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CREDIT INSIGHTS

GSO July 2020 Market Commentary

Performance Overview

- US high yield bonds led the rally and returns are now positive year-to-date
- US and European loans experienced net upgrades
- Defaulted asset exposure in US and European CLOs increased month over month

Loans and high yield bonds continued to rebound globally in July as positive vaccine news and progress on stimulus packages in both the US and Europe seemed to boost investor sentiment. In fact, US high yield bond returns year-to-date have now turned positive after leading the performance rally in July. This was despite the US Federal Reserve (the "Fed") pulling back on corporate bond and ETF purchases as continued retail demand, coupled with a slowdown in bond issuance month-over-month, created a strong technical backdrop globally. For loans, newly issued US Collateralized Loan Obligations ("CLOs") and ramping CLO warehouses led prices higher in the secondary market given subdued levels of primary issuance in July. European loan issuance, on the other hand, increased month-over-month, likely contributing to the modest underperformance compared to US loans.[1]

For the first time in 2020, US and European loans experienced monthly net rating agency upgrades in July.[2] This, along with the price appreciation of CCC-rated loans, caused CLO fundamentals to largely improve month-over-month as evidenced by declines in exposure to CCC-rated assets, declines (improvement) in weighted average rating factors ("WARF"), and an increase in weighted average spreads ("WAS"). However, as defaults continued in both regions, the defaulted asset exposure increased by 0.2% for both US and European CLOs.[3] S&P Ratings estimates that nearly 15.5% of US and 11.5% of European below investment grade companies could default by March 2021 in a most pessimistic scenario.[4]

Market Returns (as of July 31, 2020)

	July	QTD	YTD
S&P / LSTA U.S. Leveraged Loan Index	1.96%	1.96%	-2.74%
Bloomberg Barclays U.S. High Yield Index	4.69%	4.69%	0.71%
Credit Suisse Western European Leveraged Loan Index	0.82%	0.82%	-3.02%
Credit Suisse Western European High Yield Index	1.84%	1.84%	-4.03%
S&P 500	5.64%	5.64%	2.38%
Euro Stoxx 50	-1.51%	-1.51%	-13.30%

Market Outlook

The recent increase in COVID-19 cases across many cities and states in the US has begun to have a negative impact on the US economy. The escalation of US-China tensions creates further uncertainty in the already vulnerable economy. However, the Fed and Congress continue to take steps to combat the COVID-19 related recession. In late July, the Fed extended its support through the end of 2020 and will sustain historically accommodative policies until the US economy has "weathered recent events," per Fed chair Jerome Powell. Additionally, Congress continues to negotiate its second stimulus package. With positive vaccine news, strong housing figures, and a better than expected second quarter earnings season, the early stages of the recovery in the US may appear to be V-shaped; however, we believe volatility remains on the horizon and continue to expect a square-root shaped recovery.

Central banks and governments in Europe also remain committed to supporting a recovery. The European Union ("EU") agreed in July to a €750 billion stimulus package aimed at rescuing the European economies most impacted by the pandemic. This agreement in particular sends a strong message of solidarity within the EU as bonds will be sold collectively, rather than individually, and much of this money will be given to member nations hardest hit by the pandemic as grants, rather than loans that would increase their debt load.[5]

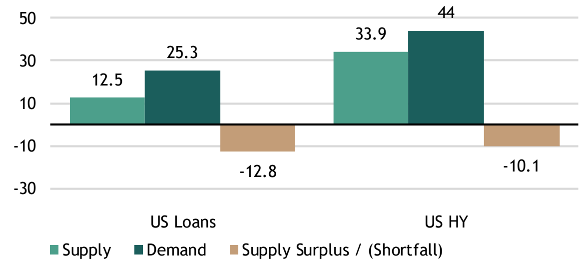
We expect active management to play an important role in portfolio returns as the economy continues to recover. Credit selection will play an increasingly important role as policies and capital flows normalize. We also expect investor demand for yield to be supportive of below investment grade credit markets given that yield of the traditional 60% equity/40% bond portfolio allocation has eroded and currently produces just 150bp of income annually, on average.[6]

