Invesco

Invesco Senior Secured Loans

US Loan Market Snapshot

Monthly US loan market update: January 2019 (covering December 2018)

Global markets ended 2018 on a sour note with US equities returning -9.03% in December, their worst monthly performance since the Global Financial Crisis.[1] Negative market sentiment was driven by concerns over slowing global growth amid tightening US monetary policy and further trade tension with China. The Federal Reserve (Fed) delivered a "dovish hike" during the month by simultaneously raising rates by another 25 basis points and reducing its guidance for 2019 rate increases; however, the Fed's inclination to further increase rates was poorly received by nervous investors. Amid the turmoil, senior secured loans were impacted by investors' risk aversion and the resulting selling pressure. Outflows during the month were driven by retail and institutional accounts rotating into cash amid weaker overall market sentiment and lower future rate expectations. On a relative basis, loans significantly outperformed equities, and were nearly in line with high yield returns in December. Away from the technical weakness, credit fundamentals in the loan market remain supportive of low defaults in 2019 given issuers' strong earnings growth and manageable interest coverage ratios. Overall, loans returned -2.54% for the month, bringing 2018 returns to 0.44%,[2] which meaningfully outpaced fixed rate credit during the year.

Loan market technicals were pressured in December by heavy withdrawals from the asset class, including $9.9 billion of retail outflows.[3] CLO issuance also slowed markedly amid declining loan prices and widening liability spreads. New CLO issuance is still expected to remain strong in 2019, however the pace of CLO creation will likely remain muted until the market stabilizes. Meanwhile, new loan supply slowed to a trickle in December as widening primary and secondary loan spreads discouraged opportunistic transactions from coming to market.

As loan spreads continued to widen, the percentage of loans trading above par declined to under 1% during December. Notwithstanding this price weakness, loans outperformed high yield during the volatile fourth quarter. Over that period, loan returns of -3.45% outpaced high yield returns of -4.63%.[4] The largest 100 loans – which tend to be the most liquid - collectively underperformed the broader loan market by 62 basis points in December,[5] highlighting the technical nature of the selloff. Overall, "CCCs" (-3.34%) succumbed to the prevailing risk aversion, underperforming higher quality deals. "BBs" (-2.56%) actually underperformed "Bs" (-2.52%) due to the aforementioned technical selling pressure in larger, liquid loans.[5] The average price in the loan market was $94.16 at the end of December.[5] At the current average price, senior secured loans are providing a 8.44% yield inclusive of the forward LIBOR curve.[6]

Fundamentals

- PMI's have lately come off 2018 highs; however, they – along with continued strength in labor markets – continue to indicate moderate economic growth. The consensus expectation is for economic growth to remain solid in 2019, albeit moderating from 2018 levels.
- The trailing 12 month default rate held steady at 1.63% [5] in December with just one new default during the month by Catalina Marketing.

Technicals

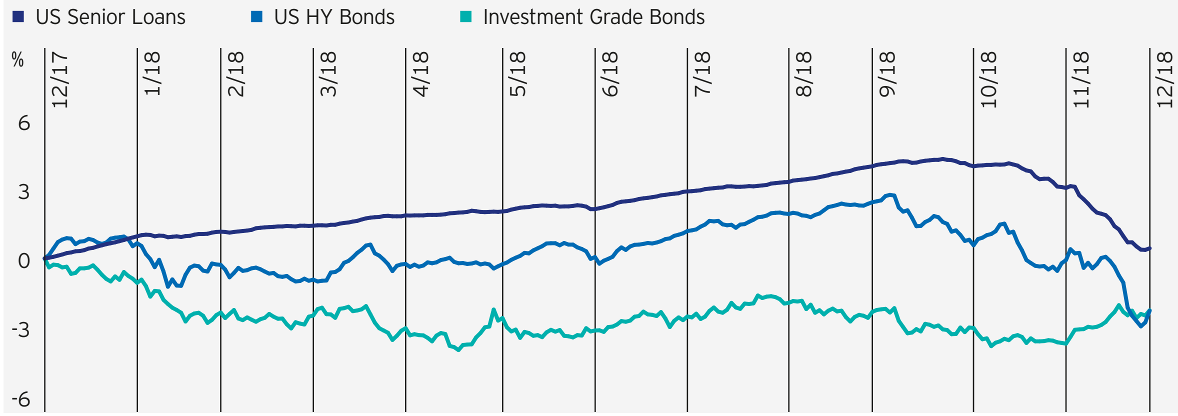
- Despite minimal levels of new issuance in December, outflows contributed a loose technical dynamic.
- Gross CLO volume was $8.4 billion in December, with $5.7 billion of issuance net of resets and refinancings. Gross and net new issuance for 2018 were $277.6 billion and $130.6 billion, respectively.[3]
- Retail mutual funds and ETFs reported an outflow of -$9.9 billion[3] during the month. Outflows in November and December lowered 2018's total inflows to $737 million.
- New issuance volume was $8.3 billion in December, nearly all of which was related to acquisition activity. For the year, gross issuance was $704 billion, and was $302 billion excluding refinancing and repricing activity, an increase from $258 billion last year.[3]

Relative value/market opportunity

Despite sustained price declines during the fourth quarter, loans have bested high yield since the onset of market volatility at the beginning of October. This added to material year-to-date outperformance of loans versus high yield of +2.70%, while maintaining loans' outperformance versus investment grade of +2.69%.[4] As in past episodes of elevated market volatility, weakness in high yield eventually does impact demand for loans as changing spread differentials alters the relative value consideration for crossover investors, and as high yield funds tend to liquidate loan holdings to raise cash for redemptions. However, this weaker market technical is misaligned with the stable credit fundamentals underpinning loan issuers, and has caused many performing credits to trade moderately below par.

