OAKTREE | Insights

Oaktree Credit Quarterly

4Q 2024

The LME Wave

A surge in liability management exercises (LMEs) has manifested from a potent combination of weak credit documentation, elevated debt costs, impending maturities, and resourceful sponsors in need of a way to create equity value. While most of the sub-investment grade credit universe remains healthy, the sheer amount of outstanding debt means even a relatively low distress rate can inspire significant LME volume. LMEs remain ill-defined but generally encompass actions taken by a troubled borrower to restructure its debt obligations outside of court rather than through a formal bankruptcy process, or to raise money through unconventional means in order to address a liquidity need.

Executing an LME can generate the runway required for a borrower to avoid or postpone a "full" default. However, this creative debt management technique may lead to divergent outcomes for investors that hold the same instrument, presenting both attractive new-money opportunities and the potential for a re-ordering of the priority of pre-existing claims on the borrower's collateral. It's therefore essential that investors deftly navigate the risks and opportunities present in the LME wave, instrumental to which is drawing upon robust legal acumen and maximizing the benefits of scale and industry relationships.

The Origin

If the onset and acceleration of the LME wave were to be explained in just two charts, the two below would be highly effective.

Figure 1: Most Senior Loans Now Lack Meaningful Covenants

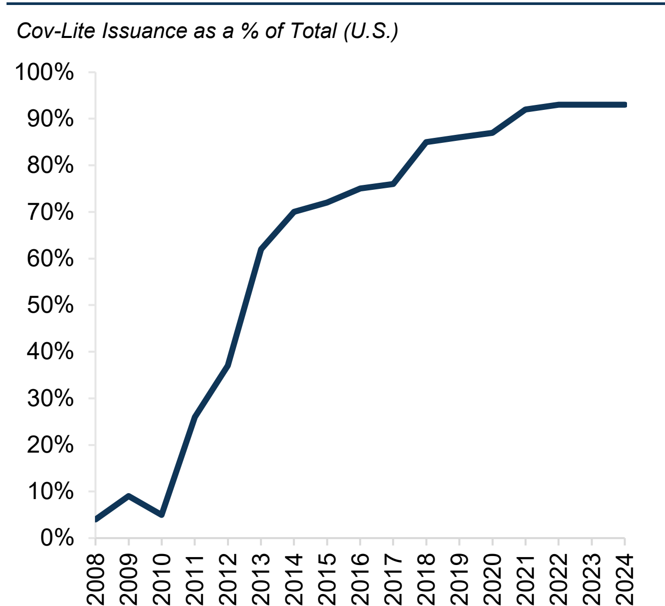
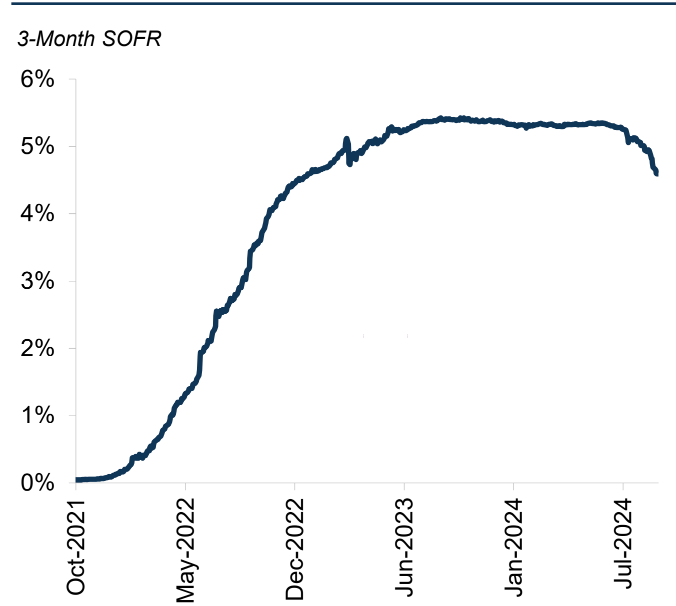


Figure 2: Base Rates Have Significantly Increased



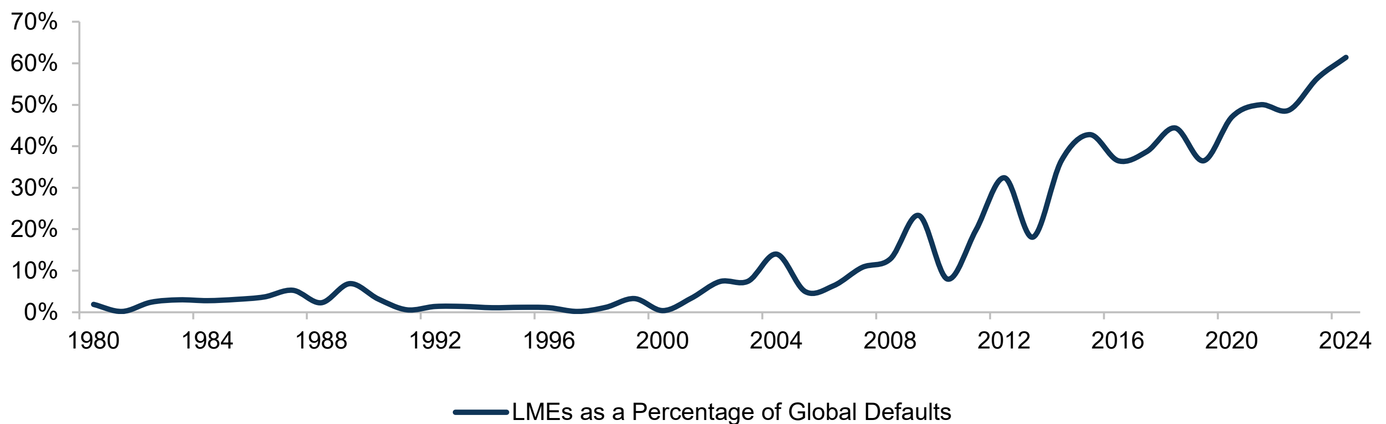
Source: Pitchbook, Bloomberg

Firstly, over 90% of senior loans are now issued with no meaningful covenants.[1] Documentation standards deteriorated rapidly during the era of ultra-low interest rates following the Global Financial Crisis, as investors compromised on lender protections amid the chase for yield. Weak documentation gives borrowers increased flexibility to avoid defaults, and pursue creative ways to raise additional capital, including through issuing new debt that is senior to existing debt in the capital structure. Crucially, it also allows borrowers to pit creditors against each other, creating a prisoner's dilemma that allows the company to obtain concessions. **Fundamentally, this permits the potential for asymmetrical outcomes for lenders invested in the same instrument, a factor that partly explains the oft-used term "creditor-on-creditor violence."**

If loose documentation standards formed the groundwork for the LME wave, the most significant catalyst that pushed borrowers to exploit them was the historic increase in interest rates in 2022. For floating-rate borrowers, elevated base rates are almost immediately reflected in coupon payments: since the start of 2023, the average coupon in the senior loan market has been 8.9%, up from less than 5% in 2020.[2] While most sub-investment grade credit issuers have demonstrated remarkable resilience to this increased interest burden, a meaningful cohort of challenged borrowers may need additional liquidity to run their businesses, and/or struggle to meet upcoming maturities.

For this stressed subset of borrowers, conducting an LME presents the opportunity to secure new liquidity and/or cut their existing debt burden. This may help to avoid – or at least delay – a formal bankruptcy process which, in addition to being very expensive, typically results in a change-of-control transaction pursuant to which creditors exchange their debt for all or substantially all of the equity of the bankrupt company, leaving the sponsor with little to no value. Given the cost, time, and loss of equity associated with an in-court restructuring, an LME is increasingly the preferred option. (See Figure 3.) For private equity sponsors, even if LMEs may only delay the eventual day of reckoning, they can provide additional runway to drive improvement in their portfolio companies without the need to contribute more equity, and without the need to crystallize a loss.

