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Concern Over Stagflation Fuels Volatility

- Leveraged loans experienced lighter issuance, a re-acceleration of retail inflows, a decline in collateralized loan obligation (CLO) activity, and a significant two-week rally (+1.89% 3/15-3/31) after seeing prices slide between late January and mid-March.
- Notable contributors by sector were energy, diversified media, gaming, and lodging. The laggards were telecom, broadcasting, and housing. The yield to a three-year takeout was 7.04%, up from 5.27% at the end of 4Q21, which primarily reflected the yield curve.
- In the high yield space, rising Treasury rates, the war in Ukraine, rising commodity prices and supply chain disruptions were the causes of the large drawdown in 1Q22.
- The overall ICE BofA U.S. High Yield Index returned -4.53% and the ICE BofA U.S. High Yield Constrained Index had a -4.58% return.

LEVERAGED LOANS

Ample Reason to Add Higher Quality

While the loan market reclaimed some of the losses sustained since Russia invaded Ukraine, increased economic uncertainty and concern over stagflation fueled volatility and limited new issuance, although mergers and acquisitions remained strong.

Coming into the year, the market was pricing about three rate hikes. By the end of the first quarter, it was pricing in eight more hikes after the one that occurred in March—all of which should benefit the loan asset class as inflationary pressures continue. The headline Consumer Price Index is at 7.9%, and with the war in Ukraine it's likely to go higher.

Suffice it to say, this is not an environment to be adding more risk. We're being more cautious instead given the potential for margin compression from increased cost pressures.

Even so, loans as an asset class continue to do well in a lot of different environments, and we expect that to continue. The only potential headwind is the economy. If we get into a recession earlier than expected, meaning this year rather than 2023, then it's going to impact everyone, not just us. Hence, the cautious stance mentioned earlier.

We still expect 2-2.5% GDP growth, and that would be fine for this asset class. It's what we've had the last dozen years or so, and in that environment most companies should do well. They'll be leveraged, they'll continue to generate free cash flow—maybe a little less with interest rates higher, but nonetheless positive.

While mergers & acquisitions (M&A) continued to drive significant demand in the first quarter, sellers now are probably are being a little more unrealistic about expecting last year's multiples when buyers are being more cautious about what they're willing to pay in the current macro environment. However, private equity continues to be very opportunistic. If strategic buyers don't want to pay up, private equity investors might be more willing to step in where they see value rather than return capital to investors. If so, M&A could have another healthy year, even if it's off last year's pace.

In terms of collateralized loan obligations, the impending switch from the London Interbank Offer Rate to the Secured Overnight Financing Rate (SOFR) pulled considerable demand forward in 2H21. That coupled with the macro volatility has slowed issuance, but we still expect it to be a healthy year. Not that long ago, a $100 billion year was considered outstanding, and we're certainly on that track now. Even if CLO formation is down from last year, 2022 could still be one of the strongest in 15 years. There's still a lot of capital ready to be deployed for CLOs. As things start to settle down from a macro perspective, we would expect to see solid demand for such floating-rate debt.

Highlights

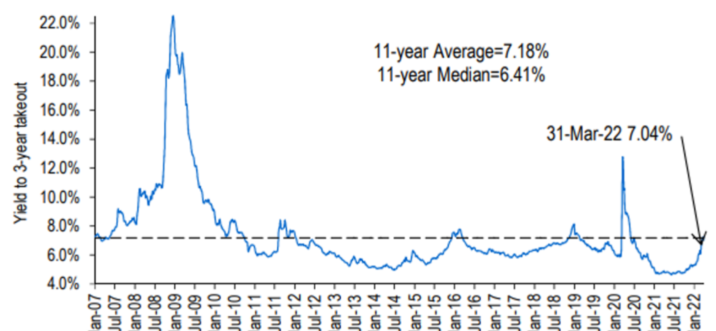
Key Trends: Leveraged loans experienced lighter issuance, a re-acceleration of retail inflows, a decline in collateralized loan obligation (CLO) activity, and a significant two-week rally (+1.89% 3/15-3/31) after seeing prices slide between late January and mid-March.

