2024 Bank Loan Market Outlook

By Frank Ossino, Senior Managing Director and Senior Portfolio Manager

Newfleet ASSET MANAGEMENT

A Virtus Investment Partner

Frank Ossino, sector manager of bank loans, reviews 2023 and discusses his 2024 investment thesis and expectation of a 7-8% total return:

"The steady increase in interest rates has resulted in a second straight year of outperformance for bank loans as other fixed rate asset classes were negatively impacted. Importantly, the rise in rates has led to a corresponding increase in the coupon, which provided a cushion against intermittent bouts of volatility. Add to that a better-than-expected economy, and the backdrop for loans was optimal. Going into 2024, we believe that loans may be at an attractive "cruising altitude" due to their high current income, adequate cushion in the event of volatility, the fact that they are usually backed by secured collateral, the reasonably supportive economy, and higher-for-longer rates.

> "The committee is not thinking about rate cuts at all."
>
> – Federal Reserve (Fed) Chairman Jerome Powell, post-November Fed meeting press conference.

However, as investors increasingly turn their focus towards the later stages of the cycle, the loan market will not be immune to macroeconomic concerns. So, despite a better-than-expected macro backdrop, this points to playing slightly more defense than offense at this time in positioning, especially as data begins to suggest a slowdown. Patience and being active during these times will allow for attractive investment opportunities in the next year.

In 2024, we believe investors can be constructive on the loan market without being overly bullish on fundamentals, as the current yield profile provides a cushion against volatility. On top of that, the growing narrative supporting a soft landing, the high current coupon, and spreads wide of non-recession historical averages all make loan valuations still attractive. Even assuming a return to historical long-term default rates, lower-than-average principal recovery rates, and eventual rate cuts, the current jumping-off yield appears adequate enough to result in a net positive outcome over the next twelve months—this, while also maintaining the benefits of seniority in the capital structure as we head into a possible shift in the cycle."

2023 Review – Loans are on track to return 12% in 2023, making it the best total return year since the Global Financial Crisis (GFC) and in line with our initial forecast for equity-like returns this year.

One of the main stories of the year was the unexpected resilience of the U.S. economy. A robust jobs market and better-than-expected savings allowed the consumer to continue to spend. Corporations worked through destocking and cost savings programs while finding that prices may be more inelastic than thought. The result was better-than-expected earnings and cash flow. The backdrop allowed risk metrics we watch—loans priced below 80 cents, and the downgrade/upgrade ratio—to both improve throughout the year. Leverage also ticked down.

> "I'm not seeing a lot of evidence that the economy is weakening."
>
> – Neel Kashkari, Fed Reserve Bank of Minneapolis President, November 2023.

Borrowers were also able to weather the interest rate storm. While debt service requirements have certainly increased—in many cases, interest expense has doubled in the last year—the better-than-expected economy has acted to partially blunt higher interest costs.

ECONOMIC INDICATOR

	4Q22	1Q23	2Q23	3Q23
Real GDP (YoY%)	0.7	1.7	2.4	2.9
CPI (YoY%)	7.1	5.8	4.0	3.5
Unemployment (%)	3.6	3.5	3.6	3.7
Non-Farm Payrolls (000s)	284	312	201	165**
Average Hourly Earnings	4.8	4.3	4.4	4.3

Source: Bloomberg LP. Data as of September 30, 2023. **Forecast.

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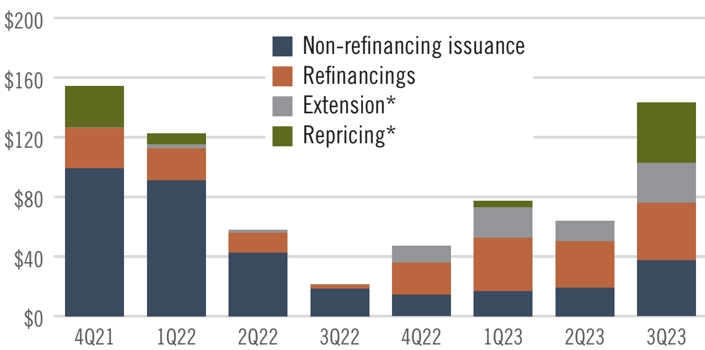
Regarding the technical environment, the spring's bank failures heightened concerns around broad capital markets access. Quarterly Senior Loan Officer Surveys throughout the year have shown tightening credit conditions. The high cost of capital also impaired new issuance—especially acquisition financing as it relates to private equity achieving return hurdles. Instead, we saw a material pickup in activity that pushed out near-term maturities via refinancing transactions. That's not to say we did not see new deals: payment processor WorldPay was successfully spun out of FIS with a new $5.2 billion term loan—one of the largest executions since the GFC.

