

**Goldman Sachs Exchanges**  
**Corporate Credit Concerns**  
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**Allison Nathan:** US interest rates have surged recently as concerns about a potential recession have ebbed. That's made it more expensive for companies to borrow money, so what could that mean for the health of corporate America? I'm Allison Nathan and this is Goldman Sachs Exchanges.

On this special episode, we're breaking down the concerns around corporate credit that were the topic of our most recent Top of Mind report, now available on GS.com. We dig into whether the higher-for-longer interest rate environment could lead to distress or even a wave of defaults across the corporate credit market. We speak with Boaz Weinstein, founder and CIO of Saba Capital Management, and Goldman Sachs's chief credit strategist

Lotfi Karoui.

Karoui is generally optimistic about corporate America's credit outlook. He believes that healthy fundamentals should allow most corporates to weather the more challenging borrowing environment.

**Allison Nathan:** We've seen a sharp rise in interest rates, and the narrative is rates are going to be higher for longer. How concerned are you that we're nearing the end of the benign credit cycle and the beginning of a major default cycle?

**Lotfi Karoui:** Well, I think the risk of a full-blown default cycle is still fairly low, at least if we're talking about the next 12 months. And by full-blown default cycle, I really mean an environment in which defaults spike to double-digit levels. What is more likely, in our view, is just a continued reversion towards the longer than average. 3.5 to 4% annual default rate, if I take the US leveraged finance space as a benchmark. And that's our baseline view for year end 2023.

Now, the mean reversion is to be expected, like you said,

we've witnessed a significant increase in the cost of funding at a time when the ability for companies to offset that increase to get stronger earnings growth is quite limited because growth has been oscillating at levels below potential. The other thing that's important to keep in mind is that we had two consecutive years of very low default rates, and that was largely reflective of the impressive policy response that followed COVID. And so I would characterize things as a mean reversion without a severe deterioration.

Now, there's two ingredients to that view. One, the prospects of a soft landing of the economy have become brighter. Default and recessions tend to be very highly correlated. In fact, if you go back 35 or 40 years, what you see is that every time the US economy entered a recession, defaults in the high-yield markets started to accelerate. Oftentimes, reaching double-digit levels. And so the fact that the prospects of a soft landing have become brighter over the last couple of months gives us reasonable confidence that we'll likely see mean reversion in defaults but not a spike. Of course, things could be different this time around, but the fact that the odds of a recession have declined the last couple of quarters give us confidence that

the risk of a major inflection point is unlikely.

And then two, from a micro standpoint, the starting point is actually quite solid. Debt coverage ratios -- just to take that as an example -- remain at close to their highest levels in many decades. Of course, they'll start deteriorating as companies replace old debt with new debt that costs more, but the starting level matters. And I think, fundamentally, companies are still, by and large, in a position to withstand that transition to a higher-for-longer cost of capital, again, assuming that the economy holds up and that we avoid a full-blown recession.

Now, under the surface, we are keeping a close eye on some pockets in the leveraged finance space, and the broadly syndicated loan market is one example. And in fact, we do expect a faster pace of defaults in the broadly syndicated loan market relative to the high-yield bond market. The reason for that is actually quite straightforward. The bulk of the borrowing in the broadly syndicated loan market is floating in nature, and so the ability of those companies, particularly those that rely to a large extent on the loan markets so they have funding needs, to make that transition to a higher and longer cost

of capital environment is a lot more constrained. And we've started to see some of that the last couple months. I think that divergence has more momentum to go.

But if we're talking about a spike, a 9-10% default rate, I think that's still unlikely, at least for the next three to four quarters.

**Allison Nathan:** When do we get concerned, though, about refinancing risk? Is it right to be concerned about a coming maturity wall for corporates in 2024 or 2025?

**Lotfi Karoui:** Over 70% of the issuer base in the leveraged loan market are actually companies that have so-called loan-only capital structures. And so they rely entirely on the broadly syndicated loan markets for their funding needs, and so the entirety of their debt stack or liabilities is floating. Refinancing in this type of situation doesn't really matter because you pay more, net of hedging costs, every time the Fed delivers a hike irrespective of whether you're refinancing old debt with new debt.

There is a little bit of an acceleration of the maturity wall in the high-yield bond market in 2024/25. Typically,

companies choose to refinance upcoming maturities around a year to a year and a half before the actual deadline hits. Having that pattern will likely prevail this time around, and this is one of the primary reasons why we expect financing to increase a lot.

