Leveraged Finance Asset Allocation Insights

PineBridge® INVESTMENTS

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A More Balanced Outlook for High Yield and Loans

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The performance of leveraged finance asset classes was mixed in August. High yield bonds experienced negative total returns as Treasury rates traded higher and spreads traded wider. Weighted-average bid prices on bank loans held relatively steady, as the asset class generated a positive total return.

In general, investors reacted to growth concerns related to accelerating Covid cases due to the Delta variant and the prospect of Fed tapering in the first quarter of 2022 (or even sooner). Meanwhile, with over 90% coverage on second-quarter earnings, we are seeing strong results across most sectors and expect few defaults.

In recent months we have been maintaining a preference for floating-rate collateralized loan obligation (CLO) debt and bank loans, the prices of which have been supported by strong technical conditions, with steady inflows from retail investors, heavy CLO origination, and lower supply due to the slower summer season. However, given the recent underperformance of the high yield asset class in general and of the reopening/cyclical sectors in particular, we have tempered our enthusiasm for floating-rate asset classes and now have a more balanced outlook for high yield bonds vis-à-vis bank loans and CLO debt.

The following sections reflect the investment team's views on the relative attractiveness of the various segments of below-investment-grade corporate credit. Conviction scores (CS) are assigned on a scale from 1 to 5, with 1 being the highest conviction.

US Leveraged Loans

Kevin Wolfson, Portfolio Manager, US Leveraged Loans

2.8 (unchanged)

Fundamentals: While loan issuers have reported strong year-over-year (y/y) gains in the second quarter, cost headwinds from labor and materials remain a concern. The spread of the Delta variant and its potential impact on growth has increased investor anxieties; sectors that benefit most from the reopening of economies, such as travel and leisure, have come under pressure, driven by the uncertain near-term outlook. Despite the increased risk, market liquidity remains ample and the default rate continues to drop. The last-12-month (LTM) default rate of the S&P/LSTA Leveraged Loan Index finished July at 0.58%, the lowest level in over nine years and well below the recent peak of 4.2% in September 2020.

Valuations: The spread to maturity of the S&P/LSTA Leveraged Loan Index widened slightly over the last month to Libor+408 as of 17 August from Libor+404 as of 20 July. Over the same period, BB spreads widened 12 basis points (bps), while spreads on single-Bs and CCCs widened 5 bps and 4 bps, respectively. The weighted average bid of the market has pulled back over the last month and declined as fewer loans trading above par discouraged repricing. Although spreads remain tight to pre-pandemic levels, loans appear relatively attractive on a risk-adjusted basis versus other alternatives.

About This Report

Leveraged Finance Asset Allocation Insights is a monthly publication that brings together cross-sector views within our leveraged finance fixed income group. Our global team of investment professionals convenes in a live forum to evaluate, debate, and establish top-down guidance for the asset classes that make up the leveraged finance investment universe. Using our independent analysis and research, organized by our fundamentals, valuations, and technicals framework, we take the pulse of each segment of the leveraged finance market.

Technicals: Demand continued to outpace net new supply in July despite a slowdown in new CLO formation and retail inflows. The first half of August saw relatively robust new issuance, although the calendar began to slow as loan market participants took late-summer vacations. Expectations are for issuance to accelerate again after Labor Day, with a continued focus on M&A driven transactions.

US High Yield

John Yovanovic, CFA, Head of High Yield Portfolio Management

2.8 (unchanged)

Fundamentals: JP Morgan notes that most companies beat EBITDA expectations in the second quarter and have provided positive forward guidance. Importantly, only 10% of issuers missed on earnings (as of 13 August). Despite positive commentary, specific industries note labor and input cost pressures, and some sectors are still disentangling supply chains disrupted by Covid, although that should be largely sorted out by year-end. Commodity prices remain mixed but at healthy levels for producers. We are still positive.

Valuations: Treasury and equity market volatility have left Bloomberg US Corporate High Yield Index spreads range-bound, widening 20 bps since mid-July to 310 bps as of 18 August. This area provides some cushion for higher US Treasury yields and is near our model's target of 270-300 for option-adjusted spreads (OAS). Near term, spreads are fair, though the view on 2021 is that total returns will be positive absolute and still attractive relative to other options. BB credit continues to be favored, though returns among rating tiers are closer than in July. Credit dispersion among issuers remains small historically, and valuations remain range-bound near all-time tights.

Technicals: A continuation of first-time issuers and refinancings led to $34 billion being priced through mid-August, making for $380 billion in new issuance year-to-date; 2020 was a record year at $441 billion (JP Morgan Securities as of 13 August). Rolling four-week flows are zero. The steady new-issue calendar, lighter trading, and market volatility have led to neutral technical conditions despite sharp downside moves in specific issues.

US CLO Tranches

Laila Kollmorgen, CFA, Portfolio Manager, CLO Tranche

2.6 (+0.2)

Fundamentals: With lower anticipated defaults in the US combined with active management and good credit selection, we anticipate CLO fundamentals, which remain good across all metrics, to improve.

