Senior Loan & High Yield Review – 4th Quarter 2018

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Macro Overview

Mounting fears regarding the pace of interest rate hikes by the Federal Reserve, increased tensions between the U.S. and China over trade, and concerns over slowing global growth led to volatile conditions in both equity and fixed income markets during the final quarter of 2018. These fears led equities to fall 13.52% in the quarter, as measured by the S&P 500. The decline in equities during the quarter induced selling across a wide spectrum of asset classes, including high-yield bonds, which fell 4.64% and senior loans which were down 3.42%. The risk-off sentiment led to a flight to quality, notably into U.S. Treasury Bonds. As Treasury's increased in value, interest rates declined. The yield on the 10 Year U.S. Treasury Bond had its first quarterly decline since the second quarter of 2017 as the yield moved from 3.06% at the end of the third quarter to 2.68% at the end of the fourth quarter. Despite the volatility in the fourth quarter, senior loans outperformed most fixed income asset classes in 2018. Loans finished the year marginally positive at 0.47% (Exhibit 1) while high-yield bonds were down 2.25% (Exhibit 2), investment grade corporate bonds were down 2.24% and the Bloomberg Barclays Aggregate Index, a good proxy for the overall bond market, finished the year up one basis point.

Exhibit 1 **– U.S. Senior Loan Performance: 1997 – 2018**

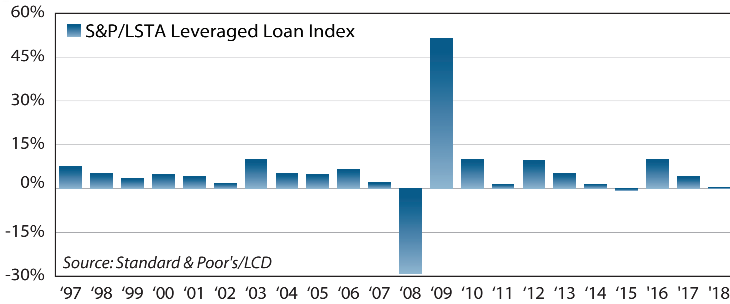
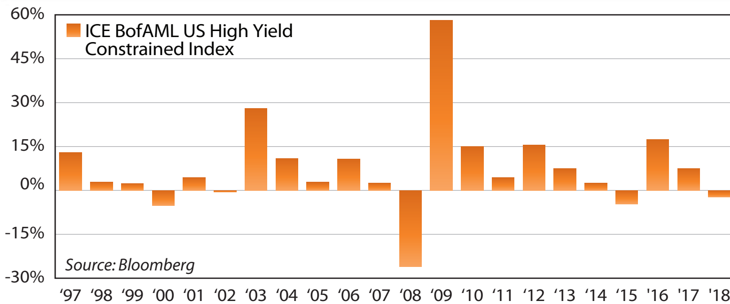
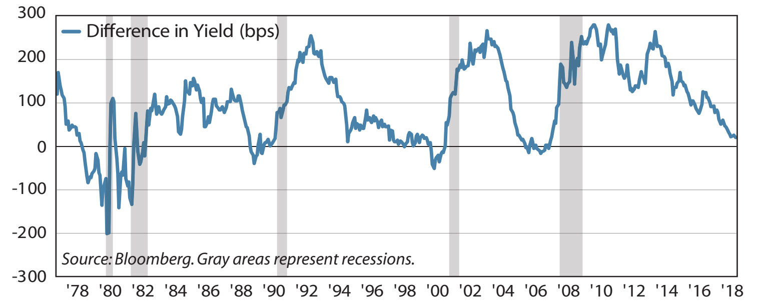


Exhibit 2 **– U.S. High-Yield Bond Performance: 1997 – 2018**



As we enter 2019, the prevailing market narrative remains negative. Many pundits are calling for a significant economic slow-down or even a recession. We believe that while there is likely to be some slowing in the U.S. economy in 2019 relative to the robust growth experienced in 2018, recession risk remains very low. This is our rationale. As corporate management teams grapple with the potential implications of the unsettled trade dispute between the U.S. and China, we believe they are delaying planned capital deployment. After all, until there is clarity on how the trade dispute will be resolved, management teams will find it challenging to make well informed decisions around the timing and how best to deploy capital investment. Therefore, we believe that a slowing of capital investment will produce a modest slowing in the global economic growth rate. Moreover, we believe that the trade dispute will give the Federal Reserve cover to pause or slow interest rate increases which should calm markets until the trade dispute is resolved. Importantly, we believe the trade issues with China will eventually be resolved and that the resolution will provide clarity to free up the pent-up global capital investment discussed above, which will eventually provide a boost to global growth rates. Finally, the yield curve, as measured by the spread between 2-year and 10-year U.S. Treasury yields, while flat, is not inverted. While the current market narrative suggests that the yield curve is close to inversion, which would be viewed as a negative leading indicator for the U.S. economy, we believe that the yield curve will not invert in the near term (Exhibit 3).

