Senior Loan & High Yield Review – 1st Quarter 2017

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Macro-Economic Overview

Equity markets led the way in the first quarter of 2017, with the S&P 500 Index up 6.07%. Other risk-asset markets such as emerging markets debt and corporate high-yield debt also performed well, up 3.87% and 2.71%, respectively. The positive backdrop for these asset classes continues to be that the U.S. economy is on solid ground, in our opinion, with unemployment claims near the 2000 decade low, increasing CPI, and Real GDP expansion. The proposed economic agenda under the Trump administration which includes lowering individual and corporate income tax rates, increased infrastructure spending, and reduced regulatory burden on businesses has the potential to accelerate the U.S. growth rate. While implementing the agenda in its entirety and the timing remain uncertain, it has nonetheless buoyed risk markets up to this point (Exhibit 1 & 2: Returns).

Exhibit 1 **– U.S. High-Yield Bond Performance: 1997 – 1Q 2017**

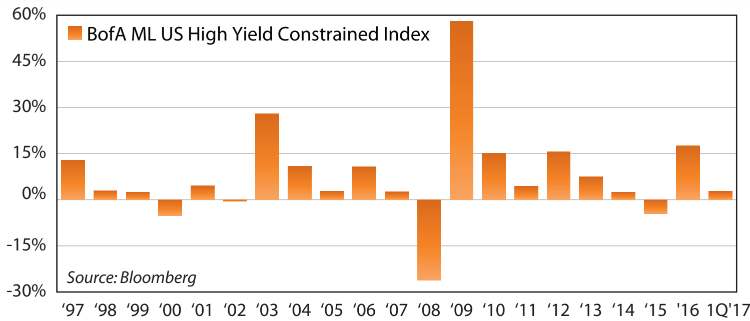
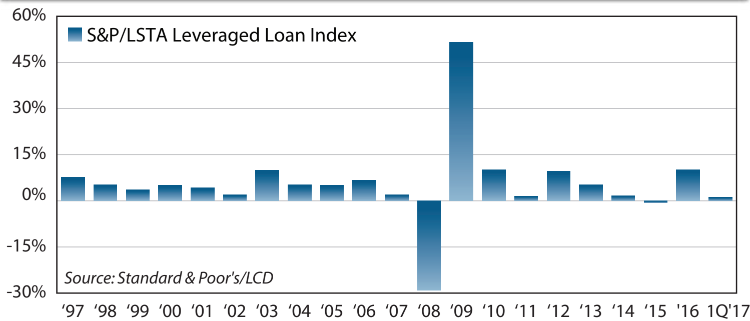


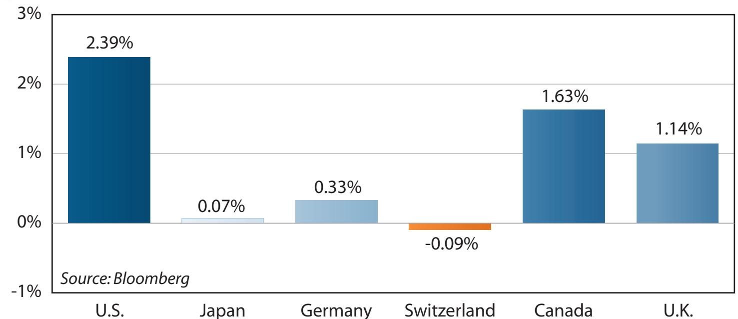
Exhibit 2 **– U.S. Senior Loan Performance: 1997 – 1Q 2017**



Long-term interest rates remained largely unchanged in the quarter. The 10-year U.S. Treasury was at 2.39% at the end of the quarter, down 5 basis points (bps) from the quarter ending 12/31/2016. Shorter term interest rates followed the Federal Reserve's 25bp rate hike in March, pushing 3-month LIBOR to 1.15%, up 15 bps for the quarter.[1] Interest rates have already experienced a significant move from the post BREXIT[2] lows (from 1.36% on 7/8/2016 to a peak of 2.63% on 3/13/2017 for the 10-year U.S. Treasury Bond) and, as we pointed out at year-end, while we may see some consolidation before the next leg up in interest rates, we continue to believe that the bottom is in for U.S. interest rates.

