

## Audio Transcript: Credit Roundtable: What Comes Next for Corporate Credit? October 9, 2023

**Katie Klingensmith** [00:00:01] Welcome, everybody, to today's Credit Roundtable. Part of Brandywine Global's Around the Curve Podcast conversations. I'm Katie Klingensmith with Brandywine Global, and I am delighted to be joined by two colleagues from the Global Fixed Income team. I have Bill Zox who's very focused on credit with a deep expertise in high yield, as well as Andrew Bogle, who spends a lot of his time working with the multi-sector teams and can also obviously speak to us about what's going on in credit markets. Well, there's a lot going on in credit markets. So, let's get started first with Andrew. It would be great if you could just give us a sense of the macro backdrop. But just in general, what has been driving the US yield curve recently?

**Andrew Bogle** [00:00:46] Yeah. Thanks, Katie. And it's a great question. And it sure is topical. We've seen roughly 50 basis points wider on the long end of the US yield curve over the past three or four weeks, and it's been quite a wild ride. There's a lot of speculation as to what exactly is driving it higher. But our conclusion is it's actually a pretty simple idea, and it's that the yield curve is starting to listen and take more seriously to what the Federal Reserve has been trying to tell investors for the last year straight. We think that the 30-year part of the yield curve was depressed and inverted for a substantial period of time, mostly because investors weren't giving the Fed the credit that they were actually going to stay higher for longer. And with the most recent summary of economic projections from the Federal Reserve, which raised their 2024 dots from something akin to four and a quarter to four and three quarters, investors are now taking seriously the fact that the Fed is here to stay and will stay for a considerable period of time. And so the negative term premium that we've been having for the vast majority of the year, about half of that just disappeared since the Federal Reserve has spoken last. So, the rise in rates primarily at the long end of the curve as investors adjust for what may be a much more hawkish Federal Reserve.

**Katie Klingensmith** [00:02:09] That's a great place to start. And as we think about what that curve means for investors in credit, Bill, where would you put us in the overall credit cycle? And are there particular data points or dynamics that you're watching to understand what comes next?

**Bill Zox** [00:02:23] Sure. I mean, along the lines of what Andrew was just saying, I would start with the economic cycle. And quite simply there, we don't want to confuse a long lag with a soft landing. So, I think that I totally agree with Andrew. The Fed is very likely to do what it has been saying and more likely to stay tight for too long because they don't want to risk making two inflationary policy errors in a row. I just think that it's a very low probability that the Fed doesn't, a much higher probability that this ends in a recession. So, in terms of the credit cycle, we're late cycle. We've been late cycle for quite some time. I think we're still late cycle. Notwithstanding that, triple Cs have been by far the best performing part of the high yield market. So, that is inconsistent with what you would expect in terms of being late cycle. But I still think it makes sense to be positioned as if we are late cycle, which again is what I believe. In terms of what I'm looking for, you know, I think that you're likely to see signs of the narrative shifting from a soft landing to hard landing or recession in financial markets before you see it anywhere else. It doesn't have to be the case, but I think most likely we'll see it in financial markets. I do think that the performance of equities over the last few months or so, that performance is instructive. They've been weak for a couple months, probably in my mind, reflecting the move much higher in real yields in the Treasury market. I don't think it's the kind of action that's

consistent with a recession, though. You know, I think that when you get to recession, you have to deal with these higher real yields, but then you have to deal with significant pressure on earnings. I'm not seeing that in the equity market yet. So, in terms of when this recession comes, I don't have a lot of conviction in when that will come, but expect to see signs of that in financial markets. And I'm not seeing too many signs of that right now.

**Katie Klingensmith** [00:04:48] So much there that I want to follow up on, Bill, including the information that we as fixed income investors glean from equity markets. But before we move on, I think we're generally going to be talking about credit markets in the US and the macro situation in the US. But, Andrew, I know you and team are also looking global. Are you noticing any particularly different trends or opportunities outside of the US or should we keep this conversation US focused?

