ANGELO GORDON

Angelo Gordon's Capital Markets Perspectives

FOURTH QUARTER 2023

Published October 2023

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Angelo Gordon's Capital Markets Perspectives (CMP) is a quarterly publication that provides information and our portfolio managers' views on the credit and real estate markets. We hope you find this to be a valuable resource and enjoy our latest look at the markets.

Angelo Gordon is a leading alternative investment firm, managing approximately $74 billion* across a broad range of credit and real estate strategies. Founded in 1988, the firm has been investing on behalf of pension funds, corporations, endowments, foundations, sovereign wealth funds, and individuals for nearly 35 years.

Over our entire history, Angelo Gordon's investment approach has consistently relied on disciplined portfolio construction backed by rigorous research and a strong focus on capital preservation.

We have grown by pursuing strategies that complement and build on our core capabilities, and we now have over 700 employees in offices across the U.S., Europe, and Asia. Combining deep industry sector and market expertise with a collaborative, knowledge-sharing culture, we creatively seek out investment opportunities that allow us to exploit inefficiencies in global credit and real estate markets.

** Angelo Gordon's (the "firm") currently stated AUM of approximately $74 billion as of June 30, 2023 reflects fund-level asset-related leverage. Prior to May 15, 2023, the firm calculated its AUM as net assets under management excluding leverage, which resulted in firm AUM of approximately $53 billion last reported as of December 31, 2022. The difference reflects a change in the firm's AUM calculation methodology and not any material change to the firm's investment advisory business. For a description of the factors the firm considers when calculating AUM, please see the disclosure linked here.*

CMP Overview

In the third quarter of 2023, market participants continued to observe strong performance in corporate credit and residential mortgage-backed securities against a backdrop of heightened volatility in the interest rate and equity markets.

In corporate credit, both the U.S. and European high yield markets posted positive returns in the third quarter. U.S. high yield bond spreads tightened, while European high yield spreads were flat. In both Europe and the U.S., lower-rated bonds continued to outperform their higher-rated counterparts on both a quarterly and year-to-date basis. Positive earnings data lifted sentiment early in the quarter, though those gains were later reversed by heightened anticipation of a higher-for-longer interest rate environment and positive economic growth. In U.S. high yield, the trailing 12-month default rate, including distressed exchanges, declined in the third quarter; however, the cumulative defaults and distressed exchanges recorded year-to-date already rank as the eighth-largest annual total on record.

In structured credit, home prices continued to rally and RMBS spreads continued to tighten during the third quarter. The average 30-year fixed mortgage rate in the U.S. rose to 7.5% at the beginning of October – the highest level since 2000 – making the strength in the housing market even more remarkable. Supply of homes remained constrained, with the well-publicized "lock-in effect" limiting sales of existing homes and new listings below historical averages. In asset-backed securities, spreads leaned positive but were mixed overall during the third quarter. Senior fixed-rate tranches were modestly wider, while down-in-credit profiles and floating-rate tranches saw modest spread tightening; however, ABS spreads remain wide of February 2022 levels. Consumer performance data has generally been within underwritten expectations but continues to deteriorate to pre-pandemic levels, with some sub-sectors already underperforming that period. In commercial real estate debt, interest rates continued to drive investor sentiment in the space. Increased risk-free rates, coupled with the reduced availability and heightened cost of financing, have been particularly challenging for commercial real estate owners. As a result, many borrowers have been negotiating extensions to their current commercial real estate loans.

Sponsored middle market lending volume, including direct and syndicated activity, increased marginally quarter-over-quarter but was lower year-over-year in the third quarter. Meanwhile, terms for direct lender-led deals remained favorable, with all-in yields on first-lien term loans edging higher during the quarter.

Turning to real estate, global economic indicators have shown persistent disparities, creating a challenging dilemma for central banks as they try to determine the appropriate time to begin interest rate reductions. As a result, real estate investors find themselves in a state of uncertainty. What has remained certain, however, is that the interest rate hikes implemented by central banks in 2022 and 2023 have put significant downward pressure on real estate valuations. Against this backdrop, the ongoing slowdown in real estate transaction activity has continued, with investors facing challenges related to limited financing availability, the rising cost of debt, and overall uncertainty regarding valuations. Nonetheless, underlying fundamentals for nearly all real estate sectors – with the exception of U.S. office – have remained stable. We anticipate an impending wave of distress due to elevated debt maturities and substantially higher interest rates, and we maintain our expectation that market dynamics will create opportunities to identify high-quality assets at reset valuations, even within sectors with strong fundamentals.

In the U.S., market participants continue to grapple with a heightened interest rate environment, which has led to investors adopting a more cautious approach. As a result, transaction volume through the first nine months of 2023 fell approximately 55% year-over-year. Valuations have continued on a downward trend, according to the RCA Commercial Property Price Indexes. However, public market sentiment suggests the potential for further declines across nearly all sectors. We believe investors will likely remain hesitant to transact until the bid-ask spread narrows – a trend expected to materialize as we enter 2024.

In Europe, interest rates have increased 400 basis points since 2020 but inflation remains above target levels, thus central banks have continued tightening monetary policy. This has caused real estate investment volumes to slow dramatically, down more than 50% year-over-year in the second quarter. Furthermore, rising interest rates have pressured cap rates across the region. Core stabilized properties in strong markets are now trading at cap rates that are 75 to 150 basis points wide of recent lows, severely impacting property values. We expect the material amount of debt maturing beginning in late 2024 will result in a significant amount of stressed and distressed sellers entering the market.

In Asia, GDP growth was exhibited across the region despite challenging global market dynamics. Overall, real estate fundamentals in Asia have been mixed. Although there have been pockets of softness, the industrial sector has broadly remained robust throughout the region; meanwhile, office sector performance has been more variable, with resilience noted in Japan and Korea while challenges persist in China and Hong Kong.

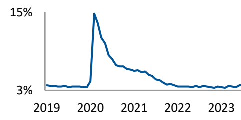
Josh Baumgarten
Co-Chief Executive Officer
Co-Chief Investment Officer
Head of Credit

Adam Schwartz
Co-Chief Executive Officer
Co-Chief Investment Officer
Head of Real Estate

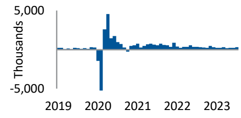
Economic Dashboard & Market Indices

Job Market

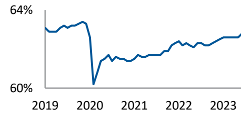
U.S.—Unemployment Rate	As of 9/30/2023
Latest Level	3.8
Change from Prior Period	0.0
Frequency	Monthly



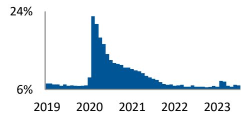
U.S.—Non-Farm Payroll	As of 9/30/2023
Latest Level	336.0
Change from Prior Period	▲ 109.0
Frequency	Monthly



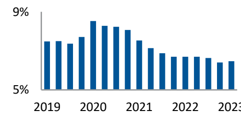
U.S.—Labor Participation Rate	As of 9/30/2023
Latest Level	62.8
Change from Prior Period	0.0
Frequency	Monthly



U.S.—U-6 Unemployed & Margin & Part-Time as Percent of Labor Force & Margin	As of 9/30/2023
Latest Level	7.0
Change from Prior Period	▼ (0.1)
Frequency	Monthly

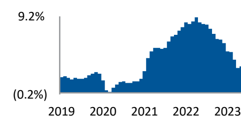


Eurozone Unemployment Rate	As of 6/30/2023
Latest Level	6.5
Change from Prior Period	▼ (0.1)
Frequency	Quarterly

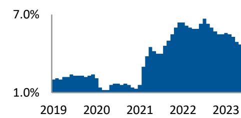


Inflation

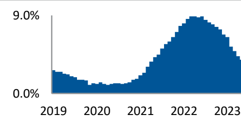
U.S. Consumer Price Index (CPI) Y-o-Y (%)	As of 9/30/2023
Latest Level	3.7
Change from Prior Period	0.0
Frequency	Monthly



U.S. CPI Goods Less Food & Energy Y-o-Y (%)	As of 9/30/2023
Latest Level	4.1
Change from Prior Period	▼ (0.3)
Frequency	Monthly

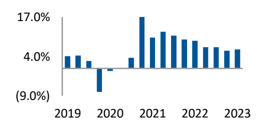


U.S. Producer Price Index (PPI) Y-o-Y (%)	As of 9/30/2023
Latest Level	3.4
Change from Prior Period	▼ (0.2)
Frequency	Monthly

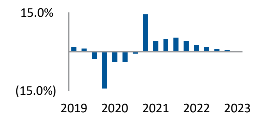


GDP Growth

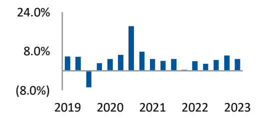
U.S.—GDP Y-o-Y (%)	As of 9/30/2023
Latest Level	6.3
Change from Prior Period	▲ 0.4
Frequency	Quarterly



Eurozone—GDP Y-o-Y (%)	As of 9/30/2023
Latest Level	0.1
Change from Prior Period	▼ (0.4)
Frequency	Quarterly

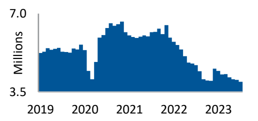


China—GDP Y-o-Y (%)	As of 9/30/2023
Latest Level	4.9
Change from Prior Period	▼ (1.4)
Frequency	Quarterly

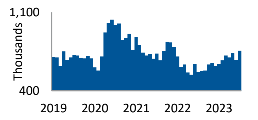


Housing

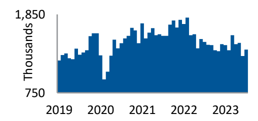
Existing Home Sales	As of 9/30/2023
Latest Level	4.0
Change from Prior Period	▼ (0.1)
Frequency	Monthly



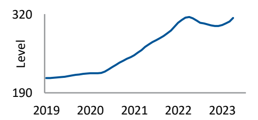
New Home Sales	As of 9/30/2023
Latest Level	759.0
Change from Prior Period	▲ 83.0
Frequency	Monthly



Housing Starts	As of 9/30/2023
Latest Level	1,358.0
Change from Prior Period	▲ 89.0
Frequency	Monthly



Case-Shiller Index of Home Value in 20 Cities	As of 7/31/2023
Latest Level	313.7
Change from Prior Period	0.0
Frequency	Monthly



Note: All charts are based on a five-year trend.
Source: Bloomberg (All).

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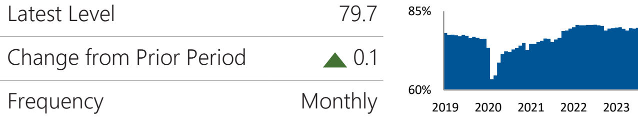
Economic & Market Confidence

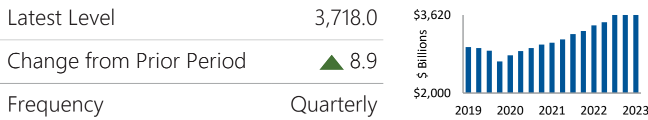
Capacity Utilization as a Percent of Capacity — As of 9/30/2023

Latest Level	79.7
Change from Prior Period	▲ 0.1
Frequency	Monthly



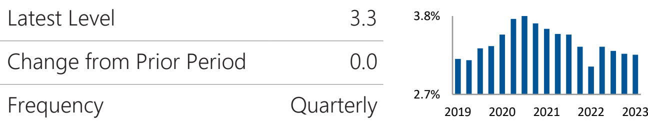
Private Fixed Investment Nonresidential SAAR — As of 9/30/2023

Latest Level	3,718.0
Change from Prior Period	▲ 8.9
Frequency	Quarterly



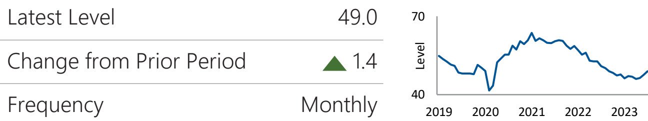
Residential Fixed Investment as a Percent of GDP — As of 9/30/2023

Latest Level	3.3
Change from Prior Period	0.0
Frequency	Quarterly



ISM Manufacturing Index — As of 9/30/2023

Latest Level	49.0
Change from Prior Period	▲ 1.4
Frequency	Monthly

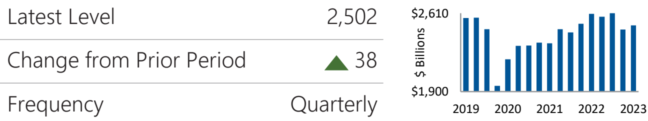


Manufacturing Inventory Change Q-o-Q ($) — As of 9/30/2023

Latest Level	38.8
Change from Prior Period	▲ 26.9
Frequency	Quarterly

Exports of Goods/Services — As of 9/30/2023

Latest Level	2,502
Change from Prior Period	▲ 38
Frequency	Quarterly



Shipping Rates — As of 9/30/2023

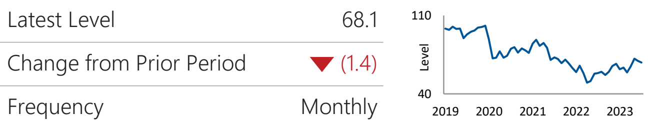
Latest Level	1,701
Change from Prior Period	▲ 615
Frequency	Quarterly

Personal Income Level — As of 8/31/2023

Latest Level	23,084
Change from Prior Period	▲ 88
Frequency	Monthly

Michigan Consumer Confidence Sentiment — As of 9/30/2023

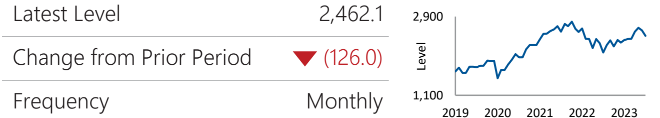
Latest Level	68.1
Change from Prior Period	▼ (1.4)
Frequency	Monthly



Equity

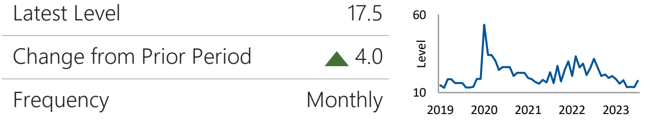
U.S. Equity Markets—Russell 3000 — As of 9/30/2023

Latest Level	2,462.1
Change from Prior Period	▼ (126.0)
Frequency	Monthly



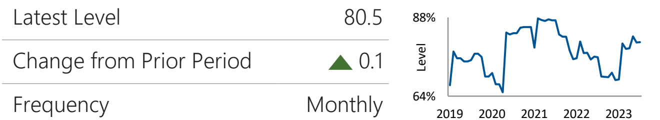
U.S. Equity—VIX — As of 9/30/2023

Latest Level	17.5
Change from Prior Period	▲ 4.0
Frequency	Monthly

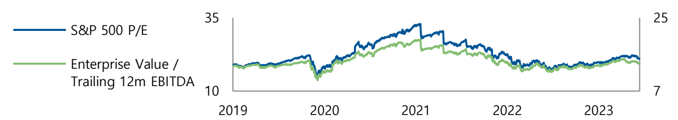


S&P 500 Percentage Exceeding Earning Estimates — As of 9/30/2023

Latest Level	80.5
Change from Prior Period	▲ 0.1
Frequency	Monthly

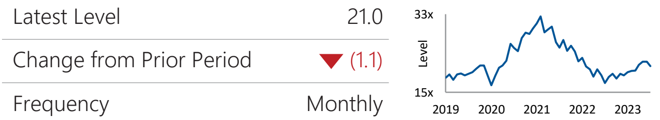


S&P 500 Historical Valuation Levels — As of 9/30/2023



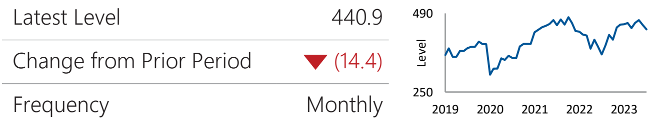
Trailing P/E on S&P 500 — As of 9/30/2023

Latest Level	21.0
Change from Prior Period	▼ (1.1)
Frequency	Monthly



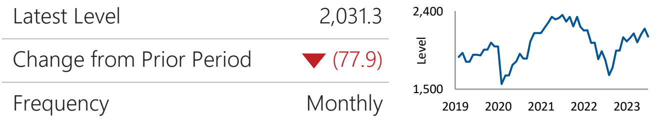
Equity Markets—Euro Stoxx — As of 9/30/2023

Latest Level	440.9
Change from Prior Period	▼ (14.4)
Frequency	Monthly



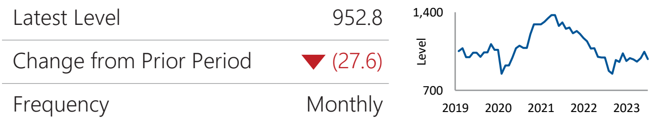
Equity Markets—MSCI EAFE — As of 9/30/2023

Latest Level	2,031.3
Change from Prior Period	▼ (77.9)
Frequency	Monthly

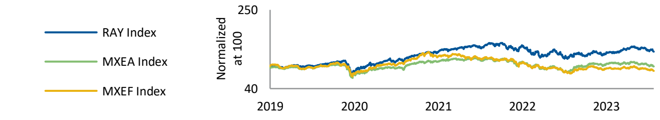


Equity Markets—MSCI EM — As of 9/30/2023

Latest Level	952.8
Change from Prior Period	▼ (27.6)
Frequency	Monthly



Russell 3000 & MSCI EAFE & MSCI EM — As of 9/30/2023

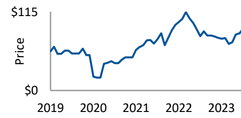


Note: All charts are based on a five-year trend.
Source: Bloomberg (All).

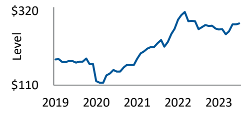
Economic Dashboard & Market Indices *(continued)*

Commodities

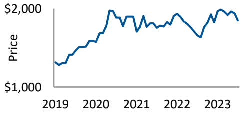
WTI Crude Oil Price	As of 9/30/2023
Latest Level	90.8
Change from Prior Period	▲ 7.2
Frequency	Monthly



Reuters/Jefferies Commodity Index	As of 9/30/2023
Latest Level	284.5
Change from Prior Period	▲ 2.6
Frequency	Monthly

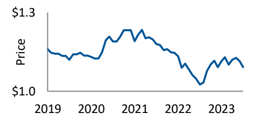


Gold	As of 9/30/2023
Latest Level	1,848.6
Change from Prior Period	▼ (91.6)
Frequency	Monthly

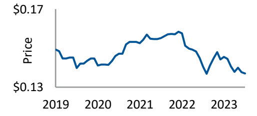


Foreign Exchange Rates

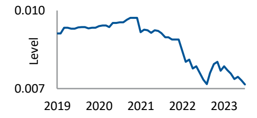
Euro Spot Rate vs. 1 USD	As of 9/30/2023
Latest Level	1.06
Change from Prior Period	▼ (0.03)
Frequency	Monthly



Yuan Spot Rate vs. 1 USD	As of 9/30/2023
Latest Level	0.1370
Change from Prior Period	▼ (0.0007)
Frequency	Monthly

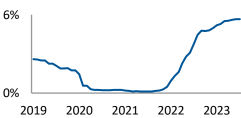


Yen Spot Rate vs. 1 USD	As of 9/30/2023
Latest Level	0.0067
Change from Prior Period	▼ (0.0002)
Frequency	Monthly

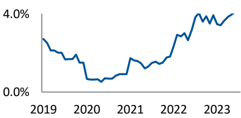


Rates

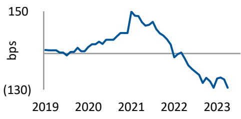
Libor 3M	As of 9/30/2023
Latest Level	5.66
Change from Prior Period	▼ (0.01)
Frequency	Monthly



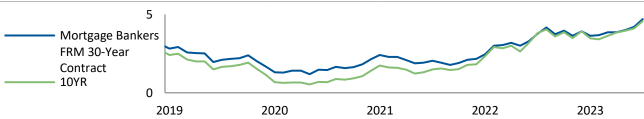
Treasury 10-Yr Yield	As of 9/30/2023
Latest Level	4.57
Change from Prior Period	▲ 0.46
Frequency	Monthly



Swaps 2-Yr vs. 10-Yr	As of 6/30/2023
Latest Level	(123.42)
Change from Prior Period	▼ (30.04)
Frequency	Monthly



30-Yr Mortgage & 10-Yr Treasury — As of 9/30/2023



Note: All charts are based on a five-year trend.
Source: Bloomberg (All).

