Blackstone Credit

CREDIT INSIGHTS

August 2021 Market Commentary

Performance Overview

Below investment grade credit rebounded in August, as positive technicals overcame Delta variant concerns. High yield and loans outperformed U.S. investment grade bonds, which were dragged down by a modest increase in Treasury yields in August.

Having drifted wider earlier in the month amid the heavy primary calendar, credit spreads firmed ahead of Labor Day as supply dwindled. After selling off 5bp following Fed Chairman Powell's dovish speech at Jackson Hole, investment grade spreads substantially retraced to finish nearly unchanged for the month while high yield spreads tightened by 6bp. Interest rates rose slightly and the yield curve also flattened modestly, with the 5-year Treasury rising 9bp and the 30-year rising only 4bp.[1]

European credit posted strong returns, as the supply-led spread widening of the early summer receded, with loan returns bolstered by a rebound in the lower quality segment following July's brief sell-off.

Ongoing supply chain issues continue to restrict economic growth as manufacturing PMIs fell to a six-month low and inflation hit a 10 year high of 3% in August.[2]

This year's total default volume is on pace to be the lowest since 2007 with only one default in August. High yield and loan last twelve-month ("LTM") default rates declined further, with the loan par-weighted default rate ending the month at 1.07%, down 6bp from the July LTM period. The par-weighted high yield default rate including distressed exchanges ended the month at 1.14%, down 3bp from the month prior.[3]

There were no new defaults recorded for European loan or high yield issuers in August. As result, the LTM par-weighted default rate remained at 0.70% and 1.1% for European loans and high yield bonds, respectively.[4]

- Primary loan, bond supply eased over the month in the run up to Labor Day, as demand across the credit asset classes drove returns
- CLO issuance defied the August slowdown with the US market firing on all cylinders
- We remain optimistic on the economic recovery in the final months of 2021, although continue to assess supply chain issues and the spread of the Delta variant
- The Fed signaled the start of tapering with plans to reduce asset purchases from as early as November

Market Stats (as of August 31, 2021)

	August	QTD	YTD
S&P / LSTA U.S. Leveraged Loan Index	0.47%	0.46%	3.76%
Bloomberg Barclays U.S. Corporate Investment Grade Index	-0.30%	-0.13%	-0.22%
Bloomberg Barclays U.S. High Yield Index	0.51%	0.90%	4.55%
Credit Suisse Western European Leveraged Loan Index	0.48%	0.52%	3.45%
Credit Suisse Western European High Yield Index	0.36%	0.70%	3.98%
S&P 500	3.04%	5.49%	21.58%
Euro Stoxx 50	2.63%	3.41%	20.56%

	Spread			Yield			Price		
	Level	ΔMTD	ΔYTD	Level	ΔMTD	ΔYTD	Level	ΔMTD	ΔYTD
U.S. Loans	405	-2	-16	4.27%	-0.03%	-0.44%	$98.25	$0.21	$2.05
U.S. HY	288	-6	-74	4.61%	-0.02%	-0.35%	$105.23	-$0.05	$0.27
EU Loans	405	-9	-33	3.72%	-0.02%	-0.16%	€ 98.74	€ 0.21	€ 1.38
EU HY	343	-17	-77	3.51%	-0.13%	-0.74%	€ 101.37	€ 0.47	€ 2.79

1 Bloomberg
2 IHS Markit, Eurostat August 31, 2021
3 J.P. Morgan Default Monitor September 1, 2021
4 Credit Suisse Default Report, August,2021

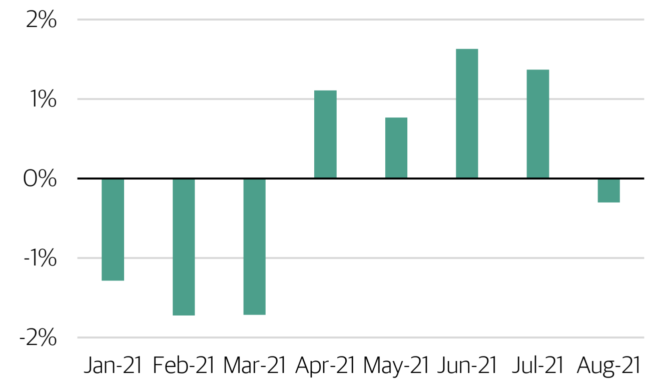
U.S. Investment Grade Market

U.S. investment grade bonds gave back some performance in August, returning -0.30% amid a second month of spread widening as rates continued to rally. This pushed returns back into the red for the year but we believe demand for the asset class remains strong.[5]

