Collateral Thinking

2019 outlook - Loans at crossroads

Bank of America Merrill Lynch

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Leveraged Loan Strategy
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Rising libor lifts all loans

Buoyed by libor, loans have outperformed most other asset classes YTD. Expectations of rising libor should continue to stimulate loan demand next year, but credit risk might get in the way. The loan market is at crossroads between the economic cycle - which is healthy and hence leading to increasing libor, and the credit cycle - which is showing some cracks and hence leading to lower risk appetite. In our opinion, higher libor will remain the dominant factor next year, keeping support for the loan product intact. As such we expect 2019 to be another year for ccompetitive total returns in loans.

The best is behind us

At the same time, we think that cycle tights are behind us. Going forward we expect earnings growth to decrease, central bank balance sheet to deflate, yield curve to flatten and baseline volatility to increase. While none of these reasons in themselves indicate an imminent cycle turn to us, we do think risk appetite will decline next year. However, solid fundamentals, and expectations of positive earnings growth should keep a cap on the spread widening, producing decent entry points through the year.

Credit losses to increase marginally

As a consequence of higher funding costs, higher volatility and lower investor risk appetite, we expect credit losses to increase next year. We estimate that par default rates will climb 60bps to 2.5%, and recoveries will be lower than 2018. We also think that a bulk of losses will be concentrated amongst the lowest quality issuers that have been struggling to generate ebitda growth. These are also issuers that may not be able to fully absorb the next 100bps increase in libor.

Expect wider spreads, lower returns and issuance

We expect 2yr loan discount margins to average 440bps over the next 12 months, which is 40bps higher than the average this year. We also think that the variance around the average will increase to 50-75bps from the current 20-30bps given higher volatility. We are forecasting new money supply to decrease by 10% while repricings should decline by 20%. On the whole, we expect loans to deliver returns of 4.2%-4.7% in 2019, given higher current income but also higher credit and capital losses vs 2018.

Relative value

We expect loans to outperform bonds again next year, but not without periods of comparatively more spread widening vs bonds. We like migrating up in credit quality: 1st liens over 2nd liens, and BBs over Bs. Within rating bands, we like BB2s over BB1s, and B2s over B3s, given that the B3/B2 spread differential is at cycle tights. We continue to see value in EUR denominated loans.

Risks

While our base case is for markets to stabilize at wider levels, there are notable risks. Currently we view these risks (trade wars, populism, corporate cracks, oil) as being isolated, and thus there is money waiting on the sidelines. However, should these seemingly idiosyncratic events happen with a high enough frequency, investors may start pricing in a cycle turn.

Table 1: 2019 USD loan forecasts

Issuer default rate	2.40%
Par default rate	2.50%
New money issuance	$410bn
2yr discount margin	440bps
Total return	4.2% - 4.7%

Source: BofA Merrill Lynch Global Research

Refer to important disclosures on page 17 to 18. 11938450

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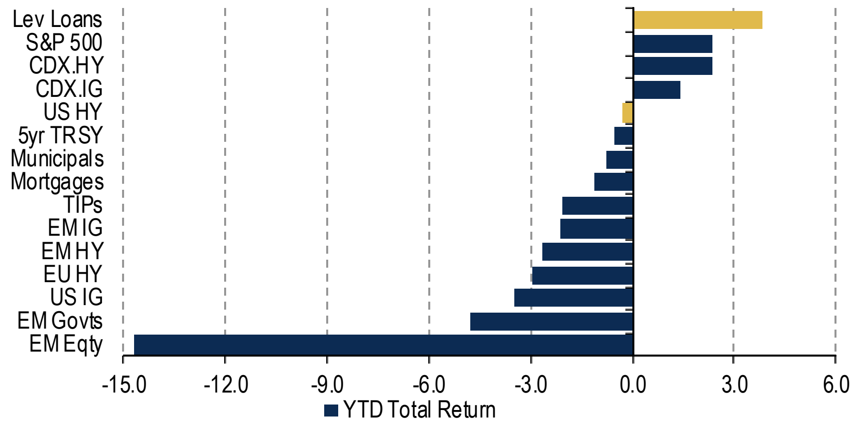
Contents

Loans at crossroads

Rising libor lifts all loans

Loans have had a good run this year having produced one of the best total returns across asset classes YTD. So far the asset class has generated 3.8% return with another 0.5% slated in coupons for the remainder of the year which should help them finish the year above 4% assuming no meaningful spread widening. Comparatively HY and IG bonds have produced -0.3% and -3.5% respectively, while US equities are sitting at a 2.4% return. Amongst rating buckets, Bs have outperformed BBs by 110bps. Across sectors, transportation, healthcare are the best performers, while gaming and autos have lagged the broader market.

Chart 1: Loans have outperformed all other asset classes in 2018



Source: BofA Merrill Lynch Global Research, Bloomberg, ICE BofAML Global Bond Index

What has set loans apart within corporates is Libor. Investors have bought into the product due to the appeal of earning higher coupons. Retail has poured $15bn into the asset class YTD, while new CLO creation is close to matching the past annual record of $120bn. At the same time issuers are also choosing loans as the preferred method of financing given lower carrying costs compared to bonds, as well as flexible call structures and credit agreements. In the face of robust demand, loan 2yr discount margins have tightened through 2018: starting the year at 433bps, setting a low print of 381bps in April, and now backing up to 415bps. At the same time, all-in yields have increased 90bps from 5.2% to 6.1% this past year.

As we think about what lies ahead, we evaluate how demand might change next year. The good news for yield sensitive investors is that libor should be staying course. Our house view is of another 5 fed hikes from here through 2019, which will put upward pressure on libor. This should continue to stimulate loan demand. What might get in the way is credit risk. Most of the tailwinds that credit enjoyed over the course of this cycle peaked in 2018, and are set to decline from here. We therefore think that risk appetite will be comparatively lower next year, and effect of cracks in the credit market, within loans or elsewhere, could be more pronounced resulting in higher volatility. According to us the tights of this credit cycle are behind us, and we are on our way to higher spreads. However, we are also cognizant of the strong earnings backdrop, and factors such as current debt and capex growth, which suggest low likelihood of a cycle turn here. As such we think the move wider will remain modest.

The loan market is at crossroads between the economic cycle - which is healthy and hence leading to increasing libor, and the credit cycle - which is showing some cracks and hence leading to lower risk appetite. How 2019 shakes out will ultimately depend on which factor has more pull. From data points we currently possess, we think higher libor should remain the dominant factor next year, keeping support for the loan product intact, and forecast 2019 to be another year for competitive total returns in loans.

At the same time, a natural consequence of incrementally lower investor risk appetite, and thus a higher bar to fund lowest quality issuers, is that credit losses should increase next year. We expect default rates to be higher and recoveries to be lower in 2019 vs 2018. While we find lending conditions today to still be accommodative, we think they will get more constrained when an increasing number of micro and macro risks manage to keep volatility on the higher side. Having said that, projected credit losses are still on the lower side of the spectrum ~80bps in 2019 vs 50bps this year on the back of default rates climbing 60bps to 2.5%.

