Blackstone Credit

CREDIT INSIGHTS

February 2021 Market Commentary

Performance Overview

- US and European loans and high yield bonds posted positive returns in February, whereas US investment grade bond returns were negative
- The increase in interest rates is leading retail investors into US loans
- Default and distressed activity in the global credit markets continues to improve

Global below-investment grade corporate credit continued to perform well in February, with loans generating particularly strong returns amid ongoing retail inflows, strong CLO creation, and limited net new issue supply. US loans and high yield bonds returned 0.6% and 0.4%, respectively, in February, bringing year-to-date returns to 1.8% and 0.7%. European loans and high yield bonds returned 0.8% and 0.6%, respectively, bringing year-to-date returns to 1.7% and 1.1%. In contrast, US investment grade corporate bonds returned -1.7% in February and -3.0% year-to-date.[1]

Interest rates moved significantly higher in February, including a one-day spike of 14bp in 10-year Treasury yields to 1.52% on February 25, which led to weakness in the equity and fixed-rate credit markets. Higher rates are being driven by generous stimulus and expectations for a sharp increase in consumer spending as vaccinations reach critical mass. The strength of the economic rebound can be seen in company earnings reports, where revenues have beaten analyst estimates at a record pace for the last few quarters and revenue growth for S&P 500 companies has turned positive year-over-year in 4Q20.[2] Higher rates led to retail cash flowing into US loan funds; $4.2 billion of total capital inflows was recorded in February, and out of high yield funds which recorded $2.7 billion of outflows during the month. Surprisingly, despite negative year-to-date returns in investment grade bonds, retail inflows totaled $21.6 billion in February, bringing the year-to-date total to $76.9 billion.[3]

From an issuance standpoint, the rates volatility has not impacted corporate access to credit. While the potential for a higher, steeper, and more volatile yield curve could increase corporate borrowing costs, many issuers have already taken advantage of historically low rates to extend their maturity profiles. For this reason, the impact of higher long-term rates to corporate cash flows could be years away.[4]

Default and distressed activity in the credit markets has remained low since the mid-2020 volatility spike, and we continue to see a meaningful reduction in our watchlist names quarter over quarter. In February, a modest $1.6 billion of US loans and high yield bonds defaulted, resulting in the lowest rolling four-month default volume since September 2018.[5] The positive US loan issuer upgrade trend that started towards the end of 2020 continued into February with 29 upgrades compared to 22 downgrades during the month. Additionally, after a record year of fallen angels in 2020, we expect nearly $300 billion of US high yield debt to be upgraded to investment grade by 2022, with $38 billion occurring already this year. In Europe, the number of issuers downgraded has returned to low levels last seen before the COVID-19 pandemic. The recent slowing in the pace of downgrades has led to optimism that defaults will remain below expectations this year, despite continued elevated levels of CCC-rated borrowers.[6]

Market Stats (as of February 28, 2021)

	February	QTD	YTD
S&P / LSTA U.S. Leveraged Loan Index	0.59%	1.78%	1.78%
Bloomberg Barclays U.S. High Yield Index	0.37%	0.70%	0.70%
Credit Suisse Western European Leveraged Loan Index	0.81%	1.73%	1.73%
Credit Suisse Western European High Yield Index	0.60%	1.12%	1.12%
S&P 500	2.76%	1.72%	1.72%
Euro Stoxx 50	4.57%	2.65%	2.65%

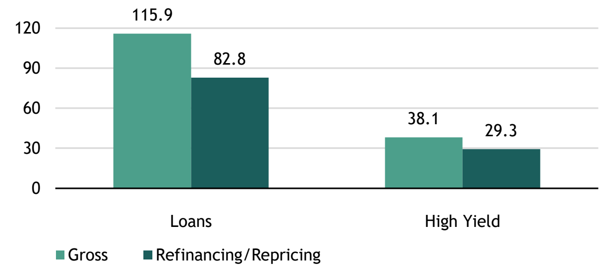
	Spread			Yield			Price		
	Level	ΔMTD	ΔYTD	Level	ΔMTD	ΔYTD	Level	ΔMTD	ΔYTD
U.S. Loans	407	-14	-36	4.33%	-0.15%	-0.37%	$97.79	$0.42	$1.59
U.S. HY	326	-36	-34	4.93%	-0.03%	-0.03%	$104.55	-$0.14	-$0.41
EU Loans	417	-22	-43	3.82%	-0.03%	-0.05%	€98.61	€ 0.64	€ 1.26
EU HY	395	-25	-29	3.59%	-0.11%	-0.20%	€99.42	€ 0.46	€ 0.84

