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CAPITAL PARTNERS

CREDIT INSIGHTS

GSO June 2020 Market Commentary

Performance Overview

In June, global credit markets continued their rebound from March lows with lower quality loans and bonds leading the rally in both the US and Europe.[1] Returns overall were buoyed by the effects of continued stimulus from central banks and governments despite a bout of volatility toward the end of the month as investors reacted to a spike in COVID-19 cases in the US.

- The market rebound from March lows continued despite volatility towards the end of June.
- Investors continue to flock to credit markets for incremental yield given low global interest rates.
- US defaults increased while European defaults remain muted.

Strong retail demand for high yield was a key technical driver of performance globally in June. Retail flows into European high yield funds surpassed the prior month, and US high yield funds experienced inflows of $6.5 billion, bringing the quarterly total to $44.0 billion, the largest quarterly inflow on record, easily surpassing the previous record of $20.6 billion in 1Q12.[2] This record amount of capital was deployed into a robust pipeline of new issue bonds as US companies in particular continued to prefer issuing longer-term, fixed rate debt over shorter-term, floating rate debt. Loan issuance in both regions also increased but remained lower than average in the US.[3]

US loan and high yield default activity further accelerated in June as a total of 15 companies in the US defaulted affecting $23.4 billion of debt – the sixth highest monthly total on record.[4] Default activity in Europe continued to be more muted.[5] Loan downgrades persisted in June globally, albeit at a slower pace compared to recent months.[6] These ratings actions, coupled with elevated levels of defaults in the US, have continued to place pressure on Collateralized Loan Obligations ("CLOs"), but certain CLO metrics have already begun to improve alongside the rally in loan prices.

Market Returns (as of June 30, 2020)

	June	2Q20	YTD
S&P / LSTA U.S. Leveraged Loan Index	1.14%	9.70%	-4.61%
Bloomberg Barclays U.S. High Yield Index	0.98%	10.18%	-3.80%
Credit Suisse Western European Leveraged Loan Index	1.57%	11.89%	-3.80%
Credit Suisse Western European High Yield Index	2.34%	10.98%	-5.77%
S&P 500	1.99%	20.54%	-3.08%
Euro Stoxx 50	6.49%	17.80%	-11.97%

Market Outlook

Global economies continue to deal with the effects of COVID-19, social unrest, and rising geopolitical tension. But notwithstanding a recent spike in US cases, we believe the worst of the virus impact is likely behind us. That said, we are closely monitoring the re-acceleration of COVID-19 in the US, as a reversal of recent reopening measures in many cities and states would deepen the economic damage from the pandemic and elongate the path to a complete recovery.

The S&P 500® recorded its best quarterly performance in 2Q20 since 1998, and the current recession may end up being the shortest in history, beating the six-month recession in 1980. But the market recovery remains stimulus-led, driven by the speed and magnitude of global policy responses rather than consumer and industrial fundamentals.[7] Although some stimulus and central bank support may extend beyond the pandemic, we believe that emergency government support will wane and thus do not expect a "V-shaped" recovery where the pre-COVID-19 levels of economic activity, employment, and profitability are reached in the near term.

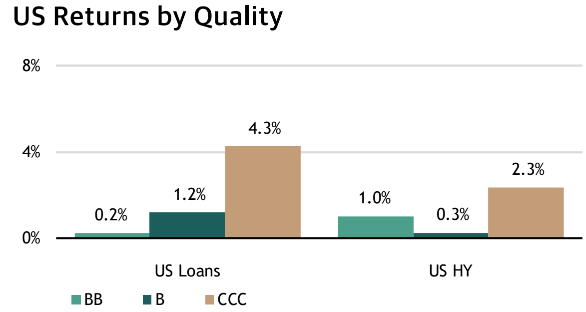
In the US, we expect defaults to continue to increase, and JP Morgan forecasts 2020 loan and high yield bond default rates of 5% and 8%, respectively, with a decline to 3.5% and 5%, respectively, for 2021, predicated on economic recovery during the second half of 2020.

