Senior Loan 2018 Outlook

Senior Loan 2018 Outlook: Rewards, Risks and Reality

Jeff Bakalar
Chief Investment Officer and Co-Head, Senior Loans

Dan Norman
Co-Head Senior Loans

We believe the most significant risk resides in CCC and below-rated loans, as any unexpected uptick in volatility skews risk significantly to the downside

As we enter 2018, the macro environment continues to remain supportive for credit markets generally. Broadly speaking, we believe corporate earnings will benefit from recent above-trend line nominal growth and corporate tax cuts, the combination of which should allow companies to absorb modest labor cost increases and, perhaps, a rise in certain commodity costs. However, we also think the start of the unprecedented unwinding of accommodative global monetary policy, the persistence of low yields around the world, and the long recent stretch of low volatility in broad capital markets, has driven yield-hungry investors to overlook the potential risks that do exist in credit. While we do believe that fundamental, performance-based credit risk is still quite manageable over the foreseeable future and that systemic volatility and distress is unlikely to emerge this year, our outlook as to the reality of what might lie ahead falls somewhere in between "Don't Worry, Be Happy", and "Brother, Can You Spare a Dime."

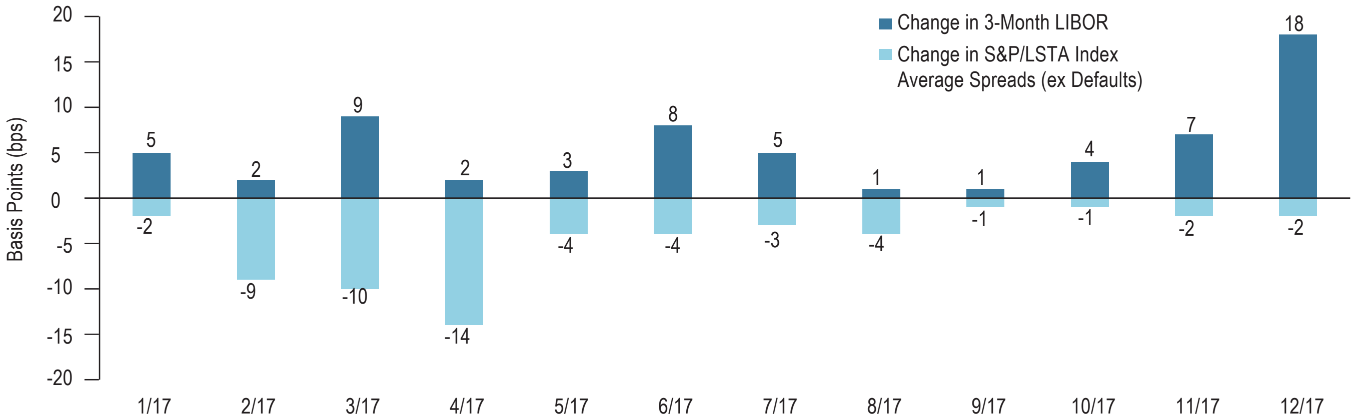
The Potential Reward: Attractive Spreads and Coupons

In terms of monetary policy, we believe the Federal Reserve's cautious pace of interest rate normalization and balance sheet reduction will continue under the guidance of the Fed's new chairman. Slow and steady is likely to remain the status quo, particularly given stubbornly low inflation relative to target. This sets the stage for three to four interest rate increases in 2018, which would clearly benefit the floating rate senior loan market, while crimping returns on traditional bonds with any meaningful duration.

On a slightly less sanguine note, we do expect refinancing activity will continue to cause moderate credit spread compression in 2018. However, given the seismic shift in monetary policy following the Global Financial Crisis which caused credit spreads to widen considerably relative to their longer-term average, we must look to the pre-crisis period in order to evaluate today's credit spread experience through a wider lens and from a more balanced perspective. For the period from 2000 through 2008, the S&P/LSTA Leveraged Loan Index (the "Index") average credit spread was 2.90%. That figure stood at 3.41% as of December 31, 2017.

It's quite natural as a rate cycle progresses for the spread component of a loan's coupon to decline as the base rate rises (a function of economic growth and declining risk premium). To that end, over the course of the new year, we expect interest rate movements to more than offset any further compression and thus support the overall coupon, a trend that played out generally in 2017. For context, over the twelve months ending December 31, 2017, average credit spreads compressed approximately 55 basis points (bps), with 35 bps of that reduction happening in the first four months of the year. Meanwhile, 3-month LIBOR increased nearly 65 bps over the course of 2017, offsetting the spread reduction and holding the overall coupon for the asset class relatively steady over that time period. We expect the same dynamic to hold in 2018; modest spread compression, outpaced by the expected lifts in short-term rates.

