FS INVESTMENTS®

Q3 2021 Corporate credit outlook

Enjoying the ride

Halfway through the year, credit markets have been surprisingly predictable. Returns are almost directly in line with those we forecast entering 2021, technicals remain supportive and fundamentals continue to improve. We see few catalysts to change this strong market backdrop — but this environment creates new and unique challenges for investors.

Robert Hoffman

Managing Director, Investment Research

As Managing Director of Investment Research, Robert leads the team that analyzes the fundamentals behind market movements, macroeconomic trends and the performance of specific industries—as well as their potential impact on investors. His over two-decade tenure in the financial services industry includes experience as a loan portfolio manager and senior credit analyst focused on corporate loan issues. Robert serves as the firm's primary subject matter expert on the corporate credit markets and select alternative investment solutions, developing targeted communications and educational resources.

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Director, Investment Research

Kara is a Director on the Investment Research team at FS Investments, where she leads research efforts on the corporate credit sector and helps develop strategic education on liquid alternatives. She holds bachelor's degrees in Finance and Accounting from Villanova University and has experience investing private credit funds and in public accounting. Kara is a Co-Chair of the FS Women's Network and also volunteers with the firm's financial literacy and education programs.

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All data as of June 10, 2021, unless otherwise noted.

INDEXES

High yield bonds are represented by the ICE BofAML High Yield Master II Index, which is designed to track the performance of U.S. dollar-denominated below investment grade corporate debt publicly issued in the U.S. domestic market. Loans are represented by the S&P/LSTA Leveraged Loan Index, which is a market value-weighted index designed to measure the performance of the U.S. leveraged loan market.

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The COVID-19 pandemic ushered in a new era of unprecedented market moves and a seemingly endless amount of records. Within credit, markets witnessed some of the fastest and largest spread widenings, spread tightenings, inflows, outflows and countless other measures of market health. With the pandemic now (hopefully) firmly in the rearview mirror for domestic markets, a new environment has emerged for high yield bonds and senior secured loans. This environment is one where markets have been quite, well, predictable. And yet, at risk of overusing a word that was so in vogue nearly 18 months ago, the environment today is also unprecedented. Only five times in the past 34 years has the previous year-end yield to maturity predicted the following year's return within 200 basis points.

Key takeaways

- Credit markets have had a solid first half of 2021, with returns almost directly in line with those we forecast.
- The backdrop for credit heading into Q3 remains favorable given improving credit fundamentals, falling default rates and balanced supply/demand conditions.
- Spreads have nearly reached our year-end forecast. We anticipate returns being predominantly income based for the remainder of 2021.

It has been our experience that markets are normally not this boring. Inevitably something happens that shakes the foundation of stability that markets often crave. But roughly halfway through 2021, positive pandemic progress and a strong domestic economy have brought about a period of calm, stability and strength to credit markets. This poses a new and unique set of challenges for investors. One, tight spreads and low yields make finding returns more difficult, especially for passive or benchmark-constrained investors. Two, investors need to remain vigilant about where and how the next source of material credit volatility will emerge.

Market returns for the year provide one of our strongest examples of market predictability. When writing our Q1 and 2021 outlook, an environment when yields and spreads were marginally higher than where they are today, we noted that income returns for high yield bonds and loans would yield roughly 1.4% and 1.1% per quarter, respectively. When factoring in the potential for spread tightening, offset partially by rising U.S. Treasury rates, we estimated full-year 2021 returns at 6.8% and 6.7% for high yield and loans, respectively. After nearly six months, actual returns for high yield and loans are 3.11% and 3.15%, respectively. Accounting for another half-month of income between the time of writing and the end of June, the 6-month annualized returns for both markets are within 12 basis points (bps) of our estimate for the year. Again, we do not view this as a testament to our skills at forecasting, but rather an example of just how predictable the market has been. As we think about Q3, we see little to change our expectation that broad index returns will largely be driven by income, yielding a total return for high yield and loans of 1.4% and 1.0%, respectively. Capital appreciation, at least for passive, index-driven investors, is likely to remain severely limited.

While equity markets sit at all-time highs and credit market spreads are at or near post-Global Financial Crisis (GFC) tights, risks remain. We do not think that just because markets are at highs, they must be poised to fall; there have been multiple multiyear periods when credit markets maintained tight spreads. But markets remain exposed to headline issues that could upset the favorable narrative. Fed watchers are growing increasingly nervous as inflation statistics hit multidecade highs. Markets seem willing to believe the narrative that elevated pricing pressure is predominantly transitory, but any change in this view could cause a swift risk-off mentality to sweep across markets. The fundamental improvement in the underlying economy and credit metrics for companies would likely remain intact, but this certainly bears monitoring.

