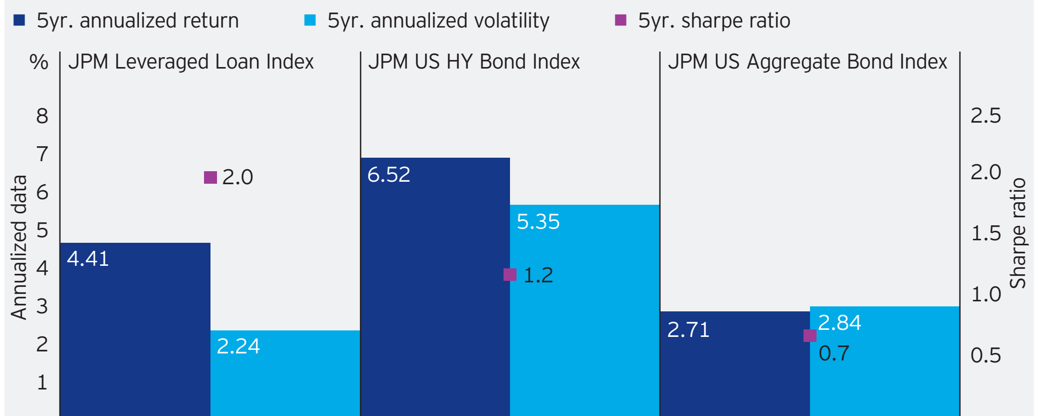
Investment Insights
US Senior Loan Market: 2017 Review and 2018 Outlook

Scott Baskind
Head of Global Senior Loans, CIO

Entering 2018, strong fundamental credit conditions and attractive yields relative to other credit products warrant an allocation to senior secured loans. Improving economic growth together with healthy borrower balance sheets and rising short term interest rates form a favorable backdrop for the asset class. Due to their defensive position in the capital structure and short duration, loans can uniquely provide strong current income while exhibiting relatively low volatility as the chart below illustrates. Historically speaking, no other asset class offers investors a similar blend of secured credit exposure and insulation from interest rate risk. These are appealing features heading into 2018 given an uncommonly long economic cycle in which growth remains supportive and expectations of further interest rate normalization/tightening remain high.

The loan asset class has offered a more attractive Sharpe Ratio than other credit related investments and we expect this dynamic to persist in 2018.



Source: JPM Leveraged loan Index, JPM US HY Bond Index and JPM US Aggregate Bond Index as of Dec. 31, 2017. **Past performance is not a guarantee of future results.** An investment cannot be made in an index. Returns stated are total returns.

2017 review

Loans delivered returns of 4.25% in 2017, as price stability and coupon income drove favorable absolute and volatility-adjusted performance. Our expectations of firming economic growth, low defaults, and supportive loan market technicals all materialized during the year while total returns landed on the low end of our 4-5% forecast. LIBOR increased from 1% to 1.69% during the year, enhancing the floating rate component of coupon income. However, the trajectory of LIBOR was flatter during the first 9 months of the year than was expected. This both delayed the benefit of rising short-term rates to loan investors and eased duration concerns at times, prompting some investors to periodically rotate into longer duration fixed income asset classes. Meanwhile, the rise in LIBOR was offset by 55 bps of nominal spread compression. The compression stemmed from an issuer-friendly environment which enabled borrowers to both lock in a lower cost of capital on new debt and reprice existing debt[1]. The unprecedented $715 billion wave of repricings and refinancings impacted spreads more than forecasted. Finally, the absence of price appreciation was in line with our initial expectations, as the year-end average loan price of $97.96 ended down slightly from $98.49 at the beginning of the year. With the majority of the market trading at or above par to start the year, price appreciation potential was limited.

