Senior Loan 2019 Outlook

A Balanced Perspective

Prepared by Dan Norman and Jeff Bakalar
Co-Heads of the Senior Loan Group

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Executive Summary

- With the prospects of further increases in LIBOR and stable-to-expanding credit spreads, we believe loans will continue to provide high income and attractive risk-adjusted returns in 2019
- Despite increasing credit risk and uncertainty, much like the asset class did in 2018, we believe loans will continue to dampen portfolio volatility in 2019
- Our 2019 outlook seeks to guide investors to a better understanding of the current loan market environment as they navigate the income investment landscape and establish portfolio allocation strategies for the coming year

Year in Review and Expectations for 2019

2018 was a year marked by increasing uncertainty (economic, geopolitical, valuations, etc.), with episodic bouts of sharp volatility across capital markets. In this changing and challenging environment, senior loans have thus far outperformed equities and other spread sectors. Despite a particularly volatile October and November across most asset classes, senior loans continued to provide attractive risk-adjusted returns (Figure 1). We view year-to-date performance as a testament to the ability of loans to dampen volatility across a broad portfolio, without materially sacrificing yield.

Our expectations dashboard provides a high-level summary of our 2019 outlook. Despite increasing credit risk and uncertainty, we believe loans will continue to dampen portfolio volatility in 2019, much like the asset class did in 2018.

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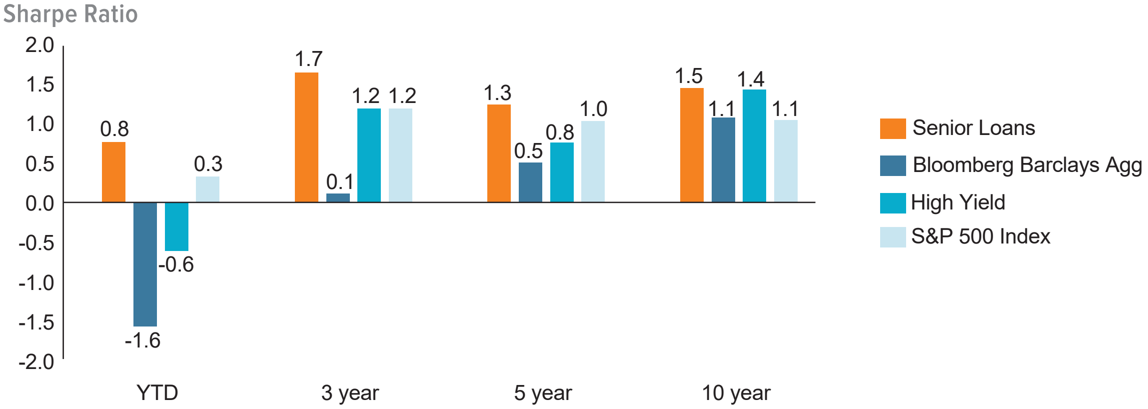
Figure 1. Senior loans: A Track Record of Historically Strong Risk-Adjusted Returns



As of November 30, 2018. Sources: Bloomberg Barclays and S&P. Senior loans represented by the S&P/LSTA Leveraged Loan TR index. High yield represented by the Bloomberg Barclays U.S. Corporate High Yield TR USD. Past performance does not indicate future results. Indices are not investible.

2019 Loan Market Return Drivers and Expectations

Macro Headwinds/Volatility

- Overall volatility expected to persist as macro conditions evolve.
- Macro worry list is myriad. However, no single catalyst has been credibly quantified.

Technicals

- Demand should remain supportive and increasingly subject to Fed action.
- New issue supply subject to macro and M&A conditions. Reasonable balance is necessary to maintain credit spreads and support market values.

Total Returns

- Continued upside potential for gross coupons stemming from rising short-term rates and potentially diminished by market value downside stemming from heightened volatility.
- Our base case for expected 2019 gross loan returns is 4-5%.
- Underlying factors include continued upward movements in short-term interest rates and stable to modestly increasing credit spreads, offset by potential market value reduction due to increased macro volatility.

Defaults

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

Fed Policy

- Fed appears to be on pace with communicated direction of rates.
- However, recent dovish comments and greater uncertainty surrounding economic growth (U.S. and global) has the potential to reduce expectations.

