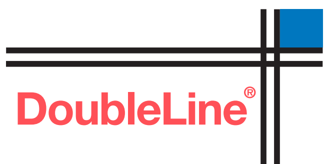


The Case for Public Credit in Today's Environment

October 31, 2022 | Chris Stegemann

Key Takeaways

- DoubleLine believes fixed income currently presents the most attractive opportunity set of the past decade.
- When allocating capital across fixed income markets in today's environment, the DoubleLine team is finding more compelling opportunities in public credit sectors than the private credit markets.
- Should there be a positive shift in investor sentiment, credit spreads have the potential to compress quickly.
- Relative to equities, fixed income currently offers a more compelling return-per-unit-of-risk profile

Fixed Income Landscape Today

This year has been a historically tumultuous period for fixed income. The combination of persistently high inflation, hawkish central bank policy and elevated interest-rate volatility has contributed to higher U.S. Treasury yields and wider credit spreads. The drawdowns endured in the fixed income market over the past year have given way to an investment opportunity set not seen in over a decade. Over the past year, yields across various segments of the fixed income market have more than doubled. *(Figures 1 & 2)* The repricing from the low-yielding environment over the past decade to the higher-yield environment of today has caused a significant drawdown, which can be seen in trailing one-year fixed income returns. *(Figure 3)*

Fixed Income Yields Offer More Attractive Yields Today vs. One Year Ago
Darker bars represent Oct. 31, 2021. Lighter bars represent Oct. 31, 2022.

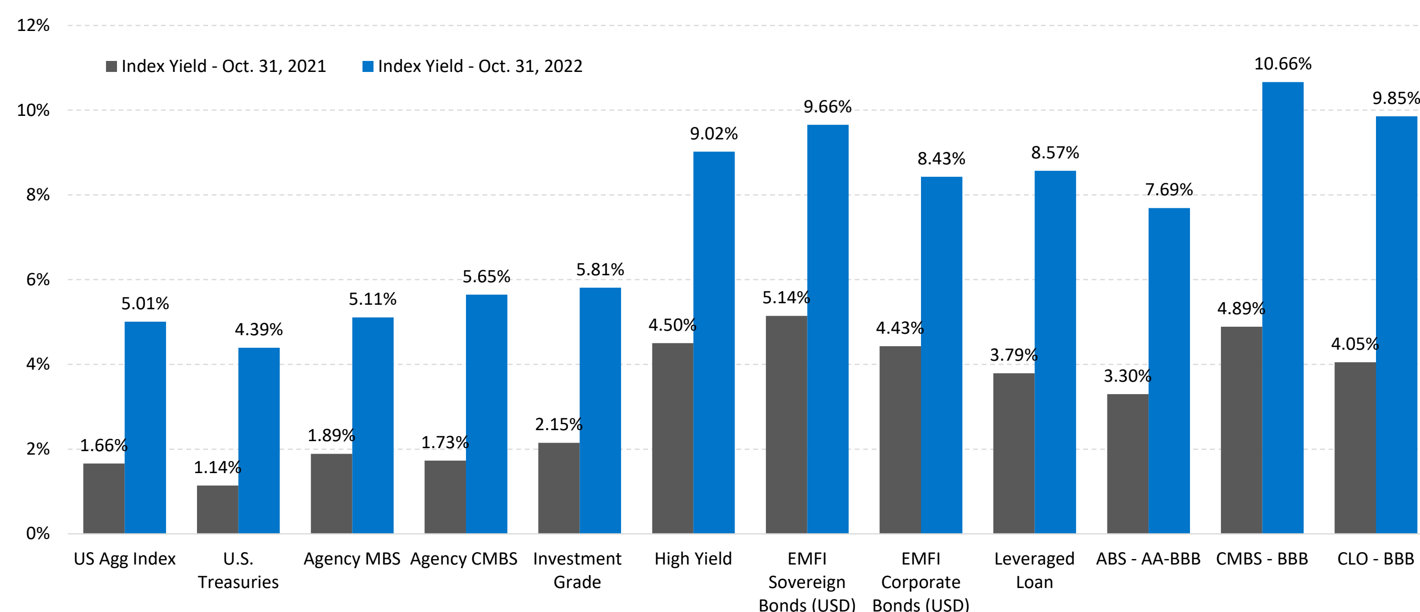
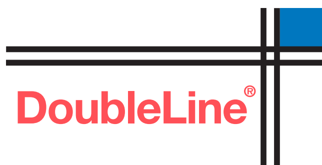


Figure 1 – Yields Year-over-Year (YoY)
Source: Bloomberg, DoubleLine. Please see definitions at the end of this article.



