The Case for Senior Loans

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Q4 2024 market update

Looking back at 2024, there has been a significant focus on the uncertainty of the US macroeconomic backdrop and its potential implications for the senior secured bank loan market. Paramount among these concerns are three key questions:

1) How are underlying issuers able to handle increased debt service costs with higher interest rates?

2) Where are we in the interest rate cycle and how will this affect issuers?

3) What effect will a potential recession have on issuers?

This piece provides our view on the current market environment and attempts to answer these critical questions.

Why loans now?

In our view, there are three compelling reasons to consider investing in senior secured loans today:

1) Potential high level of current income

Current income is comprised of two key components—base interest rates (which are expected to stay higher for longer) and credit spreads (which continue to remain wide). Coupon income for bank loans today is 8.26%, which is near its highest since 2009[1]. Market expectations are for rates to remain higher for longer, well above pre-2022 levels. Loans have proven to provide consistent, stable income through varying market cycles, including recessionary periods and periods of falling rates.

2) Rates are expected to stay higher for longer

Loans carry minimal duration risk, with an average duration of approximately 45 days. As a floating-rate asset class, the high base rates have resulted in elevated coupons, thereby enhancing total returns. While coupon rates are projected to decline as the Federal Reserve lowers interest rates, overall interest rates are expected to stabilize at levels significantly higher than those seen over the past decade. In the context of the Fed's planned "recalibration" of interest rate policy, the coupon rate over the next 6-12 months is anticipated to remain above historical averages. As of December 31, 2024, only a single 25 basis point rate cut is expected for the entirety of 2025, which is likely to further boost loan returns for the full year.

3) Compelling relative value

Loans have consistently provided some of the best yields in the fixed income market, while also offering downside risk mitigation due to their senior position in the capital structure and being secured by the company's assets. Currently, loan spreads are near historical levels, in contrast to high-yield bond spreads, which are close to all time tights not seen since before the GFC in 2008. This makes loans have an attractive entry point. Additionally, loans offer these high yields without any duration risk. In a recessionary environment, loans provide further downside risk mitigation by being senior, meaning they have the highest priority for repayment in the event of default. Therefore, the senior secured nature of these assets may offer added protection during economic downturns.

Yields

Current loan yields and spreads look very attractive both on a historical and a relative basis. A loan's yield is based on both coupon payments, which is the interest return, as well as on principal return. The average coupon for loans is 8.26%, outpacing the average high yield coupon of 6.42%[1]. After averaging around ~170 bps less than high yield bonds over the past fifteen years, this is the first time in history the average loan coupon has surpassed that of high yield bonds. It was only around three years ago when loans were yielding ~4.80%; loans recently have been yielding ~400 basis points more than that[1].

Senior Loans: A Core Holding In Any Environment

A unique combination of appealing characteristics

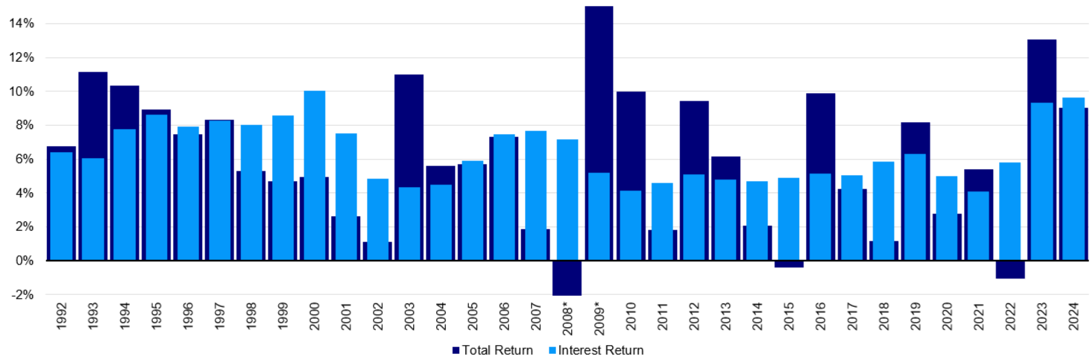
			Investors Looking for:
1	**High Income**	• Potential for competitive monthly income and strong risk adjusted returns • Strong relative value[1]: ◦ US Loan Yield to 3yr: 8.79% ◦ European Loan Yield to 3yr: 7.42%	**Potential High Yield**
2	**Senior Secured Status**	• Highest priority to be repaid; lenders have first right to collateral in the event of a default • Higher recovery in case of default	**Potential Risk Mitigation**
3	**Floating Rate Feature**	• Effective duration of 0 years • "Pure" credit exposure, no duration risk	**Hedge Against Interest Rate Risk**
4	**Diversification Potential**	• Low correlation with investment grade fixed income[2] • 0.40 when comparing Loans to IG Bonds	**Alternatives Asset Class Exposure**
5	**Compelling relative value**	• Loans have offered one of the best yields in fixed income despite their senior secured status[1]	**Potential High Comparative Returns**