Source: Voya Investment Management

Looking Back: How the Evolution of the Senior Loan Market Will Shape the Path Ahead

Ten years removed from 2008, it is easy to forget how much of our current investment landscape was shaped by central banks' unprecedented response to the global financial crisis. This extraordinarily accommodating monetary policy ushered in a prolonged period of historically low yields, causing many to expand their investible universe. With their senior-secured status, relatively attractive yields and floating rate nature, the loan asset class has become "mainstream," representing a permanent strategic allocation in many large fixed income portfolios.

Assessing risk in the current environment requires a closer look at both current loan technicals and fundamentals, as well as a comprehensive view of the loan market's evolution since the 2008 crisis.

Indeed, the growth in the loan market since the crisis has been robust. Senior loans now constitute a larger portion of the new issue credit market than unsecured high yield bonds. As a result, in 2018 the S&P/LSTA Leveraged Loan Index's amount outstanding surpassed the $1 trillion mark. Incremental demand from increased U.S. CLO issuance, inflows from loan funds and continued support from the broader institutional buyer base have, through the first three quarters of 2018, all contributed to a healthy demand environment. That incremental demand drove borrowers' cost of financing lower, a welcomed dynamic amongst leveraged issuers who gained certain flexibilities in their capital structure (e.g., ability to refinance and call loans cheaper than bonds).

With this growth comes increased attention, and one does not have to look hard to find media headlines pointing to mounting concerns about the health of the market. Certain pockets of the financial press argue that the market is dangerously overheated and question whether it can sustain such growth levels without giving up many of the protections the asset class boasts for its investors. Pundits cite loosening documentation, elevated leverage, a growing prevalence of first time loan issuers and an increase in B2/B3 rated issuers as cause for larger systematic concerns. As is typical in many circumstances, public opinion on the asset class, some of which is grounded in fact, lacks the appropriate context. Assessing these risks requires a closer look at both current loan technicals and fundamentals, as well as a comprehensive view of the loan market's evolution since the 2008 crisis.

Market Technicals: Drivers of Supply and Demand

As noted, attractive growth opportunities and relatively low financing costs have encouraged more borrowers to issue in the senior loan market. Appealing relative and absolute yields in the post-crisis era have motivated investors as well. As noted in Figure 2, loan issuance has steadily increased in tandem with demand. We believe issuance is likely to remain strong in 2019, although down slightly from 2018 levels. Supply should continue to meet the needs of CLO issuance, and we believe that CLO issuance could reach to near the levels of 2018 (i.e., around $120 billion).

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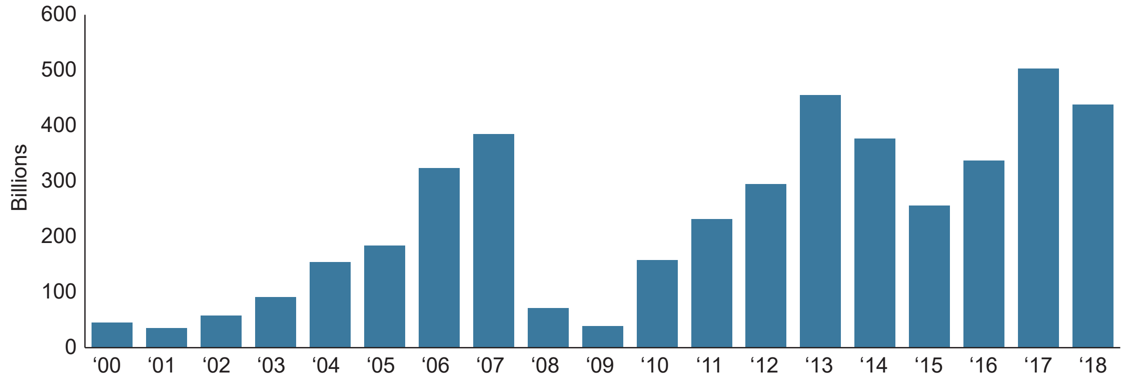
Figure 2. Loan Issuance has Steadily Increased

Institutional Issuance



Source: S&P/LCD; S&P/LSTA Leveraged Loan Index; as of November 30, 2018

Of note, while CLOs are a significant portion of the loan investor base, their percentage of ownership in outstandings has remained relatively stable over time. Excluding banks, CLOs have long been the largest investor in the loan market, with share of loan market outstandings between 50-60% for nearly every year for the past 15 years. Additionally, it is important to understand that the features of CLO structures, particularly their reinvestment period of approximately 3-5 years, create long-term stable capital for the loan market that is not marked-to-market and is better able to sustain volatility. We believe that the presence of a healthy CLO market is a good thing for the loan market and is a driver of lower volatility for the asset class, which benefits all investors.

