

The Insight: Conversations – On the Lookout with Armen Panossian and David Rosenberg

Harry Whitelaw

Hello and welcome to the *Insight by Oaktree Capital*. In this episode, we'll chat about topics from our recent credit quarterly, taking a broad look at the risks and opportunities in today's credit markets, including where pockets of relative value may be found and how a global approach can benefit credit portfolios. I'm Harry Whitelaw and I'm delighted to be joined by Armen Panossian, Oaktree co-CEO and head of performing credit. And David Rosenberg, our head of liquid performing credit.

Armen, David, welcome to the podcast.

David Rosenberg

Thanks for having me.

Armen Panossian

Thanks, Harry.

Harry

Let's start off with a big one, the U.S. economy. Armen, a few years ago it seemed a recession was imminent, but I think the economy surprised us all with its resilience. Now after a few years of tighter monetary policy and residual inflation, how are we looking today?

Armen

Thanks, Harry. I think it's a little bit too early to tell because we still are in a little bit of a state of flux on the economy. I think the tariff impact is still unclear in terms of its lasting impact. I think everybody agrees that it'll have some impact. The question is it going to be short-term or long-term or persistent, and we'll see that play through the numbers. Companies certainly change their buying behavior and their transactional behavior following that tariff news waiting to see where it all settles out. And I think the waiting to see part of that calculus will result in lower sales over the course of the next few quarters.

And in the meantime, I think separate and apart from this tariff related noise, we are seeing some weakness in the low to middle income part of the consumer market in the U.S. I wouldn't say to an alarming level where we think a recession is imminent as a result of it, but there certainly are cracks that we are seeing in that consumer base that can become bigger over time. Meanwhile, the markets are just blazing ahead as if nothing is a problem. And I think that it's a variety of reasons why one could argue that that might be the case, but I'm sure we'll get into that in a moment. But for me at least, I think there's a little bit of a disconnection between the markets and what the fundamental economy is showing in terms of potential risk factors that could materialize down the road.

David

Yeah, I think that's exactly right. I mean, you think about how excited the market is and how everything just kind of goes up and to the right, but if you look at the fundamentals and so far earnings have been pretty good, but if you kind of start thinking about soft data versus hard data, the reality is it seems pretty clear to me that you're starting to see people kind of cut back on spending because of all this uncertainty. And so I agree with Armen. I don't think we're going plunging into the abyss, but the market seems to just have this ability to turn a blind eye to anything negative these days.

Harry

It's an unusual contradiction, right? I mean, we wouldn't say the economic backdrop is catastrophic, but there are a few weak points and some uncertainty. But David looking at equities, you would think the world is pretty perfect, right?

David

Yeah. When you look at a p/e multiple, it's around 24 today, and you kind of look back in history and if you look back, I think it was JP Morgan did a study, you go back to 1985, every time the p/e of the S&P was above 22, the four 10 year returns were between negative two and positive two. It doesn't mean that's where things are going today, but it does mean things are pretty fully valued. So you need tremendous growth from here going forward just for equities to stay where they are.

The data on the low end consumer in particular is a little scary. I mean, my auto analyst came to me the other day and said car repossessions are above 2019 levels. Think about that for a second. Most people, the last bill you stop paying is your car because you need it to get to work. In the Global Financial Crisis, people stopped paying for their mortgage on their home before they stopped paying for their car. But today, a lot of people just can't afford the car and the banks are taking them away, and that's not a healthy consumer.

Harry

Well, looking at the equity's point again, we must mention Howard's latest memo, Calculus of Value, out Wednesday, the 14th of August. He makes an interesting distinction looking at the S&P 500 and he actually says mag seven, despite its high p/e ratios, potentially less worrying than the rest of the index because these are great companies, they're growing earnings, huge competitive moats, so maybe it's the rest of the index where we should be a little bit more worried perhaps.

David

Yeah, I think that's right. You coined it in the memo of the S&P 493 is the problem, and that's a p/e multiple of 21. So still pricing and a lot of growth, and those companies aren't going to benefit all of them, at least from AI and all this crazy change in the world. They're just your regular way companies.

