Leveraged Finance

- The high yield market advanced 2.44% during the quarter, according to the ICE BofAML High Yield Index, with CCC-rated issues leading. Despite some outflows from mutual funds, technical factors, on balance, provided support to the market, as issuance declined during the quarter and the market continued to shrink.
- The leveraged loan market posted positive returns for the quarter, gaining 1.93% and building on the previous two quarters. It was the strongest quarterly performance for loans since fourth quarter 2016. Gains occurred across all sectors, with Retail and Metals & Mining leading the way, and Diversified Media and Utilities lagging. There were no new defaults this quarter, signaling a reduction in forward looking projections.

HIGH YIELD

The high yield market continued to benefit from an improving economy, as issuers experienced growth in revenue and operating income, rising interest coverage ratios, and slightly declining leverage levels. Rising interest rates, combined with a healthy economy, contributed to a narrowing of yield spreads.

The high yield market advanced 2.44% during the quarter, according to the ICE BofAML High Yield Index, with CCC-rated issues leading. But CCCs outperformed BBs by just 50 basis points (bps), down from 370 bps in the second quarter. Spreads tightened across the rating spectrum, with CCCs narrowing the most. In September, the spread on the ICE BofAML High Yield Index compressed to its narrowest level in 10 years. Leading sectors for the quarter were Cable & Satellite and Healthcare, while Retail and Autos lagged.

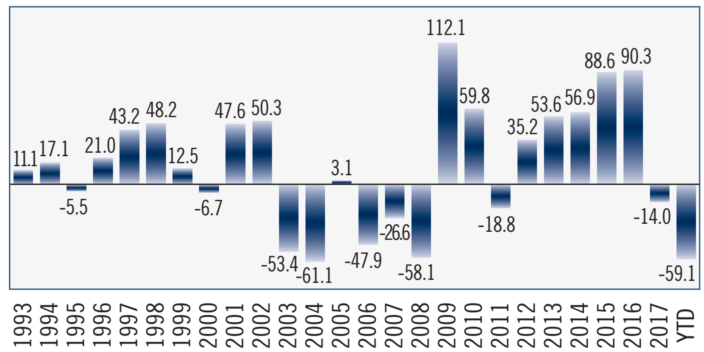
Year-to-date, the market overall advanced 2.51%, with lower quality issues leading the way. CCCs were up 6.92%, Bs up 3.48%, and BBs up just 0.55%, as measured by the ICE BofAML High Yield Index.

Along with strong fundamentals, technical factors have been supportive. Data from J.P. Morgan shows that on the demand side, outflows from mutual funds continued, but at a less rapid pace. In the third quarter, they totaled $1 billion, down from $24.5 billion in the previous two quarters.

Despite the outflows, the technical factors generally remained supportive of the market. Gross issuance year-to-date amounted to just $168.3 billion, down from $255.6 billion over the same period in 2017, according to J.P. Morgan. Issuance during the quarter shrank, amounting to $42.1 billion, or about half the quarterly average of the past seven years. Historically a strong month, September was particularly weak, with issuance of $18.2 billion, down from $43.3 billion in September 2017.

With the decline in issuance, the high yield market has continued to contract, declining by approximately $5 billion in the third quarter, while year-to-date, the market is down about $64 billion. In fact, the supply shortfall (net supply less net demand) is running at the most negative rate since 2004.

SUPPLY SURPLUS/SHORTFALL ($bn)



Source: J.P. Morgan

As for the purposes of the new issuances, refinancings continued to dominate, making up 62% of the total for 2018. Acquisitions made up 20% of total issuance, followed by general corporate uses, at 14%.

Much of the issuance that would normally occur in the high yield market appears to be going to the leveraged loan market. The appeal of a leveraged loan over a high yield bond is that companies can issue loans that are callable at par within six months. In contrast, in the high yield market, the company must issue a bond that is non-callable for several years, and when it becomes callable, it will be at a premium.

Defaults remained low, at 2.02%. Although this is up from 1.07% a year ago, issuers remain largely in good financial health. In the third quarter, ratings upgrades outnumbered downgrades 80 to 63, according to J.P. Morgan.

Our View

Given the strong fundamentals, we believe valuations are roughly within the range of fair value. We see more appealing valuations in the higher quality segment of the market. Thus, we are focused on quality over yield. Nevertheless, we continue to employ our bottom-up approach in which we will buy lower quality issues if they represent attractive values.

LEVERAGED LOANS

The leveraged loan market posted strong performance in the third quarter, with the Credit Suisse Leveraged Loan Index returning 1.93%. It was the strongest quarterly performance for loans since the fourth quarter of 2016. Year-to-date, the index returned 4.36%, outperforming both investment grade and high yield bonds.

All sectors posted gains for the quarter, with Retail and Metals & Mining leading, while Diversified Media and Utilities lagged. Retail, Metals & Mining, and Energy have driven returns throughout 2018, while Diversified Media, Automotive, and Paper & Packaging have trailed. Lower quality loans outperformed higher quality during the quarter. Split B/CCCs returned 4.34%, according to J.P. Morgan, with Bs following (+2.04%), and then BBs (+1.76%).

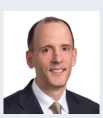
Demand continues to be strong, driven in part by rising interest rates and LIBOR, which continues to climb as well. Three-month LIBOR rose from 1.69% in December 2017 to 2.38% at the end of September. As a result, the average coupon on the J.P. Morgan Leveraged Loan Index rose from 5.0% to 5.7%. Flows into loan funds have been positive in 34 of the past 36 weeks, and year-to-date flows totaled $15.5 billion, the most in five years. Collateralized loan obligation (CLO) volume has been healthy as well, hitting $103.5 billion year-to-date, and on track to exceed strategist estimates. On the supply side, gross issuance dropped off from record volumes in recent quarters. Year-to-date gross loan issuance is $594 billion, down 19% vs. the same period in 2017; this is mostly due to a decline in refinancing activity.

Our View

There were no new defaults this quarter, signaling a reduction in forward looking default rate projections. Market technicals remain solid and this is supported in part by strong demand from Asian investors for high quality loans, and also among CLO and retail investors. Looking ahead, our rigorous individual credit research analysis aims to take advantage of attractive risk/reward valuation potential opportunities created by recent market volatility. Therefore, we continue to be overweight in higher quality loans, as we consistently have been for some time.

Authored by:

Leveraged Loans



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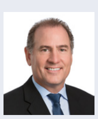

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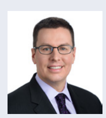
High Yield



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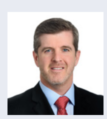

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Seix Investment Advisors is an investment management boutique focused exclusively on managing fixed income securities since 1992. Seix seeks to generate competitive absolute and relative risk-adjusted returns over the full market cycle through a bottom-up focused, top-down aware process. Seix employs multi-dimensional approaches based on strict portfolio construction methodology, sell disciplines, and trading strategies with prudent risk management as a cornerstone.