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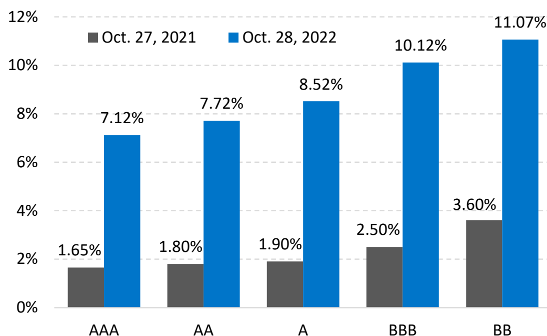
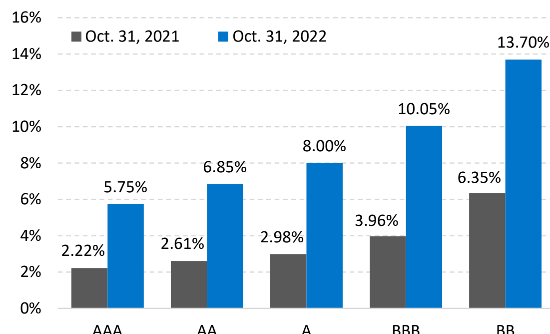
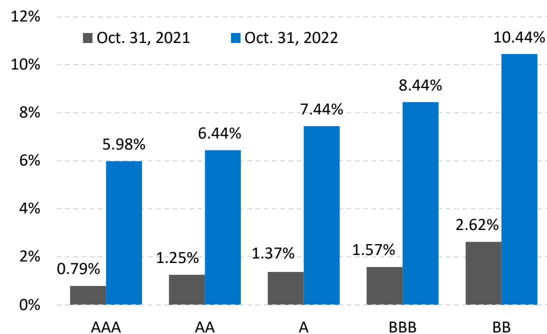
Attractive Yields Across the Securitized Capital Structure







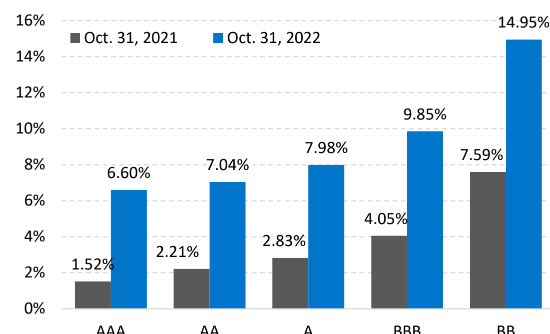


Figure 2 – Securitized Yields
Source: Bloomberg, DoubleLine. * RMBS non-QM as of October 28, 2022 due to weekly pricing.

