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Blackstone Credit

CREDIT INSIGHTS

July 2022 Market Commentary

- **Credit markets rebound to post positive monthly returns**
- **Supply/demand technical drives up prices**
- **ECB hikes for first time in 11 years as Eurozone inflation hits new highs**
- **Resilient 2Q earnings fuel risk on sentiment**

Performance Overview

July brought with it a sustained rally across equities and fixed income that moved monthly returns for global credit markets back into positive territory for the first time this year.

Macro remained a key driver, and despite persistently high inflation, markets turned dovish amid weakening economic data and an inverted Treasury yield curve. GDP data showed the US economy shrank for a second straight quarter.

The Fed remained hawkish in the face of persistent inflation and strong labor markets, responding to June's record high US CPI print with a 75bp hike in July. It hasn't ruled out another similar increase although emphasized that future decisions would be data dependent.[1]

In Europe, the ECB hiked rates for the first time in 11 years by 50bp, ending an era of negative rates in the region.

A generally better-than-feared second quarter earnings season also contributed to the return of risk-on sentiment, with more companies beating rather than missing reduced expectations through the end of July.[2] Commodities and materials continued their recent weakness – and oil prices declined another 4% over July global economic growth slowdown fears.[3]

Equity and debt markets alike pared back losses incurred so far this year. The S&P 500 soared 9.1% in July, the best monthly advance since November 2020.[4] The 10-year Treasury closed the month at 2.65% after reaching 3.5% in June,[5] while the yield on the 10-year Bund retreated below 1% by month end.

Credit spreads tightened from peaks earlier in the month and secondary market prices rebounded from this year's lows as buyers returned.

In both the US and Europe, the equity and rate rally as well as strong technical dynamics enabled high yield to outperform other credit markets in both regions. The market posted its largest monthly return since 2009.[6]

The rally also reduced the combined number of US loans and bonds trading at distressed levels (sub-$70 for bonds/sub-$80 for loans) to $123.4 billion, down -12% month on month. That's still up 318% over the last nine months from October's seven-and-a-half year low of $29.5 billion but remains significantly below the $549 billion of combined distressed debt in March 2020.[7]

Meanwhile loans trading above $96 have risen from 14% in early July to 49%.[8] One default over the month nudged the US high yield bond and loan default rates to 1.09% and 1.12%, respectively.[9] Recoveries for high yield and loans over the past 12 months are 60.3% and 64.1%, which compare to their 25- and 24-year annual averages of 39.9% and 64.4%, respectively.[10]

In Europe, the trailing 12-month par default rate was at 0.2% for loans and at 0.0% for high yield through the end of July.[11]

Market Stats (as of July 31, 2022)[12]

	July	QTD	YTD
S&P / LSTA U.S. Leveraged Loan Index	2.14%	2.14%	-2.51%
Bloomberg U.S. Corporate Investment Grade Index	3.24%	3.24%	-11.61%
Bloomberg U.S. High Yield Index	5.90%	5.90%	-9.12%
Credit Suisse Western European Leveraged Loan Index	2.37%	2.37%	-4.57%
Credit Suisse Western European High Yield Index	4.45%	4.45%	-11.11%
S&P 500	9.11%	9.11%	-13.34%
Euro Stoxx 50	7.33%	7.33%	-13.73%

Past performance is not necessarily indicative of future results.

Market Stats (cont'd) (as of July 31, 2022)

	Spread			Yield/Yield w. Forward Rates			Price		
	Level	ΔMTD	ΔYTD	Level	ΔMTD	ΔYTD	Level	ΔMTD	ΔYTD
U.S. Loans	514	(40)	103	5.78%/ 8.40%	(0.64%) / (0.6%)	0.94%/ 2.6%	$ 93.64	$ 1.48	$ (5.00)
U.S. HY	469	(100)	186	7.77%	-1.14%	2.91%	$ 90.42	$ 4.59	$ (13.14)
EU Loans	651	(74)	238	4.76%/ 5.42%	0.16%/ (0.47%)	0.94%/ 1.89%	€ 92.11	€ 1.42	€ (6.60)
EU HY	620	(58)	260	7.13%	-1.02%	3.37%	€ 88.88	€ 3.84	€ (11.35)

