PGIM FIXED INCOME

All the Credit® Episode 28

Transcript

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Female Voice: You're listening to All the Credit, a monthly podcast series brought to you by PGIM Fixed Income an active global fixed income investment manager. And now your host senior portfolio manager, Mike Collins.

Mike Collins, CFA, Host and Senior Portfolio Manager: Hello! Welcome to Episode 28 of All the Credit, PGIM Fixed Income's monthly podcast. I'm Mike Collins, just one of the many investment professionals at PGIM Fixed Income and your host of All the Credit. Last cycle, which ended a whole two plus years ago with the sharp COVID-related recession, was actually a fairly typical, elongated cycle. And, if you recall, as the cycle matured, we had been regularly updating our analysis of where we were in the credit cycle. Like what inning were we in in the cycle? But, wow, this cycle is a lot different. It's been very compressed with rapidly changing and almost exaggerated swings in economic, inflation, policy, market, and in corporate fundamental dynamics. And for large global investors in corporate bonds like PGIM Fixed Income, it's certainly been a challenge keeping up with the shifting trends. Two years ago it was all about the reopening trade. And then the emphasis shifted to companies that could benefit from or at least not be negatively impacted by rising inflation. And then with the onset of the war in Eastern Europe, of course, we really started focusing on credits that were more immune to those events. Recently consumer demand has abruptly shifted away from goods—particularly larger durable goods—back towards services. And, of course, now we're all stress testing our industries and companies for their interest rate sensitivity and their exposure to looming recession risk. It's like we've already had a bunch of mini cycles within this already abbreviated cycle. So, we're going to try to unpack all of these trends in today's podcast. We'll discuss the big picture with regard to the underlying trends in corporate credit fundamentals—earnings, leverage, upgrades and downgrades, and default and recovery expectations. And we'll assess how well-equipped the corporate bond market is to withstand a potential slowdown. Furthermore, we'll dive into which industries are likely to be the winners and losers as we go forward into the next phase of this high-speed cycle. We'll evaluate some of the looming risks, or fault lines, that are beginning to emerge. Finally, we'll highlight some of the interesting opportunities we're finding across today's credit markets. There's going to be enough going on in today's corporate credit market to make a credit analyst's head spin, and we happen to have PGIM Fixed Income's Co-Heads of Credit Research with us today, two of our very best and most senior credit research professionals. Janet Crowe is a managing director and Co-Head of Credit Research at PGIM Fixed Income. Previously Janet was our Head of U.S. Leveraged Finance Credit Research. Prior to joining PGIM Fixed Income well over 20 years ago, Ms. Crowe worked in Prudential's private debt division as a credit analyst originating direct private placements and also was a workouts specialist. Janet received a Bachelor of Science in accounting from Rutgers University and an MBA in finance from Fairleigh Dickenson University. We also have Brian Barnhurst. He's also a managing director and our other Co-Head of Credit Research. Previously Mr. Barnhurst was a high yield portfolio manager for PGIM's Fixed Income's U.S. High Yield Team, and he spent several years in our London office as a portfolio manager on our European Leveraged Finance Team. Prior to becoming a portfolio manager, Brian was a high yield credit analyst and a leveraged bank loan analyst, covering a variety of sectors including energy, autos and a range of food, beverage, and consumer sectors. Mr. Barnhurst was a high yield portfolio manager along with me when I was doing that way back in the early [2020s]. Brian received a Bachelor of Science in business administration with a concentration in finance from Villanova University and holds the Chartered Financial Analyst or CFA designation. Janet, Brian, and I are here to give you all the credit. Welcome to All the Credit, guys.

Janet Crowe, Co-Head of Credit Research: Well, Mike, thank you for having me. Appreciate being on the show.

Brian Barnhurst, CFA, Co-Head of Credit Research: Thanks, Mike, looking forward to the discussion.

Mike: Yeah. So, a lot to cover here; right? So, let's dive into it. Brian, why don't we start with you. Update our audience. With all these shifting dynamics going on underneath the corporate credit market, what do the fundamentals look like? That's something we can always hang our hats on; right? Are these companies going to default or not? What are the leverage trends? What are you seeing in those upgrades, downgrades? And how do we assess that in today's crazy environment?

