



Scott Baskind

Head of Global Private Credit, Chief Investment Officer



Kevin Egan

Senior Portfolio Manager, Co-Head of Credit Research

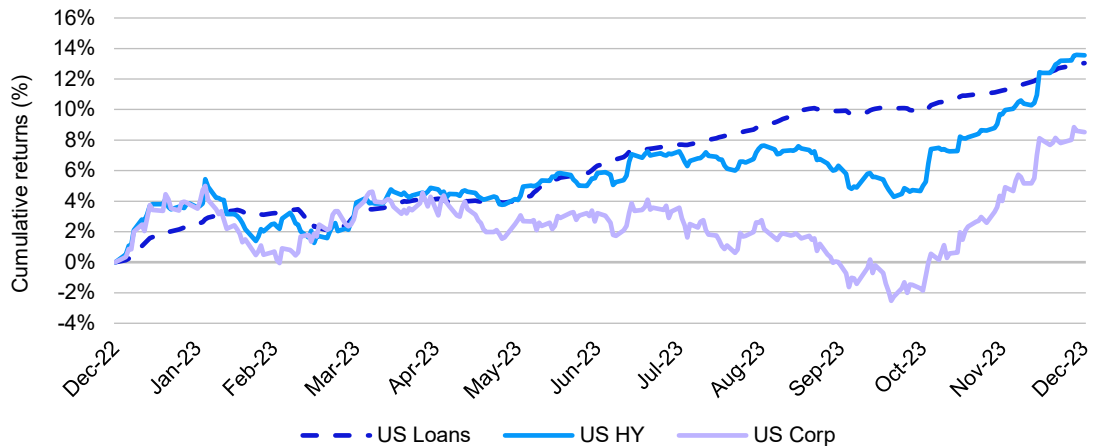
Summary

- **2023 was an exceptional year for loan returns** (second highest on record) on both a relative and absolute basis, driven primarily by robust coupon that is near all-time highs¹
- **We expect 8% loan returns in 2024**,² again powered by strong carry partly offset by expected price erosion at the lower end of the credit quality spectrum
- **We forecast a 3.75% - 4.25% default rate in 2024** driven by a combination of maturity and liquidity challenges, but which are largely already priced by the market

2023 recap

The US leveraged loan market returned 13.04% in 2023,³ exceeding the 10% total return expectation we previously outlined for the full year. Calendar year returns include 9.31% of contribution from coupon and 3.73% of contribution from price gains.⁴ As shown in Figure 1, the asset class performed well relative to longer duration credit, nearly matching high yield bond returns of 13.46% while outpacing investment grade bond returns of 8.40%. Compared to both asset classes, loans exhibited far less volatility.⁵ As in so many prior years, loans proved yet again in 2023 to be an exceptional vehicle for investors to earn relatively strong risk adjusted returns with low volatility.

Figure 1: Loans outperformed in 2023 with muted volatility



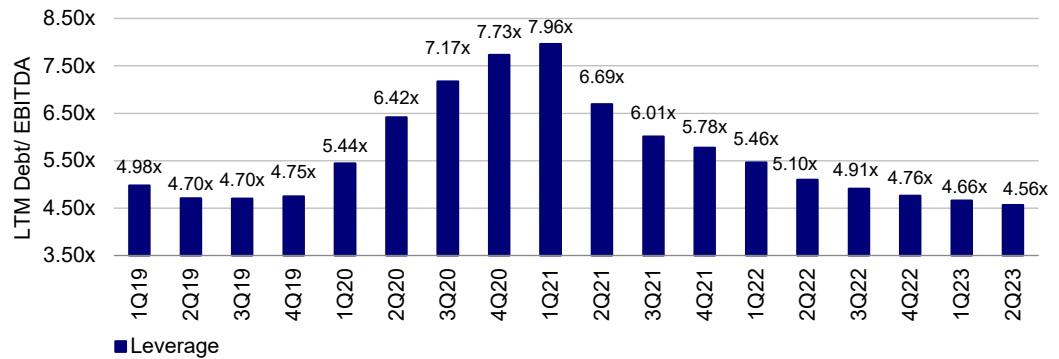
Source: Credit Suisse; Barclays; Bloomberg as of December 31, 2023. The Credit Suisse Leveraged Loan Index represents US Loans, the Credit Suisse High Yield Index represents US High Yield, and the Bloomberg US Corporate Investment Grade Index represents US Corporate. An investment cannot be made in an index. **Past performance is not a guarantee of future results.**

