

# KKR CREDIT

MARKET REVIEW

Q2  
2021



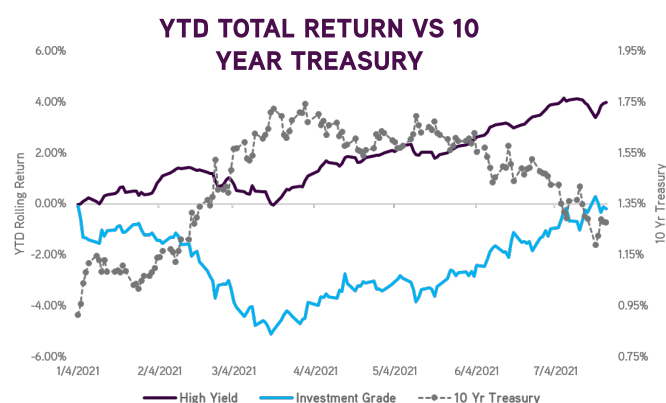
**DIAL M  
FOR  
MARKET**

# Dial M for Market

**CHRISTOPHER A. SHELDON**

TAL REBACK & KRIS NOVELL

We began the year recognizing that the fundamental investing landscape had dramatically shifted. We related to this new investing paradigm through Hitchcock's lens of *Vertigo* in the first quarter, as many of the market's characteristics continued to send mixed messages to investors but simultaneously did not show signs of a slowdown. We now find ourselves halfway through 2021 and we will use this letter to spend some time reflecting on the evolution of the credit markets. In particular, we have been reflecting back on how the last sixteen months have transformed the structure of the markets as the global economy finds its footing amidst a new era of policy that has a higher reliance on government intervention on the fiscal side and reflationary strategies on the monetary side. This quarter we will continue our Hitchcockian analysis, once again taking a cue from the "Master of Suspense." Hitchcock did not rely on cheap jump scares but rather the slow burn of anticipation. Similarly, we believe this market will continue to keep investors on their toes, especially as the Fed gets closer to tapering and reflationary trends continue. Despite the positive tailwinds of rapid growth we are currently experiencing, we want to highlight and caution that this is a new chapter in history. We cannot discount the impact of higher than anticipated inflation on corporate margins, labor and wages, as well as cost of goods. Akin to a Hitchcock plot, we do not know with certainty what the future holds as we look to manage life with virus variants and an increasing role of big government.



“There is no terror in the bang, only in the anticipation of it. **ALFRED HITCHCOCK**”

	YIELD	SPREAD	Q2 2021	YTD
<b>US High Yield</b>	3.86%	304	2.77%	3.70%
BB	3.10%	219	2.90%	2.68%
B	4.21%	349	2.11%	3.32%
CCC	6.40%	583	4.09%	9.51%
<b>High Yield Distressed</b>	17.66%	1704	10.21%	29.88%
<b>US Bank Loans</b>	4.23%	406	1.47%	3.28%
BB	3.18%	300	0.83%	1.58%
B	4.40%	420	1.52%	3.15%
CCC	7.85%	763	3.42%	10.02%

