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"Omicronic" Fatigue Meets Inflation and Fed Hawkishness

> In the loan space, leveraged buyouts ("LBOs"), mergers & acquisitions ("M&A"), and refinancings continued to drive issuance, and the confluence of higher inflation and tighter monetary policy drew more retail and institutional investors into floating-rate debt.

> The high yield market continues to be pulled in different directions as the market struggles with virus variant concerns, degree and longevity of economic growth, Federal Reserve policy, and whether the inflationary forces we are experiencing will abate within a reasonable time frame.

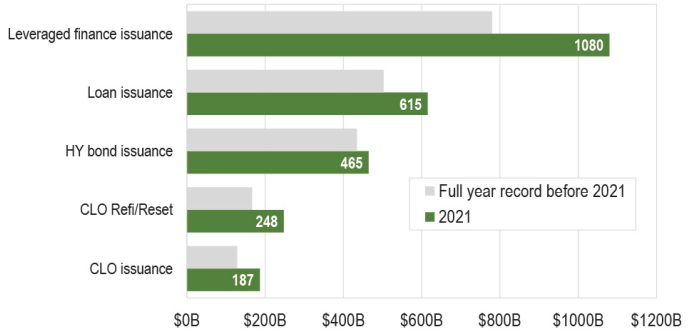
> While market volatility has increased due to the meaningful change in the outlook for central bank policy, we continue to believe that the fundamental backdrop for the asset class remains supportive and defaults will remain low for the foreseeable future.

LEVERAGED LOANS – Merger Mania Continues to Drive Supply While Attractive Rates Drive Demand

Leveraged loans enjoyed a strong year in 2021. As we enter 2022, the dual forces of inflation and higher interest rates should keep the loan asset class in focus and technicals should remain strong. Demand should outstrip supply. From a positioning perspective, we expect to be a bit more cautious in 2022 as peak GDP growth is likely behind us and higher wages and energy prices, coupled with continued supply chain issues, put pressure on margins and EBITDA growth.

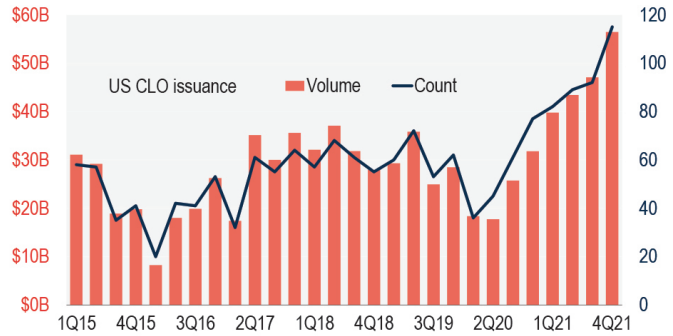
From a sector perspective, information technology, services, and healthcare should continue to draw sizable allocations, while enthusiasm for financials and chemicals may drop a bit. In any case, we would expect healthy issuance of leveraged loans to continue this year given continued strength in LBOs and M&A. Private equity sponsors have a phenomenal amount of cash to put to work, and they're certainly not going to give it back to their investors. And with continued low yields in the investment grade space, loans could once again enjoy healthy inflows from mutual funds, ETFs, and CLOs. The U.S. CLO market is now the largest securitized credit sector in the country, according to Bank of America.

Loan issuance records fall across the board in 2021...



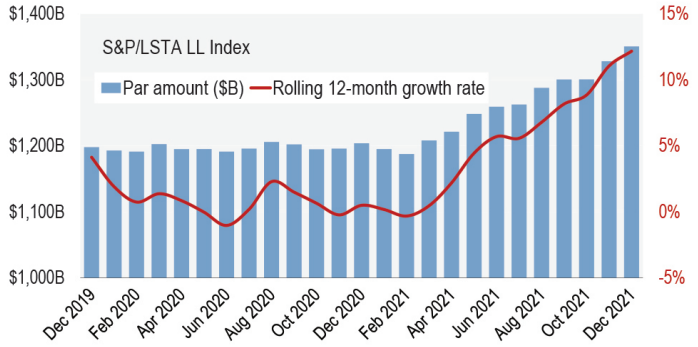
Data through Dec. 31, 2021.
Source: Leveraged Commentary & Data (LCD)

...as demand for floating-rate debt skyrockets...



