Audio Transcript: Credit Roundtable: It Pays to Be Patient
July 26, 2023

Katie Klingensmith [00:00:00] Welcome, everybody, to today's conversation as part of Around the Curve, Brandywine Global's podcast talking to many of our experts across the firm about different events and topics going on in fixed income markets. I'm Katie Klingensmith, and I am pleased to introduce three of my colleagues as part of an ongoing set of conversations we're calling the Credit Roundtable. All three of these folks are members of the Brandywine Global Fixed Income Team, but they have different areas of expertise. I'll first introduce John McClain. He is focused on credit, high yield corporate credit strategies. He's joined by Renato Latini, who is an associate portfolio manager, focused more on the global strategies. And his colleague, we have Kevin O'Neil, who is an analyst and can provide some more insight on the specific sectors. Well, welcome the three of you. Lots to cover today, and that certainly is no surprise given that 2023 has started out a pretty wild year. Just before we get into the specifics, I want to bring Renato in and get us started on what's going on with the overall macro backdrop. What has shifted this year? What surprised you in the rates environment? How have you understood 2023?

Renato Latini [00:01:18] We've come from a period of exceptional accommodation from a fiscal and monetary standpoint for post-COVID to a period where global central banks are extremely focused on inflation, and inflation ran well above target. Still is, but we need to keep in context that central banks are still in this normalization process. And I think that's the word we would use to describe the current macro environment. We're still normalizing through a kind of a messy and noisy process, but the efforts of central banks globally to tame inflation, I think, are starting to take hold. We're starting to see some signs that that inflation environment is moderating quite a bit. Job market is still healthy. And when you think about the balance sheets that expanded versus the ones that were pretty responsible during COVID. You know, we had plenty of high yield management teams we can point to that reduced gross debt. We've got a consumer that didn't necessarily lever up or come into this with a great deal of leverage. That was really the sovereign that took on the most debt through this cycle. The Fed bought a lot of bonds from the US government. One of the economists that we like to follow highlights that some of the losses in the rates market carnage that we saw last year have been socialized and sit on the Fed's balance sheet rather than beating up the consumer as you would have seen in normal rate cycles. So we've got an economy that's been largely rates insensitive. We think that those lags of monetary policy are starting to take hold, and we're starting to see it come through in the data at this point. But still in this process of a noisy normalization from a period of exceptional accommodation.

Katie Klingensmith [00:02:56] Any specific read on what the Fed will be up to next?

Renato Latini [00:03:00] I think the market's giving the Fed another hike. They still have credibility on the line being quite late to the game to start to tighten policy after inflation was running hot. So I think for credibility purposes and to anchor long-run inflation expectations that the Fed's probably got another hike in them in the July meeting. It needs to maintain that credibility. I think they've done a good job of taking out rate cut expectations, which I think was a major goal for the Federal Reserve for this year.

Katie Klingensmith [00:03:29] Well, I want to bring Kevin into this. We've given this a start with the macro and the Fed. How would you characterize what has happened and where we are generally with credit markets?

Kevin O'Neil [00:03:39] If I think about where I, my outlook at the beginning of this year was fairly sanguine versus where we are now. Profit margins have relatively stood up fairly well in the face of record tightening. And so now my prediction maybe been, and I think a lot of people's prediction has been pushed out in terms of hard landing, But you're seeing that with inflation coming down, job market is still strong, and fundamentals are still in place. You see a higher probability of a soft landing being able to occur. That's probably not where I was at the beginning of this year. But now I see that a chance of that happening where I thought it was a low probability at the beginning of the year.

Katie Klingensmith [00:04:20] So, John, I feel like this is a moment where you can do a little bit of I told you so. You and team came in 2023 with a pretty optimistic view of high yield opportunities. What would you add in terms of what's going on with credit, especially high yield, and what's shifted so far these first six or seven months of '23?

John McClain [00:04:41] Sure, Katie. We've been very positive on high yield dating back to really the end of 2Q of last year. And at that point, we started to see yields reach 9% and spreads in the high 500 range. That's an attractive entry point into the asset class, given the fact that corporate balance sheets are strong, and corporations were sitting on excess liquidity. They weren't able to deploy it during COVID. And therefore, we don't see a meaningful pickup in defaults anytime soon. And what's particularly interesting as we stand here today with the S&P 500 north of 4500, we've had a very limited drawdown since the beginning of 2022 in equity markets. Meanwhile, high yield's doubled in yields from a little north of 4% to almost eight and a half percent. And so we feel like the yield is compelling, and the asset class is levered towards the front end of the yield curve. And given the meaningful inversion that we're seeing, we want to lend to companies short as opposed to long right now, given kind of the uncertainty that we're seeing with the macro backdrop.

