2023 Bank Loan Market Outlook

By Frank Ossino, Senior Managing Director and Senior Portfolio Manager

Frank Ossino, sector manager of bank loans, discusses his 2023 investment thesis: "The current fundamental backdrop requires vigilant quality positioning to guard against the early stages of a possible economic downturn. That said, we believe valuations now imply a risk-adjusted total return opportunity in line with long-term equity return expectations. This opportunity would come with the added benefits of attractive current income, duration risk management, seniority, and security."

2022 Review – The year, which started with solid expectations for economic growth and measured Fed rate hikes, was quickly affected by the Russian invasion of Ukraine, which worsened inflation and drove market volatility.

Fundamental conditions remained stable for much of the year, with better-than-expected first and second quarter earnings. Borrowers were able to reduce costs to shore up margins and execute price increases on the back of solid consumer demand. As late as July, inflation data combined with a strong jobs report fueled investor hopes that the Fed may have had room to slow the tightening cycle sooner than anticipated and achieve a soft landing. These hopes were dashed during the Jackson Hole meeting in August, when the Fed firmly reiterated its commitment to hike rates at the expense of economic stability.

As a result, stubbornly high inflation was met with an aggressive rate hike cycle, raising market worries around the financial health of the consumer and the ability for borrowers to service higher interest rates. Disappointing inflation data prints in September drove investors to quickly price in a higher probability of inflation.

Thus far, third quarter earnings have been acceptable, though the forward guidance has warned of waning consumer demand. As rate increases typically take 12-18 months to sink in, their impact will only be fully realized in the coming quarters. 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.

In the meantime, metrics that gauge credit distress – including the ratio of credit downgrades to upgrades, default rates, and loans priced below 80 cents – have all ticked higher during the year. While the data points are still historically low and manageable, they point to the possibility of the start of a down cycle. Investors have reacted by moving up in quality. While total return for CCC-rated risk is down 12.6% at YTD in October, B-rated risk is down 2.9%, and BB-rated risk is positive for the year – up 1.1%.

Despite the likelihood of a negative return for 2022, loans will have outperformed all other fixed rate asset classes as the Fed's rate hikes disproportionately hurt longer-duration investments.

FIXED INCOME RETURNS

As of 10/31/2022	Price	Yield to Worst	Duration to Worst (yrs)	YTD Total Return
U.S. Aggregate	86.4	5.00%	6.1	-15.70%
U.S. Treasury	87.1	4.40%	5.9	-14.30%
Investment Grade Corporates	85.5	5.90%	7.0	-19.60%
Securitized — ABS	93.7	5.50%	2.8	-5.90%
Securitized — CMBS	88.0	5.70%	4.6	-13.20%
Securitized — MBS	85.3	5.10%	6.0	-14.90%
Muni Bond	96.3	4.20%	7.3	-12.90%
Emerging Market USD Aggregate	77.9	8.50%	5.9	-21.20%
U.S. High Yield	85.7	9.10%	4.0	-12.50%
Floating Rate Loan (Performing)	**92.2**	**S+667**	**0.25**	**-2.25%**

Source: Bloomberg LP. As of October 31, 2022. Loans are calculated on a three-year discount margin basis. Floating Rate Loan is the Morningstar LSTA U.S. Leveraged Loan Index. All other indices are Bloomberg.

Opportunity: Valuation and Income – The current loan market valuation of +667, wider than the historical average of +526, implies that the total return opportunity for loans is approaching long-term equity return expectations. We estimate that the go-forward, risk-adjusted return profile for loans may be in the high single-digit range. For context, these valuations have only been seen in the context of recessionary periods, including the 2002 tech recession (+593), the 2011 U.S. credit downgrade (+717), the 2015 energy crisis (+714) and the late 2018 Fed pivot (+551). We view the 2008 Great Financial Crisis (+2373) and the March 2020 COVID crash (+1076) as outliers.

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PRICE/DISCOUNTED SPREAD MOVEMENT OF LOAN INDEX

Price/Discounted Spread Movement of CS Index Loans, December 31-November 10

	Average Price			Average DM to 3-Year		
	12/31/21	11/10/22	% Change	12/31/21	11/10/22	Bps Change
All	98.39	92.32	-6.2%	L+439	L+633	194
Liquid Loans	98.59	93.51	-5.2%	L+409	L+591	182
BB	99.42	97.52	-1.9%	L+307	L+362	55
Single B	99.15	92.72	-6.5%	L+444	L+670	226
CCC	90.61	77.18	-14.8%	L+945	L+1503	558
Defaulted	85.52	44.12	-46.5%	L+1737	L+3705	1968

Source: Credit Suisse Leveraged Loan Index. As of November 10, 2022.

