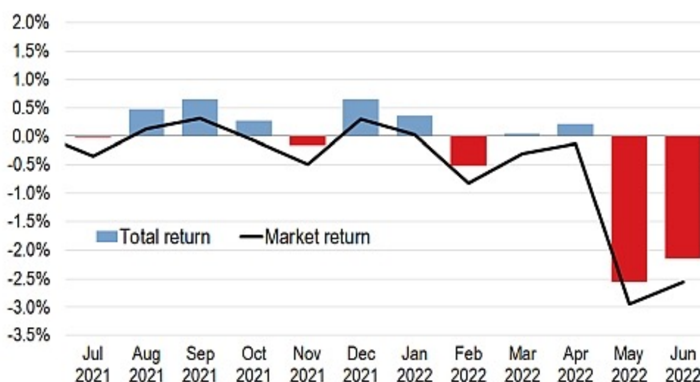
SEIX INVESTMENT ADVISORS
A VIRTUS INVESTMENT PARTNER

Navigating Headwinds and Headaches

- Loans lost 4.45% in 2Q22 while the YTD loss stands at 4.55%.
- The new-issue market remained open, but volume dropped while the cost of debt rose as markets were in a risk-off mode. The size of the loan asset class shrank slightly for the first time in 16 months, with the index par amount outstanding declining to $1.41 trillion.
- The high yield market as measured by the ICE BofA U.S. High Yield Index (H0A0) declined -9.97% in the second quarter of 2022, capping off the worst start for the year since inception of the index. The second quarter decline took the return for the year to a decline of -14.04%.
- As a result, the H0A0 Index ended the first half at a yield to worst of 8.94%, improving the prospects for above-average future returns.

U.S. LEVERAGED LOAN RETURNS, MONTHLY



Data through June 30 2022.
Sources: Leveraged Commentary & Data (LCD), S&P/LSTA Leveraged Loan Index

LEVERAGED LOANS

CLOs Add Ballast

Despite their attractive yields and hedge against inflation, leveraged loans were not immune from the broader market volatility experienced in the second quarter, underscoring opportunities to shed lower quality positions and buy more highly rated credits.

Technicals in the market continue to be supported by CLOs but offset by retail redemptions although redemptions appear to have slowed. Collateralized loan obligation (CLO) creation appears to be on track for another $100 billion year, so the recent redemptions we have seen have been easily absorbed by the CLO community. The CLO community has provided ballast for the loan market.

When it comes to fundamentals, the commodity-related sectors are obviously all improving. Some of the COVID-impacted sectors like gaming and airlines also continue to improve. Technology has been for the most part improving, although there are some outliers that have not. Telecom/media is improving with some exceptions.

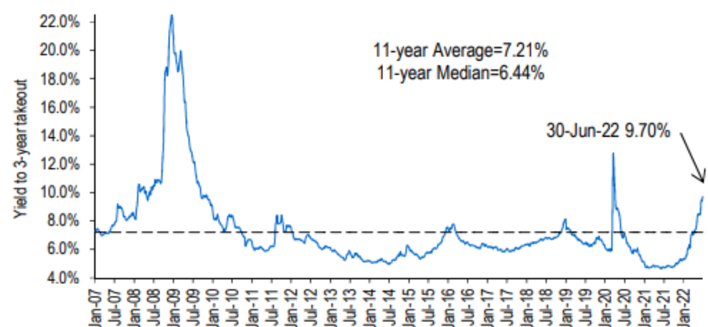
2Q Trends

Performance: For 2Q, the J.P. Morgan Leveraged Loan Index saw a return of -4.05%. All industry segments declined with the least declines in energy -1.41%, utilities -2.24% and chemicals -2.84%, and the greatest declines were in housing -6.59%, consumer products -6.36%, and telecom/media -5.46%.

Single-B rated loans returned -4.74% compared to returns of -3.0% and -8.3% for BB and Split B/CCC rated loans, respectively.

As of 6/30/22, the yield to 3-year takeout was 9.70% (vs. Q1: 7.04%), up 266 basis points (bps) for the quarter, primarily reflecting price declines. The price on the J.P. Morgan Leveraged Loan Index as of 6/30/22 was approximately $92.45, down from $97.64 at 3/31/22 (down $5.19).

