US Loan Market Snapshot

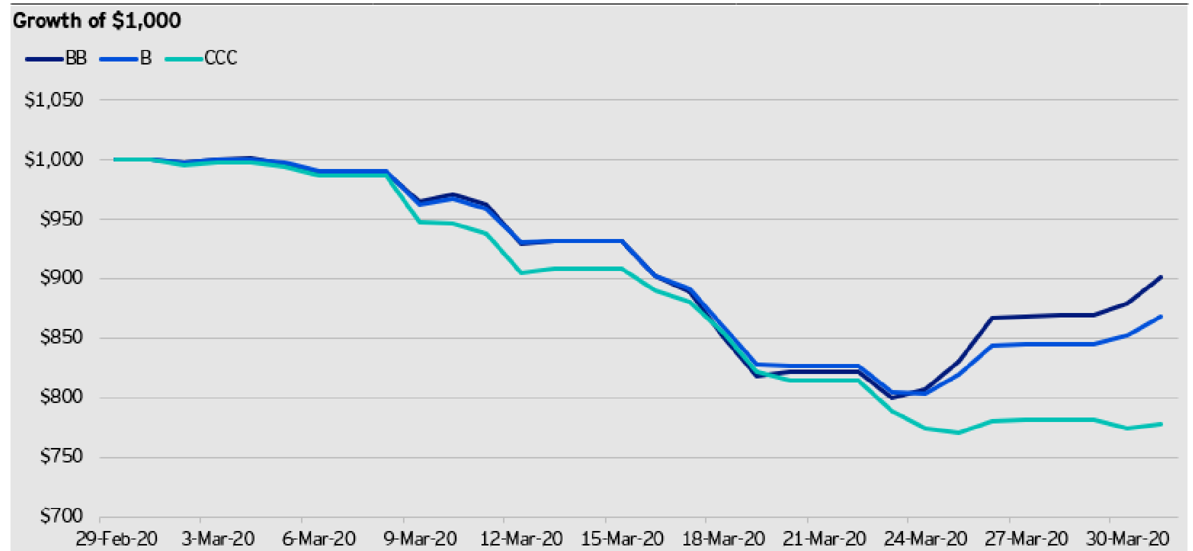
Monthly US loan market update: April 2020 (covering Mar)

A historically challenging month for the loan market ended more positively than it began, as investors took solace in the collective actions of the US Federal Reserve (the Fed) and Congress to backstop the suddenly vulnerable American economy. Since late February, financial markets have sought to price in the escalating health and economic costs of a global pandemic. The introduction of increasingly restrictive social distancing measures across the world aimed at containing the spread of COVID-19 put a sudden stop to vast swaths of social and commercial activity. Simultaneously, Saudi Arabia and Russia initiated an oil price war as an OPEC agreement to limit production broke down despite collapsing demand. With investors struggling to calculate the economic damage likely to result from this unprecedented situation, volatility soared in March to levels not seen since the throes of the global financial crisis (GFC) in 2008. In response, the Fed announced monetary stimulus programs going well beyond the extraordinary measures taken during 2008, and Congress passed $2 trillion of fiscal support for individual Americans, small and large businesses, states, and municipalities. The size and speed of the policy response, mirrored by other nations as well, dwarfs that of 2008 and spurred a remarkable relief rally in risk markets towards the end of the month.

Facing a suddenly challenged credit outlook as well as redemption pressure from retail and institutional accounts, the loan market plunged in unison with equities and other corporate debt markets during March. The sectors most directly impacted by COVID-19 (Oil & Gas, Airlines, Retail, Gaming & Leisure) and, specifically, the issuers with the thinnest financial flexibility to weather a sharp downturn, fared the worst. However, the volatility was as extreme on the way up as it was on the way down. Behind the staggering headline price declines in March were also some of the largest-ever one-day gains in the loan market, and in risk assets more broadly, as fiscal and monetary support measures curbed the perceived tail risks. Overall, the loan market returned -12.37% during the month, bringing the year-to-date return to -13.05%.[1]

Amid the turbulence, loans underperformed high yield bonds (-11.76%) and investment grade (-7.47%).[2] The percentage of loans trading below $80 soared from 5% to 57% before ending the month at 24%.[3] Prices declined across the board, but with significant dispersion by sector; the Oil & Gas sector was the worst performing at -31.95% and the Cable and Satellite TV sector was the best performing at -4.71%.[1] Through the first half of March, price declines were roughly equivalent across the quality spectrum as liquid, high quality credits were heavily sold to raise cash for redemptions. However, high- and mid-quality credits recovered towards month-end once the technical pressure driven by liquidity needs abated and buyers became more active. Low quality remained under pressure even as the market rallied due to a focus on credit concerns. Ultimately, "BBs" (-9.86%%) outperformed "Bs" (-13.18%) and "CCCs" (-22.20%).[4] The average price in the loan market was $83.18 at the end of April.[4] At the current average price, senior secured loans are providing a 9.30% yield inclusive of the forward LIBOR curve.[5]

After a broad sell-off, quality dispersion increased as the month progressed



Sources: LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index as of March 31, 2020. **Past performance is not a guarantee of future results.** An investment cannot be made directly in an index.

