CREDIT INSIGHTS

GSO September 2020 Market Commentary

Performance Overview

- Loans continued their asent while high yield was softer in September
- US 2020 default forecasts largely revised down
- US and European CLO new issue equity more attractive as spreads on liabilities tighten

Global credit markets were mixed in September. US year-to-date loan returns briefly turned positive before a bout of volatility caused markets to retrench late in the month. We expect this volatility to continue amid a contentious US election, lack of clarity around a new US stimulus package, uncertainty around Brexit, and the potential for winter to bring a further increase in COVID-19 virus cases.

In a sign that initial US default forecasts for 2020 were overly dire, many rating agencies and banks have revised their 2020 and 2021 default expectations downward. In September just four US companies defaulted totaling $2.9 billion; however, last-twelve-month ("LTM") default rates remain elevated at 4.26% for loans and 5.80% for high yield, compared to 20-year historical averages of 3.0% for loans and 3.1% for high yield. European LTM par-weighted default rates remain low at 1.1% for loans and 2.9% for high yield bonds compared to 15-year averages of 2.4% and 1.5%, respectively.[1] With a higher correlation to the more volatile equity markets and decreased demand from US and European high yield retail funds, performance of high yield bonds in the US and Europe was negative for the month. Loans, on the other hand, benefitted from an increase in US and European Collateralized Loan Obligation ("CLO") issuance.[2,3]

US and European CLOs overall exhibited continued strength month over month. The percentage of CCC-rated and defaulted assets held in US CLOs decreased by -0.5% and -0.1%, respectively, and, with loan prices continuing to improve, US and European CLO weighted average portfolio prices increased and equity net asset value improved during the month.[4]

Market Returns (as of September 30, 2020)

	September	3Q20	YTD
S&P / LSTA U.S. Leveraged Loan Index	0.63%	4.14%	-0.66%
Bloomberg Barclays U.S. High Yield Index	-1.03%	4.60%	0.62%
Credit Suisse Western European Leveraged Loan Index	0.74%	2.78%	-1.13%
Credit Suisse Western European High Yield Index	-0.52%	2.69%	-3.24%
S&P 500	-3.80%	8.93%	5.57%
Euro Stoxx 50	-2.30%	-0.69%	-12.58%

Market Outlook

The International Monetary Fund is estimating 2020 GDP growth of -4.3% in the US and -7.2% in Europe year-over-year.[5] These estimates are consistent with an assumed lack of a new US fiscal package and a loss of recovery momentum in Europe. Fiscal policy in the US is at risk of being less supportive with the expiration of the CARES Act unemployment benefits, which provided greater than 100% income replacement for the median wage earner. Although a proposed $2.2 trillion stimulus package is being negotiated between the White House and Congress, based on current government gridlock, it seems relatively unlikely that meaningful supplemental benefits will be renewed before the election. This has yet to be reflected in retail sales figures or consumer sentiment and remains a downside risk.

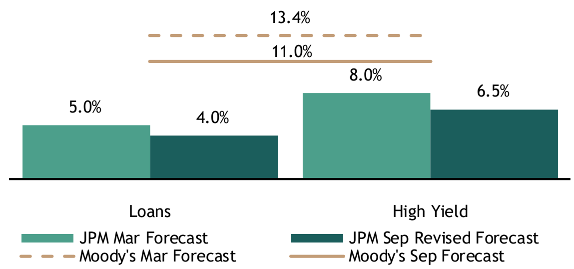
The Federal Reserve and other central banks globally will likely respond to the slowdown in market recovery by keeping interest rates at historically low levels to further support economic growth. These actions will continue to challenge yield-seeking investors. We believe that alternative forms of income such as loans and high yield bonds should be considered as part of an asset allocation in this environment.

Our active management strategy aims to reduce risk and enhance credit quality by insulating our portfolios from COVID-19 impacted sectors. To this end, we will reduce risk where there is limited earnings visibility, focus on resilient capital structures positioned to perform well in any market cycle, and continue to enhance the underlying credit quality of the portfolio via trading programs.

