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WEALTH SOLUTIONS

Three Reasons Investors Should Be Excited About Credit in 2023

With the U.S. economy expected to slow in 2023 and higher interest rates making borrowing more expensive for businesses, investors could be excused for being cautious about investing in such assets as high yield bonds and leveraged loans. However, there are three reasons for investors to be optimistic that, in the current environment, credit could help portfolios outperform.

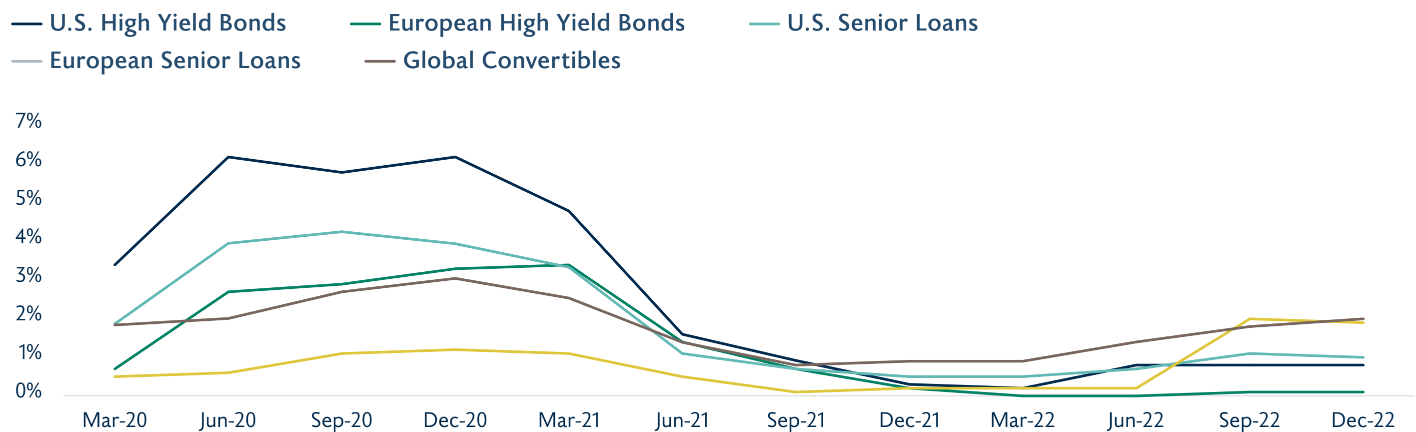
1. It's a Credit Picker's Market

- *Businesses are largely healthy, but we believe defaults could roughly double next year, favoring managers who can distinguish between solid and shaky credits.*

In 2022, interest rate risk drove the relative outperformance of floating-rate vs. fixed-rate assets. This dynamic may change in 2023 if, as expected, economic growth slows in the United States and elsewhere. Near-term default risk should remain low, helped by less than 7% of outstanding bonds maturing in 2023[1] and businesses being quite healthy. However, defaults (**Figure 1**) could roughly double: High yield bond and leveraged loan default rates are forecast to rise in 2023 to 3.00% and 3.50%, respectively, and in 2024 to 3.25% and 4.00%.[2]

Figure 1

Default Rates Could Double From Current Rates, Making Active Management Crucial



Note: Data represents trailing 12-month default rates and do not include distressed exchanges. There is no assurance that such events or projections will occur, and actual outcomes may be significantly different than those shown here.
As of December 31, 2022.
Source: Credit Suisse, JPMorgan, FTSE.

We could see significant volatility and dispersion, based on quality, in fixed income markets if investor optimism is not borne out. In addition, a slowing economy, higher rates and tight capital markets could make leveraged credit markets more vulnerable to increased defaults. As a result, it will be essential to separate the best borrowers from the rest, making 2023 a credit picker's market.

2. Banks Aren't Funding Private Equity Deals

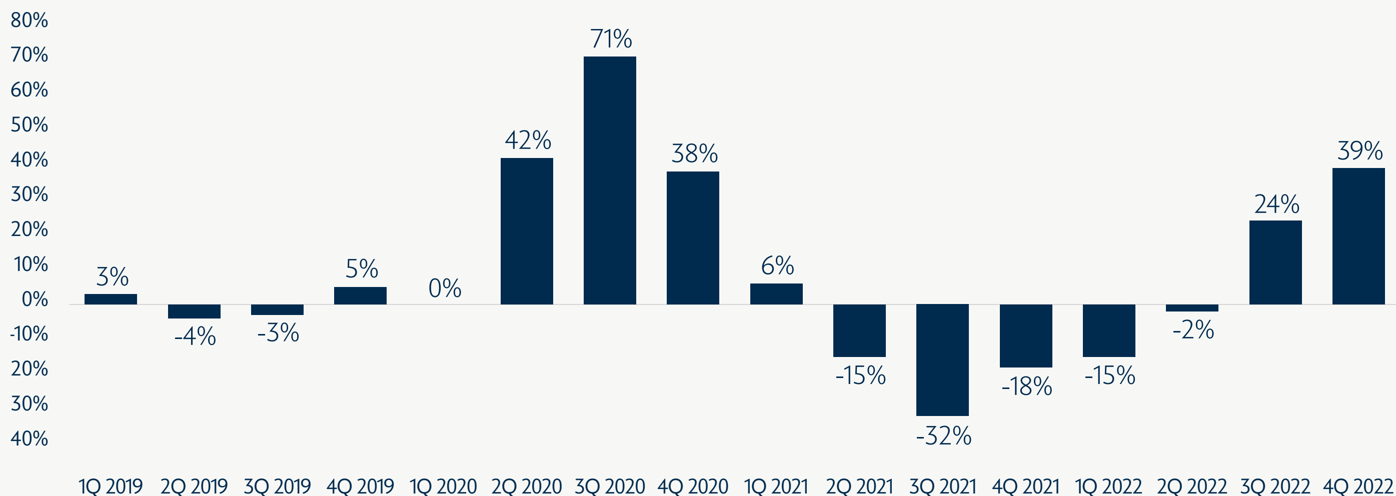
- *Banks are tightening lending standards, while private equity firms want to put a stockpile of dry capital to work, opening an opportunity for direct lending.*