Figure 1. The Pace of Credit Spread Compression Has Declined Significantly From Early 2017 and is Expected to Remain Moderate in 2018.



As of December 31, 2017.
Source: S&P/LSTA Leveraged Loan Index and S&P/LCD.

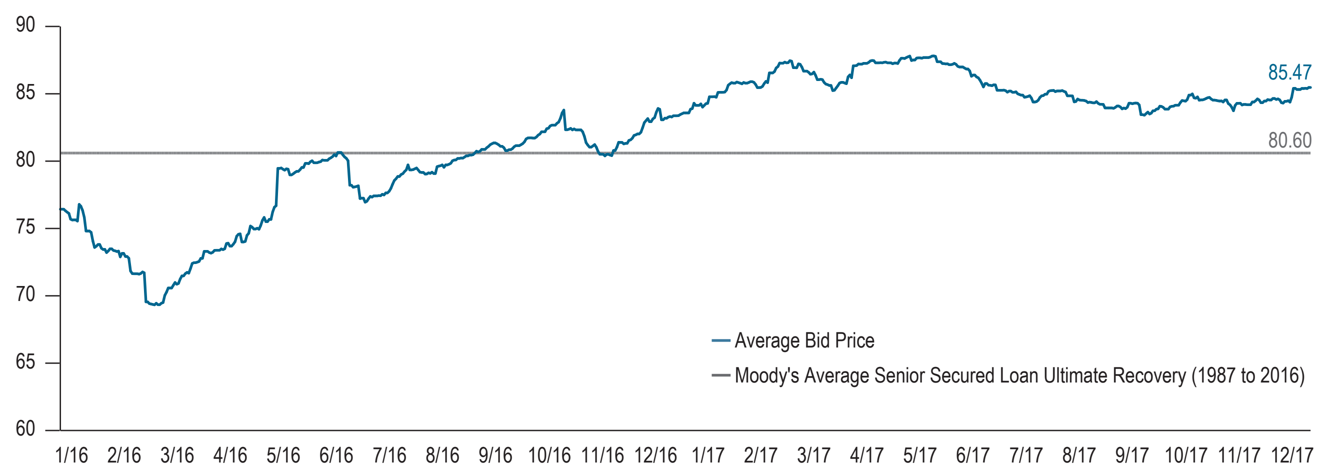
Volatility and the Downside Risks

While current valuations across capital markets have increased the likelihood of short-term price corrections, overall volatility is expected to remain reasonably muted, particularly across the senior loan asset class. As such, we do not expect the average Index bid to move dramatically in either direction in 2018, unless an unanticipated catalyst of volatility emerges. Assuming the probability of such an event is low (as we do, given the inability to credibly identify what that trigger point(s) would be), it's possible that bids could grind modestly higher from their current average of 98 (as of December 31). That move, however, would not have much impact on the total return for the year. We believe that demand for yield should continue to attract investors of all stripes to the asset class, and that ex-refinancing (i.e., new loan) supply should rise modestly along with economic conditions, and remain generally balanced relative to demand.

Breaking it down by ratings cohorts, the B/BB part of the Index was priced at 99 as of December 31, indicating no meaningful headroom for capital appreciation in 2018. Combined with solid fundamentals, we believe there's also little downside risk for the year in these cohorts. However, with diminished monetary policy support, the margin for error in the lowest quality and distressed parts of the market is quite thin. As Figure 2 shows, prices for CCC-rated assets are higher than the long-term average recovery rate for the asset class of 80%. At these valuation levels, we believe the most significant risk resides in CCC and below-rated loans, as any unexpected uptick in volatility skews risk significantly to the downside, making it difficult for that highly risky part of the market to repeat the outsized total returns witnessed over the last two years. As such, we see the best value in well-performing B and B+ rated loans, which offer an attractive yield with fewer downside risks both from a fundamental and market value perspective.

