Bank Loan Market Update

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

APRIL 2024: OUTLOOK AND IMPLEMENTATION

- April's themes revolved around economic data consistent with growth and rate-induced volatility, which caused investors and the Federal Reserve (Fed) to rethink the timing of any rate cut cycle.
- April's 0.60% monthly gain was the smallest this year but outperformed fixed rate asset classes, including high yield (-1.00%), investment grade (-2.49%), and 10-Year Treasuries (-3.35%).
- Performance was entirely attributable to income (+0.76%), partially offset by softer prices (-0.16%).
- The YTD return of 3.07% also leads credit sectors and is on pace with our full-year target.
- Both retail and institutional demand are outpacing new loan issuance as M&A/leveraged buyout (LBO) financing remains limited. The firm tone and open capital markets allow borrowers to reprice loans and extend maturities.
- At a 9.8% yield to maturity, loans retain their coupon advantage, especially as rates stay higher for longer and the economy moves closer toward a soft landing or avoiding a recession altogether.
- Risk underperformed for the first time since October 20023, with CCC-rated loans down 0.68%. BBs returned 0.65%, mainly on coupon, and B risk returned 0.75%.
- Telecom-related industries underperformed, while healthcare, entertainment, and utilities outperformed.

Fundamentals

- Above-trend growth and three straight months of hotter-than-expected inflation data reconcile Fed Chairman Jerome Powell's recent remarks saying, "It would take longer than expected to gain the level of confidence needed to cut…" He also stated that the Fed can keep rates steady for "as long as needed." As expected, The Fed kept rates unchanged in May's Federal Open Market Committee meeting.
- First quarter earnings results (mostly public filers to start) have been good.
- The downgrade/upgrade ratio ticked up to 1.8x from 1.6x in March – still below the eight-month high in December (2.4x).
- Two borrowers lifted the loan payment default rate (by $ amount) to 1.3%, with both pointing to higher interest expense as the driver. We also saw two liability management exercises. Including out-of-court restructurings, the default rate was 4.3%, up from 4.2% in March.
- The backdrop of a resilient economy and residual stickiness in inflation makes it difficult to see multiple rate cuts this year – especially as the U.S. presidential election nears. However, today's lower-than-expected April jobs and ISM figures have pulled forward rate cut expectations to a 15% chance in June, a 30% chance in July, and a 52% chance in September.

Technicals

- Demand is exceeding supply. Capital markets contacts tell us that the M&A/LBO screening and auction process is slow, so we expect the near-term new issuance calendar to remain limited while the risk-on tone persists.
- Retail fund inflows were $1.6 billion, the strongest month since April 2022 (early on in the rate hike cycle) and the sixth straight month of inflows. Retail investor risk appetite has improved commensurate with the economy, and delays in the rate cut cycle make the income carry attractive.
- Collateralized loan obligation (CLO) issuance exceeds last year's pace with $17.4 billion of new issuance and $19.6 billion of refinancing and reset transactions. Recall that resets create loan demand by extending a CLO's ability to reinvest in the market. The YTD volume is now $66.2 billion – more than half of all CLO issuance last year ($116 billion). We believe there still are roughly 160-170 warehouse portfolios open to buy loans and 30 CLOs in various stages of syndication. We expect healthy issuance to continue in the near term and believe the only major setback may be the ability to find loan supply to fill portfolios.
- The gross loan supply was $40.2 billion in April – flat with March and below the refinancing-heavy January volume of $65.6 billion. Refinancings continue to make up most of the transactions, although opportunistic deals, including debt-financed dividends, have been a growing use of proceeds.
- Repricing transactions also remain prevalent. We have now repriced 14% of the loan market, saving borrowers an average of 54 basis points (bps) or $1 billion in aggregate annual interest expense. The current risk appetite has also increasingly allowed lower-rated cohorts to participate in balance sheet and interest expense management.
- Voluntary repayments remain elevated at $39.4 billion. Accelerated repayments act as a demand driver as proceeds typically need to be reinvested back into the market.

Pricing

- Loan prices softened slightly for the first time since October 2023 to 96.6. BB loans are 99.5, B-rated loans are 98.3, and CCC-rated loans (6% of the market) sit at 81.

- Still, 50% of the loan market is priced at par or higher, the highest since January 2021. This level typically spurs repricing activity (it was at 40% in January when we saw a flood of repricing volume). Roughly 74% of the market is now priced at or above 99 cents.
- As new supply remains limited, investors have bid up lower-rated cohorts to pick up any remaining discount in performing loans. Specifically, more than 30% of B- risk is at or above par versus 17% last year. The single B category has 60% of its loans at or above par – the highest level since January 2021. About 62% of the BB- and B+ buckets are at par or a higher price.
- On the stressed side, loans bid at 80 cents increased to 4%, up from 3.5%, but lower than a year ago (6.2%). We did see loans below 50 cents increase and loans in the 60-70 cent bucket jump – likely due to idiosyncratic events during the month.
- Valuations widened by two bps to SOFR+465 – still well inside post-GFC averages (+530).
- While valuations may appear historically rich, the yield advantage in an above-trend-growth economy and the delay in rate cuts make loans relatively attractive to other asset classes driven by the yield advantage.

Implementation

- Continued supply/demand technical and above-trend growth justifies our fully invested positioning.
- Earnings will be a near-term focus as we transition from public filers to private reporters.
- We have been taking advantage of higher loan prices – selling into irrational over-par bids, managing outsized positions, and reducing risk where prices look rich, in our view.

For information about Newfleet's retail fixed income strategies, please visit www.Virtus.com.

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