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SEPTEMBER 2020 LEVERAGED FINANCE UPDATE

HIGH YIELD AND LOAN MARKET RECAP

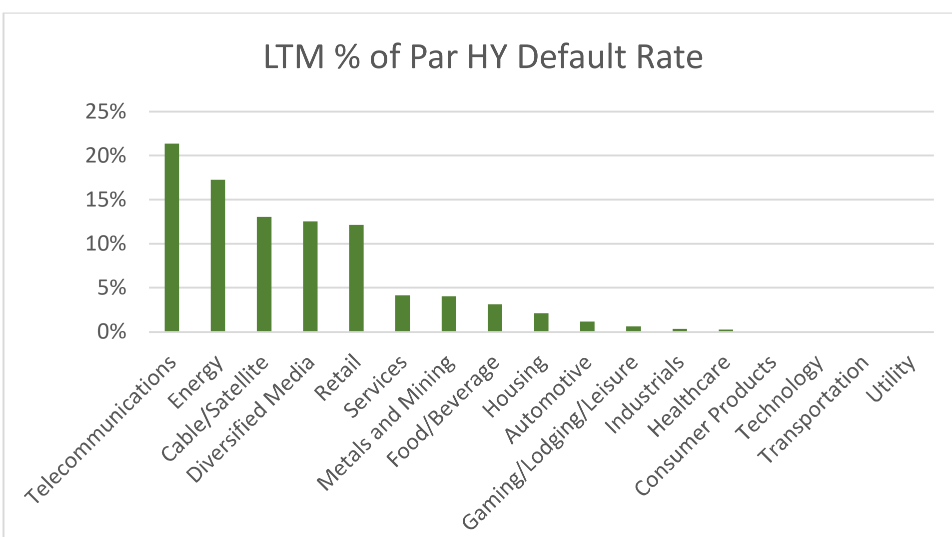
September broke a six-month run of positive returns for the High Yield (HY) market with HY bonds posting a -1.04% return. Leveraged Loans (LL) outperformed their bond counterparts, returning +0.69% for the month. HY issuance was strong with $45.5B of new supply but subsequent Mutual Fund and ETF outflows of $6B put downward pressure on returns as demand waivered. Additionally, in HY, Energy was the largest industry driver of underperformance, returning -4.3% for the month. Performance by rating tier within LL fell in line along the rating scale with CCC-rated loans returning +3.09% and highest quality BB-rated loans just barely reaching positive territory with a +0.11% return. Service and Information Technology materially contributed to LL performance; together, they account for nearly 25% of the index weighting and returned +1.14% and +0.61%, respectively.

HY and LL outperformed the S&P 500 during September, with equities posting a -3.8% return. This outperformance was most notable in the lower-rated loans. HY CCC-rated bonds returned +0.43%, and as noted above, CCC-rated loans returned +3.09% despite the risk-off trading in equity markets.

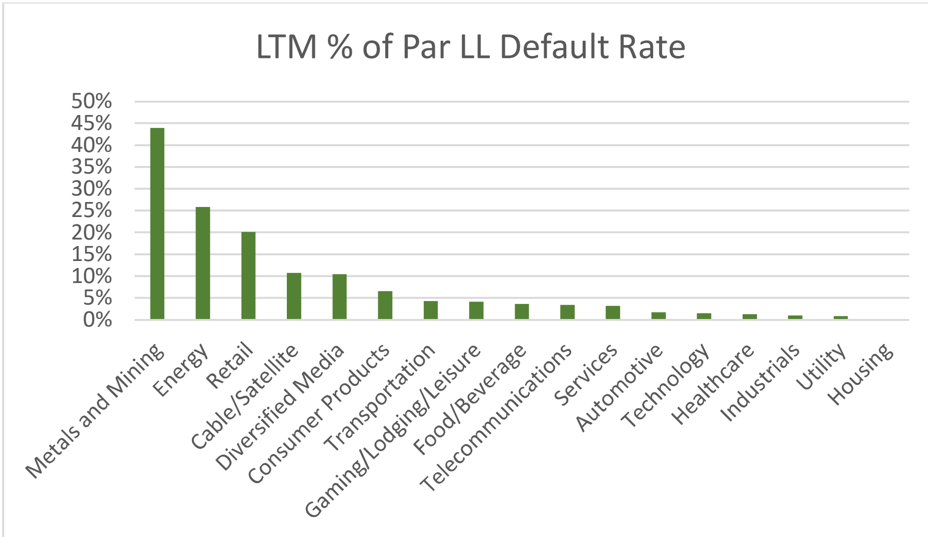
DEFAULT ACTIVITY

Default activity has meaningfully subsided over the past two months. The Federal Reserve continues injecting liquidity into the markets. With no indication of Fed support subsiding, forecasted default rates have come down. The combined HY and LL default rates stand at 5.49%, down from 5.53% at the end of August. Early forecasts for the 2021 HY and LL combined default rate are 3.5%, falling in line with historical averages.

