

Audio Transcript: Credit Roundtable: An Interesting Place to Be May 23, 2023

Katie Klingensmith [00:00:00] Welcome, everybody, to our first ever Credit Roundtable as part of Brandywine Global's ongoing series of conversations, Around the Curve. I'm Katie Klingensmith with Brandywine Global, and I'm pleased to introduce three of my colleagues from the Global Fixed Income team. The first one is Bill Zox. The second, Renato Latini, and the third, Kevin O'Neil. While they all work in fixed income, they have very different perspectives. Bill manages corporate credit strategies, so he's going to have a lot to say about high yield and especially about the US credit markets. Renato works on the multi-sector teams, has a lot of research focus on the Fed and a history in looking at emerging market credits. And Kevin O'Neil is an analyst on the team and can give us quite a bit of detail looking at individual names and sectors and the liquidity and dynamics within the credit markets in the US. So with that, there's a lot to cover, and this year has certainly been a year of rather disorienting different directions in bond markets. Just get us started, Bill, with some level setting about what's going on with rates. The Fed just hiked once, one more time, maybe they're not going to hike again. It's hard to know with all the different Fed speak. Where do you think we are, broadly speaking, in the rate cycle right now?

Bill Zox [00:01:18] Sure. Well, I think the Fed wants to pause, and the market has discounted a pause. And breakeven inflation has come down quite significantly at this point. So, I think that everything is really set up for the Fed to pause. The bigger question from there, which Renato and Kevin I'm sure will weigh in on, is when do the rate cuts come? And I think that the market might be getting ahead of itself on discounting rate cuts. We're more of a believer on our team in a long pause and do not see the conditions for a rate cut right now.

Katie Klingensmith [00:01:55] All right. So, Renato, the Fed is under a lot of pressure. Do you think that there's the chance that they actually cut rates in 2023?

Renato Latini [00:02:02] The narrative is data dependence. And right now, I think we do have to take the Fed at their word here. So, with labor markets not necessarily being a great leading indicator, oftentimes unemployment is at its low prior to an economic downturn. I think the Fed still has to continue to talk tough. So, it'll depend on the degree of softness in labor markets that may occur later this year that I think will guide the Fed's cutting program if that does result later on in the year.

Katie Klingensmith [00:02:33] Well, Bill, you already told us that you're expecting a long pause. Obviously, everyone, including the Fed, is data dependent. What does that mean for credit duration?

Bill Zox [00:02:42] Normally, the front end in high yield, short-duration high yield, is a very dangerous part of the market, surprisingly. And there's two reasons. One, it's adverse selection. Really, there's usually a good reason why these high yield bonds have not been refinanced when they're close to maturity. And in effect, it's like picking up nickels in front of a steamroller to focus on that part of the market. But this time is very different, and there's actually a lot of very high-quality opportunities on the front end of the curve. And you combine that with the inversion on the Treasury curve and you're talking about very high single-digit yields with good high yield credits that have minimal risk of default. So, there are opportunities farther out in the high yield curve as well. But I really think it is a good time to focus on the front end in high yield.

Katie Klingensmith [00:03:42] Well, I want to bring Kevin in. And Kevin, I welcome your insights about where to be on that credit curve. But I'd also like to start getting some perspective on some of the recent dramatic news stories around stress in the banking sector. And if you think that this, the overall financial stability picture and growth picture, going forward could be seriously threatened by more questions around bank stability.

Kevin O'Neil [00:04:06] I think without a doubt the Fed action in both ways where you had banks had to contend with extreme easing policy for two years and then extreme pivot where you saw kind of the tight, the fastest rate-hiking cycle in decades. That's a lot for banks to contend with. I think banks had experience dealing with, kind of, the credit portion of their portfolio and managing that aspect, but I don't think they were prepared for such extreme volatility within the rate markets. And obviously, some were less prepared than others. And when I think about what would cause the Fed to cut this year, I think you have to look at some of these regional banks. And because I don't think that, at Renato's point, the labor market will deteriorate, you know, to that extent this year. So, it would really be stress within banking that I think would move the Fed's hand this year.

