Blackstone Credit

CREDIT INSIGHTS

September 2021 Market Commentary

Performance Overview

- Record month, quarter for supply across credit markets
- Tapering, rising rates spark volatility as headwinds grow
- Reopening trade in focus, leisure and travel outperform
- Recovery still on track despite lower growth

Supply hit records in credit markets during September as issuers pushed through increased volatility in the second half sparked first by fears of contagion from China Evergrande Group's missed payments, and then on the Federal Reserve's signal it would start to taper its $120 billion bond buying program.

U.S. equities bore the brunt of the weakness, suffering their worst month since March 2020,[1] while the 10-year Treasury breached 1.5% on expectations the Fed may look to increase rates beginning in 2022.

Buffered by technical factors, leveraged finance assets rebounded from the volatility, which instead offered a buy-the-dip opportunity. High cash balances across credit market investors helped absorb the increased supply. Fundamentals remain healthy; there were no new defaults in Blackstone's U.S. and European liquid credit portfolio in Q3.

Spreads subsequently tightened across U.S. investment grade bonds as well as U.S. and European loans. Performance across credit was mixed depending on rate sensitivity; U.S. leveraged loans outperformed amid increased retail and CLO demand for floating-rate assets, while index returns for U.S. investment grade bonds stayed negative for a second month as rate volatility soured sentiment towards longer-dated fixed rate assets. U.S. high yield bond returns also ended the month in negative territory but their European counterparts posted gains.[2]

Lower quality and energy credits, fuelled by rising oil and gas prices, led the pack in terms of performance, while the reopening trade remained a key theme as COVID vaccination rates increase and the U.S. gets ready to open its borders. Companies in the travel and leisure sectors performed well, and we expect airlines and movie theaters to benefit from the return to normal.

That said, gathering headwinds make for a more uncertain outlook and as October got underway concerns around trade, energy prices, inflation, rates, the U.S. debt ceiling—currently pushed out till December—and supply chain logjams created a more jittery market. We believe there is scope for more persistent market volatility in the coming months.

Market Stats (as of September 30, 2021)

	September	QTD	YTD
S&P / LSTA U.S. Leveraged Loan Index	0.64%	1.11%	4.42%
Bloomberg Barclays U.S. Corporate Investment Grade Index	-1.05%	0.00%	-1.27%
Bloomberg Barclays U.S. High Yield Index	-0.01%	0.89%	4.53%
Credit Suisse Western European Leveraged Loan Index	0.44%	0.96%	3.90%
Credit Suisse Western European High Yield Index	0.11%	0.80%	4.09%
S&P 500	-4.76%	0.23%	14.68%
Euro Stoxx 50	-3.53%	-0.40%	12.95%

[1] Reuters, September 30, 2021

[2] J.P. Morgan High Yield and Leveraged Loan Research, September 30, 2021

Market Stats (cont'd) (as of September 30, 2021)

	Spread			Yield			Price		
	Level	ΔMTD	ΔYTD	Level	ΔMTD	ΔYTD	Level	ΔMTD	ΔYTD
U.S. Loans	399	-6	-44	4.19%	-0.08%	-0.51%	$98.62	$0.37	$2.42
U.S. HY	288	0	-72	4.68%	0.07%	-0.28%	$104.64	-$0.58	-$0.31
EU Loans	403	-2	-56	3.74%	0.02%	-0.14%	€ 98.89	€ 0.15	€ 1.54
EU HY	345	2	-79	3.54%	0.03%	-0.71%	€ 101.35	(€ 0.02)	€ 2.76

U.S. Investment Grade Market

Rate volatility impacted U.S. investment grade returns in September as U.S. interest rates rose and the yield curve flattened. The 5-year rose 19bp while the 30-year rose 11bp, and the U.S. investment grade index declined 1.05%.[3]