In terms of spreads, we think the loan 2yr DM will average 440bps next year, 40bps higher vs 2018 average. We also think that the variance around the average will increase to 50-75bps from the current 20-30bps given higher volatility.

Finally, we think new money supply will decrease by 10% to $410bn, while repricings should drop comparatively more, to $210bn. We are looking for LBO activity to pick up, M&A to stay flat, and refinancings to drop next year given our house rate current projections. Given expectations of higher libor, we believe there will be decent demand for loans, all else equal. CLO new issuance should remain decent (~10% lower YoY), while retail funds could reverse some of their recent outflows if equities stabilize.

Adding everything up, we expect loans to deliver returns of 4.2%-4.7% in 2019, given higher current income but also higher credit and capital losses vs 2018. Though loan returns in 2019 will likely be lower than this year, we think the asset class will be one of the few places in fixed income to offer mid-single digit total returns.

The year ahead in loans

Key macro assumptions

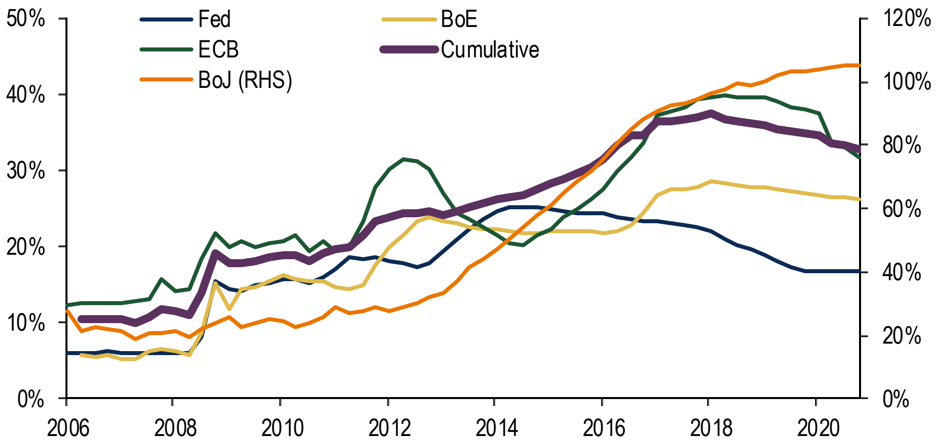
Before we take a deep dive into each of our forecasts, we take a look at some of the factors that are shaping our view of the macro picture next year. Our base-case scenario assumes the following five key developments taking place at some point over the coming months/quarters:

US corporate earnings growth slows down. Reported yoy EPS growth of S&P1,500 index (captures the full spectrum of issuers, from large to mid to small caps) has peaked at 25% in Q2 and is currently tracking 23% for Q3. While the extent of the slowdown in growth is not significant, it was the first quarter out of eight when the yoy EPS growth failed to exceed the growth rate of a preceding quarter. We think this data point helps explain a relatively strong market reaction in October, which was less about the strength of earnings at hand and more about resetting expectations for the future.

Earnings are poised to experience further deceleration in growth as we go into the next year, as favorable effects of tax reform recede. Earnings were growing at 10-12% pace prior to tax reform, and we see few reasons to suggest this is not where growth is headed eventually, perhaps by Q3/Q4 2019. We still view this as a healthy growth environment, and would not use this as an argument for increased risk of a turn in credit cycle.

Global central bank balance sheet starts to deflate. The Federal Reserve was engaged in rolling off its balance sheet at about a $25bn/mo average clip in 2018. At the same time, its actions were offset with a continued expansion of QE programs by the ECB and BOJ, at $30bn/mo and $25bn/mo in US dollar equivalents respectively. This dynamic will change next year, when the Fed hopes to at least maintain but ideally increase its pace of roll-offs to $50bn/mo, while the ECB stops its purchases in January. Even if the BOJ continues at its current pace for a while, this means the aggregate balance sheet starts to deflate next year for the first time in this new monetary policy experiment that was underway since the GFC. As such, on a cumulative basis, 2018 is expected to represent the peak in central bank balance sheets as a percentage of GDP, and this measure is set to decline from here (Chart 2). Granted the pace of decline is measured, it is nevertheless net negative vs 2018.

Chart 2: G4 central bank balance sheets as a share of GDP



Source: BofA Merrill Lynch Global Research

Volatility set all-time record lows in 2017 and then shifted into a higher gear this year, with at least two meaningful global shocks rocking the markets in February and October, aside from more localized events hitting EM, IG, and EU sovereign markets at different points in time. And while the direct link between central bank liquidity and volatility is hard to prove with precision, the connection appears evident. So we assume this link produces frequent and more pronounced volatility shocks next year. We do not yet see reasons why such shocks would necessarily lead to a more material reassessment of prospects for the cycle at this stage, although we remain open-minded when it comes to this particular point. For now, we are setting ourselves up to be able/willing to increase portfolio credit risk as/if such volatility shocks materialize.

Inflation peaks. Core PCE has oscillated around 1.5% for over five years, before it made a breakthrough to 2.0% in 2018. This year's environment provided a good backdrop for a temporary upswing in inflation, with factors ranging from tight labor markets to strong GDP growth to higher oil prices all contributing to the outcome.

Going forward, we expect the environment to normalize somewhat, with fading tax reform effects and accumulating costs of the trade war leading the way to slower economic growth. Oil has appreciated by 50% from Sept 2017 to Sept 2018, before retracing over 20% in the last few weeks. As such, it is likely to turn from a tailwind and into headwind for inflation. In the meantime, our economists forecast core PCE rising to 2.3% by Q3 2019 before softening to 2.2% by the end of 2019.

Yield curve flattens. The 10/2yr US Treasury yield curve has flattened by 120bps over the past three years, just as the Fed has hiked short-term rates by 200bps, implying a 6bps of flattening for every 10bps of hikes. We do not expect this reaction function to change going forward, and given the current yield curve level of around 30bps, would not be surprised to see it flat and perhaps even modestly inverted after the next 2 maybe 3 rate hikes. Such an event should create a natural barrier for the Federal Reserve to continue hiking interest rates, as the FOMC has in the past generally refrained from raising Fed Funds more than once or twice into a flat yield curve.

Once the yield curve is flat, the consensus is all but certain to start vocally entertaining odds of the next recession, and this is going to make it more difficult for the Fed to continue tightening policy in a constructive way in our opinion. We do not view the link between yield curve and timing of recessions as direct/immediate/automatic; however we do recognize a lagged and variable connection between the two. During the pre-GFC cyclical turn, it took around 18 months between the initial curve flattening in Dec 2005 and sharp tightening in credit conditions in Jul-Aug 2007. In the late 1990-ies the curve initially flattened in mid-1998 and the credit contraction did not arrive until mid-2000.

