European Loan Market Snapshot

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

The Credit Suisse Western European Leveraged Loan Index ("CS WELLI" or the "Index") returned 0.57% in September, comprised of principal return of 0.24% and interest return of 0.33%. The year-to-date ("YTD") total return was 2.37%.[1]

September was generally characterized by low volatility across most asset classes. Fixed income markets steadily sold off throughout the month, resulting in total returns of -0.1% (-0.5% YTD) for European sovereigns and -0.9% (0.8% YTD) for German Bunds. During the month Brent Oil and WTI returned 6.9% and 4.9%, respectively.

Volatility did return late in the month, when a wider-than-expected Italian deficit target of 2.4% of GDP was announced. Heavy falls were seen across Italian assets – Italian banks' equity prices had their worst day since June 2016 (Brexit) – although limited contagion into general European equity and fixed income markets occurred. Approximately 2% of the CS WELLI are Italian borrowers (by notional amount).[1]

Loan supply in September was €8.8 billion, which brings YTD issuance to €67 billion. Supply was dominated by the much-anticipated, jumbo cross-border buyout transactions for Akzo Nobel Specialty Chemicals and Refinitiv. Akzo's financing included €1.8 billion of term loans, priced at E+375 and Refinitiv's financing included a $2.75 billion equivalent Euro-denominated term loan priced at E+400.

Arrangers (and the market in general) were well aware of these imminent jumbo deals and strategically launched several deals beforehand. Given the attractive price-whispers for the jumbo deals, lenders were able to push back on pricing and deal documentation for several deals, increasing the risk/return tradeoff for investors. With supply reduced following the Akzo and Refinitiv transactions, clearing margins became tighter for new deals – particularly given that the deal pipeline has lightened as we enter the final quarter of the year. CLO liabilities have drifted wider to approximately 1% for AAA tranches and recent tightened primary deal economics limits the arbitrage attractiveness. However, demand from other institutional investors (commingled private placement and segregated accounts) remains strong – filling any gap left by CLOs – and these other institutional investors are willing to buy lower margin paper than CLOs. Positively, CLOs provide a strong back-bid if the market were to trade off and CLO warehousing continues at its current pace. This market dynamic is illustrated by S&P's Loan Market Commentary and Data's supply/demand balance measure, which shows a shortage on a rolling-three-month basis not seen since January.[2]

The CS WELLI's nominal value (size of the market) at the end of the month was €270 billion.[1]

Returns

- Positive returns were seen across the majority of sectors forming the CS WELLI. The Energy sector led returns at 3.93%, tracking the rally seen in energy markets (this sector represents less than 1% of the Index by market weight).[1] The Media/Telecommunications sector returned 0.81% (the largest sector in the Index, at 21%).[1] The Consumer Durables and Consumer Non-durables sectors were the largest detractors from Index, returning -0.30% and -0.59%, respectively.[1]
- All loan rating categories had positive returns during the month: CCC rated loans were the outperformer at 1.70% – to be expected given the high concentration of energy-related names (see above) – while BBs and Bs returned 0.48% and 0.60%, respectively.[1]
- The average price of loans in the European market ended the month at €99.07, which is an increase of €0.34 from last month and was reflected in the three-year discount margin of 3.84%.[1]
  In comparison, the spread-to-worst for European high yield bonds was 3.98%, with September returns of 0.05% and YTD returns of 0.21%.[3]

Fundamentals

- The Euro area's composite PMI was lower in September (-0.3 month-over-month to 54.2), although remained firmly in expansionary territory. Interestingly, manufacturing export new orders dropped to the 50-breakeven level (their lowest level since June 2013), possibly reflecting an indirect effect of trade (tariff) protectionism developments. The overall composite reading suggests that GDP growth-momentum has cooled marginally, yet still implies a healthy annualized GDP rate of 2%. Core inflation is likely to remain steady at around 1% over the coming months and headline inflation (1.7%) should remain supported by higher oil prices.
- The September ECB meeting was uneventful as President Draghi showed confidence in the macroeconomic outlook with unchanged dovish tapering talk. He also reaffirmed confidence in rising core inflation (note German inflation is near 5-year highs) that pushed Bund yields to their highest level since May. The ECB remains on schedule to end balance sheet expansion by year-end. The short end of the interest rate curve remains anchored as the ECB continues to signal that rates will remain low well past the end of QE. Forward guidance results in Euribor remaining below zero and is expected to remain so until late 2019 at the earliest.
- The principle risks to European growth continue to include Italian budget proposals (at-odds with the European Commission policy and associated potential downgrade from rating agencies), ongoing tariff developments, and Brexit negotiations. Brexit talks continue, with the Irish border a key factor to be navigated. The situation remains very fluid with daily developments.
- There were no defaults in September. The last twelve month default rate for the S&P European Leveraged Loan Index (based on principal amount) is 0.11%, well below the historical average annual default rate of 3.88%.[4]

Technicals

- The European CLO market remained active in September, with €1.6 billion issued, bringing YTD volume to €20.8 billion. There have been 50 transactions YTD (versus 33 for the same period last year). While YTD new issuance is close to last year's record, CLO arbitrage is starting to meet some headwinds amid widening liabilities and tightening loan spreads. CLO primary AAA spreads were approximately 12bps wider over the month and around 100bps at the end of September, last seen in November 2016. There are approximately 30 issuers in the CLO pipeline.[2]

Index returns (%)	2013	2014	2015	2016	2017	July 2018	Aug 2018	Sept 2018	YTD 2018
Credit Suisse Western Europe Leveraged Loan Index (EUR-HDG)	8.73	1.96	3.14	6.52	3.30	0.51	0.36	0.57	2.37
Credit Suisse Western Europe HY Index (EUR-HDG)	9.10	4.31	1.36	9.63	6.28	1.39	0.17	0.05	0.21

Source: Credit Suisse, as of Sept. 30, 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 Sept. 30, 2018.
2. Standard and Poor's (S&P) / Loan Market Commentary and Data (LCD) as of Sept. 30, 2018.
3. Credit Suisse Western European High Yield Index as of Sept. 30, 2018.
4. S&P European Leveraged Loan Index, average default rates covering June 1, 2007 through Sept. 30, 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

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