2020 Bank Loan Market Outlook

By Frank Ossino, Senior Managing Director and Senior Portfolio Manager

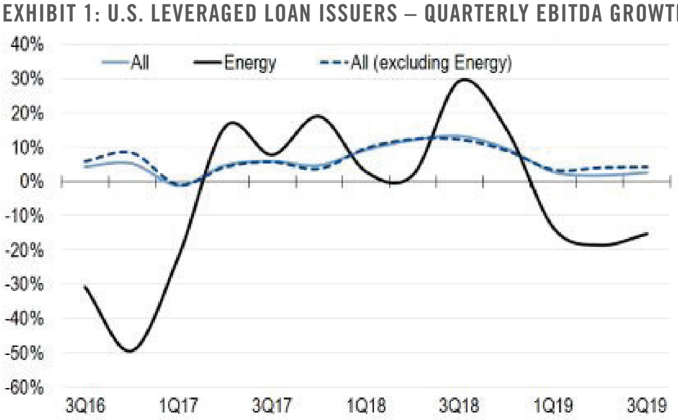
Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

Frank Ossino, sector head of the bank loan asset class at Newfleet Asset Management, discusses the opportunities and areas of concern for bank loans as we enter 2020.

2019 Review – On the back of still supportive, albeit decelerating, macroeconomic conditions and a pivot toward a lower interest rate regime in the U.S., 2019 was a good year for risk assets and fixed income in general, especially long duration markets. Despite a declining rate environment, the loan market will close 2019 up nearly 8%, driven largely by coupon. The year began with a rally post the December 2018 sell-off. Three Federal Reserve interest rate cuts led to over $30 billion in retail mutual fund outflows. The continued trade issues with China provided near-daily volatility (up and down), and credit-specific earnings/news resulted in sharp moves in price on a number of credits driven by the heightened focus on lower-tier credits and the impact of credit agency downgrades as it relates to collateralized loan obligation (CLO) portfolios.

Opportunity – We remain constructive on the asset class, but recognize that credit selection will be the path to outperformance. Going into 2020, financial markets appear to be less concerned about recession compared to this time in late 2018. With the data pointing to continued low inflation, central bank accommodation, and GDP growth in the 2% area, the year could extend the long post-crisis recovery and set up nicely for risk assets, including loans. Coupled with a very manageable maturity wall and strong interest coverage metrics, we remain positive but with reservations. U.S./China trade issues are not yet resolved, and credit conditions have deteriorated somewhat as evidenced by an uptick in loans trading below 80 cents on the dollar and a spike in credit agency downgrades that have increased the size of the B- and CCC rating cohorts.

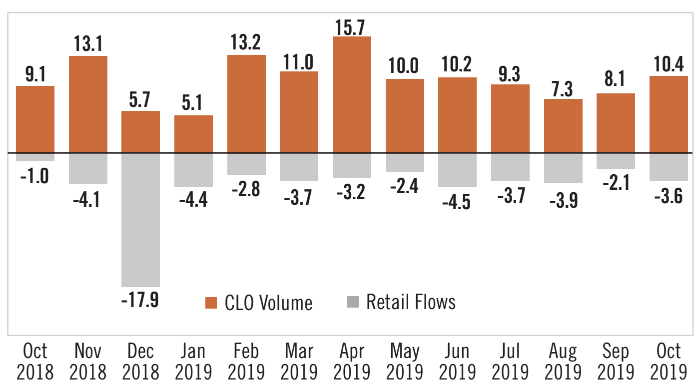
EXHIBIT 1: U.S. LEVERAGED LOAN ISSUERS – QUARTERLY EBITDA GROWTH



Source: LCD, an offering of S&P Global Market Intelligence.

On the demand side, the Fed pivot to a rate cut path in 2019 resulted in consistent monthly redemptions from retail funds. Absent a rising rate environment in 2020, our expectation is that retail loan investors—now only 12% of the market—will continue to sell the asset class, but perhaps at a more tapered pace. Conversely, we expect CLO issuance in 2020 to be in a range similar to 2019 (around $100 billion) as institutional investors—domestic and foreign alike—gravitate toward the attractive long-term risk-adjusted return profile of the loan market and the benefits the CLO wrapper afford for such exposure. Regarding supply, issuance was down roughly 30% in 2019 due to limited M&A opportunities, but also a result of market share loss as borrowers elected to finance themselves through the high yield market where overall demand was more robust. Much of the loan issuance was to refinance existing loans. All else equal, we expect issuance to remain muted in 2020, as refinancings slow but also as high yield continues to take share in a range-bound interest rate environment.