The new issue pipeline for loans globally continues to look light, which may further support loan secondary prices. We expect future high yield retail flows to be volatile but remain positive as investors search for yield amid low interest rates. As companies report 2Q earnings in July and August, we will closely monitor the depth of damage done and outlook, which will drive potential idiosyncratic volatility.

[1] Based on S&P/LSTA Leveraged Loan, Bloomberg Barclays High Yield, Credit Suisse European Leveraged Loan, and Credit Suisse High Yield indices, as of June 30, 2020.
[2] JP Morgan, Lipper, June 30, 2020; includes weekly and monthly reporting funds if reported by July 8, 2020.
[3] LCD for US investment grade and European loan and high yield bond issuance, JP Morgan for US loan and high yield bond issuance, as of June 30, 2020.
[4] JP Morgan Default Monitor, July 1, 2020.
[5] Credit Suisse Default Monitor, July 2, 2020.
[6] JP Morgan, as of June 30, 2020.
[7] Bloomberg Finance L.P., as of June 30, 2020.

US Loan and High Yield Markets

Limited new issue US loan supply and strong demand for US high yield bonds continued to drive positive performance for both asset classes in June. US loans and high yield bonds returned 1.14% and 0.98%, respectively. Deeply distressed assets outperformed their higher-quality cohorts with CCC-rated loans returning 4.26% and CCC-rated bonds returning 2.35% for the month.[8]



Strong demand for high yield bonds was driven by the US Federal Reserve's (the "Fed") continued expansion of accommodative measures in June. These included the loosening of terms for the Secondary Market Corporate Credit Facility and the commencement of individual bond purchases. US high yield bond funds logged roughly $6.5 billion in net inflows as a result.[9]

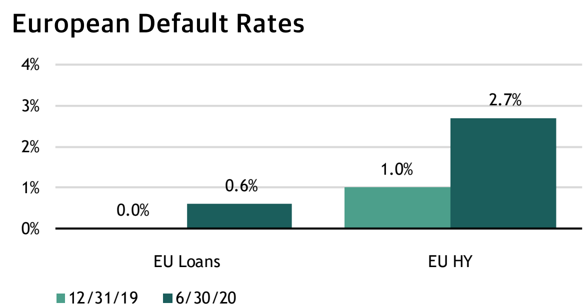
In tandem, US high yield bond issuance surged to $62 billion in June, now the largest monthly total on record.[10] Senior secured bonds continue to represent an elevated portion of high yield issuance, particularly within COVID-19 affected sectors. Absent further widespread COVID-19 shutdowns, we expect a return towards more normal levels of high yield issuance as many companies have addressed their liquidity needs.

Persistently low interest rates continue to damper retail investor demand for loans. Three-month LIBOR stood at 0.30% on June 30, down 161bp year-to-date, and loan fund outflows totaled $1.8 billion in June bringing the year-to-date total to $22.0 billion.[11] In response to the low interest rate environment, approximately 84% of loan transactions in June priced with a LIBOR floor above 0%, however, only 37% of outstanding loans contain a floor compared to 59% two years ago and a record high of 92% in December 2016.[12] Loan issuance increased by $19 billion month over month to $29 billion but remains muted relative to historical averages.

The pace of rating agency downgrades of US loans and bonds slowed in June while defaults accelerated. The par-weighted last 12-month ("LTM") default rate increased to 3.96% for loans and 6.19% for high yield, representing 5-year and 10-year highs, respectively. The year-to-date default total of $106 billion ranks as the second highest annual total trailing only the $205 billion total for 2009.[13]

European Loan and High Yield Markets

European central banks continued to provide credit market support through asset purchases and bank stimulus in June. These actions have counteracted fundamental market deterioration and bolstered returns for the month.[14]



European loans and high yield bonds returned 1.57% and 2.34%, respectively, in June despite heightened volatility towards the end of the month in reaction to COVID-19 concerns. The best performers in June were CCC-rated loans and high yield bonds, which returned 6.02% and 8.30%, respectively.[15]

