Floating Rate Bank Loan Strategy

Newfleet
ASSET MANAGEMENT
A Virtus Investment Partner

Sector Assessment

FUNDAMENTALS
Broad market fundamentals have modestly improved and remain acceptable. The S&P/LSTA Leveraged Loan Index default rate by number declined substantially during the quarter.

TECHNICALS
Loan market technicals remained strong as investor cash continued to flow into the asset class in anticipation of rising rates, while net new issuance stayed relatively muted.

VALUATIONS
Valuations appear slightly rich but are still attractive on a risk-adjusted relative basis.

Important Developments this Quarter

Overview: Post-election expectations of faster economic growth and rising inflation continued into the first quarter as optimistic investors waited for clarity on President Trump's fiscal policies. As the quarter progressed, support for the "Trump trade" weakened as the new administration experienced bumps in the road with its aggressive agenda and visible opposition. In March, the Federal Reserve raised rates for the second time in three months, the Brexit process formally began, and crucial European elections loomed closer.

Europe: Political and economic developments in Europe captured attention during the first quarter. On March 29, nine months after voting to leave the European Union, Prime Minister Theresa May triggered Article 50 of the Lisbon Treaty to start the two-year process for the U.K.'s exit from the 60-year-old alliance. As the U.K. embarks on a path of complex and surely contentious negotiations, other European nations (and the Continent as a whole) are bracing for elections that will test the strength of right-wing populism and euro skepticism. While the Netherlands rejected its anti-European candidate in March, the more consequential French polls follow in late April/early May, and German elections will take place in September. Against this backdrop of political uncertainty, economic recovery in Europe is underway. The fear of deflation has diminished and positive economic data are emerging, albeit unevenly across the eurozone. The European Central Bank (ECB) held rates steady in March and announced no additional stimulus. There is a growing conviction that the end of quantitative easing is in sight, especially because the ECB is running out of options in terms of bonds it can buy.

Federal Reserve: While accommodative monetary policy persists in Europe, as well as in Japan, the Fed acted on its stated "confidence in the robustness of the economy" by raising its benchmark rate another quarter of a percentage point to a range of 0.75% to 1.0%. The probability of the move reached nearly 100% as the Fed's March meeting drew closer. Labor market conditions and inflation both are approaching the decision-making body's target levels. Chair Janet Yellen continued to emphasize a gradual approach to rate hikes with two more projected in 2017.

U.S. Economy: The U.S. economy has indeed been resilient over the past few months. GDP increased at an annual rate of 2.1% during the fourth quarter of 2016, ahead of expectations though short of its 3.5% level in the third quarter of 2016. Labor market conditions remain firm, with 4.7% unemployment at the end of February. Though long-term inflation expectations have eased as a result of lowered expectations for fiscal stimulus, realized inflation measures have been trending higher. Core PCE (personal consumption expenditures ex food and energy), the Fed's preferred gauge, reached 1.8% in February and is approaching the 2% goal. Consumer confidence and the housing sector remain supportive.

Treasuries: The yield curve flattened over the quarter, with rates higher on the front end of the curve and relatively unchanged on the long end. The yield on the 10-year U.S. Treasury ended the quarter at 2.39%, modestly below the 2.45% yield at year-end 2016. Having surged in the aftermath of the presidential election, the benchmark yield was in a holding pattern for much of the first two months of 2017 as investors reevaluated the pace and likelihood of Trump's growth-oriented fiscal policies. Rising expectations of a March rate hike pushed the 10-year bond to a three-year high of 2.63%. Yields subsequently retreated on the Fed's message of gradual hikes. This was reinforced by the failure of Congress to repeal Obamacare, and its implications for accomplishing other items on Trump's pro-growth agenda. The attractiveness of the U.S. bond market relative to other developed markets like Germany, Japan, and the U.K. has helped to keep a lid on U.S. yields. The demand for safe-haven assets amid the ebb and flow of political risk in Europe, namely France, has also benefited U.S. yields.

U.S. TREASURY YIELDS

	12/31/15	12/31/16	3/31/17
2 year	1.05%	1.19%	1.26%
5 year	1.76%	1.93%	1.92%
10 year	2.27%	2.45%	2.39%
30 year	3.02%	3.07%	3.01%

Source: Bloomberg L.P.