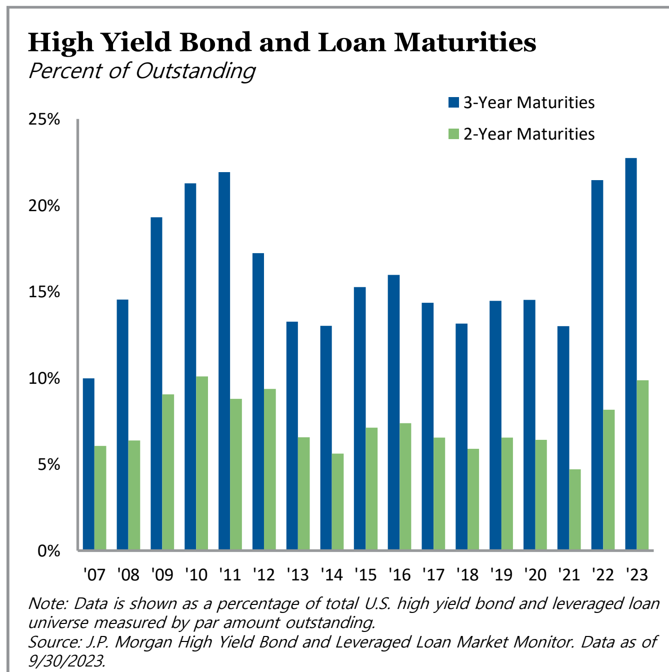
Leveraged Loans

Leveraged loan performance remained strong in the third quarter of 2023. The J.P. Morgan U.S. Leveraged Loan Index posted a 3.3% return and ended the quarter with a yield of 10.0% and a spread of 541 basis points. The leveraged loan asset class outperformed many alternatives in September, against a backdrop of heightened investor focus on rising interest rates, heavy capital markets activity, and a series of retail inflows into the space. As of the end of September, the J.P. Morgan U.S. Leveraged Loan Index recorded a 10.1% year-to-date gain, outperforming high yield and investment grade year-to-date returns of 6.2% and 0.5%, respectively. In Europe, the J.P. Morgan European Leveraged Loan Index posted a 4.1% quarterly return, ending the third quarter with a spread of 526 basis points and yield of 8.8%. On a year-to-date basis, the J.P. Morgan European Leveraged Loan Index returned 11.6% as of the end of the third quarter. In our view, the high average coupon for leveraged loans makes the asset class well-positioned for investor inflows as we continue through 2023.

The default rate for leveraged loans was 2.7% in the U.S. and 1.3% in Europe as of the end of the third quarter. Looking ahead, J.P. Morgan is forecasting that the U.S. loan default rate will rise to 3.5% in 2023 and 4.0% in 2024, hovering above the long-term average of 3.1%.

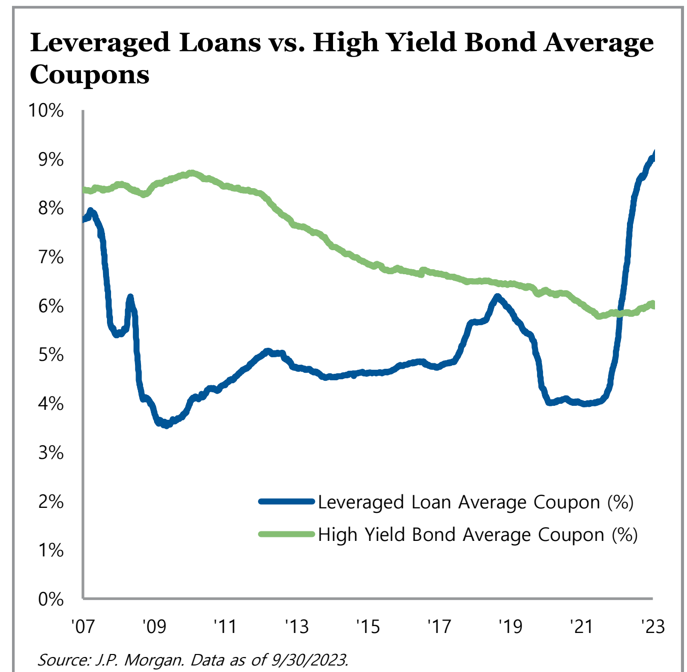
In terms of new issuance volume, market participants observed a pick-up in primary market activity in the third quarter. Notably, September's gross institutional loan issuance totaled $58.1 billion; excluding refinancing and repricing activity, net issuance volume totaled $17.3 billion, which is the most elevated level recorded since March 2022.

As we head into the final months of 2023, investors are focused on the impact of a higher-for-longer interest rate environment and rising geopolitical tensions. Against this backdrop, we anticipate the potential for greater volatility in the credit markets and will continue to monitor the impact of rising interest rates on companies' free cash flow. Thanks to the dramatic move in the base rate from 10 basis points in the first quarter of 2022 to above 550 basis points at the end of the third quarter of 2023, we expect cash flows for leveraged credits that did not hedge their floating rate debt to meaningfully decline. In this environment, we believe market participants will be closely monitoring corporate earnings and seeking to ensure issuers have adequate sources of liquidity to manage operations and drive earnings growth.



Note: Data is shown as a percentage of total U.S. high yield bond and leveraged loan universe measured by par amount outstanding.
Source: J.P. Morgan High Yield Bond and Leveraged Loan Market Monitor. Data as of 9/30/2023.

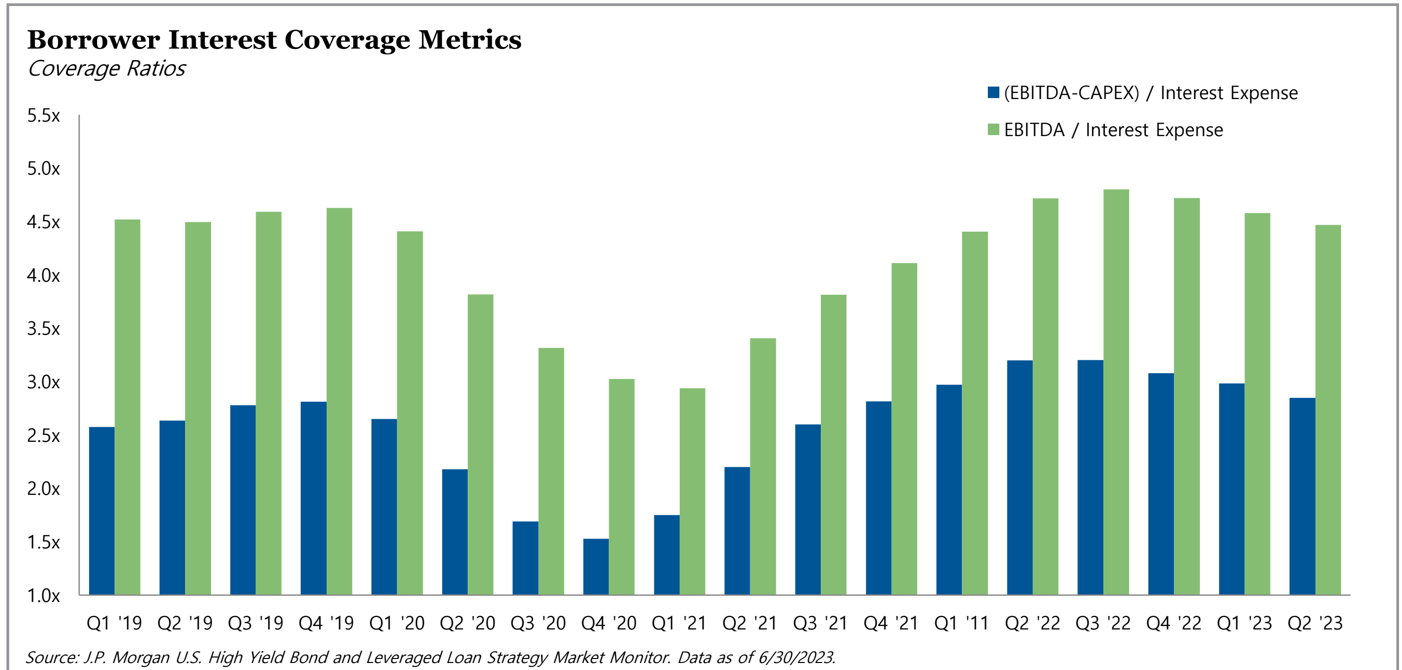
Issuers are starting to come to market to address upcoming maturities, and we expect this trend to continue.



Source: J.P. Morgan. Data as of 9/30/2023.

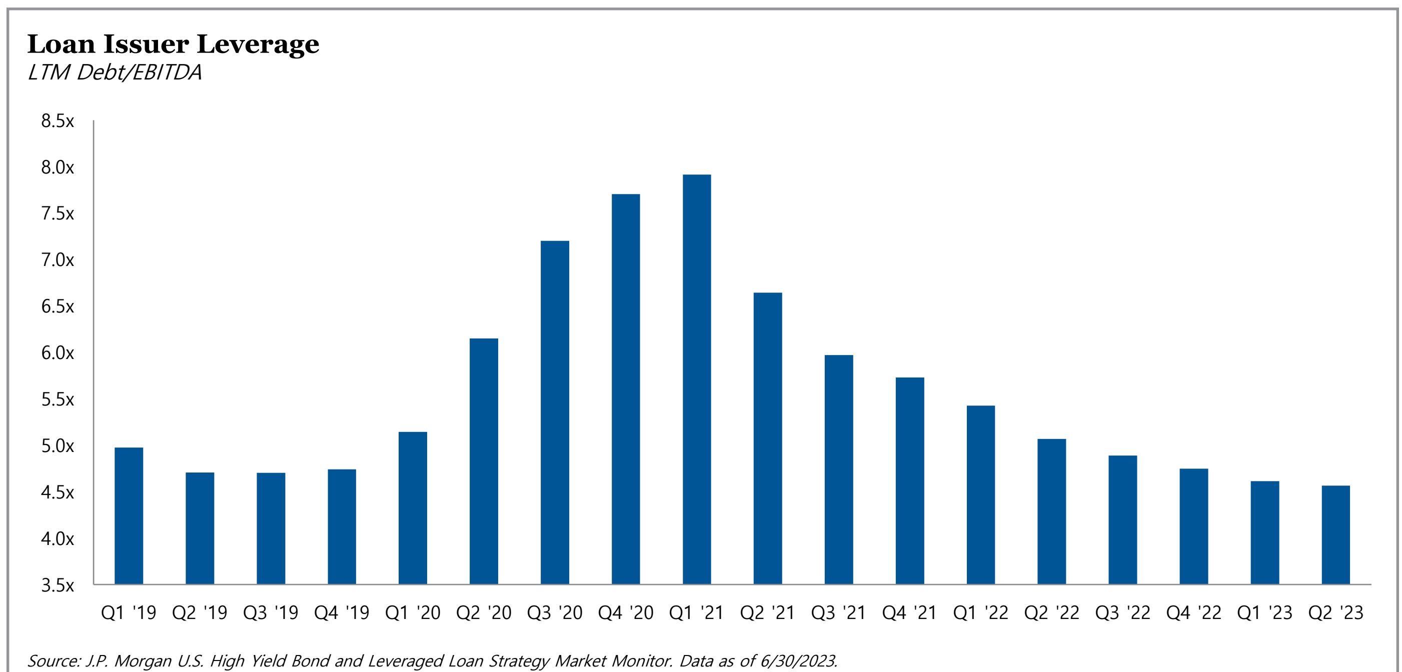
The average coupon for leveraged loans continued to exceed that of high yield bonds due to the higher base rate. A key metric to watch will be the impact of higher base rates on issuers' balance sheets and cash flows.

Leveraged Loans *(continued)*



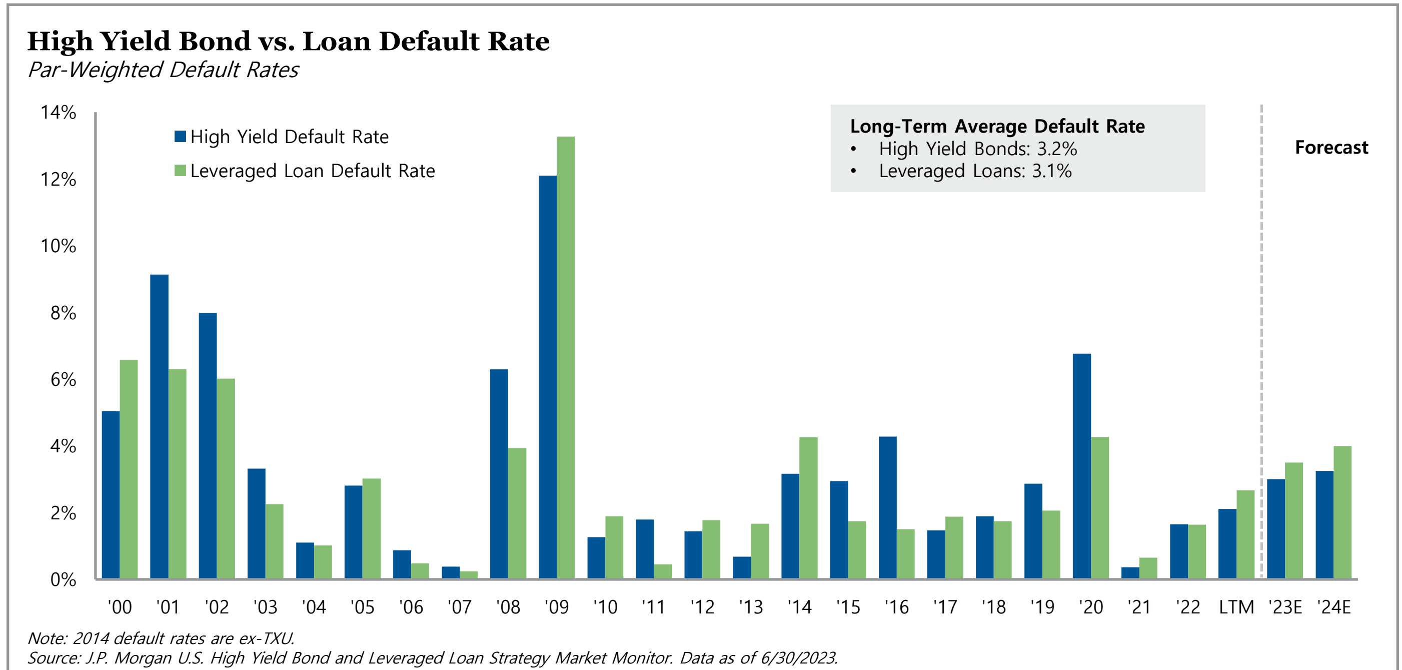
Source: J.P. Morgan U.S. High Yield Bond and Leveraged Loan Strategy Market Monitor. Data as of 6/30/2023.

Borrowers' coverage metrics continue to reflect the impact of rising interest rates and are expected to continue to erode over the coming quarters.

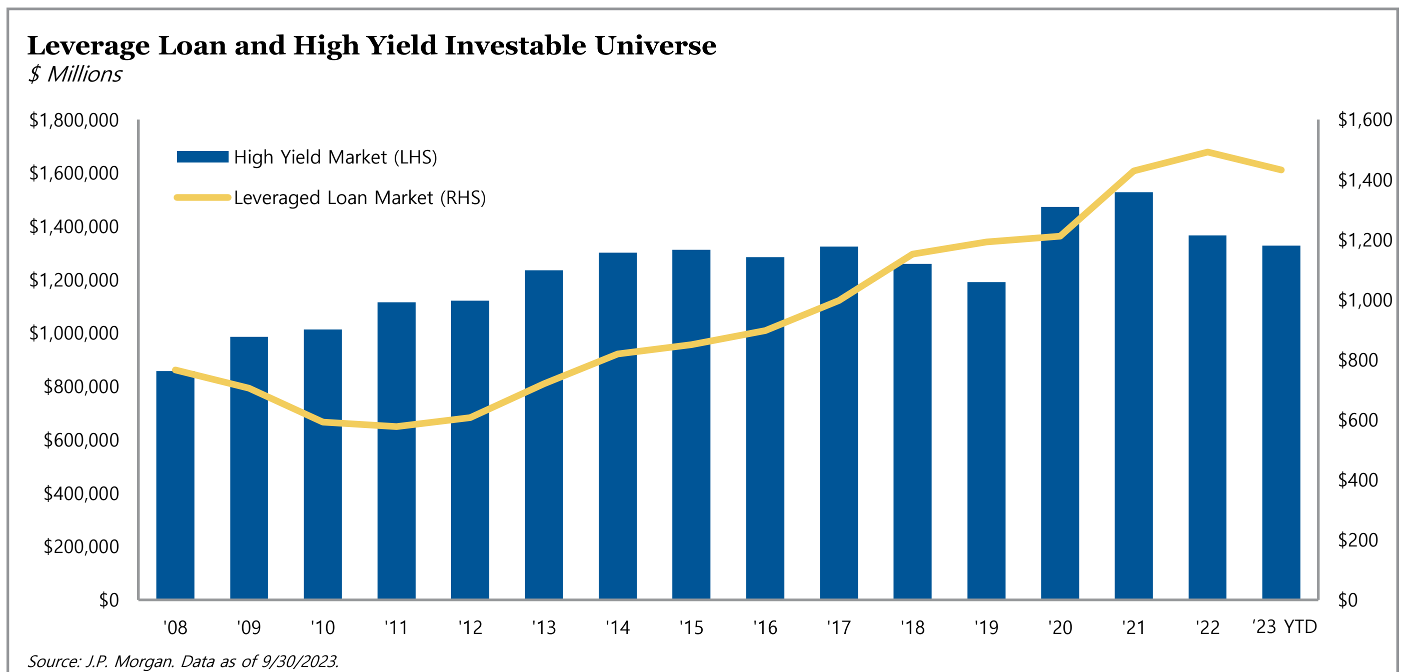


Source: J.P. Morgan U.S. High Yield Bond and Leveraged Loan Strategy Market Monitor. Data as of 6/30/2023.

Leverage for loan issuers is at a four-year low, albeit comfortably above the average among high yield issuers.



We continue to expect default rates to rise for both loans and bonds. Most sell-side analysts expect default rates to hover near their long-term averages in 2023 and increase in 2024.



The U.S. leveraged finance market – as measured by the total value of leveraged loans and high yield bonds in the market – continues to expand, providing opportunities in both the primary and secondary markets.

Maureen D'Alleva
Portfolio Manager

For more information on CLOs, click here.

High Yield Credit

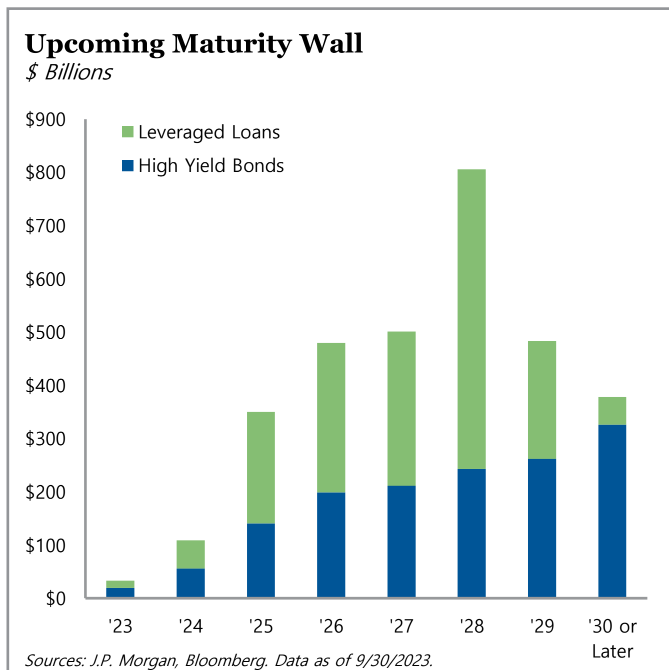
Both the U.S. and European high yield markets generated positive performance in the third quarter, with gains of 0.7% in the United States and 1.7% in Europe for the three-month period ended September 30, 2023. While better-than-expected earnings reports lifted credit markets early in the quarter, positive economic growth data and hawkish U.S. Federal Reserve sentiment amplified a higher-for-longer interest rate narrative, which factored into September's reversal of prior months' gains. For the first nine months of the year, U.S. high yield produced a return of 6.2%, while the European high yield return reached 7.0% year-to-date.

In the United States, high yield bond spreads ended September at 420 basis points – tightening 9 basis points during the third quarter and 70 basis points year-to-date – and yields rose to 9.0% at the end of the quarter. Lower-rated bonds continued their outperformance relative to higher-quality bonds; CCCs rose 2.4% while BBs generated a 0.1% loss in the third quarter. Year-to-date, CCCs significantly outperformed BBs, generating returns of 12.5% and 4.4%, respectively. In Europe, high yield spreads remained essentially flat in the quarter, ending at 493 basis points. Lower-quality CCCs bested BBs both during the third quarter – returning 4.6% versus 1.0% – and year-to-date, generating returns of 6.8% and 6.0%, respectively.

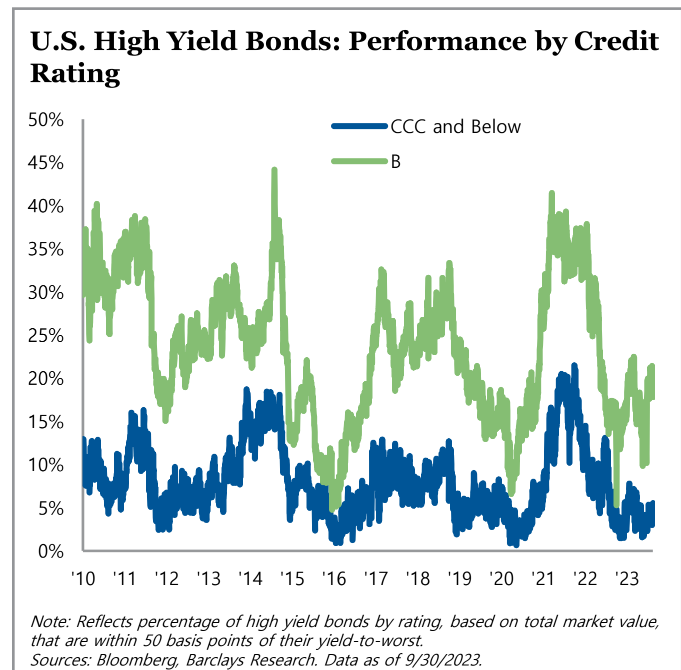
During the third quarter, 19 U.S. companies defaulted or completed a distressed exchange on a combined $11.5 billion of debt, which drove the 12-month trailing default rate down from 2.7% to 2.1%. However, the combined $63 billion of defaults and distressed exchanges across 64 companies year-to-date already ranks as the eighth-largest annual total on record. During the third quarter, the European high yield market experienced five defaults, resulting in the 12-month trailing default rate rising 72 basis points to 2.1%. Year-to-date, 12 companies have restructured, affecting a combined €9.7 billion of European currency bonds.

