SEIX INVESTMENT ADVISORS
A VIRTUS INVESTMENT PARTNER

Despite a Rough 3Q, Loans Continue to Hedge Against Inflation and High Yield Valuations Become More Attractive

> Leveraged loans continued to outperform most other asset classes in Q3, generating a 1.19% return, per the Credit Suisse Leveraged Loan Index, providing investors with the inflation hedge that they have come to expect from the loan asset class. The average price of a loan declined marginally from 91.96 on 6/30 to 91.60 on 9/30. Yields did exactly what one would expect of bank loans in a rising rate environment with the index yield rising from 9.08% to 10.28% as the 3-month LIBOR increased from 2.29% to 3.75%.

> High yield spreads widened significantly since the beginning of the year, making high yield valuations more attractive. Issuer quality in many sectors also increased, suggesting that free cash flow and cash on hand should provide a strong buffer to bridge an economic downturn if the economy stalls.

LEVERAGED LOANS

Caution in the Face of Inflationary Forces

Overall performance was solid for most sectors, as fundamentals remained in good shape, although we saw margin compression for some sectors such as technology, healthcare, and consumer goods. While interest rate coverage overall remained strong for the leveraged loan market, we have likely peaked for the near-to-intermediate term. The Federal Reserve's (Fed) continued push to raise rates and contain inflation will be a headwind for some lower quality issuers going forward, but we maintain that holders are being compensated for that future risk. With dollar prices around 92 and yields above 9%, we have historically seen attractive returns for holders twelve months out.

Another issue we hear from our clients is regarding "Cov-Lite." We need to realize that Cov-Lite, now representing 90% of the overall bank loan market, has made a significant difference in the way companies can maneuver through difficult times. Covenant restrictions in the past triggered financial events so harsh as to make a turnaround all but impossible. However, as the market has matured, we see the removal of such covenants as potentially enabling companies to work through difficult market cycles and maintain their ability to service their debt.

Still, the increasingly volatile current environment underscores the need for active management. Focusing on higher quality companies that generate significant free cash flow to maintain and service their debt is crucial during these tumultuous times.

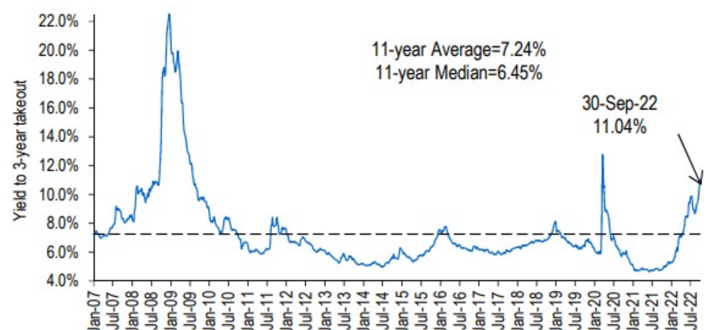
3Q 2022 Bank Loan Trends

Performance: For 3Q, the JP Morgan Leveraged Loan Index saw a return of 1.46%. Top contributors by industry were: utilities +3.54%, transport +3.36% and energy +3.01%. Detractors included metals & mining -2.96%, and consumer products -0.06%.

Single-B rated loans returned +1.27% compared to returns of +2.47% and -1.88% for BB and Split B/CCC rated loans, respectively.

As of 9/30/22, the yield to 3-year takeout was 11.04% (Q2: 9.70%), up 134 basis points (bps) for the quarter, primarily reflecting a surge in the forward curve. The price on the index was more muted at approximately $92.20, down $0.25 for the quarter.

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 September 30, 2022

	Leveraged Loan	Liquid	Second Lien	BB/B	EUR/GBP
Market Value ($mn)	1,407,324	476,510	64,861	1,262,798	253,387
Number of Loans	1,709	199	234	1,398	454
Number of Borrowers	1,492	199	227	1,225	368
Average Rating	B	Split BB	Split B/CCC	Split BB	B
Margin	L+364	L+322	L+710	L+347	L+374
Current Yield	7.39%	6.93%	11.76%	7.12%	5.09%
Years to Maturity	4.62 yrs	4.72 yrs	5.67 yrs	4.68 yrs	4.52 yrs
Price	92.20	91.91	85.51	93.18	89.55
Yield	11.04%	10.63%	16.74%	10.48%	11.04%
Spread	678bp	638bp	1248bp	622bp	807bp
DM	727bp	686bp	1296bp	670bp	935bp

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.

