Bank Loan Market Update

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

APRIL 2023: OUTLOOK AND IMPLEMENTATION

- Loans quickly rebounded in April (+1.05%) after the banking crisis in March (-0.03%). Secondary prices firmed (+0.31%), but interest income (+0.74%) has been driving total return.
- While swift actions by the Fed and others help in steadying markets, we still believe volatility may increase, particularly as it relates to tighter lending standards, CLO creation, and overall demand for risk assets.
- The firmer tone resulted in a pickup in new issue activity, although most of that was associated with maturity extensions and refinancing existing debt rather than new money supply. Retail fund flows are now stabilizing at a slower redemption level, but CLO creation is also slowing.
- Year-to-date returns are +4.31% − the best four-month stretch since the start of 2019.
- Lower-rated credits outperformed, with CCC risk returning +1.48% and B risk returning +1.15%, while BBs underperformed, gaining 0.86%. With credits rated BB- or better priced at 98.2, there is little room for further price appreciation in this cohort, making coupon the primary driver of return.
- The dramatic rise in the base rate has pushed the market yield to maturity to 10.4% − higher than that of March 2020, and the highest since the spring of 2009. For reference, the market yield to maturity was 4.8% one year ago. At these levels, risk-adjusted possibilities approach long-term equity return profiles without the associated equity volatility – implying that a meaningful amount of cushion has been priced in.
- Regarding the SOFR transition, the deadline for LIBOR cessation is June 30th. Roughly 40% of the loan market has already transitioned, and the current robust refinancing market is accelerating the process. We believe that between refinancings, amending existing documents, and, on a worst-case basis, falling back to the prime rate, the transition will be completed on time.

Fundamentals

- First quarter earnings have come in better than feared, but post-quarter macro data is beginning to show signs of a slowdown while inflation measures still point to sticky prices. Economic consensus puts a probability of recession at 65%, with 1Q24 forecasted to hit a low in GDP of +0.10%.
- We await the May Senior Loan Officer's Survey for insight into changes in bank lending standards. Tighter capital markets for borrowers could trigger a credit cycle contraction, potentially leading to downgrades, CLO structure stresses, and defaults.
- The FOMC unanimously decided to increase the Fed Funds rate by 0.25% at its May meeting, and doesn't rule out a hike in June if inflation stays too high. Loan borrowers are beginning to feel the impact of higher rates via lower cash flow/interest coverage ratios, which have started to decline (4.2x in 4Q22 versus 4.5x in 3Q22). The total share of borrowers with cash flow coverage of less than 1.5x has increased to 14.1% from 13.1% and should increase further as upcoming quarters carry the full run rate of previous rate hikes.
- We also track three stress indicators, all of which continue to move higher, albeit at a reasonable pace:
  - The trailing twelve-month default rate increased to 1.42% in April after the default of National Cinemedia. Defaults have risen off the low of 0.26% a year ago, but are still below the 10-year average (1.9%) and overall historical average (2.7%). We expect defaults to walk up to long-term average levels by December this year.
  - Loans priced below 80 cents are 6.2% of the market – above the 5-year average (3.9%), but below historic periods of stress (around 10%).
  - The downgrade/upgrade ratio has increased to 2.5x from less than 1x a year ago. This is still below the 6 to 1 ratio we have seen in historic periods of volatility. The average credit rating in the market is now B+.

Technicals

- Despite less CLO issuance, the technical remains supportive due to a manageable refinance-heavy calendar.
- Retail fund outflows slowed to $2.8 billion (down from $6.8 billion in March) for its twelfth straight month of redemptions.
- At $5.1 billion, April was the slowest month for CLO issuance this year, and roughly half of March's level. Anticipation of a Fed pause, heightened recession risk, and difficult economics surrounding CLO creation are dampening demand. Still, five CLO transactions were announced in May at the time of this writing.
- Repayments declined to $12.2 billion after the amortization-heavy repayment total of $22.6 billion in March.
- A refi-oriented calendar (58% of the volume) increased volume to $23 billion − more than double March's number. The result was a meaningful reduction in loans due in 2024 (3.3% of the market) and 2025 (12.2%), which partially alleviates the immediate need for capital markets access. Still, with little new money issuance, the market shrunk to $1.4 trillion.

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Pricing

- Secondary prices improved to 93.7 − still below the January month-end high of 94.2, but better than the 2023 opening level of 92.4.
- As prices improved, so did the mix. Loans priced 98 or higher now make up 49.8% of the market, up from 47.4% in March, with a majority of this price basket rated BB- or better.
- BB risk is now priced at 97.8 cents. B-rated loans are at 94.7, and CCCs (6% of the market) are at 77.3 cents.
- Loan valuations tightened to +576 on a 3-year discount margin basis – tight to the start of the year (+645) but wide to the 10-year average (+506).

Implementation

- Our up-in-quality positioning is unchanged amid slowing growth, continued Fed tightening, and several possible volatility-inducing events, such as private company 1Q earnings announcements, regional bank challenges, Ukraine's spring offensive, and China's reopening.
- Much of our focus has been on managing position sizes and participating in refinancing transactions within existing positions where we are comfortable extending maturities.

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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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