The Case for Senior Loans

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Q2 2024 market update

As we continue in 2024, there has been a significant focus on the uncertainty of the US macroeconomic backdrop and its potential implications for the senior secured bank loan market. Paramount among these concerns are three key questions:

1) How are underlying issuers able to handle inflation pressures and will they be able to pass along increased costs to their consumers?

2) Where are we in the interest rate cycle and how will this affect issuers?

3) What effect will a potential recession have on issuers?

This piece provides our view on the current market environment and attempts to answer these critical questions.

Why loans now?

In our view, there are three compelling reasons to consider investing in senior secured loans today:

1) Potential high level of current income

Current income is comprised of two key components—base interest rates (which are expected to stay higher for longer) and credit spreads (which continue to remain wide). Coupon income for bank loans today is ~9.19%, which is near its highest since 2009[1]. Market expectations are for rates to remain higher for longer, well above pre-2022 levels. Loans have proven to provide consistent, stable income through varying market cycles, including recessionary periods and periods of falling rates.

2) Are rates higher for longer?

Loans have virtually no duration risk (average ~45 days). The forward SOFR curve currently implies an average 3-month SOFR rate of approximately 5% over the course of 2024. This reflects the broadly adopted market view that the US Federal Reserve (Fed) will pivot to easing interest rates late in 2024 and will lower interest rates cautiously. Recent economic data has been more supportive of a higher for longer interest rate environment, benefiting higher loan coupons.

3) Compelling relative value

Loans have offered one of the best yields in fixed income, while providing downside risk mitigation by being senior in the capital structure and being secured by the assets of the company. Loans have offered these high yields with no duration risk. In a recessionary environment, loans offer downside risk mitigation by being senior which means they are the highest priority to be repaid in the event of default. Senior secured assets may offer added risk mitigation throughout recessionary periods.

Yields

Current loan yields and spreads look very attractive both on a historical and a relative basis. A loan's yield is based on both coupon payments, which is the interest return, as well as on principal return. The average coupon for loans is 9.19%, outpacing the average high yield coupon of 6.24%[1]. After averaging around ~170 bps less than high yield bonds over the past fifteen years, this is the first time in history the average loan coupon has surpassed that of high yield bonds. It was only around three years ago when loans were yielding ~4.80%; loans recently have been yielding over 400 basis points more than that[1].

Senior Loans: A Core Holding In Any Environment

A unique combination of appealing characteristics

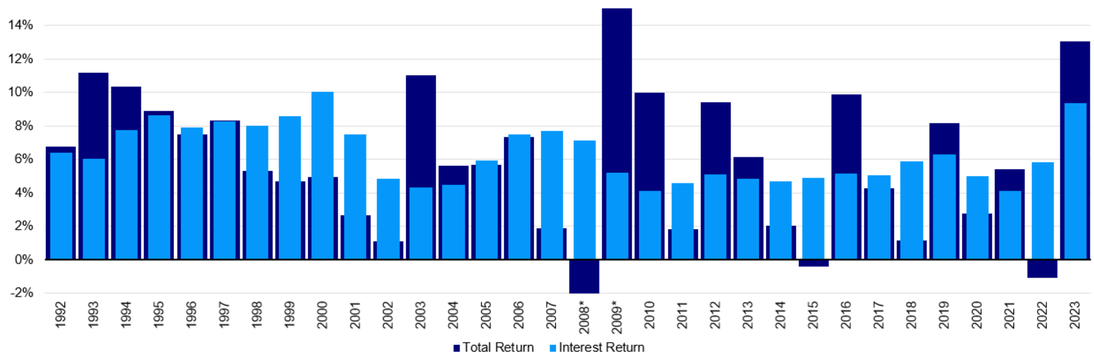
			Investors Looking for:
1	**High Income**	• Potential for competitive monthly income and strong risk adjusted returns • Strong relative value[1]: ◦ US Loan Yield to 3yr: 9.36% ◦ European Loan Yield to 3yr: 8.32%	**Potential High Yield**
2	**Senior Secured Status**	• Highest priority to be repaid; lenders have first right to collateral in the event of a default • Higher recovery in case of default	**Potential Risk Mitigation**
3	**Floating Rate Feature**	• Effective duration of 0 years • "Pure" credit exposure, no duration risk	**Hedge Against Interest Rate Risk**
4	**Diversification Potential**	• Low correlation with investment grade fixed income[2] • 0.43 when comparing Loans to IG Bonds	**Alternatives Asset Class Exposure**
5	**Compelling relative value**	• Loans have offered one of the best yields in fixed income despite their senior secured status[1]	**Potential High Comparative Returns**

