Dis-Loan-Cation: Today's Bank Loan Market

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by Team
of Pacific Funds

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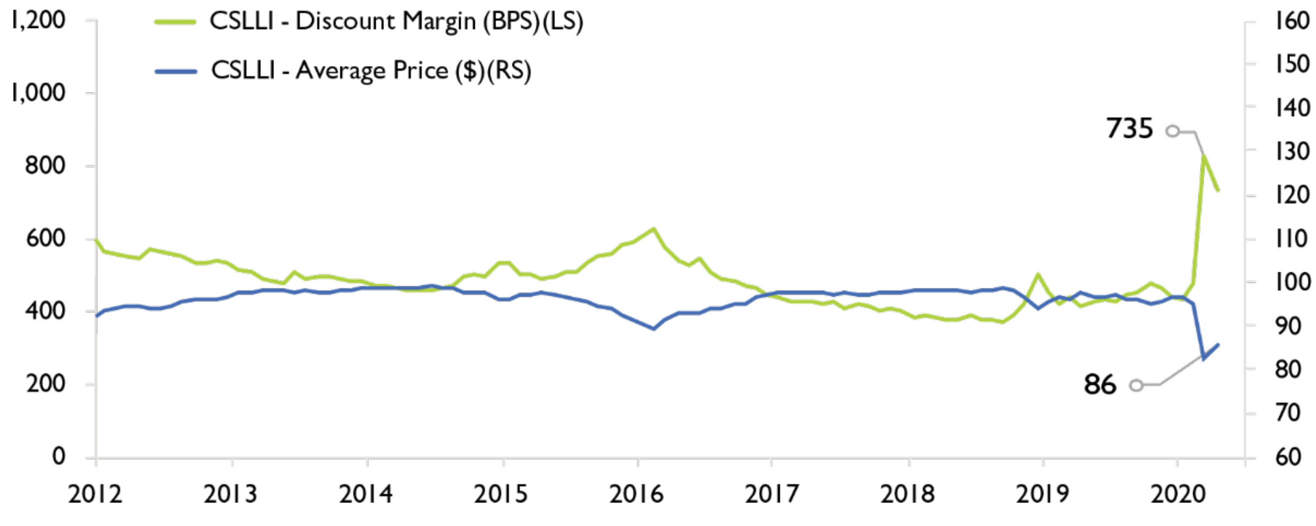
March saw the greatest level of credit-market volatility since the Global Financial Crisis (GFC). Despite the improvement in prices in April and in May, valuations across credit markets remain historically attractive as investors assess the short- and long-term effects of this global pandemic. In this commentary, we focus on potential bank-loan opportunities and risks.

The novel coronavirus' impact on economic activity and capital markets led to the second worst quarterly return in bank-loan history (worst quarter was fourth quarter of 2008). The market drawdown peaked on March 23, with the average price of the Credit Suisse Leveraged Loan Index hitting $76, resulting in a 4-year effective yield of 12%. The selloff was exacerbated by the weak technical environment, which saw significant outflows from loan mutual funds. Already weakened sectors, such as energy and retail, and more Covid-related sectors, such as travel and leisure, saw the steepest declines. The last week of March saw a comeback, regaining almost half the March losses as stabilizing fiscal and monetary policy, along with severely oversold conditions, set the stage. April saw a modest improvement in prices, with some of the distressed areas recovering. In April, the benchmark returned 4.29%, bringing year-to-date returns to -9.46%

Chart 1: Bank-loan prices moved to 2009 levels with a swiftness not seen even during the GFC



Source: Credit Suisse, as of April 30, 2020

Given our focus on larger companies, it was interesting to note the outperformance of large-cap issuers during the March selloff. Larger issuers outperformed, despite their greater degree of liquidity, as the selloff was both technical and fundamental. Year-to-date through April, loan/facility sizes over $1 billion returned -8.29% versus loan/facility sizes $200-300 million returning -11.92%