Katie Klingensmith [00:05:52] Perfect. And there's there's so much there, John, that I want to unpack. I'm going to let Renato react to this one first. John just mentioned that there's really nice carry. There have been really nice yields. But there have been across all sectors of bond markets because the curve, especially on the short end, is just so much higher. How much of the opportunity that we're seeing right now is really fundamentally about the underlying curve, and how much of it is about spread sectors?

Renato Latini [00:06:20] I think since last year, as John had mentioned, you had a big increase in yield. So a lot of that heavy lifting was done through the dollar price, not necessarily the spread. Spreads did widen, as John highlighted. So you have had spread ightening, certainly, and the yield curve is influencing what kind of yield you could get. But just keeping in mind that that macro backdrop, the degree of tightening the Fed's undergone over the past 12 months, it's time to pick credits here, not just necessarily have a broad allocation to high yield. Really be thoughtful about where you want to allocate capital. And so if we do have this uncertainty, those front end credits John's highlighting, with strong balance sheets and management teams, can weather 200, 300 basis points of spread widening from here and still give you a positive total return on a 12-month basis.

Katie Klingensmith [00:07:11] John, what would you say yield or spread that matters more?

John McClain [00:07:15] Well, you've got to focus on both. And really what again is particularly interesting is you would argue that, hey, with spreads at 400 basis points, that's historically a little bit snug. But given the balance sheets that we see in the high yield asset

class are reasonably strong, given the index construction is geared towards the double B portion of the market, given the fact that corporations in the high yield space borrow fixed as opposed to floating, we feel very comfortable with spreads at 400 basis points. And more importantly, the eight and a half percent yield that you're getting in the asset class given the front end curve inversion. So both things matter, and we would think that what you've seen really this year is a microcosm of what we've seen over the past five years. If you've invested in core fixed income in the Agg-like products, you've earned less than 1% over the last five years. And that's really not keeping up with inflation, that's not keeping up with purchasing power. So you need to take a bit more credit risk, particularly where it's compensated reasonably. So, in high yield, and you can generate returns that keep up with inflation, keep up with purchasing power. And high yield over the past 12 months has been one of the few segments within fixed income where the yield has been above inflation consistently.

Katie Klingensmith [00:08:40] But I want to push back a little bit on that eagerness to take some risk. We've just established that there's a lot of uncertainty about what the Fed will do over the next couple of meetings and what the rest of this year will look like. You can still make the case for those short duration exposures in the high yield space?

John McClain [00:08:59] Absolutely. What we're trying to do is isolate the number of variables that are going to impact the credits that we invest in. And by shrinking the time horizon, you eliminate many of the forward-looking variables, both macro and micro. And given the fact that we see relatively flat credit curves with this inverted yield curve, there are still a meaningful amount of opportunities in the front end of high yield. The other component here is that typically there would not be as many options that we have seen, but we have seen limited refinancings in our marketplace over the past 18 months, which has left a number of issuers with debt outstanding two, three or four years out, when typically those bonds would have been refinanced in a lower yield type of environment.

Katie Klingensmith [00:09:44] So even with the upsurge in bankruptcy, Chapter 11s at their highest for more than a decade, you're not worried about it?

John McClain [00:09:52] Well, that's an interesting stat, right? So the past decade, we've really only had COVID in terms of a true default cycle. You've got to really go back to the GFC. And that's one of the things that's important for our listeners to understand is our expectation around defaults is that they will tick up. If you look at high yield, leveraged loans, and private credit, defaults are running somewhere between 1 to 3%, depending on where you're looking. That's relatively low. It's below the historical average. So, if you're below historical average, certainly, you're going to converge to that average level over time. But we do not see a meaningful default cycle. We had one in 2020, so a number of the weaker credits within the high yield asset class filed for bankruptcy, reorganized with a cleaner balance sheet, and they're not going to file again. Additionally, what's drawn down in high yields over the past decade was really energy. And those companies have pristine balance sheets at this point in time and a very different commodity backdrop. They're focused on free cash flow, not growth, and that's very helpful from our perspective. And the last thing that I would highlight is the depth and breadth of liquidity sources available to businesses that have a reasonable business prospect going forward. It's not just high yield bonds, it's leveraged loans, it's private credit, convertible debt markets, equity issuance, and a lot of creativity from CEOs that we saw during COVID. You securitized anything that wasn't bolted down to the ground. And so it wasn't just hard assets. It was things like intellectual property that were being securitized. And we think that we're going to continue

to see this creativity. So there will be access to capital in some form or fashion. It's just going to be more expensive.