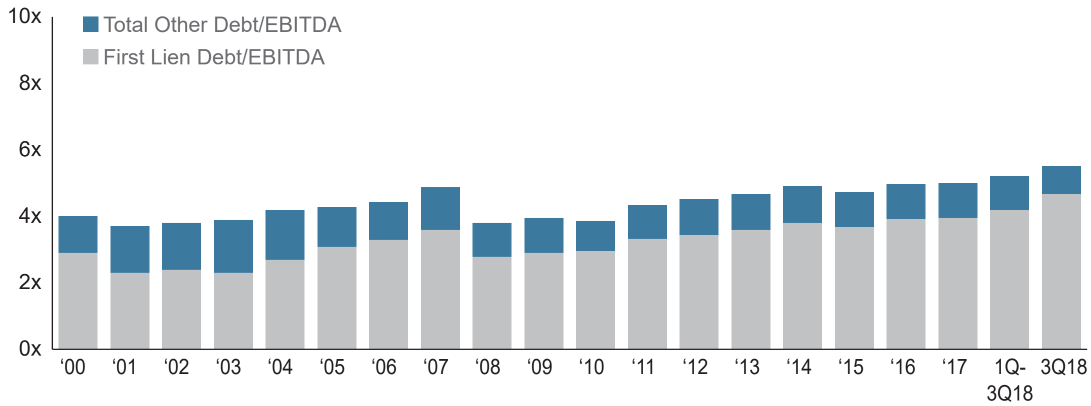
Of course, there are other important buyers of loans, including mutual fund investors and traditional asset-allocating institutions such as pension funds and insurance companies. These investor types survey the loan investment thesis through a continuum of lenses, from pure total return and yield, to Sharpe ratio and correlation of returns through cycles. As a result, overall attraction and staying power can vary, depending on market conditions. Again, assuming the directional nature of interest rates continues to be higher, we envision most investors will continue to find loans an interesting tool in the income asset class "tool box."

Credit Quality and Default Expectations

Shifting from technicals to credit fundamentals and the health of the borrower base, it is clear that the combination of a growing senior loan market and strong underlying company performance over the last several years, has brought steadily increasing leverage levels (Figure 3).

Figure 3. Leverage Increases with the Growing Loan Market

Average Leveraged Debt Multiples (New Issues)



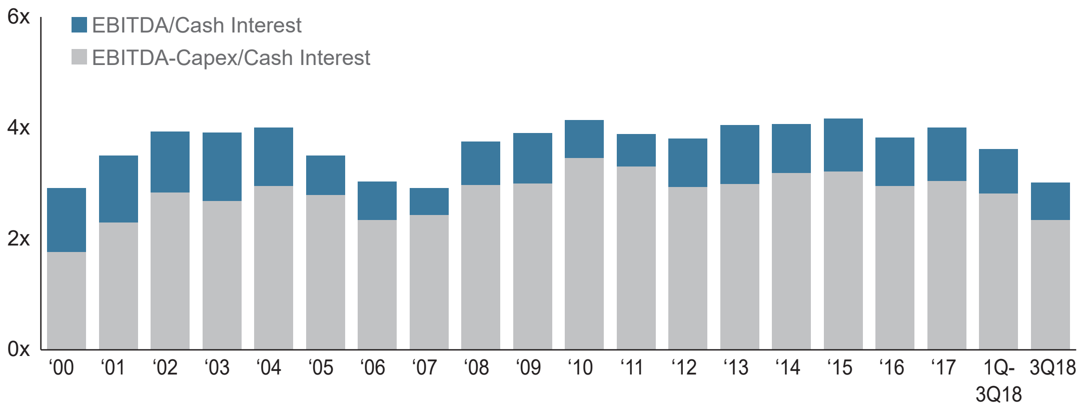
Source: S&P Capital IQ; as of September 30, 2018

Broader economic growth, and, in turn, generally favorable corporate earnings are expected to continue in 2019, which would support a reasonably benign credit environment, even at moderately elevated leverage levels.