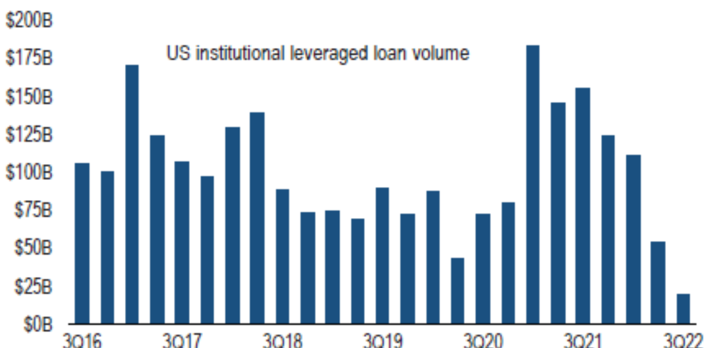
Issuance: 3Q gross issuance totaled $24.0 billion, which was a quarterly low since 1Q10. Notably, this is the seventh consecutive month of no repricing deals amid higher yields. Year to date, acquisition financing leads in use of proceeds, totaling $126.8 billion (62% of total volume), while refinancing activity totals $52.3 billion (26%), repricing activity totaled $7.5 billion (4%), general corporate financing totaled $6.7 billion (3%), and dividend financing/other totaled $11.2 billion (5%).

Demand: 3Q fund outflows totaled -$13.2 billion. Year-to-date 2022 inflows for loan funds totaled +$1.9bn (-$4.5bn ETF), which compares to inflows of +$35.7 billion over the first nine months of last year and +$46.5 billion (+$10.0 billion ETF) for the full year 2021.

CLO volume totaled $33.8 billion (ex-refinancings) compared to 2Q's volume of $42.7 billion ($40.0 billion ex-refinancing and $2.7 billion refinancing). Year to date, the CLO market has priced a total of $105.1 billion (ex-refinancing) in new deals, down 20% year-over-year, an impressive total given the pull forward last year owing to the impending switch from LIBOR to SOFR.

Default Rates: The loan par-weighted default rate including distressed exchanges ended September at 1.63%, deteriorating 49 bps for the quarter. For context, the long-term average default rate for leveraged loans is 3.1%.

LOAN ISSUANCE PLUMMETS TO A POST-CRISIS LOW IN THE THIRD QUARTER...

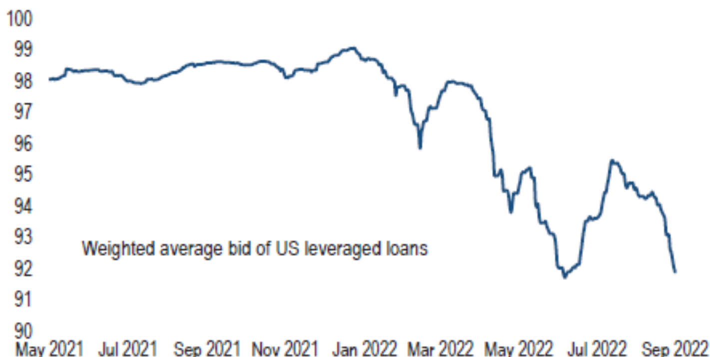


Data through September 30, 2022. Source: Leveraged Commentary & Data (LCD).

...AS INVESTORS SHUN RISK AMID HEADLINE INFLATION NUMBERS...

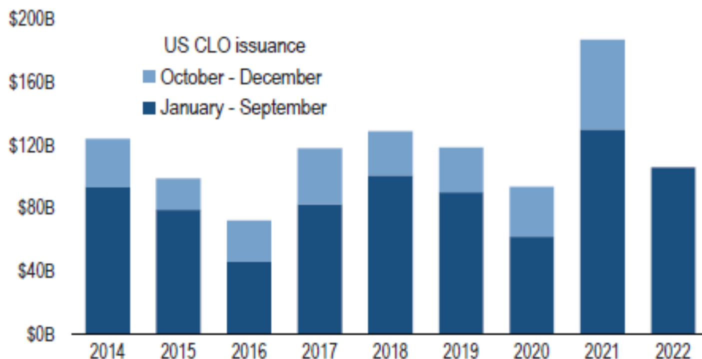
Data through September 30, 2022. Source: Leveraged Commentary & Data (LCD).

...PROMPTING UNCHARACTERISTIC VOLATILITY IN THE ASSET CLASS



Data through September 30, 2022. Sources: Leveraged Commentary & Data (LCD); Morningstar LSTA US Leveraged Loan Index.

DESPITE CHALLENGES, 2022 HAS BEEN AN ACTIVE YEAR FOR CLOs



Data through September 30, 2022. Source: Leveraged Commentary & Data (LCD).

Takeaway: Leveraged loans continue to outperform other asset classes (tracked by Bloomberg and Morningstar) despite retail outflows, and higher rates are boosting yields as increased LIBOR works its way into each loan in the markets.