Katie Klingensmith [00:11:38] There are a lot of somewhat unique factors coming together. And I know Kevin talking to you, one of the big trends that we've been watching is what's happening with the consumer, and how that influences the health of a lot of these corporations. Bring us up to speed there.

Kevin O'Neil [00:11:55] Sure. So, yeah, I've been very focused on the consumer, not only from the companies that I like to follow, but also how it relates to kind of the domestic economy. In fact, I think when you think about what caused this inflation surge originally, it was obviously supply chain issues and then combination of the Russian invasion. But then I think what prolonged it a bit more, certainly fiscally supported, was the strength of the consumer and the consumer spending. So, when that pivots to becoming inflationary to disinflationary, which I think we're very close to, is what I'm really trying to track--when that turning point really occurs. So, what do I see right now? Broadly in aggregate, consumers are still strong. You know, Renato talked about kind of where your debt-to-income levels are. You didn't see a huge amount of leverage up at the consumer level. Checking account, saving balances. They're still elevated versus pre-COVID. And now you're and plus they've gotten wages, right? So, you've had higher, gotten job gains, and so now your disposable income has increased. So, that's the positive. Where do I see cracks? I follow a lot of the card spending because even though you have these savings, doesn't necessarily in turn mean they're going to spend them. We have seen kind of mixed results with the, and you saw that with the retail sales where the growth of the spending is maybe moderating at still elevated levels, but the growth isn't there. And we're starting to see some strain in maybe the lower-end customers. Where delinquencies at an aggregate level are maybe normal, you're seeing them start picking up at and at the growth rate that could be concerning at this point where the lower-end consumer could start to be in trouble, especially against these higher interest rates.

Katie Klingensmith [00:13:46] So given what John was explaining around where we are in the credit cycle and given those consumer dynamics, you had noted before that you think that it's really a time of picking names. How do you see the bankruptcy cycle and the fundamental credit risks right now?

Renato Latini [00:14:02] Start with balance sheet stewardship through the COVID crisis as your starting point. When you see companies that reduced gross debt, not just hoping for an EBITDA uplift to delever, that's probably where you want to take your first cut. I think some of the problematic sectors that we've seen before, that we've already talked about. Energy, some of the metals and mining names that are now focused on free cash flow rather than growth is a good starting point as well. And focusing on that front-end paper, 7 to 9% yields, scope to weather wider spreads and still give you positive total return on a 12-month basis is a good place to start. When you look at equity market cap cushion for those names, it's substantial versus the debt burden on the balance sheet as well. And you've already been rewarded for that, but still wanting to harvest those yields in this environment, not ignore them, even though you may want to be not just blindly dipping down the quality or grabbing some some triple C beta. There are good names to be found, I think, within the high yield universe, plenty of them. And you just want to focus on that management team, balance sheet stewardship, and focus on free cash as opposed to growth.

Katie Klingensmith [00:15:20] So not necessarily too high, too hot to touch, but definitely matters what the individual company, how their structure, their financing needs. So I want to bring John back in here. I understand that there's some similarities across high yield markets in issuance with leveraged loans and private credit, but some very different sets of risks. John, what's going on across these different spaces?

John McClain [00:15:43] Yeah. Despite the fact that all three of these asset classes are considered below investment grade, they're very different at this point in time. So if you think about high yield, what we see is kind of more of a large-cap bias towards the types of businesses that permeate our marketplace. You're dealing with companies with multiple hundreds of millions to billions of dollars of EBITDA, traditionally more public focused as opposed to private equity sponsored, and borrowing fixed as opposed to floating. Additionally, what we would say is the sectors that permeate these asset classes are materially different. We see much more energy exposure, commodity exposure in general in the high yield space, where you see more of what we consider to be the problem sectors permeate leveraged loans and private credit, and that would be TMT, which is technology, media, and telecommunications, as well as healthcare. The other main difference would be if you think of leveraged loans, that looks more like high yield did post-global financial crisis and would be more of a mid-cap type of marketplace and much more private focused with more floating rate exposure. And certainly with the amount of heavy lifting the Fed has done, those base rates have changed materially. And so go forward interest coverage looks a bit challenging in the loan space. And then when you go to private credit that looks like what high yield did pre-GFC. You're dealing with much more middle market types of entities, smaller types of businesses. And again, we see even more of the troubled sectors in those spaces. And what I would say, too, is that with the public companies, there's a lot of discipline that is created from public markets. You see a company with their equity down 50 to 70%, or a bond getting downgraded. Typically, that's a catalyst for a management team to react. Maybe they slow down share buybacks and dividends, maybe they focus on balance sheet repair. You can't see any of this in the private credit market. It's extremely opaque. There are no ratings, there is no public equity to monitor. So, I think what you will eventually see over the next 6 to 12 months is a very quick change in the underlying fundamentals of that asset class.