On the surface, these figures may seem concerning and lead some to argue that risk levels today are appreciably worse than they were in 2007. (As evidence that this conclusion cannot be drawn in a vacuum, one of the catalysts to high leverage levels is simply higher overall company/enterprise valuations, whether ultimately justified or not.) However, while risk has increased based on this simple math alone, we believe that it is less acute than headline figures imply. As a starter, while the trend in leverage per the chart above looks similar to what took place in 2004-2007, it would be inappropriate to necessarily assume a similar outcome (i.e., imminent recession). Simply put, that downturn was not driven by excessive issuer leverage. The factors central to the ensuing unwind (2008-2009), namely market-value based financing leverage for investment purposes and a mountain of unsold loans in the new issue pipeline, do not play a meaningful role in today's story. Broader economic growth and, in turn, generally favorable corporate earnings are expected to continue in 2019. This should support a reasonably benign credit environment, even at moderately elevated leverage levels. In addition, the refinancing activity over the last several years has extended the loan maturity profile and reduced interest burden in many cases via margin reductions. We believe this provides the foundation for a technical backdrop during the next credit cycle that is not outside of the historical norm.

Figure 4. Robust interest and coverage ratios help to mitigate undue concerns about increasing leverage

Average Cash Flow Multiples (New Issues)



Source: S&P Capital IQ; as of September 30, 2018

Partially offsetting the elevated leverage phenomena during this credit cycle are the healthy interest and coverage ratios of borrowers (Figure 4). However, we certainly remain mindful that good coverage ratios often tell a subjective story, particularly given what can be generous non-GAAP adjustments to cash flows, which can inflate the "advertised" measure. Furthermore, rising rates will inevitably have a negative impact on coverage ratios as well, although at this juncture we do not view even terminal short term rates as being systematically destructive. Finally, it is no secret that we now see less unsecured debt in an average borrower's capital structure than what existed pre-crisis. This has diminished the subordinated debt cushion to senior lenders, which is likely to have at least a moderately unfavorable impact on ultimate recovery levels (again, simple math). Even still, as we see it, this does not result in "game-changing" levels.

We believe the current environment provides a compelling reason to actively avoid the riskiest parts of the market (CCCs and below and certain loans rated B-).

All-in, as to prevailing balance sheet risk, we find the overall fundamental picture reasonably stable and sustainable under all but the more draconian economic forecasts. Nonetheless, the risk still warrants a watchful eye. We argue that sufficient corporate earnings and overall GDP growth will continue to provide a supportive backdrop to allow the vast majority of borrowers to weather another year or so of short-term rate lifts. Still, we believe that the data provides a compelling reason to actively avoid the riskiest parts of the market (CCCs and below and certain loans rated B-). We believe these borrowers will be the most vulnerable subset of the market when it comes to an unhealthy mixture of slowing earnings and rising borrowing costs.

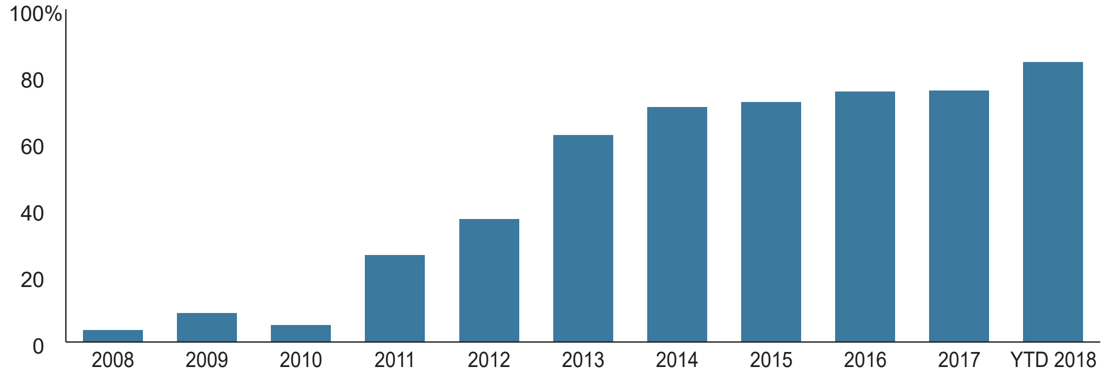
The Continuing Saga of "Cov-Lite" Loans: Separating Fact from Fiction

