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CREDIT INSIGHTS

GSO August 2020 Market Commentary

Performance Overview

- Recovery continued in August globally
- US defaults decreased significantly in August
- US and European CLO fundamentals improved month over month

Loans and high yield bonds globally continued to recover in August, driven by a generally positive macro tone and positive news on the development and approval timeline of multiple COVID-19 vaccines. The most notable development this month was the decrease in US monthly default volume – only three companies representing a total of $1.6 billion in loans and high yield bonds defaulted during the month. This marked the first month since February with less than $10 billion in default volume and registered the lightest monthly default total since December 2019.[1]

US below investment grade credit, particularly high yield bonds, experienced heavy issuance volumes in August, defying the typical late summer slowdown. This was likely a result of issuers trying to get ahead of any volatility that may return in the fall.[2] In stark contrast, European below investment grade issuance decreased significantly and altogether halted for high yield bonds. This created a slightly more favorable technical backdrop for European loans and high yield bonds in the secondary market despite demand slowing across the board due to a decrease in European collateralized loan obligation ("CLO") issuance as well as a slowdown in high yield retail fund inflows.[3,4]

CLO fundamentals have largely improved month over month globally as loan prices, particularly CCC-rated loan prices, continue to recover. New loan supply has also come to market with higher spreads helping support CLO weighted average spread ("WAS") tests.[5]

Market Returns (as of August 31, 2020)

	August	QTD	YTD
S&P / LSTA U.S. Leveraged Loan Index	1.49%	3.48%	-1.29%
Bloomberg Barclays U.S. High Yield Index	0.95%	5.68%	1.67%
Credit Suisse Western European Leveraged Loan Index	1.20%	2.03%	-1.85%
Credit Suisse Western European High Yield Index	1.35%	3.22%	-2.73%
S&P 500	7.19%	13.24%	9.74%
Euro Stoxx 50	3.21%	1.65%	-10.52%

Market Outlook

Although the cycle low for both the economy and financial markets has likely passed, we expect to see continued volatility and high unemployment due to the number of small businesses that have permanently closed or filed for bankruptcy. The global lockdown has produced cautious consumers, and we believe the rate of personal savings will remain elevated, travel will remain restrained, and people will spend more time at home until a vaccine is available. The longer-term consequences of the lockdown, including the impact of ineffective remote learning and the absence of cultural institutions, remain to be seen.

Central banks globally made announcements in August suggesting interest rates will continue to remain low. In the US, the Federal Reserve (the "Fed") announced that it is less concerned about high inflation and will target inflation that averages 2% over time. This means that following a stretch of low inflation, the Fed may allow inflation to run above 2%.The Fed has also indicated that it will keep rates lower for longer in the current cycle, and Wall Street economists estimate rates may remain low until early 2025. Additionally, the Bank of England hinted at the possibility of sub-zero rates and sustained intervention in private credit markets. A persistently low interest rate environment will continue to present challenges for investors looking for yield. We believe that income-oriented investors will continue to benefit from an allocation to credit to solve for this challenge.

Political uncertainty is heightened in the US as we approach the November election, but markets are currently favoring Biden's chances to win and may already be pricing in a Biden victory. To put this into historical context, no party has retained the White House when either a 20% correction or a recession has occurred in an election year, both of which have taken place in 2020 in addition to the ongoing pandemic. Higher volatility has also been negative for an incumbent. That said, it is important to consider the potential policy effects of a Democratic sweep in November. We will likely see an increase in taxes, additional regulations around financial services, less M&A and share buybacks, and potentially the reinstatement of the Glass-Steagall act in some form.

