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Senior Loans 2018 Outlook

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Mid-Year Update and Outlook:

Performing to Plan

When we began 2018, we anticipated a year of reasonably supportive credit fundamentals, more unwinding of accommodative global monetary policy, and a continued furlough from any significant and sustained levels of volatility. We also believed that investors, still hungry for yield, were likely to continue to turn a bit of a blind eye to the percolating risks, particularly in lower quality. For the most part, our initial outlook has thus far largely played out, including the anticipation of a series of volatility spikes in broader capital markets. As generally expected, the senior loan asset class weathered those episodes particularly well. As a result, our full-year expectations for 2018 remain intact, and we continue to see an attractive risk-return opportunity in the senior loan asset class.

Volatility and Global Forces

At the beginning of the year, we advanced the notion that there would be periods of notable chop driven by rate normalization, causing longer duration credit to struggle. That assumption has generally materialized. Total returns across most fixed income asset classes were flat to negative through the first half of the year, and the S&P 500 eked out a 2.65% total return, managing to recover after posting -0.76% in Q1 2018 (Figure 1).

Against this backdrop, the S&P/LSTA Leveraged Loan Index ("Index"), as anticipated, displayed a high level of stability with limited market value losses, positive total returns each month this year, and a total return of 2.16% through June 30, 2018. That is not to say that all parts of the loan market saw such smooth sailing. Despite a compelling six-month return of 4.70%, CCC-rated loans faced headwinds during the peaks of market volatility in March and April, posting returns of 0.00% and -0.04% for those respective months. That experience may be a brief glimpse into what would likely play out when a perpetually bullish credit/valuation view starts to more meaningfully materialize. The potential impact underscores our continued preference to underweight CCC and below-rated loans.

Figure 1. Asset Class Returns 1H 2018

Index	Total Return
S&P 500	2.65%
S&P/LSTA Leveraged Loan Index	2.16%
Bloomberg Barclays U.S. High Yield 2% Issuer Cap Index	0.16%
Bloomberg Barclays U.S. Aggregate Index	-1.62%
Bloomberg Barclays U.S. Corp 5-10 Year Index	-2.95%

As of June 30, 2018.
Source: S&P/LSTA and Bloomberg Barclays.

The Forward View: In our view, the cacophony of macro-economic and geopolitical concerns will remain puzzling to investors, leading to a somewhat murky picture of the real risks on the horizon. Rich valuations established in 2016 and 2017, particularly in other markets, and continued tensions across local (read 2018 mid-term elections) and global (much of which is now attributable to trade) political arenas, will likely lead to further bouts of volatility in the coming months. Consequently, investing predictability will prove to be more challenging. That said, assuming that volatility does not take on a systemic nature, the unique structure of the senior loan asset class should provide a harbor against macro headwinds and keep current return expectations on course.

Fed Policy

U.S. Federal Reserve policy remains on pace with the prescriptive path communicated over the past several quarters. The variables at this point, which could collude in some fashion to derail the plan, include a lack of inflationary pressure, declining confidence in global synchronized growth, and a range-bound U.S. 10-year Treasury anchoring what could turn into an inverted yield curve. However, at this point, given the strength of recent indicators and constructive Fed "speak," we believe it's unlikely that we'll see a sudden departure from the program, and short-term rate policy should continue to support senior loan coupons for the remainder of this year and likely well into next year.

The Forward View: The Fed stays the course, which would likely be a solid tailwind for loan performance and a headwind for traditional fixed income.

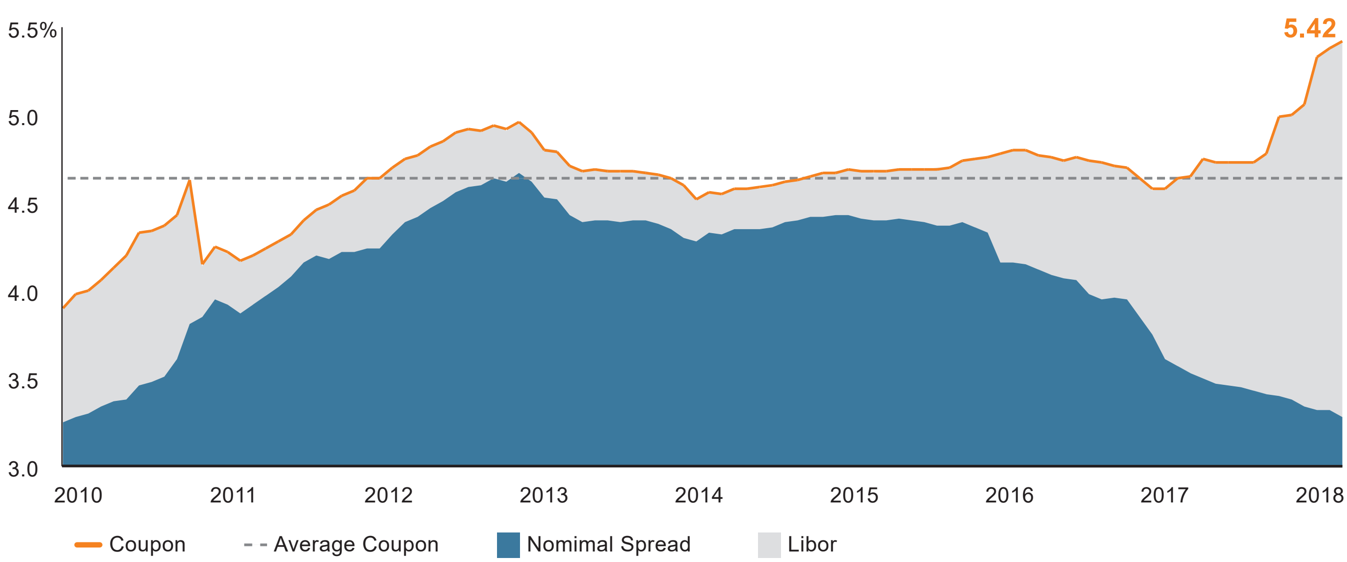
Inside the Loan Market: Fundamentals and Technicals