Are there reasons to be concerned? The maturity wall is actually not that front loaded, and so I think there's capacity on the investor side to absorb it and finance it. Companies, at least in the high end of the quality spectrum, have a little bit of deleveraging capacity, too. And so they can use internal resources to pay back the debt. So I don't think it's a source of a concern. It would have been if we had a very front-loaded maturity wall with unusually large refinancing needs, but that's not the case today.

**Allison Nathan:** But Boaz Weinstein is somewhat more concerned. He acknowledges that corporate fundamentals look relatively healthy today, but cautions that may not last long. He also points out that technical factors, such as how many buyers there are versus sellers, rather than fundamentals tend to govern credit markets, and technicals, he warns, can turn against investors on a dime.

A lot of people point to the fundamentals and say, “Look, IG, high yield. Balance sheets are relatively healthy and a lot of debt is locked in at low rates, so there's reasons to believe that you shouldn't be that concerned about credit defaults.” Do you agree with that assessment?

**Boaz Weinstein:** It's counter-intuitive to think that corporate America in the aggregate has seen higher rates actually leading to lower interest expense. How is that possible? Because we have some long-dated borrowing and we have this sharply inverted curve and we have a lot of cash on balance sheets, which maybe will get burned off or used, but in the meantime it's earning 5.25% or 5.5%, so corporates have weathered the storm well.

But then again, the economy has been reasonably strong, so it's not that surprising. But there's this period in late '24/mid-25 time frame where refis will need to be done. And if in fact inflation is not coming down more, it is going to be painful.

The other thing I just want to say about your question is it presumes that credit spreads will be governed by

fundamentals. For the last few years, credit spreads have been governed a lot more by technicals than by fundamentals. The kind of standard thing I see out of corporate research at the various banks, when there is a big widening of credit spreads, the bank's research analysts will say, "We don't think high-yield spreads of 550 basis points can be supported by the expected default rate." If you price in how many defaults you need, we don't see the economy having a 9.5% default rate for the next three years.

And that is to suggest that's actually how credit spreads are priced, and they're not. They're priced by things like "more sellers than buyers" and that sort of thing. And/or one has to be paid to hold junk when it's not loved, an extra couple hundred basis points to justify the illiquidity, the uncertainty. So when times are tough, through a technical lens, you could see things shift quite quickly, just like they did during COVID where all of a sudden there were too many sellers of bonds. And as a credit investor, if you don't have a lot of spread, you can lose a year's worth of carry in a pretty short time.

**Allison Nathan:** More broadly, Weinstein argues that



credit spreads aren't sufficiently pricing the current high level of macro uncertainty and that corporate defaults will almost certainly rise from here. Are we at the end of a benign credit cycle? Are you worried that we are about to see a more concerning default cycle ahead?

**Boaz Weinstein:** All of this is very hard to tell because we have, I'd say, an exceptional number of pieces of data that are conflicting with each other. We have strong jobs, yet we have senior lending officers of banks tightening standards. We have different indicators that are telling us no landing, soft landing, hard landing. You take the 100 top forecasters, the chance for recession is there, and the average at the end of Q2 was something like 54%. So we're very close to either side of 50/50.

I don't have a crystal ball, so I look at it like what is actually priced in? And so if it's either side of 50/50 but then you go and look at the market, the VIX, which is the next month's implied volatility, how uncertain are markets, what's the range of outcome for equities? We're at a 42-month low. Credit spreads on the investment-grade side, having weathered the regional bank crisis, are again very low. They're not at the low, but they're nearing the bottom

quartile of low spreads. But I feel like we're in the top quartile of uncertainty.

My approach is to think about how much uncertainty is there? How much uncertainty is being priced into options? I look at credit as an option. And so from my perspective, even though I push back against crystal balls, I do see resonance with the data that's showing a pickup in default rate. If you look at the trailing 15 weeks of number of bankruptcies -- and it's mainly been in the private credit market -- but you're seeing the effect of higher rates for longer and some challenges even absent any recession where the number of bankruptcies now is at a 13-year high for the last quarter. If this continues, I really do think it's not prognostication anymore. It's almost certainty that the default rate's going to rise.

**Allison Nathan:** So where do credit spreads go from here? Karoui views an expected rise in default rates as just a reversion to their long-run average from very low default rates in recent years. And this, he says, is consistent with some modest tightening in credit spreads ahead.

As we've been discussing, you do expect to see defaults

rising a bit but from very low levels, so this is more of a normalization. What should that mean for credit spreads that are already relatively tight?

