Leveraged Finance: Resilience Abounds

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> The ICE BofA US High Yield Index had a 6.5% return. In terms of credit ratings, BB's gained 5.7%, single B's +5.7%, CCC's +12.2%, and distressed +25.2% for the quarter. The confluence of election results and COVID vaccine announcements set the stage for a powerful rally, led by companies with strong business models and a significant liquidity runway to deal with the pandemic.

LEVERAGED LOANS

Higher Rates Spark Greater Interest

With rates moving higher, loans have become more popular. The Collateralized Loan Obligations (CLO) market has rebounded strongly and coupled with recent big ETF inflows, loans are moving up in price. We still favor the asset class below the average dollar price of $98, and would not be surprised if loans outperform high yield this year, assuming rates continue to move up gradually.

With the influx of fallen angels last year into high yield, the high yield market is about two-thirds BBs, which could weigh on returns given the small coupons and longer duration of this rating cohort. Our base case is 5-6% returns in loans this year, something that may be tough to achieve in most fixed income categories. Assuming the pandemic doesn't worsen from here, we think defaults will hover in the 4% area, while government stimulus and Fed accommodation are in full effect, further supporting the economy.

With the 10-year Treasury above 1% for the first time since last March, the first week of 2021 saw the largest inflows for loan ETFs since January 2020. It was also the ninth consecutive week where loan ETFs experienced net inflows. Finally, December also represented the first monthly inflow for loans since September 2018.

4Q Performance Led by Telecoms

For 4Q, the JP Morgan Leveraged Loan Index returned +3.8%, bringing the 2020 return to +3.2%. For the year notable contributors by industry were telecom +6.0%, metals & mining +5.6%, and healthcare +5.4%, while laggards were energy at -5.9%, gaming, lodging & leisure at -2.5%, and transport at -1.2%.

As of 12/31/20, the yield to a three-year takeout was 5.1%. That widened 23 basis points (bps) for the year. The price on the Index was approximately $97.1, up from $94.5 at Q3, and down from $97.3 at the end of 2019.

Issuance: Technical Trends Remain Very Bullish

Fourth-quarter gross issue volume was $109 billion, down 22% year-over-year, but a recovery from $67.8 billion in 3Q and $46.4 billion in 2Q, while 1Q was $199.0 billion.

The 2020 gross issuance totaled $422.2 billion, up 8% from the $391.6 billion that priced last year. Net issuance (ex refinancing/repricing) of $192.7 billion in 2020 was slightly greater than the $192.2 billion in 2019.

For the full-year, the breakdown for 2020 issuance was: refinancing/repricing – 55%; M&A – 34%; dividends – 7%; general corporate/other – 4.0%. Middle-tier volume totaled $318.1 billion (76% of gross volume), while upper tier issuance totaled $84.8 billion (20%) and the lower tier CCC volume totaled $17.4 billion (4%).

Demand

Loan funds reported an inflow in December of $520 million ($730 million in ETFs minus $210 million that left actively managed funds). While that marked the market's first inflow since September 2018, 4Q and 2020 fund flows continued a negative trend, albeit less negative, recording an outflow of -$0.6bn and -$26.9 billion (compared to -$37.2 billion in 2019), respectively.

In the U.S. CLO market, 4Q gross volume of $38.6 billion ($31.9bn ex-refinancing) increased 10% year over year. In the full year 2020, 338 US CLOs priced for $125.1 billion ($91.7 billion ex-refinancing) compared to the 342 U.S. CLOs totaling $161.2bn ($119.2bn ex-refinancing) that priced in 2019 (-23%). U.S. CLO issuance in 2020 was strongest in 1Q at $41.8 billion, compared to volumes of $18.1 billion in 2Q, $26.6 billion in 3Q, and $38.6 billion in 4Q.

Default Rates

The loan par-weighted default rate ended December at 3.95%, up 16 bps month over month and up 231 bps from 1.64% at the start of the year. The sectors most affected were travel, retail, and energy. Including distressed exchanges, the loan default rate was 4.27%. The loan default rate ex-energy dropped to 3.57%.

Takeaway

Retail outflows in the fourth quarter decelerated. CLO formation provided continued support. 4Q index pricing continued to rally, contributing to performance. In a lower interest rate environment and with the Fed indicating accommodation, LIBOR levels remained low with the year-end three-month LIBOR at 0.25 bps compared to 1.9% at year-end 2019. Looking ahead, we would expect positive technical trends to continue, with CLOs starting out with a big backlog, which has led to too much excess cash in the market, as new issue volume remains muted.

Outlook

While leveraged loan investors are noticeably reacting to rates, it's important to remember that this asset class has historically done well in all environments.

With increased retail interest likely to continue at least in the near term, we have been tactically deploying cash and investing in names that still appear to have some upside potential. One recent example: a pet retailer whose debt was selling in the low 90s with good likelihood of an IPO. It wasn't rated well, because it had a couple of tough years, but as hordes of cooped up consumers bought dogs in the last 12 months, its business rebounded, adapting to the pandemic with curbside delivery. On Jan. 13, the company was able to price its IPO, and we anticipate proceeds may be used to pay down debt.