Source: [1]CS LLI and CS WELLI as of June 30, 2024. [2]Morningstar correlation data from June 2003 to June 2024 2024. Updated quarterly. Past performance does not predict future returns.

US loans have offered consistent high income in all market environments

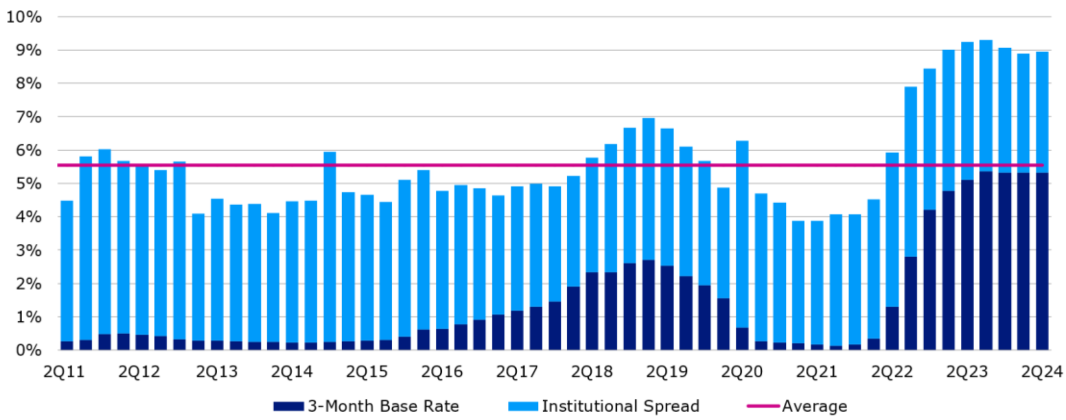
Past performance does not predict future returns.

Three years of negative returns over the past 32[1]



Source: [1]Credit Suisse Leveraged Loan Index data through December 31, 2023, updated annually. *Denotes returns in excess of the axis. 2008 returns were –28.75%, 2009 returns were 44.87%.

Total US loan coupons at highest levels in decades



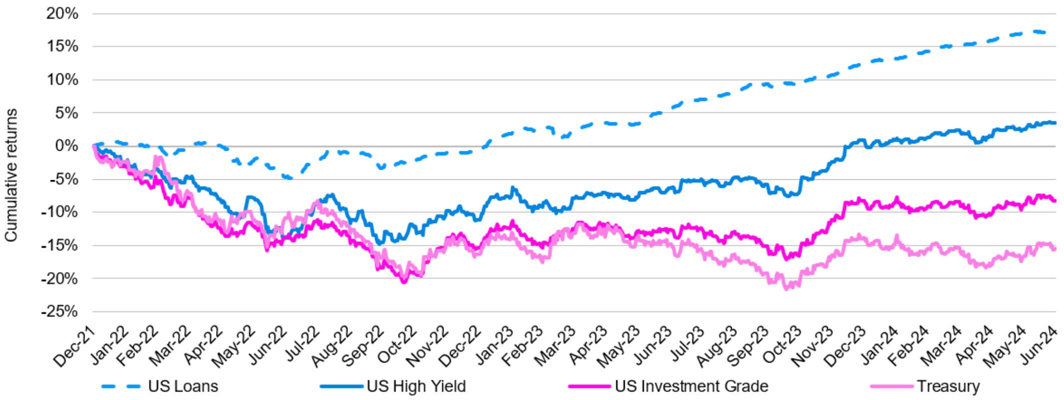
Source: Pitchbook LCD as of June 30, 2024. Base rate reflects the average during the quarter. Uses three-month LIBOR (prior to 2023) or SOFR (2023 or later) plus the weighted average institutional spread.

