THE CARLYLE GROUP

GLOBAL ALTERNATIVE ASSET MANAGEMENT

Carlyle Comment

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The Current Credit Market Outlook

By Mark Jenkins

Mark Jenkins, Carlyle Head of Global Credit, made the following comments on a call with Carlyle fund investors on July 11. Comments have been edited for brevity and clarity.

The Credit Market Environment

It's common to hear that we're in a "Goldilocks" credit market environment these days, with widespread belief that it's sustainable for another couple of years. But eventually, the porridge is going to be too cold. Today you are seeing high yield bonds priced at a spread of 400 to 425 basis points over Treasuries. Back in 2006, we reached spreads of 200 bps and many of us thought the market was ready to implode, but it took fully 2½ years to happen.

So the main thing to focus on right now is that we have had over eight years of balance sheet support from the central banks. And now people like Bank of England Governor Mark Carney, European Central Bank President Mario Draghi and Fed Chair Janet Yellen have almost in unison said, "OK, we're now going to start unwinding that. So we're letting the air out of the balloon." This is a good thing, because we all know that we're eventually going to go through an actual economic recession.

Right now the yield curve is flat if you look between 10-year bonds and 30-year bonds—a range of only about 60 basis points (0.6%). As the central banks start tightening against a backdrop of a growing economy, you would expect that the back end of the curve would go up—meaning that longer-term rates would start rising. The implication is that the market then believes that we're not going to go into a massive recession, but there is not a tremendous amount of growth on the outward years of the curve. As a result, the front end of the curve is going to start going up, the back end, just by definition, has to go up, and investors are probably going to rotate out of bonds into equities because the bonds are going to get crushed, and as a result of that, and you're going to see upward movement in credit spreads.

The past eight years coming out of the financial crisis, for a lot of credit investors—whether they want to admit it or not—has very much been a beta trade, where for the most part broad exposure to the indices has paid off. We've had this unprecedented period where we have had growth and yet credit spreads have narrowed. But now we're going into a period where you're looking for good beta, i.e. people who are really going to follow the market but who are also good portfolio managers in the right sectors—whether it be direct lending or bank syndicated loans. And then you're going to want to look for good alpha managers as well, because it's going to be harder to find differentiated performance, to produce excess returns above benchmarks.

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The Importance of Portfolio Construction

When I say portfolio construction is really important, I'm thinking about a sector like energy. Managers who were overweight energy three years ago— with oil prices at \$90 to \$100 a barrel —may have thought they could never go to \$30, which was basically almost a subprime mortgage type of event. In fact, energy is the only sector in the past nine years that has totally restructured. There have been 142 restructurings in the oil and gas space in the past two years, and now, coming out of the back end of that, with oil prices between $45 and $50, we're actually seeing some value being created. But the backdrop was that a tremendous amount of value was destroyed during the sector's restructuring.

Even against a generally benign credit backdrop—with good liquidity, capital structures with a lot of equity underneath the debt stack and low defaults—spreads are tight and continue to tighten as money flows in. So in this environment, what is an appropriate risk premium investors should expect to earn? We define the credit risk premium as the difference in corporate bond yields vs. the relevant reference or benchmark, either Treasuries or LIBOR, in excess of losses due to defaults. And if someone can consistently invest when credit risk premiums are greater than 300 basis points, then they can generate over time roughly 12 percent unlevered returns. Today that credit risk premium is somewhere around 180 to 200 basis points, so well below that 300.

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On a broad diversified portfolio, it's under 300 basis points, but in certain sectors it can be in excess of 300 basis points right now. And that's where the alpha comes from. So for any investor, not just a credit investor, you do need to have a healthy balance between equity, credit, rates, currencies, etc.—you should have diversity in your portfolio and be conscious of the potential for dislocation. For example, the credit risk premium in energy well exceeded 300 basis points in the past couple of years, and if you were able to have the fortitude and the ability to capture that risk premium, then you would have realized that alpha, or excess return.

In terms of sectors, a robust portfolio construction would include high yield, when that dislocates, that's very attractive from a risk-return perspective; then there are pooled credit opportunities, and then opportunistic credit—really one-off negotiated transactions. And I think you have to swing among those three because not any one of those individual buckets will be sizeable enough for a strategy.

