ARES

Ares Global Liquid Credit: Market Views

2020 Outlook

December 2019

Authored by **Ares Global Liquid Credit Leadership & Portfolio Management Team**

INTRODUCTION

Following a year in which global below-investment grade credit markets have exceeded performance expectations, we look ahead to the accommodative stage that has been set for 2020. This year's healthy economic and fundamental backdrop, combined with supportive monetary policy, contribute to a continued favorable environment for credit investing in the coming twelve months. Going forward, we expect reasonable earnings results as economic growth continues at a slow but steady pace, while global central banks remain static yet vigilant. While we are optimistic of the market environment in the next year, the potential for episodic volatility remains likely as geopolitical tensions persist and growth patterns continue to diverge globally. Looking ahead, we believe that these opportunities will continue to present themselves to nimble investors such as Ares[1] who took advantage of these quick dislocations to generate alpha as they remain actively positioned for what's to come.

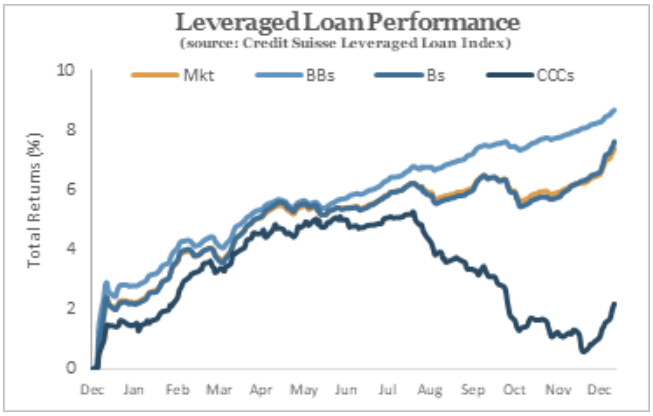
In the following outlook, we reflect on the impact of 2019 and evaluate the risks and opportunities that set the backdrop for 2020, where we believe bottoms-up managers with an unwavering focus on discerning security selection, distinctive geographic insights, and skilled asset allocation will be poised to deliver outperformance.

2019 IN REVIEW: DISPERSION EMERGES

The beginning of 2019 offered an attractive entry point for high yield bonds and leveraged loans, and as a result both asset classes have exceeded most performance expectations in the U.S. and Europe. In 2019, the high yield bond and leveraged loan markets transformed into a universe of "haves" and "have nots." Following a "rising tide" scenario in the first quarter, dispersion intensified as late cycle sentiment took over global credit markets. Interest in fixed rate assets was buoyed by a dovish pivot from the Federal Reserve ("Fed") and revitalized stimulus by the European Central Bank ("ECB"). Market participants benefitted from a quality bias as the hunt for income contributed to a rising tide of negative yielding assets and a tourist bid for the high-quality cohort.

U.S. REVIEW

In the U.S., 2019 was marked by increased dispersion and a strong preference for fixed-rate duration following the Fed's mid-cycle adjustment. Credit spreads reached year-to-date tights in April, grinding tighter across the ratings spectrum, before late cycle sentiment engulfed the market. As a result, the divergence between the highest and lowest quality segments of the market became increasingly evident from both a credit rating and spread perspective. Defensive industries largely outperformed cyclicals, and the high yield market was able to fend off significant spread widening within Energy, the largest sector in the market, to generate a +13.2% return through December 12th[2].



The percentage of bonds trading outside of market levels increased steadily to 82%[3], while approximately 10% of loan market constituents declined by 10 points or more year-to-date[4] as

