Blackstone Credit

CREDIT INSIGHTS

January 2021 Market Commentary

Performance Overview

Global below-investment grade corporate credit returns started 2021 on a strong note as the rally in risk assets continued. US loans and high yield bonds returned 1.2% and 0.3%, respectively, in January, and European loans and high yield bonds returned 0.9% and 0.5%, respectively. In contrast, US investment grade corporate bonds returned -1.3% in January as a steepening of the yield curve pressured trading levels.[1]

- US and European loans and high yield bonds posted positive returns in January, whereas US investment grade bond returns were negative
- Primary issuance levels were elevated with refinancing and repricing activity dominating the primary market
- There were no defaults in the US or European below-investment grade credit markets

The continuation of a risk-on sentiment in credit markets occurred alongside an anomalous, Reddit-fueled short-covering rally (and subsequent reversal) focused on a handful of US stocks. Although our proprietary Systematic models suggest that default probabilities for certain high yield issuers that were targeted were little changed in January as the benefit of higher enterprise values were largely offset by higher enterprise value volatility, we note that a few stressed borrowers in COVID-19 impacted sectors were able to capitalize during the frenzy by offering new equity to repay debt. More broadly, other stressed companies have continued to take advantage of low rates and tight spreads to issue debt and extend their liquidity runway.

Primary issuance levels were elevated in January across the global credit markets as issuers took advantage of strong capital market conditions, low spreads, and expiring collateralized loan obligation ("CLO") call protections to reprice and refinance debt at an accelerated pace. We expect this trend to continue in the foreseeable future.

There were no defaults in the US below-investment grade credit market in January. As a result, the US last twelve-month ("LTM") par-weighted default rates for loans and high yield bonds decreased by 16bp and 13bp, respectively, to 3.8% and 6.0%. These compare to long term averages of 3.0% for loans and 3.1% for high yield bonds.[2] There were also no defaults in Europe in January, and the loan and high yield bond LTM par-weighted default rates remain low at 1.1% and 3.3%, respectively.[3]

Market Stats (as of January 31, 2021)

	January	QTD	YTD
S&P / LSTA U.S. Leveraged Loan Index	1.19%	1.19%	1.19%
Bloomberg Barclays U.S. High Yield Index	0.33%	0.33%	0.33%
Credit Suisse Western European Leveraged Loan Index	0.91%	0.91%	0.91%
Credit Suisse Western European High Yield Index	0.52%	0.52%	0.52%
S&P 500	-1.01%	-1.01%	-1.01%
Euro Stoxx 50	-1.84%	-1.84%	-1.84%

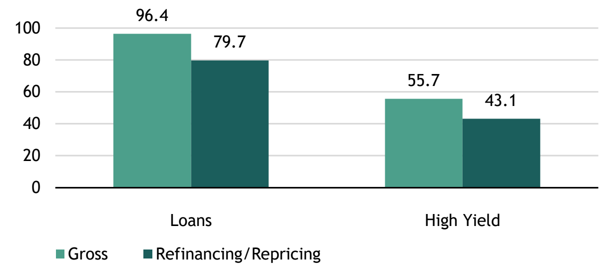
	Spread			Yield			Price		
	Level	ΔMTD	ΔYTD	Level	ΔMTD	ΔYTD	Level	ΔMTD	ΔYTD
U.S. Loans	421	-22	-22	4.48%	-0.22%	-0.22%	$97.37	$1.17	$1.17
U.S. HY	362	2	2	4.97%	0.00%	0.00%	$104.69	-$0.27	-$0.27
EU Loans	438	-21	-21	3.85%	-0.02%	-0.02%	€97.98	€0.62	€ 0.62
EU HY	420	-4	-4	3.70%	-0.08%	-0.08%	€98.96	€ 0.38	€ 0.38

[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 January 31, 2021.
[2] JP Morgan Default Monitor, February 1, 2021.
[3] Credit Suisse Default Report, February 3, 2021.

US Loan and High Yield Markets

Refinancing and repricing activity dominated the US loan and high yield primary markets in January, accounting for 83% of gross loan issuance and 77% of gross high yield bond issuance as the ongoing economic recovery and limited net new issue supply pushed more loans and bonds above par and towards their call prices, respectively.[4]

US Loan and High Yield Issuance ($ in bn)



The average loan bid price increased by $1.08 during the month to $97.37, a higher level than pre-COVID-19. Said differently, 13% of loans were trading above par and 74% of loans were trading above $98 in January, compared to 4% and 56%, respectively, at the end of 2020. Loan funds in January experienced net inflows of $4.2 billion, the largest monthly inflow since March 2017, further supporting loan prices and driving repricings higher.[5] The average bid price for high yield bonds at the end of January remained elevated at $104.69, with many bonds at or near their respective call price.