Valuations: BBBs are at 240-425, BBs at 515-725, and Bs at 700-1,000. BBB rated CLOs are fair value compared to high yield (HY) OAS (310) and to BB rated leveraged loans (310). BB rated CLOs are trading wide of single-B HY (355) and leveraged loans (435) on an OAS basis. The three-month cross-currency Japan yen/US dollar basis is approximately -10 bps, almost unchanged over the month, Longer-term cross-currency hedges also are roughly unchanged. US dollar assets remain attractive when hedged on any term. (Valuations based on Bloomberg and S&P/LCD data as of 17 August.)

Technicals: Demand remains good as primary and secondary supply has lightened in July and August. We see spreads staying range-bound.

European Leveraged Loans

Evangeline Lim, Portfolio Manager, European Leveraged Finance

2.7 (unchanged)

Fundamentals: Eurozone business activity appears to have grown at its fastest rate in more than 15 years in July, which was the fifth successive month of private-sector growth since the pandemic began, constituting a record uninterrupted recovery. Output growth was mostly driven by services, while manufacturing also grew despite a slowing rate of expansion. However, there are fears of interruption to the rebound due to the low but increasing probability of a reintroduction of lockdown measures.

Valuations: Loans continue to look attractive, especially as credit fundamentals are expected to remain positive despite noise from inflation and supply chain interruption. We expect new-issue spreads to maintain levels seen in July.

Technicals: The European loan market is currently in a summer lull. With CLO managers rushing to complete the ramp of recently issued CLOs amid the month-long hiatus in new-issue activity, loan bids are grinding higher despite the expectation of a busy pipeline after the summer.

European High Yield

Evangeline Lim, Portfolio Manager, European Leveraged Finance

2.8 (unchanged)

Fundamentals: Eurozone business activity appears to have grown at its fastest rate in more than 15 years in July, which was the fifth successive month of private-sector growth since the pandemic began, constituting a record uninterrupted recovery. Output growth was mostly driven by services, while manufacturing also grew despite a slowing rate of expansion. However, there are fears of interruption to the rebound due to the low but increasing probability of a reintroduction of lockdown measures.

Valuations: Valuations look fair given the low default environment, improving fundamental outlook, and an expected continuation of Europe's accommodative monetary policy versus the US.

Technicals: The secondary HY market has held up relatively well despite some spillover of US market weakness. The hiatus in primary issuance has contributed to a more balanced technical picture. There is little evidence of accounts raising cash despite the anticipation of a busy new-issue pipeline in September.

European CLO Tranches

Laila Kollmorgen, CFA, Portfolio Manager, CLO Tranche

2.6 (+0.2)

Fundamentals: As in the US, European CLO fundamentals also remain good month-over-month. Active CLO management combined with good credit selection continue to show up in positive tailwinds for CLO fundamentals.

Valuations: BBBs are at 275-425, BBs at 575-825, and Bs at 750-935. BBB rated CLOs are fair value to BB rated HY and leveraged loans, while BB rated CLOs are cheap to single-B European HY and leveraged loans. European CLOs benefit from a Euribor floor of zero, which adds about 55 bps to the yield of European CLOs. The current euro/US dollar three-month swap, at about negative three bps, means that while European and US BBB/BB/B CLOs might be similar on a spread basis, the benefit of the Euribor floor highlights the relative value of European CLO tranches. That said, secondary market comparisons are very deal-specific. (Valuations based on Bloomberg and S&P/LCD data as of 17 August.)

Technicals: While demand remains strong in Europe, higher-than-anticipated primary supply has caused spreads to soften modestly. Secondary supply has been light and is only likely to pick up after the summer holiday. We expect spreads to remain range-bound, however.

Global Emerging Markets Corporates

Steven Cook, Co-Head of Emerging Markets Fixed Income

2.5 (unchanged)

Fundamentals: With second-quarter results in line with our expectations of deleveraging, we maintain our positive scores. According to JP Morgan, second-quarter revenues are up 54% y/y among the half of corporates that have reported (as of 16 August). Companies that have reported in Latin America and in Central and in Eastern Europe, the Middle East, and Africa still have an overwhelming positive skew in their expected credit trajectories over the next six months: 36% positive versus 3% negative (PineBridge Investments calculations as of 18 August). Results from Asia will be key to challenging or reaffirming our fundamental outlook, which currently is at odds with market sentiment.

Valuations: We maintain our valuation scores, as overall HY spreads are roughly flat on the month, with CEMBI Broad Diversified spreads at 260 bps despite some large moves in certain segments. The most significant move was seen in China HY, which widened by more than 300 bps at the end of July and retraced nearly half of that through mid-August (JP Morgan as of 17 August). We retain a bullish longer-term score given the spread pickup on offer versus other asset classes.

Technicals: Issuance dropped off significantly this month, with $9 billion of supply and $19 billion in scheduled inflows, not including calls/tenders. We expect supply to pick up significantly in September, particularly if sentiment in Asia improves. YTD issuance of $372 billion is up 16% y/y, but net issuance of $83 billion accounts for 86% of full-year 2021 expected net issuance, so we expect next month's issuance to be digested. We retain our bullish score based on the demand side, where we see inflows continuing, including new allocations to the asset class given the fundamental outlook and relative spread pickup. (Technicals data from JP Morgan as of 16 August.)

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