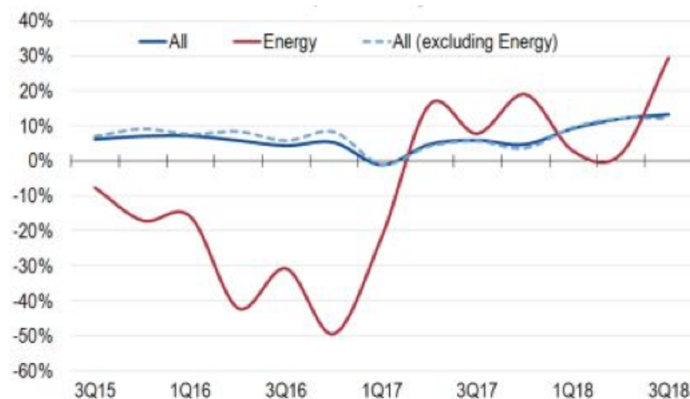
2019 | BANK LOAN MARKET OUTLOOK

Authored by Frank Ossino, Senior Managing Director and Senior Portfolio Manager

OPPORTUNITY – With eight increases to the federal funds rate since late 2015, the rising rate environment and its impact on interest rate sensitive asset classes has, as expected, resulted in loan market relative outperformance in 2018. In fact, loans currently are the only fixed income asset class with a positive total return, besting high yield and investment grade bonds, emerging markets debt, and U.S. Treasuries.

Overall, the fundamental backdrop for bank loans remains in good shape going into 2019 as U.S. GDP growth in the 2-3% range is typically supportive for credit risk assets. Macroeconomic underpinnings including issuers and their revenue, earnings, and cash flow are healthy (Exhibit 1). Open capital markets, strong debt service metrics, and minimal near-term maturities should also provide a continued runway for credit risk assets in 2019. However, after three quarters of exceeding top and bottom line expectations, risk markets sold off late in 2018 as forward guidance was reset lower. Issuers incorporated higher interest rates, slower global growth, and the impact of trade/tariffs on cost structures and margins into their forecasts. Risk markets, including loans, repriced risk lower. With the default rate below 2% and forward looking default pressure indicators low, (loans trading below 80 cents or issuers with thin debt service ratios) our default forecast for 2019 is 2%.

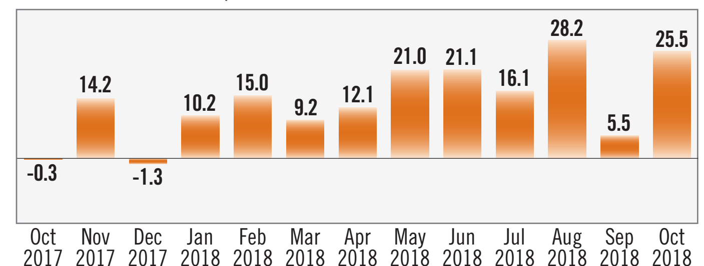
EXHIBIT 1: QUARTERLY EBITDA GROWTH



Source: LCD, an offering of S&P Global Market Intelligence.

As it relates to market technicals (supply/demand), the loan market has exceeded $1 trillion in size with trading volume exceeding $50B per month across over 1,500 issuers (Exhibit 2 shows monthly changes in outstandings). Expectations for rising interest rates fueled strong demand from all channels, including retail investors as well as institutional buyers in both separately managed accounts and collateralized loan obligation (CLO) form (Exhibit 3). Foreign investors have also been well represented as bank loan buyers. A rising rate environment and still-favorable fundamentals should result in continued strong broad demand for the asset class. Early expectations are for consistent retail fund demand and roughly $100B of new demand from the CLO investor base.

EXHIBIT 2: MONTHLY CHANGE IN LOAN MARKET OUTSTANDINGS ($B)

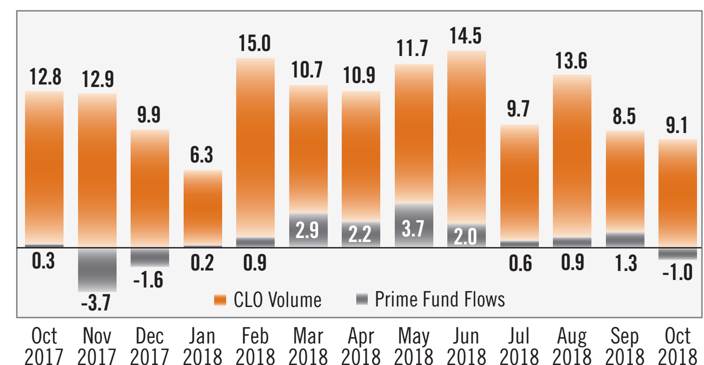


Oct 2017 | Nov 2017 | Dec 2017 | Jan 2018 | Feb 2018 | Mar 2018 | Apr 2018 | May 2018 | Jun 2018 | Jul 2018 | Aug 2018 | Sep 2018 | Oct 2018

Source: LCD, an offering of S&P Global Market Intelligence, S&P/LSTA Leveraged Loan Index.