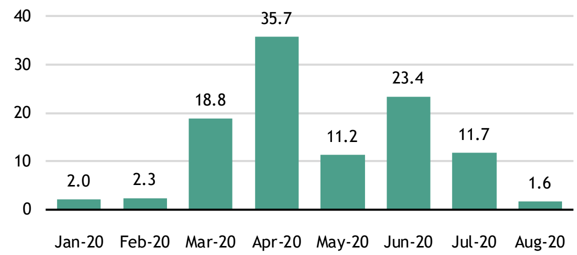
[1] JP Morgan Default Monitor, September 1, 2020.
[2] JP Morgan High Yield Bond and Leveraged Loan Market Monitor, September 1, 2020.
[3] LCD, as of August 31, 2020.
[4] JP Morgan, Lipper, as of August 31, 2020.
[5] Barclays CLO & Leveraged Loan Monthly Update, September 2, 2020.

US Loan and High Yield Markets

The recovery in the US loan and high yield markets slowed in August as COVID-19 cases increased, but performance for the month remained healthy at 1.49% and 0.95%, respectively. High yield returns in August were particularly subdued compared to previous months as the market absorbed an unusually busy month of August primary activity compounded by a rally in treasuries.[6]

Although the US par-weighted last-twelve-month ("LTM") default rates remain elevated at 4.38% for loans and 5.77% for high yield bonds, monthly default volume decreased significantly month over month to just $1.6 billion, representing an 86% decrease compared to $11.7 billion in July.[7] Looking forward, the pipeline of potential future defaults for loans and high yield bonds is relatively low, and the market is pricing in far less default risk going forward, with distress ratios for loans and high yield bonds continuing to decline.[8]

US Monthly Loan and High Yield Default Volume



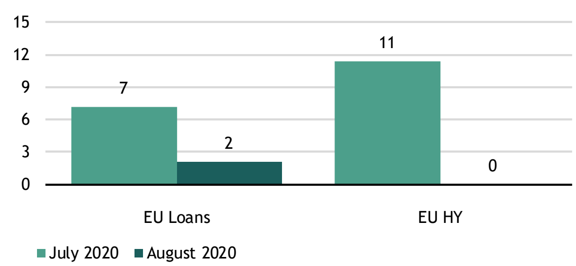
The outperformance of US loans relative to high yield can be partially attributed to the rally in lower quality loans, which outperformed the smaller universe of lower quality bonds. B and CCC-rated loans returned 1.53% and 4.07%, respectively, in August compared to 0.70% for BB-rated loans. In high yield, B and CCC-rated bonds returned 0.96% and 1.98%, respectively, compared to 0.61% for BB-rated bonds. Retail demand for US loans remained low in August, likely due to low rates, but this was more than offset by continued buying from CLOs.[9] Although CLO issuance was down 66% month-over-month due to the seasonal summer slowdown, CLO warehouses collectively remained active buyers of loans.[10] Supply, on the other hand, increased month over month but remains subdued compared to pre-COVID-19 issuance levels. Loans experienced $23 billion in gross issuance and $12 billion in net issuance, up 82% and 45%, respectively, month over month.[11]

Despite a net outflow during the week ending August 19, the first since July, US high yield retail funds experienced net inflows for the month totaling $6.2 billion, representing a 30% decrease month over month.[9] US high yield issuance totaled $54 billion which far outpaced the initial forecast of $12 billion and represents the third highest monthly total on record. Year-to-date gross issuance now stands at $299 billion, up 69% compared to the same period last year.[11] Issuance this month has been concentrated in BB-rated bonds, some of which were priced with surprisingly low yields. In fact, BB-rated Ball Corporation set a record low yield for their 10-year bonds during the month pricing at 2.875%. August also brought the return of energy deals as oil prices stabilized and investor confidence in the industry returned.[12]

European Loan and High Yield Markets

Despite an increase in new COVID-19 cases across Europe, European loans and high yield bonds continued to recover in August. Monthly returns of 1.20% for loans and 1.35% for high yield bonds were driven in large part by a relatively strong technical backdrop resulting from a significant decrease in primary issuance. Additionally, investor sentiment was buoyued by better virus testing and contact tracing in Europe which allowed policymakers to avoid national lockdowns by treating any "second wave" with more targeted measures, such as wearing masks outdoors and closing certain high risk activities.[13]