U.S. Spread Level Changes and Percentiles

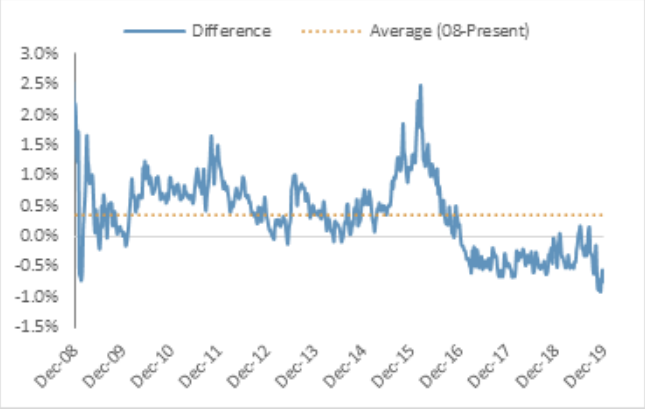
	CURRENT 12/5/2019		RECENT TIGHTS 4/18/2019		FYE 12/31/2018		CHANGE FROM RECENT TIGHTS		CHANGE FROM 12/31/2018	
	Level	Percentile	Level	Percentile	Level	Percentile	Level	Percentile	Level	Percentile
U.S. LOANS										
CSLLI	491	37%	435	16%	551	65%	56	21%	-60	-28%
Upper Tier	258	11%	258	11%	391	81%	0	1%	-133	-70%
Middle Tier	512	41%	459	18%	575	66%	53	23%	-63	-25%
Lower Tier	1460	87%	1137	38%	1200	53%	324	49%	261	35%
US HIGH YIELD										
HUC0	400	28%	373	14%	533	66%	27	13%	-133	-38%
BB	221	6%	220	6%	360	63%	1	0%	-139	-57%
B	409	28%	403	27%	574	73%	6	2%	-165	-44%
CCC & Below	1125	79%	871	39%	1104	76%	254	40%	21	3%
Energy	801	89%	522	50%	693	81%	279	39%	108	8%

Sources: ICE BAML HY Indices, Credit Suisse Leveraged Loan Index. Percentile rankings compare spreads across post-crisis ranges since January 2010, where 0% is the tightest part of the range and 100% is the widest. Data evaluated on a weekly basis.

investors grappled with late cycle indicators such as the inversion of the U.S. Treasury yield curve in August.

From a relative value perspective, the Fed's pause on future interest rate hikes in March and its three rate cuts in 2019 were a tailwind for high yield technicals; retail fund flows improved from a net outflow of -$46.9bn in 2018 to an inflow of +$18.8bn in 2019, and new-issue volume increased by 44% year-over-year as companies took advantage of compressed yields[5]. In the loan market, technicals were steady as new-issue supply and CLO origination normalized from recent all-time highs. While the asset class continued to face weaker retail demand, retail loan fund outflows moderated and their share of the loan market decreased to 8%[6]. As a result, bond yields subsequently compressed to levels inside of their senior secured counterparts intra-year, with the differential approaching post-crisis highs earlier this year.

U.S. Bond and Loan Differential



Sources: ICE BAML HY Indices, Credit Suisse Leveraged Loan Index.

EUROPEAN REVIEW

The European loan and high yield bond asset classes were stable sources of income and capital appreciation in 2019. As the year progressed and accommodative rhetoric became more apparent, the percentage of negative-yielding European investment grade bonds increased from ~2% at the end of 2018 to ~15% by the end of November[7]. This trend led to the emergence of a "tourist" bid within the high yield market as traditional investment grade buyers reached for yield within BB-rated issues. The loan market witnessed a strong bid for high credit quality assets as well, attributable to CLO activity which increased year-over-year[8]. Supply was robust in both markets, though companies increasingly turned to the high yield market as yields compressed throughout the year. Though leverage ticked higher, interest coverage ratios remained at robust levels. We expect this trend to persist given continued low interest rates. Moreover, while overall leverage within the loan market is higher, it remains below pre-financial crisis levels. Furthermore, new issue leverage within the high yield market has broadly stabilized and currently stands at 5.0x compared to 4.5x in 2016[9].

