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Oaktree's Panossian: Why Interest Rates May Stay Higher for Longer

ARMEN PANOSSIAN
CO-CHIEF EXECUTIVE OFFICER AND HEAD OF PERFORMING CREDIT AT OAKTREE CAPITAL MANAGEMENT

Despite financial markets pricing in interest rate cuts beginning in May or June of 2024, Oaktree's Co-Chief Executive Officer and Head of Performing Credit, Armen Panossian, thinks investors should be prepared for the possibility that the U.S. Federal Reserve may instead wait until it is forced into action.

Speaking with the *Financial Times*, Panossian offered two reasons why the central bank may opt for caution: First, policymakers were scrutinized for their 2021 comments that inflationary pressures were "transitory," and secondly, they will not want to risk even the appearance of influencing the upcoming U.S. presidential election. Given those considerations, Panossian said the central bank could instead decide to retain its firepower in case it has to respond to a major event.

Panossian said that although credit markets face an uncertain macroeconomic outlook, 2024 should nevertheless offer opportunities for investors. He shared the following views:

- High yield bond yields remain attractive, particularly when comparing BB-rated debt with investment grade bonds. At the same time, while defaults are expected to rise, credit quality has improved—roughly half of high yield bonds today are rated BB, versus one-third a decade ago.[1]

- Leveraged loans that were bought at deep discounts are now trading above par. However, the rising likelihood of refinancing or repricing once rates decline has caused spreads to tighten. Yields are also high at 9.4%, but this may be a function of valuation mechanics (e.g., loss provisioning, an income statement expense that lenders can use for potential delinquent interest payments) and higher leverage.

- Private credit yields have decreased slightly (spreads are about 100-150 bps tighter versus last year) as deal volume declined as a result of capital market and merger & acquisition activity slowing in the face of higher interest rates. Still, the opportunity remains substantial, with large investor inflows into BDCs[2] coupled with demand from private equity firms for private credit due to the certainty and speed that private lenders can provide compared with traditional banks.

Given this environment, Panossian stressed the importance of credit investors working with an asset manager that has a proven track record of skillfully navigating through various market cycles while seeking to avoid losses.

ENDNOTES

[1] Bond ratings are grades given to bonds that indicate their credit quality as determined by private independent rating services such as Standard & Poor's, Moody's and Fitch. These firms evaluate a bond issuer's financial strength or its ability to pay a bond's principal and interest in a timely fashion. Ratings are expressed as letters ranging from 'AAA', which is the highest grade, to 'D', which is the lowest grade. Credit ratings are subject to change.

[2] A BDC, or business development company, is a closed-end investment company is regulated by the U.S. Securities and Exchange Commission under the Investment Company Act of 1940. BDCs primarily invest in small and midsize companies (often privately held or founder-owned). BDCs were initiated by the U.S. Congress in 1980 under the Small Business Investment Incentive Act to help facilitate investment in small, growing, U.S. businesses by offering a financing alternative for firms that may otherwise have difficulty accessing traditional financing via bank loans or public markets. To maintain BDC status, the company must invest 70% of its assets in qualifying BDC assets. Generally, these are private U.S. companies or public U.S. companies with a market capitalization of less than $250 million at the time the investment is made. The remaining 30% can generally include other non-qualifying assets.

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Contact Us

brookfieldoaktree.com

info@brookfieldoaktree.com

+1 855-777-8001

ID 1318

00231-5

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