The fact that current loan market total return opportunities may be reaching equity long-term averages is significant since loans offer added benefits that equity lacks. Chief among them are low duration and seniority within the borrower's capital structure – i.e., holding assets that are first in line for repayment and recovery in case of a borrower default. These protective characteristics allow for lower levels of volatility, leading to attractive returns per unit of risk when compared to other risk assets.

LOANS AND HIGH YIELD VERSUS EQUITY MARKETS

	Annualized Return	Standard Deviation	Return Per Unit of Risk	Rolling 3-Year Periods		
				Best	Worst	% Negative
Leveraged Loans	5.26%	5.42%	1.0	17.5%	-8.0%	3%
High Yield Bonds	6.99%	8.43%	0.8	26.1%	-7.6%	7%
Large Cap Equity	9.39%	14.73%	0.6	32.8%	-16.1%	18%
Small Cap Equity	8.79%	19.26%	0.5	29.6%	-17.8%	13%

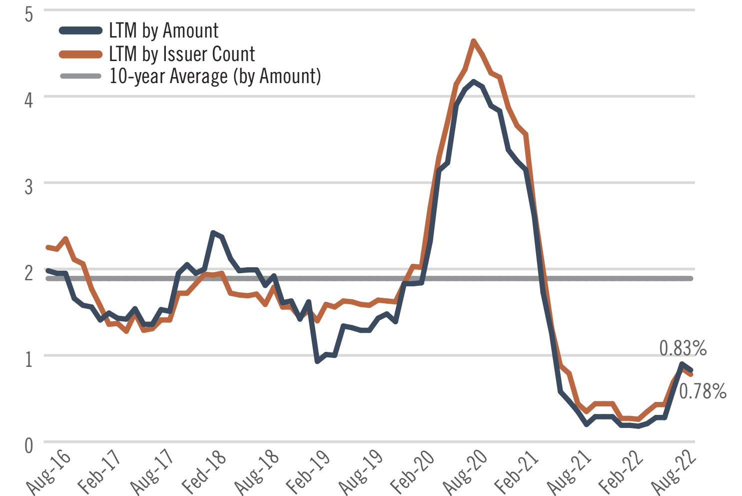
Sources: Credit Suisse, Standard & Poor's, FTSE Russell, Bloomberg. As of September 30, 2022. The High Yield, Leveraged Loan, Large Cap Equity and Small Cap Equity Markets are represented by the Bloomberg U.S. Corporate High Yield Index, Credit Suisse Leveraged Loan Index, S&P 500® Index and the Russell 2000® Index, respectively. Returns were calculated using monthly data and begin with the inception of the Credit Suisse Leveraged Loan Index on 1/1/92. **Past performance is not indicative of future results.**

Fundamentals Are Challenged – Domestic GDP for 2022, originally forecast to be 3.9%, is now forecast to hit below 2%. The consensus for GDP growth for 2023 is now at 0.4%, and is forecast to improve to 1.4% by 2024. These are weak numbers with little room for error. With minimal growth as the starting point, and higher and more sustained interest rates to combat inflation, the backdrop is challenging for credit risk assets. These rate increases usually take some time to be fully felt in the economy, and this lag in response could lead the Fed to overtighten.

Moreover, rolling 3-month downgrades have now exceeded upgrades since April. This has resulted in higher costs of capital, and, in some cases, limited access to capital. For context, the downgrade-upgrade ratio reached near 6:1 during the 2000-2002 recessionary period, which led to a default rate of around 6%.

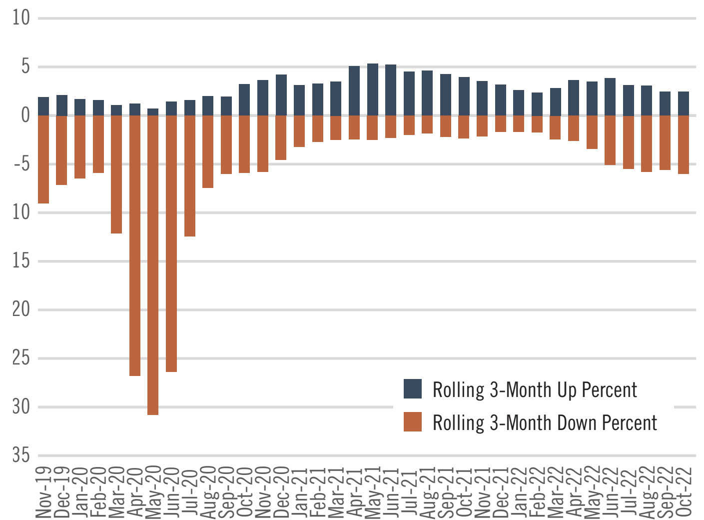
The default rate decreased slightly to 0.83% in October, but with 7.1% of the loan market priced below $80 amid increasing downgrades, our view is that defaults could walk up to a 3% rate at the end of 2023 – still in line with historic averages. However, over the next two years, it could reach 6% – in line with the 2000-2002 recessionary period.