Brian: So, Mike, current credit fundamentals are quite healthy. Whether it's IG corporates, high yield loans, whether it's the U.S. or Europe, particularly with respect to interest coverage, we're at all-time highs with cash liquidity metrics. Debt metrics are a bit more mixed with leverage or gearing ratios largely consistent with the middle or the upper range or the post-global financial crisis period. You'll recall that leveraged measures, particularly in leveraged finance, were actually structuring lower in the years preceding the GFC. In part, that's because of the structural bull market in rates we've had, the lower absolute cost of debt funding, and, therefore, greater corporate ability to manage and service higher debt lines. Bull equity markets have helped, too, over the last several years, affording higher enterprise valuations, allowing companies to carry greater debt loads—a bit circular there. It is quite important to highlight that, while credit metrics are currently quite healthy, these are point-in-time measures that are derived from largely backward-looking inputs. And in our view, and we'll talk about this, credit fundamentals for the market as a whole are generally at or slightly past peak in most sectors given that we've now had a pretty big move in nominal interest rates. And ultimately that's going to filter through to funding costs, cash flow. And also, because we'll talk about this, too, we expect economic growth to slow from here. There are exceptions. Those are the COVID-impacted service sectors that are still benefiting from reopening trends and demand. Most notably travel and transportation. And then, of course, the commodity sectors—particularly oil and gas—where the fundamentals there are quite strong if credit metrics should continue to improve going forward. And I also want to point out that, while there's clear relevance to the starting point for corporate balance sheets or credit metrics for liquidity, it's the expected change in corporate earnings trajectory and corporate credit fundamentals that drive markets and market valuations. And that the ultimate destination for credit quality is going to be largely determined by the duration and intensity of any potential economic shock or contraction. Looking forward, the two most critical trends that we and everyone around the shop are watching are really growth and inflation. And the combination of those two factors have created considerable uncertainty about where the global economy and markets are going to be in 12 and 24 months time. And it's so uncertain because the Fed and central banks are really trying to do something that they haven't had to do in decades—turn back inflation. I would venture to say that really nobody knows how to solve for lower inflation, but it is clear that it's really hard to solve for that lower inflation without impacting the labor market, creating a softer labor market. And everyone talks about these stats, but they're still pertinent. You know, in 11 of the past 14 tightening cycles in the United

States, we've had a recession. So, the market's rightfully worried about the growth picture. And, as I mentioned before, we are too. And on that front, it's pretty clear to us that growth is slowing, but there's also lots of moving parts and potentially distortionary inputs; right? We've had a shift in spending from goods to services following durable spending that went well above trend during the pandemic. Now, we're seeing that shift back towards services. We're seeing that payback in the durable space. We've seen it with retailer inventories, et cetera. We'll talk about that a little bit later. And then there's this kind of animal spirits effect, where we're exiting really a difficult two years for everybody. For the consumer, where baseline behaviors were altered. You were stuck in your home. And there's a payback for travel and services spending, the so-called “revenge spending”. And then there's the time and distance on this broad-based inflation that's just seemingly now starting to constrain the consumer's ability to spend. The consumer is really becoming more economically sensitive. You can see that as the excess savings phase has gotten a lot of air time and the savings rate now dip below long-term averages, it may be a sign of the consumers becoming overwhelmed. And then you throw in monetary policy, which has really just started to move. That acts on a lag. We're in the midst a very aggressive hiking cycle. That puts us to the earnings picture. And really interesting, the earnings estimates for listed companies, in the United States and Europe, have actually increased slightly this year. Which is a bit non-intuitive. And we with argue given our expectation for slower growth and the inability for companies to continue to push through pricing without any subsequent demand destruction, that there's a really good probability that the second quarter, the third quarter are going to mark the beginning of earnings revisions. We see margins as perhaps the most at risk in the shorter run relative to pretty lofty expectations. Interesting, there may be some overoptimism on the side of the management teams. But the companies that we follow, they really continue to expect to take price without impacting end demand. And we think maybe that phenomenon is coming to an end alongside commodity prices, which remain a pretty sizeable headwind for consumers and businesses. And given that that's largely the byproduct of multiple years of underinvestment on the supply side, the energy headwinds are likely to remain for some time. And then on the flip side, the counter balance is the labor market is really strong, and it's hard to see that changing materially in the short run. And then just one final point, I think slowing growth really underscores the importance of a sizable and experienced global research capability. Growth is not binary. And slower growth impacts are not distributed evenly, nor are they predictable in a linear fashion. And the impacts are disproportionate on industries, on subindustries and can be exacerbated by company-specific factors like balance sheet, liquidity, cost structure, better protections. All those impacts evolve with the passage of time, and I think it really speaks to the need to have a large, global, experienced research team to evaluate those evolving risks in time in partnership with our portfolio management colleagues.