**Andrew Bogle** [00:05:14] Yeah, we certainly keep our eye on the world on a day-to-day basis. And while the trends, I would say, rhyme around the world, I think the timing and kind of the play out of how monetary and fiscal policy has been implemented over the course of the last 18 months may differ in different areas. So for us, primarily, we tend to watch five major bond markets, all with slightly different timing, and that's obviously the US, the United Kingdom, European bond market, the Japanese bond market, and the Chinese bond market. And I think you have a lot of similarities in the United States, the United Kingdom, and Europe, where you had an incredibly aggressive monetary response to inflationary conditions. And each of those economies, as Bill alluded to, is starting to feel their way through what that actually means with elevated rates for longer periods of time. And you've seen, you know, equities and inflation respond slightly differently. Some, you know, receding a little quicker than others around the world. But ultimately, we think the story there, not at the same time, but the story might end at the same place. The Japanese and Chinese bond markets are completely different. The Bank of Japan is underway with their yield curve control experiment and what that means for the strength of the Japanese yen. And can they really keep yields repressed to the level in which they feel which they feel is appropriate? And then the Chinese bond market is kind of its own animal this year, just reflecting what was supposed to be one of the greatest reopenings and economic powerhouses coming back online at the beginning of this year. But the reopening story in China has largely fizzled. The property market woes are still real, and that bond market is responding in tow. So the Asian bond market staying more under control, generating more positive returns, certainly relative to their Western peers. But we do think a lot of policy rhymes globally and certainly is worth paying attention to, to form views for a multi-sector strategy.

**Katie Klingensmith** [00:07:28] So, I want to stay with you, Andrew. We heard from Bill talking through what we could glean from financial markets in terms of a potential recession or a change in the economic growth dynamics in the US. It's interesting that defaults have still been pretty low, both in the investment grade and high yield space. Why is that and are you optimistic that these numbers will stay pretty low?

**Andrew Bogle** [00:07:51] Yeah. So yeah, they are, historically speaking, pretty low. But we must admit that the default rate in high yield has ticked up over the course of the year. And, you know, generally this should be seen as a sign of stress for credit markets. But I do think it's worth bifurcating two different types of defaults that make their way into that calculation. There are the traditional what you would think of as a default in a credit market where a company goes out of business, lays off its employees, and has a real economic impact to the broader economy. But there are also elements that get characterized as a default. And mostly what I'm talking about here are distressed exchanges. And we've had

quite a number of those as well this year as high yield bonds have been stressed and trading in the 60 to 70 cent range on the dollar. Sometimes what these companies will do on their own internally is make a conscious decision that they would like to exchange out some of those lower-trading bonds, and they may swap their investors into a secured bond with a higher coupon, and that is characterized as a default. And when a company does that, that contributes to the default rate for the high yield index. But what's interesting about those type of defaults is there really is no economic consequence. There's no broad reaction. Everybody still goes to work the next day, everybody still gets paid. The only thing that really happens is a line item on a fixed income investors balance sheet has a new name, a new maturity, and a new coupon schedule. And so we think that the default rate is set to continue to rise. But it will be very interesting to see which is the larger contributor to that rise in defaults. Is it going to be more of the financial engineering inside of a Treasury Department that may be advantageous for corporations to take advantage of whatever situation their bonds are in? Or is it going to be more of the traditional close the doors, sell the inventory at a discount, and tell your employees to go home for the rest of the year? That will be very interesting to see.

**Katie Klingensmith** [00:10:08] That's really interesting to just understand what the numbers are actually telling us. I mean, Bill, react to this in general. What are you making of the default rates today and where they'll go going forward? And maybe tell us why spreads are still as low as they are, given how many concerns are out there?

**Bill Zox** [00:10:28] Yeah. You know, I think that Andrew addressed a good portion of this. From the bottom up, defaults are increasing, but they're still well below average. So, depending on the data set that you're looking at, they're probably in the 2 to 2 and a half percent range. Average defaults are probably more in the low to mid, maybe even high threes, depending on your data set and your time period. So, I would say defaults are accelerating but still below average.

