The Case for Bank Loans Remains Strong

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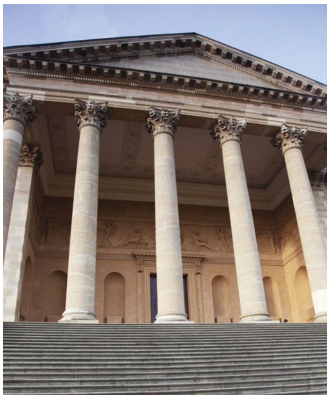

We entered 2018 with a favorable view on bank loans based on overall strong issuer fundamentals, supportive technical conditions, a healthy U.S. economy and global macroeconomic backdrop, and the likelihood that interest rates would continue to rise. Our outlook and investment thesis at the midyear point remains essentially unchanged.

Bank loans continue to perform well. Through May, the asset class has generated nine consecutive months of positive returns. Bank loans notably have outperformed the mostly negative returns of other fixed income asset classes year to date. *In the current rising interest rate environment, bank loans have demonstrated the importance of their floating rate feature and corresponding low correlation to fixed-rate securities.* Three-month LIBOR (London Interbank Offered Rate), the benchmark rate against which bank loans periodically are reset, has been rising steadily consistent with the federal funds rate. When LIBOR rises, the loan coupon rises, thus reducing the risk tied to interest rate moves.

Demand for bank loans remains strong as both retail and institutional investors have been adding bank loans to their portfolios as a preemptive measure against the impact of a rise in short-term interest rates and as a diversifier in their broad fixed income portfolios. Though bank loan prices subsequently have moved closer to par (face value) and offer minimal price appreciation potential, the attractiveness of the asset class resides in its "income carry" where increases in LIBOR-boosted coupons are currently only partially offset by any spread tightening. If rates continue to rise, the "income carry" could improve even further.

As expected, the Federal Reserve raised its key interest rate in June another quarter percentage point to a range of 1.75% to 2.00%, its seventh hike in the current tightening cycle. The expectation of additional hikes in 2018 reinforces the reason to own bank loans as a potential interest rate hedge coupled with their features as an investment secured by collateral, low correlation to other fixed income classes, and income.

While we remain constructive on the bank loan asset class, the concerns we had at the beginning of the year are still present, including heightened geopolitical tensions, an adverse impact from quantitative tightening, and negative implications of a flattening yield curve. Further, any shift to a risk-off environment and deteriorating fundamentals would negatively impact loans and risk assets in general. For the loan market specifically, we have seen a degradation in credit terms and a growing number of lower-quality issuers, as well as evidence of late-cycle behavior in some credit metrics. Idiosyncratic risk remains high and there are areas of stress in certain industries. In this environment, rigorous credit research is paramount to identifying and avoiding problematic securities. Newfleet has deep expertise in bank loans and an in-depth credit research process. The firm's consistent, time-tested sensible investment style and philosophy underlie its strength in managing bank loan portfolios. ■

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