2021 Bank Loan Market Outlook

By Frank Ossino, Senior Managing Director and Senior Portfolio Manager

Frank Ossino, sector manager of bank loans, discusses the opportunities and areas of concern as we enter 2021. We remain constructive on the asset class — expecting a coupon-clip return profile — as technical factors are supportive and fundamentals slowly heal while the Fed continues to provide macroeconomic and capital markets support. All this notwithstanding, we emphasize the importance of core credit analysis and selection, diversification, and risk management in the face of certain developments in the loan market that we are monitoring.

2020 Review – The bank loan market began the year on constructive footing, with January posting positive returns based on the Federal Reserve's (Fed) accommodative monetary policy and a still-supportive macroeconomic backdrop. Beginning in late February, the remainder of the year was dominated by the emergence of the COVID-19 global pandemic, the associated economic and earnings fallout, and the fiscal and monetary policy response. March 2020 was truly historic. For just the second time in its history, the loan market posted a double-digit loss (-12.8%), narrowly behind the largest monthly loss ever (-13.2% in October 2008). At the low point, loans hit a price of 76.5 cents, a level not seen since June 2009. Attractive valuations, central bank market intervention, a partial reopening of the economy, and a $2 trillion federal stimulus bill was the recipe for a strong rebound that began in April and a near full retracement on price. Recent, very encouraging results on the vaccine front may solidify the market's path to a positive total return.

EXHIBIT 1: PRICE/DISCOUNTED SPREAD MOVEMENT OF CS INDEX LOANS
March 23-November 12

	Average Price			Average discount margin to 3-yr life		
	3/23/20	11/12/20	% Change	3/23/20	11/12/20	Bps Change
All	76.48	94.36	23.4%	L+1275	L+536	-739
Liquid Loans	74.98	96.26	28.4%	L+1342	L+488	-854
BB	79.44	97.94	23.3%	L+1062	L+337	-725
Single B	77.33	97.38	25.9%	L+1305	L+511	-794
CCC	63.56	81.37	28.0%	L+2197	L+1315	-882
Defaulted	31.19	49.23	57.8%	L+8556	L+2572	-5984

Source: Credit Suisse Leveraged Loan Index

Opportunity – Despite a valuation that appears fair to long-term averages, we remain constructive on the asset class into 2021 and can see a coupon-plus type total return next year given the existing discount to par and yield enhancement provided by the re-emergence of LIBOR floors in new transactions. The containment of the virus, and ultimately the development of a vaccine, continue to be the determining factors in the prospects for bank loans as well as other risk assets. The size and scope of additional stimulus, which is a necessary bridge to a vaccine, is another key variable. With the Fed and global accommodation providing support, we believe the case for bank loans can be made for income in a low-yield environment. The income pickup relative to other income asset classes provides a strong rationale for exposure to the space.

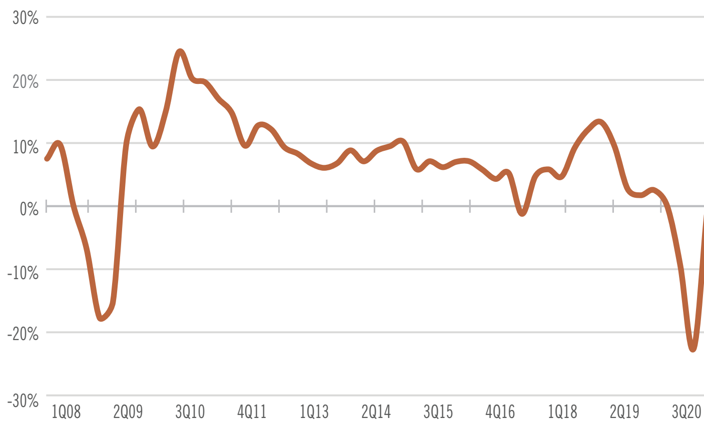
EXHIBIT 2: BANK LOANS VS OTHER ASSET CLASSES