Mike: Those are great thoughts, Brian. And one of our big themes this year is that it is not a great year to just take beta, meaning just be long absolute levels of credit risk, that it's all going to be about the alpha. And as the economy goes through these gyrations, we're seeing that really play out here. And then you mentioned earnings. I know earnings expectations even for the third and fourth quarter of 2022 were still kind of in 10 percent plus range. And I think we feel generally as a firm that those, like you said, will probably have to come down. And so, Janet, what's your take on the overall quality of company fundamentals going into this slowdown?

Janet: Yeah, I agree with a lot of what Brian said. He touched upon the labor market, and this is near and dear to things I've been looking at. It's tight, and our analysts every day are trying to figure out, with the rising cost, can their companies pass that through; right? And that's in their analysis and their projections, on a daily basis they're struggling with this. You know, early explanations, it's very difficult to figure this out. Early explanations were, you know, the pandemic aid and the public health concerns. Do they have childcare? This whole massive retirement. The great resignation. Those were the causes; right? Now we're two years later, and you look at the numbers, the available jobs open, and I think historically it's been around 7 million prior to COVID. April 21, we're at 9.3 million and today at April 22nd, we're 11.4 million jobs open, this 2 million increase in one year. You look at this, and you're trying to give guidance to teams to say, how do you think about whether or not, you know, how those costs impact the company every day? And we've got this geographic imbalance, I think, going on; right? And we can talk about that a little bit later. We have lack of skilled workers still. People just found other places to work. We're seeing that in restaurants, in airlines. All these different industries, lifeguards. I mean, it's real-world stuff. They just moved on to other jobs. And it's kind of fascinating to me. Some of this, I think, might relate to the same amount of retirement. So we talk about the great resignation, that was about 2 million people. So, a lot of uncertainty, don't have an answer there for you, but definitely some uncertainty. And our team is trying to grapple with this every day as they do their forward-looking projections.

Mike: So, Brian, with regard to upgrades and downgrades, I know up until recently we saw, you know, a huge ratio of many more upgrades to downgrades. I think it was 3 to 1 at one point in the high yield market over last year as the rating agencies really got aggressive and downgraded a lot of credits when COVID hit, and now it feels like they're kind of racing to catch up. What are you seeing there recently?

Brian: You know, Mike, the reality is that it's really a lagging indicator because of the cadence in the process of the rating agencies tends to lag the actual improvement or deterioration in credit metrics. So, I really wouldn't ascribe much informational value to the current gauge. And the current case, as we talked about before, we see a higher probability that credit fundamentals are weaker, not stronger moving forward.

Janet: And, Mike, I agree with Brian, it's a lagging indicator. If you take the bank loan asset class specifically, which is typically a more levered asset class and has got more levered over the years, I would expect more downgrades there.

Mike: Right. So that's a great segue, because I want to dive into the industries now. Brian, you mentioned some of the big change in dynamics from, different one industry to another. And we do every quarter a sector roundtable, both in our high yield credit research team and our investment grade credit research. And I was actually struck by the one we did a couple of months ago where we score every industry. You know, are they improving? Stable or deteriorating? And a lot more industries just a few months ago were kind of downgraded. Meaning their fundamentals are not improving anymore. And very few are upgraded; right? So, again, it feels like we're a little bit ahead of the curve here as we're looking forward a year or so out to try to gauge where these fundamentals are going to be in the future. So, to that point, Janet, like what are some of the industries that your team is focused on? Who are going to be the winners and losers in this cycle?