Other issues and risks are more specific to credit markets themselves as a function of rising risk tolerance and low credit spreads. When markets get complacent, risks inevitably find a way to seep into the system. In 2000–01, it was the rise of telecom as the largest sector in high yield, at roughly one-third of the index, before the bubble burst. In the GFC, it was the creation of a financing system that became ever dependent on the music never stopping—combined with a real estate bubble, weak documentation and sky-high leverage. These types of issues tend not to appear overnight, and we don't see signs of them broadly in markets today, but investors should remain vigilant. Record levels of new issuance by companies, record levels of new CLO creation, and rising tolerance for leverage create the types of conditions that could give rise to future problems.

For now, credit markets appear poised to continue generating relatively stable, income-based returns. Improving credit fundamentals, falling default rates and balanced supply/demand conditions support this view. Given tight spreads and a dearth of capital appreciation potential, we believe active management from investors will be key to generating incremental returns on top of income. Credit markets have been predictable so far in 2021, but history tells us this won't always be the case.

Return outlook

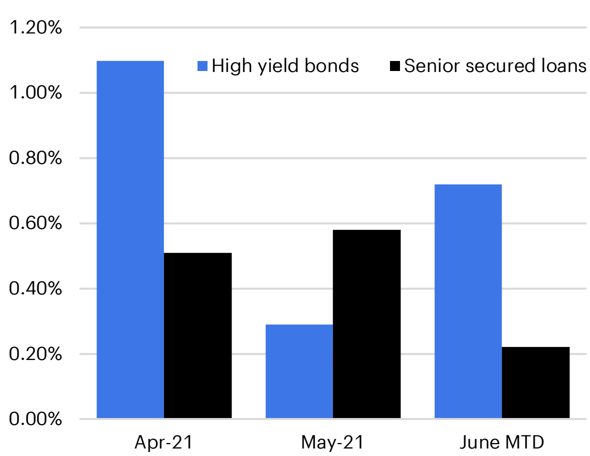
Key takeaways

- High yield bonds and loans have had a solid first half of 2021, with returns roughly even in each market.
- We believe returns in Q3 will be primarily anchored by income generation.

Credit markets have had a solid first half of 2021. Other than a flat return in March for loans, each market has been positive every month this year. In the second quarter, as of June 10, high yield bonds have returned 2.12%. This is directly in line with our forecast, which called for 1.3% income return during the quarter with the potential for roughly 90 bps of price appreciation throughout the balance of the year. While the timing of capital appreciation via spread tightening was uncertain, faster-than-anticipated vaccine deployment and reopening served as the catalyst in Q2 to push total returns above income returns. We believe it's possible for further incremental returns above income over the balance of the year, especially considering the improved quality of the market, as we discussed in "Quantifying COVID: Credit markets one year later," although it's likely to become incrementally more difficult as yields fall and spreads compress.

The loan market is up 1.32% quarter to date, relatively in line with our expectation of 1.1% income return plus the potential for some price appreciation. While the high yield market has largely met our target for price gains, we anticipated about 89 bps of capital appreciation in the loan market during the balance of the year, meaning there is still a bit more room for price appreciation here relative to high yield.

Q2 monthly credit returns



Source: ICE BofAML U.S. High Yield Index, S&P/LSTA Leveraged Loan Index, as of June 10, 2021.

We now turn to the third quarter and the second half of 2021. Markets and the economy have moved extremely quickly for most of the past year. Many dynamics and indicators suggest that we have moved to a mid-cycle environment. For credit, this likely means returns driven less by spread compression with some opportunity for active credit selection.

As noted, spreads have nearly reached (or are slightly below) our year-end forecast of post-GFC tights. We could see further modest spread tightening at the broad index level, but we maintain conviction that returns will be driven mostly by income. That would suggest roughly 1.38% return for high yield and 1.02% for loans in the third quarter.

The economic backdrop remains very favorable for risk assets, despite our forecast for growth to decelerate from Q2's robust rate. Credit fundamentals continue to improve and a balanced technical market should remain supportive. We see pockets of opportunity in certain areas such as event-driven situations and structured products, which we detail further throughout this piece.

