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Fall Rollercoaster: Economic Deceleration and Policy Uncertainty

> In the loan space, retail inflows moderated but remained healthy. CLO formation provided continued support. The 3Q index ticked up modestly, and default rates remained very low.

> In high yield, increased COVID cases, slightly higher Treasury yields, weaker economic data, and robust supply levels were the key themes for the quarter.

LEVERAGED LOANS

Strong Demand and a Fall in Supply Underscore Attractiveness

For all the volatility in equities, leveraged loans enjoyed strong technicals in the third quarter of 2021 as cash flowed into the market from multiple angles, the Federal Reserve (Fed) moved toward tapering asset purchases, and other central banks either signaled or instituted rate hikes to counter higher inflation.

With the world awash in liquidity, easy money policies have clearly ended. The big question is how long it will take the Fed to raise interest rates following big jumps in commodity prices, especially oil and gas. At any rate, loans continue to be seen as a hedge against inflation, and the current mergers & acquisitions market suggests there will be plenty of more loans to choose from. Private equity firms alone still have plenty of cash to deploy. Whatever loans come out of such transactions will no doubt draw interest in the CLO market, where U.S. bank and insurance companies have supplanted Japan as the biggest buyers.

As a result, the yield on the JP Morgan Leveraged Loan Index at this writing was about 4.8% and spreads were around 400 basis points (bps). To put that in context, pre-COVID tights were about 340 bps, considerably above 2018 tights. While the market price rose to around 98 in early October, we believe there is still some upside potential, and we believe that we could see additional tightening in the asset class.

With CCCs comprising about 12% of the index, we believe that there are better places to find value, even though CCCs have been the best performing segment of the market year to date. CCCs and even defaulted loans are both up about 15% year to date versus 2.25% for BBs, and 4.25% for single-Bs.

3Q 2021 Bank Loan Trends

Performance: For 3Q, the JP Morgan Leveraged Loan Index returned +1.18%. The year-to-date return was +4.67%, with split B/CCC loans (+2.1%) outperforming B loans (+1.22%) and BB loans (+0.76%). For the quarter, notable contributors by industry were metals & mining (+3.97%), energy (+1.89%) and diversified media (+1.67%), while laggards were cable & satellite (+0.72%), food & beverages (+0.88%), and gaming & leisure (+0.90%).

As of 9/30/21, the yield to 3-year takeout was 4.77%, up one bp for the quarter. The price on the index was approximately $98.78, up from $98.59 at 6/30/21.

LEVERAGED LOAN INDEX PROFILE
Summary profile of J.P. Morgan Leveraged Loan Indices
As of September 30, 2021

	Leveraged Loan	Liquid	Second Lien	BB/B	EUR/GBP
Market Value ($mn)	1,381,097	482,592	63,769	1,237,569	296,257
Number of Loans	1,636	197	233	1,357	450
Number of Borrowers	1,466	197	226	1,210	370
Average Rating	B	Split BB	Split B/ CCC	Split BB	B
Margin	L+354	L+312	L+721	L+339	L+370
Current Yield	4.06%	3.55%	7.94%	3.85%	3.79%
Years to Maturity	4.96 yrs	5.08 yrs	5.97 yrs	5.08 yrs	4.89 yrs
Price	98.78	98.88	97.97	99.47	98.87
Yield	4.77%	4.26%	8.70%	4.35%	4.20%
Spread	414bp	362bp	807bp	372bp	415bp
DM	430bp	386bp	812bp	391bp	415bp

Note: Yield, spread and DM are to 3-year takeout and based on forward curve analytics. Source: J.P. Morgan

Issuance: 3Q gross issuance totaled $160.6 billion. Year to date, leveraged loan issuance has totaled $655.5 billion or $284.3 billion net of refi/re-pricing—up a considerable 110% and 138% year over year, respectively.

M&A was a big driver, accounting for 48% of issuance. Refinancing–27%; Repricing–11%; Dividends–9%; General Corp/Other made up the balance with 5.0%.

Demand: Retail loan funds saw a 10th consecutive inflow in September. Inflows totaled a more modest $7.2 billion for the quarter following $13.6 billion of inflows in 2Q and $14.1 billion of inflows in 1Q.

CLOs: As for the CLO market, in 3Q U.S. CLOs priced $96.9 billion (Q2 priced $108.8 billion). Year to date, 677 U.S. CLOs have priced totaling $309.5 billion ($126.1 billion ex-refinancing and $183.4 billion refinancing) compared with 229 U.S. CLOs totaling $86.5 billion for the same period last year.