Janet: Great question. So, in the high yield sector roundtable really quickly, the U.S. saw downgrades. Airlines. Building materials. Consumer. Restaurants and retail. Europe, they saw chemicals, food, healthcare, and retail struggling very much so on the retail side with lower fundamental trends and scores. Inflation there in Europe is really taking a toll on the customer. And we can talk about that a little bit later. If you think about who the losers are. To me it's retailers. Consumers are fighting this inflation. Large retailers have inventories building in some goods that they bought as customers switched to services. It's time to go out and get that vacation in that you've been putting off for over two years. And as a result, when you're buying your food staples and your paper products, you're no longer shopping the other shelves, and they're feeling that pain and so are other retailers. So, it's going to be a big shift there. You're going to see heavy discounting, and the inventories are going to build. The second industry would be, I think, leisure. This one is interesting.

There's been a ton of pent-up demand, we just touched upon it. Lots of summer travel. But it's not going well. Airlines tickets are super expensive. They've got labor issues at the airports, and it's basically not enjoyable to travel. So, I think in the fall this could become a more questionable sector, the leisure and travel sector. So, we'll have to see. And then the other thing is some of these large discretionary, like RVs. I'm following RVs; it's typically a leading indicator for recession. Sales in April year-over-year for RVs were down 31 percent. The towables, which is the more mainstay of the business, was down 32 percent. And motor homes were down 20 percent. So that's year-over-year for the month of April. Now, it's off of a very tough comp. Last year was a very strong year for them. We have motor homes, which are less impacted due to the affluence of the purchaser of a motor home, but we'll have to see if this $5 gasoline, after an extended period of time, has any impact. I think it's going to be a pretty interesting indicator to watch.

Mike: And, Brian, who would you highlight as your winners and losers?

Brian: You know, I think the commodity sectors have the potential to fare much better than one may anticipate in a typical recession with demand destruction. And the key reason there is underinvestment; multiple years of underinvestment. We could talk about metals, but probably oil and gas are the most acute examples of underinvestment and the constraints on calling on more supply when it's needed. So, I think those sectors, you know, are set up to fare well or better than one may anticipate. And I agree with Janet, I think autos are a really interesting case. I mean, she made the point that auto sales, you know, have been running at around recession levels, basically since the start of the pandemic. It's created a lot of replacement, pent-up demand. And that not to say that, it's a big ticket item, that autos would be immune to the ability of the consumer to spend if we were to have some sort of recession. But I do think that sector is set up from a positive replacement demand standpoint at some point because of the underselling that's occurred over the last three years. So, I think that's a super interesting sector as well. And then, you know, nothing earth shattering, but the typical durable sectors, like healthcare and utilities, packaging, you know, should all fare better in a slowing economic backdrop.

Mike: Yeah. I know some of the home builders, maybe they're like the autos; right? Typically, in a rising rate environment, those sectors are really interest-rate sensitive, and they tend to have big drawdowns. But we've actually been seeing value in some of the home builder bonds. They've underperformed, the autos and home builders have underperformed because of the rising rates. But what's your view on those in terms of the way they're positioned today versus some past cycles?

Janet: Yeah, so we had a deep dive by our home building analyst two or three weeks ago, and he brought up some very good points. They haven't overbuilt; right? So, supplies are tight. The millennials and the X-genners, I mean, they've decided that, I think probably because of COVID, that they want to be in a home. Rents are a big, big determinant here. The median rent for a studio to two-bedroom apartment right now in the largest 50 MSAs has reached its highest point in history at $1,840 in May of 2022. This is a 15 percent year-over-year increase. This is an interesting point because that's going to push or could push someone from a rental into a home. So, there's going to be time to see this; right? But what they have noticed and some of the home builders that have reported is that the people have them switch to lower finishes. The incentives are still 1 percent of the sales price. They're usually 3 to 4 percent of the sales price. They are starting to make the units a little bit smaller to kind of tailor it. So, look, I think it's in good shape. Spreads will widen here though because affordability will be an issue, I believe. But I think they're going to be in much better shape as we move down the road.