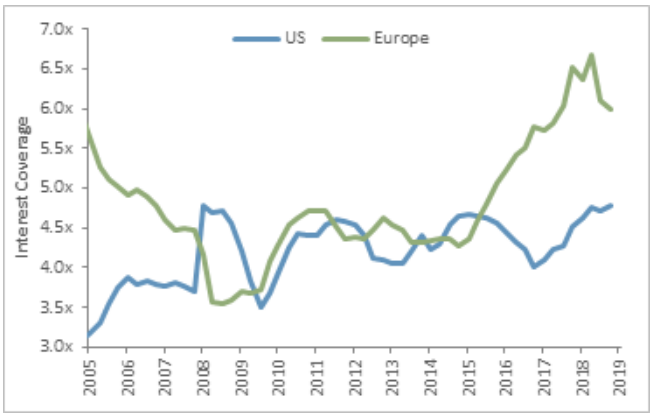
Dispersion was a key theme in the European market. Demand from nontraditional high yield investors and CLOs contributed to a decompression between single Bs and BBs. Dispersion has also been ever present in sector performance with the best performing high yield sector outperforming the least-well performing high yield sector by 8.9% while the best performing loan sector has outperformed the least-well performing loan sector by 5.1% YTD[10]. Geopolitics was one of the larger forces shaping the market in 2019 and contributed to the divergence as well, as the U.S.-China trade talks and continued Brexit negotiations influenced market sentiment.

2020 OUTLOOK: OPPORTUNITIES AND RISK

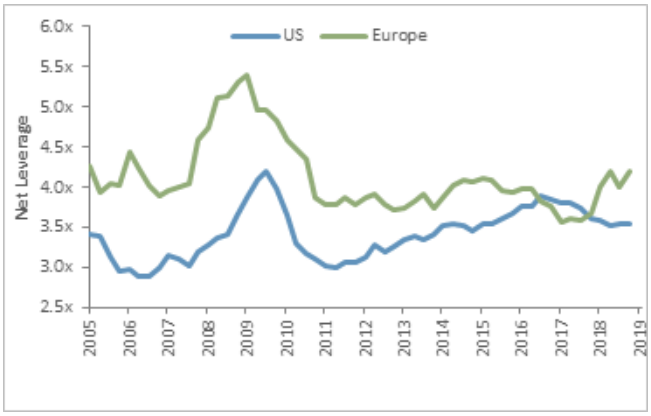
Unlike 2019, when market participants could own mostly higher-rated instruments and still outperform, we believe the opportunity set for active managers is robust heading into 2020. We expect dispersion to continue, emphasizing the importance of avoiding credit mistakes while taking advantage of oversold opportunities to navigate both headwinds and tailwinds. Looking ahead, we believe the market environment will test the full depth and breadth of an active manager's toolkit.

Corporate Fundamental Trends

Interest Coverage



Net Leverage



Source (Interest Coverage, Net Leverage): J.P. Morgan.

OPPORTUNITIES

Positive Economic Growth: We expect variability of GDP growth to remain muted around the 2% level. This is ultimately supportive for credit spreads, which tend to be more driven by changes in GDP growth than the absolute level. While leading indicators are losing momentum, the willingness of central banks to intervene is apparent and beneficial for the go-forward growth prospects in the U.S. and Europe.

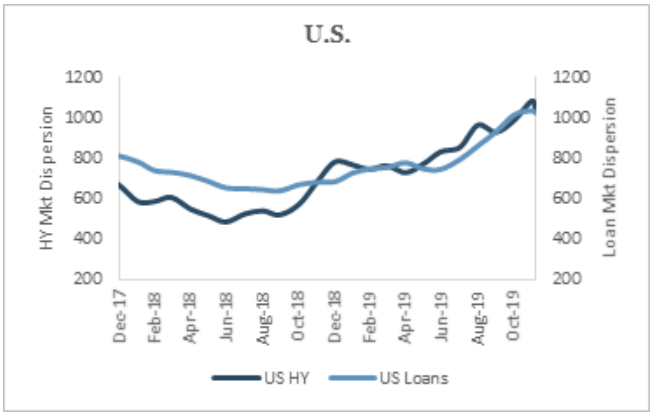
A Healthy U.S. Consumer: Given personal consumption accounts for nearly 70% of U.S. GDP, an area to monitor will be the extent to which weakness in manufacturing affects the consumer. At present, consumer sentiment remains high and a bright spot in the economy. Indirectly, housing indicators have strong momentum across the board and on the labor front, initial claims and unemployment are at all-time lows, indicating sound consumer health. Consumer confidence, spending and debt levels have been relatively supportive, but we believe signs of deterioration would be a reason to become more defensive in positioning.