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U.S. Dollar: The U.S. dollar declined steadily over the quarter in the wake of falling bond yields, disappointment with the progress on Trump's fiscal stimulus plans, and the Fed's dovish posture on future rate moves. The Bloomberg Dollar Index (a basket of 10 leading currencies against the U.S. dollar) ended the quarter at 1223.05, modestly above its pre-election level and well below its post-election high on January 3 of 1277.53. Perhaps most symbolic of the new administration's struggle to actualize its campaign pledges was the strengthening of the Mexican peso versus the U.S. dollar. During the election season, the peso rose and fell with candidate Trump's standing in the polls. This reflected his hardline stance on tariffs, immigration, and the future of NAFTA. At the end of the first quarter of 2017, the peso was the top-performing currency in the world (+10.8%) and had recouped its losses against the dollar.

Oil: Until early March, oil had hovered around $55 per barrel following OPEC's November 30, 2016 agreement to curb output in support of prices. Reports of record-high levels of U.S. output, however, reignited worries of an oil glut. Despite a drop in production and strong compliance with the OPEC accord among participating countries, fears that U.S. oil production could overwhelm OPEC's cuts drove prices down. On May 25, OPEC will decide whether to extend the agreement, which went into effect for six months on January 1. Brent Crude, the international benchmark, touched a low of $49.92 per barrel before rising at quarter-end to $52.71 on encouraging signals of an extension from the cartel.

Loan Market Performance Summary

The broader fixed income market, as represented by the Bloomberg Barclays U.S. Aggregate Bond Index, returned 0.82% for the first quarter of 2017. Most spread sectors outperformed U.S. Treasuries during the quarter and spreads tightened. Longer duration assets and lower quality within each sector were key drivers of performance.

The **loan market**, as measured by the S&P/LSTA Leveraged Loan Index (S&P/LSTA), posted a solid return of 1.15% for the quarter. However, performance was seasonally weak for a first quarter. It was the third consecutive quarter of declining returns, as the loan market rally over the past 13 months has pushed the market toward par and left less potential for price appreciation. First quarter returns declined on a year-over-year and sequential basis from a gain of 1.55% in the first quarter of 2016 and 2.26% in the fourth quarter of 2016, respectively.

> The supply and demand imbalance continued into the first quarter with strong loan market demand and minimal net new loan issuance. This pushed prices above par and triggered an aggressive wave of refinancings into lower-spread loans.

> Lower quality paper and the commodity industries continued to lead performance as prices of loans in these sectors recovered after being heavily beaten down during last year's sell-off. CCC, second lien, and defaulted paper were up 5.02%, 3.61%, and 3.06%, respectively, in the first quarter. Higher quality credit underperformed, with BB-rated paper lagging but up 0.66%.

> On an industry basis, energy led all sectors by a wide margin for the quarter, returning 4.7% despite a March dip in energy prices that dragged down the energy index by 2.4% for that month. Other outperforming sectors included radio & television and metals at 3.13% and 2.63%, respectively. Retailers were laggards (-1.97%) as consumer preferences continue to shift from bricks and mortar and mall-based consumption to online shopping. Performance was much more dispersed across industries during the first quarter. Roughly half of the industry sectors outperformed the overall market in contrast with recent quarters when the commodity sectors far outperformed.

> To put loan market performance into context, loans underperformed high yield (+2.71%) and investment grade corporate bonds (+1.42%), but outperformed the 10-year Treasury (+0.78%) as Treasury yields fell modestly during the quarter.

Loan market technicals remained strong during the quarter. Investor cash continued to flood into the asset class in anticipation of rising rates, while net new issuance stayed relatively muted.

> The market remained in a supply deficit with demand outstripping supply, which resulted in a wave of repricings. First quarter gross loan issuance totaled $169 billion, an increase of 66% from the fourth quarter and a record for a single quarter as capital markets were wide open throughout the quarter. M&A volume picked up during the quarter, but a large portion of the issuance was opportunistic volume such as repricings and recapitalizations that did not add much net new supply to the market. Repayments from M&A and bond-for-loan take-outs continued at an elevated level, limiting net supply. Repricing volume, including deals done via amendment, topped $200 million in the first quarter with an average interest savings of 91 basis points. We continue to observe a distinct trend of more aggressive issuance given the excess demand and more limited pricing differentiation between credits. Negative trends include higher levels of adjustments to cash flow, loan-only capital structures with less junior capital to absorb losses, and loose covenant structures. These developments may result in poor performance down the road for the current vintage of issuance in terms of defaults and recoveries.