U.S. INSTITUTIONAL LOAN VOLUME ($B)

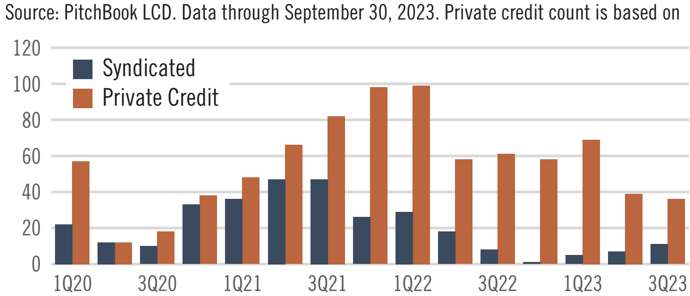


Source: PitchBook LCD. Data through September 30, 2023. *Reflects repricings and extensions done via an amendment process only.

2023 also saw the proliferation of private credit—now $1.5 trillion in size—which, along with high yield and the broadly syndicated loan (BSL) market, became another significant capital market of non-investment grade borrowers that addressed financing needs. Indeed, in 2023 the BSL market saw par repayments in several transactions that were refinanced in the private credit space, including Finastra ($5.3 billion), Hyland Software ($3.4 billion) and PetVet ($3.0 billion). High yield market transactions also contributed to loan repayments. All told, the BSL market shrunk to $1.4 trillion—this, at a time when loan demand moderated but remained acceptable, thus acting as support for prices. Finally, we cannot write a 2023 review without mentioning the transition to SOFR from LIBOR on June 30th. After years of planning across financial markets globally, the transition occurred with no issue.

COUNT OF LEVERAGED BUYOUTS FINANCED IN BSL VS. PRIVATE CREDIT MARKETS

Source: PitchBook LCD. Data through September 30, 2023. Private credit count is based on



transactions covered by LCD News.

Although the path was not a straight line, the better-than-expected appetite for credit and no duration risk in a rising rate environment resulted in loan spread tightening and outperformance relative to fixed rate asset classes and even equities.

2024 Outlook – The odds of a positive total return are high given the starting yield profile. A large component of return is typically tied to the income carry, and current yield has historically been a good general indicator of next-twelve-month returns. In fact, it is this carry that acts as ballast against price volatility, often fully offsetting negative price performance. Of the monthly returns going back to 1999, only 22% of the months posted negative total returns. Further, of those negative months, 68% posted losses of less than 1%. These observations form the basis of our 2024 outlook.

We enter the new year with a gross yield to maturity jumping-off point of 10.6%. Fundamentally, our expectation is for defaults in a slow growth environment to finish the year at a 3% rate, slightly higher than the long-term historical average of 2.7% and higher than the current 0.73% last-twelve-month figure. Importantly, we are forecasting loan recoveries of 50%—less than the historical average of 70-80%—due to the loosening of credit agreements that allow for more lax protections at the expense of lenders. Lastly, while higher-for-longer rates is our assumption, we will model three 0.25% rate cuts in 2024, consistent with the current Fed Funds Futures market. Historically, leveraged loans have seen strong performance even after a pause in Fed rate hikes.

