Blackstone Credit

CREDIT INSIGHTS

March 2021 Market Commentary

Performance Overview

US below-investment grade corporate credit delivered flattish returns in March, as an early-month boost from the congressional approval of President Biden's $1.9 trillion American Rescue Plan was offset by heavy supply and rising interest rates. Rates were also a headwind for US investment grade corporate bonds, which posted another month of negative returns following the Federal Reserve's mid-month announcement that it would continue to keep the policy rate at zero through 2023 despite their expectation for higher inflation.

The performance trajectory of European loans and high yield bonds was more mixed in March, as high yield bonds recorded another positive monthly return, while loan performance was flat.

- US and European loan performance was flat in March while high yield bonds posted positive returns in both regions. US investment grade bond returns were negative
- Credit markets continue to experience record levels of new issuance globally
- Default and distressed activity in the global credit markets continues to improve

Interest rates continued to move higher in March with the 10-year treasury ending the month yielding 1.74%. Higher rates contributed to pockets of volatility in the equity and fixed-rate credit markets during the month.[1] High yield bond spreads tightened during March offsetting the rise in rates and resulting in a modest 0.15% gain for the month. Retail investors reacted to the steepening Treasury curve by withdrawing $5.4 billion from high yield funds compared to net retail inflows of $3.2 billion for US loans during the month.[2]

Credit markets globally experienced a continued surge in new loan, high yield, and CLO issuance in March, capping a record-breaking quarter of volumes and leading to elevated levels of secondary trading. Blackstone Credit traded $22 billion of credit assets globally, a 100% increase over the prior quarter, and was the top-ranked loan trader of US primary and secondary loans.[3]

Default and distressed activity in the credit markets continues to remain historically low. Only one US high yield issuer defaulted in March, and the US loan market experienced no defaults. This muted activity led to a further decrease in trailing default rates with the US Last Twelve Month ("LTM") high-yield default rate ending the month at 5.37%, down 139 basis points ("bp") year-to-date, and the US loan LTM par-weighted default rate ended March at an eleven-month-low of 3.34%, down 61bp year-to-date.[4] There were no new defaults recorded for either European loan or high yield issuers in March, which kept the LTM par weighted default rate unchanged month-over-month at 1.10% and 3.40% for European loans and high yield bonds, respectively.[5]

Market Stats (as of March 31, 2021)

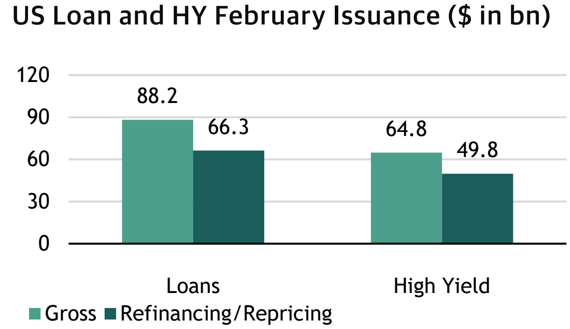
	March	QTD	YTD
S&P / LSTA U.S. Leveraged Loan Index	-0.00%	1.78%	1.78%
Bloomberg Barclays U.S. Corporate Investment Grade Index	-1.72%	-4.65%	-4.65%
Bloomberg Barclays U.S. High Yield Index	0.15%	0.85%	0.85%
Credit Suisse Western European Leveraged Loan Index	0.00%	1.72%	1.72%
Credit Suisse Western European High Yield Index	0.47%	1.59%	1.59%
S&P 500	4.38%	6.13%	6.13%
Euro Stoxx 50	7.78%	10.51%	10.51%

	Spread			Yield			Price		
	Level	ΔMTD	ΔYTD	Level	ΔMTD	ΔYTD	Level	ΔMTD	ΔYTD
U.S. Loans	414	7	-29	4.39%	0.06%	-0.32%	$97.79	-€ 0.24	$1.36
U.S. HY	310	-16	-50	4.94%	0.01%	-0.03%	$104.55	-€ 0.39	-$0.80
EU Loans	425	8	-34	3.81%	-0.01%	-0.07%	€98.61	-€ 0.32	€ 0.94
EU HY	384	-11	-40	3.48%	-0.11%	-0.31%	€99.42	€ 0.21	€ 1.05