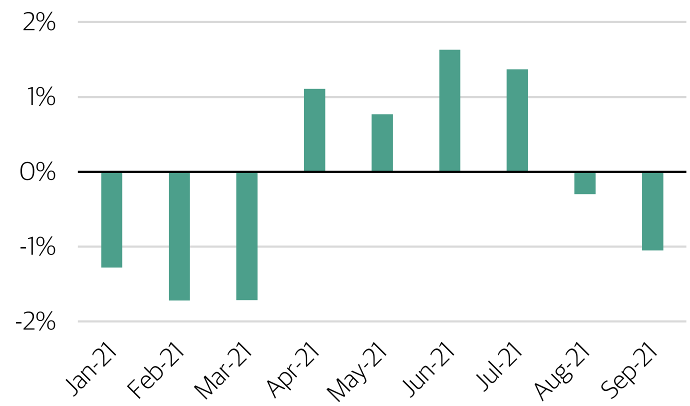
Issuance picked up post-Labor Day, taking year-to-date supply to $1.09 trillion.[4] October supply estimates are for $90-$100 billion.

Any reduction in issuance on the back of the 3Q earnings season could push investment grade spreads tighter. In September they compressed by 3bp to finish the month near post-Global Financial Crisis ("GFC") tights.

Energy names had another strong month, while BBB-rated names also outperformed higher-rated bonds.[5] Upgrades of non-financial high-grade debt outnumbered downgrades in 3Q by $103 billion to $7 billion, contributing to a strong positive net rating change.[6]

Inflows persisted as buyers looked to take advantage of any back up in yields, and this year's retail fund flows rose to $138 billion, well ahead of the rest of credit.[7]

Historical U.S. Investment Grade Bond Returns[8]



U.S. Loan and High Yield Markets

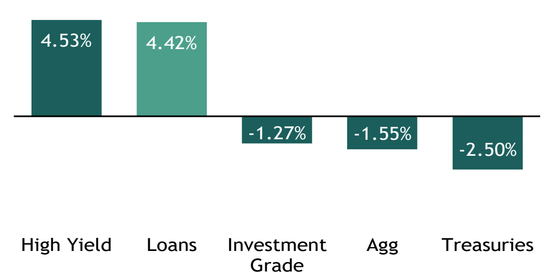
Demand for floating-rate assets shielded loans against the choppier markets in September and issuers racked up $69 billion of issuance, paving the way for an annual issuance milestone.[9] M&A dominated volumes, including the largest LBO to hit the market in the post-GFC era for Medline Industries.[10]

Demand helped secondary loan prices strengthen over the month to $98.9 on average,[11] while spreads tightened to 399bp, and returns rounded out at 0.64%.[12] Inflows came from CLOs, along with quarter-end amortization paydowns, and another $2.3 billion of flows into loan mutual funds.[13]

In high yield, rising rates have been met with an orderly response so far and equity weakness was largely cushioned by strong cash balances. Debt spreads were flat on the month, CCCs outperformed the more rate-sensitive BBs, and rising oil and natural gas prices fueled energy names.[14]

Total returns for high yield just tipped into the red and the average price of bonds eased to $104.64 from $105.23 at the end of August.[15]

U,S, Loan and High Yield Year-To-Date Performance [16]



The high yield market maintained its record year-to-date issuance pace and current low borrowing rates pushed supply 16% ahead of 2020. Refinancing remained a key theme, but M&A supply also increased during the month.

[3] Bloomberg Barclays U.S. Corporate Investment Grade Index
[4] LCD News, October 1, 2021
[5] Credit Suisse Daily Strategy, October 5, 2021
[6] JPM Research, October 12, 2021
[7] Credit Suisse Strategy Daily, October 5, 2021
[8] Bloomberg Barclays Corporate Index, September 30, 2021
[9] LCD News, October 1, 2021
[10] LCD News September 30, 2021
[11] S&P/LSTA U.S. Leverage Loan Index
[12] S&P/LSTA Leveraged Loan Index
[13] Lipper FMI, J.P. Morgan, October 1, 2021
[14] Credit Suisse Daily Strategy, October 5, 2021
[15] Bloomberg Barclays U.S. High Yield Index
[16] Source: J.P. Morgan, September 30, 2021

European Loan and High-Yield Markets

In loans, strong primary issuance during September took this year's volume to €107 billion, almost double the €54.3 billion reported in the same period last year.[17]

It was still not large enough to test cash balances, which were bolstered by repayments and by robust CLO issuance, helping absorb the month's supply with relative ease.

