Bank Loan Market Update

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

DECEMBER 2021: OUTLOOK AND IMPLEMENTATION

- December's 0.64% return was a fitting close to a year that set multiple records and saw the first phase of the transition away from the loan market's base rate LIBOR.
- Full year return was 5.20%, driven by investor demand and steadily improving credit fundamentals during the year. The loan market has now averaged 4.93% annually since the global financial crisis (2010-2021).
- Lower quality loans finished the year as the best performing cohort in 2021, up 12.45%, while BB risk was up 3.12% and B risk was up 5.22%.
- All industries except utilities (down 0.06%) were up in December. On a full year basis, the COVID recovery was demonstrated in industry outperformance within airlines, hotels & gaming, leisure activities, and autos. Energy and metals/mining posted double digit gains but account for less than 3% of the market. The only down industry for the year was radio & TV (down 0.75%).
- The market transition to SOFR-based loans is now "live".
- To learn more on our view on loan performance for the upcoming year, read our 2022 Bank Loan Market Outlook.

Fundamentals

- Macroeconomic forecasts have been walked down (consensus GDP growth is 3.9% in 2022 and 2.5% in 2023) as the impact of labor shortages, raw material costs, supply chain bottlenecks and a stubborn pandemic persist. The stalled Build Back Better spending bill has also contributed to the possibility of slower growth in 2022.
- The possibility of higher interest rates to curb inflation is increasing at a time when growth could be slowing. Fed Fund Futures point to three rate hikes in 2022 and another three hikes in 2023.
- Still, we continue to believe that we will grow above-trend in 2022 and recognize the resilience showcased by borrowers last year. We are mindful that persistent inflation, supply chain bottlenecks, and COVID variants could create both broad based and idiosyncratic volatility.
- With no defaults in December, the default rate remained at 0.29% – near the all-time low of 0.15% set in June 2007 and well inside the historical average default rate of 2.82%. In 2021 only five issuers totaling $3.4 billion in debt defaulted versus 50 issuers with $45.7 billion in debt in 2020. Open access to capital provided liquidity for borrowers to refinance existing debt and push out maturities. Earnings growth also aided in debt service as (EBITDA less CAPEX)/Interest expense improved to 3.3x – its highest level since 2011.
- There is simply very little stressed inventory outstanding – loans priced below 80 account for less than 1% of the market, CCC risk accounts for 5.2% of the market, and only 9% of borrowers maintain interest coverage less than 1.5x – so our next twelve-month default forecast is less than 1%.

Technicals

- Supply and demand both downshifted in the month after both posting a memorable year.
- Retail inflows totaled $2.6 billion in December – thirteen straight positive months and 48 of the last 52 weeks – and now totals $38 billion YTD. We expect retail demand to continue if a rising rate environment does develop. While today retail makes up roughly 10% of the market, that share has been as high as 20% in 2017/18 (rising rate period) and 30%+ in 2013 (taper tantrum).
- CLOs printed $10.8 billion in December. Volume slowed in the month because managers had been aggressively coming to market with transactions earlier ahead of this year's transition to SOFR. While new CLO issuance could be slow to materialize as investors weigh return profiles in a SOFR-based world, we believe the resilience of the structure coupled with its protection against rising rates and its real income stream should continue to create interest. The record amount of issuance ($180 billion+) in 2021 is a testament to that. Japanese investors and favorable changes to insurance company capital requirements to hold CLO exposure should only add to demand.
- Gross supply was $13.8 billion in December, the lowest level in a year which totaled a **record** $615 billion in gross issuance. Just over half of this issuance was M&A related – a **record-setting** amount. The loan market now stands at $1.35 trillion – **another record**.
- Repayments totaled $37.5 billion and includes year-end scheduled amortization. For the full year, **a record** $362 billion of loans comprising 30% of the market were repaid, driven both by M&A activity and the refinancing of existing debt with new loans which were, in many cases, repaid via a high yield bond offering.

Bank Loan Market Update

Pricing

- Loan prices improved to 98.6, up from 96.2 to start the year. We are going into 2022 at the highest level since the global financial crisis.
- The grind higher was reflected in loans priced at par or higher, which now accounts for 15.4% of the market. This is up from 6.0% in November, but less than the 2021 high set in February of 34.7%. The share of loans at 99 or higher now accounts for 75% of the market.
- Prices may suggest limited price upside (which we tend to agree with and forms our “coupon-clip” return forecast) but we recognize that the market has previously reached higher levels still. For example, in December 2019 loans at par or higher accounted for 53% of the market.
- Even the riskier cohorts of the market are demonstrating stretched valuation with nearly 20% of the CCC cohort priced at par or higher.
- Spreads on a three-year average life basis tightened to L+428. Though this number is inside historical averages (post-global financial crisis average is L+526), it is still attractive from a long-term strategic perspective (compared against a tight of L+371 reached in September 2018 during the last rising rate period), especially because bank loan exposure actively addresses duration management, income, and return per unit of risk.

Implementation

- As the year begins, the primary new issuance calendar is slowly reopening. Still, we suspect volume could be lighter than normal until the CLO issuance market finds its legs through the LIBOR to SOFR transition.
- We ended 2021 with a high pass-rate and will continue to scrutinize all transactions.
- Portfolios are entering the year fully invested to take advantage of our view around a benign credit environment and continued demand for floating rate exposure.
- Our positioning will remain at market risk. While the COVID premium has dissipated, the yield differential between B risk and BB risk is inside historic averages, and valuations at lower credit tiers are historically unattractive, the fundamental and technical backdrops tell us it is too early to go up in quality.

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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.

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