Collateral Thinking

Time to dip your toes

Top of the stack

The free-fall in the loan market over the last week surpasses even the price action post-Lehman bankruptcy in its ferocity. The loan index now trades at a recessionary-level 2yrDM of 1800bps (985bps to maturity). While in most recessions the loss of demand takes time to ripple across the economy, the current shock to demand and supply has been sudden and total, and likely to create an unprecedented break in economic activity. We fear that the complete loss of revenues for businesses in some cases will cause severe a liquidity crunch, and COVID-linked industries could be hurt irreversibly. As such we think that the rate of defaults over the next 6-9 months may turn out to be higher than any comparable historical stretch.

While we recognize that there could possibly be another leg of capitulation going forward, we think it is impossible to time the market, and that such dislocations don't come about very often. Today's Fed actions directly targeting IG corporates, also make us feel a bit more at ease, all things equal. As such, we think that at these levels one is supposed to pick up par credits that have enough liquidity and might be able to pull through the next 6-9 months.

Perhaps even more compelling is the dislocation between HY and Loans. Our relative model indicates that post last week's selloff, the loan index is >300bps cheaper than where it should be vs the HY index, making today the biggest dislocation since the financial crisis. We think HY spreads have downside from here in playing catch up to loans, and also having exposure to Fallen Angels. As such swapping out of bonds into comparable loans presents a good entry point here, in our opinion.

Market technicals

Over the past week, cumulative demand for loans was only $100mn, a continuous drop from the previous week's already weak demand of $126mn. On the supply side, new issuance halted completely since last week. Retail funds kept fleeing the market, greatly impacted by the volatile and vulnerable macroeconomic conditions.

Performance

Loans in the LCD index have lost -11.2% during the past week as the COVID-19 outbreak dragged down the market. YTD, loans have lost a cumulative of -17.9%, while HY has lost -18.7%. We think there is comparatively more downside in HY going forward. Within ratings, CCC loans have underperformed YTD with a total loss of nearly -20%.

23 March 2020

Leveraged Loan Strategy
United States

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Table 1: Loan performance

Index	Level	1wk Δ	2wk Δ	YTD Rtn
All Loan	78.3 pts	-10.0	-15.7	-17.9%
BBs	80.1 pts	-10.9	-16.6	-18.7%
Bs	79.1 pts	-10.4	-16.1	-17.9%
CCCs	66.1 pts	-7.9	-13.9	-19.3%

Source: S&P LCD

Table 2: HY performance

Index	Level	1wk Δ	2wk Δ	YTD Rtn
US HY	1009 bps	+278	+445	-18.7%
BBs	767 bps	+246	+390	-16.4%
Bs	1101 bps	+308	+500	-19.7%
CCCs	1873 bps	+368	+586	-25.7%

Source: BofA Global Research

Table 3: Fund flows ($mn)

Asset	1wk	2wk	YTD	LTM
Loans	-2,410	-1,978	-30,616	-35,029
US HY	-2,814	-5,752	+11,203	+6,484
US IG	-38,694	-6,336	+186,886	+314,772

Source: EPFR Global

Refer to important disclosures on page 9 to 10.
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Timestamp: 23 March 2020 01:09PM EDT

Top of the stack

Two weeks ago we advised against catching a falling knife, as we expected the economic situation to get worse. The knife turned out to be particularly sharp. The free-fall in the loan market over the last week surpasses even the price action post-Lehman bankruptcy in its ferocity. Back then it took 6 weeks for the loan market to decline from 90s into the 70s; comparatively this episode the same decline has taken only 3 weeks (Chart 1). The loan index now trades at a recessionary-level 2yrDM of 1800bps (985bps to maturity). We think the rapid decline witnessed by risk markets, including loans has been a result of the collective realization that not every country can emulate China or South Korea, a notion we had put forward weeks ago. Which means US may follow the European playbook, where the leading indicator – Italy – is far from plateauing, indicating we may be flying blind for the foreseeable future. This is the reason that we think that most official efforts, today's included, to appease market jitters have been only partly successful. How do you measure the length of the rope you need if you don't know how deep the pit is?