Source: [1]S&P UBS LLI and S&P UBS WELLI as of December 31, 2024. [2]Morningstar correlation data from December 2003 to December 2024. Updated annually. **Past performance does not predict future returns.**

US senior secured loans have offered one of the best yields in fixed income

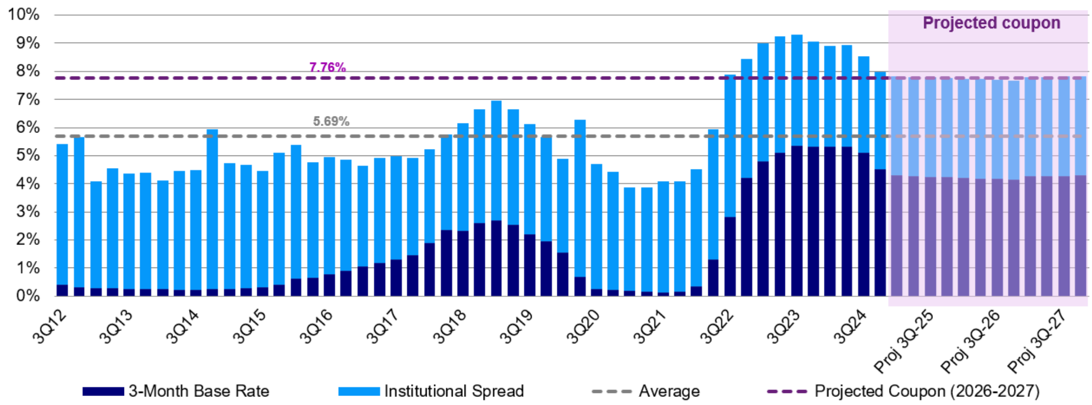
Past performance does not predict future returns.

Three years of negative returns over the past 33[1]



Source: [1]S&P UBS Leveraged Loan Index data through December 31, 2024, updated annually. *Denotes returns in excess of the axis. 2008 returns were –28.75%, 2009 returns were 44.87%.

Even with future cuts, US loan income projected to remain at attractive levels



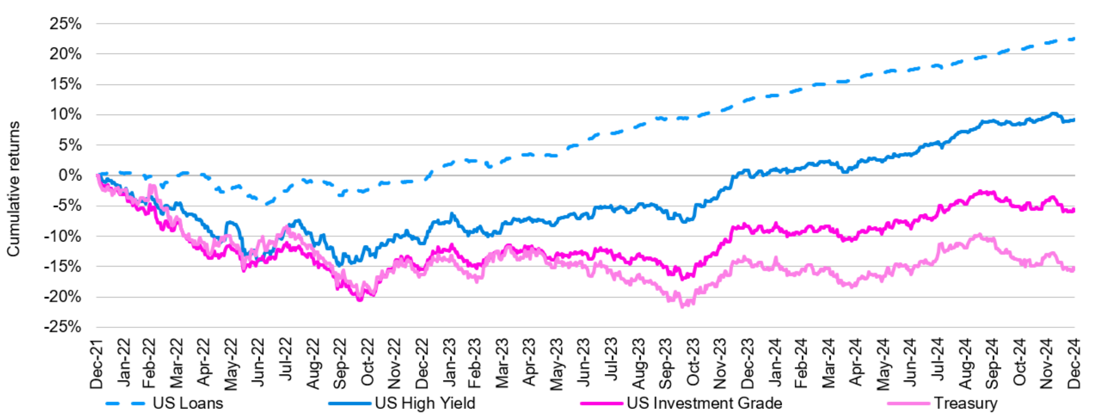
Source: PitchBook Data, Inc. as of December 31, 2024, updated quarterly. Base rate reflects the average during the quarter. Uses three-month LIBOR (prior to 2023) or SOFR (2023 or later) plus the weighted average institutional spread. (Purple) Forecasted coupon for 4/15/25, 7/15/25, 10/15/25, 1/15/26, and the same dates in 2026 and 2027 using average trailing 4 quarters spread levels and forward 3m SOFR rates as of January 6, 2025. 2025-2027 represented by the forecasts as of 1/15/25. With dashed purple line representing average projected coupon in 2026-2027. There can be no assurance that any projected returns can be realized.