Of course, the most easily lambasted market development over the last few years has been the proliferation of covenant lite ("cov-lite") loans in the market (i.e., senior secured loans that do not incorporate traditional maintenance covenants such as maximum leverage and minimum coverage ratios). So much has been written and inferred about cov-lite loans, we are concerned it may actually become a topic of conversation at family holiday gatherings. While we suggest you stick to less controversial topics (like politics), should the conversation go in this direction, it is important to know that cov-lite loans are not a new or separate type of asset class. Cov-lite loans still reside at the senior-most position in a borrower's capital structure and benefit from a legal pledge of the borrower's assets.

Most importantly from an investment standpoint, the value of a maintenance covenant should never be confused with the protection that comes from having a pledge on the issuer's collateral.

Figure 5. What are the risks as "cov-lite" loans increase?

Cov-Lite Issuance (%)



Source: S&P/LCD; S&P/LSTA Leveraged Loan Index; as of November 30, 2018

It goes without saying that any borrower would prefer to issue a loan with few or no maintenance covenants, and as indicated by Figure 5, a large percentage of companies in today's market are able to do so given the strong demand for loans over the last several years. We believe it is important to recognize that, while growing demand for the asset class has enabled more borrowers to reduce or eliminate maintenance covenants from their institutional credit tranches, the increase in demand has also created the positive development of a more diversified investor base. Twenty years ago, banks were the primary holders of senior loans. Today, we see a developed secondary market, with a multitude of institutional investors (e.g., CLO's, SMA's, mutual funds) that all contribute to improved market liquidity, i.e., the ability – all things equal – to transact at a desired price. In the give-and-take of supply and demand, as a manager, we are of the opinion that the trade-off of maintenance covenants for liquidity is, in most cases, a worthwhile one.

Further, it is important to understand that cov-lite is not necessarily a binary indicator of the inherent weakness or strength of an underlying credit. Nor is it a harbinger of heightened payment default risk. In fact, for a loan with covenants, a covenant breach may automatically trigger an Event of Default for a loan, even if the issuer's ability to make payments on the loan is unimpeded. A cov-lite loan in the same financial position would not be subject to the restrictions that are imposed on a covenant defaulted borrower, giving the corporate management team the flexibility to manage their business when they need it most – during a financial crisis or recession.

The substantially greater historical average recovery after default of senior loans, which is a hallmark of the asset class, is a direct by-product of being secured, not necessarily the result of having a set of maintenance covenants.

Most importantly, from an investment standpoint, the value of a maintenance covenant should never be confused with the protection that comes from having a pledge on the issuer's collateral. Put another way, the substantially greater historical average recovery after default of senior loans, which is a hallmark of the asset class, is a direct by-product of its secured status, not necessarily the result of having a set of maintenance covenants. Cov-lite senior secured loans typically have the same type of collateral with the same priority as other senior loans, meaning that potential recoveries from collateral are not directly affected by the presence or absence of covenants. More covenants does not equal higher credit quality or higher recovery potential. (In today's market, you can justifiably argue the inverse is true.) In the final analysis, we believe it is more prudent to focus on credit fundamentals, rather than bemoaning the lack of maintenance covenants.

Conclusion: What is most important in 2019? Doubling-down on bottoms-up research and focus on quality

Fundamentally, while there is no shortage of traditional signs of late cycle behavior, there is also no credible evidence that we are on the precipice of systemic risk. U.S. GDP third quarter growth stood at a 3.5% annualized rate. Unemployment is remarkably low. Consumer confidence is still pretty high, and there may even be some signs of wage inflation. As a result, we believe that the Fed will stay the course with its rate hikes in 2019, but we acknowledge that they may pause at some point in the near future. Regardless, we believe that the vast majority of borrowers should be able to continue to meet their debt obligations in 2019. In other words, we believe default activity should be reasonably contained without any meaningful and/or significant surprise to the downside. We remain constructive on near-term economic and EBITDA growth over the near-term, but are cognizant of risks that could derail this outlook.