Simultaneously, our rates strategists forecast the yield curve at +5bps by the end of Q3 2019 as a product of 3.50% on the 10yr and 3.45% on the 2yr.

Trade war fades. With Democrats retaking the majority of US Congress, we think they may now have enough clout to be able to distract the Trump administration with various inquires and investigations. As such, the administration may eventually lose its focus on trade, although we would not be surprised to see one more push to apply higher pressure on China during the lame duck session. We think the fact that S&P500 has bottomed out 100pts away from wiping out all post-tax reform upside coupled with the fact that other major trading partners, including Canada, Mexico, the EU and S Korea, were able to achieve new arrangements in exchange for token concessions should both translate into eventual resolution of trade issues with China.

Across all assumptions we listed above this is the one we have the least conviction on. If it turns out we are incorrect, we think further escalation of tensions with China is the fastest track from here to the next recession.

The best is behind us

By most standards, the US economy is the shining star in the global map today. Many emerging economies are either slowing down or in outright recession, while EU has its fair share of problems with Brexit and Quitaly at a time when ECB support is receding. Comparatively, the US is running at a 2.9% GDP growth rate, the economy is at full employment, is still in expansionary territory, consumer confidence is at high levels, and we are seeing some early signs of wage inflation. Consequently, the Fed is likely to continue down its hiking path, and our economics team is now calling for 5 rate hikes from now through year-end 2019. As it comes to the underlying economic strength, the picture is still clearly constructive. However as we noted above, this backdrop is expected to soften in 2019 as a result of slowdown in earnings growth as well as less support from the central banks.

Financial markets usually peak before the real economy which is perhaps why despite solid economic metrics, we have seen idiosyncratic events turning market sentiment. We saw the equity market react violently late last month on trade war warnings from a handful of companies, though in aggregate the Q3 earnings season has beaten analyst expectations (EPS and sales have beaten expectations by 5% and 1% respectively), and EPS guidance has been better than the long-term average. We are now also seeing this play out in the credit markets. Today, for a company, the penalty for missing earnings is more than the reward for beating them.

The above are reasons why we believe that cycle spread tights are now behind us. Going forward, we expect baseline volatility to increase, with sustained periods of high volatility which will keep spreads from going another leg tighter. On the other hand, fundamentals are still solid with loan issuer revenues and earnings growing at 7.5% and 14.5% YoY in Q3, and topline growth expected to remain healthy as long as our economic forecasts hold up. As such, we think the widening will remain in check, and chances are that the fallout from idiosyncratic risks will remain contained and markets will stabilize at wider levels.

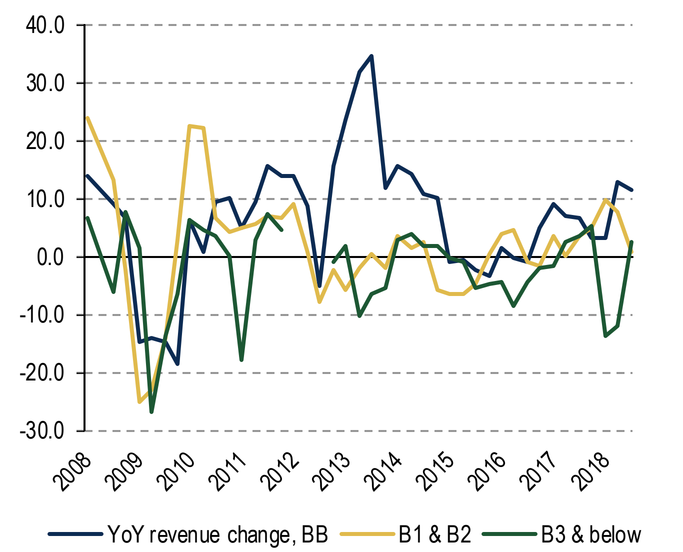
Credit losses to increase but remain benign

Short term, credit risk increases marginally

Loan market fundamentals remain healthy, in line with the broad economy. Earnings growth has been in mid-teens, while revenue growth continues to come in at high single digits. While we expect net income growth to rein in next year given high base effects due to this year's tax reform, revenue growth should be decent if the economy continues on the trajectory our economists are forecasting. Having said that, the combination of higher funding costs and lower investor risk appetite will, in our opinion, result in some issuers facing financing pressures next year, leading to incrementally higher default rates.

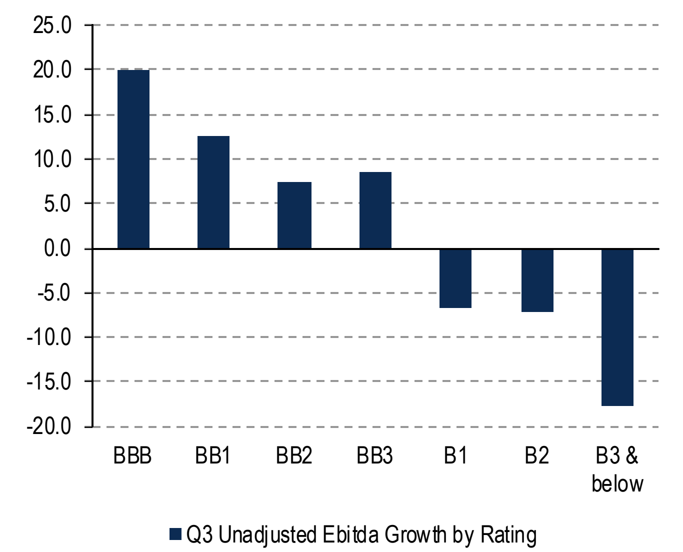
Our base case is that the bulk of credit losses will be concentrated amongst the lowest quality issuers as they are meaningfully more vulnerable than the rest of the market. As Chart 3 shows, this segment of issuers didn't really experience a revenue boost to the same extent as higher quality companies that issue loans. While BB issuers reached peak growth rates of 20-30%, high single-B issuers spent a better part of the credit cycle at 0-10% revenue growth, while B3 and below issuers struggled to register positive revenue growth even in good market conditions. Chart 4 shows the rating wise composition of the current loan market EBITDA growth, and underscores the extent of weakness in low quality issuer earnings. Additionally, B3 and CCC issuers collectively will have an outsized drag on their free cash flow from debt service in the event libor increases another 100bps, while coverage ratios for the broad loan market are healthy enough to be able to absorb that impact.

