Blackstone Credit

CREDIT INSIGHTS

November 2020 Market Commentary

Performance Overview

- US and European loan and high yield bond year-to-date returns are now positive
- There were no US loan or high yield bond defaults during November
- US and European CLO equity arbitrage and equity net asset values continue to improve

The global credit markets experienced a significant rally in risk assets during November, and US and European loan and high yield bond year-to-date returns are now solidly positive. CCC-rated loans and bonds led the rally, outperforming their higher quality counterparts. The recovery was particularly strong among industries most severely impacted by COVID-19, such as travel and leisure.

The US and European equity markets also rallied during the month, driven by positive COVID-19 vaccine announcements and encouraging Chinese factory data, both of which raised hopes for an expedited global economic recovery in 2021. The S&P 500 and Nasdaq Composite both reached record highs while the Stoxx Europe 600 rose 14% in November, a record month for the regional equity benchmark. Meanwhile, the US dollar and Treasuries weakened as the upbeat mood favored risk-taking over haven assets.[1]

November was the first month since August 2018 without a single US loan or high yield bond default, resulting in a month-over-month decrease in the last-twelve-month ("LTM") par-weighted loan and bond default rates. In Europe, loan LTM default rates peaked year-to-date but remain historically low at 1.3%, and the LTM high yield default rate decreased 10bp month-over-month to 3.2%.[2]

Global CLO equity arbitrage and equity net asset values continued to improve in November as CLO liability spreads tightened and US and European loan prices continued to recover. US CLOs also showed improvements in exposure to CCC-rated loans and defaulted assets.[3]

Market Returns (as of November 30, 2020)

	November	QTD	YTD
S&P / LSTA U.S. Leveraged Loan Index	2.23%	2.43%	1.76%
Bloomberg Barclays U.S. High Yield Index	3.96%	3.41%	5.13%
Credit Suisse Western European Leveraged Loan Index	2.66%	2.91%	1.76%
Credit Suisse Western European High Yield Index	4.08%	4.38%	1.00%
S&P 500	10.95%	8.00%	14.02%
Euro Stoxx 50	18.09%	9.48%	-4.30%

Market Outlook

With multiple efficacious vaccines, better therapeutic treatments, more readily available testing, and more certainty on the US election outcome, we expect the rally in risk assets to continue, and we remain positive in our outlook for 2021. However, major economies globally are back in or near-lockdown, and Europe is likely to fall back into negative growth this quarter. While the US will likely avoid a widespread lockdown like the one that occurred in March, in large part due to political polarization, local shutdowns will weigh on consumer spending and the labor market. Unfortunately, colder weather, "quarantine fatigue," and holiday gatherings will likely overwhelm shutdown measures, so we do not expect COVID-19 cases to get under control until a vaccine is more widely distributed, hopefully mid-2021.

US Congressional leaders are close to agreeing on a $900 billion bipartisan COVID-19 relief package, as they race to complete both a pandemic stimulus package and a federal spending bill to keep the government open before the government spending deadline of December 18.

In Europe, central banks have significantly bolstered market liquidity and continue to play a role in the economic recovery; however, their efforts have yet to boost inflation expectations. Although recent vaccine news has been positive and the global markets have shown resiliency against the resurgence in COVID-19 cases, the European Central Bank (the "ECB") has confirmed its plan for further easing.

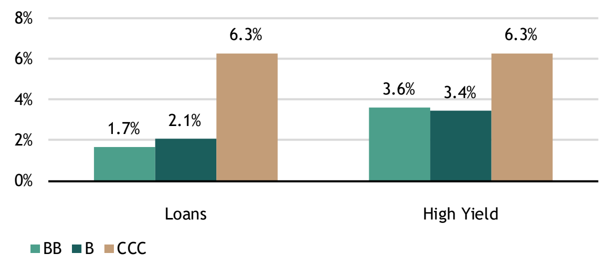
The technical and fundamental backdrops for the global credit markets remain favorable with a consensus view for continued spread tightening and falling defaults rates across loans and high yield bonds globally. JP Morgan continues to forecast a decline in US 2021 default rates to 3.5% each for loans and high yield bonds, consistent with the long-term averages of 3-3.5%, and forecasts a further decline in default rates in each during 2022 to 2.0% as the global economy continues to normalize. Credit Suisse is forecasting a decrease in 2021 European loan and high yield default rates to 1.1% and 1.5%, respectively.[4]