On the supply side, we expect opportunistic refinancings to slow next year due in large part to the minimal near-term maturity profile of the market and aggressive repricings that have already taken place in 2017 and 2018. Equity/valuation volatility, large cash positions held at private equity firms, and open capital markets, could result in increased M&A volume. This coupled with continued demand to finance transactions via loans rather than using high yield bonds could result in the loan market becoming bigger than the high yield market in 2019.

EXHIBIT 3: MONTHLY LOAN DEMAND ($B)



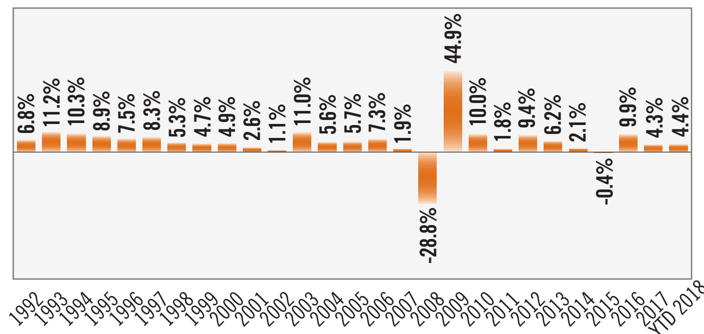
Oct 2017 | Nov 2017 | Dec 2017 | Jan 2018 | Feb 2018 | Mar 2018 | Apr 2018 | May 2018 | Jun 2018 | Jul 2018 | Aug 2018 | Sep 2018 | Oct 2018

Source: LCD, an offering of S&P Global Market Intelligence.

Risk assets are finishing the year on softer footing. Loan market prices declined to 96.8 in November 2018, down 1.9% from the start of the year. Recent loan price weakness has reintroduced some price appreciation potential back into the loan asset class and possibly a dollar cost averaging

opportunity where a still-healthy fundamental picture, interest rate hedge, and attractive "income carry" profile is still intact. Our base case gross risk-adjusted forecast of roughly 6.0% starts with an average three-month LIBOR rate of 3.00%. We also assume the spread component of coupon will remain flat at 3.30%, resulting in an all-in coupon of 6.30%. We then factor in the realization of 50 bps of price appreciation as well as an 80 bps loss rate (2% default rate x 40 bps loss). The upside to this forecast is driven by the velocity of interest rate increases (any increase in LIBOR against which loans are benchmarked), partially offset by the possibility of spread tightening. A dovish Fed (fewer rate increases) or slower growth environment could negatively impact our initial forecast. Ultimately, bank loan returns have historically been income-carry weighted and remarkably consistent (Exhibit 4). Comprising over half of the investor base, institutional investors, namely CLO investors and other longer-term, non-mark-to-market investors provide meaningful ballast to overall market stability given they are not subject to buy/sell pressures associated with retail funds. A total return of LIBOR plus spread provides investors an attractive long-term risk-adjusted return and may even provide some slight appreciation possibilities going into 2019.

EXHIBIT 4: TOTAL RETURNS BY YEAR

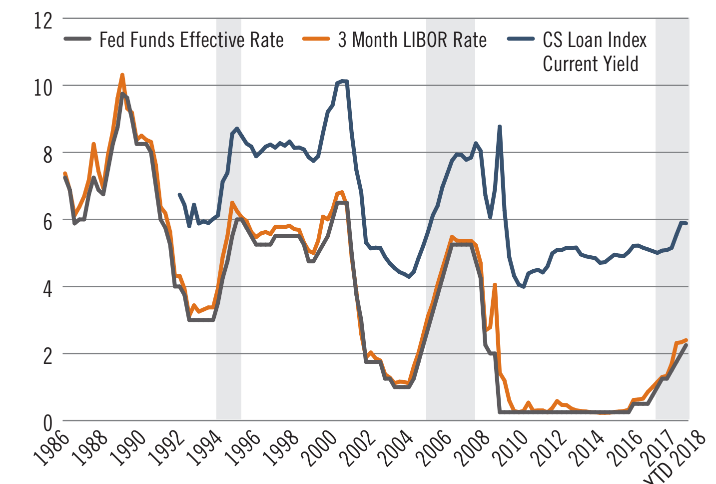


Past performance is not indicative of future results.
Source: Credit Suisse Leveraged Loan Index as of 11/30/2018.