Katie Klingensmith [00:18:03] They're really different animals. Well, a related subject just around liquidity and where people are issuing, and I want to bring Kevin back in here. I know you have focused for a while on credit walls, and where there will be refinancing risks. We haven't talked about this recently. What's the update here?

Kevin O'Neil [00:18:21] I think you can relate it to John's response where because you had such a large issuance of debt in '21 at a record low, you're not seeing the interest, the interest coverage is still elevated versus the leveraged loan market, which is already feeling that tightening cycle. So, while I guess the argument for the extended maturity wall is maybe not as big of a, you know, that was very much a 2022 argument versus a 2023, which is probably more normalized. But normalized isn't necessarily bad. If fed funds rates have to remain above five for the next 2 to 3 years, now it's a different circumstance. So, because you had such a great issuance at low levels, the cost of capital hasn't flowed through like you've had seen in other markets. So, it's still a positive, but maybe it's normal versus last year where it was really extended.

Katie Klingensmith [00:19:16] Fair enough. All right. Well, I want to take us over to thinking about some relative opportunities in some of the multisector or at least strategies that allow for elections across different credit qualities. And Renato just to bring you in

here first. When you look across all of the credit space from a multisector perspective, what do you like?

Renato Latini [00:19:36] Yeah, I like front-end high yields, as this pertains to credit, I like front-end high yield with that 7 to 9% yield bogey, strong management team, and a balance sheet focused on free cash that can weather that 200 to 300 basis points spread widening. Within IG, belly credits as well. I think the sectors that we're focused on more so are going to be those energy, metals, and mining names consistent with the strong management teams, balance sheet stewardship.Within IG, if we're talking about 10 year, 30 year, spreads are tight. So, if you want that duration exposure, our preference probably is for developed market sovereigns, rather than taking that exposure through IG. And then we do have some local emerging market rates stories that have played out very well. These are, particularly in Latin America, these are central banks that were really aggressive on hiking rates as inflation was increasing, very proactive, not waiting for balance of payments crisis or an extreme FX deval before trying to get ahead of that. So, that's where we're thinking of allocating our clients capital at this point.

Katie Klingensmith [00:20:48] I want to come back to that global in just a second. But first I want to bring Kevin in to react to see if there really is any juice in IG. We've been talking a lot about high yield, but can we justify some investment grade exposure with spreads where they are?

Kevin O'Neil [00:21:00] I would say yes and no. On an absolute yield basis, yeah, I think there's opportunity. And in some cases, I feel more comfortable going triple B versus double B, where the valuations in high quality high yield may not be, justify the risk there. So, I think, we're still underweight spread duration. I don't think you want to extend yourself too far down the curve within credit or in IG, but front-end carry bonds, I think there's opportunity there. And maybe waiting for a better chance where you see further spread later in the year or next year. But to hide out in yields that are 6% plus isn't a bad thing in investment grade.

Katie Klingensmith [00:21:39] Not a bad thing. John, do you find opportunities in investment grade?

John McClain [00:21:44] We're finding opportunities everywhere, frankly. What's interesting is I would say, yes, front-end high yield makes a lot of sense. But to Kevin's point, when it comes to the rel val between high quality double Bs that are being bid up as our market is high-grading their portfolio versus what we're seeing in Triple B land, there certainly are opportunities, particularly in the 5 to 10 year part of the Triple B marketplace and investment grade. We're also seeing opportunities in select emerging market corporates and in the convertible bonds space as well with the legacy zero coupon busted converts offering very attractive opportunities in names that don't permeate the high yield marketplace.

Katie Klingensmith [00:22:32] John, I understand that you and your team have continued to favor some financials. Is this still the case? And does that mean that you essentially think that the banking crisis in the US is all finished?

John McClain [00:22:46] We certainly did have banking exposure going into the banking crisis, and we have maintained that. What we started with is risk mitigation, where we re-underwrote every credit portfolio, assuming that banks were going to pull back meaningfully from lending on a go-forward basis and would be focused on building their

balance sheet and have time to deal with the increased regulation that we believe is going to come. But then we moved towards opportunity identification. And what we saw there was a number of opportunities to take advantage of non-bank lenders, things like mortgage originators or servicers, you could think of. We certainly like a number of the credit card banks as well that don't face flighty deposits. They're already paying market rate for deposits. And so we certainly do see a number of opportunities in the diversified financial space. And we believe that this will continue to be a very attractive opportunity.

