Leveraged Finance: Snapbacks, Agility, Rising Defaults, and Focus on Quality

> Leveraged loans bounced back in the second quarter, led by the previously battered energy and retail sectors, as well as metals and mining.

> Retail outflows abated. CLO formation provided modest support. Index pricing rebounded off the low point in March, and LIBOR levels remained low.

> The high yield market had its best quarter since 2009, with CCC's, distressed high yield, and energy among the top performing segments. BB's also finished strong, partly thanks to the fallen angel universe which continue to present potential opportunities.

> Investors understanding the potential opportunity have pumped nearly $30 billion into high yield year to date, which materially reversed negative trends we saw through much of March. We continue to believe now is a good time to invest in high yield as a core investment or an income enhancement addition to a broadly diversified portfolio.

LEVERAGED LOANS

Every Sector Contributed

For the second quarter of 2020, the JPMorgan Leveraged Loan Index showed a return of 9.78%. That was a fairly substantial snapback from the first quarter decline, but it still left year-to-date loans down about 4.49%. For the quarter, notable contributors by industry were: energy, which was up about 26% (after being oversold in Q1); metals and mining, up 18%; and retail, up 12%. No sector detracted from the quarterly performance, but more defensive industries like cable and satellite saw a 3.8% contribution, and telecom contributed about 6.6%. On a ratings basis, BB's gained 6.6% for the quarter, B's jumped 11.5%, and B/CCC segment advanced 13.7%. As of the end of the quarter, the yield to a three-year takeout was 7.14%, which contracted 334 basis points (bps) for the quarter.

Looking at the inverse of that, the price on the index was approximately 91.4, up from 83.7 at the end of Q1. On the supply and demand side, Q2 issuance gross volume was a modest $46.6 billion. Year to date, gross issuance totaled $246 billion, up 56% from the same time last year. However, despite the recent pick up, net issuance has been low overall at only $77.2 billion, down 25% year over year. On the demand side, Q2 retail fund flows continued to be negative, but outflows were less negative for each month of the quarter. June's outflow was $640 million, May's was $1.4 billion, and April's was $2.9 billion.

In terms of collateralized loan obligations (CLO), U.S. issuance picked up in June with 21 deals priced for $8.2 billion (though refinancing activity had yet to resume), following May's volume of $6.0 billion and April's volume of $3.9 billion. On a year-to-date basis, 132 CLOs priced in the U.S. market for a total of $59.3 billion, down about 34% year over year.

The takeaway: retail outflows continued while abating, CLO formation provided modest support, index pricing rebounded off the low point in March, and the London Inter-Bank Offered Rate (LIBOR) levels remained low with three-month LIBOR at approximately 30 bps at the end of the quarter. We would note that most new issuance feature LIBOR floors.

Performance

We were about top third in Lipper rankings for the quarter. While April was probably our weakest month, the loan market continued to improve through May and June (our best month of the quarter, thanks to a rebound in names that had been previously sold off).

From a technical perspective, there are more dollars chasing less new issuance, and we're seeing some of that dynamic bleeding into the secondary market as the typical summer lull sets in. We expect there will be some opportunities during that time, but ultimately we expect supply to decelerate in July and August.

Defaults

The default rate ended Q2 at 3.96%, up 209 bps for the quarter. Including distressed exchanges, the loan default rate was 4.18%, led by the energy, retail, and consumer sectors.

Year to date, the retail sector suffered 14 defaults, the most by far from an issue account basis, followed by eight defaults in services, six in energy, six in media, four in telecom, four in food, four in metals and mining, and three in healthcare. The stress points were not just the direct result of COVID-19; some sectors experienced a spillover effect.

Each of the defaults seemed bespoke, which is to say, tailored to companies' particular circumstances. For instance, when Brooks Brothers filed for bankruptcy on July 8, it already had debtor-in-possession financing lined up, and on July 10, there were reports of two potential buyers, one of which was willing to offer a substantial loan at zero percent interest.

A lot of other defaults happened to companies that even had liquidity, as if it to say, "Let's just rip the Band-Aid off and restructure, because the capital structure is unsustainable in the long run."

Outlook

An upsurge in defaults is likely to continue despite signs of a comeback in some parts of the economy (boosted by emergency jobless benefits that topped some workers' previous pay but are due to expire soon), while other parts appear mired in recession. While credit card spending has rebounded quite a bit, Q2 results are likely to be challenged overall. As for the rest of the year, look for company guidance on demand to drive expectations.

