

The Insight: Conversations – Keeping Composed with Justin Quaglia, Madelaine Jones, and Christopher Gray

Harry Whitelaw

Hello and welcome to *The Insight by Oaktree Capital*. I'm Harry Whitelaw, and today I'll be joined by a trio of Oaktree investment leaders. We'll chat about volatility in the credit markets, renewed interest in Europe, and take a closer look at asset-backed finance. To kick us off, we have Justin Quaglia. Justin is a credit trader here at Oaktree, mostly focused on high-yield bonds as well as distressed credit. He's also known around Oaktree for his colorful market commentaries that somehow he finds time to write every single day.

Justin, welcome to the podcast.

Justin Quaglia

Thanks for having me, Harry. Looking forward to it.

Harry

So your role means you have a very vivid, real-time experience of the market and its fluctuations. The second quarter of this year really was a roller coaster ride. How was that experience for you from the trading desk?

Justin

It was a short roller coaster ride if you really think about it. You have to look at a calendar really quickly, and if you think through it, it was like April 2nd through April 7th. It moved quickly. We had a bit of a tariff tantrum, and that was going to be the third, the fourth, the fifth. And then ultimately, when everything was kind of said and done, after a few social media posts by President Trump, we started to get a little bit more comfortable with the uncertainty around tariffs and tariff progress. But that weekend, I believe it was like the fourth, fifth, sixth, that was a pretty scary weekend, because we didn't really know what we were going to come into on Monday morning.

I often send out, as you allude to, a morning note and evening note, but some of those days I was sending out midday notes, I was sending out notes on the weekend, just keeping the people of Oaktree apprised about what was going on. So it definitely was some of the most extreme volatilities we've seen since the Global Financial Crisis, definitely since Covid, and just the volatility and the movements and the extremes of some of the movements with equities moving 3% to 5% a day, 10% someday, 12% someday. It was just things that we just haven't seen for a while.

Harry

Well, in the context of that volatility, let's talk about something I really liked in your written market outlook. Something that in fact felt very Howard Marks, the broader the range of potential outcomes, the less confidence in valuations, and the greater the likelihood of these hugely volatile price swings. How do you see those sudden moves in investor psychology ripple through the market?

Justin

I think at the end of the day, our job as investors specifically on the credit side, is to price in something that measures credit spread risk. And we need to think through what is the right valuation to assess to the uncertainty we see in the world today. And so when we look at the market, we try to say, "Okay, what are our known knows, our known unknowns? What are the unknowns that we just don't know anything about?"

We're never going to be perfect forecasters. But we try to think about the world probabilistically. We try to think about what could happen and try to assign probabilities to those types of events. We're never going to be here to tell you there's a 23.27% probability of a certain event occurring, but we can look at different events and say, "Okay, we think there's a high probability, a low probability, some sort of in-the-middle-of-the-road probability of something occurring.

And when you think through the early days of April there was a significant amount of uncertainty going through the system. We just couldn't price risk with a high degree of conviction or a high degree of certainty. And when you do that or when you can't do that, I should say, you're really just trying to reset spreads wider to a point where you think you're being compensated for risk.

So we really just tried to sit there and say, "Okay, what should the right cost for credit risk or the right compensation be for credit risk at this point based on what we know?" And early on April first, second, third, there wasn't really much for us to go off of. But when that April 9th day came around and we gave a little bit of a reprieve to our trading counterparties and a reprieve to the market with a 90-day delay in some of these tariff negotiations.

And then since then we've seen a little bit more certainty built into the market. There's still a lot of uncertainty, but the peak uncertainty we saw was definitely heading into the, call it April 8th and 9th trading days where we really didn't know what to expect, we didn't know how quickly things would be firing at us.

Harry

So spreads recovered pretty quickly as you suggest. I want to get your take on something we discussed in our last podcast with Wayne and Suzana, because I think you'll have an interesting take on this. The supply demand in balance, in the leverage credit markets over the last few years, we have seen so much demand for yield, so little issuance. How do you see that from your seat?

