PUBLIC FIXED INCOME

High Yield & Bank Loans

Market Review and Outlook

September 30, 2021

HY Market Review:

Index	3Q 2021 Return	YTD Return
BofA Merrill High Yield Constrained[1]	0.95%	4.68%
Bloomberg US Corporate HY Index[2]	0.89%	4.53%
S&P/LSTA All Loans Index[3]	1.11%	4.34%

[1]Bloomberg L.P., [2] Barclays, [3] S&P LCD

The broad high yield (HY) market's resiliency was on display during the quarter. Instability in rates accelerated and markets experienced bouts of volatility amid the spread of the Delta variant, inflationary concerns, and China's debt crisis. The ICE Bank of America Merrill Lynch U.S. High Yield Constrained Index returned 0.95% over the quarter, while the yield to worst increased 23 basis points to 4.10% by quarter-end[1]. The Bloomberg US HY index returned 0.89% over the quarter. Spreads widened 21 basis points to 289 basis points, and the yield to worst on the index increased 29 basis points to 4.04% by quarter-end[2].

Within the high yield market, the BB space with higher-quality issuers led performance as overall higher beta names underperformed in September. However, the CCC bucket performed well earlier in the quarter and was able to hold onto positive returns. The single-B space, which was the worst performing rating category within HY, still posted positive returns as the asset class remained more resilient than the investment grade space during the treasury sell-off. Energy continued to outperform the rest of the high yield space in the third quarter given the strong commodity backdrop[3].

While experiencing large fluctuations throughout the quarter, 10-year US Treasury yields ended the quarter little changed. Notably, in September the 10-year US Treasury yield rose 18 basis points to a quarterly high of 1.49%

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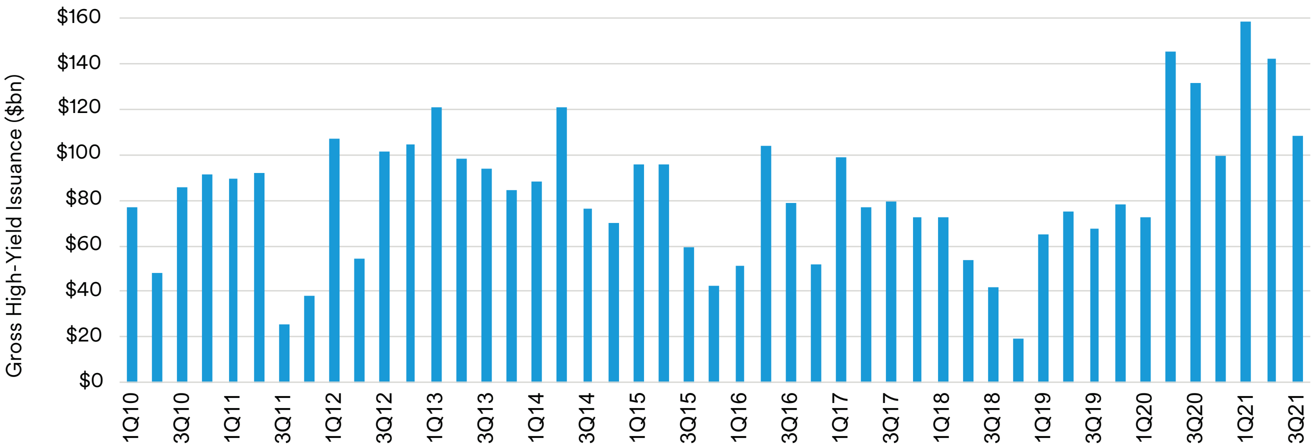
in response to a pair of hawkish outcomes at the BoE and Fed meetings, with this treasury trend continuing into October.

Despite lighter than expected issuance in September, the high yield market priced $108.5 billion of new deals during the quarter, down from the $142.5 billion priced in the previous quarter. Notably, year-to-date high yield issuance totaled $409.7 billion, which compares to $350.1 billion during the same period of 2020[4].

