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Why Investors Should Be Strategic Buyers of Credit

A conversation with Oaktree Portfolio Manager David Rosenberg

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More than a decade of historically low interest rates has left many portfolios stock-heavy. As investors move to take advantage of high yields to rebuild credit exposure, we chatted with David Rosenberg, Co-Portfolio Manager for the Oaktree Diversified Income Fund, to discuss where he sees opportunities, and what he expects for credit markets.

Highlights:

- We are entering a new market phase where credit should, in our view, outperform equities. However, amid economic uncertainty, investors should work with managers that can identify relative value between public and private credit.
- The economy appears headed for recession, but investors should not overreact because corporate defaults are unlikely to reach dangerous levels.
- Don't try to time the market. Investors should buy credit strategically.

Q: How should investors approach what you have called a "new era" for credit markets?

Credit will very likely outperform equities over the next few years. We're already seeing a recalibration in portfolio allocations that will reduce the heavy tilt toward equities built up over the last decade.

However, even in this period of attractive yields, investors will have to remain selective. The time to be picky about what you're putting in your credit portfolio is when there are concerns about the possibility of a recession. When you're building an allocation, it's tempting to just buy an index tracker for a few basis points and forget about it, but that doesn't really work in credit.

Credit exchange-traded funds (ETF) don't actually give you exposure to the market in areas such as high yield: They seek to offer exposure to a sub-segment of the market that is more liquid and sometimes lower-yielding. Also, I believe we're going into a period of greater stress. This type of environment favors managers who do rigorous credit analysis and are picky in their exposures. By definition, ETFs aren't picky, they're passive.

One interesting wrinkle is that investors today are finding great opportunities in *both* public and private credit. We've been very active in private credit. But in any private investment, you have to ask, 'Are you getting paid for the risk of illiquidity?' You have to conduct your research and be *very* selective.

Q: Demand for credit has soared as yields have risen, but investors are nervous about a recession. What can credit investors expect from the economy for the rest of this year?

I think there is a recession coming. But one thing people tend to overlook is the fact that the quality of the market today is perhaps the best we've ever seen going into a recession. This may be the most predicted recession in history, which means a couple of things: Portfolio managers, like myself and my Oaktree colleagues, have been stress-testing their portfolios for well over a year to make sure that if a recession does hit, we will be OK. So, I don't expect a ton of panic selling. Companies have also been stress testing. CEOs have been cutting back on capital expenditures and inventory, and expenses such as advertising, and redeploying that cash to strengthen the balance sheet.

Because companies have had this time to prepare for a recession, I don't think we're going to see a massive spike in defaults. In previous recessions, we've always had at least one year of double-digit defaults. This year, most strategists are forecasting a default rate of 3% to 4% for bonds and 4% to 5% for loans. That would be a big move up from a default rate that was effectively zero, but a 3% to 4% default rate for bonds is roughly in line with the 30-year average.

People are also talking about a maturity wall of debt that will need to be refinanced at higher rates in 2024, 2025 and 2026. But from a default perspective, COVID was a cleansing event. During that crisis there was a 5% default rate. Without the pandemic, those companies would have stumbled into the next recession and then defaulted. COVID pulling forward all those defaults should keep us from reaching double-digit defaults, even in a recession. That's critical, and I think people are starting to clue into that.

Q: Should investors adding credit exposure today be concerned about spreads widening?

There are two types of credit investors: tactical and strategic. Until recently, almost all credit buyers were *tactical* buyers because credit was giving you 4% or 5% yields, which wasn't attractive. So, for years, most credit investors only bought credit when spreads were wide and sold when spreads got tight.

Over the past six months, however, we've seen a shift to strategic buying. But after this massive, recent rally in credit, some investors are starting to worry that a recession is coming and that spreads might widen. Everyone always wants to time the market. But what I always tell people is, you can't time the market. Right now, there is potential to lock in 10% annualized returns in the form of *contractual payments*. That's attractive! Two years ago, that's what riskier assets like distressed debt and private equity were offering. So, investors today should ask, 'If a recession hits and spreads widen, do I care?' My view is, if you're going to look back three years from now having potentially earned 10% annually, and if you're going to be happy with that, you should consider buying. Be a *strategic* buyer. You can't time the market.

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