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The Elusive Recession

Commentary by Crescent Capital Markets

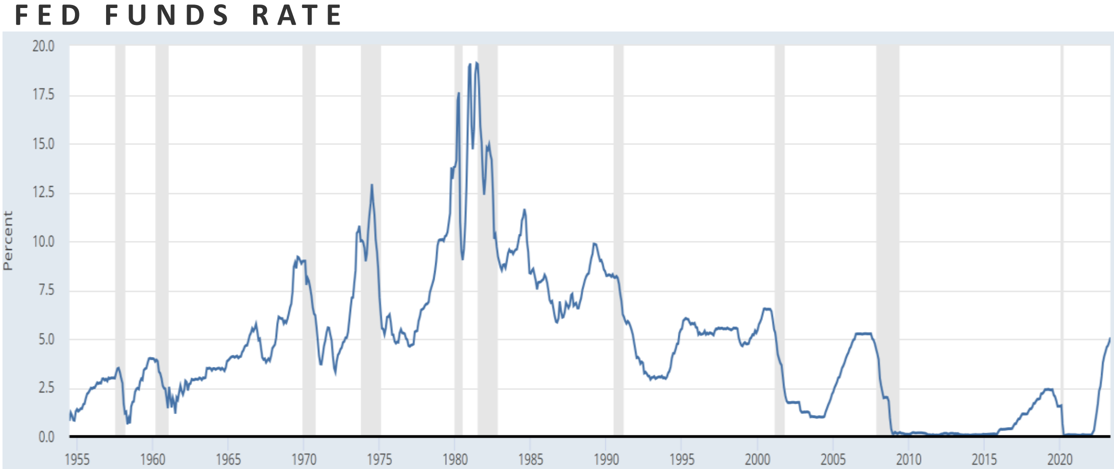
OVERVIEW

- **Credit market bearishness is pervasive while economic data is resilient**
- **Fixed income yields are at their highest level in over a decade**
- **The highest quality segments of the credit market have lagged, providing investors with an attractive entry point**
- **High yield bonds and bank loans have historically performed well following a Fed pause**

THE ELUSIVE RECESSION

Everyone seems to be bearish these days. Just about every economist is betting higher interest rates will cool the economy, resulting in a spike in corporate defaults and wider credit spreads. More than a year and 500 basis points into the central bank's rate-hiking program, an investor might reasonably expect to see a potential recession looming.

FED FUNDS RATE



Source: Board of Governors of the Federal Reserve System (US). Shaded areas indicate U.S. recessions.

Pessimistic positioning on the scale we see today can often be a contrarian indicator. When bullish or bearish sentiment reaches an extreme level, sooner or later the market moves in the opposite direction. One may wonder, is it possible economists have underestimated the lagged effect of low interest rates, $5 trillion of pandemic stimulus spending, and a greater than 40% drop in oil prices from the recent peak are having on consumer consumption?

Another sign of strength can be seen in the May employment data. The headline number – a payroll gain of 339,000 – vastly exceeded estimates, and sectors with the strongest gains were some of the hardest hit by the pandemic, including leisure, healthcare and hospitality. In fact, the unemployment rate today is only 0.1% higher than when the Fed first started hiking rates last year. This suggests the labor market will likely remain strong for months to come as the labor force participation rate has yet to return to pre-pandemic levels.