Source: KKR Credit Analysis, ICE BofAML, S&P LSTA as of June 30, 2021

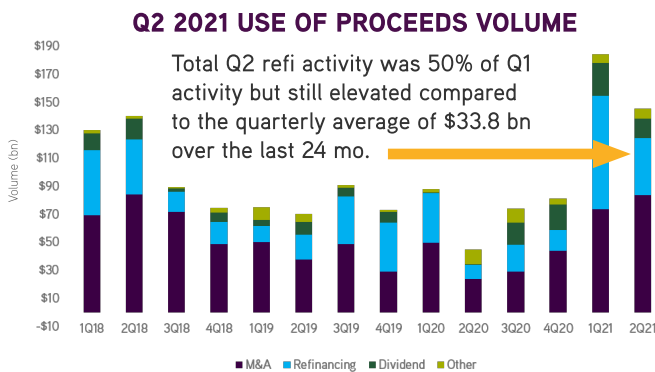
The market continued to bounce back with sustained appetite for risk assets and momentum through the reopening trade. U.S. High Yield returned +2.77%<sup>1</sup> and U.S. Bank Loans +1.47%<sup>2</sup> for the second quarter as of June 30, 2021. The quarter was another strong showing for credit markets with yields now squarely at pre-Great Financial Crisis ("GFC") tights and spreads continuing to grind tighter: U.S. High Yield spreads ended the second quarter at 304bps.<sup>3</sup> We believe the market probably continues to creep tighter in the near-term and that now is the time, more than ever, to shift an investor's portfolio composition to take advantage of what we like to call the "New Active" as this recovery will look different from others in history.

Looking back to the GFC and the immediate post-GFC chapter, distressed funds played a big role in the market, but we do not see the same type of distressed strategies like we saw a decade ago. The game has changed and shifted – we believe this is also in large part due to the structural shifts we have seen in the market. Access to distressed securities is not as easy for investors as it used to be. March 2020 is not the norm. The opportunity to find distressed for control or to buy good companies with bad balance sheets for pennies on the dollar is now more rare. Today’s “distress” has shifted into giving existing lenders the upper hand. The market has and will continue to have temporal dislocations, pockets of dispersion amongst sectors and industries, and event and or market-driven catalysts that present buying opportunities. Those closest to the credits will be able to act quickly when that time arises. The landscape does not look the same as it used to. In order to stay relevant, we believe it is important to cover a large breadth of capabilities and or tap into a large platform to track the market’s movements and population of credits in real time. As we mentioned last quarter, this is a new era of investing whereby we believe investors need to be even more hands-on, structurally creative, and proactive in managing their portfolios. We believe the more flexible investors can be the better.

**The new active is extremely hands-on, proactive asset management that is able to flexibly pivot with the market**

**OFF TO THE RACES**

The loan market remained active with \$145.8<sup>4</sup> billion of institutional issuance in the second quarter as the market continued to see strong demand for floating rate assets. CLO issuance reached \$78.9<sup>5</sup> billion for the first half of 2021, which is the highest level for any comparable period. Transactions supporting buyouts and strategic acquisitions accounted for \$83.9<sup>6</sup> billion, or 58%, of second quarter volume, which is the second highest dollar volume on record behind the second quarter of 2018. Additionally, new leveraged buyouts (“LBOs”) for the quarter totaled \$41.5<sup>7</sup> billion, which is the highest volume since the GFC.



Source: KKR Credit Analysis and S&P LCD as of June 30, 2021

With rates still at historical lows, the door remains open for borrowers to address upcoming maturities or to take action to reduce future interest expense, especially for those who may have issued debt during the pits of 2020 when clearing levels were significantly higher. A

recent stark example of this action was Carnival Corp’s May 2021 repricing where they reduced pricing from L+750 with a 1% LIBOR floor to L+300 with 0.75% LIBOR floor on their senior secured term loan B<sup>8</sup> – one of the largest spread reductions the market has seen. Overall, borrowers repriced approximately \$39<sup>9</sup> billion of loans in the second quarter compared to \$148<sup>10</sup> billion of repricing activity in the first quarter of 2021 – a sharp decline. The CLO market continued to beat ahead with the stable backdrop of liability spreads and leveraged loan supply acting as the wind beneath its wings. We still think the yield pick up is attractive and are constructive on the space. The market saw an average of approximately \$14<sup>11</sup> billion of CLOs priced per month bringing the second quarter to \$41.3<sup>12</sup> billion. The foundation of record CLO issuance has been the incredibly stable backdrop of liability spreads, triple-A spreads have held up at an average of 116bps.<sup>13</sup> Despite heavy supply of paper – will that continue to hold if the pace of issuance remains constant?