European Issuance



As interest rates are now anchored near or below zero in all major European currencies, higher yielding European loans have started to attract additional interest from investors, which in turn has helped support loan prices in the secondary market. This favorable technical backdrop was further enhanced by lackluster primary market activity, with issuance totaling just $2.1 billion, a 72% decrease month over month. This helped offset subdued demand from tepid CLO issuance, which decreased by over 70% month over month to just €0.5 billion.[14]

European high yield performance was driven largely by a rally in lower quality bonds and further supported by dearth of supply, with no high yield issuance recorded in August. CCC/Split CCC rated bonds returned 2.26% compared to 1.16% for Split BBB/BB rated bonds and 1.42% for Split BB, B, and Split B rated bonds. This may suggest that investors are increasing their risk appetite in an effort to seek yield given the low interest rate environment.

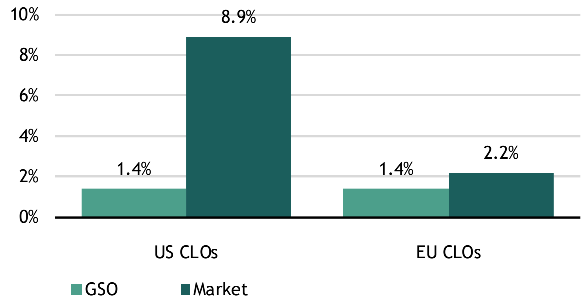
Default activity has crept up slowly in Europe but remains much lower than in the US largely due to massive fiscal and monetary stimulus and sponsor support in Europe. LTM European loan and high yield default rates ended August at 0.9% and 2.8%, respectively, and are expected to remain moderate given distress ratios are relatively low for both loans and high yield bonds.[15,16]

[6] S&P/LSTA Leveraged Loan Index, Bloomberg Barclays US High Yield Index, as of August 31, 2020;
[7] JP Morgan Default Monitor, September 1, 2020.
[8] Credit Suisse Loan Default Update, August 26, 2020; Credit Suisse High Yield Default Update, August 27, 2020;
[9] JP Morgan, Lipper, as of August 31, 2020; includes weekly and monthly reporting funds if reported by September 16, 2020.
[10] LCD, as of August 31, 2020.
[11] JP Morgan High Yield Bond and Leveraged Loan Market Monitor, September 1, 2020. Net issuance excludes repricings and refinancings.
[12] Credit Suisse High Yield Supply Surge, August 23, 2020.
[13] JP Morgan Europe Market Intelligence, September 3, 2020.
[14] LCD, as of August 31, 2020.
[15] Credit Suisse Default Monitor, September 3, 2020.
[16] Credit Suisse Loan Recap – August, September 1, 2020.

US and European CLO Markets

Rating agencies continue to resolve outstanding rating watches previously placed on US and European CLOs, and GSO is faring particularly well compared to peers. In the US, about 9% of GSO CLO tranches were put on watch for downgrade since March versus a market average of 18%. As of mid-September, all watch activity on US GSO CLOs had been resolved, and just 1.4% of all tranches were downgraded representing four single-B rated tranches. This represents significant outperformance in comparison to the broader market where 18% of all CLO tranches were placed on watch and 8.9% were downgraded. In Europe, 11% of GSO CLO tranches were put on downgrade watch versus a market average of 16%. Just 1.4% of European GSO CLO tranches were downgraded compared to 2.2% for the broader European CLO market, however 8% remain on watch.[17]

Percent of CLO Tranche Downgrades



Other metrics of CLO health have also improved on average, prompting more optimistic downgrade outlooks moving forward.[18] Both US and European CLOs experienced a reduction in exposure to CCC-rated assets and an improvement in both equity net asset value and WAS.[19]