Across a global credit platform, scale is important. For example, our structured credit team covers 500 leveraged credits globally, which helps inform what our direct lending business by giving us more insights into potential dislocations and spread shifts that we have talked about. And that shared knowledge base also identifies other opportunities that our opportunistic and distressed strategies that might otherwise be available to a standalone team of 12 people. So having scale in terms of the number of investment professionals, and being in a global footprint, inside a global organization, is extremely helpful in terms of origination, which is what we all fight over in the marketplace—namely, how we originate these opportunities to attempt to create alpha. So that's point one.

Secondly, having strategies that span the entire risk spectrum—all the way from performing to non-performing—helps inform our investment decisions, our portfolio management decisions, and helps us adjust so that we can manage against changing market conditions. So that's critically important. And then having scale allows us to step up and become a solution provider.

Potential Dislocations

First, in terms of the Federal Reserve, investors should be thoughtful about the unwinding of eight years of excess liquidity. Since the central banks used a blunt instrument to come out of the financial crisis, my sense is they're not going to be able to employ precision surgery as they unwind it. So it's going to be messy. Now, they are doing a good job by actually communicating that they're going to start tapering. I think they have been pretty clear about that. But I think we should just expect that we're going to have moments of volatility that will actually be beneficial to us in the credit markets to take advantage of, but it's going to be a bumpy road and people are going to feel uncomfortable. So that's one big macro issue. It will dislocate markets. And dislocating markets is a good thing when you look at the opportunistic side. It becomes a little more frightening for index followers, which underscores how important it is to look at the quality of the portfolio and the quality of the underlying credits that you have in your portfolio.

The second thing I worry about—I mean everybody talks about it and it's a great unknown—is leverage in China. China has not disconnected from the rest of the world — it actually has a bigger impact than a lot of people think. They seem to be able to balance their economy for a lot of good reasons because they can drive it from the central perspective, but you know if that unhinges it can have a very detrimental impact globally.

People have very short memories. For example, if you went back to the '90s the consensus was that Alan Greenspan was the maestro, and that he basically took all risk out of the marketplace. And people actually believed that, until we had dislocations around the Russian Debt Crisis and Long Term Capital Management, which closed down debt market issuance for significant periods of time. So I think people forget. Investors have short memories. And sometimes we think trees grow to the sky. Now luckily we're all credit investors so we don't believe that, and we think the world is going to end every day we wake up. So that's how we think about it. But I think broader complacency is going to hurt us, because something is going to come out of left field and dislocate the markets.

Finally, Carlyle Director of Research Jason Thomas recently published a paper on "Pessimism's Pitfalls as an Investment Strategy," which talks about the negative thinking that has plagued the market, especially among hedge funds, who have underperformed as an asset class. And his thesis is that many people have been looking for another subprime event and have been trying to gear up for/prepare for/hedge against such a catastrophic event that was a one in 100-year event. Now could it happen again, sure, but in all likelihood it probably won't, it will probably be a normal-type recession.

Mark Jenkins is a Managing Director and Head of Global Credit based in New York. He is also a member of Carlyle's Management Committee.

Prior to joining Carlyle, Mr. Jenkins was a Senior Managing Director at CPPIB and responsible for leading CPPIB's Global Private Investment Group with approximately CAD$56 billion of AUM. He was Chair of the Credit Investment Committee, Chair of the Private Investments Committee and also managed the portfolio value creation group. While at CPPIB, Mr. Jenkins founded CPPIB Credit Investments, which is a multi-strategy platform making direct principal credit investments. He also led CPPIB's acquisition and oversight of Antares Capital and the subsequent expansion in middle-market lending. Prior to CPPIB he was Managing Director, Co-Head of Leveraged Finance Origination and Execution for Barclays Capital in New York. Before Barclays, Mr. Jenkins worked for 11 years at Goldman Sachs & Co. in senior positions within the Fixed Income and Financing Groups in New York.

Mr. Jenkins earned a Bachelor of Commerce degree from Queen's University. He served on the boards of Wilton Re, Teine Energy, Antares Capital and Merchant Capital Solutions.

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