The main risks to our outlook revolve around inflation and interest rates. Further unexpected spikes in long-term interest rates could weigh on sentiment broadly throughout markets again, causing some interim volatility, although historically rising rates have tended to be a positive long-term catalyst for credit markets. Overall, we see few reasons to deter us from believing that credit markets will finish the year largely as they started, with solid, albeit primarily income-based, returns.

Return decomposition

Key takeaways

- Lower-rated credit has led the way in both markets this year.
- Much of the dispersion across industries and ratings has evaporated.
- We now see opportunities in event-driven situations such as new issue transactions or M&A.

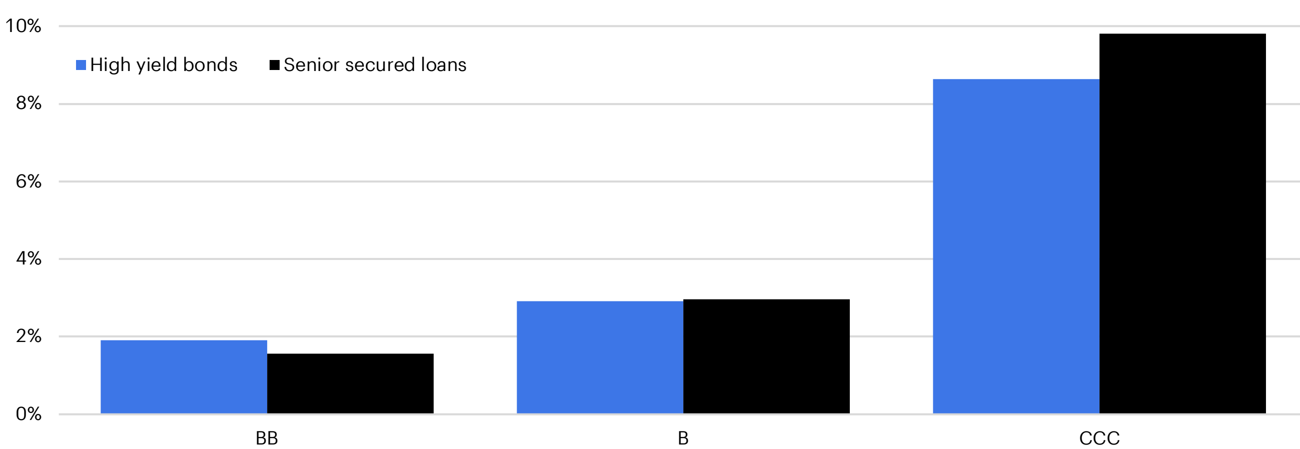
Returns throughout credit since last November have been driven by lower-rated assets, and the second quarter was no different. CCC rated bonds are up 8.64% year to date versus BBs, which have returned 1.90%. CCC loans are up nearly 10% this year. This down-in-quality rotation has led to the tightest spread between the highest- and lowest-rated BB and CCC bonds and loans since 2014. This spread has certainly been tighter, especially in the years leading up to the GFC, and we may still see some further tightening, but we believe the compression trade between CCCs and BBs has largely played out.

Dispersion among industry sectors has also declined substantially. In the high yield bond market, 19 out of 21 sectors are positive year to date, as are 20 of 21 sectors in the loan market. For much of the last year, heightened dispersion among credit ratings and industries offered opportunities for active managers. With much of that lingering dispersion now gone, further upside is likely to be more idiosyncratic in event-driven situations such as mergers and acquisitions (M&A) or new issue transactions.

As discussed further in our market technicals section, new issuance has continued at a rapid pace this year, and we see opportunity in these new issue transactions. A portfolio composed solely of new issue bonds would have outperformed high yield bonds trading in the secondary market every year since 2010. As of May 31, new issue bonds are outperforming the broader high yield market by 340 bps year to date and have, on average, carried a yield 43 bps above issues in the secondary market. Opportunities in the new issue market are best accessed via active managers as opposed to an ETF passively tracking a benchmark given the delay in index inclusion.

Over half of these issuance proceeds in the last year have been used to call or refinance existing debt as companies sought to repair their balance sheets. We believe in the second half of the year, we'll see use of proceeds shift toward M&A. M&A activity has already been robust in recent months—Q4 2020 was the busiest quarter for M&A on record—but with balance sheets largely looking healthier (see fundamentals section), we believe M&A activity will remain strong. New debt issued in conjunction with these transactions offers opportunities as outlined above, but these transactions can benefit existing bondholders as well through a "pull to par" effect if debt is refinanced. Given strength in the market, even moderate incremental returns through prepayment penalties or other gains can represent meaningful upside against the indexes.