Chart 3: YoY Revenue growth by loan issuer rating



Source: BofA Merrill Lynch Global Research, Bloomberg

Chart 4: B3 & below issuers are significantly more vulnerable



Source: BofA Merrill Lynch Global Research, Bloomberg

Currently based on a 4% expected issuer default rate in HY, our model points to a forecast of 2.4% issuer default rate in loans. Using the 20 year relationship between issuer and par default rates in loans, we think par defaults will also be in a very similar context, at about 2.5%. We expect recoveries to be in the low 60s context next year. In a more pessimistic situation if the economy slows down, or there are rising idiosyncratic risks, coverage deterioration could spill over upwards in the rating spectrum, creating additional default pressures, pushing par default rate above the historical average of 3%.

Longer term, risks mount

While credit risk is still relatively benign over the next year, what concerns us is how this cycle will end for loans. Today loan issuers have the highest gross leverage within USD corporate credit. Thus, we think the default rates could peak at meaningfully higher levels ~14% in a severe recession (past peaks have been ~8%). Our argument for a 14% default rate ("DR") rests on our understanding of substantial growth rates that loans have experienced in recent years, coupled with the higher leverage measures relative to other related asset classes.

Exacerbating losses will be recoveries which we think will be materially lower through the next default cycle as a result of three factors: poor investor protections, lesser subordination, and poor tangible asset coverage in sectors most exposed to syndicated loans (technology, services, and retail). To ascertain this numerically, we look at each credit cycle independently, comparing recoveries in its "below average" and "above average" DR period. Analyzing each credit cycle independently neutralizes any special factors present during one cycle and not the other. This is especially useful in the current cycle given we don't have any historical precedent for how to evaluate a post QE world.

What we find from the past two default experiences is that recoveries in times of "above average" DR tend to be 14 to 19 pts lower than recoveries during times of "below average" DR. Table 2 summarizes this result. By comparison the prevailing recovery rates, which defines this cycle's "below average" recoveries, is 69. Assuming that the next default experience will look more like the one in 1999- a longer, shallower cycle, taking a 14pt haircut on recoveries lands us in the mid-50 range of recovery rates for the broad index through the period of higher default rates when it arrives.

Table 2: Loan recoveries in the next default cycle could be meaningfully lower

	1999 experience	2009 experience	Next experience
Below Avg DR	75	78	69
Above Avg DR	61	59	55
Recovery haircut	14	19	14

Source: BofA Merrill Lynch Global Research, Moody's, LCD

After analyzing a variety of scenarios, we find that aggregate permanent losses for loan investors could rival those of bond investors in the next default cycle, which will be a departure from previous default experiences. We think investors should be cognizant of these long term risks in the loan asset class.

Spreads wider but returns competent

As a natural consequence of where we are in the credit cycle, we expect spreads to be wider next year. To us, the tights of this credit cycle are behind us, and spreads are set to go wider from here. This comes as a function of deterioration in both risk appetite, and the overall credit quality of the loan index next year. We expect loan 2yr discount margins to average 440bps over the next 12 months, which is 40bps higher than the current LTM average. Our estimate is based on our 3 factor model which takes in HY spread forecast, credit rating differential as well as the shape of the yield curve into account.

Our 440bps is not a year-end target, but an average over the year. In that sense, there will be periods of time where spreads will be higher or lower than this figure. In particular, given the breadth of opposing forces at work next year we think the range of spreads could be wider than this year. Loans spent a better part of this year in a narrow band of 20-30bps around the average of 400bps. We think next year the range could be 50-75bps around the average of 440bps, which means at wides, we could be north of 500bps. Those would be levels where valuations will start to look attractive once again barring any meaningful shift in underlying economic tone (note we have been of the opinion that loans are good enough to hold but not good enough to buy for most of 2H18).

The higher spreads should manifest in terms of pricing pressures in both the primary and the secondary. In the former, where spreads usually decrease in the face of increasing libor, we assume spreads to remain flat due to market environment, raising cost of funding. This is consistent with our expectation of a sharp drop in opportunistic issuer activity as explained earlier. Event-driven activity, however, is expected to be less impacted for now. While another 50-60bps higher in interest costs may prove to be punitive for refinancing transactions, it will take a bigger change in investor sentiment for sponsor driven activity to rein in. In the secondary market, we expect prices to drop by about half a point in our base case.

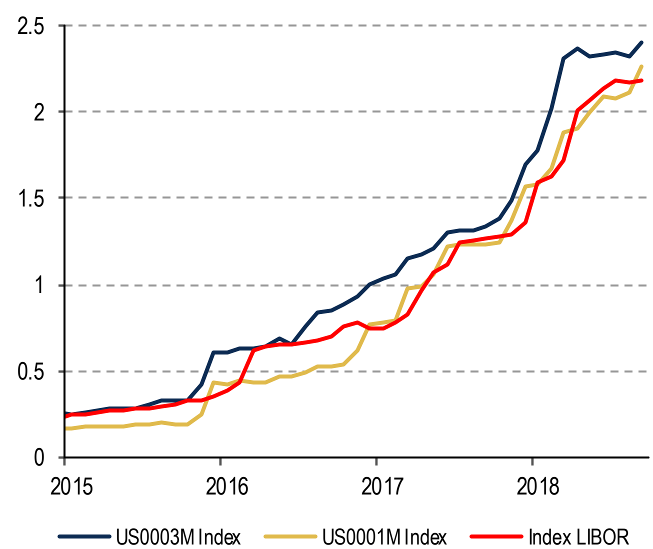
Chart 5: Actual vs estimated loan 2yr discount margins

Source: BofA Merrill Lynch Global Research, LCD

We assume 3m libor starts and ends the year at 2.8% and 3.8% respectively, in line with our rates team's forecast. In our total return model, we take a 30bps haircut on these numbers given the average index libor today has drifted closer to the 1m libor levels than the 3m libor levels that it used to traditionally hover over historically (Chart 6).

Assuming unchanged nominal spreads over libor, the average coupon loan investors stand to earn in 2019 is around 6.3%. We expect ~80bps of drag each from capital losses in the secondary as well as credit losses due to defaults, subtracting which we get about a 4.7% return over the year. This forms the top end of our forecast next year. We also draw up a scenario where the macro picture deteriorates further and the Fed is unable to deliver hikes in 2H19. Here we cut our libor increase forecast, increase our spread target, and increase default rate expectations, getting to a 4.2% total return. These results are summarized in Table 3

Chart 6: Avg index libor has drifted towards 1m libor



Source: Bloomberg, LCD

Table 3: Total return scenarios for 2019

	Start	Base case	Pessimistic
DM 2yr, bps	**413**	**444**	**466**
Avg index Libor, bps	230	350	300
Coupon equiv alent, bps	562	685	640
Current Yield, bps	**571**	**699**	**655**
Spread change, bps		31	53
Spread Duration		2	2
Key Rate change, bps		120	70
Rate Duration		0	0
Repricings drag, bps		-20	0
Capital gain, bps		**-81**	**-105**
Default Rate, pct		2.5	3
Recov ery Rate, pct		63	63
Assumed current price of future defaults, pts		90	90
Credit Loss, bps		**75**	**90**
Real total return, pct		**4.78**	**4.18**