**Katie Klingensmith** [00:10:55] And that's high yield, right?

**Bill Zox** [00:10:57] I'm sorry, that's high yield defaults. Right. Right. And then in terms of interest coverage, maybe the most important fundamental metric--off peak, but still well above average. So, our starting point was interest coverage well above historic norms. Off peak, but still well above where we have seen it over the post-GFC period or really the pre-GFC period. Still very attractive interest coverage. Then the management teams have had access to capital, so there hasn't been a ton of issuance in the high yield market, but it has been open for the most part. Maybe the most stressed triple C issuers, some of them have trouble accessing capital, but we're talking about maybe 5% of the market or so that that would have some issues. And the other 95% of the market has access to capital, whether it's in the high yield market, convertible bond market, loan market, private credit, equity--access to a wide range of capital, all different costs. So, there's a lot of flexibility there. And the management teams have had time now. They've had 15 months at least to prepare for higher interest rates and potential recession. So, I think in some cases we're talking about distressed exchanges, but for the most part, the market, it's just prudent balance sheet management. That's what the management teams are focused on. They're focused on protecting their balance sheet right now, much more so than growth or dividends or share buybacks.

**Katie Klingensmith** [00:12:40] So those all seem like factors that are pretty positive. Do you think that these really, I mean, in my mind, pretty tight credit spreads, given the amount of uncertainty, could that shift really quickly?

**Bill Zox** [00:12:52] I mean, absolutely. I mean, things can change and frequently do change quickly. But that is not the nature of this cycle. This is very different. This is a long, drawn out cycle. And by the way, we went through a pretty severe cycle in COVID. So, that's another reason why I think that spreads are more narrow and defaults. My expectation is that defaults in the next cycle, in the next recession will be something like half of what they were in the early 2000s tech telecom recession or the global financial crisis for some of the reasons that we've been talking about. But one of them is that the market was kind of cleaned up just three years ago during the COVID recession. And again, the management teams have time, will continue to have time and access to capital to prepare.

**Katie Klingensmith** [00:13:50] I just want to let Andrew respond to that. I mean, in terms of a different, if high yield is a different animal than it was.

**Andrew Bogle** [00:13:57] Oh, I would say it certainly is. And we can talk about a number of these themes throughout this conversation. But really, the COVID recession allowed corporations access to very cheap and very easy capital at a time when policy rates were taken to zero. And they did not shy away from reaching for that capital and raising that capital. And they did bring a lot of balance sheet strength with it. And that really bolsters some of what Bill was talking about when you're looking at interest coverage. There's still a lot of cash on corporate balance sheets. They have been prudent in how they manage it and how they choose to deploy that cash. But for now, I think the credit fundamentals and balance sheet management has been really responsible by corporate entities.

**Katie Klingensmith** [00:14:47] Well, let me stay with you, Andrew. There's this term around liquidity walls, and if we could hit them. What does this mean? And do you feel like this is a danger going forward in credit markets?

**Andrew Bogle** [00:14:57] So, this is essentially the pace and rate at which debt is coming due within the high yield market. How quickly companies are going to be forced to have to either refinance debt or find other ways to secure debt. And what we've seen and maybe might be different this time around is, Bill was talking how people have access to capital, but ever since the change in monetary policy and the policy rate increases that we've seen, we've seen much less of a willingness to go out there and get that capital, particularly in the high yield market. And so in response to COVID, when rates were zero, you saw record breaking issuance of high yield paper in 2020 and 2021, to the tune of \$400 to \$500 billion annually. The last two years has seen that number recede significantly, issuing about \$100 billion in '22 and just over \$100 billion so far in '23. So, that significant slowdown in issuance as firms reject the desire to lock in some of these higher interest rates on debt has changed the dynamic of that maturity wall and have brought it closer than it's ever been. If you look at the average time to maturity for the US Corporate High Yield Index, that data point is currently at four and a half years. Where historically it ran something a little more comfortably at 5 to 6, closer to 6 on the historical range of average years to maturity. And so that is something that we look at as kind of a ticking clock of, yes, these corporations, as they stand today, have been responsible and manage their balance sheet well. But it is only a matter of time. And time will only continue to march forward until these companies are forced to reconcile and deal with the higher interest costs on refinanced debt going forward.

**Bill Zox** [00:17:01] Can I just add one point to that, that I've got to give credit to John McClain who's been making this point. The bonds that will be addressed first are not those

real low coupon bonds that were put in place in 2020, 2021. Those were mostly 7 to 10 year maturities. So, they're still a number of years out. What we're really talking about addressing right now, the '25, '26 maturities, are more likely 7 to 10 year bonds that were put in place in 2017 and 2018. So, the coupons, you know, might be somewhat higher depending on how the company itself has progressed over that period of time. But it's not like we're going from three-handle coupons to nine-handle coupons for most of that refinancing that will be done over the next couple of years. You also have, you do have some 2020 at the very early stage of the pandemic. You had some very high coupon five-year bonds that were issued. So, some of those will be addressed, but they're not the three- and four-handle high yield bonds. Those are much higher coupons from the early stages of the pandemic.