[1] JP Morgan Default Monitor, October 1, 2020. Credit Suisse Default Report, October 6, 2020.
[2] LCD, as of September 30, 2020.
[3] JP Morgan, Lipper, as of September 30, 2020.
[4] Barclays Casting a New Ballot for New Issue Equity, October 2, 2020. Wells Fargo research (sourcing Intex, LPC Collateral, and Wells Fargo Securities), CLO Manager Style Guide, January 21, 2020. For U.S., peers include managers with at least 20 deals included in Wells Fargo analysis (13 managers). For Europe, peers include managers with at least 7 deals included in Wells Fargo analysis (12 managers).
[5] International Monetary Fund IMF Datamapper.

US Loan and High Yield Markets

US Loan and High Yield 2020 Default Forecasts



The recovery in US loan and high yield performance slowed in September as volatility weighed on markets. Loans, which were supported in the secondary market by an increase in CLO creation and continued buying from existing CLOs, returned 0.63%, bringing the year-to-date return to -0.66%. In contrast, high yield bonds experienced a decrease in demand from retail funds and returned -1.03% for the month, reducing the year-to-date return to 0.62%.[6]

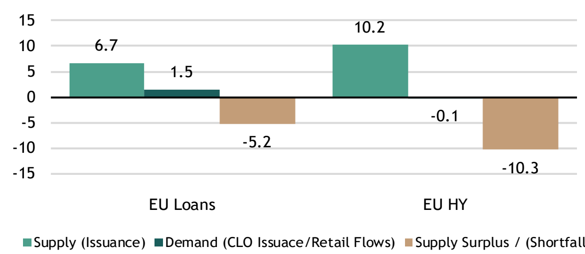
With the significant recent reduction in default activity, the better than expected economic recovery in 3Q, and stabilizing energy prices, default forecasts for 2020 have largely been revised downward. Moody's modified its speculative credit default forecast of 13.4% to 11.0%, and JP Morgan revised its 2020 loan and high yield default forecasts of 5% and 8%, respectively, to 4% and 6.5%. JP Morgan forecasts a further decline for 2021 loan and high yield default rates to 3.5% each.[7] Credit issuers' 2Q results evidenced the additional liquidity levers available to companies as they were able to bolster quarterly cash balances, which increased by a whopping 88% year-over-year across GSO's US borrowers, likely in response to higher leverage and slower top-line growth.[8]

Following a quiet summer, loan issuance increased to $24 billion during September.[9] This weighed on secondary loan prices as cash was deployed in the primary market but was partially offset by demand from $10 billion in new CLO issuance. The uptick in loan issuance can be at least partially attributed to an increase in dividend recap activity as sponsors took advantage of strong market conditions to pay dividends. Borrowers have also been refinancing existing debt to extend maturities given the strength of the market. Additionally, acquisition-related loan primary activity gained traction in September; however, it was late arriving with 70% of September's M&A volume launching in the second half of the month.[10] Demand from retail funds remains underwhelming with monthly net outflows from open ended loan funds of $1.4 billion in September.[11]

US high yield bond investors withdrew $4.2 billion of assets from high yield ETFs and mutual funds in the week ending September 23 in reaction to concerns over the continued spread of COVID-19 and heightened political uncertainty in the US. As a result, monthly net high yield retail flows turned negative in September for the first time since March totaling -$7.7 billion.[13] Against this weak demand backdrop, US high yield primary activity remained robust with $51 billion of gross issuance in September, the busiest September ever, which weighed on the performance of US high yield bonds in the secondary market.[11,12]

European Loan and High Yield Markets

September EU Supply and Demand



Similar to the US, the performance recovery in European loans and high yield bonds lost momentum in September and returns totaled 0.74% and -0.52%, respectively, as COVID-19 infection rates worsened across most of Europe. Geopolitical risks also weighed on performance as Brexit uncertainty and tensions between Germany and Russia intensified. Supply and demand technicals have proven to be a key influencer of relative performance in Europe as loan prices were supported by an increase in CLO issuance while anemic high yield demand from retail investors weighted on bond returns.[13]