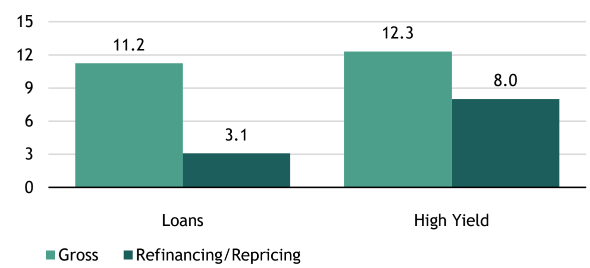
Gross issuance levels were also elevated at $96 billion for US loans and $56 billion for US high yield bonds, representing the ninth and second most active month of record, respectively.[6] While we expect repricing activity to continue at elevated levels in the near term, certain high yield issuers have priced deals exceptionally tight resulting in mixed performance, with the average January deal trading up just 0.5 points on the day of issue.

Turning to loan issuers, we are starting to see lenders push back on aggressive refinancing terms with several notable examples in January and early February. In one such transaction, the existing first lien term loan of a single B-rated software provider proposed a 50bp reduction in spread, with further automatic step-downs based on leverage. The transaction ultimately cleared the market with only a 25bp margin reduction and a removal of the step-down provisions.

European Loan and High Yield Markets

Similar to the US, European loans and high yield bonds experienced a surge in primary activity during the month. European loan issuance soared in January representing the highest level of primary activity in the European loan market since January 2020. High yield bond issuance doubled month-over-month. Despite the vast number of syndications, the supply has been well absorbed without major signs of indigestion as the technical balance remains well supported by cash deployed from repayment activity as well as ongoing CLO purchasing.[7]

EU Loan and High Yield Issuance (€ in bn)



The increase in issuance across the European below investment grade credit markets can be partially attributed to refinancing activity; 65% of gross high yield bond issuance in January represented refinancing activity while the figure was much lower for European loans at 28%.

Refinancing activity in Europe has been more moderate given loan and high yield prices have not yet recovered to pre-COVID-19 peaks. European loan prices stand at €98 on average, compared to €98.5 in January 2020. Likewise, European high yield bond prices average €99, compared to €99.2 a year prior. Fortunately, short-term refinancing needs in Europe are low. Less than 4% of European bonds mature within a year, and just 3 loan transactions mature in 2021.[8]

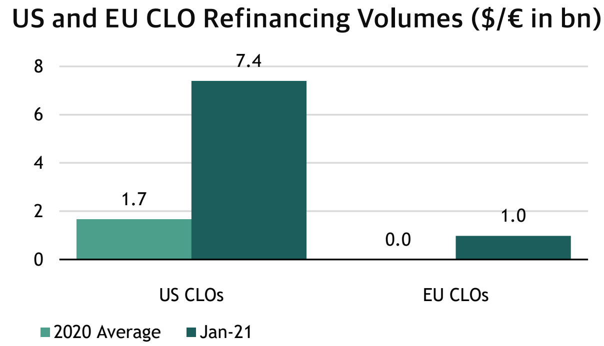
Environmental, social, and governance ("ESG") considerations are becoming increasingly important for investors, particularly in Europe. In January, we saw 6 transactions issued in the primary market with ESG-linked margin ratchets, whereby the initial margin is reduced by 2.5-10bp on average when the issuer meets certain ESG criteria tested annually. This compares to just two such transactions in all of 2020. In early February, one transaction which had not yet allocated, flexed the ESG margin ratchet upwards by 5bp to 15bp, setting a new ceiling for this covenant. This new level is material to both total margin and yield and is also based on data which may be difficult for analysts to track compared to traditional leverage criteria.

[4] JP Morgan High Yield Bond and Leveraged Loan Market Monitor, February 1, 2021.
[5] JP Morgan, Lipper, as of January 31, 2021. Includes weekly and monthly reporting funds if reported by February 10, 2021.
[6] JP Morgan High Yield Bond and Leveraged Loan Market Monitor, February 1, 2021.
[7] LCD, as of January 31, 2021.
[8] Credit Suisse European Credit Trades & Themes: Lev Fin Maturity Wall – No Cause for Concern, January 20, 2021.

US and European CLO Markets

Refinancing activity dominated the US and European CLO markets in January with volumes surging during the month from subdued levels post-pandemic. In the US, 22 CLOs refinanced for $7.4 billion, and 3 European CLOs refinanced for €1.0 billion, representing 46% and 56% of total issuance in each region, respectively. We expect this trend to continue throughout the year as CLOs issued last year with non-call periods of 1-year are now exiting these periods.