European loans and high yield bonds experienced a surge in new issue supply in June, returning volumes to healthier levels in the wake of COVID-19. Loan issuance totaled €6.97 billion in June, bringing year-to-date issuance to €37.24 billion, lagging the first half of 2019 by only 6%. With a broader investor base than loans, the high yield market was quicker to reopen in Europe after the initial COVID-19 impact. High yield bond issuance in June totaled €13.66 billion, representing the second highest monthly volume on record and bringing year-to-date issuance to $37.17 billion, substantially higher than the €29.73 billion seen in the first half of 2019. High yield issuance was supported by steady retail fund inflows, which totaled €1.7 billion in June.[16]

Unlike in the US, few European companies have filed for bankruptcy this year. Significant fiscal support in Europe, comprised of revolver facilities and government-guaranteed loan schemes, has warded off defaults in the region, and levels of distress as measured by trading prices have receded quickly. The distress ratios for loans and high yield decreased in June to 4.6% and 8.6%, respectively, from 5.9% and 10.1% in May.[17] The LTM loan and high yield default rates were stable month over month at 0.6% and 2.7%, respectively, compared to 0.6% and 2.6%.[18]

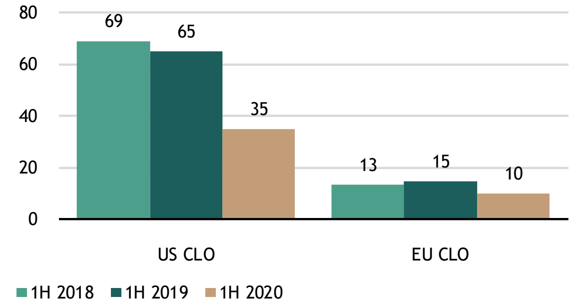
With the benign passing of the June 30, 2020 Brexit deadline, the increased likelihood of more government stimulus, and the potential for European central bank purchases of sub-investment grade debt, the outlook for below investment grade credit remains favorable.

[8] S&P/LSTA Leveraged Loan Index, Bloomberg Barclays US High Yield Index, as of June 30, 2020;
[9] JP Morgan, Lipper, as of June 30, 2020. Includes all weekly and monthly reporting funds, if reported by July 8, 2020.
[10] JP Morgan High Yield and Leveraged Loan Market Monitor, July 1, 2020.
[11] Bloomberg Finance L.P., as of June 30, 2020.
[12] JP Morgan, as of June 30, 2020.
[13] JP Morgan Default Monitor, July 1, 2020. Year-to-date default total includes distressed exchanges.
[14] Citi European Credit Strategy H2 Outlook, June 25, 2020.
[15] Credit Suisse European Leveraged Loan and High Yield indices represented by CCC/Split CCC-rated loans and high yield bonds, as of June 30, 2020.
[16] JP Morgan, Lipper, June 30, 2020.
[17] Credit Suisse Credit Strategy, July 2, 2020.
[18] Credit Suisse Default Report, July 2, 2020. Represents LTM par default rates of Credit Suisse Western European Leveraged Loan and High Yield indices.

US and European CLO Markets

Rating agencies slowed their pace of loan downgrades in June; however, incremental downgrades and defaults, particularly in US loans, have put further pressure on CLO overcollateralization tests and interest diversion tests.[19] While partially offset by the rally in CCC-rated US and European loan prices, negative rating watch actions turned into downgrades for 125 US and European CLO tranches in June as the rating agencies finalized these reviews. This pace implies that it may take many months for the rating agencies to work through the 2,013 US and European CLO tranches initially placed on watch for downgrade.[20] For GSO's US and European CLO tranches, 8% and 9%, respectively, have seen ratings actions (negative watch), versus a peer cohort of 15% and 13% in the US and Europe, respectively. While the majority of tranches originally put on negative watch remain under review, many peers have already seen multiple CLO tranche downgrades in several vintages where GSO still remains without having had a CLO tranche downgrade in the US and has seen only one CLO tranche downgrade in Europe.[21]