We believe there are a number of potential interest rate catalysts on the horizon. First, we believe the market is not fully pricing in the potential for reflation in the U.S. Wage growth has increased and commodity prices have stabilized/improved from the trough in February of 2016. Second, the narrative from the Federal Reserve (Fed) has been that short-term rates will continue to increase, and, discussions have intensified concerning the size of the Fed balance sheet and how they might begin to shrink its size. A decision to begin slowing the reinvestment on the Fed balance sheet, taken in isolation, could send interest rates higher, notwithstanding the potential for a more hawkish stance on rates should inflation begin to increase at an even greater rate. Finally, we believe that we are likely to see an overt tapering of the Quantitative Easing (QE) program underway via the European Central Bank (ECB). In December, Mario Draghi, President of the ECB announced a covert tapering whereby he trimmed monthly bond purchases from $80bn to $60bn, but extended the length of time in which QE would be in force. The market interpreted this as additional stimulus, however, we believe this sets the table for an additional cut to their QE program later this year. We also believe that when the ECB does in fact pull back its QE, that it will lead to higher rates in Europe. Such an increase would likely carry through to the U.S., given the high correlation between German Bunds and U.S. Treasury yields (Exhibit 3: 10-yr yields as of 3/31/2017).

Exhibit 3 **–10-Year Government Bond Yields: 3/31/17**



High-Yield and Senior Loan Market Overview

High Yield bond spreads over U.S. Treasuries tightened modestly in the quarter by 29 bps from year-end. While spreads are in fact tight to historical norms (the long-term average spread over U.S. Treasuries is T+591, December 1997 – March 2017), we believe there is room for further tightening given that spreads remain wide of the tight spreads experienced in May 2007 of T+245 (Exhibit 4).

Defaults in the commodity sensitive sectors of the high-yield bond market drove the high-yield default rate up to its 2016 peak at 3.82% in May 2016, but the default rate has since fallen to 1.90% (0.64% excluding the Energy and Metals/Mining sectors). This is well inside the long-term average default rate of 3.31% (March 1999 – March 2017; Exhibit 5). We believe the low default rate is reflective of the relatively sound financial condition of most companies and the strong backdrop of a healthy macroeconomic environment.

Exhibit 4 **– U.S. High-Yield Bond Spread (OAS)*: December 1997 - March 2017**

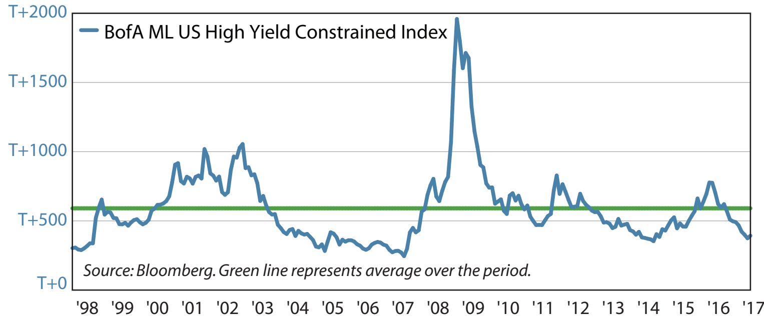
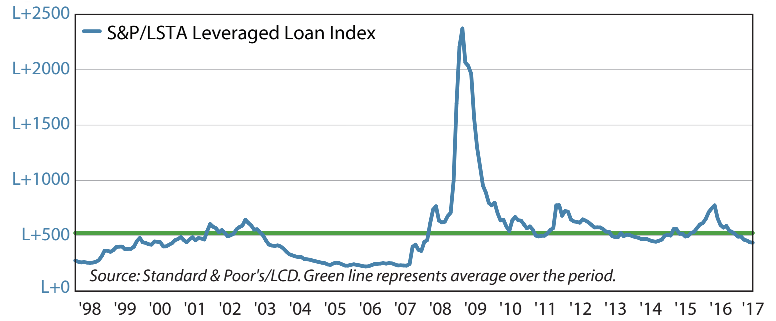


Exhibit 6 **– U.S. Senior Loan Spread over LIBOR[3]: December 1997 - March 2017**



According to JP Morgan, the senior loan asset class benefitted from +$12.7 billion of inflows into retail mutual funds and exchange-traded funds in the first quarter. That comes on the heels of 2016 where total flows into the asset class were +$9.2 billion. We believe the appeal of senior loans has increased as short-term interest rates, most notably LIBOR, has been increasing. Moreover, we believe that with the potential for additional interest rate hikes on the horizon, LIBOR should continue to migrate higher throughout 2017. The primary challenge in the senior loan market will likely be the pace of refinancing, whereby issuers come to the market to reduce the spread they are paying on their senior loans. This could potentially reduce the yield to investors in the near term while anticipating higher LIBOR rates to ultimately push the yield higher in the senior loan market.