Figure 1 | Quarterly Issuance

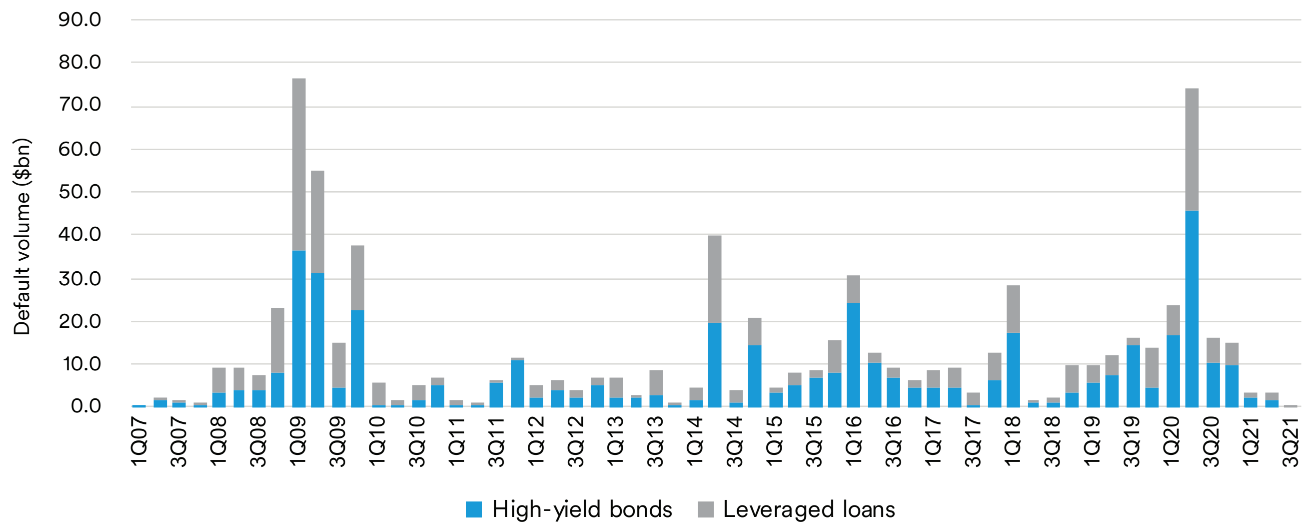


Source: J.P. Morgan

High yield funds experienced their first quarter of inflows this year, reporting +$1.9 billion during the quarter, following -$3.3 billion of outflows in the second quarter and a -$10.6 billion outflow in the first quarter[5].

The LTM Moody's HY U.S. par weighted default rate including distressed exchanges declined to 0.80%, after hitting a cyclical peak of 6.5% just over a year ago[6]. In the third quarter just two companies defaulted, affecting $855 million, and one company completed a distressed exchange affecting $282 million in loans (combined $1.14 billion). Notably, this was the lowest quarterly default volume inclusive of distressed exchanges since the fourth quarter of 2013 ($1.10 bn)[7].

Figure 2 | Default Volume



Source: J.P. Morgan

Despite a favorable macro environment and solid corporate earnings, volatility crept into the market early in the quarter. The market was challenged in July as the rate rally intensified and equities experienced periods of volatility amid the spread of the Delta variant. Early in the month, the high yield market performed well, supported by a favorable macro environment. As the month progressed, US Treasuries plunged due to lowered inflation expectations, contributing to the risk-off tone as more investors questioned the sustainability of the recovery. Market softness was partially offset by optimism surrounding the strong start of earnings and a rebound in consumer demand. Despite growing Delta variant concerns, the high yield market was firm heading into August.

August was a tale of two halves for the high yield market, as the market was challenged by treasury rate unpredictability and Delta variant concerns, only to display resiliency during the late-summer slowdown in both primary and secondary markets. As expected, the strong second quarter corporate earnings reports helped boost market sentiment in a time of slight weakness. Despite low liquidity, thin trading volumes, and a pending Fed announcement, the broad high yield remained well supported in the second half of August. U.S. stocks opened higher ahead of Jackson Hole during which investors expected more commentary on tapering. However, markets dipped following hawkish Fed headlines and the chaotic scenes that played out in Afghanistan. Even with the slow pace of secondary market activity and the primary market lull, the market remained firm heading into September.

The broad high yield market was challenged in September as investors absorbed a sharp increase in Treasury yields, the largest losses for the S&P 500 since March 2020, and a new issue calendar that ended up underwhelming heightened expectations. China's regulatory crackdown on the technology sector contributed to the weakness, especially in global equity markets. As the month progressed, rising commodity costs fueled inflation concerns. Volatility was short-lived, as investors embraced the Fed's bullish outlook on economic recovery despite ongoing concerns coming from the Chinese debt market and the Delta variant. In the final week of September, the drop in underlying Treasury prices impacted markets and triggered selling in interest rate-sensitive bonds. Much like the previous week, investors continued to brace for the possibility of tapering, the global impact of China's debt crisis, and elevated inflation levels.