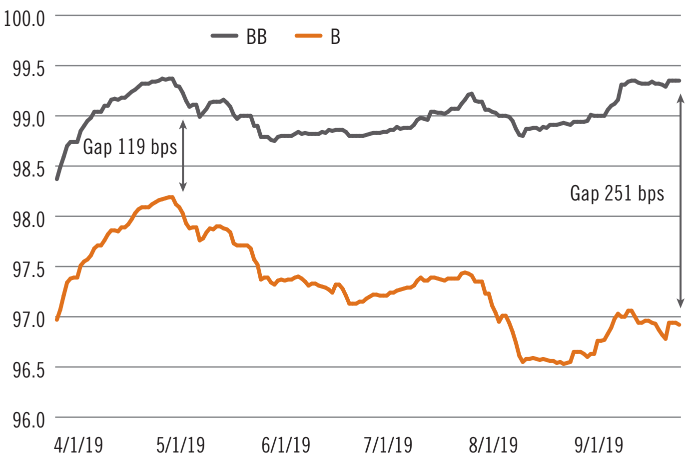
EXHIBIT 2: MONTHLY LOAN DEMAND ($B)



Source: LCD, an offering of S&P Global Market Intelligence.

Bifurcation was a major buzzword in loans in 2019 due to multiple factors. While lower-tier credit was widening due to credit downgrades and their impact on CLO structures, the higher quality cohort was in favor with investors at a time when high yield bond issuance increased and was used to repay quality loans, in essence, coupled with M&A-related repayments, shrinking this part of the market. The current widening credit bifurcation could create rotation opportunities.

EXHIBIT 3: WEIGHTED AVERAGE BID PRICE OF BB AND B RATED LOANS



Source: LCD, an offering of S&P Global Market Intelligence. S&P/LSTA Leveraged Loan Index.

Our initial 2020 risk-adjusted return expectation for the loan market consists largely of coupon. As illustrated in the accompanying table, we assume that three-month LIBOR declines to 1.75%, as the short end of the interest rate curve is firmly anchored by central bank accommodation. We will initially keep spread unchanged as the significant amount of lower spread refinancings completed in 2019 could partially offset any spread widening in the lower credit tier cohort.

EXHIBIT 4: 2020 FORECAST

Avg 3 month LIBOR	1.75%
Spread	3.50%
All in Coupon	**5.25%**
Price Appreciation	1.33%
All in Total Return	**6.58%**
Risk Adjustment (2.5% Default at 40% Loss)	-1.00%
Risk Adjusted Return	**5.58%**

Source: Newfleet estimates.

Currently, the loan market is priced at 96 cents. Assuming a three-year average life, we assume a 1.33% realization in price over the year, which makes our unadjusted total return expectation 6.58%.

Finally, as the low credit tier cohort has expanded, we assume a slight increase in defaults to 2.5%, but still below historical averages. Given the aggressive underwriting vintage, we expect the next cycle to realize a recovery rate less than the 80 cent (20 cent loss) historical average. At a 2.5% default rate and 60 cent recovery (40 cent loss), our risk-adjusted 2020 loan market return forecast is 5.58%.

Turning to the transition from LIBOR to the Secured Overnight Financing Rate (SOFR) as the reference rate, much progress was made in 2019. We have arrived at one of four possible SOFR calculations. The market next will learn the spread adjustment, i.e., the adjustment to SOFR that will initially make the rate equal to LIBOR-based loans. That will allow us to know the economics of a SOFR-based loan and, in turn, begin to price risk with this new base rate. The next steps in 2020 are workable fallback language, operationalizing the transition, and finally hardwiring documentation. For more detail on the phase out of LIBOR, see Newfleet's Update on LIBOR.

