SEIX INVESTMENT ADVISORS LLC®
A VIRTUS INVESTMENT PARTNER

# Leveraged Finance

> The high yield market experienced a difficult fourth quarter in an environment in which global economic growth appeared to be slowing. Issuance continued to shrink during the quarter and outflows from mutual funds totaled -$20.2 billion. Fundamentals remained healthy, however, and defaults were low by historical standards.

> Leveraged loans experienced a significant sell-off in the fourth quarter, nearly offsetting the positive performance of the year's first three quarters. Loan issuance for the year amounted to the second-highest on record, but it dropped off sharply in the fourth quarter as demand from mutual funds turned negative. Demand from CLOs, however, remained strong.

## HIGH YIELD

The high yield market performed poorly in the fourth quarter in a risk-off environment that saw the S&P 500 Index plummet 9.0% in December, the worst end of year performance since the Great Depression. Slowing global economic growth trends, falling oil prices, and disappointing signals from the Federal Reserve contributed to the slump.

The yield spread over Treasuries rose dramatically in December, rising 103 bps to 567 bps, or 213 bps above the low reached in early October. Yield on the J.P. Morgan U.S. High Yield Index rose to 8.23% in December, its highest level since April 2016.

For the quarter, the J.P. Morgan U.S. High Yield Index fell -4.79%, bringing the return for the year to -2.39%. CCC-rated issues performed worst despite outperforming for the first three quarters of the year, while B-rated issues led all others. Among sectors, energy lagged most during the quarter, down nearly 10%, and was off -6.49% for the year. Utilities held up best, slipping only -0.84% for the quarter. For the year, only four sectors managed to produce positive returns, with utilities leading at 1.68%, according to J.P. Morgan.

As for market technicals, new issuance continued to wane, and the market continued to shrink. In December, no new issues were priced, only the second time that has ever happened, the previous time being the height of the financial crisis in November 2008. For the quarter, issuance amounted to just $19 billion, a 10-year low and down from $73 billion in the fourth quarter of 2017. For the year, issuance came to just $187.4 billion, down 43% from 2017, according to J.P. Morgan.

On the demand side, December saw mutual fund outflows of -$7.2 billion, the 10th largest ever and bringing the total for the quarter to -$20.2 billion. For 2018, outflows came to -$45.1 billion, making flows negative the second straight year. In 2017, flows amounted to -$20.3 billion while in 2016 they were positive at $9.6 billion.

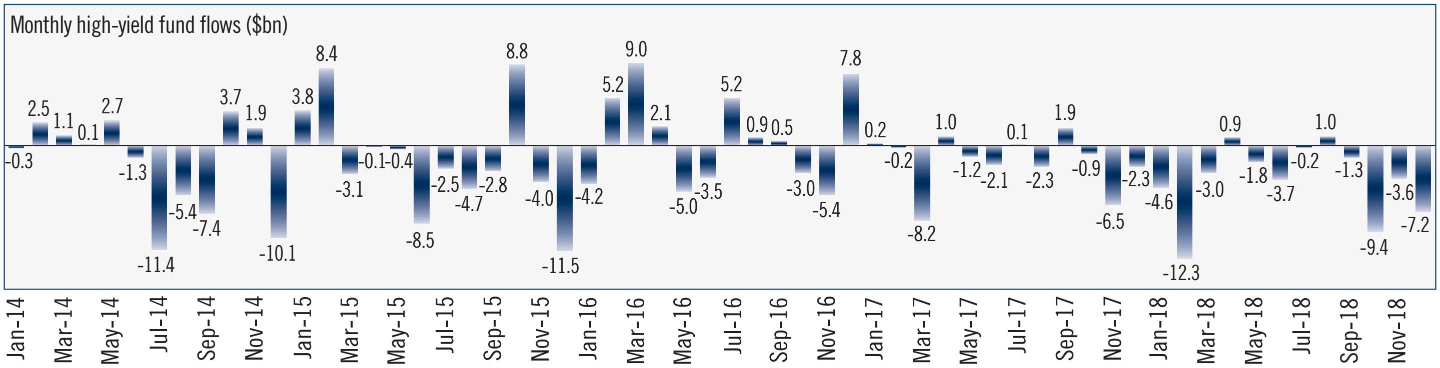
Default activity rose somewhat in 2018, but with fundamentals still strong, it continued to be relatively low. The par-weighted U.S. default rate reached 1.81% (excluding iHeart Media, it was just 1.08%), up from 1.28% in 2017. Compared to 2016, however, when the rate hit 3.57%, and to the long-term average of 3.46%, this rate remains low.

### Our View

With the December sell-off, the yield on the index rose to 8%, and then the market rebounded pretty solidly, so we believe the 8% yield may represent a floor on prices of sorts. The cheaper valuations that emerged in December have also presented us with new potential opportunities, so we are taking advantage of those while remaining highly selective.

We expect to see more bouts of volatility in 2019, and we will continue to capitalize on these potential opportunities to buy high-quality issues cheaply. More specifically, we're looking at shorter duration, higher quality companies with good free cash flow generation.

HIGH-YIELD FUNDS REPORT AN OUTFLOW FOR THE TENTH TIME IN 2018




Source: Lipper FMI

While 2018 was a challenging year, it's interesting to note that the market has never posted two calendar years with back-to-back negative returns. So, we believe that given the still-healthy fundamentals, a mid-single-digit return is not unreasonable in 2019.

## LEVERAGED LOANS

The leveraged loan market was hurt in the fourth quarter as investors were spooked by negative press and news that the Federal Reserve may not increase rates in 2019 as rapidly as expected. These factors caused a reversal of mutual fund flows, which had been positive through the first three quarters of 2018.