Chart 1: Number of weeks since heavy selloff first started

Source: S&P LCD

Now that we have established that the US is headed into a downturn, we turn to its shape. We think it will look a lot like the GFC– which started with a surprise shock, followed by a rapid decline and an equally swift recovery, on the back of quick government intervention. The difference in our opinion lies in the duration of the downturn – we think the default curve this time around might turn out to be even more compact (narrower and taller) than 2009. While in most recessions, the loss of demand takes time to ripple across the economy, the current shock to demand (and supply) is sudden and total, and likely to create an unprecedented break in economic activity. We fear that the complete loss of revenues for businesses in some cases will cause severe a liquidity crunch, and COVID-linked industries could be hurt irreversibly. As such we think that the rate of defaults over the next 6-9 months may turn out to be higher than any comparable historical stretch. Note that we refrain from using the usual LTM (last twelve month) default rate measure, because we think that this cycle may be shorter than others that came before it, possibly even inside of 12 months, rendering that measure irrelevant.

This brings us to recovery expectations. While most economists are on the same page regarding the double digit GDP contraction in Q2, some optimistic narratives suggest that recovery may start as early as Q3. We aren't able to wholeheartedly agree- we point once again to China- and say that other nations' recovery trajectories are likely to be less impressive than a government that rules with an iron fist. Additionally, restarting the economy after a near complete halt in certain geographies and industries will require a bumpy transition period, and it's likely that recovery evades us for most of this year.

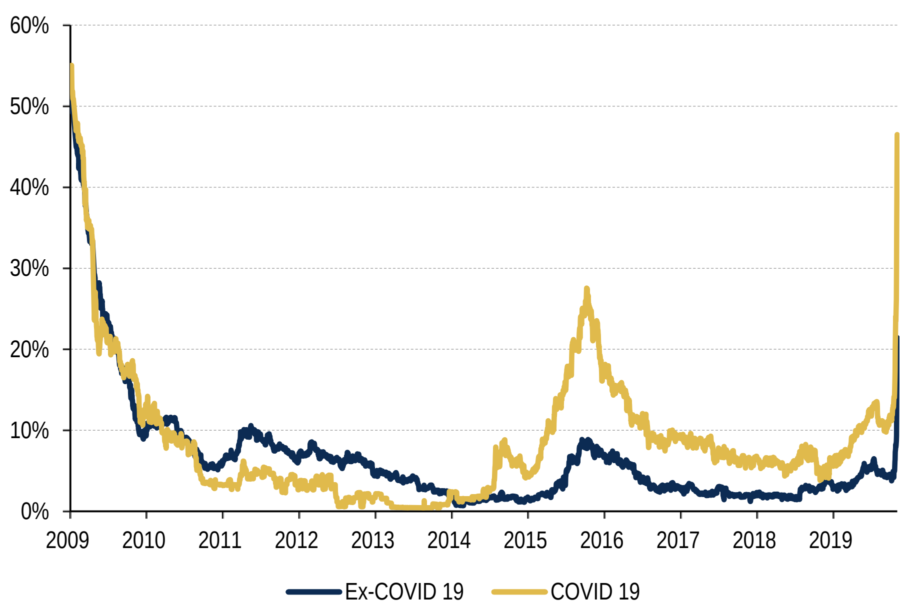
Having said that, we don't anticipate the default cycle to last 2 years like the GFC either. Firstly, global medical intervention is likely to bear fruit within a year, removing the reason for economic shutdowns. Secondly, as is now clearly evident through its novel programs, the Fed is able and willing to do whatever it takes to stabilize the economy, which ultimately will steer the economy away from entering a prolonged recession or a depression.