Source: BofA Merrill Lynch Global Research

Gross issuance to shrink by 15%

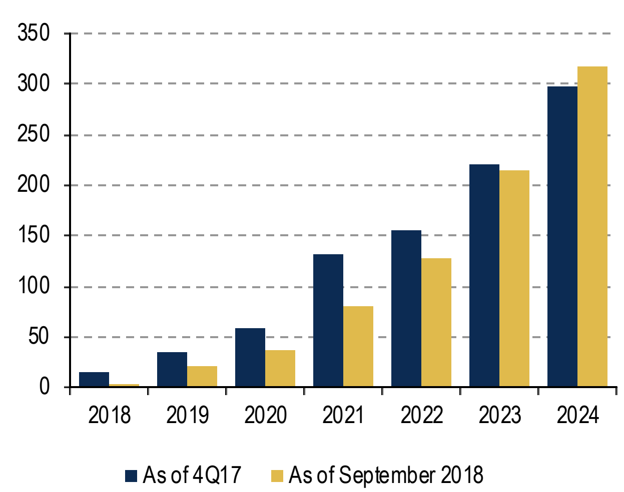
We think new money supply will be directionally lower by about -10%, resulting in issuance of ~$410bn assuming we reach our 2018 forecast of $450bn. Repricings will likely continue to slow - we expect about 20% of the loan market, or $220bn, to reprice over 2019. This brings our 2019 gross issuance forecast to $630bn, a 15% decline over this year's levels. The YoY decline is on the back of another year of shrinking opportunistic issuance which is expected to decline by -40%. M&A supply is expected to take a back seat while LBO issuance could pick up by +15%. In terms of net issuance, we think the index could add another $200bn in 2019 giving the USD leveraged loan market a realistic shot at becoming bigger than the USD HY bond market next year.

New money issuance to decline by 10%

We think 2019 will be a year defined by sponsor activity in the leveraged loan space. Tax reform has already reduced the incentive of companies to take on opportunistic debt. Now with significantly higher interest rates, companies have little incentive to refinance their deals. Only 4% of the outstanding market matures through 2020. LBO issuance on the other hand will be driven by the record amounts of cash sponsors are sitting on, and the need for them to create value for their LPs. Further their biggest challenge - company valuations - just got easier with October's selloff wiping out most of this year's equity gains. As such we see LBO issuance rising ~15% in 2019 vs +3% this year.

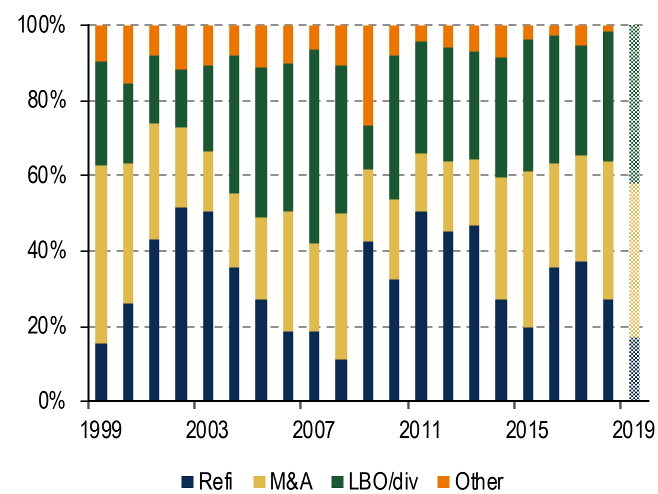
Corporates on the other hand have generally been uncomfortable setting aside large amounts of capital for acquisitions or capex in the face of policy and geopolitical headwinds. Bouts of volatility make it difficult for corporates to plan equity-financed purchases. As such we don't think corporates will materially raise their M&A ambitions next year vs 2018, and we have pegged a small increase of 2% in M&A related issuance in 2019. This compares to +15% YoY growth in acquisitions this year.

Chart 7: Loan Maturity Profile ($bn)



Source: BofA Merrill Lynch Global Research, LCD

Chart 8: Distribution of Loan UOPs

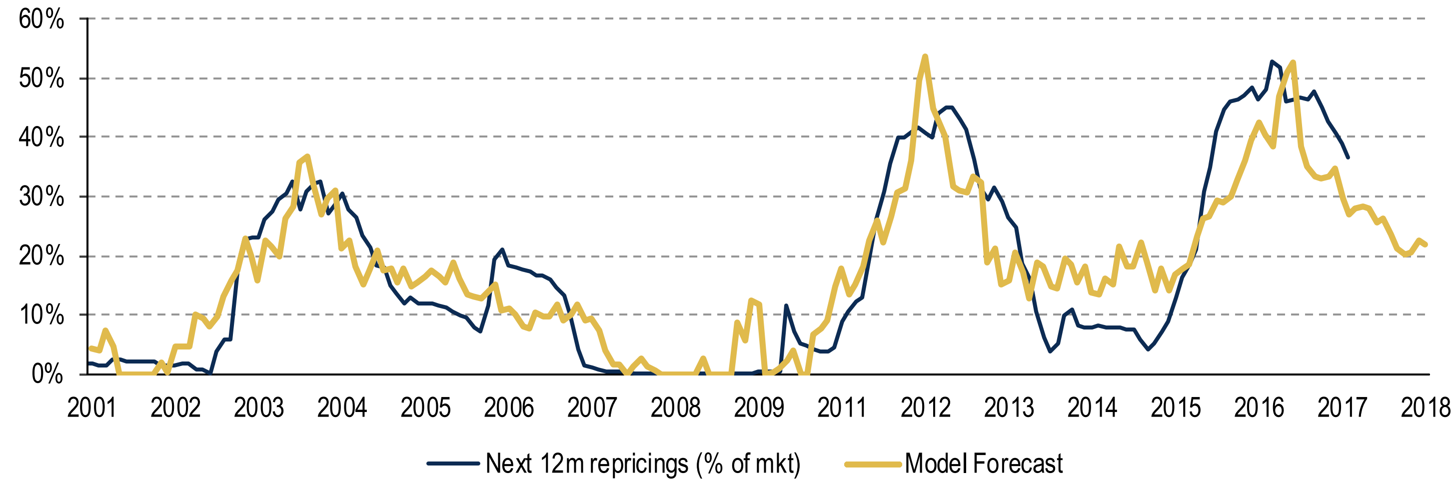


Source: BofA Merrill Lynch Global Research, LCD

Repricings to decline by 20%

We expect repricings to slow down to about $220bn, or 20% of the market over the next 12 months. This call is unchanged from when we first published it in the summer (detailed here). Since then the LTM repricing activity has come down from 50% of the market to 37% today, and we think this figure will continue to converge towards our estimated 20% mark (Chart 9). Our model takes inputs from 1) proportion of loans trading above par 2) CLO arb 3) yield curve and 4) real rates, and explains 75% of the variation in repricings on a 12m forward looking basis. Two of these factors currently are supportive of higher repricings: loans trading above par have increased from 24% in June to 36% at the end of Oct. Additionally, the 2s10s curve has flattened, incentivizing more activity. Remaining two factors are pulling repricings lower: CLO arb has been trending lower, and higher 10yr real yields are also putting pressure on volumes.

