

Episode 30

# Research recap: Q2 2022

## Corporate credit outlook

The team reviews their top five ideas for credit markets in 2022, and how they've played out as we kick off Q2.

Kara O'Halloran (00:00):

Welcome back to Fireside, a podcast from FS Investments. My name is Kara O'Halloran, and today we are kicking off our Q2 Outlook content with an episode all about credit markets. Like really most major asset classes, credit has had a bit of a rough start to the year, but the headline numbers don't tell the full story, so with me to parse through everything we've seen in credit markets this year and talk about what we can expect going forward is Rob Hoffman, the head of our research team.

Rob Hoffman (00:30):

Hello, thanks for having me.

Kara O'Halloran (00:31):

Yeah. Thanks for coming on; our credit guy.

Rob Hoffman (00:36):

Yeah.

Kara O'Halloran (00:36):

Rob, let's talk a little bit about what we've seen so far this year. Thinking back to 2021, credit was very calm, pretty steady. I think I might have used the word boring at times and Q1, not so much. High yields, as of now, is down 4.5% this year; the worst start to a year in history. The most acute pain was felt in double B bonds, those highest rated. They're down 5.4% triple Cs are down less, down less than 4%. Loans, on the other hand, are only down 10 basis points. There's a lot of things going on in the markets. Walk us through what happened in credit in the first quarter.

Rob Hoffman (01:17):

Yeah. It feels, to a certain extent, pretty bad, I think. High yield has been down for each of the first three months of the year and that's the first time that's happened since Q4 of '18. Then you'd have to go back to 2015 to find another period when that's happened. For only the third time in seven years or so has high yield had this type of rough start. I think, as we look at some of the factors that have influenced that, I think about it in three buckets. The first that has had the most pronounced impact is certainly interest rates and what's gone on with the interest rate picture, but then you have geopolitical tensions and, I think, these bubbling concerns about how is the economy going to respond to the fed raising rates and does that create longer term growth problems, which certainly impacts negatively credit markets for that to materialize, but I think the story has really been all about interest rates so far.

Kara O'Halloran (02:13):



Yeah, exactly. I walked through those returns that we've seen. If we think about just a broad risk off market, what we've seen has not aligned up with that. Right?

Rob Hoffman (02:26):

Yeah.

Kara O'Halloran (02:26):

We're seeing those, the most duration sensitive parts of the high yield market, the double Bs, selling off the most. Then as we said, loans, which have very little duration sensitivity, obviously with their floating rate down only 10 basis points.

Rob Hoffman (02:39):

Yeah. When you look at high yield as a place to start, your yield is up by nearly 2% from the beginning of the year through the end of the first quarter, but if you look at spread as a real measure of how is the market pricing and risk, spreads are only 40 basis points wider. It's a very small move on the spread side. Even despite geopolitical tensions and some of the other things going on, that really hasn't materialized in the market to any large degree. It's really been all about the interest rate move, the increase in the 10 year, how that's flowed through to markets. It's interesting.

Rob Hoffman (03:19):

We've written a lot about how high yield is not historically interest rate sensitive, negative empirical duration, very resilient through periods of rising rates. I think that maybe what we're seeing, and we've talked about this in other markets, equity markets and other places, that when interest rates approach the zero bound, things start to get really wonky. I think maybe we're seeing a little bit of that now as the interest rate environment is slowly normalizing. The impact that it's having on markets, including something like high yield, has been a little bit atypical from where you're coming from and where rates are going.

Kara O'Halloran (03:59):

Yeah. It's almost like we turned the calendar page and markets kind of woke up and we're like, oh. I've got to bring some of this stuff in. Okay. Let's get real tactical and just talk about the second quarter, because I want to talk about credit throughout the rest of the year as well, but I want to first talk just about Q2. What are you most closely watching there and what are your expectations for credit markets over the next three months?