Figure 3: LMEs Represent Over Half of All Defaults



Source: Moody's, Barclays Research, as of August 2024

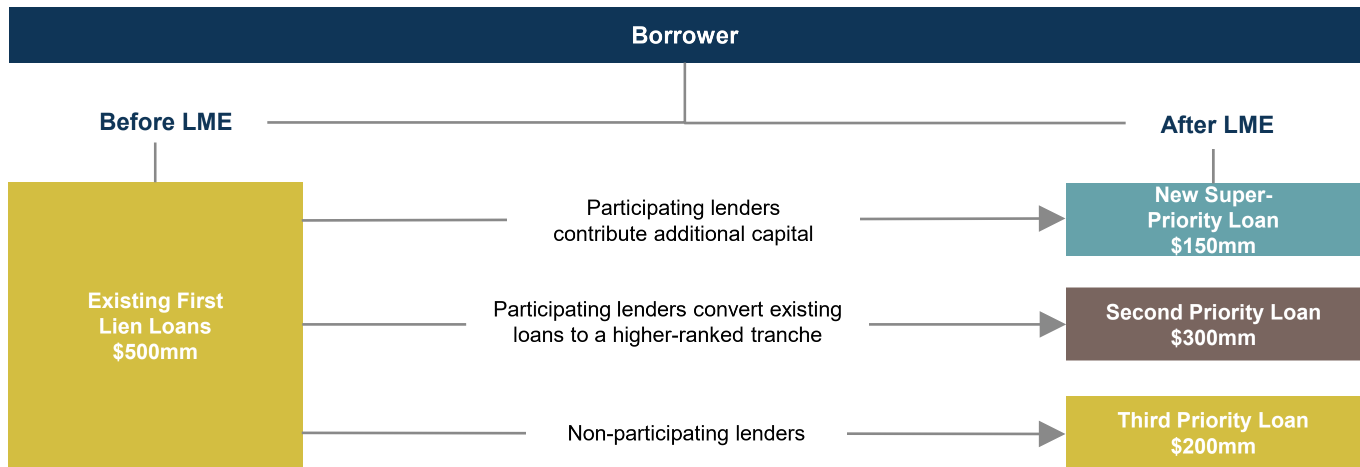
Exercise Methods

The breadth of the term "liability management exercise" (i.e., indicating any action to manage liabilities) is such that basic amend-and-extend transactions (generally benign transactions that involve pushing out maturities) and even debt buybacks could be considered LMEs. For the purpose of this piece, we'll focus on the more contentious LMEs in which (a) new money is provided on a priming basis, and/or (b) creditors holding the same instrument experience disparate outcomes.

Prominent Forms of LMEs

- **Uptier:** With support from a majority of existing lenders, a borrower amends its credit documentation to permit the issuance of new debt that is senior to the existing debt. Typically, the new senior debt is provided by the majority lenders, who, in addition to providing the new money, get to elevate the priority of their claims on existing collateral, subordinating the claims of other minority creditors that hold the same instrument. (See Figure 4.)

Figure 4: Sample Uptier Transaction



Source: Oaktree observations

- **Drop-Down:** The borrower moves collateral from loan parties (against which existing lenders have a claim) into an unrestricted subsidiary or non-loan party (against which existing lenders have no claim). The unrestricted subsidiary or non-loan party entities can then issue new debt that is structurally senior to, or secured against, this transferred collateral. This new debt may be issued to third parties that do not hold debt in the capital structure, or to certain existing lenders. Pro forma for such a transaction, non-participating existing lenders are left with less collateral securing their claims.

- **Double-Dip:** A financing in which a lender seeks to maximize its recovery by establishing multiple independent claims against a borrower's corporate enterprise. As this credit enhancement provides downside protection in the event of a restructuring, the stressed company can attract new lenders with more favorable terms. A pure double-dip may be perceived to be more lender-friendly than a drop-down or uptier; while the new debt may dilute the claims of existing lenders, it doesn't prime existing lenders or transfer away collateral.

Participation Awards

For the borrower to achieve the aim of raising new liquidity or cutting existing debt, not all lenders can receive a favorable option. As mentioned, the flexibility of documentation enables the borrower to offer different terms to different lenders.

Participation in an LME is generally encouraged via offering certain existing lenders better terms for supporting the new transaction (e.g., receiving second-out loans rather than being left with third-out). Recently we've observed a trend toward more "benign" LMEs, in which the differential in recoveries between participating and non-participating lenders has been reduced, so that sponsors can maximize participation in the transaction.

In recognition of the fact that non-participating lenders typically receive the worst outcomes in an LME, CLO managers – the largest holders of broadly syndicated loans – have updated their own documentation to facilitate greater participation in LMEs.

LMEs often lead to the formation of creditor groups. While each situation is different, in the context of an LME, a common breakdown is as follows:

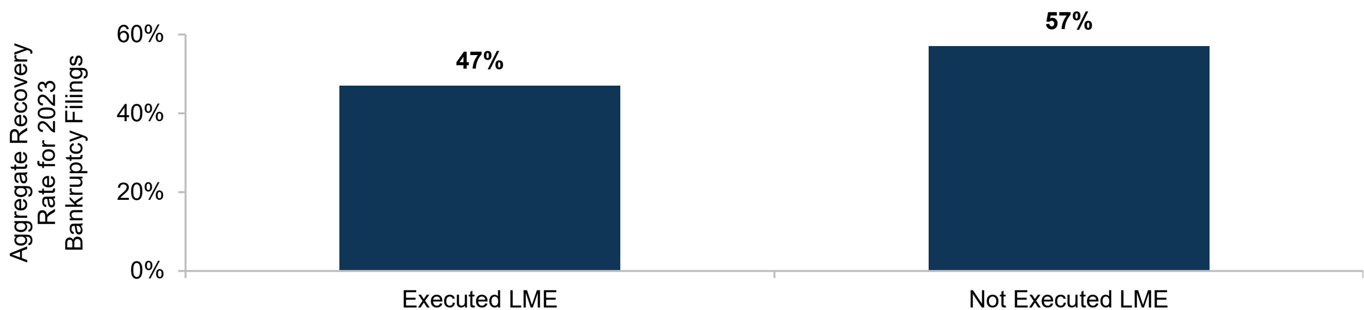
- **Steering committee of the ad-hoc group:** Typically comprised of the largest lenders, the steering committee negotiates directly with the borrower to structure and implement the LME. The steering committee members generally receive the best economics, including through fees paid for backstopping new money, and the ability to roll up their pre-existing debt on the most beneficial terms.

- **Ad-hoc lenders:** This group typically doesn't drive the LME but achieves some protection by participating in the transaction, albeit on terms that are often less advantageous than those offered to the steering committee.
- **Non-participating lenders:** Don't participate in the LME, and are thus left with their existing debt, which is generally subordinated in lien priority to the debt holdings of the participants.

Unequal Outcomes

Since LMEs only impact a borrower's balance sheet and don't affect its business operations, there is a significant risk that despite the transaction the company will eventually need to file for bankruptcy. If a bankruptcy filing does occur post-LME, the negative impact to lender recoveries can be substantial. (See Figure 5.)

Figure 5: Aggregate Recovery Rates Are Lower for Post-LME Issuers



Source: Fitch Ratings, Bank of America Global Research, as of December 31, 2023

However, the true impact can be harder to discern, since recoveries can vary greatly across lenders. Although historically, with certain exceptions, lenders holding the same debt instrument were generally treated on a pro rata basis, LMEs can disrupt this outcome, creating a significant disparity in recoveries across otherwise similarly situated lenders.

Indeed, the biggest determiner of recoveries in a bankruptcy for individual lenders may be their participation (or lack thereof) in an LME. For example, non-participating lenders who didn't exchange their prepetition debt for new senior debt may be left with a recovery far worse than if the LME hadn't occurred. Meanwhile, **participating lenders, who access the new debt (either as an existing lender who exchanges their old debt or as a new-money external lender) can receive enhanced recoveries, generally based on their greater priority of payment.** Ensuring participation in an LME, and in the steering committee, is often a function of size of holdings, proven restructuring experience and relationships, and having the scale and capital to commit to new-money opportunities.

Defense Mechanisms

Protecting against LMEs is important for both opportunistic and performing credit investors, despite the reality that these two groups generally have different entry points. Once invested in a credit, opportunistic lenders – who likely purchased the loan or bond at a discount – and performing investors – who generally invest at or near par – have similar incentives to protect the value of their investments.

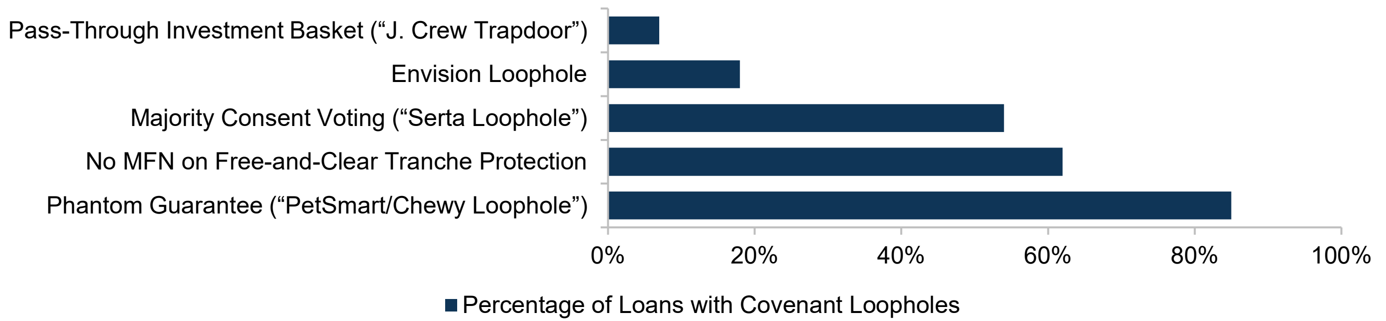
Potential defense mechanisms include:

- **Blockers:**

  – Lender protections incorporated into credit documents that attempt to close loopholes that a borrower might otherwise exploit. These are often added after an LME has been consummated in an effort to avoid the risk of a future LME.