Investment grade bond funds continued to experience strong inflows totaling $32 billion in August, up slightly from $31 billion the month prior as buyers took advantage of a back up in yields.[6] Asian demand returned to prior levels and overall international demand is expected to remain robust in the fall given yields remain elevated relative to domestic levels in Europe and Asia.

The pace of new issue supply picked up in early August after a July slowdown, but moderated toward the end of the month to total $86 billion, consistent with July's issuance level. New issue concessions ticked up slightly as demand waned.[7]

Historical U.S. Investment Grade Returns[8]



U.S. Loan and High Yield Markets

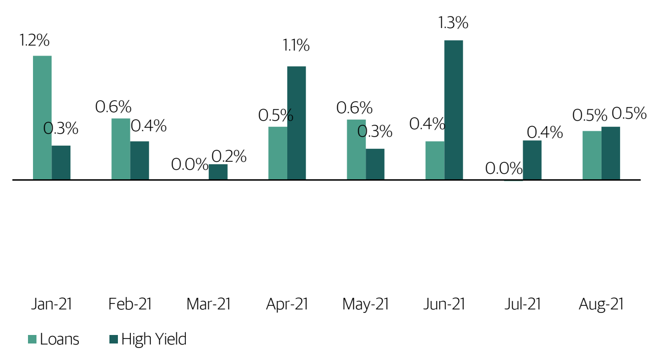
U.S. loans returned +0.47% in August as CCC-rated companies that underperformed in July reversed course and posted solid gains. CCCs outpaced BB and B-rated loans by 54bp and 49bp, respectively.

Demand for loans remained exceptionally strong with record net CLO issuance in August totaling $19.2 billion and retail loan fund inflows of $1.25 billion.[9]

U.S. high yield bonds returned +0.51% in August as tighter spreads offset a slight upward shift of the Treasury curve. New issuance slowed ahead of the Labor Day holiday before resuming in September.

A glance at U.S. high yield credit fundamentals released in August showed continued signs of improvement in 2Q21 with revenues increasing 8.9% quarter-over-quarter, EBITDA increasing 17.5% and leverage decreasing to 5.14x from 5.91x in Q1.[10]

U.S. Loan and High Yield Returns[11]

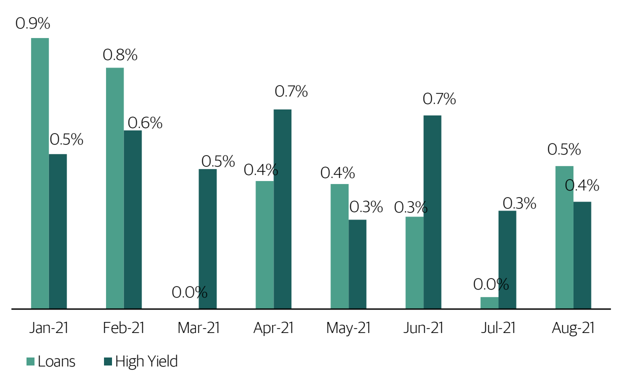


European Loan and High-Yield Markets

European loans returned +0.48% in August, as limited primary supply and continued economic recovery acted as tailwinds to performance. Primary new loan supply plunged to just €0.9 billion in August, from July's €12.8 billion, as credit markets took a breather ahead of the summer holidays. Higher quality loans outperformed lower quality loans again during the month, as investment managers continue to favor quality credits going into year-end.[12]

European high yield bonds returned +0.36% in August, as spreads tightened, and defensive sectors continued to lag. With limited secondary price movement, carry once again did the heavy lifting in terms of monthly return drivers. A small but consistent stream of inflows to the asset class and light street inventory combined to improve the modest tone notably as the month ended.[13]

European Loan and High Yield Returns[14]