LEVERAGED LOAN FORWARD PERFORMANCE POST A PAUSE IN FED POLICY HIKES

Month of Last Hike	Fed Funds Terminal Rate %	Leveraged Loan Forward Returns %			
		3 months	6 months	9 months	12 months
Dec-18	2.50	3.89	5.58	6.67	8.64
Jun-06	5.25	1.73	3.68	5.89	7.54
May-00	6.50	1.85	2.48	5.15	6.22
Mar-97	5.50	2.18	3.74	5.33	7.62
Average		**2.41**	**3.87**	**5.76**	**7.51**

Source: J.P. Morgan. Data as of November 21, 2023.

With these assumptions, under this methodology, all else equal, we see a risk-adjusted 2024 total return profile of 7-8%.

Viewed on a spread basis, the current market valuation sits wide to 5-, 10-, and 15-year averages. Just as interesting is that current spreads are also wide to non-recession averages. Therefore, in a soft-landing scenario, loan valuations appear attractive. Interestingly, note that spreads are already at roughly two-thirds of recession averages, implying that a recession scenario may already be mostly priced in.

HISTORICAL SPREADS

	Leveraged Loans (LL)	LL BB	LL B1/B2	LL B3	LL CCC
Current	526	308	466	721	1379
2023 High	592	341	562	854	1694
2023 Low	500	293	451	694	1280
1 Yr Average	546	317	505	779	1481
5 Yr Average	490	313	471	662	1263
10 Yr Average	465	316	457	677	1280
15 Yr Average	524	355	519	741	1291
U.S. Recession Average	805	554	859	1145	1605
U.S. Non-Recession Average	473	326	466	658	1173

From: J.P. Morgan/S&P/IHS Markit. Data as of November 17, 2023.

The second leg of our thesis introduces risk. Maintaining a senior secured position in a borrower's capital structure allows for reduced volatility, which leads to very attractive return per unit of risk compared to other risk asset classes. In fact, loan valuations today are especially attractive when compared to long-term equity returns, even when adjusted for defaults and losses. Again, we estimate that the go forward risk-adjusted return profile for loans to be in the high-single-digit area—near long-term equity return expectations with materially less volatility (defined as standard deviation).

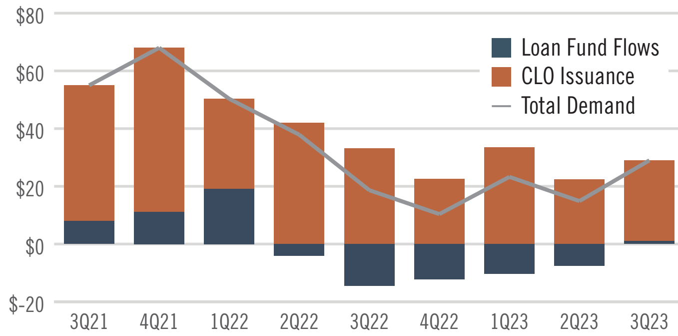
LOANS AND HIGH YIELD VS. EQUITIES (1/1/92-9/30/23)

	Annualized Return	Standard Deviation	Return Per Unit of Risk	Rolling 3-Year Periods		
				Best	Worst	% Negative
Leveraged Loans	5.48%	5.37%	1.0	17.5%	-8.0%	3%
High Yield Bonds	7.09%	8.35%	0.8	26.1%	-7.6%	6%
Large Cap Equity	9.76%	14.76%	0.7	32.8%	-16.1%	17%
Small Cap Equity	8.79%	19.32%	0.5	29.6%	-17.8%	13%

Past performance is not indicative of future results. Source: Credit Suisse, S&P, FTSE Russell, Bloomberg LP. Data as of September 30, 2023. The Leveraged Loans, High Yield, Large Cap Equity, and Small Equity Markets are represented by the Credit Suisse Leveraged Loan Index, Bloomberg U.S. Corporate High Yield Index, S&P 500® Index, and the Russell 2000® Index, respectively. Returns were calculated using monthly data and begin with the inception of the Credit Suisse Leveraged Loan Index on January 1, 1992.