From a sector standpoint, technology is now the largest sector in the Fund, but the portfolio is still underweight at 12% versus nearly 14% in the Credit Suisse index. However, a sizeable amount of new issuance continues to flow into that sector, increasing its weighting in the index. Another key focus for us will be healthcare and financials.

HIGH YIELD: AFTER A BUMPY RIDE, A POWERFUL RALLY

Performance

The ICE BofA US High Yield Index had a 6.5% return. In terms of credit ratings, BB's gained 5.7%, single B's +5.7%, CCC's +12.2%, and distressed +25.2% for the quarter.

The confluence of election results and COVID vaccine announcements set the stage for a powerful rally, led by COVID-type technology plays—i.e., companies with strong business models and a significant liquidity runway to deal with the pandemic.

For example, going into the election, BB's were returning about 1.9%. By the end of the quarter, the prospect of a "blue wave" and ramped up vaccinations, helped BB's to nearly triple as mentioned above. CCC's basically doubled.

One of the biggest beneficiaries was a large real estate company with substantial retail holdings that was trading extremely cheap given investor fears of companies on the front line of contagion. After vaccine announcements, that company turned in a very good performance. So did some gaming companies as customers tired of sheltering in place started driving to casinos.

Fallen angels also contributed to performance—i.e., quality companies that many have been mispriced as potential (or imminent) downgrade candidates. One example: a sizable home builder with ample free cash flow and liquidity that rallied as mortgage rates headed lower. Another example: a BB-rated retailer with a very good balance sheet and strong COVID protocols, which posted better-than-expected earnings during the quarter.

Another bright spot in the 4Q high yield picture was what we call orphan credits, or small cap issuers. Example: an air lease company that appeared well poised to withstand concerns about aviation with a lot of liquidity, significant levers to pull, and a good business model.

On the downside, distressed and CCC issues clearly detracted from performance. Defaults, which started the year at 2.63%, finished at 6.2%. Nearly a third of those defaults were in the energy sector.

Energy: Focus on Quality and Operating Leverage

We still are underweight the energy sector. While we've narrowed that gap versus the index, finding additional opportunities at this point in the cycle will pose a number of questions. Sure, a strong global economic recovery should be positive for oil. But will the precipitous fall-off in business travel be with us for some time? Will millions of workers resume commuting after widespread vaccinations? In any case, there's a lot of pent up demand from people who want to get out of their homes and drive to casinos and tourist destinations.

With so much dislocation and uncertainty, it's no wonder energy companies are reluctant to invest in long-lived assets after massive write-offs last year. We typically look for higher quality companies that have free cash flow cushions, decent equity market access, assets that can be sold, and low cost structures.

We think oil will probably stay above $40/bbl for a reasonable length of time, but in the longer term one has to worry about electric vehicles and autonomous vehicles that are all electric. They may be several years down the road, but autonomous vehicles are already being rolled out in certain areas.

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Current Strategy

With a greater likelihood of improved operating leverage across a variety of sectors, we have reduced our exposure to investment grade (IG) in some strategies, and that will probably trend a little bit lower as spreads tighten. In this environment, we expect to be more comfortable with credit risk than we are with interest rate risk. Thus, we have spent a lot of time in the orphan credit or small cap issuer space. Financial sectors comprise our biggest overweight both on an absolute basis and a relative basis. We are also looking to find value in the worldwide consumer cyclicals and some parts of the more defensive telecommunications/cable sectors.

Outlook

Between massive fiscal and monetary stimulus and improving fundamentals, we see a high likelihood of a very strong, globally synchronized economy in 2021, which will support continued spread tightening throughout the year. We're already through our long-term median spread levels, but are still wide of where we were this time last year. The difference now (and something that doesn't get a lot of attention) is there has been an upgrading of the asset class, which is to say, when defaults picked up, the weakest companies washed out, and a record amount of fallen angels fell into the high yield category.

Of course, there may be some pockets of volatility, but that will underscore the importance of active management and rigorous attention to relative value opportunities, particularly companies that have adjusted to "the new normal" and proven they can operate profitably at much lower revenue.

The bottom line: 2021 will be a time to move up in credit quality and make sure the portfolios hold debt from companies with a lot of levers to pull if they experience an unforeseen setback, be it a longer-than-expected rollout of COVID vaccines or a slower economic rebound.

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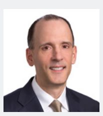
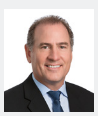
Authored by:

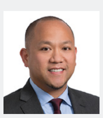
Leveraged Loans



George Goudelias
Head of Leveraged Finance, Managing Director,
Senior Portfolio Manager
Seix Investment Advisors

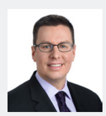


Vincent Flanagan
Portfolio Manager,
Senior High Yield Research Analyst
Seix Investment Advisors

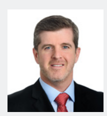


Eric Guevara
Portfolio Manager,
Head of Leveraged Loan Trading
Seix Investment Advisors

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

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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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