Secondary loan markets subsequently rose to €98.89 by month-end, the highest level since October 2018.[18] CCC-rated assets and sectors such as Leisure & Gaming and Retail were standout performers during the month.

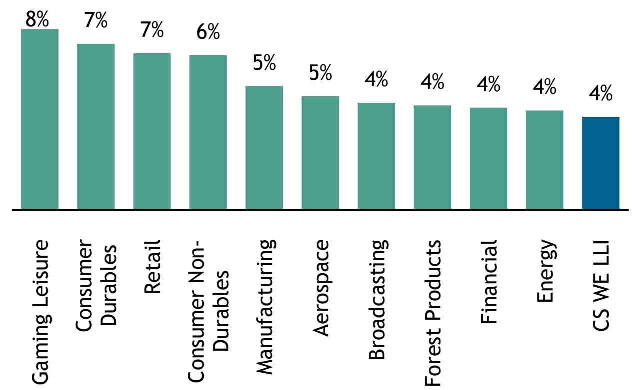
New issue volumes were not as strong as anticipated in high yield, but the pace remains well ahead of the past two years. The pipeline points to an expected increase in issuance through October raising the YTD volume from €96.8 billion at the end of September.[19]

Bond prices recovered after briefly repricing lower during the volatility, and cash balances were lifted by inflows into the asset class to the tune of €75 million after August's outflow.[20]

European credit posted another positive month of returns where loans outperformed bonds, returning 0.44% versus 0.11% for high yield.[21]

As headwinds increase, macro and credit fundamentals are expected to substitute the buy-the-market strategy that has worked well over the past 18 months.

Top 10 European Loan Sector Year-to-Date Returns[22]



U.S. and European CLO Markets

Global CLOs recorded another strong month of issuance in September amid supportive conditions including asset availability and healthy arbitrage.

The market's recovery from the pandemic was a key topic at the various conferences in London, which, along with the search for yield, has brought more investors into the market.

U.S. supply rose to $129.82 billion through month-end, overtaking the previous annual high set in 2018.[23]

European CLOs notched up the year's second highest monthly tally, putting 2019's annual high point in its sights. The activity led Morgan Stanley to increase its European new issue forecast to €30 billion for the year.[24]

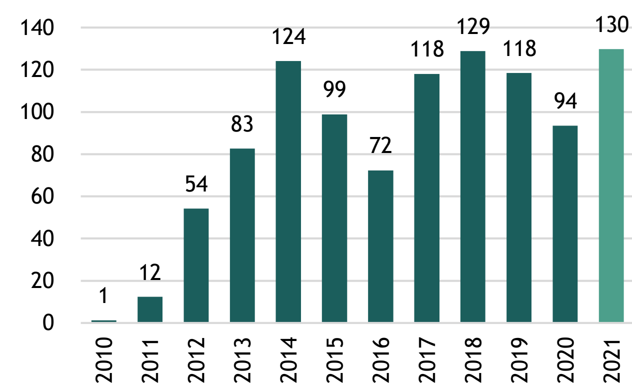
Relative value versus other assets helped push the top-rated European new issue spread for one new transaction inside 100bp by month-end,[25] having widened earlier in the year on heavy supply.

Rate hike expectations should support floating-rate CLO bonds, especially CLO BBs, which look dislocated to other similarly rated assets.[26]

In primary and secondary, tier-one managers continue to secure more attractive pricing relative to lower-tier issuers.

Blackstone printed three new issue CLOs over the month, Bethpage Park and Nyack Park in the U.S., and Dillon's Park in Europe.