Justin

I've been fortunate enough to be sitting in this seat for a while and seeing how credit markets reacted during the Covid crisis and coming out of the Covid crisis where interest rates were essentially zero for anybody that wanted to borrow. And Howard's written a lot about this specifically in his Sea Change memo talking through just the decades of low interest rates that we've experienced.

And now once 2022 hit and you started to see the Fed increase interest rates, all of a sudden now the spread to base rate dynamic has changed materially. Spreads in the high market, people want to say, should average about 500 basis points over a cycle. When you're doing that off of a call it 0 to 1% interest rate base rate, you're really only talking about 5% to 6% all on yields. But when you're doing that off of a base rate in the low 400s or the low four percents, you're talking about a much more meaningful return for investors.

And so specifically, even when you look at the BB part of the market, there were days going back to 2022 and today where you're getting BB risk between 6% and 8%. That's obviously come down since it's high in terms of yields and wide in spread.

Harry

Well, let's talk about that quality point quickly as well. The market quality has changed since when you started and certainly since when Oaktree started. So those historical spread comparisons, maybe not that meaningful sometimes?

Justin

Yeah, it's hard because if you look at the market today it's probably around 54% or 55% of the market is a BB-rated security or issuer at this point in time. And when you think through, "What does that mean?" That just means the market's higher quality than it's ever been before. And when you're thinking through a higher quality market, you're getting paid an outsized compensation for the risk quality in the market at this point in time, given to what we've experienced over historical periods of time.

I think there are people out there who say high yield spreads during period of recession should be 900 to 1,100 basis points, or high yield spreads during a normal course of business should be around 500 basis points. But when the quality of the underlying issuer improves, when interest coverage increases, when leverage goes down, I don't think you should necessarily be compensated at 500 basis points to 1,000 basis points for that if the issuers are improving in quality.

Harry

So you are mostly trading those B-, BB-rated performing sub-investment grade bonds, but you also do trade stress bonds on behalf of our opportunistic group. Looking outside that 90%, 95% [00:09:30] of the market, which is just fine, how's the troubled segment of the market feeling right now? Where are the pressures that you are seeing?

Justin

So, I think if you zoom out right now, the underlying technical that the market's spending a lot of time trying to analyze is really the difference between the mean spread of the market and the median spread of the market. And you'll see right now that the mean spread of the market is over 100 basis points wide to the median spread. And what is that signifying? That means that there's a select few credits or a select few sectors that are rather large in size trading at historically wide spreads, and that's bringing up the average amount.

Now, when you dissect that further, you're looking at telecom, you're looking at media, you're looking at retail. Those, I would say have some of the names with the kind of more problem child in it right now that need to get worked out. Whether there's an imminent maturity coming up or some sort of liability management exercise that we're expecting with those types of names, that is where the market's focused right now.

Harry

That's been a great update on the credit markets so far. But before we let you go, you've been trading credit for over a decade. I'm curious how the nature of credit trading has changed over that period.

Justin

When I double-click into how things have changed over my career, there are prominent things I think that stand out. The first is obviously coming out of the Global Financial Crisis, when you look at the Dodd-Frank Reform and the Volcker Rule. That's going to basically change the dynamic of what investment banks or the bulge bracket banks that we're used to mean to the market. They're not the liquidity providers that they once were.

The second thing is really just the growth and evolution of ETFs and macro credit products and what it means to passive investing. We've seen the active to passive shift in the equity markets, but now we're starting to see that in credit markets. That's also allowed more model-driven or systematic investors to use those products on a daily basis and perhaps inject a little bit extra liquidity into the system.

The other ones that I like to bring up a lot are just the emergence and obviously the robust growth of private credit, which we've talked about a lot on this podcast, but private credit's changed the game. It's allowed the credit markets to continue to function when you would normally see certain risk transfer events go through the system.

We've also talked about in past about trace reporting, which is basically the ability to enhance the transparency in the marketplace so that every trade is printed on a ticker tape someplace where people can see where it takes place. And then the last thing is just the growth of opportunistic investors in the marketplace and what those investors can bring to the table as far as a tool kit is concerned from a capital solutions' problem.