[1] LCD for European loan and high yield bond issuance, JP Morgan for US loan and high yield bond issuance, LCD for CLO issuance, as of July 31, 2020.
[2] JP Morgan, as of July 31, 2020, for US loan downgrades; Credit Suisse Credit Strategy, July 27, 2020.
[3] Barclays CLO & Leveraged Loan Monthly Update, as of July 31, 2020.
[4] Reuters, "How the Coronavirus is Crushing Credit Ratings," July 29, 2020.
[5] New York Times, "E.U. Adopts Groundbreaking Stimulus to Fight Coronavirus Recession," July 27, 2020.
[6] Assuming a portfolio comprised of 60% S&P 500 and 40% Bloomberg Barclays US Aggregate Bond Index as of July 31, 2020.

US Loan and High Yield Markets

US loans and high yield bonds outperformed their European counterparts in July returning 1.96% and 4.69%, respectively. High yield bond year-to-date total returns turned positive late in the month and now stand at 0.71% as of July 31, 2020. Loans and high yield have now recouped 75% and 95%, respectively, of the $20+ price declines that occurred between late February and late March.[7]

July US Supply and Demand



The Fed slowed purchases of bond ETFs by roughly 50% in July; however, this did not appear to have a significant impact on retail demand for high yield as these funds experienced monthly net inflows of $8.1 billion.[8] Bond issuance slowed dramatically to $26.7 billion, a 55% decrease month over month, which created a very supportive technical backdrop as investors put cash to work in the secondary market.[9] Issuance totals staged a surprising rebound in August, with issuance topping $40 billion during the first two weeks alone of the typically seasonally slow month.[10]

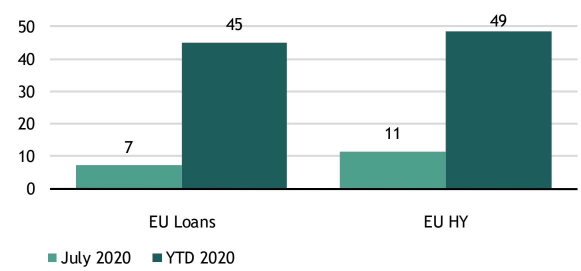
Loan demand in July was driven primarily by CLO issuance, which increased 16% month-over-month to $9.1 billion. Loans also experienced net inflows of $42 million, the first monthly net inflow since January 2020.[11] Loan new issue supply decreased to just $12.5 billion, which also helped support secondary loan prices.[8] Investor risk appetite appeared to increase for US loans as almost all of the month's new issue supply was rated single-B and one dividend recap transaction was completed. August issuance is expected to decrease to about $7 billion.[12]

Defaults continued in July with 13 companies defaulting affecting $11.7 billion of loans and bonds, the majority of which (65%) can be attributed to four large defaults in the Energy and Retail sectors. The par-weighted last 12-month ("LTM") default rate increased to 4.36% for loans and 6.22% for high yield, both now representing 10-year highs. We noted a few interesting takeaways regarding recoveries. JP Morgan reports issuer-weighted LTM recovery rates of 43% for loans (47% for 1st lien loans) and 17% for high yield bonds. These are each considerably lower than their respective long-term averages; however, we would note that low recoveries in the Energy and Retail sectors, which GSO has generally been underweight, have had an outsized impact. Excluding these sectors, which we estimate represent approximately 40% of loans and 50% of high yield LTM defaults by volume, we estimate LTM loan and high yield issuer-weighted recoveries of 54% and 26%, respectively.[13] As defaults continue to increase globally, we remain cognizant of both lender-and sponsor-driven aggression during active restructurings, which will be important factors in estimating recovery values and trading levels.