Chart 9: Predicted vs realized repricing activity (% of loan market repriced over the next 12 months)



Source: BofA Merrill Lynch Global Research, LCD, Intex, Bloomberg

Index AUM to increase

There has been substantial interest in the loan market becoming bigger than the HY bond market. While we aren't there yet, we think there is a reasonable chance we do so by YE 2019 if the economy holds up and libor rate increases as per expectations. This year, the biggest driver of index growth has been debt from first time issuers. Of the $151bn growth in the index YTD, 59% has come from these issuers. Next biggest source of growth has been add-ons from existing issuers which has accounted for $65bn in net issuance YTD, already surpassing last year's $18bn of annual contribution. Here, bond issuers have provided an outsized contribution, representing $33bn of the $65bn in add-ons. We think this will continue to be the case in 2019 as we see more loan-for-bond take outs. All told, the net issuance in the loan market could hit the $200bn mark next year (about 50% of all new money issuance), putting the index-eligible loan market at the verge of $1.3tn and ahead of the $1.25tn in the HY market, assuming HY market shrinks/grows at lesser rate next year, which is our base case.

Relative value

Loans vs HY

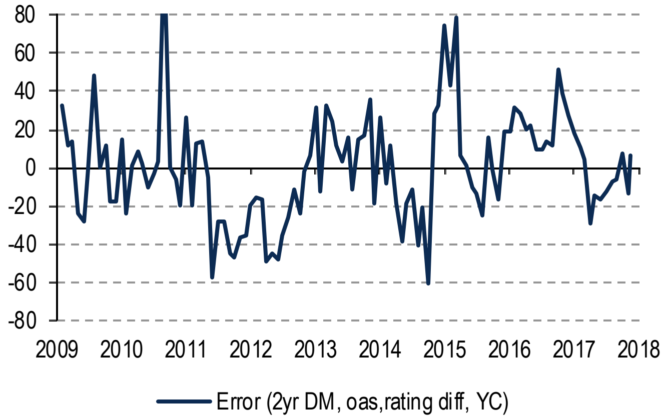
Chart 10 shows how the difference between the actual and estimated (based on HY spreads) loan spreads has evolved over time. The higher that value, the cheaper loans are vs HY bonds. Going into the year loans appeared cheaper than bonds according to the post crisis relationship between their spreads. This quickly changed after loans staged a rally through Feb, swaying to the rich end of the spectrum. Since then, loans have gradually mean reverted to their neutral relationship with bonds, implying we are close to fair value in loans vs HY bonds today, after the recent sharp selloff.

Though the degree of spread movement in loans is generally lower than bonds, loans tend to overcompensate when market conditions become challenged. Chart 11 shows the trailing 12-month spread beta between loans and bonds. It measures the relationship between monthly loan and bond spread changes over a rolling 12 month basis. We make three observations here. First, the general drift of the spread beta all things equal is lower, i.e. the natural tendency for the loan market is move lesser in spreads compared to the bond market. Second, occasionally the market corrects, where we see a jump in the spread beta usually in times of worsening credit conditions. The 5 jumps we see in the chart are in July 2007 (recession), August 2011 (US downgrade), June 2013 (taper tantrum), Feb 2015 (Commodity crisis) and March 2016 (China woes).

Third, on average the spread beta jumps about 0.4x in these episodes, and it happens very quickly.

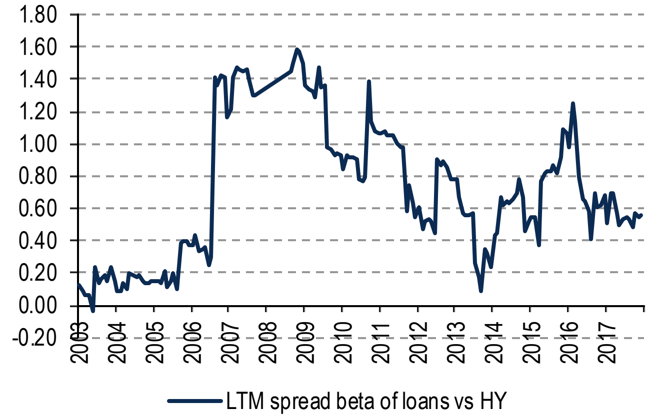
Since 2016 we are back down to 0.55x spread beta of loans to HY, which means for every 100bps change in HY spreads, loans have moved 55bps on an LTM basis. As we go into tougher financial markets next year, we expect that reaction function to increase. LTM loan spread beta to HY could jump to nearly 1x, meaning loan spreads might widen more than HY spreads over a period of a few weeks, when the next material shock arises. If HY, currently at 420bps were to quickly move another leg wider to say 500bps, it could take loan spreads wider by nearly 120bps from here i.e. to 530bps. We think this level forms the ceiling for loan spread widening next year, and we will be buyers there.

Chart 10: Actual minus estimated loan spread



Source: BofA Merrill Lynch Global Research,LCD, ICE BofAML Global Bond Index

Chart 11: Loan spread beta to HY



Source: BofA Merrill Lynch Global Research, LCD, Bloomberg, ICE BofAML Global Bond Index

BB2s vs B3s

Until then we like to migrate up in quality: BBs over Bs and 1st liens over 2nd liens. Looking at narrow credit ratings, we find BB2s to be the least strained as they have been widening relative to BB1s since last year. A year ago the spread differential between BB2 and BB1 spreads was 19bps, which today has widened to 35bps, the highest in a year. At these levels the BB2/BB1 spread differential is near the post crisis peaks this metric has reached on 3 prior occasions, each time rebounding from there.

On the contrary, BB3 and B3s are the most stretched in their respective rating buckets, with the latter in particularly unchartered territory. The BB3/BB2 spread differential has compressed since 2016, reaching 38bps today, but higher than the cycle tights established in 2013 at 18bps. Meanwhile B3/B2 spread differential has collapsed from a high of 460bps in 2016 to 85bps today, representing a cycle tight in this metric. Combining these lofty valuations with their fragile state of fundamentals, we think B3 and below issuers will be the first domino to fall in 2019 when faced with challenging market conditions. This represents a challenge for leveraged loans as most of the growth in the market last few years has come from B2 and B3 issuers. We don't necessarily believe in making a blanket negative recommendation on B3 loans, but rather think that strong credit analysis is a precondition to invest in this strata of issuers.