Mike: Yeah, that's really interesting; right? The typical sectors that do poorly, some of them are actually pretty well positioned. The energy, the home builders, the auto builders, the really deep cyclicals typically get clobbered in a downturn, but they haven't had those excesses build up. In some ways the whole corporate bond market, to Brian's point earlier, the leverage in the system from a credit standpoint isn't as excessive as it's been in some past cycles. The fact that this has been a really short two-year cycle, I think is a little bit of a benefit; right? Because you have haven't had that long buildup really in some of the excesses, which is may be our saving grace.

Janet: And, Mike, you can fact check me, but I believe that the leisure and lodging and the residential home building make up like 6 and 5 percent of GDP, which is very considerable. So, these two sectors are super important as we look forward.

Mike: Yeah, so we'll see how that plays out. Another sector I'll throw out there which happens to be one of our bigger overweights, more in our investment grade and the multi-sector portfolios I manage is the financial sector and the banking sector. And, again, another sector that in some past downturns, think the great financial crisis, they really blew up, and this time it's much different. The banks just went through these Federal Reserve stress tests and generally passed with flying colors. I mean, the capital ratios they have, the liquidity they have, the asset quality, meaning the underwriting's actually been better this time around than it has been in the past. So that's another sector that might actually hold in better, act more like a utility sector than a deep cyclical. So, we'll see how that works out.

Janet: Except for the mortgage originators.

Mike: Yeah, some of the dicier, sub-prime, aggressive, electronic, kind of mortgage originators, I think are already starting to feel a little bit of pain.

Janet: Yeah, but I think it will just go back to like some kind of normalization, not where we were in the great recession, at least that's what it feels like.

Mike: Yeah, generally mortgage underwriting is so much better than it was in 2005, 2006 and 2007. It's night and day. So, thank you. Let's shift to some of the risks in the system; right? So overall leverage isn't that bad. Some of the big, deep cyclical industries that we usually worry about are actually pretty well positioned. We're not sure if we are going to have just a slowdown, a mild recession, or big recession. To your points, there's so much uncertainty in that outlook. What else are we seeing? Like what are some of the other fault lines, we call them, or potential cracks in the system that could cause more systemic problems; right? Typically wherever all the money goes tends to cause problems in the downturn. Where have you seen some of those riskier parts of the market start to evolve?

Brian: I think one of the big themes is that we've become accustomed to an abundance of cheap capital at the onset of stress or distress. It's actually one of the reasons I think that defaults have been structurally lower post the global financial crisis. And there's a linkage there with inflation. I mean, depending on the success of central banks and combatting the stickiness of inflation, how persistent it is, it's really possible that the systematic support that we're really anchored to—we're going to have to unanchor ourselves —from the Fed, from the ECB may be unavailable. At least in a systematic way, we've got monetary or fiscal that's come in and really helped to flood the market with liquidity and restore confidence. So, I think to the extent that we have an economic contraction of sorts and/or inflation is more persistent than anticipated, that we really got to unanchor ourselves from this notion that there's an abundance of cheap capital of fiscal and monetary support, at least in a systematic way. And that may alter the default experience of credit markets that, again, we've become accustomed. So, I think that's a big them and a key one to watch as this tightening cycle and economic slowdown and inflation picture develop further.

Mike: Sure enough, some of that liquidity is already hitting the markets. Like the high yield market has had hardly any issuance over the last couple of months; right? So that liquidity, that demand for credit there is already starting to dry up. And, Janet, do you think that that will ultimately be a problem for some of these borrowers?

Janet: Well, the maturity wall, at least in high yield and bank loans, is out; right? It's not in the near term. So, feeling like that won't be a big problem as we move to 2023 and 2024. It's going to get down to, Mike, the basics of the blocking and tackling and picking the right credits; right? There will be credits that won't be able to pass these increases along; right? Then high yield and definitely bank loans is a more levered asset class that it has been during the great recession, that it is today. So that overall market, at least at PGIM here we've got—I don't want to use the exact hit rate—but we've got a pretty low hit rate. And it's all about picking the winners and the losers.