As would be expected during the summer month of August, global CLO issuance slowed significantly. Eight US CLOs priced during the month totaling just $3.5 billion compared to $9.6 billion the month prior. There was also a notable trend of refinancings of CLO fixed rate tranches during the month. While numerous, these were small in volume and emerged to opportunistically take advantage of the low swap rates by swapping into lower fixed rate coupons. In Europe, CLO issuance also slowed with just two deals pricing totaling €0.5 billion, one of which was issued by GSO with a weighted average cost of capital ("WACC") of 226bp. The outlook for the European CLO market has been improving, and both Barclays and Wells Fargo revised their full year 2020 forecast upward for European CLO issuance to €15-18 and €20 billion, respectively, from €12-15 billion and €15 billion, respectively. This outlook is contingent upon stable liability levels and loan spreads.[20,21] Additionally, recent US CLO issuance estimates of $80 billion for the year outpace the original estimate of $50-60 billion but continue to lag 2019's total of $118 billion.[22]

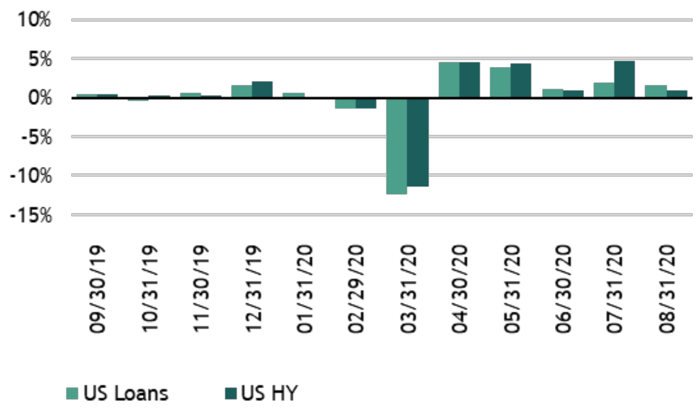
Spreads on US CLO tranches tightened across the capital stack by 15-50bp during the month with the exception of BB-rated tranches which were unchanged.[23] Spreads of higher rated CLO tranches are now approaching year end 2019 levels, and CLO AAA-rated tranches have reached L+130 or tighter as of this writing. GSO issued one static US CLO during August with a WACC of 179bp, the tightest for any post-COVID-19 CLO as of August month end.[24]

European CLO spreads tightened by 18-70bp across all tranches during August.[25] Secondary CLO trading volume remained robust, but BWIC volumes were lower than in June and July given the summer slowdown. With tighter liability spreads across US and European CLOs and an increasing number of pre-COVID warehouses converting into CLOs, the path to CLO execution feels more secure. We believe banks have been increasing commitments to new CLO warehouses and loosening the terms offered to managers as compared to pre-COVID CLOs.

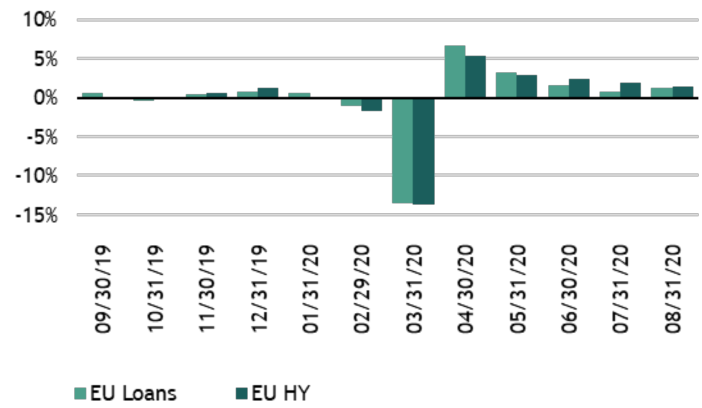
[17] Kanerai and Barclays, as of September 15, 2020. Fitch actions from Watch Neg to Outlook Neg is not regarded as action in this analysis.
[18] Wells Fargo CLO Monthly Market Overview, September 2, 2020.
[19] Barclays CLO & Leveraged Loan Monthly Update, September 2, 2020.
[20] LCD, as of August 31, 2020.
[21] Wells Fargo CLO Monthly Market Overview, September 2, 2020.
[22] Credit Suisse Credit Strategy CLO Update, September 15, 2020 for recent issuance forecast; Barclays, May 15, 2020, for original forecast.
[23] BofA Global Research, as of August 31, 2020.
[24] LCD, as of August 31, 2020.
[25] Citi, as of August 31, 2020.