  – However, blockers can be imperfect and are inconsistently applied. Many outstanding loans still contain the loopholes exploited in previous LME situations. (See Figure 6.)

Figure 6: Documentation Loopholes Remain in Many Outstanding Loans



Source: Covenant Review, Barclays Research, as of August 2024

- **Cooperation agreements:**

  – Co-op agreements contractually unite creditors in an effort to create negotiating leverage against a borrower which might otherwise seek to pit such creditors against each other. Used defensively, a cooperation agreement can prevent non-pro-rata outcomes among signatories by preventing such parties from entering into side-agreements with the borrower.

  – The strength of a co-op primarily derives from its scale, which can help prevent transactions that require majority consent. This can be highly effective against uptiers (which generally have a 50.1% consent threshold) but is much less effective against drop-downs, where the borrower has more flexibility to act without the support of the existing lenders.

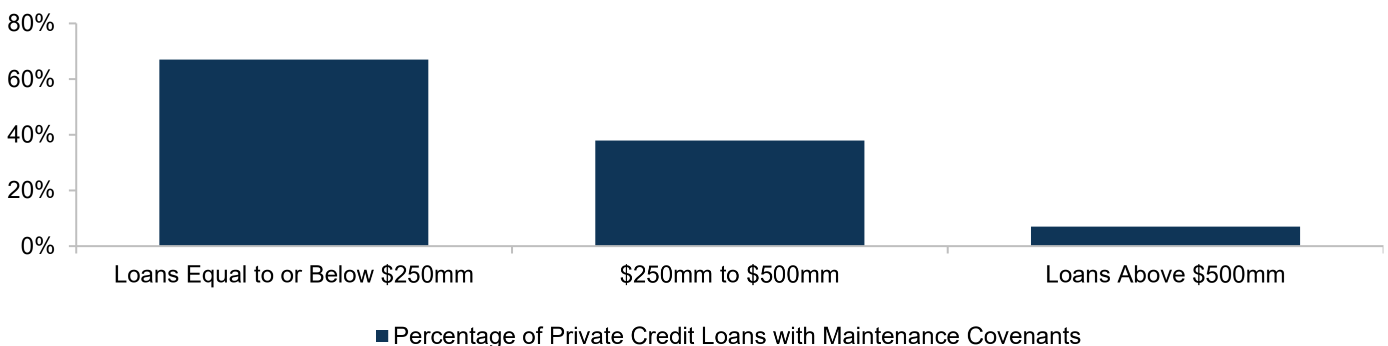
Blockers and co-ops can represent valuable (though also fallible) tools in a lender's arsenal, but often the best safeguards for value are scale, proactivity, and industry relationships. And for performing credit investors who may wish to avoid borrowers that later conduct an LME, sometimes diligent credit underwriting may be the best protection.

Coming to Private Credit?

To date, LMEs have been mostly limited to public credit, which is marked by diffuse groups of many lenders, multiple classes of debt, and loose documentation. Direct lending, which is typically characterized by small lender groups and tighter documentation, has largely resisted the LME wave. However, there are indications that LMEs may spread further into the private debt universe.

Private credit covenants have become less robust as money has flooded the market and managers have competed for deal flow. Maintenance covenants – those tested on a regular basis – are noticeably absent from larger private loans, where the competition with the syndicated market is most intense. In fact, less than 10% of loans above $500 million have maintenance covenants.[3] (See Figure 7.) This reduces early warning signs for lenders and impedes their ability to negotiate with the borrower. With this segment of the market set to compete with the public loan market for returning M&A deal flow in 2025, we could see further erosion of documentation standards.

Figure 7: Maintenance Covenants Are Lacking in Large Private Loans



Source: Moody's Investor Service

Meanwhile, an increasing portion of private loans are switching from cash-pay to payment-in-kind (PIK), with PIK more than doubling as a percentage of business development company (BDC) income since 2018.[4] Temporarily suspending cash interest payments while accruing more debt that eventually must be paid in cash might provide stressed or distressed borrowers with a brief respite. However, such a maneuver is unlikely to solve any fundamental problems associated with overleveraged capital structures.

Private credit loans that contain weak documentation or that are made to issuers that must rely on paying PIK interest may be candidates for future LMEs. Though private credit capital structures are often less complex, borrowers may still have loopholes to exploit. That said, in all likelihood, LMEs will remain less prevalent in the private credit market than in the broadly syndicated loan market.

Surfing the Wave

With interest rates likely to remain elevated for longer, loan documentation remaining weak, and private equity sponsors keen to avoid painful restructurings, we'll likely continue to see LMEs continue at pace. If one includes the probable progression of LMEs in Europe and the potential for LME activity in the (now very large) private credit market, we could be looking at an extended wave of liability management exercises.

Whether an existing or new-money lender, performing or opportunistic, seeking to protect value or capture upside, the same core attributes will best equip investors to navigate this dynamic. **Having the scale, experience and industry reputation required to navigate LMEs and ensure success has never been more crucial.**

Credit Markets: Key Trends, Risks, and Opportunities to Monitor in 1Q2025

(1) Treasury Yields Continue to Confound Expectations

Treasuries sold off during the fourth quarter as market expectations regarding the pace of interest rate cuts once again proved to be overly ambitious. With the U.S. economy remaining strong and the potential for inflationary policies from the new administration, investors are now anticipating only one or two interest rate cuts in 2025.[5]

As a result, the 10-year Treasury yield rose by nearly 80 basis points in the quarter, returning to the level seen in May 2024.[6] (See Figure 8.) Term premium – the compensation received for holding longer-dated bonds – has returned to the Treasury market. The 10-year yield ended the fourth quarter 33 basis points above the 2-year yield, with the 30-year an additional 20 basis points higher than that.[7] This reflects concerns about the sustainability of the U.S. national deficit and the impact of stubborn inflation.

Dramatic rate moves weren't limited to the U.S. In the UK, government bonds came under heavy pressure: the 10-year gilt yield reached its highest level since the Global Financial Crisis, largely driven by worries about sticky inflation and elevated debt levels in the UK.[8] At the end of the quarter, the 10-year gilt yield stood at 4.57%; in 2020, the yield on the same instrument briefly dropped below 0.20%![9]

The rates sell-off was particularly painful for assets with greater interest rate sensitivity, including long-dated fixed income: U.S. investment grade bonds, which have an average duration of 6.6 years (over double that of the high yield market), returned -2.8% in 4Q2024.[10]

On the other hand, higher base rates may continue to be a positive tailwind for floating-rate assets, including senior loans and CLOs, helping provide a strong yield despite compressed spreads. As we discussed in a recent podcast, we believe the power of high income shouldn't be underestimated as a driver of credit returns.

Figure 8: The 10-Year Treasury Yield Increased Dramatically in 4Q2024

Source: Federal Reserve Bank of St. Louis

(2) Record-High Issuance for CLOs

A strong fourth quarter brought CLO issuance to an annual record in both the U.S. and Europe, with $509 billion and $89 billion of volume, respectively, in 2024.[11] Refinancing and reset activity constituted a large portion of this volume, as managers took advantage of compressing liability spreads. (See Figure 9.)

Exceptional investor demand for CLO debt has derived from several factors:

- Elevated base rates: as a floating-rate product, higher reference rates translate directly into higher income for CLO debt investors.