Rob Hoffman (04:23):

Yeah. It's a tough call. When you just take the broad brush of how people are looking at credit markets right now, you look at things like retail fund flows. Everybody's putting money into floating rate loans, everybody's pulling money out of high yield. Again, I think along these lines of interest rates and where people expect rates to go. The hard part in looking at well, what's going to happen in Q2 is that it's not a foregone conclusion. If you go back and look at an environment like year end 2017 and what happens say through those first nine months of 2018, the yield of high yield was basically the same as where it is now. The spread of high yield is basically the same as where it is now. In high yield generated two and a half percent returns as interest rates on the 10 year went from 2.4 to 3%. To sit here and say, well, high yield is definitely going to be down in the second quarter, there's plenty of periods of time in where the statistics have looked pretty similar and that hasn't happened.

Kara O'Halloran (05:26):

Not to just keep throwing stats out there, but another interesting stat is there's been 18 times in the history of the high yield market where we've seen the five year treasury spike more than 70



basis points. We've certainly seen that happen this year, but in 16 of those 18 times, high yield has posted positive returns in the following three months. Certainly, the markets take time to digest those spiking interest rates, but there's precedent for sure for this resiliency that we've seen in high yield.

Rob Hoffman (05:57):

Yeah. One of the other stats and graphs that we put in the outlook actually that I thought was really interesting is that if you just look at the current yields of the market today and high yield versus loans, it's actually expanded to the point where high yield out-yields loans on a current yield basis by more than it has since 2018. That could portend to favor high yield versus loans in the second quarter, but there's a number of wild cards that go into that. Clearly what happens to the 10 year, the five year, the path of interest rates over the course of the second quarter. As we think about some of these other things in addition to interest rates, the war in Ukraine, do you have growing concerns about longer term growth outlooks?

Rob Hoffman (06:42):

Those have a major impact on what will happen in the second quarter because if those other risk factors start to pull back, high yield at a spread of 370, it could easily tighten back down to where it was beginning of the year. As we think about credit fundamentals, that picture is still really good across both markets. They're generating more cash flows than ever before. Despite concerns about inflation, margins are higher than they've ever been before. Leverage levels are largely falling. Default rates are super low. The fundamental picture was really good, and I think that could lead you to a spread tightening environment if some of these other risks out there, like real credit risks, don't materialize or grow in popularity over the course of the second quarter.

Kara O'Halloran (07:32):

Yeah. We've kind of started to see that over the last couple of weeks too, just the last two weeks of March, almost like a snap back in markets broadly and in credit as we're looking past some of, I guess, these near term risks.

Rob Hoffman (07:45):

Yeah. On the interest rate side, obviously it's been this huge wild card. We've seen this, what, hundred basis point move in 10 year treasury rates. It's unclear where things are going to go from here. I think the natural inclination from everybody would be to say that rates are going to go higher, and talking with Laura, our chief economist, a rate call of two and a half to 3% by the end of the year and we sit at 260 or something like that today. Historically, once the fed really starts going, the 10-year doesn't move up necessarily.

Kara O'Halloran (08:24):

Yeah. I think that's a good time to reinforce that, just because the fed is controlling the short end of the yield curve. I think the average 10 year rate that we see during fed rate hike cycles is a hundred basis points. In history, that has been the average. We've already seen that. I'm certainly not saying that rates won't go up more because we do have quantitative tightening happening. There's a lot more going on this cycle, but I think it's always really important to reinforce the notion that long term rates are not moving in lockstep with the fed.

Rob Hoffman (08:55):

Yeah. Look, to get specifically to what you're talking about in Q2, I think the prevailing trend is perhaps the most likely that loans continue to outperform, investors continue to favor floating rate over fixed rate, we continue to favor asset classes like CLO securities. Things like that don't



have the same level of duration sensitivity can continue to do well. If fundamentals do well and rates continue to go up, I think that would be the most popular view to take. I do think though it's worth paying attention to the... I don't know if you call it the contrarian side or the other side of that there are environments where fixed rate markets can continue to do all right. When you think about high yield, yeah it's down four and a half, 5% year to date, but the investment grade corporate market's down eight and a half, 9%. Even the Barclays Ag is down over 7% from where we are right now.