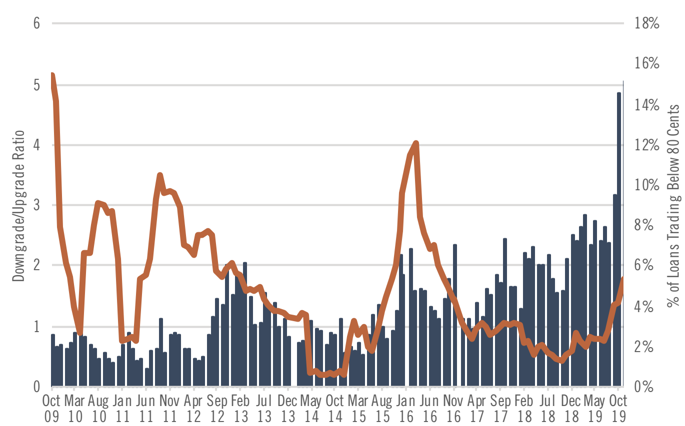
EXHIBIT 5: RISK ADJUSTMENT MATRIX

		Loss Rate (1 minus Recovery Rate)						
		20%	**25%**	**30%**	**35%**	**40%**	**45%**	**50%**
Defaults	**0.50%**	0.100%	0.125%	0.150%	0.175%	0.200%	0.225%	0.250%
	1.00%	0.200%	0.250%	0.300%	0.350%	0.400%	0.450%	0.500%
	1.50%	0.300%	0.375%	0.450%	0.525%	0.600%	0.675%	0.750%
	2.00%	0.400%	0.500%	0.600%	0.700%	0.800%	0.900%	1.000%
	2.50%	0.500%	0.625%	0.750%	0.875%	1.000%	1.125%	1.250%
	3.00%	0.600%	0.750%	0.900%	1.050%	1.200%	1.350%	1.500%
	3.50%	0.700%	0.875%	1.050%	1.225%	1.400%	1.575%	1.750%
	4.00%	0.800%	1.000%	1.200%	1.400%	1.600%	1.800%	2.000%

Source: Newfleet estimates.

Areas of Concern – Many of the hotspots in 2019 will carry into 2020 including the continued trade dispute with China and its impact on cyclicals and trade-related industries like manufacturing, as well as possible healthcare legislation (balanced billing and opioid and generic drug settlement negotiations), energy-related volatility, interest rate distortions created by global central bank accommodation, and impacts of a U.S. election year.

EXHIBIT 6: DOWNGRADE/UPGRADE RATIO AND PRICES



Source: LCD, an offering of S&P Global Market Intelligence.

As it relates to the loan market, recent late cycle behavior is now beginning to manifest itself as borrowers miss expectations and are subsequently downgraded by the credit rating agencies. The recent spike in the downgrade to upgrade ratio is the highest reading in a decade. Roughly 60% of the 2016 issuance vintage has missed expectations by an average of 30%. Credit downgrades may impact CLO structures as they manage to certain risk parameters embedded within the portfolios, resulting in violent downward price movements. Loose terms and conditions may impact future recovery rates. While negative price movements—defined here as loans below 80 cents—have largely been idiosyncratic thus far, these factors taken together could negatively impact loans more broadly as the market reprices these risks.

Implementation – We have reviewed our lower tier exposure for signs of downgrade risk and have selectively reduced holdings to get ahead of earnings misses, or sell-offs created by CLO technicals tied to credit agency downgrades. The continued widening credit bifurcation is increasingly creating rotation opportunities. As such, we are beginning to re-underwrite credits that have been negatively impacted and looking for opportunities to add in an effort to take advantage of valuations created by technical dislocations.

For more information about Newfleet's fixed income strategies, please contact:

Bill Irvine, Senior Managing Director, Institutional Business Development, Newfleet Asset Management
T: 860.760.5832 | C: 781.329.9283 | William.Irvine@Newfleet.com
www.Newfleet.com

IMPORTANT RISK CONSIDERATIONS: Credit & Interest: Debt securities are subject to various risks, the most prominent of which are credit and interest rate risk. The issuer of a debt security may fail to make interest and/or principal payments. Values of debt securities may rise or fall in response to changes in interest rates, and this risk may be enhanced with longer-term maturities. **Bank Loans:** Loans may be unsecured or not fully collateralized, may be subject to restrictions on resale and/or trade infrequently on the secondary market. Loans can carry significant credit and call risk, can be difficult to value and have longer settlement times than other investments, which can make loans relatively illiquid at times. **High Yield- High Risk Fixed Income Securities:** There is a greater level of credit risk and price volatility involved with high yield securities than investment grade securities. **Leverage:** When a fund leverages its portfolio, the value of its shares may be more volatile and all other risks may be compounded. **Liquidity:** Certain securities may be difficult to sell at a time and price beneficial to the fund.

The **S&P/LSTA Leveraged Loan Index** is a daily total return index that uses LSTA/ LPC Mark-to-Market Pricing to calculate market value change. On a real-time basis, the index tracks the current outstanding balance and spread over LIBOR for fully funded term loans. The facilities included in the Index represent a broad cross section of leveraged loans syndicated in the United States, including dollar-denominated loans to overseas issuers. The index is unmanaged, its returns do not reflect any fees, expenses, or sales charges and it is not available for direct investment. **LIBOR:** London Interbank Offered Rate.