The Insight: Conversations – Dissecting the Dual Economy with Armen Panossian and Wayne Dahl

Wayne Dahl

Hello and welcome to *The Insight by Oaktree Capital*. I'm Wayne Dahl, co-portfolio manager of Oaktree's Global Credit Strategy. And today I'm thrilled to be joined by Armen Panossian, Oaktree's co-CEO and head of Performing Credit. We're going to be discussing topics related to Oaktree's recently published *Performing Credit Quarterly* entitled, *The Dual Economy*.

Welcome, Armen.

Armen

Thanks, Wayne. It's good to be here.

Wayne

So Armen, in the latest *Performing Credit Quarterly*, we talk about this idea of a dual economy which highlights the growing disparity between what we'll call the haves and the have-nots. And I think this applies to both the consumer and companies. How do you see this growing disparity impacting credit markets today and for the rest of the year?

Armen

That's a good question, Wayne. I think in the near term, which is what you're describing, there appears to be enough liquidity in the hands of investors or savers. And those investors and savers are looking for opportunities to invest in this higher rate environment because credit is more attractive today than it's been in quite some time. Those investors and their activities have caused spreads to meaningfully compress this year. And the equity markets consistent with that general theme of a lot of investor liquidity being out there has been really, really strong. So from a 30,000-foot level, while there are some cracks here and there in the macroeconomy, it seems like everything is okay or okay enough that the Fed believes that they really don't need to do very much to change rates or to stimulate the economy using monetary policy.

Wayne

So drilling in a little bit further, we know that, you're right, the data has generally been pretty good. We're recording this on July 25th where we just had second quarter GDP come out at 2.8%. But we've definitely seen signs that the consumer is starting to slow down. Do you think that's a concern we should have from the standpoint of a credit investor?

Armen

I think it's worrisome when you see things like credit card delinquencies move up, when you see car payments having some delinquencies as well. Those directionally are not a positive sign for the overall economy. So I do think that we need to be concerned as an investor, as a credit investor or an equity investor because so much of the lifeblood of the economy is dependent on the consumer and the health of that consumer. However, not all consumers are created equal.

There are some consumers that are living paycheck to paycheck and those that are high net worth individuals. They consume different things and in different quantities and their sensitivity to economic pain or to rate pain or to inflation is very, very different. So in the case of consumers living paycheck to paycheck, things like inflation and the cost of gasoline, basic goods has been very, very painful.

Those consumers do not make enough money to clear the elevated cost of those materials or those items and still save money. And therefore they're cutting back on what they spend. If you look at some middle income or lower income come retailers and you look at their performance this year, it's been on the weaker side. And it's really because those consumers that they cater to are feeling the pinch from the inflation that occurred over the last several years. And we have not seen deflation. We just need to slow down inflation. But those elevated prices still exist and the increase in wages has not really caught up across the board across all different types of jobs.

But the other consumer out there which is the wealthy, obviously in number they are fewer but in power, they have grown. We have more billionaires today than we have ever had globally. We have a shortage of luxury items. So the biggest problem that a millionaire or a billionaire expresses is access to luxury goods, like luxury watches, luxury real estate, sports teams. Things that have experienced a significant amount of value inflation because they're in short supply relative to the growing demand, albeit off of a small base. But the wealthy have accumulated the wealth or the cash that has been sprinkled across the economy during those years of stimulus.

If you think about it, trillions of dollars were printed and dispersed across the economy and they got elevated through the money multiplier and eventually they made it into the hands of savers, which includes corporate treasuries for the healthiest and largest businesses, it includes high net worth individuals and billionaires. So that category of investor or person has become wealthier, whereas the average Joe is having some trouble paycheck to paycheck.

Wayne

Armen, I think you raised another great point, which is there are signs of weakness. I mean we have seen retail sales slowdown to some degree this year compared to times past. And again, that may not be enough to make the Fed move aggressively today. But how does that impact your investing today as you look forward? Are there sectors or industries that maybe are falling out favor from an investment standpoint that you see as potentially riskier given this slowdown that could be happening?