Mike: Meaning the issuers that come to the market we're—

Janet: Yeah, so every ten issues that come to market, we do, let's just say two or three of them.

Mike: Yep, yep. Turning away a lot of them.

Janet: And it's interesting because that also can be an opportunity, which we can talk about it as we move forward, but we should get back to that.

Mike: Yeah, yeah. So, one area that I always think about as potentially ripe for risk, obviously, we talked about like the whole growth in the crypto area. None of us are experts there, but, man, that thing is really coming unglued, and you see the leverage in the system. You see the lending that went on. The cryptos, the coins themselves are used as collateral. The machines they use to mine them are used as collateral. And when everything goes down, the whole house of cards comes down. And I look at the private debt markets. I know historically it's been a kind of a staid market. And Janet, you started your career really in our private side. And I remember we used to have private versus public softball games way back in the day. I've seen a lot of our big institutional clients shift their money in a pretty aggressive way into private equity, but private debt and private credit. And my sense is there's a lot of capital competing for deals. And I know, even in the public fixed income side, where we generally focus and PGIM Fixed Income, you know, we're also evaluating some attractive private deals that are available. What's your take in the private markets from what you're seeing?

Janet: Yeah, so I've been on a team that's been evaluating some of these privates. We've been dabbling in it, and probably since the early part of 2022. And as you said, there's a lot of money out there that's moving towards this space as investors are reaching for yield. To be honest with you, the quality of what we're seeing is not great. We've done very few of the transaction we've looked at. They're either in businesses that we are not comfortable lending to, or it's a situation where we're not being paid for the risk which we think we're taking. Pretty much sum it up that way. Most of them fall into the latter part of that description.

Mike: Yeah. And certainly, the pricing in the private markets, and I would even put the real estate markets to some extent. You talk about house prices, they haven't really moved yet. But when equities are down 20 to 30 percent and all bonds are down 5 to 20 percent, basically, it's really hard to believe that you won't have other asset classes like real estate and private debt finally at some point get marked lower, and we certainly haven't seen that yet.

Brian: I think it's important to say that the private debt market is a very opaque market. And it's true that the market has gone through a lot of growth. And we know that whenever markets go through a lot of growth and we have a lot of new participants and there's lots of capital chasing a very finite opportunity set, that there's likely to be mis-pricings and stretched underwriting. It's just very hard to observe at the moment given the opacity of the market. And it brings me back to the fault lines question, which is, for fault lines to take hold sometimes you need that economic event, a slowdown of some duration and depth. And when the tide goes out, often we find that the fault lines weren't observable pre-growth slowdown. So, I would also point out that the unknown here is potentially impactful, and it's one of the reasons why I personally struggle with. And what many market participants would say, this is, you know, one of the most uncertain times that we have been through, which is a little ironic coming out of a pandemic which nobody predicted. But there's a lot of cross currents now. We've got inflation. It looks broad based and persistent. There's no clear way out. We have this underinvestment in the commodity space creating potentially sticky commodity pricing, even in the face of demand destruction. So, you have all these cross currents. Yet with all this uncertainty, the market seems very confident that, if we do have a recession, it's going to be short and shallow. And I guess that's a fault line in and of itself. That if we do actually have a couple of quarters of really weak below trend growth or negative growth, the second derivative impact to that where the tide goes out, and then we really see some of the potential fault lines exposed.

Janet: Yeah, Brian, that's an interesting point. People do believe it's going to be shallow and I think it's because of these three large sectors that are all in really good shape that kind of drive some of the bus; right? The autos that we talked about. The home builders. People do want to travel. So maybe that's what keeps us out of the real basement.