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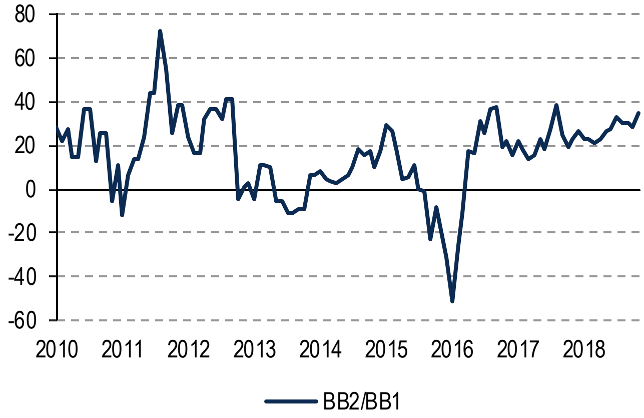
Chart 12: BB2 minus BB1 spreads



Source: BofA Merrill Lynch Global Research, LCD

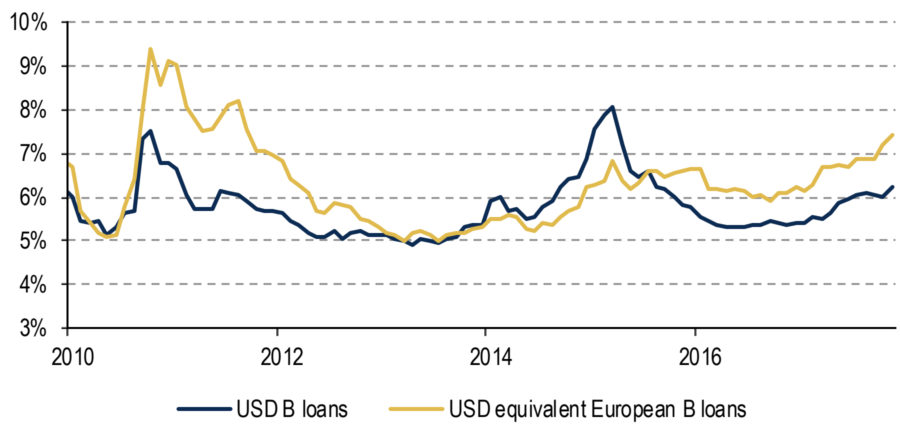
Chart 13: B3 minus B2 spreads

Source: BofA Merrill Lynch Global Research, LCD

USD vs EUR loans

We continue to see value in EUR denominated loans here on the back of the interest rate differentials within the two geographies propping up favorable FX forwards. The USD equivalent of EUR B loans is currently at 7.4%, ~1.2% higher than what B USD loans are yielding at the moment. The bump comes from the 3.5% investors can pick up in the currency forward market by entering into spot USD-EUR contracts today and EUR-USD forwards 12 months from now. The catch here is liquidity- the EUR loan market is a fraction of the USD loan market.

Chart 14: Yield comparison of USD B loans and currency hedged EUR B loans



Source: BofA Merrill Lynch Global Research, LCD, Bloomberg

Summary of HY forecasts

Within HY we expect spreads to move higher and average 425bps next year. We think issuer-weighted default rates will increase to 4.0%, which translates to 2.5% dollar-weighted rate, resulting in a 2.4% total return for the year as the base case. In the current market move we think the next stop for spreads is likely 500bps. If the market is trading in low-400s here, and is potentially headed towards 500 but not likely to break through, we think investors should be adding risk on their way there. We are still cautious on CCCs, although we clearly like them better here, after a 550bps reversal. We also like energy better at $54 WTI then we liked it at $75. Overall, with rates risk now receding – as we long expected it to – we think credit could produce some decent returns from wider levels.

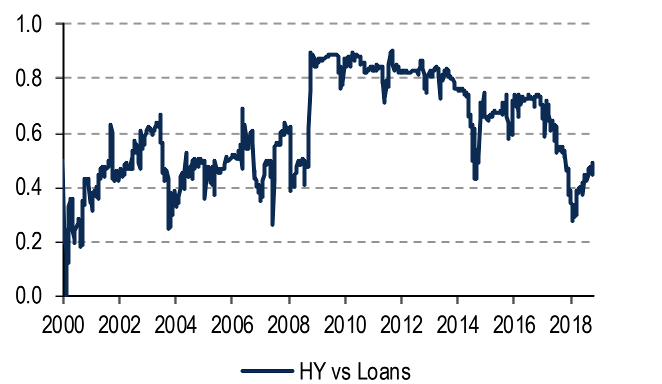
Short term divergence, long term convergence

Loans have diverged from bonds lately in a variety of ways: loan funds have seen inflows vs bond funds have had outflows for the last two years. Loan supply has declined by 7% YoY while bond supply is down about 25%. The return correlation between loans and HY has decreased to levels that existed before the crises. This has been a result of two phenomena (Chart 15).

First, the overlap of issuers within both markets has been decreasing over time (Chart 16). Today only about 23% of the issuers in the index have bonds outstanding, meaning the remaining are loan-only issuers and thus will remain relatively immune to the price movements of bonds, at least directly. As we described earlier a lot of new issuers are first time issuers, which either didn't have debt outstanding before, or used to finance themselves in the middle-market.

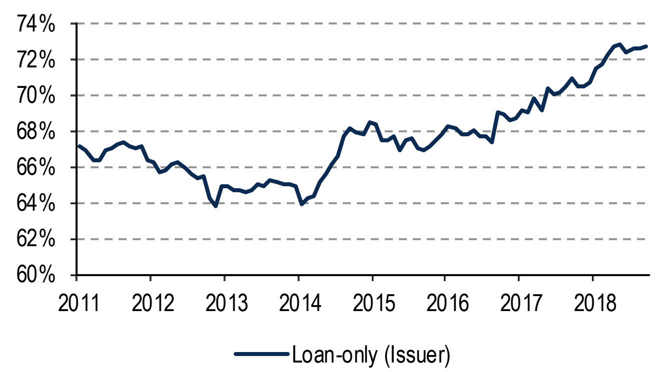
Second, the risk-retention rules that were passed for CLOs at year-end 2016 had the happy aftermath of increasing the diversification of the ultimate providers of capital both in terms of geography and mandates. Many CLO managers raised dedicated equity funds targeted towards non-traditional investors which increased the awareness of the loan product amongst them, attracted new providers of permanent capital, and brought the asset class more mainstream. This, along with the snap back of HY post energy crisis, contributed to the large correlation decline in 2017.