Throughout 2023, rising rates put the floating-rate loan asset class on pace for one of the strongest years since the Global Financial Crisis[2]. The US leveraged loan market returned 13.04% in 2023[1]. Loans still offer amongst the highest yields and are expected to remain high, as the market anticipates a higher for longer interest rate environment[3].

Asset class resiliency

Steady US loan returns stood in stark contrast to other risk assets

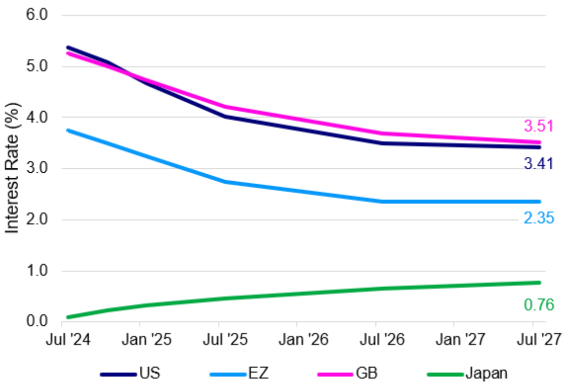
Past performance does not predict future returns.



Sources: PitchBook Data, Inc.; Bank of America Merrill Lynch; Bloomberg as of June 30, 2024. The Morningstar LSTA US Leveraged Loan Index represents US Loans, the ICE BofA US High Yield Index represents US High Yield, the ICE BofA US Corporate Index represents US Investment Grade, the ICE BofA Current 10-Year US Treasury Index-TR represents Treasury. An investment cannot be made directly in an index.

The higher interest rate environment has put pressure on borrowers due to increased interest expense cost. However, as the Federal Reserve pauses interest rate increases (or decreases rates), it can have both direct and indirect positive effects on the leveraged loan market such as:

- **Lower borrowing costs:** pausing rate hikes lowers borrowing costs for companies and potentially stimulates demand for new issuance.
- **Improved debt serviceability:** stable or lower interest rates reduce interest expense burden for companies, which can positively impact loan performance.
- **Increased investor demand:** when the Federal Reserve signals a pause in rate hikes, it may boost investor confidence and appetite for credit risk assets.

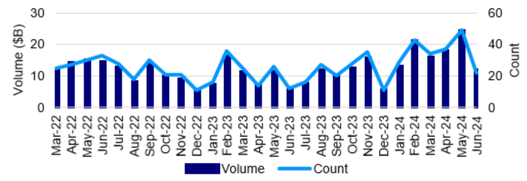


Source: Bloomberg as of July 18, 2024, based on market-implied pricing of policy rates for selected economies. Past performance is not a guarantee of future results. An investment cannot be made directly in an index. Forward-Looking statements are not a guarantee of future results. They involve risks, uncertainties and assumptions. There can be no assurance that actual results will not differ materially from expectations.

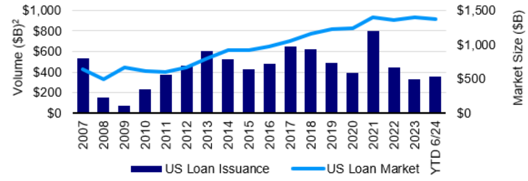
Market technicals

Last year, we saw retail demand for loans soften amidst broader risk-off investor sentiment. However, that trend has abated as some investors are becoming more comfortable with the “soft-landing” scenario for the US economy. There has also been a flow of new CLO creations through 2023 and YTD 2024. This indicates that there is still institutional investor appetite for loans. This steady CLO formation and minimal new issue helped support the loan market technical despite retail outflows and macro concerns. As of June 2024 in the US, 214 CLOs have priced $101.4B of issuance YTD, and CLOs represent ~70% of the investor base in the loan market[2]. New CLO issuance in Q1 surpassed the previous record set in 2021 and this pace continued in Q2. Moreover, as demand for loans wanes, new loan issue supply will typically respond in kind to help re-establish equilibrium in the market. For example, year-end 2023 net issuance was $88.04bn, -50% year-over-year, respectively[2]. This supply/demand imbalance forces CLOs to provide a bid in the secondary market. Having said that, the loan market has still been trading at a significant discount to par which long term investors can view as an attractive buying opportunity.

