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Leveraged Finance: Field of Yields Meets Shifting Winds

> An improving outlook for many industries and strong market technicals combined to provide another solid quarter of returns for the leveraged loan market. In the third quarter, loans provided a 4.11% return despite general risk-off sentiment in September. Returns for the loan market were positive in each month of the quarter, although the +0.69% in September trailed returns for the other two months. The retail, automotive, and consumer products sectors outperformed, while the utilities and cable/satellite sectors underperformed.

> While the loan par-weighted default rate ended September at a five-year-high of 4.26%, up very slightly (10 basis points (bps) m/m) sequentially, it appears the year-end default rate will come in significantly below the feared double-digit or high single-digit rate feared by naysayers in March and April. Including distressed exchanges, the loan default rate was 4.53%. While retail outflows continue, they are abating, with CLO formation providing modest support.

> For the high yield market, it was another strong quarter as it continued to recover from its March 23 low. Among the top performing segments of high yield were CCC's and distressed high yield.

> Other notable outperformers included small cap bonds (using ICE BofA US Small Cap Cash Pay High Yield Index) and fallen angels (using ICE BofA US Fallen Angel High Yield Index). Both indices have above market percentages in energy, which pulled the indices lower.

LEVERAGED LOANS

Performance

For the third quarter of 2020, the JP Morgan Leveraged Loan Index showed a return of +4.11%. For the year to date, loans are down -0.57%. For the quarter, notable contributors by industry were retail (+8.8%), automotive (+5.6%), and consumer products (+5.6%), and while no sector detracted from quarterly performance, but the more defensive industries, including utilities (+2.1%) and cable/satellite (+2.8%), outperformed the least.

Returns on a ratings basis were +2.6% for BBs, +4.2% for Bs and +9.1% for split B/CCC. However, year-to-date, CCC rated loans have heavily underperformed their higher rated counterparts. Split B/CCC rated loans sustained losses of -9.2% YTD, as compared to much smaller losses of -1.75% and -0.04% for BB and B rated loans, respectively.

As of 9/30/20, the yield to 3-year takeout was 5.99%, contracting 115 bps for the quarter. The price on the index was approximately $94.5, up from $91.4 at end of 2Q20.

Issuance

3Q gross issue volume was $67.8 billion. Year to date, gross issuance totaled $313 billion, up 25% from the $250 billion that priced by the same time last year. However, despite the recent pickup, net issuance has been low overall, as only $120 billion (38% of total volume) has been ex-refi/repricing. This compares to net issuance of $154 billion by the end of the first nine months of 2019 (-22%).

Demand

3Q retail fund flows continued a negative trend although outflows were less negative. September's outflow totaled -$566 million (-$249 million ETF and -$317 million actively managed), following August's -$1.1 billion outflow, July's -$1.6 billion outflow, -$1.8 billion in June, -$1.4 billion in May, -$2.9 billion in April, -$13.4 billion in March, -$2.6 billion in February, and -$26 million in January. Institutional demand, especially from Japan, has paused.

CLO Trends

US CLO issuance picked up in September, rising to its highest monthly total since February, as 41 deals priced for $12.0 billion. Year to date, 226 US CLOs have priced totaling $85.9 billion ($59.3 billion ex-refinancing and $26.6 billion refinancing) compared to 265 US CLOs totaling $126.0 billion ($91.0 billion ex-refinancing and $35.0 billion refinancing) for the same time period last year (-32%). CLO issuance may be down for the full year, but overall demand remains healthy.

Default Rates

The loan par-weighted default rate ended September at a five-year-high of 4.26%, up 10 bps m/m, up 262 bps YTD, and up 284 bps from 1.42% a year ago. This is the highest the loan default rate has been since January 2015 when it was 4.28%. Including distressed exchanges, the loan default rate is 4.53%. It's also important to note that defaults have been concentrated in a handful of sectors, such as retail (a staggering 24%) and energy (8.3%). When it comes to recoveries, retail and energy are probably skewing the recovery rate lower. The retail recovery rate alone ranges from 10 to 40 cents on the dollar, all of which underscores the case for active management with deep experience spotting relative value in multiple market cycles.

Strategy

We continued to focus on several sectors: healthcare and tech, which we are trying to increase, and energy and (less so) transportation, which we aim to reduce. Of course, we treaded carefully in COVID-impacted sectors such as gaming and retail. Retail holdings have been winnowed down to two companies that have actually benefited from the pandemic.