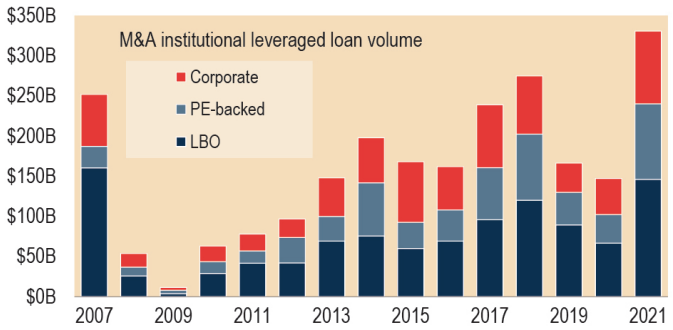
Data through Dec. 31, 2021.
Source: Leveraged Commentary & Data (LCD)

...causing the asset class to grow a hefty 12%.



Data through Dec. 31, 2021.
Sources: Leveraged Commentary & Data (LCD); S&P/LSTA Leveraged Loan Index

Of note: M&A activity crushes even pre-crisis levels...



Data through Dec. 31, 2021.
Source: Leveraged Commentary & Data (LCD)

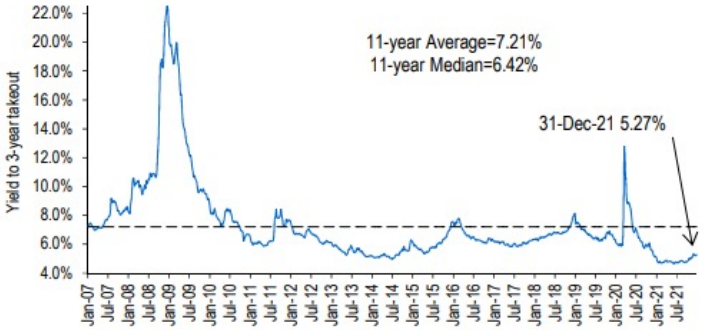
4Q 2021 Bank Loan Trends

Performance: For Q4, the JP Morgan Leveraged Loan Index returned +0.75%. Notable contributors by industry were metals & mining (+1.85%), energy (+1.39%), and technology (+1.01%), while laggards were gaming & leisure (+0.45%), utilities (+0.32%), and broadcasting (-0.86%).

For 2021 the index returned 5.46%. Notable contributors by industry were metals & mining (+16.02%), energy (+10.14%), and retail (+8.44%), while laggards were broadcasting (-0.01%), utilities (+1.44%), and cable & satellite (+2.66%). Split B/CCC loans (+12.32%) outperformed both B loans (+5.36%) and BB loans (+3.18%).

As of 12/31/21, the yield to 3-year takeout was 5.27% (versus 4.77% for 3Q), up 50 basis points ("bps") for the quarter and up 17 bps for the year amid a resetting of Federal Reserve expectations. The price on the index was approximately $98.51, down from $98.78 at 9/30/21. Loan prices ended the year $0.30 below their 2021 high on November 8th.

YIELD TO 3-YEAR TAKEOUT



Source: J.P. Morgan; IHS Markit

Issuance: Q4 gross issuance was strong again, totaling $179.6 billion. In full year 2021, leveraged loan issuance totaled $835.1 billion or $409.4 billion net of refi/re-pricing, which were up 98% and 112% from 2020, respectively.

Of note, in December 13 deals were linked to the Secured Overnight Financing Rate ("SOFR") and priced totaling $7.1 billion (25.7% of total volume), compared to 11 SOFR-linked deals in November totaling $7.2 billion (9.6% of total volume). We do not expect the transition from the London Inter-Bank Offered Rate (LIBOR) and SOFR to impact the economics of the leveraged loans asset class.