2021 credit returns by rating



Source: ICE BofAML U.S. High Yield Index, S&P/LSTA Leveraged Loan Index, as of June 10, 2021.

Spread environment

Key takeaways

- Spreads have nearly reached post-GFC levels. We could see modest spread tightening over the coming months.
- We see few catalysts that will meaningfully widen spreads. Spreads remained tight for years leading up to the GFC.

High yield bond spreads tightened consistently for the first half of the second quarter and have largely remained rangebound since, as markets have traded sideways in recent weeks. As of June 9, spreads sit at 335 bps, just above post-GFC tights of 326 bps. Entering the year, we believed spreads could touch and possibly surpass those post-GFC tights. We reiterate our conviction that this will likely happen, given that high yield spreads are less than 10 bps away from this milestone at the time of writing. While it's likely the spreads will drift tighter, especially given the strong economic backdrop and good technical picture, we do not expect a broad degree of further tightening in the high yield market.

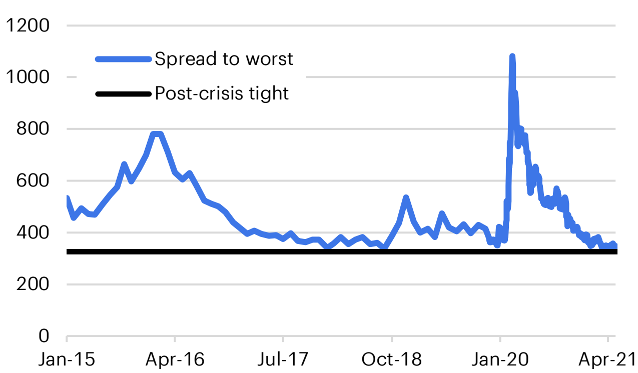
In the loan market, spreads still sit about 50 bps above post-GFC tight levels. Like in the high yield market, spreads have largely been rangebound in recent weeks. Given that loan spreads are relatively wider versus recent tights compared to high yield, and with the strong demand from both retail and institutional investors, we believe loan spreads will test those post-GFC lows in the coming months. The upshot is that loan spreads could experience slightly more tightening than high yield.

It is important to remember that tight spreads do not beget imminently wider spreads. In the years leading up to the GFC, spreads remained between 250 bps and 400 bps in high yield—both considered "tight" levels—and within a 50 bps range in the loan market for over two years. We may see small fluctuations in spreads, but we believe a catalyst would need to be present to drive spreads materially wider. Further examination of potential catalysts, such as inflation, interest rates or Federal Reserve actions, gives us little reason to change our view that spreads could remain tight for the balance of the year.

Inflation surged higher in the second quarter, with CPI exceeding consensus forecasts in recent months. Yet the 10-year Treasury has barely budged, hovering near 1.50%. Much ink has been spilled debating whether the jump in inflation is transitory or will become a sustained trend. Market expectations point to the former. Long-run inflation expectations recovered from a steep drop during the depths of the pandemic, but have steadied in Q2, despite the jump in headline inflation. Median Fed rate hike expectations, similarly, show no rate change until at least 2023. Our base case is that the current inflationary cycle will be transient and not an imminent threat to credit markets.

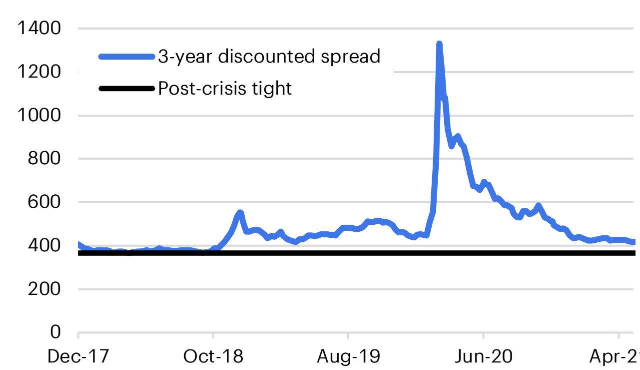
The Fed has made another policy change in recent weeks: In early June, it announced it would begin selling some of the assets purchased in the credit facilities created last year. Markets barely blinked. Granted, the Fed never made large-scale asset purchases in these facilities, but by and large credit markets were unfazed. Clearly an unexpected event (like the pandemic in 2020) can cause rapid spread widening, but outside of these unforeseen circumstances, we see few major catalysts today.