[1] Financial Times Stocks Rally as Dollar and Treasuries Pull Back December 1, 2020.
[2] JP Morgan Default Monitor, December 1, 2020; Credit Suisse Default Report, December 2, 2020.
[3] Barclays CLO Monthly, December 2, 2020.
[4] JP Morgan Default Monitor, December 2, 2020; Credit Suisse 2021 in Pictures, November 27, 2020.

US Loan and High Yield Markets

The recovery in US loans and high yield bonds accelerated in November, returning 2.2% and 4.0% for the month, respectively, led by a significant rally in CCC-rated assets. CCC-rated loans and bonds each returned 6.3% in November, outperforming BB and B-rated loans and bonds. The rally in risk assets was driven by three consecutive weeks of positive vaccine news and the start of the peaceful, if highly irregular, transition of power from President Trump to President-elect Biden. On November 9, when Pfizer released its positive vaccine news, loans returned 0.7% and bonds returned 1.1%, the largest single day returns since April and June, respectively.[5]

US Loan and High Yield Returns by Quality



The fundamental backdrop for US loans and high yield bonds continues to improve with the distressed universe (percent trading below $90) now standing at pre-COVID levels. Additionally, with no defaults occurring in November, the LTM par-weighted default rates for loans and high yield bonds decreased by 20bp and 19bp, respectively, to 3.79% and 6.15%. While these rates remain elevated compared to historical averages of 3.0-3.5%, the rates are expected to improve during 2021 and 2022 given line-of-sight on the distribution of a handful of effective vaccines and additional monetary and fiscal policy support.[6]

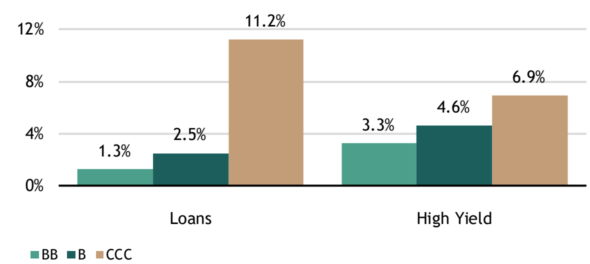
Retail demand for US loans remained tepid as investors withdrew another $0.4 billion from loan retail funds in November compared to $0.6 billion in October. Minimal demand for loans from retail investors was more than offset by CLO creation which continued, albeit at a slower pace than the previous month. Meanwhile, for US high yield bonds, November marked another month of strong retail demand with net inflows totaling $4.7 billion, reversing the $4.7 billion of outflows experienced in the two weeks leading up to the US elections.[7] Limited new issue supply was also a tailwind to US loan and high yield bond performance as gross issuance decreased in November. Loan issuance slowed significantly to $22 billion from $52 billion, largely driven by the Thanksgiving holiday, representing a 58% decrease month over month. High yield bond issuance decreased for a third consecutive month to $32 billion, which was down 14% month-over-month, but still above the average of $26 billion for November over the last decade.[8]

Investors looking to increase allocations to loans and bonds in 2021, may consider doing so in December 2020 in order to potentially benefit from the "January effect" whereby loans and high yield bonds have outperformed all other months by 63bp and 104bp, respectively, over the past 24 and 34 years.[9]

European Loan and High Yield Markets

European loans and high yield bonds returned 2.7% and 4.1%, respectively, in November, supported not only by the positive vaccine news but also by continued central bank support. The Bank of England announced a further £150 billion in quantitative easing, the ECB has confirmed additional stimulus, and European Council continues to discuss the €1.8 trillion spending package.