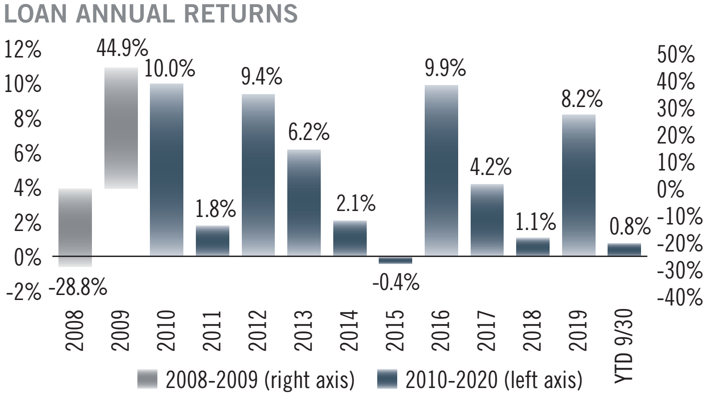
We've trimmed some of our higher quality loans to buy similar credit quality in the new issue market with many of those coming with LIBOR floors. We've done the same thing in the single-B space. Over the last several months, the percentage of loans in the portfolio with LIBOR floors has gone from about 30% to just over 40% currently. That has helped offset the decline in LIBOR that has impacted the rest of the portfolio.

We believe the new issue market continues to offer better relative value than the secondary market, and loans with LIBOR floors are clearly outperforming because of the yield advantage and the bid from CLOs for those types of loans. We would expect that to continue.

Takeaway

While retail outflows continue, they are abating. Offsetting retail outflows, CLO formation and existing CLOs provided significant support to the market. Index pricing continued to rebound off its low point in March. LIBOR levels remain low with 3-month LIBOR at approximately 0.23%. Of note, most new issuance features LIBOR floors, but it's worth repeating that returns today will be driven by a pull to par, not LIBOR. In addition, new issues will come with bigger coupons to offset lower LIBOR and more discount to par to further boost returns.

LOAN ANNUAL RETURNS



Source: Credit Suisse

Also keep in mind that even in a declining rate environment, loans have generated positive total returns, according to Credit Suisse, and loans snapped back in every material downturn since the global financial crisis of 2008-09.

HIGH YIELD

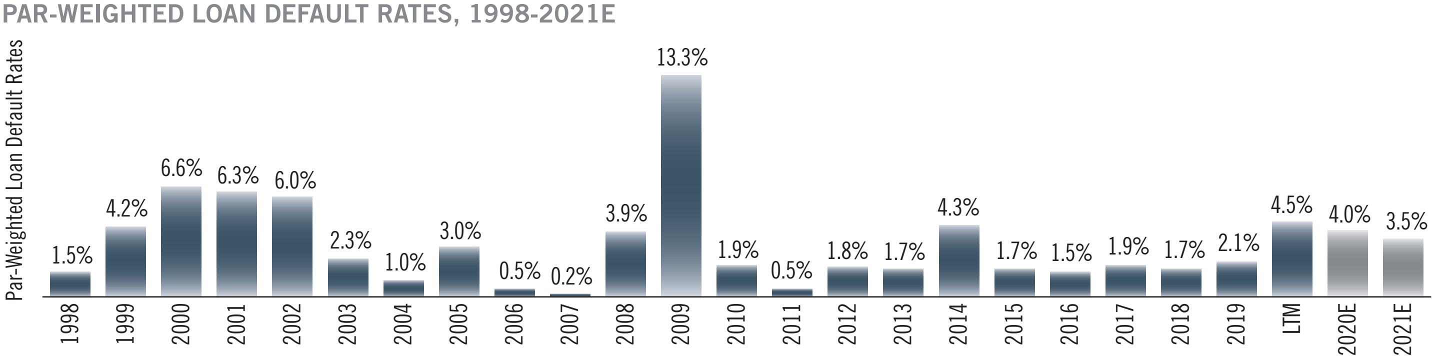
Another Strong Quarter, Led by CCC's and Distressed

The third quarter of 2020 showed another strong return as the high yield market continued to recover from its March 23 low. Top performing segments of high yield included CCC's and distressed high yield. Other notable outperformers included small cap bonds (using ICE BofA US Small Cap Cash Pay High Yield Index) and fallen angels (using ICE BofA US Fallen Angel High Yield Index). Both indices have above market percentages in energy which pulled the indices lower. Underperforming segments of high yield included non-distressed high yield, BB's and the aforementioned energy sector. In general, lower-rated securities outperformed higher-rated securities during the quarter. On a year-to-date basis, the high yield market is posting a slightly negative return through the third quarter and is posting a positive return as we write this. We believe this demonstrates the resilience of the asset class through the worst economic downturn of most of our lifetimes.