[1] US loans represented by the S&P/LSTA Leveraged Loan Index, US high yield represented by the Bloomberg Barclays High Yield Bond Index, EU loans and high yield represented by the Credit Suisse European Leveraged Loan and High Yield Bond Indices, respectively, as of February 28, 2021.
[2] Credit Suisse Credit Strategy Daily, Earnings Trends, February 26, 2021.
[3] JP Morgan, Lipper, as of February 28, 2021; includes weekly and monthly reporting funds if reported by March 10, 2021.
[4] Credit Suisse Credit Strategy Daily, Rates Tantrum, February 26, 2021.
[5] JP Morgan Default Report, March 1, 2021.
[6] LCD, as of February 28, 2021.

US Loan and High Yield Markets

US loans performed well in February driven by high levels of demand from $4.2 billion of retail inflows and $15.0 billion of CLO creation. This demand drove loan prices higher and, with 35% of loans trading above par at February-end, elevated levels of repricing and refinancing activity continued. Loan repricing and refinancing activity totaled $82.8 billion, or 71.5% of gross issuance, in February, bringing the year-to-date total to $162.5 billion.[7] This trend has driven new issue spreads lower with primary spreads now below secondary for both single-B and BB loans.[8] Single-B and BB primary loan spreads stand at 361bp and 256bp, respectively, compared to secondary spreads of 421bp and 284bp.

US Loan and HY February Issuance ($ in bn)



US high yield bonds rallied in the first half of February but trimmed some of those gains towards the end of the month as Treasury yields surged and spreads could no longer fully absorb the movement. With refinancing activity continuing to dominate the high yield bond market totaling 77% of gross issuance, spreads are now 3bp lower than where they began the year, but prices also declined $0.14 on average amid the rate move.

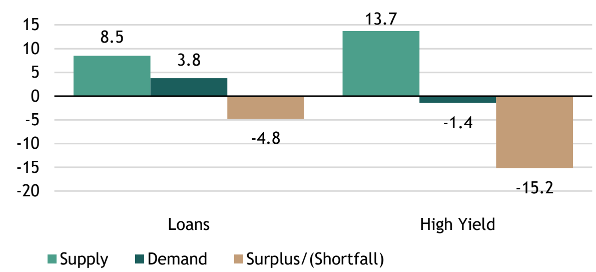
Throughout February, we continued to increase exposure in our US portfolios to certain sectors impacted by the COVID-19 pandemic such as airlines, theaters, entertainment, and travel. Select names in these sectors provide meaningful convexity to our portfolios given our ability to purchase at discounted prices and our favorable outlook for these sectors as economies begin to reopen globally.

Despite continued spread tightening, we currently favor relative value in loans compared to high yield bonds due to their shorter duration, expectations for continued retail inflows amid a rising interest rate environment. We also expect more stable demand for loans due to elevated levels of CLO issuance.[9]

European Loan and High Yield Markets

European loan market technicals remained firm in February, as primary issuance decreased while CLO creation increased month-over-month driving loan prices back to pre-COVID-19 levels. Despite elevated loan prices, refinancing activity decreased and totaled just €0.5 billion, or 5% of gross issuance, in February.[10]

EU Loan and HY Surplus/Shortfall (€ in bn)