**Katie Klingensmith** [00:18:17] There's a lot of other things I want to cover, but I just briefly want to bring in Andrew, in terms of liquidity overall. And there's been a lot of conversation around private credit markets maybe having less liquidity now than they did and impacting public markets. Is that something that matters to what you're doing?

**Andrew Bogle** [00:18:33] Oh, sure, it certainly does, Katie. The growth of the private credit market has been incredible over the course of the last 5 to 10 years, arguably growing from a nominal size of, you know, maybe \$50 to \$100 billion to now rivaling the size of the public high yield markets, with public debt, sorry, private debt currently sitting at roughly \$1.2 trillion. And so in an odd sense, this has actually helped the high yield market in terms of its structure and fundamental players who are in this market. You have to remember that the players in the private credit market are there for a reason. And that they generally can't access deal terms that they otherwise would desire in the public high yield market, so they go to a private issuer of credit. And so that's actually helped the health of the public high yield market, resulting in generally higher quality mix of bonds in the high yield index. So, the private market is something that we watch closely, although it is challenging to watch and have a great read on what's happening on the day to day. But we do get insights into the private credit market by watching some of the publicly traded business development companies. These are the companies who are ultimately in the private credit game, who are offering loans to these corporations, and the larger public entities are reporting on their books. You know, all of the hundreds of line items of loans that they're making and the current status of these loans as well. And so one of the metrics that we track closely to make sure that we are keeping an eye on private credit is what's called a non-accrual rate at a business development company (BDC). And this is essentially a count or a percentage of how many loans are in that private book that are currently not paying interest on their loan. And what's been really remarkable is that these numbers have remained healthy so far to date. You can look at both the larger and the smaller BDCs, but generally the non-accrual rates are low single digits and are not showing significant signs of uptick. And while that may seem counterfactual on its face. There is some concern that maybe that number is not truly reflective of the state of that market. The thing that's important to remember about the private credit market is it's almost entirely floating rate debt. And so these should be the corporate entities that feel the impact of a change in policy rate first and see their interest expense rise first. But these large BDCs are usually associated with other forms of capital as well, a broader pool of capital. And so while you look at maybe one BDC that may have a \$20 billion loan book, that broader BDC may have something akin to \$100 billion to \$200 billion of assets under management. And so we're curious if BDCs are getting creative in ways that they're finding to get capital into companies that otherwise wouldn't be able to access it. And so while we do keep a close eye and are somewhat surprised at the non-accrual rates in BDCs is as well behaved as it has been, we do take it with a grain of salt, and we're not throwing all of

our weight to say that that is the number giving you the all clear sign in the private credit markets.

**Katie Klingensmith** [00:22:13] I want to bring us to a close with just a couple of other final questions. I know that, Andrew, you work with the multi-sector team, and you look for information that's coming from equity and other financial markets when determining if you want to be in credit and where you want to be in credit. Just sum it up in a broad relative sense of, given all of the risks and the potential opportunities, what do you like right now?

**Andrew Bogle** [00:22:37] In various areas of the credit market or in the equity market, I should say, really the big theme that we're watching for is essentially when a consumer has run out of money. This is a really big theme on the back of COVID. Everybody knows that there was a very large transfer of wealth from the government to the private sector, and every third-party sell-side shop has their chart that shows how those excess savings are drawing down and when those eventually cross the x-axis and go below zero. And so, what we're really trying to pay attention to in the equity results and the earnings calls that we're listening to is just how healthy the domestic consumer still is. If there's been any shift in spending preferences to lower-cost goods or lower-quality goods, if there's been any real change in what management teams are telling you about their forecasts for sales and top-line revenue numbers. And as Bill alluded to earlier, there has not been any serious red flags that jump out and say we are at or very close to the bottom. The consumer has remained very resilient throughout the cycle and has not given any indication that those excess savings are essentially gone or very close to gone. And so, we like to watch again the major consumer-focused equity earnings releases as a broader indication to what's happening in the macro framework. And so, it leaves you with the question of looking at this stuff, what do we like? And I would say that still, for the time being, although I agree with Bill, that we are starting to get, see some late-cycle indicators, we do still like high yield credit, and we do think that it's an asset class that can earn you a good total return for the time being. But we are keeping it on a tight leash. As Bill mentioned, we would recommend positioning to be more of a conservative stance, whether it's a higher in quality or shorter in duration asset within the space. But for the time being, with the yields that you're being offered within high yield, we think an allocation is warranted.