US Investment Grade Market

The rally across the rate curve acted as a strong tailwind for the investment grade market in July, enabling the market to recoup all of June's losses and more, to post a return of 3.24% in July. That trimmed the year-to-date loss for the asset class to 11.61%.[13]

Having widened to 160 bps in early month volatility, option adjusted spreads tightened during the subsequent rally to 1.44% by month end. The yield-to-worst declined to 4.33% by month end, from 4.70% at the end of June.[14]

Demand returned, especially for duration, given market expectations for interest rate hikes to level off sooner than expected. Average prices rose over two points to end the month at $94.87.[15]

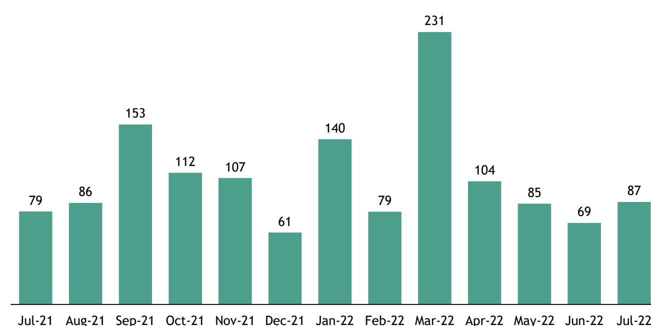
In the final week of July, the 18-week stream of fund outflows reversed to bring a $700 million inflow into the asset class for the first time since February. This was driven by strong ETF inflows which offset mutual fund outflows.[16]

Issuers responded to the improved sentiment by pricing $86.9 billion of new issuance over the month, a three-month high. Still, issuance in the year-to-date of $795 billion lags last year by 7%.[17] Financial-sector borrowers dominated supply fresh from reporting second-quarter earnings.

Pent-up demand paved the way for oversubscriptions, in particular for longer-dated paper from higher-quality issuers. New issue concessions dropped from 40bp on deals earlier in the month to 17bp in the final week.[18]

That said, borrowing costs continued to rise over the first part of the month. The average new issue yield rose to 4.87%, up 20bp from June, while average pricing for new issue single-As in July was T+151, compared with a T+119 average so far in 2022.[19]

US Investment Grade Issuance Ramps Up in July[20] (Bn)



US Loan and High Yield Markets

High yield led the July rebound across US loans and bonds following June's dismal performance. High yield's return was the best among global credit markets, and nearly erased June's 6.73% loss. Average prices rallied nearly $4, while spreads contracted over 100bp from wides of more than 600bp at the start of the month, to 497bp at month end.

A combination of the equity and rates rally, as well as the technical supply/demand imbalance, drove the move higher. Limited new issue, rising star upgrades which have caused the outstanding universe to contract, and calls, tenders and interest payments have left high yield fund cash balances at their highest levels in two years.[21]

The rally encompassed all rating cohorts, including the beaten up CCC-rated segment which posted its first monthly gain this year of 4.95%.[22]

Flows to high yield retail funds reversed with a nearly $5 billion inflow just ahead of month end. It's the largest inflow since June 2020, leaving YTD outflows at $30.5 billion.[23]

US loans gained 2.14% in July, the highest reading since November 2020, helping pare back the combined May/June loss of 4.66%.[24] Having fallen to $91.75, the lowest reading in almost two years at the start of the month, CLO demand helped loan prices rally three points on average.[25]

Outflows continued over the month so that $13.6 billion has exited loan retail funds since May. The year-to-date inflow now sits at $8.9 billion from highs of $24.9 billion through April.[26]

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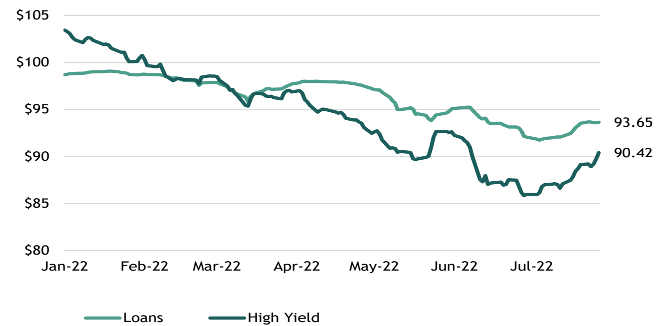
Meanwhile, cash balances across loan funds increased to 5.83% over the second quarter, which is their second highest reading over the past decade.[27]