One-Year Fixed Income Performance Overview | As of October 31, 2022

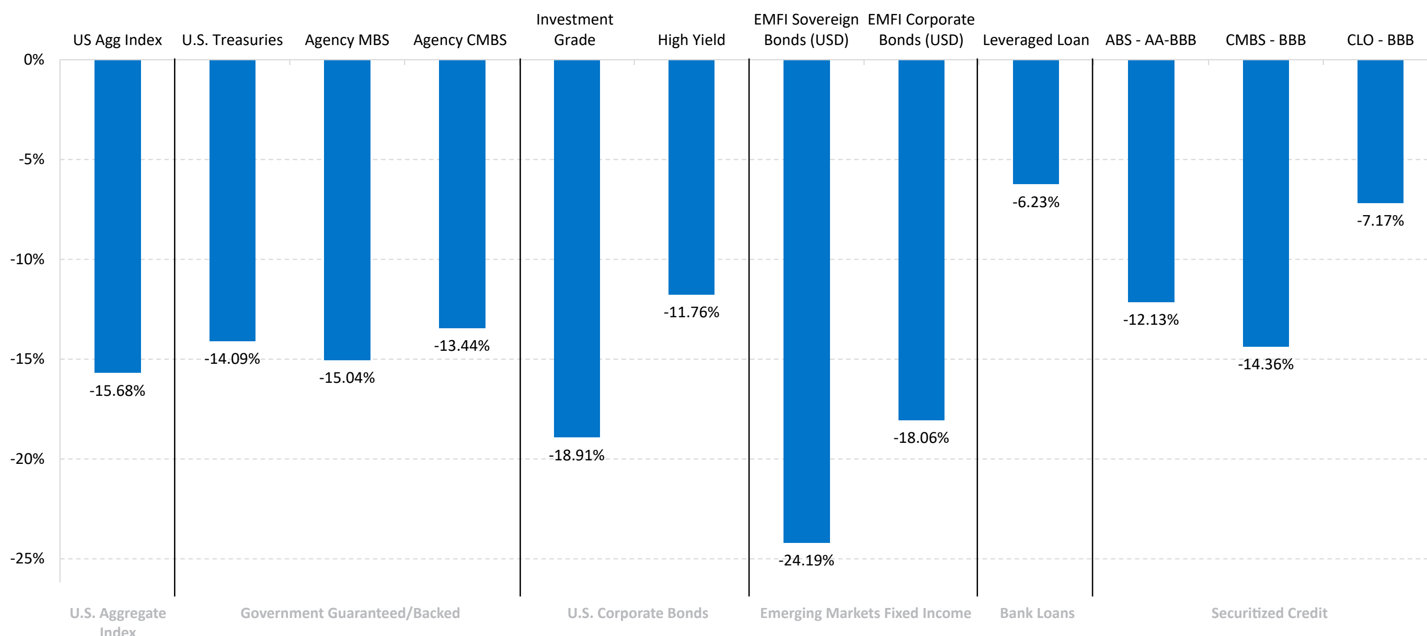
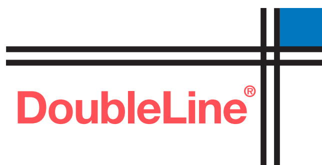


Figure 3 – One-Year Returns
Source: Bloomberg, DoubleLine



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Private Credit vs. Public Credit

Valuations in public-market fixed income are attractive on historical and risk-adjusted bases, with unlevered yields on high-quality assets near 6%, intermediate credit yields in the high single digits and low-to-midteen yields for below-investment-grade parts of the public credit markets. In addition to far more attractive all-in yields, most of the public credit markets are currently priced at discounts, with many sectors of below-investment-grade credit pricing 10-25 points below par, a far cry from where they were only one year ago. *(Figure 4)*

Fixed Income Index Prices | Darker bars represent Oct. 31, 2021. Lighter bars represent Oct. 31, 2022.