HIGH YIELD

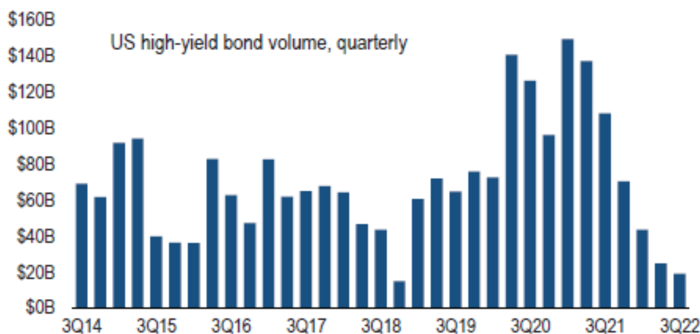
Good Opportunities After a Challenging Summer

Performance: The weak third quarter followed the worst first half of a year since inception of the ICE BofA U.S. High Yield Index ("H0A0)") on January 31, 1996, with the index declining 14.04%. The third quarter began with a strong July that had the ICE BofA U.S. High Yield Index increasing 6.02%, which was the best month for the asset class since the global financial crisis. The performance in July was driven by positive technicals, declining Treasury rates (the 10-year ended 2Q with a yield just above 3% and bottomed at less than 2.6% in early August) and a changing perception that a potential economic slowdown might not be as bad as feared. The month of July was led by the higher quality part of the market that is more rate sensitive as BB's outperformed single-B's that outperformed CCC's. This reversed around the time that rates bottomed in early August

continued

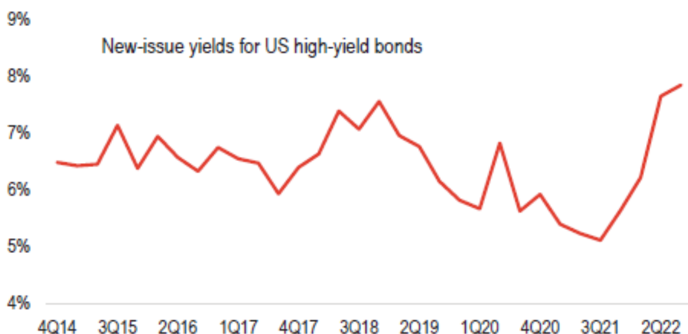
and began to move higher, driving underperformance of the more rate sensitive BBs. By August 11, the option-adjusted spread for the index had come in by about 150 bps for the quarter as the market appeared to buy into the thought of a more dovish Fed.

IN FIXED-RATE, THERE HAS BEEN CAPITULATION IN HIGH-YIELD BONDS...



Data through September 30, 2022. Source: Leveraged Commentary & Data (LCD).

...AS DEBT COSTS SKYROCKET, SLAMMING THE DOOR ON REFINANCINGS



Data through September 30, 2022. Source: Leveraged Commentary & Data (LCD).

Spread Changes: The September CPI report seemed to reverse that thinking resulting in an underperformance of CCCs as market participants began to price in a greater risk of the Fed continuing to tighten into an economic slowdown. By the end of September, index spreads widened out to 543 bps. While spreads on BBs (ICE BofA BB US High Yield Index, or H0A1) and single-B's (ICE BofA Single-B US High Yield Index, or H0A2) tightened for the quarter, CCCs (ICE BofA CCC & Lower US High Yield Index, or H0A3) actually widened. However, due to CCCs having wider spreads (more than 1,250 bps) and higher coupons as well as a change in constituents due to downgrades, their total return (including interest) for the quarter beat out BBs and single-B's. Returns for each segment were: BBs (H0A1) -0.881%; single-B's (H0A2) -0.588% and CCCs (H0A3) -0.167%.

Sector Returns: For the index, aerospace/defense, oil field services and refining sectors outperformed, while the healthcare, real estate investment trusts, banking, and pharmaceuticals sectors lagged.

Default Activity: According to JPMorgan, the high yield default rate for the quarter increased by 37 bps to 1.57%. Year to date, $12.2 billion in bonds have defaulted.

Supply for the quarter/year: High yield gross, refi, and non-refi issuance year-to-date totals $90 billion, $44 billion, and $46 billion, respectively. For the quarter there was $18.9 billion in gross supply in high yield or $9.3 billion in net supply. This is the lightest issuance quarter since 1Q09.

Flows: Retail withdrawals for high yield bond funds total $8.7 billion in 3Q22, which raised the year-to-date outflow to a record $53.6 billion.

Outlook

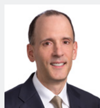
High yield as an asset class remains well positioned with remarkably high interest coverage and low leverage. While liquidity has suffered, higher quality is a compelling opportunity in this market. That is not to say that we are not going to have some volatility in the near term, but we believe that would be an additional buying opportunity for longer term investors. Considering how high yields and spreads have risen lately, we believe the backdrop is solid.

Security selection will be key as volatility, uncertainty, and inflationary pressures continue, but high yield investors in general should still get paid to wait.

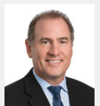
continued

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

Seix Investment Advisors, a division of Virtus Fixed Income Advisers, LLC, 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.

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.

The commentary is the opinion of Seix Investment Advisors. This material has been prepared using sources of information generally believed to be reliable; however, its accuracy is not guaranteed. Opinions represented are subject to change and should not be considered investment advice or an offer of securities.

Past performance is no guarantee of future results.

All investments carry a certain degree of risk, including possible loss of principal.

Mutual Funds, ETFs, and Virtus Global Funds are distributed by **VP Distributors, LLC**, member FINRA and subsidiary of Virtus investment Partners, Inc.

2208 10-22 © 2022 Virtus Investment Partners, Inc.

virtus.com • 1-800-243-4361