta kind of comes along, cyclicals do well, small and big caps do well. When rates go up, the market kind of flocks to quality because it's getting concerned. Guess what that quality is? It's the mega caps and they make up 40%. So it's like heads, I win; tails, you lose kind of thing.

That's kind of the market we're in right now, right? So you have this asymmetric risk profile. The stat that I think sums this up most…

[00:24:29] Lara Rhame: So, does this worry you, going at looking ahead, I think…

[00:24:33] Andrew Korz: …yeah…

[00:24:33] Lara Rhame: …you know, it's…

[00:24:36] Alan Flannigan: …short and sweet. Yes.

[00:24:37] Andrew Korz: Yeah. I mean, anytime you get this sort of disregard for downside. And I think the biggest risk here is not necessarily rates.

We talked about the massive concentration. Most of these stocks are not highly levered. So they're kind of, I don't want to say immune to higher rates, but to a certain extent, their business models are. It's a hiccup in the growth story, right? And I think, we were talking about this yesterday, high valuations were above 21 times valuations on the S&P, which is historically high.

Yeah. I think a lot of investors…we've been close to there for 18 months, right? So it's like our valuations, even predictive of corrections anymore. Should I even be looking at them? Well, they may not be predictive in terms of the timing of a correction or when it's going to happen.

But in terms of the risk of a sharper correction, if you're 21 times and something disappoints, there's potential for significant downside there, right, versus if you were trading at 16 or 15 times. Right.

[00:25:39] Lara Rhame: And I think that, to me, is the power of the expectations, I mean, you've said it, 18 months. And during a time when I think there was widespread concern. You heard CEOs talking about risk of recession, and yet we just got upside beat after upside beat on the economy, which gave you the upside beats on the earnings, which gave you the lift in valuation.

[00:26:05] Andrew Korz: Yeah, let me just give you one step because part of this is secular. I mean, I, we cannot impress enough how important the AI narrative here is. It's remarkable.

There's metrics out there that basically aggregate up all the long-term earnings expectations for companies, right? So over the next three to five years, analysts make sort of estimates on what they expect companies earnings to grow over the long term. If you aggregate those up into sort of the index number, in early 2023, kind of before the AI mania, it was around 9 or 10% long-term earnings growth, which is strong.

Now it's closer to 18 or 19% long-term earnings growth over the next three to five years. The only time we've ever surpassed that was the dot-com bubble. Yeah. Right. So, you are not only pricing good earnings over the next couple years, you're pricing it durably into the future. Wow. And even if you're of the belief that nominal GDP growth can continue to be 6%–7%, which would be great, we would all love that, right?

Economic theory would tell you that earnings should not be growing 20 when the economy is growing six or seven. Yeah. Right? So there is this disconnect and the only way you kind of square that circle is, you think inflation goes to the moon, which wouldn't be good. You think, basically, the labor share of income just goes way down, which would cause lots of societal problems that we already have.

Or productivity goes to the moon, which I think is what people kind of expect. It's a lot to bet on, again, to your point…

[00:27:27] Lara Rhame: I would love that, but yeah, it's a lot to…

[00:27:29] Andrew Korz: …to your point, to bring it all full circle, that's optimism priced in, right? And that's kind of where we're sitting today.

[00:27:36] Lara Rhame: I think the one thing I'll say is that, in years where we have every economist expecting a recession, the joke is that you're not going to get a recession.

I'm worried that the opposite may be true. That if everybody's expecting a perfect incredible growth, on the horizon, sunny days forecast, you may actually get some rain that you're not bringing up.

[00:27:57] Andrew Korz: Complacency is dangerous, it really is.

[00:28:00] Lara Rhame: Alan, look at your market and tell us what that is. Is it priced for full optimism? Are we hard over on the optimism meter?

[00:28:09] Alan Flannigan: I think we are, it's not all the way at the end of the meter, spreads are not at all-time tights. They're tight, 90th percentile range, but not all-time tight. And given the setup where there is limited new supply, particularly in high yield, but in loans as well, just 10% of the gross issuance this year has been that new supply.

It's all been refinancing and repricing. But what you are seeing is that there's been a significant willingness of the market to refinance and reprice. So there is that kind of bullish sentiment from that respect and what that ultimately results in is there's less spread, less income being paid, particularly in loans where this activity has been quite high.

And the thing that has been a little bit interesting, I call this kind of like a Billy Madison moment, if I may, where the loan market seems, from the activity going on, everything's telling you it's good, great, grand, wonderful, and nobody's allowed to yell in the bus, no yelling in the bus, right?

Classic line. Love that line. But the concern is that while this is happening in the market activity, you do have that uptick in defaults that I described. You do have recovery rates that are at just about the lowest they've ever been. You do have a preponderance of borrowers that are out there with higher leverage levels increasing that are really having higher borrowing costs bite at their bottom line.

And so the concern for loan investors is, okay, we're on the bus, but when we show up, will somebody have eaten our lunch. And that's the concern from the perspective of, is there too much optimism priced in? And are we allotting for that expected credit loss, which happens in these markets, especially if the economy sours a little bit.

Yeah. All right. I think one market you want to quickly take us through CRE because I think that is one market where we can say that the optimism is not fully priced.

[00:30:05] Andrew Korz: I wouldn't use the word optimism to describe commercial real estate over the past couple of years. I would say it's outperformed, but optimistic would not be the word. No, I mean, I think you kind of have to draw the line between what public markets are saying and where properties are trading in private markets, too. I mean, equity rates in the public markets continue to be challenged. Actually, as I mentioned, CMBS has performed really well.

So this is where we've talked for a long time about the difference between equity real estate and debt real estate. You can have a scenario where equity holders are really challenged, which is again, it's in the public market pricing right now while debt investors are still getting paid back. And that's kind of the environment we're in because fundamentals are still pretty good in private markets.