CLO Issuance



Total monthly issuance of CLOs increased in June to $7.9 billion in the US and €2.4 billion in Europe, compared to $6.0 billion and €1.0 billion in May; however, year-to-date issuance lags 2019 levels in both markets. CLO warehouses formed before the COVID-19 volatility have proven largely resilient but, in order to exit the initial funding stage of CLO formation, some CLO managers have issued new US and European CLOs with shorter reinvestment periods than a typical CLO issued pre-COVID-19.[22]

In Europe, four new or relatively new CLO managers were able to issue CLOs in June accounting for 44% of the month's issuance by count, proving the robustness of CLO demand in the region.[23] The overall confidence in broader syndication is improving in Europe as demand is again starting to be met with more broadly syndicated CLO transactions compared to the narrower distribution witnessed earlier in the COVID-19 period. However, most banks syndicating CLO transactions still prefer the certainty of execution through locking in liability spreads with fewer large investors over a wider syndication process among more investors.

Spreads of US new issue CLOs tightened over the quarter by 50bp-225bp as evidence of a gradual reduction of risk premia. In fact, GSO issued a US CLO during the month with a weighted average cost of capital of 211bp, the tightest for any post-COVID-19 CLO.[24] Given the overall low issuance volumes in the market and small deal sizes, however, the depth of demand remains below pre-COVID-19 levels.

Default projections for 2020 have begun to be revised downward by several research teams at the large syndication banks. This should signal a continued path to recovery for CLO structures globally.

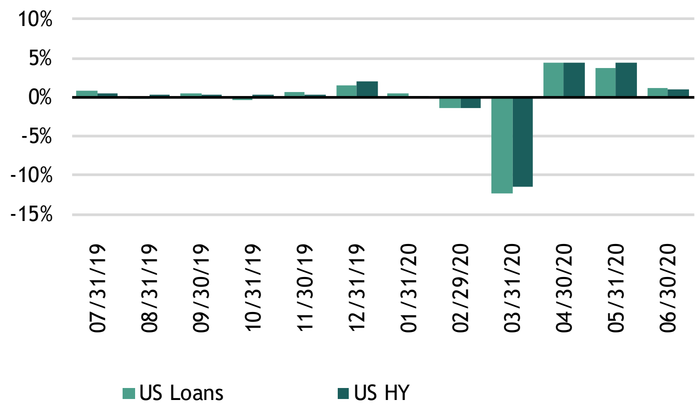
The Volcker Rule was revised at the end of June allowing US CLOs to purchase high yield bonds in an amount up to 5% of the portfolio. We view this change as neutral for CLO mezzanine tranches (BBB/BB) and a small positive for CLO equity. While the high yield market has improved in quality over the last several years – increased investor appetite for duration has resulted in secured fixed rate replacing floating loans and an increase in fallen angels has resulted in BB-rated bonds comprising a larger portion of the market - historical recoveries on average are lower for high yield bonds compared to loans, and any high yield exposure would have to be accounted for in CLO models accordingly.

Going forward, we are highly focused on the elevated level of restructurings in the US loan market and the ability for CLOs to achieve the highest possible recoveries. CLO managers are collaborating to improve the flexibility of loan documentation to allow for a more equal seat at the recovery table alongside more nimble distressed investors.[25]

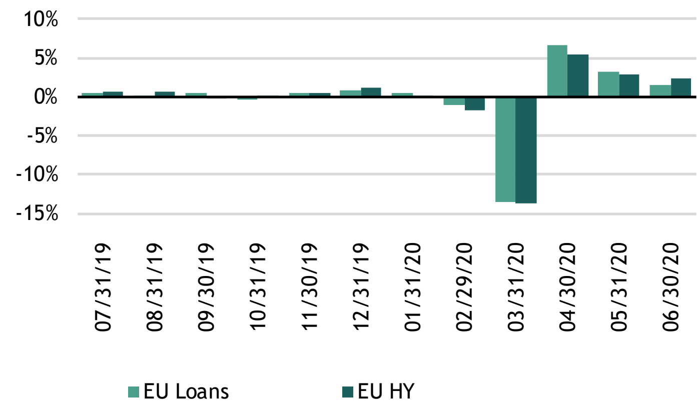
[19] JP Morgan, as of June 30, 2020.
[20] Kanerai, Intex, Bloomberg, Moody's, S&P, Fitch, Barclays Research, as of June 30, 2020. Represented by US and European BSL CLOs.
[21] Percentages are based on tranche count and peer cohort is managers in top 20 AUM, as of June 4, 2020. GSO's Holland Park CLO (European CLO) BB tranche (rated BB flat) downgraded to BB- on July 10, 2020.
[22] LCD, report from legal services providers Maples, June 23, 2020.
[23] LCD, as of June 30, 2020.
[24] LCD, as of June 30, 2020.
[25] Barclays CLOs' Shrinking Seat at the Recovery Table, June 12, 2020.