Throughout 2023 and 2024, rising rates put the floating-rate loan asset class on pace for two of the strongest years since the Global Financial Crisis[2]. The US leveraged loan market returned 9.05% in

2024[1]. Loans still offer amongst the highest yields and are expected to remain high, as the market anticipates a higher for longer interest rate environment[3].

Asset class resiliency
Steady US loan returns stood in stark contrast to other risk assets

Past performance is not a guarantee of future results.

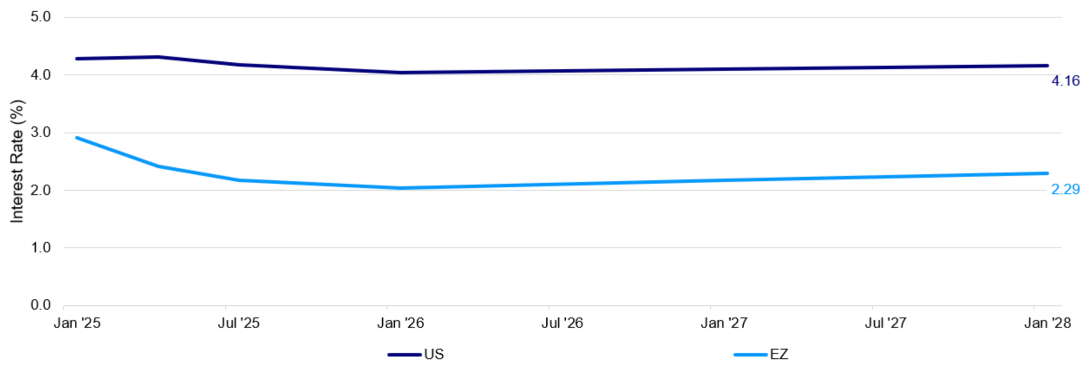


Sources: PitchBook Data, Inc.; Bank of America Merrill Lynch; Bloomberg as of December 31, 2024. The Morningstar LSTA US Leveraged Loan Index represents US Loans, the ICE BofA US High Yield Index represents US High Yield, the ICE BofA US Corporate Index represents US Investment Grade, the ICE BofA Current 10-Year US Treasury Index-TR represents Treasury. An investment cannot be made directly in an index.

The current interest rate environment has continued to put pressure on borrowers due to increased interest expense costs. However, as the Federal Reserve signals a potential pause in its policy of interest rate hikes, we anticipate several direct and indirect positive effects on the leveraged loan market:

- **Interest Rate Reductions**: Interest rates fell by 100 basis points throughout 2024[5]. This has already alleviated some of the higher interest expense burdens on borrowers leading to a decrease in default risks, making leveraged loans a more secure investment.
- **Peaking Default Rates**: With default rates expected to have peaked and now showing signs of improvement, the leveraged loan market is poised for a more stable and favorable environment. This trend indicates a healthier market with reduced risk for investors.
- **Stabilized Borrowing Costs**: A pause in rate hikes can stabilize borrowing costs for companies. This stability can stimulate demand for new issuance, as companies find it more feasible to take on new loans under predictable interest rate conditions.

