Invesco Senior Secured Loans

European Loan Market

Snapshot

Monthly European loan market update: November 2018 (covering October 2018)

The Credit Suisse Western European Leveraged Loan Index ("CS WELLI") returned 0.20% in October, comprised of principal return of -0.19% and interest return of 0.39%. The year-to-date ("YTD") total return is 2.57%.[1]

October was marked by global equity volatility and significant sell-offs (towards correction territory), resulting in negative monthly total returns for the Nikkei (-9.1%), FT SE MIB (-8.0%), and S&P 500 (-6.8%). Key catalysts included US tech stocks indicating slower growth and ongoing US-China tariff tensions (not helped by lower Chinese growth forecasts). In general, fixed income market returns outperformed equity markets, with German Bunds monthly returns of +0.6% (+1.4% YTD) while the Italian BTP returned -1.4% (-5.8% YTD), reflecting a flight-to-safety dynamic. Notably, in sharp contrast to last month, Brent Oil and WTI returned -8.8% and -10.8%, respectively, during the month.

Despite the volatility, the loan market remained firm due to a supportive technical backdrop of institutional demand and slower primary issuance. Outside of borrowers with idiosyncratic credit issues, managers were prepared to buy on dips in the secondary market given the expectation of slower primary issuance for the remainder of the year.

In terms of demand, CLO issuance remained constrained by year-to-date AAA liability pricing (approximately 100 basis points ("bps")). Many managers opted to delay pricing until 2019 rather than squeeze themselves into the back end of a busy year – YTD ther e has been €23 billion of CLO formation, which is well above the €15 billion over the same period last year. However, the slowdown of CLO demand was offset by continued inflows into commingled private placement funds and segregated accounts. The reduced reliance on one part of the capital markets (increased investor diversity) is a sign of progressing market maturity.

While loan supply remains solid, it has slowed from the levels seen during the first three quarters of the year. Loan supply in October was €4.3 billion, which brings YTD issuance to €71.6 billion. As the flow of M&A-related activity slowed, with major jumbo deals clearing last month, October was characterized by a steady flow of refinancing transactions. Cross border deals continued to be brought to market during the month, including Thor Industries, a $2.3 billion term loan financing backing its acquisition of German recreational vehicle manufacturer Erwin Hymer. The financing included €675 million TLB at EURIBOR + 400 (0% floor) at 99 Original Issue Discount (OID).

The CS WELLI's nominal value (size of the market) at the end of the month was €279 billion, a 29% increase since the beginning of the year.[1]

Returns

- CS WELLI returns were led by the Retail (+1.11%) and Consumer Non-durables (+0.67%) sectors, while the Consumer Durables (-2.92%) and Housing (-0.23%) sectors were the largest detractors.[1]
- CCC rated loans underperformed, returning -0.47% in the month (associated with Energy-related credits). BBs and Bs returned 0.05% and 0.33%, respectively.[1]
- The average price of loans in the European market ended the month at €99.03, which equates to a three-year discount margin of 3.83%.[1] In comparison, the spread-to-worst for European high yield bonds was 4.62%, with October returns of -1.36% and YTD returns of -1.15%.[2]

Fundamentals

- Euro area PMI (and other) readings from May through September were consistent with GDP growth of about 2%. The Euro area's 3Q GDP was weaker than expected, growing only 0.2% quarter-over-quarter (half of market expectations). PMI trends are consistent with trend-like growth of around 1.2%. While Euro area weakness is not uniform across countries (Germany and Italy softer; Spain and France are holding up better) and some due to temporary factors (e.g., auto-sector impacts and weaker external demand due to global trade jitters), the uncertainty around how far the weakening can extend is a key topic for the market. Consensus is for 3Q headwinds to partially abate, with a moderate uptick in 4Q GDP.
- Weaker growth and downside risks are a challenge for the ECB's communication as it prepares to stop net asset purchases in December; the focus will be on reinvestments. Market volatility witnessed towards the end of the month somewhat overshadowed the October ECB meeting, with President Draghi managing to successfully turn the meeting and press conference into a dull event. The recent weaker-than-expected data was discussed, but the full conclusions and ramifications were left impending until the new forecasts become available in December. Moreover, the overall balance of risks surrounding the Euro area growth outlook is still "broadly balanced" according to Draghi. Reinvestments were not discussed by the ECB Governing Council. Regarding Italy, Draghi expressed confidence that the EU and Italian government will reach an agreement on the budget. There were no changes to forward guidance on deposit rates; thus, Euribor is expected to remain below zero until late 2019.
- On the political front, a key development was Merkel's (Germany) announcement that she will not run in the CDU leadership contest in December. Italian budget proposals remain in flux, similar to the ongoing US-China tariff talks and Brexit negotiations. In addition, the political debate in Germany has turned towards fear of a no-deal Brexit affecting Germany's export industry.
- There were no defaults in October. The last twelve month default rate for the S&P European Leveraged Loan Index (based on principal amount) is 0.11%, below the historical average annual default rate of 3.85%.[3]

Technicals

- European CLO supply was €2.4 billion in October, bringing YTD volume to €23.3 billion. There have been 56 transactions YTD (versus €15 billion / 37 for the same period last year). CLO primary AAA spreads has remained stable around the 100bps vicinity.

Index returns (%)	2013	2014	2015	2016	2017	Aug 2018	Sept 2018	Oct 2018	YTD 2018
Credit Suisse Western European Leveraged Loan Index (EUR-HDG)	8.73	1.96	3.14	6.52	3.30	0.36	0.57	0.20	2.57
Credit Suisse Western European HY Index (EUR-HDG)	9.10	4.31	1.36	9.63	6.28	0.17	0.05	-1.36	-1.15

Source: Credit Suisse, as of Oct. 31, 2018. Past performance is not a guide to future returns. An investment cannot be made directly in an index.

1 Credit Suisse Western European Leveraged Loan Index (CS WELLI) as of Oct. 31, 2018.
2 Credit Suisse Western European High Yield Index as of Oct. 31, 2018.
3 S&P European Leveraged Loan Index, average default rates covering June 1, 2007 through Oct. 31, 2018.

Investment Risks

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. 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 low. 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 the investment grade bonds, junk bonds involve greater risk of default or price changes due to changes in the issuer's credit quality. Diversification does not guarantee profit or eliminate the risk of loss.

Important information

All data provided by Invesco, as at Oct. 31, 2018 in Euro unless otherwise noted.

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