Mergers & acquisitions accounted for 50% of Q4 issuance. The rest stemmed from refinancing (18%), repricing (14.4%), dividends (12.8%), and general corporate/other (4.8%).

For 2021, M&A comprised 37% of issuance, refinancing 27%, repricing 24.4%, dividends 8.3%, and general corporate/other 3.3%.

Demand: Loan funds saw a 13th consecutive inflow in December. Overall inflows in 2021 totaled $45.4 billion ($10.0 billion in ETFs), compared to outflows of $26.9 billion over the same period in 2020.

CLOs: In Q4 U.S. CLOs priced $107.2 billion (compared to $96.9 billion in Q3). In 2021, U.S. CLOs priced $421.1 billion ($183.7 billion ex-refinancing and $237.4 billion refinancing) compared with $125.8 billion in 2020.

Default Rates: Continued to be very muted. The loan par-weighted default rate including distressed exchanges ended December at 0.65%, down 362 bps for the year.

LEVERAGED LOAN INDEX PROFILE

Summary profile of J.P. Morgan Leveraged Loan Indices as of December 31, 2021

	Leveraged Loan	Liquid	Second Lien	BB/B	EUR/GBP
Market Value ($mn)	1,441,879	498,602	69,866	1,305,344	303,315
Number of Loans	1,655	197	239	1,375	452
Number of Borrowers	1,478	197	233	1,226	370
Average Rating	B	Split BB	Split B/CCC	Split BB	B
Margin	L+355	L+316	L+711	L+340	L+371
Current Yield	4.10%	3.63%	7.84%	3.89%	3.81%
Years to Maturity	4.98 yrs	5.07 yrs	6.22 yrs	5.09 yrs	4.82 yrs
Price	98.51	98.59	98.07	99.26	98.65
Yield	5.27%	4.80%	8.95%	4.84%	4.33%
Spread	414bp	366bp	782bp	371bp	426bp
DM	476bp	436bp	835bp	436bp	427bp

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

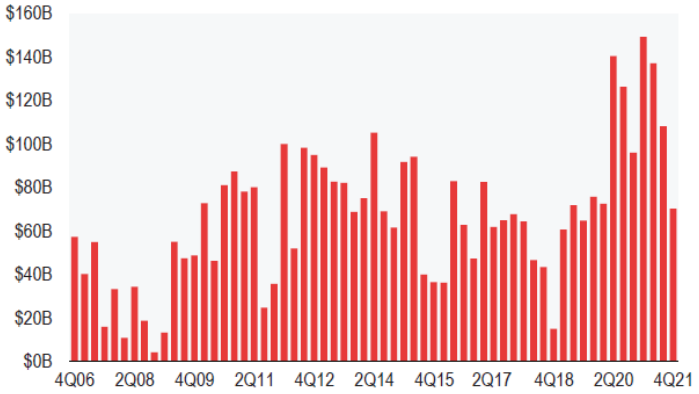
continued

HIGH YIELD – Continuing to Recover from One of the Worst Months of the Pandemic

The high yield market as measured by the ICE BofA High Yield Index ("H0A0") increased 5.36% for the year. The option adjusted spread ("OAS") for the benchmark tightened 76 bps during the year offsetting an increase in Treasury rates. The yield on the H0A0 index began the year at 4.24% and ended the year at 4.32%. This action is consistent with past periods of rising rates – i.e., spreads tighten as the economy improves and the underlying fundamentals of the issuers improves. This occurs as Treasury rates increase, also due to the improving economy.

Top performing segments of the market included CCC's, distressed high yield and energy. This is consistent with the improving economic backdrop. Further, longer-duration bonds as measured by the ICE BofA 10+ Year U.S. Cash Pay High Yield Index increased more than 8.6% for the year offsetting the headwind from the move higher in Treasury rates. This universe is more weighted to the energy sector than the overall market which at least partly explains the relative outperformance.