Performance: For 1Q, the JP Morgan Leveraged Loan Index return was essentially flat (a 0.01% loss). Notable contributors by industry were energy (+1.11%), diversified media (+0.42%), and gaming, lodging & leisure (+0.31%), while laggards were telecom (-0.61%), broadcasting (-0.56%), and housing (-0.54%).

Single-B rated loans returned 0.09% compared to returns of -0.04% and -1.62% for BB- and CCC-rated loans, respectively.

As of 12/31/21: The yield to 3-year takeout was 7.04% (compared to 5.27% in 4Q), up 177 basis points (bps) for the quarter, primarily reflecting the yield curve. The price on the index was approximately $97.64, down 87 cents from $98.51 at 12/31/21.

YIELD TO 3-YEAR TAKEOUT



Source: JPMorgan

LEVERAGED LOAN INDEX PROFILE

Summary profile of J.P. Morgan Leveraged Loan Indices as of March 31, 2022

	Leveraged Loan	Liquid	Second Lien	BB/B	EUR/GBP
Market Value ($mn)	1,491,798	508,809	73,271	1,354,456	305,380
Number of Loans	1,710	198	245	1,424	458
Number of Borrowers	1,506	198	238	1,252	371
Average Rating	B	Split BB	Split B/CCC	Split BB	B
Margin	L+358	L+319	L+706	L+343	L+375
Current Yield	4.39%	3.93%	8.12%	4.19%	3.94%
Years to Maturity	4.92 yrs	5.08 yrs	6.07 yrs	5.02 yrs	4.80 yrs
Price	97.65	98.03	94.27	98.30	97.37
Yield	7.04%	6.48%	11.35%	6.64%	5.59%
Spread	447bp	391bp	878bp	407bp	476bp
DM	608bp	553bp	1039bp	568bp	552bp

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

Issuance: 1Q gross issuance totaled $120.5 billion ($84.2 billion net of refi/re-pricing), reflecting a 20-month low of $21.6 billion issuance in March.

Mergers & acquisitions accounted for 60% of issuance followed by refinancing–24%, repricing–6%, dividends–4%; and general corporate/other–6%.

Demand: Loan funds saw a 16th consecutive inflow in March. 1Q inflows totaled $18.7bn ($2.1bn ETF), which compares to inflows of $14.1 billion over the same period in 2021.

CLOs: 101 U.S. CLOs priced totaling $50.3 billion ($31.2 billion ex-refinancing and $19.1 billion refinancing) compared with 234 U.S. CLOs totaling $106.3 billion for the same period last year (-53% year over year).

Default Rates: The loan par-weighted default rate including distressed exchanges (notably Sinclair's Diamond Sports Group) ended March at 0.65%, up 21 bps for the quarter.

HIGH YIELD

Investors Recoil from Rate Volatility, Inflation, and Geopolitical Risks

Rising Treasury rates, the war in Ukraine, rising commodity prices and supply chain disruptions were the causes of the large drawdown in 1Q22.

The overall ICE BofA U.S. High Yield Index returned -4.53%, and the ICE BofA U.S. High Yield Constrained Index had a -4.58%. return. BB's, the most Treasury sensitive part of the market, had a -5.37% return, Single-B's returned -3.86%, and CCC's returned -3.79%.