**Lotfi Karoui:** Spreads have tightened quite a lot the last two or three months, but they remain wider relative to the type that we reached before the start of the hiking cycle. Our baseline forecast is essentially very modest spread tightening. Our view is that returns will likely be dominated by the carry component going forward, and so we don't see a lot of scope for spreads to materially tighten from here. That is not a negative view on fundamentals. We are still constructive on the fundamental picture, but it's simply acknowledging that there are natural valuation constraints on spreads at the moment.

If you take the investment-grade market as an example, you look at how much IG index pays relative to cash, it's between 10 and 20 basis points. A world in which the entire investment-grade corporate bond market barely pays anything relative to cash is a world in which the ability of spreads to materially tighten from here is quite limited. But we need to keep in mind that credit and, more generally, fixed income markets have the best level of yield

support they've had in over 15 years. The fact that we're getting close and we may even have passed the end of the Fed hiking cycle also means that rates volatility will continue to decline on a forward basis. And so you have a good value proposition from a carry standpoint and then a solid case for rates volatility to decline. And so that means good absolute total returns.

And there's a really interesting stat that I like a lot. If you looked at the share of the S&P 500 that has a higher dividend yield than the corresponding corporate bond yield, it's the lowest it's been in probably two and a half decades. And so from a total return or an all-in-yield standpoint, credit and, more generally, fixed income can add a lot to a multi-asset portfolio.

**Allison Nathan:** Weinstein, however, believes the odds are against further credit spread tightening, given that spreads already sit at the low end of their post global financial crisis range. So he doesn't think that owning corporate credit looks compelling today.

**Boaz Weinstein:** Right now, CDXIG sits at around 63 basis points. And it's been, leaving aside the '08

insanity and even times like '02 when you had Enron and Worldcom and 9/11 and all that stuff, in the last 14 years, it's been in the range of 46 to 150. And it sits right now at around 63. Now, sometimes people say, "Look, if it ever got near 46, I'm going to short it because that always works." But you have to think about it vis-à-vis my earlier comment about outcomes and ranges. What kind of world are we in when we're at 46? And that's the low. And what kind of world are we in when we're at 100 or 125 or at 80?

And for example, just to give you one more point in time, December 2018, we had a very bad month for the S&P. The Fed was hiking into a slowdown. You had some China-US tension about trade. IG was not around 63 then. It reached a peak of 95 and closed the year at 85. So when I teleport you to that moment and I say there was no inflation, there was no heavy QT to come, there was no Ukraine, there was no really bad data out of China, an inverted yields curve, very high credit constriction from senior loan officers, certain other economic data that's forward looking that is concerning like "only ever seen in a recession," 50% of the forecasters predicting recession. And none of those things were true then yet spreads were 50% wider.

Now, maybe it was too wide then, but around 63 is pretty darn low. The price ain't right for the world we're in. And there should be rainbows in the sky for spreads tighter than this, and maybe we're about to get them. But I think that we just don't have enough excess spread. And especially when you consider where can I get spread elsewhere?

So I look, for example, at that inverted curve and say if you buy a single A corporate with 5-year maturity and you have this inversion from t-bills to five years, you're making a pretty bold bet because you could be in t-bills and get the same yield and not have any duration and not have any credit risk, and all you would have to worry about is FOMO in case somehow things got even more better and you wanted that duration. I think there's a lot of beauty in the simplicity of t-bills. They keep offering more.

Then on the other hand, if you wanted real risk, if you look at agency mortgages, whether it's specific pools that you have expertise in assessing or even just the futures market, you're getting a very high spread. Why are you getting a high spread? Number one, technicals that the buyers of

mortgage paper being the Fed and banks are now sellers. And number two, interest rate vol is high, so the uncertainty about refinancing in mortgages is elevated. So I think some combination of agency mortgages plus t-bills is going to risk adjusted do far better than corporates.

**Allison Nathan:** Finally, we explore the outlook for private credit markets in this higher rate environment. Karoui points out that private credit could face distress ahead but doesn't see this risk as systemic. How concerned are you about the outlook for private credit?

**Lotfi Karoui:** Like the broadly syndicated loan market, the bulk of the borrowing on the private side is floating in nature. And so there is a little bit of a payment shock that borrowers in private debt markets are going through, and that creates challenges of course. But those challenges are cyclical. And so to me, irrespective of the path of the economy over the next 12/24 months, I think the ability of the asset class to withstand a full-blown default cycle will be tested sooner or later, but, again, those are cyclical challenges.

I disagree with the narrative that you sometimes hear that

the size of private debt markets, which is around 1.5 trillion today, is problematic from a systemic risk standpoint. As much as I think we'll test the ability of private debt as an asset class to withstand a full-blown default cycle, I don't think private debt markets pose an additional level of systemic risk or pose any meaningful threat to financial stability for two reasons.