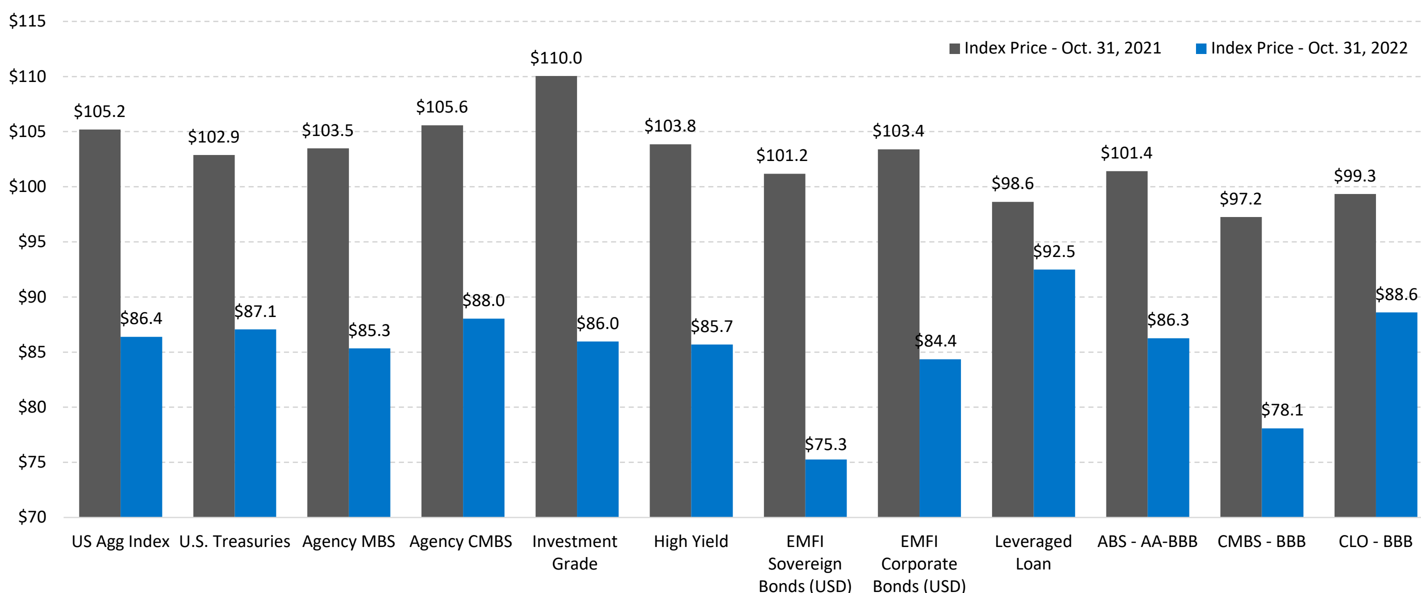
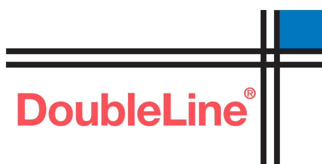


Figure 4
Source: Bloomberg, DoubleLine

DoubleLine favors public (versus private) credit in today's environment to take advantage of both higher yields and price appreciation potential. Broadly speaking, private credit was more compelling as a source of increased carry when interest rates were at or near historical lows and credit spreads were at all-time tights. Now, with the effective federal funds rate close to 4% and trending higher, Treasury yields across the curve at their highest levels in over a decade and credit spreads in a number of sectors at post-Global Financial Crisis levels only witnessed during the onset of the COVID-19 pandemic, the value represented across public credit sectors looks far more compelling relative to private credit.

Notably, direct lending in the private credit market typically consists of leveraged loans originated at par with little, if any, potential for price appreciation. While there are instances where loans might be made at discounts, these investments typically operate as carry trades. Given current market conditions, we are biased in favor of buying discounted bonds and/or loans at 10-to-30-point discounts rather than originating a par loan with a similar yield profile. In addition, DoubleLine has observed that return profiles in the private market have not yet fully adjusted to reflect the appropriate illiquidity concession, due largely to slower-moving capital flows and transaction activity within private markets.

Today, we can construct an opportunistic portfolio that yields in the 9%-to-12% range with the potential for price appreciation in the more liquid public markets. For most of the past decade, comparable yields required sourcing from the private markets and/or employing leverage. Additionally, sourcing yields in the low to midteens through the private market over the past decade typically required investment in locked-up or other relatively illiquid structures. Now it is possible to source the same yield profile in the public markets with daily or quarterly liquidity.



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Discounted bond prices, wider spreads and higher all-in yields now appropriately compensate fixed income investors with multiyear horizons. Timing the bottom of the market is difficult and, once forward-looking sentiment shifts to a more positive tone, history suggests that spreads could tighten quickly as market participants change from net sellers to net buyers and flows into the credit markets turn positive. This phenomenon might be amplified by the relatively limited supply and liquidity conditions that the fixed income market is currently experiencing.

