European Loan Market Snapshot

Monthly European loan market update: February 2019 (covering January 2019)

The Credit Suisse Western European Leveraged Loan Index ("CS WELLI") returned 1.15% in January, comprised of principal return of 0.77% and interest return of 0.38%.[1]

January was a good month for leveraged loans. In general, risk assets rebounded from the broad-based sell-off seen in December. Much of the impetus was generated via a dovish US Federal Reserve, a sharp rally in oil prices (up more than 15% during the month), and improving US-China trade developments. In Europe, the Euro Stoxx 50 Index returned +5.3%,[2] with the Stoxx Europe 600 Index - Banks Supersector returning +4.7%.[3] Core bond markets were relatively muted with Bunds and Treasuries returning +0.8% and +0.5%, respectively (local currency). The US high yield market was particularly strong during the month returning close to 5%, a monthly return not seen for at least seven years.[4] While economic data points to a moderating macro environment in the Euro area, US central bank policy via "Powell Put" has had a clear positive effect on global markets and confidence.

The underlying dynamics of the European loan market were balanced with modest supply and primary pipeline met with subdued demand as CLO arbitrage remained elusive given wide liability spreads.

In terms of supply, European new-deal issuance has been muted (€1.7 billion versus €12.3 billion for the same period last year), the quietest January since 2012.[5] Deal flow has been characterized by a flurry of modestly-sized add-on transactions for seasoned borrowers and a few LBO-related financings (e.g. event organizing company with €483 million TLB priced at E+400 rated B/B2). Several larger deals are reported to be in early-bird phase (pre- general syndication) and a number of jumbo cross-border deals are also expected in the near future; discussions with arrangers suggest that supply will continue to be slow, with 2Q earmarked for potential acceleration. According to a American financial services company there are currently 12 transactions in the forward calendar pipeline totaling €3.6 billion of institutional loan volume.[6]

From a demand perspective, the CLO market continues to stutter. CLO AAA liability margins have widened over recent months and remain close to recent highs in the E+110 area. CLO arbitrage is stretched – the difference between new issue loan margins and weighted average new issue CLO debt – remains at the tight end (less attractive for CLO managers) of its range in recent years. This makes a challenging environment for new CLO deals to price with attractive equity returns. Unfortunately for CLO managers, unlevered funds and well-ramped CLO warehouses can more easily navigate the current pricing trends and are willing to do primary at margins tighter than what CLOs require, resulting in new deals being successfully syndicated without the need of CLO warehouses.

The CS WELLI's nominal value (size of the market) at the end of the month was €285 billion.[1]

Returns

- All but one of the sectors within the CS WELLI had positive total returns for the month. The Energy sector led with a 2.0% return, followed by the Forest Products/Containers and Media/ Telecommunication sectors returning 1.9% and 1.8%, respectively. Index sector laggards were the Metals/Minerals sector returning 0.2% and the Consumer Durables sector returning -2.8%.[1]
- By ratings, BB rated loans returned 1.8%, B rated loans returned 1.0%, and C CC rated loans returned 0.2%. USD lo ans within the index returned 2.12% for the month (approximately 28% of the CS WELLI, contributing 0.59% to the CS WELLI's return) and EUR loans returned 0.81% (approximately 66% of the CS WELLI, contributing 0.53% to the CS WELLI's return).[1]
- At month end, the average price of the CS WELLI was €97.39, which was up €0.84 during the month and the greatest monthly gain since January 2017. The CS WELLI's three-year discount margin is 4.41% (-32 basis points across the month).[1] For comparison, the Credit Suisse Western European High Yield Index returned 2.49% for the month and had a spread-to-worst yield of 4.99%.[7]

Fundamentals

- The Eurozone economy has been slowing over the past six months. The economy has already slowed from real GDP growth rates of approximately 2.5% in 2017 – well above the region's potential growth rate – but the slowdown has been exacerbated by several factors that may not dissipate quickly. The clearest trigger was a regulatory shock from the EU commission: the imposition of new World Harmonized Light Vehicle Test Procedure (WLTP) regulations for testing diesel cars in the EU from September 2018. The auto industry is important to manufacturing in Germany, France, and Italy; therefore, it is not surprising that WLTP has had a dramatic effect on the Eurozone's real GDP growth, reducing it to 0.16% quarter-on-quarter (qoq) in 3Q-2018 and 0.22% in 4Q-2018. Overall business sentiment indicators have weakened sharply over the last six months. Other factors contributing to the slowdown are the trade war and tariffs initiated by President Trump, the slowdown in China, French protests, and Brexit.
- Growth is not expected to decelerate further into 1H19, with some signs of stabilization coming from stronger-than-expected growth in France and fiscal expansion in Germany. Italian GDP contracted again in 4Q (by 0.2% qoq) and entered a technical recession, though it may be short-lived. Positively, France and Spain came in stronger than expectations at 0.3% qoq and 0.7% qoq, respectively.
- Macroeconomic indicators have made the ECB more cautious, acknowledging that growth risks are tilted to the downside. Targeted longer-term refinancing operations (TLTRO) replacement could be announced in the next few months, while the central bank will be watching the impact of the end of QE. Euribor remains negative, with no changes to ECB forward-guidance announced at the January meeting.
- There were no defaults during the month. The last twelve month default rate for the S&P European Leveraged Loan Index (based on principal amount) is 0.00%, well below the historical average annual default rate of 3.76%.[8]

Index returns (%)	2013	2014	2015	2016	2017	2018	Jan 2019
Credit Suisse Western European Leveraged Loan Index (EUR-HDG)	8.73	1.96	3.14	6.52	3.30	0.55	1.15
Credit Suisse Western European HY Index (EUR-HDG)	9.10	4.31	1.36	9.63	6.28	-3.85	2.49

Source: Credit Suisse, as of Jan. 31, 2019. **Past performance is not a guide to future returns.** An investment cannot be made directly in an index.

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.

1 Credit Suisse Western European Leveraged Loan Index (CS WELLI) as of Jan. 31, 2019.
2 Euro Stoxx 50 Index as of Jan. 31. 2019. The Euro Stoxx 50 is derived from the EURO STOXX index and represents the largest Supersector leaders in the Eurozone in terms of free-float market capitalization.
3 Stoxx Europe 600 Index – Banks Supersector, as of Jan. 31, 2019. The Stoxx Europe 600 Index, covering the 600 largest companies in Europe, is divided into 19 Supersectors according to the ICB industry classification and reflects the exposure to a certain sector in terms of free-float market capitalization.
4 J.P. Morgan US High Yield Index as of Jan. 31, 2019.
5 S&P / LCD as of Jan. 31, 2019.
6 S&P / LCD as of Feb. 4, 2019.
7 Credit Suisse Western European High Yield Index as of Jan. 31, 2019.
8 S&P European Leveraged Loan Index, average default rates covering June 1, 2007 through Jan. 31, 2019.