European high yield bonds experienced considerable weakness late in the month as rate movements weighed on total returns. Unlike January where the selloff was driven by COVID-19 risk, duration risk bore the brunt of the high yield bond weakness in February. European bonds also suffered from a weaker supply/demand technical. Demand for European high yield remains subdued with €1.4 billion of net outflows from retail funds during the month.[11] Supply increased month-over-month to €13.7 billion – the highest level of primary activity since October 2017. With nearly half of the European bond market trading above call price, refinancing activity remained high in Febriary totaling €10.1 billion, or 73% of gross issuance.[12]

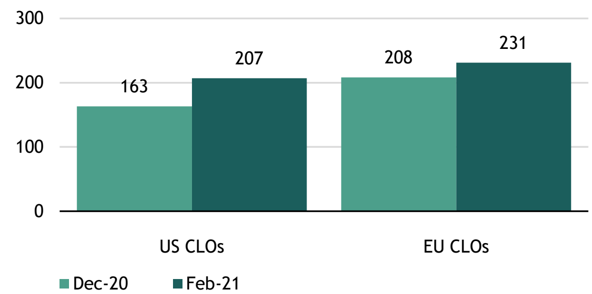
Similar to our US portfolios, we continued to increase exposure in our European portfolios to certain sectors impacted by the COVID-19 pandemic in February. Our favorable outlook for sectors such as travel and leisure received an additional boost when Prime Minister Boris Johnson unveiled a roadmap to UK reopening. The February announcement resulted in a wave of bookings through cruise line operators and travel agents and bouyed performance of issuers in the sector. Cinemas were also top performers following the news.

[7] JP Morgan High Yield Bond and Leveraged Loan Market Monitor, March 1, 2021.
[8] Credit Suisse Credit Strategy Daily, Loan/HY Rel Val, February 24, 2021.
[9] Goldman Sachs Duration Trumps Repricing, February 28, 2021.
[10] LCD, as of February 28, 2021.
[11] JP Morgan, Lipper, as of February 28, 2021.
[12] LCD, as of February 28, 2021.

US and European CLO Markets

Refinancing activity continued at elevated levels in the US and European collateralized loan obligation ("CLO") markets in February with volumes continuing to surge from subdued levels post-pandemic. In the US, 27 CLOs totaling $11.7 billion refinanced, and 13 European CLOs totaling €4.1 billion refinanced, representing 44% and 52% of total issuance in each region, respectively.

US and EU CLO Equity Arbitrage (bp)



We expect this trend to continue throughout the year given the combination of favorable CLO liability pricing, and the increased amount of CLOs coming out of their 1-year non-call periods. Across our own CLO portfolios, we had a busy month pricing the reset of Thayer Park CLO, a 2017 vintage $500 million USD CLO, Dartry Park CLO, a 2015 vintage €400 million European CLO, and Clarinda Park, a 2016 vintage €400 million European CLO. As a result of this activity, On average the weighted average cost of capital was reduced by 14bp and the average life was extended by 4 years.

The chart above illustrates how CLO equity arbitrage in the US and Europe has increased meaningfully year-over-year. This is due to falling CLO debt costs, which has driven arbitrage levels to heights not reached since 2016.[13] Managers continue to mobilize around this trend as evidenced by the 162 US CLO warehouses open in February, up from 128 in January. The growing US CLO pipeline is being met by heavy demand for AAA-rated tranches from US domestic banks. The European CLO new issue pipeline remains light in comparison, but we expect new issuance activity to accelerate in the second quarter given there are currently 46 warehouses open, up from approximately 35 in December.[14]

In both the US and Europe, we expect elevated levels of CLO issuance to further increase the demand for loans as the share of the loan market held by CLOs continues to grow. This is happening alongside the ongoing economic recovery and notably global CLO fundamentals were mostly improved month-over-month, as CCC exposure declined further and weighted average rating factors ("WARFs") rebounded. Exposure to CCC-rated loans decreased by 0.2% to 7.2% for US CLOs and by 0.1% to 5.7% for European CLOs. Average US and European CLO WARFs decreased by 31 points and 18 points, respectively, ending the month with average WARF scores of 3061 in the US and 3212 in Europe.[15]

Market Outlook

We remain cautiously optimistic as the market focuses on a return to more normalized levels of in-person activities and spending. We view the distribution of the Johnson & Johnson one-shot vaccine, and more effective vaccine distribution generally, as an offset to the risks of lifting mask mandates and new virus strains.