As of 11/12/2020	Price	Yield to Worst	Duration to Worst (yrs)
U.S. Aggregate	109.6	1.23%	6.4
U.S. Treasury	108.7	0.60%	7.1
Investment Grade Corporates	114.2	1.95%	8.7
Securitized — ABS	103.3	0.56%	2.1
Securitized — CMBS	108.6	1.48%	5.3
Securitized — MBS	106.4	1.34%	3.4
Muni Bond	113.5	1.32%	4.9
Emerging Market USD Aggregate	102.9	4.37%	6.9
U.S. High Yield	102.2	5.00%	3.6
Bank Loans	**96.0**	**L+525**	**0.25**

Loans are calculated on a 3-year discount margin basis
All indices are Bloomberg Barclays
Loan market is the S&P/LSTA Leveraged Loan Index

Stabilizing Fundamentals – The decline in GDP as a result of COVID-19 has dramatically and negatively impacted borrower cash flows and has reduced the ability to cover fixed charges such as interest, scheduled amortization, and non-debt-financed capital expenditures. The hardest hit industries have been those directly affected by stay-at-home orders and other social distancing policies such as airlines, gaming/hotels/leisure, consumer related, commodities, and areas within healthcare.

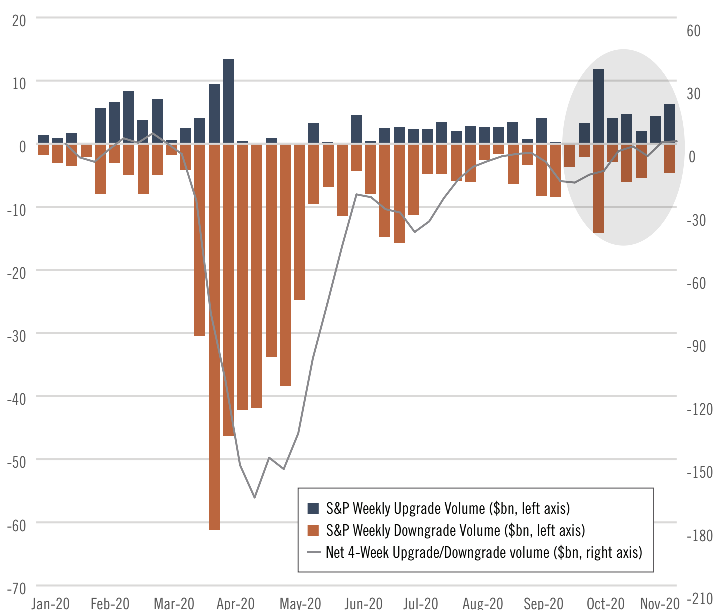
EXHIBIT 3: U.S. LEVERAGED LOAN ISSUERS – QUARTERLY EBITDA GROWTH



Data through September 30, 2020
Source: LCD, an offering of S&P Global Market Intelligence.

The result was a significant increase in downgrades and an increase in defaults (4.1% as of October), which have since slowed as monetary and fiscal support has provided liquidity even to the most troubled sectors. A bottoming of earnings in the second quarter and sequential improvement in the third (especially in less COVID-19-impacted industries), coupled with open capital markets, have removed some of the tail risk in the near/medium term.

EXHIBIT 4: UPGRADES ARE PICKING UP



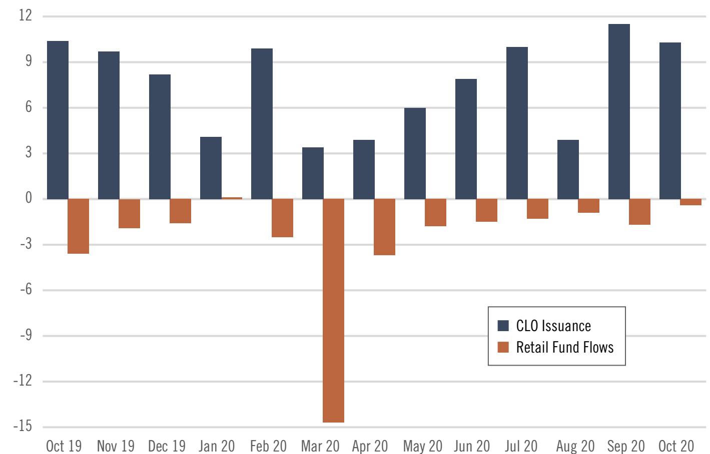
Source: Credit Suisse

Nonetheless, the velocity of downgrades and defaults took a toll on loan structured products, namely collateralized loan obligations (CLOs), as a number of vehicles reported failing a number of over-collateralization and interest coverage tests.

