US Senior secured loan market: 2016 review and 2017 outlook

Entering 2017, senior secured loans present an attractive allocation opportunity amid supportive overall credit conditions for borrowers and the benefits that should accrue to owners of floating rate instruments during periods of rising interest rates. As shown in the chart below, loans have provided a combination of strong current income with relatively low volatility given their defensive position in the capital structure and short duration. The asset class delivered strong performance versus our expectations in 2016, providing investors with favorable absolute and volatility-adjusted returns of 9.88%. The year was broadly characterized by a “risk-on” tone following a brief period during the early months in which market fears over global risks carried over from the back half of 2015. Post mid-February, concerns over the impact of slower Chinese growth abated, alleviating pressure on commodity prices and ushering a period of loan price appreciation. As has been the case throughout the post-Global Financial Crisis era, volatility in loans was relatively muted as their senior secured status helped absorb short bouts of uncertainty while the floating rate feature of the asset class insulated loans from the pressure felt by longer duration assets late in the year once interest rates began to rise.

Scott Baskind
Managing Director
Chief Investment Officer

The US loan asset class has delivered a more attractive Sharpe Ratio than other credit investing opportunities and we expect this dynamic to persist in 2017

Source: JPM Leveraged loan Index, JPM US HY Bond Index and JPM US Aggregate Bond Index as of Sept. 30, 2016. Past performance is not a guarantee of future results. An investment cannot be made in an index. Returns stated are total returns.

1 Credit Suisse Leveraged Loan Index as of Dec. 31, 2016.
Loans remain defensively positioned compared to fixed rate alternatives with respect to interest rates. We believe the key factors which influence rates will continue to be supportive in 2017—accommodating macro conditions including healthier economic growth, low unemployment, and slowly mounting inflation. Based on those factors, along with the fiscal policy pronouncements of president-elect Trump, which broadly indicate higher levels of spending and inflation, we anticipate that the path to interest rate normalization will continue through 2017 at a measured pace. As rates trend higher, loans stand to benefit as LIBOR floors increasingly fall away. However, the freely callable nature of loans allows for issuers to reprice and refinance at lower spreads in strong market environments, a dynamic that played out during the back half of 2016.

Following Trump's election, the prospects for deregulation, tax reform, and higher fiscal spending may coalesce to support the corporate earnings environment in 2017. We anticipate that the supportive economic backdrop, recent efforts by issuers to refinance debt to extend maturities and lower spreads, and a gradual pace of interest rate normalization will also contribute to a continued benign default environment for below investment grade corporations. With the average loan price at 98.49\(^1\) and the median prices above par, we anticipate return potential for the asset class of 4-5% in 2017.\(^2\) We believe strong current income will drive returns, although price appreciation should be limited given that much of the market is bid at or above par as shown in the chart below.\(^1\)

### Most of the US loan market is currently bid above par

<table>
<thead>
<tr>
<th>Bid price</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0-$60</td>
<td>0.91</td>
</tr>
<tr>
<td>$60-$80</td>
<td>2.21</td>
</tr>
<tr>
<td>$80-$90</td>
<td>4.50</td>
</tr>
<tr>
<td>$90-$100</td>
<td>24.06</td>
</tr>
<tr>
<td>&gt;$100</td>
<td>68.31</td>
</tr>
</tbody>
</table>

Source: S&P LCD, loans represented by the S&P LSTA Leveraged Loan Index, as of Dec. 31, 2016.

### Fundamentals

Given the anticipated action from US Fed policymakers, we expect interest rate risk to be a primary focus in capital markets during 2017 as less credit sensitive asset classes have significant exposure to rates. For US loans, however, credit/default risk is always at the forefront. Credit fundamentals remain stable heading into 2017 as economic growth has accelerated in the back half of this year and issuers have lowered interest costs and extended maturities. For an event of default to occur, a company either must be unable to service its debt or be unable to refinance its debt at maturity. Following a wave of refinancings in 2016 which both lowered interest costs and extended near term maturities, those risks have been broadly reduced. As shown in the chart below, issuers are currently operating with a significant earnings cushion and have the ability to absorb either higher interest expense or short lived weakness in earnings, with EBITDA significantly exceeding interest expense.

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1 S&P LCD and Invesco as of Dec. 31, 2016
2 The anticipated return is not guaranteed
Default expectations are benign as companies are operating with a significant earnings cushion and a dearth of near-term maturities

Cash flow multiples of new issue loans

- EBITDA - Capex/cash interest
- EBITDA/cash interest

Pockets of credit weakness remain in the US loan market, but are mainly isolated to commodity sectors, which have dominated the default landscape, as well as borrowers exposed to shifting trends at retail. The current trailing twelve month default rate of 1.58% remains below the historical average of 3.1%.\(^1\) For 2017, there are few immediate catalysts for the default rate to move meaningfully higher, and we expect the default rate to be approximately 2.3%.

Technicals

Technical conditions were a tailwind throughout most of 2016 and expectations are for them to stay supportive in 2017. During the year, supply net of refinancing and re-pricing transactions remained relatively light while demand accelerated across the spectrum as net inflows from commingled funds/SMA’s, CLO’s, retail mutual funds, and ETFs were substantially positive. Technicals strengthened in the concluding months of the year as CLO demand ramped up - as shown in the chart below, 2016 CLO issuance of $111.7 billion matched 2015 levels and exceeded both our 2016 expectations and long term averages. Expectations for next year are that CLO issuance will continue normalizing with roughly $60-70 billion of issuance as regulations that require CLO managers retain ownership in each transaction continues to modestly impact deal formation.\(^2\) We expect CLO issuances, as well as demand from institutional accounts, to remain the cornerstone of the loan investor base.

US CLO Issuance is expected to slow but should remain ahead of long term averages

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2 Morgan Stanley 2017 US Credit Outlook
The second half of 2016 recorded significant inflows from retail mutual funds, a reversal from the prior two years. The loan asset class attracted retail inflows of $13.3 billion in the second half of the year, bringing 2016 total inflows to $6.9 billion.\(^1\) We expect the recent trend of inflows to continue as investors seek the diversification benefits\(^2\) provided by the loan asset class during a period of rising interest rates.

Overall as we look forward to 2017, we believe senior secured loans are poised to continue delivering attractive risk-adjusted returns given a favorable technical backdrop and healthy overall fundamental credit conditions. Importantly, loans are well positioned for the long awaited start to the normalization of interest rates compared to other asset classes. In previous periods of upward shifts in the yield curve, loans have outperformed high yield and investment grade bonds on average – with defaults expected to remain low, we anticipate this strong performance to continue.

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1 J.P. Morgan as of Dec. 31, 2016
2 Diversification does not guarantee a profit or eliminate the risk of loss.
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All data provided by Invesco unless otherwise noted. All data is US dollar and as of December 31, 2016, unless otherwise noted. 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.

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