On the supply side, European loan issuance remained subdued totaling €6.7 billion in September, a 30% decrease year over year and the lowest September total in five years. Issuance year to date is down 8% compared to the same time period in 2019. Meanwhile, €10.2 billion of high yield bonds priced in September bringing quarterly issuance to the highest level since 2016 and year-to-date issuance now totals 22% greaterthan the same period last year.[14]

On the demand side, European CLO issuance increased to €1.5 billion compared to just €0.5 billion the previous month.[13] In comparison, demand for European high yield bonds decreased month over month with €108 million of net outflows, inclusive of €169 million in the week ending September 23, the second largest weekly outflow post COVID-19.[15] However, we believe the overall high yield technical picture remains firm as evidenced by strong performance of new issue transactions post-syndication.[16]

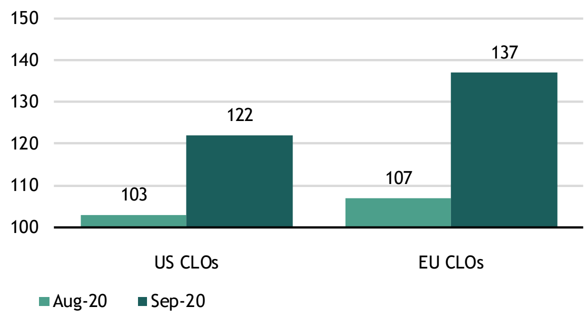
European default rates remain subdued, and distress ratios of European loans and high yield bonds continue to decrease and now stand at 4.8% and 5.5%, respectively, compared to 8.3% and 7.0% for their US counterparts.[17]

[6] S&P/LSTA Leveraged Loan Index, Bloomberg Barclays US High Yield Index, as of September 30, 2020;
[7] Moody's Default Report, JP Morgan Default Monitor.
[8] GSO, Axiom, as of June 30, 2020.
[9] JP Morgan High Yield Bond and Leveraged Loan Market Monitor, October 1, 2020.
[10] LCD, as of September 30, 2020.
[11] JP Morgan, Lipper, as of September 30, 2020; includes weekly and monthly reporting funds if reported by October 2, 2020.
[12] Credit Suisse Credit Strategy Daily, October 1, 2020.
[13] Credit Suisse European Leveraged Loan and High Yield Bond Indices, as of September 30, 2020.
[14] LCD as of September 30, 2020.
[15] JP Morgan, Lipper, as of September 30, 2020.
[16] Credit Suisse European Credit Trades & Themes: High Yield Recap, October 6, 2020.
[17] Credit Suisse Default Monitor, October 6, 2020.

US and European CLO Markets

Attractive CLO equity arbitrage, represented by the difference between average loan and CLO liability spreads, fueled an increase in CLO issuance globally and led to the busiest month of origination since April 2019 in the US.[18] 23 deals priced in the US totaling $10.3 billion and 4 deals priced in Europe totaling €2.8 billion.

US and European CLO Equity Arbitrage
(Loan Spread Minus CLO Liability Spread)



Only 78 managers in the US have issued a CLO in 2020, compared to 106 managers during the same period last year. There are fewer smaller managers issuing CLOs because not every manager has access to affiliated equity. In fact, over half of US CLO managers with less than $5 billion of assets under management have yet to issue a deal this year. In Europe the trend is less pronounced as 37 European managers have issued a CLO during the first 9 months of 2020, compared to 43 managers in the same period of 2019.[19]

Newly issued CLO liability spreads continue to tighten in both regions adding to the attractive equity arbitrage. Top tier US managers with post-COVID portfolios were able to price their AAA tranches inside of L+130, and the US CLO primary market also experienced the return of the first 5-year reinvestment CLO in September. While European CLO liabilities also tightened in the primary market month over month, reinvestment periods remain at 3 years.[20]