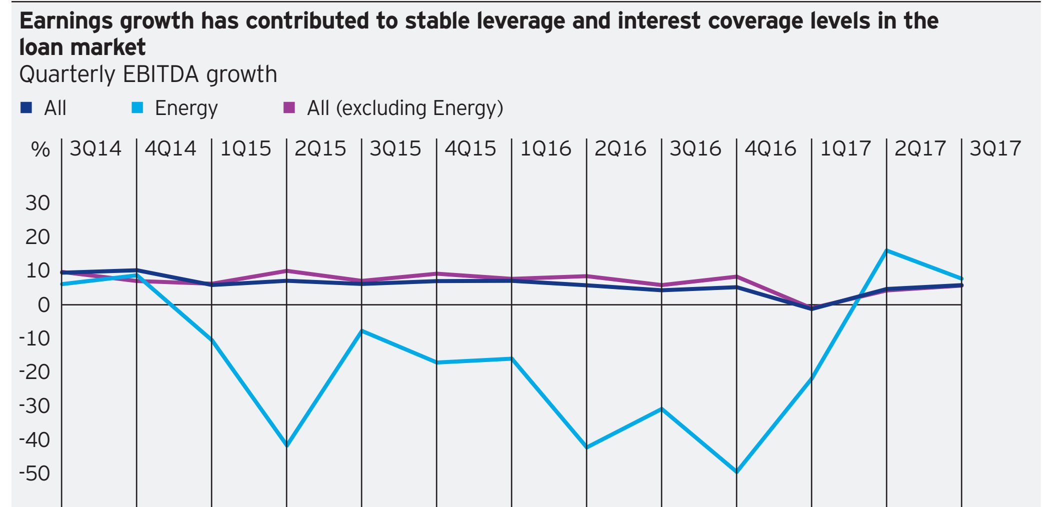
Overall, the year was broadly characterized by strong fundamentals — including accelerating economic growth, improving corporate earnings, and low defaults — which bolstered demand for US credit broadly. Speculation over Federal Reserve (Fed) policy and fiscal stimulus prospects further added to demand for loans. The technical support for loans stemmed mostly from greater than expected collateralized loan obligations (CLO) formation — $117.1 billion versus initial expectations of $60-70 billion — and a relative scarcity of acquisition-related new supply. All of these factors contributed to stable loan prices throughout the year, but also the aforementioned repricing activity.

2018 outlook

Looking forward to 2018, we expect loans will again generate approximately 4.0–4.5% total returns.[2] Underpinning this forecast is the strong fundamental credit environment which remains intact. Firming US GDP growth, a sustained recovery in energy prices from the depths of 2016, generally healthy corporate earnings, and improved issuer balance sheets after a wave of refinancings all presage that the low current default rate of 2.05% will remain below the approximate 3.0% historical average this coming year. With issuer distress isolated largely to the retail sector, as well as other highly levered and/or secularly challenged companies, we expect the default rate to be 2.0–2.5% in 2018, driven by a few individual issuers with large capital structures. This translates to another year of marginal expected credit losses for the overall market. Despite the supportive credit backdrop, we expect that price appreciation will remain an approximately neutral contributor to 2018 returns as 66% of loans currently trade above par.

Earnings growth has contributed to stable leverage and interest coverage levels in the loan market

Quarterly EBITDA growth



Source: LCD, an offering of S&P Global Market Intelligence as of Dec. 31, 2017

FOR INSTITUTIONAL INVESTOR USE ONLY - NOT FOR FURTHER DISTRIBUTION

This leaves coupon as the primary driver for loan returns. Currently, loans' average spread is 357 bps[3] and LIBOR is 169 bps, which provides a current coupon of approximately 5.2%. We expect LIBOR will continue to rise as the sturdy economic environment ultimately creates higher core inflation which, in turn, would substantiate policy rate increases and cause short term rates to rise further. Currently, the Federal Reserve is guiding for three additional policy rate increases and is scheduled to reduce its balance sheet by over $400 billion during the coming year. These anticipated steps towards policy normalization will add upward pressure to rates, and could send LIBOR north of 2% by year end, further padding loan investors' coupon income.