Katie Klingensmith [00:04:58] Bill, what do you think? Do you think the banking sector crisis is contained at this point?

Bill Zox [00:05:02] Well, I think the market does not have too much concern about the money center banks and the super-regional banks. And I think that makes sense. But when you get down below that, so call it the banks with \$50 billion to roughly \$200 billion in assets, the jury's still out on that. And I think that is potentially an area of great opportunity in the market, but also an area where, you know, if we have further flare-ups, the policymakers might have to get more involved to support the banking system.

Katie Klingensmith [00:05:39] A lot of questions on banking stability this year and other questions around the overall financial stability of the US and the global banking system, as well as other potential threats to growth. Yet, spreads are that wide. Bill, why not?

Bill Zox [00:05:55] Well, defaults are still very low. They're increasing, but they're still in the, call it, the 2% area in high yield in the US. And fundamentals are still very strong. Recoveries when there have been defaults have been relatively high. So, I just don't think that we've seen the fundamental picture in credit that would lead to higher spreads. It's very different when you're going from high inflation to low inflation than the cycles that we have seen since the early 2000s. And in a high inflationary environment, it's good for credit quality. You're servicing in the high yield market, in almost all cases, fixed-rate obligations with highly inflated assets and cash flows, and it makes it much more difficult to default.

Katie Klingensmith [00:06:49] All right, Renato, would you, do you think that the market is not seeing something? And these spreads are still pretty tight just because we haven't seen defaults yet?

Renato Latini [00:06:59] And normally after 500 basis points of rate increases from the Fed, QT and then a banking crisis, you would expect spreads to really blow out here. But I do think Bill is right in that the complexion of the high yield market is a lot different than it has been in prior downturns. Part of that interest rate selloff that we saw last year brought the dollar price of the high yield index down to below where it's been in prior periods of stress. And the maturity wall has been termed out. And when you look at the constituents of the high yield index, it is higher quality. And so, I think it's been pretty good debt management, liability management from these management teams in the high yield

universe through the COVID crisis, taking advantage of low rates and tight spreads and refinancing quite a bit of debt through that period. In addition to paying now gross debt, the high yield universe really hasn't grown much for years. That's been disintermediated in other parts of capital markets, like private credit. And so, I do think there's this sense of a healthier high yield market at this time. And that may be explaining why spreads are pretty well-contained sitting here around 500 basis points on the index right now.

Katie Klingensmith [00:08:12] Well that gets us right to something I wanted to ask Bill about. And you mentioned it earlier, liquidity walls. So, rates are a lot higher now. And if companies have to go back and refinance, it's certainly going to be a lot more expensive for them. Why is this not a problem? And frankly speaking, just overall, reacting to what Renato said, why have we not seen more spread widening given these recessionary fears?

Bill Zox [00:08:36] Well, we've been facing these issues for over a year now. So, the management teams of high yield issuers have had time to prepare for higher rates and recession, and they've had access to capital, whether it's in the high yield market, which has become more expensive, or the loan market, private credit, but also convertible bonds have opened up. So that's a market where you can give up some equity upside but buy your coupon down to a much more reasonable level. Or they've had access to equity, both public and private equity. So, the real important point is, is that they should be adapting to an environment with much higher rates for an extended period of time. So, they should be focused on interest coverage, not leverage. But they have time to adapt.

Katie Klingensmith [00:09:31] Kevin, I want to bring you in here around the liquidity structure in the high yield and corporate credit market. And also, if there are any specific reflections after this last quarter of earnings.