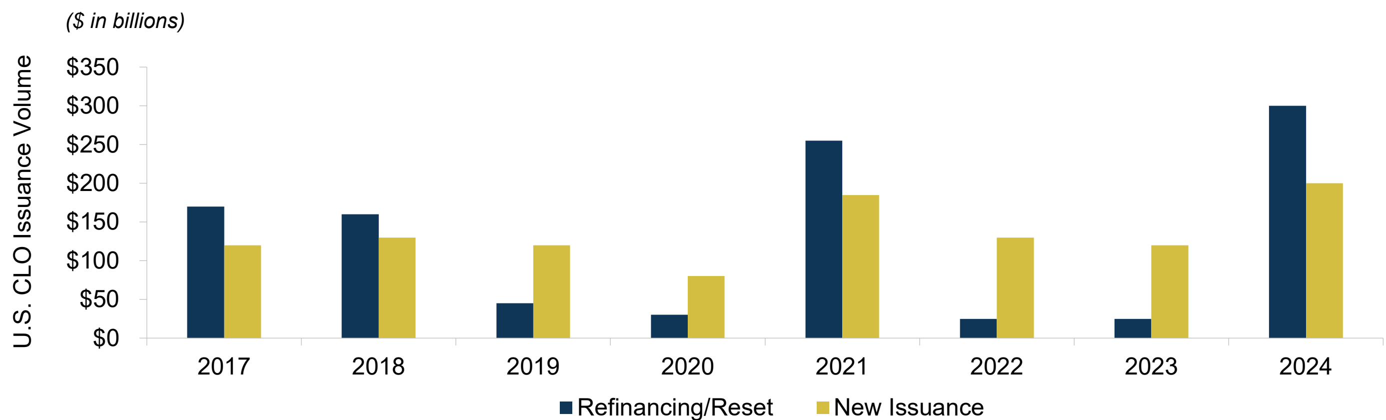
- An attractive spread premium: partly due to their perceived complexity, CLOs have continued to offer additional spread compared to similarly rated corporate bonds. Despite significant tightening, BB-rated CLOs offered a spread of 580 basis points in the fourth quarter.[12]

- Greater understanding of the robustness of CLOs: more investors now appreciate CLOs' resilience, achieved through numerous structural protections and prudent active management that has kept default rates very low.

CLO spreads have tightened after an exceptional year for total returns. The AAA tranche, the safest and largest part of the CLO structure, has seen over 40 basis points of spread compression in the last year, with compression in the lower-rated tranches even more significant.[13] While this may limit future returns for CLO debt investors, it should benefit CLO equity holders.

Tighter liabilities are accretive to CLO equity returns, with lower funding costs supporting the arbitrage that drives cashflows to the equity tranche. In addition to issuing new CLOs with cheaper debt, CLO managers can refinance the debt on existing CLOs at a lower cost. Of course, while securing tight liabilities is key to CLO manager success, the true test will remain avoiding credit problems in the underlying loan portfolio.

Figure 9: CLO Issuance Was Exceptional in 2024



Source: Pitchbook

(3) Bubble Territory?

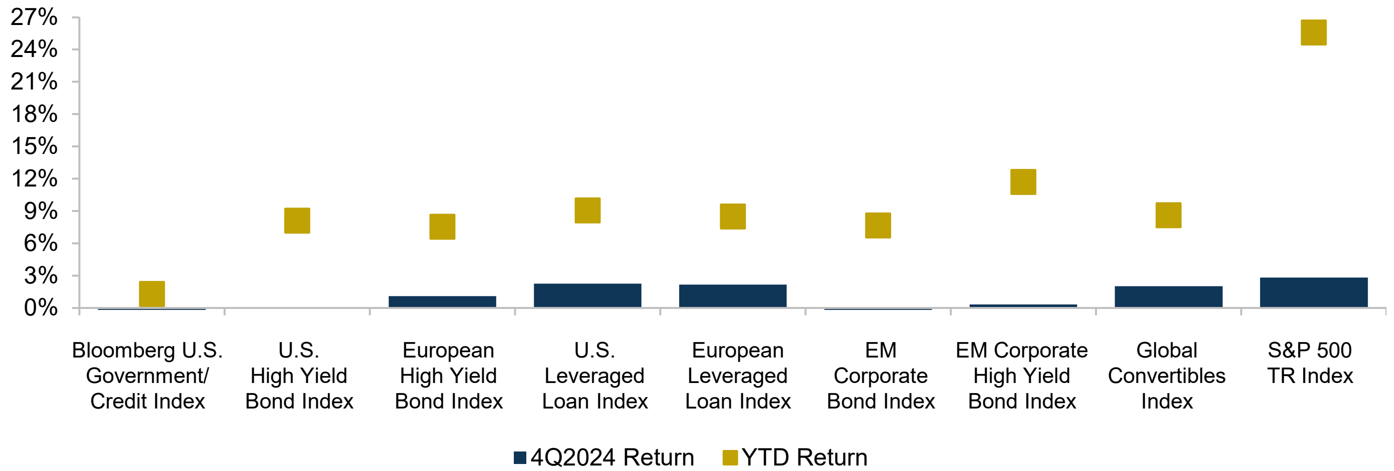
In a recent memo revisiting a subject he wrote about 25 years ago, co-chairman Howard Marks outlines why he believes a bubble is more a psychological state than a quantitative calculation:

> In my view, a bubble not only reflects a rapid rise in stock prices, but it is a temporary mania characterized by – or, perhaps better, resulting from – the following:
>
> - highly irrational exuberance (to borrow a term from former Federal Reserve Chair Alan Greenspan),
> - outright adoration of the subject companies or assets, and a belief that they can't miss,
> - massive fear of being left behind if one fails to participate ("FOMO"), and
> - resulting conviction that, for these stocks, "there's no price too high."

Looking at the S&P 500 today, Howard indicated that while optimism has prevailed in the market for the last two years, the atmosphere isn't necessarily one of wild exuberance. That being said, high valuations in the S&P could make it harder to achieve strong future returns, with high p/e ratios effectively meaning investors are relying on companies generating profits for many years to come.

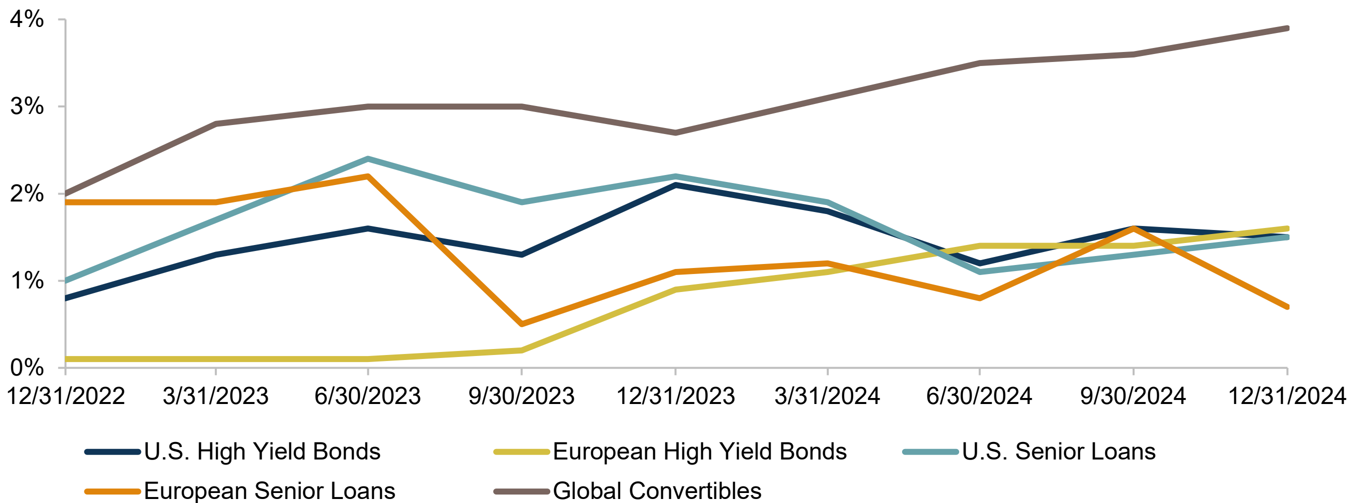
> It shouldn't come as a surprise that the return on an investment is significantly a function of the price paid for it. For that reason, investors clearly shouldn't be indifferent to today's market valuation. (*On Bubble Watch*, January 2025)

Performance of Select Indices



As of December 31, 2024
Source: Bloomberg, Credit Suisse, ICE BofA, JP Morgan, S&P Global, Thomson Reuters[15]

Default Rates by Asset Class



Source: JP Morgan for high yield bonds; Credit Suisse for loans through 2Q2023, UBS since 3Q2023; Bank of America for Global Convertibles
Note: Data represents the trailing-12-month default rate; excludes distressed exchanges

High Yield Bonds

Market Conditions: 4Q2024

U.S. High Yield Bonds – Return: 0.2%[14] | LTM Default Rate: 1.5%[15]

- **Yields in the asset class remain elevated:** Yields ended 2024 at 7.4%, roughly 100 bps above the ten-year median. (See Figure 10.) At the end of 2024, over 30% of high yield bonds had yields above 7%, compared to less than 7% at the beginning of 2022.[16]
- **Lower-quality bonds outperformed in 4Q2024:** CCC-rated bonds, the lowest credit rating category, returned 2.4% during the period, benefiting from their shorter duration amid rising Treasury yields. Meanwhile, B- and BB-rated bonds returned 0.3% and -0.5%, respectively.