Performance

The ICE BofA US Distressed High Yield Index was one of the top performing segments of high yield during the quarter, which is generally a headwind for relative performance. The distressed index can show strong performance over short periods, but generally has not been a solid area for investment over time. After all, the annualized return of the ICE BofA High Yield Index since December 31, 1996 through the end of 3Q20 is 6.65%, while the ICE BofA US Distressed High Yield Index is -0.93%. Our strict credit process that has held up through several market cycles will naturally keep us underweight this part of the market most of the time.

PAR-WEIGHTED LOAN DEFAULT RATES, 1998-2021E



Source: JPMorgan, Data as of 10/5/20.

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Current Strategy

We continue to find value in what we believe are some of the overlooked segments in high yield including fallen angels, small issuers, orphan credits (credits that do not neatly fit into a sector analysts coverage) and unloved and/or misunderstood segments. In addition, BBB's that are priced like high yield companies offer an area where we are finding some value. We have been adding to securities in many of the COVID-affected sectors such as gaming and leisure. Our focus has been on good businesses that have strong liquidity that can bridge the gap to a more normalized environment.

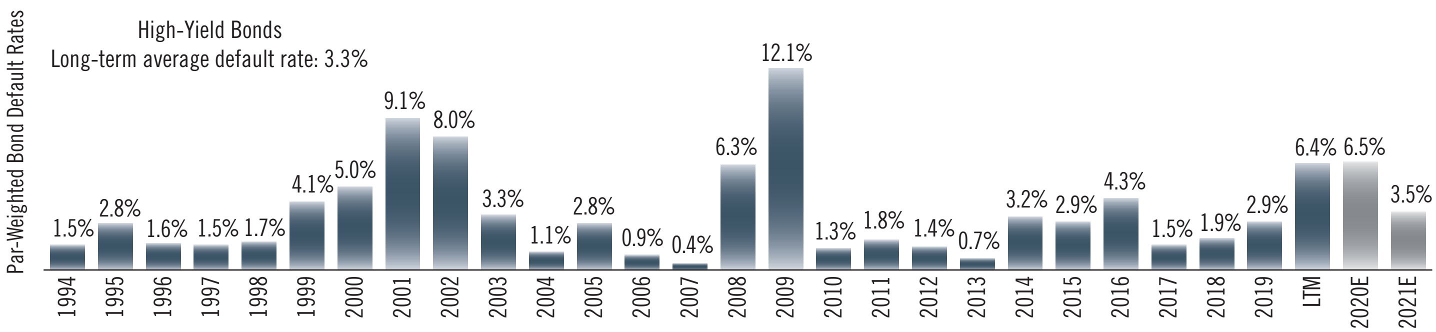
We have also been adding to certain names in the retail sector that we include in our COVID-affected group. This has been a sector that has been much maligned and for good reason. However, we believe we are finding good values in retailers that we do not believe will be "Amazoned" any time soon. This is an easy sector for portfolio managers to hate and ultimately avoid. However, we believe certain credits have been able to differentiate their product, and the bonds of these companies offer attractive potential for investment.

Outlook

As of September 30, the yield-to-worst on the ICE BofA US High Yield Index was 5.76% with an option adjusted spread of 541 bps, which is roughly 60 bps wider than the long-term median. Our view is that spreads will generally move tighter over the course of the next year as defaults peak and economic growth continues to improve. We are unsure when we will get back to normal as well as what normal actually might look like. Having said that, we do believe that people want to get back to something normal as quickly as possible, which is providing a tailwind for certain sectors.

The Citi Economic Surprise Index has been hitting all-time highs over the past couple of quarters as the economy continues to improve against expectations that have been too low. This is an important characteristic of the current environment. We believe this dynamic is also at work within certain sectors, as many companies have reported quarterly results that have exceeded even the most optimistic projections. As a result, security selection is critical to performance in this environment. There is no pandemic playbook to review when thinking about potential investment opportunities.

PAR-WEIGHTED HIGH YIELD BOND DEFAULT RATES, 1994-2021E



Source: JPMorgan, Data as of 10/5/20.

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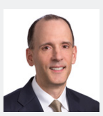
Authored by:

Leveraged Loans



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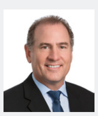

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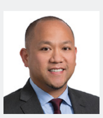

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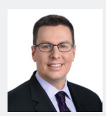
High Yield



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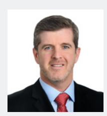

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ICE BofA U.S. High Yield Cash Pay Index is an unmanaged index consisting of all domestic and Yankee high-yield bonds maturing over one year. The quality range is less than BBB-/Baa3 but not in default (DDD1 or less). The **J.P. Morgan Domestic High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