Blackstone Credit

CREDIT INSIGHTS

December 2020 Market Commentary

Performance Overview

- US and European loans and high yield bonds ended 2020 with positive returns
- Defaults remain manageable globally
- US and European CLO WARFs and equity net asset values improved

The global credit markets continued their upward momentum in December, ending the year with positive returns across the board. US loans and high yield bonds returned 3.1% and 7.1%, respectively, in 2020, and European loan and high yield bond full year returns totaled 2.4% and 1.9%. Higher risk assets generally continued to lead the rally.

A general risk-on sentiment continued in December as both the US and Europe initiated COVID-19 vaccination programs. At the same time, an additional US COVID-19 stimulus program was agreed, and the United Kingdom finalized the Brexit trade agreement with the European Union concluding a long period of political uncertainty. US and European equity markets continued to trade higher in December, with US stocks ending the month at record highs, in spite of a continued increase in COVID-19 cases globally and the emergence of a new, more contagious strain of the virus in both the UK and in the US.

US default activity picked up in December after a pause in November bringing 2020 default volumes to $130 billion in total, second only to the $205 billion recorded in 2009. In Europe, default volumes likewise picked up from more benign levels in November with volumes for full year 2020 totaling €23 billion across loans and high yield.[1]

Global CLO weighted average rating factors ("WARFs") improved in December and could continue to improve with the implementation by Moody's of certain rating methodology changes for CLOs, as referenced in our prior monthly market update. The continued recovery in US and European loan prices in December contributed to further improvement in global CLO equity net asset values.[2]

Market Returns (as of December 31, 2020)

	December	4Q20	2020
S&P / LSTA U.S. Leveraged Loan Index	1.35%	3.81%	3.12%
Bloomberg Barclays U.S. High Yield Index	1.88%	6.45%	7.11%
Credit Suisse Western European Leveraged Loan Index	0.61%	3.54%	2.38%
Credit Suisse Western European High Yield Index	0.94%	5.36%	1.95%
S&P 500	3.84%	12.15%	18.39%
Euro Stoxx 50	2.33%	12.03%	-2.07%

Market Outlook

With a second US COVID-19 relief package now approved and a Brexit trade deal finalized, we maintain our positive outlook for 2021. While COVID-19 cases continue to rise globally amid the emergence of new, more virulent strains and a slower than anticipated vaccine rollout, we believe these to be short term risks to the ongoing economic recovery. The markets will likely continue to look through any near-term weakness and instead remain focused on the longer-term relief efforts on the horizon.

While significant uncertainty remains related to COVID-19, the U.S. political landscape has come into focus, at least from a policy perspective, following runoff elections in Georgia that left Democrats with control of both houses of Congress in addition to the Presidency. We expect policy makers to initially focus on COVID-19 stimulus before shifting to healthcare, energy, infrastructure, tax policy, and potentially Big Tech regulation. Based on Biden's cabinet selections and public statements thus far, as well as the political realities of a 50-50 split in the Senate, we expect a policy agenda which helps mitigate the risk of a sharp uptick in defaults in certain sectors such as healthcare and energy.

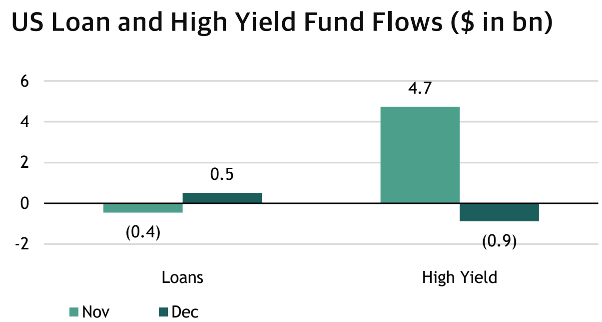
The approval by lawmakers in the United Kingdom and European Union of the "zero tariff-zero quota" Brexit trade agreement, which went into effect on New Year's Day, is seen as beneficial for companies and credit issuers broadly going forward as exporters on both sides will no longer be subjected to higher tariffs and costs.

As outlined in Blackstone Credit's 2021 Global Credit Market Outlook, below investment grade global credit markets are expected to generate mid-single-digit full year returns in 2021 primarily driven by interest coupons and further supported by modest price appreciation, consistent with the views of most strategists. Market participants anticipate supportive technical and fundamental backdrops with spreads expected to tighten and defaults expected to fall.

[1] JP Morgan Default Monitor, January 4, 2020. Credit Suisse Default Report, January 5, 2021.
[2] Barclays CLO Monthly, January 5, 2020.

