2023 Loan Market Outlook

Rising Rates Should Provide a Tailwind, Although There Could be a Mild Recession in Late 2023

SUMMARY

In 2023, we expect mid-single digit total returns for the loan market depending on the depth of the recession and short-term interest rate progression. In 2022, the loan market demonstrated its "all-weather" appeal by materially outperforming other fixed income markets and nearly generating a positive return. As of 12/21/2022, J.P. Morgan's Leveraged Loan Index was down 0.22% year to date, while J.P. Morgan's Domestic High-Yield Index was down 9.86%, 10-year Treasuries fell 14.07%, investment-grade bonds were down 13.14%, emerging market bonds fell 14.93%, and the S&P 500® Index dropped 18.53%, according to Bloomberg. The average BB-rated loan price was 97.75 and yielded an attractive 7.18% (336 basis points spread), according to J.P. Morgan, while the average B-rated loan price was 92.87 to yield an attractive 9.88% (602 bps spread). In perhaps the most widely predicted recession in history, we expect economic growth to slow into late 2023 with a mild recession in the United States. According to Bloomberg, the market expects short-term rates to rise in early 2023, peak near mid-year, and drift lower to end the year near today's 4.33% level. We expect rising rates to provide a tailwind to the floating rate loan asset class. We also expect defaults to tick up in 2023 to more recessionary levels near 3.0% from 1.6%. Our material underweight in lower-rated loans should dampen defaults' negative impact on our portfolios.

POSITIONING

We remain a flexible, nimble value-oriented leveraged loan manager focusing on the potential for downside protection which you should expect from a credit manager. During market selloffs in June, August, September, and December, the market volatility worked in our favor, allowing us to selectively purchase assets at attractive prices. Since 2Q 2022 we have positioned our portfolio more conservatively, pruning more fully leveraged issuers and companies that may be impacted by inflation and lessening discretionary spending. This approach will probably continue well into 2023 unless the current economic trend changes. We expect the market to remain volatile near-term owing to uncertainty.

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ECONOMIC OUTLOOK AND CONSIDERATIONS

On the margin, we expect inflation to be more persistent than the market anticipates, which means short-term interest rates could stay higher for longer and push the United States into a mild recession in late 2023 or early 2024. Consensus expects U.S. GDP to slip quarterly from 3Q 2022's +2.6% to -0.5% in 4Q 2023 which would seem surprisingly orderly, but directionally correct, although recession expectations contrast with stubbornly low unemployment rates including 3Q 2022's 3.6%. In the United States, there has never been a recession with less than 6.0% unemployment, and we are closely monitoring this indicator. So far, several large cap technology companies have announced significant employment reductions, as have several Wall Street firms. We expect wider hiring freezes and employment right-sizing in early 2023. Inflation, which appears to have peaked, remains near four-decade highs. The market remains hopeful inflation will rapidly return to pre-COVID, under 2%, levels, but the time frame seems aggressive to us. We note in the past twenty years inflation was held down by constant offshoring and outsourcing. Lingering supply chain issues which have led to a re-shoring/re-industrializing stance would seem to support higher inflation. Ongoing geopolitical challenges in the Ukraine, with China, and the energy emergency in Europe also seem to support higher inflation.

NEW ISSUANCE

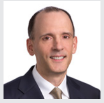
Under a mild recession scenario, we expect new issuance to rise modestly from this year's $250 billion level. In a volatile and transitory 2022 the loan market issued $250 billion in 348 transactions, according to J.P. Morgan. The year's activity level was about 60% of 2019's $392 billion and 2020's $422 billion. Loan volume was skewed towards the beginning of the year with $121 billion issued in 1Q, $61 billion in 2Q, $24 billion in 3Q, and $24 billion in 4Q. J.P. Morgan expects new issuance to rise to $300 billion in 2023. We believe opportunistic financing, possibly mergers & acquisitions, and maturity extension transactions could lead new issuance in 2023.

DEFAULTS

We expect default rates to rise from 1.6% to near 3.0% in 2023 under a mild recession. We continue to reduce exposure to marginal credits. According to J.P. Morgan, the overall high yield market leverage (which includes many loan-issuers) was 4.2x at 3Q 2022, which is a comfortable level, and about 10% above the 3.87x 3Q 2012 low. We expect leverage to drift lower in 4Q 2022 owing to fundamental momentum. Loan market interest coverage (EBITDA/interest expense) was 4.58x at 2Q 2022, near the 1Q 2019 4.79x peak and the beginning of the J.P. Morgan index.

Authored by:

Leveraged Loans



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About 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.

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INDEX AND INVESTMENT TERM DEFINITIONS

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 **S&P 500® Index** is a free-float market capitalization-weighted index of 500 of the largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and are not available for direct investment.

Basis Point (bp) is equal to 0.01%. **Credit Ratings** noted herein are calculated based on S&P, Moody's, and Fitch ratings. Generally, ratings range from AAA, the highest quality rating, to D, the lowest, with BBB and above being called investment grade securities. BB and below are considered below investment grade securities. If the ratings from all three agencies are available, securities will be assigned the median rating based on the numerical equivalents. If the ratings are available from only two of the agencies, the more conservative of the ratings will be assigned to the security. If the rating is available from only one agency, then that rating will be used. Ratings do not apply to a fund or to a fund's shares. Ratings are subject to change. **Default Rate** is most commonly referred to as the percentage of loans that have been charged off after a prolonged period of missed payments. Defaulted loans are typically written off from an issuer's financial statements and transferred to a collection agency. In some cases, a default rate may also be a higher interest rate charged to a borrower after a specified number of missed payments occur.

IMPORTANT RISK CONSIDERATIONS

Credit & Interest: Debt instruments are subject to various risks, including credit and interest rate risk. The issuer of a debt security may fail to make interest and/or principal payments. Values of debt instruments may rise or fall in response to changes in interest rates, and this risk may be enhanced with longer-term maturities. **Bank Loans:** Bank loans may be unsecured or not fully collateralized, may be subject to restrictions on resale, may be less liquid and may trade infrequently on the secondary market. Bank loans settle on a delayed basis; thus, sale proceeds may not be available to meet redemptions for a substantial period of time after the sale of the loan. **High Yield Fixed Income Securities:** There is a greater risk of issuer default, less liquidity, and increased price volatility related to high yield securities than investment grade securities. **Market Volatility:** The value of the securities in the portfolio may go up or down in response to the prospects of individual companies and/or general economic conditions. Price changes may be short- or long-term. Local, regional or global events such as war, acts of terrorism, the spread of infectious illness or other public health issue, recessions, or other events could have a significant impact on the portfolio and its investments, including hampering the ability of the portfolio's manager(s) to invest the portfolio's assets as intended.

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