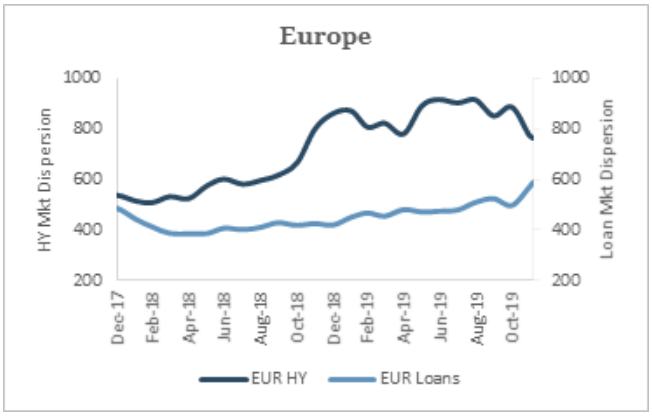
Convergence of Public and Private Markets: The ongoing shift of risk from public to private markets has led to an uptick in demand for direct lending, which has caused the asset class to more than double in size over the past 5 years[11]. This has driven a convergence of lending markets, as non-bank lenders have increased their participation in larger deals to fill the void created by banks that now focus their resources on mega, multi-billion tranche transactions. Though the growth of liquid credit markets has stagnated as a result of non-bank lenders gaining market share, companies have increasingly turned to both public and private markets for their financing solutions. We believe this trend presents an opportunity for managers with integrated and scaled businesses in both markets, such as Ares, as issuers increasingly seek partners with flexible capital. Despite headlines that point out the obvious risks of this rapid growth, Ares' leadership in this market will ultimately allow for an extraordinary degree of selectivity in allowing credits into public and private portfolios.

Search for Income Continues: We expect demand from investors searching for yield to continue against a backdrop of increasing negative yielding assets across the globe. Given the stable macro environment and accommodative monetary policy, we believe leveraged finance represents one of the few sources of attractive income-driven return potential heading into 2020.

Elevated Dispersion: As of December, dispersion remains elevated across global leveraged credit markets. This is most profound in the U.S. high yield bond market, which is hovering around peak levels within each rating category. The divergence in quality has resulted in lower tier portions of the market in the 80-90th percentile of spread levels post financial crisis, while the high-quality segments of the market are on the opposite end of the spectrum. In Europe, dispersion among single B loans and bonds is elevated on a credit spread basis. With single B loans representing ~65% of the market, single B high yield bonds representing ~30% of the market and as the proportion of high yield bonds within 25% of the average spread of the index is now at a decade low[12], we expect the theme of decompression will be a key talking point of the market. We believe this backdrop provides the ideal opportunity set for managers to uncover value through the discrete credit selection of instruments that are being unfairly punished or rewarded.

Credit Market Dispersion (Upper Quartile Spreads Less Bottom Quartile)





Sources: Ares, Credit Suisse Leveraged Loan Index, Credit Suisse Western European Leveraged Loan Index, ICE BAML HY Indices.

RISKS

High Quality Valuations: The flight to quality in 2019 has pushed high quality credit spreads near post-crisis tights. While elevated, dispersion in this cohort is limited when compared to the middle- and lower-credit quality segments of the market. We believe high quality assets are susceptible to spread widening as investors move further down the credit quality spectrum to pick up both spread and yield, with a potential economic surprise to the upside serving as a catalyst. While managers that "hid" in higher quality segments were able to outperform in 2019 alongside the broader market, we believe that discerning credit pickers such as Ares will separate from the pack in the coming year as rigorous credit diligence becomes increasingly imperative.