Kevin O'Neil [00:09:44] Sure. So, I'll say two things because I think what Bill highlighted earlier in the discussion was where I think Brandywine really sees value is in front-end credit, especially high yield, where the maturity well, let's say it really truly begins in '25, '26, maybe '27. It's somewhat normalizing, whereas last year they really extended. But to me, that's an area where because of the yield inversion, because you have greater visibility to the business model over the next two or three years, versus 5 to 6 years, and you have that kind of starting yield, to me, that part of that structures might have the best risk/return profile in all of bonds because you're not taking a lot of duration risk, but you're still getting paid, you know, a significant yield. And then kind of to tack on to the, kind of, the fundamental argument, you know, we've just, we're at the tail end of first quarter earnings. And by and large, these earnings have been fairly positive, or at least not as bad as maybe the expectation. And with that kind of uncertainty that's going along with the broader market from a bondholder's, we like that because that makes management teams more conservative where they're not extending and they're not putting forward a huge amount of CapEx because they're concerned with what's going on in the economy. And, you know, that might not be best for equity holders long term, but from bondholders, we like that mindset.

Katie Klingensmith [00:11:14] Renato mentioned that the high yield market really hasn't grown over a period of time. But I know there's been a lot of focus on issuance in the investment grade market. What are you seeing?

Kevin O'Neil [00:11:23] So, it's interesting. So, obviously we all read a ton of research and opinions from third parties. And I hear, I see a lot of headlines, "Spreads need to go

higher", you know, "Avoid credit", and maybe rightfully so. But if you look at, kind of, the trend in the IG new issue market, that's not reflective of all. You're seeing, I think, over half a trillion dollars have already been issued this year with concessions less than ten basis points. And the books are, you know, over three times covered. So, there's kind of a disconnect because there's still really strong demand when high quality companies come to the market. There's still a decent amount of demand from, for those type of bonds.

Katie Klingensmith [00:12:10] Obviously, liquidity has been a big focus this year. So, Bill, when you look at all of these different dynamics, and you have your choice among credit quality, are you liking investment grade or high yield more right now and why?

Bill Zox [00:12:23] You know, in general, we like high yield a lot better than investment grade because, you know, as Renato said, these spreads in high yield are right around 500 basis points. But you add that to a very high base rate, and you're talking about yields in the high single digits, call it an eight and a half to 9% range for much of the last year. And returns historically have been very strong in high yield from absolute yields at those levels. So, I think that is the best opportunity. In the investment grade space, we do find these regional banks, as I said earlier, call it, \$50 billion to \$200 billion in assets, a very intriguing opportunity. You have to be judicious, you have to be well diversified. But I know how that's going to end. Those banks will end with access to debt and equity capital, and I am sure that their spreads will be well inside of where they are now. Right now, some of those regional bank spreads for high triple B, low single A issuers are as wide as high yield spreads, and that will not persist. And if they do come under pressure, that's going to be even worse for other parts of the financial markets.

Katie Klingensmith [00:13:50] Definitely compelling math. Kevin, I want to bring you in here. If you have any additional perspective, going a step further, looking at sectors and some of the sort of issuance and liquidity dynamics within the sectors.

Kevin O'Neil [00:14:02] Yeah, I think, I think Bill, both Bill and Renato, you know, I would reiterate much of what they said, especially when you think about well, I don't think there's any so-called home runs to be had right now. But I do think what's most important on the market right now is to, kind of, avoid the major losses, the ones. And so, when I think about where I'm focused most on. These starting yields of 6, 7, 8%, even 5% in some of these IG, that's more than enough. I'm willing to kind of bide my time earning a decent yield for that greater opportunity or the home run, so to speak, where you really want to put risk to work. So right now, I'm maybe avoiding long-term spread duration because I'm getting paid to stay further up on the curve.

Katie Klingensmith [00:14:52] So, Bill, I know your investment process is a little bit different, and you guys are very focused on being in the markets and being really nimble and going in and out. But you mentioned your views on smaller banks in the US. Are there other sectors or spaces that you find particularly enticing right now?

