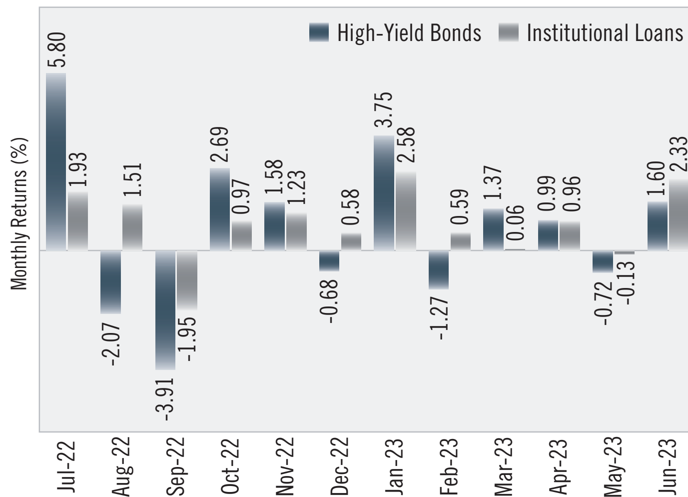
SEIX INVESTMENT ADVISORS
A VIRTUS INVESTMENT PARTNER

LEVERAGED LOANS

Continuing to Outperform Expectations

Leveraged loans continued to outperform expectations, up seven percent year-to-date, setting the stage for a potential double-digit year.

LEVERAGED LOANS PROVIDED THEIR SECOND STRONGEST RETURNS SINCE MAY 2020



Past performance is not indicative of future results. Source: J.P. Morgan, S&P/IHS Markit.

While defaults have ticked up (trailing 12-month now at 2.9% versus 0.4% in 2021 and 1.6% in 2022 per J.P. Morgan), they are still relatively low given the historical average default rate of 3.1% for bank loans (per J.P. Morgan), and we underweighted the CCC part of the market. That is part of the reason our default experience over the years has been roughly a third of the index.

Overall, we continue to be constructive on the market, but at the same time wary of where we are in the economic cycle. We are happy leaning more toward higher quality, safer names while trying to avoid the big downdrafts that some names are likely to see.

Looking ahead, recall that we previously projected roughly 6% returns for the year. The market is already past that, with a return of 6.54% through June 30, 2023. Bank of America recently upped their overall return target for 2023 to 11%, which essentially assumes investors would just clip a coupon and the market goes sideways for the rest of the year. That might be a little bit too simplistic, but certainly achievable again with yields gaining about 75 basis points a month and technicals remaining very strong as we are seeing a lot of repayments and retail outflows abating.

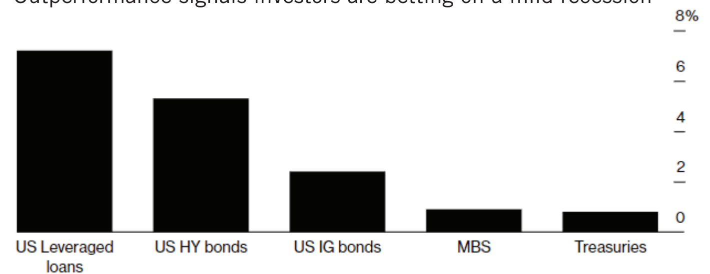
2Q 2023 BANK LOAN TRENDS

Takeaway: Collateralized loan obligation (CLO) activity remains steady and supportive, while retail outflows continue to moderate. Issuance remains relatively low, providing technical support. On balance, the J.P. Morgan Leveraged Loan Index saw an uplift in price/yield widening on LIBOR/SOFR increase. Default rates continue to tick up.

Performance: For 2Q, the Index saw a return of 3.17%, with the month of June up 2.33%. The 1H23 return for that index through June 30 was 6.54%.

LEVERAGED LOANS BEAT FIXED INCOME

Outperformance signals investors are betting on a mild recession



Past performance is not indicative of future results. Source: Bloomberg. Note: Return figures are year-to-date.

