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US senior secured loan market: 2015 review and 2016 outlook

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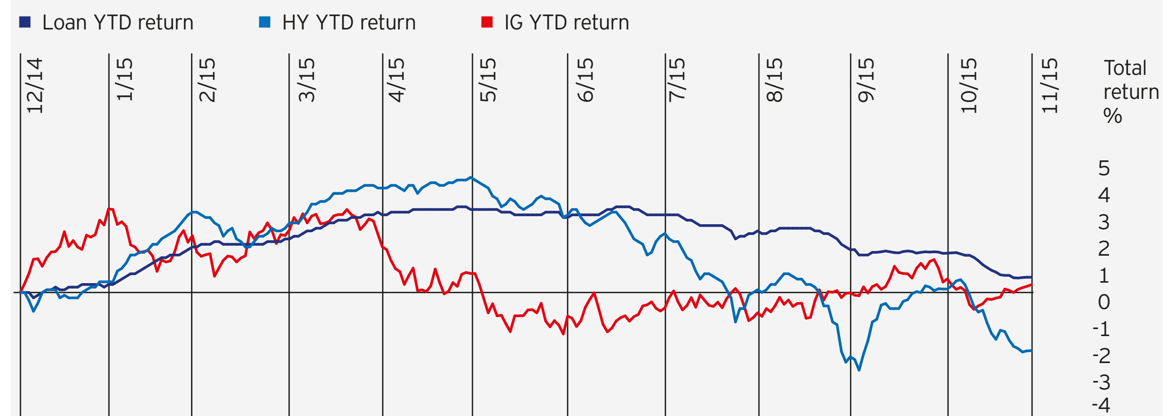
Entering 2016, we remain constructive of the senior secured loan asset class. Despite the asset class' underperformance versus our expectations in 2015, the volatility-adjusted performance was compelling in our view as loans were relatively insulated from the broader macroeconomic headlines that profoundly impacted other "risk" asset classes. This theme of reduced volatility has been consistent in the post-Global Financial Crises era. Loans' senior position in the capital structure, secured status, short duration, and limited commodity exposure (4.7%)[1] have positioned the asset class defensively against some of the key risks influencing performance in 2015 - mainly the potential for elevated defaults as well as the potential for an increasing interest rate environment.

Loans have provided relatively stable returns despite border market volatility



Source: Credit Suisse as of Nov. 30, 2015. Loans represented by the Credit Suisse Leveraged Loan Index; HY represented by the Credit Suisse High Yield Bond Index; IG represented by the Credit Suisse Liquid US Corporate Index.

We anticipate that loans' defensive positioning, particularly as it relates to increasing interest rates, will benefit the asset class when compared to fixed interest rate alternatives. The first rate liftoff has occurred and the path to normalization is likely to be at a slow and methodical pace. The US Federal Reserve (Fed) has specifically highlighted 3 parameters that will contribute to its interest rate policy: (1) healthy GDP growth, (2) low unemployment, and (3) healthy inflation. The combination of these factors are key contributors to a healthy macroeconomic underpinning and a benign default environment for below investment grade corporations. We anticipate returns for the asset class of 5-5.5% in 2016, largely driven by the coupon and little benefit from price appreciation.* There is potential for upside to our estimate from capital appreciation, but we are hesitant to expect appreciation due to the general "risk off" tone that has permeated the capital markets.

1 Credit Suisse Leveraged Loan Index, as of Nov. 30, 2015
*The anticipated return is not guaranteed

The dynamics that occurred in 2nd half of 2015 have created an opportunity to enhance our base case assumption and are expected to be a strong influence on return expectations: (1) pockets of weakness weighed on the market- especially in commodity-related sectors (2) bifurcation of performance across the risk spectrum as higher quality "BB" rated loans outperformed lower quality "B" and "CCC" rated issues (3) new issues priced wider than historical averages resulting in a recalibration of secondary prices/ spreads and (4) a weaker technical backdrop pushed spreads wider. We believe the confluence of these factors has created an opportunity for loans, especially for investors utilizing the loan asset class as a long-term strategic allocation.