Armen

Yeah, I mean the magnificent seven, I mean, these are some of the best companies that have ever existed in the following sense. You mentioned competitive moats and size, but in addition to that, the conversion of their profitability to cash flow, it's really high because they really don't have the same level of hard investment, capital investment that's needed traditionally in other businesses, the railroads and those other capital intensive businesses that were much the story in the 20th century. The new model is asset light. Obviously AI has some pretty deep asset investment needed, but the conversion, the profitability that comes off of these businesses hasn't been seen before.

Now the 493, I think they're more traditional. I mean a more traditional type of business that actually has real capital investment, more normalized growth prospects, more normalized cash flow conversion. And so the multiple in that part of the market being at 20 or more is challenging I think, because there're probably some portion of them that are overvalued and just benefiting from the halo effect of buying the dip mentality in the equity markets.

And that's really because since the Global Financial Crisis, there hasn't been a sustained downturn, sustained as defined by more than a couple quarters. And so if you did buy the dip at any point when you saw more than a 10 or 15% decline in the equity markets over the last 10 to 15 years, you probably made money. And so that occurred again in April. And I think those periods of buy the dip occur very fast.

Harry

Howard does say in the memo, basically, anybody under the age of 35 hasn't seen a proper crisis. That does include me, maybe includes you two as well.

David

It does not sadly include me.

Armen

Nor me.

David

I think Armen makes a good point. You think about the 493. If those companies want to grow, you have a railroad or you have a metals company, whatever you want to call it, steel mill, you want to grow, you have to build things, you have to go build another factory, you have to hire a bunch of people. There's friction to that growth. The magnificent seven can grow very quickly because it doesn't need to make that kind of investment.

Harry

Well, the topic of geographical allocation is definitely one that's on the rise. Potentially it's more talk about reallocation than actual action. In our written credit quarterly piece, part of our conclusion is that in our area, sub-investment grade credit, the U.S. given its huge scale, is really still the core of these markets, right?

David

I think that's right. In sub-investment grade it's a little bit unique because the U.S. sub-investment grade market is so much bigger and so much deeper than all the other markets. So going to emerging markets, going to Europe, you can do it, but you can't do it in the same size. You can't replace the U.S. because the U.S. is so much bigger. I think that's going to be a real factor.

Harry

Well, let's look at the issuance situation as well. We've spoken over the last few years about limited issuance in the leveraged finance markets. We know the story here: high rates, harder for PE companies to realize investment, slows everything down. How are we looking today though? Are things starting to un-gum a little bit?

Armen

In the case of loans and bonds, it was high base rates are making the private equity math not work. And it has resulted, as you put, in a gumming up of the system where private equity firms are holding their positions longer, waiting for the markets to return. They're hoping and expecting a decline in rates will open up the opportunity to sell a business at the same or better multiple that it paid 3, 4, 5 years ago for that same business.

Late last year when President Trump was elected and private equity sponsors started looking at the market opportunity, they were getting pretty excited that 2025 would be a banner year for monetization of their portfolios. And then pretty soon after taking office, the tariff noise that came in and that resulted in a delay of the release of that potential opportunity.

And in addition to just the uncertainty that tariffs create, it created an extension of the narrative of inflationary risk, which then leans on rates staying higher for longer or that runs counter to the thesis of, "Rates will decline and my multiple will improve and I should just wait it out." So the volume M&A deal volume related to leverage buyout activity certainly hasn't picked up in a material way in 2025 as a result of these overhangs. But there are some small green shoots.

We are seeing a little bit of a pickup in the dialogue we are having with private equity firms asking us for financing reads associated with existing investments. "Can you give me a debt package? Can you price this particular loan? If I were to sell this and I were to staple financing to it, what would that staple look like?" And so that activity that, this is more anecdotal obviously, and it won't show up in the numbers as of yet, but we do think that there's a little bit of an un-gumming occurring and it's partially driven by people feeling better about life generally and that the tariffs won't be as big a deal. It's also partially because there has been muted issuance and as a result spreads have compressed.