European High Yield Bonds – Return: 1.1%[17] | LTM Default Rate: 1.6%[18]

- **Spreads contracted modestly in the period, but yields remain high:** At the end of the fourth quarter, yield spreads were still near the low end of the historically normal range of 300–500 bps. However, yields in the market remain elevated.
- **Overall quality in the high yield bond market remains strong:** BB-rated bonds make up roughly 60% of the European high yield bond market, and B-rated bonds make up roughly 30%.

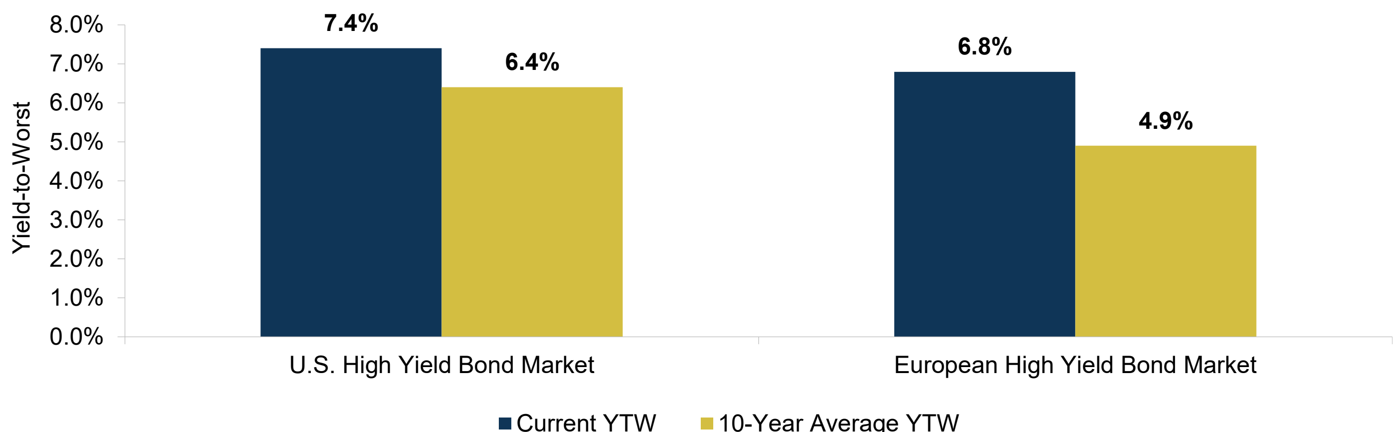
Opportunities

- **High yield bonds continue to be priced at a discount to par:** Investors are able to earn capital appreciation and high coupon income.
- **Attractive yields are still on offer in the high yield bond market:** Although spreads have narrowed moderately, yields continue to be elevated, giving investors the opportunity to earn attractive contractual returns.
- **Issuers' fundamentals remain robust:** Interest coverage is comfortably above the historical average. With less than 10% of the high yield bond market set to mature by 2027, the risk of near-term defaults is limited.

Risks

- **The new administration's policies and their potential impact remains uncertain:** Policy changes in the U.S. may affect corporate taxes, the budget deficit, and national debt.
- **Elevated inflation and high labor costs may impair issuers' fundamentals:** Input costs remain high even though inflation has slowed.
- **Heightened geopolitical risk may put pressure on economic growth:** Geopolitical tensions, including the wars in Ukraine and the Middle East and complicated China/U.S. relations, may give rise to volatility within the global supply chain.

Figure 10: The High Yield Bond Markets Still Offer Attractive Yields



Source: ICE BofA US High Yield Constrained Index and ICE BofA Global Non-Financial High Yield European Issuer, Excluding Russia Index, as of December 31, 2024

Senior Loans

Market Conditions: 4Q2024

U.S. Senior Loans – Return: 2.3%[19] | LTM Default Rate: 1.5%

- **U.S. senior loan prices rose during the fourth quarter:** Positive performance was supported by high coupon income and sustained demand from CLO issuance.
- **Gross issuance in the asset class remained robust:** Activity in the loan primary market accelerated in 4Q2024; in 2024, gross issuance totaled $1.4 trillion, which is the highest annual volume on record. However, refinancings/repricings continued to dominate issuance.

European Senior Loans – Return: 2.2%[20] | LTM Default Rate: 0.7%

- **European loans recorded a positive return in 4Q2024:** While prices were relatively flat during the period, strong coupon income continued to drive returns.
- **Lower-quality loans continued to outperform:** The lowest-quality portion of the senior loan market, CCC-rated loans, returned 3.5% during the quarter. Meanwhile, B- and BB-rated loans returned 2.1% and 2.2%, respectively.

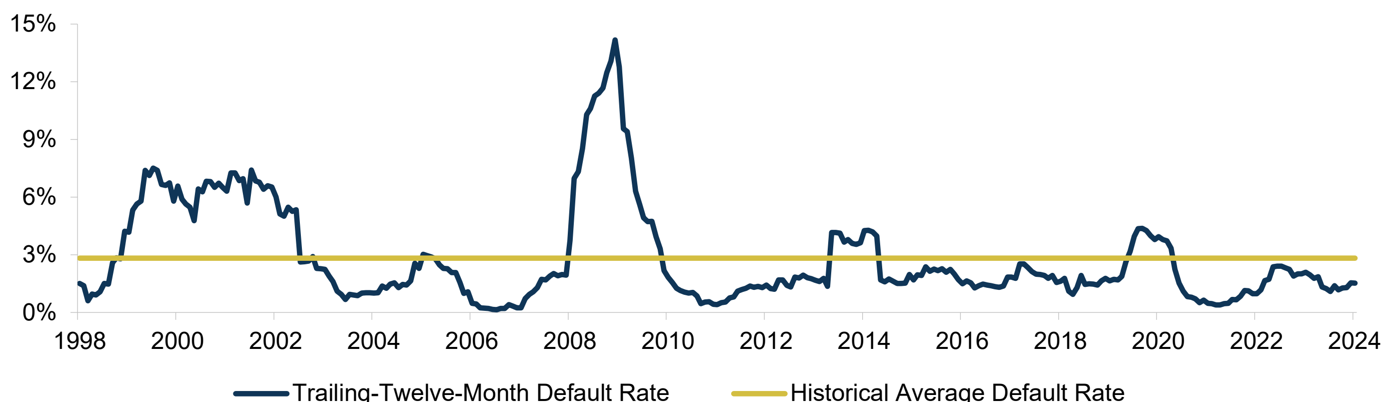
Opportunities

- **High coupons should continue to attract investors:** We expect floating-rate loans to remain compelling throughout 2025, unless there's a meaningful decrease in reference rates.
- **The outlook for defaults appears manageable:** While default rates in the U.S. and European loan markets are expected to increase moderately, they'll likely remain below their non-recessionary averages. (See Figure 11.) This is mainly due to the limited volume of maturities in 2025-26 and the increasing presence of alternative capital sources, such as rescue financings.
- **Given their stable buyer base, loans could experience less volatility compared to other asset classes:** The primary holders of leveraged loans, CLOs, face minimal selling pressure, and the asset class generally attracts long-term institutional investors due to the extended cash settlement period.

Risks

- **Recovery rates remain significantly lower than the historical average:** The growing prevalence of loan-only capital structures has led average recovery rates in the asset class to decline to 45%.[21] We anticipate this trend will persist through this default cycle.
- **A decline in interest rates could diminish demand for floating-rate assets:** Further interest rate cuts may negatively impact investors' appetite for floating-rate assets, despite interest rates currently being above their ten-year average.