US GDP growth is estimated to be 7% year-over-year in 2021, the fastest rate since 1984.[16] Accordingly, defaults are expected to remain low, and JP Morgan recently lowered their US loan and high yield bond default forecasts for 2021 to 2% apiece from 3.5% previously, citing a stronger economic recovery, a sizeable fiscal stimulus package, declining COVID-19 cases, and continued vaccine dissemination.[17] We will be watching for any potential unexpected fallout from this explosive growth given the US and global economies have not run this hot in many years.

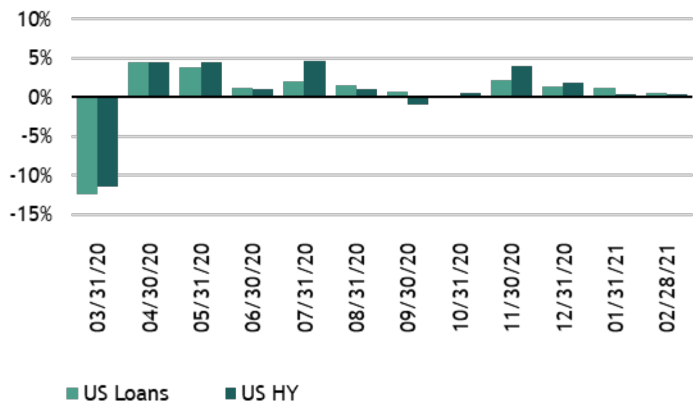
With record liquidity and fiscal spending, we expect further steepening of the yield curve. The expectation for robust growth has, in turn, driven expectations for short-term reflation and a concurrent rise in rates on the long end of the curve. This has been a global trend and, as rates rise, debt instruments with floating rates should provide an attractive option for many investors relative to fixed-rate securities whose prices will tend to decline to reflect the higher interest rates relative to their fixed coupon streams. Floating rate income producing investments like loans are a way to minimize risks associated with rising rates and a steepening yield curve while maintaining a competitive yield.

Lastly, until labor markets have a clear line-of-sight towards historically normal levels, the Federal Reserve is likely to continue to provide accommodative monetary policy. We expect the repricing wave to continue in both the US loan and high yield bond markets albeit potentially at a slower pace, with loan repricing and refinancing activity forecasted to reach $200 billion by the end of 1Q.

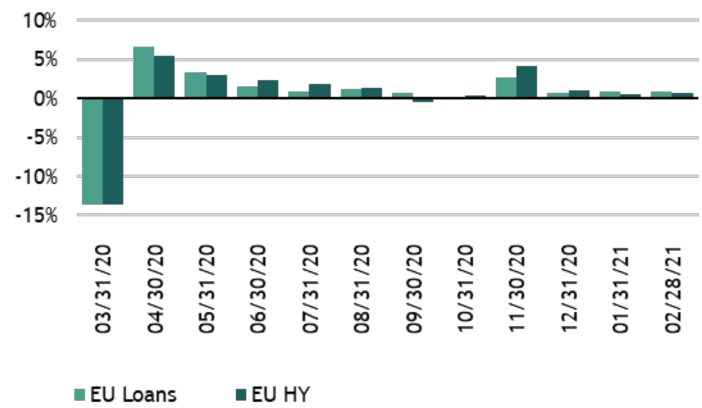
[13] Barclays US Credit Alpha, February 26, 2021; Barclays CLO & Leveraged Loan Monthly Update: February 2021, March 2, 2021.
[14] LevFin Insights CLO Insight, March 4, 2021.
[15] Barclays CLO & Leveraged Loan Monthly Update: February 2021, March 2, 2021.
[16] Goldman Sachs Global Investment Research, as of March 13, 2021.
[17] JP Morgan Default Monitor, March 1, 2021.