In broadly syndicated loan markets today, single B-rated broadly syndicated loans have a roughly 340 to 350 spread. That same statistic a year ago it was above 400. It was probably in the 425 zip code. In the private credit landscape, a new first lien sponsor lending vanilla LBO loan is pricing around a 450 to 500 spread. And that same number about a year ago was about 550 or more. So there has been spread compression on muted deal volume, but that is helping to make the LBO math work and therefore this un-gumming of the system is I think starting up right now.

David

And you're seeing it for sure on the liquid side as things start to pick up. I've always learned that supply follows demand, not demand following supply. So people show up with money, bankers will find something to sell you. And people are showing up with money. And so as we talked about before, a lot of people looking at relative value and saying, "Hey, if I can earn 7 or 8% in credit and that compares to what I would hope to be getting out of equities in this environment, maybe less, than maybe rotating a little, if I'm 80/20 equities credit, maybe 70/30 makes a little more sense." And as that starts to happen across the market in waves, you see a lot of money coming into credit.

And so we've seen a pretty big pickup. A matter of fact, this month, the month of August is usually very quiet. They have the bankers are required to take their mandatory two-week holiday once a year per the regulators. And usually you'll see the junior bankers do it in August and the senior bankers do it in December. And for the first time really ever that I can remember, I've heard the head of a trading desk at a bank reach out to their traders, say, "Hey, you may need to rethink your vacation plans for August because it's so busy." And that's pretty rare because there's a whole plan behind this to make sure that everyone takes their time at the same time we get it out of the way and the markets can go back to activity. And they're saying, "You may need to stick around because the new issue market just keeps going."

Harry

And, David, quite good issuance in Europe as well, actually potentially benefiting from lower base rates than we have over here in the U.S. A bit of a sentiment shift towards Europe as well, and actually the issuance across liquid loans, direct lending there has been pretty strong over the last few months.

David

Very strong. And the value is very good in Europe. You get a pick-up, normally I say 50 basis points of additional yield is fair value because Europe is a smaller, less liquid market, you should get paid for that. But when you're getting paid 75 to 100 basis points pick up, that's very attractive. And so we were seeing that in some cases, especially in loans, there's a big pick-up for European loans.

And a lot of people, we're hearing from other people, obviously we're not alone in seeing that value, but it's one of the things I watch very, very closely because if it is a smaller and more shallow market, if everybody starts flooding into Europe, then that value, you'll start bidding prices up and so you need to be nimble to take advantage of that, in my opinion.

Harry

And, Armen, one place we are seeing quite a lot of activity is refinancing between liquid, private, private liquid, back and forth. It seems sponsors are super savvy. It seems almost every deal now is going to be a dual track and they're just going to pick what works best for them.

Armen

It absolutely is. When a sponsor wants to do a new deal, if they want to buy a company, they come to the direct lending market and they say, "Give me a read. Let me know what the pricing is, what the terms are." And "Oh, by the way, I am talking with the banks." And in addition to that, you have a tighter and tighter window to respond. You don't have three weeks to do your diligence, you have a week or less. And so that speed of the market has certainly accelerated and the competitive dynamic between private and public, it's not hidden at all. It's very, very well known now. It makes sense because I think historically the private markets have been there to support private equity sponsors to do deals in those events where the public markets have seized up.

And so having a second option or having a healthy private credit market and a healthy public credit market is an important piece of a private equity sponsor's management of their future access to capital in doing deals. So they want to feed both markets. One is not going to win necessarily at the death of the other or at the cost of death of the other. I think they will both learn to live with each other. And frankly, there are some deals that come through the public markets and they get it effectively syndicated away by the bank into a private context. In addition, private credit managers or direct lenders are partnering with banks more and more frequently with sourcing relationships and tie-ups. The line between public and private is blurring in some respects with those types of partnership arrangements.

Harry

David mentioned the benefits of blending in European high-yield loans into his global portfolios, this is a multi-asset context. Armen, on the private side, how are you viewing European direct lending at the moment? This has been a very bank driven market historically, but a huge cohort of middle market borrowers. What kind of runway does that create for alternative lenders wanting to get in on the action?