Fundamentals

- The most jarring economic data points during March were the 3.3 million and 6.6 million initial jobless claims for the weeks ended March 21 and March 28, respectively. This sobering view into the economic state of affairs illustrates the challenge at hand and explains the enormous government response thus far.
- The trailing 12-month default rate fell to 1.84% during the month with only Foresight Energy joining the list of recently defaulting issuers.[6]

Technicals

- Loan technicals varied during the month but were generally negative. With no new supply and no new CLO issuance, technicals were dictated by the interplay between fund managers' cash raising efforts (both for redemptions and defensive positioning) and the opportunistic buying activity that gained strength as the month progressed.[6]
- The new issue CLO market ground to a halt as loan price volatility and widening liability spreads made new structures all but impossible to bring to market. AAA spreads temporarily exceeded 400 bps before settling in the range of 250 bps by month end. Existing CLO structures seeking to build par remained active buyers in the secondary market as prices declined.[6]
- Retail mutual funds and ETFs reported an outflow of $9 billion during the month.[6] Despite the uptick in outflows, the loan market continued to function; retail AUM now comprises just 6% of the overall loan market.[6]
- New issuance activity simply stopped with just $4.3 billion in new deals.[6] The handful of transactions in market at the beginning of the month were mostly shelved as market conditions worsened.

Relative value/market opportunity

March's risk-off frenzy drove loan spreads to post-GFC highs; however, spreads have not eclipsed the all-time wides observed during the GFC. There are several key differences in how the market is structured today versus 2008 that we believe bode well for greater stability. Firstly, the loan market has significantly less leverage now than during the GFC.[7] Secondly, there is substantially less bridge risk today stemming from deals that banks have underwritten, but not yet syndicated, and which they could dump into the market to de-risk their balance sheets.[7] Thirdly, the potential for forced liquidation of CLO warehouses is less threatening today, with less than $20 billion of warehouses currently versus $40-50 billion in 2007, a time when the loan market was less than half its current size.[8] The economic fallout from COVID-19 will certainly increase risk to a large percentage of the loan issuer base; however, it is important to recognize the relative absence of these market structure risks which exacerbated loan price volatility in the 2008 crisis.

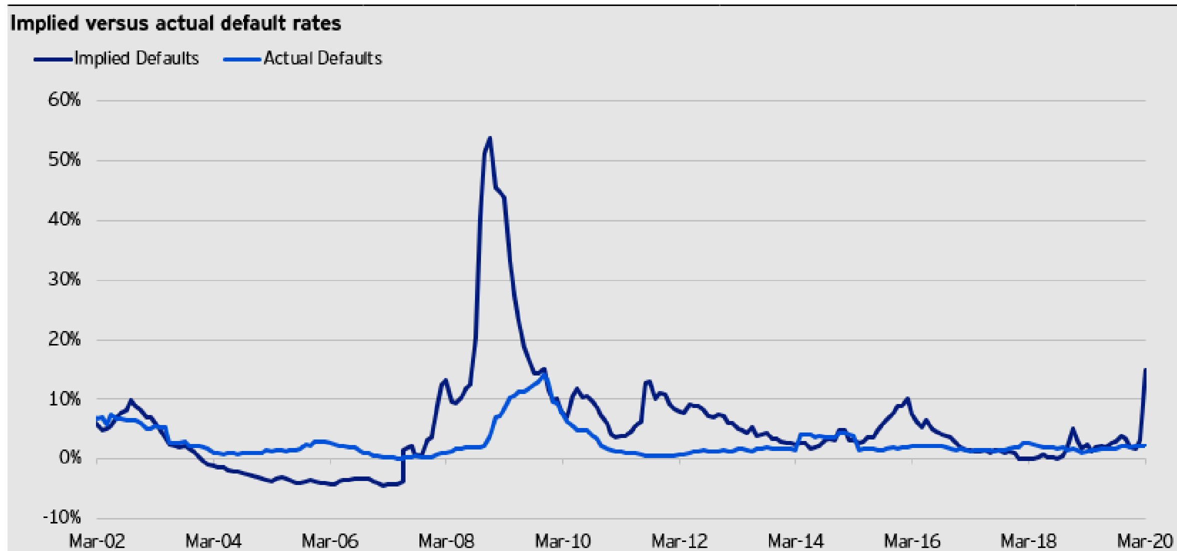
Differences in market structure – today versus Global Financial Crisis

	Current		2007	
	$ billions	% of market	$ billions	% of market
Outstanding total return swap lines	<$90	<10%	$250	45%
Underwritten deals yet to be syndicated	<$45	<4%	$330	60%
CLO warehouses	<$20	<2%	$40-$50	8%