The problem here is that whether the downturn lasts 3 months or 9 is the difference between life and death of many small and medium sized businesses that don't have capital buffers. If an end is in sight within the next 3 months, then the scale of the fiscal stimulus being promised may be enough. The US economy is worth $5tn a quarter, and a $2tn stimulus package can roughly fully offset ~33% of US economic activity for 3 months. Furthermore, the large quantity of unutilized private capital between PE and PD strategies is also likely to come to the rescue if the path to recovery is clear and quick. However, if there is even a reasonable chance that the recovery doesn't start within a 6 month period, then disruption in business revenues, supply chains, and labor will start to become a lot more permanent, and capital inflows will become a lot more hesitant.

To buy or not to buy

The market price action reflects this fear. At $79, the average loan is now in distressed territory. The rout is understandably being led by sectors most impacted by Oil and COVID-19 (Energy, Materials, Hotels/Leisure, Retail, Services). Distress ratio, defined as the % of loans trading <80, in these sectors is >2x the rest of the index (Chart 2), highlighting the uneven degree of stress across sectors. Dispersion, another measure of credit risk is also the highest since 2009, indicating that the wedge between the haves and have nots is becoming thicker. The silver lining here is that not everybody is a loser, and part of the market is benefitting from current circumstances.

Chart 2: COVID-linked sectors are undress more duress



Source: BofA Global Research, S&P LCD

While we recognize that given our above narrative, there could possibly be another leg of capitulation going forward, we think it is impossible to time the market, and that such dislocations don't come about very often. Today's Fed actions directly targeting IG corporates, also make us feel a bit more at ease, all things equal. As such, we think that at these levels one is supposed to pick up par credits that have enough liquidity and might be able to pull through the next 6-9 months. Given the velocity of the correction, we are seeing scores of high quality BB loans in non-COVID and non-Oil industries that are trading below 85. We think it's time to start sifting through those. Below is a list of BBB or BB+ credits that mature after 2022 and are currently trading below $85.