Geopolitical Climate: The geopolitical environment was a consistent source of volatility in 2019. Market sentiment swayed at the direction of the latest Brexit and U.S. trade related headlines, and an increasingly polarized backdrop in the U.S. has forced investors to assess the potential for an anti-business election result in 2020. Though December's U.K. election and a "phase one" trade deal between the U.S. and China are supportive for risk assets, the potential for Brexit and global trade tensions to weigh on sentiment remains. We continue to focus on geopolitical tensions, which are expected to be a source of volatility moving forward.

Central Bank Misstep: While 2019 was marked by supportive and largely well-telegraphed central bank action, the potential for a misstep remains as Christine Lagarde begins her first full year as President of the ECB, and Jerome Powell continues to assert his independence from the executive branch ahead of the 2020 presidential election.

Loan-Only Capital Structures: We have seen a growing supply of lower-rated debt, particularly in the loan-only segment of the market. Due to the potential downgrade risk for these loan-only issuers and lack of technical support from CLOs, we remain selective on this cohort of loans given their increased leverage profile through the tranche, lower spread per turn of leverage and lower recoveries. In contrast, we believe loans with subordination can provide more compelling risk-adjusted returns and seek to continue identifying these attractive opportunities as we head into 2020.

CONCLUSION

Though cracks exist, the lack of a systemic economic or fundamental catalyst bodes well for the high yield bond and leveraged loan asset classes going forward. **In the U.S., we expect both leveraged loans and high yield bonds to return 5-7%[14]** and enter 2020 with a bias towards the middle of the credit curve due to a supportive economic and fundamental backdrop, combined with tight valuations in the high-quality market cohort. In both markets, we expect current coupon and modest price appreciation offsetting a slight uptick in default rates. **In Europe, we expect a 3.5-4.5%[14] return for leveraged loans and a 2-3%[14] return for high yield bonds**, and remain defensively positioned to preserve capital in the event of any market volatility. Globally, we believe elevated credit dispersion and episodic bouts of volatility will persist, providing an ideal opportunity set for differentiation amongst active managers. In this environment, we believe Ares can produce attractive risk-adjusted returns through nimble portfolio management, a rigorous approach to credit selection, and by utilization of our global footprint across public and private markets.

For any further information, please contact ***credit@aresmgmt.com****.*

ENDNOTES

(1) Past performance is not indicative of future results.
(2) Source: ICE BofAML High Yield Indices.
(3) Source: BofAML High Yield Chartbook. As of November 30, 2019.
(4) Source: Credit Suisse, Ares. As of November 18, 2019.
(5) Source: J.P. Morgan. As of December 6, 2019.
(6) Source: J.P. Morgan. As of December 6, 2019.
(7) Source: ICE BofAML Euro Corporate Bond Index. As of November 30, 2019.
(8) Source: S&P LCD. As of December 10, 2019.
(9) Source: S&P LCD. As of September 30, 2019.
(10) Source: ICE BofAML European Currency High Yield Index, Credit Suisse Western Leveraged Loan Index. As of December 10, 2019.
(11) Source: Goldman Sachs. As of December 10, 2019.
(12) Source: J.P. Morgan. As of November 2019.
(13) Source: Credit Suisse Leveraged Loan Index. As of December 2019.
(14) Based on Ares market observations. Projections and forward looking statements are not reliable indicators of future events and there is no guarantee that such activities will occur as expected or at all

INDEX DEFINITIONS

The Credit Suisse Leveraged Loan Index ("CSLLI") is designed to mirror the investable universe of the $US-denominated leveraged loan market. The index inception is January 1992. The index frequency is daily, weekly and monthly. New loans are added to the index on their effective date if they qualify according to the following criteria: 1) Loan facilities must be rated "5B" or lower. That is, the highest Moody's/S&P ratings are Baa1/BB+ or Ba1/BBB+. If unrated, the initial spread level must be Libor plus 125 basis points or higher. 2) Only fully-funded term loan facilities are included. 3) The tenor must be at least one year. 4) Issuers must be domiciled in developed countries; issuers from developing countries are excluded.