High yield bond spreads



Source: ICE BofAML U.S. High Yield Index, as of June 10, 2021.

Senior secured loan spreads



Source: S&P/LSTA Leveraged Loan Index, as of June 10, 2021.

Credit fundamentals

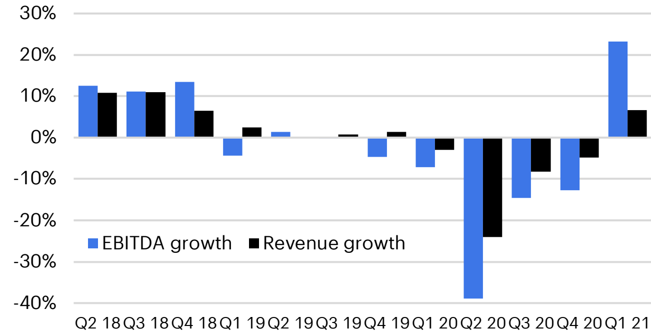
Key takeaways
- Credit fundamentals improved across the board in Q1.
- We are closely watching interest coverage statistics to gauge companies' ability to satisfy their debt obligations given robust issuance.
- Interest coverage statistics are not worrisome at current levels, and we expect continued improvement in the coming quarters.

Credit fundamentals improved across the board during the first quarter, according to the most recently available data. In the high yield market, EBITDA grew 23.3% year over year, its highest rate since 2010. While some of this can certainly be attributed to base effects given last year's depressed levels, on a quarter-over-quarter basis EBITDA was up 12.8%. The loan market also saw strong 16% EBITDA growth year over year. Revenue grew in both markets on both a year-over-year and quarter-over-quarter basis, and we expect to see these strong growth rates continue when second quarter data is released. Based on consensus estimates, Q2 is largely expected to be the strongest quarter for growth given the impact of additional stimulus checks, vaccine deployment and economic reopening.

We have been watching leverage levels closely given the robust issuance over the past year, and we have written in previous outlooks that we expected leverage to increase temporarily before declining as EBITDA figures improve. Consistent with our expectations, we began to see that improvement in Q1 2021. Leverage declined in both the high yield and loan markets and is now off its record highs. We expect to see continued improvements in the coming quarters, especially given our expectations for strong EBITDA growth. However, given the robust new issuance we've seen, we believe leverage will remain elevated versus prior cycles. Low interest rates have created an extremely favorable financing environment with low debt service costs. For that reason, we'll instead be closely watching interest coverage stats as a way to gauge companies' ability to satisfy their debt obligations. These figures also improved in both markets last quarter.

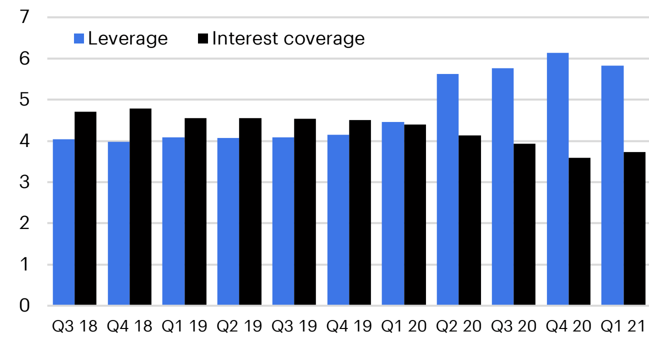
Overall, we continue to monitor credit fundamentals. Both high yield and loans have shown marked improvements lately, and we expect this to continue in Q2 when data is released.

High yield EBITDA and revenue growth



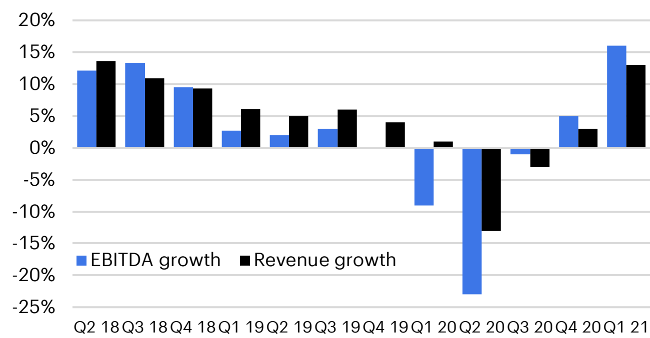
Source: J.P. Morgan, as of March 31, 2021.