U.S. LEVERAGED LOAN DEFAULT RATE



Source: Leveraged Commentary & Data (LCD); Morningstar LSTA U.S. Leveraged Loan Index. As of September 30, 2022.

ROLLING 3-MONTH UPGRADE AND DOWNGRADES

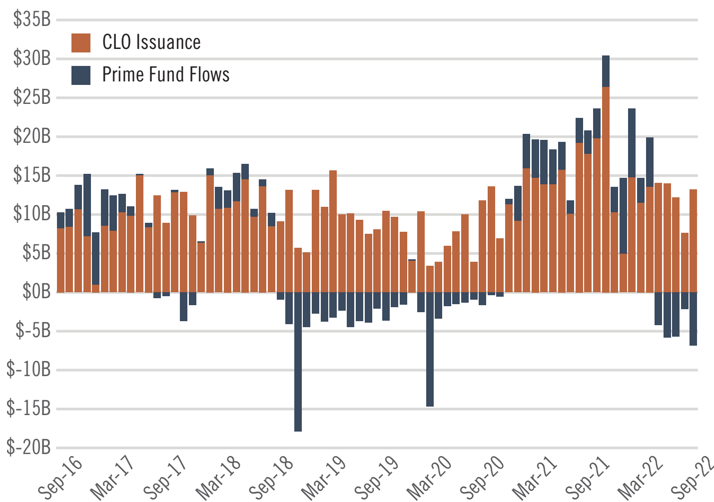


Source: Leveraged Commentary & Data (LCD); Morningstar LSTA U.S. Leveraged Loan Index. As of October 31, 2022.

Supportive Technical Factors – In one of the surprise stories of the year, the CLO market for 2022 is on track to be a top-three year for volume, behind only 2018 and 2021. This is significant, as CLO issuance has supplied demand for loans in a year when, despite a rising rate environment, retail investors have pulled $4.4 billion out so far, YTD. As retail demand is expected to stay weak, we are also concerned that CLO issuance could slow as investors scrutinize underlying loan credit concerns.

Factors that could impact near-term volume include minimal new issue loan supply, and, recently, a lack of investor appetite for AAA-rated notes. Since CLOs represent over 70% of market demand, the appetite for this long-term, non-marked-to-market capital with no forced sell triggers will need to stay resilient for the market to maintain technical balance.

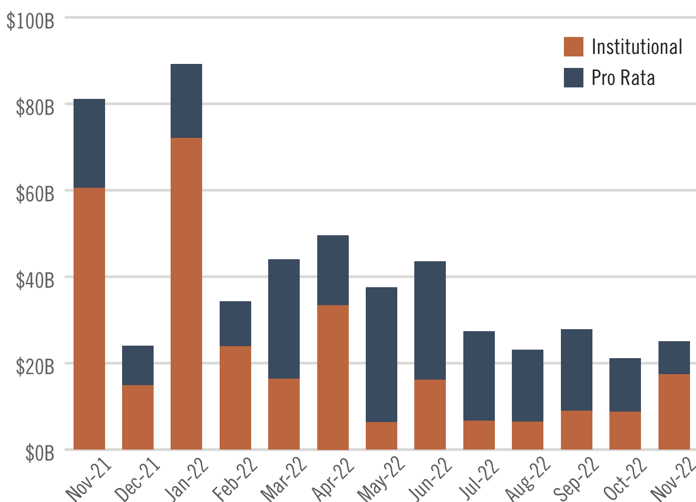
INVESTOR TECHNICALS: MONTHLY EST. INSTITUTIONAL CASH FLOWS



Source: Leveraged Commentary & Data (LCD). As of September 30, 2022.

Regarding new issue loan supply, macro volatility and an increasing cost of capital – not to mention a number of transactions that failed to clear the market post-Labor Day – have materially slowed new issue volume. Institutional loan issuance is down roughly 64% to $209.5 billion YTD. Volatility and wider spreads have also slowed the refinancing market. While the maturity wall remains manageable, it is critical that borrowers handle their debt balances, particularly to address the transition from LIBOR to SOFR.

U.S. LEVERAGED LOAN VOLUME



Source: Leveraged Commentary & Data (LCD). As of November 18, 2022.