US CLO issuance



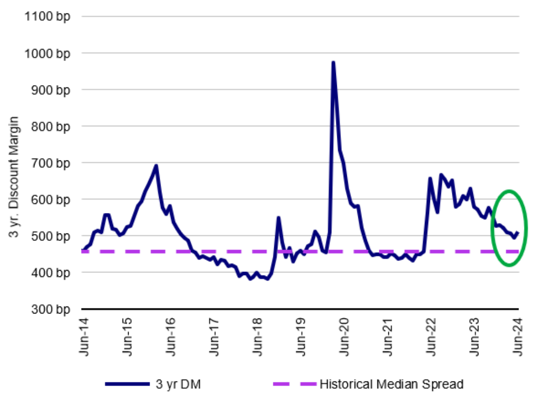
US loan new issuance and market growth



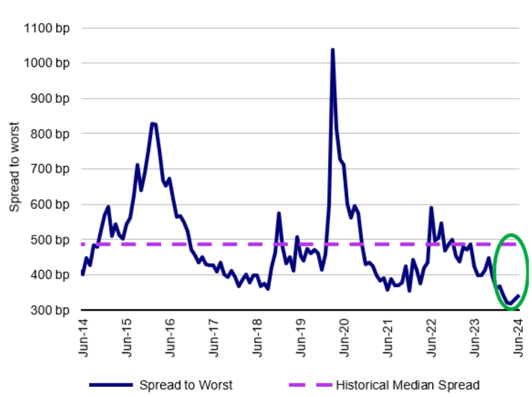
Source: PitchBook Data, Inc. and Credit Suisse as of June 30, 2024.

Relative valuations also favor bank loans compared to most fixed income asset classes. Loan spreads are currently wide of their long-term average, while high yield bond spreads are currently tight to their long-term average. Loans have also been outyielding high yield bonds with loan coupons being historically high.

Loan spreads are still 49 bps above historical levels



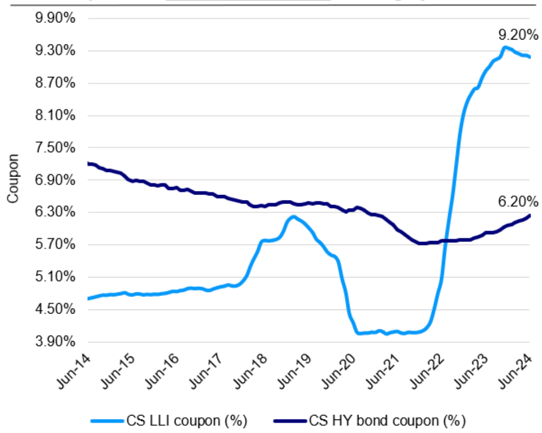
While HY bond spreads are 150 bps below historical levels



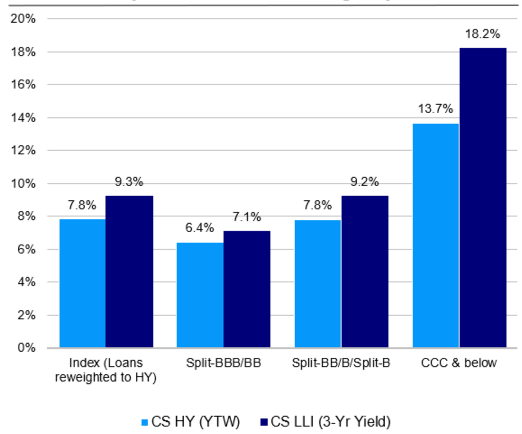
Source: Credit Suisse Leveraged Loan Index & Credit Suisse High Yield Index as of June 30, 2024. Past performance is not a guarantee of future results. Long term averages based on date from 01/31/1992 – 6/30/2024.