U.S. CLO Historical New issuance ($ in bn)[27]



[17] LCD European Playbook, October 1, 2021
[18] Credit Suisse Western European Leveraged Loan Index
[19] LCD, October 1, 2021
[20] J.P. Morgan (preliminary data)
[21] Credit Suisse Western European Leveraged Loan Index
[22] Credit Suisse Western European Leveraged Loan Index
[23] LCD CLO Global Databank
[24] Morgan Stanley CLO Primer, September 20, 2021
[25] LCD, September 28, 2021
[26] J.P. Morgan Research, Debutante Ball, September 24, 2021
[27] LCD, September 30, 2021: reflects new issuance excluding refis and resets

Market Outlook

After what's been a record quarter for supply fuelled by supportive conditions, including rock-bottom rates and demand for higher-yielding assets, we move into the final quarter of the year facing greater macro headwinds. Among them are concerns about the economic recovery after 2Q 21 U.S. GDP growth was almost 200bp below the consensus, prompting economists to lower their forecasts for the rest of the year.[28] In Europe, at the macro level, supply chain constraints again weighed on growth, as manufacturing PMIs fell for a 3rd consecutive month. [29]

Inflationary pressures are also mounting. Global commodity, food and energy prices have soared in 2021 YTD, with consumer inflation measures increasing at the fastest pace in decades, crude oil nearing its highest levels since 2014, and the U.S. producer price index for all commodities up 20.4% in September, the sharpest annual increase since 1974. Higher energy costs pushed Eurozone inflation higher to 3.4% in September, and job creation moderated to a 6-month low. [30]

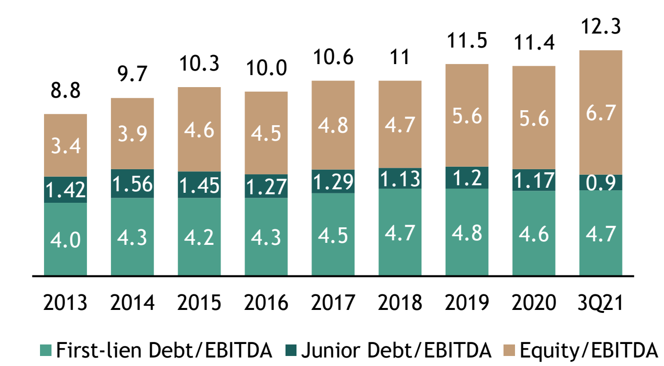
Despite potential speed bumps ahead, we remain convinced in the strength of the economic recovery, powered by pent up demand among U.S. consumers. The Fed's plans to start tapering, in our view, reflects its belief in the recovery and the progress made towards maximal employment and its inflation goals. Should inflation continue to surprise to the upside, expectations for rate hikes, which we expect to start next year and to increase in 2023, could be brought forward.

There are various reasons for remaining bullish on the U.S. recovery including the vaccine uptake and efficacy, the development of the Merck antiviral pill, which we see as a potential game changer in the reopening theme, as well as household and business consumption. However, we note persistent labor market struggles and supply chain problems, as we are seeing both play out in Blackstone portfolio companies. The slow-down in growth in China and the knock-on impact on the global supply chain is another concern we are monitoring.

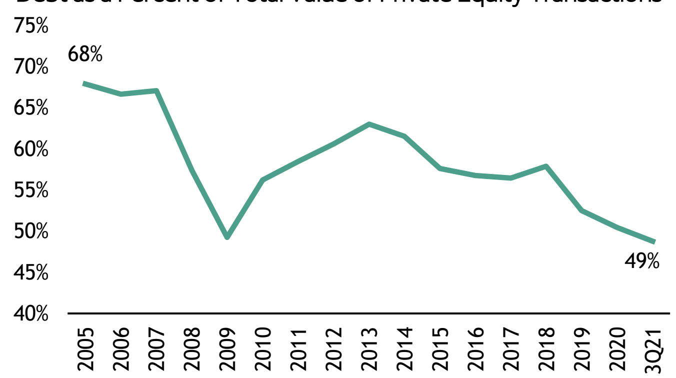
As such, we believe that investors should consider assets with exposure to the real economy, including those that will benefit from continued economic reopening. We also believe e-commerce and related logistics businesses will continue to see strong growth. That should benefit assets and sectors with positive exposure to interest rates, including short-duration and floating-rate assets.