Armen

We're certainly seeing more deal flow in Europe these days than we would've expected to see a year or two ago. The European direct lending market, like the publicly traded market, is meaningfully smaller than the U.S. market in terms of issuance and activity. However, the adaptivity is picking up. So again, more deal flow, more interest in Europe. But in addition to that, European companies, because they were relying so heavily on the banking as you put it heavily banked market. They generally have more reasonable capital structures, not overlevered because the banking market was not conducive to heavily adjusting EBITDA or cash flow to make a capital structure work. You don't see aggressive add-backs, and you also have a starting point of lower valuations in Europe for the same type of business than compared to the US because there has been some country to country differences in legal regime, some obviously overhang from the Russia-Ukraine war and how that has impacted some supply chains in Eastern Europe.

So, there's real reasons why there should be some discount in enterprise valuations for European businesses versus the U.S. But if you come from the point of, "Hey, the starting valuations were lower, cheaper. The capital structures were more creditor-friendly than equity-friendly." And there is a shift happening where Europe has to spend more money on itself. And there's been a lot of talk about that, that it's a good time to be a private equity sponsor looking to buy a business in Europe and there may be some tailwinds that may last a few years.

Harry

Makes sense. So, we've talked about deployment. I think we were kind of saying the U.S. is going to remain the core, but we're enjoying accessing opportunities around the world. David, when we have these conversations, we always have the conundrum of spreads being tight, but yields being pretty good. How do you maintain that balance of putting money to work but not compromising on credit quality amid the fight for yield?

David

Well, when you think about it, we're never going to push for yield for yield sakes. So, we're always going to go with where we see quality and then see where the yield falls out from there. But right now, I think that the difference is that you can look at spreads and as you pointed out, spreads are low. But the yields are good. And so, what I have found is when you look at spreads versus yield, and you think back about the way the market has evolved, we went through a decade of rates near zero, 10 years. 10 years builds a lot of muscle memory. When rates are near zero, the yields are low, and so no one's going to below investment grade for a 4 or 5% return. It doesn't justify the risk.

So, you need some total return on top of that. And if you want total return, you have to have wide spreads because bonds and loans don't trade up unless spreads can compress. It's just the fixed income math. So, the model for 10 years was when spreads are wide, you jump in, when spreads are tight, you jump out. Jump in, jump out trade bonds and loans like stocks in a way. Now, what I find the difference is yield is 7 or 8%. And I often go to people now and say, "Well, do you really need a total return on top of the 7 or 8%?" And a lot of people say, "No, I was trying to solve for 7 or 8% when the yield was five and I needed two or three points of total return. But if I can get all of that out of income, it's a lot more reliable to just sit on something and grind out the income than trying to time your entry in and out."

And so, now spread becomes not the most important thing, if you will. You have to look at spreads, but also at price and also at yield. And you're finding that when you start to break 7%, that tends to be kind of a magical number for a lot of companies. A lot of institutions are using 7% in their actuarial formulas. A lot of endowments give away 5% a year and then assume 2% inflation. So, every which way you look at it, when you can start locking in 7% and higher, then things start to get a lot more attractive. Howard talks about the contractual nature of credit a lot. There's a contractual return. We buy our bonds or loans, we sit on them. If we do our job right and there's no defaults, then we're going to get back our 8% when the day is over because that's the deal.

Harry

So, a yield-driven world out there. Armen, even in the private credit world, it's becoming a bit of a beta game in some of the more commoditized, congested, particularly mainstream direct lending strategies. Where can lenders go in search of those slightly less efficient markets where you can get a bit of an edge and generate those slightly higher returns?

Armen

So, yeah, I think the market, the direct lending and private credit opportunities, that has certainly evolved over the last 10 years. 10, 15 years ago, lending to private equity sponsors wasn't quite as well established as it is today. Doing that is certainly the core part of private credit or the core part of direct lending and really the best way to develop a portfolio that has adequate diversification and consistency in deployment, so my comments to follow are not to suggest that clients or LPs should not be allocating to first lien direct lending to private equity sponsors. That is certainly the largest, most predictable part of the market, but where you could get additional return without taking on meaningful additional risk is where you go into more complex lending opportunity sets. Some of those are sector-specific, some of those are product-specific.