Figure 2. With Valuations Above Long-term Recoveries, the Most Significant Risks are in CCC-Rated Loans

Weighted Average Prices for CCC Loans (January 2016 through December 2017)

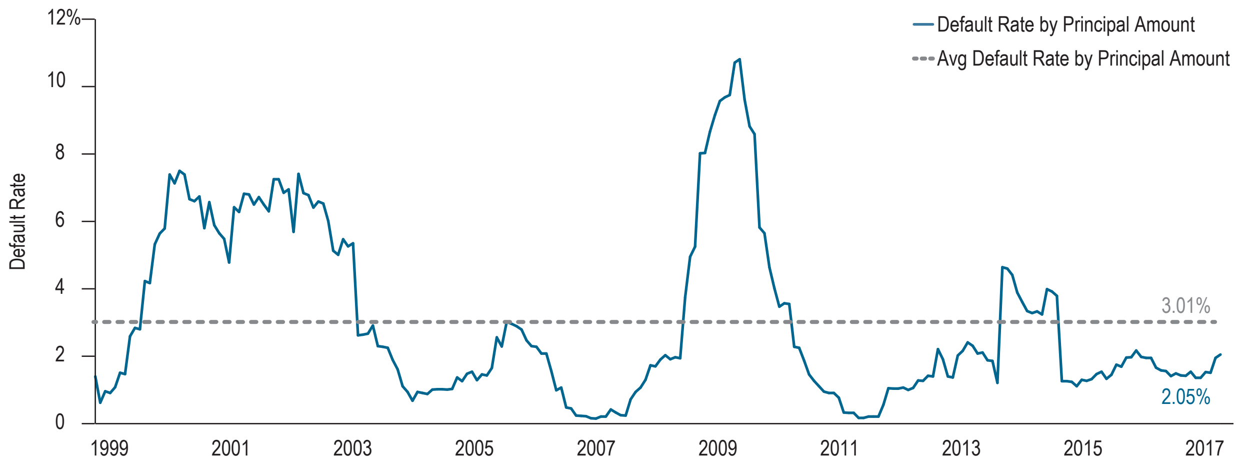


As of December 31, 2017.
Source: S&P/LSTA Leveraged Loan Index and S&P/LCD. Ultimate Recovery is based on the value that a creditor actually receives at the resolution of the default, usually at the time of emergence from bankruptcy. Loan Ultimate Recovery Rate information is obtained from the Moody's Ultimate Recovery Database, which includes over 5,200 loans and bonds from more than 1,000 North American corporate defaulters. Criteria: Pre-1996: L+250 and Higher; 1996 to Date: L+225 and Higher; Prior to 2011, media and telecom deals were excluded. There were too few deals in 1991 to form a meaningful sample.

Against this backdrop of decent growth, generally beneficial changes in corporate tax rates, and a methodical and well-telegraphed rise in interest rates, the average default rate for the Index is likely to remain below its historical long-term average of 3%. However, we would be remiss to not address the idiosyncratic and sectoral risks which remain intact, if not increasing into the New Year. Even though average trailing default rates are quite low currently, there are a small number of industries or industry sub-sectors that continue to exhibit signs of stress. Current examples are the continued struggles of over-leveraged oil and gas companies (the rise in the price of the actual commodity notwithstanding), certain aspects of the retail sector, and parts of the traditional wireline telecommunications and health care industries. As we progress through 2018, we believe other idiosyncratic risks will emerge, the impact of rising borrowing costs on the most leveraged (typically CCC/below rated) issuers being one of them. Accordingly, we believe it's prudent to seek broad, yet responsible, diversification across sectors and issuers in order to minimize the impact of any one issuer default or a clustering of defaults in a given sector.

Figure 3. Lagging Twelve-Month Default Rates Remain Well Below the Long-term Average

S&P/LSTA Leveraged Loan Index Default Rate by Par Amount (December 1998 to December 2017)



As of December 31, 2017.
Source: S&P/LSTA Leveraged Loan Index and S&P/LCD. S&P/LSTA Index lagging twelve-month default rate comprises all loans, including those not tracked in the LSTA/LPC mark-to-market service. Vast majority are institutional tranches. Principal default rate is calculated as the amount defaulted over the last twelve months divided by the amount outstanding at the end of the prior period.

The Bottom Line – Expected Total Return for 2018

Given the aforementioned supportive coupon we anticipate for senior loans in 2018, our base case total return for senior loans falls in a bandwidth of 4.5-5.5%. Our breakdown of the components of that return is illustrated in Figure 4.

Remember, however, that even the "Bear" case in loans in terms of spread (i.e., lower) can prove beneficial when it comes to the asset class' contribution to a diversified income-generating portfolio. All things equal, the plausible environment in which credit spreads compress into that "left-side" territory is one of unquestioned, evidenced economic strength, in which the Fed and perhaps central bankers globally are likely to execute fully on their prescribed tightening path (both policy rates and balance sheet). Again, that's a scenario in which upward moves in LIBOR do the heavy lifting when it comes to preserving the coupon, AND one in which the return outlook for traditional bonds – those with a measureable degree of duration risk – would naturally come under at least some degree of pressure.