European Loan and High Yield Markets

European loan and high yield markets remained supported by favorable government commitments as leaders agreed on the EU Recovery Fund and stimulus from central banks continued. European loans and high yield returned 0.82% and 1.84%, respectively, in July.[14]

European Issuance



European high yield in particular benefitted from Bank of England ("BOE") purchases which now reached almost 70% of the £10 billion total goal. This represents a pace averaging £500 million per week, much more aggressive than the previous round of quantitative easing ("QE") in 2016. By the end of the QE programs, the BOE and European Central Bank will own 6% and 15%, respectively, of the total market. This compares to 4% for the Fed.[15]

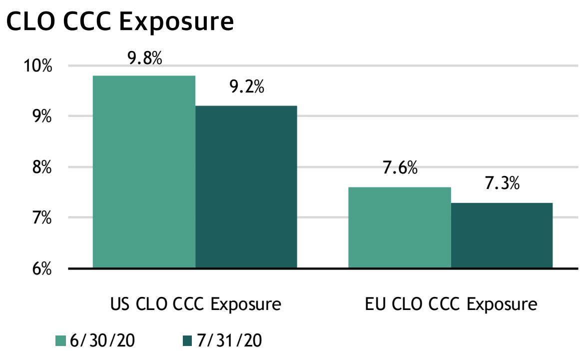
European loan and high yield issuance slowed slightly in July but remained at healthy pre-COVID-19 levels. Loan issuance totaled €7.2 billion, bringing year-to-date issuance to €45.0 billion, lagging the same period last year by only 8%. High yield bond issuance totaled €11.4 billion, bringing year-to-date issuance to €48.5 billion, substantially higher than the €37.9 billion issued during the same time period in 2019.[16] High yield issuance was supported by steady retail fund net inflows, which totaled €892 million.[17] The recovery in European loans and high yield bonds should be further supported in August by an expected decrease in supply as primary issuance is projected to slow.

Downgrades of formerly investment grade bonds to BB (fallen angels) have caused a divergence in credit quality between European loans and high yield bonds. BB-rated bonds now account for half of the European high yield market, while 70% of the loan market is rated single B.[18] Default rates for European loans and high yield bonds now sit at 0.9% and 2.8%, respectively, much lower than their US counterparts.[19]

[7] S&P/LSTA Leveraged Loan Index, Bloomberg Barclays US High Yield Index, as of July 31, 2020;
[8] JP Morgan, Lipper, as of July 29, 2020. Includes all weekly and monthly reporting funds, if reported by July 29, 2020.
[9] JP Morgan High Yield Bond and Leveraged Loan Monitor, August 3, 2020.
[10] JP Morgan, August 14, 2020.
[11] LCD for CLO issuance, as of July 31, 2020; JP Morgan, Lipper for fund flows, as of July 29, 2020.
[12] Credit Suisse Credit Strategy, July 31, 2020.
[13] JP Morgan Default Monitor, August 3, 2020. Recovery rates excluding Retail and Energy based on GSO calculations using JP Morgan default data.
[14] Credit Suisse European Leveraged Loan and High Yield indices, as of July 31, 2020.
[15] Credit Suisse Credit Strategy, July 23, 2020.
[16] LCD, as of July 31, 2020.
[17] JP Morgan, Lipper, July 31, 2020.
[18] High yield BB-rated exposure includes BB-rated and Split BB-rated bonds; loan B-rated exposure includes B-rated and Split B-rated loans.
[19] Credit Suisse Default Report, August 5, 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 July, and both US and European loans experienced net upgrades for the month for the first time in 2020.[20] This, combined with an increase in average CCC-rated loan prices, has resulted in improvements to certain CLO test scores such as percentage of CCC-rated loans, weighted average rating factor, and weighted average spread. US CLO junior overcollateralization tests also improved slightly month over month.[21] However, CLO debt tranches were not themselves insulated from downgrades. Rating agency downgrades for US and European CLO tranches increased to 143 in July, up from 125 in June.[22] As of this writing, GSO has received two downgrades of a US CLO tranche and one downgrade of a European CLO tranche.[23]



Despite improving fundamental trends, July equity distributions for US CLOs were lower than the prior quarter, and Bank of America estimates that 17% of all deals had no equity distributions in July. This was largely due to the mismatch between the LIBOR reset dates for the liabilities versus the LIBOR reset dates on the underlying loans as the LIBOR rate has been declining. Also, to a lesser extent, the change from 1-month to 3-month LIBOR on the underlying loans had an impact as well as more loans are starting to reset LIBOR quarterly as they look to preserve liquidity. We expect an improvement in equity payments in October when liability tranche payments will be reflective of July's lower LIBOR.[24]