That should also underpin demand for leveraged loans in the months ahead. On the supply side, primary issuance across credit markets rolls on through October, but conditions are already tougher amid the increased uncertainty, while volumes will start to ease as year-end approaches. There's also a dent in the pipeline for LBO deals now that the jumbo Medline deal has cleared. [31]

Average EV Multiples ($ in bn) [32]



Debt as a Percent of Total Value of Private Equity Transactions[33]



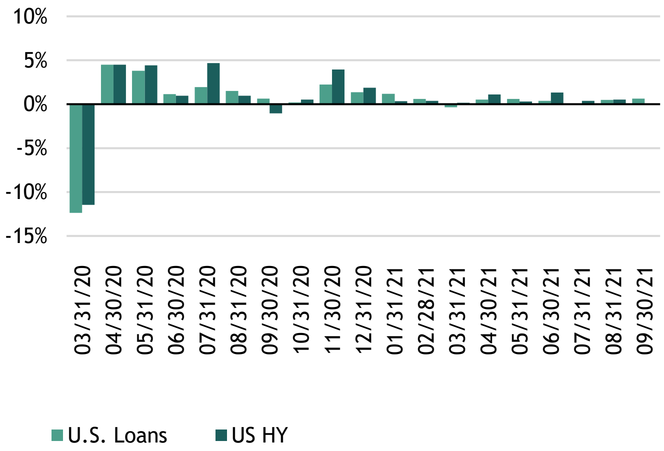
Private equity sponsors are still sitting on large piles of dry powder and while leverage multiples have increased, so have the equity checks sponsors write to finance acquisitions.

The average loan-to-value on new investments has declined to a low of 44% in 1H 2021 from 68% before the GFC as sponsors offset higher multiples with greater equity contributions. Meanwhile, the average default rate on sponsor-backed leveraged loans decreased to 0.68% during 1H 2021. That's 68% lower than the 2.14% rate for other companies with leveraged loans outstanding, and default rates are expected to remain low by historical standards over the near term.[34]

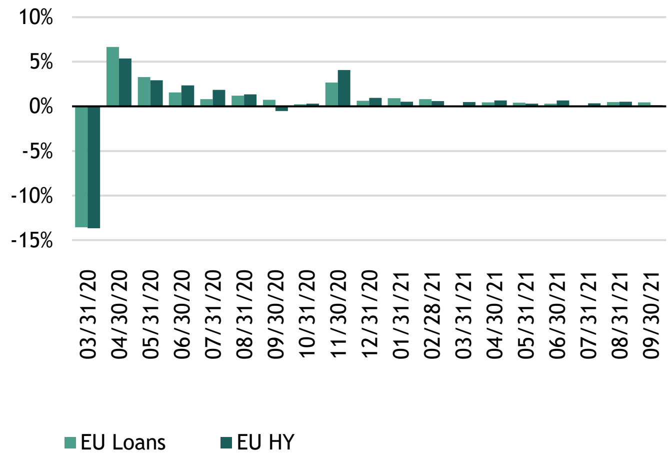
[28] Conviction in the Recovery Remains Strong, Joe Zidle, October 2021
[29] IHS Markit, Eurostat October 2021
[30] IHS Markit, Eurostat October 2021
[31] Credit Suisse Strategy Daily, October 8
[32] LCD Loan Quarterly Report and LBO Report, as of 3Q 2021
[33] LCD LBO Report, as of 3Q 2021
[34] Blackstone Credit, as of March 2021

Market Snapshot (as of September 30, 2021)[35]