High yield leverage and interest coverage



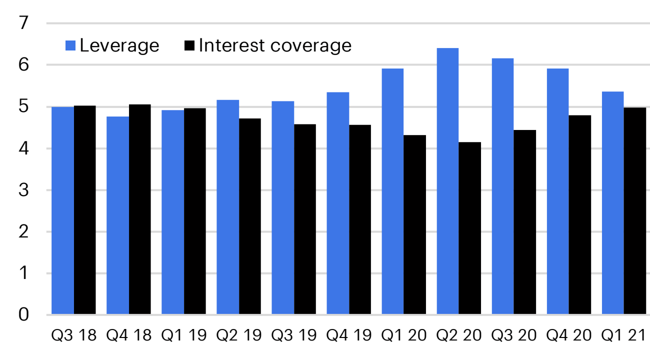
Source: J.P. Morgan, as of March 31, 2021.

Loan EBITDA and revenue growth



Source: S&P/LSTA, as of March 31, 2021.

Loan leverage and interest coverage



Source: S&P/LSTA, as of March 31, 2021.

Downgrades and defaults

Key takeaways
- Default rates have plunged in recent months as large defaults roll out of the trailing 12-month calculation.
- We believe defaults rates will fall to 2% in high yield bonds and remain below 2% in the loan market.

Default rates in bonds and loans have plunged in recent months to 2.58% and 1.52%, respectively. These levels are at a 15-month low in for high yield and 20-month low for loans as many of the large defaults that occurred during the height of the pandemic lockdowns in late Q1 and early Q2 rolled out of the trailing 12-month calculation.

New default activity has been especially benign in recent months. As of May 31, six companies in total have defaulted this year across both bonds and loans, the lightest start to a year since 2011 and the lightest five-month stretch since 2018.

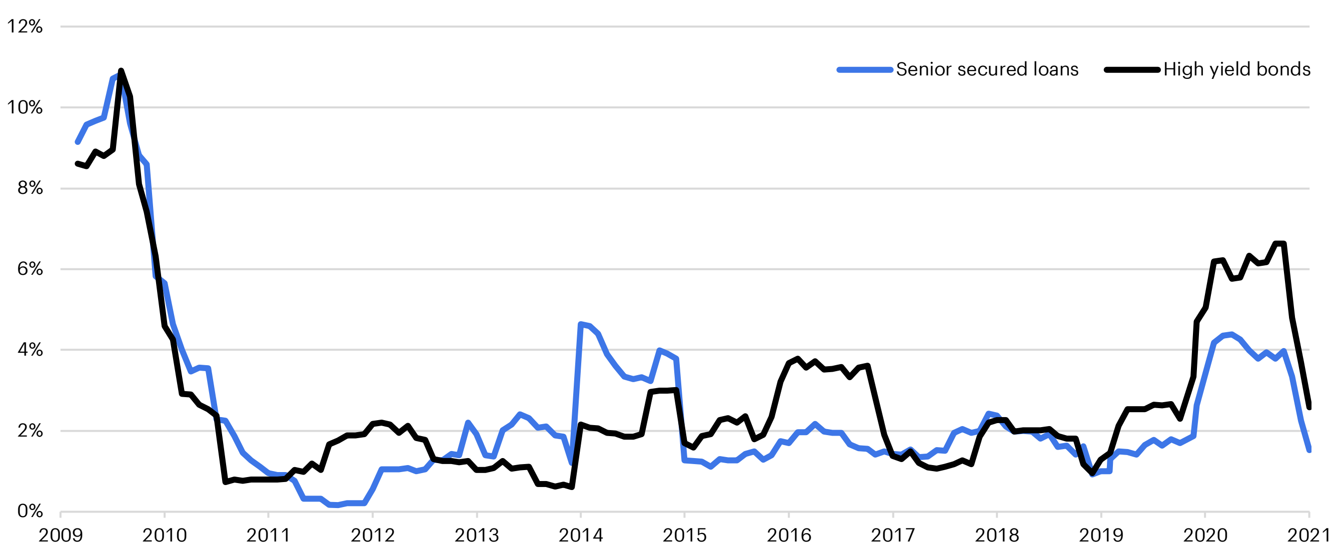
Corporate earnings have continued to improve, the new issue market is strong and interest rates—and therefore debt service costs—remain low. The record issuance that began last year has continued at a rapid pace this year, extending maturities for many credit issuers. We believe that these conditions, along with an economy that has almost fully reopened, create a backdrop that will sustain these low default rates.

