GSO
CAPITAL PARTNERS

CREDIT INSIGHTS

GSO May 2020 Market Commentary

Performance Overview

- The market rebound from March lows continued.
- US high yield bonds were clear winners, though loan performance was also strong globally.
- Central bank support for markets was on display with Fed purchases of ETFs in the US and expanded relief proposals in Europe.

Global credit markets posted strong returns in May, continuing the rebound from March lows. Yield-focused investors appeared more comfortable with risk in light of developed-market government and central bank support as well as indications that many economies were past the COVID-19 peak and would begin a slow return to normalcy.

Companies looking to shore up their liquidity and extend maturities took note of the healthier market conditions: US investment grade and high yield bond issuance totals in May were well above monthly averages. US loan new issuance, as well as European loan and high yield bond new issuance, also increased month-over-month in May, but remained anemic relative to typical levels.[1]

Given historically low global interest rates, investors continue to flock to credit markets for incremental yield. The rally in May was particularly strong for US high yield bonds, where demand from retail fund inflows supported prices despite elevated issuance. By contrast, for US loans and European loans and high yield bonds, limited new-issue supply appears to have been a key driver of price appreciation as managers were largely forced into the secondary market to put cash to work.[2,3]

The continued rally in loan prices caused secondary spreads for Collateralized Loan Obligations ("CLOs") to tighten, most notably in BB-rated mezzanine tranches.[4] This occurred despite the continuation of rating agency downgrades on the underlying loan collateral and the negative impact this had on key ratios in CLOs.[5]

Market Returns (as of May 29, 2020)

	MTD	QTD	YTD
S&P / LSTA U.S. Leveraged Loan Index	3.80%	8.47%	-5.68%
Bloomberg Barclays U.S. High Yield Index	4.41%	9.11%	-4.73%
Credit Suisse Western European Leveraged Loan Index	3.28%	10.16%	-5.29%
Credit Suisse Western European High Yield Index	2.91%	8.45%	-7.92%
S&P 500	4.76%	18.19%	-4.97%
Euro Stoxx 50	4.94%	10.62%	-17.33%

Market Outlook

As the global economy emerges from the pandemic, recovery expectations are threatened by new infections and geopolitical tensions.

The consequences of social distancing measures enacted to combat COVID-19 are likely to lead to materially elevated defaults in high yield bonds and loans in 2020, particularly in the energy sector as it grapples with slack demand as well as the impact of the oil-price war earlier this year. An elevated unemployment rate and a more cautious consumer will also be critical to assessing the economic recovery. We believe the initial strong rebound in economic data will moderate, giving way to a longer, drawn-out recovery that resembles a "square root" symbol.

In the meantime, monetary and fiscal measures are providing direct support for US credit markets and asset prices. In Europe, governmental support has been similarly generous, as illustrated by the near doubling of stimulus at the end of May. But further intervention depends on continued political cohesion, which could become a challenge if economies across Europe recover unevenly.

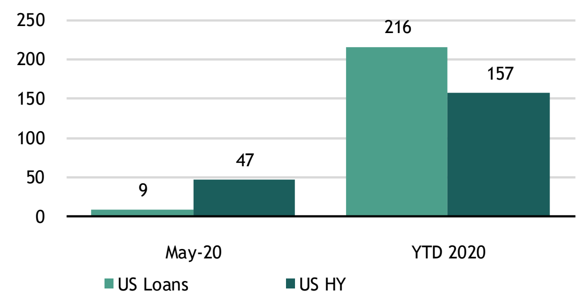
Although significant challenges clearly remain for many companies impacted by COVID-19, we see attractive investment opportunities. We are focused on second- and third-order impacts and are spending time with management teams to better understand these risks. Longer term, we expect shifts in how people consume, work, and live, and by understanding these trends and applying our views to credit selection, we can both play offense and remain focused on capital preservation.

[1] LCD, as of May 29, 2020.
[2] Based on S&P/LSTA Leveraged Loan, as of May 31, 2020; Credit Suisse European Leveraged Loan, Bloomberg Barclays High Yield, and Credit Suisse High Yield indices as of May 29, 2020.
[3] JP Morgan, Lipper, May 29, 2020.
[4] Bank of America, Citi, May 29, 2020.
[5] Credit Suisse Research, June 2, 2020.