Figure 11: Default Rates Are Still Below the Historical Average



Source: J.P. Morgan, as of December 31, 2024; excludes distressed exchanges[22]

Investment Grade Credit

Market Conditions: 4Q2024

Return: -2.8%[23]

- **Investment grade debt faced headwinds in 4Q2024:** Longer-dated interest rates rose as inflation fears resurfaced and the U.S. Federal Reserve indicated further policy rate cuts may not come as soon as expected.
- **Lower-quality credit outperformed during the quarter:** BBB-rated corporate bonds outperformed the highest-rated segment of the investment grade market by over 90 bps in the fourth quarter.[24] This was primarily because the lower-rated segment has higher coupons and the shortest average duration within the asset class.
- **Issuance remained robust in 4Q2024:** Gross issuance of investment grade bonds exceeded $241bn during the period, bringing FY2024 issuance to $1.6tn, the second largest annual total for both issuance volume and deal count.[25] Demand for investment grade credit remained more than sufficient to absorb the supply; the primary market had an average oversubscription rate of 3.8x.[26]

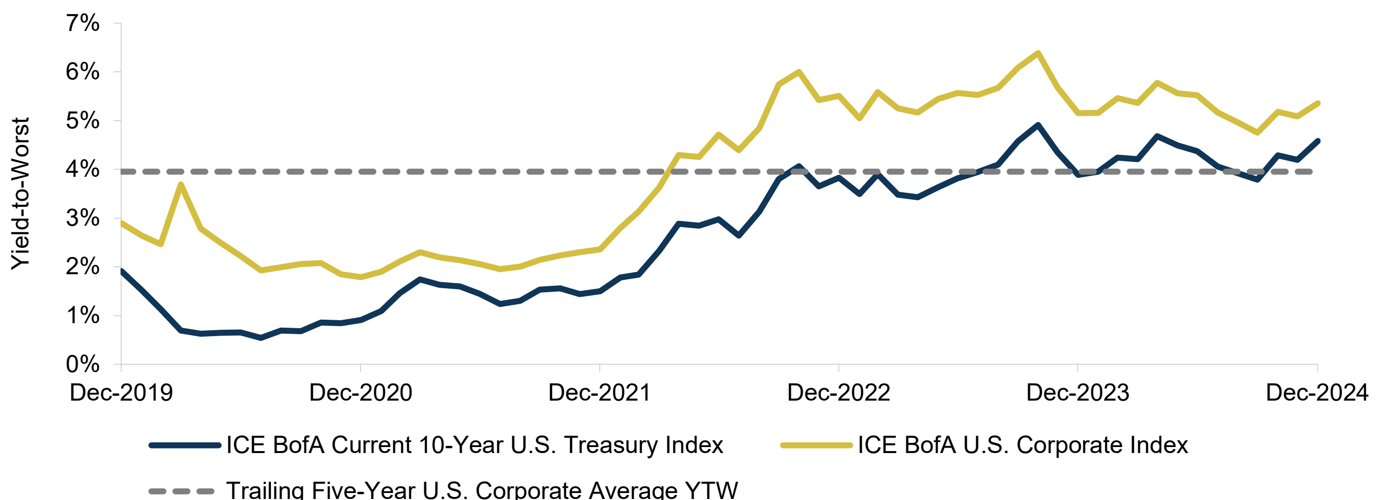
Opportunities

- **Investment grade bond yields remain elevated:** High-quality corporate debt yields ended the quarter at 5.4%, which is substantially higher than the five-year average of 3.2%. (See Figure 12.)
- **If economic activity slows, investment grade debt may benefit:** The asset class has a higher average credit rating and duration than high yield bonds, meaning it could remain less volatile if risk sentiment declines, credit spreads widen, or interest rates continue to fall.

Risks

- **Fixed-rate asset classes may face challenges if interest rates don't decline as much as currently anticipated:** At year-end, market participants projected less than two rate cuts in 2025. Additionally, many of the more rate-sensitive credit markets could experience volatility if the Fed takes a more patient approach.[27]
- **If interest rates meaningfully decrease, there may be less demand for low-yielding fixed income securities:** Investors may reach for higher yields in riskier asset classes in order to meet their target returns. On the other hand, inflows from money market investors seeking additional incremental return in the investment grade markets could increase, given the assets held in money markets have risen to $6.9tn.[28]

Figure 12: Investment Grade Bond Yields Remain Well Above the Five-Year Average



Source: Bloomberg

Emerging Markets Debt

Market Conditions: 4Q2024

EM Corporate High Yield Bonds – Return: 0.3%[29]

- **EM corporate high yield bonds delivered robust returns in 2024, even as the fourth quarter's performance was dampened by higher global interest rates:** The year was marked by broad-based returns, as the asset class recorded double-digit returns across each major region. During the quarter, the modest decline in EM bond prices was offset by high coupon income and further yield spread tightening. EM's spread premium versus U.S. high yield is near the historical average; however, spreads in the asset class are currently around the tightest they've been in six years.
- **The asset class experienced stable capital market conditions:** In 2024, EM high yield bond issuance surged to $124 billion, more than double the subdued levels seen in 2022 and 2023.[30] Despite EM fund outflows, which intensified after the U.S. Presidential election, investor appetite remained strong during the fourth quarter, including for debut issuers and Argentine corporates that re-emerged after a political and macroeconomic turnaround in the country. Investor confidence was supported by (a) additional U.S. Federal Reserve rate cuts, (b) resilient global economic activity, including in Southeast Asia and Latin America, and (c) a declining EM high yield default rate (3.5% in FY2024) and no new EM sovereign defaults.
- **U.S. trade policy and idiosyncratic issues contributed to EM currency volatility:** EM currencies experienced their weakest quarter since mid-2022, primarily due to U.S. dollar strength and depreciation in key Latin American currencies, including the Brazilian real. (See Figure 13.) Potential U.S. trade conflicts with EM countries (e.g., China and Mexico) add another layer of uncertainty, posing risks to investment flows and sectors vulnerable to trade disruption. EM country-level fundamentals may begin to weaken due to persistently elevated interest rates, trade tensions, and currency pressures.

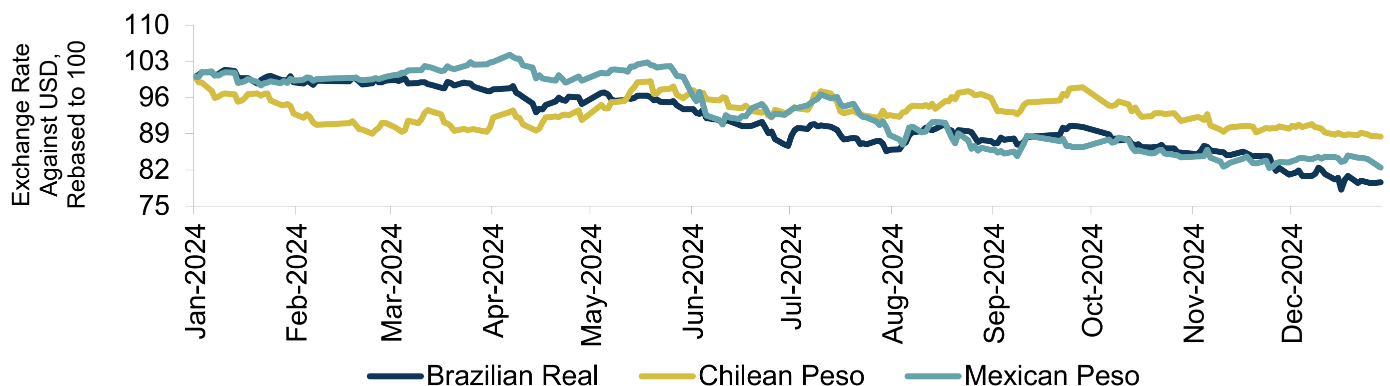
Opportunities

- **The investable universe in EM is expanding:** Improved financing conditions have supported additional debt-financed transactions, including M&A activity and the emergence of new borrowers.
- **Mispriced assets emerge periodically across the diverse regions and industries within EM:** These various segments are all at different stages in the credit cycle and exposed to idiosyncratic risks.
- **EM currently offers a yield premium to other asset classes amid a healthy financing environment:** The CEMBI High Yield Index yield remains above 8%, even as the volume of distressed bonds is relatively low and default rates have stabilized.

Risks

- **A disruption or slowdown in global trade may put pressure on EM export-driven economies:** Trade conflicts between the U.S. and EM countries could impact large EM economies and reroute trade flows, reshaping global trade dynamics.
- **Market stability may have increased investor complacency:** A surge in EM issuance, including of lower-quality bonds, may suggest complacency following a relatively calm period across key markets.
- **Geopolitical tensions could have negative long-term effects on EM debt capital flows:** Investor confidence in EM credit could decline if ongoing conflicts escalate or if China/U.S. relations worsen.

Figure 13: Latin American Currencies Weakened in 2024



Source: Bloomberg

Global Convertibles

Market Conditions: 4Q2024

Return: 2.1%[31] | LTM Default Rate: 3.9%[32]

- **Convertible bond prices increased in the fourth quarter upon strong equity market performance:** In November, Donald Trump's U.S. presidential election victory – and the Republican party taking control of the House of Representatives and the Senate – continued to fuel the equity market rally (particularly for mega-cap companies), as investors viewed his policies as "pro-business."
- **Primary market activity remained healthy during the quarter:** New issuance of global convertibles totaled $35.8bn across 51 new deals in 4Q2024. The majority of issuance was concentrated in the U.S., and primarily within the technology and industrial sectors.