EU Loan and High Yield Returns by Quality



Similar to the US, the European credit markets also experienced a significant rally in lower rated assets, particularly CCC/Split, CCC-rated, and defaulted loans, which returned 11.2%, compared to Split BBB and BB-rated returns of 1.3% and 2.5%, respectively. CCC/Split, CCC-rated, and defaulted bonds returned 6.9%, also outperforming their higher quality cohorts.[10]

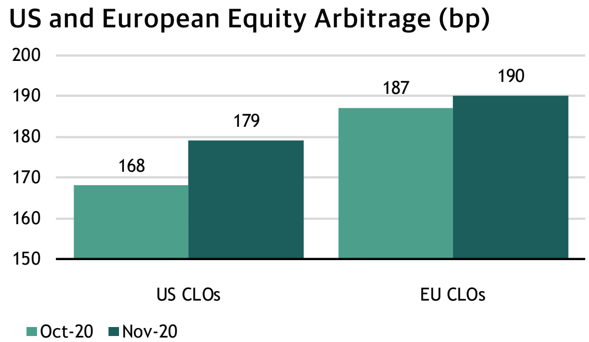
European CLO issuance dropped significantly month over month with only five deals pricing totaling €1.7 billion; however, this was partially offset by a decrease in primary loan market activity. European loan issuance totaled €4.1 billion down from €5.1 billion the previous month. With most European loan borrowers locking in pricing before expected volatility from the US presidential election, the primary market was slow to restart early in the month. The pipeline for the rest of the year will likely be focused on smaller buyout and M&A transactions.[11]

European high yield bond primary activity also slowed with €6.3 billion of monthly issuance, a 52% decrease month over month. Concern regarding volatility leading up to the US election was also evident in European high yield bond fund flows. For the week ending November 4, retail investors withdrew €978 million from European high yield funds, representing the largest weekly outflow since March. Subsequent demand for European high yield bond funds was been positive, and net inflows totaled €420 million for November.[12]

After falling to pre-COVID-19 levels in October, the European loan par-weighted LTM default rate increased to 1.3% in November, the highest rate year-to-date. However, this rate remains low and is below the long-term average. The European high yield par-weighted LTM default rate declined to 3.2% this month and remains notably lower than the US high yield default rate.[13]

[5] S&P/LSTA Leveraged Loan Index, Bloomberg Barclays US High Yield Index, as of November 30, 2020.
[6] JP Morgan Default Monitor, December 1, 2020.
[7] LCD, as of November 30, 2020. JP Morgan, Lipper, as of November 30, 2020. Includes all weekly and monthly reporting funds if reported by December 2, 2020.
[8] JP Morgan Leveraged Loan and High Yield Bond Market Monitor, December 1, 2020.
[9] JP Morgan High Yield and Leveraged Loan Morning Intelligence, December 10, 2020.
[10] Credit Suisse European Leveraged Loan and High Yield Bonds Indices, as of November 30, 2020.
[11] LCD as of November 30, 2020; LCD News Today, Europe November 19, 2020.
[12] JP Morgan Lipper, as of November 30, 2020.
[13] Credit Suisse Default Monitor, December 2, 2020.

US and European CLO Markets



CLO new issue equity arbitrage, measured by average loan asset spreads less average CLO debt spreads, continued to improve month over month for both US and European CLOs as spreads on liabilities continued to tighten. The new issue equity arbitrage for US and European CLOs stands at 179bp and 190bp, respectively, up 11bp for US CLOs and 3bp for European CLOs month over month. CLO equity net asset values also improved globally as loan prices continue to recover.[14]

In November, new CLO creation decreased in both regions following elevated levels in October. In the US, 17 deals priced totaling $7.4 billion representing a 42% decrease month-over-month. In Europe, five CLOs priced totaling €1.7 billion, representing a 57% decrease month-over-month. Primary spreads tightened by 7-50bp on average in the US and by 5-60bp on average in Europe across tranches and this trend is expected to continue.[15] Issuance projections for 2021 range from $90-110 billion in the US and €20-30 billion in Europe and we expect this to be accompanied by elevated levels of refinancing and repricing activity.