Fixed Income vs. Equities

S&P 500 1, 3, 5, 10-Year Forward Annualized Real Returns from Different CAPE® Ratios

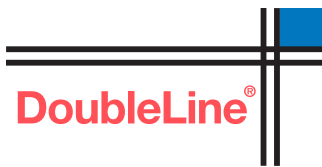
	CAPE® Ratio			S&P 500 1-year Ann. Forward Total Returns			S&P 500 3-year Ann. Forward Total Returns			S&P 500 5-year Ann. Forward Total Returns			S&P 500 10-year Ann. Forward Total Returns		
Quintile	Min	Avg	Max	Min	Avg	Max	Min	Avg	Max	Min	Avg	Max	Min	Avg	Max
1	13.3	19.8	21.6	-20.0%	17.8%	53.6%	0.5%	18.4%	32.8%	7.3%	19.0%	28.6%	8.2%	12.3%	16.7%
2	21.6	23.5	25.4	-43.3%	13.7%	56.4%	-8.2%	13.2%	32.0%	0.5%	12.3%	25.3%	6.3%	10.0%	15.3%
3	25.4	26.2	27.1	-38.1%	10.2%	46.0%	-15.1%	8.3%	29.1%	-4.8%	6.6%	18.9%	5.3%	7.7%	9.0%
4	27.2	29.4	31.9	-36.1%	11.0%	48.0%	-9.8%	11.1%	27.6%	-6.6%	7.2%	18.5%	2.7%	6.1%	8.4%
5	32.0	37.2	44.2	-26.6%	4.6%	39.8%	-16.1%	-0.3%	20.7%	-3.8%	-0.7%	4.0%	-3.4%	1.3%	7.1%

Figure 5
Source: Barclays, Bloomberg, DoubleLine. Annualized (Ann.)

Equities also have participated in the market sell-off this year, with the S&P 500 Index down 18.2% from its high on Jan. 4.[1] On a historical valuation basis, however, U.S. equities remain at elevated levels, as measured by the cyclically adjusted price-to-earnings (CAPE®) ratio. The S&P 500 CAPE® ratio was 38.3 at year-end 2021 and was at 28.5 as of Sept. 30, which is in the 66th percentile over the past 30 years during which the S&P 500 CAPE® ratio averaged 27.2.[2] Historically, a lower CAPE® ratio has provided greater one-, three-, and five-year forward annualized real returns versus a high CAPE® ratio. *(Figure 5)*

As bond investors, we believe yield is an important driver of forward returns. As mentioned earlier, the current yield to worst for many bonds rated IG are in the mid- to high single digits. *(Figure 3)* Further down the capital structure, yields are in the low double digits. By way of comparison, long-run average annualized return for equities is roughly 7.2%.[3] Certainly, equities are more attractive now versus only 10 months ago, however, from a return-per-unit-of-risk standpoint, DoubleLine believes fixed income is more attractive than equities at their respective valuation levels. ■

[1] October 31, 2022
[2] Data period: September 1992 through September 2022
[3] Annualized return of the MSCI ACWI from December 31, 1987, through October 31, 2022



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Chris Stegemann
Manager, Product Specialists

Mr. Stegemann joined DoubleLine in 2017. He is a member of the Product Specialist Team. In this capacity, he is responsible for various aspects of DoubleLine product marketing, investment strategy updates, portfolio communications and competitive analysis, with a focus on DoubleLine's International & Emerging Market Fixed Income strategies. Mr. Stegemann is also responsible for producing market commentary and dedicated strategy content. As part of the Product Specialist team he attends the Fixed Income Asset Allocation, Macro Asset Allocation, Emerging Market Fixed Income and Structured Product meetings. Prior to DoubleLine, Mr. Stegemann was in mutual fund distribution for Putnam Investments. He holds a BS in Finance and minors in Accounting and Economics from Elon University, Martha & Spencer Love School of Business. Mr. Stegemann also holds the Series 3, 6, 7, 63 and 65 Licenses.

Indexes used in Figure 3:

US Agg Index: Bloomberg US Aggregate Bond Index; **U.S. Treasuries:** Bloomberg US Treasury Index; **Agency MBS:** Bloomberg US MBS Index; **Agency CMBS:** Bloomberg US CMBS (ERISA Only) Index; **Investment Grade:** Bloomberg US Credit Index; **High Yield:** Bloomberg US Corporate HY Bond Index; **EMFI Sovereign Bonds:** J.P. Morgan EMBI GD; **EMFI Corporate Bonds:** J.P. Morgan CEMBI BD; **Leveraged Loans:** Morningstar LSTA US Leveraged Loan TR USD; **ABS AA-BBB:** Bloomberg US ABS Index; **CMBS BBB:** Bloomberg US CMBS Investment Grade BBB Index; **CLO BBB:** Palmer Square CLO BBB Total Return Index

Asset-Backed Securities (ABS) – Investment securities, such as bond or notes, that are collateralized by a pool of assets, such as loans, leases, credit card debt, royalties or receivables.