[1] Bloomberg, March 31, 2021
[2] JP Morgan, Lipper, as of March 31, 2021; does not include funds that report on a lag.
[3] Blackstone Credit, IHS Markit, March 31, 2021
[4] JP Morgan Default Monitor, April 1, 2021.
[5] Credit Suisse Default Report, April 7, 2021

US Loan and High Yield Markets

US loans performed well in early March, but the burgeoning pipeline of new issue transactions put downward pressure on secondary loan prices as investors raised cash to make room for primary allocations. Average US loan secondary prices fell $0.24 during the month to end at $97.79, as 88 primary transactions totaling $55.3 billion allocated over the same period. Notably, this was the second highest monthly total on record.[6] Loans of the highest quality and liquidity gave back the most gains while lower quality loans continued to rally, driven by an improving economic outlook and investors' search for yield.



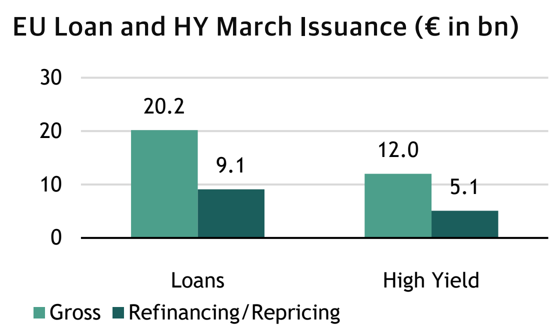
As the top recipient of new issue allocations, per LCD, Blackstone Credit is uniquely positioned to take advantage of the strong primary calendar. Sourcing loans in the primary market at original issue discounts of 0.5-2% is highly accretive to our portfolios, particularly when most performing loans have returned to trading near par.

US high yield bond spreads tightened during March offsetting the rise in interest rates and resulting in a modest 0.15% gain for the month. Now 50bp tighter than where they started the year[7], US high yield bond spreads are approaching their all-time tights leaving less cushion should interest rates rise further, as we expect, during 2021. High yield issuance of $64.8 billion in March established a new high becoming the most active month of issuance on record.[8] COVID-impacted sectors and short duration high yield bonds continued to perform well in March, while bonds in the energy sector gave back a portion of their significant year-to-date gains given the retreat in crude prices from recent highs.

Notably, on March 5th, ICE Benchmark Administration formally announced that 1-week and 2-month USD London Inter Bank Offering Rate ("LIBOR") settings will cease beginning December 31, 2021 and all other LIBOR settings will cease immediately after June 30, 2023. This announcement was expected given the ongoing transition from LIBOR to the alternate Secured Overnight Financing Rate (**"**SOFR**"**). Of significance, the Rate Spread Adjustment, a key economic component in the LIBOR to SOFR transition, was struck in March 2021 using the 5yr LIBOR minus compounding SOFR in arrears median level for 1M,3M, 6M and 12M tenors. The most referenced floating rate, 3M USD Libor, will be replaced by daily simple SOFR averaged over a 3-month period with an adjustment of 26.16bp.[9]

European Loan and High Yield Markets

Similar to the supply/demand dynamic in the US, the European loan market experienced a surge in primary issuance during the month which put pressure on secondary loan prices. Average European secondary loan prices fell €0.32 over the month ending at €98.61. Over the same period, 42 primary transactions allocated.[10]



European high yield bond performance experienced pockets of weakness but ended in positive territory for March as the market digested a wave of new issue supply amid continued rate volatility. Demand for European high yield bonds increased with €135 million of net retail inflows during the month. Despite year-to-date net outflows of €1.4 billion and the torrent of supply, high yield markets have remained relatively stable, with secondary spreads roughly 40bp tighter year-to-date, likely reflecting improving credit fundamentals[11]