And really, if I zoom out, what this means is that credit spread widening that we once thought of, seeing spreads with a 900 handle, seeing spreads with 1,000 handle just aren't happening like they used to because there's too many investors that are going to step in into any period of bad volatility that we see.

Harry

So a lot of evolution, lots more pools of capital, lots of sources of funding, more technology. Fair to say, your role though still about relationships at its heart?

Justin

Yeah. I think any part of the investing world's about relationships, when it comes to sourcing idea, when it comes to negotiating through a trade idea or through some sort of private credit solution, I think the name of the game is personal relationships and business relationships and how you tie the two, and how you build up trust between yourself and your counterparties.

Harry

Awesome. Justin, here's to another decade of Oaktree, and thanks for joining the podcast.

Justin

Thank you very much, Harry.

Harry Whitelaw

Now we're heading to London to speak with Madelaine Jones, portfolio manager for our European High Yield Bond and European Senior Loan strategies.

Madelaine, how's it going?

Madelaine Jones

That's very lovely here today. It's actually sunny.

Harry

London in the sun, perfect. Well, I'm very excited to be chatting in Europe with you amid what feels a little bit like a perception shift towards European markets. We're fans of Europe, but it's maybe been a little bit in the shadow of the U.S. over the past decade or so, perhaps lacking those high profile equity superstars like the Magnificent Seven. But now Europe is really getting attention again, right?

Madelaine

Well, I think the U.S. has been legitimately the favored place to be. The economic growth backdrop in the last few years has been much stronger, but also I think Europe has had its issues. Of course, we had the Ukraine invasion and inflation that came out of that, and I think that has added to some of the concerns for investors. But we are certainly seeing the conversation change in recent months, and more investors now looking at Europe. And Europe is a very big market for credit. It may not have those high-growth equity stocks that you reference, but for us as credit investors, we have lots and lots to do.

Harry

What's an important point in the equity world, you are looking for those individual blockbusters. You're just happy with a good cohort of companies that pay their coupons and offer you the contractual returns that we enjoy as credit investors?

Madelaine

Absolutely. That's what we're looking for. We don't need, and we don't rely on high growth to underpin our underwriting. We're looking for credits that can just perform, pay our coupon, that we can see a way to repayment at the end of its term. And for that we need okay economic conditions. We don't need blockbuster macro growth and we don't need blockbuster company growth for that. We just need a reliable level of cash generation to support our lending.

Harry

We think it's a pretty stable backdrop in Europe, but what's actually the credit market landscape? What are we dealing with here in the sub-investment grade space, particularly?

Madelaine

Large market, established markets. I mean, Oaktree, we've been in Europe since 1999. We were one of the first really to establish a European High Yield Bond platform, much like our U.S. high yield bond franchise, doing exactly the same credit work and deciphering the fundamentals of each company we look at. But amongst the first, and since then, since 1999, that high yield bond market has grown substantially. It's a very high-quality market, is predominantly BB issuance across Europe, diversified by country, diversified across varying different industries.

And the same for European loans. Again, a market that's been around since the late '90s in syndicated form. Diverse again across geographies and companies and industries. A lot of it's supporting private equity LBOs, a nice lower volatility asset class. We don't actually in Europe have retail investor buyers of loans. That means that it's quite a stable investor base.

Harry

And we should touch on the CLO market as well. That's been a real winner for Europe, right? Loads of debut issuers, existing managers issuing more and more CLOs. That's really risen to dominate the loan market in Europe.

Madelaine

Yes, I think the CLO buyer base must be around 70% of the primary, could even be north of that. Again, a really good quality by a base that doesn't have inflows and outflows. That's locked up structures. And that means, again, the fundamental underpinning of the market is very robust.

Harry

And we've seen direct lending rise in Europe as well almost becoming a complement to your liquid markets as Europe's historically been intermediated by very, very old banks. But now private credit is a big deal in Europe.

Madelaine

It is. I think it may even been more of a big deal here in Europe than it was in the U.S., because I guess the array of different geographies means that probably more of the small, midsize company, which has been historically banked by small, midsize regional banks. And the shift overtime to make that more penalizing for the banks to own that kind of risk meant that the solution of private debt market has evolved for a good number of years now. It's for us a performing syndicated loan market. That has been a useful place for the development of our market into more bigger and medium-sized companies. The direct lending market of today used to be what the syndicated loan market was maybe a decade plus ago.