Below Investment Grade/Non-Investment Grade – Term indicating a security is rated below investment grade (IG). These securities are seen as having higher default risk or being prone to other adverse credit events. They typically pay higher yields than higher-quality bonds in order to make them attractive. They are less likely than IG bonds to pay back 100 cents on the dollar.

Bloomberg US Aggregate Bond Index – This index represents securities that are SEC registered, taxable and dollar denominated. It covers the U.S. investment grade, fixed-rate bond market, with components for government and corporate securities, mortgage pass-through securities and asset-backed securities. These major sectors are subdivided into more specific indexes that are calculated and reported on a regular basis.

Bloomberg US Asset-Backed Securities (ABS) Index – This index is the ABS component of the Bloomberg US Aggregate Bond Index, a flagship measure of the U.S. investment grade, fixed-rate bond market. The ABS index has three subsectors: credit and credit cards, autos and utility.

Bloomberg US CMBS (ERISA Only) Index – This index measures the performance of investment grade commercial mortgage-backed securities (CMBS). The index includes only CMBS that are compliant with the Employee Retirement Income Security Act of 1974, which will deem ERISA eligible the certificates with the first priority of principal repayment as long as certain conditions are met, including that the certificates be rated in one of the three highest categories by Fitch, Moody's or Standard & Poor's.

Bloomberg US CMBS Investment Grade BBB Index – This index measures the BBB-rated market of U.S. Agency and U.S. non-Agency conduit and fusion commercial mortgage-backed securities (CMBS)deals with a minimum current deal size of $300 million. The index includes ERISA eligible (eligible for the Bloomberg US Aggregate Bond Index) and non-ERISA eligible securities.

Bloomberg US Corporate High Yield (HY) Bond Index – This index measures the U.S. dollar-denominated, HY, fixed-rate corporate bond market. Securities are classified as HY if the respective middle ratings of Moody's, Fitch and S&P are Ba1, BB+ or BB+ or below. The Bloomberg US HY Long Bond Index, including bonds with maturities of 10 years or greater, and the Bloomberg US HY Intermediate Bond Index, including bonds with maturities of 1 to 9.999 years, are subindexes of the Bloomberg US Corporate HY Bond Index.

Bloomberg US Credit Index – This index is the U.S. credit component of the Bloomberg US Government/Credit Index. It consists of publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity and quality requirements. To qualify, bonds must be SEC registered. The US Credit Index is the same as the former US Corporate Index.

Bloomberg US Mortgage-Backed Securities (MBS) Index – This index measures the performance of investment grade, fixed-rate, mortgage-backed, pass-through securities of the government-sponsored enterprises (GSEs): Federal Home Loan Mortgage Corp. (Freddie Mac), Federal National Mortgage Association (Fannie Mae) and Government National Mortgage Association (Ginnie Mae).

Bloomberg US Treasury Index – This index measures U.S. dollar-denominated, fixed-rate nominal debt issued by the U.S. Treasury with a remaining maturity of one year or more. Treasury bills are excluded by the maturity constraint but are part of a separate Short Treasury Index.

Collateralized Loan Obligation (CLO) – Single security backed by a pool of debt.

Commercial Mortgage-Backed Securities (CMBS) – Securitized loans made on commercial rather than residential properties.

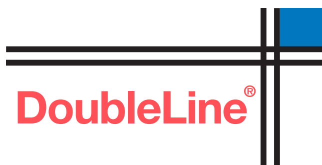
Conduit Loans – Type of loans, also known as commercial mortgage-backed securities (CMBS) loans, that are commercial real estate loans pooled together with similar commercial mortgages and sold on the secondary market. On the secondary market, conduit loans are divided into tranches based on risk, return and loan maturity.