High yield bonds backing Leverage Buy Outs ("LBOs") totaled €1.2 billion in March and reached an all-time quarterly high of €6.5 billion in Q1. Similarly, LBO-driven loan volume totaled €2.8 billion in March, pushing the Q1 volume to €10.9 billion, its highest level since the Global Financial Crisis.[12]

March registered another milestone in relation to responsible investing in Europe, with the first sustainability-linked European high yield bond being issued with pricing linked to Environmental, Social and Governance ("ESG") criteria. With increasing emphasis being placed on ESG, this type of issuance is a trend which will likely gather pace in the year ahead.[13]

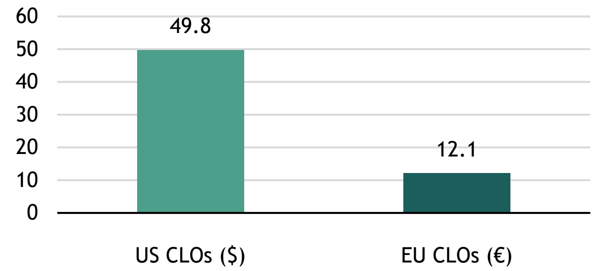
Notably, the first below investment grade loan transaction with pricing linked to the new Sterling Overnight Index Average (SONIA) benchmark launched during March. SONIA is the replacement reference rate to GBP LIBOR, the latter of which will cease to be published on December 31, 2021.[14]

[6] S&P/LSTA Leveraged Loan Index, LCD, as of March 31, 2021.
[7] Bloomberg Barclays High Yield Index, March 31, 2021
[8] JPMorgan
[9] Alternative Rates Reference Committee
[10] Credit Suisse Western European Leveraged Loan Index, LCD as of March 31, 2021.
[11] JPMorgan European Credit Weekly, April 1, 2021
[12] LCD, March 31, 2021
[13] LCD/S&P Global Market Intelligence
[14] LCD/S&P Global Market Intelligence

US and European CLO Markets

The record setting pace of US CLO issuance continued in March, totaling $49.8 billion, the highest monthly total on record.[15] Demand was bolstered by strong interest in AAA-rated paper from regional US banks, offsetting weaker demand for lower-rated CLO tranches which caused spreads to widen toward the bottom of the capital stack. Average spreads on BBB-rated and BB-rated CLO tranches ended the month at 375bp and 765bp, respectively, both up 40bp since February.[16]

US CLO and EU CLO March Issuance ($/€ in bn)



European CLO issuance totaled €12.1 billion in March, the second highest monthly total on record.[17] Average spreads widened on all tranches over the month as investors globally became fatigued by the heightened levels of supply.[18]

As resets and refinancings line up to price in time for an April closing, liability pricing differentiation continues to increase between new issue and reset/refinancings. Additionally, we are seeing significant dispersion of pricing across the 100+ US CLO managers with the market expressing meaningful demand for more seasoned managers. Due to the heavy CLO new issue pipeline, we are also witnessing significant congestion across the market as rating agencies, banks, and other market participants struggle to process the volume of new transactions.

Blackstone Credit had an exceptionally busy month of CLO issuance in March with a total of 5 new transactions. We priced Thompson Park CLO, a $508 million USD CLO that held the AAA tight at L+100. We also priced the refinancing of Catskill Park, a $612.5 million USD CLO. In Europe, Blackstone Credit priced the refinancing of Griffith Park CLO, a €372 million EUR CLO, priced Carysfort Park CLO, a €485 million EUR CLO and priced the reset of Elm Park CLO, a €465 million 2016-vintage European CLO. This caps an exceptionally busy first quarter during which we priced an average of one new CLO transaction per week.[19]

This breakneck pace of issuance is likely to continue given that an additional €40-50bn of European CLOs and $170-180bn of US CLOs are likely to be refinanced or reset in 2021.[20] This should bode well for CLO equity returns given liabilities remain near post-crisis tights, but loan spreads remain relatively wide.