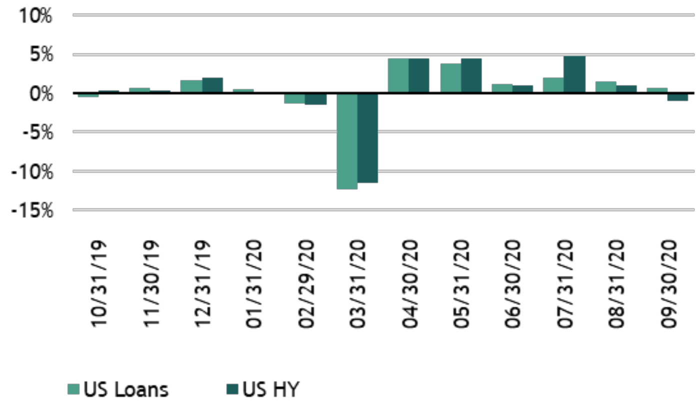
In the secondary market, CLO liability spreads for US and European CLOs experienced tightening across most of the capital stack in September, until volatility from the loan market spilled over late in the month. Ultimately, spreads of US CLO tranches rated AAA-A widened over the month by 5-10bp while spreads for BBB and BB rated tranches tightened by 15bp and 75bp, respectively, and spreads across European CLO tranches widened over the month by 2-20bp.[21] Generally, European CLO spreads remained firmer for higher rated tranches compared to mezzanine tranches, and there was further bifurcation within tranches of the same rating, with CLOs with portfolios perceived as underperforming lagging those with higher quality portfolios. This was most pronounced within European CLO tranches rated BBB and below. Secondary trade volumes were elevated during September as activity picked up across most CLO tranches and Bids Wanted in Competition ("BWIC") activity was twice the amount recorded in August and the third heaviest month of the year. Year-to-date BWIC volume in Europe now totals $12.3 billion and is already well in excess of 2019 levels.[22]

Of note, Moody's proposed key revisions to their current treatment of ratings of underlying loans on review for upgrade or downgrade as well as ratings with a negative outlook. Currently, for purposes of calculating CLO Weighted Average Rating Factor ("WARF") tests, ratings on review for downgrade are adjusted down by two notches while ratings on review for upgrade are adjusted up by one notch. Ratings with a negative outlook are also adjusted down by one notch. The proposed revision by Moody's would require just a one notch adjustment for ratings on review for downgrade or upgrade and no adjustments would be applied based on rating outlook status. This change is expected to improve CLO portfolio WARF scores and serves as an acknowledgement that the existing methodology was too restrictive to CLO portfolios during times of stress. As a result, Citigroup expects wider performance dispersion between managers, particularly at the mezzanine tranches.[23]

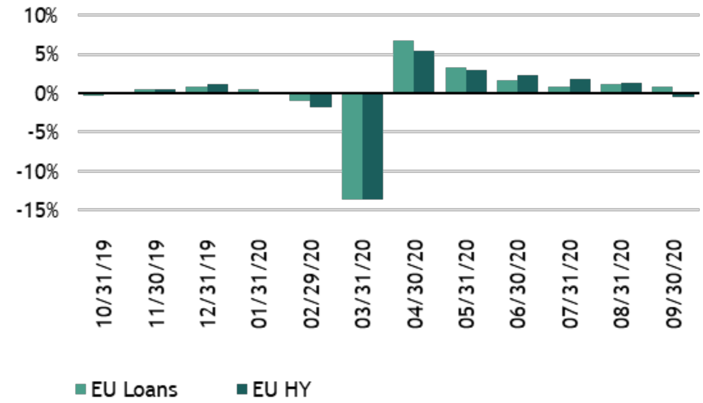
[18] Credit Suisse Credit Strategy Daily (Loan September Recap), October 6, 2020.
[19] LCD CLO Market Remains Resilient in Q3, September 28, 2020; manager counts as of September 30, 2020.
[20] LCD, as of September 30, 2020.
[21] BofA Global Research for US CLO spreads, as of September 30, 2020. Citi for European CLO spreads, as of September 30, 2020.
[22] Citivelocity, as of September 30, 2020.
[23] Citi CLO Mezz & Moody's Update, September 18, 2020.