Robust coupon income – currently near all-time highs – grew throughout the year thanks to rising base rates and, to a lesser extent, wider new issue spreads. Over the course of 2023, CME Term SOFR increased from 4.59% to 5.38%⁶ while nominal loan spreads increased from 3.69% to 3.98%.⁷ Together with the delayed realization of SOFR increases during late 2022 which had not yet reflected in loan contract resets, loan market coupon grew from 8.14% to 9.36% during 2023.⁸

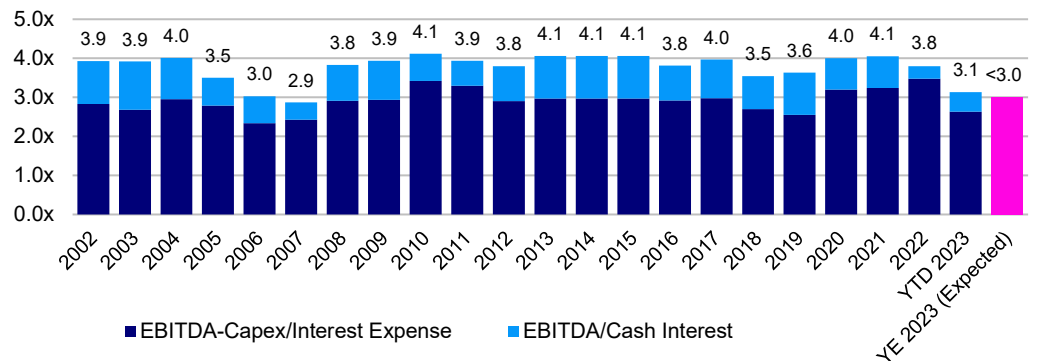
Meanwhile, a largely benign credit environment supported broad based price appreciation across the loan market despite central bank efforts to tighten financial conditions and a consistent (but diminishing)

trend of rating agency net downgrades. Better-than-expected economic performance in 2023 underpinned healthy earnings progression for most borrowers, supporting their ability to service debt amid rising interest expense (see Figure 2) and facilitating access to capital markets for many to extend near-term maturities. Both the broadly syndicated and private credit markets provided options for issuers to address liquidity shortfalls or extend / refinance near-term maturities during the year. As a result, the par weighted default rate remained not far from cycle lows at 1.53%.⁹ The percentage of loans trading below 80 declined to just 4.5%,¹⁰ as good a signal as any that credit stress in the market is contained.

Figure 2: Interest coverage and leverage reflect broadly healthy credit fundamentals



Source: JP Morgan as of June 30, 2023. Data with a two quarter lag.



Source: PitchBook Data, Inc. Interest coverage ratios of leveraged loans, data through September 30, 2023. Data with a quarter lag.

The surprisingly constructive macroeconomic backdrop enabled lower rated loans to outperform higher rated loans in both price advances and total returns. The average loan price increased from \$91.89 to \$95.32 during the year,¹¹ with gains most pronounced amongst the B and CCC cohorts. As loan market conditions improved, access to the primary market expanded but remained most accommodating for higher quality issuers. For the year, 62.3% of gross issuance came from issuers rated B or below, versus 75.4% last year.¹² Refinancing activity was the dominant transaction type, growing 168% versus the prior year.¹³ However, new issuance for uses beyond managing maturities was limited by the dearth of acquisition activity in the private equity and corporate realms.¹⁴ Net new issuance (ex-refinancing / repricing) of \$81.8 billion (bn) was down 50% versus prior year.¹⁵ Reflective of the selective funding environment, leveraged buyouts financed with loans during 2023 featured the lowest leverage levels since 2010 and the highest sponsor equity contributions on record.¹⁶