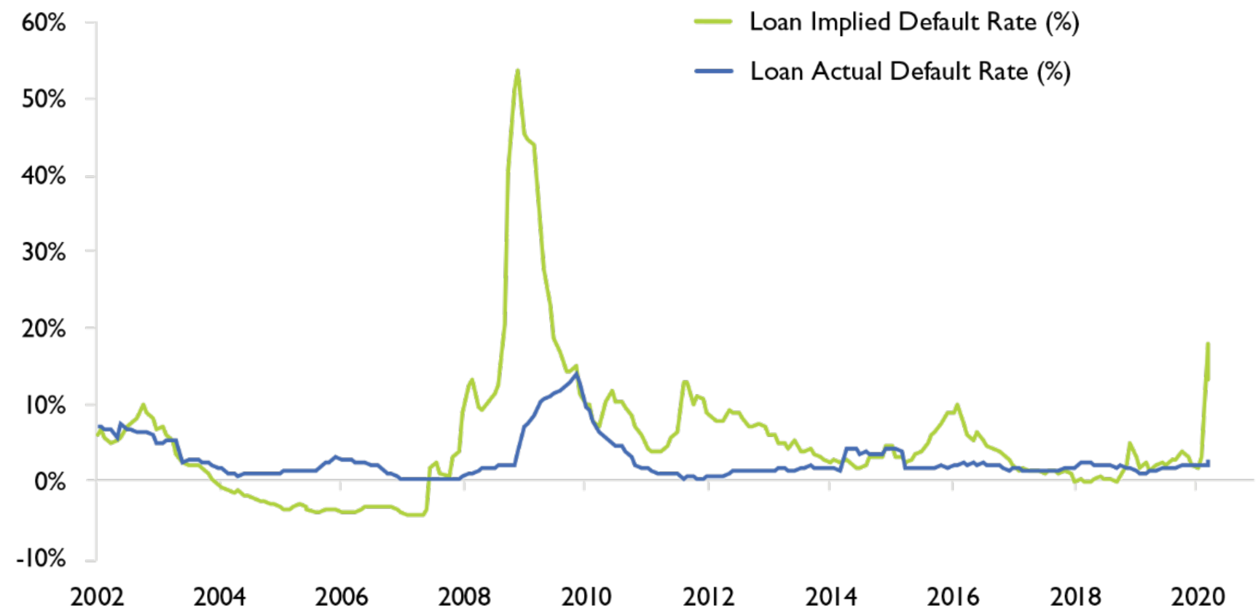
Current valuations

With extraordinary fiscal and monetary responses supporting capital markets, technical conditions also improved, resulting in a firm April and May. This brought the average dollar price of the Credit Suisse Leveraged Loan Index to $86, with a 4-year effective yield of 7.90%. Despite the rally, this continues to be a historically wide valuation (Chart 2). We also like to use implied default rates as a yardstick for valuations. As of May 15, implied defaults stood at 13%, pricing in this annualized default rate for the next several years. To put this implied rate in perspective, realized defaults in 2009 peaked at 13.3%, with the average default rate over the three years (2009-2011) at 5.71%. This high implied default rate is indicative of the continued downside currently priced into the bank-loan market.