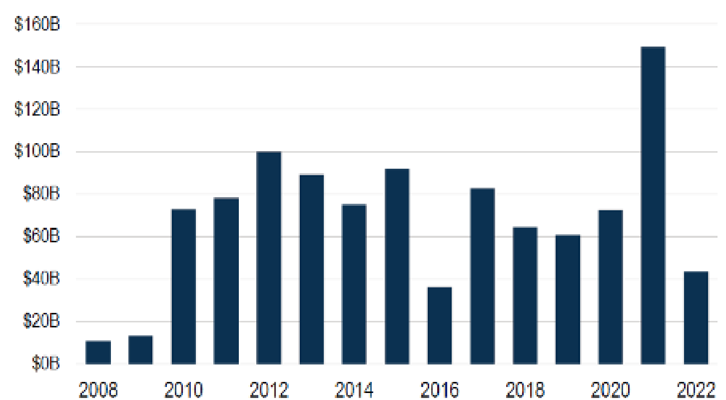
The yield to worst on the overall index went from 4.24% to 6.16%. However, the option-adjusted spread (OAS) widened from 301 bps to 344 bps, mainly due to the Treasury yield moving up. BBs went from a 340 bps to 519 bps, and the OAS went from 211 bps to 248 bps. On the Single-B index, yields went from 468 bps to 636 bps, and the OAS went from 350 bps to 391 bps. Finally, the yield on CCC's went from 720 bps to 943 bps, and that OAS widened from 618 bps to 654 bps.

Default Activity: Including distressed exchanges, the U.S. high-yield bond default rates increased 18 bps to 0.50% during the quarter and were down 475 bps in the last 12-month period, according to JPMorgan.

Issuance Was Very Light: Obviously, the market is kind of shut down with the rising rate requirement. For the quarter, it was $46.5 billion, while re-financings were at $24.8 billion. That's down from last year's pace of $158.8 billion and $43.6 billion ex-refi.

Flows: Year to date 2022, outflows for high yield funds total $25.3 billion (-$13.0 billion ETF), which compares to outflows of $10.6 billion during first quarter of 2021.

U.S. HIGH-YIELD BOND ISSUANCE, Q1



Data through March 31, 2022.
Source: Leveraged Commentary & Data (LCD).

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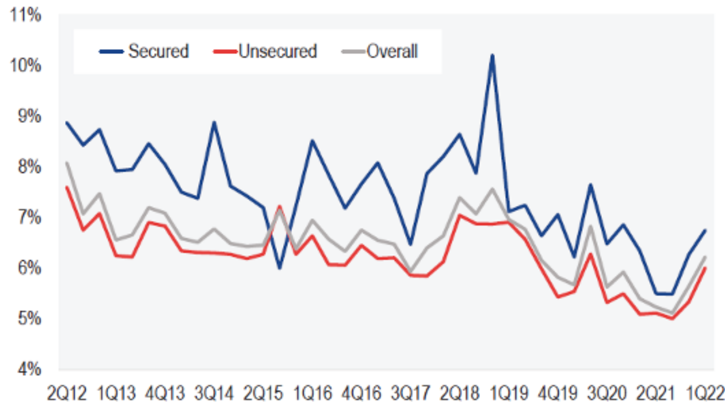
NEW ISSUE YIELDS FOR U.S. HIGH YIELD BONDS



Data through March 31, 2022.
Source: Leveraged Commentary & Data (LCD).

Outlook

Once rates stabilize, there may be more yield cushion for spreads to tighten. That might not happen immediately. Investors might want to wait and see what happens to the economy, what the Fed is doing, with what oil and gas companies are doing. As we've said before the high-yield asset class enjoys some of the best credit quality ever.

One of the themes worth considering is deep discount Double-B's, particularly companies that have scalable growth opportunities without requiring a lot of capital and/or can generate free cash flow. In an inflationary environment, companies do not want to be burning cash because their cost of capital is going up.

Another theme worth watching is pent-up millennial demand for housing which could continue to be a tailwind, especially if supply chain issues improve as we expect. The big question, though, is when mortgage rates start to bite.

When it comes to retail, long-standing cabin fever from the pandemic could drive other opportunities. While we recognize the secular issues the industry has, as the economy opens further, people are going to be looking for excuses to get out of the house as the weather gets warmer, whether it's a trip to the mall or visiting restaurants, even if inflationary pressures put a damper on such spending.

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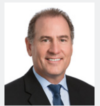
Authored by:

Leveraged Loans

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

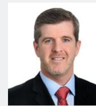


Vincent Flanagan
Portfolio Manager,
Senior High Yield Research Analyst
Seix Investment Advisors

Eric Guevara
Portfolio Manager,
Head of Leveraged Loan Trading
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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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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