Armen

Yeah. I think generically I would say deep cyclicals are concerning. Now why is that? Because with all of this stimulus, those deep cyclicals have actually done pretty well in the last few years. Think of a building products company. As people stayed home from work, they spent money on their homes. As rates have risen since the pandemic, they're staying in their homes because they can't afford the next home. So on balance for the last several years, people who have had some disposable income have spent it on their homes and many of them have received stimulus for which they did spend on those improvements. If you were to just look at the last two or three years of performance of these businesses you would say, wow, I really want to lend to or invest in these businesses.

But if you think about the prolonged impact of higher rates and some cracks in the economy showing themselves through middle income or lower middle income consumer credit delinquencies picking up, then I think that you really ought to avoid deep cyclicals generally, especially in those areas where it is discretionary. Building products rises to the top of that list, but there are others as well such as leisure and travel. So we're looking generally at those industries and asking ourselves if the businesses are too levered and could they sustain a 10 to 30% decline in revenue and what does that look like from a cashflow perspective? And are they too levered in that type of a stress case scenario? And I think that in some cases especially with floating rate borrowers that did not hedge their interest rates. If we roll the clock forward and if we do see continued slowdown in middle and lower income consumer spending, I think we could see some challenges for those deep cyclicals, especially the highest levered ones.

Wayne

As we look at these industries that you've mentioned where they are definitely at risk of seeing a slowdown, do you see an increased risk of default in any areas of the market? I think people are generally surprised that given a 500 basis point increase in the risk-free rate, that we haven't seen a lot of stress within borrowers and we haven't seen a significant increase in default amongst these borrowers? Do you think this could be ahead?

Armen

Absolutely. And I think that there's a few explanations as to why you haven't seen the defaults materially pick up. One is, with all the stimulus that was printed, it created inflation. And for a lot of businesses, although they went through a period of time of volatility where their cost of goods was increasing, businesses that are leaders in their industries have been able to pass through price increases, cost increases to their consumers. And therefore the consumer is starting to hurt now, but the business had the ability to grow its nominal dollars of revenue and grow its nominal dollars of EBITDA given inflation. And even though the cost of the liabilities went up 500 basis points, their EBITDA or their cash flows went up enough, at least in the near term, to satisfy that elevated interest expense.

Now, not every business did well during COVID or during this inflationary period, so there are going to be losers. There already are very stressed businesses, and there are companies that have underinvested in their own infrastructure. And I think if and when they do default, the loss severities will be significant because of that underinvestment. So think of a company that can't make its interest expense, one of the levers it could pull is slowing down its capital expenditures or research and development or adding to its inventory or really stretching its payables, these are all drags on cash flow. And if you're not doing those things because you don't have the cash flow to sustain that because your interest expense is too high, eventually you will become uncompetitive and that means your loss severities will be more significant.

So that's the explanation as to why a lot of businesses haven't defaulted already. It's really, again, that they've inflated themselves through this, but we're reaching the point now where inflation is coming down, it's not deflation, but it's coming down into acceptable territory. We're seeing consumers feel the pinch more and more and cut back on their spending on certain items. We're seeing delinquencies pick up in consumer debt. So I think that some portion of the over levered borrowers will default. And where is that locus of the biggest pain? It's really in floating rate borrowers that were the subject of leveraged buyout transactions in 2018, 2019, or 2021.

And the reason I mentioned them is because generally speaking, leveraged buyout sponsors preferred floating rate debt, generally speaking, they did not hedge that floating rate debt. And generally speaking, private equity firms maximized leverage, and so they maximized it at a time when base rates were near zero. Fast-forward to today, a lot of those businesses have grown, but not all of them. And I would hazard a guess that something like 15 to 25% of the broadly syndicated loan market in the U.S. is subject to risk of default because of elevated cost of borrowing, essentially taking its toll on the company. And now over the next two years or so, there's going to be a significant number of maturities to be dealt with for a company that will absolutely look over levered, given today's rate environment. So yes, defaults are going to pick up, but there's a reason why it's been delayed.