There's just not that much trading. So we don't really know exactly where value is, but we can probably say, given the fact that more deals are not occurring at today's quote unquote valuations. That investors are not pricing the most positive outcome, because if they were, they'd probably be buying more properties.

[00:31:01] Lara Rhame: Well, but isn't this what we always say that when markets are challenged, it's actually the best opportunity to dive in and buy. And it's a very sort of ironic, to

me, comment on investors' psychology that the one market where there may be more deals and optimism isn't priced in is the one that you really are having to convince people is a good opportunistic time to dive in.

Whereas markets where everything's trading at the tippy top, people are still, you know, falling over themselves to get it.

[00:31:33] Andrew Korz: Greedy when others are scared and scared when others are greedy.

[00:31:35] Lara Rhame: We're not very good at that. As animals, as investing animals.

[00:31:38] Andrew Korz: No, that's not how our brains are wired.

[00:31:39] Lara Rhame: No.

[00:31:39] Andrew Korz: But I do think there's some nuance there.

It does bring up the question to your point. Is it a quote-unquote, buy low opportunity? I think maybe in some cases, certainly the big buy low opportunity would be going and buying a bunch of office properties. I don't know a bunch of people who are doing that right now. But I think in a normal real estate downturn, you have a situation where like fundamentals are going sour.

And as a result, you know, the economy's weak. Rates are getting cut, and you have sort of financial buyers who can come in and scoop up those assets and finance them at low rates and then ride the wave back up as the economy recovers and make really nice returns. Today, it's the opposite. The backdrop is the opposite actually in this quote-unquote downturn or correction, whatever you want to call it.

Fundamentals are good. That's not the issue. And rates are not going down, right? Right. So the outlook in terms of what you do to take advantage of priced pessimism is different than what you might normally do. Instead of being sort of the distressed buyer coming in. It's more coming in and operators who can roll up their sleeves and actually increase rents or it's taking advantage of the higher interest rates as a lender.

So I think the, the gate, the playbook, if you will, of this type of pessimism is a little bit different than you might expect.

[00:32:49] Lara Rhame: All right.

Before we get to our one thing that we're watching and wind up this research roundtable, I just want to put in just one...you're on the clock...Andrew Korz. I want to put out an advertisement for our Outlooks. We love talking about them because we put a lot of time into writing them. It is something that I think really gives us a chance to get out of the day-to-day markets and take a look at where things are going, how investors need to consider the next quarter and how alternatives can really help with the challenges that we're experiencing from the traditional 60/40, be it high correlation, be it peak optimism now becoming a vulnerability.

All of these things, I think, we really break down with thoughtful articles and really fantastic research. So I hope that you'll take a minute to visit the show notes or visit our website

fsinvestments.com and take a look at our outlooks and reach out to us for further conversations about it.

All right, Alan, I'm going to start with you. One thing you're watching.

[00:34:04] Alan Flannigan: I am watching the rate of upgrades and downgrades in leverage credit. So one of the things that we've written a lot about is the quality of the composition of the market in high yield, a lot of double B's, a lot of B's with very good fundamentals, and the rating agencies have been upgrading them commensurately. In loans, the opposite's been happening. You've been having downgrades exceeding upgrades at about a 2 to 1 rate and, you know, lower rated credits that already have weaker fundamentals falling off the ratings radar.

[00:34:33] Lara Rhame: All right. Andrew?

[00:34:35] Andrew Korz: So in equities, I will say we are sort of seeing an upswing, I would say, in capex and in business investment.

A lot of that has to do with AI. A lot of it's being done by sort of the quote-unquote hyperscalers. We saw those, that spending get absolutely, penalized in 2022 in parts of last year. This year, investors seem to be fine with it. It's going to be very interesting to see if markets start to penalize that spending, what companies start to do. So I'm really interested to see how this spending cycle goes.

[00:35:06] Lara Rhame: Yeah.

[00:35:07] Andrew Korz: ...sorry. And then I'll just quickly go CRE and then we'll wrap up with you. So in CRE and public markets, I'm watching the stock prices of the commercial real estate brokers. They're kind of pure plays on will transactions start happening again.

So I'm watching that. And then in private markets, I'm watching distress and distressed sales. We've kind of seen a moderation in new distress, which is a good sign. If we start seeing sales out of distress, you know, defaulted properties start to get sold. That tells me that we're starting to enter the later stages of the correction.

So those are the two things I'm watching.

[00:35:38] Lara Rhame: All right. I'm going to finish up with initial jobless claims. My canary in the coal mine for the U. S. economy, it is the number of people that go to the unemployment office and register for new unemployment benefits if they've been laid off. And it's sort of independent of the monthly job reports that have had some inherent problems lately.

So initial claims, if it hits 300, that higher is worse. And I think we need to at that point start thinking about, has there been some bigger deterioration in the job market that so far has really hung in there at really healthy levels.

[00:36:17] Andrew Korz: Let's hope it stays down.

[00:36:19] Lara Rhame: Yeah. All right, guys. This has been really fun.

[00:36:22] Andrew Korz: It has.

[00:36:23] Alan Flannigan: Absolutely.

[00:36:23] Lara Rhame: I'm glad we got to this.

[00:36:24] Andrew Korz: Another quarter gone by.

[00:36:25] Lara Rhame: Man, I can't believe we're probably going to be recording Q4 before we know it.

[00:36:29] Andrew Korz: Well, then we'll really be in the election season. Yeah. So. It'll be interesting.

[00:36:33] Lara Rhame: Alright. Interesting times. Thanks again. Awesome.

Thanks a lot. Thanks Lara.

[00:37:00]