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December 2020 Leveraged Finance Update

High Yield And Loan Market Recap

As 2020 began, investors were mostly concerned about tight risk premia and absolute low levels of yield in the 11th year of a bull market cycle. After the spread of COVID and its life-threatening risks became truly apparent in late February, capital markets swiftly sold off and credit access froze. In response, global central banks moved quickly to expand quantitative easing programs, while governments enacted massive fiscal stimulus programs to stabilize economies and buffer unemployment. In the U.S., the 10-year Treasury yield dropped from 1.57% on 2/19 to 0.54% on 3/9 as investors flocked to safe assets backed by the U.S. dollar. After the Fed announced its Secondary Market Corporate Credit facility (SMCCF) on 3/24 to buy Investment Grade bonds, investor confidence returned, promoting a massive recovery in financial assets. By year-end 2020, High Yield (HY) and Leveraged Loans (LL) yields reached all-time lows. The HY market finished 2020 with a 4.24% YTW, while LL ended at a 5.10% YTW.

The final month of 2020 saw continued positive returns for HY (+1.91%) and Loans (+1.3%). During 2020, HY was +6.17% and Loans were +2.78%. Returns within the asset classes swung wildly: in March, HY was -20.56% YTD while Loans were -19.76%. Fiscal and monetary stimulus helped HY stage a 33% comeback and Loans managed a 28% rally from the lows to post a respectable year. Within HY, BBs led the performance for the first three quarters with an +8.62% return until 4Q20 when increased risk appetite spread to lower-rated segments. Higher risk CCC-rated bonds were +12.19% in 4Q20 to finish the year at +2.58%. CCC-rated LL were +5.39% and had the strongest returns in 2020, while single-B and BB-rated LL trailed with +3.16% and +0.3%, respectively. The difference between credit buckets within HY and LL is surprising, but Treasury rates have demonstrated they are a powerful driver of returns.

There was significant performance diversion for credit issuers whose businesses were either inadvertent victims or beneficiaries from consumer adaptations in the new COVID environment. HY Entertainment/Film returns were -24% for 2020 while Food & Drug/Retail returns were +16%, a difference of 42%. In LL, Energy underperformed with a -7.3% return for 2020 while investors flocked to Food & Drug/Retail (+17.6%) as the sector benefited from abnormally high earnings due to panic buying/hoarding.

Interestingly, new issuance was incredibly strong and skyrocketing default rates never materialized in 2020. These factors are connected. As the Fed intervened in the IG credit market with the SMCCF and spreads quickly compressed, investors were forced to move further out the risk curve into HY to achieve greater income. With stronger demand for HY, the new issue market quickly reopened and remained extremely active throughout 2020. The HY new issue market was +62% y/y in 2020 with $405B of deals priced. As HY new issue demand remained intense, investors provided significant liquidity to companies during a period of heightened uncertainty, allowing companies to refinance debt and keeping default rates lower. LL gross issuance was $288B in 2020, -7% y/y and -34% from 2018. Default rates ended 2020 at 6.15% for HY and 3.79% for LL.

Relative Valuation In High Yield and Leveraged Loans

Any analysis in HY and LL valuation naturally includes concerns surrounding absolute yield levels in the current low interest rate environment. However, HY and LL still screen attractively based on relative valuation. The alternatives for yield include a 0.92% yield for the 10-year U.S. Treasury, the Barclays Aggregate Index yield at 1.12%, and the US IG corporate index yield of 1.78%. While they may appear initially low, the HY index at a 4.24% YTW and LL at a 5.10% YTW provide attractive incremental income, especially as corporate issuers focus more on repairing balance sheets after increasing leverage for liquidity purposes during 2020. On a spread basis, the asset classes still screen attractively as seen in the table below.

	12/31/2019	12/31/2020	Change	Median Since Inception
HY Spreads				
HY BB-B Index	372 bps	390 bps	***18 bps wider***	**489 bps**
BB-Rated	213 bps	281 bps	***68 bps wider***	**326 bps**
B-Rated	370 bps	422 bps	***52 bps wider***	**503 bps**
CCC-Rated	1,012 bps	804 bps	***208 bps tighter***	**991 bps**
LL Spreads				
CS LL Index	461 bps	486 bps	***25 bps wider***	**452 bps**
BB-Rated	262 bps	305 bps	***43 bps wider***	**305 bps**
B-Rated	470 bps	469 bps	***1 bps tighter***	**490 bps**
CCC-Rated	1,365 bps	1,167 bps	***198 bps tighter***	**1,074 bps**

Source: Credit Suisse, ICE BAML

Companies are carrying large cash balances as a safeguard against further reductions in business activity, and many cut significant costs during the onset of the pandemic, which could lead to greater free cash flow generation as the recovery gains steam. Corporate EBITDA and profitability will grow in 2021 from the gradual economic re-opening as vaccines are more widely distributed, allowing for greater consumer and business confidence. These dynamics will likely reduce new issuance activity in HY, providing a potential tailwind for additional spread compression.