AREAS OF CONCERN – There are no shortages of risk events that can negatively impact our forecast. They include 1) geopolitical tensions in the form of trade tensions and their impact on demand, costs, and profitability, 2) continued deflating central bank balance sheets (U.S. and EU, at least) and their impact on interest rates and the shape of the curve, 3) the possibility of the Fed overshooting, and 4) what now appears to be a slowdown in global and corporate growth and its effect on cash flow, enterprise valuations, and in turn, loan-to-value coverage metrics. Energy-related volatility, telecom (declining wireline use), and retail (Amazon effect) are some industries we are watching closely. Re-underwriting cyclical (autos and chemicals) weightings is also prudent in our view. As it relates to the loan market specifically, loosening credit terms and investor protections, less capital structure subordination, and an increased cohort of lower-rated issuance could result in less than historical average recovery of principal on defaulted loans in the next cycle. Industries with thin tangible asset coverage (technology, retail, and services) could be impacted here.

Accordingly, we are refreshing our investment thesis across borrowers and industries with an eye toward our industry weights, credit quality, and liquidity positioning as credit selection will be the primary differentiator next year, in our view.

EXHIBIT 5: PERFORMANCE IN RISING RATE ENVIRONMENTS
Fed Funds Effective Rate, 3 Month LIBOR, and Select Fixed Income Performance



Returns	1994	2004-2006*	2017-2018 YTD†
Loan Index	10.32%	18.62%	8.80%
High Yield Index	-1.03%	25.74%	10.26%
Bond Index	-2.92%	11.10%	1.89%
Treasury Index	-3.38%	9.41%	0.61%
7-10 Year Treasury Index	-5.75%	5.17%	-0.26%

Past performance is not indicative of future results.
As of 9/30/18. Loan Index is the Credit Suisse Leveraged Loan Index. Bond Index is the Bloomberg Barclays U.S. Aggregate Bond Index. Treasury Index is the Bloomberg Barclays U.S. Treasury Index. 7-10 Year Treasury Index is Bloomberg Barclays US Treasury 7-10 Year Index.
*Arithmetic cumulative returns from 2004 – 2006. Source: Barclays Live, Credit Suisse Leveraged Loan Index, Bloomberg.
†1/1/2017–9/30/2018.
The indexes are calculated on a total return basis with net dividends (and capital gains if applicable) reinvested. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges and they are not available for direct investment.

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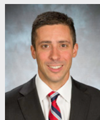

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Newfleet leverages the knowledge and skill of a team of investment professionals with expertise in every sector of the bond market, including evolving, specialized, and out-of-favor sectors. The team employs active sector rotation and disciplined risk management to portfolio construction.

IMPORTANT RISK CONSIDERATIONS: Credit & Interest: Debt securities are subject to various risks, the most prominent of which are credit and interest rate risk. The issuer of a debt security may fail to make interest and/or principal payments. Values of debt securities may rise or fall in response to changes in interest rates, and this risk may be enhanced with longer-term maturities. **Bank Loans:** Loans may be unsecured or not fully collateralized, may be subject to restrictions on resale and/or trade infrequently on the secondary market. Loans can carry significant credit and call risk, can be difficult to value and have longer settlement times than other investments, which can make loans relatively illiquid at times. **High Yield- High Risk Fixed Income Securities:** There is a greater level of credit risk and price volatility involved with high yield securities than investment grade securities. **Leverage:** When a fund leverages its portfolio, the value of its shares may be more volatile and all other risks may be compounded. **Liquidity:** Certain securities may be difficult to sell at a time and price beneficial to the fund.

The **Bloomberg Barclays U.S. Aggregate Bond Index** measures the U.S. investment grade fixed rate bond market. The index is calculated on a total return basis. **Bloomberg Barclays U.S. Treasury Index** measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index. STRIPS are excluded from the index because their inclusion would result in double-counting. The indexes are calculated on a total return basis with net dividends (and capital gains if applicable) reinvested. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges and they are not available for direct investment. The **Credit Suisse Leveraged Loan Index** is a market-weighted index that tracks the investable universe of the U.S. dollar denominated leveraged loans. The index is calculated on a total return basis, is unmanaged and not available for direct investment. The unmanaged index returns do not reflect any fees, expenses, or sales charges. **LIBOR:** London Interbank Offered Rate.

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