Mike: Yeah. And companies, in general, and consumers, in general, you know, are pretty de-levered. Talk about de-anchoring away from this monetary support, this backstop, Brian; right? We've kind of been anchored to believe that, when you have a downturn, it's a global crisis; right? We've had, you know, the .com thing blew up in 2000. We had the great financial crisis. We had COVID. And we've had some really nasty events over the last decade or two. And maybe this recession isn't one of those; right? Maybe it is a slowdown. Maybe it's okay. Maybe it's natural. And maybe it's not that bad. And maybe the fact that these companies are fairly well positioned, it doesn't turn out so bad. So maybe this is a great opportunity to shift a little bit from the risks and the fault lines—and there are many and they may or may not come to fruition—to where the opportunities are. There's been a huge sell off in the global asset markets, from equities to bonds. Government bonds are down 10 to 20 percent, depending on the duration. Credit strategies are down, like I said, 5 to 20 plus percent. These bond prices for really the first time in a long time, are not above par; right? Mortgage, the average price, dollar price on the agency mortgage-backed securities index is at like $0.90 on the dollar; right? These things are all trading at big discounts. Is that something, Brian, that could be an opportunity?

Brian: It's super interesting. Because of this really low rate regime we've been in, the corporate bond market in the U.S. and Europe has basically repriced their capital structure to very low coupons. And a byproduct of the shift in rate regime we've experienced this year is the duration impact of that, where we've had a big bond price selloff; right? High yield bond price is off, you know, 15, 16 points from the start of the year. You've got 250 or 300 billion of investment-grade rated bonds trading below $75 price. These are really high-quality, blue chip companies. So that's a really interesting opportunity set with the ability to invest in really good fundamental businesses at more attractive dollar price valuations. You know, with the long-term perspective, I think there'll prove to be some pretty good opportunities there. It's also interesting in the lower tier of the credit markets, the low coupon phenomenon was also experienced by CCC-rated credits in leverage finance. And so, they've had order of magnitude bigger, but similar directional dollar price movement. And, you know, you've got the average CCC bond trading in the 70s, and you think about historical recoveries for that space in the 40s. You can take out commodities, you know, you're starting to get to a really interesting relationship between current dollar price and potential recovery upon default. This is obviously very simplistic framework, but it's interesting to think about, particularly if you're more positive on the economy going forward, and you think that an economic event is late 2023 or 2024, and you think about coupon carrying, et cetera. So, for our more flexible portfolios that can go down in quality or travel across markets or geographies, it's really a target-rich environment with maybe some atypical targets in what we typically associate with a more stressed credit environment from a dollar price standpoint. So, it's a very interesting investment landscape at the moment.

Mike: Yeah, might be an interesting opportunity. I know our high yield team is looking at more of this kind of bar-belled type strategy where you pick the credits that are going to survive, a lot of the industries and credits we've talked about. But, wow, there are a lot that are priced with very high default probabilities. And I'll just do the basic math. If these are trading at $0.70 on the dollar, and the recoveries are 40, there's like a 50 percent default probability priced in on that whole basket of bonds; right? So, if you're good at the security selection component, which we hopefully are and believe we are, there is an opportunity there. And, Janet, where else do you see value being created in the markets?

Janet: Yeah. Look, on this distress side, portfolio managers are running the runs, looking at anything that's trading $0.80, $0.70, $0.60. These are credits we passed on, but we might be able to find value there. Even if it's 20 points of value; right? We've got analysts signing NDAs, getting copied up, taking the deep dive on credits and seeing if whether or not we can move forward. Those—we can do priming loans there. We talked about creditor on creditor violence. I mean, it's being done to us. And, you know, we've got to move from a more passive role that we've historically taken to more of an active role. And we've had very good success with that strategy in 2021. And we've got our analysts working when they have the time to peel back the onion on some of these credits, and I think we can find some value there.

Mike: Yeah, I know even some of the investors in the multi-sector strategies that I manage have also benefitted from these quasi-distressed opportunities that could have pretty good returns.

Janet: Yeah, we have these couple distress analysts, they've partnered up very well with our credit folks. We've had a lot of good success.

Brian: When the markets become volatile and spreads widen, negotiating power shifts back to the capital providers, aka, to the PGIMs of the world, and that creates really interesting opportunities to extract better terms, investor protections in new or rescue-type financings. And to your point, we're really set up to capitalize and take advantage of that across markets. And the shift in that negotiating power is a seat change from what we'd experienced post-global financial crisis, ex-the very short pandemic period where documentation has deteriorated markedly, and investor protections have become a lot looser. And it's led to some of the things that Janet was talking about. So, that's a big trend, the shift in negotiating power to the providers of capital from the users of capital.

