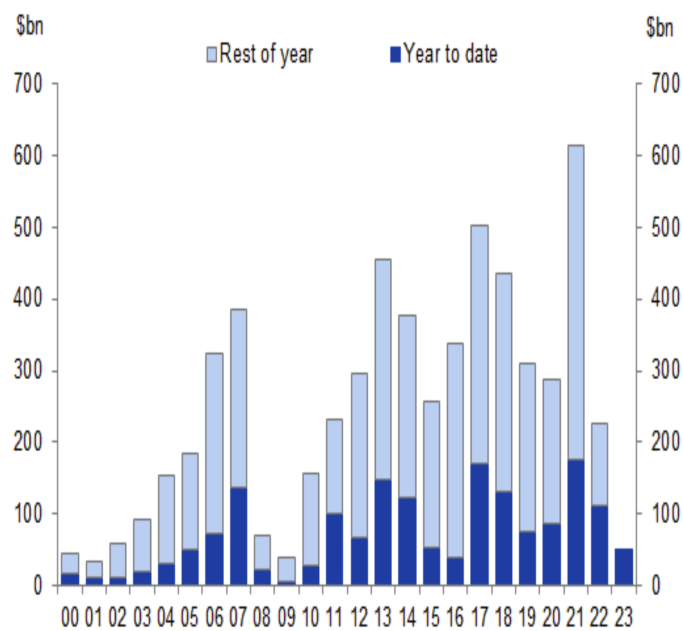
PUBLIC CREDIT

The high yield and leveraged loan market performed strongly in the first quarter on the back of positive investor sentiment towards risk assets. Specifically, the high yield and leveraged loan market was up 3.84% and 3.26% for the quarter. As we have discussed in prior letters, high yield has a much larger percentage of higher quality companies than the leveraged loan market as evidenced by the fact that BB issuers make up close to 50% of the market compared to just a little over a third before the 2008 global financial crisis. According to JP Morgan data, the 364 basis point outperformance of BBs versus CCCs for the month was the second largest outperformance gap since March 2020. However, both markets experienced significant volatility as a result of the turmoil in the US and European banking sectors. Spreads widened significantly post-SVB failure only to tighten modestly into month-end after the actions taken by governments and central banks to alleviate fears of broader contagion.

In fact, the primary reason that the high yield market was even able to generate a positive return for the month was the higher quality nature of the market. As we have discussed in prior letters, high yield has a much higher percentage of higher quality companies than the leveraged loan market as evidenced by the fact that BB issuers make up close to 50% of the market compared to close to just little over a third before the 2008 global financial crisis. In fact, the market was up 1.37% for the month as interest rate duration from BB issuers mitigated losses from the widening of spreads. According to JP Morgan data, the 364-bps outperformance of BBs versus CCCs for the month was the second largest outperformance

Figure 10. US leveraged loan issuances has ground to a halt after record issuances in 2021



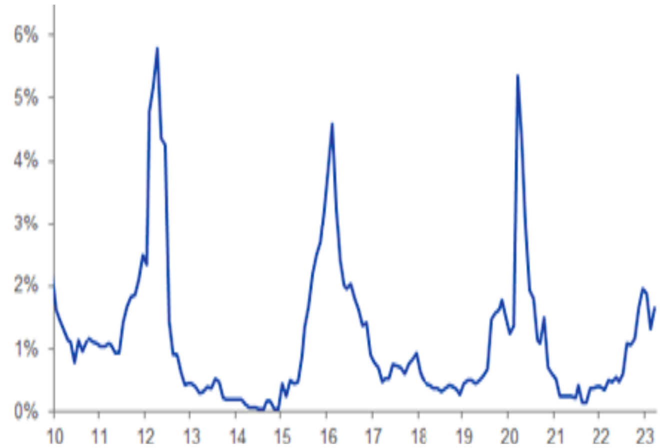
Source: S&P Capital IQ LCD, Goldman Sachs Research.

gap since March 2020. Leveraged loans, on the other hand, were close to flat as spreads widening offset income gains. Figure 10 shows leveraged loan issuance has almost come to a complete halt as CLOs, who are the largest marginal buyer, have seen their new issuance fall and investors remain cautious on the asset class.

