2022 Bank Loan Market Outlook

By Frank Ossino, Senior Managing Director and Senior Portfolio Manager

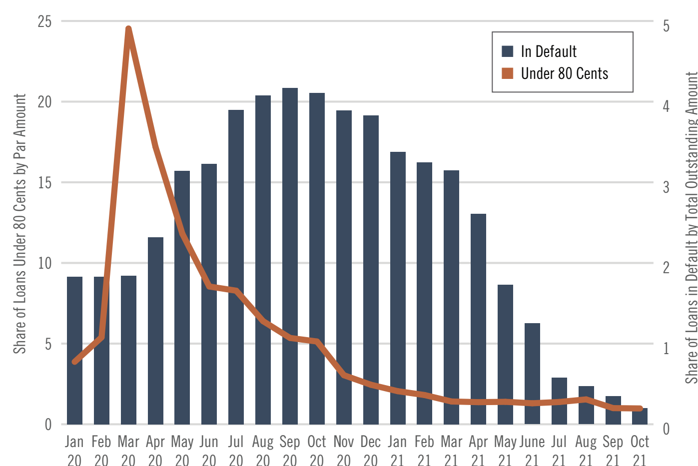
Frank Ossino, sector manager of bank loans, discusses his 2022 investment thesis: "We anticipate a coupon-clip return profile. The macroeconomic backdrop remains favorable, and the technical picture is healthy, but current valuations now make this a credit-picker's market because several current challenges may create idiosyncratic results among borrowers. Still, we remain constructive on the asset class as investors weigh the impact a rising rate environment might have on fixed rate portfolios. All this as we enter a major change in the loan market – the transition from LIBOR- to SOFR-based loans."

2021 Review – The bank loan market got off to a strong start as the interest rate curve steepened in response to additional government stimulus. The macroeconomic picture improved steadily in the first half of the year due to the vaccine rollout and successful cost reduction efforts from companies. By summer, a rise in Delta variant cases, China's capital markets crackdown, and the looming Fed taper negatively impacted credit risk assets, though it was short-lived.

With CLO issuance closing 2021 at a record high, demand for floating rate, income-producing investments allowed borrowers to push out maturities and strengthen balance sheets. Open capital markets also allowed companies to raise record amounts of loans—$621 billion by mid-November—for M&A, LBOs and other opportunistic uses including dividends.

Easing COVID-19 cases and a rapid post-COVID economic recovery has set up credit risk nicely going into 2022. However, this is partially offset by challenges created by such a rapid recovery, including labor shortages, supply chain disruptions, and still-high raw material costs. Indeed, the recent pickup in inflation and its impact on rates (and fixed rate investments) is making the thesis on bank loans increasingly attractive despite current valuations.

EXHIBIT 1: TOTAL SHARE OF LOANS PRICED UNDER 80 CENTS AND LOANS IN DEFAULT



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

Opportunity – In 2021, a low-default, improving fundamental environment was met with increasing interest rate volatility, which resulted in the loan market outperforming fixed rate sectors – YTD results illustrate this dynamic (Exhibit below). We believe we could see a continuation of this in the near and medium term.

The post-COVID price recovery has valuations currently sitting inside long-term historical averages, but in our view this still makes long-term strategic exposure appealing based on 1.) a real income opportunity in a global low (sometimes negative) real yield environment, 2.) low correlation to traditional fixed rate investments, and 3.) compelling return per unit of risk. This thesis is especially attractive as interest rates may currently have more of an impact on total return than credit risk.

EXHIBIT 2: FLOATING RATE LOAN TOTAL RETURNS COMPARED WITH OTHER ASSET CLASSES

As of 11/10/2021	Price	Yield to Worst	Duration to Worst (yrs)	YTD Total Return
U.S. Aggregate	105.2	1.69%	6.8	-1.53%
U.S. Treasury	102.9	1.17%	7.2	-2.48%
Investment Grade Corporates	110.6	2.24%	8.8	-0.86%
Securitized — ABS	100.8	0.93%	2.3	-0.21%
Securitized — CMBS	105.3	1.78%	5.1	-1.09%
Securitized — MBS	103.4	1.92%	4.7	-0.97%
Muni Bond	113.9	1.13%	5.1	1.14%
Emerging Market USD Aggregate	99.9	4.38%	7.1	-1.58%
U.S. High Yield	104.2	4.16%	4.0	4.89%
Bank Loans	**98.7**	**L+421**	**0.25**	**4.91%**

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

With loans closing the year priced near 99 cents, the COVID premium gone, and no signs of significant distress, total return opportunities are rare. Our next twelve-month return expectation centers around the coupon. However, we expect increased return dispersion across borrowers as idiosyncratic risks caused by current business challenges result in individual winners and

losers. As the market approaches par, credit selection will become increasingly important.