Capital market appetite for financing leveraged buyouts with high yield bonds froze in 2022, leaving banks saddled with billions of dollars-worth of hung loans that they cannot sell at par.[3] Now, many banks are trimming balance sheet risk (**Figure 2**) and shying away from financing leveraged buyouts, mergers, and acquisitions. At the same time, private equity firms have record amounts of dry powder and want capital partners to help finance deals.

Figure 2

Banks Tighten Lending Standards, Creating a Potential Direct Lending Opportunity

Net Percentage of U.S. Banks Tightening Standards for Large and Middle-Market Companies



Note: Large and middle-market companies defined as firms with annual revenues of $50 million+.
As of December 31, 2022.
Source: Federal Reserve economic data, Bloomberg.

This may create an attractive opportunity for investors like Oaktree, with capital available to fill the void. The rewards can be meaningful: the yield spread now offered is wider than is available in traditional middle-market deals.[4] Also, lenders can now secure covenants and protections that were impossible last year, when markets were awash with capital, making these deals even more appealing.

3. A Potential 'Sea Change' Favors Bargain Hunters

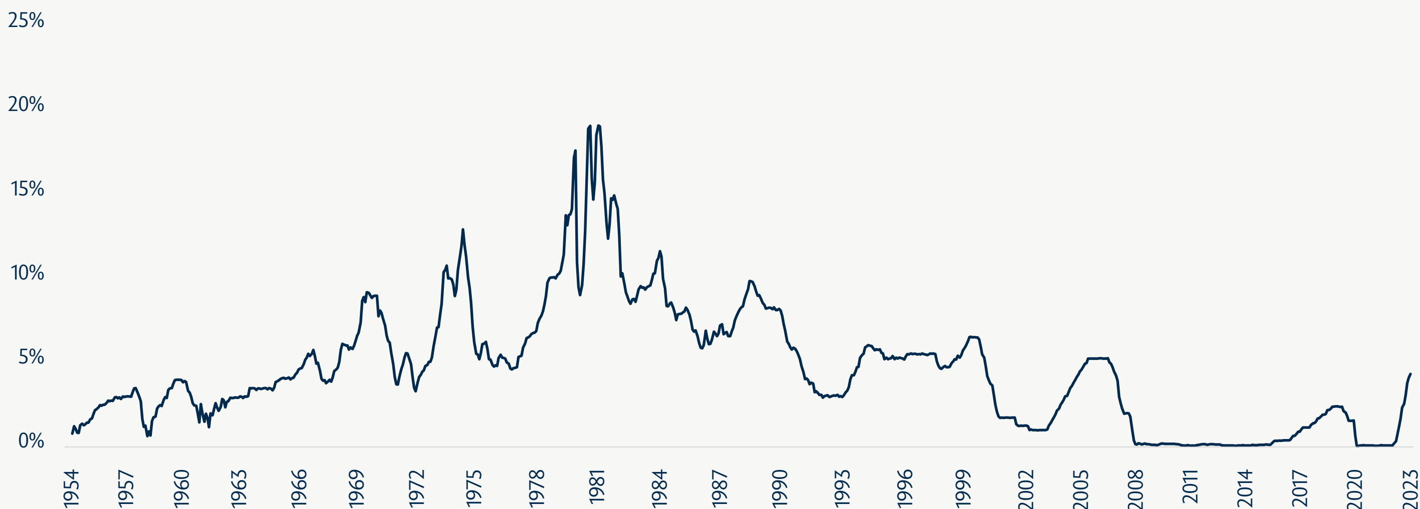
- *Higher interest rates can create better opportunities to gain solid returns from credit, positioning the asset class to potentially outperform for years.*

The consensus expectation that a federal funds rate of ~4.5% (**Figure 3**) is an aberration that will soon revert to lower levels is perhaps a misguided perspective. In our view, the near zero rates that followed the Global Financial Crisis were not the norm historically and are unlikely to be repeated soon. We believe that the base interest rate over the next several years is more likely to average 2-4%.

Figure 3

Higher Rates Foreshadow a 'Sea Change' That Could Create Bargain-Hunting Opportunities

Historical Federal Funds Effective Rate



As of January 1, 2023.
Source: Federal Reserve Bank of St. Louis.

In his memo titled *Sea Change*, published December 13, 2022, Oaktree Capital founder Howard Marks summed up the opportunity like this: "Investors can now potentially get solid returns from credit instruments, meaning they no longer have to rely as heavily on riskier investments to achieve their overall return targets. Lenders and bargain hunters face much better prospects in this changed environment than they did in 2009-21. And importantly, if you grant that the environment is and may continue to be very different from what it was over the last 13 years – and most of the last 40 years – it should follow that the investment strategies that worked best over those periods may not be the ones that outperform in the years ahead."

ENDNOTES

[1] Calculation based on Bank of America, Credit Suisse data, as of December 31, 2022.

[2] JPMorgan Default Monitor, as of February 1, 2023.

[3] Hung loans occur when a bank fully underwrites a financing with a short-term bridge loan but then fails to place the longer-term high yield bonds at an acceptable price, leaving the bank holding a bridge loan that then requires restructuring into a term loan or note.

[4] Oaktree market observations, as of January 23, 2023.

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