Despite sparse new issuance, collateralized loan obligation (CLO) origination remained strong. US CLOs priced \$139.3bn (or \$116.2bn ex-refinancings) across 322 structures.¹⁷ Of that, \$108.1bn (or \$88.4bn ex-refinancings) came from structures that purchase broadly syndicated loans (BSL) while the remainder came from structures that purchase middle market / private credit loans. CLO formation served as a critical pillar of support for loan demand during 2023. Retail funds recorded outflows of \$17.7bn, however the withdrawals ceased by mid-year.¹⁸

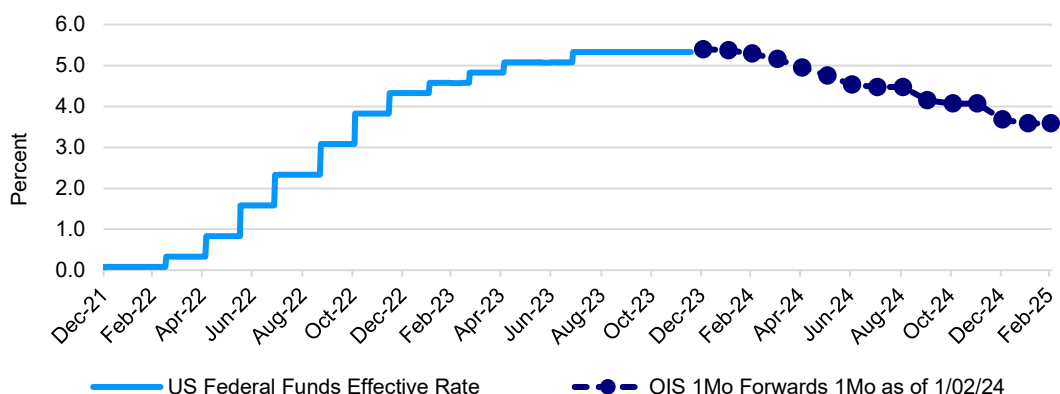
2024 outlook

Looking ahead to next year, we would like to outline our loan market expectations for 2024. In doing so, we acknowledge the unstable geopolitical landscape hinging on developments in the Middle East. Our forecast that follows assumes that the emerging conflict remains relatively contained and does not materially alter the operating environment for loan issuers nor prevailing capital market sentiment.

We expect loans will deliver coupon-minus total returns of approximately 8.0% in 2024.¹⁹ Loan market coupon is currently 9.36%,²⁰ a function of nominal loan spreads at 3.98%²¹ and CME Term SOFR at 5.38%.²² The forward SOFR curve currently implies an average 3-month SOFR rate of approximately 4.5% over the course of 2024.²³ This reflects the broadly adopted market view that the US Federal Reserve (Fed) will pivot to easing interest rates in 1H 2024, but will unwind prior rate hikes cautiously

amid firm growth, low unemployment, and inflation that remains above target. We expect a gradual decrease in base rates (depicted in Figure 3 below) will be partly offset by new issuance continuing to clear wider than outstanding loans, raising the overall market's nominal spread.

Figure 3: Policy makers are expected to pivot in 2024, but rates should remain elevated



Source: Bloomberg as of January 2, 2024, unless otherwise noted. **Past performance is not a guarantee of future results.**

From a macroeconomic perspective, the economy normally slows in response to the Fed's tightening of financial conditions and the 2022-2023 tightening cycle was particularly aggressive. However, monetary policy famously operates with long and variable lags. In the case of 2023, transmission of costlier / less abundant capital to the real economy lagged due to excess consumer savings exiting the pandemic, robust labor markets, and the prevalence of fixed rate consumer and corporate debt. Going forward, we anticipate that growth could moderate in 2024 as some of these shock absorbers fade. As a result, we foresee loan prices declining modestly next year as risk premia widens. The price declines should be more pronounced at the lower end of the credit quality spectrum as those issuers have less financial flexibility / balance sheet cushion to absorb weaker cash flows and are more vulnerable to an increase in perceived credit risk. That said, we would note the encouraging evidence of disinflation and increasingly dovish signals from the Fed in recent months. These factors should lessen the downside risk to earnings / cash flows (and thus loan prices) in 2024.