In contrast to high yield, returns for CCC rated loan assets were left in the red, compared with BB and single-B loans which posted positive returns.[28]

The improved sentiment tempted some issuers out to market, but although demand improved, clearing levels remained sufficiently high to keep issuance subdued. High yield supply though June is running 77% behind the same period last year, while loan issuance is 56% behind last year's record pace.[29] Goldman Sachs lowered its issuance forecast to $135 billion for 2022 from $225 billion.[30]

US Loan and High Yield Prices Rally in July[31]



European Loan and High Yield Markets

European credit markets demonstrated a strong performance in July as markets rallied despite a relentless stream of negative macro developments. Returns moved back to positive territory for the month at 2.37% for loans, and 4.45% for high yield, helping to pare the year- to-date losses across both markets.[32] The high yield return is the strongest since April 2020 and the second highest total monthly return of the last 10 years.[33]

On the macro front, July's ECB hike was larger-than-expected at 50bp, and stronger-than-expected second quarter Eurozone GDP growth and another high July CPI report at 8.9% may provide impetus for the ECB to maintain a hawkish stance at its September meeting. Three-month Euribor has moved into positive territory for first time since 2015 following the rate increase.[34] The ECB also rolled out a new anti-fragmentation tool to support markets.

UK inflation touched a fresh 40-year high prompting the BofE to hike rates by 50bp in early August, and EUR/USD broke parity for the first time since 2002.[35] There was also political turmoil as first the UK and then the Italian prime ministers departed their respective posts.

The Nord Stream pipeline and evolving gas supply shortage weighed on related sectors, including chemicals and building materials, prompting S&P to take various rating actions on European chemical companies.[36] The absence of any significant shocks on the earnings front through the end of July may suggest the market overextended to the downside during the June selloff.[37]

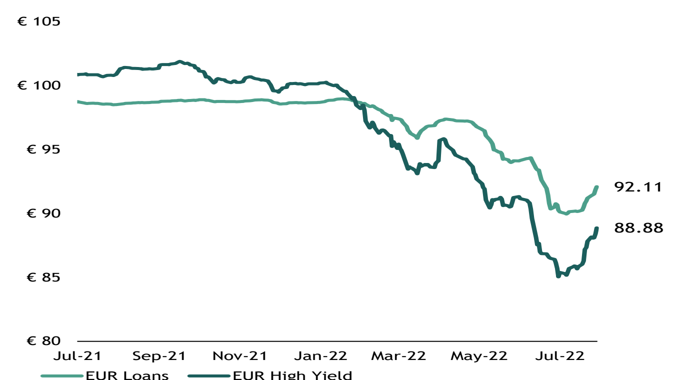
Against this backdrop the iTraxx crossover blew through year-to-date wides of 635 earlier in the month, before retracing to close to 500 by month end.[38] In high yield cash, yields and spreads tightened by 100bp/60bp during July as average prices rallied more than three points to €88.88 by month end.[39]

Outflows reversed, bringing inflows to high yield ETFs in the final weeks, while on the supply side high yield issuance continues to significantly lag the same period last year by 81%.[40] Appetite for duration improved, while higher beta high yield sectors including Airlines/Travel/Gaming and Retail outperformed later in the month.[41]

The technical dynamic supported loans in July amid limited liquidity. The uptick in CLO supply combined with loan issuance that is running 65% behind the same period last year[42] pushed prices up to €92.11.[43] In contrast to high yield, higher-quality credits outperformed but there was compression across the ratings spectrum as CLOs dipped into single B and CCC names once again.[44]

The percentage of distressed loans fell to 2.5% in July from a 21-month high of 3.7% in June, and the default environment remained benign.[45]

European Loan and High Yield Prices Rally In July[46]



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US and European CLO Markets

The CLOIE switched from outperformance in June to underperforming all other US credit products in July, although returns for the index at 0.58% were still positive.[47]

Issuers continued to price deals in both regions, even as limited investor demand pushed liability spreads wider.