As of June 30, 2018, the lagging twelve-month default rate by par amount stood at 1.95%, still well inside of the longer-term asset class average default rate (approximately 3.0%). As predicted at the beginning of the year, we continue to see below average default rates over the near future, with no material increase until perhaps late 2019. This is supported by reasonably good average earnings growth at the issuer level, manageable debt service loads (even in the face of rising borrowing costs) and shadow default rates that are currently quite low. That is not to say that idiosyncratic risks and stress in certain sectors (notably, retail, certain pockets of telecom and oil & gas) do not persist. Taken together, however, elevated stress in those areas is not considered hefty enough to materially alter the course of a solidly growing U.S. economy, and reasonably favorable non-investment grade company performance as a result.

Market "technicals" have also held reasonably firm thus far in 2018. Unlike 2016 and 2017, the supply side of the equation has managed to generally keep pace this year, with Index outstandings increasing to over $1 trillion over the course of the year. Not only has overall new supply increased, but — importantly — there has also been a material rise in new paper via fresh acquisition-related deals. In fact, M&A activity totaled over $84 billion in second quarter volume, the highest quarterly figure on record, according to S&P/LCD. This infusion was quite welcome, particularly given the strong demand year-to-date for floating rate loans via the two primary visible channels of demand in the asset class — CLOs and retail loan funds. CLO issuance has been impressive so far, with approximately $70 billion in issuance through the first half of the year. This pace is likely to continue, particularly now that Risk Retention regulations have been sidelined, opening up the potential manager base for issuance of those vehicles. On the retail side, fund inflows have been positive every month of 2018, totaling nearly $12 billion.

The Forward View: Fundamentally, while there is no shortage of traditional signs of late cycle behavior, there is also no credible evidence that we're on the precipice of systemic risk. In other words, we believe default activity should be reasonably contained without any meaningful surprise to the downside. Technicals, always more difficult to predict and often quickly changing, appear to be even-keeled at this point. The combination of the two (stable fundamentals and technicals) typically leads to low volatility in market values, which can be an important variable in the total return story.

Figure 2. Rising LIBOR Continues to Drive Attractive Senior Loan Coupons



As of June 30, 2018.
Source: Voya Investment Management, LS&P/LCD.

Spreads and Coupons

At year-end 2017, average nominal spreads for the Index stood at 3.41%. As of June 30, spreads have been trimmed by only 13 basis points (bps), to 3.28%. Compared to the twelve months ending December 31, 2017, in which the average credit spread compressed approximately 55 bps (with 35 bps of that reduction happening in the first four months of the year), it is clear that the velocity of compression driven by refinancing activity has diminished. The more recent stability of spreads is due, in large part, to the aforementioned historic pick-up in M&A-related deals in the 2nd quarter of this year, but also to a notable widening in CLO debt tranche pricing (always a major driver, directionally, of loan spreads over time).

With relatively steady credit spreads and two rate hikes so far from the Fed, coupons in 2018 have moved appreciably higher. As demonstrated in Figure 2 below, the pace of credit spread compression has moderated over the course of the year, while the contribution of LIBOR to the overall coupon has increased sharply.

The Forward View: We anticipate one or two more rate lifts this year and believe that LIBOR will comprise an increasingly larger part of the overall coupon as we move forward in the rate cycle. This should occur — all things equal — against relatively stable market values, providing a nice environment for further solid performance on the part of loans, on both an absolute and relative basis.

Summary

So far, our January assumptions and expectations for 2018 have largely held, be they fundamental or technical in character. Gathering all the tea leaves leads us to believe that loan coupons for this year and likely next will be driven primarily by increases in LIBOR, with limited credit spread compression and modest market value changes. Our updated breakdown of the drivers of total return for 2018 are illustrated in Figure 3 below. We still believe the greatest downside risks reside in the lowest credit quality parts of the market, particularly given their greater susceptibility to volatility and market stress.

Figure 3. Halfway Point: Updated Outlook for Remainder of Year

Components of Total Return	January 2018 Outlook	June 2018 Updated Outlook	Voya Comments
Credit Spread	3.0%	3.2%	Anticipate approximately 10 bps of spread compression from current level of 3.28%
Average LIBOR at 2018 Year-End	2.1%	2.4%	LIBOR as of 6/30 likely has the next rate lift already priced in, so while we do still expect one or two more rate lifts this year, we have only included one increase in this calculation
Gross Credit Loss Upon Default	-0.1%	-0.1%	Forecasting modest par defaults for 2018
Market Value Changes	-0.5% to 0.5%	-0.6%	With approximately 43 bps in market value decline YTD, we anticipate ~20-30 bps decline in the second half of 2018
Total Return Outlook	**4.5% to 5.5%**	**4.9%**	**Currently on pace for a near 5% total return for 2018**

Source: Voya Investment Management

Investment Risks

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.

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