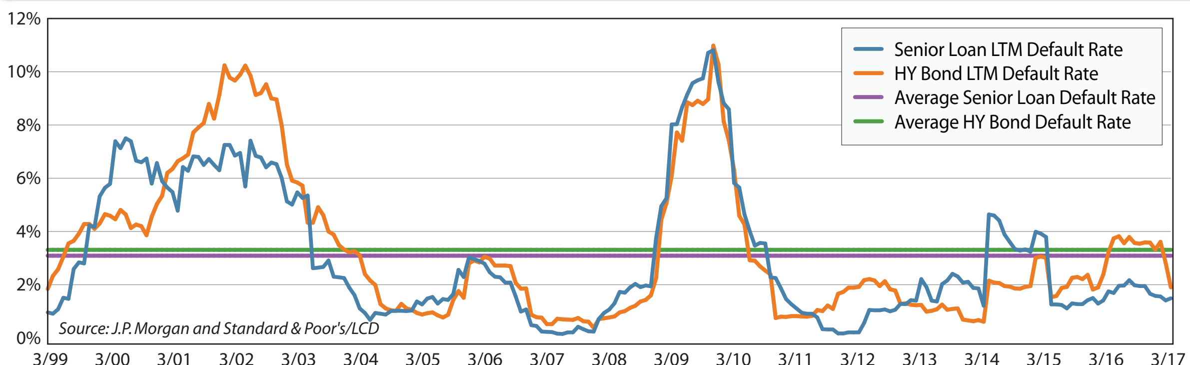
The default rate for senior loans remains low at 1.49% and we believe it is likely to remain low given the overall health of the U.S. economy. This is below the long-term average default rate of 3.09% (March 1999 – March 2017; Exhibit 5). Finally, the current spread of L+438 compares favorably to the pre-credit crisis average spread of L+372 (December 1997 – June 2007) and remain relatively in-line with the long-term average spread of L+525 (December 1997 – March 2017; Exhibit 6).

Conclusion

The U.S. economy has quietly and methodically continued to expand. We remain confident that this favorable environment will persist for the near to intermediate term which typically bodes well for risk assets. We continue to believe that we are in a good part of the economic cycle to own high-yield bonds and senior loans and that the cycle still has a long runway. Specifically, we believe senior loans, given their senior secured position in the capital structure, floating interest rate, attractive income and low default rate are well positioned as we move through 2017. We also believe that high-yield bonds should continue to perform well given their mid-cycle valuations and anticipated declining default rate.

As we evaluate new investment opportunities, decisions will continue to be rooted in our rigorous bottom-up credit analysis and focus on the opportunities that we believe offer the best risk and reward balance.

Exhibit 5 **– Senior Loan and High-Yield Bond Historical Default Rates[4]: March 1999 - March 2017**



All charts shown herein are for illustrative purposes only and not indicative of any investment. The performance illustrations exclude the effects of taxes and brokerage commissions or other expenses incurred when investing. Past performance is not indicative of future results and there can be no assurance past trends will continue in the future.

