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Q&A: Talking Credit Opportunities With Armen Panossian

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Even at a time of economic uncertainty and high interest rates, we believe there is no shortage of opportunity for investors in public debt and private credit markets. Investors today can find highly attractive risk-adjusted returns in the high yield market, where credit quality is the best, it has been in many years. Meanwhile, commercial banks have pulled back on lending to businesses, creating opportunities for private, non-bank lenders to provide direct loans at highly favorable rates, especially to high-quality middle-market companies. At the same time, the dramatic shift in the lending market has created a growing group of good companies with bad balance sheets. Many of these firms may emerge as targets for distressed debt investors in the next few years as interest rates stay higher for longer, creating conditions where firms face the dual challenge of higher debt-servicing costs with lower revenues as the economy slows.

Oaktree's Armen Panossian recently sat down with Bloomberg Intelligence's *FICC Focus* podcast to talk about market conditions, bond returns, and how Oaktree's decades of experience in credit positions the firm to find new investment opportunities.

Q: How significant is the opportunity in private credit today?

Private credit represents a very large opportunity set. Today, with banks stepping away from lending because of regulatory reasons and balance sheet losses from syndication, we are finding opportunities to generate attractive risk-adjusted returns in the heart of the private credit or corporate direct lending market.

As a consequence of both higher rates and economic dislocation, what we're finding is that you can lend on a first-lien basis to large businesses being bought by private equity firms at a cost of debt between 11% and 13%. That's the best risk-adjusted return I can think of currently in the market—and one that's certainly much higher than it's been at any time in the last 10 years. For these reasons, we believe it's a great vintage and a great time to really lean into private credit, even in the most highly trafficked part of the market.

Q: Will the Federal Reserve's monetary policy achieve its goal of a soft landing for the U.S. economy?

If you look historically at periods of rapid rate increases, it usually takes about 18 months from the rate peak to experience stress or distress in the markets. You also have seen historically a 100% correlation with an inverted yield curve resulting in a recession. No one has given me a compelling argument to say this time is materially different. I think that the next 12 to 24 months are going to look a whole lot worse than the last 12 months.

Q: Where do you see areas of opportunity that might weather a potential downturn?

I think high yield bonds are probably the most interesting of the publicly traded credit products. The high yield universe has the highest credit quality it has seen in many years with the highest percentage of BB-rated credits in at least a decade. These companies might have the opportunity to de-lever by the time you get to maturity on a nominal-dollars perspective. So, I think earning a 9% yield-to-maturity on high yield bonds today is probably more like 9.5-10% in terms of actual recovery, because a good high yield issuer is going to refinance its bond one year or 18 months before its maturity. To me, that's a very attractive risk-adjusted return, given the size and leverage of those borrowers.

I also think we are embarking on a great set of circumstances for distressed debt investing. Sectors like software and healthcare are still pretty high quality, but they are not levered appropriately given the cost of borrowing at this time. With base rates at over 5%, these companies are going to have a very tough time managing their cash flow because their debt burden is too high. These are great examples of good companies with bad balance sheets, which is a recipe for a very attractive distressed investment opportunity that I think will unfold over the next couple of years.

Looking at credit markets more generally, at some point duration will be your friend, but I think something has to break first. Conventional wisdom says we'll need a recession or some other trigger to bring down rates. There will be a buying opportunity in high-quality duration, but it's just not here yet.

Q: How do you think Oaktree's expertise and scale will benefit the firm and its investors as private credit markets grow?

There's not enough private credit capital relative to private equity demand. Based on our numbers globally, there's over $2 trillion of private equity capital looking for deals. Last time I checked, private equity sponsors are not known for returning drawn capital. So that money is going to be spent. It might take two years, or three years, but it is not going to take 10 years.

Given this, if you consider demand to deploy private equity capital, and juxtapose that with what's happening in the banking environment and what's happening with bank tolerance for lending or using their balance sheet to earn syndication fees, those two things are going in opposite directions. Based on our numbers, there's only about $300 billion of private credit dry powder. That is a huge mismatch, and indicates that certainly more growth is possible. Oaktree's size and scale mean we should be well positioned to capitalize on this opportunity.

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