SEIX INVESTMENT ADVISORS LLC®
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Leveraged Finance

> The **high yield** sector delivered another quarter of positive performance against a backdrop of improving fundamentals. At current valuation levels, we believe there is limited potential for spread tightening. Nevertheless, positive fundamentals for many high yield sectors could be supportive of current spread levels for some time.

> Positive fundamentals and strong technicals have supported **leveraged loans**. Robust CLO issuance has offset soft retail demand resulting from range-bound Treasury rates.

HIGH YIELD

The high yield sector posted a positive return in the fourth quarter but it was the weakest quarter of 2017. The quarterly return of 0.47% brought the year-to-date return to 7.5%, as measured by the Bloomberg Barclays High Yield Index. By credit quality, BBs (+0.39%) and Bs (+0.36%) had similar returns while CCCs (+1.02%) outperformed. Energy (+1.98%), boosted by rising oil prices, was the leader on a sector industry basis, while Telecommunications (-2.32%) and Retail (-0.63%) lagged.

Gross issuance for the quarter was $72.5 billion, the lowest of the year. For 2017, issuance was $320 billion compared to $286 billion in 2016. Net issuance, however, was only $120 billion, the lowest level since 2011 ($110 billion). In terms of flows, 2017 saw outflows of $20.3 billion compared to inflows of $9.6 billion in 2016. ETFs, however, had inflows of $1.5 billion for 2017. Trading volumes have generally been good at $12 billion for the year, and dealer inventories at year end were about $5 billion. Overall, technical conditions for high yield are favorable with flexible supply able to adjust to modest demand.

Fundamentals for the high yield issuer universe continue to improve as evidenced by favorable year-over-year metrics for revenue and EBITDA growth, interest coverage, and leverage. The default rate has been creeping up slightly but reflects a number of large capitalization structures that were anticipated to default and were already priced into the market. The fundamental backdrop provides a good tailwind for high yield in spite of valuations that are close to post-Financial Crisis tights.

Our View

The potential for tightening is limited at current valuation levels. In this environment, we believe that playing defense is the most prudent course of action and we have positioned our portfolios accordingly, which includes an upgrade in quality. At the same time, we will take advantage of opportunities as they arise, such as price volatility or situations where an individual credit brings down an entire sector. The economy nonetheless continues to improve and issuer fundamentals are positive. As investors keep up their search for yield in a still-low interest rate environment, we think that a mid-single-digit return is a reasonable expectation for 2018.

LEVERAGED LOANS

Over the course of the fourth quarter, leveraged loan market investors faced the passage of tax reform legislation, the third Federal Reserve (Fed) rate hike of 2017, a spike in oil prices, and a seasonable slowdown in activity. Leveraged loans, as measured by the JP Morgan Leveraged Loan Index, generated a return of 1.24% for the quarter, bringing the year-to-date return to 4.25%. Industry leaders during the three-month period were Energy (+2.63%), Utility (+2.17%), and Retail (+1.39%) while Consumer Products lagged (-0.63%). At quarter end, the yield to three-year takeout was 6.31%.

The issuance profile has remained opportunistic. For the year, repricings and refinancings have accounted for about 45% and 30% of gross issuance, respectively. The balance reflected M&A corporate, general corporate purposes, and dividends. The majority of the issuance has been in the middle quality tier with BBs and Bs representing about 71% of the issuance. The upper tier accounted for 25%, and the lower tier (CCC) accounted for about 3.7%.

On the demand side, retail fund flows continued a negative trend since August with a fourth quarter reading of -$3.95 billion. Strong inflows for the first seven months of 2017 offset the negative trend to result in an inflow of $13.5 billion for the full year. By comparison, inflows in 2016 were $9.2 billion. Range-bound U.S. Treasury yields have had a dampening effect on retail investor demand.

While retail investors remained on the sidelines for the quarter, the collateralized loan obligation (CLO) component of demand showed continued strength. CLO formation had gross volume of $71.3 billion for the quarter, bringing the year-to-date total to a robust $282.2 billion. That represents 571 deals, which compares to about $111.8 billion across 251 deals in 2016. Excluding refinancings/repricings, net volume for 2017 was approximately $117 billion.

Broad-based fundamentals for the leveraged loan issuer universe are favorable, including leverage, interest coverage, and corporate cash levels. Some trouble spots among sectors do exist, such as in retail. The par-weighted loan default rate ended the year at 1.84%, which reflected a much quieter year for defaults than the 2015-2016 period.

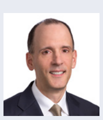
LIBOR, against which leveraged loans periodically are reset, remains supportive. Three-month LIBOR ended 2017 at 1.70%, an increase of 70 basis points for the year.

Our View

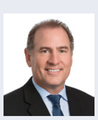
We are overall constructive on leveraged loans, especially on a risk-adjusted relative return basis. Fundamentals are favorable and the U.S. economy provides a positive backdrop. Whether or not the Fed diverges from the projection of three interest rate hikes in 2018, LIBOR should continue on a path toward 2% or higher, helping to offset any spread tightening that occurs during the year. Our concerns mainly reside on the macroeconomic and geopolitical fronts, for example, the potentially adverse impact of a slowdown in China. These concerns aside, we expect that 2018 will be similar to 2017 in terms of the expected range of returns for the asset class.

Authored by:

Leveraged Loans

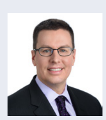


George Goudelias
Head of Leveraged Finance, Managing Director,
Senior Portfolio Manager
Seix Investment Advisors

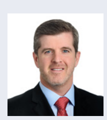


Vincent Flanagan
Portfolio Manager,
Senior High Yield Research Analyst
Seix Investment Advisors

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

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