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Index Returns	Q1 2017	Q1 2016	12 Mo Ended 3/31/17	12 Mo Ended 3/31/16	Q1 2017 By Rating		
					BB	B	CCC
Senior Loans	1.15%	1.55%	9.72%	-1.25%	0.66%	1.14%	5.02%
High-Yield Bonds	2.71%	3.25%	16.87%	-3.96%	2.02%	2.33%	4.28%
Investment Grade Corporate Bonds	1.42%	3.92%	3.41%	0.98%			
Preferred Securities	5.21%	1.60%	5.95%	5.72%			
U.S. 10-Year Treasury	0.78%	4.78%	-3.97%	3.05%			
Emerging Market Bonds	3.87%	5.09%	7.87%	3.72%			
Municipal Bonds	1.58%	1.67%	0.15%	3.98%			
S&P 500	6.07%	1.35%	17.17%	1.78%			
Default Rate (Trailing Twelve Months)	Q1 2017	Q1 2016	FYE 12/31/16	FYE 12/31/15			
Senior Loans (LLI)	1.49%	1.75%	1.58%	1.50%			
Long-Term Average (Since March 1999)	3.09%	3.16%	3.11%	3.19%			
High-Yield Bonds[4]	1.90%	3.22%	3.32%	1.82%			
Long-Term Average[4] (Since March 1999)	3.31%	3.31%	3.32%	3.32%			
Technicals	Q1 2017	Q1 2016	FYE 12/31/16	FYE 12/31/15			
Average Senior Loan Price (LLI)	$98.22	$91.51	$98.08	$91.26			
Long-Term Average Senior Loan Price (LLI)	$93.83	$93.72	$93.77	$93.76			
Loan Spreads (Discounted Spread to a 3-Year Life)	L+438	L+658	L+465	L+714			
Long-Term Average Loan Spread (3-Year Life)	L+525	L+525	L+526	L+523			
Average High-Yield Bond Price (HUC0)	$100.80	$89.92	$99.59	$88.82			
Long-Term Average High-Yield Bond Price (HUC0)	$94.05	$93.82	$93.96	$93.90			
High-Yield Bond Spread (OAS)*	T+393	T+705	T+422	T+695			
Long-Term Average High-Yield Bond Spread (OAS)*	T+591	T+596	T+593	T+594			
YTW for High-Yield Bonds (HUC0)	5.88%	8.39%	6.17%	8.76%			
YTM for High-Yield Bonds (HUC0)	6.21%	8.58%	6.48%	8.90%			
U.S. 3 Month LIBOR	1.15%	0.63%	1.00%	0.61%			
U.S. 10-Year Treasury Yield	2.39%	1.77%	2.44%	2.27%			
Flows & Issuance	Q1 2017	Q1 2016	FYE 12/31/16	FYE 12/31/15			
Retail Senior Loan Fund Flows	$12.7 bil	($5.7) bil	$9.2 bil	($21.7) bil			
Institutional (CLO) Senior Loan Flows	$17.3 bil	$8.8 bil	$73.3 bil	$99.5 bil			
Retail High-Yield Bond Flows	($7.4) bil	$8.0 bil	$9.6 bil	($16.6) bil			
Senior Loan Gross New Issue	$331.0 bil	$35.2 bil	$485.4 bil	$325.8 bil			
High-Yield Bond Gross New Issue	$97.2 bil	$51.2 bil	$286.2 bil	$293.2 bil			

[1] LIBOR–London Interbank Offered Rates
[2] The referendum where UK citizens voted to leave the European Union.
[3] The spread over LIBOR is the discounted spread to three-year life. The "spread" for a senior loan is typically priced over 3-month LIBOR. Essentially, investors earn a risk-free rate plus a "spread" for the risk of a given company.
[4] High-yield bonds are represented by J.P. Morgan's high-yield bond universe. Senior loans are represented by the S&P/LSTA (Loan Syndications and Trading Association) U.S. Leveraged Loan Index and based on the last twelve months (LTM).
*Option Adjusted Spread (OAS) is the current spread over a treasury security of similar tenor.
Source of flows & issuance: J.P. Morgan High-Yield Market Monitor & Leveraged Loan Market Monitor. Source of senior loan and Collateralized Loan Obligation (CLO) data: S&P/LCD. Source of high-yield bond data: Bloomberg and J.P. Morgan. For illustrative purposes only and not indicative of any investment. Past performance is no guarantee of future results.

Index Definitions:
Senior Loans–S&P/LSTA Leveraged Loan Index (LLI) is designed to track the current outstanding balance and spread over LIBOR for fully funded term loans.
High-Yield Bonds–BofA Merrill Lynch U.S. High Yield Constrained Index (HUC0) tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market but caps issuer exposure at 2%.
Investment Grade Corporate Bonds–BofA Merrill Lynch U.S. Corporate Index tracks the performance of U.S. dollar denominated investment grade (BBB/Baa-rated or better) corporate debt publicly issued in the U.S. domestic market.
Preferred Securities–BofA Merrill Lynch Fixed Rate Preferred Securities Index tracks the performance of fixed rate U.S. dollar denominated preferred securities issued in the U.S. domestic market.
U.S. 10-Year Treasury– BofA Merrill Lynch Current 10-Year U.S. Treasury Index is a one-security index comprised of the most recently issued 10-year U.S. Treasury note.
Emerging Market Bonds–BofA Merrill Lynch U.S. Emerging Markets External Sovereign Index tracks the performance of U.S. dollar emerging markets sovereign debt publicly issued in the U.S. and eurobond markets.
Municipal Bonds–Barclays Municipal Bond Index tracks the performance of the tax-exempt bond market.
S&P 500–S&P 500 Index is a capitalization-weighted index comprised of 500 stocks used to measure large-cap U.S. stock market performance.

Indexes are unmanaged and an investor cannot invest directly in an index.

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Senior floating rate loans are usually rated below investment grade but may also be unrated. As a result, the risks associated with these loans are similar to the risks of high-yield fixed-income instruments. High-yield securities tend to be less liquid than higher-quality debt and are subject to greater market fluctuations and risk of loss than securities with higher ratings.