On the other hand, spread compression is likely to continue through 2018, mitigating the incremental coupon benefit from higher rates. However, we do expect the pace of spread compression to slow for a couple of reasons. Firstly, repricings of higher rated loans have begun to meet resistance from the CLO buyer base which will not buy loans that do not adequately match liability costs. As spreads for the highest rated loans begin to reach a floor level, this may generate opposition to further repricing of lower rated loans for which investors expect a credit risk premium. Secondly, event-driven loan supply stemming from mergers and acquisitions (M&A) and leveraged buy-out's (LBO) is likely to increase modestly during 2018 as acquisition activity tends to rise in periods of economic expansion and as tax policy uncertainty subsides. Additionally, private equity sponsors have reportedly raised a record amount of capital ready to be deployed into new investments[4]. Thus, a better balance between supply and demand in 2018 would alleviate pressure on lenders to accept the same degree of spread compression they did in 2017.

In addition to the compression of spreads, the issuer-friendly environment which defined the loan market in 2017 also gave borrowers an upper hand in document negotiation. This led to a weakening of credit agreement covenants. To the extent that the market remains extremely well bid and under-supplied, we would expect to see this trend continue in 2018. The key to mitigating the effect of covenant slippage on loan portfolios is avoidance. Our rigorous credit selection process places significant emphasis on documentation review and reflects weaker credit agreement protections via our recovery analysis. Despite a relative shortage of new issue supply in 2017, we maintained our characteristically high primary deal turndown rate in order to preserve the integrity of our portfolios, which we will continue in 2018.

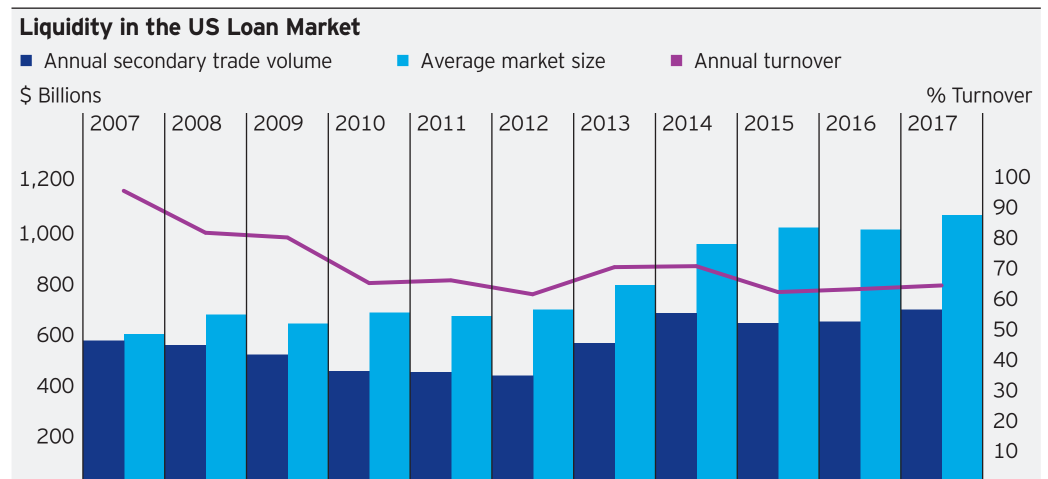
From a demand perspective, we expect another year of robust demand for loans. CLO's, which have represented 50–60% of the loan buyer base in each of the last two years[5], have been impacted by risk retention regulation far less than was expected. CLO managers responded effectively to new requirements by designing regulation-compliant CLO structures in order to serve the growing institutional demand for CLO liabilities. Thus, we expect CLO issuance to approach $100 billion again in 2018.

Retail, on the other hand, has been a less reliable source of demand. ETF and mutual fund inflows slowed notably in mid-2017 and turned to outflows by year end. An important determinant of this demand is the US yield curve, which has flattened in recent months. Due to the high historical correlation between retail flows into loans and the 10 year Treasury yield, we expect to see modest retail demand in 2018 absent a pick-up in forward inflation expectations, which would help restore a steeper relationship between short and long term rates.