Table 4: High quality issuers trading sub $85

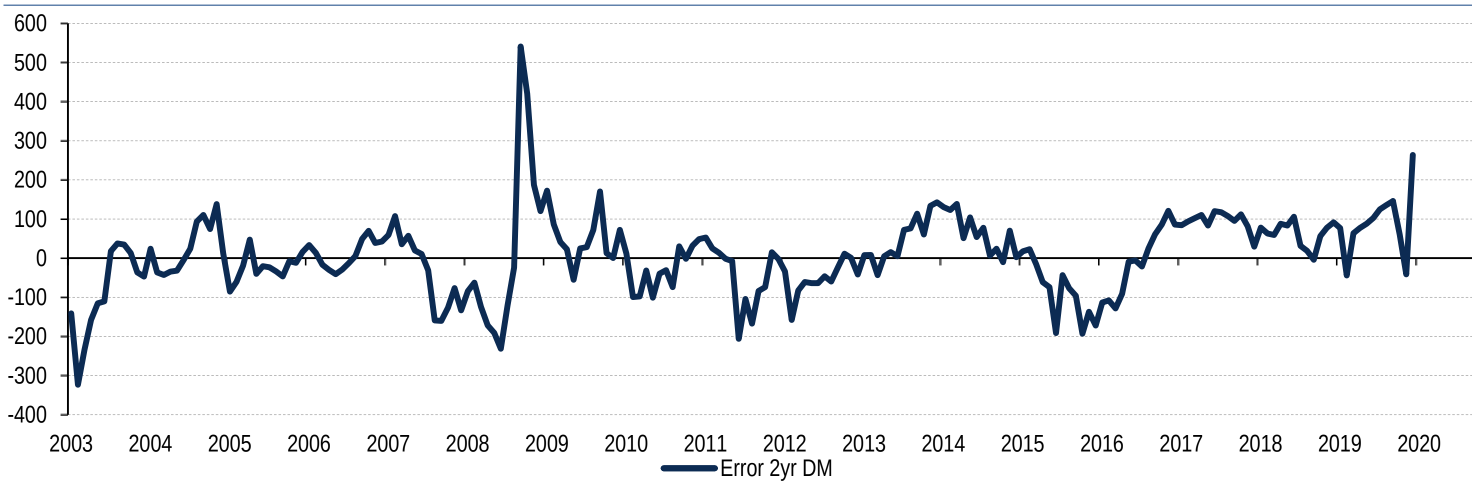
Ticker	Issuer Name	Sector	Face ($mn)	Facility Rating	Maturity Date	Facility	DM
PBI	Pitney Bowes	Capital Goods	650	BBB-	1/17/2025	Term Loan B	1,470
AER	International Lease Finance Corp	Financials	1500	BBB	10/6/2023	Term Loan B	900
THO	Thor Industries	Real Estate	1515	BB+	2/1/2026	Term Loan B	847
BPY	GGP Inc	Real Estate	2000	BB+	8/27/2025	1ST Lien TL	828
SBGI	Sinclair Broadcast Group	Cable/Media	1370	BB+	1/3/2024	Term Loan B-2	822
USFOOD	US Foodservice Inc	Food Producers	2162	BB+	6/27/2023	Term Loan B	811
INEGRP	Ineos Group Ltd	Chemicals	1660	BB+	4/1/2024	Term Loan B	794
ARMK	Aramark Corp	Food Producers	1780	BBB-	3/11/2025	Term Loan B	738
AXTA	DuPont Performance Coatings Inc	Chemicals	2435	BBB-	6/1/2024	Term Loan B-3	691
GEO	Geo Group Inc	Real Estate	792	BB+	3/22/2024	Term Loan B	680
SBGI	Sinclair Broadcast Group	Cable/Media	600	BB+	9/30/2026	Term Loan B	661
DAEHIM	Doosan Infracore	Capital Goods	660	BBB-	5/18/2024	Term Loan B	660
CC	Chemours Company	Chemicals	900	BB+	4/3/2025	Term Loan	645
VICI	VICI Properties	Real Estate	2100	BBB-	12/20/2024	Term Loan B	644
SSNC	SS&C Technologies Inc	Financials	1983	BB+	4/16/2025	Term Loan B-3	589
SSNC	SS&C Technologies Inc	Financials	1375	BB+	4/16/2025	Term Loan B-4	589
SSNC	SS&C Technologies Inc	Financials	1841	BB+	4/16/2025	Term Loan B-5	589
CTL	CenturyLink Inc	Telecoms	5000	BBB-	3/15/2027	Term Loan B	584
USFOOD	US Foodservice Inc	Food Producers	1500	BB+	9/13/2026	Term Loan B	576
ARMK	Aramark Corp	Food Producers	900	BBB-	1/15/2027	Term Loan B-4	566
GDI	Gardner Denver Inc	Capital Goods	928	BB+	3/1/2027	Term Loan B	562
JBSSBZ	JBS USA	Food Producers	1891	BBB-	5/1/2026	Term Loan B	549
CHTR	Charter Communications Holding Co LLC	Cable/Media	3804	BBB-	2/1/2027	Term Loan B-2 Extended	488
TRUN	TransUnion LLC	Financials	2600	BB+	11/16/2026	Term Loan B-5	485
LVLTPT	Level 3 Communications	Telecoms	3111	BBB-	3/1/2027	Term Loan B	477

Source: BofA Global Research, S&P LCD, Markit

Loans dislocated compared to bonds

Perhaps even more compelling is the dislocation between HY and Loans. Our relative model indicates that post last week's selloff, the loan index is >300bps cheaper than where it should be vs the HY index, making today the biggest dislocation since the financial crisis. Could this dislocation get worse- Yes- especially in price vacuums exacerbated by liquidity gaps. Will it ultimately mean revert- also Yes. We think HY spreads have more downside from here to catch up to the widening witnessed in loans. Additionally, we are just at the beginning of an entire Fallen Angel wave that is likely to put pressure on the HY market this year, something we don't worry about in loans. As such swapping out of bonds into loans presents a good entry point here, in our opinion.