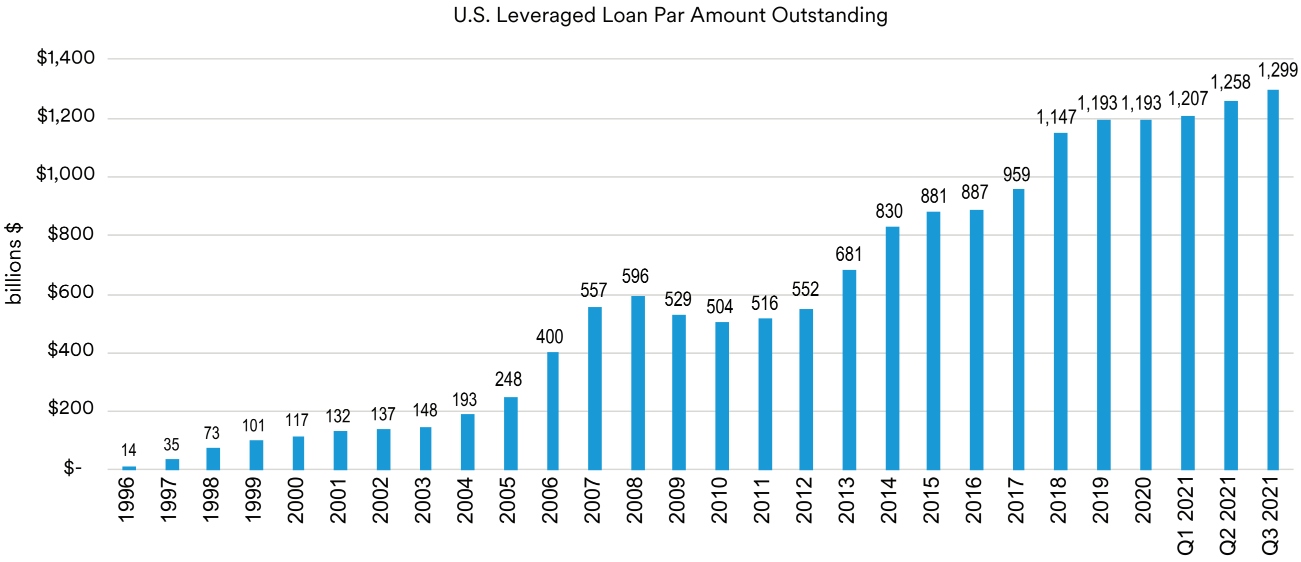
BL Market Review:

The leveraged loan market recorded an impressive quarter amid surging investor demand as the prospect for rising rates drove yield-starved investors toward the floating-rate asset class. The S&P/LSTA Leveraged Loan Index returned 1.11% during the quarter. The CCC-rated cohort once again led, returning 2.09%, while single-B loans returned 1.14%. BB and BBB rated loans returned 0.83% and 0.70%, respectively. The weighted average bid of the S&P/LSTA Index rose 83 basis points in the quarter and climbed 25 basis points year-to-date to 98.62. This is 20 basis points higher than the prior 2021 peak, 98.42 on June 12, and the highest reading since October 2018. The weighted average bid has gained 243 basis points since the end of 2020 and 543 basis points in the last 12 months[8].

Spreads continued to tighten during the quarter, narrowing from L+417 bps to L+413 bps by the end of September. The BBB space drove the spread compression, tightening from L+216 to L+210 during the third quarter. Spreads of BB loans widened slightly from L+307 to L+309 and spreads on single-B loans widened from L+426 to L+428, while CCC spreads narrowed from L+829 to L+827[9].

Record primary CLO issuance and a consistent stream of retail inflows buttressed a heavy primary calendar, leading to a largely unprecedented quarter. The volume of primary CLO issuance reached a record $46.7 billion. The previous high quarterly tally was in the second quarter, when managers printed $43.4 billion in new-issue CLO paper. Notably, the third quarter was the third consecutive quarter that the market has established a new issuance record, with deal flow at $130 billion in the year to date, via 262 new-issue deals from 109 managers, surpassing the yearly volume record of $129 billion in 2018. Retail inflows totaled +$7.2 billion, following +$13.6bn of inflows in the second quarter and +$14.1 billion in the first quarter[10].