Market Snapshot (as of September 30, 2020)[24]

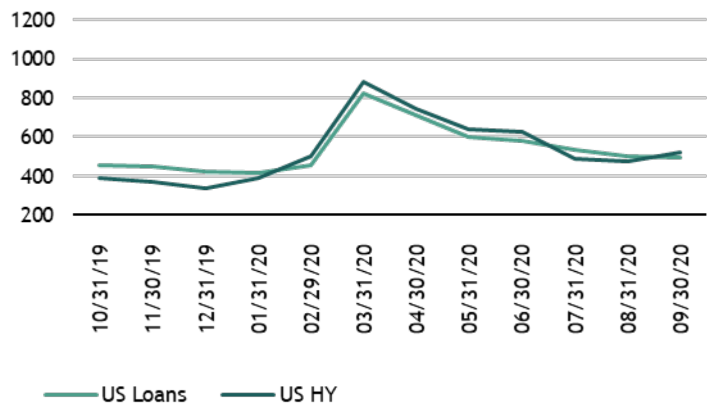
US Credit Monthly Returns



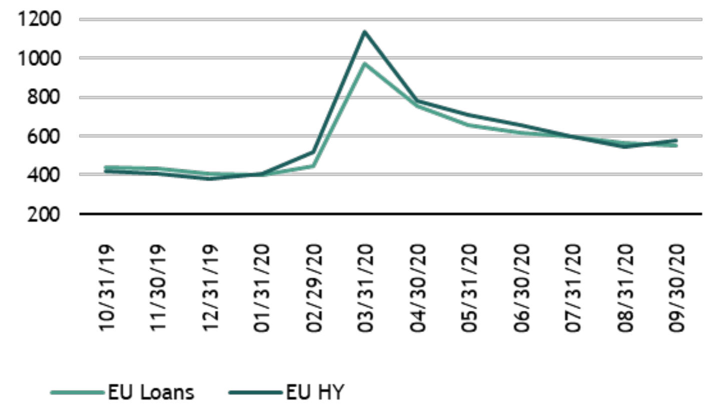
EU Credit Monthly Returns



US Credit Spreads (bp)



EU Credit Spreads (bp)



	Spread			Yield			Price		
	Level	ΔMTD	ΔYTD	Level	ΔMTD	ΔYTD	Level	ΔMTD	ΔYTD
U.S. Loans	494	-6	71	5.74%	-0.06%	-0.39%	$93.18	$0.33	-$3.54
U.S. HY	517	40	181	6.12%	0.25%	0.14%	$99.58	-$1.41	-$1.66
EU Loans	549	-15	143	3.96%	-0.02%	-0.19%	€94.59	€0.32	-€ 3.72
EU HY	577	31	196	5.43%	0.17%	1.02%	€93.34	-€ 0.74	-€ 6.09

	Level	MTD Return	YTD Return
Dow Jones Industrials	27782	-2.18%	-0.91%
S&P 500	3363	-3.80%	5.57%
Russell 2000	1508	-3.34%	-8.69%
Euro Stoxx 50	3194	-2.30%	-12.58%
DAX	12761	-1.43%	-3.69%
MSCI Emerging Markets	1082	-1.58%	-0.91%
MSCI World	2367	-3.41%	2.12%

	Level	ΔMTD	ΔYTD
1-Month Libor	0.15%	-1 bp	-161 bp
3-Month Libor	0.23%	-1 bp	-167 bp
10-Year Treasury	0.68%	-2 bp	-123 bp
3-Month Euribor	-0.49%	-2 bp	-11 bp
6-Month Euribor	-0.48%	-4 bp	-16 bp
10-Year German Bund	-0.52%	-13 bp	-34 bp

[24] 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 August 31, 2020. Equities, LIBOR, Euribor, US Treasury, and German bund sourced from JP Morgan daily updates.

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