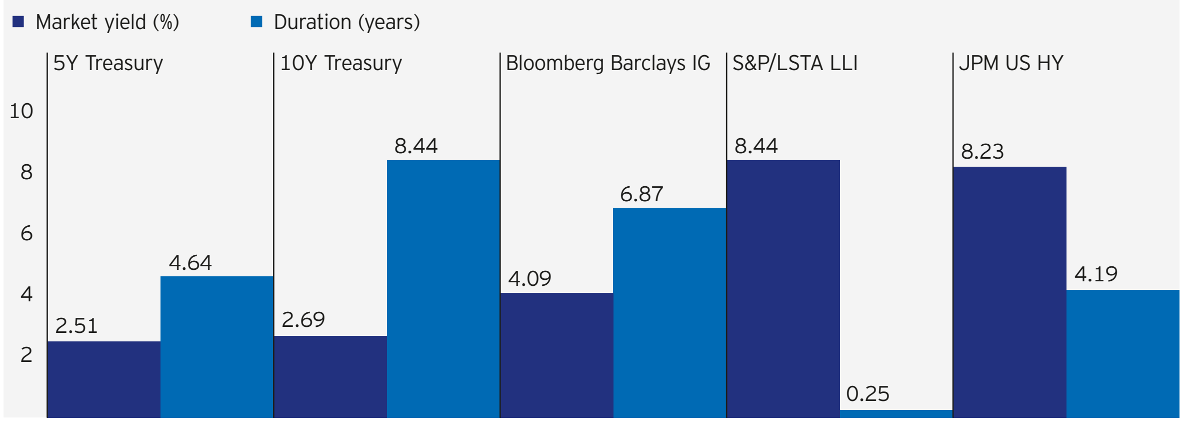
Adding to the selling dynamic in recent months has been retail investors' belief that loans have become less attractive as expectations for future rate increases have diminished. While coupon accretion stemming from base rate increases is likely to slow relative to 2018, loans continue to offer a compelling high return / lower volatility opportunity for investors harboring concern about the maturation of the US economic growth cycle. As illustrated throughout a volatile 2018 for risk assets, loans' senior secured status helped stabilize the asset class in the face of higher market volatility, enabling loans to decouple from broader credit markets to a degree. The defensive positioning within issuers' capital structures has served investors well historically from a risk adjusted return perspective and should continue to insulate the asset class from volatility that may arise in 2019. To the extent that technical weakness dissipates and the loan markets' solid fundamentals come back into focus in 2019, recent price weakness could develop into a significant opportunity for long-term minded loan buyers. A truncated pipeline of expected defaults in the year ahead indicates that recent loan market indigestion has created a degree of mispricing not seen since early 2016, a year that ultimately delivered above average loan market returns.

Loans have significantly outperformed during 2018
2018 total returns



Source: Bloomberg L.P. as of Dec. 31, 2018. US Senior Loans represented by S&P/LSTA Leveraged Loan Index; US HY Bonds represented by BAML US High Yield Index; Investment Grade Bonds represented by the BAML Investment Grade Index. Equities represented by S&P 500 Index. Returns shown are total returns in USD. **Past performance is not a guide to future returns.** An investment cannot be made directly in an index.

Loans offered investors a high level of current income with short duration



Source: Bloomberg L.P., Barclays, JP Morgan, and S&P LCD as of Dec. 31, 2018. **Past performance is not a guarantee of future results.** An investment cannot be made directly in an index.

Relative yield

	$ Price	Yield to worst (%)	Spread to worst	At forward Libor	Duration (years)
5 Year Treasuries	100-17	2.51	-	-	4.64
10 Year Treasuries	103-25	2.69	-	-	8.44
Bloomberg Barclays US Agg Index	100.09	3.28	T + 0.66	-	5.87
Bloomberg Barclays IG Index	99.50	4.09	T + 1.43	-	6.87
JPM US HY Bond Index	93.67	8.23	T + 5.67	-	4.19
S&P/LSTA Leveraged Loan Index[5]	**94.16**	**L + 5.51**	**T + 5.98**	**8.44%**	**0.25**

Source: S&P LCD, Barclays, JP Morgan and Bloomberg L.P. as of Dec. 31, 2018. Loan "spread to worst" and "at forward Libor" incorporate LIBOR forward curve as of Dec. 31, 2018.

1 S&P 500 Index as of Dec. 31, 2018
2 S&P/LSTA Leveraged Loan Index as of Dec. 31, 2018
3 JP Morgan as of Dec. 31, 2018
4 S&P/LSTA Leveraged Loan Index and Bloomberg as of Dec. 31, 2018. High yield represented by BAML US High Yield Index; investment grade represented by the BAML Investment Grade Index.
5 S&P LCD as of Dec. 31, 2018
6 S&P LCD and Invesco as of Dec. 31, 2018

Important information

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