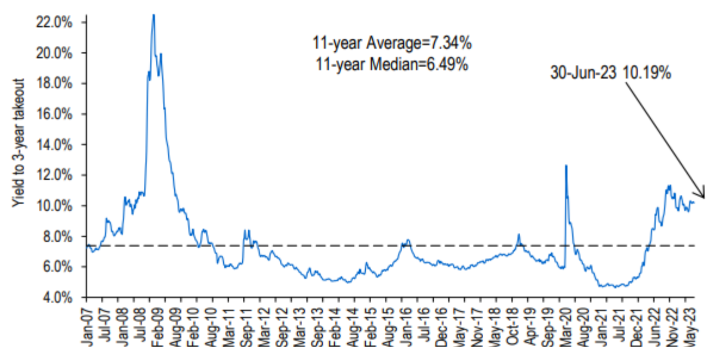
For loans in 2Q, top contributors by industry were telecom +5.18%, housing +4.42% and utilities +4.12%. Laggards were broadcasting +0.74%, chemicals +2.27%, and healthcare +2.66%.

From a ratings perspective, Single-B rated loans returned +3.24% compared to returns of +2.65% and +4.93% for BB and Split B/CCC rated loans, respectively.

As of 6/30/23: The price on the J.P. Morgan Leveraged Loan Index was $94.97, up $1.20 for the quarter.

The yield to 3-year takeout was 10.19% (Q4: 9.98%), up 21 basis points for the quarter.

YIELD TO 3-YEAR TAKEOUT



Source: J.P. Morgan, S&P/IHS Markit

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LEVERAGED LOAN INDEX PROFILE

Summary profile of J.P. Morgan Leveraged Loan Indices as of June 30, 2023

	Leveraged Loan	Liquid	Second Lien	BB/B	EUR/GBP
Market Value ($mn)	1,361,994	492,575	58,302	1,222,290	306,389
Number of Loans	1,566	199	213	1,299	455
Number of Borrowers	1,344	199	206	1,110	364
Average Rating	B	Split BB	Split B/CCC	Split BB	B
Margin	L+370	L+335	L+713	L+357	L+393
Current Yield	9.52%	9.02%	14.91%	9.19%	7.88%
Years to Maturity	4.40 yrs	4.45 yrs	5.09 yrs	4.47 yrs	4.19 yrs
Average Price	94.97	96.08	83.80	96.80	94.42
Yield	10.19%	9.33%	18.66%	9.30%	9.94%
Spread	572bp	487bp	1412bp	483bp	625bp
DM	476bp	390bp	1318bp	387bp	603bp

Note: Yield, spread, and DM are to 3-year takeout and based on forward curve analytics. Source: J.P. Morgan; S&P/IHS Markit.

From a fundamental perspective, net issuance totaled $16.4 billion in 2Q, which was up slightly from $14.0 billion in 1Q; however, these two were the lightest volumes since 1Q10, a period that saw a quarterly average of $50.3 billion. Year to date, leveraged loan issuance totals $136.8 billion, or $30.5 billion net of refi/re-pricing, compared to $181.0 billion or $125.1 billion over the same period last year (-24% and -76%, respectively).

The biggest factor in that lower issuance was a drop-off in mergers & acquisitions. As a result, deal sponsors have a lot of dry powder, and they are deploying it very slowly. The deals that we are seeing are smaller, as the sponsors are putting in much bigger equity checks to lower leverage with less debt and improve the cashflow profile of the company. They can probably add debt later, but for now we are seeing sponsor deals as low as four times leverage, which is well below leverage levels seen in sponsor deals over the last 10 years.

Demand: 2Q fund outflows total -$7.6 billion. Of note, June's outflow totaled -$113 million (+$507 million ETF and -$620 million actively managed), which followed an outflow of -$4.4 billion in May, and -$3.1 billion in April.

2Q23 U.S. CLO volume (excluding refinancings and resets) was $21.3 billion compared to $40.8 billion in 2Q22. Year to date, volume totaled $55.3 billion (excluding refinancings and resets) compared with $72.0 billion (excluding refinancings and resets), -23% y/y.

Default Rates: The loan par-weighted default rate including distressed exchanges ended June at 2.94%, deteriorating 72 bps for the quarter. For context, the long-term average default rate for leveraged loans is 3.1%, according to J.P. Morgan.