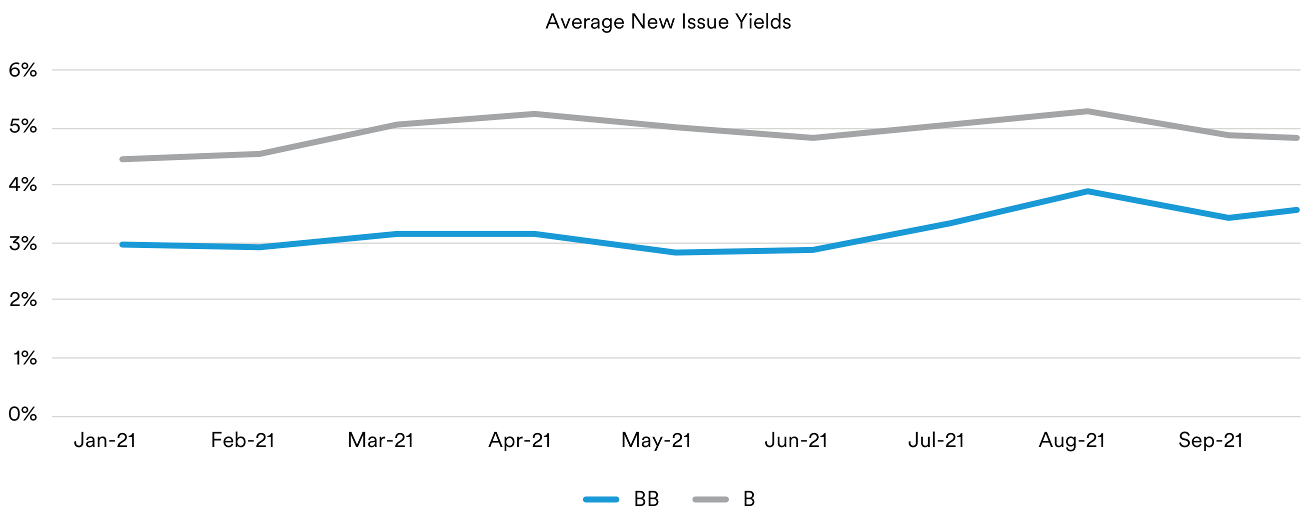
Figure 3 | Par Amount Outstanding



Represents all U.S. Leveraged Loans as set forth by S&P Leveraged Commentary and Data ("S&P LCD") as of September 30, 2021.
Source: S&P LCD

Total institutional volume was $155 billion, up from $147 billion in the second quarter but below the record-setting $185 billion in the first quarter. Prior to this year, the last quarter with higher volume was the first quarter of 2017. M&A activity continued to support volumes, with $92.4 billion of supply launched during the quarter for acquisitions and buyouts, a new record high. LBO deal volume hit a post-Global Financial Crisis high of $44.4 billion. Volume was led by a healthcare company's $7.27 billion term loan B offering, and benchmark offerings. The surge of issuance propelled the amount of institutional U.S. leveraged loans outstanding to a record $1.3 trillion. Notably, private equity-backed companies tapped the loan market for $27.6 billion during the quarter to fuel M&A activity, the most since the second quarter of 2018. Total institutional loan volume through the third quarter was $487 billion, surpassing the prior high for the first three quarters of $405 billion in 2017 and on track to surpass the 2017 full-year record of $503 billion[11].