The primary market for CLOs globally was very active in January with strong new issuance and elevated refinancing activity, the combination of which continues to provide a tailwind for loan demand globally. Europe set a record for January issuance this year with €0.8 billion in total, and the US was just $1 billion shy of setting a record with $8.6 billion in total during the month.[9]



Attractive CLO equity arbitrage remained the main driver for elevated new issuance levels globally in January. AAA spreads are now at the tightest level since mid-2018 for US and European CLOs as investors show renewed interest for high-quality, floating-rate debt. New issue US CLO tranches tightened across the entire capital stack, with mezzanine tightening by up to 80bp over the month. European CLO tranches tightened by 20-80bp.[10]

CLO fundamentals continue to improve globally month-over-month as the underlying loans strengthen. Exposure to CCC-rated loans and defaulted assets decreased in January for both US and European CLOs. In fact, defaulted assets in US CLOs is just 0.3% or 10bp above the levels seen one year ago, and there are no defaulted assets in European CLOs.[11]

Towards the end of the month, we witnessed extensive CLO equity supply enter the market as investors looked to monetize gains following payments in January. The equity focus appeared to abate when a large list of high-quality BBB-rated CLO tranches came to the market. As we bid for these names, dealers did not seem overly anxious to take down risk and we believe many of the names traded through to end accounts. It will be interesting to see in the coming weeks whether dealers start to try to refill their balance sheets should additional paper surface for sale and trading levels become better defined. Currently, dealer inventory appears to be largely populated with the same lower quality tranches from one month prior.

Blackstone Credit was active in the CLO market in January, selectively rotating some accounts out of higher quality paper and also rolling some mid-to-lower quality exposure as part of select refinancing activities.

Market Outlook

We remain bullish on the global economy and note that the number of approved COVID-19 vaccines may increase to five in the coming months. Improved vaccine availability should lead to declines in hospitalizations and increases in mobility and will likely fuel a robust rebound in demand for in-person services. With elevated savings rates in the US and Europe, we believe the pent-up demand for these services, particularly leisure and entertainment experiences, is significant and will accelerate throughout 2021. Additionally, the expected COVID-19 relief bill in the US should further support consumer savings and fuel spending. We acknowledge the uncertainties surrounding the efficacy of existing vaccines against new variants of COVID-19, but even so, we are confident that we are facing these new strains on firmer footing in regards to development, distribution, and approvals than we were one year ago.

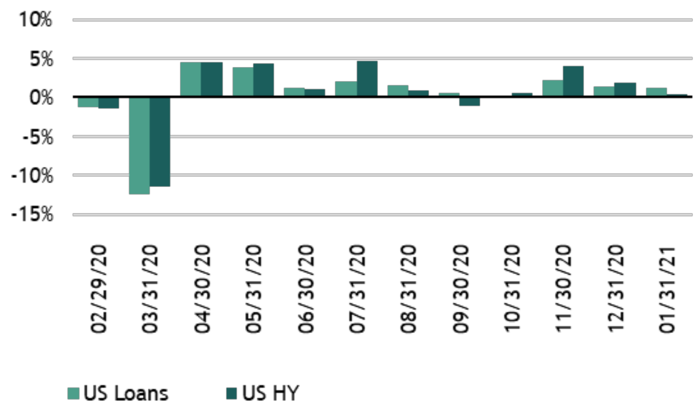
The credit markets continue to experience strong investor demand, but longer duration, high quality bonds are currently producing negative real yields.[12] This is a condition not experienced in recent US history, and we believe it will likely not be tolerated further in the event inflation rates move noticeably higher. This is particularly true given that the Federal Reserve has guided that they will remain accommodative in the near-term even if inflation were to track above their long-term target. We expect shorter-term reflation and the 10-year Treasury rate to continue increasing with the potential to hit 2%, further making the case for floating rate, non-traditional fixed income allocations.

We recommend that investors focus on higher spread, shorter duration investments. The average duration of investment grade and high yield bonds remain high at 8.7 years and 3.7 years, respectively.[13] We do note that credit selection remains important as the strength of the rally has pushed spreads of certain securities to levels that we consider marginal for their underlying risk. Our recommendation for Europe is similar, as we believe that although the risk of a sharp increase in rates is lower, the yield pickup from adding duration is even more marginal due to the flatness of the European curve.

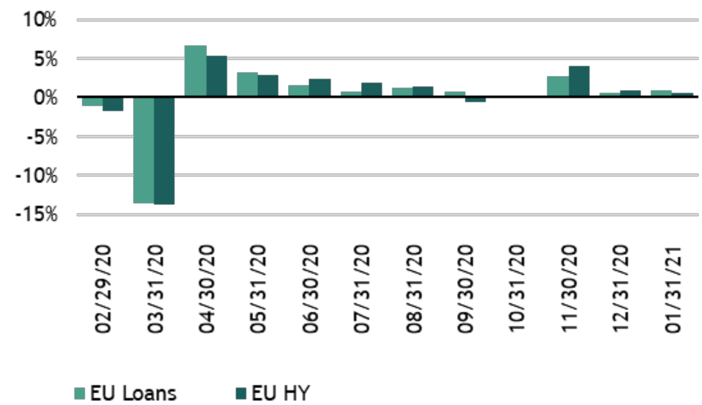
[9] LCD, as of January 31, 2021.
[10] BofA Global Research for US CLO spreads, as of January 31, 2021. Citi for European CLO spreads, as of January 31, 2021.
[11] CLO & Leveraged Loan Monthly Update, February 2, 2021.
[12] Bloomberg Barclays US Aggregate Bond Index.
[13] Bloomberg Barclays Corporate Bond and High Yield Bond Indices, as of January 31, 2021.