When I look at companies now, they're north of 600 million EBITDA coming to our market. When I think about that where we were decade ago or so, the 50 million size EBITDA company was really the mainstay of the broadly syndicated market. Now that's gone to direct lending. And they've gone to direct lending because there they structure them well and appropriately for that quality market.

Harry

We've got a broad credit market here across high yield, loans, CLOs, direct lending. Of course, the economic backdrop in Europe has been a real point of interest too. I mean, the first half of the year has been a real blur. It's easy to forget just how big a deal things like Germany releasing its debt break are and the increased spending in Europe. How do you expect that to play out?

Madelaine

Well, that's huge. I mean, Germany has been on a tight fiscal reign for a very, very long time. It's suffered from the Ukraine conflict, driving up gas prices, making some of their industries very challenged. So, it needs to have an enhanced fiscal stimulus, and that's exactly what the government has done. And we think that's very welcome. And that's going to mean spending in defense, of course, spending in infrastructure products.

And the ripple out across companies across Europe will be very profound. But I think there's other things around the ECB. We have in Europe a less difficult inflation, inflation is more under control. I think that means the ECB can be more relaxed about monetary policy, and indeed has reduced rates, which is again a good positive backdrop for the companies that we lend to.

Harry

I think the German spending was probably the headline, but spending across Europe, there's going to be areas, AI, data centers, renewable energy, industrialization, military. It's broad, it's not just one country, one industry. This is a big shift in spending patterns. These factors, they should be supportive for Europe and the economy. I don't want to evoke the old boring is good stereotype here, but some of the features we like in Europe are some of the defensive features about the credit market that we think should be quite protective for investors going forward.

Madelaine

I think that's true. I actually think part of the issues that investors have been nervous about Europe, given our proximity to the Ukraine conflict and the ripple out of that are reasons why the companies we look at have been a little bit more conservative in recent years.

So, now we look at the balance sheets, and they look very good, the leverage looks good. Companies, managements have been more inclined to de-lever and to hold cash, rather than do equity-friendly behavior, more M&A, more dividends, et cetera, et cetera. Those aggressive parts of the market, those aggressive agendas have been limited, leaving us a good pool as credit investors to play in.

Harry

And the default rate prediction for European sub-investment grade credit fairly limited, two and a half-

Madelaine

Fairly.

Harry

... 3%. I'm sure you don't want 3% yourself. Where do you think that 3% would come from, and how are you going to, I'm sure trying to avoid any in your own portfolios?

Madelaine

Well, you make a good point. I mean, it's low, but yes, we would rather not have any. Because the skill of the manager in long-term outperformance is outperforming on the downside and protecting investors against credit losses. Of that 2-3%, it comes from various different industries. There's no one top-down thematic, other than it tends to be of a cohort of issuance, which was 2017, 2019, 2021, where lending was again exuberant, where the thesis of the equity return was built around low rates and that low rates continuing.

And unfortunately, that didn't play out for those companies very well. And a lot of them have survived to a period of time, just about paid the coupon. But eventually the balance sheet reveals to be unsustainable, and that's where those issues will come from and that crosses many different sectors, but it's the thematic of too much leverage. And when we look at our companies and issuance when it comes to our primary market, getting the right balance sheet on the right company is absolutely number one.

Harry

Is it still a bit of a battle for allocations out there in the primary market?

Madelaine

Yes, I mean, the asset class is popular, and so we have to be mindful of getting good allocations, and we make sure that we are working hard to ensure allocations are excellent. It helps to be with a big credit shop, which is well recognized to be a tier one underwriter of good assets. We play across many different strategies, as you pointed out, direct lending, senior loans in Europe, high yield bonds in Europe. All these make us a tier one buyer of assets and we look to get good allocations because of that.

Harry

Let's finish with the kind of role European credit can play in a portfolio. Madelaine, how do you see that?