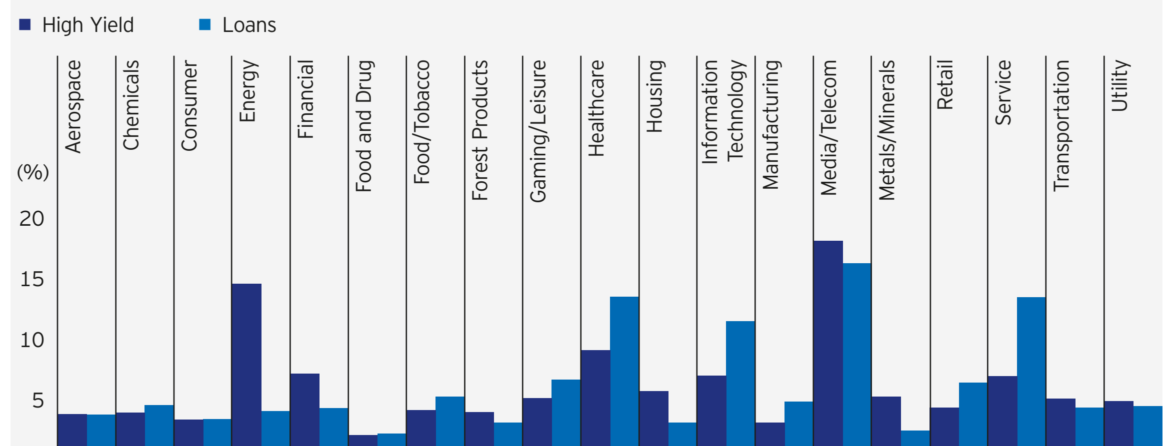
We believe loans are well positioned - offering spreads above of historical averages while also being currently attractively valued, in our opinion. The current discount and elevated spreads imply a default rate in excess of our expectations. We anticipate that defaults will remain below historical averages. Additionally, loans issued toward the second half of 2015 have been accretive to portfolios - pricing at spreads far in excess of historical averages. As of the end of November, BB-rated deals priced at spreads 90bps wide of their historical average and B-rated new deals priced over 150bps wide of their historical average. At current levels, with the average price in the loan market at $92.90[2], we believe there is potential for upside to our return estimate.

Fundamentals

We anticipate credit risk to be a big focus in the 2016 as investors remain vigilant and the appetite for riskier deals is met with resistance. The fundamental environment remains generally healthy for loans as slow but positive GDP growth rate is supportive of a benign default rate. Issuers in general have used the last few years to strengthen balance sheets- improving profit margins, generating strong free cash flow, refinancing debt at cheaper rates, and deleveraging. We believe the probability of a recession- the primary driver of elevated defaults- remains low. Pockets of weakness have emerged- particularly in commodity related sectors as companies attempt to rationalize costs structures in order to adapt to the new price climate. We've also seen weakness in the retail sector as consumer behavior has shifted toward spending on autos, homes/households, and experiences rather than traditional retail clothing. More broadly, fundamentals remain relatively strong.

Energy and commodities remain a big question heading into 2016 and are expected to heavily influence the overall market return and default expectations. Exposure to commodities is relatively low for the loan asset class at only 3.15% for energy and 1.5% for metals and mining.[1] We believe that some positions in the sector trade below fair value and could provide upside from currently levels.

CS Leveraged loan index vs. CS high yield bond index exposure



Source: Credit Suisse as of Nov. 30, 2015

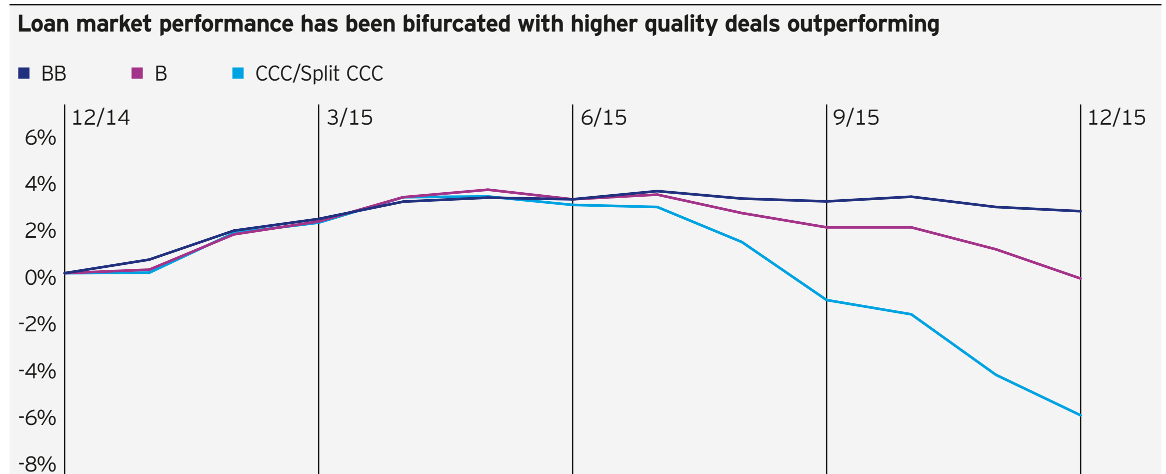
Our outlook for defaults remains in the 2-2.5% context as few catalysts exist on the horizon. In order to induce a default, there needs to be a catalyst- either (1) the company cannot service its debt or (2) the company cannot refinance debt at maturity. Digging further into those catalysts, there is a dearth of near term maturities with only 1.4% of the market maturing in 2016.[2] We expect defaults to be heavily influenced by energy and commodity related names- and with exposure to troubled sectors muted, we think defaults should remain below the long term average of 3.1%.[2]

