SEIX INVESTMENT ADVISORS LLC®
A VIRTUS INVESTMENT PARTNER

Leveraged Finance: Resilience, Caution, and Selectivity

> The worldwide rally in bonds continued to help the high-yield market in 2Q19, with the exception of riskier CCC-rated issues, which lost their luster as fears of an economic downturn increased.

> While spreads tightened in June, high-yield bonds (as represented by the ICE BofAML High Yield Cash Pay Index returned +2.57% in the quarter with BBs (+3.15%) outperforming B (+2.42%) and CCC (+0.64%). Year-to-date, high yield bonds posted gains of +10.15% with BB-rated bonds (+10.76%) narrowly outperforming B (+9.87%) and CCC (+8.59%) rated bonds. While we expect spreads to tighten over the near term, we are more cautious over the long term.

> In the leveraged loan market, flagging mergers and acquisitions put a damper on activity in 2Q19 as LBO loan supply was significantly lower than 1Q19. But investor interest in collateralized loan obligations endured as banks showed the most interest in top-rated tranches of newly issued CLOs and money managers and insurance companies made up the lion's share of buyers of mezzanine tranches, according to Citi Research.

HIGH YIELD

The high yield market held up remarkably well in 2Q19, even as the 10-year Treasury dropped below 2% and interest rate sensitive spreads were roughly flat. With the Federal Reserve signaling further accommodation, the ICE BofAML High Yield Cash Pay Index finished the quarter at 2.57%, the second best quarter since 1Q17. All segments finished strong, with the exception of CCCs, which continued to underperform. The clear outperformers in the second quarter were BBs.

Overall fundamentals softened a bit with the release of first-quarter earnings reports, which showed a softening in revenue, year-over-year declines in EBITDA (earnings before interest, depreciation, and amortization), a moderate uptick in leverage, and a modest decline in interest coverage. While the default rate increased, it was still only about 1.5%, which is a little lower than the beginning of 2019 and lower than a year ago, according to JPMorgan's' June 2019 Default Monitor.

Technicals, meanwhile, remain supportive, owing to a significant supply shortfall. Gross issuance was up about 11%; net issuance showed a low single-digit increase. Valuations remained a range of fair value given low expected defaults by market participants, including JPMorgan.

This late in the economic cycle, active managers have to be very credit selective with rigorous bottom-up analysis and close scrutiny of high yield spreads. Therefore, we have been selling BB's, which currently have a fairly negative convex, and trading into select BBBs to pick up yield. We're also trying to match up maturities as best we can, because this is not necessarily the time to be increasing duration in a portfolio.

Outlook

The big question hanging over the market is: how many times will the Federal Reserve (Fed) cut rates by the end of the year? As of July 9, the Fed Fund futures market was suggesting two or three quarter-point rate cuts. Whatever the number, if the Fed is early enough with its next round of cuts for the economy to have a "soft landing," that could be very constructive for high yield. But if the Fed is a little late or the economy slows more than expected, that obviously would not be good for the asset class.

The bottom line: we are going to go to where we think there's value, and at the moment that is moving up in credit quality. We're underweight CCC's. We're also underweight energy, but can envision some potential relative value opportunities among certain "fallen angels" in the natural gas sector. Gas prices have plunged in recent years.

LEVERAGED LOANS

The leveraged loan market remained resilient in 2Q19. The JP Morgan Institutional Leveraged Loan Index gained 1.59% in April, dropped 24 bps in May, then recovered 28 bps in June. Through the first half of 2019 the index has returned 5.58%. Notable contributors by industry were retail at 7%, broadcasting 7%, cable 6.6%, and the laggards were metals and mining at +2% and consumer products at a little over 4%.

As of the end of the quarter, the yield with three-year takeout was 6.43%, down 170 bps a year to date. The price on the index was approximately 96.9, and that was up from 96.8 at the end of 1Q19 and up from 94.5 at the beginning of the year.

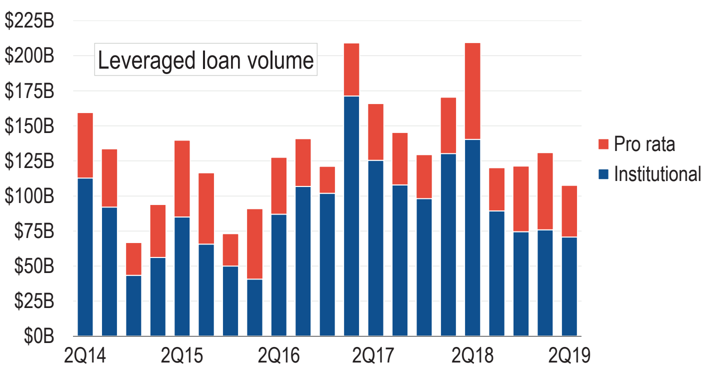
Supply and Demand

Gross issuance volume in the second quarter was $91 billion for the quarter, down substantially from $257 billion from the same period a year ago. Repricings were down to $4 billion for the quarter compared to $241 billion in 2018 while $51 billion paid down through scheduled amortizations as well as bond-for-loan issuance. Mergers and acquisitions represented about 44% of the issuance, refinancings accounted for 41%, and general corporate dividends (and other) came to 15%. In terms of ratings tiers, the middle tier once again was the majority at 72%, the upper tier was 24%, and the lower tier was 4%.