Katie Klingensmith [00:23:43] All right, Kevin, we've talked a fair amount about sectors and emphasized that even though there are some broad influences that make the sectors more or less attractive, the individual names matter more. But broadly speaking, are there sectors that you particularly like right now and others that you're avoiding?

Kevin O'Neil [00:24:01] Wel, I think we're probably reiterating what both Renato and John said in terms of sectors that we favor: energy, more cyclical tilt. Energy, the capital discipline there, and the fact that even if we do come across a global slowdown, we do think energy prices will be, remain somewhat supportive. What I'm avoiding? It's tough to say. I almost have a quality tilt versus a sector tilt where maybe I'm avoiding maybe a lot of the triple C issuers, although they've done very well in the last month. I'm not trying to catch that, catch the tail end of any type of market rally. I mentioned maybe the higher quality high yield as well as maybe something I'm avoiding. So, sector-wise, I think there's opportunities if you find the right company, I think. But you have to be careful with your credit quality at the moment.

Katie Klingensmith [00:24:55] Renato, you mentioned before that one of the spaces that you and team like right now is emerging markets, that you've seen some really attractive opportunities in Latin America. What can you add about global or regional perspectives, where you're seeing interesting ideas?

Renato Latini [00:25:12] I still think it's the, from a credit perspective, I still think it's the US. There are select emerging market issuers that I think offer value, again, consistent with the sector outlook that we've talked about. From a global perspective, credit faoring the US, picking spots in EM. And I think it's just taking advantage of that US yield curve here. And you don't have to reach for yield to generate strong income for investors at this point. We want to take advantage of that.

Katie Klingensmith [00:25:44] John, what about you? You have some global strategies. Are there other things that you think are interesting outside of the US?

John McClain [00:25:51] Absolutely. Especially when you look at, for example, if you look at the sterling market, and you look at that curve relative to the US. There's opportunities in both high yield and investment grade sterling-denominated paper where you can pick up material yields as well, as long as you're willing to sacrifice a bit of liquidity. And then on the European side of things, not only are we finding attractive opportunities in European issuers, but we certainly see a divergence between reverse Yankee issuance where we're seeing US companies' debt denominated in euros trades at a meaningfully wider spread relative to the US marketplace. So, that opportunity is particularly compelling because we do believe that that will reverse over the course of the next 12 to 24 months.

Katie Klingensmith [00:26:39] Alright. Well, I want to wrap us up and give each of you an opportunity to highlight what you think will be the most different the latter part of 2023 versus the first half of the year. I want to start with Renato.

Renato Latini [00:26:54] I think the biggest difference that we're going to see as we move through the year is going to be the interest rate sensitivity of the real economy to Fed policy. And I think we were largely insensitive in the beginning of the year. As we move through this, costs have been passed through to a lot of issuers, particularly in private credit, where your cap structure is all floating rate. And so I think we will start to see this normalization continue and eventually the impact of tighter monetary policy. I think it's been more supply chain normalization as we move through this year. Still having a resilient consumer. Wage increases still continuing at a clip above the level of comfort for the Fed. But I think, you know, as margins come back to Earth, we'll start to see things normalize. You know, we don't have to go off a cliff or anything like that. So continued favorable backdrop for fixed income assets.

Katie Klingensmith [00:27:53] Kevin, from your perspective, what will be different?

Kevin O'Neil [00:27:56] So, I hope that you're going to have that lack of fear of how high these fed funds have to go. We do predict that we're going to have, you know, a hike in July. That could be the last, I think early in the year. There was a lot of question where we're going to end the year. I think, you know, there's confidence there now that at least we're very close to the peak, given kind of where we've seen recent inflation measures. So, I look at it with that removal fear, I'm very confident to be in the front end, capture my carry, and be patient for a greater opportunity where you're actually getting paid to be patient, which doesn't always occur in fixed income. I don't have to take excessive risk to get a decent return. So, alleviating that fear on the front end I think makes me more confident that I'm not going to lose a ton of money in the front end.

Katie Klingensmith [00:28:46] So, a lot of macro. John, the final word.

John McClain [00:28:50] As Kevin said, you're paid to be patient at this point in time. If you look at the beginning of the year, investors were fearful, and the market was strong. Now investors are chasing performance, and they're going to be greedy. And I believe that the market is going to be particularly choppy in the back half of 2023. So patience is warranted at this point in time, given where valuations are across all asset classes.

Katie Klingensmith [00:29:14] Well, thank you so much, John McClain, Renato Latini, Kevin O'Neill for being part of today's conversation of Around the Curve at Brandywine Global.