Market Outlook

As we pass the one-year mark since COVID-19 drove historic dislocations in global markets, our outlook remains optimistic. Vaccination rates have increased dramatically in the US and UK, and, although we continue to closely monitor variants as well as elevated case counts in certain pockets of the world, the line-of-sight to reopening and recovery in most developed economies has not been clearer.

Markets are increasingly pricing in a robust economic recovery, but with a clear divergence between performing and stressed assets. Much of the recent outperformance has been driven by a recovery in stressed, lower-rated issuers in COVID-impacted sectors. We believe this wave may be cresting in credit as the momentum of the reopening trade has carried bonds and loans closer to fair value. As a result, careful credit selection will play a larger role in determining performance in the coming months and quarters.

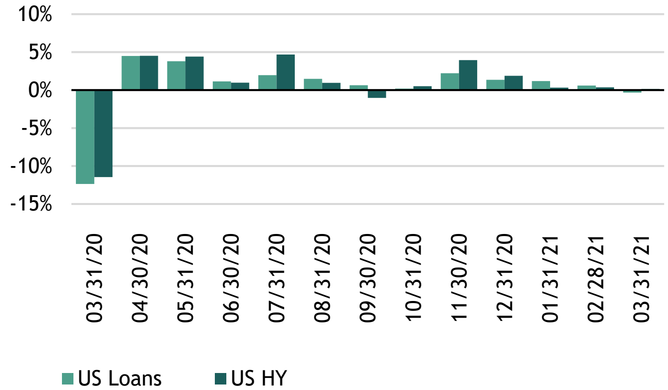
Additionally, we believe that a short-term uptick in wages and prices is ahead. This stems from the combination of fewer workers in the workforce, elevated levels of pent-up demand for entertainment and services, and limited supply of these services due to continued social distancing measures. This will impact inflation and long-term rates, particularly since a near-term shift in policy is unlikely. The Fed has again restated its plan to keep the policy rate at zero through 2023 despite higher inflation expectations. We believe investors should consider assets with shorter durations and the ability to reset rates as a hedge against inflation risk and higher long-term interest rates.

The approval of President Biden's $2.3 infrastructure plan as announced would be a strong tailwind for many of our positions in the building materials and construction sectors, despite anticipation of the plan being already partially reflected in current valuations. The plan envisions a 32-51% increase to current FAST Act transportation spending, which, by our estimates, could translate into a 5-9% increase in aggregates and concrete spending. While the timing of the bill's passage remains uncertain (we estimate that the lag between passage to actual spending could be 12-18 months), assuming a 4Q21 approval, this bill would most likely impact late-2022 or early-to-mid-2023 performance in these sectors with a 5–8-year tail.

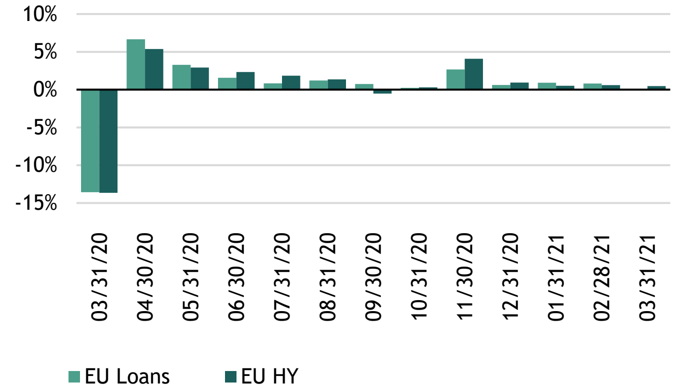
[15] LCD CLO Global Databank, March 31, 2021
[16] Bank of America Global Research, March 31, 2021
[17] LCD CLO Global Databank, March 31, 2021
[18] Citibank
[19] Blackstone Credit
[20] Barclays Credit Research, March 2021

Market Snapshot (as of March 31, 2021)[21]

