Bank Loan Market Update

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

APRIL 2021: OUTLOOK AND IMPLEMENTATION

- The steady positive return profile in loans resumed in April (up 0.51%) after a pause in March. This occurred despite an increase in new money primary issuance as leveraged buyout (LBO) and other merger & acquisition activity (M&A) created a healthy amount of supply.
- YTD, loans are up 2.3%, outpacing fixed rate (and longer duration) credit alternatives including Investment Grade bonds (down 3.4%), High Yield credit (up 2.0%), and the 10-year U.S. Treasury bond (down 6.0%).
- Riskier loans continued to outpace quality as investors continued to search for yield. CCC risk gained 1.3% in April while BB risk was up 0.28% and B risk gained 0.50%. The CCC cohort has now posted gains for 13 straight months.
- Industries with direct COVID-19 risk, including Energy (up 1.5%) and Leisure (up 0.90%), continued to outperform while defensive industries such as Utilities (down 0.10%) and Food (up 0.40%) underperformed.
- We anticipate the return profile in loans from this point to be centered around the coupon. While the small percentage of credits priced below 80 cents (now 1.1% of the market and the lowest since mid/late 2014) indicates some level of market health, it also provides a very limited opportunity set for total return potential going forward. In our view, this means loss avoidance and active credit selection are again the primary drivers of future outperformance in the near/medium term.
- Still, at a valuation of L+427 (on a 3-year average life basis), we believe that long-term strategic exposure to the space is warranted based on four major themes – few alternatives for real income, low correlation, duration risk management, and compelling long-term risk-adjusted return.

Fundamentals

- The fundamental environment is benign with supportive monetary and fiscal policies, liquid capital markets, credit upgrades exceeding downgrades, and the start of a strong 1Q earnings season. We are seeing top line growth and, just as important, cost savings. With almost half of the Russell 2000 having reported, 5% have beaten sales expectations and over 60% have exceeded earnings forecasts.
- Regarding rising costs, we are hearing strong anecdotal evidence from borrowers that they are announcing customer price increases and they appear to be sticking.
- All evidence points to continued fiscal and monetary support.
- U.S. GDP was 6.4% on a 1Q annualized basis driven by meaningful consumer pent-up demand – personal consumption increased an annualized 10.7% in 1Q, the second fastest rate since the 1960s – partially offset by continued supply chain/manufacturing bottlenecks.
- The default rate declined to 2.6% and now sits below the 2.9% historical average and inside the current cycle peak of 4.17% in September 2020. Fitch Ratings has lowered its default rate for 2021 to 2.5% from 4.5%. Fitch also lowered its 2022 default forecast to 2.5%-3.5% from 4%-5%. The revisions result in a 2020-2022 cumulative forecast of 9%-11%, which would finish below the three-year cumulative default rate of 15% during the 2008-2010 financial crisis.

Technicals

- Supply/demand is in balance as continued strong demand for floating rate income is offset by increased new primary issuance to finance LBO and M&A activity rather than the straight refinancing transactions we saw earlier in the year.
- Retail inflows totaled $5.7B, the fifth straight month (or 16 of 17 weeks) of inflows. YTD inflows now total $14B.
- CLO new issuance was $12.8B in April and $52.1B YTD – its best start since the Global Financial Crisis (GFC). Institutional demand for very short duration income is not dissimilar to retail and shows no signs of slowing given an attractive arbitrage between loan spreads and CLO liability costs and an adequate supply of new issue loans.
- Gross new issue supply was $53B in April with roughly over half issued to finance LBO and M&A transactions. YTD gross supply is $237.5B of which 44% is LBO/M&A, a pace of acquisition financing not seen since the GFC and perhaps a sign of corporate confidence (as well as low financing costs, of course).
- Repayments totaled $39B in the month, resulting in a net new supply figure of $14B.
- The forward net new issuance calendar has declined dramatically to less than $6B today from $20B to start the month.

Pricing

- Loan market prices inched up to 97.8, from 97.6 in March, and are at the highest level since October 2018. The majority of the market (70%) is priced between 98 and par.
- BBs were unchanged at 99.1 while B risk improved slightly to 99.0 and CCCs – 8% of the market – are now 92.

- Price improvement pushed loans trading over par to 15.6% of the market, up from 10.6% in March, but lower than the 35% in February. We expect repricing and refinancing deals to remain muted, all else equal.
- Loan spread to a 3-year life tightened to L+427 in April. For context, while we remain tight to historical (post GFC) averages (L+532), we have seen valuations tighten to mid L+300s during the last rising-rate environment of 2017/18.
- Spread differential between BB and B risk (+138 incremental spread) is also inside historical averages (+186), making security selection increasingly important. This delta was as wide as L+391 in March 2020.

Implementation

- With earnings season as the backdrop, we continue to focus our fundamental analysis on the identification of business models that may be permanently impacted by the pandemic and on the impact of rising raw material and labor costs on margins and debt service. A number of consumer-driven industries such as Retail, Consumer Products, and elements of Leisure and Services are getting additional scrutiny as we study the possibility of altered consumer spending and consumption habits.
- We will look to remain fully invested given the balanced technical backdrop, continued federal and fiscal support, and constructive fundamental picture.

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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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