US Loan and High Yield Markets

Roughly $20.5 billion in net inflows landed in high yield bond funds in May as the US Federal Reserve (the "Fed") buoyed sentiment by fulfilling its promise to purchase high yield exchange traded funds. In stark contrast, US loan fund flows remained negative with more than $1.4 billion of net outflows in May, continuing a trend year to date, but at a more modest pace compared to April.[6]

US Issuance



Demand for high yield bonds and limited new issue supply in loans drove strong returns in May of 4.41% and 3.80%, respectively, with spreads ending the month meaningfully narrower in both asset classes. Digging deeper into the drivers of performance, the lowest-rated loans and bonds rallied the most, with CCC-rated loans and bonds outperforming their higher-quality cohorts with returns of 5.26% and 6.11%, respectively.[7]

Investors seeking yield in the low-rate environment continue to drive demand for high yield bonds. High yield inflows in April and May drove spreads meaningfully tighter. In response, US high yield issuers looking to enhance liquidity or extend maturities were active in May, issuing $47.3 billion of new bonds, the heaviest monthly total in more than two years. Issuers took note of the market's preference for security, as senior-secured issuance represented about 30% of this total.[8]

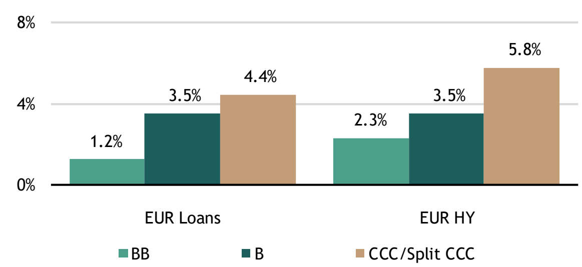
The spike in issuance of well-rated, secured high yield bonds, as well as downgrades of formerly investment grade credits into the BB-ratings universe ("fallen angels"), has fueled the recent divergence between loans and high yield in terms of both credit quality and market size. With $22 billion in fallen angels entering the US high yield market in May, BB-rated bonds now account for more than half of the US high yield market,[10] while the US loan market is overwhelmingly rated single B. The US high yield market, as measured by the Bloomberg Barclays US High Yield Index, now stands at $1.4 trillion in size, representing a 12% increase since year-end 2019. Loans, as measured by the S&P/LSTA Leveraged Loan Index, total $1.2 trillion outstanding, which is relatively flat year to date.[9]

The pace of downgrades slowed in May for US loans and high yield bonds. However, the par-weighted last 12-month ("LTM") default rates increased to 3.17% for loans and 4.85% for high yield, representing 5-year and 10-year highs, respectively. Eight companies defaulted in May, affecting $5.1 billion in bonds and $6.1 billion in loans, compared to $36 billion in loans and bonds in April.[10]

European Loan and High Yield Markets

Market sentiment in Europe was bolstered by central bank support in May, with leaders escalating discussion about financial relief and new sources of income to combat economic hardship posed by COVID-19. That included a European Commission proposal late in the month to disburse €750 billion in loans and grants from 2021-2024, as part of a 7-year budget plan.[11]

European Returns by Quality



With the likelihood of more government stimulus, returns in European loans and high yield bonds ground higher in May with loans gaining 3.28% for the month and high yield advancing 2.91%. In a reversal from April, prices of lower-quality credits rallied the most, similar to US counterparts. The best performers in May were CCC/Split CCC-rated high yield bonds, which returned 5.78%, and similarly-rated loans, which returned 4.43%.[12] However, these are a smaller cohort than BB and single B-rated assets in the European high yield and loan indices.

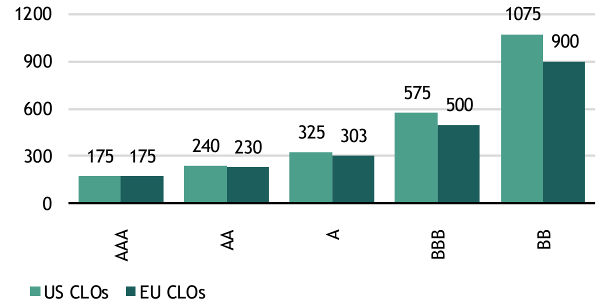
As markets in Europe stabilize, the distress ratio for European loans fell to 7.14% at the end of May, from 12.09% in April. The LTM European high yield default rate was 2.6% at the end of May, compared to 0.7% in April, while the loan default rate was significantly lower at 0.6%, unchanged from April.[13]

May brought the reopening of the European loan market, with new issue volume totaling €2.28 billion after virtually no issuance in March and April. This takes the volume for 2020 to €29.0 billion, down slightly from the €30.9 billion recorded in the same period last year. European high-yield bond issuance in May stood at €2.45 billion, up from the €1.67 billion in April, and zero issuance in March, bringing year-to-date volume to €23.52 billion. That is only slightly behind the €25.85 billion in the same period in 2019.[14] High yield issuance has been supported by steady retail fund inflows, which totaled €942 million during May.[15]

