Bank Loan Market Update

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

JUNE 2022: OUTLOOK AND IMPLEMENTATION

- After a 2.56% loss in May, the loan market recorded another 2.16% loss in June, marking the first back-to-back monthly losses in the loan market since February/March 2020 and November/December 2018 before that. The two month loss ranks only behind the February/March 2020 loss of 13.53% as the worst in the last ten years. The last time loans posted such declines prior to the pandemic was August 2011 (down 4.40%) as S&P downgraded the U.S. credit rating. As recession fears intensify, risk markets have clearly shifted from re-pricing interest rate risk to credit risk.
- Still, YTD loans (down 4.55%) are outperforming high yield (down 14.04%), S&P 500 (down 19.96%), and investment grade bonds (down 13.93%).
- CCC risk posted its fifth straight month of losses (down 3.49%). B risk was also down 2.30%, while quality BB continued to outperform (down 1.77%).
- All industries declined in June, with home furnishing (down 3.69%), paper/packaging (down 3.14%) and cosmetics (down 2.86%) leading the underperformers, while commodity-based industries such as energy (down 1.17%) and metals/mining (down 1.42%) outperformed.
- At L+663 (3-year discount margin basis), current valuations are introducing some total return, recognizing that markets are still re-pricing credit now. This, coupled with a rising base rate (and commensurate coupons) may provide a dollar cost average entry point for long-term investors. For context, the following is a list of loan market valuations during historic periods of volatility: the 2002 tech recession (+593), the 2011 US downgrade (+717), the 2015 energy crisis (+714) and the late 2018 Fed pivot (+551). We view the 2008 GFC (+2373) and March 2020 Covid (+1076) as outliers.

Fundamentals

- Fundamental environment is tenuous, and investors are increasingly pricing in a recession scenario.
- Federal Reserve U.S. GDP forecasts for 2022 and 2023 were reduced to 1.7% for each year during the June Fed meeting. This is down from the 2.8% and 2.3% forecast, respectively, at the March meeting. Our expectation of slowing but still adequate growth is unchanged, but we recognize that marginal borrowers may be impacted. Indeed, downgrades exceeded upgrades for a second straight month.
- As we enter 2Q earnings season, current consensus is for 5.3% earnings growth. Management forward guidance will be critical and could create price volatility.
- Slower growth appears to be helping the Fed by easing supply chain bottlenecks (Shanghai to Los Angeles Container Freight Benchmark Rate was down 12.3% in June) and lowering commodity prices (the Bloomberg Commodity Spot Index was down 13% in June). Accordingly, the 5-year Breakeven Rate this month declined further to 2.5%. This is down from a high set on March 25th (3.7%). But the market will ultimately need to see CPI trend lower.
- June saw Revlon Inc. default, which pushed up the default rate to 0.28% − still well below the 2.8% historic default rate.

Technicals

- Demand continued to fade, especially among retail investors, as economic uncertainty outweighed higher rates.
- Retail reported $5.8 billion of outflows in June – the second straight month of redemptions.
- CLO issuance ($12.6 billion) remained surprisingly resilient. YTD issuance of $71.4 billion is only 14% off last year's record pace. While AAA liabilities continue to widen, making the structure arbitrage increasingly difficult, managers and investors are finding creative ways to structure portfolios and come to market. We have seen an increasing amount of "Print & Sprint" transactions whereby a CLO portfolio is quickly constructed to take advantage of current valuations. This implies there is a level where institutional investors care to add exposure. This acts as a good barometer of where demand lies. Still, a less than attractive arbitrage as we enter the slower summer months could be a demand headwind.
- New issue loan volume improved to $15.9 billion in June, up from only $6.5 billion in May, and was driven largely by a single transaction – CDK Global ($3.6 billion). Still, YTD volume is roughly 50% behind last year's pace as M&A and leveraged buyout activity has slowed and the cost of capital to finance transactions has increased. The light issuance volume is partially offsetting less demand.
- Repayments declined further to $12.8 billion, the second lowest number ($10.9 billion in March 2022) in nearly two years. Volatile capital markets and depressed loan prices are making refinancing transactions nearly non-existent.

Pricing

- Loan prices reached 92.2 in June – the lowest since August 2020 – and down over 5 points in the last two months as markets reprice credit risk. We were as high as 99 in mid-January.

- The volatility has dramatically shifted the price mix since April. Today, only 3.9% of loans are priced over 98 compared to 73.1% in April. There are virtually no loans priced over par versus 15.4% of the market over par coming into 2022. Instead, now roughly 55% of the market is priced 90-95 versus 6% only two months ago.
- Regarding the stressed parts of the market, loans below 80 continue to rise and now comprise 2.8% of the market. While low, the 80-90 cohort has increased to 13.4% from 1.4% in April.
- A level of total return opportunity has entered the market. At current levels, loan valuations are +663 bps on a 3-year DM basis. This prices in a 6-7% default rate at current levels.

Implementation

- We continue to hold a cash position, ready to take advantage of dislocations in the primary and secondary markets as they arise.
- Focus remains on de-risking the portfolio by re-allocating to higher quality credit, adding to seasoned issuers we have historically monitored, and industries that are less sensitive to the current inflationary environment.

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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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