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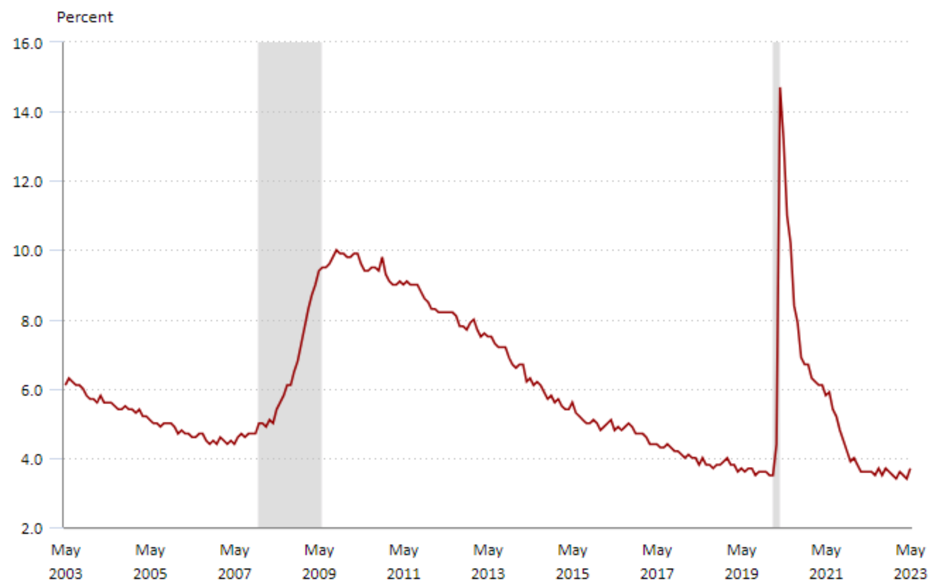
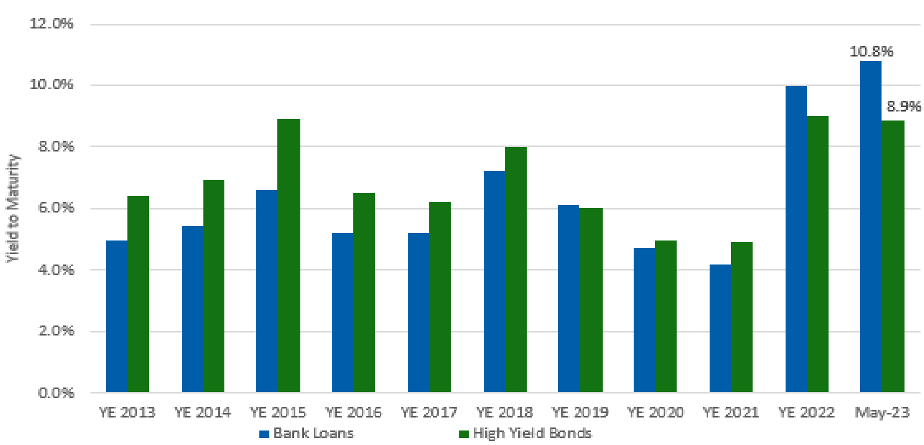
UNEMPLOYMENT RATE



Source: U.S. Bureau of Labor Statistics. Note: Shaded area represents recession, as determined by the National Bureau of Economic Research.

It could take several quarters before the labor market cools and the economy shows signs of slowing. Meanwhile, yields on U.S. high yield bonds, bank loans and CLO debt tranches are at the highest levels in a decade and are providing equity-like returns, with investors earning nearly 9% in high yield bonds, more than 10% in syndicated bank loans (see graph below), and 9.0-13.5% in CLO debt (*Source: J.P. Morgan CLOIE Index*). Income will once again be the primary driver of return given the high carry offered by these asset classes, with yields sitting in the 90th percentile rank of the post-GFC period according to Goldman Sachs.

YIELD TO MATURITY



Source: Morningstar SP LTSA Loan Index and ICE BAML US HY Index

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Despite all of the bearishness, the best performing segment of the credit market this year has counterintuitively been the lowest quality tier. Triple-C rated bonds and loans have outperformed the double-B rated cohort by a factor of nearly two times year-to-date. That makes the double-B rated bond and bank loan cohorts look most appealing to us, as the current market opportunity for entering those bonds and loans is among the best we have seen in recent years.

We are often asked what to expect if the Fed pauses and holds interest rates steady. JP Morgan examined the performance of high yield bonds and bank loans following a Fed pause. Over the past 30 years, there have been five instances of Fed policy transitioning to a pause, which notably lasted an average of 10 months until the onset of the first rate cut. Historically, high yield bonds and bank loans performed well following a pause with an average 12-month forward total return of +12.3% for high yield and +7.5% for bank loans.

HIGH YIELD & BANK LOAN FORWARD PERFORMANCE POST A PAUSE IN FED POLICY HIKES

Month of Last Hike	Fed Funds Terminal Rate	HY Forward Return 12 months	Bank Loan Forward Return 12 Months
December 2018	2.50%	14.08%	8.64%
June 2006	5.25%	11.83%	7.54%
May 2000	6.50%	3.33%	6.22%
March 1997	5.50%	15.72%	7.62%
February 1995	6.00%	16.51%	-
Total Average		**12.30%**	**7.51%**

Source: JP Morgan

We see two key factors as contributing to this solid performance over time. First, the fundamentals following a policy pause remained favorable and not weak enough to elicit a rate cut. And secondly, rates were a tailwind for performance with 5-year U.S. Treasury yields declining an average 101 basis points over the next year. The current backdrop has caused credit markets to reprice, setting the stage for potentially strong performance for the balance of the year should a recession remain elusive.

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About Crescent Capital

Crescent Capital Group is headquartered in Los Angeles with offices in Boston, Chicago, London, and New York. With more than 100 investment professionals and over 210 employees, the firm invests at all levels of the capital structure, with a significant focus on below investment grade credit through strategies that invest in senior bank loans, unitranche loans, high yield debt, mezzanine debt, and other private debt securities. As of March 31, 2023, Crescent Capital Group managed over $41 billion of privately-originated debt investments as well as marketable securities. For more information about Crescent Capital Group, please visit www.crescentcap.com.

Legal Information and Disclosures

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