1 Credit Suisse Leveraged Loan Index, as of Nov. 30, 2015
2 S&P LCD, as of Nov. 30, 2015

Technicals

Throughout most of 2015 technicals were stable- benefiting from supportive CLO issuances and institutional allocations offsetting outflows from retail mutual funds. Technicals weakened in the concluding months of the year as CLO demand slowed and the typical buyers of lower quality deals (i.e. hedge funds, distressed funds) were hesitant to deploy incremental risk in-light of the broader capital market volatility and losses taken in the energy sector early in the year. General risk aversion led to a bifurcation of performance across the rating spectrum as shown in the chart below with higher quality "BB" rated issues outperforming the lower part of the credit spectrum.

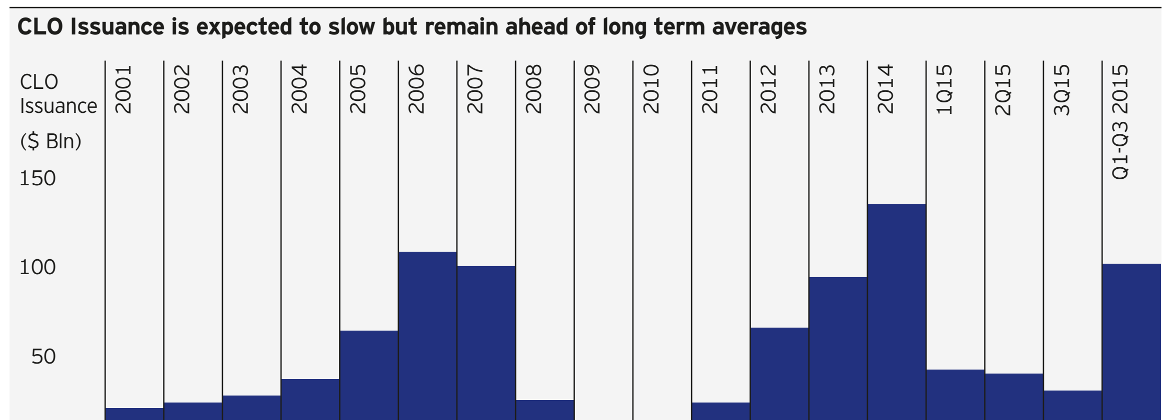
Loan market performance has been bifurcated with higher quality deals outperforming



Source: Credit Suisse as of Nov. 30, 2015. Loans represented by the Credit Suisse Leveraged Loan Index.

CLO issuance of $103 billion through the end of November slowed from last year's record pace of $124 billion but remained well above historical long term averages. Our expectations for next year are for CLO issuance to normalize at ~$50-$70 billion as new regulations become effective requiring CLO managers to retain ownership in each new transaction. Despite the expected slowdown, levels should be in line with other periods of healthy technical conditions. We expect CLO issuances as well as demand from institutional accounts to remain the cornerstone of the loan investor base.

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



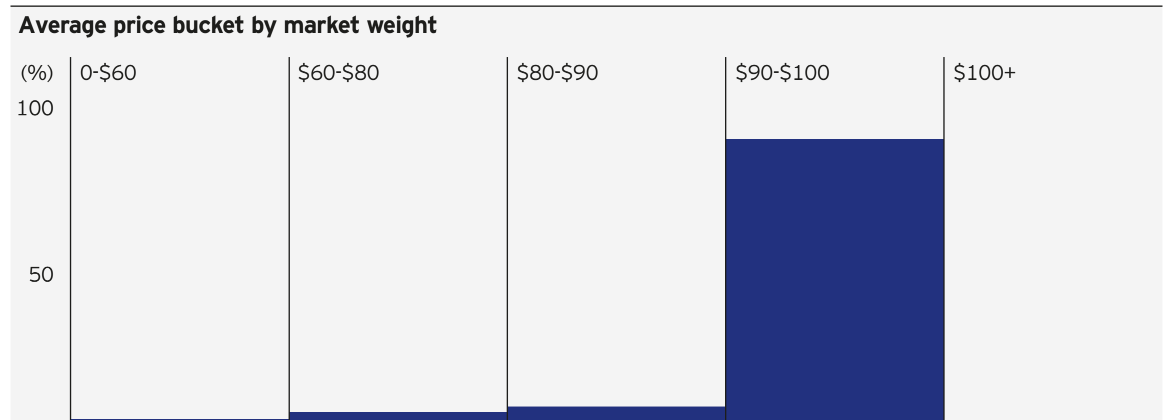
Source: S&P LCD, data from January 2001 through September 2015

