Bank Loan Market Update

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

FEBRUARY 2023: OUTLOOK AND IMPLEMENTATION

- ► Risk investors appear to have been too complacent on inflation and the path of interest rates by the Federal Reserve (Fed). Solid economic data provoked renewed hawkish sentiment from the Fed and prompted the market to reassess the path and height of rates, resulting in risk asset volatility.
- ► With that backdrop, loans returned 0.59% in February – a 0.09% decline in price completely offset by 0.66% of income return. This was the fifth straight monthly gain. Loans benefited from a lack of duration risk and a healthy technical.
- ► Loans outperformed high yield (-1.30%), investment grade bonds (-3.14%), and the S&P 500 (-2.44%).
- ► Despite the broad risk-off tone, the riskiest loan credits continued to outperform as demand from CLOs supported prices. CCC-rated loans were up 2.87% compared to B-rated loans (0.62%) and BB-rated loans (0.07%).
- ► Technology and healthcare – laggards last year – outperformed alongside energy and consumer products. Conversely, last year's winners, such as utilities, underperformed. The wirelines sector was effectively the only negative performer.
- ► With a current coupon now over 8.5% and a market price of 94.1 cents, the gross total return opportunity is now roughly 10.5%, assuming the discount is amortized over three years. Even adjusting for a higher default and loss environment, this puts risk-adjusted possibilities near long-term equity return profiles without the associated equity volatility.
- ► After a 0.25% rate hike in early February, Fed fund futures point to another 0.25% increase at the March Fed meeting.

Fundamentals

- Fourth quarter earnings season has been particularly disappointing, posting the lowest number of results that beat forecasts (1.6% versus the long-term average of 4.6%) since the Great Financial Crisis. Soft first quarter earnings guidance also does little to support optimism around fundamentals and cooling investor sentiment around risk assets.
- That said, stresses eased as recent data – strong retail sales, a resilient labor market, a tick up in manufacturing activity – increased the odds of a mild recession, or at least a recession that has been postponed. It appears last year's rate increases, especially those announced in late 2022, have yet to flow through the economy.
- Current consensus puts the probability of recession at 60%, down from 65% last month.
- However, that positive economic data, combined with the surprise increase in consumer prices and the improving Chinese economy and its impact on global prices, could provide the Fed with room to maintain its hawkish stance. Indeed, interest rate futures are now pricing in three rate increases in March, May, and June, and no reduction in rates this year.
- The default rate, now at 1.02%, is at a 20-month high. Healthcare and technology are trouble spots as those sectors struggle with the impact of rising labor costs and rising debt service costs, respectively.
- While the default rate is still below the 10-year average (1.9%) and historical average (2.7%), concerns include 1.) the higher-than-average volume of loans priced at stressed levels, 2.) the still-increasing ratio of downgrades to upgrades, which is now over 3:1, and 3.) the concentration of B-risk (46%) with EBITDA/interest expense less than 1.5x.

Technicals

- The technical is constructive – macroeconomic headwinds and a higher cost of capital continue to hamper M&A and LBO activity, leaving healthy demand without any net new issuance supply. The market has shrunk by roughly $13 billion YTD.
- Retail funds posted their tenth straight month of outflows ($2.7 billion and $4.1 billion YTD) after 17 consecutive months of inflows. Credit risk continues to dominate retail sentiment despite the benefits of loan exposure in a rising rate environment.
- CLO issuance jumped to $15.7 billion from 36 distinct transactions – the most since November 2021, and above the trailing monthly five-year average of $11 billion. Still, we also saw several pre-CLO warehouses liquidate, driven by investors that are less optimistic about the path of the economy and future returns. The health of the CLO market, which hinges on the return of Japanese investors, its relative value versus other structured product asset classes, and performance of the loans held in the portfolio, will have an impact on the direction of the loan market.
- Repayments rose to $23.2 billion. Repayments associated with a bond issuance to address near-term loan maturities made up $8 billion of the total. With capital markets open, we expect borrowers – even lower-rated borrowers − to focus on maturities by extending existing loans or refinancing maturities through the bond market.
- Gross volume totaled $27.3 billion, but nearly 80% of it was associated with a refinancing transaction.

Pricing

- Secondary prices ticked slightly lower to 94.1 from 94.2 last month.
- BB risk is now priced at 98.5 cents. B-rated loans are at 94.7, and CCCs are at 76.8 cents.

- The price distribution did not change materially in the month. Only 2.8% of the market is priced at 100 or higher. At the other end, the stressed cohort – i.e., loans priced less than 80 – makes up 5.4% of the market, still above the five-year average of 3.7%.
- The ability to "buy the index price" is challenging, with nearly 60% of the market priced at 97 or better.
- Spreads have tightened to +567 from +645 (three-year discount margin basis) to start the year. Meanwhile, three-month LIBOR and SOFR are now at 4.97% and 4.92%, respectively. Current valuations imply a meaningful amount of cushion is priced into the market.

Implementation

- We are tracking several positive factors that may point us to slowly begin repositioning portfolios with a riskier bias. However, we believe it is too early to broadly pivot away from our defensive positioning as headwinds remain.

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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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