LIBOR Cessation Update – From an operational perspective, the loan market has successfully transitioned from LIBOR to SOFR. However, even as LIBOR cessation is scheduled for June 2023, less than 20% of the market is currently priced using SOFR. The Loan Sales and Trading Association (LSTA) is concerned that too many borrowers may be dependent on traditional refinancing plans to make the transition, which could be challenging as capital markets access remains volatile. We agree with the LSTA that borrowers pivoting to amendments to get the transition done may create a traffic jam.

Areas of Concern – We enter 2023 with no shortage of catalysts that could disrupt global macro economies: the impact of higher interest rates and debt service on sectors such as housing and technology, erosion of consumer demand due to stubbornly high inflation, the ongoing impact of the Russia/Ukraine war on Western European countries, and China's zero-COVID lockdowns. Tighter capital markets access could also negatively impact marginal borrowers.

One concern specific to the loan market is the persistent erosion of credit quality – the result of a decades-long low interest rate environment. Since 2010, the number of lower-rated single-B loans and "cov lite" loans containing looser protections for lenders have grown to become increasingly larger portions of the overall loan market. As we enter a potential economic downturn, these concerns will put a premium on core fundamental analysis, credit selection, and active management.

COVENANT-LITE AND SINGLE-B LOANS HAVE BECOME A LARGER PORTION OF THE MARKET

Date	Oct 2010	Oct 2015	Oct 2022
Total Outstanding ($ bil)	$509.75	$850.92	$1,424.30
Market Value Outstanding ($ bil)	$472.18	$797.16	$1,313.11
Number of Issuers	686	935	1194
% of Cov Lite Loans (at Par)	17.84%	64.02%	88.58%
Breakdown by Facility Rating (at Market Value)			
A	0.00%	0.00%	0.00%
A-	0.00%	0.00%	0.00%
BBB+	1.09%	0.00%	0.00%
BBB	1.13%	2.26%	0.29%
BBB-	3.76%	5.79%	5.25%
BB+	9.03%	9.31%	7.08%
BB	14.41%	13.12%	5.24%
BB-	16.33%	15.87%	12.65%
B+	18.76%	17.12%	12.52%
B	12.00%	21.30%	26.48%
B-	6.24%	6.48%	23.35%
CCC+	1.78%	3.81%	3.02%
CCC	2.21%	0.81%	1.57%
CCC-	0.82%	0.12%	0.23%
CC	0.43%	0.08%	0.13%
C	0.01%	0.00%	0.00%
D	3.46%	1.57%	0.33%
NR	8.53%	2.38%	1.87%

Source: Morningstar LSTA U.S. Leveraged Loan Index. As of October 31, 2022.

Implementation – A less accommodative Fed, the negative impact of higher interest rates on debt service, and the erosion of consumer demand due to inflation may result in today's incremental borrower becoming the inventory of future distress and defaults.

As of this writing, we expect a slowdown in economic growth for 2023. We will therefore continue to re-underwrite existing positions in portfolios, focusing particularly on the borrower's ability to service debt in the current environment, and its future need for capital markets access. We will retain our up-in-quality bias going into 2023 while we look for constructive data points such as economic markers, attractive technical dislocations, corporate earnings guidance, or risk-off capitulation. Any number of these catalysts could result in a bottoming out and a shift in Fed priorities, which we would view as a signal to look for higher-risk opportunities.

For more information on the Newfleet Fixed Income strategies, please contact:

John Madden, Managing Director, Institutional Business Development
Newfleet Asset Management
O: 212.548.1042 | C: 646.322.4656 | John.Madden@virtus.com
www.Newfleet.com

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The **Bloomberg Emerging Markets Hard Currency Aggregate Index** is a hard currency Emerging Markets debt benchmark that includes USD-denominated debt from sovereign, quasi-sovereign, and corporate EM issuers. The **Bloomberg Municipal Bond Index** is a market capitalization-weighted index that measures the long-term tax-exempt bond market. The **Bloomberg U.S. Aggregate Bond Index** is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS. The **Bloomberg U.S. Corporate High Yield Bond Index** measures fixed rate non-investment grade debt securities of U.S. corporations, calculated on a total return basis. The **Credit Suisse Leveraged Loan Index** is a market-weighted index that tracks the investable universe of the U.S. dollar denominated leveraged loans. The index is calculated on a total return basis, is unmanaged and not available for direct investment. The **J.P. Morgan EMBI Global Index** tracks the total return for the U.S. dollar-denominated emerging markets debt, including Brady bonds, Eurobonds, and loans. **LIBOR:** London Interbank Offered Rate. The **Morningstar LSTA U.S. 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 **S&P 500® Index** is a free-float market capitalization-weighted index of 500 of the largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. **SOFR:** The Secured Overnight Financing Rate. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment.

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