Improving Macro Backdrop – The U.S. economy was healthy prior to the COVID-19 exogenous shock and corresponding economic shutdown and should return to trend growth over time as treatments and vaccines become available. Additionally, stimulus could extend the constructive backdrop for credit risk. Pockets of opportunity still remain to take advantage of CLO-structure-induced dislocations.

Supportive Technical Factors – On the demand side, retail fund flows have been steadily negative, totaling over $19 billion year to date through October. The correlation between the U.S. 10-year Treasury and retail fund flows is highly positive. Thus, as the 10-year declined from 1.88% to start the year to 0.87% in October, retail investors continued to make redemptions.

EXHIBIT 5: CLO ISSUANCE AND RETAIL FUND FLOWS



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

Conversely, CLO issuance has totaled over $70 billion year to date through October. CLO issuance has healed since March and remains the primary buyer of loans, representing over 70% of the market. This is long-term, non-marked-to-market capital with no forced sell triggers, providing real ballast to the asset class. While CLO issuance is behind the 2019 pace, it reflects continued interest in an income-producing strategy from investors with long time horizons who find the benefits of a CLO wrapper attractive. We expect CLO issuance to be in the $80-90 billion area in 2021. Regarding new issue loan supply, issuance was down roughly 15% in 2020 due to limited M&A opportunities, but also a result of continued 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 flat in 2021 as refinancings slow, but it can pick up if investor demand grows in the face of a steepening yield curve.

With retail funds now accounting for only 6% of the market, we believe any further redemptions will be manageable. In fact, the prospects of fiscal stimulus, possible infrastructure spending (bi-partisan interest), widespread COVID-19 vaccine distribution and its impact on reopening the economy can potentially be inflationary, resulting in demand for loans by the retail community. Such incremental demand in a flat supply backdrop could result in higher prices.

LIBOR Cessation – Progress has been made regarding the end of LIBOR's useful life at the end of 2021. This includes the selection of a replacement — the Secured Overnight Financing Rate (SOFR) — and the insertion of fallback language into new and existing loan documentation to address when LIBOR is no longer quoted. The operationalization of the new rate also continues.

Areas of Concern – The impact of COVID-19 on public health and global economies will remain a major risk in 2021 until vaccines are fully approved and easily accessible by the general public. Until then, the threat of economic lockdowns to protect public health could result in further economic pain. Energy volatility, interest rate distortions created by global central bank accommodation, and a new U.S. government administration also may create pockets of volatility during the year.

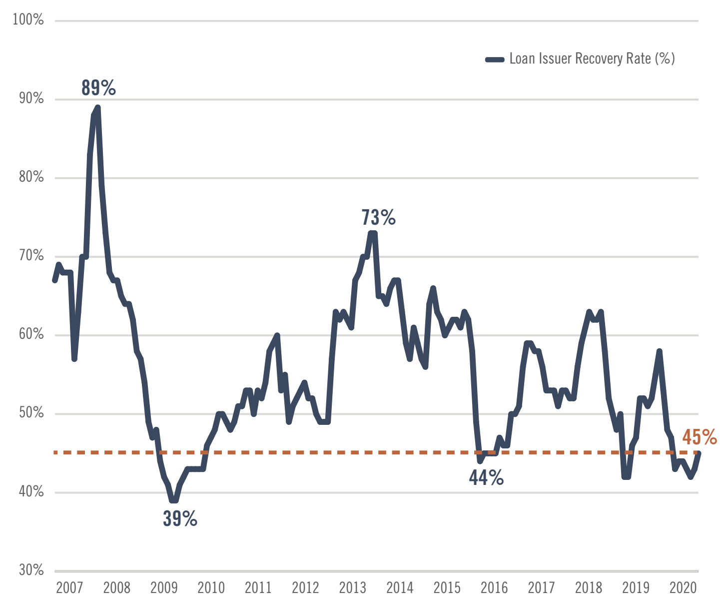
As it relates to the loan market, the degradation of credit quality coupled with aggressive or loose documentation terms are worth focusing on as they may impact loss given default assumptions driven by lower-than-historical loan loss recoveries. Indeed, while we continue to focus on credits with adequate capital structures and secondary sources of repayment, which typically enhance recovery, we have prudently reduced our internal recovery expectations to address these market developments.