While we hope that some balanced research can help calm nerves in a time when it is easy to react to short-term market sentiment, we are not naïve to the reality of what investors face with increasing capital markets volatility, a flattening yield curve, and a general resignation that the best for this cycle is probably over. Still, money must be put to work, and we believe there continues to be a compelling investment thesis for the loan market.

- **Relative value and return prospects remain attractive.** Historically, loans have performed well in later-cycle conditions, as they benefitted from short-term rate increases and typically outperformed fixed-rate, duration sensitive asset classes. Market value returns are likely to decline as we move later in 2019, particularly as volatility across market continues and investor sentiment shifts. However, coupons should increase in 2019 as a function of increasing short-term rates, little refinancing activity, and potential credit spread widening. All-in, we see total return as a coupon-minus-a-little, and somewhere in the 4-5% range.
- **Credit losses are likely to pick-up, but remain benign relative to historical average.** The aforementioned backdrop of strong earnings and reasonably sufficient interest coverage levels has helped keep default rates below historical averages through 2018. We expect them to remain relatively low over the next year. According to a survey conducted by LCD, asset managers expect the 12-month rate to conclude 2019 at about 2.54% by dollar amount, still comfortably below the historical average.

In this environment, loan selection, always a critical component of portfolio construction, is more important than ever. To that point, we haven't yet seen any adversely developing industry themes outside of ongoing sector issues in Retail (though we have seen some improved sentiment in 2018 across some of our large holdings), legacy O&G sector issues (mainly ongoing restructurings) and some technology-specific weakness in Telecom subsectors (wireline). There are some idiosyncratic credit concerns with some specific issuers but nothing that is deemed an omen of broadly-based, system-wide risk. We remain vigilant in our credit selection in specific industries such as Software, Industrials, Auto and Business Services. We continue to watch for any pick-up in inflationary pressure in the cyclical names (Industrial, Transportation, Chemical sectors in particular) and assess the impact of the recently implemented U.S. trade tariffs on the earnings of obligors that rely in some capacity on outsourced supply chain management systems.

From a credit quality perspective, we favor BBs that are appropriately priced, strong single Bs over weaker single Bs (a notable credit spread give-up notwithstanding) and 1st lien loans over 2nd liens. The worst performing single Bs, and most if not all issuers in distressed territory (i.e., CCC and below) warrant increased caution and due diligence.

General Investment Risks:

All investing involves risks of fluctuating prices and the uncertainties of rates of return and yield inherent in investing. All security transactions involve substantial risk of loss.

Domestic Equity: Exposure to financial and market risks that accompany investments in equities. Markets are volatile and can decline significantly in response to adverse issuer, political, regulatory, market or economic developments. Small cap stocks may be more volatile and less liquid than stocks of larger more established companies.

Fixed Income: Exposure to financial, market, prepayment, credit and interest rate risks. The value of an investment in a fund is not guaranteed and will fluctuate. Higher yielding bonds are subject to greater volatility and credit risks. A fund may invest in securities guaranteed by the U.S. Government as to timely payments of interest and principal, but a fund's shares are not insured or guaranteed. Bonds have fixed principal and return if held to maturity, but may fluctuate in the interim. Generally, when interest rates rise, bond prices fall. Bonds with longer maturities tend to be more sensitive to changes in interest rates.

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REITs: Real Estate Investment Trusts may be sensitive to factors such as changes in real estate values and property taxes, interest rates, cash flow of underlying real estate assets, supply and demand, and the management skill and credit-worthiness of the issuer. REITs may also be affected by tax and regulatory requirements.

Non-Diversified Strategies: Due to the concentrated nature of non-diversified and sector funds, they may experience greater volatility than funds with a broader investment selection/strategy.

Diversification does not guarantee a profit or ensure against loss. **Past performance is no guarantee of future results.**

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