

MARCH 2024: OUTLOOK AND IMPLEMENTATION

- ▶ With a 0.85% gain in March, loans finished the quarter up 2.46%, with nearly all the return attributable to coupon as rates stay higher for longer. Loans are on track with our full-year return forecast of 7-8%.
- ▶ Data continues to strengthen the argument for a soft landing, and the “last mile” of inflation is proving to be sticky, resulting in delayed expectations around the timing and velocity of the rate cut cycle.
- ▶ The technical continues to be supportive. While M&A activity is increasing, the lack of meaningful supply in the face of demand from retail and institutional investors has resulted in above-par loan prices, allowing borrowers to reprice and refinance existing debt. Capital markets are open for all risk cohorts.
- ▶ 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 has outperformed quality due to higher coupons and investor appetite for discounted loans. BBs returned 0.80%, B risk returned 0.87%, and CCCs returned 1.01%.
- ▶ The telecom and media industries underperformed. Cable company Altice's aggressive announcements suggesting an out-of-court restructuring of its looming maturities negatively impacted both its secured loans and unsecured bonds.

Fundamentals

- Economic data continues to surprise to the upside, and market sentiment on risk is improving. Consumption data is strong. Labor demand has stabilized at an elevated level. Recent U.S. manufacturing activity expanded for the first time since September 2022, with nine industries reporting manufacturing expansion.
- Quarterly EBITDA growth for loan borrowers (public filers) increased to 3.1% in 4Q23 compared to 1.8% in 2Q23. The growth allowed for quarterly sequential deleveraging and improved interest coverage.
- In another constructive sign, the ratio for downgrades to upgrades eased to 1.6x in March, down from a seven-month high in December (2.4x) and now at a five-month low.
- The loan payment default rate (by \$ amount) fell to 1.1% — the lowest level in 13 months and well below the long-term average of 2.7%. When including out-of-court restructuring and other coercive liability management transactions, the default rate is 4.2%, up from 4.0% in January. We will quote this metric given that current loose documentation terms increasingly allow for out-of-court distressed transactions that effectively act like payment defaults.
- The Fed kept rates unchanged in the March Federal Open Market Committee meeting while reiterating its forecast for three rate cuts this year despite some recent uptick in price pressure.
- 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. Fed Fund futures currently have the chances of a May rate cut at 7% and 50/50 odds of a cut in June.

Technicals

- The new loan supply shortage relative to demand continues to drive the market technical.
- Retail fund inflows were \$2.1 billion — seven straight weeks of inflows and the highest monthly level since April 2022 — as investor risk appetite improves and delays in the rate cut cycle make the income carry attractive.
- Collateralized loan obligation (CLO) issuance remains strong with \$15.5 billion of issuance in March. The YTD volume is now \$48.8 billion — 45% ahead of last year's pace. We believe there are roughly 170 warehouse portfolios open to buy loans and 20 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 improved to \$40.3 billion in March, better than February's \$36 billion but below the refinancing-heavy January volume of \$65.6 billion.
- M&A activity is encouraging, but the lion's share of transactions (over 50% this month) centered on opportunistic activity, primarily refinancings to push out debt maturities.
- Repricing transactions also remain prevalent. We have now repriced 10% of the loan market, saving borrowers an average of 55 bps in interest expense. The current risk appetite has allowed lower-rated cohorts to participate in balance sheet and interest expense management.
- As demand outstrips supply, we have observed an increase in private credit transactions coming to the broadly syndicated loan (BSL) market to refinance loans. YTD, private-to-BSL refinancings have created \$11.8 billion in new loan volume. Recall that last year, the BSL market lost over \$16 billion in loans to the private credit market.
- Voluntary repayments spiked to \$40.5 billion, highlighted by the repayment of Galderma with proceeds from its IPO.

Bank Loan Market Update

Pricing

- Loan prices improved by 0.07% in March to 96.7. Strong demand and limited supply are supportive, but much of the market is now price-constrained.
- BB-rated loans are 99.5, while CCC is 81. Loans rated single B, which account for 62% of the market, closed at 98.3.
- Loans priced at par or higher increased to 39% of the market. For context, this figure was 40% in January, spurring a wave of interest-saving loan repricings. We anticipate the same will occur in the near term. With another 41% priced over 98 cents, almost 80% of the market is priced at 98 cents or higher.
- Investor risk sentiment has improved:
- Roughly 27% of B- risk is priced over par. Nearly 50% of B risk is also at par or higher.
- On the stressed side, loans bid at 80 cents make up only 3.5% of the market.
- Valuations tightened to SOFR+463 – well inside post-GFC averages (+530).
- While valuations may appear historically rich, the yield advantage in an increasingly likely soft-landing scenario and the delay in rate cuts make loans relatively attractive to other asset classes. Even in a mild recession, the starting yield-to-maturity of 9.8% cushions against volatility.

Implementation

- The tone in loans remains constructive primarily due to the supportive technical and continued carry.
- Our strategy in the near term is unchanged: We will remain fully invested and selectively add risk in the primary and secondary markets commensurate with the current economic backdrop.
- We are watching for opportunities related to a possible technical dislocation in the CLO market caused by the negative announcements around the Altice France capital structure, which is comprised of \$7 billion in loans held by a large swath of investors and portfolios.

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