Outflows from retail mutual funds have been elevated since early 2014. The loan asset class has reported outflows from retail mutual funds for 18 of the last 20 months totaling $46 billion during that period.[1] Year to date outflows have totaled $14.7 billion.[1] We find this trend surprising given the diversification benefits of the loan asset class and the fact that institutional investors have taken the opposite tact, moving heavily into loans during this same period. We don't think this trend of outflows is likely to reverse until there is more clarity around the pace of the continued US interest rate increases during the mid-part of 2016. Incremental demand or even the stabilization of retail outflows could provide potential upside to return expectations.

1 J.P. Morgan as of Nov. 30, 2015

The weaker fundamentals in just a few sectors, exasperated by lack of buyers, particularly in the lower quality "B" and "CCC" rated issues, have led to an uneven dispersion of prices in the market. Relatively small "pockets of weakness" in the lower quality spectrum have dragged down the average price in the market. The average price in the market is $92.90, but excluding the energy sector, the average price is $94.20.[1] The vast majority of the market still trades above $90, as shown in the table below.

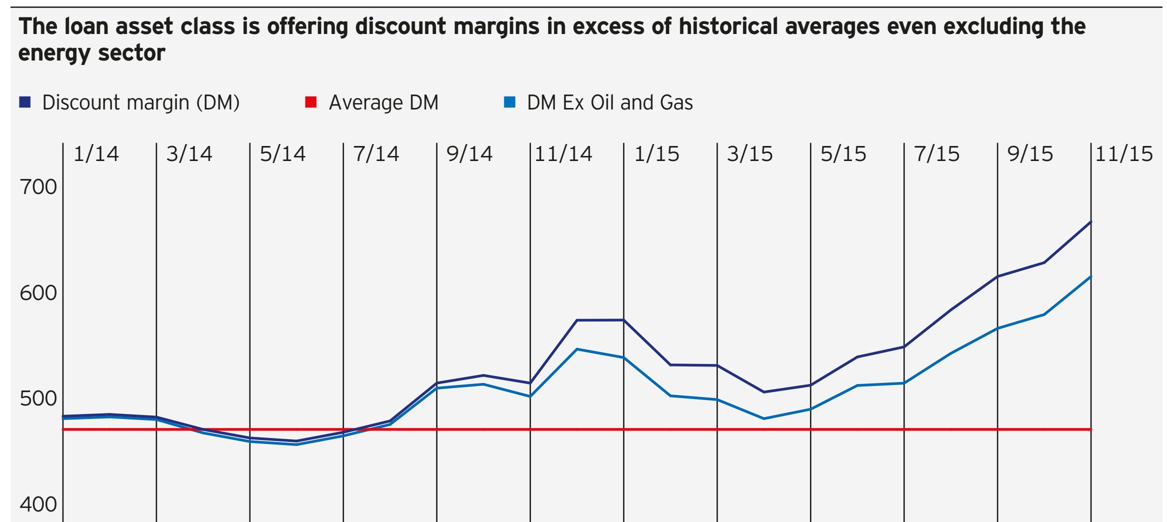
Average price bucket by market weight



Source: Credit Suisse as of Nov. 30, 2015. Market weight as represented by the Credit Suisse Leveraged Loan Index.

The market corrections have pushed discount margins on new issue transactions as well as discount margins in the secondary market to levels wide of historical averages as shown in the table below. We believe that despite the headwinds that will carry into 2016, the underpinnings of the loan market remain supportive. We believe loans remain well positioned to provide a relatively high level of current income, with short duration and potential for price appreciation due to the discounted prices.

The loan asset class is offering discount margins in excess of historical averages even excluding the energy sector



Source: S&P LDC as of Nov. 30, 2015. Loan asset class represented by the S&P LSTA Leveraged Loan Index. Average DM represents the periods Jan. 31, 2000 to Nov. 30, 2015, excluding 2008-2009, as this period of very high volatility and severe market dislocation does not represent normal market activity.

1 S&P LCD, as of Nov. 30, 2015

Important information

All data provided by Invesco unless otherwise noted. Data as of Dec. 18, 2015, 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.

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