

Leveraged Finance

- > The high yield market eked out a positive return in the second quarter while issuance continued to decline and flows to mutual funds and ETFs remained negative. Defaults remained about even with last year, at 2.06%, while credit quality continued to improve.
- > The leveraged loan market posted a return of 0.78% for the quarter, continuing the trend of the first quarter. Issuance continued to be robust, hitting the second-highest level on record, and demand remained strong.

HIGH YIELD

The ICE BofAML US Cash Pay High Yield Index turned in a positive return of 1.00% for the second quarter, roughly matching the decline of the first quarter. BBs continued to underperform while CCCs were the biggest outperformers. This performance is not surprising in an environment in which rates are moving higher. BBs are more interest-rate sensitive, and CCCs benefit from a growing economy and improving issuer fundamentals.

Year-to-date, spreads on CCCs have tightened more than 100 basis points (bps), with the bulk of that coming in the second quarter. Spreads on BBs have widened by about 40 bps, and again most of that came in the second quarter.

The credit quality of the market continues to improve while the size of the market continues to shrink. CCCs now make up just 12.5% of the index, down 150 bps year-to-date. The fair market value of the high yield sector has declined about \$60 billion this year due largely to declining issuance.

Issuance during the quarter amounted to \$53.5 billion, down from \$72.7 billion in the first quarter. Year-to-date, issuance totaled \$126.3 billion, off more than 28% from the first half of 2017. Most of the issuance, 64%, went to refinancings in the first half while 19% was used for acquisitions, and 14% went to general business purposes. The issuance in the high yield market is in marked contrast to both the bank loan market and to the investment grade corporate market, both of which have seen robust issuance in 2018.

On the demand side, outflows continued during the quarter as investors sought to de-risk their portfolios. Year-to-date mutual fund outflows amounted to \$25.5 billion, or about 8.3% of the asset class. Of that, \$19.7 billion came from actively managed funds, and \$6.9 billion came from exchange-traded funds. These were the largest outflows since 2014, and they cumulatively reversed about 92% of the flows that came into the market after the credit crisis between 2009 and 2012.

These outflows appear to be hurting ETFs more than actively managed funds. For the latter, the outflows amount to 7.7% of the assets under management (AUM), but for ETFs, these outflows come to 13.1% of their AUM.

These large outflows might be expected to present a challenge for high yield, but other technical factors are counterbalancing the drop in demand. First, dealer inventories are relatively small, at about \$3 billion, and second, issuance has been very light.

Defaults for the first half of the year roughly matched those of the same period last year, at 2.06%. Excluding one large issuer, iHeart Communications, the default rate was just 1.33%.

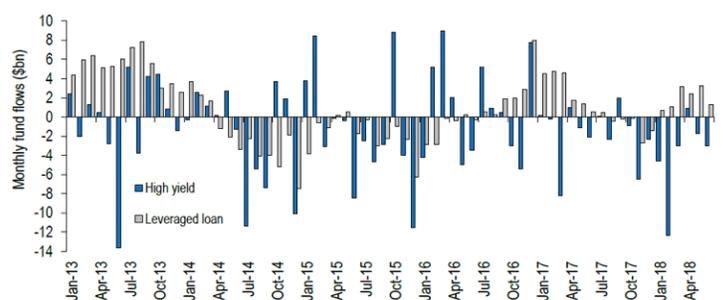
Our View

We continue to look for potential opportunities to move the portfolio toward higher credit quality. The CCC-rated part of the market has clearly been pricing in good economic news, so we've been able to shift out of those and into BBs without giving up much yield. In fact, the allocation to CCCs may now be close to the lowest in the history of the strategy.

We believe that fund outflows indicate that investors are missing what is happening in the high yield market. Credit quality is improving, and companies are focused on deleveraging.

We continue to find potential opportunities in the cable sector and in the energy sector. We believe that given current energy prices, fundamentals are better than the market is reflecting. But, in general, our focus is more on quality than on yield. This will ensure that if a difficult market emerges, we will be well-positioned to handle it.

BOND AND LOAN MONTHLY FLOWS



Sources: Lipper FMI, J.P. Morgan.

LEVERAGED LOANS

The Credit Suisse Leveraged Loan Index returned +2.38% for the first half of 2018. The percentage of loans trading above par hit 20.1% at the end of June, according to JP Morgan, close to the low reached in July 2016. At quarter end, the 3-year takeout yield was 6.84%, the highest level since April 2016.

On the supply side, issuance was robust. Gross volume came to \$258.8 billion, up from the first quarter and the second-highest volume on record. Most of the issuance (94%) came in the middle credit quality tiers, BBs and Bs. Much of the new supply is

opportunistic, with repricings accounting for 41.6% of the second quarter total and refinancings making up 23.3%. Excluding repricings and refinancings, issuance amounted to \$90.7 billion, and on this basis, year-to-date net new supply is running 19% ahead of last year's post-crisis high.

Demand remained steady as flows to mutual funds have been positive since the beginning of the year. In the second quarter, flows amounted to \$8.3 billion, bringing the year-to-date total to \$11.9 billion. CLO formation was also robust, with gross volume hitting \$86.4 billion, a new quarterly record.

Our View

We are cautiously optimistic on the market and on the economy, but are approximately 800-1000 bps overweight on higher quality issues. Ultimately, we believe the current yield within the market compensates investors very well, considering where we sit within the credit cycle.

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Leveraged Loans



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