GSO
CAPITAL PARTNERS

CREDIT INSIGHTS

GSO April 2020 Market Commentary

Performance Overview

- Credit markets continued their impressive rebound despite a rising tide of downgrades and defaults
- Significant central bank market intervention relieved technical selling pressure that mounted in March
- Issuance remains subdued for loans, but increased for high yield driven largely by retail inflows globally

In April, credit markets continued their impressive rebound from the lows of March and posted strong returns globally. US loans gained 4.50% and European loans returned 6.66%, their highest monthly returns since 2009. US and European high yield also rebounded meaningfully with returns of 4.51% and 5.38%, respectively. All four asset classes, however, remain in the red year to date.[1]

Unprecedented intervention into capital markets by central banks in April significantly relieved technical selling pressure that had built up in March. At the same time, aggressive fiscal stimulus measures helped ease investors' mounting fundamental concerns stemming from a rising tide of ratings downgrades and increased defaults.

The flood of rating downgrades that hit the credit markets in April impacted both US and European loans. In the US, 228 loans out of a total of 1446 loans in the S&P/LSTA Leveraged Loan Index were downgraded in April, following the 144 in March.[2] In Europe, the trend has been similar. S&P, Moody's and Fitch have collectively downgraded approximately 17% of the number of rated European loans outstanding.[3] This has led to a meaningful increase in the amount of B-rated and CCC-rated loans outstanding globally.

Despite the highly effective intervention by the Fed and other central banks to normalize capital markets, some companies that entered the COVID-19 crisis with precarious balance sheets, particularly in the retail and energy sectors, were tipped into default in April.

Per JPMorgan, a record 19 US companies filed for bankruptcy or missed an interest payment in April. Including distressed exchanges, the US high yield default rate ended April at a 10-year high of 4.92%, up 142 basis points (bp) since March and up 354bp year over year. For loans, the par-weighted default rate ended April at a five-year-high of 2.97%.[4] In Europe, the April default rate ticked higher, but only modestly, to 0.6% for loans and 0.7% for high yield, compared to historical averages of 2.6% and 1.6%, respectively.[5]

Market Returns (as of April 30, 2020)

	MTD	QTD	YTD
S&P / LSTA U.S. Leveraged Loan Index	4.50%	4.50%	-9.13%
Bloomberg Barclays U.S. High Yield Index	4.51%	4.51%	-8.75%
Credit Suisse Western European Leveraged Loan Index	6.66%	6.66%	-8.30%
Credit Suisse Western European High Yield Index	5.38%	5.38%	-10.53%
S&P 500	12.82%	12.82%	-9.29%
Euro Stoxx 50	5.41%	5.41%	-21.22%

Market Outlook

April's rebound has been notable but credit spreads remain attractive, and we are now largely left with a market that we believe is priced at levels more in line with fundamental concerns rather than technical selling pressure. With corporate earnings season in full swing, we continue to update our bottom-up analyses, having already re-underwritten most names to revised downside scenarios that reflect the economic shutdown and a square-root-shaped recovery.

Absent a broad market sell-off, however, we would expect loans to remain relatively range bound in the near term. Modest, expected selling from US retail loan funds should continue to be absorbed by CLOs and opportunistic buyers. Loan prices globally are also likely to be supported by the dearth of new-issue supply. After the modest existing pipeline is syndicated, banks' appetite for underwriting new loans will likely remain subdued until secondary trading levels improve globally.

High yield inflows, on the other hand, are expected to remain robust due to the apparent investor preference for fixed coupons in any declining rate environment. This in turn should continue to drive new issuance toward high yield bonds throughout 2020. The Fed-induced rally in high-quality, high yield bonds compressed spreads from the recent wides in March. But we believe opportunities remain in secured bonds and in select single-B rated credits in the US and in Europe.

