Bank Loan Market Update

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

SEPTEMBER 2021: OUTLOOK AND IMPLEMENTATION

- ► A September to remember: near-record levels of investor demand have been able to adequately digest what all market participants expected – a near-record setting pace of LBO- and M&A-related new issue supply, including one of the largest LBO loans since the Great Financial Crisis (Medline Industries).
- ► The loan market returned 0.64% in September – an eight-month high.
- ► Loans are up 4.42% YTD, and up 8.4% on a last twelve-month basis.
- ► Return profiles across risk cohorts were consistent with recent months – BB risk up 0.52% and B risk up 0.64%, although continued investor reach for yield allowed CCC loans to outperform, returning 1.39% for the month.
- ► The Packaging industry was the only negative contributor in the month (down 1.10%) while the rally in Energy (up 1.07%), Commodities/Metals (up 1.77%) and Leisure Goods (up 1.19%) outperformed. The remaining sector returns were mostly evenly distributed (up 0.40% to 0.70%)

Fundamentals

- Continued monetary and fiscal policy accommodation has created a strong macroeconomic rebound. This coupled with a slowdown in Delta variant cases creates a very constructive backdrop for risk assets, but the near term is not without possible risk-off catalysts.
- The September Fed meeting saw GDP forecasts increase to 3.8% in 2022 and 2.5% in 2023 while inflation projections rose to 2.2% for 2022 (from 2.1% in the June meeting) and remained unchanged at 2.2% for 2023.
- Regarding the upcoming 3Q earnings season, company management teams are increasingly discussing stubborn supply chain bottlenecks, labor shortages, and consistently high raw material costs. While many have reduced operating costs and adequately raised prices to consumers, there is some level of risk around price elasticity of demand if the environment persists, which could negatively impact margins.
- The loan default rate is 0.35% – the lowest level since April 2012. Defaults should remain low in a backdrop of minimal distressed loans in the market (CCC totals 6.3% of the market and loans priced below 80 cents total less than 1% of the market), open capital markets access, and an improving macroeconomy.

Technicals

- Near record M&A-fueled issuance was met with strong demand driven by CLO creation. Investors are searching for low duration real income producing opportunities with low correlation to other fixed income asset classes as we get closer to a period with less monetary accommodation and, perhaps, more persistent inflation. Specifically, investors are especially focused on the impact a rising rate environment might have on their fixed rate portfolios.
- Retail inflows totaled $3 billion in the month – the tenth straight month of inflows – and now totals $26.8 billion YTD. Still, while retail portfolios (funds and ETFs) total $133 billion, they only account for roughly 10% of the market ($1.3 trillion).
- CLO issuance continues to be the demand driver, printing $17.4 billion of issuance in September, second only to a record August ($19.2 billion). This level of issuance is consistent with our market survey of open warehouses (demand) and a function of transactions being pulled forward ahead of the first step of LIBOR cessation at year-end. YTD issuance now totals $129.8 billion – breaking the 2018 record of $128.9 billion despite still having three months left in the year.
- At the same time, loan issuance exploded to $69 billion in September with roughly 60% tied to M&A financing. Only January 2017 ($78.0 billion) and March 2021 ($73.4 billion) printed more loans. Our capital markets network believes the pace of new issuance may slow going into year-end, but companies and private equity sponsors remain confident in deploying capital.
- Repayments totaled $17.8 billion in September as fewer refinancing transactions were announced. Still, we still expect the figure to remain healthy as open capital markets activity, increased amount of loans priced over par, and increased M&A transactions can all result in par loan paydowns.

Pricing

- Loan prices reached a post-pandemic high of 98.6, the highest level since October 2018.
- As prices continued to advance, loans priced above par rose to 26%, up from 15% in August, but still below the post-pandemic high set in February 2021 (35%).
- Today, roughly 78% of performing loans are priced at 99 or higher, limiting total return opportunities and creating a coupon clipping return environment.
- Spread on a three-year average life basis tightened slightly to L+413; the tightest level since October 2018 (L+376).

For Institutional Investor Use

- Valuation is tight to historic levels but remains strategically attractive for portfolios seeking real income with low correlation to other fixed income asset classes that can reduce duration risk.

Implementation

- As expected, our recent activity to harvest trading gains is allowing us to rotate into a large opportunity set via the primary new issuance market.
- With third quarter earnings season approaching, we have refreshed our thesis on several industries that may be negatively impacted by continued supply chain bottlenecks and rising input costs, including labor. We have actively reduced in areas including Retail, Packaging, and Manufacturing/Industrials while adding to less inflation-sensitive sectors such as Technology and Gaming.

Paul Privitera

Director – Institutional

Paul.Privitera@Newfleet.com

Phone: (860) 839-0705

Past performance is not indicative of future results.

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.

Newfleet Asset Management's industry trends and observations are the result of research conducted by the portfolio management / research team. These observations reflect their industry expertise and have been prepared using sources of information generally believed to be reliable; however, their accuracy is not guaranteed. Opinions represented are subject to change and should not be considered investment advice.

Investing is subject to risk, including the risk of possible loss of principal.

AR 1955939 10/2021

For Institutional Investor Use