Wayne

Yeah, and Armen, you mentioned this growth in leveraged buyouts and these companies that largely rely on this floating rate debt or loans to finance themselves. Obviously there's issuance both in the public markets and in the private markets in this space where we've seen tremendous growth over the last several years. How do you differentiate between the risks in the public market and the private credit markets when it comes to these particular companies that are probably at a higher risk today given this potential slowdown in growth and consumption?

Armen

It's a great question, and I wish I had a crystal ball, but I'd make the following comments. First of all, big picture, the quality of borrowers in the broadly syndicated loan market is not that different than the quality of borrowers in the private credit market, but for one distinction, and that distinction is, in the private market, they skew towards being smaller businesses. The core middle market are companies with 25 to 50 million of EBITDA, and that's smaller than a typical broadly syndicated loan borrower. The typical broadly syndicated loan borrower will be 70 to 200 million of EBITDA. So that is an important risk factor because generally speaking, bigger businesses perform better through cycles than smaller businesses do. They tend to be the leaders in their sector. They tend to be able to have more negotiating leverage against their suppliers and their customers. So bigger is, I would say generally better, all things being equal.

But ignoring the size question, the direct lending market and the broadly syndicated loan market have been the financing tools of choice for private equity firms. So most of it is LBO related, most of it is first lien and most of it has very similar leverage profiles. I would say private credit probably has a little bit higher leverage on average per borrower than broadly syndicated markets do, but they're not materially different. So if we start from that point, we say, "Well, which of those markets will experience more stress?" I would say probably, from an underlying borrower perspective, the stress will probably be more acute, but not materially more, in the private credit market.

However, the private credit market has the following benefits. First of all, they have better legal protection in their documents, which allow for more frequent and earlier conversations between their lenders and their borrowers. Second, the relationship is bilateral or a small club of lenders versus a borrower, and those lenders are all par owners of that debt. There really isn't much trading in direct lending. Now, the reason that's important is if a company goes through stress or challenge, the lenders are all similarly situated in that they're all par lenders and then none of them are really desiring or set up to take over the management of businesses, or of many businesses. That is not the preferred outcome.

And therefore, direct lenders generally prefer to strike a reasonable deal with a private equity sponsor for them to put in some additional capital and stay in control of the business without the lenders having to really turn the screws. Now, that is a material difference between private credit markets and public credit markets.

In public credit, the debt trades and therefore some portion and potentially a material portion of the debt tranches can be owned by investment managers with a lower cost basis. And therefore, their approach to those troubled situations is different. They are fine with owning those businesses. They are fine with just folding their arms and not being constructive in a restructuring. They just take the view, you just pay me par or I'll go away. Or even more nefarious, they could say, "Well, how about I exchange my part of the loan into a super senior investment security and leapfrog the rest of the lenders?" I mean, they call this lender-on-lender violence.

But if you have a 50 cent cost basis in debt where everybody else is at 100 cents, you may be willing to exchange that at 75 cents into a superior instrument because it's better than the 50 cents you got, and it's still accretive to the company. It's not a great outcome for the other lenders, but it is still accretive to the company and still good for that particular low cost basis lender. So there's a lot of back and forth and negotiating that can occur when people or investors have different cost bases in troubled companies.

Wayne

Armen in the *Performing Credit Quarterly*, you mentioned the growth in private credit vehicles, BDCs. How do you think that growth and that expansion of capital has helped or potentially hindered the private credit market?

Armen

Well, the private credit market was a purely institutional income seeking investment opportunity for most of the last 15 or so years. But in recent years, there has been a growth in BDCs, or business development corporation, AUM, both in terms of publicly traded BDCs as well as private ones. Specifically in the private ones, they are very accessible to high net worth individuals. And as I mentioned earlier, there has been a significant growth in the wealth of high-net-worth individuals and the number of high net worth individuals. And so they are now accessing private credit through private BDCs that take in subscriptions monthly, and therefore the investment manager must deploy that capital pretty quickly because if they don't, then their dividend can erode, it could get diluted. And so that month to month technical change in appetite of these business development corporations can, and I would say, has changed the quality of the private credit market.