$12.21 billion priced across 28 transactions in the US, which, although below the volumes for each of the previous three months, was sufficient to boost demand and prices on the underlying loan assets.

The continued activity led JP Morgan to revert to its original $110-120 billion forecast for CLO volume for 2022, after previously reducing expectations to $90-100 billion in June.[48]

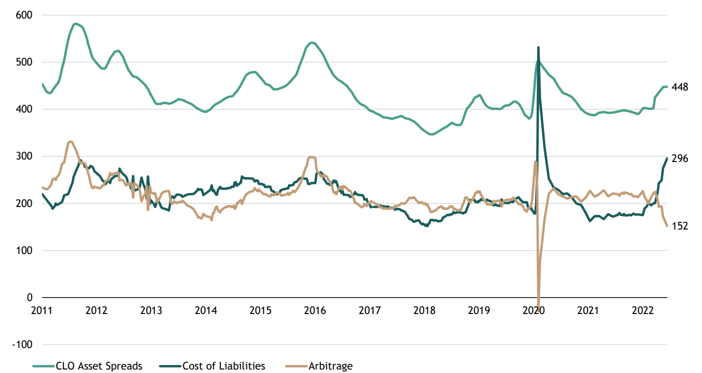
In Europe, €2.3 billion from 6 deals priced in July, up sharply from just one deal in June, and again supporting secondary loan prices.

Still, issuance was expected to ease going forward. That's not only due to the August slowdown, but also because the run up in loan prices has reduced the estimated benefit of managers buying discounted assets for CLO equity investors.

Primary spreads increased sharply month over month across the debt stack in the US and Europe with BBBs widening the most among IG rated tranches across both regions.[49] CLO AAA spreads peaked at 260bp for one US new issue in late July,[50] although generic spreads are lower at 215bp.[51] In Europe, AAAs have crossed 200bp on recent transactions, while generic spreads ended the month at 191bp.[52] Funding costs have risen to 284bp and 358bp in the US and Europe respectively.[53]

A look at credit metrics shows an improvement in CLO Weighted Average Rating Factor and CCC buckets in US BSL CLOS from June. In Europe, the WARF improved while CCC buckets were flat month over month. On the other hand, market value metrics such as the Weighted Average Price, CLO equity NAV and BB Market Value Over-Collateralization improved due to the recovery in the loan market across both regions.[54]

Wider CLO Liability Spreads Pressure the CLO Equity Arbitrage [55]



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Market Outlook

July's rally brought some much-needed respite from this year's volatility, while enabling credit markets to recover some of the losses incurred over the first half.

And with the improved sentiment came better buying interest to take advantage of what, in our view, was an attractive entry point into the loan and high yield markets. Heavy outflows from both asset classes over the second quarter had driven much of the prior price declines, as the combination of the Fed's efforts to slow inflation and a more bearish view among investors on credit and recession risk caused them to withdraw funds.

That left the prices available on bonds and loans as we moved into July below what we consider to be "fundamental" fair value based on credit risk, and history has shown that buying assets at deep discounts can translate into strong returns[56] that are well above the long-term averages.[57]

So far, the rally has continued into August, helped by a supportive technical dynamic. On the supply side, primary issuance remains limited, while on the demand side, cash balances are high in both loan and high yield accounts. Loans, and to a lesser degree high yield, have benefitted from continued CLO demand given ongoing supply in that market, while high yield retail funds also received the largest inflow, of nearly $5 billion, since June 2020 just ahead of month end.[58]

Barring any adverse macro developments, the current technical is largely expected to persist over the quieter August holiday period, causing markets to grind tighter over the near-term.

But market sentiment remains fragile, in our view. As Vice Chairman Byron Wien notes in the Blackstone's Quarterly Webcast Q3 2022: It's All in the Fed's Hands Now, low sentiment can give rise to strong rallies and this isn't the start of a new bull trend. Rather, he argues, stocks have further to fall before they regain equilibrium with bonds.[59] As a result, it's hard to imagine there won't be further volatility ahead.