Bill Zox [00:15:08] Sure. Non-bank financials is another area. It's, you know, these are the companies that will really benefit from what's going on in the banking sector. And we're already seeing it. We have some exposure to consumer, non-bank consumer lenders, auto lenders, even mortgage originators and servicers. And if you just compare their equity performance to the regional bank equity performance since early March, I mean, it's a huge outperformance. We're talking about like 10 to 20% appreciation compared to the regional bank ETF that's down in the high thirties since early March. So, the market has figured out that as the banks back off of some of these opportunities, it will become much

less competitive for some of these non-bank financials. And I think there's a very good opportunity in that part of the market as well.

Katie Klingensmith [00:16:09] All right. Well, Renato, I know in some of the strategies that you work on, you have a global view and can look at credit outside of the US. Are you finding interesting opportunities ex-U.S. right now?

Renato Latini [00:16:20] I think from, this is a bit beyond credit, but from a relative value standpoint, there are some pretty compelling local-currency emerging market stories where central banks, particularly in Latin America, have been really proactive on raising rates as inflation reared its head. They were early to this, not waiting for a balance-of-payments crisis or a large currency devaluation to start acting. And so, we think those local rate stories can present a pretty compelling valuation anomaly to take advantage of. It's a little more difficult to see in hard currency outside of the US at this point. Certainly, some of these US operators or developed market-based companies with operations in the emerging world I think could stand to benefit, particularly some of these commodity producers. But right now, the focus has been more US-centric.

Katie Klingensmith [00:17:12] Bill, would you add to this?

Bill Zox [00:17:13] In our high yield strategies, we don't really take currency risk. So, we're focused more on can we pick up spread and yield in comparable credits outside the US. And in some cases, you have reverse Yankee issuance where US issuers are borrowing in non-US markets, where you can pick up spread and yield. That's not, those opportunities are not abundant right now. But you do find them on occasion. And we're highly focused on looking for those opportunities. And as they present themselves, we'll take advantage of it.

Katie Klingensmith [00:17:50] Well, I want to do a couple of little roundtables. Lots of different things to keep track of here. I want to start with the bad news and go around and ask each of the three of you what you think could be the biggest risk to credit markets, to the macro outlook going into the rest of 2023. And with that, I'll go ahead and start with Renato.

Renato Latini [00:18:15] I think the biggest risk would be kind of a boom-bust cycle that we, the economy, experienced in the late seventies, early eighties, where the Fed takes their foot off the brake too early or starts a cutting cycle, and that really causes inflationary expectations to become firmly entrenched. I think that would be the biggest risk based on the degree of tightening we've seen so far, lending conditions. You know, there's reason to believe that nominal GDP should start to behave and come down here and with it inflation over time. So, I think it's really prudence from the central banks and also on the part of fiscal authorities globally that we're not engaging in pro-cyclical fiscal policy that makes the job of the central banks ever more difficult on the inflation front.

Katie Klingensmith [00:19:08] Yeah. Kevin, what keeps you up at night?

Kevin O'Neil [00:19:12] So I cover a lot of consumer-related businesses, and what you've seen over the past year is that a lot of them have sacrificed volume for price, which theoretically drives through or flows through into inflation. So why I don't think that'll be the case in 2023, we haven't seen that pullback yet. What will make them pull it back? Because of course they're going to want to expand their profit margins. But will the consumer push back? Now, if you look at what's driving the consumer right now, they still

have, you know, a large excess savings capacity, and they haven't really extended themselves. Now, where these excess savings are, they have a larger cohort which won't be, you know, more willing to spend. So that's the dynamic that I'm really watching, is will these companies continue to have the pricing power, which is good for margins, but will make that, the job of the Fed, that much more difficult and may, you know, keep rates higher for longer.

Katie Klingensmith [00:20:13] Policy overstep, corporate pricing policy. Bill, do you want to add to the doom?