Because when it was purely an institutional product, it was a drawdown product. And therefore investment managers could be patient. If they didn't like the quality of the instruments, the pricing on the instruments, they could give it a quarter or two or three before they resume deployment. But in the case of BDCs, especially with those investment managers that have a considerable portion of their assets under management in direct lending from these BDCs that take monthly flows, they cannot be as disciplined. And that has changed the quality of the market for sure, in terms of pricing, in terms of leverage being too high in new deals. And we think that the risk factors around private credit for those that are not disciplined is materially increased as a result of the democratization of this asset class.

Wayne

Armen, historically, investors in loans have enjoyed very high recovery rates, lately, those recovery rates have been declining. Do you see dispersion amongst recoveries when it comes to these positions in the public markets versus the private markets.

Armen

It's hard to get that from the information. The reason is this, in the private credit market, because the lenders are incentivized to not realize a default or to not experience a default or a loss, they are more willing to agree to amendments that involve covenant waivers, that involve piking or paying paid-in-kind coupons of what were formerly cash coupons. And so what we've seen in the past and what we're likely to see going forward is a lower default rate for private credit versus public credit. It doesn't mean that the stress is not there. I think the stress is the same. But you will probably see muted default rates in private credit versus public. But when you do see a default in either, where there's actually restructuring, I think that both categories of lending will have materially lower recovery rates this time around versus in prior periods for the reason that the leverage levels are generally higher these days than they were 10 years ago or during the Global Financial Crisis.

And in the case of public markets, because they lack covenants, the owners of these businesses are able to maintain control of these businesses for an extended period of time and allow for the under-investment of those businesses. So if you think about it, if an equity sponsor that's out of the money still retains control for three or four years and they just take wild bets or they minimize capital expenditures or investment in the business, the business, once the lender takes it over is going to be materially impaired or worse off than if the music had stopped immediately and the transfer had occurred immediately. In the case of private credit, you do have covenants. As a result, lenders are able to talk a little bit more early in the process and either agree to cut their coupon in exchange for equity coming in or doing something that allows for a more bilateral discussion between the borrower and the lender rather than getting stonewalled by the owner of the business.

Wayne

We've talked a little bit about some of the companies and industries that may struggle as you see a slowdown in general consumption, but again, there is still a pretty large part of the economy that's doing quite well and continuing to spend. And where are you seeing those positive opportunities today in the credit markets? Are there particular sectors or industries that you think still provide great opportunity for investment?

Armen

Absolutely. I think the markets are so big that there are opportunities to find good investments and opportunities to avoid bad ones. I mean, if you think about the broadly syndicated loan market, the high yield bond market, the private credit market in the U.S. alone for all three, each of them is about $1.3 to $1.5 trillion. In the case of the broadly syndicated loan market, there's 1500 borrowers. In the case of the bond market, there's 800 borrowers. There are a lot of choices investment managers could make to avoid bad investments or to make good ones that will pay principal and interest as they come due. Now with that said, I think that there are certain asset classes to highlight because there's very attractive investment opportunities for different reasons.

One is asset-backed finance. Asset-backed finance is a private credit asset class that is experiencing an expansion because of a regulatory shift. The Basel III regulations that we've already seen in Europe are becoming global. And in the U.S. what that means is that certain legacy areas of investing or lending that banks used to do are no longer accretive from an equity standpoint. They just need to hold too much equity capital to remain in that business.
So they are withdrawing from some of these businesses and creating opportunities for investment managers to step in where they are leaving. So that inefficiency caused by this withdrawal is creating an attractive investment opportunity for those that know the underlying collateral in asset-backed finance. That could include aircraft, it could include royalties of different types, equipment finance. It just touches so many different end markets and that's why I think it's super attractive and it's a very high-income producing asset class as well.