Last quarter, we anticipated a 2% default rate in each market. The rate in the loan market has already fallen below this level and the high yield market is inching closer. We believe that defaults in the loan market will continue to edge down and that the rate in the high yield market will reach or potentially fall below the 2% threshold.

In addition to dwindling default levels, both markets have seen heightened levels of upgrades. Rating agency upgrades have outpaced downgrades in the high yield market each month this year at a 2-to-1 rate. Through the end of May, the volume of upgraded bonds year to date exceeds the total volume upgraded in 2020. These statistics are similar in the loan market. Year to date, the ratio of upgrades to downgrades by volume is 1.86:1. Last year, nearly 47% of all loan issuers were downgraded.

As discussed in our fundamentals section, many companies have repaired their balance sheets at favorable rates and extended debt maturities. Those actions, combined with the large number of fallen angels looking to regain investment grade status, should help sustain high upgrade-to-downgrade ratios, ultimately improving the quality of each market by ratings mix.

Trailing 12-month default rates



Source: J.P. Morgan, as of May 31, 2021.

Supply/demand technicals

Key takeaways

- Technicals have been more balanced throughout 2021 following the significant excess supply in 2020.
- We expect to see continued demand for loans, a relative tailwind for the asset class.
- A slowdown in levels of fallen angels plus rising stars should keep high yield technicals relatively balanced.

Supply and demand technicals in the high yield market have remained remarkably balanced this year, especially when compared to 2020's extreme supply surplus. New issuance has remained extremely strong since last summer; in fact, 7 of the 10 highest monthly issuance volumes occurred over the past year. Though issuance is strong, the dearth of fallen angels has certainly aided in reducing supply as only $2.4 billion of investment grade debt has fallen to the high yield market. Last year, over $237 billion was downgraded.

The primary driver of the moderating technical picture in the high yield market has been the use of proceeds; over half of the issuance this year has been used to refinance bonds that have exited their call protection. Because so much of the high yield universe has been refinanced over the past year, we expect issuance to moderate somewhat over the next quarter, and we anticipate a shift in the use of proceeds toward M&A.

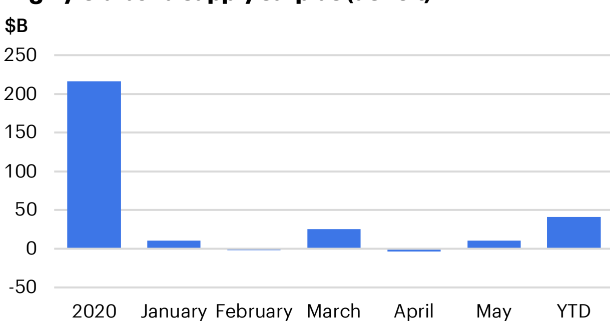
If fallen angels were the buzzy topic of 2020, rising stars became the topic du jour entering this year as investors expected many of the record levels of fallen angels to return to investment grade status. Rising stars, however, have been moderate to start the year; only $16 billion of high yield debt has been upgraded to investment grade. We continue to believe we will see more rising stars over the balance of the year, which could potentially create a source of opportunity for active managers given the spread compression that historically accompanies a return to investment grade. Not only do we expect these upgrades to offer opportunity for credit investors, but increased rising stars will help keep the overall demand picture more balanced given our issuance outlook.

High yield outflows have continued as rising long-term interest rates have deterred retail investors. Bond returns, however, have historically not been impacted by rising rates—even when driven by rising inflation. We expect, as investors continue to see steady returns in the high yield market, these outflows may reverse or at least moderate.

Loans have seen a similar overall technical pattern as high yield, although the drivers are somewhat different. Loan issuance has been extremely strong this year. Even given a very active primary market, demand has largely kept pace due to the combination of steady retail inflows for the first time since 2018 and active collateralized loan obligation (CLO) issuance. As discussed in our CLO section below, we anticipate strong institutional demand for loans to continue, balancing the supply/demand picture in the loan market.

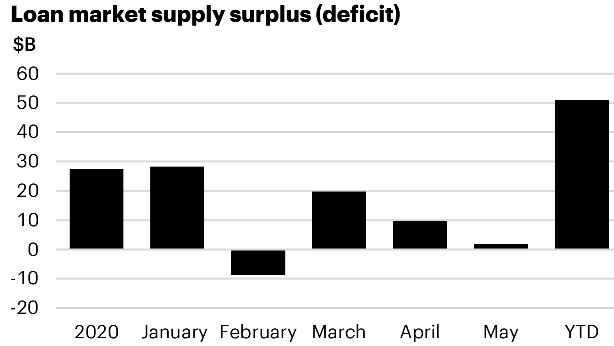
Issuance in both markets has been skewed down in quality, as B rated issues have made up the majority of new deals. While we believe that the economic and fundamental backdrop remains supportive for now, we think that this dynamic bears close watching should any market themes change dramatically.