HIGH YIELD ENDS A RECORD YEAR ON A RELATIVELY QUIET NOTE U.S. High-yield Bond Volume



Data through December 31, 2021.
Source: Leveraged Commentary & Data (LCD).

Market Return: After a slightly negative performance from the start of the quarter through mid-November, the spread of the Omicron virus caused a significant drawdown in the high yield market in late November. This was followed by an even more powerful December rally that more than offset the late November sell-off.

The overall ICE BofA U.S. Cash Pay High Yield Index ("J0A0") gained 0.71%, and the ICE BofA BB-B U.S. Cash Pay High Yield Constrained Index ("JUC4") delivered a 0.73% return. Double BB's were up 0.72%. Single-Bs were up 0.82%, and CCC's were up 0.25%.

Spread Changes: The ICE BofA U.S. Cash Pay High Yield Index started the quarter with a 4.02% yield to worst and widened 21 bps to end 4Q21 with a 4.24% yield.

The ICE BofA BB U.S. Cash Pay High Yield Index ("H0A1") started the quarter with a yield to worst of 3.21% and widened 19 bps to end 4Q at 3.40%.

The yield to worst on the ICE BofA Single-B U.S. Cash Pay High Yield Index ("J0A2") started the quarter at 4.47% and ended at 4.68%.

CCC's widened 36 bps from 6.84% to 7.20% during the quarter.

Sector Returns: Energy, transportation, and basic industry were the best performing sectors in H0A0, and the worst performing sectors were utilities, telecommunications, and insurance.

Default Activity: Including distressed exchanges, U.S. high yield bond default rates decreased 9 bps to 0.29% during the quarter and were down 647 bps in 2021, according to JP Morgan.

Supply: Due to the Omicron virus, at $11.5 billion December's issuance was the lowest supply month since March of 2020. For the quarter, high yield issuance totaled $70.4 billion ($42.5 billion ex refinancings). For the year, high yield issuance totaled $483.8 billion ($193.1 billion ex refinancings).

Supply mix for the year broke down as follows: 60% refinancings, 16% general corporate purpose, and 24% in the mergers & acquisitions/leveraged buyout/dividend category.

Flows: For the quarter, high yield fund outflows totaled $1.1 billion. For the year, those outflows totaled $13.6 billion (+$842 million ETF), compared to inflows of $44.3 billion over the same period in 2020.

Outlook: The high yield market continues to be pulled in different directions as the market struggles with virus variant concerns, degree and longevity of economic growth, Federal Reserve (Fed) policy, and whether the inflationary forces we are experiencing will abate within a reasonable time frame.

As we write this, the market volatility has increased due to the meaningful change in the outlook for central bank policy. The yield for the market has widened 35 bps so far in 2022 due to a rise in Treasury rates as well as a 14 bp widening in OAS. BB's were underperforming CCC's by 90 bps as of January 10, 2022, presenting some attractive potential opportunities in this highest quality segment of the high yield market for long-term fixed income investors.

We continue to believe that the fundamental backdrop for the asset class remains supportive and defaults will remain low for the foreseeable future. The fundamentals of the

underlying issuers in the high yield market are a key consideration when investing in the asset class, and we are more sanguine about the impact that Fed policy will have on the fundamentals than current market volatility would seem to indicate. Further, we believe as much as 10% (and possibly more) of the asset class could be upgraded into investment grade over the next 12 to 24 months. This could provide a solid technical backdrop for the asset class as these dollars are recycled back into high yield.

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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. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and are not available for direct investment.

LIBOR is a benchmark interest rate at which major global lend to one another in the international interbank market for short-term loans. LIBOR, which stands for London Interbank Offered Rate, serves as a globally accepted key benchmark interest rate that indicates borrowing costs between banks.

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

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Negative Convexity refers to the shape of a bond's yield curve and the extent to which a bond's price is sensitive to changing interest rates.

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