Market Snapshot (as of August 31, 2020)[26]

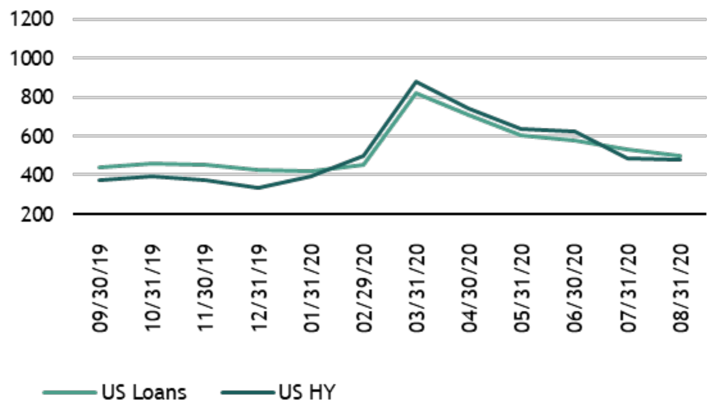
US Credit Monthly Returns



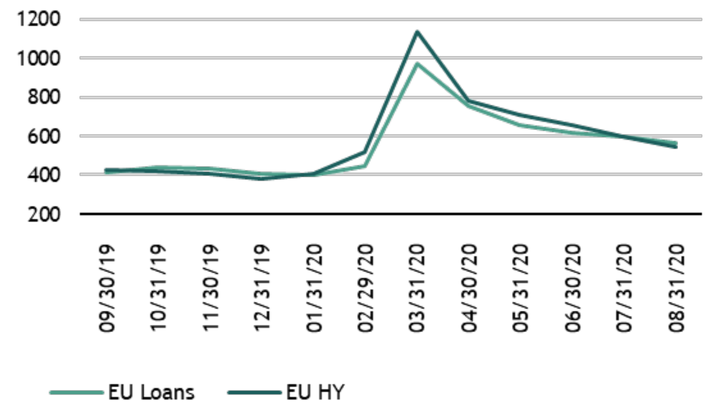
EU Credit Monthly Returns



US Credit Spreads (bp)



EU Credit Spreads (bp)



	Spread			Yield			Price		
	Level	ΔMTD	ΔYTD	Level	ΔMTD	ΔYTD	Level	ΔMTD	ΔYTD
U.S. Loans	500	-30	77	5.80%	-0.32%	-0.33%	$92.85	$1.22	-$3.87
U.S. HY	477	-11	141	5.86%	-0.17%	-0.12%	$100.99	$0.63	-$0.24
EU Loans	564	-34	158	3.97%	-0.05%	-0.17%	€94.27	€1.04	-€ 4.04
EU HY	546	-53	165	5.26%	-0.36%	0.84%	€94.08	€1.22	-€ 5.35

	Level	MTD Return	YTD Return
Dow Jones Industrials	28430	7.92%	1.30%
S&P 500	3500	7.19%	9.74%
Russell 2000	1562	5.50%	-6.39%
Euro Stoxx 50	3273	3.21%	-10.52%
DAX	12945	5.13%	-2.29%
MSCI Emerging Markets	1102	2.24%	0.68%
MSCI World	2456	6.72%	5.73%

	Level	ΔMTD	ΔYTD
1-Month Libor	0.16%	0 bp	-161 bp
3-Month Libor	0.24%	-1 bp	-167 bp
10-Year Treasury	0.71%	18 bp	-121 bp
3-Month Euribor	-0.47%	-1 bp	-9 bp
6-Month Euribor	-0.44%	-4 bp	-12 bp
10-Year German Bund	-0.40%	13 bp	-21 bp

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

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