I think the other potential opportunity set is rescue lending. Rescue lending is something that we are very active in when the markets do dislocate or when the markets do have to refinance. A lot of these loans that are coming due in 2025 through 2027, they're going to need additional capital to pay down the existing loan balance to make it refinanceable. And so that gap capital is equity-like in its risk and return and it will create a tremendous investment opportunity for special situations, opportunistic credit, that type of investor, is going to have a lot to choose from as we approach these maturities. So that's something that Oaktree is also very mindful of. We don't want to be too early in deploying there because we think that the bulk of that opportunity is in front of us, not behind us.

And then finally I would say there are sectors that are just not that cyclical. Take life sciences for example. We're very active in life sciences, direct lending. Those businesses have performance that is really not tied to GDP or inflation even. These businesses are focused on saving lives or changing lives. And if they're good at that, if the management teams are good at that, then it kind of doesn't matter whether we're in a recession or not. If you're curing cancer, then that's a very valuable business. So we are looking always to invest in businesses that have low or no cyclicality or have no correlation to other industries. And life science is a very good example, but there are others as well.

Wayne

Armen, it sounds like there are definitely a number of opportunities still to make in the credit markets. And credit markets have really enjoyed this, what our chairman Howard Marks referred to as sea change in interest rates over the last few years as yields have risen. What would you say to investors today that may think "I've missed this opportunity?" Is it too late or is there still a very compelling opportunity for investors in credit today?

Armen

There absolutely is, but I think credit selection is paramount. I don't think it makes sense to be cavalier and just buy the market. I do think you need to be a credit picker. Because there is again, something like 15 to 25% of the market that absolutely has default risk and should be avoided in below investment grade credit. What I would point to is absolute return. If you look at high yield bonds, while their spreads are on the tighter end of historic norms at about 300 basis points, from a yield-to-worst perspective, they're about as attractive as they've ever been.

And the high yield bond market is actually higher quality than it's been for about 15 years as expressed by average ratings. More of that market is BB today than it's been in the last 15 years. So if you're able to earn a 7 to 8% yield-to-worst on a portfolio of diversified high yield bonds and lock in that return by buying bonds that are trading at a discount. And if you do a good job of avoiding bad situations, then you lock in a pretty attractive total return between now and when you get repaid on those instruments.

And if you do buy it at a discount, you also get a pull to par that might give you a better outcome, a better return than the yield to worst I was even just talking about. So I think that's really attractive. I think it's super attractive for pension funds that historically have wanted something like a 7% return. I think you're potentially getting that and then some in high yield with a pretty low risk instrument if you work with a manager that knows how to separate the weak from the stronger credits. And in private credit, while there are certainly some excesses in lending practices that are troubling, I do think that that market is also big enough at $1.4, $1.5 trillion that you are able to still put together a diversified portfolio of private credit that will avoid losses and defaults as well.

Wayne

So it sounds like despite the fact that we are seeing some growing divergence amongst consumers and amongst companies, there is still a very healthy environment for investors today. The one question I would have as well is the Fed is obviously paying attention to all these same factors, and many people have been anticipating the Fed to ease policy over the last 18 months, which they have not done. Do you think that investors will be disappointed in the near term, or will the Fed finally ease policy into some of these shifting dynamics?

Armen

I think we have to start with what's the Fed's mandate. The Fed's mandate is to keep prices stable and to keep employment full. It's really the dual mandate. It is not to support asset values or asset prices. So will they change rates because of the dual economy? I think that the Fed may reduce rates a little bit given the trajectory of inflation and CPI. I don't think it'll be material changes in the rates unless and until there is an unexpected shock to the economy that impacts employment or creates a recession. Because shocks by definition are unknowable or unpredictable. I don't know what that will be, but assuming away a shock, I just don't see the Fed materially reducing rates just because investors want to see it. I think the Fed, however, does have a very powerful tool with base rates being as high as they are.

So I would think that if there is a shock, the Fed is going to act very aggressively to counter that shock. And maybe the investment opportunity created on the back of that shock might be short-lived. Investors that are waiting for the dislocation to invest, may need to be very nimble and quick to buy securities, to invest at that time while the Fed is figuring it out and waiting for the impact of their regulatory changes to be felt in the economy. I think that'll be an attractive investment, but it might be a shorter than expected investment horizon.