Chart 3: Loans are most dislocated to bonds since the Financial Crisis



Source: BofA Global Research, S&P LCD, ICE Data Indices, LLC

We think this jolt in loans has also opened up pockets of value on bond-loan capital structures, where senior secured loans are yielding higher than unsecured bonds of the same issuer. Below we present a list of possible dislocations on bond-loan capital structures.

Table 5: Dislocations on capital structures

LOANS						BONDS				
TickerLoan	Cusip	Sector	Lien	DM	YTM	ISIN	Type	OAS	YTM	Spread Diff
RRD	74971KAK	Cable/Media	FL	1,049	11.90	US257867BB61	Sr Unsecured	770	8.38	-279
REYNOL	76173FAU	Materials	FL	1,062	12.06	US761735AV10	Sr Unsecured	831	9.02	-231
EM	15911AAC	Healthcare	FL	891	10.36	US15911NAA37	Sr Unsecured	732	8.13	-159
SSNC	78466DBD	Financials	FL	646	7.91	US78466CAC01	Sr Unsecured	539	6.44	-107
STWD	85570DAD	Financials	FL	671	8.19	US85571BAL99	Sr Unsecured	568	6.35	-103
TEACLL	88023HAC	Services	FL	919	10.67	US88023JAA43	Sr Unsecured	840	9.09	-79
WEX	96208UAP	Financials	FL	542	6.82	US96208TAA25	Sr Unsecured	467	5.22	-75
ADSWST	00100UAG	Services	FL	418	5.45	US00790XAA90	Sr Unsecured	357	4.90	-61

Source: BofA Global Research, S&P LCD, ICE Data Indices, LLC, Markit

Market Technicals

Over the past week, cumulative demand for loans was only $100mn, a continuous drop from the previous week's already weak demand of $126mn. CLO creation stayed soft at $971mn, as CLO arbitrage trended down in March (Chart 5). On the supply side, new issuance halted completely since last week, greatly impacted by the vulnerable market conditions. On the YTD basis, supply barely outweighed demand by $790mn as of Mar. 20th. Retail funds kept fleeing the market as investors stayed cautious facing the increasing volatility.

Table 6: Weekly Technicals ($mns)

	YTD as of 3/20/20	3/20/20	3/13/20	3/6/20	2/28/20
Retail flows (a)	-7,202	-1,374	-2,819	-1,412	-1,440
CLO creation (b)	15,267	503	1,995	1,512	2,363
Coupons (c)	13,892	971	950	1,481	937
Demand (a+b+c)	21,957	100	126	1,582	1,859
Issuance Ex-repricings (d)	90,172	0	0	380	2,476
Repayments (e)	69,004	NA	3,193	4,742	8,308
Supply (d-e)	21,167	NA	-3,193	-4,362	-5,832
Demand net of Supply	790	NA	3,319	5,944	7,691

Source: S&P LCD, EPFR Global.
Values in $mn. Weekly coupon values are estimated by dividing each month's coupon payment by 4.

Performance by segment

Loans in the LCD index have lost -11.2% during the past week as the continuous COVD-19 outbreak kept dragging down the market confidence. YTD, loans have lost a cumulative of -17.9%, while HY has lost -18.7%.. Within ratings, CCC loans have underperformed YTD with a total loss of nearly -20%. However, during the past week, BB loans have underperformed while CCC loans have help up slightly better.

