Bank Loan Market Update

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

AUGUST 2022: OUTLOOK AND IMPLEMENTATION

- The July rally driven by lower CPI and strong jobs numbers lost some steam in August as slowing growth and a very vocal Fed reminded markets of its firm commitment to fight inflation at the expense of economic growth.
- Loans gained 1.54%, but sentiment weakened over the month, especially around the Fed's Jackson Hole meeting.
- Year-to-date, loans (down 1.01%) are outperforming high yield (-11.04%), the S&P 500 (-16.14%), and investment grade bonds (-13.75%).
- CCC risk posted its first positive month (up 0.94%) since January, and BB risk was up 1.38% and is now positive for the year (up 0.29%). Single B risk gained 1.66%.
- All industries posted positive returns in August, with building products (4.04%) leading the way while healthcare, a traditionally defensive sector, underperformed (0.40%).
- Current market valuation of SOFR+354 at $94.6 implies a total return opportunity in the 8%+ area. These are long-term equity-like return expectations with the added benefits of duration management (floating rate) and credit risk management (seniority and secured).

Fundamentals

- Fundamentals have become more challenging as the Fed's commitment to fighting inflation leads to a continued path of higher rates while growth slows. The full impact of these rate increases will become more apparent in coming quarters.
- Downgrades have exceeded upgrades for four straight months.
- The month saw four companies default, increasing the default rate to 0.60%, up from historic lows of 0.28% in July.
- Still, better recent inflation data and improved supply chain issues may allow the Fed to slow the tightening cycle sooner than expected. This, coupled with continued health in the labor market, could point to a soft landing.

Technicals

- Very thin supply was met with equally light demand.
- Retail reported $2.1 billion of outflows in August – the fourth straight month of redemptions despite a rising rate environment.
- CLO issuance of $7.6 billion marked the lightest amount since January ($4.9 billion) as a combination of improved loan prices in July and early August and wide CLO liabilities continued to make the equity arbitrage challenging for many managers. We are keeping an eye on increasingly aging CLO warehouses that might be forced to liquidate if issuers cannot find a way to come to market.
- New issuance supply was $5.8 billion in August. While August is typically slow, we have not seen such low levels since March 2020. For further context, new supply was $20.3 billion in August 2021.
- The primary issuance market is reopening. The long-awaited Citrix Systems transaction has officially launched. The syndication of Citrix along with TV ratings company Nielsen Holdings and auto supplier Tenneco Inc could dictate the tone of the technical in the near term.

Pricing

- Loan prices were up $0.92 to end the month at $94.56. We were as high as $99 in mid-January.
- There are effectively no loans trading at par or higher. The bulk of the market (74%) is in the $95 to $100 area.
- Regarding the stressed parts of the market, the total share of loans below $80 continued to creep higher up to 3.3%. We started the year at 1% of the market below $80. Still, the 10-year historic average is 4% and has reached 10% of the market in other periods of stress, including the 2011 U.S. downgrade and the 2015 oil mini-cycle.
- At L+562 (3-year discount margin basis) and a $94.6 dollar price, spreads remain wide of long-term averages and have total return potential, given the discounted average price. With interest rates expected to keep rising (including a 0.75% increase at the September Fed meeting), we believe this marks an attractive dollar cost average entry point for long term investors. For context, loan market valuations during historic periods of volatility include the 2002 tech recession (+593), the 2011 U.S. 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

Implementation

- The primary market could look attractive, as its deals may need to arrive with compelling terms to clear the current environment.
- As investor angst increases around slowing growth and its impact on credit markets, our current up-in-quality position has performed well. We expect to maintain our current positioning.

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Past performance is not indicative of future results.

The **Morningstar 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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