Forward interest rates – US and European implied market expectations

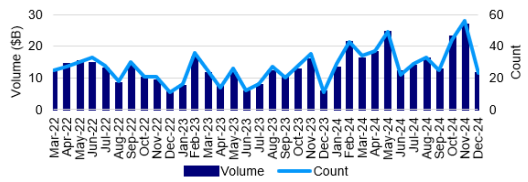


Source: Bloomberg as of January 15, 2025, based on market-implied pricing of policy rates for selected economies. **Past performance is not a guarantee of future results**. An investment cannot be made directly in an index. Forward-Looking statements are not a guarantee of future results. They involve risks, uncertainties and assumptions. There can be no assurance that actual results will not differ materially from expectations.

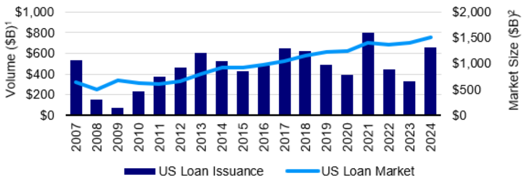
Market technicals

Last year, we saw retail demand for loans soften amidst broader risk-off investor sentiment. However, that trend has abated as some investors are becoming more comfortable with the “soft-landing” scenario for the US economy and higher for longer interest rate narrative that will benefit loan investors. There has also been a flow of new CLO creations through 2024. This indicates that there is still institutional investor appetite for loans. This steady CLO formation helped support the loan market technical despite retail outflows and macro concerns. As of the end of 2024, 424 CLOs have priced $201.34B of issuance in the US, and CLOs represent over 70% of the investor base in the loan market[2]. CLOs continue to be the major source of institutional demand, and new issuance of CLOs recorded its 2nd highest year on record just behind 2021. Moreover, as demand for loans wanes, new loan issue supply will typically respond in kind to help re-establish equilibrium in the market. For example, year-end 2023 net issuance was $88.04bn, which is -50% year-over-year[2]. This supply/demand imbalance forces CLOs to provide a bid in the secondary market.

US CLO issuance[1]



US loan new issuance and market growth

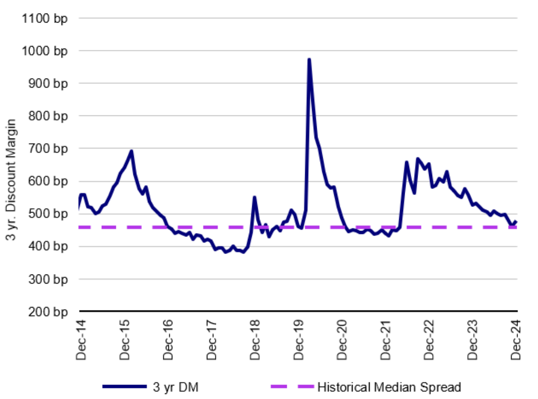


Source: [1]PitchBook Data, Inc. as of December 31, 2024. [2]S&P UBS Leveraged Loan Index size (par value) as of December 31, 2024.

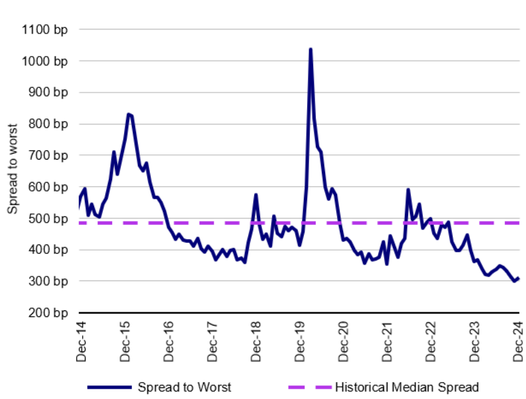
Relative valuations also favor bank loans compared to most fixed income asset classes. Loan spreads are currently near their long-term average, while high yield bond spreads are currently tight to their long-term average. Loans have also been outyielding high yield bonds with loan coupons being historically high, and many sell side firms have stated they prefer loans to high yield for 2025.