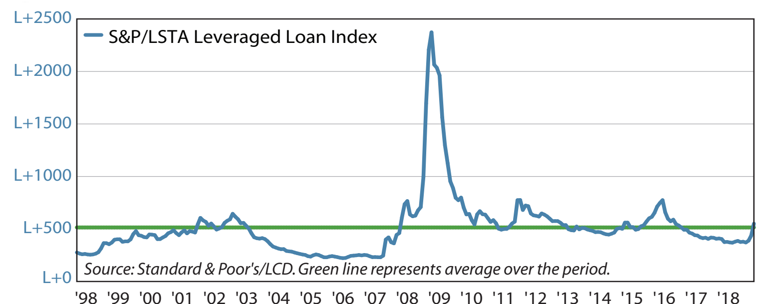
Exhibit 3 **– Spread between 2-year and 10-year U.S. Treasury Yields: January 1977 – December 2018**



Senior Loan and High-Yield Market Overview

Senior loan spreads over 3-month LIBOR[1] increased 180 basis points ("bps") during the quarter to L+551 bps (Exhibit 4). This was primarily due to high

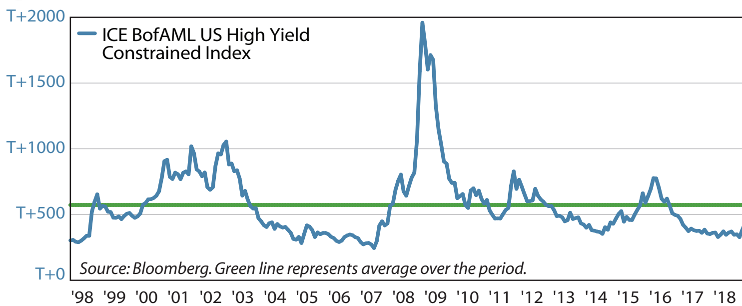
Exhibit 4 **– U.S. Senior Loan Spread over LIBOR[1]: December 1997 – December 2018**



outflows in the senior loan market. In fact, 4Q18 saw the largest retail outflows on record at $15.2B and December outflows of $9.9B was the largest single month in history. The cause of the outflows arose primarily out of a general concern for the sustainability of growth in the economy due to the on-going trade dispute with China and the implication that the Fed tightening cycle which began in December 2015 may be coming to an end. Importantly, the default rate for senior loans remains low, at 1.63% and we believe it is likely to remain low given the overall health of the U.S. economy. This is well below the long-term average default rate of 2.97% (March 1999 – December 2018; Exhibit 5).

High-yield bond spreads over U.S. Treasuries increased 206 bps during the fourth quarter to T+534 bps. The cause of the high-yield spread widening is similar to the increases in senior loan spreads. High-yield bond funds experienced one of the largest quarterly outflows on record with $20.2B of outflows and for the full-year experienced the largest outflow on record at $45.1B. While spreads have widened, they remain tight to the historic average (the long-term average spread over U.S. Treasuries is T+573, December 1997 – December 2018). We believe there is room for tightening throughout the remaining cycle given that spreads remain significantly wide of the lowest spreads experienced in the previous business cycle (May 2007 of T+245, Exhibit 6). The high-yield default rate declined 21 bps from the previous quarter and ended the quarter at 1.81%. The default rate remains well inside the long-term average default rate of 3.17% (March 1999 – December 2018; Exhibit 5). We believe the low default rate is reflective of the sound financial condition of most companies in the high-yield market and the supporting backdrop of a healthy macroeconomic environment.

Exhibit 6 – U.S. High-Yield Bond Spread over Treasuries (OAS)*: December 1997 – December 2018



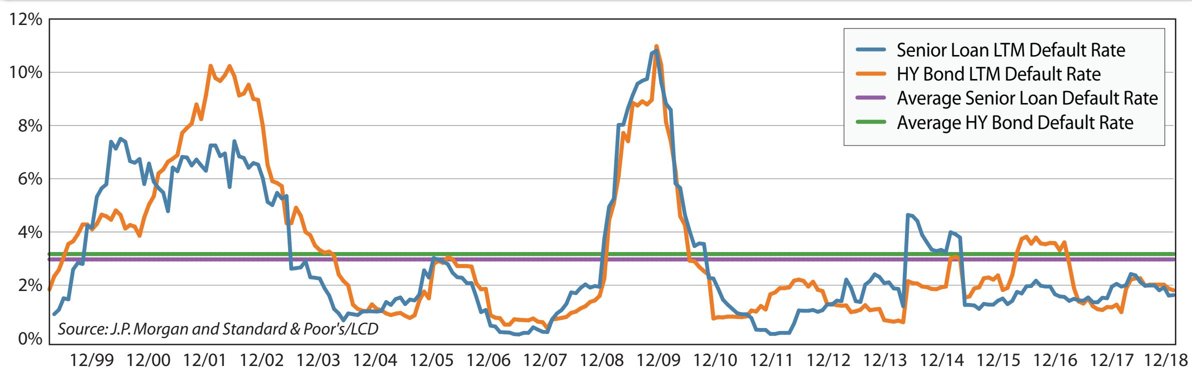
Conclusion

The combination of healthy labor and inflation data in the U.S., less accommodation from global central banks and increased U.S. Treasury issuance to fund greater deficits will likely continue to increase interest rate volatility and drive interest rates higher over time. However, we believe that until the trade dispute with China is resolved, the Fed will pause further interest rate hikes and longer rates are likely to remain range-bound. Once trade is resolved, higher growth rates and eventually higher interest rates should continue to pressure long-duration (the most interest rate sensitive) bond returns.

