Bank Loan Market Update

APRIL 2022: OUTLOOK AND IMPLEMENTATION

- The back-half rally in March continued into April until investors turned their focus on economic uncertainty and the ability of borrowers to service their debt amid rising rates, leading lower-rated cohorts to weaken. Loans gained 0.22% in April and continued to recover February's losses on a total return basis as market prices (down 0.13% in April) leaked for the fourth straight month, though this was offset by coupon gains (0.35%).
- YTD, loans (up 0.11%) are outperforming high yield (-8.0%), S&P 500 (-12.9%), and investment grade bonds (-12.3%).
- As investors increasingly focus on economic growth, CCC risk continued to underperform (-0.50%) compared to BB (up 0.42%) and B risk (up 0.19%).
- Curiously, the largest loans, or L100, underperformed (-0.12%). We suspect this was driven by crossover investors that typically buy the largest credits to gain market exposure who are now reallocating.
- Supply chain-sensitive industries underperformed, including home furnishings (-2.12%), building materials (-0.58%), autos (-0.48%), and retail (-0.24%). Meanwhile, energy (up 0.67%) and less inflation-sensitive industries such as utilities (up 1.02%), outperformed.
- The Fed unanimously raised the Federal Funds Rate by 50 basis points (bps) at the May meeting – the steepest incremental increase since 2000 – and announced the start of its balance sheet reduction program ($47.5 billion) on June 1st. Current expectations are for a 50-bps rate increase in each of the June, July, and September meetings. <u>With that, our base rate (LIBOR and SOFR) should steadily increase, and, in turn, provide a higher distribution yield to investors.</u> Note, however, that the higher cost of capital could hurt marginal borrowers, making active management critical.

Fundamentals

- Reported 1Q earnings have exceeded expectations. With 85% of the S&P 500 market cap reporting, earnings are beating estimates by 6.8%, with 77% of companies topping projections.
- Still, concerns around persistently high inflation and its impact on growth is walking down 2022 US GDP growth forecasts again to 3.2% from 3.4% last month.
- <u>We expect growth to decelerate but still stay at a level that is adequate for credit, above the 20-year trend line average of 1.9%.</u> A low unemployment rate of 3.6% in March, with demand for labor exceeding supply, points to a still-healthy economy.
- While the 2022 CPI consensus forecast is 6.9%, the 2023 estimate declines to 3.0% in 2023 and 2.0% in 2024. The 5-year inflation breakeven rate also shows declines (3.2%) from recent highs in March (3.7%).
- <u>Interest coverage is currently strong (1Q22 Non-Adjusted EBITDA less CAPEX/Interest of 3.3x versus 2.9x in 2008). Our sensitivity analysis points to adequate debt service cushion pro forma for a rising rate environment and reductions in cash flow. But we recognize that the marginal borrower, particularly the 15% of the loan market with interest coverage of less than 1.5x, may be negatively affected.</u>
- With no new bankruptcies in the last four months, the loan default rate sits at 0.18%, just above the 2007 record low of 0.15%. We would expect a slow uptick in defaults in the next 12 months, but still well below the historic average (2.8%).

Technicals

- Demand is still strong among CLO portfolios and retail funds. We suspect that multi-asset, crossover, credit hedge funds, separately managed accounts, and other non-traditional loan investors may be putting pressure on loan prices as they rotate into other asset classes based on relative performance.
- Retail inflows hit $6.3 billion in April. We expect this demand to remain elevated, especially as the current distribution yield starts to increase in line with higher base rates.
- CLO issuance ($13.6 billion) exceeded March ($11.2 billion) – a sign that institutional investors still find the floating rate asset class attractive. YTD issuance of $44.3 billion is 17% off last year's pace, though 2021 was a record issuance year. We consider monthly issuance over $11 billion to be adequate demand.
- New issue volume increased to $35.8 billion, but YTD levels are still roughly 37% behind last year. The forward calendar is very manageable at roughly $20 billion, but notable transactions that will enter the pipeline shortly are Citrix Systems ($7 billion), CDK ($4.4 billion), Nielsen Holdings ($6.4 billion), and Twitter (expecting $6.5 billion).
- Repayments totaled $22.3 billion. We expect this form of demand to remain volatile as the maturity wall remains minimal, few loans are trading above par, and any increased cost of debt could slow refinancing and high yield issuance that might have been used to repay loans.

Bank Loan Market Update

Pricing

- In early April, loans fully recovered their pre-Ukraine invasion levels, reaching 98+ bps. However, prices retreated to end the month at 97.5 as risk assets sold off.
- The recent softness in price puts only 1% of the market at par or higher. 72% of the market is priced at 98-100. As it relates to stressed credits, 1.6% of the market is priced at 80 or less, well inside the five-year average of 3.5%
- At current levels, loan valuations are +448 bps on a 3-year DM basis. Note that the base rate portion of total return is steadily increasing – consistent with a rising rate environment. For example, using the consensus 2022 3-month SOFR rate of 1.97%, go forward return expectations could be in the 6-7% area, with all else being equal.
- Both the primary and secondary markets are repricing risk wider.

Implementation

- Heightened selectivity, especially around first-time issuers, or credits with interest coverage less than 2x, has resulted in cash balances for our portfolio that are slightly higher than the historical average – dry powder as the market reprices risk.
- We have pivoted up slightly in credit rating quality – specifically, increasing BB risk by over 3% in the month while reducing B risk by 2% – and have concentrated investments in seasoned borrowers where we have had a long history following the business and its drivers.
- Inflation mitigation continues as we increase exposure to less inflation-sensitive industries such as technology while reducing exposure in food/beverage, packaging, and manufacturing.
- Potential ratings degradation could affect CLO structures, especially as B risk now accounts for 27% from just 9% five years ago. We are underweight CCC and B- cohorts. After reviewing our lower tier credit exposure, we are currently comfortable with our debt service tail risk.

Paul Privitera

Director – Institutional

Paul.Privitera@Newfleet.com

Phone: (860) 839-0705