Chart 2: Discount margins (spreads) remain historically wide

Source: Credit Suisse, as of April 30, 2020

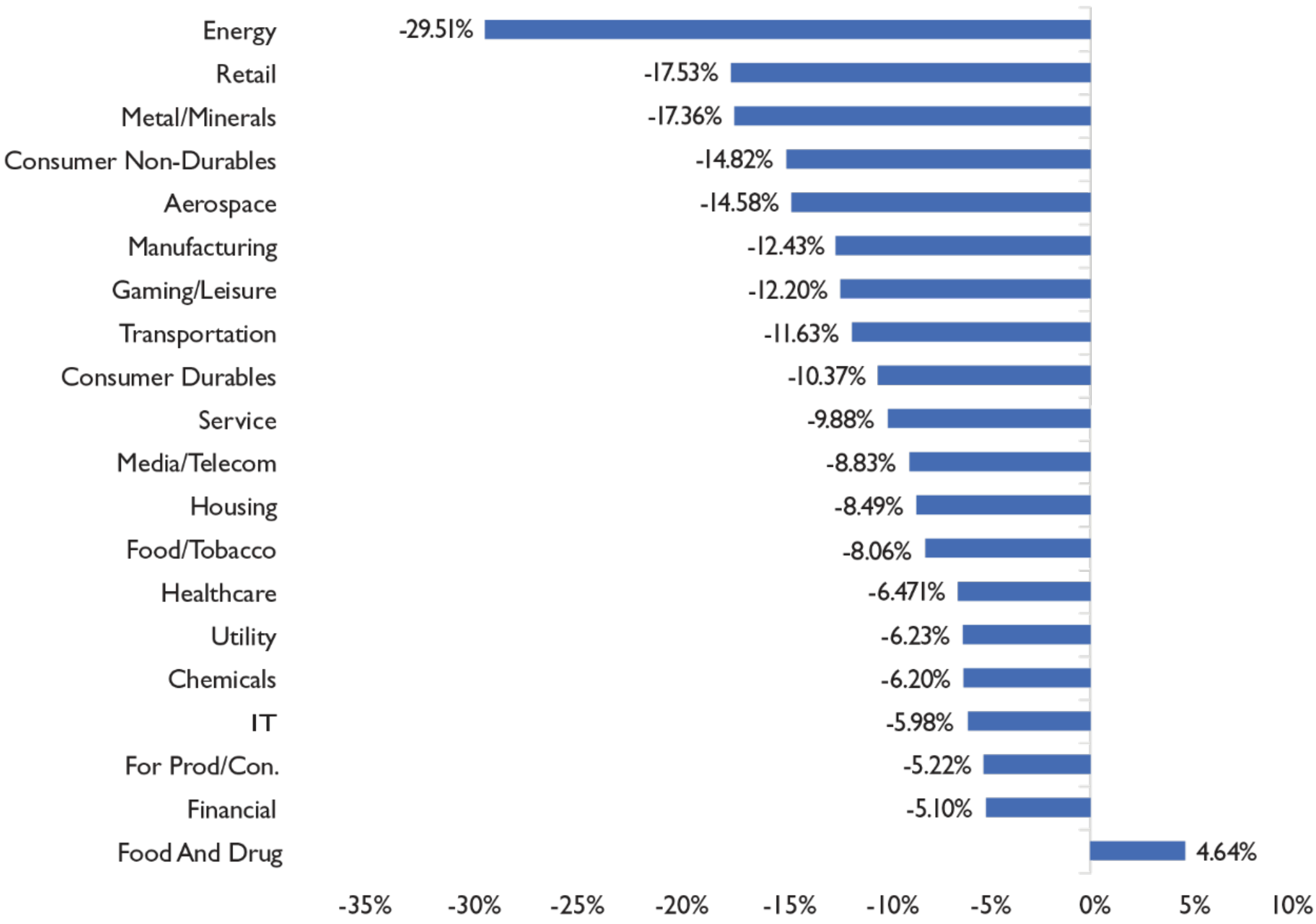
Chart 3: Implied default rates (13% annualized) are indicative of the downside being priced into the loan market



Source: JP Morgan, as of April 30, 2020

While there has been improvement in bank loans since the March 23 low, sector dispersion shows the impacts from the novel coronavirus on earnings of many "Covid-19 sectors." Industries that have seen material impairments and impacts from government shutdowns have continued to lag less-cyclical sectors. The two most impacted sectors have been energy and retail, two sectors entered this volatile period already weakened from technological changes and consumer habits.