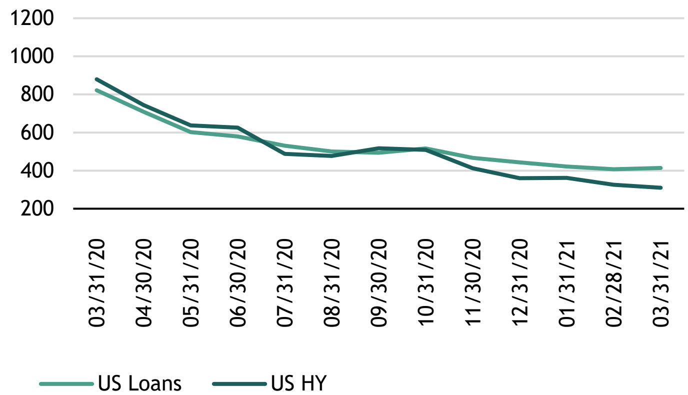
US Credit Monthly Returns



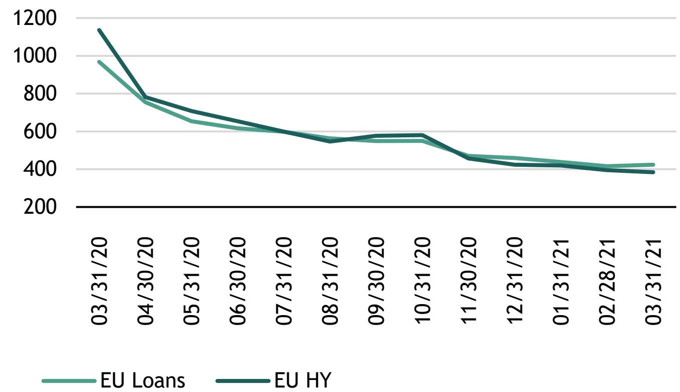
EU Credit Monthly Returns



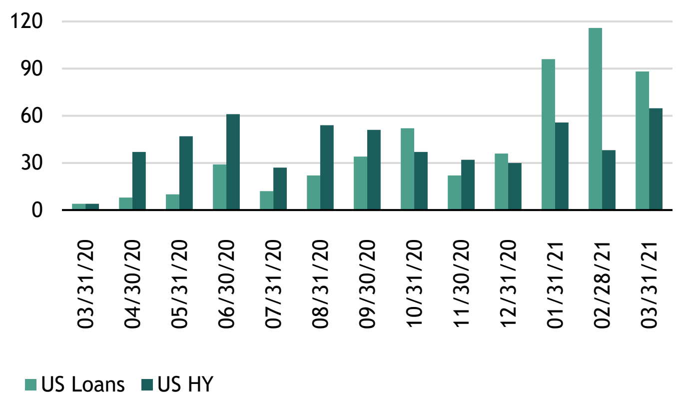
US Credit Spreads (bp)



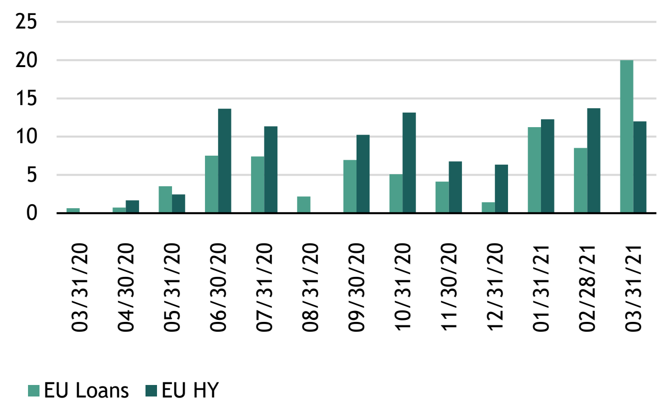
EU Credit Spreads (bp)



US Credit Issuance ($ in billions)



EU Credit Issuance (€ in billions)



[21] 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 March 31, 2021.

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