5 Bloomberg Barclays Corporate Investment Grade Index, August 31, 2021
6 J.P. Morgan, August 31, 2021
7 Credit Suisse, September 2, 2021
8 Bloomberg Barclays Corporate Index, August 31, 2021
9 J.P. Morgan High Yield Bond and Leveraged Loan Market Monitor September 1, 2021
10 J.P. Morgan 2Q21 HY Credit Fundamentals
11 S&P Leveraged Loan Index and Bloomberg Barclays High Yield Index, as of August 31, 2021
12 Bloomberg Leveraged Finance Chart Book, LCD, August 2021
13 Credit Suisse European High Yield Review August 2021
14 Credit Suisse Western European Leveraged Loan Index, Credit Suisse Western European High Yield Index, as of August 31, 2021

U.S. and European CLO Markets

Global CLO formation defied the typical August slowdown, racking up $41.1 billion of issuance compared to a rolling twelve-month average issuance of $35.2 billion. U.S. CLO issuance increased to $33.3 billion in August, of which only 12% came from refinancings, up from $26.1 billion of gross issuance in July. In contrast, European CLO issuance fell to €6.6 billion in August from €9.5 billion in July, although remained well above the average €1.7 billion of supply priced in the previous four Augusts.[15]

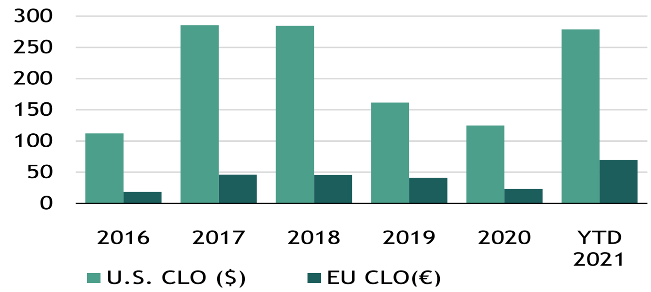
In response, J.P. Morgan raised their full year global issuance forecast to $185 billion from $165 billion, which, if realized, would exceed the prior $161 billion record set in 2018.

Top rated new issue spreads for broadly syndicated CLO tranches ended August modestly wider in the US, and wider in Europe month-over-month, while narrowing in lower rated tranches.

Global CLO fundamentals mostly improved month-over-month. In particular, Weighted Average Rating Factor scores and Equity NAV values improved on average in both U.S. and European CLOs.

The Junior OC Cushion also improved for U.S. CLOs but deteriorated for European CLOs. Balances of CCC-rated assets remained flat in Europe while decreasing by 0.2% in the U.S. during August. Weighted Average Price was up marginally over the month in both U.S. and European CLOs.[16]

U.S. and EUR CLO Historical Total issuance ($/€ in bn) [17]



Market Outlook

New COVID-19 cases appear to have peaked in the U.S. during mid-September and are generally on the decline throughout much of Western Europe. We expect reported new cases to continue to reduce as vaccine rates increase. That said, reaching herd immunity, including vaccinations, may be challenging. Despite federal mandates vaccination levels are increasing slowly, due to significant political polarization. We continue to believe that federal mandates may exacerbate labor shortages and drive wage inflation by keeping some of the vaccine-hesitant out of the workforce.

We reiterate our prior expectation that Delta will have only a modest economic impact on the second half of 2021, and we remain optimistic on the economic recovery. We continue to see strong pent-up demand for out-of-home experiences and believe that consumers broadly are well positioned to increase spending as soon as they can do so safely. Consumer mortgage debt service as a share of disposable personal income is at a record low and most new mortgages are going to borrowers with high credit scores on average. Additionally, corporations remain flush with cash leading us to be ever more optimistic for a sustained recovery. A note of caution however regarding supply chain issues and shipping bottlenecks, which we envisage will disrupt inventories, not just into the looming holiday shopping season, but well into 2022.

Based on economic data releases through mid-September, we reiterate our expectations for continued reflation in wages and prices due to the combination of fewer available workers, elevated levels of pent-up demand, low inventories, and aforementioned supply chain issues. We view the Federal Open Market Committee's September 22 guidance for tapering later this year as well as the accompanying dot plots suggesting hiking to 1% by 2023-end and 1.75% by 2024-end as consistent with our expectation that the Federal Reserve will be hawkish enough to avoid a runaway inflation scenario. That said, we believe that increases in "stickier" metrics, such as rent and wages, suggest that inflation may not be solely transitory. As such, we expect interest rate duration is more likely to be a headwind than a tailwind for the remainder of 2021.