US Loan and High Yield Markets

The recovery in US loans and high yield bonds continued at a slower pace in December, with returns of 1.3% and 1.9% for the month, respectively, with CCC-rated assets continuing to drive returns. CCC-rated loans returned 2.3%, outperforming BB and B-rated loans, which returned 1.1% and 1.4%, respectively. Likewise, CCC-rated bonds returned 3.2% outperforming their higher quality counterparts, of which BB-rated bonds returned 1.6% and B-rated bonds returned 1.7%. The rally in risk assets was primarily driven by the passing of a second US COVID-19 relief bill and the roll-out of multiple vaccines.[3]



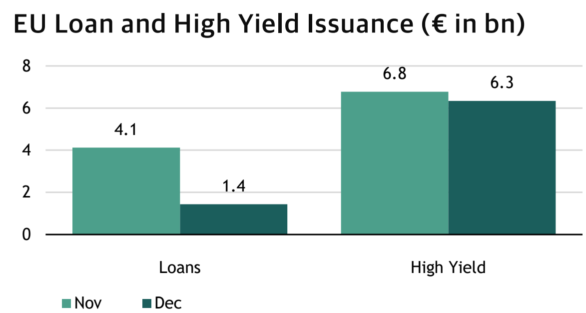
Demand for US loans increased month over month as retail fund flows turned positive and CLO creation increased, and we expect relatively stable demand for loans from retail funds in 2021. After 26 consecutive months of net outflows totaling $86 billion of withdrawn capital, flows for US loan mutual and exchange traded funds turned positive in December with a total of $0.5 billion in net inflows, likely from investors seeking to reduce duration. Meanwhile, investors withdrew $1.9 billion from US high yield funds in December; however, we expect stable demand in the near term as investors continue to be attracted to fixed rate coupons in the current low interest rate environment.[4]

US loan supply also increased month-over-month with total issuance of $35.5 billion, up from $21.4 billion in November, representing a 66% increase and bringing full year issuance to $422 billion, an 8% increase year-over-year. For high yield bonds, gross issuance decreased for a fourth consecutive month to $30.1 billion in December, which was down 7% month-over-month. Full year high yield bond gross issuance totaled $450 billion, the highest annual issuance total on record and 57% higher than the 2019 total.[5]

The fundamental backdrop for US loans and high yield bonds continues to improve as issuers have generally reported improved earnings and defaults have fallen to relatively low levels. Leverage and interest coverage have improved by 2.7x and 1.2x, respectively, for public high yield issuers quarter-over-quarter alongside strong revenue (+21%) and EBITDA (+51%) growth.[6] Although default volume ticked up in December following a November without any defaults, activity was muted totaling just $3.9 billion. The last twelve-month ("LTM") par-weighted default rates for loans and high yield bonds were slightly up month-over-month ending the year at 3.95% and 6.17%, respectively. We expect these rates to decrease in 2021 and 2022 as the continued roll-out of the COVID-19 vaccine allows for a gradual return to normal.[7]

European Loan and High Yield Markets

The rally in European loans and high yield bonds also continued at a slower pace in December with returns totaling 0.6% and 0.9%, respectively. Similar to the US, the European high yield market experienced a significant rally in lower rated assets. CCC/Split-rated high yield bonds returned 2.2%, outperforming their higher quality counterparts. BB-rated bonds returned 0.7% and B-rated bonds returned 1.0% in December. For European loans, B-rated loans were the highest returning quality cohort.[8]



European loan issuance decreased in December to €1.4 billion, from €4.1 billion the previous month. Annual European loan issuance ended 2020 down 20% year-over-year, although there was an improving inventory of primary issuance in the pipeline as investor demand continues to rebound overall, driven largely by an uptick in European CLO issuance.

European high yield bond primary activity, on the other hand, finished the year strongly with monthly issuance of €6.3 billion, representing the largest December volume on record. Demand from retail investors was muted in December with total net outflows of €51 million following three consecutive weeks of net outflows. Year-to-date net fund flows from high yield funds totaled -$2.2 billion.[9]

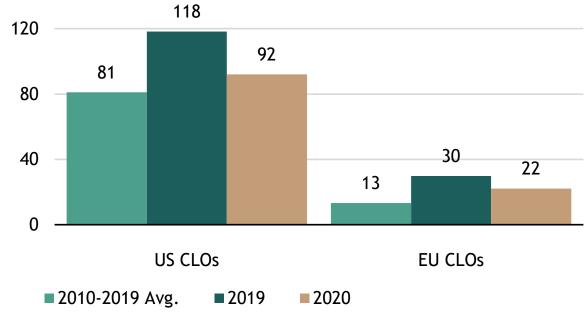
The European loan LTM par-weighted default rate decreased to 1.2% in December, after peaking in November. The European high yield LTM par-weighted default rate increased to 3.3% this month but remains notably lower than the US high yield default rate.[10]