In April through August, the pace of defaults in the HY and LL markets was averaging 20 companies. Capital markets, invigorated by Fed support, slowed this trend in August with only three companies defaulting. In September, we saw four companies default on their debt, representing $2.9B of market value. Two of the names were in the Energy sector and accounted for 70% of the defaulted amount. Year to date, Energy has accounted for 17.25% of defaults across HY and 25.83% of defaults in LL. We see Energy continuing to be an outsized portion of defaulted issuers in the months to come.



Source: JP Morgan



Source: JP Morgan

Single-name defaults can have an outsized impact on the trailing default rate. At times, it is informative to adjust these rates by excluding idiosyncratic situations. Reasons specific to industry or a company's balance sheet can result in an issuer struggling with debt loads for years before default. Two such defaults occurred this year in Cable/Satellite and Telecommunications subsectors with Intelsat and Frontier Communications. Both companies had been burdened with outsized debt for years: Intelsat had $14.5B in debt and Frontier had $17.5B. Adjusting default rates for the combination of HY and LL for these two companies, we see a 25% drop to 4.11% versus 5.49%. Once adjusted, the default rate is more in line with historical averages.

Rating Downgrades in the CLO Market

Downgrade activity has receded dramatically across the LL market. We have written in previous notes about the importance of the CLOs in the LL market with CLOs being the largest buyers of LL. Recent statistics point to a continued thawing of conditions for CLOs due to lower downgrade activity from the rating agencies. For background, CLOs have ratings-based tests to manage the loans held within their structure. If a CLO tranche exceeds the allowable weighting in lower-rated loans, it will be forced to mark a certain amount of the lower-rated loans at the lowest price. This dynamic could cause managers to sell lower-rated loans. In April, there was a high of 252 loan downgrades by S&P. By August, that number has fallen to twenty. The high number of downgrades resulted in 37% of BBB-rated CLO tranches and 55% of BB-rated CLO tranches being placed on "negative watch" by the rating agencies. As of late September, only 5% of each of the BBB-rated and BB-rated CLO tranches remain on watch. This reduction in downgrade activity will help lower financing costs for CLOs and drive continued demand for LL. This resurgence in demand will foster positive technical dynamics for the LL market.

BHMS Strategy Returns	Mo	QTD	YTD	Index
High Yield Composite Gross	-0.52%	5.03%	2.71%	BHMS
High Yield Composite Net	-0.54%	4.97%	2.52%	BHMS
Bank Loan Composite Gross	0.55%	4.22%	-0.60%	BHMS
Bank Loan Composite Net	0.55%	4.19%	-0.68%	BHMS
Asset Class	**Mo**	**QTD**	**YTD**	**Index**
HY Return	-1.04%	4.71%	-0.29%	ICE BAML HY Index
HY BB Return	-1.42%	4.17%	2.72%	ICE BAML BB HY Index
HY B Return	-0.90%	4.61%	-1.94%	ICE BAML B HY Index
HY CCC Return	0.43%	7.68%	-8.33%	ICE BAML CCC HY Index
Leveraged Loan Return	0.69%	4.13%	-0.83%	CS Leveraged Loan Index
LL BB Return	0.11%	2.47%	-2.08%	CS Leveraged Loan BB Index
LL B Return	0.59%	4.13%	-0.15%	CS Leveraged Loan B Index
LL CCC Return	3.09%	9.62%	-3.72%	CS Leveraged Loan CCC Index
HYG	-0.93%	4.05%	-1.25%	Ishares Iboxx High Yield
BKLN	-0.34%	2.61%	-1.96%	Invesco Senior Loan ETF
S&P 500 Return	-3.80%	8.93%	5.57%	S&P 500
Russell 2000 Return	-3.34%	4.93%	-8.69%	Russell 2000 Index
CS Leveraged Equity Index	-4.54%	5.56%	-2.64%	CS Leveraged Equity Index
10yr Beg	0.71%	0.66%	1.92%	10yr Treasury
10yr End	0.69%	0.69%	0.69%	10yr Treasury
10yr Return	0.22%	0.05%	12.74%	10yr Treasury
	Beg Mo	**Beg Qtr**	**Beg Year**	**Ending YTW/STW**
HY YTW	5.36%	6.85%	5.41%	5.76%
HY BB YTW	3.94%	5.14%	3.85%	4.40%
HY B YTW	5.52%	7.03%	5.38%	6.00%
HY CCC YTW	11.94%	14.53%	11.80%	11.77%
HY STW	506	647	372	545
HY BB STW	357	473	213	403
HY B STW	529	672	370	574
HY CCC STW	1,171	1,414	1,012	1,154
LL YT3Y	6.13%	7.25%	6.27%	6.02%
LL BB YT3Y	3.86%	4.75%	4.29%	3.93%
LL B YT3Y	5.78%	6.82%	6.36%	5.70%
LL CCC YT3Y	14.98%	17.88%	15.29%	13.94%
LL ST3Y	589	700	461	579
LL BB ST3Y	363	452	262	369
LL B ST3Y	555	657	470	547
LL CCC ST3Y	1,474	1,760	1,365	1,371

CONTACT INFORMATION

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