Bank Loan Market Update

JUNE 2024: OUTLOOK AND IMPLEMENTATION

- Current coupon (+0.75%) more than offset softer loan prices (-0.40%) as demand for loans slowed on the back of lower inflation and cooling economic data, which together pulled forward rate cut expectations. Specifically, CLO creation slowed as it became increasingly challenging to find appropriately priced loans in the secondary market while the primary new issue market remains thin. This, while CLO liability spreads continued to tighten.
- The busy refinancing/repricing calendar is also effectively pricing risk lower, which is reflected in lower prices.
- June total return was 0.35%. For the quarter, loans returned 1.90%. YTD return is 4.40% – on track with our full-year guidance of 7-8%.
- Fixed rate outperformed this month, consistent with the pickup in rate cut sentiment with high yield up 0.94%, investment grade credit up 0.63%, and the 10-year Treasury Index up 1.29%. Still, YTD loans continue to outperform primarily due to the continued yield advantage.
- We expect refinancings to continue with roughly 44% of the market still priced at par or higher.
- <u>Investment thesis remains intact</u> - The asset class continues to post a strong year driven by a supportive economic backdrop, borrowers managing higher interest expense, a favorable technical environment, and a yield advantage relative to other fixed income asset classes.
- Risk outperformed with CCC-rated loans up 0.66%, largely due to their higher current coupons. BBs returned 0.35%, outperforming B risk which was up 0.31%. All cohorts saw market prices decline.
- All industries weighted 1% or more of the index were positive except for aerospace & defense, which declined 0.49%.

Fundamentals

- A string of economic data was welcome news for the rate cut camp. Declining inflation readings including CPI, PPI, and core PCE, combined with cooling labor market data (higher Jobless claims), pulled forward market rate cut expectations. While a chance of a July rate cut is less than 10%, market expectations of a September rate cut have increased to 65%, up from 45% at the start of the month.
- Still, the Fed has reiterated that continued inflation deceleration and economic weakness are needed for a sustained rate cut regime.
- <u>Borrowers have increasingly had to manage higher debt service costs, but this year's repricing and refinancing wave has resulted in material interest expense relief for a growing portion of the market. At an average savings of 54 bps, 30% of the $1.4 trillion market has collectively saved about $2.25 billion in interest costs.</u>
- The result is cash flow coverage – or (EBITDA less CAPEX)/Interest expense – improving slightly to 2.63x in 2Q24 from 2.49x at 4Q23. Still, for context, this ratio was near 3.5x pre-rate hike regime and 23% of the market currently has cash flow coverage less than 1.5x.
- The downgrade/upgrade ratio improved slightly to 2.1x from 2.2x in May but remains elevated after reaching a low of 1.6x in March.
- The loan payment default rate (by $ amount) declined to 0.90% but including out-of-court restructurings, the default rate was 4.3%. Out-of-court transactions have been concentrated in healthcare equipment & services as well as software & services and have picked up as borrowers try to engineer a way to manage interest expense without bankruptcy.

Technicals

- Demand declined to its lowest level this year but remains well above supply.
- Retail fund inflows totaled $804 million, a four-month low and down from $3.1 billion in May.
- Collateralized loan obligation (CLO) issuance slowed to $11.3 billion (only $6 billion associated with broadly syndicated loans), a six-month low. Still, YTD issuance is $101 billion and on pace for a record issuance year.
- <u>Inclusive of repricing transactions, overall gross volume was $141 billion. However, over 75% of the total was refinancing or repricing related.</u> Given little M&A and LBO business, opportunistic deals including loans to pay dividends has increased.
- Voluntary repayments increased to $44.8 billion as borrowers took advantage of open capital markets, including both High Yield and Private credit, which have repaid $29 billion and $9.4 billion of loans respectively YTD. Accelerated repayments act as a demand driver as proceeds typically need to be reinvested back into the market.
- Loan portfolio Bids-Wanted-In-Competition (BWICs) created $5 billion in supply and weighed on the market.

Pricing

- Loan prices softened for the first time since January, down 0.40% to 96.6. BB loans are 99.3, B-rated loans are 98.1, and CCC-rated loans (6.2% of the market) sit at 83.3. Approximately 75% of the market is priced over 99 cents.
- Loans priced at par of higher fell to 44% of the market, compared to 62% in May. The repricing wave is acting to reset market spreads and makes it difficult for investors to buy over par loans (fear of being refinanced at par) so prices cooled. Still, this level of over par prices supports continued spread cutting exercises by borrowers in the near term.
- On the stressed side, loans bid at 80 cents held flat at 4.4% of the market and remain lower than a year ago (6.7%).
- Valuations widened to S+459 assuming a three-year life, driven by lower prices and nominal spread tightening due to repricings. Despite the widening, loan spreads across all rating buckets except CCC are still near historic tights.
- With spreads well inside post-GFC averages (+528), loans appear rich on an absolute spread basis. However, valuation remains attractive relative to fixed rate asset classes driven by its continued yield advantage.
- Indeed, with a yield-to-maturity of 9.8% compared to 4.2% in December 2021 (pre-rate hikes), loans remain attractive on a yield basis.

Implementation

- We expect the issuance calendar to fill after the holiday but remain refinancing heavy. The receipt of scheduled quarterly amortization payments should provide incremental support to loan prices, so we will remain fully invested.
- As in May, we have been taking advantage of higher loan prices by selling over par loans and rotating into the primary market with new issue discounts without sacrificing our current risk positioning.
- Our semi-annual industry re-underwriting will begin in the coming weeks.
- At the same time, we are assessing the recent softer economic data as a possible catalyst to reposition credit risk ahead of the possibility of an economic slowdown.

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