**CLO SPREADS REMAIN ATTRACTIVE: THEN VS NOW**

	AAA	AA	A	BBB	BB	HY CORP	LL CORP
2006	24	37	65	150	350	335	224
2007	25	47	100	225	435	298	244
2008	170	370	600	800	1275	730	542
2020	165	220	290	415	820	644	661
2021	100	150	190	290	625	304	406

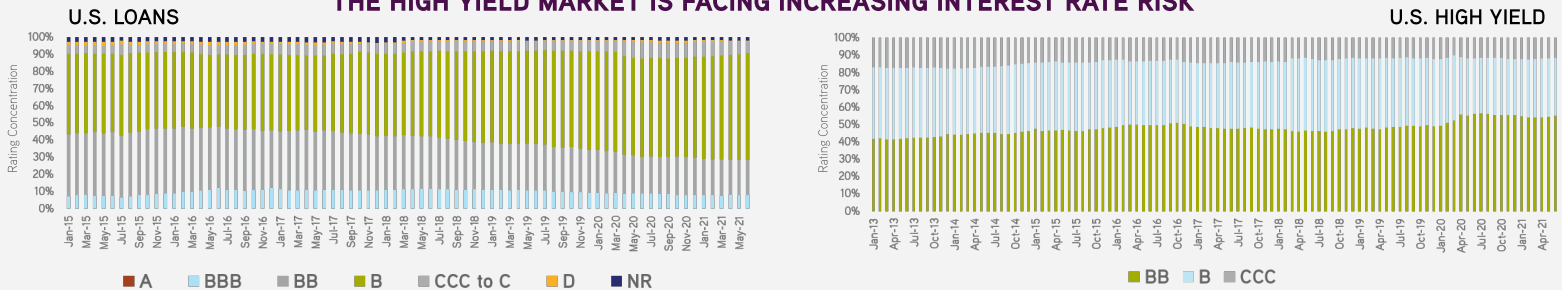
Source: KKR Credit Analysis, Wells Fargo Research, ICE BofAML, S&P LSTA, as of June 30, 2021, 2020, 2008, 2007, and 2006

The majority of issuance in the second quarter also skewed towards single B rated issuers with 43%<sup>14</sup> of issuance originating from borrowers with at least one single B- rating. With M&A and LBOs driving activity in the loan market, it is particularly noteworthy to highlight that we have witnessed structural changes over the course of the last sixteen months as the market's composition continues to evolve drastically on the heels of the 2020 drawdown, which we discussed in our Q4 letter *Symphony No. 2020: A Market Composition*. The share of outstanding loans rated single B has increased during the pandemic and currently stands at 62.2%<sup>15</sup> of the U.S. loan market, with Single B- loans accounting for 25%<sup>16</sup> of loans outstanding, an all-time high. In the

high yield market, BBs now account for 55%<sup>17</sup> of the market, which demonstrates the difference in credit quality amongst the two segments of the market. We have remarked many times that there has been increasing credit risk in the loan market, but now it is more visible through the higher concentration of single B or lower rated loans. While the loan market is experiencing growing credit risk, the high yield market is experiencing growing interest rate risk.

Our current house view is that the Fed will move short rates in 2023 and that the long end of the curve will gradually increase – ending 2021 at 1.75%<sup>18</sup> which means there will be volatility ahead in high yield.

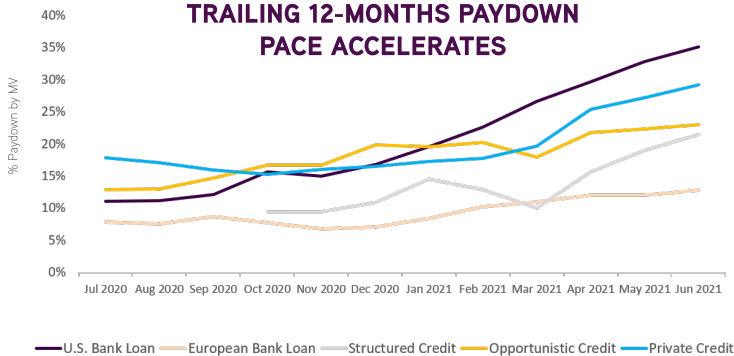
**WHILE THERE IS INCREASING CREDIT RISK IN THE LOAN MARKET, THE HIGH YIELD MARKET IS FACING INCREASING INTEREST RATE RISK**