We remain confident that the favorable backdrop for the macro economy will persist for the near to intermediate term. Specifically, we believe senior loans, given their senior secured position in the capital structure, floating interest rate, attractive income and low default rate relative to history are well positioned as we move through 2019. We also believe that high-yield bonds, when managed appropriately, can continue to perform well relative to other fixed-rate bonds given their mid-cycle valuations and low default rate relative to history. Moreover, we believe that even slower domestic growth is unlikely to lead to a significantly higher default rate for senior loan or high-yield bond issuers in 2019.

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

Exhibit 5 – Senior Loan and High-Yield Bond Historical Default Rates[3]: March 1999 – December 2018



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	Q4 2018	Q4 2017	12 Mo Ended 12/31/18	12 Mo Ended 12/29/17	Q4 2018 By Rating BB	B	CCC
Senior Loans	-3.42%	1.10%	0.47%	4.11%	-3.50%	-3.29%	-5.53%
High-Yield Bonds	-4.64%	0.42%	-2.25%	7.47%	-3.13%	-4.83%	-8.30%
Investment Grade Corporate Bonds	-0.04%	1.12%	-2.24%	6.47%			
Preferred Securities	-4.55%	0.43%	-4.34%	10.58%			
U.S. Aggregate	1.64%	0.39%	0.01%	3.54%			
U.S. 10-Year Treasury	3.88%	-0.29%	-0.02%	2.06%			
Emerging Market Bonds	-0.54%	0.50%	-3.69%	9.27%			
Municipal Bonds	1.69%	0.75%	1.28%	5.45%			
Mortgage-Backed Securities	2.08%	0.15%	0.99%	2.47%			
S&P 500	-13.52%	6.64%	-4.38%	21.83%			
Default Rate[3] (Trailing Twelve Months)	Q4 2018	Q4 2017					
Senior Loans (LLI)	1.63%	2.05%					
Long-Term Average - *Since March 1999*	2.97%	3.03%					
High-Yield Bonds	1.81%	1.27%					
Long-Term Average - *Since March 1999*	3.17%	3.23%					
Technicals	Q4 2018	Q4 2017					
Average Senior Loan Price (LLI)	$93.84	$98.05					
Long-Term Average Senior Loan Price - *Since Dec 1997*	$94.17	$93.99					
Senior Loan Spread Over LIBOR[1]	L+551	L+405					
Long-Term Average Senior Loan Spread[1] - *Since Dec 1997*	L+515	L+521					
Average High-Yield Bond Price (HUC0)	$92.31	$100.59					
Long-Term Average High-Yield Bond Price - *Since Dec 1997*	$94.48	$94.32					
High-Yield Bond Spread (OAS)*	T+534	T+363					
Long-Term Avg. High-Yield Bond Spread (OAS)* - *Since Dec 1997*	T+573	T+582					
YTW for High-Yield Bonds (HUC0)	7.95%	5.84%					
YTM for High-Yield Bonds (HUC0)	8.01%	6.20%					
U.S. 3 Month LIBOR[2]	2.81%	1.69%					
U.S. 10-Year Treasury Yield	2.68%	2.41%					
Flows & Issuance (billions)	Q4 2018	Q4 2017	FYE 12/31/18	FYE 12/29/17			
Retail Senior Loan Fund Flows	-$15.2 *(Est.)*	-$4.3	$0.7	$13.1			
Institutional (CLO) Senior Loan Flows	$27.5	$34.6	$130.6	$117.1			
High-Yield Bond Fund Flows	-$20.2 *(Est.)*	-$9.5	-$45.1	-$20.3			
Senior Loan Gross New Issue	$109.3	$241.4	$703.7	$973.9			
High-Yield Bond Gross New Issue	$19.0	$72.5	$187.4	$328.1			

[1] 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.
[2] LIBOR–London Interbank Offered Rates
[3] 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 for all data: Bloomberg, unless otherwise noted.
Source of flows & issuance: J.P. Morgan High-Yield Market Monitor & Leveraged Loan Market Monitor.
Source of high-yield bond data: Bloomberg and J.P. Morgan.

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–ICE BofAML 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–ICE BofAML 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–ICE BofAML 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. Aggregate-Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS, ABS and CMBS.
U.S. 10-Year Treasury–ICE BofAML 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–ICE BofAML 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–Bloomberg Barclays Municipal Bond Index tracks the performance of the tax-exempt bond market.
Mortgage-Backed Securities–Bloomberg Barclays US Mortgage Backed Securities Index tracks agency mortgage backed pass-through securities (both fixed-rate and hybrid ARM) guaranteed by Ginnie Mae, Fannie Mae, and Freddie Mac.
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.

Past performance is no guarantee of future results. Historical performance figures for the indices are for illustrative purposes only and not indicative of any actual investment. 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.