Cyclically Adjusted Price-to-Earnings (CAPE®) Ratio – This ratio measures valuation by using real earnings per share (EPS) over a 10-year period to smooth out fluctuations in corporate profits that occur during different periods of a business cycle. It is also known as the "Shiller P/E ratio" for Yale University Dr. Robert Shiller, who popularized its use.

Employee Retirement Income Security Act (ERISA) of 1974 – U.S. tax and labor law that establishes minimum standards for pension plans in private industry. It contains rules on the federal income tax effects of transactions associated with employee benefit plans.

Federal Funds Rate – Target interest rate, set by the Federal Reserve at its Federal Open Market Committee (FOMC) meetings, at which commercial banks borrow and lend their excess reserves to each other overnight. The Fed sets a target federal funds rate eight times a year, based on prevailing economic conditions.

Investment Grade (IG) – Rating that signifies a municipal or corporate bond presents a relatively low risk of default. Bonds below this designation are considered to have a high risk of default and are commonly referred to as high yield (HY) or "junk bonds." The higher the bond rating the more likely the bond will return 100 cents on the U.S. dollar.



J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBI GD) – This index is a uniquely weighted version of the EMBI. The EMBI tracks bonds from emerging markets (EM), and comprises sovereign debt and EM corporate bonds. The EMBI GD limits the weights of index countries with larger debt stocks by only including specified portions of those countries' eligible current face amounts of debt outstanding.

J.P. Morgan Corporate Emerging Markets Bond Index Broad Diversified (CEMBI BD) – This index is a uniquely weighted version of the CEMBI, which is a market capitalization-weighted index consisting of U.S. dollar-denominated emerging markets corporate bonds. The CEMBI BD limits the weights of index countries with larger debt stocks by only including specified portions of those countries' eligible current face amounts of debt outstanding.

Morgan Stanley Capital International All Country World Index (MSCI ACWI) – This market capitalization-weighted index is designed to provide a broad measure of stock performance throughout the world. It comprises stocks from 23 developed countries and 27 emerging markets.

Morningstar LSTA US Leveraged Loan TR USD – This index (formerly the S&P/LSTA Leveraged Loan Index) tracks the market-weighted performance of institutional weighted loans based on market weightings, spreads and interest payments.

Mortgage-Backed Securities (MBS) – Investment similar to a bond that is made up of a bundle of home loans bought from the banks that issued them. Investors in MBS receive periodic payments similar to bond coupon payments.

Non-Qualified Mortgage (Non-QM) – Any home loan that doesn't comply with the Consumer Financial Protection Bureau's existing rules on qualified mortgages (QMs). Usually this type of alternative mortgage loan accommodates people who are not able to prove they are capable of making the mortgage payments. Just because it is a non-QM mortgage loan does not necessarily mean high risk or subprime mortgage risk, and in many cases these non-QM mortgage loans require a high FICO score but simply do not check all the boxes associated with a QM loan. Non-QM loans for mortgages are protected by the lender against any type of lawsuit should the borrower become unable to afford the loan.

Palmer Square CLO BBB Total Return Index – This index tracks on a total return basis the BBB-rated component of the Palmer Square CLO (collateralized loan obligation) Senior Debt Index, which comprises CLOs issued after Jan. 1, 2009, and meet certain inclusion criteria.

Par – Short for "par value," par can refer to bonds, preferred stock, common stock or currencies, with different meanings depending on the context. Par most commonly refers to bonds, in which case, it means the face value, or value at which the bond will be redeemed at maturity.

Residential Mortgage-Backed Securities (RMBS) – Securitized loans made on residential rather than commercial properties.

S&P 500 Index – This unmanaged capitalization-weighted index of the stocks of the 500 largest publicly traded U.S. companies is designed to measure performance of the broad domestic economy through changes in the aggregate market value of the 500 stocks, which represent all major industries.

Subprime – Below-average credit classification of borrowers with a tarnished or limited credit history, and which are subject to higher than average interest rates. Subprime loans carry more credit risk and, as such, will carry higher interest rates.

Yield to Worst (YTW) – The lowest yield of a bond that can be received short of default.

You cannot invest directly in an index.

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