There was approximately $41 billion of new issuance volume in the U.S. in the third quarter, driven by $25 billion of primary pricing in September – the highest monthly volume since January 2022; this increased the year-to-date issuance total to nearly $137 billion, compared to $90 billion during the first three quarters of 2022. In Europe, high yield new issuance amounted to €13 billion during the quarter, bringing the year-to-date total to €47 billion.

Following inflows of $4.2 billion in the second quarter, U.S. high yield funds experienced $3.9 billion of net outflows in the third quarter, bringing year-to-date net redemptions up to $14.5 billion. In Europe, high yield fund outflows of €1.1 billion during the third quarter more than offset net inflows from earlier in 2023, resulting in year-to-date net outflows of €340 million as of the end of September.



More than $2.2 trillion of high yield bonds and leveraged loans have upcoming maturities in the next 5 years.



Dispersion within the high yield market remains elevated.

Ryan Mollett
Global Head of Credit Solutions

For more information on Credit Solutions, click here.

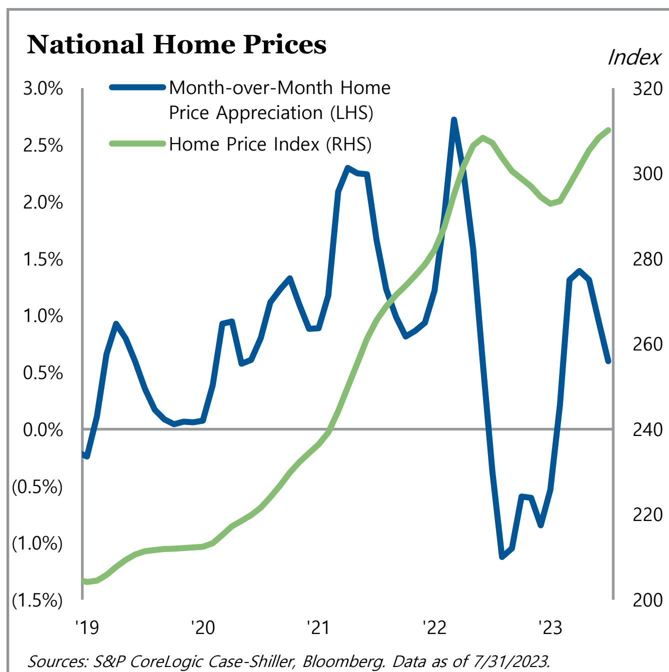
Structured Credit: RMBS

RMBS spreads tightened during the third quarter, despite risk markets being weaker. The sector continues to be in focus given favorable dynamics for its underlying collateral, including the de-levering of mortgages and relatively strong obligors. Credit risk transfer (CRT) tranches tightened significantly, with deep credit tranches as much as 200 basis points tighter while the belly of the stack contracted by up to 100 basis points. Senior non-qualified mortgage (NQM) spreads were little changed, while BBB-rated NQM spreads tightened by 25 basis points and legacy RMBS spreads were around 10 basis points tighter. Spreads are also sharply tighter on a year-to-date basis; most spreads are 50 to 100 basis points tighter, though pockets of CRT tightened 200 to 300-plus basis points. Despite this positive performance throughout 2023, most of the sector's spreads remain 50 to 100 basis points wide of February 2022 levels, offering a runway for additional potential upside. Year-to-date total returns were between 7% and 18% for mezz and subordinate CRT tranches and in the range of 3% to 5% for legacy RMBS.

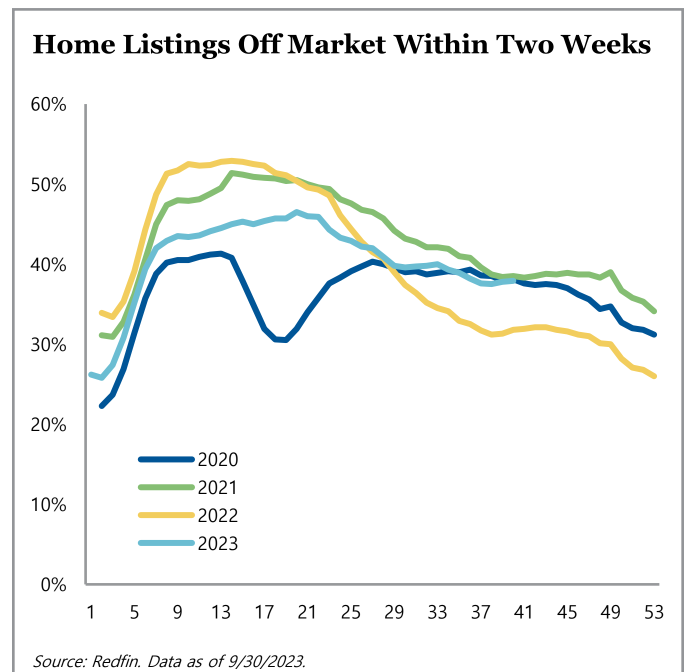
At $15.5 billion, RMBS issuance was roughly flat quarter-over-quarter, as a decline in CRT issuance was offset by gains in jumbo 2.0 and single-family rental during the third quarter. Issuance fell 47% year-over-year in the third quarter. Year-to-date issuance totaled $49.5 billion, down approximately 62% year-over-year amid limited origination activity and higher securitization coupons. Sell-side analysts predict full-year 2023 issuance will be $60 to $70 billion, down from $127 billion in 2022 and $213 billion in 2021.

Home prices continued to rally, with the S&P CoreLogic Case-Shiller U.S. National Home Price Index up 5.3% through the first seven months of 2023, exceeding the prior peak in June 2022 by 0.6%. Of the 20 markets tracked by the S&P CoreLogic Case-Shiller Home Price Indices, 12 were at their all-time high; most of the laggards were from the west coast, including San Francisco and Seattle, where prices were below their peaks by 10.8% and 10.1%, respectively.

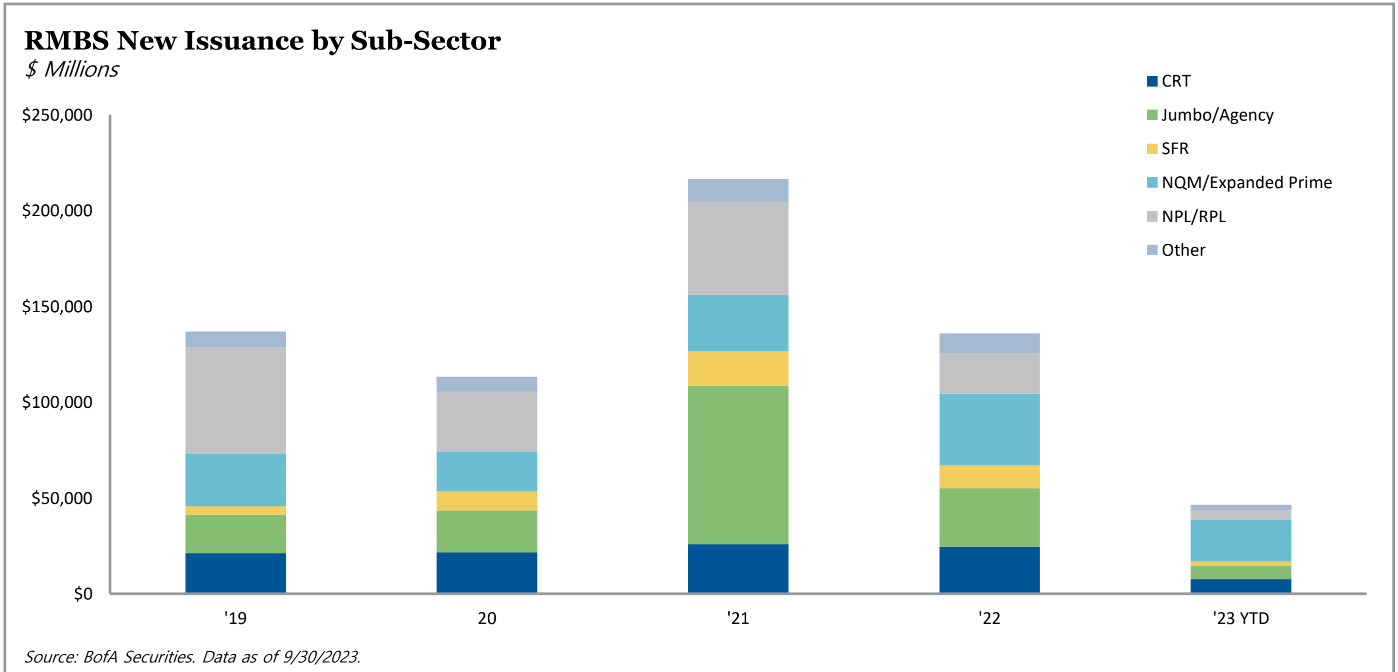
Prevailing mortgage rates were around 7.5% at the start of October, reaching the highest level since 2000 and making the strength in home prices even more remarkable. With the effective mortgage rate outstanding at 3.6% as of October 2023, the well-publicized "lock-in effect" has hampered existing home sales volume, which sat at a mere 4 million units. Total listings amounted to 1.1 million in August, in line with the previous few months but down significantly from pre-pandemic years. New listings, which offer a timelier view of current supply, totaled 391,000 in August – the fewest for that month since 2011, according to the National Association of REALTORS®. Cumulatively, new listings totaled only 2.95 million through August 2023, compared to 3.6 to 4.1 million in the first eight months of 2018 to 2020 and 4.0 and 4.3 million in the first eight months of 2021 and 2022, respectively.



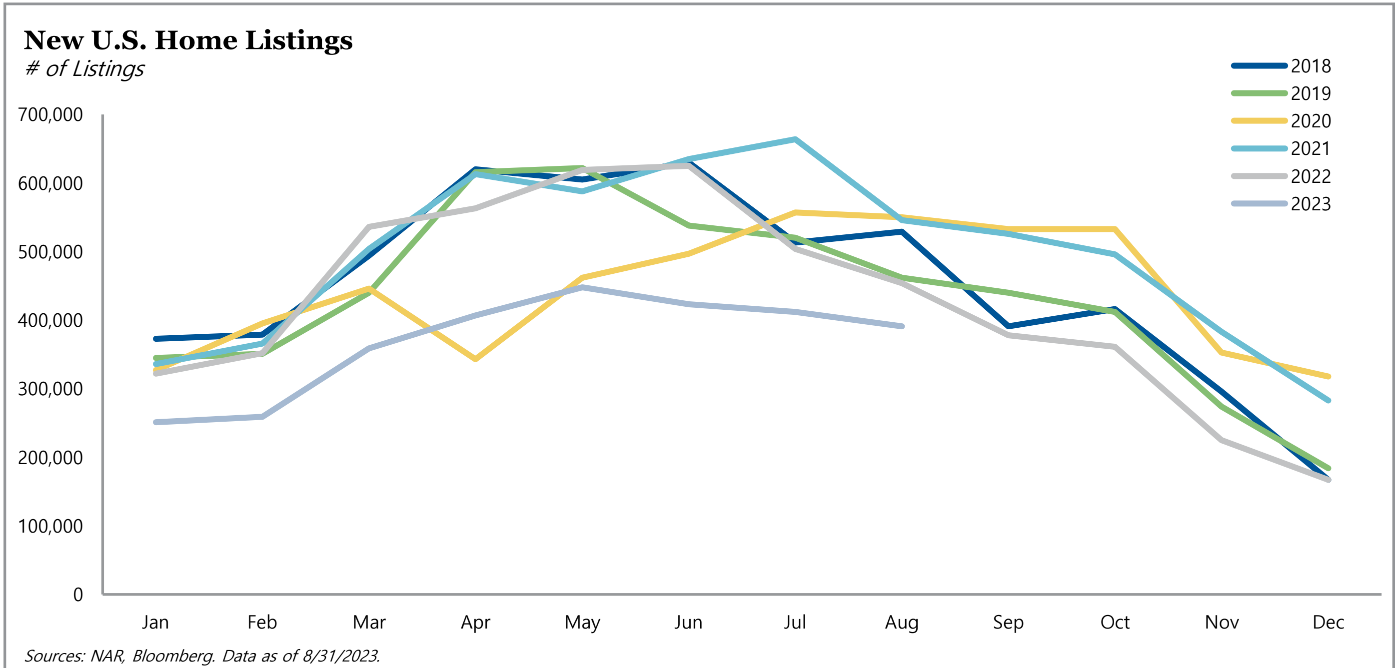
After declining in the second half of 2022, home prices have now exceeded last year's peak.



As of the end of the third quarter, the share of listings going off market within two weeks has remained consistent with the past few years.



Muted housing activity has limited RMBS new issuance.



Cumulative new listings through August 2023 are well below the levels recorded in the first eight months of prior years.

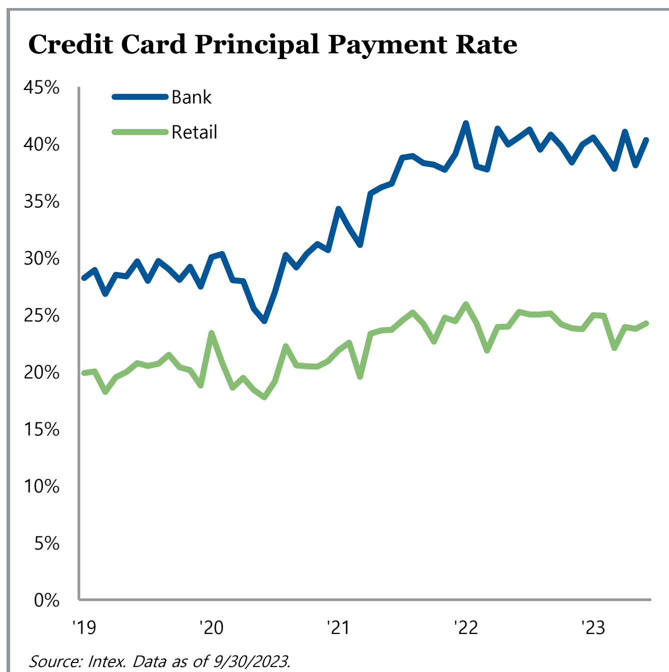
Structured Credit: ABS

ABS spreads leaned positive but were mixed overall during the third quarter; senior fixed-rate tranches were modestly wider, while down-in-credit profiles and floaters were generally modestly tighter. Senior fixed-rate credit card ABS were 5 to 20 basis points wider, while subordinate tranches were flat to 5 basis points wider. Triple-B subprime auto spreads were 20 to 25 basis points tighter, while BB-rated auto and private student loan ABS narrowed by 15 basis points. BB-rated consumer ABS and esoteric ABS sub-sectors were generally 5 to 10 basis points tighter. Year-to-date spreads have also been somewhat mixed. Triple-B subprime auto loans were 135 basis points tighter, and BB-rated auto and consumer loans tightened 95 to 100 basis points. Credit card ABS are roughly 10 to 25 basis points wider, and private credit student loans are flat to 30 basis points tighter. However, ABS spreads remain well wide of February 2022 levels. For example, BB-rated auto and consumer loan spreads are 190 and 300 basis points wider, respectively.

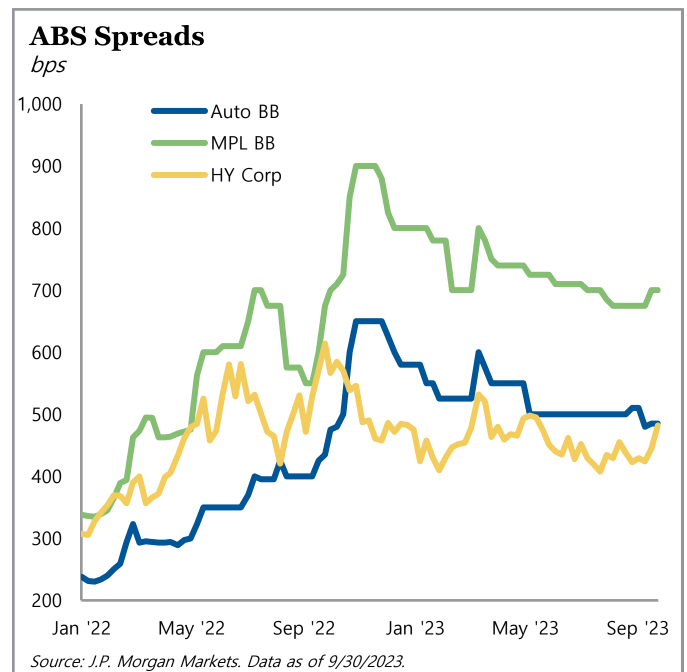
Primary issuance activity totaled $77 billion in the third quarter, up 3% quarter-over-quarter and 37% year-over-year amid sharply higher auto volume. Third quarter activity brought year-to-date ABS issuance to $215 billion, up approximately 6% year-over-year.

Consumer performance data has generally been within underwritten expectations but continues to deteriorate to pre-pandemic levels and, in certain sectors, is already underperforming that period. Unsecured consumer loans were weaker with flat prepayments, and delinquencies are underperforming pre-pandemic comparisons. Auto data was more mixed, with some short-term improvement in prepayments and delinquencies. However, prepayments remain on the low end of their historical average, and defaults rose given the otherwise steady rise in delinquencies; the latter is now mostly in line with or underperforming pre-pandemic comparisons. Meanwhile, credit card performance has been stable; while a slow grind to pre-pandemic levels has been emerging, credit cards continue to far outperform pre-pandemic levels. Overall, student loan performance was a little softer, but legacy private credit student loans continued to generate ample recovery proceeds.

Notably, following the student loan payment moratorium's end, federal student loan payments resumed in October. There is a 12-month "on-ramp" period, which gives borrowers a grace period to begin resuming payments. Non-payments during that grace period will not be reported as delinquent to credit bureaus – thereby limiting the impact on credit scores – though interest will still accrue. Bank of America estimates the average payment will be approximately $250 per month. As noted in last quarter's CMP report, we expect the payment resumption will create a drag on household disposable income; additionally, given student loans' low position in the payment hierarchy, missed payments following the on-ramp period are likely to negatively impact credit scores for many consumers. That said, the effect on consumer incomes and credit performance may not be fully observable until after the on-ramp period concludes.

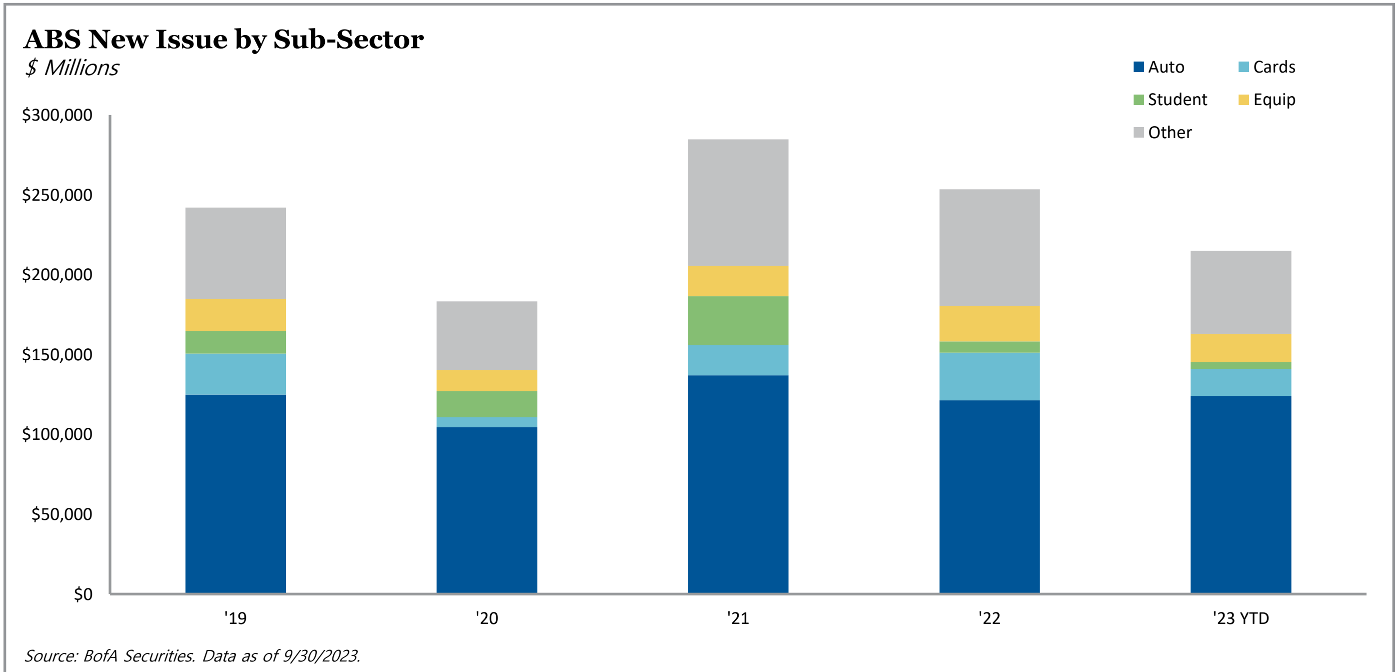


Credit card principal payment rates have remained stable.