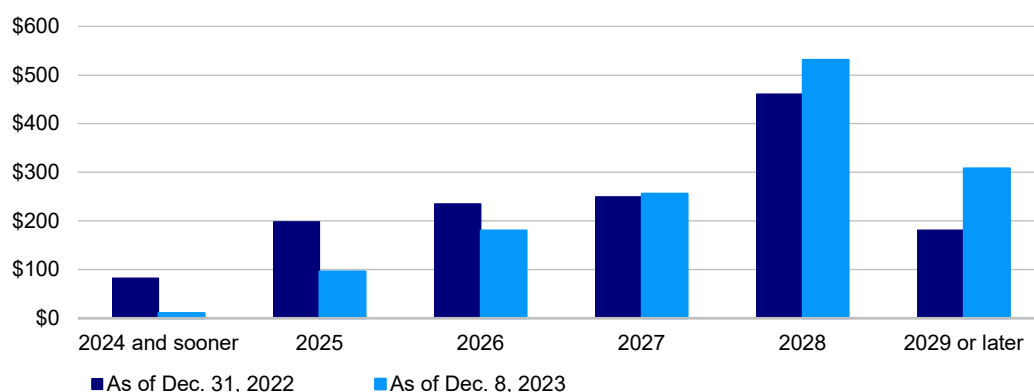
Loan market technicals should provide some degree of price support in 2024 despite weaker expected fundamentals. Subdued merger and acquisition / leveraged buyout activity in the face of costlier capital contributed to sparse new issuance in 2023, which we think is likely to persist into 2024. Even if deal-making activity suddenly accelerates as the rates trajectory inflects lower, new loan issuance to support transactions generally requires several months of lead time prior to syndication. Rather, we expect the vast majority of issuance again will target refinancing of existing debt. The loan market was chronically short on new supply throughout 2023, and we see no clear catalyst for this to change next year.

On the demand side, we expect \$125bn of new CLO origination in 2024, \$90-100bn of which will acquire BSLs. Attractive equity arbitrage available to "Tier I" managers who have best execution on liability placement as well as significant CLO equity capital that has been raised and needs to be deployed via new structures will support CLO formation. CLO AAA liability spreads tightened throughout 2023 and we expect this trend to continue, aided by our expectation that US banks will re-emerge as a source of demand for new AAAs as their older vintage CLOs amortize more rapidly creating a need to redeploy the returned capital. This \$90-100bn of BSL CLO origination would be slightly ahead of 2023's output of \$88.4bn and would support trading levels for both existing and new issue mid- and high-quality loans.

On the other hand, with outstanding CLOs increasingly bumping up against CCC ownership thresholds that trigger collateral value haircuts, we expect CLO managers will have little appetite for CCC (or likely-to-become CCC) loans for the foreseeable future. BSL CLOs account for 63% of the broadly syndicated loan market,²⁴ so the absence of demand for weaker credits from this enormous buyer cohort is material. This technical dynamic contributes to our view that lower rated loans will generally underperform in 2024.

We expect loan defaults will increase in 2024 to 3.75-4.25%. Firstly, this forecast reflects what we view as a relatively manageable maturity wall. It bears mentioning that maturity walls have not historically been a significant driver of defaults and we do not expect this will change in 2024. Just 2.9% of loans outstanding are maturing in 2024-2025 and are rated CCC.²⁵ These issuers may face a challenging path to extending / refinancing, especially with many older vintage CLOs now past their reinvestment periods and thus limited in their ability to extend maturities. Still, we expect many will find solutions within their existing lender groups or from other pockets of capital (such as private credit funds) as we saw this year. For context, the majority of outstanding loans due in 2024 and a significant portion of the outstanding loans due in 2025 were addressed via amend & extend transactions or refinancings during 2023 (see Figure 4).