Source: KKR Credit Analysis, ICE BofAML, and S&P LCD as of June 30, 2021

Another notable trend for the loan market has been the accelerated pace of repayments amidst tightening yield levels. Ultimately, this illustrates the reinvestment risk in the current landscape as this trend leads to proceeds being reinvested at a time when spread levels are significantly tighter. Thus the challenge becomes re-generating the same level of yield and income in a portfolio against a tighter backdrop. We analyzed different segments of the loan market through representative KKR portfolios to determine if this trend was isolated or specific to pockets of the market. What did we find?

**TRAILING 12-MONTHS PAYDOWN PACE ACCELERATES**

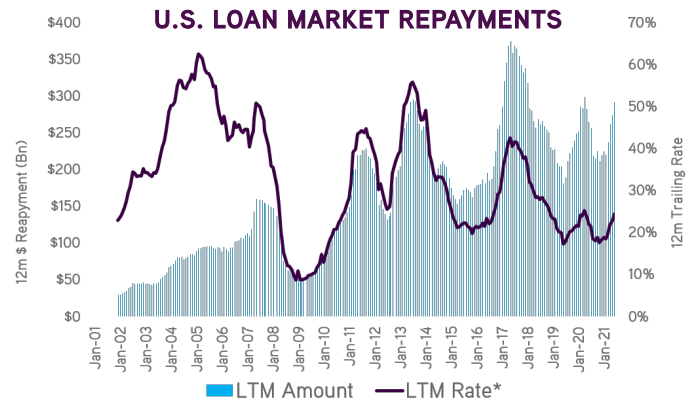


Source: KKR Credit Analysis as of June 30, 2021

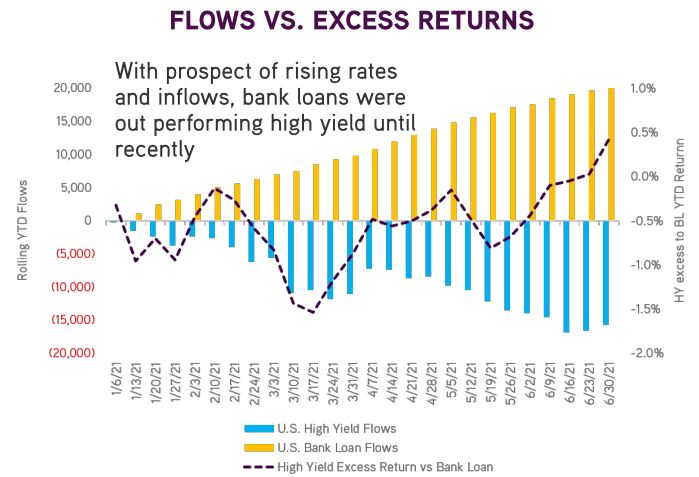
In the broadly syndicated loan market, the trailing twelve month paydown levels have increased – inching towards north of 35% as of June 30, 2021. In the European bank loan market, paydowns have also steadily increased, albeit at a slower pace. These moves have coincided with the tightening of single-B loans primary spreads across the US and Europe. Across the structured credit universe, paydown levels have been lower than bank loans over the last twelve months. However, due to continued tightening in CLO pricing, there has been an acceleration in paydown and refinancing activity in the second quarter. In the private debt arena, we have a similar story to tell with the twelve month trailing paydown levels increasing 10% during the second quarter to 29% as of June 30, 2021, ultimately implying a steeper turnover rate for private credit portfolios and the continued need for new origination activity amidst a competitive backdrop.