One, the risk of a run on a private debt fund, similar to your run on a bank, is very low almost by design. And then two, leverage, which is typically the channel that amplifies losses in the system and help propagate things, is used in very reasonable doses. BDCs are a good example. Leverage is capped to 2x. And so this is not nearly a vulnerability that is as pronounced as what we had before the global financial crisis with the structure of private markets, particularly on the mortgage side. And so again, there are challenges, but I don't think they're systemic.

**Allison Nathan:** What are the implications of your outlook for private credit for the border default cycle?

**Lotfi Karoui:** The nature of the default cycle within private debt markets is something that will be really



interesting to study and look at, and there's certainly a number of differences between public and private debt markets that are important to keep in mind. But the biggest one is that the relationship between the lender and the borrower is different on the private side.

Usually people refer to that as the ability to amend and extend, which is something that you also encounter on the public side. The difference, however, is that, on the private side, that process is more efficient and that partly or primarily reflects the nature of the relationship between the borrower and the lender. Oftentimes, it's one borrower, one lender, and so the ability to execute an amend-and-extend plan in a more efficient way is certainly better on the private side than it is on the public side. So that's potentially a catalyst that could make the next default cycle a little more benign on the private side relative to the public side.

**Allison Nathan:** Weinstein, for his part, expects private market defaults to rise if interest rates don't decline meaningfully. And he doesn't believe that lenders' ability to amend loan structures and extend maturities to avoid defaults will change that.

**Boaz Weinstein:** It's not your father's bond market. It's not your father's high-yield market. The high-yield market itself, the bond market has not seen tremendous growth. It's marginally bigger than it was a decade ago, but there's been huge growth from what was a cottage industry in private credit. And those are not marked every day, so it's less transparent. And we've had a very benign default rate, so it didn't much matter. But you have a lot of smaller companies that found it very easy to get a loan from a BDC or some regional bank or through a loan that multiple CLOs were investors in.

And in the same way that the SPAC market created a world where you saw very high failure rate in some of those companies that were innovation growth equities that, in 2020, were, you know, the darling of the market and, in 2022, were struggling and had to do down rounds and some of them have run out of cash, you could look at that and say is that really that meaningful to corporate America? These are not major companies. But in number in quantity, you add a lot of problems in the stock market. And I think in private credit, it's not quite esoteric. You have some real companies that are suffering. And I think

that there's going to be a schism between the default rate of private borrowers and the public borrowers.

It matters also because one thing that we're watching closely is what senior loan officers are telling the Fed they're doing, and you're seeing significant lending standard tightening. So they're restricting the supply of credit not just for those companies but generally at a time when the economy may indeed be slowing down, even if we're not necessarily overwhelmingly likely to enter a soft or hard landing.

And so I think that private credit is a very interesting place to look because it might be the place that gives you the first warning. And it might be a false positive, but private credit to me is giving a pretty bearish picture right now for risk assets.

**Allison Nathan:** I've heard the argument, though, that the ability to amend and extend in the private markets means that the default cycle could actually be shallower and less severe. What is your take on that?

**Boaz Weinstein:** I'll tell you, as often as I hear the

phrase “amend and extend,” you might guess the phrase that sounds like it that I hear the other half of the time, which is “amend and pretend.” And so that's a “forestalling the inevitable” type thing. Someone told me a BDC that has a large exposure to a private company, had made 21 amendments to a single company in a period of two or three years to avoid the default. There is a lot of financial creativity that could be used, but ultimately, if that was a winning strategy, if all you had to do with troubled companies on average is give them more time and you would earn super normal returns from it, well, that would be awesome. But I think the feeling is that it gets pushed out, and it's going to happen nonetheless. And that doesn't mean that the reasons it got pushed out are not going to have an impact on the broader economy.

And also, given where valuations are, given where credit spreads are, given where equity multiples are, if we do not have interest rates come down -- and the Fed so far has been more right than Mr. Market, which said the Fed would never go to the levels that we're at now -- I think that, couple that with a slowdown, you're going to see something that affects the broader market even with amend and pretend.

**Allison Nathan:** With concerns about corporate credit continuing to swirl, we'll keep a close eye on it from here. I'll leave it there for now. If you enjoyed this show, we hope you follow on your platform of choice and tune in next week for another episode of Goldman Sachs Exchanges. Make sure to like, share, and leave a comment on Apple Podcasts, Spotify, Google, or wherever you listen to your podcasts. And if you'd like to learn more, visit [GS.com](https://www.gs.com) and sign up for Briefings, a weekly newsletter from Goldman Sachs about trends shaping markets, industries, and the global economy.

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