US loans have offered more attractive valuations than high-yield bonds

Loan spreads are near historical levels



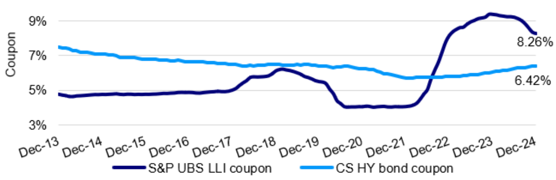
While HY bond spreads are below historical levels



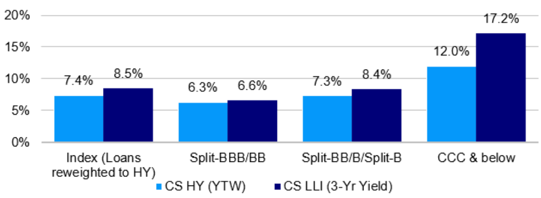
Source: S&P UBS Leveraged Loan Index & Credit Suisse High Yield Index as of December 31, 2024. **Past performance is not a guarantee of future results.** Long term medians based on data starting from 01/31/1992.

Loans have offered higher yields than high-yield bonds and have been preferred by many sell-side firms

Loan coupons are <u>~194 bps higher</u> than high-yield bonds



Loans still out-yield HY bonds on a ratings adjusted basis



Many sell side firms prefer loans to high yield bonds

*"…shifting to an **overweight allocation on loans vs. HY**…binding valuation constrains for HY… leaves **carry as the main driver** to relative performance of loans vs. HY"*

- Goldman Sachs

*"…**loans are outyielding bonds on a forward curve-adjusted basis**…HY yields have tightened so much that entry points for **loans are looking more attractive**…"*

- Barclays

*"We **continue to prefer loans over HY**… loans screen more attractive to HY in valuations…"*

- Morgan Stanley

Sources: S&P UBS Leveraged Loan Index & Credit Suisse High Yield Index as of December 31, 2024. Morgan Stanley, Barclays, and Goldman Sachs quotes are as of October 17, October 4, and October 10, 2024, respectively.

Market fundamentals

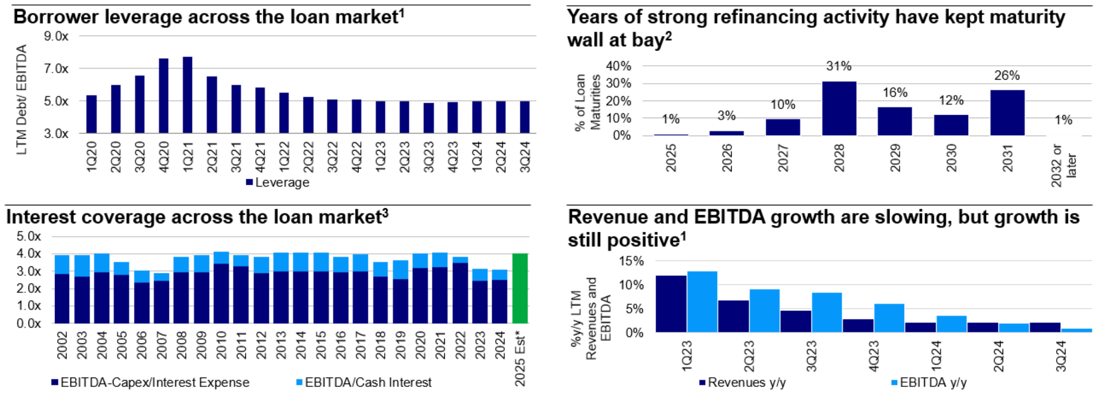
While technicals are finding an equilibrium, market fundamentals for underlying issuers remain relatively strong.

The US trailing twelve-month default rate at the end of December 2024 was 4.70%. While the risk of defaults remains the largest risk to loan investors, it is important to note that defaults are expected to have peaked and are projected to fall this year. Additionally, the senior secured nature of loans has historically provided a high recovery rate in the event of default. Furthermore, firms that go through liability management exercises tend to have higher recovery rates compared to those that do not.

We still see the risk/return opportunity stronger in the loan market than in high yield which has seen spreads compress this year. The average leverage of companies in the leveraged loan market serves as an indicator of the financial health of bank loan issuers. The majority of borrowers continue to have healthy balance sheets, and average leverage in the market has returned to pre-pandemic levels. Borrowers have also pushed out their debt maturities. Currently only ~1% of outstanding loans mature in 2025, leaving little refinancing risk in the market.