The faster pace of loan downgrades and defaults in the US relative to Europe has placed incremental pressure on US CLOs. As a result, tranche ratings reviews for US CLOs have been more likely to result in downgrades relative to European CLOs. Additionally, US CLOs have higher CCC asset exposure of 9.2% as compared to 7.3% for European CLOs as of July 31, 2020 and less junior overcollateralization cushion (210bp for US CLOs compared to 363bp for European CLOs as of July 31, 2020).[17] This is not to suggest that European CLOs have remained unscathed from recent events. Ratings-based WARF tests are under pressure and can limit the ability of European CLOs to trade. A recent Bank of America report estimated the average WARF is now around 3,380 suggesting close to 90% of CLOs are breaching the ceiling for this test.[25]

Total monthly issuance of CLOs increased in July to $9.1 billion in the US and €2.6 billion in Europe, compared to $7.9 billion and €2.4 billion, respectively, in June. Year-to-date issuance continues to lag 2019 levels in both markets, but CLO warehouses formed before the pandemic continue to ramp and have largely supported secondary loan prices, particularly in the US.[26]

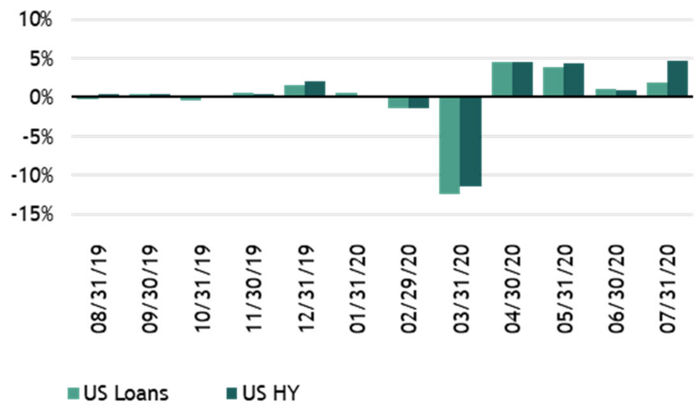
Spreads of European new issue CLOs tightened across the capital stack by 5-75bp on average, and deals contained more bifurcated prints with regards to deals with more perceived risk (typically CLO portfolios with some tail risk and/or lower market value overcollateralization) and cleaner deals (portfolios with less credit risk or credit impaired positions). US new issue CLOs also printed with tighter spreads month over month for AAA and AA-rated tranches. However, further down the stack, US CLO mezzanine tranches priced wider by 28bp on average.[27]

In the European CLO secondary market, bids wanted in competition ("BWIC") activity reached record levels reflecting elevated secondary market trading activity. With defaults ticking up across US and European loans, CLO managers continue to work together on revised indenture language that would allow CLOs to participate in restructurings requiring capital contributions by utilizing either excess interest or the injection of new capital into the CLO.

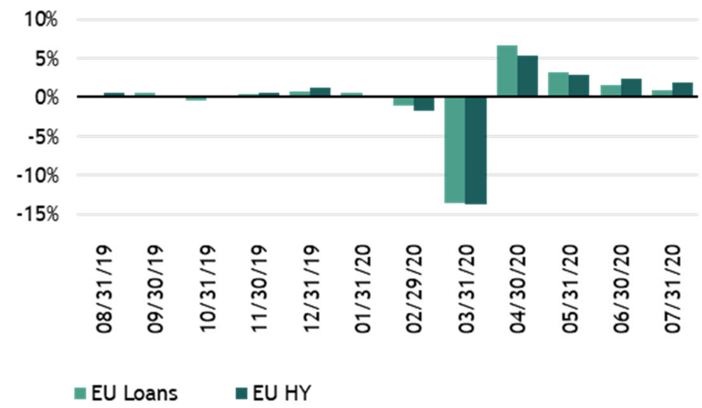
[20] JP Morgan, as of July 31, 2020, for US loan downgrades; Credit Suisse Credit Strategy, July 27, 2020.
[21] Barclays CLO & Leveraged Loan Monthly Update, August 4, 2020.
[22] Kanerai, Intex, Bloomberg, Moody's, S&P, Fitch, Barclays Research, as of July 31, 2020.
[23] GSO's Holland Park CLO (European CLO) BB tranche (rated BB flat) downgraded to BB- on July 10, 2020; Cumberland Park CLO (US CLO) B3 tranche downgraded to Caa1 on August 11, 2020; Treman Park CLO (US CLO) B3 tranche downgraded to Caa1 on August 14, 2020.
[24] BofA CLO Weekly, July 17, 2020.
[25] LCD, (EUR) Topical: European loans settle into summer equilibrium, as of July 31, 2020.
[26] LCD, July 31, 2020.
[27] Barclays CLO & Leveraged Loan Monthly Update, August 4, 2020.