In mixed portfolios with an asset allocation across high yield, leveraged loans, and structured credit, the pace of repayment has been more muted over the last twelve months in large part due to the bond allocation in the strategy. However, this particular pattern is not new for the credit markets. It demonstrates the market’s position in the current cycle. We believe it is important to assess relative value across capital structures as the frequency of potential portfolio turnover grows further; supporting our view that strategies that can flex and toggle allow for a more defensive position in this current environment.

With all that said, the continued expectation of rising rates has us currently favoring floating rate assets. High yield benefited from the large impact of duration and quickly snapped back – especially longer dated paper, many of which are now trading well north of par. The energy sector is a good example of a segment of the high yield market that benefited from duration. Energy currently accounts for 13.67%<sup>19</sup> of the high yield market, and 63%<sup>20</sup> of energy names are rated BB as a result of being Fallen Angels and thus originally issued with longer maturities because of the investment grade profile.



Source: KKR Credit Analysis and S&P LCD as of June 30, 2021



Source: KKR Credit Analysis and S&P LCD as of June 30, 2021

## The continued expectation of rising rates has us currently favoring floating rate assets

On the relative value spectrum, floating rate paper offers more convexity relative to fixed rate paper in this environment. This is evident in the BB and Single B loan space across U.S. and Europe as well as CLO BB tranches. Despite spread compression over the last year in CLO tranches and loans post the height of the volatility in March 2020, current spread levels appear relatively cheaper compared to five and ten year historical averages.

		US BONDS					US BANK LOANS				US CLOS		
Percentile		HY	BB	B	CCC	BB-BBB	BLs	BB	B	CCC	A	BBB	BB
Current Spread		304	219	349	583	112	406	300	420	763	205	310	635
1yr		100%	98%	98%	100%	98%	95%	54%	97%	100%	80%	89%	84%
5yr		100%	85%	95%	100%	37%	66%	42%	74%	100%	77%	81%	62%
10yr		100%	92%	97%	100%	62%	83%	71%	87%	100%	88%	90%	66%

		EU BONDS				EU BANK LOANS			EU CLOS		
Percentile		HY	BB	B	CCC	BLs	BB	B	AA	BBB	BB
Current Spread		296	231	405	677	449	349	445	325	600	850
1yr		91%	93%	84%	91%	93%	61%	79%	84%	71%	80%
5yr		82%	78%	86%	85%	55%	35%	71%	63%	49%	58%
10yr		91%	89%	90%	88%	77%	67%	85%			

Source: KKR Credit Analysis, ICE BofAML, and S&P LCD as of June 30, 2021

## THE NOT SO INVISIBLE HAND

Even as treasury rates turned experienced volatility this quarter, high yield continued to stand resilient in the face of rising rates and emerging inflation threats. Issuance for the first half of the year exceeded \$286<sup>21</sup> billion, and the second quarter printed \$137<sup>22</sup> billion of issuance, a modest decline from the \$149<sup>23</sup> billion in the first quarter of 2021 and just shy of the print the second quarter of 2020 saw with the help of the Fed at \$140.5<sup>24</sup> billion. All four metrics from the pandemic era are all-time quarterly records. Investors and Issuers alike cannot ignore the undeniable and unprecedented opportunity for borrowing created by the Fed coupled with the insatiable yearn and

Quiet down Carl, I'm still on hold with the Fed



Illustration by: Jerry Capria, KKR Credit

hunt for yield. In the second quarter, bond spreads waned tighter through the first half to support low cost outcomes. The average T+313<sup>25</sup> spread at pricing for issues in June inked a new pandemic-era low, down from T+538.<sup>26</sup>