Table 7: Return metrics

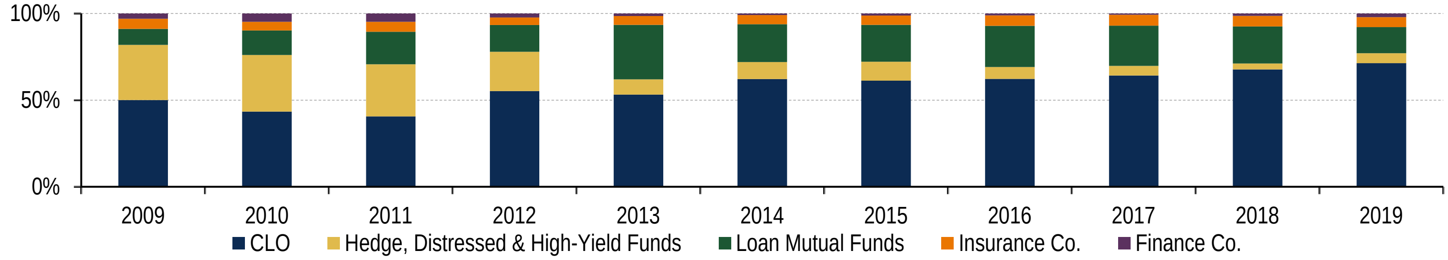
	For the period between 3/15 and 3/22		
	Total Return	Price Return	YTD Return as of 3/22
All Loans	-11.2%	-11.3%	-17.9%
BB Loans	-11.8%	-11.9%	-18.7%
B Loans	-11.3%	-11.5%	-17.9%
CCC Loans	-10.4%	-10.6%	-19.3%

Source: BofA Global Research, S&P LCD

Appendix

CLOs are an important factor to consider in the loan market given they are the single biggest buyer of loans and represent 71% of the primary demand within this asset class. Loan retail funds are the second largest buyers although their participation has shrunk since the peaks of 2013. Since then, we have seen increasing activity from CLO managers. At the same time, hedge, distressed & high yield funds have played a lesser role in the primary market.

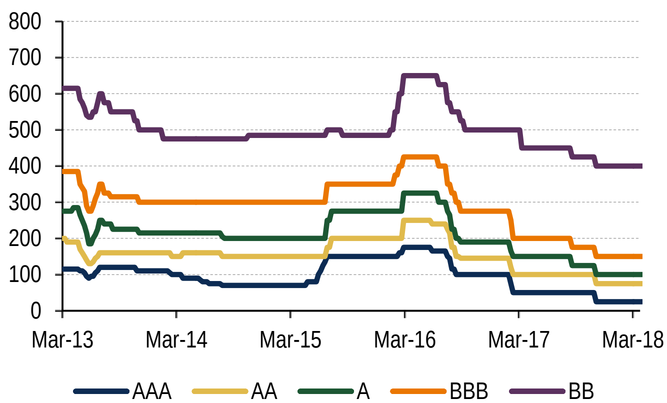
Chart 4: Primary institutional investor market by type



Source: S&P LCD

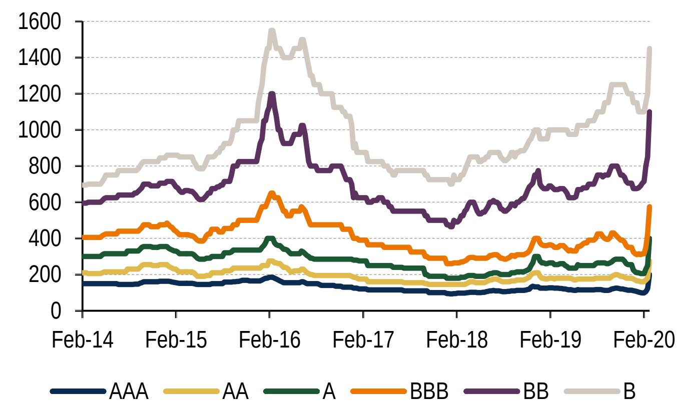
Three generations of CLOs exist today, CLO 1.0 (pre-crisis), and CLO 2.0/CLO 3.0 (post-crisis). The market is primarily driven by the latter. Below charts show CLO spread levels by tranches.