[3] S&P/LSTA Leveraged Loan Index, Bloomberg Barclays US High Yield Index, as of December 31, 2020.
[4] LCD, as of December 31, 2020. JP Morgan, Lipper, as of December 30, 2020. Includes all weekly and monthly reporting funds if reported by December 30, 2020.
[5] JP Morgan Leveraged Loan and High Yield Bond Market Monitor, January 4, 2021.
[6] JP Morgan 3Q20 high yield credit fundamentals.
[7] JP Morgan Default Monitor, January 4, 2021.
[8] Credit Suisse European Leveraged Loan and High Yield Bonds Indices, as of December 31, 2020.
[9] JP Morgan Lipper, as of December 31, 2020.
[10] Credit Suisse Default Monitor, January 5, 2021.

US and European CLO Markets

Average CLO WARFs and equity net asset values improved month over month for both US and European CLOs. US CLOs experienced an improvement in WARF of 31bp on average and 14bp for European CLOs in December. As Moody's has published its final updated methodology for the calculation of WARF in CLOs, this quality metric may continue to improve over time. Additionally, the continued recovery in global loan prices led to improvements in net asset values for US and European CLOs of 10.9% and 2.2%, respectively.[11]

US and European CLO Issuance ($/€ in bn)



In December, new CLO creation increased in the US with 23 deals pricing totaling $9.8 billion, representing a 33% increase month-over-month and bringing total annual issuance to $92 billion, a 22% decrease from 2019. In Europe, CLO issuance was flat month-over-month with 5 deals pricing totaling €1.7 billion, including Marino Park, which Blackstone Credit priced with the tightest post-COVID-19 weighted average cost of capital at the time of issuance. This brings 2020 total issuance to €22 billion, a 26% decrease year-over-year. Despite the decline in issuance, 2020's total remains higher than the prior 10-year average, although this does include a period of depressed volumes from 2010-2012 as the market recovered from the Global Financial Crisis.

The elevated levels of refinancing and repricing activity expected in the CLO primary market in 2021 started to materialize for US CLOs in December with refinancing activity totaling $2.5 billion, the largest monthly total since February.[12] Primary spreads decreased by 0-35bp on average in the US and by 0-25bp on average in Europe across tranches.

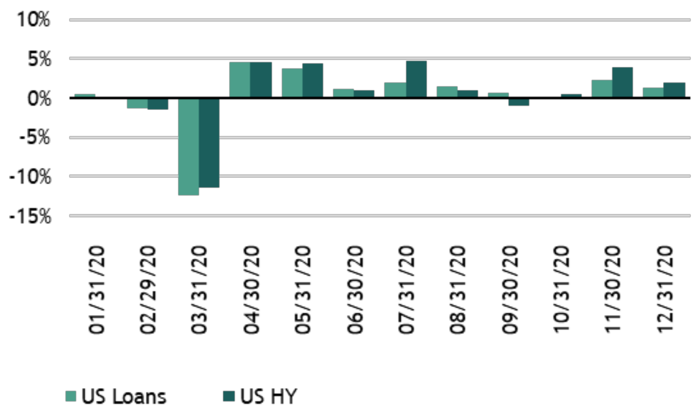
Of note, the number of managers able to issue a CLO in 2020 decreased year-over-year in both regions. In the US, 94 managers issued at least one CLO in 2020, which included five first-time managers, the lowest number since 2016. This compares to 2019's record of 108 managers. In addition, 30 managers that issued at least one CLO in 2019 have not returned in 2020, or 28%. Only 43 managers issued a CLO in Europe, compared to 50 in 2019. Key risks for 2021 include possible consequences of this issuance trend, including potential manager consolidation or a surge in issuance from dormant managers due to pent-up investor demand.

US and European CLO secondary spreads also tightened across tranches in December, with most of the tightening occurring in the lower rated tranches. US CLO tranches rated BB tightened by 75bp, while tranches rated AAA-BBB tightened by 15-40bp. In Europe, CLO tranches rated BBB tightened by 27bp and BB tightened by 30bp. Meanwhile European CLO tranches rated AAA-A tightened by 7-10bp.[13] Secondary trading volumes remained healthy in December, with BWIC volumes of $3.3 billion in the US, up from $3.0 billion in November, This brings 2020 volumes to $51 billion, up 41% year-over-year. In Europe, BWIC volumes totaled €674 million in December, from €808 million in November, bringing total volume in 2020 to €13 billion, 91% higher than the previous year.[14]