YIELD TO 3-YEAR TAKEOUT



Source: J.P. Morgan, IHS Markit

LEVERAGED LOAN INDEX PROFILE

Summary profile of J.P. Morgan Leveraged Loan Indices as of June 30, 2022

	Leveraged Loan	Liquid	Second Lien	BB/B	EUR/GBP
Market Value ($mn)	1,421,333	478,659	70,255	1,288,832	272,951
Number of Loans	1,721	199	242	1,426	463
Number of Borrowers	1,513	199	234	1,253	375
Average Rating	B	Split BB	Split B/CCC	Split BB	B
Margin	L+361	L+323	L+706	L+346	L+375
Current Yield	5.68%	5.24%	9.55%	5.46%	4.32%
Years to Maturity	4.79 yrs	4.95 yrs	5.92 yrs	4.86 yrs	4.67 yrs
Price	92.45	92.10	89.12	93.06	89.72
Yield	9.70%	9.35%	13.96%	9.27%	9.45%
Spread	661bp	628bp	1087bp	619bp	788bp
DM	744bp	708bp	1170bp	701bp	917bp

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

Seix Investment Advisors is a division of Virtus Fixed Income Advisers, LLC ("VFIA"), an SEC registered investment adviser.

Issuance: 2Q gross issuance totaled $60.6bn ($40.9bn net of refi/re-pricing) reflecting a 23-month low of $16.3bn issuance in June. Secured Overnight Financing Rate (SOFR) issuance is now accounting for nearly all total issuance in the primary market as all deals priced in June were SOFR-linked.

Profile of issuance: M&A–58%; Refinancing–33%; Repricing–0%; General Corp/Other–9%.

Demand: 2Q fund outflows totaled $3.2 billion, reflecting outflows in June of $4.1 billion and May of $4.4 billion, partially offset by inflows in April of $5.3 billion. Year-to-date inflows are $16.5 billion compared to inflows of $27.7 billion for the same period last year.

CLOs: Gross U.S. CLOs volume totaling $43.5 billion ($40.8 billion ex-refinancing) compared with $50.3 billion for the same period last year (-14% year over year).

Default Rates: The loan par-weighted default rate including distressed exchanges ended June at 1.14%, up 49 bps for the quarter. For context, the long-term average default rate for leveraged loans is 3.1%.

Takeaway: The loan product experienced an acceleration of retail outflows, a more modest decline in CLO activity, a substantial decline in issuance, and a significant widening in yield as prices declined for the quarter.

Outlook

We foresee a volatile 2Q earnings season with many industries likely to reset their 2022 outlooks based upon sharply higher inflationary pressures which will likely pressure margins, as well as shifting consumer and industrial demand. We believe lower earnings expectations are a precursor to a market bottoming process. Market pricing is attractive at 586 basis points (bps) spread according to J.P. Morgan on July 18, 2022.

Year-to-date loan price reductions reflect many market uncertainties and offer a historically attractive entry point. (According to J.P. Morgan, when loans trade above 8% and/or below a price of $94.00, forward 12-month returns have historically averaged +9.1%). It remains difficult to time the market bottoms, so we are selectively adding higher quality positions. We are prepared to deploy more capital during periods of market dislocation which likely includes the upcoming earnings season.

Many statistics point to a solid, but slowing underlying U.S. economy; however, Federal Reserve actions, inflationary pressure and supply chain disruptions should likely further dampen economic growth over the next few quarters. We are uncertain if we will enter a technical recession, but we are prepared for a profit recession in many industries. Inflation reached a 40-year high in June 2022 according to the U.S. CPI Urban Consumers Price Index at 9.1% up from 2.6% in March 2021. Gasoline, food, and housing costs are the latest inflation hot spots which we believe could linger. The markets currently expect rates to peak near 3.5% in early 2023, before the Fed begins an easing cycle.

HIGH YIELD

After a Rough First Half, Some Potential Entry Points

The high yield market as measured by the ICE BofA U.S. High Yield Index (H0A0) declined -9.97% in the second quarter of 2022, capping off the worst start for the year since inception of the index. The second quarter decline took the return for the year to a decline of -14.04%.

We began the year with the knowledge that the Fed would begin a tightening cycle. However, we were also met with an invasion of Ukraine and another shutdown in China that further exacerbated inflationary and supply-chain pressures. This was followed by stubbornly high inflation data that have contributed to an increasingly hawkish Fed.

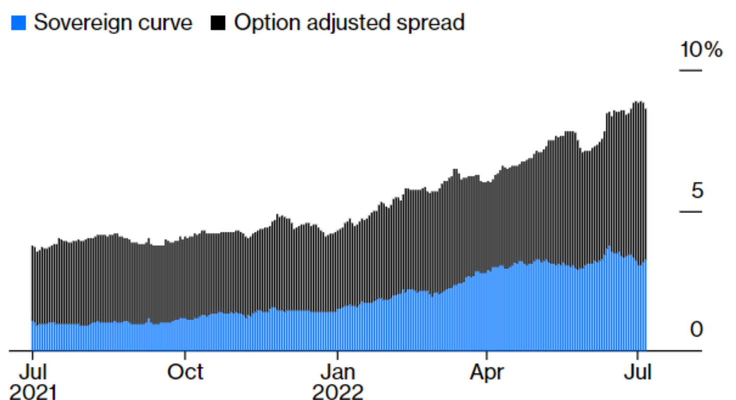
As a result, the H0A0 Index ended the first half at a yield to worst of 8.94%, improving the prospects for above-average future returns.

