Bank Loan Market Update

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

AUGUST 2020: OUTLOOK AND IMPLEMENTATION

- August marked five straight months of gains in the loan market. It has now retraced the March COVID-related losses from a total return (i.e., including income) perspective. On a price basis, the market has retraced 84% of the price sell-off. Loans, while underperforming High Yield, have rallied with other risk assets on continued central bank support, progress on a treatment/vaccine, better than feared 2nd quarter earnings, and a firm technical.
- The loan market returned 1.49% in August. The YTD return is now down 1.29%.
- Consistent with a risk-on background, BB risk underperformed in the month (up 0.7%) compared to B risk (up 1.5%) and CCCs (up 4.0%). The spread differential (to a 3-year life) between BB and B risk continues to compress, now under 200 basis points, and is through the long-term average of 245 basis points.
- All industries reported positive performance. Stressed industries such as Leisure (up 2.9%), Aerospace (up 2.8%), and Retail (2.5%) outperformed. Defensive industries such as Cable (up 0.55%) and Utilities (up 0.04%) underperformed.
- With one- and three-month LIBOR rates touching 0.15% and 0.25%, respectively, loan new issuance has seen a resurgence of LIBOR floors in transactions to compensate investors in this low rate environment. From March to August, about two-thirds of loan new issues had a 1% LIBOR floor. That is up from 25% during the same time last year.
- Continued global central bank accommodation has opened capital markets. This, coupled with possible additional U.S. federal fiscal stimulus and a slowly healing economy, provides a good setup for risk and income-generating assets.

Fundamentals

- As expected, 2Q earnings reported the deepest decline in operating results for public filers in the S&P/LSTA Loan Index since the Index first tracked the data in 2002. Quarterly EBITDA growth declined 23% in 2Q after a 9% drop in 1Q. These results were worse than those of the Great Recession. Directly impacted COVID-related industries such as leisure/casinos, autos, energy, retail, and elements of healthcare were the most impacted.
- If there is any silver lining, 2Q results exceeded very low expectations and macroeconomic data is slowly beginning to improve, setting up for a possible continued recovery in the second half of the year.
- Poor earnings have degraded average total leverage (6.4x) and interest coverage after CAPEX (2.7x) metrics.
- Nearly 40% of the loan market (by par volume) has been downgraded, but the pace has slowed since March as accommodative capital markets and tighter spreads from the heavy monetary and fiscal response have provided liquidity even to the most troubled sectors and have removed some of the tail risk.
- Default activity slowed in August to $1.5B from two issuers, increasing the trailing 12-month default rate to 4.08%. Energy and Retail make up the lion's share (29% and 13%, respectively) of all loan defaults this year.

Technicals

- The loan market technical remains very supportive driven by a very light new issuance calendar, voluntary prepayments, and healing, albeit low, demand. The forward calendar net of anticipated repayments remains negative.
- Retail redemptions totaled roughly $944MM in August. YTD outflows are roughly $18B. Despite sequential improvement in flows, retail demand could remain soft given the current low interest rate environment.
- CLO issuance was the lowest this year at $3.2B. YTD issuance of $47.6B is down roughly 42% YOY versus the comparable period in 2019. While structured product spreads have slowly tightened and participants find creative ways to issue transactions, the CLO market could remain challenged until the total return arbitrage hurdles required by investors can be reasonably achieved. A limited loan issuance calendar and stricter warehouse terms also create a headwind for these structures.
- Gross institutional new issuance totaled $18B in August as a number of "pre-COVID" underwritten M&A financing transactions cleared. Volume is down 16% YTD. Repayments totaled $8.6B. Loan market size reached a new record at $1.2T this month.
- Very little new issuance has been announced going into September. We do expect announcements to be centered around opportunistic transactions, possibly associated with smaller M&A, and refinancing deals in an effort to push out maturities and create runway.

Pricing

- The loan market was priced at 92.9 in August. This is well above the March 23 "COVID low" of 76.2, but still below the 96.7 price at the start of the year.

- Prices ground higher in the month. With quality credits now back to mid-March levels, the riskiest cohorts led the way as investors re-underwrite still-discounted credits. BBs closed at 96.8 while B risk improved a full point to 95.5. CCCs closed up 3 points to 81 and are now back to near late-February levels.
- The distribution of index prices is solidly in the mid-90s with 72% of issue prices at 95 or above, up from 60% in July and only 8% in March. The deep discount end of the market improved with 6% of the market now less than 80, meaningfully lower than the high of 57% in March.
- With the early rally in higher quality largely behind us, investors have refocused on lower-rated and discounted cohorts in an effort to add total return opportunities (and CLO managers adding discounted credits to manage CLO structure tests) to portfolios.
- Loan spread to a 3-year life closed the month tighter at L+573, from L+619 in July and a steady improvement from the March wide of L+1076. Assuming a 60% recovery on defaulted credits, the level is implying a 4-5% default rate is priced into the market.
- Spreads are approaching the lifetime historical average of low/mid L+500s, so we will call the market approaching fair value. However, we point to the risk-adjusted income pickup relative to other risk and income asset classes as the rationale to maintain exposure to the space and even a possible increase in exposure relative to other risk alternatives for long-term, income-seeking investors.

Implementation

- A nearly non-existent new issuance calendar, continued voluntary repayments, and healing demand should continue to support the technical picture in the near term, providing some comfort to remaining fully invested at the moment.
- The swift rally in prices implies much of the low-hanging fruit has been picked, renewing credit selection as a focus.
- We will be starting our bi-annual industry reviews with our analyst team shortly.

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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.

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