Regarding the technical picture, we correctly forecasted that retail demand would remain weak and collateralized loan obligation (CLO) issuance would slow as investors increasingly focused on credit risk. Initial forecasts show roughly $100 billion in CLO demand next year. We anticipate that retail fund flows may see another year of redemptions. On the supply side, a high cost of capital could result in another slow new issuance year. The offset, however, may be borrowers continuing to target the maturity wall by refinancing into longer-dated loans. The wild card is the potential demand created via loan repayments with private credit and high yield bond take-outs.

U.S. LEVERAGED LOAN MARKET – MEASURABLE INVESTOR DEMAND ($B)



Source: PitchBook LCD; Morningstar Direct. Data through September 25, 2023. Fund flows data includes monthly reporters.

Areas of Concern – A worse-than-expected economic slowdown tops our list of concerns going into 2024 and could impact our forecast. The Fed remains committed to fighting inflation at the expense of economic growth. With minimal/flat growth as the starting point and interest rates potentially being higher for longer—and the full impact of these rate increases becoming more apparent—the backdrop could be challenging for credit risk assets. Corporate management teams are increasingly discussing pressures on the consumer and changes in their behavior. Indeed, recent economic data—slowing job creation and wage inflation, rising credit card and auto loan delinquencies, dwindling savings, and the restart of student loan payments—are beginning to point to the slowdown investors expected in 2023. The lagged transmission rate regarding Fed rate hikes and its impact on the cost of capital may now be starting to impact corporate and consumer decisions. A corresponding tightening of capital markets access—as shown in recent Senior Loan Officer Surveys—could also negatively impact marginal borrowers. If growth has slowed to a level where Fed intervention is needed, this typically indicates an environment where defaults have picked up.

ECONOMIC INDICATOR FORECASTS

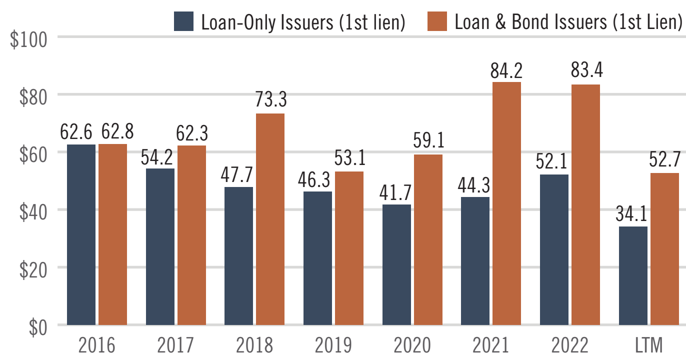
	4Q23	1Q24	2Q24	3Q24	4Q24	1Q25
Real GDP (YoY%)	2.2	1.6	1.2	0.5	0.8	1.2
CPI (YoY%)	3.4	3.1	2.9	2.6	2.4	2.3
Unemployment (%)	3.9	4.0	4.2	4.4	4.4	4.3
Non-Farm Payrolls (000s)	117	50	37	56	100	100
Average Hourly Earnings	4.0	3.9	3.6	3.4	3.3	3.1

Source: Bloomberg LP. Data as of September 30, 2023.

As it relates to loans, we have seen a clear impact of interest rate coverage on borrowers. In fact, nearly 20% of loan market borrowers now maintain interest coverage (EBITDA/Cash Interest) less than 1.5x—up from 9% in mid-2021. Again, a surprise in 2023 has been the resiliency of EBITDA, partially offsetting further degradation and even allowing for leverage statistics to improve.

With CLO structures accounting for roughly 69% of the primary investor market, a possible slowdown in CLO issuance—whether driven by relative value, less appetite for credit, or any impairment for existing CLO structures to continue reinvesting—is also worth monitoring. Issuance expectations are in the $100 billion area for 2024, down from over $180 billion in 2021, roughly $130 billion in 2022, and an estimated $100-110 billion in 2023.

RECOVERY RATES FOR LOANS AND HIGH YIELD – Recovery Rate (%)



Source: J.P. Morgan. Data as of November 11, 2023.

Lastly, the persistent degradation of credit quality created by a decades-long low interest rate environment will put a premium on core fundamental analysis. We expect the loosening of credit documentation terms and conditions to reduce loan default recovery rates.