MULTI-SECTOR APPROACH TO CREDIT INVESTING CONTINUES TO SHINE

Investors who have allocated to active public credit strategies that have the ability to pivot between leveraged loans and high yields have continued to benefit. These strategies were generally overweight leveraged loans in 2022 to limit duration as the Fed began increasing interest rates. Investors are now shifting their exposure from leveraged loans to high yield as the Fed nears the end of its rate hiking cycle and higher interest expenses as a result of the rise in short-term interest rates have put pressure on the fundamentals of leveraged loan borrowers. A large fraction of the leveraged loan borrower universe consists of private equity sponsored companies that were liberal in their utilization of the 'cheap debt' rationalizing that higher leverage was warranted, given that debt service costs were manageable when base rates were close to zero. Moreover, over 85% of leveraged loans are covenant lite which provides less protection for creditors and could exacerbate losses if there were to default. Figure 11 depicts the percentage of leveraged loans trading below $0.60 which has been creeping higher over the past several quarters as investors have become more discerning.

Figure 11. The percent of leverage loans trading below $0.60 has climbed but remains well below past peaks



Source: S&P Capital IQ LCD, Goldman Sachs Research.

A LOOMING DISTRESSED OPPORTUNITY?

The rapid rise in interest rates in the last year and the related drop in new issuance of high yield bonds and leveraged loans have dramatically expanded the opportunity set for distressed credit. At this same time in 2022, there were few names trading at distressed levels and today there are well over 100 issuers. Unlike past cycles which were restricted to secularly declining businesses or specific sectors such as energy that had more binary-like characteristics, current opportunities are incredibly diverse, as almost every type of company has been impacted by the combination of higher interest rates and reduced financing options.

The opportunity set has increased significantly with the number of issuers with debt trading at a yield above 15% that have substantial assets and whose creditors have much better prospects in a restructuring.

The last meaningful expansion of distressed liquid credit opportunities occurred during the early days of the pandemic, but it was short-lived, largely because of government intervention. We believe the opportunity building now will persist for much longer, because (a) the disruptions of the last three years have likely wrought economic damage that we're only beginning to see and (b) governments and central banks can no longer use unlimited stimulus to bail out economies, given the need to control inflation.

The business models, balance sheets, and valuation assessments of many companies were predicated on ultra-low interest rates continuing in perpetuity. We believe the failure of Silicon Valley Bank is likely to be a harbinger of opportunities to come in the credit markets.

Emerging Market Debt: Proceed with Caution

In 2022, based on widely used JP Morgan indices, the emerging market corporate high yield bond index and the emerging market hard currency sovereign bond index recorded losses of 10% and 16%, respectively – among the worst annual total returns for these indices since 1999. The causes were both internal – most notably the war in Ukraine – and external, primarily rising interest rates and elevated inflation in developed markets. While a few concerns have been resolved, such as those related to China's zero-Covid policy, the majority continue to remain.

However, the spreads of EM assets currently aren't reflective of bear market conditions. The current rally in EM sovereign bonds has seen valuations catch up with fundamentals and from here we see the rally facing headwinds from potentially higher US Treasury yields. Within corporates, credit fundamentals remain strong, but corporate buffers may be tested by the coming slowdown, with all sectors impacted by tighter liquidity. Aggregate leverage remains low, though we expect the number of issuers with extended balance sheets to increase going forward.

We believe that in order for these valuations to hold or even expand, a lot needs to go right. First, the economic recovery in China and greater Asia needs to continue unabated. Next, the war in Ukraine needs to be contained or, better yet, ended. And rising political risk in Latin America needs to be controlled. Moreover, EM assets could be subject to another bout of intense volatility if fears resurface about a potential global recession in the second half of the year or 2024. While we continue to monitor for pockets of opportunities, we remain cautious at best.