A shift in the technical backdrop could be one trigger that causes the rally to fade. Already banks have taken advantage of the improved sentiment to bring new deals in August, and, provided the better tone continues, they are expected to try and syndicate the roughly $42 billion of loans sitting in the pipeline come September.[60] However, there is a potential question over the strength of demand from the loan market's largest buyer base, CLOs. Liability spreads have so far lagged the broader market rally, remaining sticky at elevated levels. Meanwhile asset prices have risen, reducing the estimated excess interest and "pull-to-par" benefit of managers buying discounted assets for CLOs. In our view, this could curtail CLO creation and ultimately loan demand at a time when banks may need it most.

Any further worsening in economic conditions or earnings shocks could also halt the rally, with the realization of true economic deterioration in the months ahead likely pushing spreads wider as default risk rises. Through the end of July, second-quarter earnings had generally proved relatively resilient, but there were warnings from some companies that higher prices are starting to impact demand, while others have announced hiring freezes and cutbacks.

A look at some recent macro data releases provides a somewhat mixed message. The Treasury yield curve remained inverted through much of July,[61] while the latest GDP numbers sent another reminder that the US economy is slowing, due to inflation and rising rates, and consumer confidence has also dropped.[62] However in our view the other key pre-conditions for a recession (LEIs below zero, corporate profit growth turning negative, and unemployment increasing) are not yet sending that signal. Rather, July's jobs report provided additional evidence of ongoing momentum in the economy with the data beating the consensus in every key metric and the unemployment rate falling to a post-COVID low of 3.5%.[63]

Contrary to the current market's assessment, this strengthens our view that we are not in a "real" recession. Our chief investment strategist, Joe Zidle, continues to believe that higher rates and a longer tightening cycle will be necessary to bring about positive real rates across the curve. With the direction of rates skewed to the upside, we believe this should support floating-rate loans in the months ahead.

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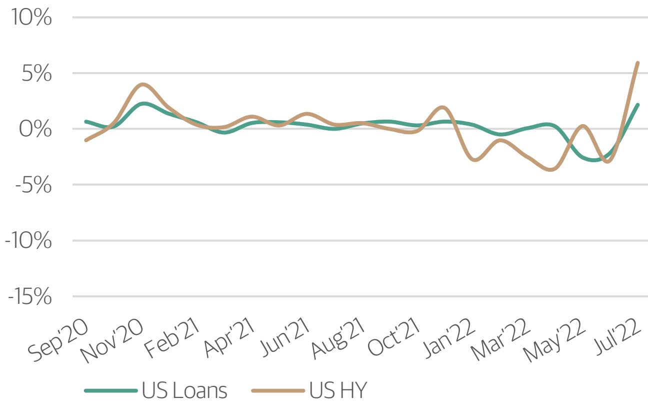
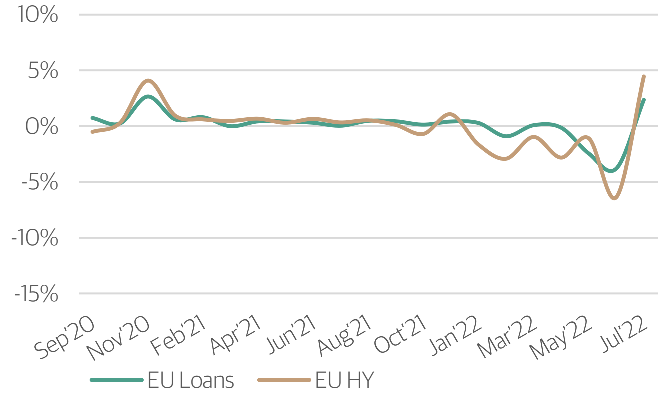
Market Snapshot

(As of July 31, 2022)[64]