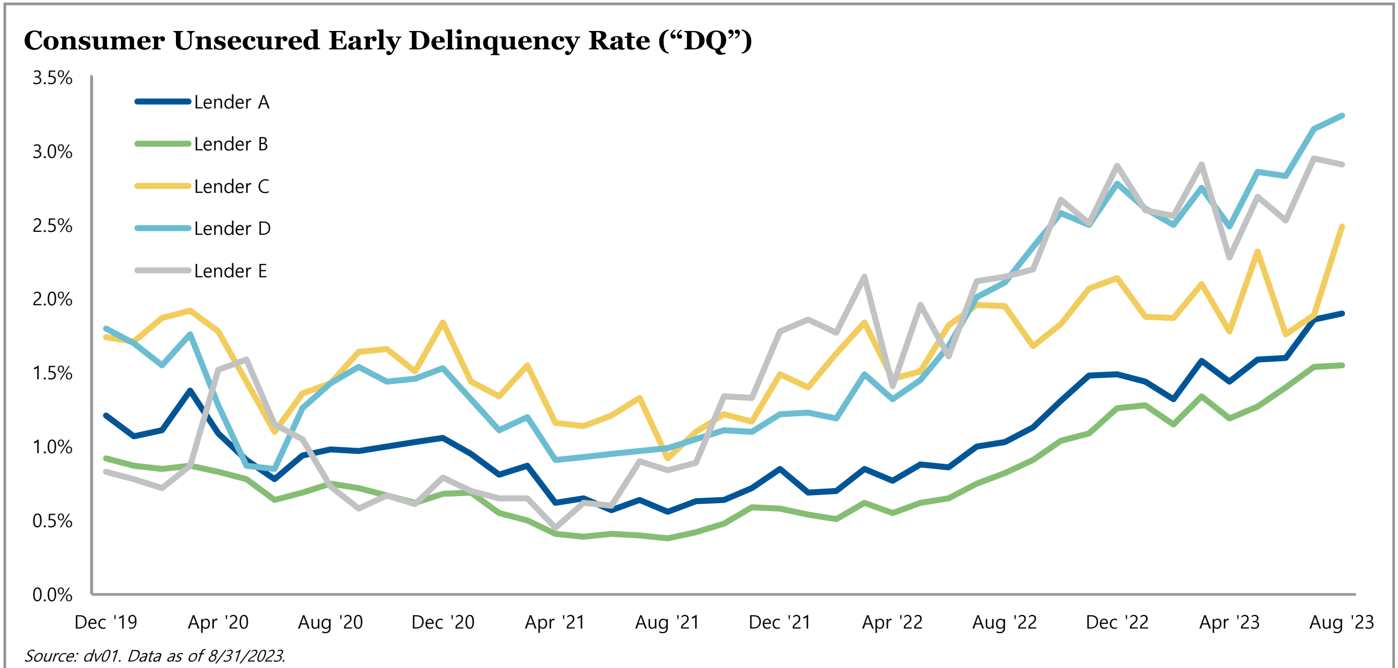


ABS spreads are still wide of February 2022 levels.

Structured Credit: ABS *(continued)*



ABS issuance has been driven by the auto and esoteric sectors.



Early delinquencies are rising for unsecured consumer loans.

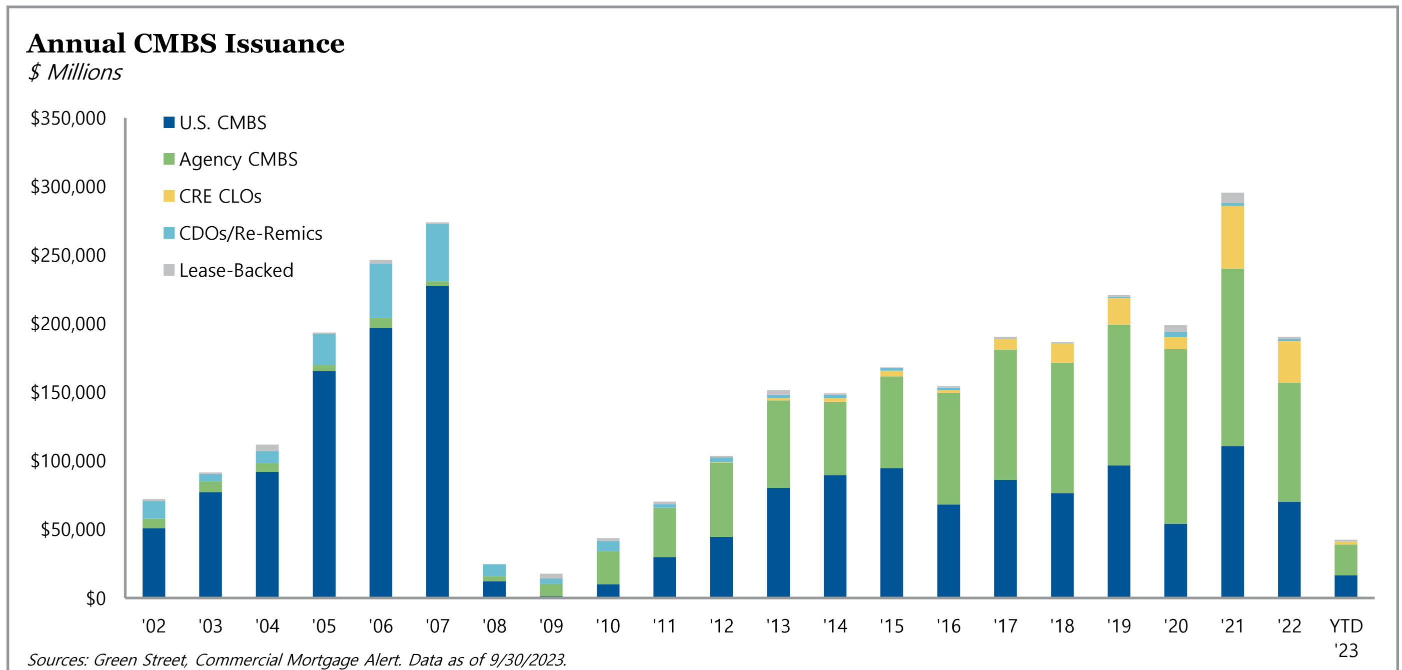
Structured Credit: CMBS

The biggest story of the quarter was once again interest rates. With employment measures still strong and inflation data running hotter than anticipated, market participants are being forced to push back predictions of when the Federal Reserve will begin cutting rates. This issue is particularly painful for commercial real estate values, as higher risk-free rates make the ownership of any risky asset relatively less attractive. Further adding to the challenges of the asset class, the availability and cost of financing accessible to property owners has worsened. Regional banks have historically provided approximately 38% of financing to the commercial real estate market, but challenges in the regional banking sector have greatly reduced these institutions' willingness to lend.

In this context, we have observed that borrowers are frequently negotiating extensions to their current loans. Within the CMBS market, $3.24 billion of loans that were scheduled to mature in 2023 had been modified by September. The most comprehensive measure of distress in the CMBS market is the percentage of loans that have been transferred to special servicing. In August, this figure rose to 6.67% – the seventh consecutive monthly increase and exceeding the 4.92% level recorded twelve months earlier. The office, mixed-use, and multifamily property types saw the greatest increases in the percentage of loans transferred to special servicing, at 7.72%, 7.03%, and 3.55%, respectively; meanwhile industrial, lodging, and retail were stable to slightly improved, at 0.33%, 7.07%, and 10.07%, respectively.

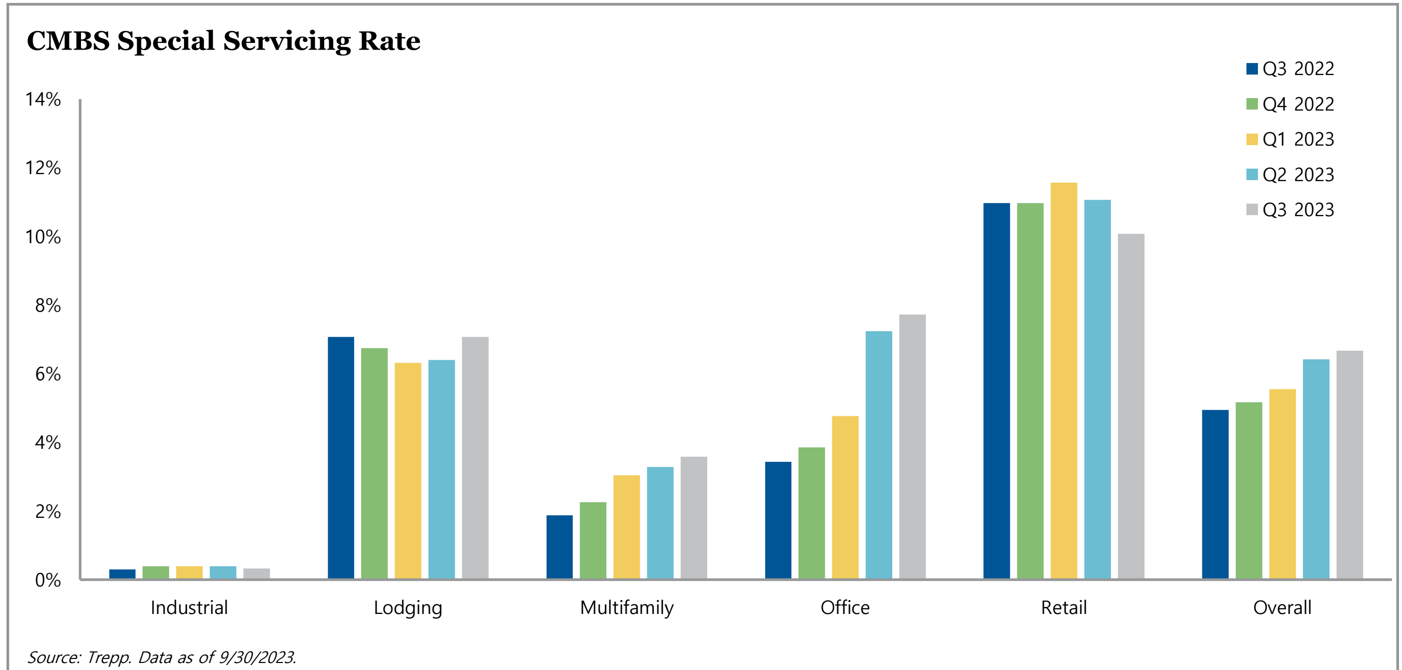
Wider spreads, higher rates, and limited real estate transaction actively have kept issuance levels subdued. For the first nine months of this year, CMBS issuance volumes are down 58% year-over-year, conduit volumes are 31% lower, and SASB volumes are down 71%. Year-to-date CRE CLO issuance has declined even further, dropping 78% year-over-year. We believe that in order for the logjam in the commercial real estate debt markets to break loose, the securitization market will need to be at the forefront.

Despite the limited supply of new issue bonds, CBMS spread tightening lagged other structured products during the third quarter of 2023. Conduit bonds across the capital stack – from AAA to BBB- tranches – were relatively unchanged during the quarter. However, we saw price movement in deals across both the SASB and conduit sectors, where investors have differentiated views of credit or credit events have already occurred. As investors formulate opinions on interest rates, real estate values, and the outlook for a slowing economy, we expect the CMBS and commercial real estate credit markets will continue to diverge, providing opportunities for investors to capitalize on market dislocations.

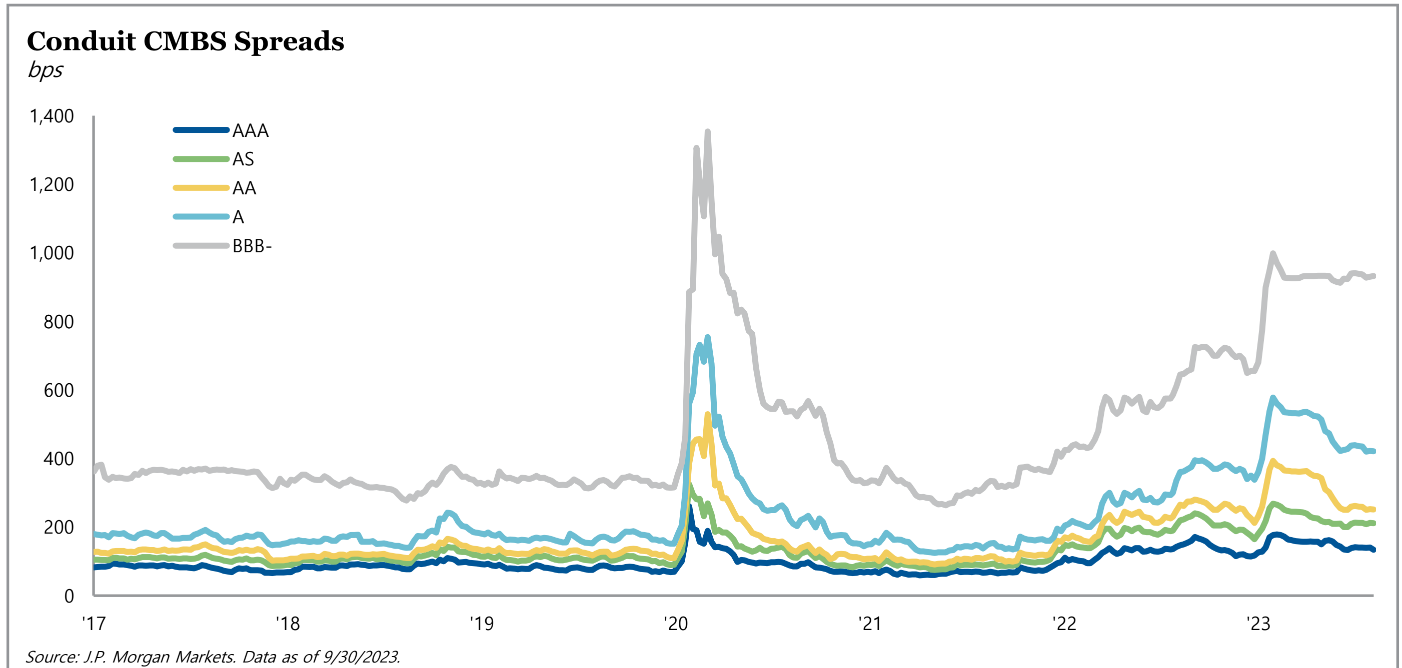


Sources: Green Street, Commercial Mortgage Alert. Data as of 9/30/2023.

CMBS issuance continues to lag historical volumes, driven by high interest rates and lender reluctance to lend to commercial real estate. The few deals that have been issued year-to-date were primarily 5-year loans, versus 10-year loans – the historical norm.



The percentage of CMBS loans in special servicing increased by 25 basis points in the third quarter, with loans secured by lodging properties driving the majority of the increase.



Conduit CMBS spreads below the AAA level continued to drift wider during the period and are now near levels seen at the peak of the COVID-19 panic.

TJ Durkin
Head of Structured Credit & Specialty Finance

Yong Joe
Co-Portfolio Manager, Structured Credit

Andrew Solomon
Portfolio Manager, Commercial Real Estate Debt

For more information on Structured Credit & Specialty Finance, click here.

Middle Market Direct Lending

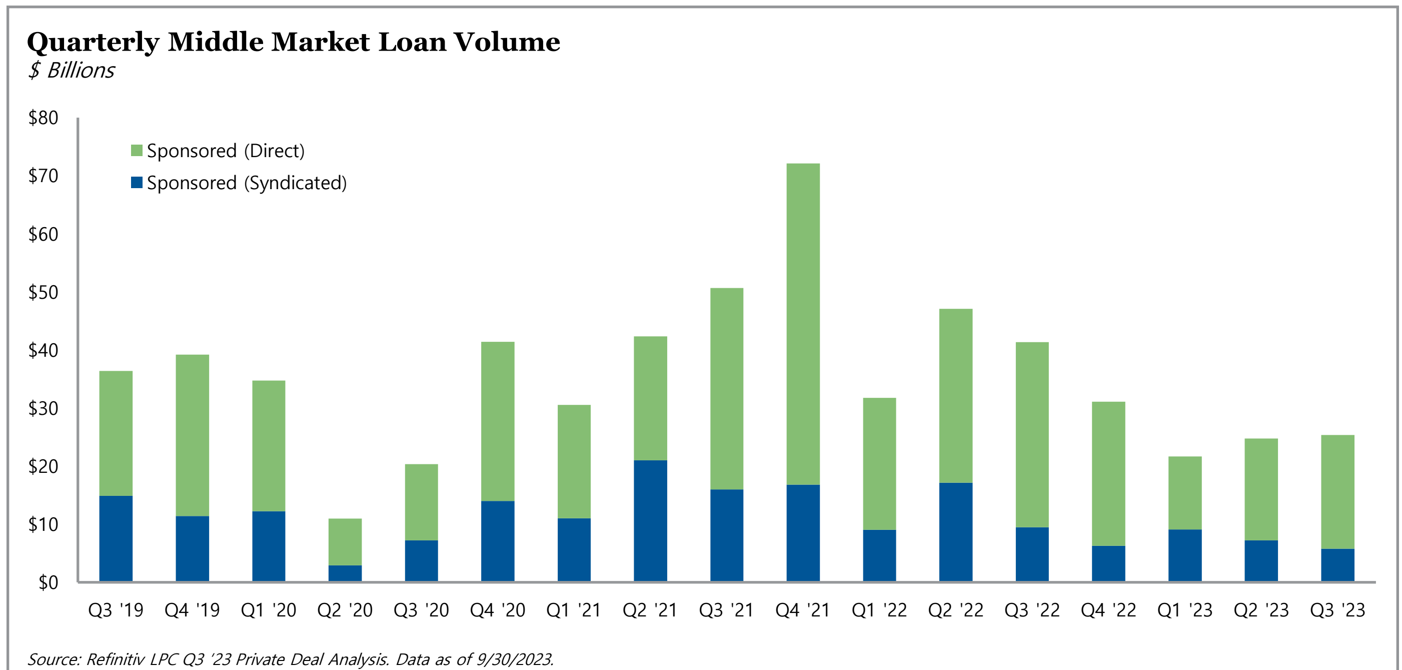
Total sponsored middle market volume, including direct and syndicated activity, was $25 billion in the third quarter – up 3% quarter-over-quarter but down 40% year-over-year. Direct lending comprised the lion share of sponsored volume at $20 billion and, in contrast to the marginal increase in total sponsored volume, was up 12% from the prior quarter. Furthermore, private credit continued to be the preferred source of financing, with the ratio of direct lending to syndicated volume climbing to 3.4x. Middle market M&A and LBO volume both increased from the prior quarter, with lower middle market (LMM) volume experiencing the largest quarter-over-quarter gain at 36%.

Terms for direct lender-led deals continued to be favorable during the third quarter, as evidenced by the increase in the yield premium over large corporate deals, which rose to over 250 basis points. All-in yields on first-lien term loans edged higher to 12.3%; in contrast, large corporate yields tightened to 9.7%. The increase in all-in yields was driven by the LMM, while the core and upper middle markets experienced declines. However, spreads across the market moderated from their elevated levels. The average spread on LMM loans retreated to 615 basis points, while broadly syndicated loan spreads decreased to approximately 420 basis points.

Lenders remained disciplined on leverage levels given the continued elevation of reference rates, as evidenced by total leverage for privately financed LBOs trending lower across the market. Smaller companies continued to utilize less leverage at an average of 3.9x EBITDA, while core and upper middle market businesses used more leverage, averaging 4.4x and 4.7x, respectively.

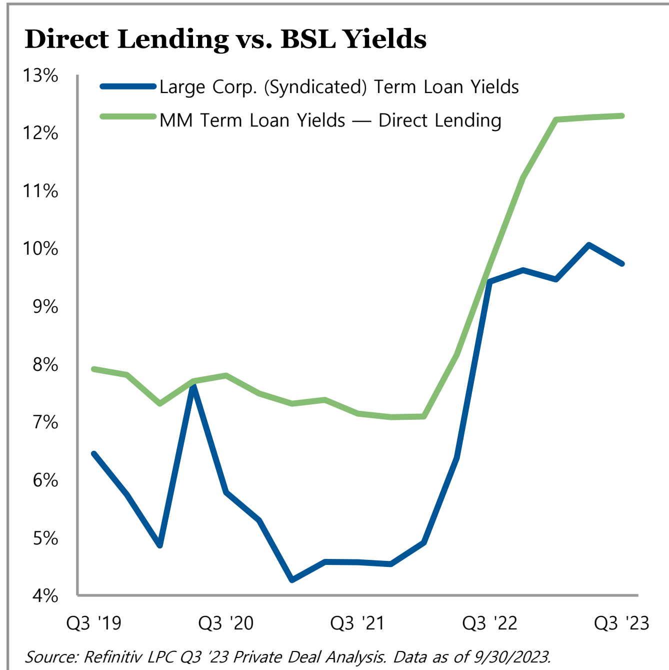
Despite concerns that borrowers are facing challenges due to sustained higher interest costs, the annualized private credit default rate decreased for the second consecutive quarter, declining to 1.41%. Defaults in the core and upper middle markets increased by 0.9% and 0.4%, respectively, while defaults in the lower middle market decreased by 1.4%. In addition, average interest coverage ratios have been relatively stable across market segments at around 2.0x, though they are at the low end of the "comfort zone" for lenders, which ranges from 2.0x to 3.0x.