A new development which may impact the loan market in 2018 is the recently passed tax reform bill. Some elements of the revised code, such as a lower corporate tax rate and an allowance for companies to fully expense capex investments upfront, may broadly benefit borrowers in the loan market. Other aspects will likely negatively impact companies, such as the newly imposed cap on interest deductibility at 30% of issuers' EBITDA, which will increase the after tax cost of debt. Overall, we expect the net impact to be balanced, if not positive, for most of the market, and that these changes will not meaningfully impact issuance in 2018. In terms of credit performance, the interest deductibility cap may disproportionately impact highly levered issuers which are more dependent on the current tax shield to generate cash flow. This change may accelerate distress for these lower quality issuers over time by incrementally straining their liquidity, but we do not expect it will contribute to higher defaults in 2018.

With respect to secondary trading in the loan market, we remain confident that markets will continue to offer robust liquidity in 2018. Despite regulatory changes in recent years intended to curtail risk taking at large banks/dealers, liquidity in the loan market has not been substantially impacted. In 2017, the loan turnover rate, or secondary trading volume as a percentage of the overall market size, was 64.6%[6]. This is in line with the annual average of 65.7% since 2010, and illustrates the healthy secondary liquidity environment for loans.

Liquidity in the US Loan Market



Source: LCD, an offering of S&P Global Market Intelligence as of Sept. 30, 2017. 2017 figure is annualized. Most recent data available.

Key risks to 2018 return expectations

Our 2018 return forecast is the outcome we believe to be most probable for the loan market; however we acknowledge that key variables could cause actual performance to differ from our base case, either positively or negatively. Important swing factors include:

- **Central bank policy:** Underperformance relative to the Fed's inflation and broader macroeconomic growth expectations could lead to fewer rate hikes than expected, which could undercut our coupon expectations and soften demand for the asset class. Alternatively, the passage of tax reform may result in faster than expected rate normalization, which could lift 2018 loan returns via coupon, absent any consequent market disruption.
- **Geopolitical shocks:** Of highest immediate concern are rising tensions with North Korea that could potentially destabilize (or worse) a major epicenter of global trade and cause widespread risk aversion in markets. South Korea, Japan, and the US are the largest sources of imports to China, as well as the largest destinations of exports from China.
- **Impact of secular shifts on default rate:** Unfolding technological advances (i.e., robotics, machine learning, autonomous and electric vehicles) and consumer behavioral changes (i.e., online shopping) will likely impact the operating environment for several industries over time. To the extent these developments accelerate unexpectedly, certain vulnerable issuers will have less time to adapt and may become financially distressed quicker than expected.
- **Contagion from troubled sectors:** In 2015/2016, the collapse of energy prices helped generate a sector-specific uptick in defaults and also weighed on the broader loan market. The impact was more pronounced in the high yield bond market due to its higher market weighting of energy issuers (14.7%) compared to the loan market (2.86%)[7]; however, contagion affected both markets materially. While we do not expect a repeat of this commodity-led downturn in 2018, there is a risk that sectors currently experiencing varying levels of stress – retail, wireline telecoms, and healthcare – could deteriorate further and undermine investor appetite for credit.

Notwithstanding these uncertainties, we expect 2018 will be another solid year for senior secured loan investors. With the market again poised to benefit from supportive fundamental and technical conditions, loans should deliver an attractive total return based on strong current income, price stability, and limited near term default risk. Loans also provide insulation from any interest rate-driven volatility which is more likely to impact longer duration asset classes. Historically, loans have performed well through periods of rising interest rates, and we expect this time to be no different. The differential between yields in high yield bonds and loans remains near historical lows, meaning investors have the opportunity to own secured credit exposure at a similar yield to unsecured credit exposure, while also assuming less duration risk. This dynamic reinforces our view that now is an opportune time for an allocation to the loan market.