Another important investor concern is how current rates will impact issuers' ability to service their debt. The average borrower has entered this cycle with a very strong ability to service their debt. Interest coverage ratios have still been robust, leaving companies with sufficient ability to absorb higher rates, and we believe interest coverage ratios will increase throughout 2025.

US fundamentals remain resilient, but higher interest rates have dampened interest coverage ratios



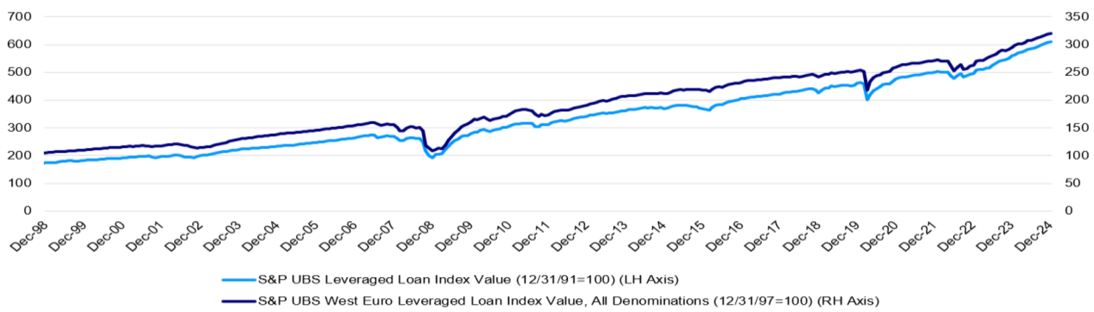
Sources: [1]JPMorgan as of September 30, 2024 (data is last 12 months); data is quarter lagged. [2] PitchBook Data, Inc., as of December 31, 2024, updated quarterly. [3] PitchBook Data, Inc. Interest coverage ratios of leveraged loans. Data through December 31, 2024. *Based on Barclays estimates, a 1% interest rate cut results in a 0.8x increase in interest coverage ratios.

Conclusion

As shown above, we believe senior secured loans are poised to perform well in our base case scenario, where resilient economic growth and strong company fundamentals bolster loan returns. This should prevent a sharp increase in defaults, sustain CLO demand, and enable investors to benefit from historically above-average coupon income. In this scenario, we expect ~8% loan returns in 2025, powered by strong carry and price stability, partly offset by mild erosion in base rates and spreads. Loans may deliver higher returns compared to bonds unless: (i) there is a significant risk-off move due to growth concerns, leading to significant spread decompression and lower rates; or (ii) loan default rates rise materially relative to those in the bond market. Neither of these scenarios are Invesco's base case.

Additionally, while the Trump presidency may lead to increased uncertainty and macroeconomic volatility, loans have historically proven to be resilient in various economic environments, providing a robust option for investors navigating potential market fluctuations. The loan asset class has consistently proven to be a reliable source of returns for investors, regardless of market fluctuations. As evidenced below, any decreases in loan values have typically been temporary. Regardless of whether interest rates are increasing or decreasing, or who is president, loans have historically provided investors with a worthwhile return on investment.

Downticks in loan valuation have historically been short-lived



Source: S&P UBS as of December 31, 2024.

[1]S&P UBS and Credit Suisse as of December 31, 2024.

[2]Pitchbook LCD, Intex, Bloomberg, Credit Suisse.

[3]Morningstar as of December 31, 2024.

[4]Invesco. There is no guarantee that the forecast will be realized. Forecast is based on coupon plus wider nominal spreads minus base rate declines minus price erosion.

[5]Federal Funds Effective Rate as of December 31, 2024.

Investment risks

Many senior loans are illiquid, meaning that the investors may not be able to sell them quickly at a fair price and/or that the redemptions may be delayed due to illiquidity of the senior loans. The market for illiquid securities is more volatile than the market for liquid securities. The market for senior loans could be disrupted in the event of an economic downturn or a substantial increase or decrease in interest rates. Senior loans, like most other debt obligations, are subject to the risk of default. The market for senior loans remains less developed in Europe than in the U.S. Accordingly, and despite the development of this market in Europe, the European Senior Loans secondary market is usually not considered as liquid as in the U.S. The value of investments, and any income from them, will fluctuate. This may partly be the result of changes in exchange rates. Investors may not get back the full amount invested.

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