Leveraged Finance

> The **high yield** sector posted a negative return for the first quarter driven by rising U.S. Treasury rates. At current valuation levels, we believe there is limited potential for spread tightening. Our focus is on quality over yield though we will take advantage of market volatility to seek potential opportunities for incremental yield.

> **Leveraged loans** delivered a positive return in the first quarter. Loans are performing as expected in the current market environment – protecting investors from rising interest rates.

HIGH YIELD

The high yield sector posted a negative return (-0.94%) in the first quarter as measured by the ICE BofAML US Cash Pay High Yield Index. Given only moderate spread widening in the quarter, the move in U.S. Treasury rates was the main driver of returns. On a credit quality basis, the higher-rated, more interest-rate sensitive segments of the market underperformed with BBs returning -1.64% followed by Bs (-0.46%). While CCCs underperformed in March, they came out on top with a positive return of 0.21% for the quarter. Among industries, Food and Drug Retail (+0.64%) and Healthcare (+0.01%) led while laggards included Food (-2.14%) and Cable and Satellite (-1.92%).

In terms of new issue activity, first quarter volume on a gross basis was about 25% lower than the year-ago period with a significant percentage being used for refinancing activity. The percentage of refinancing this year (74%) is higher than 2017 (63%), which means that the net amount to the high yield market is fairly low. In terms of demand, flows have been negative for the asset class. Fundamentals for the high yield issuer universe continue to be favorable and are expected to remain so at least in the near term. Default activity, however, did pick up during the quarter, but was fairly concentrated and notably included Claire's Stores and iHeart Communications.

Our View

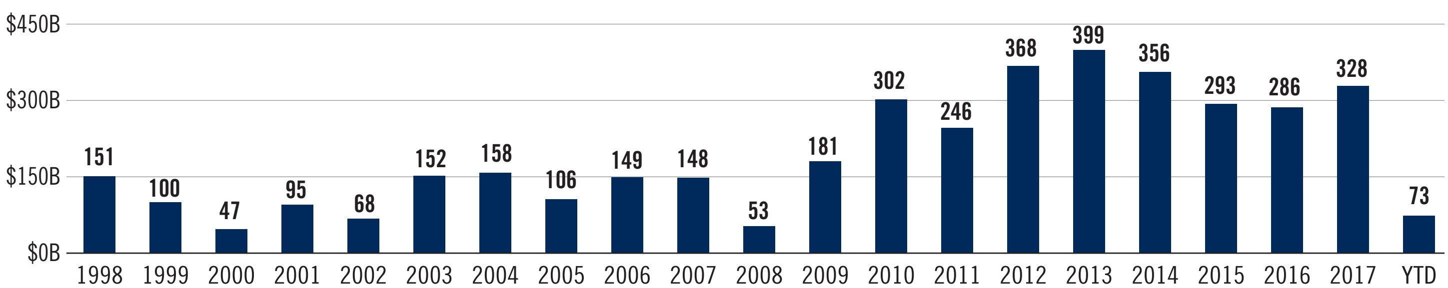
Though fundamentals are overall positive and technicals neutral, the potential for spread tightening is limited. As a strategic decision, we are focusing on upgrading the quality of portfolios. We are underweight the CCC part of the market – one of our lowest weightings in this segment in the last several years – because we do not see a lot of areas where there is adequate compensation for the assumed risk. That said, market volatility presents potential opportunities to pick up incremental yield such as we did in March in the Telecommunication and Energy sectors. Aside from these one-off situations, however, our focus is on quality over yield.

LEVERAGED LOANS

Leveraged loans delivered a positive return in the first quarter, outperforming all other fixed income asset classes that mostly had negative returns. In the current market environment, bank loans are performing as expected, which is to insulate investors from inflation and rising interest rates.