While fundraising activity in the U.S. direct lending market remained slower than last year, the third quarter was quite busy for fund closings, bringing year-to-date volume to nearly $30 billion. According to Preqin data, the number of funds in the market has decreased, but fund sizes are the largest they have ever been, with an average fund size of $1.85 billion. This dynamic implies that interest in the asset class and in partnering with fewer managers persists.

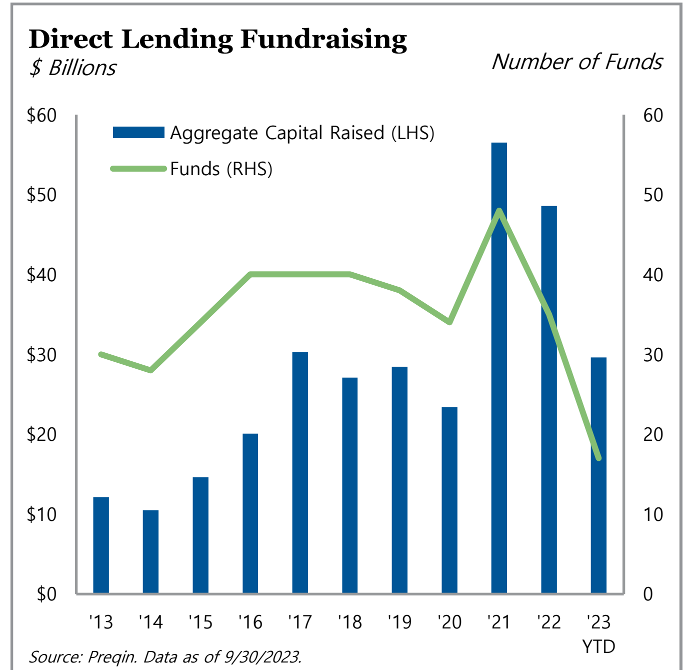


U.S. sponsored middle market loan volume totaled $25 billion in Q3 2023, representing an increase quarter-over-quarter.

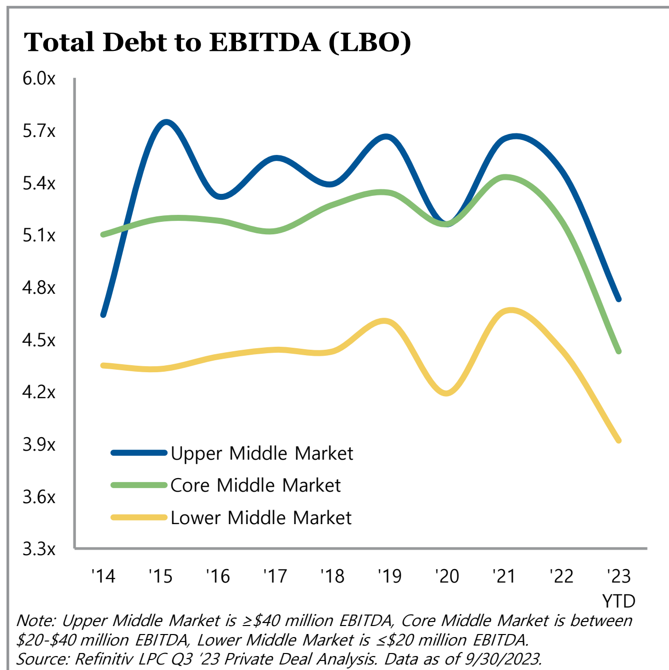
Middle Market Direct Lending *(continued)*



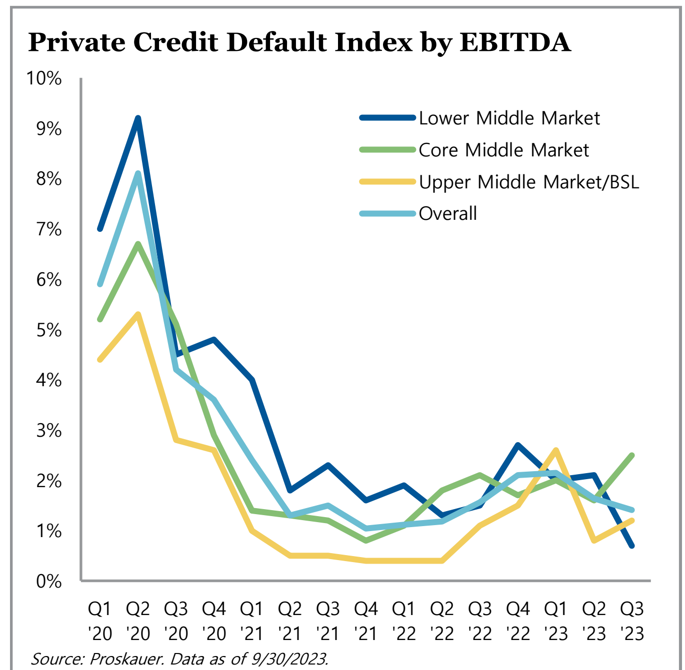
The direct lender yield premium over large corporate deals increased to over 250 basis points in Q3 2023.



Fundraising through the third quarter of 2023 reached $30 billion, hitting a record for average fund size.



For leveraged buyouts, total leverage multiples tightened across the direct lending market in the third quarter.



The private credit default rate declined in the third quarter, driven by a decrease in lower middle market defaults.

Trevor Clark
Portfolio Manager

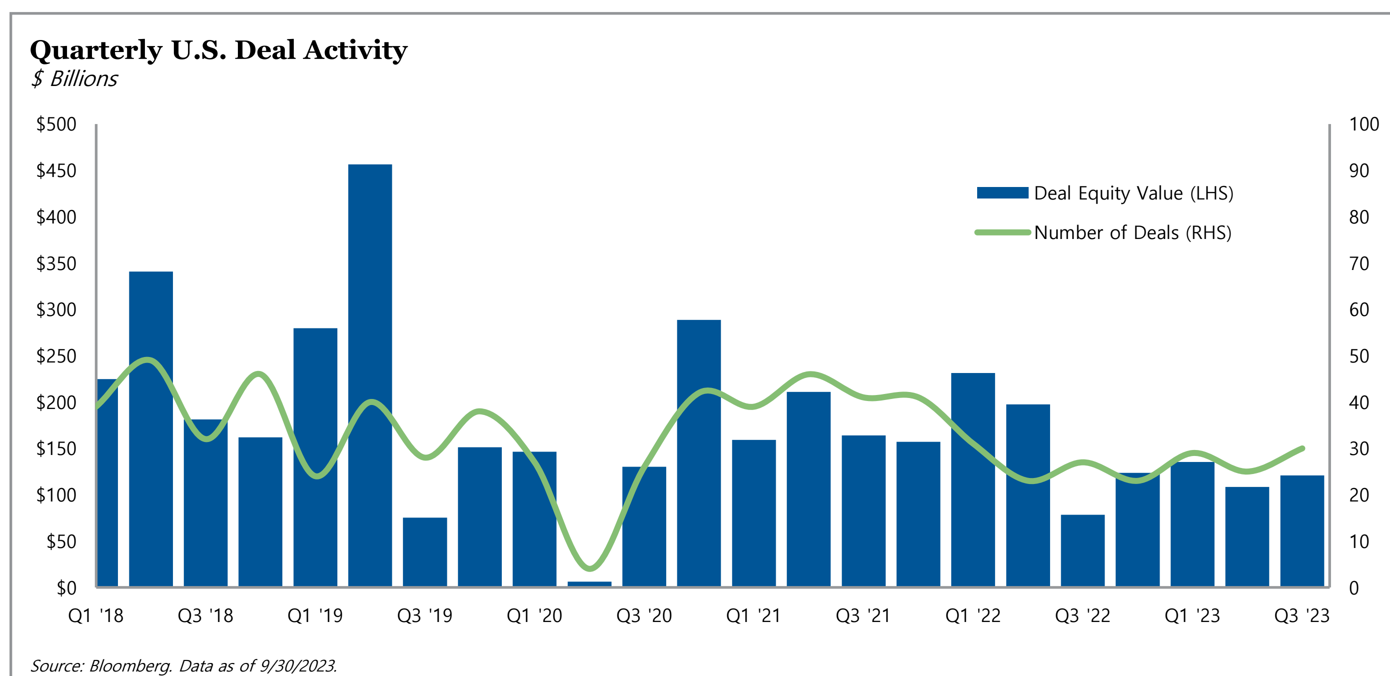
For more information on Middle Market Direct Lending, click here.

Merger Arbitrage

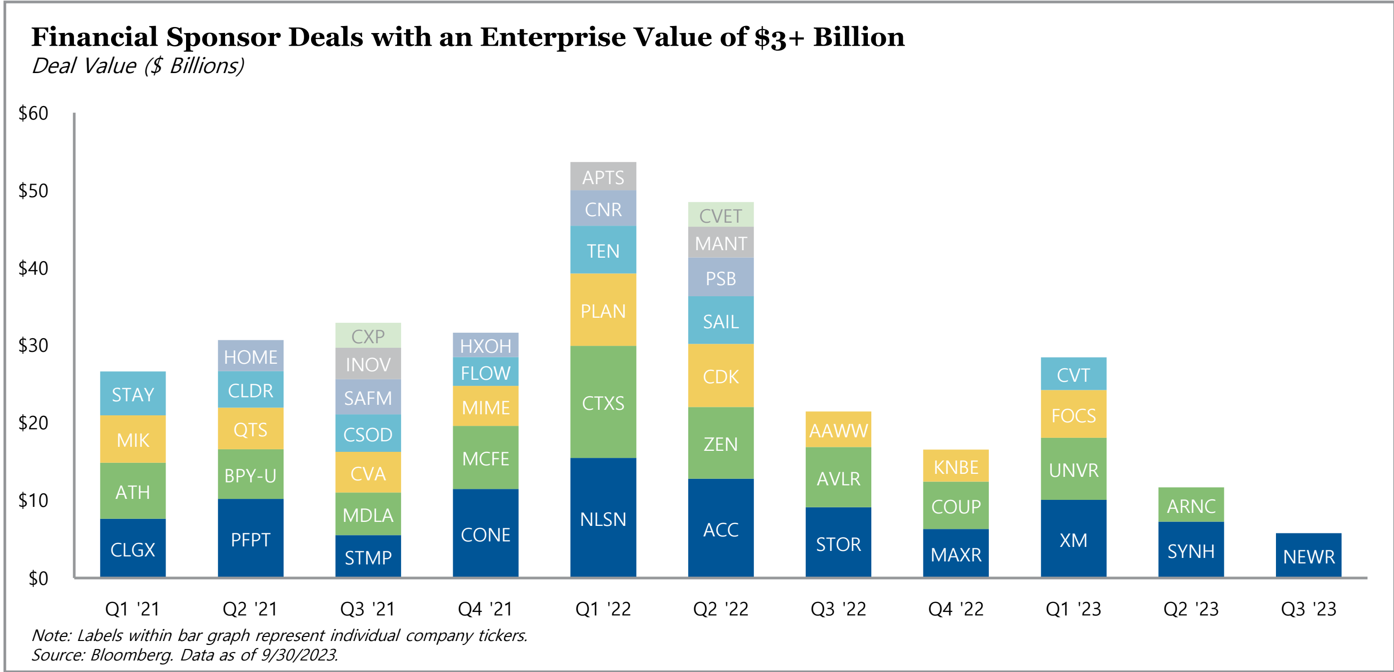
U.S. M&A activity picked up in the third quarter, with announced deal value and count up 11.5% and 15%, respectively, quarter-over-quarter. The largest deal announced during the quarter was Cisco's $28 billion all-cash acquisition of Splunk Inc. Quarterly deal volumes remain well below pre-pandemic averages; however, there were signs of improvement in the third quarter. The U.S. Federal Reserve paused on additional rate hikes and may continue to do so as it analyzes the effect of rate increases implemented thus far, leading to more certain underwriting conditions. The U.S. consumer and the labor markets have remained resilient, continuing to extend the current economic cycle. The U.S. Department of Justice (DOJ) and Federal Trade Commission (FTC) have lost or settled on all the cases related to public-company M&A transactions they have brought year-to-date, leading to greater resolve within corporate boardrooms. If an economic soft landing can be achieved, we expect M&A volumes will continue to rebound. Alternatively, in a recession scenario, history tells us that after a brief period of reduced M&A activity, the early part of a new M&A cycle is usually rewarding.

Trading during the third quarter was resoundingly bullish, as the average annualized merger arbitrage spread tightened 560 basis points and the market-cap-weighted gross spread compressed 1,010 basis points. At the end of the quarter, the average net annualized spread was 9.3% on a SOFR-adjusted basis. The positive outcome of antitrust matters in several large deals was one of the main drivers of the aforementioned gains. The FTC's attempt to block Microsoft's acquisition of Activision Blizzard Inc. was defeated in federal court. Soon thereafter, Intercontinental Exchange, Inc. offered additional divestiture remedies to the FTC, which led to a settlement in the matter. A month later, the FTC again accepted remedies to reach a settlement, this time related to Amgen's acquisition of Horizon Therapeutics plc. The FTC continued to deliver positive news to arbitrage investors when, after months of litigation speculation, it allowed the HSR waiting period to expire in Broadcom's acquisition of VMWare Inc., clearing a major hurdle toward closing that deal. After reaching a fever pitch last quarter, the antitrust risk premium that investors have placed on deals over the last two-plus years declined, though it still exists. This dynamic should allow active managers to continue to apply their deal selection expertise in order to generate alpha.

Given recent outcomes and with both the DOJ and FTC busy navigating a number of major monopoly cases, market participants are pondering whether there may be a change in antitrust regulators' focus moving forward, with attention starting to shift from novel theories of harm to more traditional concerns and general anti-competition and monopoly cases.



In the third quarter, U.S. deal activity recorded a slight quarter-over-quarter uptick but remained below average quarterly volumes.



Large financial sponsor deal activity has slowed as financial conditions have tightened.

Mark Wojtusiak
Head of Merger Arbitrage

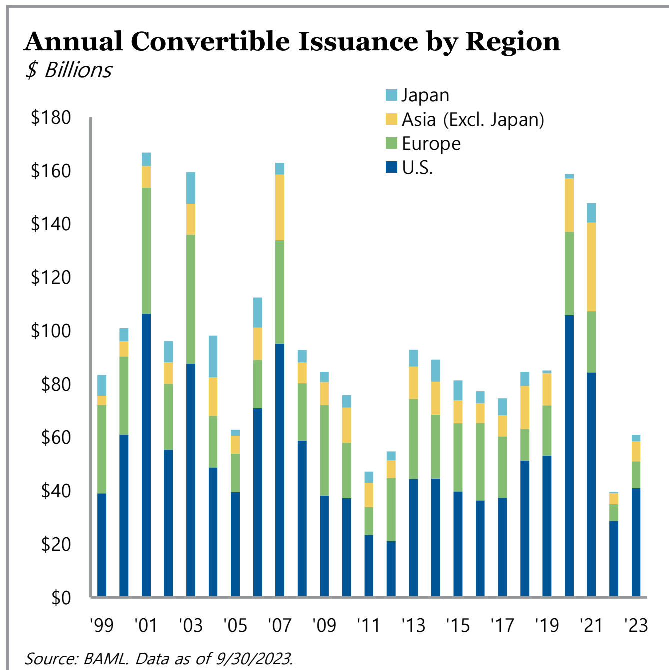
For more information on Merger Arbitrage, click here.

Convertible Arbitrage

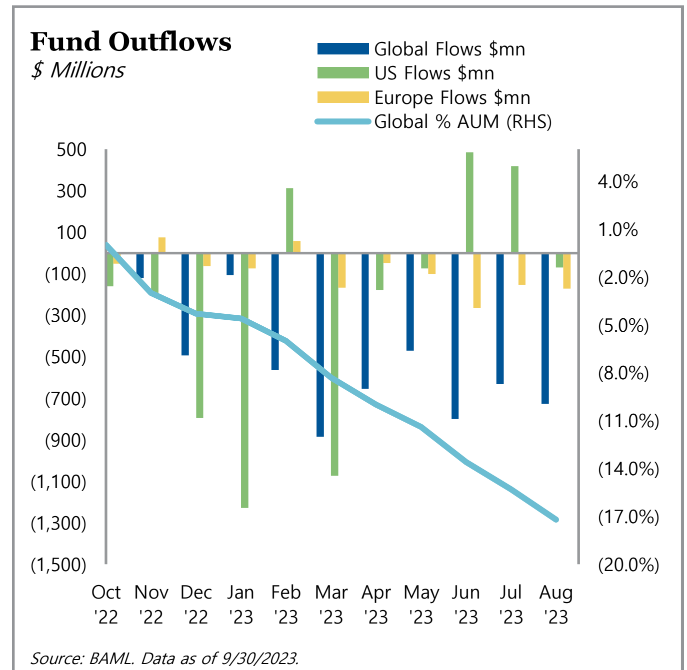
Global equity markets continued on their upward trajectory in July but ultimately gave back some of this year's gains, with the year-to-date return dropping 2.99% in the third quarter as headwinds intensified. Central banks signaled that interest rates will settle at higher levels for a longer period of time, leading to a relentless repricing in the bond markets. Economic data began to soften somewhat in the third quarter, even as consumer spending remained robust and unemployment rates stayed low. Additionally, the rally in oil prices highlighted that inflation concerns continue to linger.

While credit spreads remained supportive, global convertibles were dragged lower by interest rates and equities, falling 1.87% on an outright basis in the third quarter. Convertible arbitrage strategies, as measured by the HFRX Relative Value Fixed Income Convertible Arbitrage Index, lost 0.79% during the same period, as ongoing selling pressure from long-only investors put pressure on valuations. Meanwhile, new issuance continued at an encouraging pace. Globally, $21.5 billion of convertibles came to market in the third quarter. All regions were active, with the U.S. contributing $13.5 billion of issuance, followed by Europe with $3.2 billion, Asia – excluding Japan – with $3.3 billion, and Japan with $1.4 billion. The outlook for a meaningful increase in primary market activity in the final quarter of 2023 and the coming year has been bolstered by reinforced market expectations for a higher-for-longer interest rate environment.

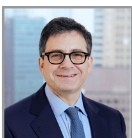
While equity market volatility ended the third quarter at depressed levels, the rise in cross-asset volatility amid the unresolved question of a soft versus hard landing for the economy, the uncertain geopolitical environment, and the upcoming earnings season should provide ample catalysts for equity volatility going forward, supporting convertible arbitrage strategies.



Global new issuance is expected to increase meaningfully in 2024.



Outflows from global and European long-only convertible funds continued in the third quarter.



Gary Wolf
Head of Convertible Arbitrage

For more information on Convertible Arbitrage, click here.

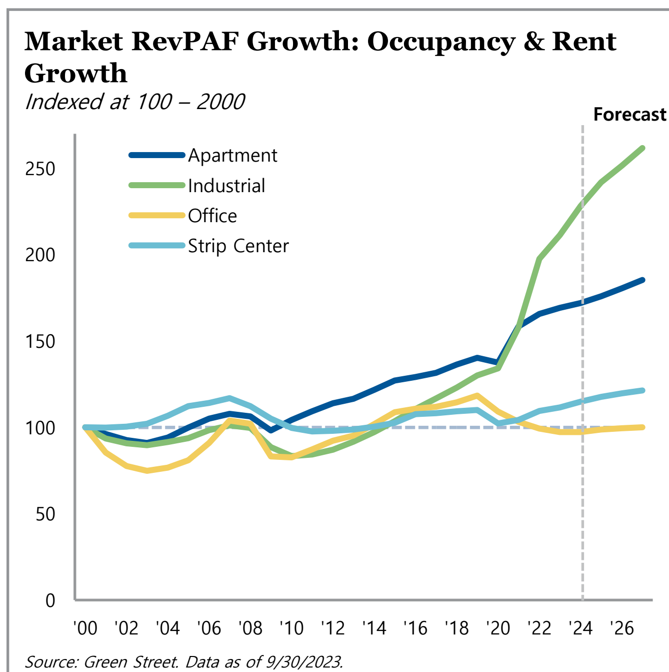
U.S. Real Estate

2023 has been an eventful year thus far, marked by themes of uncertainty and a market-wide adjustment to a new reality, which has resulted in a complicated investing environment and subdued transaction volume in the U.S. After a 40-year secular decline in interest rates, the reality of a new era of higher rates is setting in; many parts of the economy are beginning a painful adjustment, presenting both challenges and opportunities. The year started on a relatively quiet note, but the calm ended abruptly late in the first quarter, with a string of regional bank failures. While the U.S. banking system remains under pressure and will likely face increased regulatory burdens, it seems to have averted a full-blown crisis.