Index performance

Total annual return (%)	2013	2014	2015	2016	2017
Credit Suisse Leveraged Loan Index	6.15	2.06	-0.38	9.88	4.25
BAML US High Yield Index	7.42	2.50	-4.64	17.49	7.48
BAML US High Grade Index	-1.46	7.51	-0.63	5.96	6.48
10-Year US Treasury	-7.73	10.92	1.00	-0.11	2.10

Source: Standard & Poor's LCD, BofA, JPM and Bloomberg L.P. as of December 31, 2017. Senior Loans are represented by the Credit Suisse Leveraged Loan Index; High yield bonds are represented by the BAML US High Yield Index; High grade bonds are represented by the BAML US High Grade Index. Past performance is not a guide to future returns. An investment cannot be made directly in an index.

Investment risks

Most senior loans are made to corporations with below investment-grade credit ratings and are subject to significant credit, valuation and liquidity risk. The value of the collateral securing a loan may not be sufficient to cover the amount owed, may be found invalid or may be used to pay other outstanding obligations of the borrower under applicable law. There is also the risk that the collateral may be difficult to liquidate, or that a majority of the collateral may be illiquid. Compared to investment grade bonds, junk bonds involve a greater risk of default or price changes due to changes in the issuer's credit quality. Diversification does not guarantee a profit or eliminate the risk of loss. The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

1 LSTA/S&P Leveraged Loan Index as of 12/31/17
2 The anticipated return is not guaranteed.
3 CS Index as of 12/31/17
4 Prequin
5 Barclays Research
6 LSTA data as of 12/31/17
7 JP Morgan as of 12/31/17

Important Information

All data provided by Invesco unless otherwise noted. All data is USD and as of 12/31/2017, unless otherwise noted.

This document is written, unless otherwise stated, by Invesco professionals. The opinions expressed herein are based upon current market conditions and are subject to change without notice. This document does not form part of any prospectus. This document contains general information only and does not take into account individual objectives, taxation position or financial needs. Nor does this constitute a recommendation of the suitability of any investment strategy for a particular investor. Investors should consult a financial professional before making any investment decisions. Opinions and forecasts are subject to change without notice. Neither Invesco Ltd. nor any of its member companies guarantee the return of capital, distribution of income or the performance of any fund or strategy. Past performance is not a guide to future returns. This document is not an invitation to subscribe for shares in a fund nor is it to be construed as an offer to buy or sell any financial instruments. As with all investments, there are associated inherent risks. This document is by way of information only. Asset management services are provided by Invesco in accordance with appropriate local legislation and regulations.

This document has been prepared only for those persons to whom Invesco has provided it for informational purposes only. This document is not an offering of a financial product and is not intended for and should not be distributed to retail clients who are resident in jurisdiction where its distribution is not authorized or is unlawful. Circulation, disclosure, or dissemination of all or any part of this document to any person without the consent of Invesco is prohibited.

This document may contain statements that are not purely historical in nature but are "forward-looking statements", which are based on certain assumptions of future events. Forward-looking statements are based on information available on the date hereof, and Invesco does not assume any duty to update any forward-looking statement. Actual events may differ from those assumed. There can be no assurance that forward-looking statements, including any projected returns, will materialize or that actual market conditions and/or performance results will not be materially different or worse than those presented.

The information in this document has been prepared without taking into account any investor's investment objectives, financial situation or particular needs. Before acting on the information the investor should consider its appropriateness having regard to their investment objectives, financial situation and needs. You should note that this information:

- may contain references to amounts which are not in local currencies;
- may contain financial information which is not prepared in accordance with the laws or practices of your country of residence;
- may not address risks associated with investment in foreign currency denominated investments; and
- does not address local tax issues.

All material presented is compiled from sources believed to be reliable and current, but accuracy cannot be guaranteed. Investment involves risk. Please review all financial material carefully before investing. The opinions expressed are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco investment professionals.

The distribution and offering of this document in certain jurisdictions may be restricted by law. Persons into whose possession this marketing material may come are required to inform themselves about and to comply with any relevant restrictions. This does not constitute an offer or solicitation by anyone in any jurisdiction in which such an offer is not authorised or to any person to whom it is unlawful to make such an offer or solicitation.