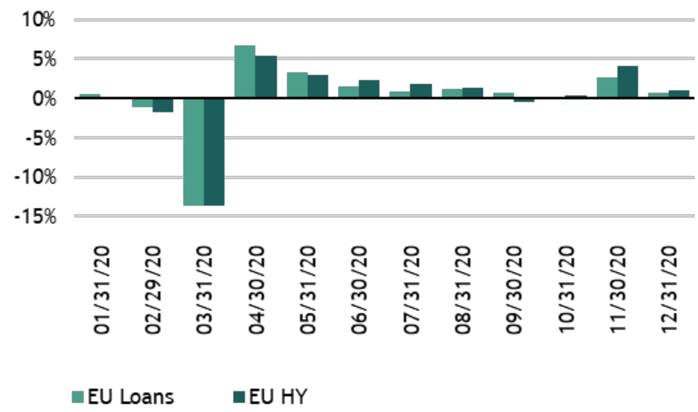
[11] Barclays CLO Monthly, January 5, 2020.
[12] LCD, as of December 31, 2020.
[13] BofA Global Research for US CLO spreads, as of December 31, 2020. Citi for European CLO spreads, as of December 31, 2020.
[14] Citi Velocity, as of December 31, 2020.

Market Snapshot (as of December 31, 2020)[15]

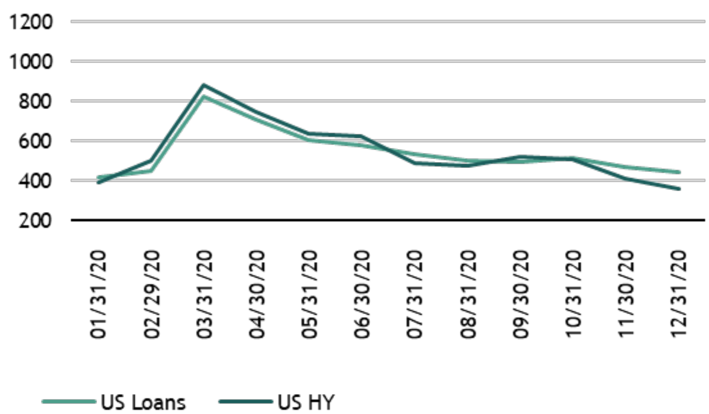
US Credit Monthly Returns



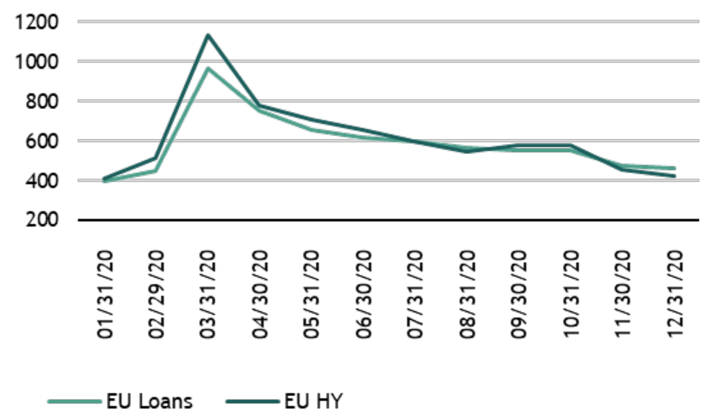
EU Credit Monthly Returns



US Credit Spreads (bp)



EU Credit Spreads (bp)



	Spread			Yield			Price		
	Level	ΔMTD	ΔYTD	Level	ΔMTD	ΔYTD	Level	ΔMTD	ΔYTD
U.S. Loans	443	-24	20	4.71%	-0.24%	-1.43%	$96.19	$1.08	-$0.53
U.S. HY	360	-52	24	4.97%	-0.37%	-1.02%	$104.96	$1.63	$3.72
EU Loans	459	-12	53	3.88%	-0.01%	-0.27%	€97.35	€0.35	-€ 0.96
EU HY	424	-33	43	3.79%	-0.33%	-0.63%	€98.58	€ 0.98	-€ 0.85

	Level	MTD Return	2020 Return
Dow Jones Industrials	30606	3.41%	9.72%
S&P 500	3756	3.84%	18.40%
Russell 2000	1975	6.59%	19.96%
Euro Stoxx 50	3572	2.33%	-2.07%
DAX	13719	3.22%	3.55%
MSCI Emerging Markets	1291	7.40%	18.69%
MSCI World	2690	4.27%	16.50%

	Level	ΔMTD	ΔYTD
1-Month Libor	0.14%	-1 bp	-162 bp
3-Month Libor	0.24%	1 bp	-167 bp
10-Year Treasury	0.91%	7 bp	-100 bp
3-Month Euribor	-0.54%	-2 bp	-16 bp
6-Month Euribor	-0.52%	-2 bp	-20 bp
10-Year German Bund	-0.57%	0 bp	-38 bp

15 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 December 31, 2020. Equities, LIBOR, Euribor, US Treasury, and German bund sourced from JP Morgan daily updates.

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