**Katie Klingensmith** [00:25:01] Bill, let me let you react to that from an overall perspective but also if there are some sectors that you're particularly watching.

**Bill Zox** [00:25:07] I do think we're late cycle, and I do think a recession will likely end this period, but that does not mean that I don't like high yield. We are late cycle. Let's focus on the, I would say there's 85% of the high yield market--it has very little chance of defaulting in the next cycle. Some might say, you know, you could say this is going to be as severe as the global financial crisis. I don't think that's anywhere close to being the case. But even in that case, you have 75% of the market that's not going to default. So focus on the 75% of the market that is least likely to default. And you're talking about yields of 7 to 10%, sometimes even higher in that part of the market. You can do it with a duration, the whole market has a duration of 3.6, and you can find these opportunities on the front end of the curve, five and a half years in, which is a very attractive part of the curve, especially in this environment with the inverted yield curve. The dollar price of the whole market is in the high eighties. That's very unusual and most of the time, definitely post-GFC, virtually all of the time the high yield market has been trading above par. So, to be able to invest in a market that is priced on average below \$0.90 on the dollar gives you much more price appreciation potential relative to price depreciation potential--very attractive. The one place where people do get hung up is in the spread, and the spread is not what you would

expect. If you're thinking about what we saw in the early 2000s or the GFC or, you know, the rules of thumb that were developed in those environments. As I said before, I think defaults this cycle will be half of what we saw in those cycles. So maybe 10 to 12% over a 2- to 3-year period of time, which is much more of a normal default experience than 20 to 25% over 2 to 3 years as we saw in those prior cycles. So, I think there is plenty of opportunity in the high yield market right now. It's important to steer away from defaults, but it's not difficult to do.

**Katie Klingensmith** [00:27:33] So just wrap it up for us, Bill, I'll let you go first. That's a pretty clear roadmap for how you'd position right now. Catalysts that would make your views or the market change going forward?

**Bill Zox** [00:27:47] Yeah, I mean, I think it's difficult. As I said earlier, I think the first signs are typically in financial markets. You know, it could be in the credit channel, could be in the real economy. But I think more likely we'll see those signs in the financial markets. And really, I think the equity market is kind of in the driver's seat. The outperformance of equities relative to any other financial assets since, you know, say the pre-pandemic period and certainly post-pandemic. It's so extreme that as one example, we've seen pressure on equities over the last couple of months when real Treasury yields moved much higher. But high yield has hung in there reasonably well compared to equities. And I just think it's because that equity cushion is so large that it's going to take a material move down in equities and put pressure on credit spreads, and I just haven't seen that yet.

**Katie Klingensmith** [00:28:54] Andrew, I'm going to give you the last word about anything that you're particularly watching that's going to change the opportunities set.

**Andrew Bogle** [00:29:01] Yeah. One area we haven't discussed yet today, but I think is critically important is the labor market. And for me, things will go okay until you see a significant change. And when I say significant change, I mean weakness in the labor market. It's been incredibly resilient thus far. You had maybe a couple head fakes earlier this year with some higher-than-expected initial claims reports, but the most recent have rescinded back down to something like a 200,000 run rate on a monthly basis. And it comes back to the consumer and how much money the consumer has left to spend. And a lot of that money is derived from their jobs. And as long as the consumer still has a job that's paying on a regular basis, we expect conditions to remain relatively tame. And so we're watching the labor market very closely and employment conditions.

**Katie Klingensmith** [00:29:54] Obviously a lot to watch, a lot that you're watching in the macro and in financial markets and the clues that we get from that. Thank you so much to Bill Zox and to Andrew Bogle for joining us today at Brandywine Global's Around the Curve Credit Roundtable. Look forward to talking to you and others next time.