On the demand side, retail fund flows continued a negative trend, recording a 2Q outflow of $8.8 billion and year-to-date outflow of $19.9 billion, modestly better than the outflow of $20.6 billion in 4Q18.

As for collateralized loan obligations (CLO), volume continued to be relatively strong. Gross volume in 2Q19 was $50 billion, up from $38 billion in 1Q19 and down from $87 billion in 2Q18. Net volume for 2Q19 was $35 billion compared to $29 billion in 1Q19. Default rates remained remarkably well contained: the loan par-weighted default rate for the second quarter was 1.3%, and that was down 42 bps on a year-to-date basis.[1]

LEVERAGED LOAN VOLUME DROPPED IN 2Q19 AMID WEAK M&A



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

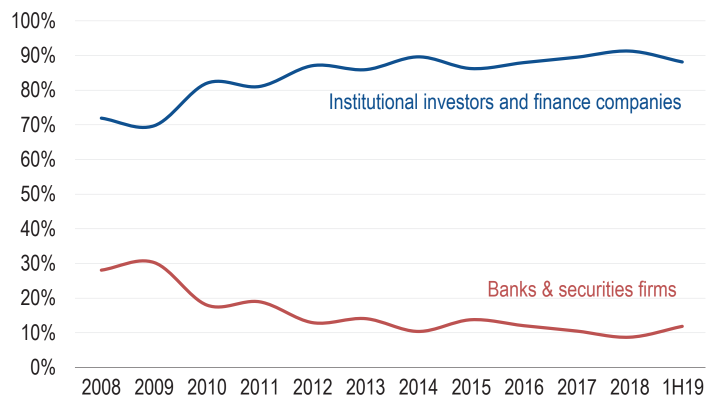
Our Takeaway

While retail outflows continued in 2Q19, albeit at a somewhat decelerated rate, robust CLO formation provided continued support in the much larger institutional market. Re-financings and re-pricings were sidelined. Index pricing increased modestly in the quarter. And in a low interest rate environment and the Fed indicating accommodation, the three-month LIBOR rate contracted 30 bps during the quarter to 2.3%.

All of which led us to be selective on new issues (e.g., gaming and leisure), avoiding some of the more aggressive loans while favoring certain potential secondary opportunities in health care, aerospace, and media. At the same time, we pared down positions in energy, telecom, and cable (the latter change stemming from a big overweight in that sector).

Against that backdrop, we have to take exception to some overly negative articles in the financial press that in our view have exaggerated the risks in leveraged loans and CLOs over the last year or so. The leveraged loan markets have obviously held up well over this timeframe as the U.S. economy continued to grow and corporate America largely maintained fiscal discipline. Of course, some overleveraged buyout deals may hit the market from time to time, but our bottom-up investment process weeds these credits out of our portfolio. All of which underscores why active management in this asset class is crucial.

PRIMARY MARKET FOR LEVERAGED LOANS (BANKS VS. NON-BANKS)



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

[1]Source: J.P. Morgan

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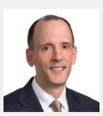
Authored by:

Leveraged Loans



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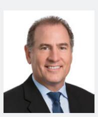

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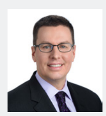

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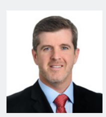

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Seix Investment Advisors is an investment management boutique focused exclusively on managing fixed income securities since 1992. Seix seeks to generate competitive absolute and relative risk-adjusted returns over the full market cycle through a bottom-up 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.

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. **ICE BofAML U.S. High Yield Cash Pay Index** is an unmanaged index consisting of all domestic and Yankee high-yield bonds maturing over one year. The quality range is less than BBB-/Baa3 but not in default (DDD1 or less). The **Bloomberg Barclays U.S. Aggregate Bond Index** measures the U.S. investment grade fixed rate bond market. The **J.P. Morgan Domestic High Yield Index** is designed to mirror the investable universe of the U.S. dollar domestic high yield corporate debt market.

The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and are not available for direct investment.

LIBOR is a benchmark interest rate at which major global lend to one another in the international interbank market for short-term loans. LIBOR, which stands for London Interbank Offered Rate, serves as a globally accepted key benchmark interest rate that indicates borrowing costs between banks.

A **Basis Point (bp)** is equal to 0.01%.

Collateralized Loan Obligations are securities backed by a pool of assets often low-rated corporate loans.

Negative Convexity refers to the shape of a bond's yield curve and the extent to which a bond's price is sensitive to changing interest rates.

Earnings before interest, taxes, depreciation, and amortization (EBITDA) is an accounting measure calculated using a company's earnings, before interest expenses, taxes, depreciation, and amortization are subtracted, as a proxy for a company's current operating profitability (i.e., how much profit it makes with its present assets and its operations on the products it produces and sells, as well as providing a proxy for cash flow).