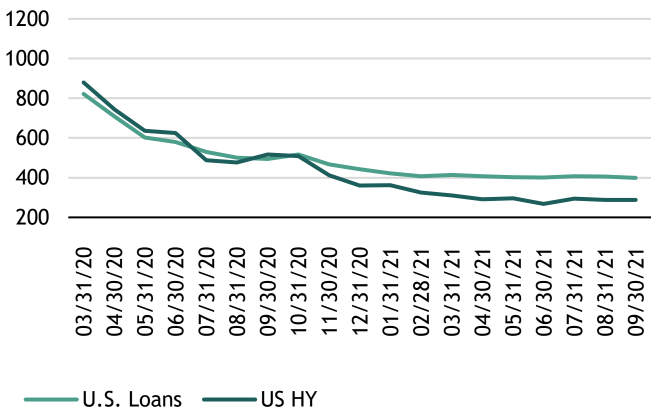
U.S. Credit Monthly Returns



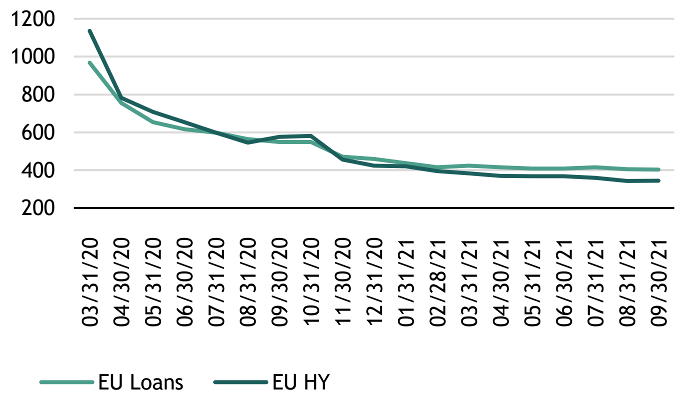
EU Credit Monthly Returns



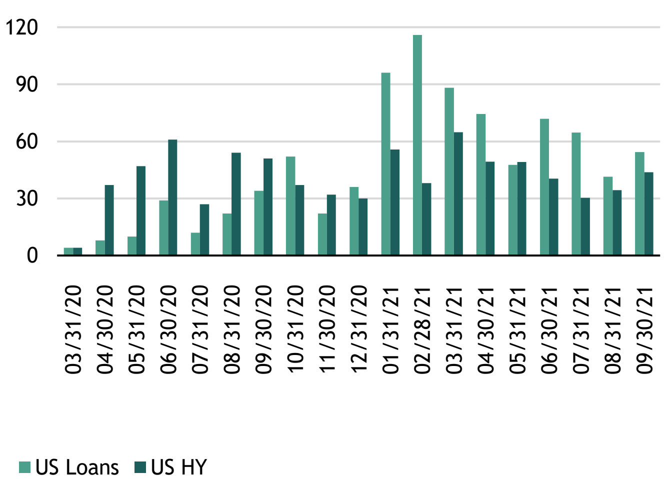
U.S. Credit Spreads (in bp)



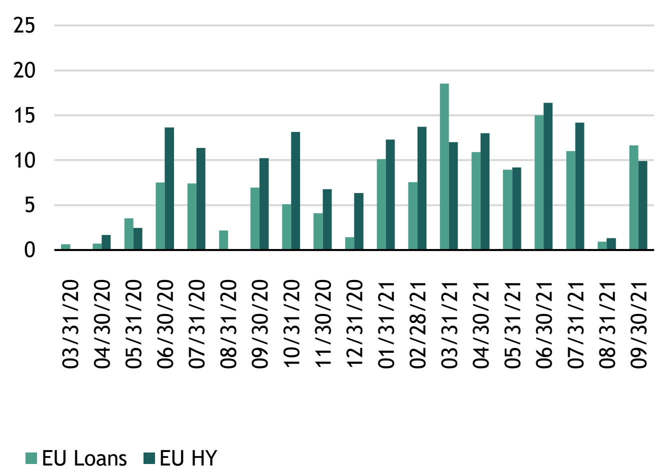
EU Credit Spreads (in bp)



U.S. Credit Issuance ($ in billions)



EU Credit Issuance (€ in billions)



35 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 September 30, 2021

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