Figure 4. Downside, Base and Upside Scenarios for 2018

Components of Total Return	Downside (%)	Base (%)	Upside (%)	Voya Comments
Credit Spread	2.5	3.00	3.3	Anticipate Moderate Spread Compression
3 Month LIBOR at 2018 Year-End	1.9	2.1	2.4	Forecasting 3 to 4 lifts for 2018
Gross Credit Loss Upon Default (3%, 2% and 1.2% assumptions)	-0.2	-0.1	-0.1	Forecasting low par defaults for 2018
Market Value Changes	-1.0 to -1.5	-0.5 to 0.5	0.3 to 0.5	Anticipate limited bid influence on total return for 2018—both to the upside and downside
Total Return Outlook	2.7 to 3.2	4.5 to 5.5	5.9 to 6.1	

As of December 31, 2017.
Source: Voya Investment Management

2018 Expectations Dashboard

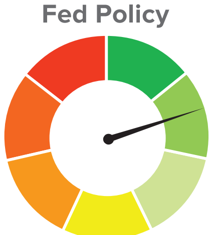
Total Returns

Continued upside potential for gross yields stemming from rising short-term rates, marginally diminished by credit spread compression and a modest weakening in bid levels (from par-plus levels).

Technicals

Demand should remain supportive and increasingly subject to Fed action. New issue supply picking up, but sustainability is uncertain. Reasonable balance is necessary to curb further credit spread compression.

Fed Policy



Fed appears to be on pace with communicated direction of rates. However, lack of inflationary pressure and a range-bound U.S. 10-Year Treasury year has introduced incremental uncertainty.

Defaults

Market consensus points to below average default rates until 2018 or even early 2019. Idiosyncratic risk and increasing stress in certain sectors (retail, telecom, and legacy oil & gas) remains the biggest downside risk.

Volatility

Overall volatility expected to remain relatively low. However, rich valuations in other markets, increasing political and geopolitical tensions definitely raising risk levels in this area.

Macro Headwinds

Macro worry list is myriad. However, no single catalyst has been credibly quantified.

Disclosures

The S&P/LSTA Leveraged Loan Index is an unmanaged total return index that captures accrued interest, repayments, and market value changes. The Index does not reflect fees, brokerage commissions, taxes or other expenses of investing. Investors cannot invest directly in an index.

General Risks for Floating Rate Senior Bank Loans

Floating rate senior bank loans involve certain risks. Below investment grade assets carry a higher than normal risk that borrowers may default in the timely payment of principal and interest on their loans, which would likely cause the value of the investment to decrease. Changes in short-term market interest rates will directly affect the yield on investments in floating rate senior bank loans. If such rates fall,the investment's yield will also fall. If interest rate spreads on loans decline in general, the yield on such loans will fall and the value of such loans may decrease. When short-term market interest rates rise, because of the lag between changes in such short term rates and the resetting of the floating rates on senior loans, the impact of rising rates will be delayed to the extent of such lag. Because of the limited secondary market for floating rate senior bank loans, the ability to sell these loans in a timely fashion and/or at a favorable price may be limited. An increase or decrease in the demand for loans may adversely affect the loans.

Important Information

This commentary has been prepared by Voya Investment Management for informational purposes. Nothing contained herein should be construed as (i) an offer to sell or solicitation of an offer to buy any security or (ii) a recommendation as to the advisability of investing in, purchasing or selling any security. Any opinions expressed herein reflect our judgment and are subject to change. Certain of the statements contained herein are statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. Actual results, performance or events may differ materially from those in such statements due to, without limitation, (1) general economic conditions, (2) performance of financial markets, (3) interest rate levels, (4) increasing levels of loan defaults, (5) changes in laws and regulations, and (6) changes in the policies of governments and/or regulatory authorities.

Voya Investment Management Co. LLC ("Voya") is exempt from the requirement to hold an Australian financial services license under the Corporations Act 2001 (Cth) ("Act") in respect of the financial services it provides in Australia. Voya is regulated by the SEC under U.S. laws, which differ from Australian laws.

This document or communication is being provided to you on the basis of your representation that you are a wholesale client (within the meaning of section 761G of the Act), and must not be provided to any other person without the written consent of Voya, which may be withheld in its absolute discretion.

Past performance is no guarantee of future results.

CMMC-SRBNKLOANS 011218 • IM0108-39378-0119 • **200631**