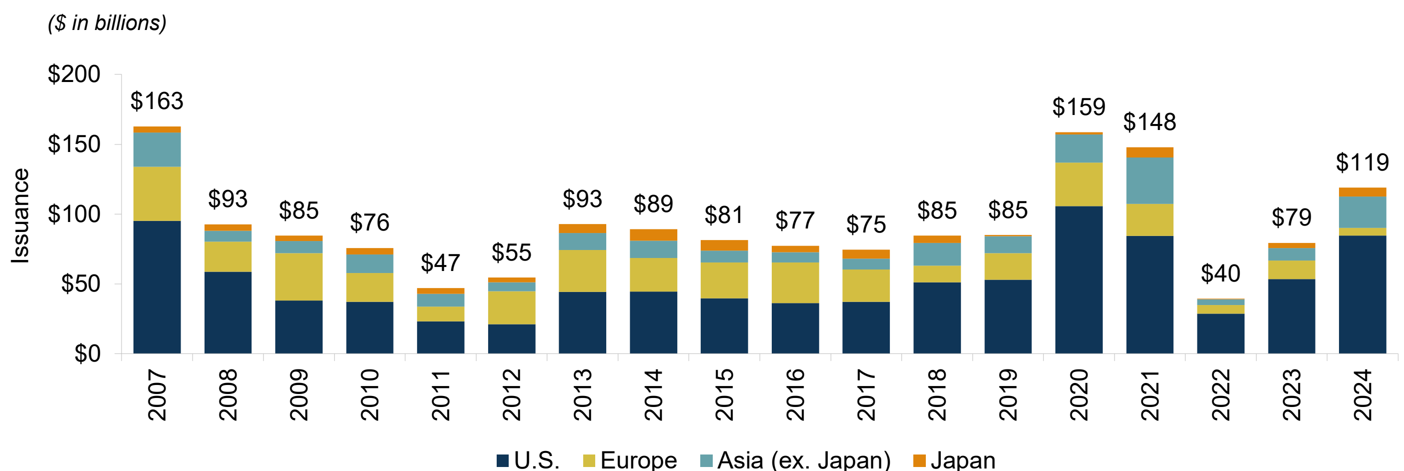
Opportunities

- **The size of the convertible bond market has continued to expand:** In an elevated interest rate environment, companies seeking new capital or those looking to refinance straight debt have increasingly turned to the convertibles market, where coupons are lower. In 2024, new issuance of global convertible bonds reached the third highest annual volume since 2007. (See Figure 14.) Moreover, there are still significant debt maturities to refinance in the next two years, meaning the convertible market may potentially grow.
- **New issue pricing and terms have meaningfully improved:** While coupons of convertible bonds are still lower than those of straight debt, many of the new issues that came to market in 2024 offer better coupons and convexity compared to several years ago.
- **Valuations outside of the U.S. are sensible:** Global ex-U.S. equities may have upside potential in the form of moderate valuations: the MSCI EAFE Index (a reasonable proxy for the ex-U.S. equity market) currently has a price-to-earnings ratio around half that of the S&P 500.[33]

Risks

- **Numerous trends threaten to slow global economic growth and weigh on equity prices:** These include concerns about sticky inflation, trade policy headwinds, and heightened geopolitical risk.

Figure 14: 2024 Was the Third-Highest Year for New Issuance of Global Convertible Bonds Since 2007



Source: BofA Global Research, as of December 31, 2024

Structured Credit

Market Conditions: 4Q2024

Corporate – BB-Rated CLO Return: 4.3%[34] | BBB-Rated CLO Return: 2.5%[35]

- **While Collateralized Loan Obligation spreads have tightened, they continue to offer a premium over equivalent corporate bonds:** BBB-rated CLO spreads tightened to 301 bps at the end of 4Q2024; this still represents an attractive premium over BBB-rated corporate bonds.
- **Primary market activity increased meaningfully in 4Q2024:** Issuance of CLOs was significantly higher in the fourth quarter of 2024 compared to the same period in 2023. CLO issuance in the U.S. and Europe totaled $58bn and €13bn, respectively, in the period, up from $32bn and €8bn in 4Q2023.[36]

Real Estate – BBB-Rated CMBS Return: 1.0%[37]

- **Real estate structured credit recorded positive performance during the quarter:** The asset class continues to benefit from improving investor sentiment around the real estate sector, which was largely driven by the 2024 interest rate cuts.
- **Valuations in the CRE market show signs of recovery:** Green Street's Commercial Property Price Index increased by 1.5% quarter-over-quarter and by 4.8% year-over-year, while the office subsector index declined by 1.1% year-over-year.[38] Most sectors rose slightly on an annual basis, suggesting that the commercial real estate market could have reached, or is close to reaching, stabilization.
- **Activity in the primary market continues to accelerate:** Private-label CMBS issuance totaled approximately $113bn in 2024, which is more than double the volume in 2023 and represents a 142.3% increase.

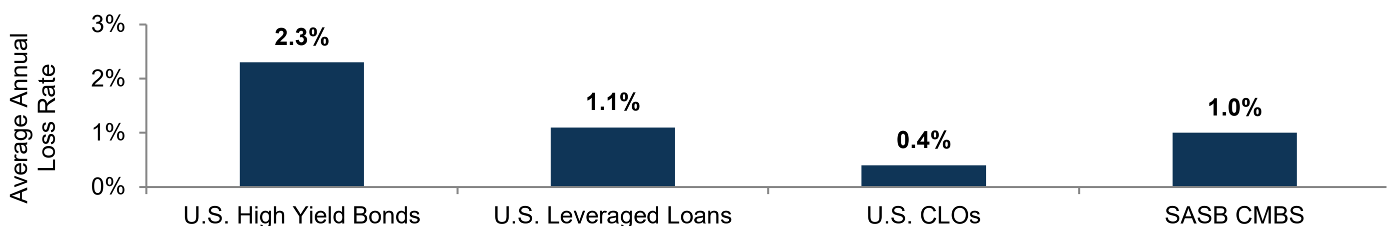
Opportunities

- **Corporate structured credit may prove resilient in an economic downturn:** CLO debt has shown significant resilience throughout various market dislocations since the Global Financial Crisis, including the pronounced fluctuations in 2020 and 2022-23, as evidenced by their low long-term loss rates. (See Figure 15.)
- **The supply of new loans may increase:** As central banks continue cutting interest rates, M&A and LBO activity, which has been lackluster in recent years, could rise, creating meaningful new loan supply.
- **Despite stabilizing valuations in the CMBS market, banks remain sidelined due to an excess of CRE loans made before 2022:** The retrenchment of banks from this space has created a substantial capital void for borrowers seeking to refinance existing assets or acquire new ones, offering an attractive opportunity for non-bank lenders with available capital and limited problems in their existing portfolios.

Risks

- **Limited new loan supply could lead to underwriting compromises:** The heightened demand but limited supply of new loans could result in some CLO managers filling warehouses with low quality paper.
- **Weakness in the office sector may persist:** The sector continues to face multiple headwinds, and its performance may continue to weigh on real estate structured credit indices throughout 2025.

Figure 15: Structured Credit Has Historically Had Lower Loss Rates than Traditional Credit



Source: JP Morgan Research (High Yield Bonds, 1978-2024), J.P. Morgan Research (Leveraged Loans, 1998-2024), Moody's (CLOs, 1993-2023, updated annually) and J.P. Morgan Research (SASB CMBS and large loan floaters, 1996-2024), as of December 31, 2024, updated quarterly unless otherwise stated.

Private Credit

Market Conditions: 4Q2024

- **The Trump administration's regulatory and tax changes could boost M&A deal flow, potentially widening private credit yield spreads:** It's highly likely that President Trump will seek to lower taxes, cut regulations, and favor policies that are pro-business. Further, we expect the Federal Trade Commission will prove far more permissive when it comes to corporate mergers and acquisitions. As a result, M&A will likely increase, creating heightened demand for private credit funding and potentially widening spreads.
- **Partnerships between banks and private credit managers are growing:** Large and regional banks are increasingly partnering with private credit managers as the regulation governing financial institutions in North America and Europe continues to evolve. Flow agreements with banks can enhance managers' sourcing capabilities, with regional banks able to offer managers privileged access to hard-to-reach corners of the lending markets.