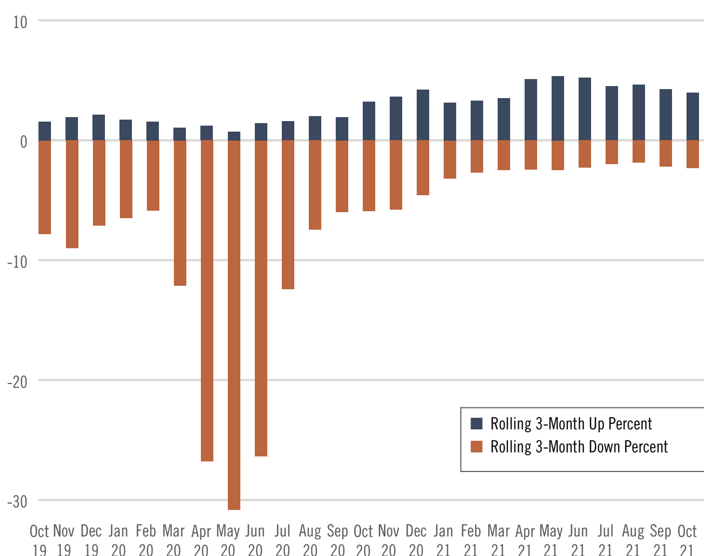
EXHIBIT 3: WEIGHTED AVERAGE BID OF US LEVERAGED LOANS

Data through October 31, 2021
Source: LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index.

Fundamentals have recovered – Anticipated above-trend growth will be constructive for credit risk assets, with domestic GDP finishing at 5.5% this year and estimated to hit 3.9% in 2022, according to Bloomberg market consensus data. While most calls with management teams addressed supply chain bottlenecks, raw material costs, and labor shortages, borrowers have done a very good job of passing price increases to consumers and realizing savings from cost reduction efforts.

Additionally, open capital markets also allowed borrowers to refinance their balance sheets and push out scheduled maturities. In this environment, credit agency upgrades have outpaced downgrades. We expect this favorable macroeconomic backdrop to continue going into 2022.

EXHIBIT 4: ROLLING 3-MONTH UPGRADES AND DOWNGRADES

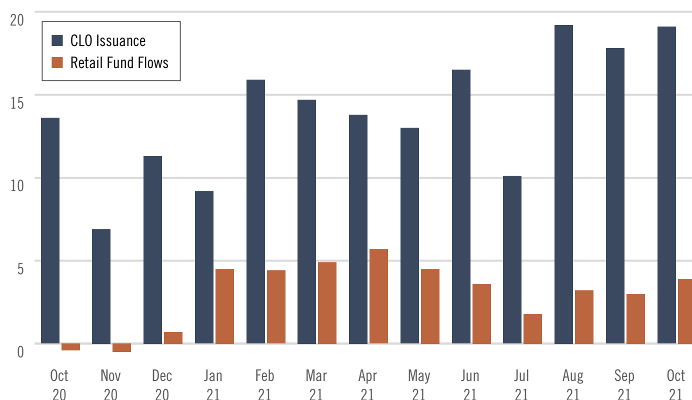


Source: LCD, an offering of S&P Global Market Intelligence.

Supportive Technical Factors – On the demand side, retail fund flows have been steadily positive with eleven straight months of inflows totaling over $30 billion year-to-date through October. The positive correlation between the U.S. 10-year Treasury and retail fund flows is very strong. Thus, as 10-year Treasuries increased from 0.92% at the beginning of the year to 1.55% in October, retail investors flocked to loans to manage duration risk.

In a rising rate environment (Fed Fund Futures point to two rate hikes starting mid to late 2022), we expect retail loan demand to continue.

EXHIBIT 5: CLO VOLUMES AND RETAIL FLOWS



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

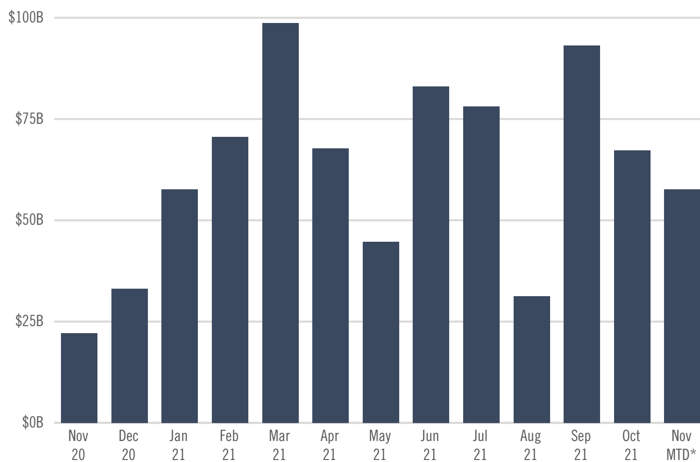
CLO issuance also benefited from institutional investor need for both income and interest rate management. An attractive cost of capital, stable new issue loan spreads, and a healthy new issue opportunity set created ideal conditions for CLO creation, which has now hit a full year record at $149 billion through October – nine straight months of double-digit volume.