Chart 15: 52wk trailing correlation between HY and Loans has decreased



Source: BofA Merrill Lynch Global Research, LCD, ICE BofAML Global Bond Index

Chart 16: Preponderance of loan-only issuers has increased



Source: BofA Merrill Lynch Global Research, LCD

The above factors have led to conditions that are more favorable to loans than bonds, leading to recent divergence between the returns of the two asset classes. However, over the longer term the theme we foresee is one of convergence between them. Credit quality of loans is virtually on top of bonds today compared to the 1.5 notches higher than bonds it was 20 years ago. This has real implications for the next default cycle when it arrives. As highlighted before, permanent credit losses stand to be in the same ball park for loans and bonds because of the higher than usual default rates and lower than usual recoveries, something most traditional loan investors are not used to seeing.

In summary, we think that loans will continue to offer value vs bonds next year, and will outperform them on a total return basis for a second consecutive year. However the degree of outperformance may be lower than 2018 given less aggressive rate increases, and higher expectations of credit losses. Over the longer term, we think investors should remain cognizant of the risks that they may face. This doesn't take anything away from our belief that loans are likely to be a bright spot within corporate credit next year, and have the potential to once again outperform other fixed income asset classes. We reconcile the two views based on investment horizons. In the short to medium term, loans are probably the best game in town in terms of stability and level of returns. As long as libor remains high, and credit risk doesn't jump materially (which is our medium term view), loans are likely to stay course. If one's holding period is longer than that then one has to pay increased attention to potential credit losses and make portfolio decisions accordingly.

Risks to macro outlook

All the forecasts we have made in this report are based on our expectation that the macro environment will remain supportive of the continued gradual evolution of this credit cycle. This backdrop could be challenged by the following key risk factors:

Populism takes hold. With time, populist electoral gains look less like an aberration: the latest print came after US midterms failed to deliver a resounding rebuke to Trumpism, instead producing a divided government. Between UK, Italy, Austria, Sweden, and Brazil – the list of election "surprises" gets longer.

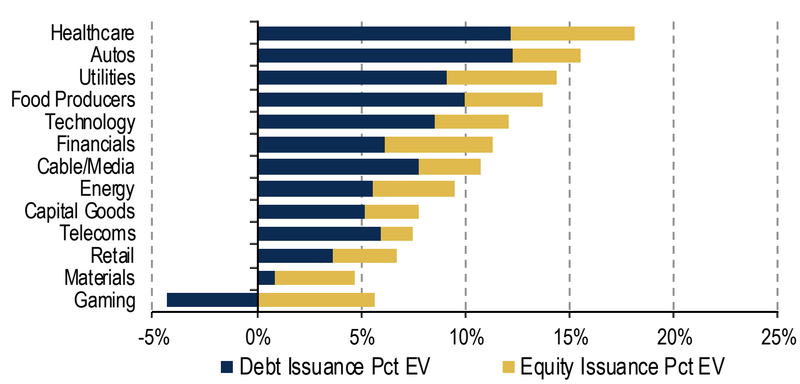
Trade barriers. Open trade requires open minds and cooperation on the part of sovereign governments. Populist and nationalist politics are pushing countries in the opposite direction. As such, there is a risk of trade wars escalating in the immediate near-term even if reason and evidence suggest this would be a mistake.

Key sectors get hit. A contraction in international trade would hit sectors that rely more heavily on global supply chains and/or cross-border final consumers, such as autos, industrials, and technology. Knowing that, the developing GE situation and meaningful declines in largest tech names, including Apple, Google, Amazon, Netflix – all down 15% or more from recent peaks – are less of a surprise. In the GE situation, we think any steps taken by the management to remediate market concerns – asset sales and/or equity raises – need to happen soon and be sizeable to matter. Thus timing and decisiveness are critical here. At $48bn in index-eligible bonds, GE could become the largest fallen angel in DM USD HY market history. The HY index widened almost 200bps on F/GM downgrades in 2005 although the market was half its current size. If HY moves wider, loans will also move in sympathy in the immediate aftermath.

Technology and healthcare.

Two sectors were responsible for a significant share of capital raised, earnings generated, and employment created in this cycle: technology and healthcare. Chart 1 ranks sectors by the total amount of new debt (IG/HY/Loans) and equity capital raised over the past five years, as a percent of their current enterprise values. Healthcare comes out at the top (also keeps that spot in absolute dollar terms, at $625bn). Technology is down the list primarily because of outsized EVs pushing the ratio lower; in dollar terms, tech is right behind healthcare, at $500bn in new debt and equity capital raised. The recent reversal in auto valuations looks less surprising through the lenses of this ranking, although this sector has a relatively small footprint in the US economy to be consequential to our broader cyclical discussion here.

Chart 17: New debt/equity capital raised by sector, last 5yrs



Source: BofA Merrill Lynch Global Research

In contrast, a protracted weakness in either one of the two key sectors – technology *or* healthcare – could be sufficient to turn the broader credit cycle, in our opinion. From this perspective, a near-bear market performance in some key technology names in recent months requires close monitoring going forward for any signs of further deterioration, especially since it is the biggest sector in Loans.

Oil and energy

Energy is a small loan sector, but nevertheless oil dropping by 27% from its recent October peak to settle at around $55-57/bbl has drawn comparisons to the experience 2-3 years ago. However, we don't think such is the case. Current survivors have re-built their cap structures while oil was in the $45-55 range, so they can operate in this range. We think fundamental pressures could resurface at oil inside of $45 and it would take further declines to $35-40 range to see meaningful credit losses picking up. However our house view is for prices to increase next year. Also importantly, the oil slide is a supply driven issue and does not demonstrate a lack of demand for the commodity, something that can be used to extrapolate an imminent downturn.

What if it's a cycle turn?

Currently we view these risks (trade wars, populism, corporate cracks, oil) as being independent and isolated, and thus there is core money waiting on the sidelines. However, should these seemingly idiosyncratic events happen with a high enough frequency, a case could be made to connect them to the broader macro changes we discussed earlier. Over time, this will chip away at investor willingness to take credit risk as they start pricing in a cycle turn. Should some of the macro risks especially from trade wars start making a more clear and widespread impact on company earnings, investors could turn off their spigots creating financing pressures for the market. This will be a world where our base case assumptions of the economic strength and earnings growth will prove to be wrong, leading to a large decline in risk appetite, shutting off primary markets 2015 style, and hitting the secondary market, bringing us back to the drawing board.

Another risk associated with a cycle turn is of B3 downgrades. Should a large number of B3s get downgraded leading to a breach in CLO CCC caps, this could restrict the largest buyers of loans from participating effectively in the primary market. This situation would create a noticeable demand gap for loans and affect expectations of loan supply. Its worthy of noting though that currently Moody's forecasts a net 3%+, upgrade for B3 and below issuers over the next 12 months, so we don't see this as transpiring in the medium term. However, we could see how the back half of next year may become more volatile as investors start looking to price in credit conditions in 2020.

To reiterate, we are still constructive on the credit cycle and believe it has a few more years to run, however we think risks described above are meaningful in terms of probabilities and potential impact. We continue to monitor their development for any signs of further deterioration that could trigger a change to our broader cyclical outlook.

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