Rob Hoffman (09:53):

High yield has actually done okay if you made an allocation shifting into an asset class that historically has weathered rising interest rates better than some other areas of fixed income. It's done that, but loans have certainly carried the torch as one of the best places in fixed income to be to start the year.

Kara O'Halloran (10:09):

And in markets in general. All right. Rob, let's talk about 2022 more broadly. We published a chart book as we do every year with our top five calls. We were talking before we came in to record about how we were doing, if we were on track with our calls or not, and you said, hey, we're actually doing pretty well. I was like, really? This year feels so different than I thought it was going to. How are we doing so well?

Kara O'Halloran (10:35):

I want to touch on a few of the things that we haven't specifically talked about so far that we were brought up in our chart book. We haven't really talked that much about spreads. Coming into the year, we said, okay, spreads are tight. They are tight for a reason. That doesn't mean they're going to go imminently wider and they could even tighten a little bit further. We said that spreads in high yield would average below 350 basis points, loans below 400. Right now the average spread for this year in high yield has been 376. It's actually a little bit tighter than I expected given what's going on. What are your thoughts on that call? Are you sticking with it? Are you going to change those?

Rob Hoffman (11:17):

I think the spread environment, theoretically, should be most impacted by real credit risk issues that pose a fundamental risk to companies and their ability to pay back debt. It should be less impacted by just where interest rates are. From that standpoint, I do think we can stand by this call. I think that depending on the path of growth and fundamentals, especially if interest rates continue to rise a little bit, which can pressure spreads, you could see spreads go lower. Pressure in terms of narrowing the gap. We're not that far off, frankly, from where we said that spreads could stay. We did indicate that we thought spreads could stay in a tight band, and so far we've seen that, despite this volatility. As I said, spreads have barely widened on the year. From that standpoint, I still feel reasonably good about looking to this as a place that markets could go this year.

Kara O'Halloran (12:12):

Awesome. Okay. Let's talk about rising stars. This is something that I think there was a lot of consensus coming into the year that we are going to see a lot of rising stars, especially after the huge amount of fallen angels that we saw during the COVID crisis, so we just kind of expected a lot of those high yield names to move back to the investment grade market. I think our call, we said rising stars to shine. Unfortunately, I think this is the one that we have to admit we've been a little off on this year so far. Rising stars do tend to have more duration sensitivity, so



they've been hit particularly hard by these rate moves. What are your thoughts on rising stars for the remainder of 2022? Do you still think they have some room to shine?

Rob Hoffman (12:56):

Yeah. Look, on one side, I think the view that a lot of companies are going to get upgraded is still very much intact. I think some of the estimates through the end of next year, 230 plus billion dollars of companies being upgraded from below investment grade to investment grade. From that standpoint, we still expect a lot of rising star volume. I think what we underappreciated coming into this year is it was some of the duration risk that could impact those credits. They start from a lower yield basis. You think about the floating rates side as floating rates rise. The yield for the loan market could be a lot higher by the end of this year, depending on the path of interest rates. That puts pressure on some of these fixed rate rising stars in the high yield market where a lot of those upgrades are expected to come.

Rob Hoffman (13:43):

From a performance standpoint, I think it's going to be more case by case where some of these things are trading and look what happens to the path of interest rates. If we've basically seeing all of the rise in the five year or the 10 year and gross stays pretty good and some of these things start to get more popular, I think you could see a lot of volume potentially move into some of these names that are really high quality for the overall high yield market and are certainly much more compelling investments today from a yield and potential return basis than they were at the beginning of the year. Look, I think we have to be very cognizant of just what has happened over the course of the first quarter from a duration sensitivity standpoint and how these names have been impacted.