We suspect some of this growth may be attributed to investors and CLO managers pulling forward issuance into this year ahead of the LIBOR/SOFR transition, so we expect 2022 volume to start slowly. Still, this long-term, non-mark-to-market capital with no forced sell triggers representing over 70% of the market will continue to provide real ballast to the asset class.

Regarding new issue loan supply, investor demand was met with increased volume as management teams and private equity investors became increasingly confident in executing M&A and LBO transactions. Institutional loan issuance is up over 130% versus last year.

All else being equal, we expect issuance to fall short of 2021 levels due to a lack of near-term maturities as well as a potentially slow start as the market continues to transition to SOFR-based loans. Still, loan issuance should remain healthy due to continued investor demand for low duration, income-producing opportunities in a rising rate environment.

EXHIBIT 6: LEVERAGED LOAN VOLUMES



Source: LCD, an offering of S&P Global Market Intelligence.
*MTD updated as of November 19, 2021

Areas of Concern – All eyes will be on the LIBOR/SOFR transition. The market has already begun to successfully launch, price and trade SOFR-based loans, while a handful of CLOs have also started issuing SOFR-based tranches. While these are both good signs that the market is embracing the transition, a change this dramatic may come with some initial volatility around LIBOR/SOFR relative value, pricing, and the impact on demand related to CLO issuance.

We believe the loan market will successfully work through the transition in the near term but suspect both new issue supply and CLO creation will start slowly and finish the year at less than 2021's volume.

Second, several indicators point to an increase in overall loan market risk, including an increase in single B risk, an increase in covenant-lite loan volume share, and a deterioration in credit agreement documentation over time. While we believe the fundamental environment will be attractive in 2022, negative catalysts such as a spike in COVID cases, Chinese economic volatility contagion, and inflation's impact on demand could all impact domestic growth, and in turn decrease debt service ability.

Put another way, a return to a less accommodative Fed and eventual return to on-trend (or lower) growth may result in today's incremental borrower becoming the inventory of future distress and defaults.

EXHIBIT 7:COVENANT-LITE AND SINGLE-B LOANS HAVE BECOME A LARGER PORTION OF THE MARKET

Date	Oct 2010	Oct 2015	Oct 2021
Total Outstanding ($ bil)	$509.75	$850.92	$1,299.44
Market Value Outstanding ($ bil)	$472.18	$797.16	$1,280.62
Number of Issuers	686	935	1163
% of Cov Lite Loans (at Par)	17.84%	64.02%	86.76%
Breakdown by Facility Rating (at Market Value)			
BBB+	1.09%	0.00%	0.00%
BBB	1.13%	2.26%	0.80%
BBB-	3.76%	5.79%	6.51%
BB+	9.03%	9.31%	6.49%
BB	14.41%	13.12%	5.14%
BB-	16.33%	15.87%	11.67%
B+	18.76%	17.12%	12.55%
B	12.00%	21.30%	27.26%
B-	6.24%	6.48%	21.23%
CCC+	1.78%	3.81%	3.64%
CCC	2.21%	0.81%	1.87%
CCC-	0.82%	0.12%	0.49%
CC	0.43%	0.08%	0.07%
C	0.01%	0.00%	0.00%
D	3.46%	1.57%	0.38%
NR	8.53%	2.38%	1.89%

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

Implementation – We are modeling above-trend economic growth in 2022 and will consequently look to remain fully invested going into the year. A combination of continued monetary accommodation and companies proactively addressing balance sheets and margins point us to another low default environment. As such, we believe it is too early to position portfolios up in quality.

However, despite the favorable backdrop, our positioning will remain at market risk as the thin valuation differential between B risk and BB risk (L+113) as of October falls within historical measures, including post-COVID (L+164), post-Great Financial Crisis (L+195), and all time (L+235).

During the early days of COVID, we focused our analysis on company liquidity. That work allowed us to then pivot to offense and take advantage of technical dislocations, the Fed-driven recovery, the vaccine-fueled reopening, and attractive total return opportunities. Since then, the COVID premium has dissipated.

We are now changing tack again. Today we are re-underwriting inflation-sensitive sectors along with credits with acute exposure to supply chain bottlenecks and labor shortages. We have actively reduced exposure to retail, autos, and areas of healthcare. Dollars have been redeployed into less vulnerable sectors such as technology and gaming as we navigate the impact of economic growing pains stemming from the post-pandemic reopening.

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

The **Bloomberg 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 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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