Bill Zox [00:20:20] Sure. I mean, I'm going to return to the banks, Katie. But, you know, I think one key question is have the policymakers and the banking system as a whole, have they done enough to stabilize these issues? And if they haven't, then I think we'll have to see more pain in the financial markets for the policymakers to summon up the political will to do everything that they will need to do to stabilize the banking system. But I think it's very important that from this point on in financial assets, it's probably going to be felt more outside of the banking system. We've already priced in quite a lot into the regional banks, both debt and equity, that are under the most pressure. And it's possible that we haven't seen the last bank to go down. So that's very different. But I think broadly speaking from a portfolio standpoint, that part of the market will probably do okay. And if there's more pain, it's more likely to be outside of that in other risk assets.

Katie Klingensmith [00:21:29] I fear if I let you guys have another go at risks for the rest of the year, I'd get another list. So, I'm going to force us into the slightly more optimistic camp and start with Kevin. Where do you think we could see a big macro surprise or a big investment opportunity that we're not totally reflecting in the markets right now, or where folks are not really focused?

Kevin O'Neil [00:21:49] So from a macro surprise, you know, I mentioned the inflation risk, but I do believe inflation will come down even without a huge recession. I don't think a recession is needed to get to a 2 to 3% inflation. So, I don't want to say I'm predicting a soft landing, but I think that's a possibility where you don't have to see a huge destruction on the employment side to see those types of inflation as they hit their goal. Now, I don't think that will drive the Fed to cut rates this year because I think they want to stay, you know, somewhat conservative, that they don't have a reversal in that stance. But I think there is a possibility that spreads don't, we've seen the high in spreads back in October, and that things will stay positive for the rest of the year. I think that's, and then from a bottom-up perspective, I think that capital discipline that we've seen across many of these management teams will somewhat reduce the risk of spreads blowing out beyond what we've seen in maybe prior recessions. Because we're not, we're starting in a place of conservative rather than aggressive. So those are the two positives that I'm looking at right now.

Katie Klingensmith [00:23:00] Those certainly make them a very constructive case for credit. Bill, what are you, what are you seeing as a best case or positive surprise for this year?

Bill Zox [00:23:12] Yeah. I mean, I really would just reiterate a lot of what Kevin just said, where you're starting from a very attractive, absolute yield. And with the inverted yield curve and flat in some cases inverted credit curves, you can generate very attractive all-in yields in high yield at the front end of the curve. And I do think that when all is said and done, we'll find that if your old rules of thumb were based on high yield getting to spreads

of, say, 600 to 800 basis points and even wider, that you need to adjust that down by 200 basis points, so a range of 400 to 600. Sure, you can get wider than that for short-term liquidity reasons. But I think that we will find when all is said and done, that 400 to 600 really is comparable to 600 to 800 in prior cycles.

Katie Klingensmith [00:24:11] Renato, would you add something that you're, that you're looking forward to this year, or an investment case that's underrecognized for 2023?

Renato Latini [00:24:19] Yeah, I think we've come from a period of extraordinary accommodation from both a fiscal and monetary standpoint. It's when I'm trying to reverse some of those policies. You know, fiscal deficit is still running at a pretty negative level at this point. But the money side of things has tightened up quite a bit. What I would say is that maybe there's a bit of insulation for the consumer and corporate America from this policy tightening in that we don't have to see some sort of catastrophic recession as a result of that. This wasn't a balance sheet recession, if anything balance sheets got really cleaned up through the COVID process for both consumers and corporates. And so, coming into this potential downturn in better standing, I think will create a bit more resilience.

Katie Klingensmith [00:25:09] I think that's a lot of top-down and bottom-up reflections on why credit markets could be a pretty interesting place for the rest of this year and going forward. Well with that, thank you Bill Zox, Renato Latini, and Kevin O'Neil for joining me as part of Brandywine Global's Around the Curve Credit Roundtable.