1 S&P/LSTA Leveraged Loan Index and Credit Suisse Western European Leveraged Loan Index for loans. Bloomberg Barclays US High Yield Index and Credit Suisse Western European High Yield Index for bonds. Data as of April 30, 2020.
2 LCD, S&P/LSTA Leveraged Loan Index, as of April 30, 2020.
3 Barclays Research, Bloomberg, April 27, 2020. Broad loan universe rep resented by the S&P European Leveraged Loan Index.
4 JPMorgan Default Monitor, as of April 30, 2020.
5 Credit Suisse Default Report, as of April 30, 2020. Represent trailing twelve-month par default rates of Credit Suisse Western European Leveraged Loan Index and Credit Suisse Western European High Yield Index.

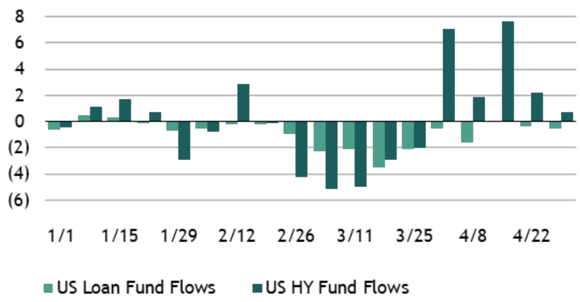
US Loan and High Yield Markets

US loans and high yield bonds rebounded strongly in April, gaining 4.50% and 4.51%, respectively, with the Fed action driving a rally largely concentrated in the higest-rated, high-quality segment of the market.

The Fed's commitment to purchase fallen angels and US-listed high yield ETFs came at time when fallen angels were increasing at record pace. This fueled a further divergence of quality between high yield and loans in April. Nearly half of the high yield universe is now rated BB, while roughly two thirds of loans have a lower B rating following ratings agency downgrades.

Average prices and spreads of high yield bonds closed the month at $90.59 and 744bp, well inside 2015/2016 lows/wides. Loan prices remained lower at $86.11 versus the 2016 bottom of $89.25 and loan spreads remained wider at 709bp versus 671bp in 2016.[6]

US Fund Flows



This divergence also manifested itself in retail fund flows during April as US loan investors exited the asset class in reaction to falling LIBOR while high yield retail funds logged record inflows. The reference rate's decline was significant: 1M LIBOR fixed at 33bp and 3M LIBOR fixed at 56bp to close the month, down 66bp and 89bp, respectively, from March month-end.[7]

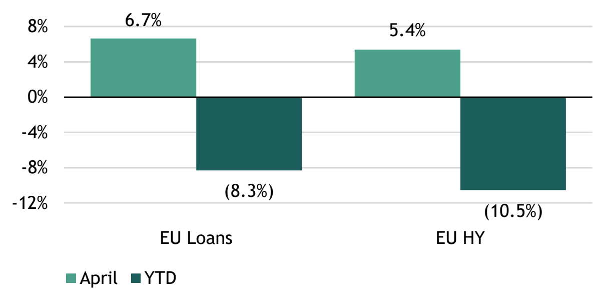
Retail funds investing in US loans posted an outflow total of -$3.2 billion in April, bringing the total to -$19.2 billion year-to-date. US high yield retail funds posted a net inflow total of $15.6 billion in April, turning flows positive year-to-date by $100 million.[8]

This surge of capital likely caused the high yield primary market to spring to life in April after the March pause, with $36 billion in deals coming to market in the busiest month since Sep 2017. Year-to-date total supply now sits at $106 billion, a significant increase relative to 2019, and the fastest pace in four years. Investor appetite was focused on high quality offerings, with 88% of volume rated BB, and secured issuance representing almost half of the volume ($17 billion, nearly a single-month record). In contrast, the US loan primary market issued just $8 billion of institutional loan volume in April after no issuance in March. Despite this, year-to-date issuance levels total $103 billion, slightly ahead of the $98 billion issued over the same period last year. For the month of May, the pace of loan supply is expected to continue to be slow.[9]

European Loan and High Yield Markets

European loans were the standout performer in the credit markets in April, returning 6.66% as investors sought out value in discounted credits. The weighting of relatively stable industries underlying European loans offset a raft of rating downgrades in April. As a result, year-to-date returns totaled -8.30% through the end of the month compared to -9.13% for US counterparts.

