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How Investors Can Find Opportunity in an Upside-Down Credit Market

A conversation with Oaktree Portfolio Manager Wayne Dahl

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Credit markets and the U.S. economy have been unexpectedly resilient amid rapid U.S. Federal Reserve rate hikes and dislocation in certain sectors of commercial real estate. Still, the possibility of a recession lingers, the yield curve is inverted, and high interest rates are keeping many investors concerned about a potential wave of corporate defaults. Oaktree Diversified Income Fund Co-Portfolio Manager and Investment Risk Officer Wayne Dahl sat down at the *Future Proof* conference on September 18 with Bloomberg's *Odd Lots* podcast to discuss how investors should view current market conditions and where opportunity — and risk — each lie. The following has been edited for brevity and clarity.

Highlights:

- Investors who doubted the Fed's commitment to higher interest rates to tamp down inflation have been taught a lesson; higher rates may persist for longer than many had thought.
- Defaults may remain low, relative to expectations, since the economic shock of lockdown pulled forward much of the corporate borrower distress that might otherwise have hit credit markets now.
- While short-term bonds, such as U.S. Treasuries, offer enticing yields and appear less risky, investors should not overlook alternative credit, which is now offering potentially attractive yields.

Q: What have investors missed about how the Fed views inflation and interest rates?

For the last year or so, the market anticipated that inflation would come down, regardless of how the economy was doing and what was happening to asset prices. Investors assumed the Fed would quickly turn around and cut rates if the economy showed signs of cooling. Back in January of this year that was the story: all sorts of credit sectors rallied, from investment grade corporate bonds to high yield, and spreads compressed.

That now appears to have been wishful thinking and more than a decade of near-zero interest rates probably is playing a role there. Just as younger folks who have no memory of a high-rate era are reluctant to take out a mortgage at 7%, apparently many bond investors assumed low rates would likely return quickly. I think we all have become used to a low-rate world and have a hard time thinking back to, say, the 1970s.

Investors should bear in mind that there are reasons to think rates could stay high for a while, or even rise. The big wild card, in terms of the long-term rate outlook, is the cost of our public debt in the United States. With interest rates now much higher, supporting $33 trillion of government debt looks potentially unsustainable.

Q: Typically, as the economy nears recession, defaults jump, but that has not been the case. What's holding back defaults, and should investors be wary or encouraged by the strength of credit?

Defaults have picked up a little bit, but from an abnormally low level. The way I think about it is that the COVID pandemic brought on the first part of this recession and, with it, many of the defaults we might otherwise be seeing now, as we potentially head into Part Two. Recall that before COVID hit, the Fed had stopped hiking, and in 2019 it actually cut rates three times. There were similar signs of a slowdown in the economy, typical of a coming recession. So, in a way, COVID accelerated a slowdown that was already happening and that brought forward a number of defaults.

That cleansed the market a little bit and cleared out a lot of the lowest-rated companies that were under the most financial stress. At the same time, you saw a number of credit downgrades where a BBB-rated borrower, for example, was downgraded to BB or B. Whatever remained in BBB was higher quality, but all borrowers who remained afloat were able to refinance at the lowest rates in history during the pandemic, so the high yield market has less of a cash flow or maturity problem today than it might otherwise have.

Q: With short-term U.S. Treasury bonds paying more than long-dated bonds, and more than inflation, why should investors look anywhere else for healthy returns?

It's true that investors can get a yield above 5% for U.S. bonds coming due in under two years, compared with 4.5% for 30-year bonds. That's an unusual, but not unprecedented, situation. What it does for us at Oaktree is shift where we take risk on credit. Right now, we're finding that taking duration risk — buying longer bonds — doesn't come with as much compensation as taking credit risk does.

For example, a structured asset or syndicated loan today might yield 400 basis points above those short-dated U.S. government bonds, meaning there is the potential to earn around 9.5% on a floating basis. There's credit risk in those securities, but the extra yield makes up for it, in my opinion. The high-yield bond market, where coupons are fixed, is yielding a bit less right now, but you still get nearly 4% above the equivalent U.S. Treasury yield.

Q: With market conditions better than many expected earlier this year, what worries you?

It's hard to define what normal is in today's market. We've been through an unprecedented period in history, with a worldwide pandemic, government actions that stimulated consumer behavior, and a pullback from globalization. Whether it's employment figures or other traditional economic indicators, people's perception of normal is shaping their expectations, while the world actually looks very different today.

To hear more, you can listen to the entire *Odd Lots podcast* on Bloomberg.

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As an asset class, private credit is comprised of a large variety of different debt instruments. While each has its own risk and return profile, private credit assets generally have increased risk of default, due to their typical opportunistic focus on companies with limited funding options, in comparison to their public equivalents. Because private credit usually involves lending to below investment grade or non-rated issuers, yield on private credit assets is increased in return for taking on increased risk.

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