Bank Loan Market Update

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

DECEMBER 2022: OUTLOOK AND IMPLEMENTATION

- In a year marked by volatility due to concerns of a rapid rate cycle in a slower growth environment, stubbornly high inflation, and a war in Ukraine, the loan market posted only its third annual loss in the history of the Morningstar LSTA Loan Index and its first loss in seven years.
- The loss for 2022 totaled only 0.60%, outperforming high yield (-11.1%), investment grade (-15.7%) and the S&P 500 (-18.1%)
- For December, loans returned 0.44% as coupon (+0.73%) more than offset slightly lower prices amid thin liquidity.
- The Fed increased the federal funds rate by 0.50% and reiterated its hawkish stance. Fed funds futures point to rates increasing again by 0.25% in both February and March before pausing and declining in the second half of 2023. Market sentiment appears to be overly optimistic despite the Fed's rhetoric.
- Concerns remain around an increasingly tenuous fundamental backdrop, but at current valuations, a meaningful amount of cushion (8%+ current market coupon) is priced into the loan market.
- With investor demand pivoting away from risk, BB loans posted a positive return for the year (up 3%), B risk was down 1.07%, and CCC-rated loans erased all their 2021 gains with a 12% loss in 2022 – their biggest annual loss since 2008.
- Industries with meaningful BB-rated borrowers (oil up 6.50%), less inflation-sensitive industries (utilities up 6.61%), and sectors rebounding from COVID (airlines up 3.90% and hotels/leisure up 2.70%) outperformed. Conversely, industries with wage inflation challenges (healthcare services down 9.52%), and businesses that sustained permanent damage from COVID (entertainment/theaters down 6.27%), underperformed. Technology hardware (down 9.32%) also lagged.
- To learn more about our loan market outlook for the upcoming year, read our 2023 Bank Loan Market Outlook

Fundamentals

- It is still unclear how economically painful it will be to bring inflation back to the Fed's target levels. The Fed has signaled its view by cutting its 2023 GDP forecast to 0.5% from 1.3% this month. Recall that it has only been nine months since the start of this rate cycle, so the full economic impact of those rate hikes has yet to be experienced.
- Current market consensus puts the probability of recession at 65%. However, certain inflation prints have been trending lower (though China's reopening could reverse this), December's jobs report exceeded estimates even amid slowing wage inflation, and capital markets access remains open. Do these signs point to a mild recession, or even a soft landing?
- The tug-of-war between the impact of rising rates on the economy and the labor market could provide the Fed with room to maintain its hawkish stance. Indeed, during December's Federal Open Market Committee meeting, the fed funds terminal rate target increased by 0.5% to 5%, and no Fed official saw rate cuts in 2023.
- The rolling three-month downgrade-to-upgrade ratio continues to climb. Ratings agencies are downgrading 2.8 borrowers for every 1 upgrade. The ratio has increased steadily since June and could be a precursor for defaults or credit restructurings as lower ratings impact capital markets access. Note: while only 6% of the market matures in 2024 or earlier, nearly 60% of those near-term maturities are rated B- or lower.
- After three months with no defaults, 2022 ended with a default rate of 0.72%. This is well below the average rate of 2.7%, but masks the underlying data points that we have been watching: the increasing share of loans priced at stressed levels (7.4% of the market is priced at less than 80 cents), and the previously mentioned increase in credit agency downgrades versus upgrades. While the default rate may climb higher through 2023, we believe that lower recovery rates may be more consequential to performance than actual defaults, as looser credit terms and conditions have eroded lender protections.

Technicals

- Retail and institutional demand continue to wane, but year-end scheduled amortization payments and a still-dormant net new issuance calendar keeps the technical in balance and supports prices.
- Retail outflows were $5.8 billion in December, capping eight straight months of outflows and YTD redemptions of roughly $12.5 billion. Retail now accounts for just under 10% of the $1.4 trillion broadly syndicated large corporate loan market.
- CLO issuance slowed further to $4.7 billion – the weakest month this year. Despite increasing concerns around macroeconomic conditions, and the difficulty for CLO equity investors to model satisfactory return hurdles, YTD CLO volume finished at $129.3 billion – the second-largest volume year, behind only last year's $187 billion and ahead of 2018's $128.9 billion. Still, the trend is softer CLO demand, all else being equal. We expect roughly $100 billion of demand in 2023.

- Repayments rose to $20 billion in December, driven by both amortization and refinancing-related transactions.
- The lack of M&A activity has resulted in decreased issuance volumes – issuance totaled just $5 billion in December versus $14.8 billion in December 2021. YTD issuance finished down 63% ($225 billion) from last year.
- At the time of this writing, the new issuance market is still silent, with no new deals launched.
- We expect the year to open with opportunistic transactions – namely, higher-quality borrowers that will look to address maturities by refinancing into longer-dated loans, bonds, or both.

Pricing

- Loan prices closed at 92.4, down from 98.6 to start the year. However, the ability to "buy the index price" is challenging.
- While the market's share of loans priced below 80 cents increases, investor demand for quality has pushed loans priced over 98 cents to make up 31% of the market, up from 19% in October. This bifurcation is to be expected in the current environment.
- At L+645 (3-year discount margin basis), valuations have priced in a meaningful amount of recession risk. With 3-month LIBOR currently sitting at 4.7% − and still rising − the gross total return opportunity is now near 11%. Even adjusting for a higher default and loss environment, this puts risk-adjusted possibilities near long-term equity return expectations.

Implementation

- We will be entering 2023 with an up-in-quality portfolio and a higher-than-normal cash/Treasury position as we study the impact of the current rate hike cycle on the economy and the ability of borrowers to service increased interest expense.
- Current positioning will allow us to actively reposition as economic weakness, technical dislocations, or constrained capital markets access create buying opportunities. Indeed, we have begun to find possible targets and will analyze them through our underwriting process.

Newfleet Asset Management
One Financial Plaza
Hartford, Connecticut 06103
877-332-8172

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.

Newfleet Asset Management's industry trends and observations are the result of research conducted by the portfolio management / research team. These observations reflect their industry expertise and have been prepared using sources of information generally believed to be reliable; however, their accuracy is not guaranteed. Opinions represented subject to change and should not be considered investment advice.

Investing is subject to risk, including the risk of possible loss of principal.

AR 2672073 1/2023

For Institutional Investor Use