HIGH YIELD

Q2 Was the Best Quarter Since 2009

March 23, 2020 is categorized as the date that the high yield market reached its low and has since corrected and has been on a positive trend through June. The positive result in June, while the weakest month of the quarter, contributed to the high yield market having its best quarter since 2009. For the month of June and Q2, CCC's, distressed high yield, and energy were among the top performing segments of the high yield market. BB's were also a top performer, but our analysis suggests that the strong performance was partly attributable to the fallen angel universe which we discuss in more detail below. Excluding fallen angels, BB's underperformed both B's and CCC's for the three-month period ending June 30.

Focus on Higher Quality HY and the Higher Spread Portion of IG

We are currently experiencing the most severe economic downturn since the Great Depression. While the economic rebound will appear to be V-shaped for a period of time, we are not of the view that the bounce back will get us back to pre-pandemic levels any time soon. Further, it is unclear if we will return to 85%, 90%, or 95%, or even 100%+ of pre-pandemic levels. There will also be many sectors that will experience permanent change: technology, retail, airlines, cruise lines, lodging, and movie theaters, to name a few. While we are hopeful that we will return to a normal economy which could be facilitated by a vaccine, new therapeutics, and/or the virus being eradicated, we are not investing with the mindset that this will occur reasonably soon. As a result, we believe higher quality high yield and the higher spread portion of the investment grade market offer solid risk-adjusted and absolute return opportunities. Given the uncertainty of the timing of the economic rebound, we do not believe the weaker parts of high yield are generally attractive such as many CCC-rated bonds and distressed high yield.

We continue to believe that fallen angels offer one of the more attractive potential investment opportunities in the high yield market. Our analysis, using the BofA US High Yield indexes, suggests that the universe of fallen angels has exhibited more attractive investment results over time when compared to originally-issued high yield. The table below shows the performance of the ICE US Fallen Angel High Yield 10% Constrained Index (H0CF) versus the ICE BofA US Original High Yield Index (H0HY) and the ICE BofA US High Yield Index (H0A0) over different time periods that concluded June 30, 2020.

Further, our analysis shows that the H0CF has outperformed H0HY in more than 94% of rolling three-year periods since inception of the index beginning December 31, 1996 (using monthly performance data) and more than 75% of the time over rolling one-year periods. Our analysis further suggests that the best time to invest in fallen angels has been during periods when the fallen angel universe was growing (i.e., there were a significant amount of downgrades), which is similar to the current market environment.

According to JPMorgan, the U.S. high yield market has seen $179 billion in fallen angels through June, which is the largest amount on record for a calendar year. Our bottom-up credit analysis is focused on identifying those fallen angels that are experiencing a cyclical hit to earnings, rather than secular, and have levers to pull to make it through the cyclical downturn. Having said that, it is also important to avoid companies that are experience a cyclical downturn that is so protracted that it begins to resemble a secular decline like we have seen in the offshore drilling sector.

Outlook

On June 30, the ICE BofA US High Yield Index yielded 6.85% (144 bps greater than the year-end December 31, 2019), with a spread of 644 bps (roughly 294 bps wider than December 31, 2019). A spread of 644 bps is still considerably wider than the long-term median spread of

	Since 12/31/96			Since 6/30/2015			Since 6/30/2017		
	H0CF	**H0HY**	**H0A0**	**H0CF**	**H0HY**	**H0A0**	**H0CF**	**H0HY**	**H0A0**
Price Return	1.859	-2.244	-1.559	1.201	-2.415	-1.932	-0.955	-3.657	-3.306
Income Return	7.673	8.120	8.073	6.234	6.539	6.510	5.884	6.285	6.248
Total Return	9.533	5.905	6.514	7.435	4.124	4.578	4.929	2.628	2.942

482 bps. Further, the increase in fallen angels that typically enter high yield as BB credits as well as the increase in defaults for high yield companies that cleanses the weakest credits from the index are both working to upgrade the credit quality of the index. We continue to believe that now is a good time to invest in high yield assets as a core investment or an income enhancement addition to a broadly diversified portfolio. Investors understanding the potential opportunity have pumped nearly $30 billion into the category year to date, which materially reversed negative trends we saw through much of March.

Even so, Fed buying is not going to have a huge effect on defaults. By the end of the year, the default rate could reach high single-digit percent, at least, which again underscores why our focus has been more on the higher quality part of high yield.

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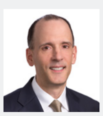
Leveraged Loans



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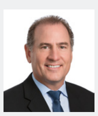

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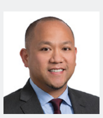

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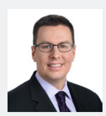
High Yield



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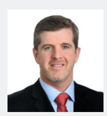

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ICE BofA U.S. High Yield Cash Pay Index is an unmanaged index consisting of all domestic and Yankee high-yield bonds maturing over one year. The quality range is less than BBB-/Baa3 but not in default (DDD1 or less). The **J.P. Morgan Domestic High 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.

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