EU Returns



European high yield has partially rebounded following its worst quarter since the Global Financial Crisis. High yield total returns were 5.38% in April but the asset class is still down -10.53% year to date, which lags other risk assets.[10] This is in part because of the more limited support of the European Central Bank repurchase program compared to US Fed actions. In addition, European high yield has a higher exposure to cyclical industries as well as industries directly exposed to COVID-19 as compared to European loans. Senior secured assets also account for a materially larger percentage of the market.[11]

Average European loan and high yield prices are now back above 2012 lows after dipping below those lows in March. Loans ended the month at €88.92, versus €82.98 in 2012 and high yield ended the month at an average price of €87.25 versus a 2012 low of €87.05. On a spread basis, both high yield securities and loans rebounded from prior period wides; high yield ended the month at 781bp versus 983bp in 2012, while loans ended the month at 755bp versus 860bp in 2012.

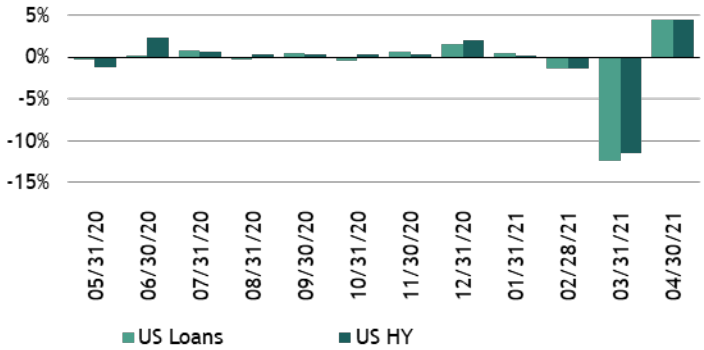
Although appetite for secondary loans and high yield bonds increased in April, there was plenty of dispersion by sector, with manufacturing, services, and transport all continuing to lag year to date. Single-B-rated loans, which account for the majority of European loan transactions, outperformed higher-rated counterparts in April. In high yield, performance for CCC/Single-B-rated bonds converged, while BB-rated bonds continued to outperform.[12]

One side effect of the recent market turmoil has been a significant decrease in primary issuance in Europe. After a very strong start to the year, the loan and high yield new-issue market was effectively closed for many weeks starting in March. The European high yield bond primary market reopened in April, with €1.67 billion of issuance, bringing high yield year-to-date volume to €21.1 billion. Europe's loan market experienced a more delayed reopening, with no institutional issuance in April and only €670 million of pro-rata volume issued during the month. That left the institutional volume total for the year at €22.9 billion through April.[13]

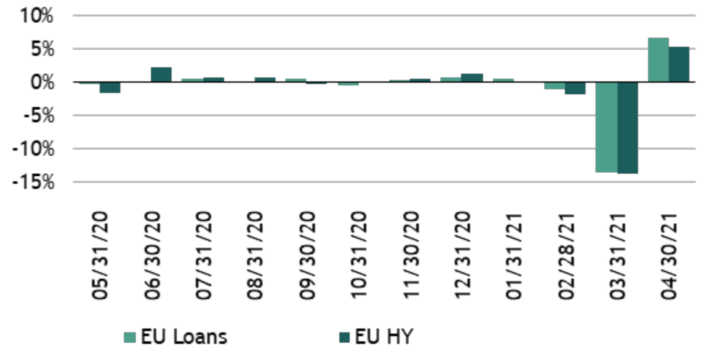
6 S&P/LSTA Leveraged Loan Index and Bloomberg Barclays US High Yield Index, as of April 30, 2020.
7 Bloomberg Finance LP, as of April 30, 2020.
8 JPMorgan, Lipper, as of April 30, 2020. Includes weekly reporting funds only.
9 Credit Suisse Credit Strategy HY and Loan April Recap, as of May 4, 2020 and May 5, 2020, respectively.
10 Credit Suisse Western European Leveraged Loan Index and Credit Suisse Western European High Yield Index, as of April 30, 2020.
11 Credit Suisse
12 LCD, Credit Suisse.
13 LCD, as of April 30, 2020.