After the fear of financial contagion subsided, attention returned to the Fed's efforts to fight inflation, which has remained stubbornly elevated. While the market had previously assumed that the Fed would be successful in containing inflation and even begin cutting rates in late 2023 or early 2024, signs of continued economic and labor market resilience led the Fed to take a hawkish stance; many market participants are anticipating a higher-for-longer interest rate environment, especially given the current consensus that the U.S. economy is on track for a soft landing. Against this backdrop, we have witnessed volatility in the Treasury market and forward projections of the Fed Funds and other benchmark rates, with the 10-year Treasury yield increasing over 150 basis points from the April low of 3.25% to a 15-year high of over 5.00% in October. The yield curve has remained inverted, but the increase in longer-duration Treasury yields has led to a steepening curve.

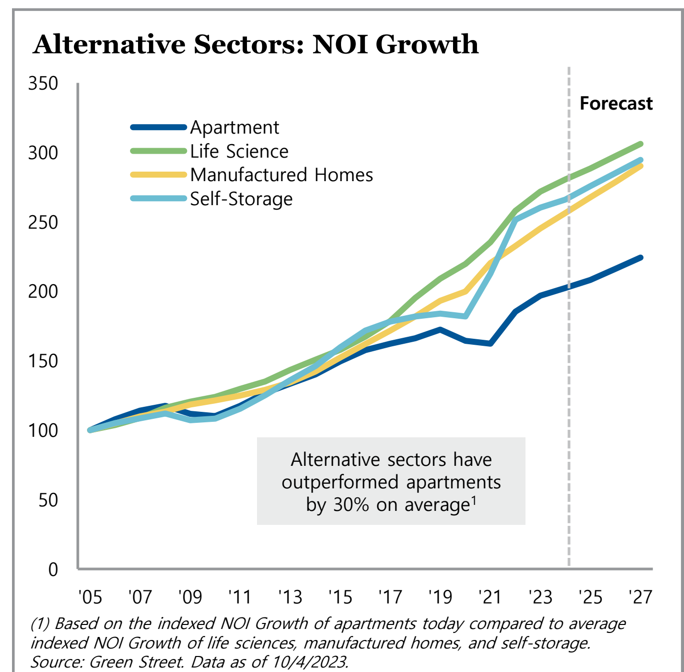
The combination of uncertainty in the economy and financial markets, historic interest rate increases, and a sharp reduction in the availability of credit has led to a significant slowdown in U.S. real estate transaction activity. Total 2023 transaction volume through the end of the third quarter amounted to $276 billion, down 55% from the comparable period in 2022 and 30% below the average transaction volume for the first nine months of the year between 2015 and 2019. However, we have recently seen signs of limited thawing in the transaction markets for favored asset classes and geographies.

While data is limited due to the reduction in transaction volume, it is clear that U.S. real estate prices are down from their early 2022 peak across the board, albeit with significant dispersion across property sectors and geographies. Moreover, there is a wide bid-ask spread between buyers and sellers in the market – driving a further reduction in transaction volume – as sellers are generally anchoring themselves to yesterday's pricing while buyers are grappling with underwriting in an uncertain economic environment and the increased cost and relative scarcity of financing. As of the end of the third quarter, RCA's transaction-based data suggests real estate values across all sectors in the U.S. are down 9% year-over-year.



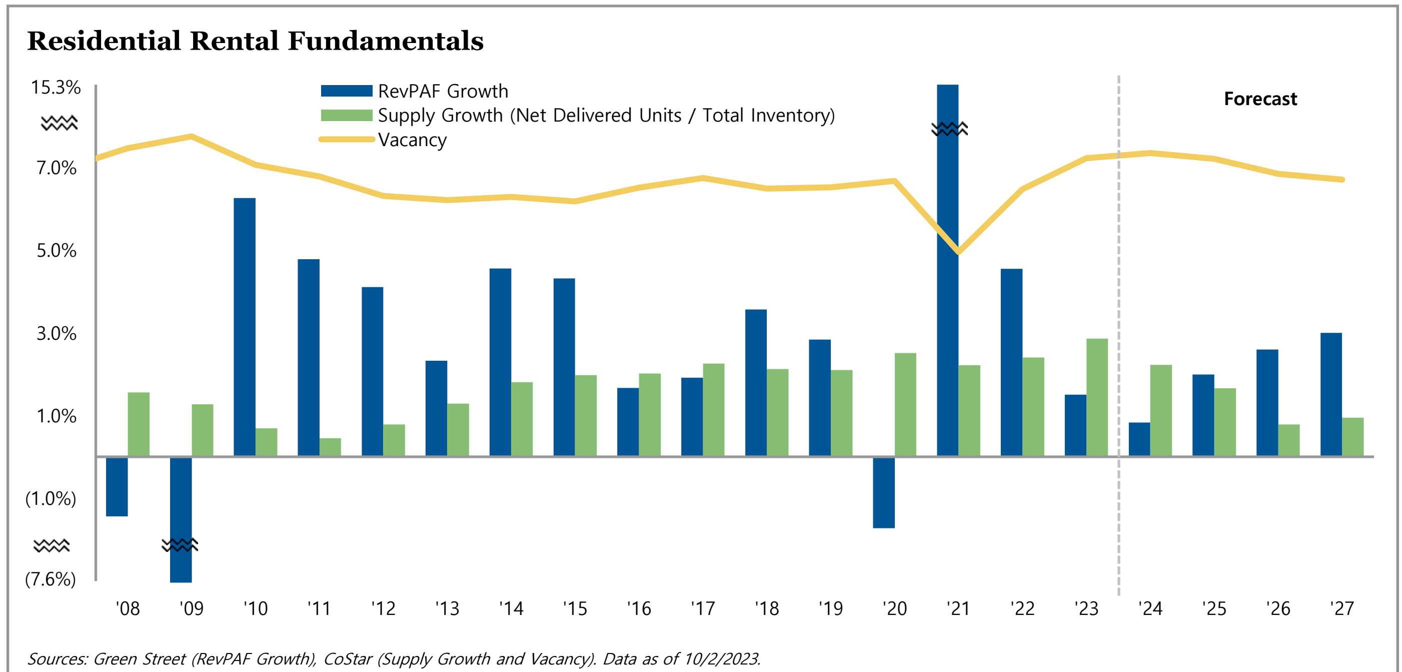
Source: Green Street. Data as of 9/30/2023.

U.S. real estate fundamentals are relatively stable for most property sectors except office.

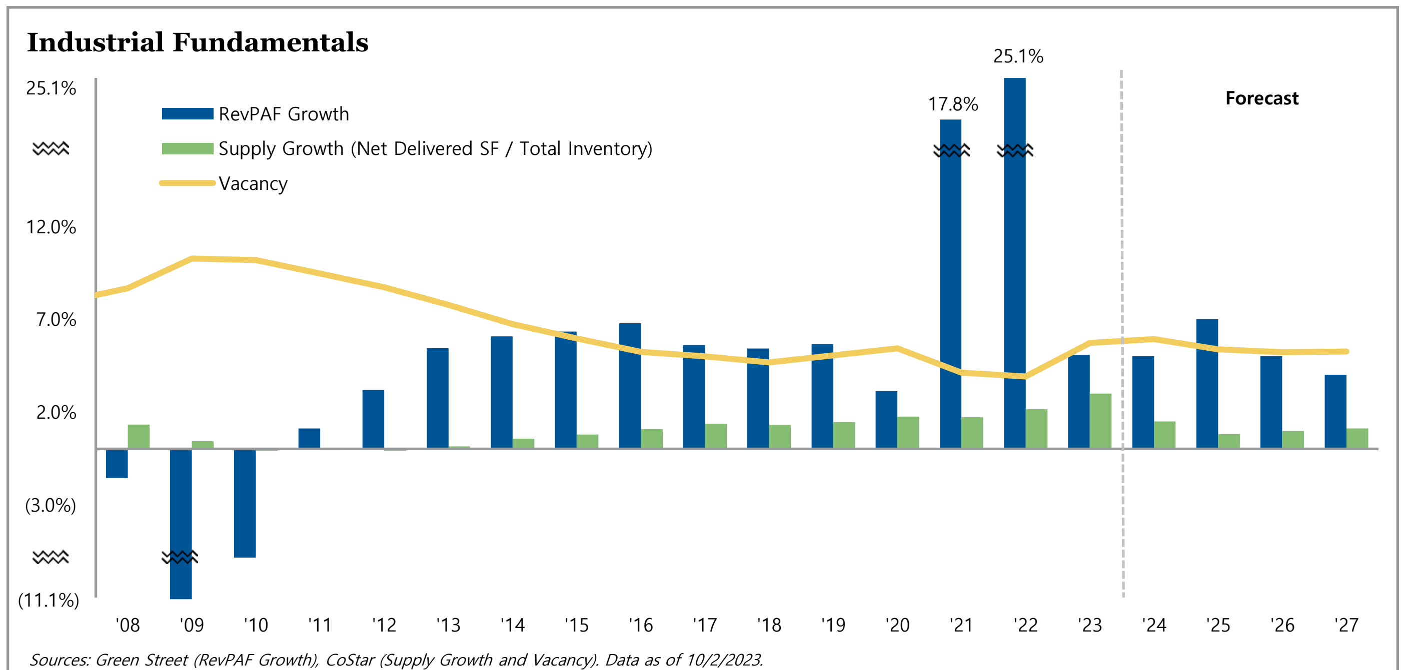


(1) Based on the indexed NOI Growth of apartments today compared to average indexed NOI Growth of life sciences, manufactured homes, and self-storage.
Source: Green Street. Data as of 10/4/2023.

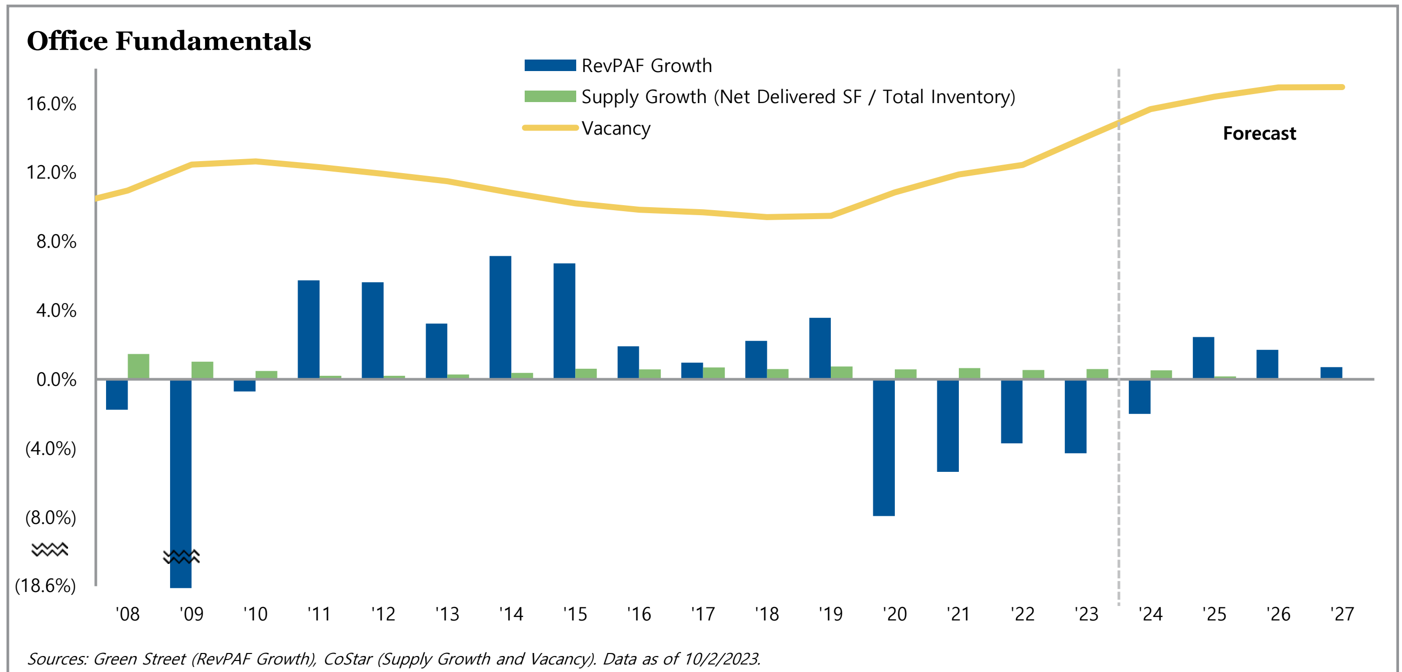
Many alternative sectors are driven by demographic and secular forces and are expected to be less impacted in a recessionary environment than the traditional "four main food groups" of multifamily, industrial, office, and retail.



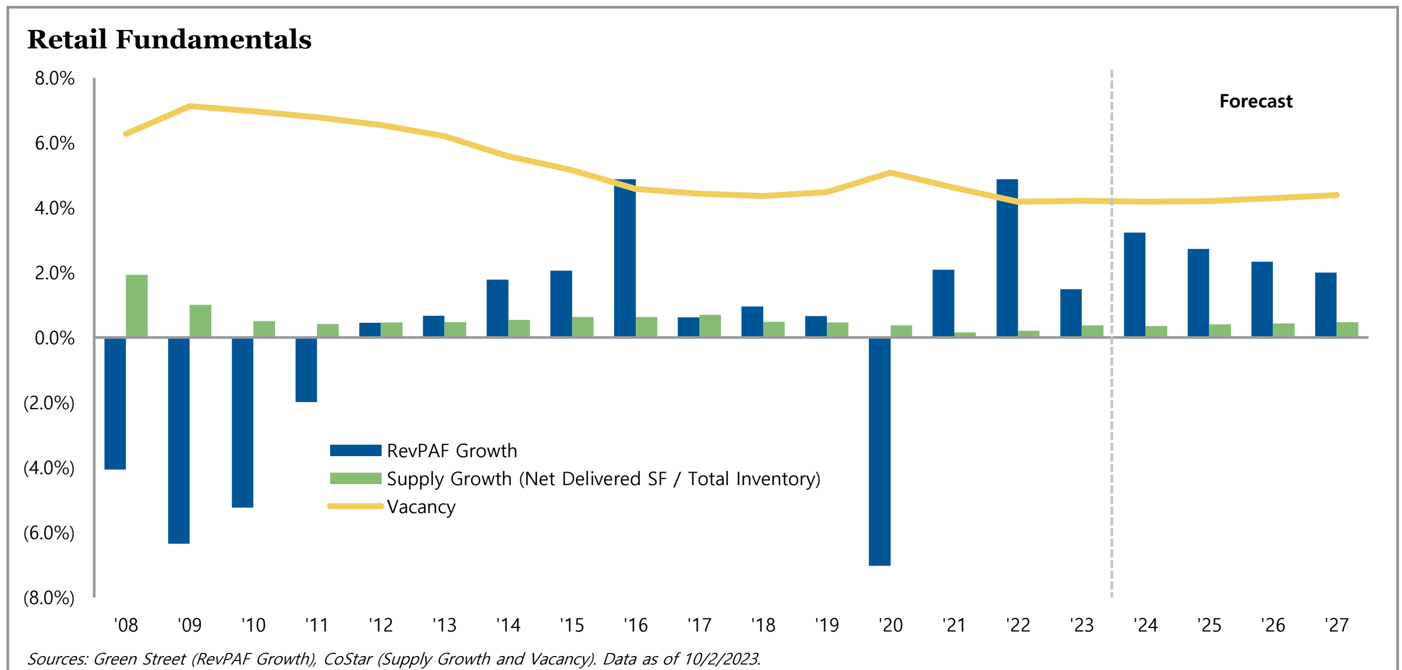
Necessity-based demand, increasing home ownership costs, and broad undersupply since the GFC have led to relative strength in the residential rental market, but affordability and consumer headwinds have driven some softening in fundamentals.



Industrial supply in primary coastal markets remains very tight due to significant barriers to entry, but secondary markets have faced elevated supply – particularly among larger format buildings – driving some softening in fundamentals.



The office market continues to struggle post-pandemic due to broad oversupply and limited demand in the leasing and capital markets, albeit with a clear flight-to-quality dynamic benefiting trophy assets.



The retail sector has benefited from strong consumer demand and limited vacancy and new supply among necessity-oriented assets, although malls and power centers continue to struggle.

Reid Liffmann
Co-Portfolio Manager
Head of U.S. Real Estate

Matt Jackson
Co-Portfolio Manager
U.S. Real Estate

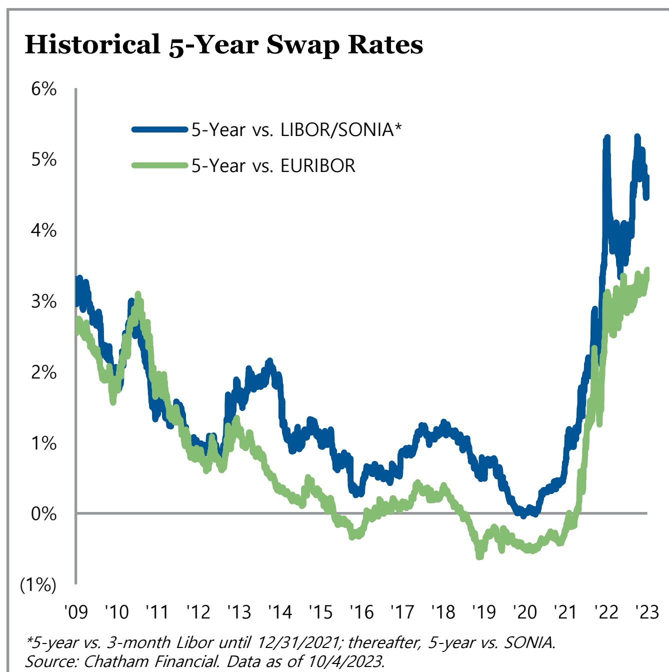
For more information on U.S. Real Estate, click here.

Europe Real Estate

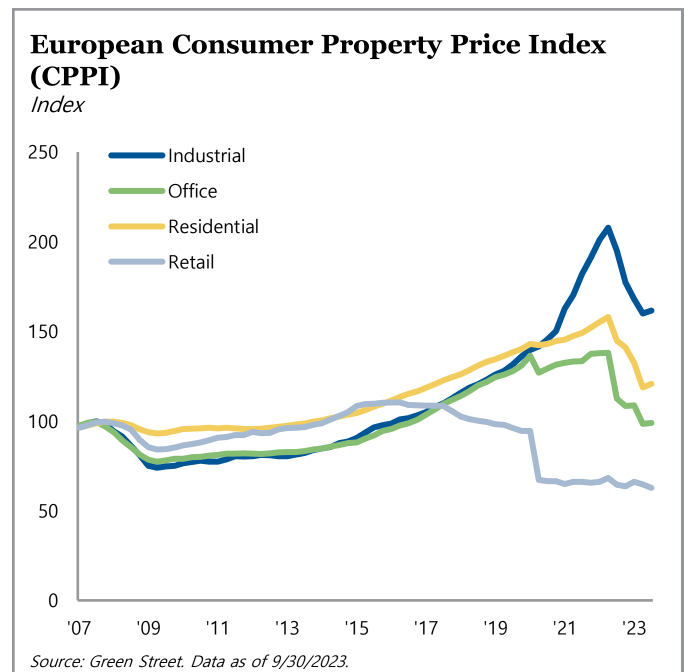
The increased cost of debt, decreased investment activity, and ongoing price corrections across sectors continue to impact European real estate markets. The European Central Bank (ECB) opted to raise interest rates again in September, and 10-year bond yields across the U.K. and continental Europe ended the third quarter approximately 400 basis points above their recent lows. With inflation still above the 2% target, it is possible that central banks continue their rate-hike programs through the end of this year and into early 2024. Levered buyers now not only face a higher cost of borrowing but also a significant increase in hedging expenses. Hedging costs, encompassing interest rate caps and swaps, have increased 200% to 300% since 2021. In some markets, it is very difficult – if not impossible – to secure hedging on debt. Current indications from the ECB suggest a pause in rate increases may occur soon, while the Bank of England seems more hesitant to pursue a near-term slowdown.

Given the price and challenge of obtaining financing, many property owners have unsurprisingly pulled back from the real estate markets. European real estate investment volume continued to decline in the second quarter of 2023, with activity falling more than 50% year-over-year – representing the lowest level across the region since 2014. The U.K. and Germany saw the slowest transaction activity since 2012. Unsurprisingly, European office leasing markets also faced declines, with take-up shrinking 25% year-over-year, caused mostly by a reduction in large leases. It seems occupiers are carefully managing space optimization to reduce costs. Office vacancy edged up slightly to 7.6% during the second quarter. Amid rising rates, European residential investment fell by over 60% year-over-year in the second quarter. Home prices dropped for the second consecutive quarter, but rental values increased given the shift from home ownership to rental and limited supply in the market.