> On the demand side, retail loan fund flows continued to improve, accelerating sequentially on a quarterly basis with approximately $16 billion of inflows, the most since the third quarter of 2013. Flows have picked up due to a combination of factors including the search for yield and the reflation trade. It appears, however, that markets are reassessing the inflation outlook following the failure of healthcare reform and the release of weaker economic data. Rates and inflation expectations have come down as of early April.

> CLO issuance started slowly in the first quarter following the implementation of risk retention rules but picked up in February and March with volume totaling $17.4 billion during the quarter. While volume was down 34% from the fourth quarter, it is still on

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a healthy annualized pace to meet most projections of roughly $60 billion in 2017. The outlook for issuance is constructive for the second quarter given the tightening in liability spreads offsetting some of the loan repricings. However, scarcity of collateral may constrain CLO issuance in the medium term.

> The improving macro backdrop and strong technicals led to an increase of $0.14 points in the average price of the loan index, to $98.22 at quarter-end.

Broad market fundamentals modestly improved and remain acceptable as the S&P/LSTA Index default rate by number declined substantially to 1.36% as of first quarter-end from 2.06% at year-end 2016. We have moved past the wave of commodity defaults, and most other industry sectors aside from retail remain fairly healthy.

> Quarterly defaults remained relatively quiet as just three defaults occurred during the quarter. The declining level of defaults is due to a recovery in commodity prices and open capital markets. Defaults remain below the long-term average of 2.75%, and are concentrated in the troubled energy and metals/mining sectors. It does not appear that default activity is spreading to other sectors, though stress appears to be increasing in the retail sector due to changing consumer preferences, and to some extent in healthcare.

> Supportive fundamentals include adequate fourth quarter earnings, strong but slightly deteriorating cash flow coverage of interest, a diminished maturity wall, and expected positive U.S. GDP growth over the next few quarters.

Current Strategy Positioning

The strategy ended the first quarter with 90% invested in senior secured first lien bank loans, 3% in non-first lien bank loans, and the majority of the remaining exposure in high yield bonds as part of our liquidity strategy.

We continued to add some risk at the margin during the quarter as a result of the improvement in the commodity markets, strong technicals, expectations that the default cycle has been pushed further into the future, as well as very open capital markets:

> The net result for the quarter was an increase by roughly 300 bps in the strategy's exposure to the lower quality credit tiers and, to a much lesser extent, high yield.

> We continue to scrutinize existing holdings to ensure that our fundamental thesis is intact, and for relative value opportunities given the large rally since February 2016 and the current wave of repricings. We also regularly review the secondary market for total return opportunities, and have added several discounted loans for this purpose.

> We have also become more comfortable with oil supply/demand dynamics and certain energy credits in favorable basins with favorable cost structures. We increased slightly our modest overweight to the energy industry through the addition of some energy credits.