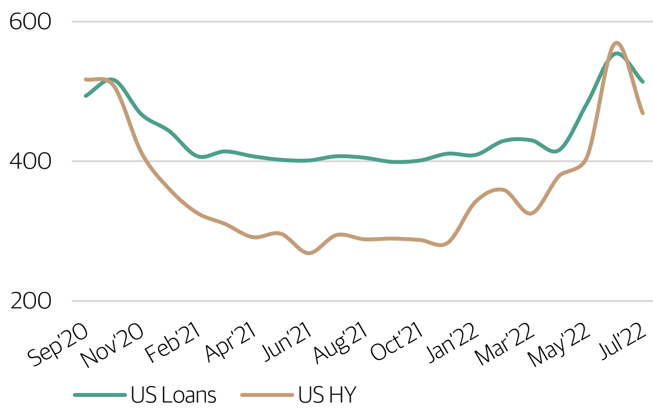
US Credit Monthly Return



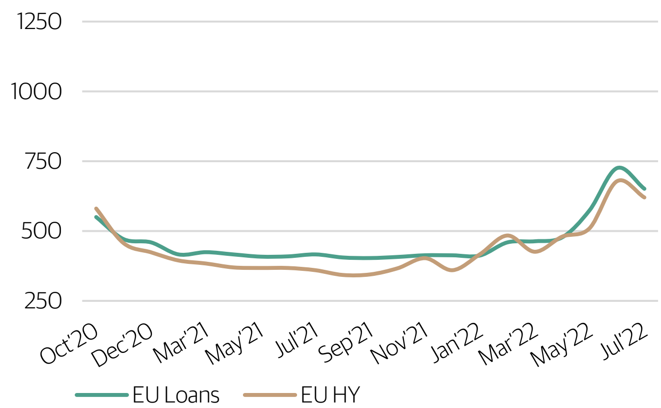
EU Credit Monthly Return



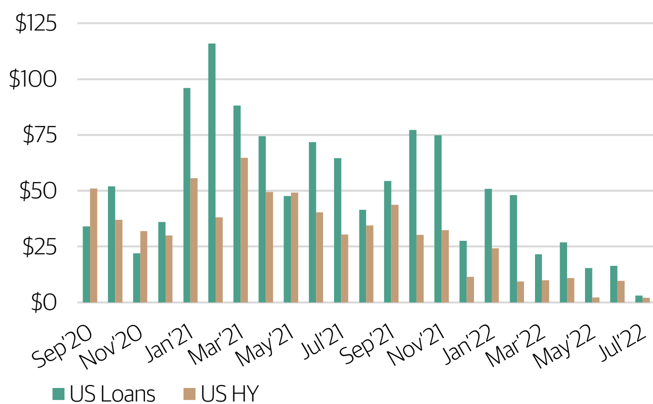
US Credit Spreads (in bp)



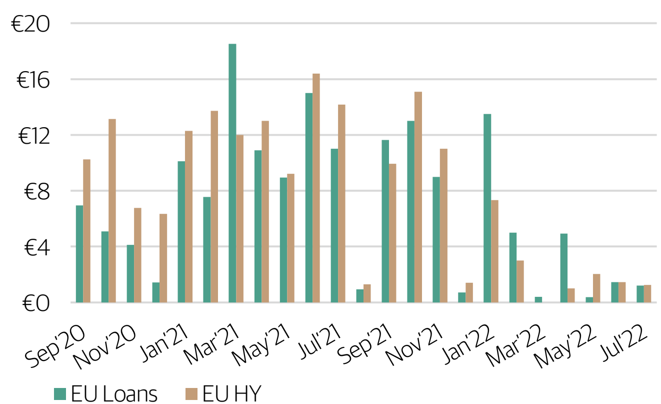
EU Credit Spreads (in bp)



US Credit Issuance ($ in billions)



EU Credit Issuance (€ in billions)



Past performance is not necessarily indicative of future results.

Key Risk Factors

In considering any investment performance information contained in the Materials, **prospective investors should bear in mind that past or estimated performance is not necessarily indicative of future results** and there can be no assurance that a Fund will achieve comparable results, implement its investment strategy, achieve its objectives or avoid substantial losses or that any expected returns will be met.

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Past performance is not necessarily indicative of future results.

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