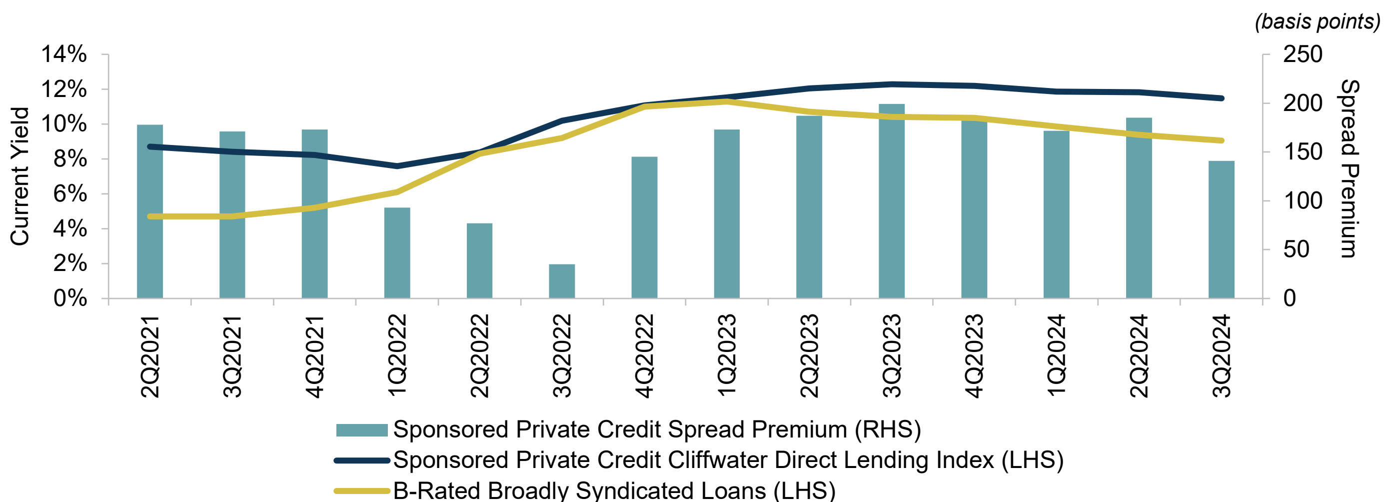
Opportunities

- **The need for private asset-backed finance is expanding:** Even if the Trump administration rejects major portions of the Basel III Endgame or loosens banks' regulatory requirements, we believe U.S. banks will continue to pull back from non-investment-grade asset-backed finance as they focus on deal making and serving their biggest (and safest) clients. Private credit managers with deep expertise in the underlying assets, bespoke deal structuring capabilities, and an appreciation for the complexity of ABF will be left to fill the funding gap.
- **Direct lending continues to offer a 100-200 bps premium:** Relative to transactions with equivalent risk in the broadly syndicated loan market, directly originated loans continue to offer investors attractive pricing. (See Figure 16.) Default rates remain modest and elevated interest rates should continue to support attractive income for direct lending investors.

Risks

- **Plenty of companies still have too much debt on their balance sheets:** Almost 10% of loans are being monitored closely or at risk of loss. If interest rates remain elevated, which the market increasingly expects, overleveraged borrowers will likely (a) swap cash pay for paid-in-kind (PIK) on their private loans or (b) seek to restructure their balance sheets, either through a formal Chapter 11 restructuring or a liability management exercise. Lenders who prioritized origination over credit selection might find a growing list of problem credits in their portfolios.
- **Ongoing macroeconomic uncertainty may continue to drive this trend:** Some of President Trump's proposed policies are potentially inflationary (e.g., tariffs, tax cuts and immigration controls). This, coupled with the massive U.S. national deficit, may put upward pressure on longer-dated rates as investors demand a higher term premium.

Figure 16: Private Credit Continues to Offer An Attractive Spread Premium



Source: Cliffwater Direct Lending Index, as of September 30, 2024 (most recent data available)

About the Authors

Armen Panossian

Co-Chief Executive Officer and Head of Performing Credit

Mr. Panossian serves as co-Chief Executive Officer, primarily focused on overseeing the organization and performance of Oaktree's investment teams. He is also Head of Performing Credit, where his responsibilities include oversight of the firm's liquid and private credit strategies and as a portfolio manager within the Global Private Debt and Global Credit strategies. Mr. Panossian joined Oaktree's Global Opportunities group in 2007. In January 2014, he joined the U.S. Senior Loans team to assume co-portfolio management responsibilities and lead the development of Oaktree's CLO business. He became head of all performing credit in 2019. Mr. Panossian joined Oaktree from Pequot Capital Management, where he worked on their distressed debt strategy. Mr. Panossian holds a B.A. degree in economics with honors and distinction from Stanford University, where he was elected to Phi Beta Kappa; an M.S. degree in health services research from Stanford Medical School; a J.D. degree from Harvard Law School; and an M.B.A. from Harvard Business School. Mr. Panossian serves on the Advisory Board of the Stanford Institute for Economic Policy Research. He is a member of the State Bar of California.

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Ms. Poli is a portfolio manager within Oaktree's Global Credit strategy, which is the firm's flagship multi-asset credit offering. She is a founding member of its Investment Committee. Ms. Poli is also a regular commentator for mainstream and financial media and has been named to Barron's list of 100 Most Influential Women in U.S. Finance. Ms. Poli joined Oaktree in 2014 following graduation from the UCLA Anderson School of Management, where she received an M.B.A. and the Laurence and Lori Fink Investment Management Fellowship. Prior thereto, she worked at PAAMCO KKR Prisma (formerly PAAMCO) where she helped manage hedge fund portfolios for institutional clients. Ms. Poli holds a B.S. degree in business administration from the University of Southern California and is a CAIA charterholder.

Oaktree's Credit Platform

Oaktree Capital Management is a leading global alternative investment management firm with expertise in credit strategies. Our credit platform has $142.6 billion in AUM and encompasses a broad array of strategy groups that invest in public and private credit instruments across the liquidity spectrum.[39] All Oaktree investment activities operate according to a unifying philosophy that emphasizes key principles including the primacy of risk-control and benefits of specialization.

Endnotes

1. PitchBook.
2. Credit Suisse Leveraged Loan Index; average coupon between January 3, 2023 and December 31, 2024.
3. Moody's Investor Service.
4. Fitch Ratings, as of December 5, 2024.
5. Bloomberg.
6. Federal Reserve Bank of St. Louis, as of December 31, 2024.
7. Ibid.
8. MarketWatch, as of December 31, 2024.
9. MarketWatch, as of December 31, 2024.
10. ICE BofA US Corporate Index, as of December 31, 2024.
11. PitchBook, as of December 31, 2024. Includes both new issuance and refi/reset activity.
12. PitchBook.
13. PitchBook.
14. ICE BofA US High Yield Constrained Index for all references to U.S. High Yield Bonds, unless otherwise specified.
15. JP Morgan for all U.S. default rates, unless otherwise specified. This figure excludes distressed exchanges.
16. ICE BofA US High Yield Constrained Index. Percentages are based on the market value of debt.
17. ICE BofA Global Non-Financial High Yield European Issuer, Excluding Russia Index (EUR hedged) for all references to European High Yield Bonds, unless otherwise specified.
18. UBS for all European default rates, unless otherwise specified.
19. Credit Suisse Leveraged Loan Index for all data in the U.S. Senior Loans section, unless otherwise specified.
20. Credit Suisse Western Europe Leveraged Loan Index (EUR Hedged) for all data in the European Senior Loans section, unless otherwise specified.
21. JP Morgan, LTM average rate, as of December 31, 2024. Default figures exclude distressed exchanges.
22. TXU was removed from J.P. Morgan's twelve-month default rate calculation in April 2015 resulting in a meaningful decrease in the rate in March 2015.
23. ICE U.S. Corporate Index for all data in this section, unless otherwise specified.
24. ICE U.S. Corporate BBB Index versus ICE U.S. Corporate AAA Index.
25. BofA Securities IG Syndicate Deal Recap.
26. Ibid.
27. As of December 31, 2024.
28. Investment Company Institute Money Fund Assets, as of December 31, 2024.
29. JP Morgan Corporate Broad CEMBI Diversified High Yield Index for all data in this section unless otherwise specified. The emerging markets debt section focuses on dollar-denominated high yield debt issued by companies in emerging market countries.
30. JP Morgan EM Corporate Research, as of January 3, 2025.
31. Refinitiv Global Focus Convertible Index for all performance data, unless otherwise indicated.
32. Bank of America for all default and issuance data in this section, unless otherwise specified.
33. Bloomberg.
34. JP Morgan CLOIE BB Index.
35. JP Morgan CLOIE BBB Index.
36. JP Morgan for all data in this section, unless otherwise specified.
37. Bloomberg US CMBS 2.0 Baa Index Total Return Index Unhedged Index.
38. Green Street Commercial Property Index, as of December 31, 2024. The index tracks the pricing of institutional-quality commercial real estate.
39. The AUM figure is as of December 31, 2024 and excludes Oaktree's proportionate amount of DoubleLine Capital AUM resulting from its 20% minority interest therein. The total number of professionals includes the portfolio managers and research analysts across Oaktree's performing credit strategies.

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