Kara O'Halloran (14:30):

Yeah. All right. Last call I want to talk about, because we haven't talked much about CLOs today and that's an asset class that we quite like. Coming into the year, we called for triple B CLOs, so collateralized loan obligations, to outperform double B corporates. That would be an investment grade rated asset outperforming a high yield asset. As of March 31st, triple B CLOs are flat on the year and double B corporates are down 5.4%, so we are spot on with that call. Do you think that can continue and what are you watching there?

Rob Hoffman (15:06):

Yeah. I do think it can continue, and as you highlight, it's a great opportunity where you can invest in a higher rated theoretically less default risk, safer security and outperform one that is lower rated with theoretically a higher return. That's exactly what's happened. I think a big part of that is the fact that CLOs, the liabilities are floating rate and they have clearly benefited from that hedge against higher interest rates. CLOs, historically, have offered really nice yield premiums over comparably rated corporate debt. That's what we've continued to see. I think they are vehicles where ultimately it's the fundamentals of the credit environment that should drive their returns.

Rob Hoffman (15:52):

As we've said many times, the fundamentals are still really good. I do think this is a dynamic that can continue. It's relatively harder for investors to access. You can't go buy an investible index that has CLOs in it, but we do think it's a part of the market, as you can sort of look outside some of the benchmark marks to find attractive areas within fixed income that can still generate really nice returns for investors. We do think this can definitely continue over the course of this year.

Kara O'Halloran (16:23):



Great. Well, I'm sure we'll be back towards the end of the year to see how we did on all of our calls. We'll bring the whole team in to do that. It'll be fun. I want to wrap up with kind of a broad question. I think sitting here, it's the first week of April, things feel very different than they did when we came into the year. I think a lot of these tail risks have happened. There's a lot of geopolitical tensions, inflation still with us, rates are rising. All of this. The fed has started hiking. Things just feel really different. A lot has happened in markets in the first quarter. Have your overall big picture views on credit changed substantially? If so, how? If not, why not?

Rob Hoffman (17:06):

I don't think so. My background as a credit investor has really been that fundamentals drive the credit environment. From that standpoint, nothing has changed and fundamentals are still really good. I do think that the interest rate picture, which is one historically you've been able to kind of ignore in credit markets, that has certainly taken center stage, and that's something that, for me, takes a little bit of an adjustment.

Rob Hoffman (17:36):

There are some really interesting dynamics going on that if you think about where the loan market is today, and as we noted from a current yield standpoint, high yield is out-yielding loans by the most it has since 2018, but if the fed raises rates by another 825 basis points move from where we are today through the end of the year, that completely changes that dynamic. It's something that is somewhat, I think, unprecedented in the history of comparing loans versus bonds. I think that some of those types of issues has changed our outlook on markets and changed how we're thinking about it. I think it gives us a lot of really interesting things to write about over the next coming months, because these are things that markets haven't seen in a long time in credit markets.

Kara O'Halloran (18:24):

Subtle plug for our content.

Rob Hoffman (18:28):

Yeah. From that standpoint, I think some of our outlook has changed and feel, to a certain extent, even more compelling about loans being able to outperform some of those types of issues, but from a fundamental standpoint, fundamentals are still really good and that historically has been a big driver of return and that's why I think it'll be really interesting to see the fundamentals take over. If the rate picture kind of pauses in terms of rising rates from the treasury side, do markets kind of normalize in their relationship before some other factor takes over and either drives markets along the continued path that they've seen in Q1, or do things turn around a little bit and look a little bit more normal from a less duration sensitivity for high yield and a market that tends to do well when fundamentals are good?

Kara O'Halloran (19:17):

All right, Rob. Well, thank you so much for joining. As you said, there's a lot to talk about and there's going to be a lot to talk about going forward, so we'll have you back on soon to update us on credit.

Rob Hoffman (19:26):

All right. Can't wait.