Chart 5: US CLO 1.0 indicative spread levels (bps)



Source: BofA Global Research

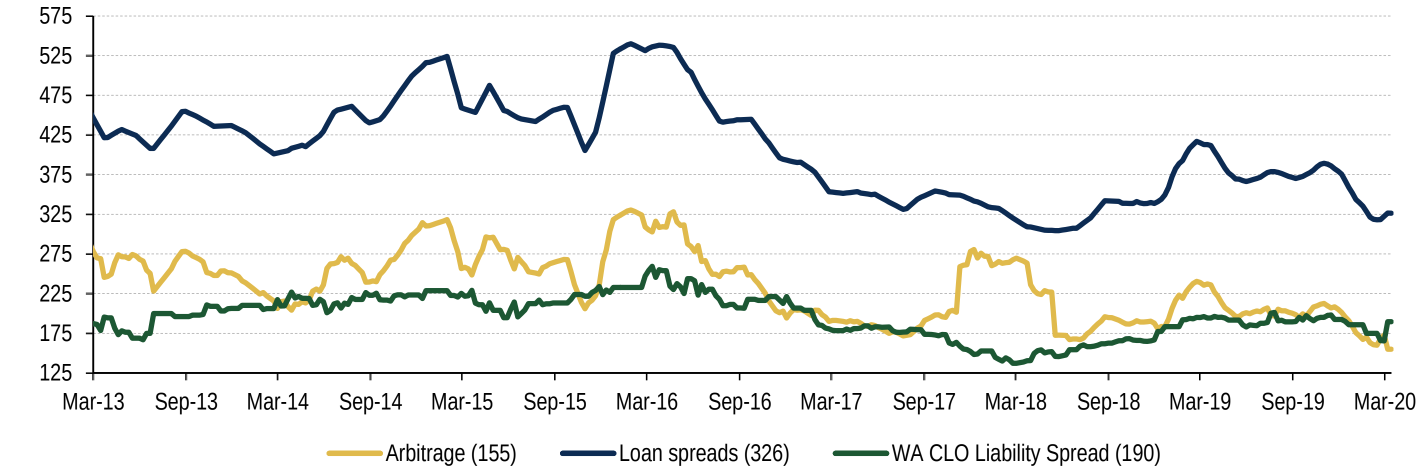
Chart 6: US CLO 2.0/3.0 indicative spread levels (bps)



Source: BofA Global Research

CLO arbitrage is a widely followed statistic in the loan market, and represents the theoretical spread that managers can capture by issuing CLOs. The below chart compares CLO asset (loan) spreads to the weighted average spreads of CLO liabilities. The difference between these two values is the theoretical arbitrage and represents the current attractiveness of creating new CLOs. A higher arbitrage number means a greater incentive for managers to bring new CLOs to the market, and thus provide incremental loan demand, and vice versa.

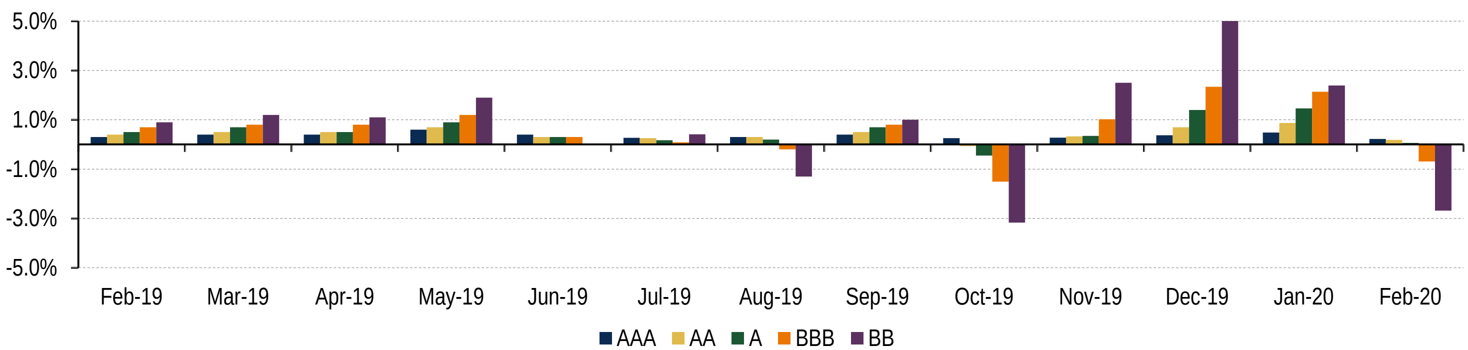
Chart 7: CLO arbitrage (bps)