Madelaine

Well, I think for multi-credit funds, it adds diversification clearly, has different technicals going on. It often has a yield pickup, but there's a relative value conversation that we can have around laying that against our U.S. exposure. So, we really find it useful there as a diversifier and a potential yield enhancer. But I shouldn't ignore the fact that in and of itself this is a deep market in credit in Europe, and it's a multifaceted market. We have different geographies, different political systems and environments, and there can just within Europe itself be combinations and tilts that you can make to diversify, to extract value across sectors, across countries. As a final remark there, Harry, as we come to the end, just coming back to your point at the beginning about lack of equity superstars in Europe. Yeah, I think that's probably valid. But to my mind, all we're looking for are stable credits. They don't need to be equity superstars or high-growth phenomena. They need to just play our contractual coupon and get our yield. That does very nicely for us.

Harry

Contractual coupon, no bad thing in an uncertain world. Madelaine, thanks for joining the podcast.

Madelaine

Pleasure.

Harry Whitelaw

Now, we're turning to asset-backed finance, a really intriguing area within the private credit universe, and something we actually covered in depth on a podcast in November last year entitled The Evolution of Asset-Backed Finance. Today, I'm speaking to Chris Gray, managing director in our ABF strategy.

Chris, great to have you here.

Christopher Gray

Great to be here, Harry.

Harry

Now your written piece in our quarterly roundup looked at the nuances of consumer lending. It's a segment of the ABF market that gets loads of attention. Tons of data out there on the health of consumers, plenty of opinions to match, and views. How do you cut through all that noise when looking at consumer lending investments?

Chris

Yeah, it's a good question. In order for us to lend against an asset, we need to understand how that asset is expected to perform and how it can perform in a downside. So macro data is the first useful high-level input, unemployment rate, personal savings rate, consumer spending rates, but that doesn't drive all consumer lending, and it's important to recognize that consumer lending is a very broad sector. There's different types of products from cell phones to auto loans to mortgages to credit cards, and there's different credits.

There's lending to high-quality super-prime borrowers, and then there's lending all the way through to deep sub-prime borrowers, and so I can't apply the same headlines to analyze all of these investments. A more nuanced analysis is really required to understand how these different products and how these credits might perform in a variety of environments. You can't be overly reliant on the data. This is something we really stress at Oaktree.

Behind every consumer loan is an originator. The originator is the company that originates or creates the loan, so we look at those guys too. We have to overlay qualitative factors. How does this originator underwrite loans? How are they motivated or incentivized? Are they being aggressive, they're trying to grow, they're trying to take market share, or are they being conservative and they're more focused on making high quality loans?

Harry

So when you're assessing these investments, what kind of factors make you feel comfortable with being the lender in that situation?

Chris

When we underwrite consumer lending investments, we're focused on two things. One is the product, two is the structure. So we like to focus on high touch essential use products that we think will be prioritized in what we call the consumer priority of payments waterfall. So think cell phones, HVACs, vehicles. If a borrower enters a period of financial stress, we want to be invested in the assets that they will defend.

And then we like investment investments backed by some kind of security. This security can improve the odds of recovery on loans that do go bad. And then structure, as I said. So I think potentially, a common misconception and something to note is that when we structure ABF deals, we don't just look at how the assets are performing, but we think about how they could perform in a downside, and we actually build in cushion and we structure around this.

Harry

Well, we should say actually, in the ABF private world unlike the more syndicated markets, you do have discretion over negotiating these structural protections.

Chris

Yeah, that's definitely right. So in the ABS world, there's banks and rating agencies and lawyers and what an investor gets as the final product is something that is already structured and is already rated, and there might be one rating agency or two rating agencies, and you negotiate the price essentially. We don't have many of those counterparties. Often, it's just the originators, the lawyers and us. Sometimes there might be a bank involved if they're a senior lender for example, but it's a bilateral negotiation between us and the originator.

And often, we can say, "Okay, if you think this is true, we'll structure it this way, but if we're right, it gets structured in this other way," and there are cash traps and equity releases and all of these different things that you can use to find this middle ground, but that protect us in a downside situation, which an ABS might not have.

Harry

Okay. I'm curious, where is all the supply coming from? Is it the classic private credit story of banks retrenching from the lending because it's now quite punitive for them and alternative lenders coming in?