Wayne

Armen, you mentioned one of the things that the Fed is certainly going to be looking at, which is the labor market. And the labor market is definitely going to be one of the key drivers of health for the underlying consumer. Really a big factor, whether it's a change in wages or whether it's jobs being lost and unemployment going up. As you do your underlying credit work and focusing on fundamentals, you talk to a number of companies, what sense do you have on companies' views of labor today? Do you see this as something that is becoming a bigger risk, that we could see a pivot in that labor market?

Armen

I think during COVID and the year or two that followed, labor markets were very tight. Because of the work-from-home environment being so acceptable, labor was very fluid and therefore could go elsewhere to the highest bidder. And in some work settings, the in-person work settings, labor demanded higher wages because of health risks. So think of healthcare service providers. Nurses just didn't want to work in hospitals as much as they did prior to COVID because they could get sick. So there has been a considerable amount of labor cost inflation and mobility over the last few years. But I think that as GDP has slowed, obviously it's still positive, but it is slowing, I think the balance between laborers and their employers is more on even footing, and therefore employers are able to be more demanding and more selective in their own practices with labor.

And there have been, but I would expect that there could be more employment cuts. And we've seen that in the tech industry. We saw it about a year and a half ago in the tech industry. But if consumption declines any further, I think that the number of job openings will decline. It's already a little bit weaker in recent months than it was a couple of years ago. But I think that that is an indicator to watch, how many job openings are there as the GDP growth rate slows.

Wayne

Now, of course we know that the labor market does tend to be a lagging indicator, but as you said, gaining that insight directly from companies could really be key in getting ahead of that and understanding the potential path or will that gap grow within consumers today?

Armen

Yeah, I think the companies that we track right now are not materially cutting labor, but you are also seeing a topping off of the inflation in their labor cost, which indicates that that balance is shifting a little bit more in favor of the employer these days.

Wayne

Armen, as we think about the things that we've discussed today, this growing disparity between consumers, this growing disparity even between companies, what would be the best advice you would have for investors today? What risks should they really be looking out for that we haven't covered already?

Armen

I think that the dual economy that we've been talking about, the difference in financial condition and spending habits and labor stability for wealthy individuals and companies versus those living paycheck to paycheck creates so much noise in the economic indicators, where at a high level, maybe things appear to be sound, but on a micro level, if you look at cohorts of the population, parts of the global economy are actually turning the wrong direction. I think it's easy for investors to get intoxicated by the investment opportunities in the current market, because they're sitting on so much cash it looks great. And so a lot of investments are happening that might end up proving to be speculative. And my concern or my warning is if you don't look at the underlying performance or health of the cohorts of the population, you might find yourself on the other side of a shock where those people have spiking defaults in their consumer debt and therefore the investors in that consumer debt are going to experience losses.

But as that occurs, there will be job losses. There's a cascading impact on the economy, it's recursive. And so I would just watch for delinquencies in payments on cars, delinquencies on payments for credit cards. For now home payments, we're not seeing a lot of foreclosures because the interest rates are so low on existing home mortgages and the value of homes as maintained itself. So people don't want to lose their homes. That's the last payment that they want to miss. But they are starting to miss their credit card payments and their car payments.

So if that were to pick up, I would really want to dig into where the most damaged or vulnerable cohort is and extrapolate what industries are going to be impacted by that. And I think it's going to be very easy to miss, because in the meantime, the macro indicators might look okay. It's easy to get lulled to sleep and to become complacent with the current Goldilocks condition of the overall market, because the average looks just fine, but the underlying separation of this dual economy is troubling.

Wayne

I think one of the takeaways that I've gained from listening to you today, Armen, is that despite the fact that risks are growing, investors probably do need to have a little bit more caution today than they've had over the last several months. But many opportunities still exist to lock in those attractive yields within the credit markets today.

Armen

I would 100% agree.

Wayne

Well, thank you very much for joining us today, Armen.

Armen

Thanks for having me, Wayne. Good to see you.