Market Snapshot (as of February 28, 2021)[18]

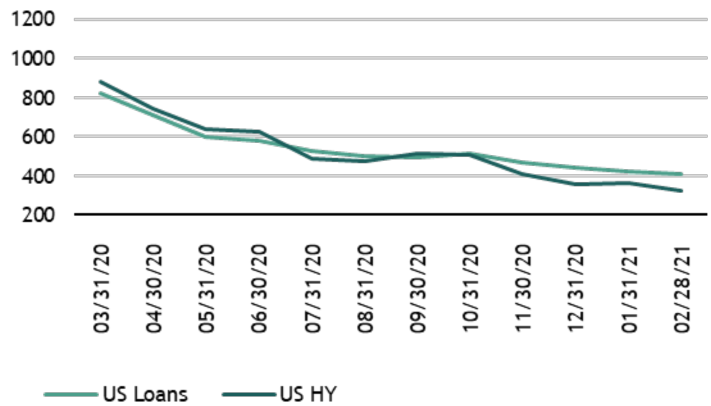
US Credit Monthly Returns



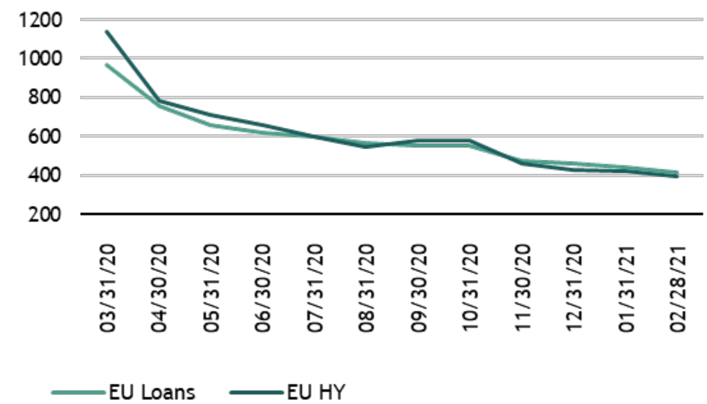
EU Credit Monthly Returns



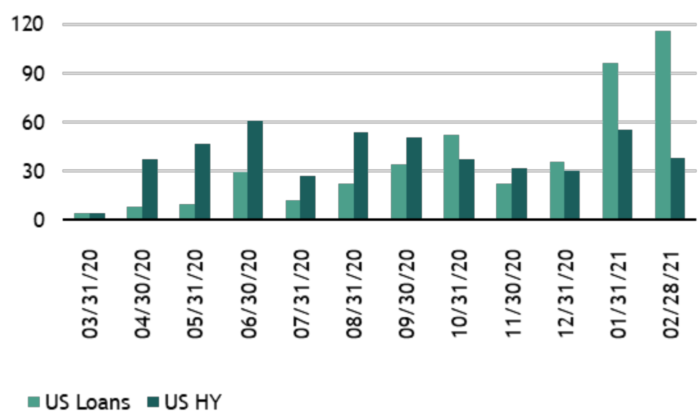
US Credit Spreads (bp)



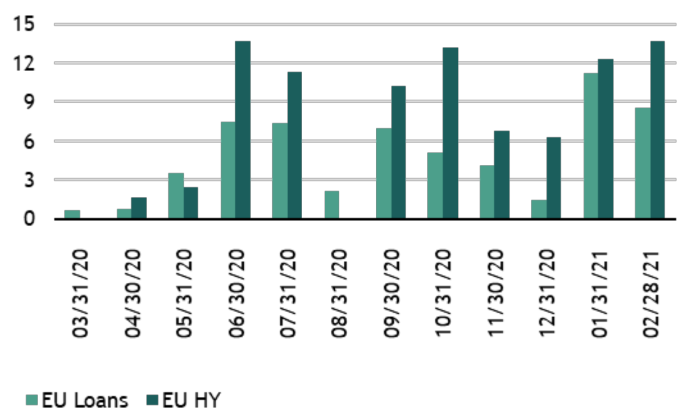
EU Credit Spreads (bp)



US Credit Issuance ($ in billions)



EU Credit Issuance (€ in billions)



[18] 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 February 28, 2021.

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