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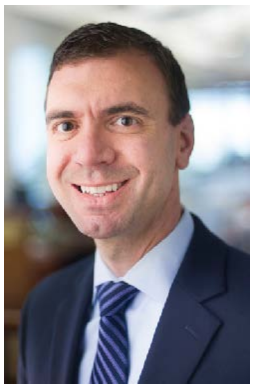
CRESCENT CAPITAL GROUP Q&A / SEPTEMBER 2020

But Wait, There's More!



John Fekete
Managing Director

John Fekete is Head of Capital Markets and leads High Yield as portfolio manager. He is a member of Crescent Capital Group's Management Committee.

We believe central bank support underpins the US credit market, fueling demand for higher-yielding assets such as US High Yield bonds, leveraged loans and structured credit. Constructive monetary policy and ultralow US government bond yields make it difficult to get bearish on credit. High yield spreads remain above the long-term average, and investors can expect 5-6% coupons along with spread tightening as the economic recovery takes hold. Credit risk has changed over the past six months, and defaults are elevated. We are seeing more of a bond picker's market today, where security selection will drive outperformance. Investors looking to corporate credit to boost returns in a world of zero interest rates may continue to be rewarded. John Fekete, head of Crescent Capital Group's Capital Markets team, discusses what is most likely to determine the future path of US High Yield returns.

Q: How has the US High Yield asset class performed since our last conversation?

Returns have been very strong since the Covid-led downturn in the first quarter when the ICE BAML US High Yield Index ("Index") returned -13.1%. The asset class experienced a sharp snap-back over the summer, recovering earlier losses and now showing a positive return year-to-date through August 31, 2020 of 0.75%. The Index Spread-to-Worst on August 31st was 506 basis points which is well below the March 31, 2020 level of 875 basis points but 134 basis points higher than where we started the year.

Q: Why is the outlook for credit brighter today than just 60 days ago?

The second quarter rebound was faster than many expected thanks largely to the Federal Reserve and US Treasury's swift policy responses to quickly restore stability to the functioning of credit markets. Our default expectations are lower today than they were in the second quarter. This is mainly because capital markets have been open to borrowers, and the equity market has been supportive. At present, markets are open to most single-B and double-B rated companies. Robust corporate bond issuance has been beneficial during the pandemic and allowed issuers to shore up liquidity to defend against the impact of Covid. Longer-term, it can become a cause for concern, but low interest rates make it relatively cheap for these borrowers to service and refinance their indebtedness.

We are also seeing green shoots in the US economy. Second quarter revenue and earnings have generally been much stronger than consensus expectations. There are signs of consumer strength in segments of retail, autos and housing. In another encouraging sign, Goldman Sachs recently updated its unemployment forecast, lowering it to 7% by the end of 2020 from a previous forecast of 9%. For comparison, that would not be too far above the historical average of 5.8% since 1948.

While we are growing more constructive, there are areas of concern. The worst of the virus looks to be behind us, but the risks have not been eliminated. We expect that there may be increased volatility around the US presidential election, but strong central bank support for capital markets is likely to limit or shorten the impact on corporate credit. Central bank policies, not defaults, are likely to determine the future path of US High Yield returns.

Q: Does the US High Yield asset class still have room to run?

There is still more room for improvement in the level of credit spreads. To put the current valuation into historical context, the Index spread today remains on the cheap side of fair value, currently higher than 55% of the time since 1996. While spreads are no longer as attractive on a historical basis compared to April, markets may not be fully considering what impact interest rates remaining at or near zero for years to come may have on increased demand for this asset class.

With a five-year risk-free rate today just over 0.25%, the Index spread of 506 basis points begins to look compelling, particularly if the Federal Reserve maintains its current policy path well into the future. At present, spreads are still considerably higher than where we began the year (372 basis points). There remains a case for additional spread tightening should defaults peak, as we expect, in the second half of 2020. The pace of ratings downgrade activity has slowed since peaking in the second quarter. US High Yield should outperform Investment Grade credit as the recovery accelerates.

Q: Which parts of the market look attractive?

The higher-quality portions of the US High Yield market recovered quickly. However, the recovery has yet to gain much traction in other areas. Today, we see value in cyclical sectors, some of which were among the hardest hit by the Covid pandemic, such as energy, local and regional casinos, and hotels catering primarily to leisure customers and less reliant on corporate and group business.

Triple-C rated credits are beginning to look attractive. We have largely avoided this segment for much of the year, but what's intriguing is spreads for this tier remain very cheap. At 1,094 basis points as of August 31st, spreads are cheaper today than 70% of the time over the past quarter century. While this represents the lowest-quality segment of the high yield market, default rates have stabilized and may be headed lower over the next 12 months, presenting a potential opportunity for investors.

We also see opportunities in structured credit in addition to upper middle market, narrowly syndicated bank loans. Tighter structural protections for investors, strong collateral packages, and higher coupons should provide outperformance versus larger, more broadly syndicated bonds and bank loans.

Q: What is your outlook on defaults?

According to JP Morgan, the trailing 12-month high yield default rate is 6.8%. The default rate has stabilized for the time being and may have peaked, with revenue and profits beginning to recover, and many issuers accessing capital markets to bolster liquidity. Home building and housing-related data has been a recent bright spot, suggesting the housing market may help to lead a recovery. It's important to note that not every Covid-impacted sector is showing improvement. Airline traffic appears to have stagnated, and airlines face considerable headwinds.

Q: What's the most important factor to producing top quartile performance in 2020?

Investment managers need to be nimble. They need to be able to minimize credit losses and also be able to fully participate in the market recovery. Value is shifting rapidly and investors need to be able to reassess new areas of opportunity. One of our tenets is to have an all-weather strategy that can generate above-market returns with below-market volatility in both positive and negative credit market environments.

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About Crescent

Crescent Capital is an independent, substantially employee-owned global credit investment manager. For over 25 years, the firm has focused on below investment grade credit through strategies that invest in marketable and privately originated debt securities, including senior bank loans, high yield bonds, and private senior, unitranche, and junior debt securities. Crescent Capital is headquartered in Los Angeles with offices in New York, Boston, and London.
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