Loans are likely to continue drifting up to par. CLO equity should be an outperformer in 2021 as the economy continues to heal, lifting credit and providing reasonable returns for investors. Private equity is already resuming M&A activity, which will require financing in the LL market. Demand for floating rate products should begin to increase as fears over higher inflation from the economic recovery become more prevalent.

We believe the current accommodative monetary and fiscal policies will require diligent individual credit selection through bottoms-up fundamental analysis. Many individual credits have already optimistically discounted a healthy recovery. Markets benefited in 2020 from the rising tide of Fed intervention and investor willingness to look through near-term weakness. We suspect the market will become more discriminating and not just blindly reach for yield in 2021. We will continue to look for idiosyncratic opportunities where we believe intrinsic values have been dislocated by the market.

CLO Market Update

It was the tenth straight year of double-digit CLO equity returns in 2020. CLO equity delivered +11.3% cash flow returns (data through 10-28-20 for CLOs reporting an October 4Q payment date). The performance is even more noteworthy considering the tenth year coincided with a global pandemic that largely shut down economic activity in North America and its capital markets for a portion of the year. This run of double-digit performance across vintages reinforces the stability and merits of the asset class to deliver returns during volatile periods. The downgrade of U.S sovereign ratings from AAA in August 2011; the Chinese Yuan devaluation and a global oil price crash in 1Q16; the 4Q18 tariff concerns along with Federal Reserve rate hike impacts; and the 2020 COVID pandemic each occurred during this 10-year period.

Dissecting 3-year returns from 2018-2020 by highest and lowest 10% of issuer cohort factors for deal average spread (WAS), deal-weighted average credit rating (WARF), CCC-rated exposure, and industry diversification help further prove the robustness of the CLO structure. Each of these metrics helps describe manager style and how returns are extracted using the provisions and limitations within each CLO. The protections within the structure have not limited the ability of top CLO managers to shine. Of the 66% of CLOs that had reported as of 10-28-20, returns ranged from 0% to 41% as 95% of reinvesting CLOs maintained a payment to the CLO equity. The cash-on-cash returns varies minimally from just below +10% to low-teens. These small ranges clustered near a +10% cash flow return indicate an efficient structure that permits investment flexibility while protecting the constituents of the CLO capital structure.

BHMS Strategy Returns	Mo	QTD	YTD	Index
High Yield Composite Gross	2.28%	5.90%	8.77%	BHMS
High Yield Composite Net	2.26%	5.84%	8.53%	BHMS
Bank Loan Composite Gross	1.25%	3.50%	2.85%	BHMS
Bank Loan Composite Net	1.25%	3.47%	2.73%	BHMS
Asset Class	**Mo**	**QTD**	**YTD**	**Index**
HY Return	1.91%	6.48%	6.17%	ICE BAML HY Index
HY BB Return	1.55%	5.74%	8.62%	ICE BAML BB HY Index
HY B Return	1.70%	5.71%	3.66%	ICE BAML B HY Index
HY CCC Return	4.11%	12.19%	2.85%	ICE BAML CCC HY Index
Leveraged Loan Return	1.30%	3.64%	2.78%	CS Leveraged Loan Index
LL BB Return	1.06%	2.43%	0.30%	CS Leveraged Loan BB Index
LL B Return	1.29%	3.31%	3.16%	CS Leveraged Loan B Index
LL CCC Return	2.16%	9.47%	5.39%	CS Leveraged Loan CCC Index
HYG	1.96%	5.80%	4.50%	Ishares Iboxx High Yield
BKLN	1.52%	3.36%	1.47%	Invesco Senior Loan ETF
S&P 500 Return	3.84%	12.15%	18.08%	S&P 500
Russell 2000 Return	8.65%	31.37%	19.99%	Russell 2000 Index
CS Leveraged Equity Index	9.89%	29.19%	25.77%	CS Leveraged Equity Index
10yr Beg	0.84%	0.69%	1.92%	10yr Treasury
10yr End	0.92%	0.92%	0.92%	10yr Treasury
10yr Return	-0.58%	-1.91%	10.59%	10yr Treasury
	Beg Mo	**Beg Qtr**	**Beg Year**	**Ending YTW/STW**
HY YTW	4.72%	5.76%	5.41%	4.24%
HY BB YTW	3.54%	4.40%	3.85%	3.24%
HY B YTW	4.98%	6.00%	5.38%	4.45%
HY CCC YTW	9.47%	11.77%	11.80%	8.27%
HY STW	437	545	372	390
HY BB STW	312	403	213	281
HY B STW	472	574	370	422
HY CCC STW	918	1,154	1,012	804
LL YT3Y	5.47%	6.02%	6.27%	5.10%
LL BB YT3Y	3.59%	3.93%	4.29%	3.29%
LL B YT3Y	5.26%	5.70%	6.36%	4.92%
LL CCC YT3Y	12.37%	13.94%	15.29%	11.91%
LL ST3Y	522	579	461	486
LL BB ST3Y	333	369	262	305
LL B ST3Y	501	547	470	469
LL CCC ST3Y	1,213	1,371	1,365	1,167

Source: Barrow Hanley

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