HIGH YIELD

Impressive Resilience

The high yield market continued its low-quality rally during Q2 as spreads on CCCs (-187 basis points (bps) as measured by the ICE BofA CCC & Lower US High Yield Index (H0A3)) tightened more than their BB counterparts (-24 bps as measured by the ICE BofA BB US High Yield Index (H0A1)) by 163 bps.

Earnings continued to provide an argument against a deep recession and, with the Federal Reserve (Fed) announcing a pause in its rate increases, the risk-on trade continued from the beginning of year. Interestingly, CCCs have outperformed BBs and the high yield market each month this year except for the month of March.

Year-to-date, we have seen CCC spreads tighten by 227 bps and BB spreads by 44 bps, driving the total return for CCCs to 9.8% versus 4.2% for BBs and 5.4% for the full high yield market (as measured by the ICE BofA US High Yield Index, or H0A0). Distressed high yield (as measured by the ICE BofA US Distressed High Yield Index, or H0DI) increased 10.98% in the first half of the year.

OUTLOOK

Supportive Technicals and Enduring Fundamentals

The fundamentals of issuers in the high yield market remain strong with interest coverage and leverage at or near the all-time best levels. There was a moderate amount of weakness with the aggregate interest coverage ratio in the first quarter, but leverage continued to decline. We anticipate these metrics will continue to show continued weakness through the balance of the year, but will remain at levels that will allow for a reasonable amount of financial flexibility for most sectors.

Technicals remain resilient as issuance remains low relative to years past and the percentage of the high yield market being upgraded back to investment grade continues to provide support. As mentioned in our 1Q outlook, we continue to believe that the banking failures we witnessed earlier this year would seem to increase the risk of at least a mild recession at some point over the next year as regional banks look to improve their liquidity profile, likely leading to tighter credit conditions. Nevertheless, we continue to believe that the higher quality segment of high yield offers value for long-term fixed income investors.

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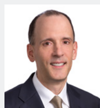
Authored by:

Leveraged Loans



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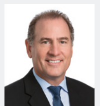

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ICE BofA U.S. High Yield Cash Pay Index is an unmanaged index consisting of all domestic and Yankee high-yield bonds maturing over one year. The quality range is less than BBB-/Baa3 but not in default (DDD1 or less). The **ICE BofA U.S. High Yield Constrained Index** is a market-value-weighted index of all domestic and Yankee high-yield bonds, including deferred interest bonds and payment-in-kind securities. Issues included in the index have maturities of one year or more and have a credit rating lower than BBB-/Baa3 but are not in default. The ICE BofA U.S. High Yield Constrained Index limits any individual issuer to a maximum of 2% benchmark exposure. The **J.P. Morgan Domestic High Yield Index** is designed to mirror the investable universe of the U.S. dollar domestic high yield corporate debt market. The **J.P. Morgan Leveraged Loan Index** is designed to mirror the investable universe of U.S. dollar institutional leveraged loans, including U.S. and international borrowers. **ICE BofA U.S. High Yield Index (H0A0)** tracks the performance of U.S. dollar denominated below investment grade rated corporate debt publicly issued in the U.S. domestic market. To qualify for inclusion in the index, securities must have a below investment grade rating and an investment grade rated country of risk. The **ICE BofA BB U.S. High Yield Index (H0A1)** is a subset of the ICE BofA U.S. High Yield Master II Index and includes all securities with a given investment grade rating BB. The **ICE BofA CCC & Lower U.S. High Yield Index (H0A3)** subset includes all securities with a given investment grade rating CCC or below. The **ICE BofA Single-B U.S. High Yield Index (H0A2)** subset includes all securities with a given investment grade rating B. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and are not available for direct investment.

The **Secured Overnight Financing Rate (SOFR)** is widely accepted as the LIBOR replacement for loans. SOFR is based on overnight Treasury Repo Rates with nearly $1 trillion of underlying daily transactions and not subject to market manipulation. Since SOFR is a daily rate, Term SOFR was developed as a forward-looking rate from SOFR futures trading.

A **Basis Point (bp)** is equal to 0.01%.

Collateralized Loan Obligations are securities backed by a pool of assets often low-rated corporate loans.

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