SEIX INVESTMENT ADVISORS LLC®
A VIRTUS INVESTMENT PARTNER

Leveraged Finance: CCC Leads High Yield in 4Q; Loans Finish Strong; Quality Beckons

> The ICE BofAML High Yield Cash Pay Index delivered a strong 2.59% return in the fourth quarter. CCC-rated bonds outperformed with a return of 3.32% compared to 2.37% for BBs and 2.89% for Bs.

> High yield fundamentals remain stable in most industries, and we are not very concerned about an imminent recession or a general credit sell-off, but we are cautious about certain industries including energy, retail and wireline telecom. Considering spreads and interest rates are relatively low, to protect the downside, now may be a good time to favor high quality issues with a duration of less than three years.

> The JPMorgan Leveraged Loan Index posted a very strong fourth quarter with a 1.85% return, boosting its full-year return to about 8.6%. While retail outflows dampened 2019, they decelerated somewhat as collateralized loan obligation (CLO) formation provided continued support.

> The default rate was a very healthy 1.64%, down about eight basis points (bps) for the year. The long-term average is about 3%, according to JPMorgan.

HIGH YIELD

The ICE BofAML High Yield Cash Pay Index delivered a strong 2.59% return in the fourth quarter. Reversing the 2Q and 3Q trend, CCC-rated bonds outperformed with a return of 3.32% compared to 2.37% for BBs and 2.89% for Bs. In December, positive news on a trade agreement with China generated a risk-on recovery in lower quality that benefited CCCs. The Treasury curve steepened with the yield on 3-month bills falling 25 bps, while 10-year rates rose a mirror 25 bps. The yield drop on the benchmark from 5.57% to 5.28% was the result of a 38-bp narrowing in the spread to 3.57%.

Technicals were positive for the sector. Although gross new issuance was a solid $287 billion for the year, more than 90% was used to finance calls, tenders and maturities. In addition, overall supply was reduced as upgrades to investment grade (Rising Stars) exceeded downgrades to high yield (Fallen Angels) by nearly $40 billion. On the demand side, flows into high yield mutual funds were positive for only the second time in seven years. Consequently, given falling supply and positive demand, the shortfall in high yield supply dropped to a record -$130.0 billion.

With the call and tender activity, the portfolios began the fourth quarter with a higher than typical cash position. Therefore, during the quarter, we focused on reinvesting the existing cash as well as the proceeds from any additional calls into high quality positions in the energy, beverage, technology and telecommunications industries.

Overall fundamentals remain stable. There were no big changes in debt-to-EBITDA, revenue and interest coverage. Leverage was up a small amount, but the overall default rate ended the year at 2.63%, up 80 bps from the beginning of the year, largely due to the energy, metals and mining space.

Supply and demand technicals during the quarter were also very positive with a demonstrable shift toward higher quality issuance and steady demand from yield-starved investors as evidenced by $3.8 billion in inflows to high yield ETFs.

With dealer inventories at their historical midpoint, we are focusing on higher quality issues including investment grade bonds. We are aiming to take off some credit risk while improving structure and not sacrificing too much in spread. At the same time, we have been looking for relative value in companies that may have missed earnings targets, for example, but are still in good shape.

OUTLOOK

The team is not very concerned about an imminent recession or general credit sell-off. We are cautious about certain industries, including energy, retail and wireline telecom, and are underweighting or avoiding them entirely. With both spreads and absolute yields relatively low, we believe that protecting the downside with higher quality issues is a good option.

LEVERAGED LOANS

Continuing to Perform

The JPMorgan Leveraged Loan Index posted a very strong fourth quarter with a 1.85% return, boosting its full-year return to about 8.6%. Notable contributors by industry were retail at 11.4%, housing at 11.2%, and cable and satellite at 10.7%. Laggards included metals and mining (-5.5%) and energy barely positive at nine bps.

As of 12/31/19, the yield to a three-year takeout was 6.3%, and that contracted 184 bps for the year. The price on the index was approximately 97.3, up from 94.5 at the beginning of the year.

Outflows Decelerate

On the issuance side, fourth-quarter gross volume was $141 billion, an improvement over a pretty weak 4Q18. On a net basis, subtracting out repricings, refinancings, and pay downs, issuance was $7.7 billion. For the full year, gross volume was $392 billion, down 44% from 2018, while net issuance was 36% lower for the year.

M&A accounted for about 40% of issuance; repricings and refinancings were about 51%; dividends accounted for 4.4%, while general corporate and other were about 4.6%. On the demand side, retail fund flows continue their negative trend, recording an outflow of $6.9 billion for 4Q19 and about $37.2 billion for the year. But from a "glass half full" perspective, each quarter was less negative than a year earlier. The first quarter outflow was $11.1 billion, the second quarter was $9.9 billion, and the third quarter's was $9.4 billion.

On the other side of the demand equation, the CLO market saw 4Q gross volume of $35 billion, down 40% year-over-year, while the 2019 full-year gross volume was $160 billion, down 42% over 2018. On a net basis, 2019 volume was almost $119 billion compared to $131 billion last year.

As for default rates, the loan par rate to default rate ending 2019 was a very healthy 1.64%, down about eight bps for the year. The long-term average is about 3%, according to JPMorgan.

Our takeaway: while retail outflows dampened 2019, they decelerated somewhat as CLO formation provided continued support. Meantime, index pricing increased nicely, contributing to performance. LIBOR, however, contracted about 90 bps for the year, with three-month LIBOR finishing the year at about 1.9%.

Sector Details

We've continued to pare down energy, which is about neutral with the index. We're not going to position ourselves based on a potential geopolitical conflict. What concerns us more is some energy companies' insatiable appetite for capital and subsequent cash burn rate while investors adhering to environmental, social, and governance principles are cutting back (or divesting) their holdings in the sector and electric vehicles are gaining popularity.

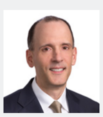
Meantime, we remain underweight the retail sector. We're reducing some of our metals and mining exposure. We took some profits on certain healthcare, cable and telecom (where we were pretty much overweight), and healthcare names.

OUTLOOK

Still compelling from a risk/reward perspective, leveraged loans offer investors income, capital appreciation, and low duration exposure. We believe loans should continue to benefit from technical upside, with yields above historical averages and potential price appreciation, as loan prices are still well below par. The positive fundamentals that drive security selection are in place for most industries, while uncertainty and headline risk persist in energy and retail. With a rise in sector dispersion and increased idiosyncratic credit volatility, active management continues to be crucial.

Authored by:

Leveraged Loans



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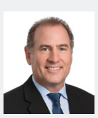

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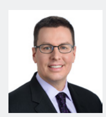
High Yield



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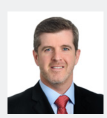

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Seix Investment Advisors is an investment management boutique focused exclusively on managing fixed income securities since 1992. Seix seeks to generate competitive absolute and relative risk-adjusted returns over the full market cycle through a bottom-up 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 BofAML 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 **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%.

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