Mike: To that point, just in the last few weeks, we've seen, a handful of deals where the underwriters, i.e., kind of the big global investment banks secured the ability to sell a large bond deal from an issuer that did a big M&A transaction, and they locked in a coupon or yield, or promised at least a cap, and then the markets would not provide that level of yield. So there have been some of these deals issued at big discounts to par. And I know we've been pretty active in pursuing some of those as well. So that's exactly what's happened there. How about internationally, Brian or Janet, anything between the U.S. and Europe or developing markets where you're seeing risks or opportunities?

Brian: Yeah, we have a pretty similar defensive posture across the shop, whether it's international, U.S., IG or high-grade or leveraged finance, but we have been order of magnitude more cautious on Europe to date this year given its proximity to, you know, the Russia/Ukraine conflict, the energy crisis that's unfolding on the continent, of the lack of easy fixed, potential for a more acute outcome if Russia were to fully switch off the gas. So, to date we've been more cautious on that market on a relative basis. We continue to have that view in the shorter run. And really the key determinant outside of valuation is thinking through, like I said, the proximity to the conflict and the energy considerations in Europe.

Mike: Yeah, certainly because of that concern for the trajectory of growth in Europe, there are actually opportunities that have emerged there too. We've seen even U.S. companies that issue in euros, their bonds are trading dozens of basis points wide in spread on a fully hedged basis to their dollar-denominated counterparts. So, you can actually take advantage of the arbitrage available because of that dislocation. So that's something we're also looking at. Any other closing remarks, Janet, before we wrap up?

Janet: I'd just say, you know, this may seem obvious, but having analysts that have studied and know their industries for 20-plus years makes us successful in finding where those opportunities are. You've got 20 companies you cover in a space, and you see this one company trading 20 points off. You kind of figure out why, dive into it, and see whether or not it makes sense. With that institutional knowledge, it makes it work.

Mike: Yeah, and with this volatility comes those opportunities for sure. And even if you're not increasing your beta in the portfolio and adding credit risk outright, wow, there do seem to be a lot of these bottom-up relative value opportunities out there, and we're positioned well for it. For example, in our multi-sector portfolios that I co-manage, we have taken than credit risk, like you've spoken about, down quite a bit. We're about as low in credit beta as we've been in a while. So, we have that dry powder, but we're seeing enough opportunities from the bottom up that we don't have to go down in quality or get really aggressive and take a lot of beta to generate the alpha we're striving for. So that's really interesting. And just for everybody listening, to put a valuation on it, to give a sense of where we are, so it's really interesting; right? The investment-grade corporate bond index has an average spread today of about 150 basis points. The high yield bond index has an average spread today of just over 500. Those numbers are right about at the historical averages or the historical medians. And, historically, spreads do not sit around at the average; right? They're either above the average in a recession, or they're below the average in a good environment. And the markets are really in no-man's lands here; right? They're trying to figure out, like we are on this call, the lack of certainty around the trajectory of this cycle and the default projections. And, you know, the winners and losers are so challenging here that the markets are really in limbo trying to figure out, is the next move wider in spread or tighter in spread? And, again, it depends on how the path goes here. But there is a lot that has been priced in already. I would say the markets are generally pricing in a reasonably high probability, probably 50 percent probability of a recession, but maybe half of that's a deep recession and half of that's kind of a mild recession. So, it really matters on the contour of the recession. If we do have a slowdown, how does it play out? Of course, if you don't have a recession, you just have a moderation in growth, I think risk assets are undervalued here. So that's the big dilemma. So, thank you, Janet Crowe and Brian Barnhurst. It's been a pleasure to have you join us on All the Credit. And for all of our listeners, please find all of our thought leadership on our website, pgimfixedincome.com. You can find our bond blog, aptly called The Bond Blog there as well. We also recently launched a new podcast called Fixed on ESG. And it's everything you ever wanted to know about environmental, social, governance factors that we apply and think about every day as we're analyzing credits and building portfolios. So, until then, thank you.

Janet: Thanks for having us.

Brian: Thanks, Mike.

[Music]

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