So, in terms of the sector-specific, lending on a non-sponsored basis, so lending to businesses that are not going through an LBO transaction, rather they are owned by an entrepreneur or a founder or a family and they are taking on a loan to do something strategic, a strategic growth initiative rather than a transaction where they're selling themselves or buying somebody else. One of the largest areas for us in that area is life sciences. Biopharma companies that are innovating and need a highly structured solution from a partner who understands a combination of both science and structure to come up with something that works for that partner.

Different but similar in that it's a complex area would be asset-backed finance. Asset-backed finance touches a variety of different industries, many of which do not have borrowers in the corporate direct lending market. It exposes or creates an opportunity to invest in those industries that otherwise might not be available. For example, shipping finance. You really don't see a shipping company with a meaningful amount of loans for example, or bonds, high-yield bonds, that you could buy in the market in a diverse way. But in the asset-backed area, you could choose to lend against a particular type of shipping vessel, a particular set of counter-parties or lessees of shipping vessels. It's a way to add diversification to a private credit portfolio by adding asset-backed finance and picking up additional return.

In addition, we've been a longtime investor in mezzanine finance providing junior capital mainly to private equity sponsors doing new deals. While currently that part of the market is not super busy because rates are so high and therefore the cost of borrowing on a mezzanine basis is too close to a private equity sponsor's required rate of return, we do expect that if rates were to decline, that the fixed rate nature of what we do in mezzanine will create a very attractive opportunity for investors to kind of lock in some yield and duration as rates do decline. Now, I compare that to first lien direct lending, where it's predominantly a floating rate asset class with a fair bit of room for repricing or tightening of spreads. And because it's mezz, at least the way we do it, it's not just a junior credit instrument, it's a junior credit instrument with some equity stapled to it, so you have the benefit of potential upside if the business does well.

Harry

And David, in your liquid multi-asset portfolios, you're blending fixed and floating rate as well, and I mean, the core of your portfolio's ultimately higher bonds, senior loans, huge markets, over a trillion each. Very liquid. Where are you looking to add additional relative value or alpha to your portfolios?

David

We talked about a few things. I do agree the fixed versus floating, we like to have a balance of those two, especially in the market today. We're seeing, as we talked about earlier, some more value in Europe, so I do like that area, and then we're also going to areas like CLOs. Double B CLOs are a pretty attractive area right now, and you get near 10% yield out of those relative to the risk, that's very attractive. RMBS I think is an attractive diversifier right now. Residential real estate has some very good stability factors to it. Basically, it's been well publicized, but when you have an average mortgage in the United States of 3% and a new mortgage closer to six, nobody can afford to sell. You sell your house today, you can only afford to buy half of it tomorrow, so that lack of supply has resulted in a lot of price stability and so good loan to value in that area. You can get a yield that's comparable to high yield, but with a very diversified and different risk profile, so that's been very attractive.

I think the key right now, when you look at the environment today and you think about all the uncertainty that we're dealing with, we're very much in protect-the-coupon mode. When you have a yield around eight, you don't need to be hero, you just need to earn it and not give it back to default, and if you can ensure you do that, you're going to come out with an outcome that people should be pretty happy with. Right now, we're not looking to be heroic, we're not chasing risk, we're not chasing yield. We're looking to focus in on things that we know are going to pay and wait for the next bout of volatility to push forward.

Harry

Looking at the broad-lev fin markets, David, we're still in that slightly weird environment where 95% of companies, absolutely fine. 5%, looking a little bit worrying.

David

Yeah, there's always a tail. But right now, the tail, while small, can have a big impact. You see it in spreads, you look at the bifurcation of the market, and you've got high yield, for example, double Bs, and called the high 200 spread range, single Bs in the low 300 spread range, and then triple Cs at 1,000, and very little in the middle. When you have those periods, that's where a lot of people really get lured into trying to buy triple Cs to keep the portfolio yield up. I call it the lazy way to get your yield up. You only need to buy two or three triple Cs and your whole portfolio yield goes higher. That, to me, is where discipline becomes the most important, which is, when everybody's chasing risk and finding ways to justify the risk they're taking, that's where you really need to be very careful about what you buy and focus in on the credit.

Harry

When we look at that tale of struggling names, particularly in the loan world, high yield, there's probably only three letters on the horizon, LME. That will probably be the reality for these struggling borrowers. LMEs are now the vast majority of defaults. The outcomes from these transactions, they've maybe got a bit more balanced over the last few years, but I think we still absolutely emphasize the importance of coming out on the right side of these transactions.

