Bank Loan Market Update

Newfleet Asset Management — A Virtus Investment Partner

MAY 2022: OUTLOOK AND IMPLEMENTATION

- ► The loan market was down 2.56% in May, posting the third worst month since the Great Financial Crisis, only behind March 2020 (down 12.37%) and August 2011 (4.41%). Increasing recessionary concerns spurred by persistent inflation and the impact of higher interest rates on borrowers made its way into the loan space.
- ► Still, YTD, loans (down 2.45%) are outperforming high yield (-7.76%), S&P 500 (-12.76%), and investment grade (-11.86%).
- ► In this backdrop, CCC risk continued to underperform (-3.87%), as did B risk (-2.85%), while BBs were down 1.77%.
- ► Supply chain- and inflation-sensitive industries underperformed, including home furnishings (-6.65%), food/beverage (-4.43%), packaging (-3.89%) and retail (-3.73%). Meanwhile, less inflation-sensitive industries and reopening businesses, including utilities (-2.19%), casinos/lodging (-2.06%), and supermarkets/drug stores (-1.98%), outperformed.
- ► We expect a 50 bps increase to the Federal Funds Rate in each of the June and July meetings. Our base rate (LIBOR and SOFR) has already begun to increase after the March and May rate hikes and is now being reflected in higher current coupons and investor distribution yields.

Fundamentals

- Fundamental environment is tenuous – a fine line between a soft landing and varying degrees of recession.
- U.S. GDP forecasts for 2022 declined from 3.2% to 2.6% during the month. Our expectation of slowing but still adequate growth stays unchanged. Still, with 2023 U.S. GDP forecasts now at only 2% (and 2024 consensus growth at 1.9%), our macro concerns have grown.
- Downgrades exceeded upgrades in the month, with inflation and supply chain pressures driving nearly 30% of the downward rating actions. This puts the rolling 3-month average of downgrades to upgrades at 1:1. For context, the ratio has averaged 1.4 downgrades to 1 upgrade for the (normalized) period between January 2010 to December 2019.
- Slower growth may help the Fed by easing supply chain bottlenecks and lowering prices as demand declines. We see this in a softer five-year breakeven rate this month (declined from 3.3% to 2.9%), and 2023 U.S. CPI consensus steady at 3% from the current annualized 8.3% level.
- May recorded the first loan default of 2022 – Talen Energy. The default rate rose to a still-very-low 0.21%.

Technicals

- Demand waned as economic uncertainty weighed on risk assets.
- Retail reported $4.3 billion of outflows in May – the first negative monthly reading in 18 months. Fund flows have turned positive again in early June as both valuations and an increasing distribution yield re-focused investors.
- CLO issuance ($13.5 billion) remained surprisingly resilient. YTD issuance of $57.7 billion is only 14% off last year's record pace. However, AAA liabilities steadily widened during the month, making the structure arbitrage increasingly difficult. We expect that macro concerns coupled with less-than-attractive arbitrage as we enter the slower summer months could be a headwind for this large component of demand.
- New issue loan volume fell sharply to $6.5 billion. Excluding seasonally slow December and August periods, this is the lowest level in two years, and the second lowest volume month since the Great Financial Crisis. YTD volume levels are roughly 43% behind last year. Light issuance volume could be a partial offset to slowing demand.
- Repayments slowed to $14.5 billion as market volatility reduced refinancing activity.

Pricing

- May's decline put loans at 94.6 after reaching lows of 93.8 late in the month. We were as high as 99 in mid-January.
- Less than 1% of the market is priced at par or higher. The 95-98 cohort now makes up 60% of the market from just 18% in April. Loans trading below 80 are still low at 2% of the market, but the amount has increased since the start of the year.
- At current levels, loan valuations are +551 bps on a 3-year DM basis. More specifically, we see valuations wide to historic averages (since 1997) at all rating levels except the riskier cohorts, which remain tight to averages.

	BBB	BBB-	BB+	BB	BB-	B+	B	B-	CCC+	CCC	CCC-
5/31/2022	L+256	L+292	L+309	L+414	L+448	L+482	L+583	L+647	L+1223	L+1194	L+178
Average	L+259	L+280	L+298	L+344	L+399	L+475	L+561	L+782	L+1129	L+1530	L+230

- This drives our view of pivoting into higher-quality loans, but also an increasing dollar cost average opportunity, especially as distribution yield increases.

- Indeed, our trading relationships tell us of opportunistic and other non-traditional loan investors entering the market at current levels, which explains the early June price gains.

Implementation

- Our pass rate has been high and has resulted in higher-than-normal cash balances for our portfolio.
- We will likely look to selectively take advantage of the upcoming primary issuance market, which we expect will come with wide spreads and new issue price concessions.
- Focus remains on credit rating quality, seasoned issuers, and industries that are less sensitive to inflation.

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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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