Market Snapshot (as of June 30, 2020)[26]

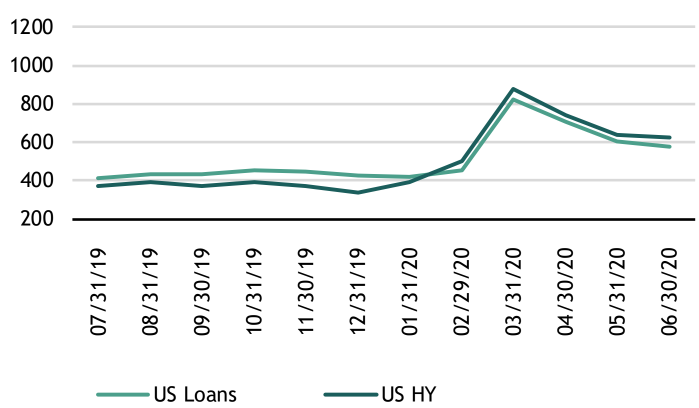
US Credit Monthly Returns



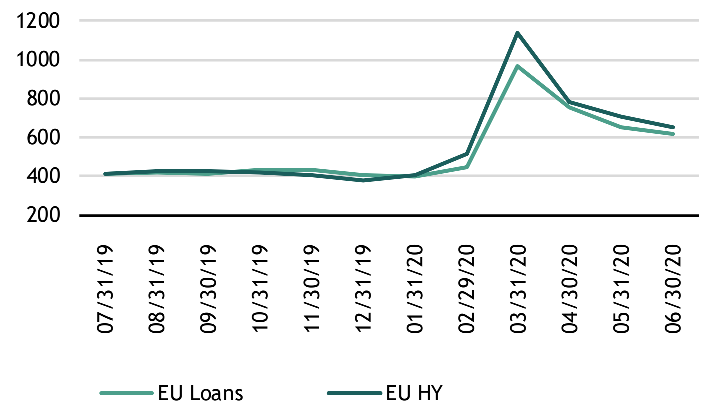
EU Credit Monthly Returns



US Credit Spreads (bp)



EU Credit Spreads (bp)



	Spread			Yield			Price		
	Level	ΔMTD	ΔYTD	Level	ΔMTD	ΔYTD	Level	ΔMTD	ΔYTD
U.S. Loans	579	-22	157	6.81%	-0.32%	0.68%	$89.88	$0.85	-$6.85
U.S. HY	626	-11	289	7.02%	-0.25%	1.04%	$95.89	$1.26	-$5.34
EU Loans	617	-37	211	4.11%	-0.09%	(0.03%)	€92.74	€1.15	-€ 5.57
EU HY	654	-53	273	6.10%	-0.60%	2.29%	€91.29	€1.78	-€ 8.14

	Level	MTD Return	YTD Return
Dow Jones Industrials	25813	1.82%	-8.43%
S&P 500	3100	1.99%	-3.08%
Russell 2000	1441	3.40%	-13.61%
Euro Stoxx 50	3234	6.49%	-11.97%
DAX	12311	6.25%	-7.08%
MSCI Emerging Markets	995	7.40%	-9.67%
MSCI World	2202	2.69%	-5.48%

	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

[26] 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 June 30, 2020. Equities, LIBOR, Euribor, US Treasury, and German bund sourced from JP Morgan daily updates.

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