Implementation – Since the spring, we had recognized the resiliency of the consumer and corresponding U.S. macroeconomy. Several factors pointed us to slowly begin pivoting the portfolio towards an incrementally riskier bias. We accomplished this by becoming more fully invested while still maintaining our overall defensive positioning. After a full re-underwriting exercise to consider economic data, improving inflation metrics, and their impact on credit, we began adding lower-rated seasoned borrowers where our investment thesis was still intact. This re-positioning has been accretive.

We are mindful, however, of the impact that higher interest rates are having on debt service.

So our current view is to expect a slowdown in economic growth in 2024, but not enough for the Fed to embark on an aggressive accommodation cycle. We will maintain our underweight to lower-rated cohorts as higher rates—and expiring hedges— work through borrower financials. At the same time, we will look for constructive economic data points and technical dislocations as signals to assess and add higher-risk opportunities.

To learn more about Newfleet Asset Management, please contact us at 212-548-1200 or visit newfleet.com. To learn more about Virtus's products, please contact us at 800-243-4361 or visit virtus.com.

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Newfleet's senior floating rate strategy is founded on the belief that downside risk can be limited, and thus losses avoided, through two complementary approaches: rigorous credit analysis and active portfolio management. Investment opportunities are carefully screened to identify "best in class" companies with leading market share, superior cash flow, and an appropriate capital structure. Combining this with active management that emphasizes broad diversification across both industry and individual securities generates a portfolio with broadly diversified loan market exposure centered on loss avoidance and adequate liquidity.

IMPORTANT RISK CONSIDERATIONS: Credit & Interest: Debt instruments are subject to various risks, including credit and interest rate risk. The issuer of a debt security may fail to make interest and/or principal payments. Values of debt instruments may rise or fall in response to changes in interest rates, and this risk may be enhanced with longer-term maturities. **Bank Loans:** Bank loans may be unsecured or not fully collateralized, may be subject to restrictions on resale, may be less liquid and may trade infrequently on the secondary market. Bank loans settle on a delayed basis; thus, sale proceeds may not be available to meet redemptions for a substantial period of time after the sale of the loan **High Yield Fixed Income Securities:** There is a greater risk of issuer default, less liquidity, and increased price volatility related to high yield securities than investment grade securities. **Leverage:** When the Fund leverages its portfolio, the Fund may be less liquid and/or may liquidate positions at an unfavorable time, and the value of the Fund's shares will be more volatile and sensitive to market movements. **Liquidity:** Certain instruments may be difficult or impossible to sell at a time and price beneficial to the portfolio, which could impact the ability to meet redemption requests upon demand.

The **Bloomberg Emerging Markets Hard Currency Aggregate Index** is a hard currency Emerging Markets debt benchmark that includes USD-denominated debt from sovereign, quasi-sovereign, and corporate EM issuers. The **Bloomberg Municipal Bond Index** is a market capitalization-weighted index that measures the long-term tax-exempt bond market. The **Bloomberg U.S. Aggregate Bond Index** is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS. The **Bloomberg U.S. Corporate High Yield Bond Index** measures fixed rate non-investment grade debt securities of U.S. corporations, calculated on a total return basis. 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 **J.P. Morgan EMBI Global Index** tracks the total return for the U.S. dollar-denominated emerging markets debt, including Brady bonds, Eurobonds, and loans. **LIBOR:** London Interbank Offered Rate. The **Morningstar LSTA U.S. Leveraged Loan Index** is a daily total return index that uses LSTA/ LPC Mark-to-Market Pricing to calculate market value change. On a real-time basis, the index tracks the current outstanding balance and spread over LIBOR for fully funded term loans. The facilities included in the Index represent a broad cross section of leveraged loans syndicated in the United States, including dollar-denominated loans to overseas issuers. The **Russell 2000® Growth Index** is a market capitalization-weighted index of growth-oriented stocks of the smallest 2,000 companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The **S&P 500® Index** is a free-float market capitalization-weighted index of 500 of the largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. **SOFR:** The Secured Overnight Financing Rate. 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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