In Europe, the Economic Sentiment Indicator ("ESI") decreased from 119 to 117.5 in August, in line with other forward-looking indicators. The high level indicates that growth projections remain strong for 3Q, but may have peaked, setting up for more moderate expectations for the remainder of 2021. Tapering is not on the ECB's near term agenda given the region's lower inflation and slower economic recovery.

On the political front, Congress continues to negotiate the $3.5 trillion spending bill, as well as raising the debt ceiling before an October 18 deadline. In the House, Speaker Pelosi is also working on the bipartisan infrastructure bill that has already passed the Senate. As before, we believe that there is a high probability that the bipartisan infrastructure bill is enacted, however the fate of the proposed $3.5 trillion spending package (and potentially higher taxes) remains less clear, particularly as a handful of recent setbacks have impacted the Biden administration's political capital. That said, we generally expect fiscal and monetary policies to remain more stimulative than historical norms, which also underpins our views for higher inflation and interest rates but low defaults.

As we enter the final months of 2021, we expect below investment grade credit to remain on path for a full year total return of 5-6% with interest rates now well below March's high but possibly poised to rise again. We believe both loans and high yield bonds will continue to outperform other fixed income in the months ahead but favor floating rate loans given our current view on relative value and the trajectory of interest rates.

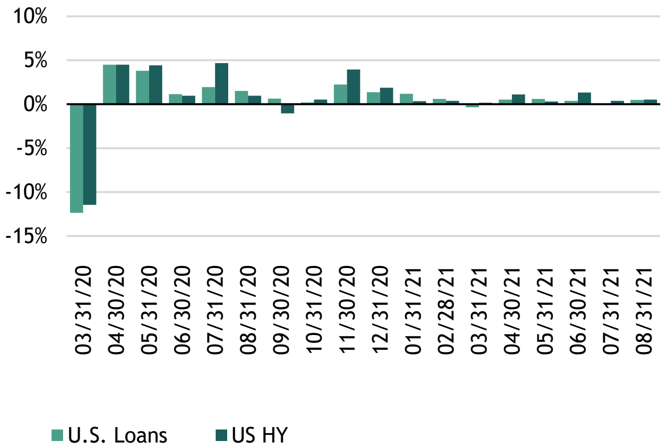
[15] LCD, August 2021, Creditflux, September 3, 2021 "Euro CLO League tables: Deal flurry takes Barclays and CVC to the top.

[16] Barclays CLO & Leveraged Loan Monthly Update August 2021, September 2, 2021

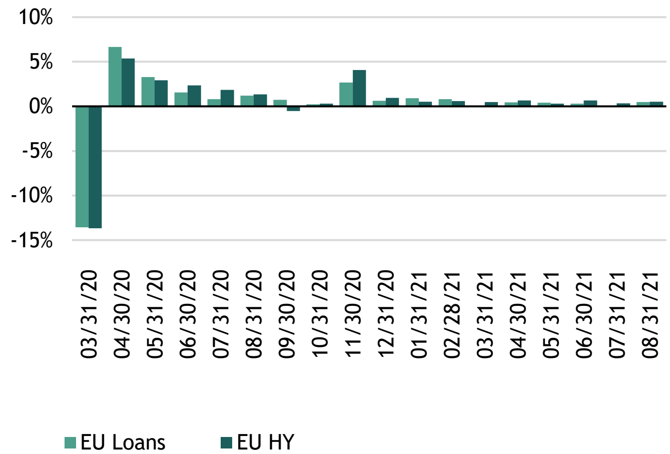
[17] LCD, August 31, 2021: reflects total issuance including new issue, refis, resets

Market Snapshot (as of August 31, 2021)[18]