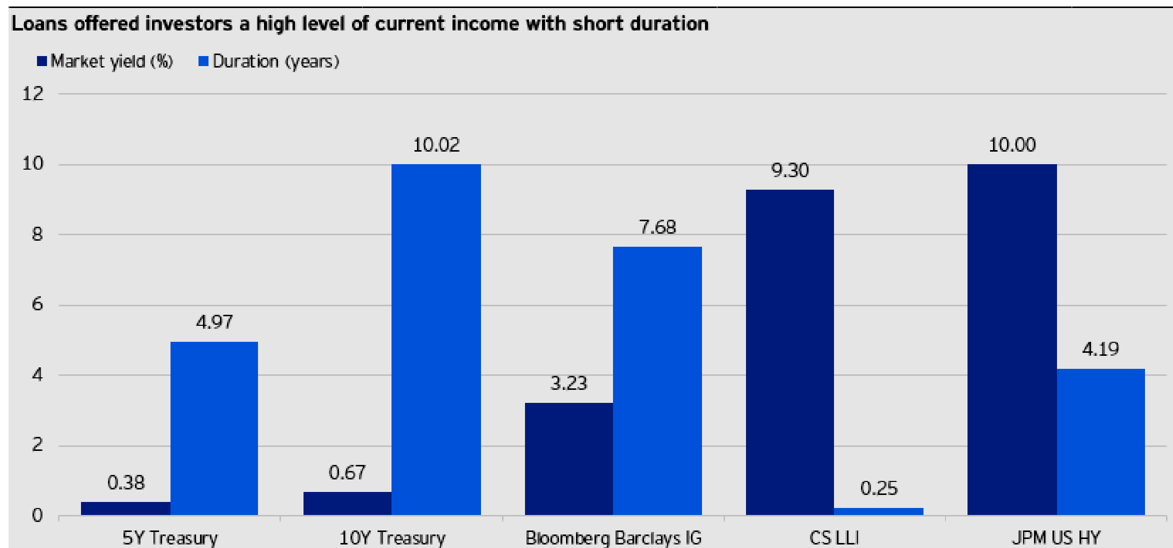
Source: JP Morgan as of March 24, 2020

Additionally, while current loan spreads paint a dire picture of investors' credit outlook, the loan market frequently overshoots in its attempts to price default risk following negative economic shocks. At the intra-month wide, loan spreads were implying a 23% default rate before the month-end rally lowered the implied default rate to 15%,[7] still well above the 10.8% peak default rate observed during the GFC.[4] The vast majority of loan issuers are not at immediate- or medium-term risk of default.[8] After the initial indiscriminate selloff in loans (and risk assets broadly), the market has subsequently become more discerning of credit risk. The reassertion of rational credit analysis will likely continue as investors gain further clarity on earnings impact and immediate cash flow risk facing issuers. However, the high levels of uncertainty overall could create dislocations between price and fundamental value that persist longer than is typical, leading to potential compelling opportunities for long-term investors with the resources to cover the entire market in depth.

Historically, loan implied default rates have overshot actual defaults



Source: JP Morgan as of March 31, 2020. Implied default rate calculated by taking implied default loss and dividing by loss given default of 40%.



Source: Credit Suisse and Invesco, Barclays, JP Morgan and Bloomberg L.P. as of March 31, 2020. **Past performance is not a guarantee of future results.** An investment cannot be made directly in an index.

Relative yield					
	$ Price	**Yield to worst (%)**	**Spread to worst**	**At forward Libor**	**Duration (years)**
5 Year Treasuries	100-19	0.38	–	–	4.97
10 Year Treasuries	107-29	0.67	–	–	10.02
Bloomberg Barclays US Agg. Index	108.20	1.59	T + 1.09	–	5.69
Bloomberg Barclays IG Index	105.31	3.23	T + 2.58	–	7.68
JPM US HY Bond Index	89.78	10.00	T + 9.49	–	4.19
Credit Suisse Lev. Loan Index	**83.18**	**10.30**	**T + 9.00**	**9.30%**	**0.25**

Source: Credit Suisse and Invesco, Barclays, JP Morgan and Bloomberg L.P. as of March 31, 2020. Loan "spread to worst" and "at forward Libor" incorporate LIBOR forward curve.

1 S&P/LSTA Leveraged Loan Index as of March 31, 2020.
2 S&P/LSTA Leveraged Loan Index and Bloomberg as of March 31, 2020. High yield represented by BAML US High Yield Index; investment grade represented by the BAML Investment Grade Index.
3 JP Morgan as of March 31, 2020.
4 Credit Suisse as of March 31, 2020.
5 Credit Suisse and Invesco as of March 31, 2020.
6 S&P LCD as of March 31, 2020.
7 JP Morgan as of March 24, 2020.
8 Fitch U.S. Leveraged Loan Default Insight as of March 27, 2020.

About risk

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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.

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