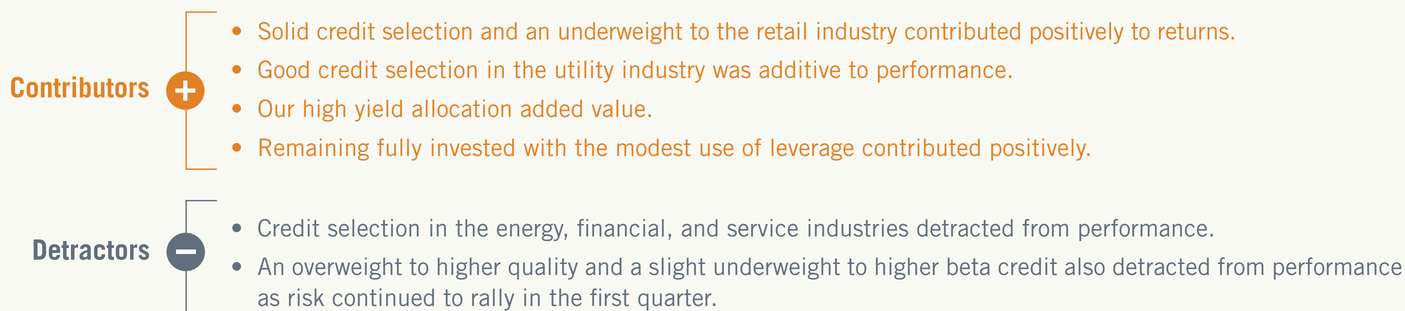
> In the new issue market, underwriting standards have weakened throughout the latter half of 2016 and into early 2017. We have noted an increase in leverage, increased loan-only capital structures, large adjustments to cash flow in marketing transactions, and several non-traditional agents bringing deals to get around Federal Reserve leverage guidelines. We see this vintage of new loan transactions as aggressive, and are passing on a substantial number of new deals.

> During the quarter, we increased our industry weightings to the food/tobacco, service, and cable industries while decreasing our exposure to information technology, utilities, and healthcare. Some of the largest industry overweights in the strategy are to the housing, cable, and chemicals industries. The largest industry underweights are to the information technology, diversified media, and retail industries.

We added risk over the past year as markets recovered and it became clearer that the default cycle had likely been pushed farther into the future. However, we continue to have an underweight to the single B and below credit tiers in the aggregate, given more compressed valuations as the market approaches par and until we have more clarity on the impact of the new administration's fiscal and regulatory policies on the economy.

We are comfortable with our liquidity position and cautiously monitor and consider it daily in managing the strategy.

HOW THE STRATEGY PERFORMED



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Looking Ahead

The outlook for leveraged loans remains constructive given a combination of solid fundamentals and technicals, the potential for rising rates, and valuations that appear slightly rich but attractive on a risk-adjusted and relative basis.

Valuations remain attractive relative to our forecast for below-long-term average defaults over the next year. Loans also offer floating rates and much lower return volatility relative to high yield, which sets up the asset class to outperform in either a too hot or too cold economy. Going forward, returns are more likely to come from coupon clipping. Total return potential appears more modest given the limited upside, with the average dollar price for the loan index at $98.22 as of quarter-end. The average price of the index remains somewhat deceiving as evidenced by the average index prices by credit tier: BBs at $100.14; Bs at $98.75; and CCCs at $83.80. Further, with approximately 62% of the market trading above par, the market will likely see some additional coupon erosion from repricings. This could be more than offset by rising Libor, depending on the Fed. The three-month Libor ended March at 1.15% and has pierced the average Libor of 100 bps. We point to 1994 and 2004/2006, as well as the fourth quarter of 2016, as examples of near-par loan markets that exhibited outperformance relative to fixed rate sectors in a rising rate environment.

Fundamentals, outside of retail and certain distressed situations, are likely to stabilize and remain acceptable as we move past the commodity default cycle, and given the forecast for positive GDP growth, solid cash flow coverage, and still-positive corporate earnings. In fact, the next default cycle has likely been pushed farther into the future as refinancings have extended maturities and due to the possibility of fiscal stimulus in the form of lower taxes and infrastructure spending. The technical picture remains solid with stable CLO issuance, positive retail fund flows, modest net new issuance, and a muted forward calendar.

The main risk in the short term is a reversal of technical trends should rates and inflation expectations change. Other risks include actions by the new U.S. administration, elections in France and Germany, and an array of geopolitical events. We remain fully invested to take advantage of the continued strong technicals in the loan market, and with incrementally more credit risk than at this time last year. However, we still generally position ourselves with an overall up-in-quality bias until we have more clarity on the impact of the new administration's fiscal and regulatory policies on the economy, inflation, and interest rates.

The **S&P/LSTA 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 index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and is not available for direct investment.

The commentary is the opinion of the subadviser. This material has been prepared using sources of information generally believed to be reliable; however, its accuracy is not guaranteed. Opinions represented are subject to change and should not be considered investment advice or an offer of securities.

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 portfolio.

For more information on the Newfleet Fixed Income strategies, please contact:

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