Market Outlook: The Waiting Game

The broad rally that boosted many leveraged credit and equity markets in the fourth quarter continued through the last three months, even as one of the main drivers of market optimism—expectations regarding near-term interest rate cuts—continued to shift. In the current installment of *The Roundup*,[1] Oaktree co-CEOs Robert O'Leary and Armen Panossian discuss their market outlook for credit investors at a moment when many are waiting to see whether this long-awaited dovish turn will actually materialize.

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When we spoke with clients at the end of 2023, we argued that credit investors had grown too complacent. As we survey the current credit landscape, we'd like to second that assessment. In the last six months, leveraged credit markets have experienced what we call a "lift-a-thon"—almost everything has rallied. High yield bond spreads are currently the slimmest we've seen in almost two years, nearly three-quarters of leveraged loans are trading at or above 99 cents on the dollar, and new deals in the private credit market are offering average yield spreads that are roughly 100-125 basis points below those seen 12 months ago.[2] While this rally has hit a few speed bumps in the first quarter—due to stickier-than-expected inflation—the positive trend persists.

This market strength obviously has multiple drivers—including supportive technicals—but, at its core, it appears to reflect investors' belief that the U.S. is on the path to a soft landing that will lead to a meaningful decline in interest rates. While we aren't overly bearish about the U.S. economy or the country's inflation outlook, we believe downside surprises are currently much more likely than upside shocks, given that markets have already priced in optimistic expectations.

In particular, we're doubtful that interest rates will decline as rapidly—or as substantially—as many investors anticipate, unless the U.S. experiences a serious recession or other crisis. If economic growth continues, inflation keeps slowing, and the unemployment rate stays within a reasonable range, then the Fed will have little reason to act aggressively. Instead, it's much more likely to remain patient, especially in an election year.

Now, we do think it's reasonable to assume that interest rates will decline modestly over the next two years, given disinflationary trends, but we think the fed funds rate is more likely to settle in the 2-4% range as opposed to 0-2%.[3] This is significant because we believe many leveraged companies will have trouble refinancing their debt as long as interest rates remain above 2%. As a result, we believe the universe for opportunistic credit will grow even larger in the coming years, while skilled performing debt investors will continue to enjoy operating in a credit picker's market.

ENDNOTES

[1] The content is derived from or inspired by ideas in 4Q2023 letters or other materials sent to clients in 1Q2024; the text has been edited for space, updated, and expanded upon where appropriate.

[2] ICE BofA US High Yield Constrained Index, as of February 29, 2024. Credit Suisse Leveraged Loan Index, as of February 29, 2024. Private credit based on Oaktree observations in the market, as of February 29, 2024.

[3] Oaktree Co-Chairman Howard Marks discussed this view in detail in his recent memo, *Easy Money*.

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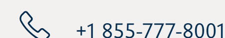
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