Figure 4: Significant progress was made extending 2024 and 2025 maturities during the year



Source: PitchBook Data, Inc; Morningstar LSTA US Leveraged Loan Index as of December 8, 2023. Shown in \$ USD billions.

Beyond maturity considerations, the softer expected earnings environment combined with another year of heightened interest costs may create liquidity challenges for some borrowers. However, we believe most of the prime candidates to face liquidity shortfalls are already known to the market and their current trading prices largely reflect these risks. For context, we estimate the loan market is currently implying a 4.13% default rate,²⁶ in line with what we believe will materialize. Assuming our Fed pivot expectation comes to fruition, the most challenged issuers (from a cash flow / liquidity perspective) will begin to see relief on interest expense later in 2024 and through 2025. Absent a significant deterioration in earnings power (which we do not expect will occur), this should help to mitigate the peak in defaults this cycle to 4%+ in late 2024 or 2025.

Overall, we anticipate 2024 will be another strong year for loan returns. The lagged effects of monetary policy tightening may result in a less supportive macroeconomic / earnings backdrop and less buoyant price environment, particularly for lower rated loans. However, we expect the rise in credit stress to be contained. The more reliably known quantity heading into next year is that coupon is near all-time highs and will remain so until / unless the Fed pivots aggressively towards lowering rates. An aggressive easing cycle is certainly possible based on historical experience, but that is not our base case nor would it materially diminish loan coupons until late 2024 even if it were to materialize. We view above-average coupon income as the most bankable pillar of our forecast for 2024.

- 1 Credit Suisse Leveraged Loan Index as of December 31, 2023.
- 2 There is no guarantee that the forecast will be realized. Forecast is based on coupon plus wider nominal spreads minus base rate declines minus price erosion.
- 3 Credit Suisse Leveraged Loan Index as of December 31, 2023.
- 4 Credit Suisse Leveraged Loan Index as of December 31, 2023.
- 5 PitchBook Data, Inc.; Bank of America Merrill Lynch; Bloomberg as of December 31, 2023. The ICE BofA US High Yield Index represents US High Yield, the ICE BofA US Corporate Index represents US Investment Grade.
- 6 Bloomberg as of December 4, 2023.
- 7 Credit Suisse Leveraged Loan Index as of December 31, 2023.
- 8 Credit Suisse Leveraged Loan Index as of December 31, 2023.
- 9 Bloomberg as of December 4, 2023.
- 10 PitchBook Data, Inc. as of December 31, 2023.
- 11 Credit Suisse Leveraged Loan Index as of December 31, 2023.
- 12 JP Morgan as of December 31, 2023.
- 13 JP Morgan as of December 31, 2023.
- 14 JP Morgan as of December 31, 2023.
- 15 JP Morgan as of December 31, 2023.
- 16 Pitchbook / LCD Data through November 30, 2023.
- 17 JP Morgan as of December 31, 2023.
- 18 JP Morgan as of December 31, 2023.
- 19 There is no guarantee that the forecast will be realized. Forecast is based on coupon plus wider nominal spreads minus base rate declines minus price erosion.
- 20 Credit Suisse Leveraged Loan Index as of December 31, 2023.
- 21 Credit Suisse Leveraged Loan Index as of December 31, 2023.
- 22 Bloomberg as of December 4, 2023.
- 23 Bloomberg as of January 4, 2023.
- 24 JP Morgan as of November 30, 2023.
- 25 JP Morgan as of November 30, 2023.
- 26 Credit Suisse Leveraged Loan Index as of December 31, 2023.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

Many senior loans are illiquid, meaning that the investors may not be able to sell them quickly at a fair price and/or that the redemptions may be delayed due to illiquidity of the senior loans. The market for illiquid securities is more volatile than the market for liquid securities. The market for senior loans could be disrupted in the event of an economic downturn or a substantial increase or decrease in interest rates. Senior loans, like most other debt obligations, are subject to the risk of default.

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