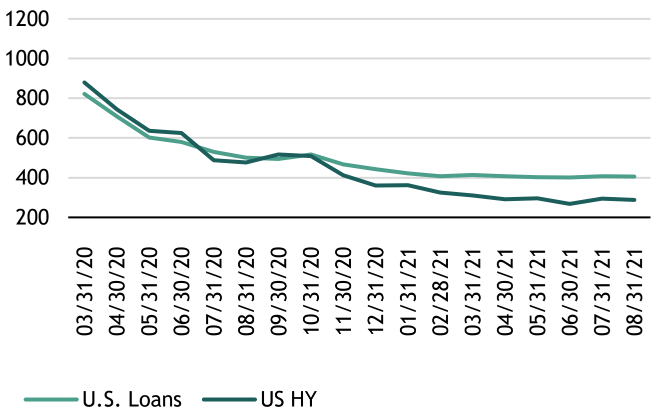
U.S. Credit Monthly Returns



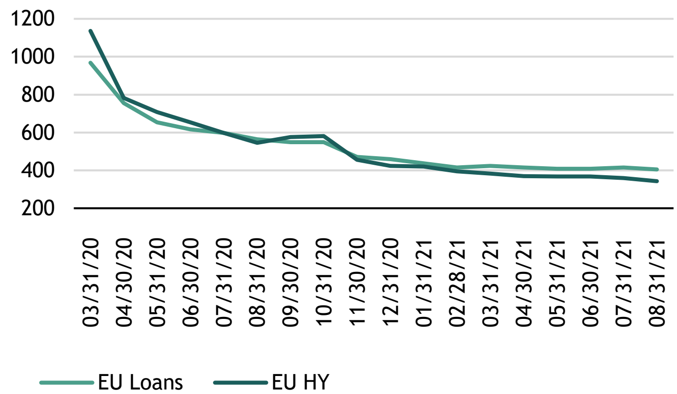
EU Credit Monthly Returns



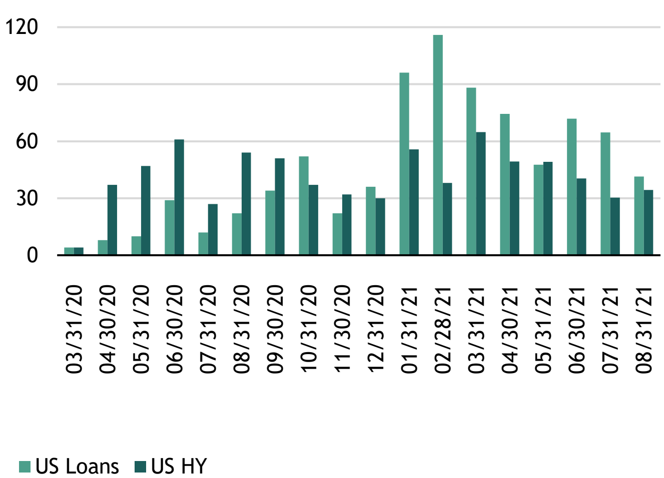
U.S. Credit Spreads (in bp)



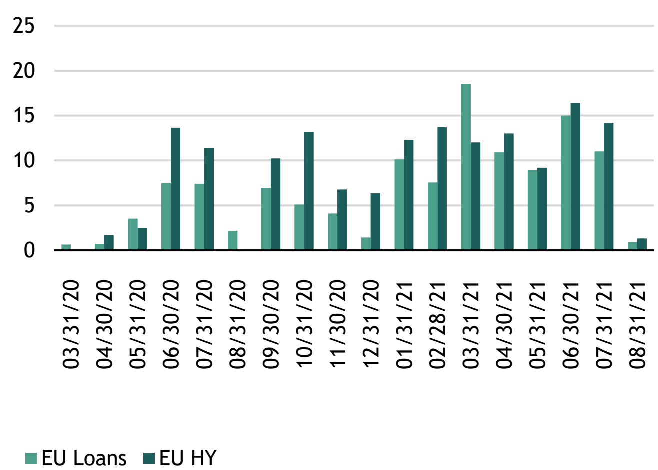
EU Credit Spreads (in bp)



U.S. Credit Issuance ($ in billions)



EU Credit Issuance (€ in billions)



[18] S&P/LSTA Leveraged Loan Index (represented by spread to maturity and yield to maturity), Bloomberg Barclays U.S. 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, 2021.

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