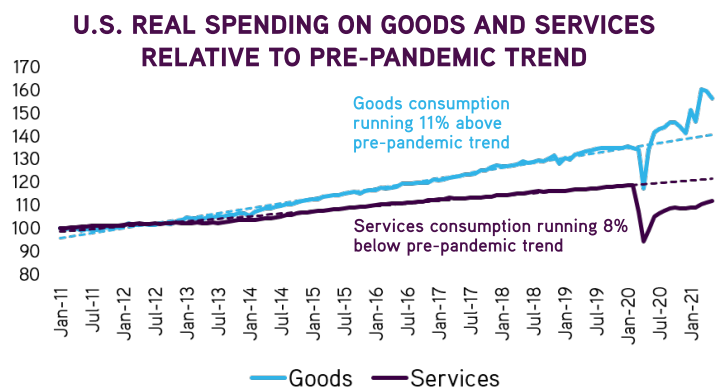
Consistent with market sentiment, refinancing led U.S. high yield bond issuance was \$202<sup>27</sup> billion for the first half of 2021, nearly 2x pre-pandemic peak volume. As we noted a number of times last year, when the capital markets reopened last year it enabled Issuers to push out their maturity walls and further kick the can down the road. This behavior combined with the large swath of investment grade Issuers who became fallen angels upon their 2020

downgrades extends the markets overall duration profile – and as we saw this quarter, that is the cohort that benefited the most from the rate rally. Often, longer duration in a low rate environment should outperform shorter duration paper. That is why investors should not underestimate the power of call protection especially with tightening spreads. While being longer dated has paid off in the midst of rate movements, we would remind investors that the longer extension also creates the potential for elevated gap risk.

## Elevated gap risk is on our minds and investors need to be mindful of this in longer duration assets

Circling back to the topic on all investors' mind: inflation and the Fed's foreseeable tapering. Thus far the market's performance in sectors where supply chain bottlenecks have been evident have been resilient. At the issuer level, the majority of recent performance has been tied to the economy reopening suggesting that inflation may be transitory. In the Fed's July 9<sup>th</sup> Monetary Policy Report, the Fed states that inflation is indeed temporary through their analysis of market implied measures and survey data based on future expectation, "Consumer price inflation has increased notably this spring as a surge in demand has run up against production bottlenecks and hiring difficulties. As these extraordinary circumstances pass, supply and demand should move closer to balance, and inflation is widely expected to move down."<sup>28</sup>

It does not completely dismiss the risk of further upward pressures on prices and that the Fed's injection of



Source: BEA, BLS, Federal Reserve, Haver Analytics, and KKR Global Macro & Asset Allocation as of July 13, 2021

liquidity into the market goes without longer-term consequences. As demonstrated in this quarter's Federal Open Market Committee ("FOMC"), a number of policy members appeared ready to discuss tapering the Fed's ~\$120 billion monthly bond buying program<sup>29</sup> in upcoming meetings as a result of the rapid progress the economy has been making.

Our Global Macro & Asset Allocation team, led by Henry McVey, base case view is that the Fed will start to introduce the taper in late July or at the end of August at Jackson Hole.

**The pandemic catalyzed a shift into goods over services consumption, which has yet to normalize**

McVey believes that the Fed will likely not actually begin to taper until late 2021 or 2022, and then will pause before raising rates in late 2022 or

2023. The KKR house view is that the Federal Reserve and its peers will continue to find ways to remain highly accommodative when it comes to short-term interest rates.