In November, Blackstone Credit upsized its US CLO Reese Park to $510 million from $408 million and concurrently tightened liability spreads across the capital stack, all after the pricing date. A post-pricing upsize is unusual, but this was the first CLO to also achieve tighter liabilities on the post-pricing upsize. The AAA-rated incremental upsized tranche tightened to just 120bp, the tightest three-year tenor AAA pricing since Blackstone Credit's Harriman Park CLO, which priced on March 6, 2020.

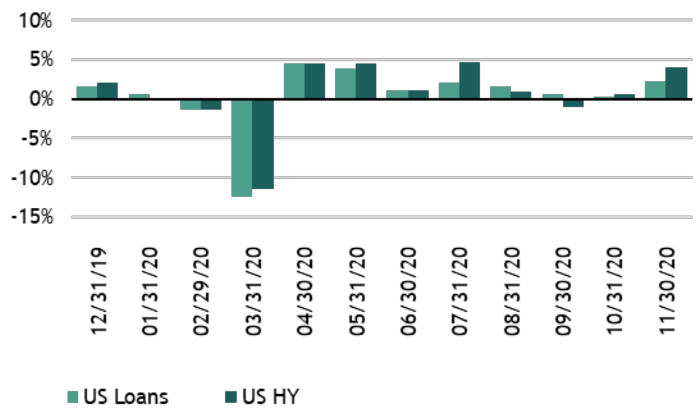
US and European CLO secondary spreads also tightened in all tranches in November, with most of the tightening occurring in the lower rated tranches. US CLO tranches rated BBB and BB tightened by 95bp and 110bp, respectively, while tranches rated AAA-A tightened by 20-30bp. In Europe, CLO tranches rated BBB and BB tightened by 70bp and 128bp, respectively, and tranches rated AAA-A tightened by 13-28bp.[16] Secondary trading volumes remained healthy in November, with BWIC volumes of $3.0 billion in the US and €725 million in Europe, but showed a slight decrease month over month from $3.5 billion and €1.0 billion, respectively.[17]

Of note, Moody's published its final updated methodology for the treatment of loan ratings in CLOs, which we previously mentioned in our September commentary. These revisions relate to the treatment of ratings of underlying loans on review for upgrade or downgrade as well as ratings with a negative outlook. Previously, for purposes of calculating CLO Weighted Average Rating Factor ("WARF") tests, ratings on review for downgrade were adjusted down by two notches while ratings on review for upgrade were adjusted up by one notch. Ratings with a negative outlook were also adjusted down by one notch. Now, Moody's will require just a one notch adjustment for ratings on review for downgrade or upgrade and no adjustments will be applied based on rating outlook status. This update is viewed as a positive for CLO mezzanine tranches broadly, and 11 of Blackstone Credit's US CLOs have been placed on review for upgrade as a result.[18]

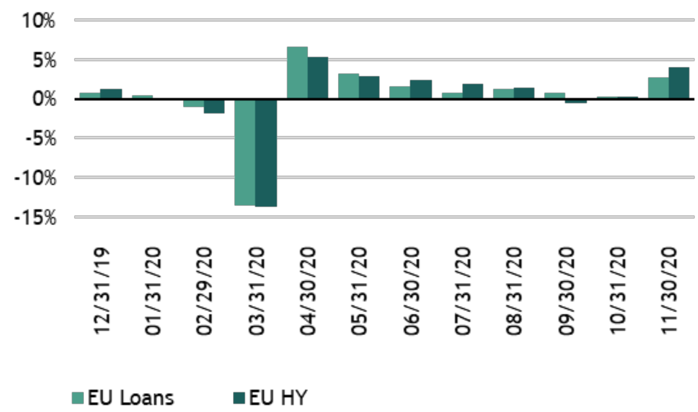
[14] Barclays CLO Monthly, December 2, 2020.
[15] LCD, as of November 30, 2020.
[16] BofA Global Research for US CLO spreads, as of November 30, 2020. Citi for European CLO spreads, as of November 30, 2020.
[17] Citi Velocity for US BWIC volumes, Barclays for European BWIC volumes, as of November 30, 2020.
[18] Moody's considers upgrading 188 US CLO tranches, December 9, 2020.