Chart 4: Sectors most exposed to the global shutdown have been the hardest hit

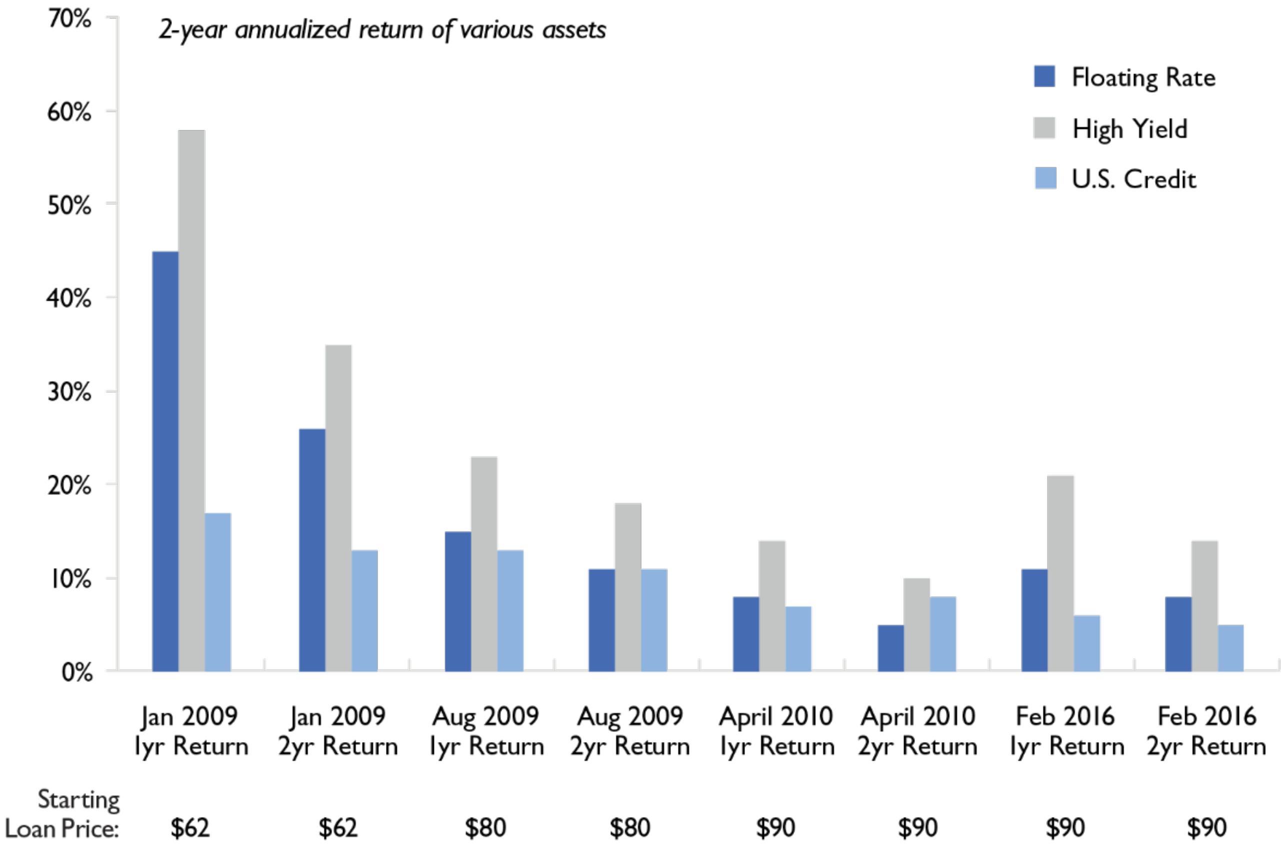


Source: Credit Suisse, as of April 30, 2020

Risks and opportunity today

We believe bank loans provide an attractive opportunity and relative value here. Current implied default rates are in excess of what we believe will be realized. Historically, index prices below $90 have meant strong total returns over the next several years as markets normalize and loans “pull to par.” As shown in Chart 5, bank loans have provided attractive risk-adjusted total returns as compared to other markets.

Chart 5: Bank loans have produced attractive returns when dollar prices have fallen below $90



Source: Credit Suisse, Bloomberg Barclays

Second, we believe there is a relative-value case for loans as compared to several other areas of credit. Historically, high-yield bonds have averaged yields 1% above bank loans given their junior positions in the capital structure. Today, high-yield bonds and bank loans have virtually similar yields (Table 1). In our view, several factors are driving this yield anomaly, such as record setting inflows to high-yield mutual funds, the significant fallen angels reducing overall yields, and the Federal Reserve's inclusion of high yield ETFs into the Secondary Market Corporate Credit Facility (SMCCF). Even more interesting is that excluding energy, high-yield bonds yield 0.75% less than bank loans. *Bank loans have limited exposure to the energy sector relative to high yield (3% versus 11%), meaning one does not have to make an investment in energy with a bank-loan allocation.*