[6] JP Morgan, Lipper, as of May 29, 2020. Includes all weekly and monthly reporting funds, if reported by June 10, 2020.
[7] Bloomberg Barclays US High Yield Index, as of May 29, 2020; S&P/LSTA Leveraged Loan Index, as of May 31, 2020.
[8] JP Morgan High Yield and Leveraged Loan Market Monitor, June 1, 2020.
[9] Bloomberg Barclays US High Yield Index, S&P/LSTA Leveraged Loan Index, as of May 29, 2020.
[10] JP Morgan Default Monitor, June 1, 2020.
[11] Goldman Sachs Research, May 27, 2020.
[12] Credit Suisse European Leveraged Loan and High Yield indices, as of May 29, 2020.
[13] Credit Suisse Default Report, June 1, 2020. Represents LTM par default rates of Credit Suisse Western European Leveraged Loan and High Yield indices.
[14] LCD European Playbook, May 31, 2020.
[15] JP Morgan, Lipper, May 29, 2020.

US and European CLO Markets

US and European CLO fundamentals remain mixed. CLO equity net asset values improved in May as a result of the broad rally in loan prices, even though downgrades and defaults persisted.[16]



Additional rating agency loan downgrades on underlying loan holdings in May worsened the Weighted Average Rating Factor ("WARF") for US and European CLOs, despite a slower pace of downgrades compared to April.[17,18] Although CCC downgrades in May were also down significantly compared to April, the percentage of CCC-rated loans in US and European CLOs increased.[19] However, the impact of larger CCC baskets on overcollateralization tests and interest diversion tests was less impactful as a result of the lift in loan prices.

Rating agencies continued to place additional CLO tranches on watch in May with a significant portion of lower rated CLO tranches now on negative watch or outlook. As of June 3, 34% of BBB, 53% of BB, and 87% of B-rated US CLO tranches and 46% of BBB, 66% of BB, and 67% of B-rated European CLO tranches were on watch for downgrade.[20] As of the writing of this commentary, a select number of BB and B-rated CLO tranches have been downgraded in June. GSO, however, continues to fare well: out of 25 CLO managers with 15 deals or more, we have the 4th lowest percentage of CLOs with at least one tranche on watch by either Moody's or S&P.[21]

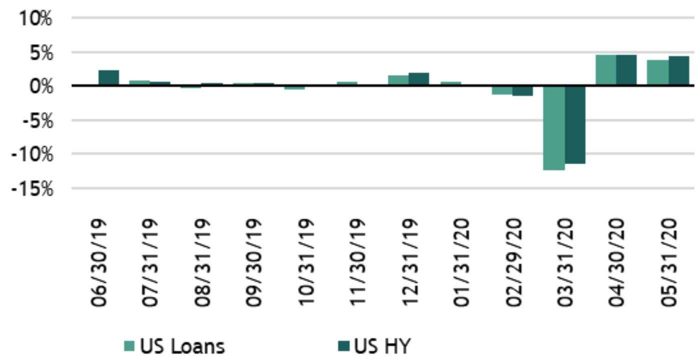
Although CLO new issuance increased month over month to $6.0 billion in the US and €1.0 billion in Europe, issuance remains relatively low primarily due to the fact that CLO liability spreads continue to lag the rally in the underlying loans.[22] A large part of European issuance in May came from the May 28 pricing of GSO's second European CLO of the year, Avondale Park CLO, which totaled €300 million. Although CLOs are being issued in Europe, they are smaller in size on average at about €310 million since the start of March compared to €420 million in January and February.[23]

Despite the mixed market conditions, investor demand, coupled with limited new CLO issuance supply, drove spreads tighter across all tranches in both US and European CLOs in May. BB-rated CLO tranches experienced the largest spread tightening, with US spreads decreasing 150bp and European spreads decreasing 275bp on average month over month.[24]

