Bank Loan Market Update

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

OCTOBER 2022: OUTLOOK AND IMPLEMENTATION

- The loan market bounced back to a 1.03% gain in October. However, loans are still down 2.25% on a YTD basis and on track for its third annual loss in history (down 0.69% in 2015 and down 29.10% in 2008)
- However, in the current rising rate environment, loans continue to outperform fixed rate and rate-sensitive assets on a YTD basis, outperforming high yield (-12.18%), the S&P 500 (-17.70%), and investment grade bonds (-19.56%).
- While much of the outperformance is duration-related, interest income has increased from 0.34% per month in January to 0.65% in October, which allows increased income cushion to partially offset price volatility.
- Higher-rated credits outperformed as investors increased scrutiny on lower-rated tiers, especially credits with downgrade risks. BBs were up 1.83%, while B risk was up 0.87%. CCCs declined 0.94%. <u>BB risk is now positive for the year (up 0.91%).</u>
- Underperforming industries included healthcare providers & services (-0.70%) and entertainment (-0.60%). Outperformers included airlines (+2.18%), aerospace & defense (+1.94%) and subsectors of energy and utilities.
- <u>Current market valuation of SOFR+355 at $92.2 implies a long-term total return opportunity in the 10% range. Even modeling in a 6% default rate and a 50% loss rate on defaults, this would imply risk-adjusted returns that approach long-term equity-like performance while maintaining the benefits of low duration, seniority, and security.</u>

Fundamentals

- On balance, third quarter earnings have been acceptable thus far. However, the forward guidance (or lack thereof) increasingly includes commentary around waning consumer/demand headwinds. The technology sector has been aggressively announcing layoffs in recent weeks. As it typically takes 12-18 months to flow through the economy, the full impact of rate increases will become more apparent in coming quarters. Remember, the rate hike cycle only started in March 2022.
- In the meantime, the three factors that the Fed is watching – unemployment, inflation, and capital markets access – all suggest the Fed still has room to tighten, albeit at a slower pace.
- The rolling three-month downgrade-to-upgrade ratio increased for the fifth straight month to 2.5 downgrades for every one upgrade. Rating downgrades directly impact cost of debt and capital markets access, and could be a precursor to rising defaults. For context, the ratio reached near 6:1 during the 2000-2002 recessionary period, which led to a default rate of around 6%.
- The default rate decreased slightly to 0.83%, with no defaults in the month. With 7.1% of the loan market priced below $80 amid increasing downgrades, our view is that defaults could walk up to a 3% rate at the end of 2023 − generally in line with historic averages.

Technicals

- <u>Retail and institutional demand continue to slow, but material par repayments and nearly non-existent primary loan issuance keep the technical in balance.</u>
- Retail posted $5.8 billion of outflows in October – the sixth straight month of redemptions after 17 straight months of inflows − as credit risk outweighs duration risk. Year-to-date, flows have flipped to negative $4.4 billion.
- CLO issuance slowed to $8.7 billion from $13.3 billion in September. This is due to investors scrutinizing underlying loan credit concerns, a lack of new issue loan supply, and recently, the lack of AAA-rated note appetite from traditional investors, including Japanese buyers and U.S. banks. Still, at $114.6 billion, CLO creation has been surprisingly good on a YTD basis, putting it on track to be a top-three year, behind only 2018 and 2021.
- New issuance loan supply was very muted – $7.3 billion – as M&A and other private equity-sponsored activity dried up.
- One positive note was the repayment of $20 billion of loans at par during the month. Managers were then able to redeploy cash into the market, and, in turn, support prices.
- The transaction pipeline (Citrix, Nielsen, Twitter) has been addressed largely by the arranging banks owning some or all of the loan. Tenneco is the next larger LBO to test the market for lower-rated, cyclical new issuance.

Pricing

- Loan prices improved slightly to $92.19. The level is just $0.45 above the July intra-month low of $91.75, but well below the mid-August high of $95.50. Recall we started the year at $98.64.

- There are effectively no loans trading at par or higher. Loans trading above $95 totaled 52.3% of the market, up from 45.6% in September as prices improved.
- However, the total share of loans below $80 increased to 7.1% and is above the 10-year average of 4%. Software, healthcare providers & services, and IT services are the most vulnerable, with 21%, 16%, and 9% priced below $80, respectively.
- We are approaching a level (10% of the market) we have seen during times of stress, including the 2011 U.S. downgrade cycle, and the 2015 oil mini-cycle.
- At L+667 (3-year discount margin basis), valuation is at a level historically reserved for extremely volatile periods, and increasingly pricing in a recession.

Implementation

- We are still re-underwriting existing holdings, with a particular focus on their ability to service debt in the current environment.
- As we digest third quarter earnings and go-forward guidance, we are finding pockets of opportunity in higher-quality credits – both primary and secondary – and expect to add in that cohort at the margin while maintaining an underweight to lower-rated cohorts.
- We continue to defensively position portfolios for the early stages of a cycle.

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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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