It is important to note that distressed companies in both bond and loan asset classes contribute materially to index yield. For example, loans trading at an average price between $60 and $80 make up 12% of the market weight of the index and carry a yield of approximately 13.75%. *Given our focus on performing loans, our underweight to distressed issuers means a likely lower-than-index yield for Pacific Funds[SM] Floating Rate Income.*

Table 1: Similar yields for greater seniority stand out for loans versus high-yield bonds

Index	Yield
CSLLI 4 Year Effective Yield	7.90%
US Corporate HY Index YTW	8.05%
US Corporate HY Index (ex. Energy) YTW	7.15%

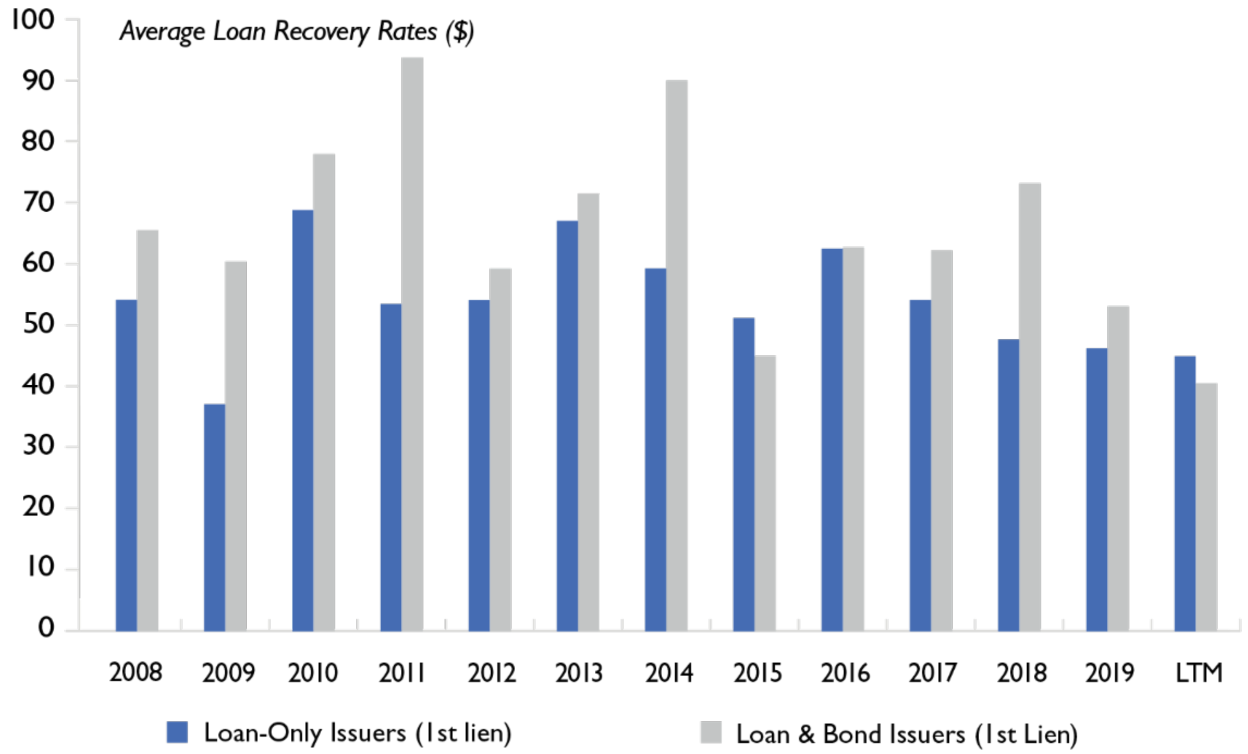
Source: Credit Suisse, Bloomberg Barclays, as of April 30, 2020

A discussion of the opportunity would not be complete without the risks, notably technicals, recoveries, and LIBOR.

We believe technicals for the asset class remain a headwind in the near-term. Bank-loan mutual fund outflows and lack of collateralized loan obligation (CLO) origination (which accounts for roughly 50% of new issue demand) means a weaker bid for new issuance. Recent developments that include AAA[1] CLOs and possibly other parts of the CLO market into the SMCCF may provide a welcome spark to reigniting CLO issuance and improvement in new issue bank-loan demand.