Chris

Yeah, there is so much scale available in consumer lending just from across the board, from large banks to regionals, credit unions and non-banks. There's been a huge growth, as we were saying earlier, in non-banks and specialty finance companies who provide additional lending products to what the banks have traditionally done. We tend to find the best relative value is in areas that were heavily trafficked in the recent past with lots of lenders or loan buyers, but now for some reason are less so, so regional lenders stepping back is a great example of this.

Other lenders may be dealing with legacy issues from post-Covid, 2021, 2022, where a range of assets underperformed expectations, and then non-bank lenders who operate more of an asset light model might be struggling to now find loan buyers. We find in those situations, we can skew the economics a bit more in our favor.

Harry

Makes sense. That's a great quick deep dive on consumer lending. It's the second that gets loads of headlines, but we really need to emphasize, it's only part of the ABF universe. Are there any additional sectors that we should be aware of?

Chris

Yeah, that's correct. Because of the cross-sector expertise that we have and we benefit from at Oaktree, we have the luxury really of being able to diversify across all of the ABF verticals. We're not pinned to 1 or 2. So another big one is equipment and transportation. This includes aircraft leasing, small, mid-ticket, business critical equipment. There's also infrastructure and energy, and we've all heard a lot over the past few years about digital infrastructure, data centers, AI, fiber leases, things like that.

There's a huge CapEx build out across America, and there's situations where we can get in and lend against cash flowing assets in a securitization structure, which we like. There's also real estate and corporate, corporate being pools of loans or accounts receivables or royalties. So there's this massive ABF universe out there.

Harry

You mentioned in the consumer context, preferring those essential items. A similar story in equipment, prefer to lend against items which are business critical?

Chris

Yeah, equipment benefits from two of the themes that I've been talking about. One, the small mid-ticket and even the large ticket aviation, for example, equipment we lend to is all business critical kit. It's necessary. Often, it can be built into the factory in a way the factory won't run without it, something like that. And two, in the equipment space specifically, there has been a pullback from the regional banks and even the larger banks that used to have their own equipment leasing teams. That has shifted away and now there's almost a gap in the market where you can come in and lend to these equipment assets, very high-quality assets.

Harry

Okay. So you've personally worked on both the publicly traded and private sides of the asset-backed universe. We mentioned this earlier. I think that's ABS for the former, ABF for the latter. What are the big differences between those two?

Chris

So by ABF, we mean asset-backed finance, and we generally use this to refer to the private side of lending against these contractual cash flowing assets. ABS, asset-backed securities, as you say, think of this as the publicly issued and traded version of ABF where deals are underwritten, they're tranching up, they're rated. That can be usually AAA down to as low as BB. They're CUSIPed and they're sold to investors as bonds. The ABS market is pretty large, efficient and liquid but the collateral types are similar. It's just the need for an ABF versus an ABS solution that can vary.

Harry

It seems that ABF, the private stuff, has a bit of a spread premium over ABS, kind of reminiscent of maybe the early days of direct lending versus broadly syndicated loans when that spread premium was pretty wide. What do you attribute that to? Is it just a liquidity premium? Are there simply less lenders in the private space?

Chris

Yeah, I'd say there's a few reasons. ABS, the traded version, is usually fully funded and based on a defined pool of assets. As we said, it's explicitly rated, it tends to be a rigid structure, and it's tradable. In ABF, we can offer tailor-made solutions to originators, so we can offer variable funding up and down. We don't need liquidity. We in particular have no need for an explicit rating and we can provide dynamic asset bases, so we can move with originator. For those reasons, we can drive a spread premium where the credit risk may match or actually improve upon an ABS, but there's just in general a lack of capital providers who can offer those flexibilities. That leaves a void that we're trying to fill, and that comes at a premium.

Harry

Awesome. That's a great place to end. Thanks for joining the podcast, Chris.

Chris

All right. Thank you, Harry.

Harry

Well, thanks to Justin, Madelaine, and Chris for joining today, and thanks to you all for listening in. Look out for future content wherever you get your podcasts or via the Oaktree public website. There is plenty of good stuff to come.