Market Snapshot (as of November 30, 2020)[19]

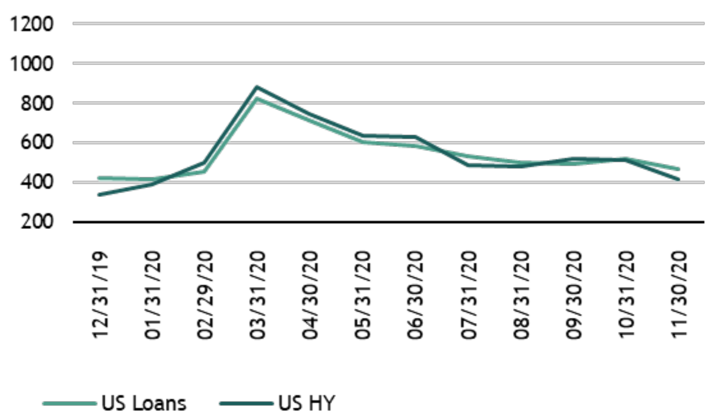
US Credit Monthly Returns



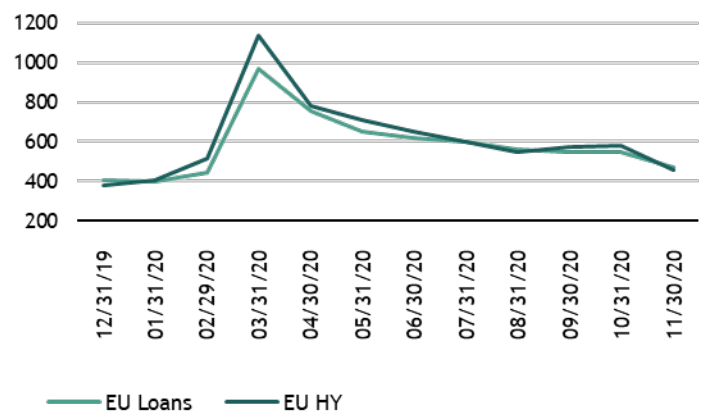
EU Credit Monthly Returns



US Credit Spreads (bp)



EU Credit Spreads (bp)



	Spread			Yield			Price		
	Level	ΔMTD	ΔYTD	Level	ΔMTD	ΔYTD	Level	ΔMTD	ΔYTD
U.S. Loans	467	-49	44	4.94%	-0.51%	-1.19%	$95.11	$1.94	-$1.61
U.S. HY	412	-96	76	5.34%	-0.76%	-0.65%	$103.33	$3.59	$2.10
EU Loans	471	-79	65	3.89%	-0.08%	-0.26%	€97.01	€2.28	-€1.31
EU HY	457	-124	76	4.12%	-1.16%	-0.30%	€97.60	€ 4.11	-€1.84

	Level	MTD Return	YTD Return
Dow Jones Industrials	29639	12.14%	6.11%
S&P 500	3622	10.95%	14.02%
Russell 2000	1820	20.72%	12.54%
Euro Stoxx 50	3493	18.09%	-4.30%
DAX	13291	15.01%	0.32%
MSCI Emerging Markets	1205	9.25%	10.51%
MSCI World	2583	12.83%	11.72%

	Level	ΔMTD	ΔYTD
1-Month Libor	0.15%	1 bp	-161 bp
3-Month Libor	0.23%	2 bp	-168 bp
10-Year Treasury	0.84%	-3 bp	-108 bp
3-Month Euribor	-0.52%	0 bp	-14 bp
6-Month Euribor	-0.50%	2 bp	-18 bp
10-Year German Bund	-0.57%	6 bp	-39 bp

19 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 November 30, 2020. Equities, LIBOR, Euribor, US Treasury, and German bund sourced from JP Morgan daily updates.

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