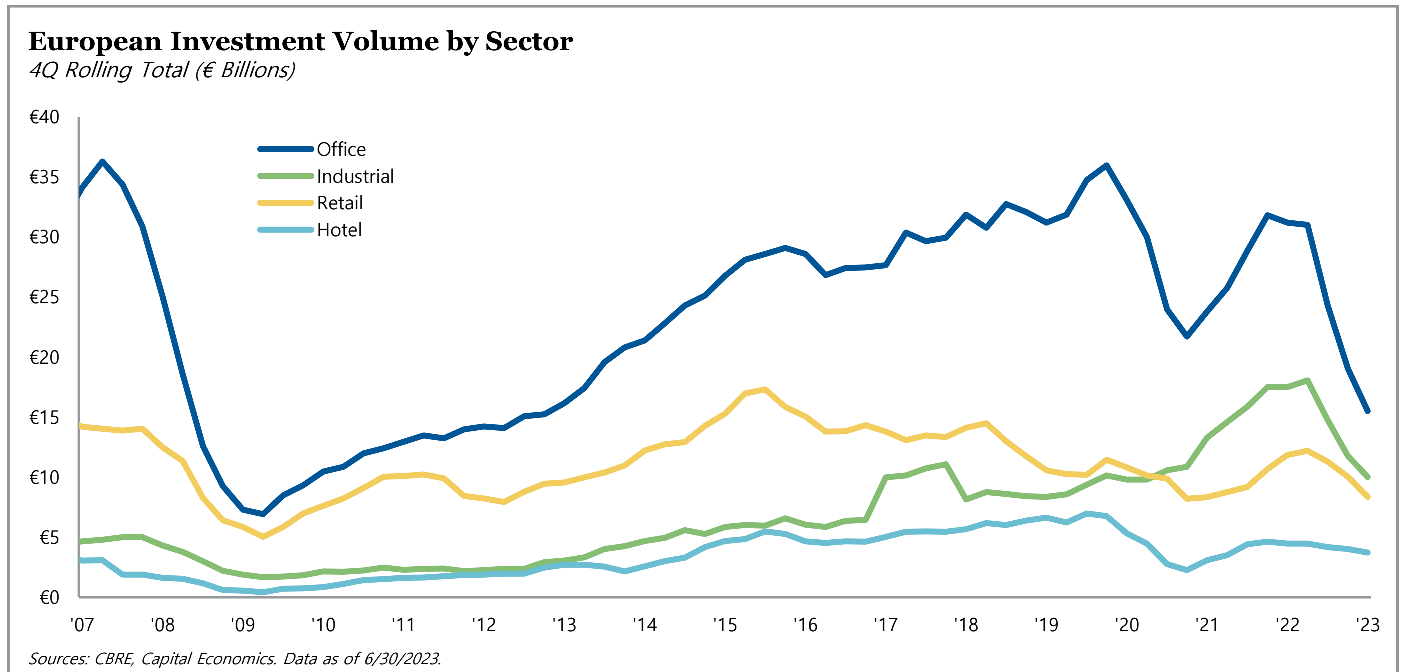
After more than a decade of low interest rates, high prices, and decreasing cap rates, the market is now facing substantial valuation decreases and price corrections across property types. The aforementioned rising interest rates have led to cap rate expansion, with the ranges varying by asset class and geography. In our experience, most institutional markets – such as Paris, London, Amsterdam, Berlin, and Stockholm – have seen cap rates expand 75 to 150 basis points, which can result in value declines in the range of 18% to 35%, depending on the previous yield levels. These declines in valuations are problematic for all real estate owners, particularly those with leverage. As debt maturities arise over the next 12 to 18 months, we expect to see some distressed sellers in the market.



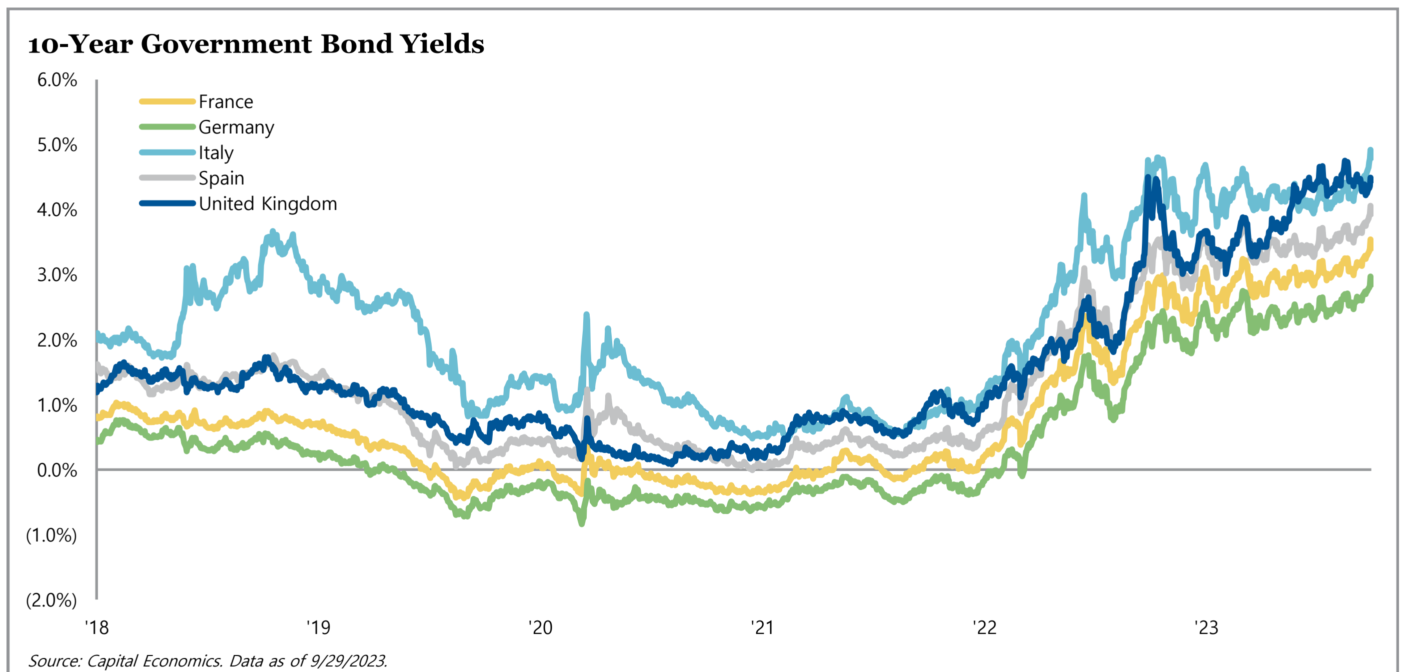
Hedging debt has become more expensive for levered owners.



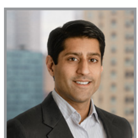
Valuations are decreasing across sectors, leading to significant cap rate expansion.



European real estate investment volume declined further across sectors in the second quarter.



With inflation still above the 2% target, base rates continued to rise in the second half of 2023.



Anuj Mittal
Co-Portfolio Manager
Head of Europe Real Estate

Tom Rowley
Co-Portfolio Manager
Europe Real Estate

For more information on Europe Real Estate, click here.

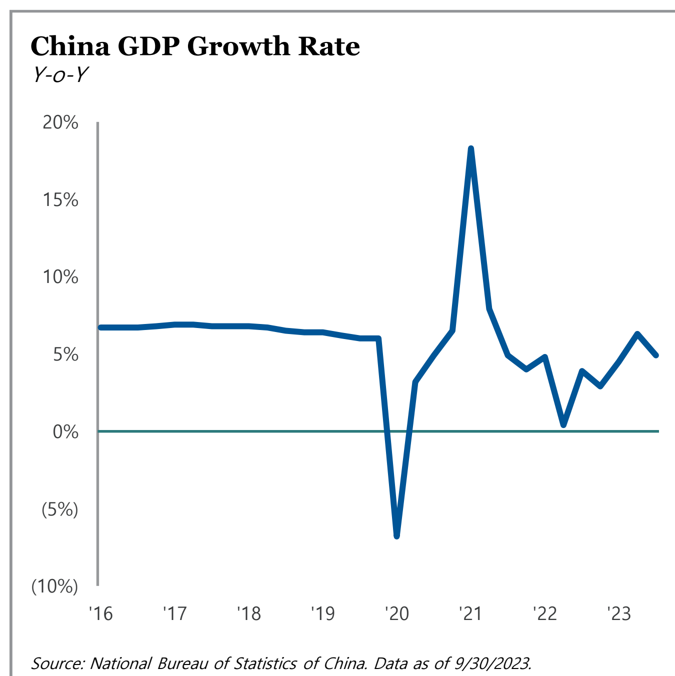
Asia Real Estate: China

China's economy gained some momentum and grew 6.3% year-over-year in the second quarter of 2023 – following expansion of 4.5% in the previous quarter – despite the impact of geopolitical tensions and overseas interest rate hikes. In December 2022, China shifted its focus to economic growth and announced the reopening of borders and relaxation of its zero-COVID policy, and accommodative macroeconomic policies continued to be announced throughout the first quarter of 2023. The People's Bank of China cut the reserve requirement ratio by 10 basis points in June, and policies supporting the real estate industry, platform enterprises, and the private economy were extended during the quarter. In the second quarter of 2023, exports increased 2.1% year-over-year and value-added industrial output rose by 3.8%. Domestic retail sales increased 8.2% in the second quarter, and online retail sales increased 10.8%. China remains highly focused on developing its advanced manufacturing sector, particularly in industries such as life sciences, integrated circuitry, and new energy. While total fixed-asset investment activity only grew 3.8% year-over-year in the second quarter, fixed-asset investment in high-tech industries grew 12.5% year over-year.

In Beijing, the recovery in office leasing demand that started in early 2023 did not continue, and leasing softened in the second quarter. Fortunately, no new supply was delivered in the second quarter. Net absorption amounted to roughly 11,900 square meters – down approximately 33% from the previous quarter – and domestic companies accounted for nearly half of the leasing demand. Overall, Grade A office rents decreased by 1.8% in the second quarter, and the office market's overall vacancy rate dropped slightly from 10.4% to 10.3%. In the Zhongguancun submarket of Beijing, known as China's Silicon Valley, rents were down 2.9% quarter-over-quarter and vacancy remained at 8.6%.

After showing signs of recovery in the first quarter, industrial and logistics leasing demand also slowed in the second quarter. Shanghai's logistics market delivered two new projects in the second quarter, adding approximately 421,000 square meters and exceeding the total space delivered in full year 2022. Industrial rents rose 2.1% year-over-year, while vacancy increased 4.5 percentage points to 13.8%.

In terms of overall market activity, total commercial real estate transaction volume amounted to RMB 88.9 billion in the first half of 2023 – down 17% year-over-year due to weaker-than-expected economic growth, subdued leasing fundamentals, prolonged overseas interest rate hikes, and ongoing geopolitical tension. Business parks and logistics warehouses remained the most popular asset classes and are well-positioned to benefit from China's structural shift toward innovation-driven growth as well as the continued expansion of e-commerce and third-party logistics companies.



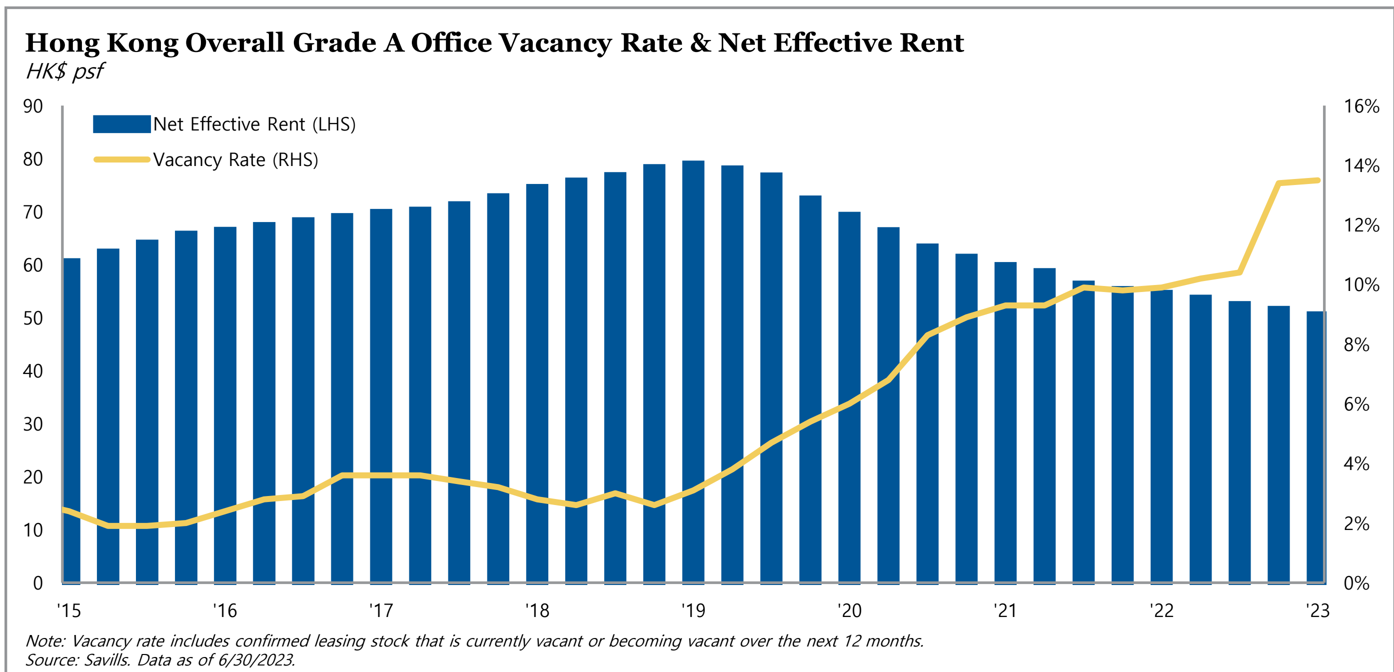
China's economic recovery remained weak.

CNY values have remained weak against the USD.

Asia Real Estate: Hong Kong

After growing 2.7% year-over-year in the first quarter of 2023, Hong Kong's economy continued to grow in the second quarter – expanding 1.5% year-over-year – driven by the strong recovery of inbound tourism and private consumption. Total exports of goods declined further in the second quarter, falling 15.2% year-over-year amid the challenging global market environment. Private consumption surged – increasing 8.2% year-over-year in the second quarter – alongside continued economic recovery. Additionally, unemployment declined from 3.1% in the first quarter of 2023 to 2.9% in the second quarter. We expect the reopening of Hong Kong's borders with mainland China earlier this year will help support continued economic recovery through the balance of 2023.

In the second quarter of 2023, residential prices retreated 7.8% year-over-year and 0.6% quarter-over-quarter – remaining below the high recorded in September 2021. This overall decline is mainly attributable to smaller residential properties, which recorded an 8.9% year-over-year decrease in prices, as compared to the 2.3% price decline for larger properties. Commercial real estate investment transaction volume fell 65.4% quarter-over-quarter to HK$18.1 billion in the first half of 2023 – the weakest six-month period since the first half of 2009, marking a 14-year low. Investment demand in the second quarter was largely supported by individual buyers, accounting for 45% of the quarterly transaction volume – the highest proportion since the fourth quarter of 2020. The office sector continued to remain weak, both in terms of tenant demand and investor interest. As of June 2023, Hong Kong's office vacancy increased slightly to 13.5%, while rents fell by 2.0% in the second quarter.



Hong Kong's office market vacancy remained stubbornly high, as China's economic recovery has been muted.

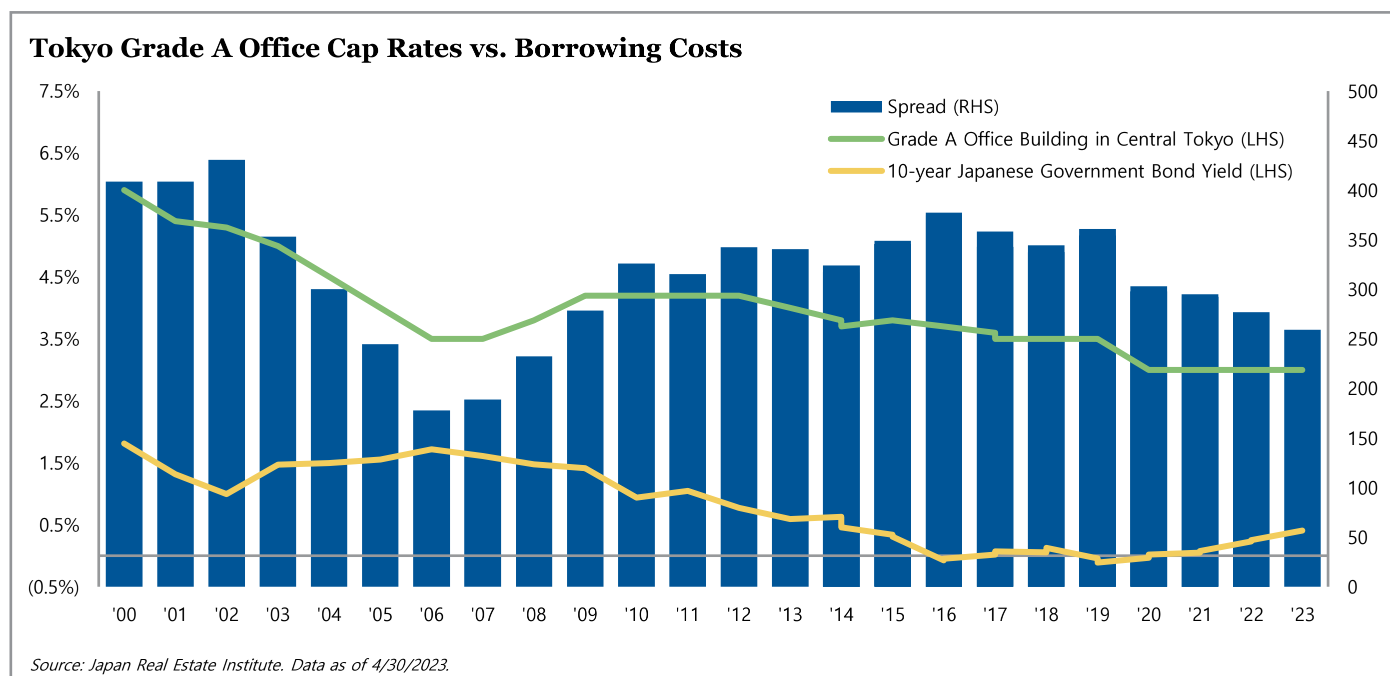
Asia Real Estate: Japan

In the second quarter of 2023, Japan's real GDP grew 6.0% quarter-over-quarter on an annualized basis, driven by strong private housing demand and net exports of goods and services. Japan's labor market proved resilient, with unemployment at 2.7% as of July 2023. The inflation rate was 3.1% in July – down from the 41-year high of 4.2% that was recorded in January – and real wages continued their 15-month decline, falling 1.6%. Since taking office in April, Bank of Japan (BoJ) Governor Kazuo Ueda has maintained the BoJ's monetary easing policy, reiterating that inflation must be accompanied by real wage growth. As a result, the Japanese interest rate market remained stable, with Japan's base rate (TIBOR) remaining below 10 basis points.

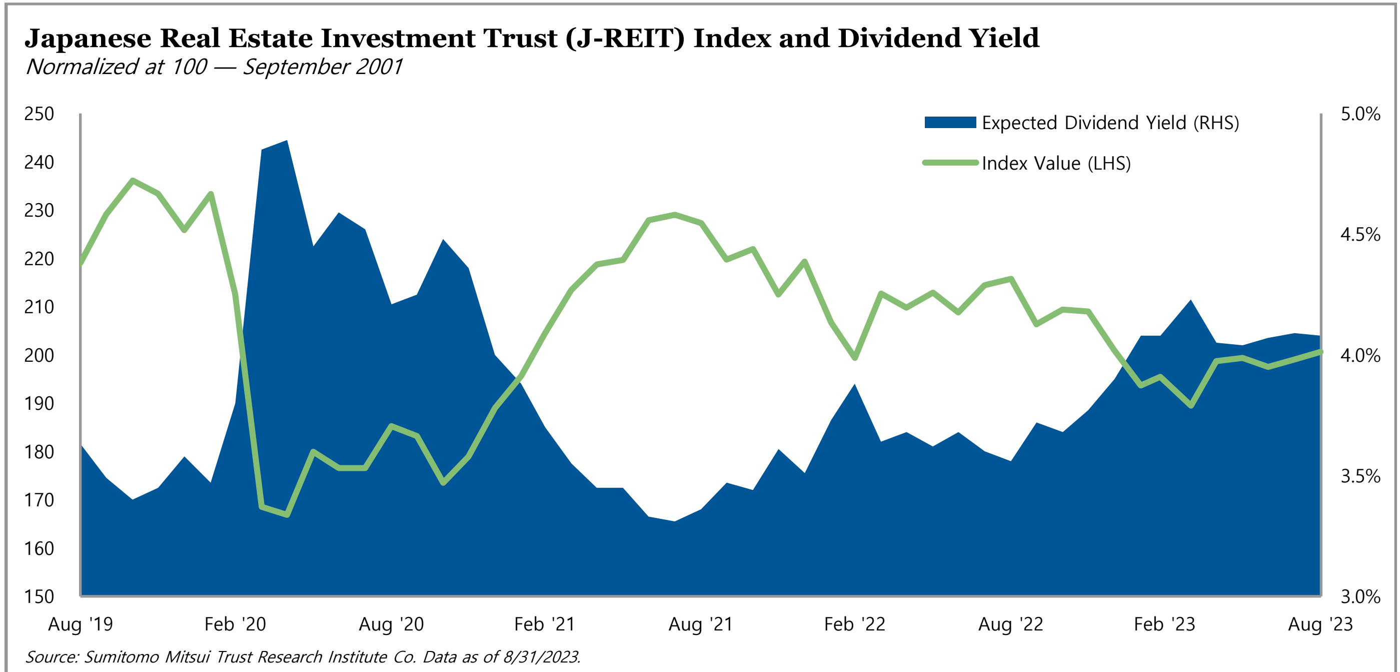
In the second quarter, office real estate fundamentals softened slightly with new supply, but also continued to be supported by unwavering tenant demand. All-grade vacancy rates increased from 4.6% to 4.9% in Tokyo and from 3.6% to 3.7% in Osaka quarter-over-quarter. During the quarter, Tokyo quickly absorbed most of the new supply – which was equivalent to 0.7% of total stock – limiting the increase in the overall vacancy rate. Osaka was also quick to absorb vacancies in existing premises that were caused by relocations to buildings completed last year. We continued to observe a trend of many companies seeking to improve their office space to attract and retain talented employees. We expect office demand will remain stable, with vacancies continuing to be filled by relocations from suburban areas, consolidations, and expansions.