For the quarter, the J.P. Morgan Leveraged Loan Index produced a return of -3.16%, resulting in full-year return of just 1.08%. All 21 sectors in the index posted negative returns, but Energy, Retail, and Diversified Media were the biggest detractors. For the year, Metals & Mining, Retail, and Transportation led while Diversified Media, Housing, Paper & Packaging lagged.

On the supply side, issuance during the quarter was steady until December, when it dropped off. Gross issuance hit $109.3 billion, the 20th highest quarterly volume on record. This brought the volume for the year to a record-high $704 billion, the second-highest ever, according to J.P. Morgan, but down 28% from last year. On a net basis (excluding repricings and refinancings), issuance came to $302 billion, up 17% over last year. A majority (73%) of the issuance occurred in middle tier of credit ratings (BB, B), while higher-rated issues accounted for 24% and lower-rated issues made up 3%.

On the demand side, retail fund flows turned negative in the fourth quarter, amounting to -$15.2 billion and offsetting the strong inflows of the first three quarters, according to Lipper.

Demand from collateralized loan obligations (CLOs), however, remained strong. Gross volume for the quarter from CLO formation came to $55.7 billion, and for the year it amounted to $277.6 billion, down slightly from $282.2 billion for 2017.

Net volume (gross volume minus refinancings, repricings, and reissuings) for 2018 was $130.6 billion, up 12% over 2017, according to J.P. Morgan.

Reflecting the asset class's robust fundamentals, the par-weighted default rate ended the year at 1.63% (excluding iHeart Media, the default rate came to just 1.02%), down from 1.84% at end of 2017.

### Our View

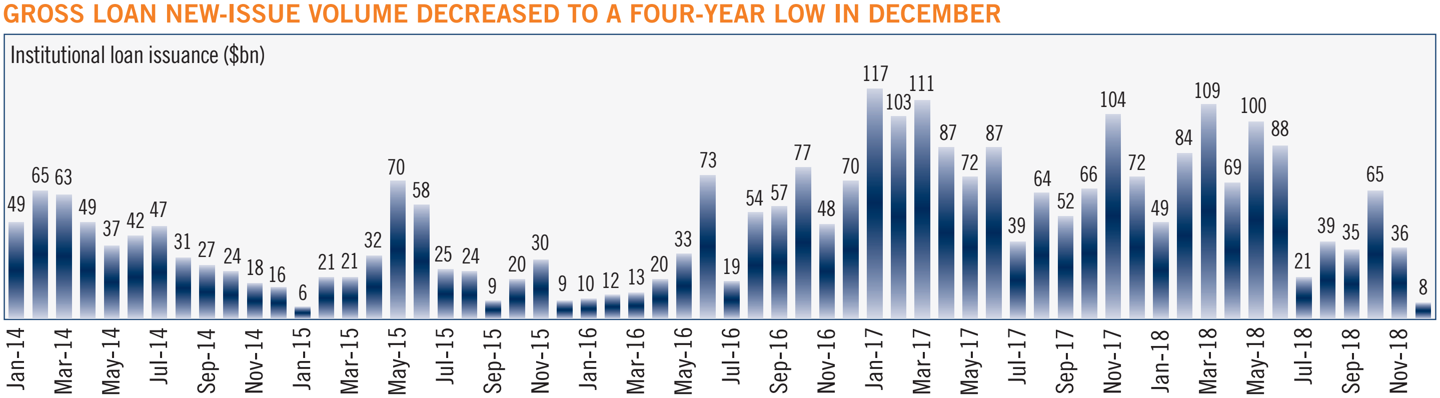
Given the healthy economic environment, we believe the sell-off was driven by a technical selloff, rather than deteriorating fundamentals. Economic growth still has a positive trend upwards, which historically has supported the asset class. In addition, companies are still reporting growth of operating earnings in the mid-to-high single digits. Many companies also continue to refinance debt to push out maturities and to pay down debt voluntarily.

The sell-off resulted in more attractive valuations, with the yield to three-year takeout finishing the year at 8.13%, the highest since October 2011. Similarly, the price on the J.P. Morgan Leveraged Loan Index ended the year at approximately $94.54, down from a high of $99.07 on October 5, 2018. Unlike in 2016, when the energy industry experienced a pullback, this one is broad-based, and opportunities are now present across all industries.

Interest rates have also been supportive. The London Interbank Offered Rate, or LIBOR, which many bank loans use as a floor on their coupon rate, has continued to rise. The 3-month LIBOR climbed to 2.8% by year-end, up approximately 110 bps for the year.

Nevertheless, the selloff in credit has created attractive opportunities, and we are taking advantage of market dislocations to capitalize on holdings that may be mispriced. Additionally, we are continuing to upgrade the credit quality of the portfolio with attractive yields.

**GROSS LOAN NEW-ISSUE VOLUME DECREASED TO A FOUR-YEAR LOW IN DECEMBER**




Source: J.P. Morgan



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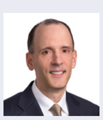
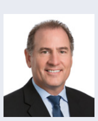
**Authored by:**

**Leveraged Loans**

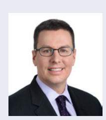


George Goudelias
Head of Leveraged Finance, Managing Director,
Senior Portfolio Manager
Seix Investment Advisors

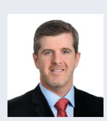


Vincent Flanagan
Portfolio Manager,
Senior High Yield Research Analyst
Seix Investment Advisors

**High Yield**



Michael Kirkpatrick
Managing Director, Senior Portfolio Manager
Seix Investment Advisors



James FitzPatrick, CFA
Managing Director, Portfolio Manager,
Head of Leveraged Finance Trading
Seix Investment Advisors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