Market Snapshot (as of January 31, 2021)[14]

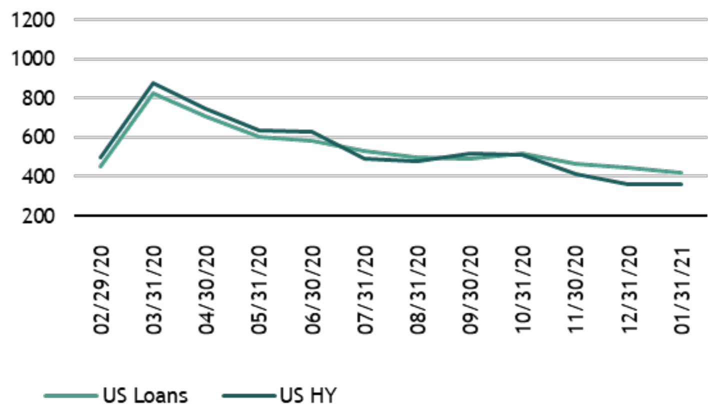
US Credit Monthly Returns



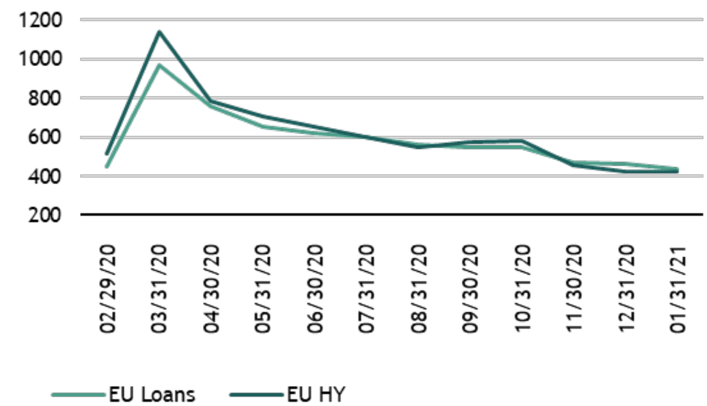
EU Credit Monthly Returns



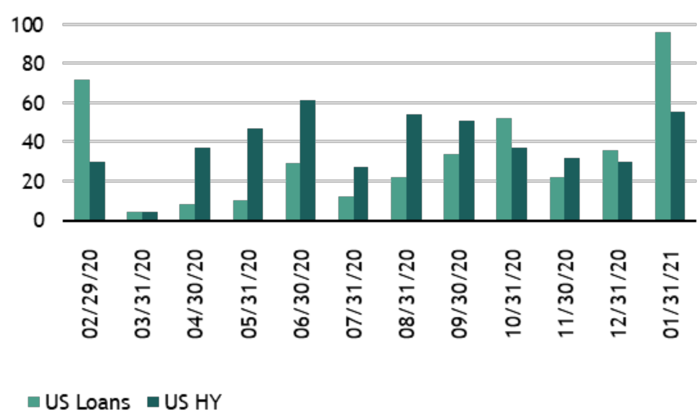
US Credit Spreads (bp)



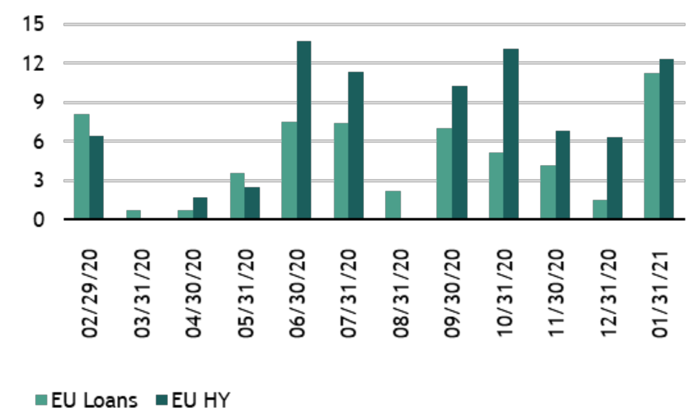
EU Credit Spreads (bp)



US Credit Issuance ($ in billions)



EU Credit Issuance (€ in billions)



[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 January 31, 2021.

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