High yield bond supply surplus (deficit)



Source: J.P. Morgan, as of May 31, 2021.

Loan market supply surplus (deficit)



Source: J.P. Morgan, as of May 31, 2021.

CLO market outlook

Key takeaways
- CLOs have had a strong first half of the year led by lower-rated assets.
- CLO securities are still trading wide to comparably rated corporate debt, which suggests potential for further tightening.
- Opportunity still exists in refinance and reset transactions.

Collateralized loan obligations (CLOs) have had a solid first half of 2021, with positive returns across the capital stack. Following broader credit market trends, lower-rated assets have led the way. We believe that the strong economic backdrop and solid outlook for broader credit markets translates to a favorable environment for CLOs for the remainder of the year. Plus, demand for floating rate assets should provide an additional tailwind to the asset class.

Returns for higher-rated and mezzanine CLO tranches were positive but somewhat below our expectations in the second quarter, suggesting there could be more room for spread compression. Lower-rated BB CLO debt, however, has returned 4.28% quarter to date through June 9, nearly double our Q2 estimate of 2.2%.

Still, CLOs are trading wide to corporate debt. While we are approaching the historical average spread between CLOs and corporate debt, other credit markets have spreads nearing or at post-GFC tights. We do not think it is unreasonable for this spread to also approach these levels. The table below shows hypothetical returns (including income) if one-quarter of the spread tightening between current levels and historical tights were realized.

We wrote earlier this year about the opportunity we saw in CLO refinance and reset transactions, given the large amount of the CLO universe that was due to exit call protection this year. These refi-and-resets are options taken by the equity holders to effectively lower the CLO's cost of liabilities, thereby lowering the overall cost of capital and allowing excess income to flow to the equity tranches.

If accessed correctly, these transactions can be beneficial to debt holders as well. Each investor in an affected tranche is given a choice: to roll their investment into the newly refinanced CLO, or to be called. Typically, call prices are at or slightly above par, meaning a CLO trading at a discount and redeemed at par can offer capital appreciation. However, it is difficult to analyze the entire universe of CLOs without advanced software and modeling capabilities. Managers with the appropriate infrastructure in place and robust experience with the asset class can better model and forecast which CLOs are expected to be reset or refinanced based on current and expected future market conditions.

Record-setting levels of these transactions have occurred year to date. Roughly $92.8 billion in CLOs have been called or reset as of mid-May. Even after this strong activity, 83% of the CLO universe remains callable, presenting a large opportunity for experienced CLO managers.

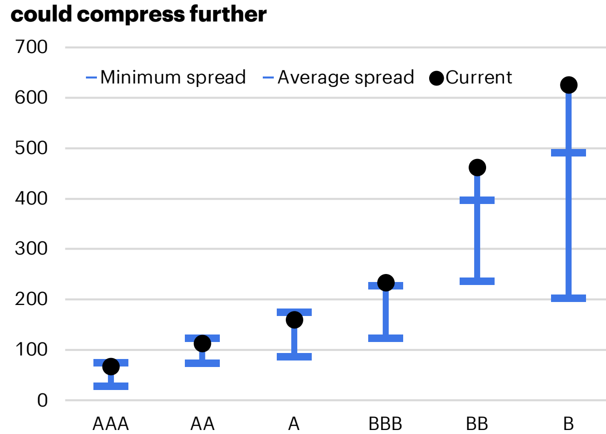
We believe market fundamentals, the relative value between CLOs and corporate debt, and the opportunity in these more complex CLO transactions all lend to a very favorable outlook for the asset class overall.

Q3 potential return

AAA	0.62%
AA	0.93%
A	1.42%
BBB	2.36%
BB	5.46%

Source: J.P. Morgan CLOIE Index, as of June 10, 2021.
Potential return assumes 1/4 spread tightening + Q3 forecast current income.

Spread between CLOs and corporate debt could compress further



Source: J.P. Morgan CLOIE Index, ICE BofAML U.S. High Yield Index, ICE BofAML U.S. Corporate Index, as of June 10, 2021.