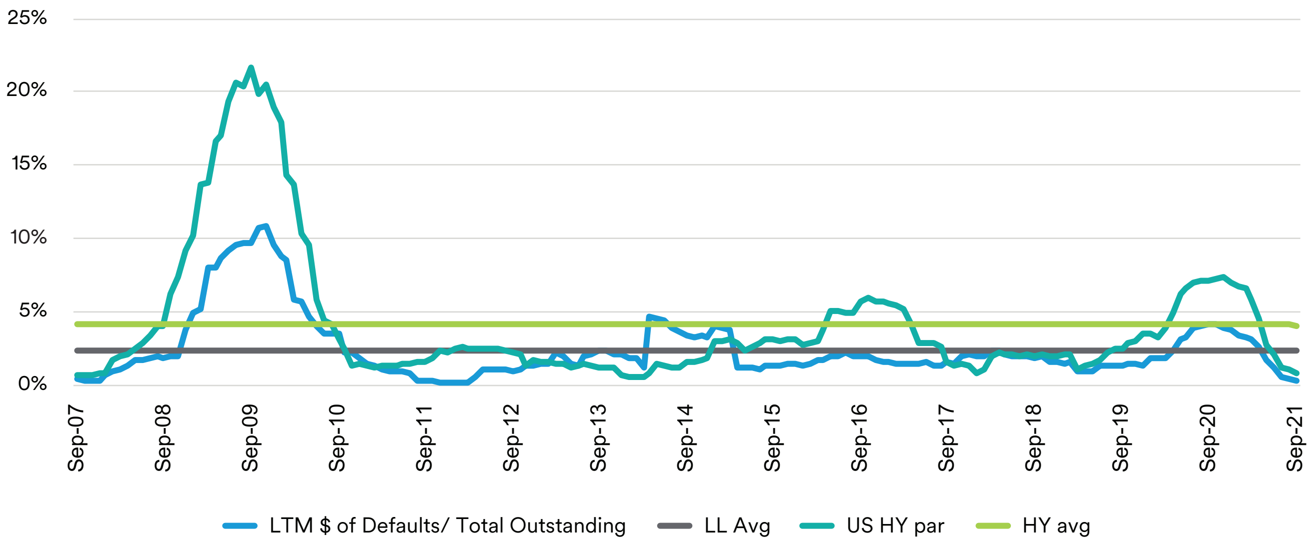
Figure 4 | Average New Issue Yields



Source: S&P LCD

In addition to the low-rate environment driving yield-starved investors toward the floating rate asset class, a historically low default rate and elevated levels of liquidity improved investor sentiment. The trailing-12-month volume of default rate ended the quarter at 0.35%, just 14 basis points above the post-global-financial-crisis low. Notably, defaults in the S&P/LSTA Leveraged Loan Index fell to just $4.1 billion in September, the lowest since April 2012[12].

Figure 5 | High Yield and Bank Loan Historical Default Rates



Source: S&P LCD, Moody'

The distressed ratio for the index (loans trading < $80) nearly fell to a seven-year low of 0.72%. By industry, sector-level distress remains highest in Broadcast, Radio and Television, at nearly 13%[13]. Among other sectors with an index share over 1%, Leisure dropped out of the rankings, with no loans in distressed territory in September[xiii].

LIBOR transition to SOFR continues to accelerate, with no new loans benchmarked off LIBOR beginning in January 2022. Existing loans will migrate away from LIBOR during the first half of 2022.

Outlook:

We believe the long-term recovery of the high yield and leveraged loan markets, along with broader risk assets, are supported by robust global growth, improving earnings fundamentals, and continued vaccine dissemination. We continue to believe the short-term will be defined by pockets of volatility as the receptiveness to vaccination by the broader population, along with ebbs and flows in variant-cases, challenge the path to herd immunity and may ultimately lead to COVID-19 becoming more endemic. Furthermore, inflationary pressure and inflections in rates will continue to take center stage as the specter of Fed tapering and interest rate hikes becomes more realistic. We remain focused on news of global supply chain disruptions and the impact these can have on input costs and the flow of goods.

Despite these challenges, we believe the high yield market will continue to be supported by strong investor demand as the depressed yields across asset classes attract investors to high yield securities. Accordingly, we continue to maintain a moderately cautious approach as pandemic-related impacts continue to challenge improvements in underlying company fundamentals. We will maintain our efforts on discerning which credits I provide the best potential for relative value opportunities to drive performance.

We believe Treasury rates will continue to be volatile in the face of persistent inflation threats. We feel such volatility will continue to put the leveraged loan floating-rate asset class in focus and support strong investor demand. We believe the supportive market conditions will continue to lead to a robust primary market, positive momentum in rating migration, and benign default rates. Accordingly, we will selectively participate in the primary market, trying to identify issuers with solid fundamentals and adding to existing higher conviction holdings.

We are beginning to see the LIBOR transition take shape with nearly all new primary LIBOR based deals containing documentation mechanisms to move to an alternative base rate once LIBOR goes away. We have recently seen the launch of several SOFR based loans in the market and expect more to follow.

Endnotes

1 Bloomberg L.P.
2 Barclays
3 Barclays
4 J.P. Morgan
5 J.P. Morgan
6 Moody's
7 J.P. Morgan
8 Data in this paragraph sourced from S&P LCD
9 Data in this paragraph sourced from S&P LCD
10 Data in this paragraph sourced from S&P LCD
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