Source: BofA Global Research, S&P LCD
Arbitrage: Loan asset spread - WA CLO spread X liability %.
Loan spreads (running avg 8wks) 60% new-issue B+/B, 20% sec B 20% sec BB.

Chart 12 shows monthly CLO returns as defined by the Palmer Square CLO index (price plus coupon returns).

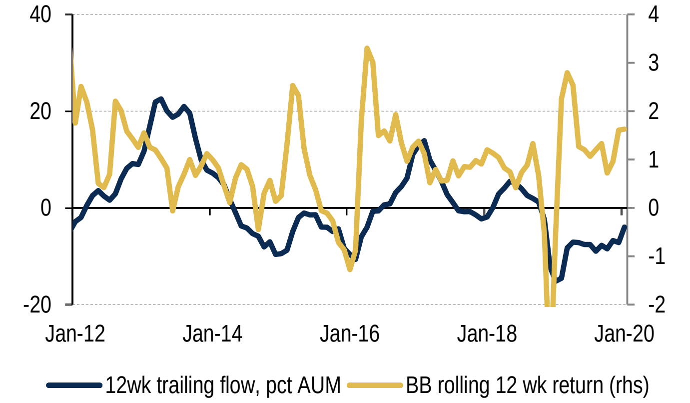
Chart 8: Monthly CLO 2.0 returns by rating



Source: BofA Global Research, Merrill Lynch PriceServe, Palmer Square CLO Indices, Bloomberg

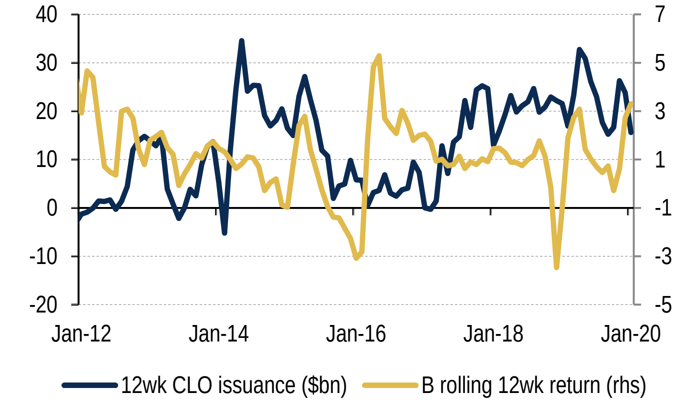
Since technicals play a big role in the loan market, following retail patterns is also essential. In general, we see that the performance of the BB section of the loan market correlates most with retail flows, while new CLO issuance seems to correlate to B Loan returns. This makes sense as mutual funds generally gravitate towards less risky investments while CLOs invest in single B rated assets on average. Chart 7 shows a measure of retail flows (12 week trailing retail flows as a percentage of outstanding AUM) vs. monthly BB Loan total returns, while Chart 8 depicts monthly CLO issuance vs. monthly B Loan total returns.

Chart 9: BB performance vs Loan retail flows



Source: S&P LCD, EPFR Global

Chart 10: B performance vs CLO creation



Source: S&P LCD, EPFR Global

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