Default Rates: The loan par-weighted rolling 12-month default rate ended September at 0.89%, down 54 bps for the quarter and down 338 bps year to date. This is the lowest quarterly default rate since February 2012.

Takeaway: Retail inflows moderated but were still healthy. CLO formation provided continued support. 3Q index pricing ticked up modestly. Default rates remained very low; however, going forward, careful credit analysis and security selection will become more important as companies weather several headwinds, including higher input costs, supply chain challenges, labor shortages, and potentially higher interest rates.

HIGH YIELD

Risk Appetites Endure Delta Blues, Slower Growth, and Taper Talk

Increased COVID cases, slightly higher Treasury yields, weaker economic data, and robust supply levels were the themes in high yield for this quarter, all of which may have frustrated investors positioned for the re-opening of the economy.

Still, investors searching for yield drew comfort from lesser quality issues. The BBs and CCCs outperformed, while single-Bs lagged. Distressed high yield, which has been a huge driver year to date, grabbed a smaller part of the market, but it still outperformed as well. Duration also outperformed in the third quarter, which was a little surprising given the backup in rates.

Performance: The overall ICE BofA U.S. Cash Pay High Yield Index (J0A0) gained 0.93% and the ICE BofA BB-B U.S. Cash Pay High Yield Constrained Index (JUC4) was up 0.93%. BB's had the best return by ratings with a 1.07% gain. Single-B's were up .69%, and CCC's were up 1.0%.

J0A0 started the quarter with a 3.8% yield to worst and widened 21 bps to end 3Q with a 4.02% yield JUC4 started the quarter with a yield of 3.10%, widened 11 bps to end 3Q with a yield of 3.21%. The yield to worst on the single-B index started the quarter at 4.20% and ended at 4.47%. CCC's widened 81 bps from 6.03% to 6.84% during the quarter, which was a complete reversal of 2Q tightening.

Sector Returns: Energy, brokerage/asset managers, and REITs were the best performing sectors in J0A0. Communications, transportation, and finance companies were among the relative laggards. Energy, hotels & REITs, and building construction were the winning sectors in JUC4, while cable/ satellite, metals & mining, and media non-cable were relative laggards, but also still positive.

Default Activity: In 3Q only two companies defaulted, affecting $855 million, and one company completed a distressed exchanged affecting $282mn in loans (combined $1.14 billion). This was the lowest quarterly default volume inclusive of distressed exchanges since 4Q13. The par-weighted U.S. high yield default rate, including distressed exchanges, ended the month at 0.99%, down 577 bps year to date. Over the year's first nine months a total of 10 companies have defaulted totaling $4.1 billion in bonds.

Supply: Issuance totaled $140.5 billion for 3Q on a gross issuance. Refinancing accounted for $83.7 billion of that total. High yield issuance totals $409.7 billion year to date. Among the most notable refinancing efforts: Carnival Corp. sold $2.4 billion of bonds in July with a coupon of 4% to buy back some of the 11.5% notes it issued in April 2020.

Flows: In 3Q, high yield funds witnessed $1.9 billion of inflows compared with -$3.2 billion in 2Q. Year to date, outflows for high yield funds have totaled $11.9 billion, which compares to inflows of $35.9 billion in 2020.

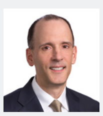
Outlook

We believe high yield bonds still offer attractive yields relative to broad fixed income. Fundamentals continue to be bifurcated across industries. We are focused on finding value in overlooked segments of the market including energy and financials (largely mortgage servicers/originators). We are also finding value in select small cap issuers. Default rates are expected to decline going forward, while fiscal stimulus and Fed accommodation continue to support the economy.

continued

Authored by:

Leveraged Loans



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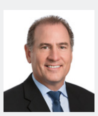

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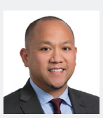

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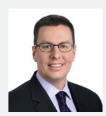
High Yield



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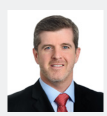

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ICE BofA U.S. High Yield Cash Pay Index is an unmanaged index consisting of all domestic and Yankee high-yield bonds maturing over one year. The quality range is less than BBB-/Baa3 but not in default (DDD1 or less). The **ICE BofA U.S. High Yield 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 BofAML 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. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and are not available for direct investment.

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

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