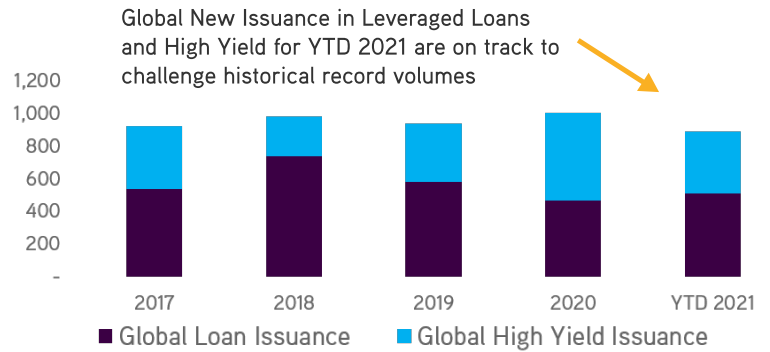
**REAR WINDOW**

From a historical view, second quarter global issuance volume was strong. While second quarter volumes did not match the fervor of the first quarter’s global print of \$275.9<sup>30</sup> billion for loans and \$195.1<sup>31</sup> billion for high yield, which was uniquely high, it did produce the highest loan volume in three years, excluding Q1 2021. In high yield, Europe’s performance was particularly notable, with that market segment posting its busiest quarter on record.<sup>32</sup>

Across the various market segments – the waters ahead seem to appear relatively calm, for now, as

strong demand ensues, inflation worries are being pushed to the rear view as businesses focus on recovering and reopening. The market’s animal spirits are awake and intact post lockdown fueling an uptick in acquisition related activity – a stark difference from when we last discussed the market’s animal spirits in the first quarter of 2020.

**GLOBAL LEVERAGED LOAN & HIGH YIELD ISSUANCE**



Source: S&P LCD and KKR Credit Analysis as of June 30, 2021

The market continues to attract capital from a diverse array of market participants and there is still a good amount of dry powder on the sidelines suggesting that the market will continue to persist until a new wrench is thrown into its system to catalyze a pause or correction.

**Inflation worries may be getting the rear view as the market continues to focus on businesses reopening**

We used this quarter as time of reflection. A reflection on how the markets have evolved structurally and how they continue to morph. A reflection on the pre-pandemic and post-GFC market cycle, and what this new era may look like vis-à-vis continued accommodative monetary policy, increasing geopolitical tensions, and the influence of big government amidst a global backdrop that continues to adapt in real time.

This brings us back to our favorite saying, “Good Yield Hunting.” We continue to be in a market where demand for good yield is infinite. Lower rates have led to a greater pace in paydowns, which have pushed market yields lower, ultimately increasing reinvestment risk. The public markets are tight and the private loan market is highly competitive. The market has become more siloed across its segments, which is why we strongly believe, the “New Active” is an investment management style that is here to stay. We have noticed many times that when an asset class, structure, or credit is storied or not perceived as good yield, market participants may shy away. However, we are seeing tremendous opportunity emerge in this arena. We believe we are back to leaning into complexity, as we do in our Opportunistic Credit and Asset Based Finance platforms to identify compelling idiosyncratic risk. We view the road ahead as one that could become bumpy, and being innately agile and finding synergies amongst investment theses will be a source of alpha when the next dislocation appears. We know volatility will be back and it always likes to come to the party when people least expect it.

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The market shifted from everything being cheap and on sale all at once, to a market where many companies needed liquidity bridges. We then saw the market shift again, as a result of so many consumer and commercial behavioral changes, to a landscape that is creating idiosyncratic trades and pockets of thematic opportunities, coupled with a large cohort of companies that are still in need of capital or a strategic thought partner due to events of 2020. This will be a non-linear recovery. Despite the market rebound, businesses and communities did not all have the same level access to the Fed's liquidity injection and stimulus.

And so, a new chapter begins. A chapter that will undoubtedly have an element of suspense and maybe a little bit of shock factor, but what we find compelling is that KKR Credit is truly designed and structured to move with the markets and its opportunity set. We tap

into our collective toolkit as a Firm and as a platform to originate, collaborate, and create structural solutions for our investors and portfolio companies as well as identify opportunities to extract excess alpha. From our Leveraged Credit platform, to Private Credit, to Structured and Asset-Based Finance, we are all-in all the time.

We want to thank our investors for your trust and partnership. As always, we welcome your feedback on our letter and are grateful for the opportunity to discuss our market views with our readers.

Christopher A. Sheldon

A handwritten signature in black ink, appearing to read 'C.A. Sheldon', with a long horizontal flourish extending to the right.



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