Logistics fundamentals were also bolstered by strong tenant demand during the second quarter, with net absorption at an all-time high of 225,000 tsubo in the greater Tokyo area. The vacancy rate for multi tenant facilities remained unchanged at 8.2%. The vacancy rate for facilities that were built more than one year ago decreased from 2.5% to 2.1%. The strong demand witnessed during the second quarter originated from a wide range of industries, including e-commerce operators, retailers and wholesalers, manufacturers of consumer goods, and service providers. However, we've also seen tenants become increasingly selective with the continued influx of new supply, resulting in greater polarization between property types and areas.

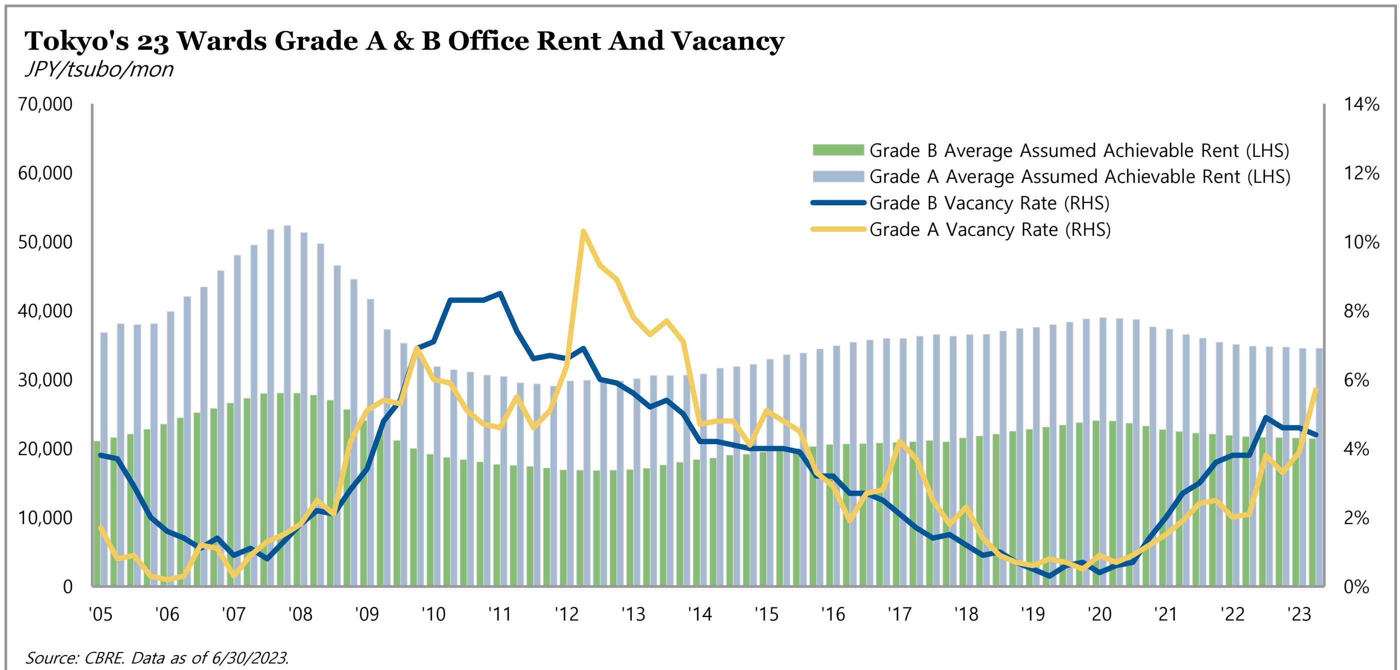
Transaction volume in the second quarter of 2023 was up 3% year-over-year – slightly above the average volume registered for the same period over the past five years. Japanese REITs (J-REITs) and foreign buyers were active in the second quarter, with investment volumes up 169% and 22% year-over year, respectively. More than 70% of transactions in excess of ¥10 billion were from the logistics sector, and the appetite for office also remained healthy, with office transaction volume in the first half of 2023 exceeding that of last year.



Japan maintained its low-rate policy, and yield spreads remained healthy.



J-REITs have started to recover, which should drive more purchases of stabilized assets in the marketplace.



Tokyo office vacancy edged up slightly, while overall market fundamentals remained stable.

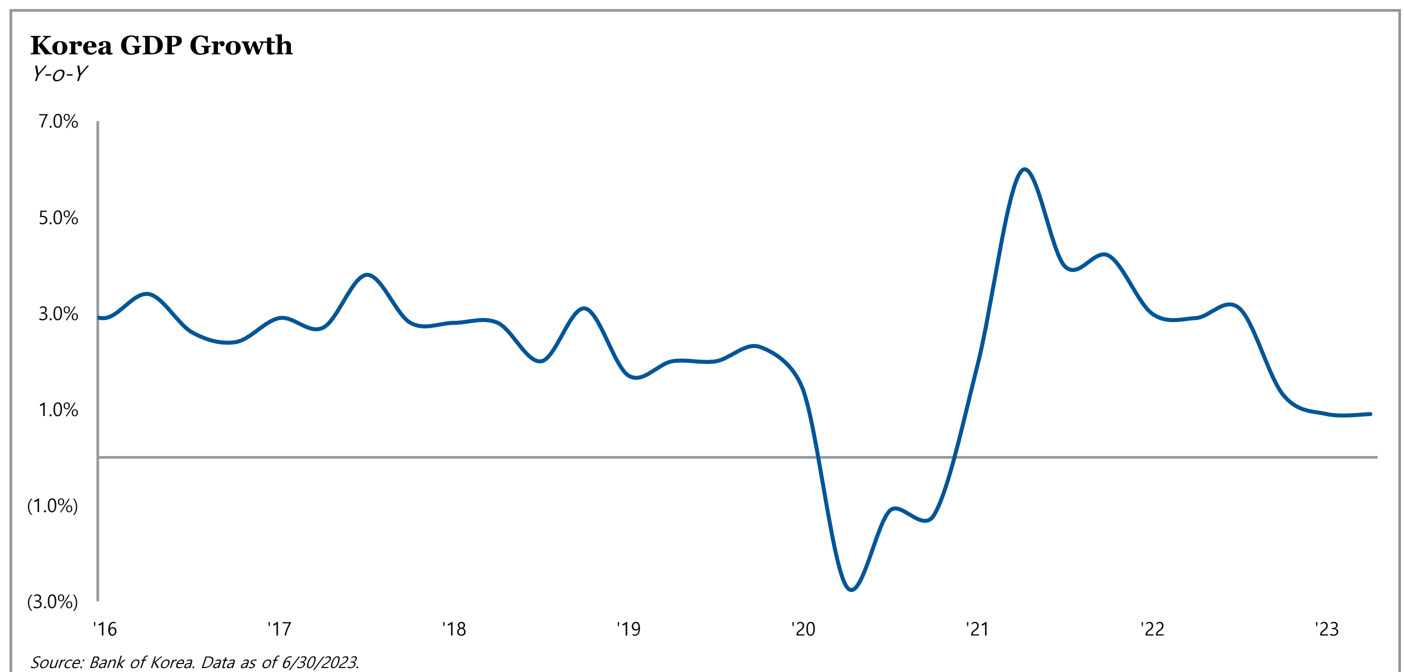
Asia Real Estate: South Korea

The Bank of Korea (BoK) held the base rate steady at 3.5% at the close of the second quarter, unchanged since January of this year. South Korea's GDP continued to grow in the second quarter and rose 0.6% quarter-over-quarter, outpacing the 0.3% quarter-over-quarter GDP growth recorded in the first quarter. However, the continued GDP growth trend was mainly driven by positive net exports – which were the result of a reduction in imports – while consumption and investments fell overall. Amid growing economic woes globally and a prolonged sluggishness in exports, the BoK lowered its forecast for 2023 growth to 1.4% in May – down from the previous forecast of 1.6%. Meanwhile, inflation showed firm signs of easing in the second quarter, with South Korea's consumer price index (CPI) up 2.7% year-over-year in June – an improvement from the 5.2% year-over-year increase recorded in January.

On the real estate front, office cap rates stood at 4.4% in the second quarter of 2023 – in line with the previous quarter. Spreads between prime office cap rates and Korean government bond yields (i.e., 5-year treasury bonds) tightened and stood at approximately 70 basis points as of the end of the second quarter. This spread tightening can be attributed to higher treasury yields, which stood at 3.7% at the end of the second quarter – up 30 basis points quarter-over-quarter. This yield movement was spurred by hawkish statements from the U.S. Federal Reserve and the BoK, which went against market expectations that the rate-hike cycle was nearing its end.

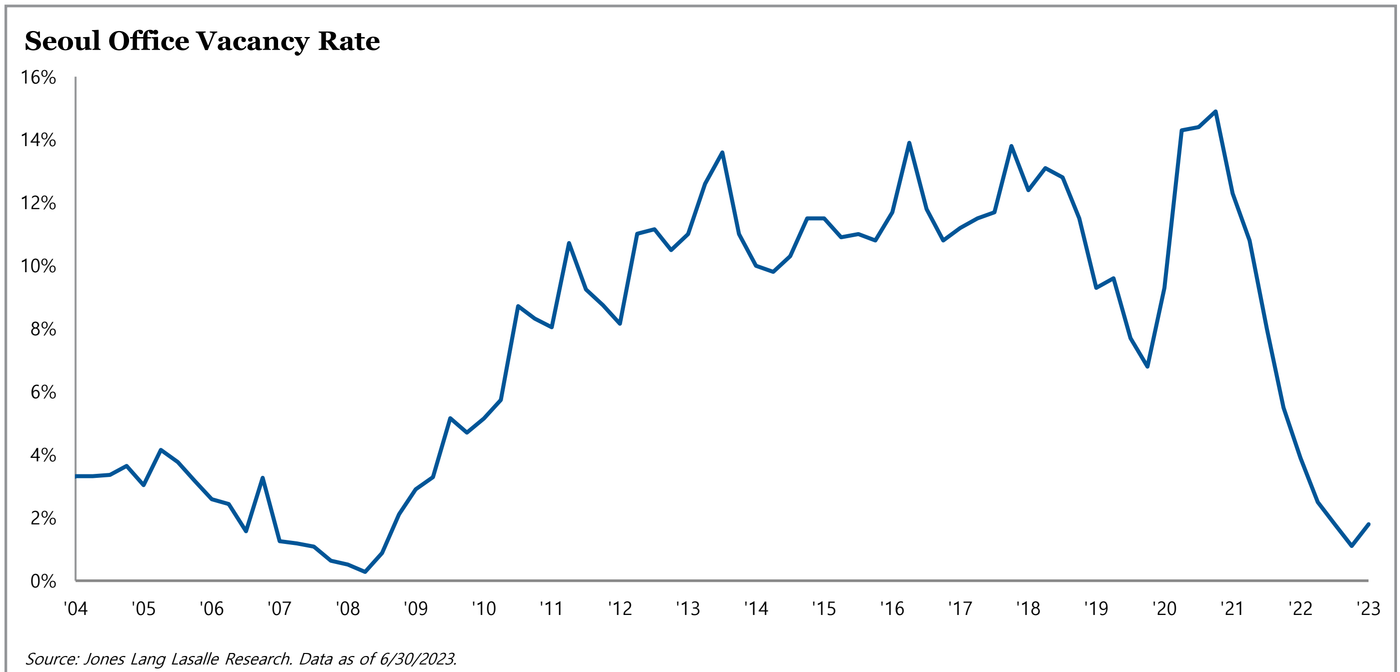
Office fundamentals remained strong, backed by robust demand. Prime office vacancy in Seoul fell to 1.8% at the end of the second quarter, down 0.9 percentage points from the previous quarter and nearing the historic lows of 2008. Office rents increased 7.1% year over-year in Seoul, which includes the Gangnam Business District, where rents rose 9.3% year-over-year. Investment activity totalled ₩3.3 trillion in the second quarter, rebounding to a level similar to that of the second quarter of 2022.

Logistics vacancy in Greater Seoul increased to 16.0% in the second quarter – up 342 basis points quarter over-quarter – and again reached an all-time high; similar to the first quarter, this was primarily driven by the short-term impact of large-scale supply. However, we are now seeing numerous sites unable to break ground, even after obtaining development approval, due to challenging financing markets and increased development costs. This trend has been observed throughout the Seoul metropolitan area, particularly in key logistics submarkets such as the South and Southeast; vacancy in the South and Southeast submarkets is expected to stabilize in the next two to three years, with reduced supply going forward, according to JLL. Meanwhile, logistics investment activity showed signs of recovery, with transaction volume totalling ₩1.0 trillion in the second quarter – up approximately 26.2% quarter-over-quarter.

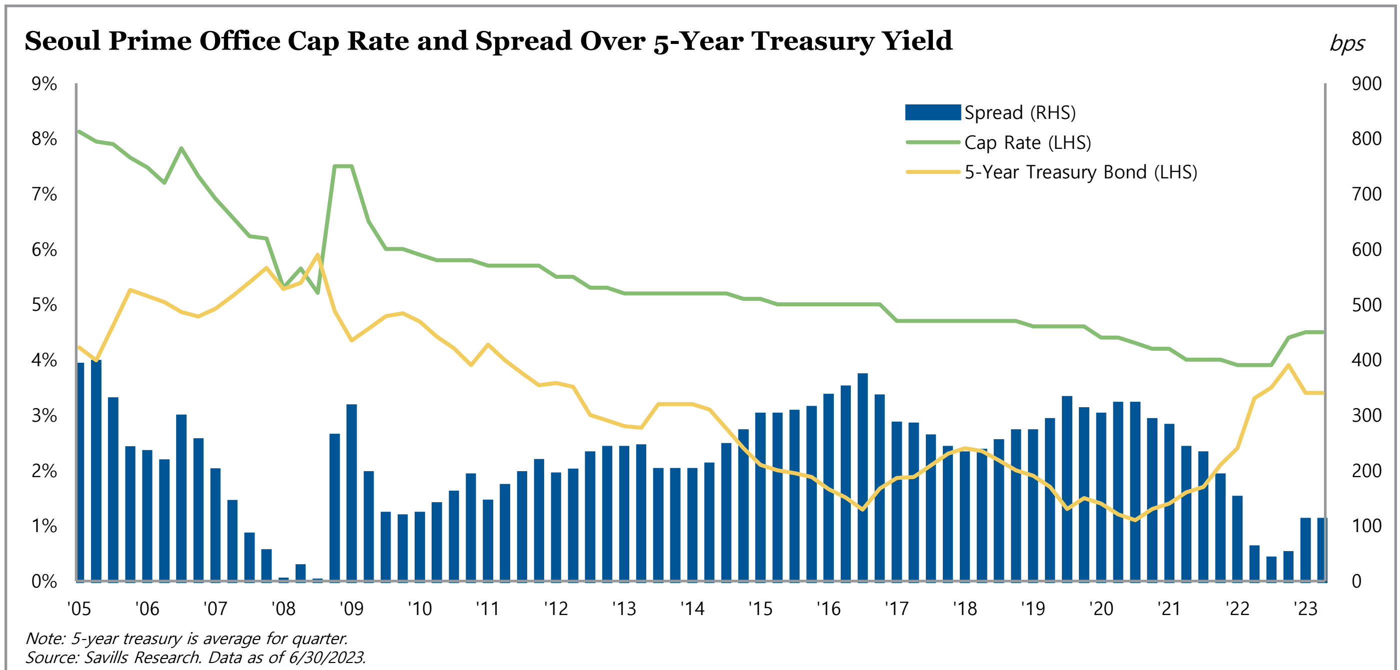


Korea's GDP growth declined as higher interest rates weighed on the economy.

Asia Real Estate: South Korea *(continued)*

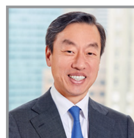


The Seoul office market is one of the strongest office markets in the world, with only fractional vacancy.



Korean Treasuries have followed the U.S. rate-hike cycle, although rates have decoupled in recent months with inflation under control.

Wilson Leung
Co-Portfolio Manager
Head of Asia Real Estate



Steven Cha
Co-Portfolio Manager
Asia Real Estate

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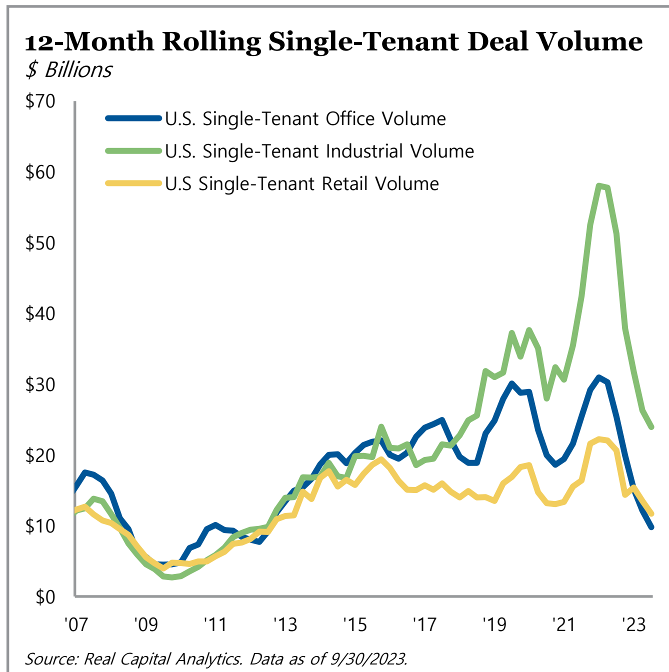
Net Lease Real Estate

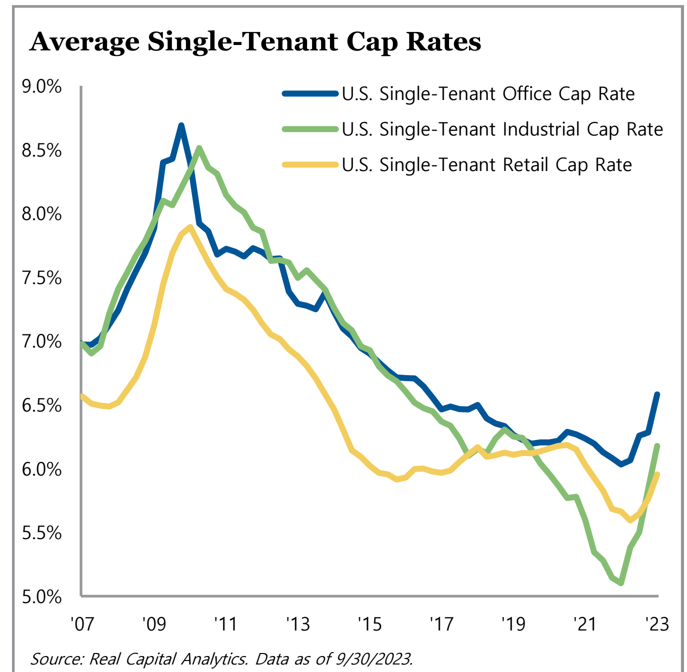
As of the third quarter of 2023, trailing 12-month U.S. single-tenant transaction volume totaled $45 billion, according to Real Capital Analytics (RCA). Since the peak recorded in the second quarter of 2022, trailing 12-month transaction volume has declined by 61%. This decline in volume can be seen across asset types, with office, industrial, and retail all down by more than 50%.

Single-tenant cap rates have begun to trend upward at a pace not seen since the fourth quarter of 2009. As of the end of the third quarter of 2023, trailing 12-month U.S. single-tenant transaction cap rates averaged 6.24% – up 20 basis points from the prior quarter – led by upward movements in office and industrial. The increase in net lease cap rates has been driven by higher borrowing costs due to elevated base rates and lending spreads. The spread between cap rates and borrowing costs is tight relative to the past 13 years, but there has been an increase in the number of corporate property owners looking to do sale-leasebacks – even at higher cap rates – as the effective cost of capital sale-leasebacks offer is lower than alternative forms of financing. Cap rates for sale-leaseback transactions – which we've recently observed in the range of 7% to 8% – are also compelling for property buyers, as they are above historical averages.

Looking ahead, there are several trends that we expect will drive an increase in sale-leasebacks, including manufacturing onshoring, U.S. capex spending on automation and the energy transition, and high corporate borrowing costs.



Transaction volume is down 61% from the peak recorded in the second quarter of 2022.



Cap rates are increasing across asset types.

Gordon Whiting
Portfolio Manager

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