Market Snapshot (as of April 30, 2020)[14]

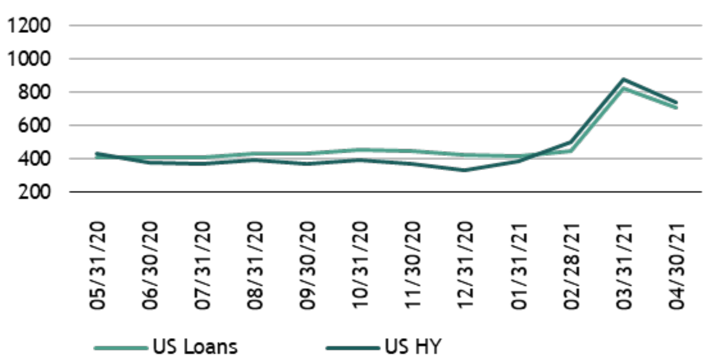
US Credit Monthly Returns



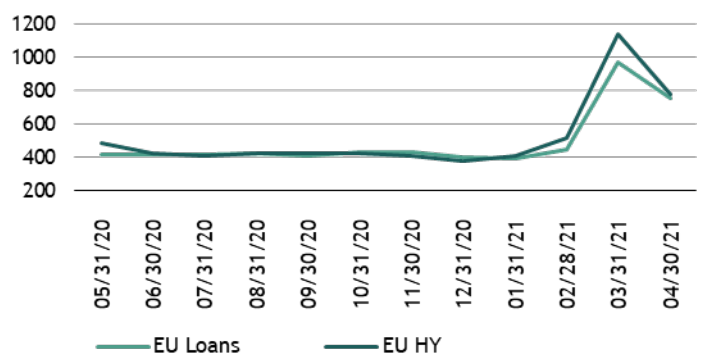
EU Credit Monthly Returns



US Credit Spreads (bp)



EU Credit Spreads (bp)



	Spread			Yield			Price		
	Level	ΔMTD	ΔYTD	Level	ΔMTD	ΔYTD	Level	ΔMTD	ΔYTD
U.S. Loans	709	-113	286	8.50%	-1.63%	2.37%	$86.11	$3.26	-$10.61
U.S. HY	744	-136	407	8.23%	-1.28%	2.25%	$90.59	$4.88	-$10.65
EU Loans	755	-213	349	4.42%	-0.39%	0.27%	€88.92	€5.29	-€ 9.39
EU HY	781	-355	401	7.38%	-3.92%	3.57%	€87.25	€4.31	-€ 12.19

	Level	MTD Return	YTD Return
Dow Jones Industrials	24346	11.22%	-14.07%
S&P 500	2912	12.82%	-9.29%
Russell 2000	1311	13.66%	-21.45%
Euro Stoxx 50	2928	5.41%	-21.22%
DAX	10862	9.32%	-18.02%
MSCI Emerging Markets	925	11.35%	-16.55%
MSCI World	2053	9.93%	-12.25%

	Level	ΔMTD	ΔYTD
1-Month Libor	0.33%	-66bp	-143bp
3-Month Libor	0.56%	-89bp	-135bp
10-Year Treasury	0.64%	-6bp	-128bp
3-Month Euribor	-0.27%	9bp	11bp
6-Month Euribor	-0.17%	11bp	15bp
10-Year German Bund	-0.59%	-12bp	-40bp

[14] S&P/LSTA Leveraged Loan Index (represented by spread to maturity and yield to maturity), Bloomberg Barclays US High Yield Index (represented by OAS and yield to maturity), Credit Suisse Western European Leveraged Loan Index (represented by 3-year discount margin and current yield), and Credit Suisse Western European High Yield Index (represented by spread to worst and yield to worst), as of April 30, 2020. Equities, LIBOR, Euribor, US Treasury, and German bund sourced from JP Morgan daily updates.

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