Armen

Well, yeah. LMEs, they often result in a chapter 11 anyway, or in a restructuring. It's just more of a delay and kicking the can down the road and creating a layered cake capital structure. Unless the company is going through a cyclical issue, that will then recover, and therefore, the kicking of the can is actually meaningful. Time ends up helping that business out. Now, for us at Oaktree, we really want to be careful of these LMEs. They're both an opportunity and a risk. The risk is that you get stuck in an LME and you're the odd person out of the transaction, and you are not given an opportunity to defend your position.

But it's also an opportunity, through our opportunistic credit strategies, providing new financing to a company doing an LME, which is highly structured, and the use of proceeds is to either generate liquidity for that company to further extend its runway or to pay out certain creditors as part of that LME, so we did do a fair number of such transactions in 2023 when the markets were more dislocated. Today, providing new financing to LMEs is a little bit less common, because the public markets, the broadly syndicated loan markets, are a little bit more open and are providing an easier save to some of these capital structures.

But as we approach the maturity wall predominately in 2027, but in some cases in 2026, there will be more need for discussion around LMEs, around potential restructurings, and other capital solutions to extend the runway that private equity firms have as they've held on to these positions longer than they thought they would and as maturities in their capital structure become a real problem to contend with.

David

I think what people are starting to realize is that the problem, when you have an LME, by definition, you have a broken balance sheet, right? That's why they're doing the LME to de-lever the credit and fix things. The problem is that everyone acknowledges that you need to fix the balance sheet, and everyone wants everyone else to be the one who takes the pain to fix the balance sheets. You have a lot of people finger-pointing at each other, saying, "Absolutely, someone needs to take a debt discount. You should do it." As a result, a lot of times, the LMEs are designed to minimize the pain to the creditors, but if you're minimizing the pain, then you're, by definition, not solving the problem, which means that you are, to Armen's point, kicking the can down the road without actually creating a solution.

The real protection comes down to doing a good job on credit, not owning them. If you own a LME, on the performing side, that means, in some way or another, something went wrong. Yes, you can position yourselves to make sure that you get treated better than others, but the best protection really is to identify the balance sheets that don't work and get out of them. That's going to be key to me.

Harry

Yeah, avoiding the situation is the best. That's first port of call. What if you are in the paper, what factors can make sure you aren't the one getting hit with that discount?

David

Yeah, you don't want to be left out, so size matters. These things we've formed, now called co-ops. The co-ops, you get the group together, and again, I always remind people, "You're not actually stopping the LME, because the covenants still allow it," but the original form of LME was very aggressive, where you have a company try and create a prisoner's dilemma. They come to you and say, "Hey, you're in a first lien. We're going to create a first out, first lien, and now you're going to be second lien unless you exchange into it, and if you don't, we're going to push you down into a third lien. You have 24 hours to decide, you're in or you're out." They create this big panic and everyone said, "Wait, don't leave me out," and they all just rush in. The terms end up being pretty aggressively negative for the creditors.

One of the things that co-op did is everyone got together preemptively and said, "We're going to form a group now and put you on notice that we're all voting together," so this whole prisoner's dilemma thing, that's not working. You can still do the LME, but we have to actually have an honest conversation about it like adults, and there has to be a real negotiation. You can't just pit everybody against each other. That's been very effective and you see a lot of companies where the creditors will get together before an LME is even discussed and just say, "Hey, putting you on notice, we have a group together now, we're aligned." I think that's effective. Then, as Armen alluded to earlier, being on the steering committee now of the co-op matters, because you may be able to create a deal that treats your debt better than someone else's, and you get a better recovery. To get on the steering committee, you have to be big and in the flow of information.

Harry

Good work for the lawyers is nothing else.

David

Always.

Harry

Well, we'll end it there. Much to ruminate on as we see a credit market with plenty of opportunities, but also one that absolutely requires prudent navigation. Thanks to Armen and David for joining today, and thanks to you all for listening in. Look out for future content wherever you get your podcasts or via the Oaktree public website.