Market Snapshot (as of July 31, 2020)[28]

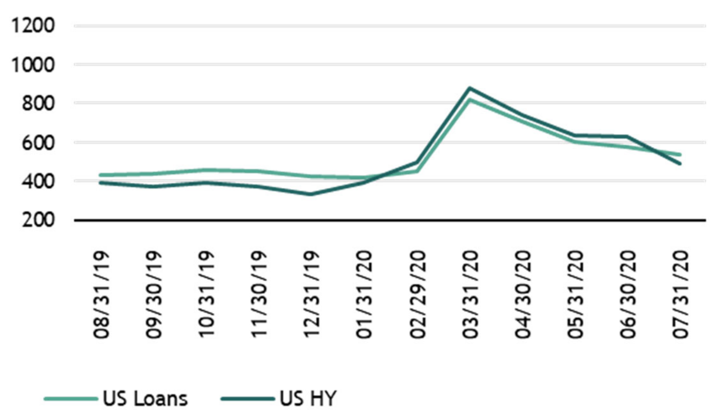
US Credit Monthly Returns



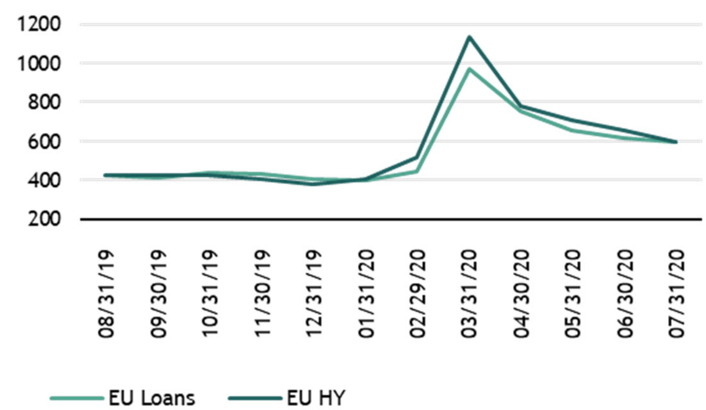
EU Credit Monthly Returns



US Credit Spreads (bp)



EU Credit Spreads (bp)



	Spread			Yield			Price		
	Level	ΔMTD	ΔYTD	Level	ΔMTD	ΔYTD	Level	ΔMTD	ΔYTD
U.S. Loans	534	-46	111	6.12%	-0.69%	-0.01%	$91.63	$1.76	-$5.09
U.S. HY	488	-138	152	6.04%	-0.99%	0.05%	$100.36	$4.46	-$0.88
EU Loans	598	-19	192	4.02%	-0.10%	-0.13%	€93.23	€0.49	-€ 5.08
EU HY	599	-56	218	5.49%	-0.62%	1.68%	€92.86	€1.56	-€ 6.58

	Level	MTD Return	YTD Return
Dow Jones Industrials	26428	2.51%	-6.14%
S&P 500	3271	5.64%	2.38%
Russell 2000	1480	2.71%	-11.27%
Euro Stoxx 50	3174	-1.52%	-13.30%
DAX	12313	0.02%	-7.06%
MSCI Emerging Markets	1079	9.03%	-1.52%
MSCI World	2305	4.82%	-0.93%

	Level	ΔMTD	ΔYTD
1-Month Libor	0.15%	-1 bp	-161 bp
3-Month Libor	0.25%	-25 bp	-166 bp
10-Year Treasury	0.53%	- 13bp	-139bp
3-Month Euribor	-0.46%	-4bp	-8bp
6-Month Euribor	-0.40%	-10bp	-8bp
10-Year German Bund	-0.52%	-7bp	-34bp

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

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