Recoveries will not be the same as prior cycles, meaning managers unable to avoid defaults may have greater downside risk than in the past. Historically, bank-loan recovery rates have averaged approximately 70% since 1992. In this recession, we believe average recoveries may likely be in the 55-65% range with a high level of dispersion. While we do not believe default rates will reach the 13% levels currently implied, we believe default scenarios in the loan market will range from 5-10%. *We believe this is critical in our approach to the asset class–avoiding defaults and workout situations is more important than ever given the lower level of recoveries*

Chart 6: Recovery rates have been falling as more covenant lite and loan only capital structures come to market



Source: JP Morgan, as of April 30, 2020

Lastly, floating-rate securities pricing off LIBOR hold two challenges in the medium-term. First, with LIBOR currently less than 0.50% and likely to move lower as funding markets normalize, this will put downward pressure on coupons. Currently, almost all bank loans have 0% or higher LIBOR floors versus the 1% LIBOR floors seen in 2013-2017. While we expect new issuance going forward to see the return of the 1% floor, this remains uncertain and a possible headwind for coupons. Additionally, the future of LIBOR as a reference rate is highly uncertain, with the market discounting SOFR (Secured Overnight Financial Rate) as its possible replacement. Market consensus for the transition remains elusive however, and the timing of any changes is likely more distant than anticipated.

Our approach, balancing the risks and opportunities

We believe the March selloff in bank loans was overdone, and the limited recovery seen in April and May provides an attractive entry point. We are cognizant of the risks, especially as it pertains to the length and severity of the economic impact. We are also mindful that for many sectors, the possibility and probability of companies' earnings returning to previous levels are difficult to assess. We believe a defensive positioning in the sectors at risk from the novel coronavirus remains warranted. As a result, we are cautious on leisure, travel, retail, and energy. Since our inception in 2007, we have managed our bank-loan strategy with a straightforward and understandable framework: A selective approach focused on larger issuers with an emphasis on downside risk. We continue that mandate, seeking to avoid deteriorating credits and honing in on large-cap companies with balance sheets and levers to pull in order to manage through this volatility.

[1]Ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest).

Learn more about Pacific Funds Floating Rate Income

Bloomberg Barclays U.S. Corporate High Yield Index represents the U.S. dollar-denominated, high-yield, fixed-rate corporate bond market.

Covenant-lite loans are a risky type of corporate debt that have fewer stipulations to protect the lender and fewer restrictions on the borrower regarding payment terms, income requirements and collateral.

Credit Suisse Leveraged Loan Index is designed to mirror the investable universe of the U.S. senior secure-credit (leveraged-loan) market.

Effective yield is the measure of return that includes interest payments reinvested and represents the total yield an investor receives.

Fallen angels refers to investment grade bonds that are given a reduced rating to "junk bond" due to a decline in the credit rating of the issuer.

LIBOR (London Interbank Offered Rate) is the benchmark reference for interest rates that banks charge each other for debt instruments and loans.

Pull to par refers to the price movement towards face value as the maturity date approaches.

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Growing Opportunities in Credit

About Principal Risks: All investing involves risks including the possible loss of the principal amount invested. There is no guarantee the Fund will achieve its investment goal. Corporate bonds are subject to issuer risk in that their value may decline for reasons directly related to the issuer of the security. Not all U.S. government securities are checked or guaranteed by the U.S. government, and different government securities are subject to varying degrees of credit risk. Mortgage-related and other asset-backed securities are subject to certain rules affecting the housing market or the market for the assets underlying such securities. The Fund is subject to liquidity risk (the risk that an investment may be difficult to purchase, value, and sell particularly during adverse market conditions, because there is a limited market for the investment, or there are restrictions on resale) and credit risk (the risk an issuer may be unable or unwilling to meet its financial obligations, risking default). High-yield/high-risk bonds ("junk bonds") and floating-rate loans (usually rated below investment grade) have greater risk of default than higher-rated securities/higher-quality bonds that may have a lower yield. The Fund is also subject to foreign-markets risk.

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