Bank Loan Market Update

OCTOBER 2021: OUTLOOK AND IMPLEMENTATION

- Loan market prices, though down slightly in October (0.07%), were more than offset by coupon (.34%), providing a positive 0.27% total return. Steady strong demand outpaced a downshift in new issue supply as markets repriced rate hike expectations (sooner) and the 10-year Treasury yield increased to 1.55% since its 1.17% recent bottom on August 2nd.
- In this environment, loans bested Investment Grade (IG up 0.25%), High Yield (HY down 0.18%) and Treasuries (T down 0.12%). On a YTD basis loans are up 4.70% compared to IG (down 0.87%), HY (up 4.49%) and T (down 4.51%.)
- CCC risk was down 0.26% – only the second down month in 2021 – while BBs returned 0.23% and B risk was up 0.33%.
- The healthcare, auto, and radio/TV industries all posted negative returns while the best performing industries included energy, utilities, and metals/mining.
- SOFR-based loan sales are picking up, with loans arranged by JP Morgan and Bank of America successfully clearing.
- Senator Elizabeth Warren has recently introduced legislation called the "Stop Wall Street Looting Act of 2021." While the bill primarily addresses private equity (carried interest, deducibility of interest, dividend distributions, liability sharing), it does introduce two potential issues for the loan market. First, it would again categorize CLO managers as "securitizers." This would effectively reimpose risk retention requirements on managers, requiring them to buy and hold 5% of the fair value of CLOs they manage. Second, Title III of the bill, "Protecting Workers When Companies Go Bankrupt," would elevate unpaid wages and employee benefit contributions, among others, to administrative claims. This would put these items ahead of secured debt, in turn potentially diluting or negatively impacting a secured lender's recovery in bankruptcy. It's very early to make any conclusions, but it is worth following closely.

Fundamentals

- The 3Q 2% GDP print was impacted by supply chain issues and a stubborn Delta variant. Consequently, consensus growth expectations for 2021 have been revised down. Nonetheless, continued monetary and fiscal policy accommodation (even despite the start of the Fed taper) coupled with a COVID recovery and optimistic consumer data should create above-trend growth for 4Q21 and through 2022, recognizing that persistent inflation and supply bottlenecks could negatively impact it.
- With roughly 33% of the Russell 2000 having reported, both revenue and earnings results exceeded estimates by 3.3% and 17.2%, respectively. Nearly every call with management teams includes some level of supply chain, raw material costs, or labor shortage discussion. Many have reduced operating costs and adequately raised prices to consumers, but we are increasingly aware of the risk of price elasticity of demand if the environment persists.
- At 0.20%, the loan default rate is the lowest since December 2011 and approaching the record low of 0.15% in June 2007. Open capital markets have allowed borrowers – even stressed credits – to address balance sheets and push out maturities. An improving macro economy and invest or demand for yield have also provided support, reflected in a decline among leading indicators of future defaults such as loans priced below 80 (0.70%) or CCC cohort (6.1%).
- We believe it is too early to move up in quality due to growth, monetary accommodation, strong earnings, ample access to capital markets, and low distress.

Technicals

- Demand remains strong and is offsetting net new supply as investors remain focused on low duration and low correlation to traditional fixed income to actively manage the impact rising rates may have on their fixed rate portfolios.
- Retail inflows totaled $3.9 billion in October – the eleventh straight month of inflows – and now totals $30.7 billion YTD.
- CLOs printed $19.2 billion in the month – the ninth straight month of double-digit issuance. Managers may be pulling forward deals ahead of the LIBOR/SOFR transition. YTD issuance now totals a record $149.4 billion but next year's issuance could start the new year slowly as the market digests the LIBOR/SOFR transition.
- A notable CLO transaction priced during the month. Onex Credit Partners priced a CLO in which $84 million of the AAA slice of the structure was priced using 3-month SOFR as the base rate. We view this as a positive step in the CLO market and, in turn, future demand for the loan asset class.
- Gross supply decelerated to $49.2 billion, as has the new issue calendar, ahead of Thanksgiving and year-end.
- An abnormally high $2 billion of supply (versus $210 million in September) was also put back into the market via CLO liquidations this month, likely the result of investors looking to realize outsized, post-COVID positive returns.
- Repayments surged in October to $45.6 billion – the third highest on record. As we expected, open capital markets activity is allowing for refinancing and recapitalization transactions and M&A activity. After the month, Dell Corporation repaid its

$3.1 billion term loan with proceeds from its spinout of VMware – cash that portfolio managers will redeploy into the market.

Pricing

- Loan prices retreated slightly to 98.55, just off the September post-pandemic high of 98.62.
- Similarly, loans priced above par declined to 24.5% – a range where we think opportunistic repricing and refinancing transactions could still take place.
- Today, roughly 89% of performing loans are priced at 98 or higher, limiting total return opportunities and creating a coupon clipping return environment.
- Spreads on a three-year average life basis widened a touch to L+416.
- Valuation is tight to historic levels but remains strategically attractive for portfolios seeking real income with low correlation to traditional fixed income that can reduce duration risk.

Implementation

- We are modeling above-trend economic growth in 2022 and as such will look to remain fully invested.
- However, despite the favorable backdrop, our positioning will remain at market risk as the current thin valuation differential between B risk and BB risk (L+113) is inside historical measures including post-COVID (L+164), post-Great Financial Crisis (L+195), and all time (L+235).
- Our re-underwrite of inflation-sensitive sectors and credits with acute exposure to supply chain or labor shortage issues is ongoing, especially as we review fresh results during the third quarter earnings season. We have actively reduced in retail, autos, and areas of healthcare where labor is a challenge. Dollars have been redeployed into less sensitive businesses within the technology sector.
- A slower M&A issuance calendar and a healthy portion of the market priced above par could make way for repricing or refinancing transactions, which may even include a switch to SOFR-based execution.

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