The Credit Suisse Western European Leveraged Loan Index ("CSWELLI") is designed to mirror the investable universe of the leveraged loan market of issues which are denominated in US$ or Western European currencies. The issuer has assets located in or revenues derived from Western Europe, or the loan represents assets in Western Europe, such as a loan denominated in a Western European currency. Loan facilities must be rated "5B" or lower. That is, the highest Moody's/S&P ratings are Baa1/BB+ or Ba1/BBB+. Only fully funded term loan facilities are included and the tenor must be at least one year. Minimum outstanding balance is $100 million and new loans must be priced by a third-party vendor at month-end. The index inception is January 1998.

The ICE BofA Merrill Lynch US High Yield Index ("HoAo") tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of $100 million. Index constituents are capitalization-weighted based on their current amount outstanding times the market price plus accrued interest. Accrued interest is calculated assuming next-day settlement. Cash flows from bond payments that are received during the month are retained in the index until the end of the month and then are removed as part of the rebalancing. Cash does not earn any reinvestment income while it is held in the index. The index is rebalanced on the last calendar day of the month, based on information available up to and including the third business day before the last business day of the month. No changes are made to constituent holdings other than on month end rebalancing dates. Inception date: August 31, 1986.

The BofA Merrill Lynch European Currency High Yield Index tracks the performance of EUR and GBP denominated below investment grade corporate debt publicly issued in the eurobond, sterling domestic or euro domestic markets. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch) and an investment grade rated country of risk (based on an average of Moody's, S&P and Fitch foreign currency long term sovereign debt ratings). In addition, qualifying securities must have at least one year remaining term to final maturity, a fixed coupon schedule and a minimum amount outstanding of EUR 100 million or GBP 50 million. Original issue zero coupon bonds, "global" securities (debt issued simultaneously in the eurobond and domestic markets), 144a securities and pay-in-kind securities, including toggle notes, qualify for inclusion in the Index. Callable perpetual securities qualify provided they are at least one year from the first call date. Fixed-to-floating rate securities also qualify provided they are callable within the fixed rate period and are at least one year from the last call prior to the date the bond transitions from a fixed to a floating rate security. Defaulted, warrant-bearing and euro legacy currency securities are excluded from the Index. Inception date: December 31, 1997 The above rules take into account all revisions up to and including December 31, 2010.

ICE BofAML Euro Corporate Index tracks the performance of EUR denominated investment grade corporate debt publicly issued in the Eurobond or Euro member domestic markets. Qualifying securities must have an investment grade rating (based on an average of Moody's, S&P and Fitch) and at least 18 months to final maturity at the time of issuance. In addition, qualifying securities must have at least one year remaining term to final maturity, a fixed coupon schedule and a minimum amount outstanding of EUR 250 million. Original issue zero coupon securities and pay-in-kind securities, including toggle notes, qualify for inclusion in the Index. Callable perpetual securities qualify provided they are at least one year from the first call date. Fixed-to-floating rate securities also qualify provided they are callable within the fixed rate period and are at least one year from the last call prior to the date the bond transitions from a fixed to a floating rate security. Contingent capital securities ("cocos") are excluded, but capital securities where conversion can be mandated by a regulatory authority, but which have no specified trigger, are included. Other hybrid capital securities, such as those issues that potentially convert into preference shares, those with both cumulative and non-cumulative coupon deferral provisions, and those with alternative coupon satisfaction mechanisms, are also included in the index. Euro legacy currency, equity-linked and securities in legal default are excluded from the Index. Securities issued or marketed primarily to retail investors do not qualify for inclusion in the index. Index constituents are market capitalization weighted. Accrued interest is calculated assuming next-day settlement. Cash flows from bond payments that are received during the month are retained in the index until the end of the month and then are removed as part of the rebalancing. Cash does not earn any reinvestment income while it is held in the index. Information concerning constituent bond prices, timing and conventions is provided in the ICE BofAML Bond Index Guide, which can be accessed on our public website (www.mlindex.ml.com), or by sending a request to iceindices@theice.com. The index is rebalanced on the last calendar day of the month, based on information available up to and including the third business day before the last business day of the month. New issues must settle on or before the calendar month end rebalancing date in order to qualify for the coming month. No changes are made to constituent holdings other than on month end rebalancing dates. Inception date: December 31, 1995.

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