



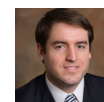
Much Maligned Bank Loans Deserve a Closer Look

Strong fundamentals and technicals support floating rate loans.

May 2019

KEY INSIGHTS

- The bank loan market appears to offer attractive relative value despite a deterioration in the underlying protections for loan investors as well as the potential for the Federal Reserve's pause in rate hikes to weigh on investor demand for floating rate instruments.
- We believe that the current environment of relatively slow but steady economic growth coupled with low inflation is ideal for bank loans, and borrower fundamentals are generally solid.
- Relatively low levels of new supply and strong demand from collateralized loan obligations are supporting the bank loan market.



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Lead portfolio manager for Total Return Fund

The bank loan market appears to offer attractive relative value despite several well-publicized and valid risk factors. First, the underlying protections inherent in the bank loan market have deteriorated. For instance, "covenant-lite"¹ issuance and structures without debt that is subordinate to the loan level have become increasingly common. Second, the Federal Reserve's pause in rate hikes could weigh on investor demand for floating rate instruments. While these are meaningful risks, we believe that our strong credit research platform will help us navigate the evolving landscape of the loan market, and the sector's generally solid fundamentals and supportive technical factors should

more than offset any drag from lower interest rates.

Potential Fed Cut Would Be Unlike Past Easing Efforts

It may seem counterintuitive to favor exposure to floating rate bank loans² when the Fed has paused its rate hikes and some analysts think that the central bank's next move will be a cut. Indeed, some Fed officials have recently been floating the idea of an "insurance cut" under certain economic conditions. However, we think that a Fed rate cut, if it transpires, would be unlike most monetary easing in the past. Based on our intermediate-term outlook, it would be more likely that a cut would be an effort to proactively extend the

¹ Covenants provide legal protection for debt holders against a deterioration in the borrower's fundamental credit metrics. "Covenant-lite" debt places fewer restrictions on the borrower and thereby provides less protection for debt holders.

² Bank loan coupons periodically reset based on a spread to a short-term benchmark rate such as the 3-month London Interbank Offered Rate (LIBOR).

1.29%

The default rate on loans in April

economic cycle and boost inflation, which has been stuck at low levels even though the economy seems healthy overall, than an effort designed to stimulate a weakening economy that is obviously falling into a recession.

In our opinion, it is probable that this type of insurance cut would be supportive of credit sectors—including bank loans—and more than offset the negative effects of a cut on the coupons of floating rate instruments. While the Fed could remain on hold for an extended period rather than cutting rates, we believe that scenario would also be supportive of credit and bank loans.

Ideal Environment For High Yield

In fact, we believe that the current environment of relatively slow but steady economic growth coupled with low inflation is ideal for high yield instruments, including bank loans (most loans have all noninvestment-grade credit ratings). Borrower fundamentals are generally solid, allowing most corporations to generate reliable cash flow that they can use to meet their debt repayment obligations. The default rate on loans was 1.29% in April, which is meaningfully lower than the 3.07% annual average since 1998.³

From a value perspective, we generally prefer exposure to the bank loan sector over high yield bonds because loan and bond yields are approximately equal, an unusual situation. Bank loans typically yield less than high yield bonds because loans are senior in the issuer's capital structure, giving them repayment priority over bonds in a default scenario. Relatedly, the "current yield"⁴ of bank loans relative to high yield bonds reflects the narrowest gap seen in roughly 10 years. Another attractive aspect of the current bank loan market is that most loans are now trading below par value. Because loan holders receive par

if the borrower refinances the debt, this reduces prepayment risk to the holder and provides some upside potential.

Strong CLO Demand And Muted New Supply Support Bank Loans

Relatively low levels of new supply and strong demand from collateralized loan obligations (CLOs) are supporting the bank loan market, helping to offset recent industrywide outflows from loan funds as investor expectations for the Fed's monetary policy have shifted away from rate hikes. Formation of new CLOs, which buy loans to repackage them into slices with different levels of risk, reached USD 15.7 billion in April, a four-year monthly high. CLO managers are competing to buy a dwindling volume of new bank loan supply. The volume of new loans (not including refinancings) for 2019 through the end of April was down 28% from the same period in 2018.

On the negative side, loan funds industrywide have experienced monthly outflows since October 2018. These outflows hit their worst level in December 2018 (when three-month LIBOR peaked) amid elevated investor concern that the Fed had overtightened policy, but CLO demand has offset some of the drag on the market from outflows. Industrywide outflows were USD 2 billion in April, the smallest figure since October 2018, indicating that the trend may be slowing.

Opportunities In Split-Rated Loans

In addition to noninvestment-grade loans, our fundamental analysis has also uncovered compelling relative value opportunities in higher-quality split-rated⁵ loans. An under-followed part of the market, these instruments reside in a "no man's land" and are generally not included in benchmarks. However, they offer meaningfully higher yields than investment-grade corporate bonds, the

³ Default rate is par-weighted. Source for all default rate, issuance, and fund flow data: J.P. Morgan.

⁴ Current yield is an asset's annual coupon divided by current price.

⁵ Split-rated instruments have high yield credit ratings from one major rating agency and investment-grade ratings from another.

“We believe that the Fed’s dovish pivot in 2019 has pushed a recession off the near-term horizon...”

majority of which have BBB ratings (the lowest tier of investment-grade credit ratings) that give them only marginally higher credit quality.

Fed’s Dovish Stance Has Pushed Recession Off The Near-Term Horizon

While we do not anticipate a recession in the near term, we think that the most meaningful risk to the bank loan market is the U.S. economy sliding into recession.

This would hurt credit sectors in general, including bank loans. In addition, in a recession scenario, defaults would rise and the Fed would need to lower interest rates, forcing down the short-term rates used to calculate coupon payments on loans. However, we believe that the Fed’s dovish pivot in 2019 has pushed a recession off the near-term horizon, an environment that could be supportive for risk assets.

WHAT WE’RE WATCHING NEXT

We continue to closely monitor communications from Fed policymakers, particularly as the central bank formally considers changes to the way that it targets inflation. The Fed could decide to explicitly communicate that it would allow inflation to exceed its 2% goal for a period of time to offset the persistent undershoots of that target in recent years. This change would have wide-ranging implications for Fed monetary policy and investor expectations of inflation.

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