EXHIBIT 6: DEGRADATION OF OVERALL CREDIT QUALITY

Date	Oct 2010	Oct 2015	Oct 2020
Total Outstanding ($ bil)	$509.75	$850.92	$1,191.92
Market Value Outstanding ($ bil)	$472.18	$797.16	$1,110.50
Number of Issuers	686	935	1155
Breakdown by Facility Rating (at Market Value)			
BBB+	1.09%	0.00%	0.00%
BBB	1.13%	2.26%	0.40%
BBB-	3.76%	5.79%	7.59%
BB+	9.03%	9.31%	7.20%
BB	14.41%	13.12%	5.10%
BB-	16.33%	15.87%	10.00%
B+	18.76%	17.12%	13.65%
B	12.00%	21.30%	25.78%
B-	6.24%	6.48%	18.35%
CCC+	1.78%	3.81%	5.24%
CCC	2.21%	0.81%	2.27%
CCC-	0.82%	0.12%	0.90%
CC	0.43%	0.08%	0.10%
C	0.01%	0.00%	0.02%
D	3.46%	1.57%	1.44%
NR	8.53%	2.38%	1.96%

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

EXHIBIT 7: LOAN ISSUER RECOVERY RATE



Source: Credit Suisse
Data through 10/31/20.

We expect the next twelve-month default rate to peak in the high single-digit area (from 4% today) and then slowly decline as COVID-19 vaccines provide a catalyst to economic recovery. This is generally in line with the credit rating agencies.

Implementation – Third quarter earnings have been reported, and the impact on our portfolios has been favorable. We are using cash proceeds generated by bond issuance used for par loan repayments to underwrite new loan issuance that is coming at wider spreads, as well as original issue discounts and LIBOR floors. We are also very active in the secondary market, buying discounted short-tenor loans of borrowers we believe have adequate capital markets access and corresponding strong paths to a par refinancing. Our constructive view on the market technical provides comfort to remaining fully invested. As we enter 2021, much of this strategy will remain unchanged, although we have now begun re-underwriting direct COVID-19-impacted credits as well, still looking for borrowers with adequate liquidity, but also businesses with staying power that may have been overlooked, especially in light of meaningful progress toward a treatment/vaccine.

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

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IMPORTANT RISK CONSIDERATIONS: Credit & Interest: Debt instruments are subject to various risks, including credit and interest rate risk. The issuer of a debt security may fail to make interest and/or principal payments. Values of debt instruments 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 are subject to credit and call risk, may be difficult to value, and have longer settlement times than other investments, which can make loans relatively illiquid at times. **High Yield Fixed Income Securities:** There is a greater risk of issuer default, less liquidity, and increased price volatility related to high yield securities than investment grade securities. **Leverage:** When a fund leverages its portfolio, the fund may be less liquid, may liquidate positions at an unfavorable time, and the volatility of the fund's value may increase. **Liquidity:** Certain securities may be difficult to sell at a time and price beneficial to the fund.

The **Bloomberg Barclays Emerging Markets Hard Currency Aggregate Index** is a hard currency Emerging Markets debt benchmark that includes USD-denominated debt from sovereign, quasi-sovereign, and corporate EM issuers.

The **Bloomberg Barclays Municipal Bond Index** is a market capitalization-weighted index that measures the long-term tax-exempt bond market.

The **Bloomberg Barclays U.S. Aggregate Bond Index** is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS.

The **Bloomberg Barclays U.S. Corporate High Yield Bond Index** measures fixed rate non-investment grade debt securities of U.S. corporations, calculated on a total return basis.

The **Credit Suisse Leveraged Loan Index** is a market-weighted index that tracks the investable universe of the U.S. dollar denominated leveraged loans. The index is calculated on a total return basis, is unmanaged and not available for direct investment.

The **S&P 500® Index** is a free-float market capitalization-weighted index of 500 of the largest U.S. companies. The index is calculated on a total return basis with dividends reinvested.

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. **LIBOR:** London Interbank Offered Rate.

The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment.

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