The highest quality segment of the high yield asset class (BBs) had the worst performance in 1Q22 due to the ratings segment's greater sensitivity to rising rates. However, during the second quarter, BBs represented the best performing ratings segment as fears of a recession began to get priced into the market. BBs, as measured by the ICE BofA BB U.S. High Yield Index (H0A1), declined -8.62% in 2Q22; Bs, as defined by the ICE BofA Single-B U.S. High Yield Index (H0A2), declined -10.70%; followed by CCCs, as defined by the ICE BofA CCC & Lower U.S. High Yield Index (H0A3), which declined -13.91%.

Top performing sectors for the year-to-date period for the high yield market included transportation excluding air & rail, gaming, and energy. The weakest sectors for the year-to-date period include non-food retail, building materials, and homebuilders & real estate.

HIGH YIELDS GET HIGHER

The jump in junk bond yield reflects both spread and rising interest rates



Source: Bloomberg data.
Note: Reflects yield to worst on Bloomberg U.S. Corporate High Yield Bond Index.

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Highlights

Spread Changes: The ICE BofA High Yield Index started the quarter with a 5.93% yield to worst and ended 1Q22 with an 8.77% yield. The BofA High Yield Index's Option-Adjusted Spread (OAS) increased from 332 to 570 bps in the quarter. The BB index started the quarter with a yield of 4.97% and ended with a yield of 7.23%. The index's OAS widened from 236 bps to 416 bps for the quarter. The yield to worst on the single-B index started the quarter at 6.36% and ended at 9.55%. The OAS on the single-B index widened from 376 to 649 bps. CCC yields rose from 9.08% to 13.74% during the quarter. The OAS on the CCC index widened from 654 bps to 1068 bps.

Default Activity: According to J.P. Morgan, including distressed exchanges, the U.S. high yield bond default rates increased 36 bps to 0.86% and were down 216 bps in the last 12-month period.

Issuance: or the quarter/year, high yield issuance for the quarter was $24.6 billion bringing YTD volumes to $71bn total or $36.7 billion ex-refi.

Flows: TD 2022, outflows for high yield funds total -42.5 billion (-$17.7 billion ETF), which compares to outflows of -$13.9 billion during the first six months of last year.

Outlook

The direction of the economy will determine how spreads end the year. Nominal GDP growth will be the strongest we have seen in decades. Companies that have pricing power and can manage through margin compression can do well. Companies that need the capital markets to refinance debt or that have any weakness in earnings could end up in a challenging situation. As discussed, we believe balance sheet flexibility is an important consideration in this environment.

Nevertheless, we believe spreads can tighten from here, but the near-term trajectory is not clear. Having said that, we believe that spreads more than compensate for the likely default environment.

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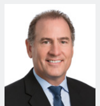
Authored by:

Leveraged Loans

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

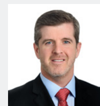


Vincent Flanagan
Portfolio Manager,
Senior High Yield Research Analyst
Seix Investment Advisors

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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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. **ICE BofA U.S. High Yield Index (H0A0)** tracks the performance of U.S. dollar denominated below investment grade rated corporate debt publicly issued in the U.S. domestic market. To qualify for inclusion in the index, securities must have a below investment grade rating and an investment grade rated country of risk. The **ICE BofA BB U.S. High Yield Index (H0A1)** is a subset of the ICE BofA U.S. High Yield Master II Index and includes all securities with a given investment grade rating BB. The **ICE BofA CCC & Lower U.S. High Yield Index (H0A3)** subset includes all securities with a given investment grade rating CCC or below. The **ICE BofA Single-B U.S. High Yield Index (H0A2)** subset includes all securities with a given investment grade rating B. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and are not available for direct investment.

The **Secured Overnight Financing Rate (SOFR)** is widely accepted as the LIBOR replacement for loans. SOFR is based on overnight Treasury Repo Rates with nearly $1 trillion of underlying daily transactions and not subject to market manipulation. Since SOFR is a daily rate, Term SOFR was developed as a forward-looking rate from SOFR futures trading.

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

Collateralized Loan Obligations are securities backed by a pool of assets often low-rated corporate loans.

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