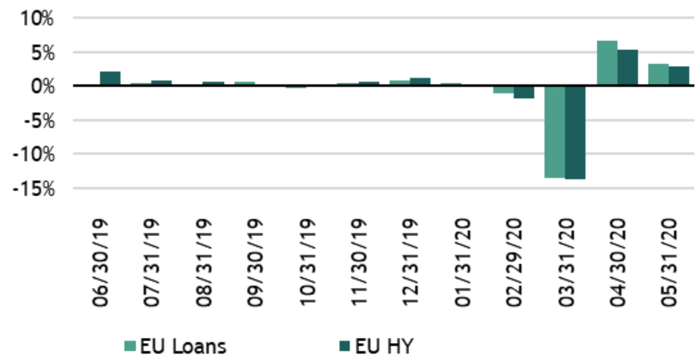
[16] Barclays CLO and Leveraged Loan Monthly Update, June 2, 2020.
[17] Wells Fargo CLO Monthly Market Overview, June 2, 2020.
[18] Bank of America CLO Weekly, May 29, 2020.
[19] Creditflux, June 9, 2020
[20] Barclays, June 3, 2020.
[21] JPMorgan, FOMO the CLO Rally, June 4, 2020. Ranking out of 25 managers with 15 deals or more.
[22] LCD, May 29, 2020.
[23] LCD, June 5, 2020.
[24] Bank of America, Citi, May 29, 2020.

Market Snapshot (as of May 29, 2020)[25]

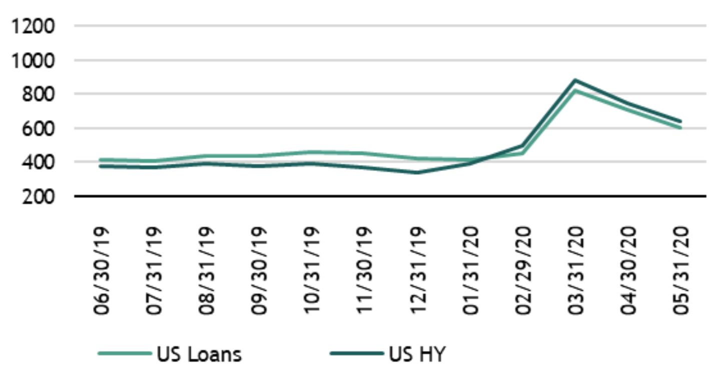
US Credit Monthly Returns



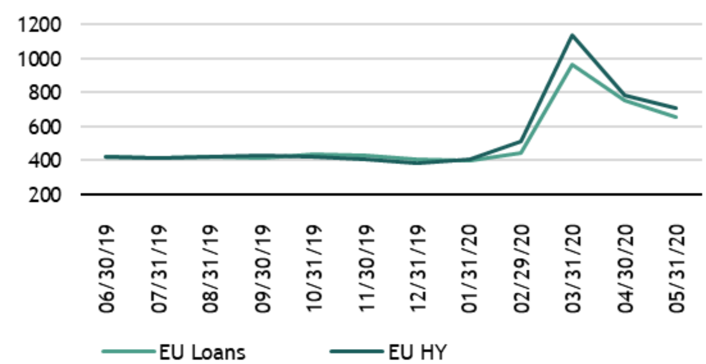
EU Credit Monthly Returns



US Credit Spreads (bp)



EU Credit Spreads (bp)



	Spread			Yield			Price		
	Level	ΔMTD	ΔYTD	Level	ΔMTD	ΔYTD	Level	ΔMTD	ΔYTD
U.S. Loans	602	-107	179	7.13%	-1.37%	1.00%	$89.03	$2.92	-$7.69
U.S. HY	637	-107	301	7.27%	-0.96%	1.29%	$94.63	$4.04	-$6.60
EU Loans	654	-101	248	4.21%	-0.21%	0.06%	€91.60	€2.67	-€ 6.72
EU HY	708	-74	327	6.70%	-0.68%	2.89%	€89.51	€2.26	-€ 9.92

	Level	MTD Return	YTD Return
Dow Jones Industrials	25383	4.66%	-10.06%
S&P 500	3044	4.76%	-4.97%
Russell 2000	1394	6.36%	-16.45%
Euro Stoxx 50	3050	4.94%	-17.33%
DAX	11587	6.68%	-12.55%
MSCI Emerging Markets	930	0.79%	-15.90%
MSCI World	2148	4.90%	-7.95%

	Level	ΔMTD	ΔYTD
1-Month Libor	0.18%	-15 bp	-158 bp
3-Month Libor	0.34%	-21 bp	-156 bp
10-Year Treasury	0.65%	1bp	-127bp
3-Month Euribor	-0.30%	-3bp	8bp
6-Month Euribor	-0.15%	2bp	17bp
10-Year German Bund	-0.45%	14bp	-26bp

25 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 May 29, 2020, except US loan returns, which are as of May 31, 2020. Equities, LIBOR, Euribor, US Treasury, and German bund sourced from JP Morgan daily updates.

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