Leveraged loans, as measured by the JP Morgan Leveraged Loan Index, generated a return of 1.58% for the first quarter, a culmination of a solid 1.07% return in January followed by

HIGH YIELD GROSS BOND ISSUANCE



	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	YTD
By Use of Proceeds												
Acquisition Finance/LBO	52%	46%	5%	16%	22%	17%	17%	26%	38%	16%	17%	15%
General Corporate	12%	11%	16%	15%	18%	18%	22%	15%	16%	22%	18%	10%
Refinancing	35%	41%	76%	66%	55%	60%	56%	54%	44%	58%	63%	74%
Dividend	1%	2%	3%	3%	5%	5%	4%	3%	2%	1%	2%	1%
By Rating												
Upper	22%	29%	35%	29%	32%	29%	39%	36%	42%	44%	40%	36%
Middle	41%	45%	54%	53%	50%	53%	42%	46%	45%	46%	45%	53%
Lower/NR	36%	26%	11%	18%	18%	17%	19%	18%	13%	10%	15%	11%

Source: JPMorgan. As of 3/31/18.

returns of 0.15% in February and 0.35% in March. Notable industry contributors during the three-month period were Energy (+3.23%) and Retail (+1.39%). Paper/Packaging and Diversified Media lagged, though each had a positive return of 1.01%. At quarter end, the yield to three-year takeout was 6.44%.

Gross issuance was $242 billion, the third highest quarterly volume on record. On a net basis (excluding repricings and refinancings), issuance was a still-strong $76.2 billion and up 17% over the comparable 2017 period.

On the demand side, retail fund flows have been on a positive trend since the beginning of the year, snapping a five-month outflow heading into the end of 2017. For the quarter, loan funds saw a $3.7 billion inflow of which $482 million was from ETFs. This compares to a $13.9 billion inflow for the first quarter of 2017. CLO formation remained robust during the quarter at $61.8 billion compared to $67.0 billion for last year's first quarter. Net volume, reflecting refinancings and resets, was $32.6 billion.

The issuance profile remains more opportunistic. For the quarter, repricings and refinancings accounted for 47% and 22% of gross issuance, respectively. The balance (31%) reflected M&A corporate, general corporate purposes, and dividends. The majority of the issuance was in the middle quality tier with BBs and Bs representing 71% of the issuance. The upper tier accounted for 26%, and the lower tier (CCC) accounted for about 3.0%.

We believe broad-based fundamentals are positive for the bank loan issuer universe. Default activity jumped in the quarter with $10.9 billion of volume, but was concentrated in a few names. The loan par-weighted default rate ended the quarter at 2.52%, up 67 basis points sequentially. Notable defaults were iHeartMedia ($6.6 billion) and Fieldwood Energy ($2.5 billion).

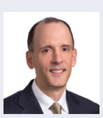
LIBOR, against which leveraged loans periodically are reset, remains supportive. Three-month LIBOR ended the first quarter at 2.3%, an increase of about 60 basis points for the quarter.

Our View

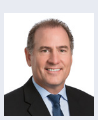
We are optimistic on leveraged loans and their ability to deliver attractive risk-adjusted relative returns while providing an interest rate hedge. We are nonetheless cautious given where we are in the current credit cycle and have, therefore, continued to move portfolios up in quality as we head into the second quarter. Given how spreads have tightened over the past few years, the spread differential between BB and B, in our mind, does not provide enough compensation for many potential B opportunities. We are finding better value in the BB segment of the market where the spread on the loan might be lower, but because LIBOR has moved up, the overall yield on these loans is actually higher than it was a year ago.

Authored by:

Leveraged Loans

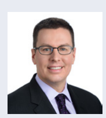


George Goudelias
Head of Leveraged Finance, Managing Director,
Senior Portfolio Manager
Seix Investment Advisors

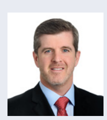


Vincent Flanagan
Portfolio Manager,
Senior High Yield Research Analyst
Seix Investment Advisors

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

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.