Loans have offered higher yields than high-yield bonds, despite being senior and secured

Loan coupons are over 300 bps higher than high-yield bonds



Loans still out-yield HY bonds on a ratings adjusted basis



Sources: Credit Suisse Leveraged Loan Index & Credit Suisse High Yield Index as of June 30, 2024.

Market fundamentals

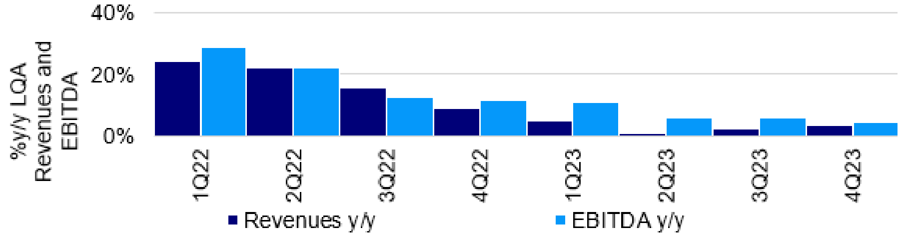
While technicals are finding an equilibrium, market fundamentals for underlying issuers remain relatively strong.

First, defaults remain low relative to historical levels. The trailing twelve-month default rate at the end of June 2024 was 0.92%, while the historical trailing default is more than double that around 2.28%.

Given a stronger than expected macro environment and receding recession concerns, we have seen default forecasts revised lower for the year. Default forecasts hover around the 3% – 4% level. We entered the year with a default forecast of 3.75% - 4.25% driven by a combination of maturity and liquidity challenges, but given unexpectedly resilient corporate fundamentals, we anticipate defaults will fall in the lower end of that range.

The risk of defaults, while small, remains the largest risk to loan investors, but the senior secured nature of loans has historically provided a high recovery rate in the event of default. Additionally, corporate fundamentals remain robust as companies continue to reduce leverage and increase revenue growth quarter-over-quarter for ten consecutive quarters.

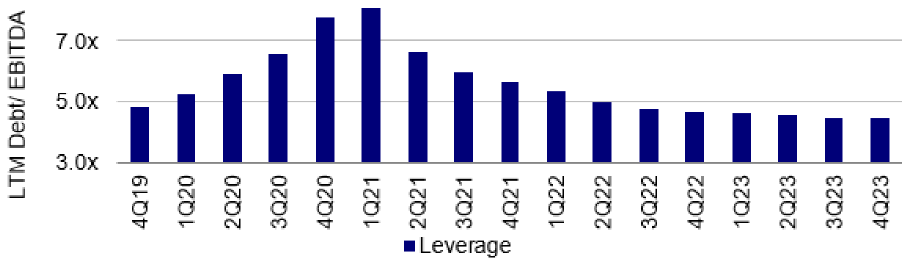
Revenue and EBITDA growth are slowing, but growth is still positive



Source: JPMorgan as of December 31, 2023.

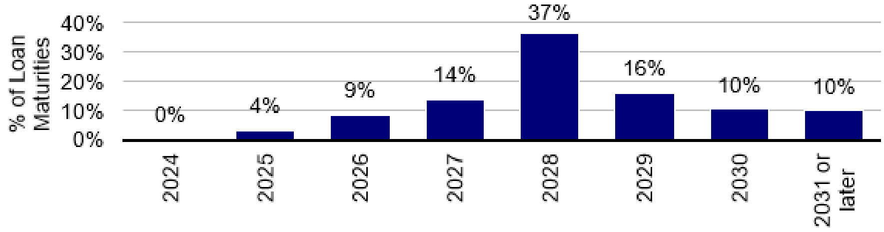
The chart below provides the average leverage of companies in the leveraged loan market serving as an indicator of the financial health of bank loan issuers. Borrowers have reduced their leverage for the 10th quarter in a row, and average leverage in the market has returned to pre-pandemic levels. Borrowers have repaired their balance sheets and pushed out their debt maturities. Currently only ~1% of outstanding loans mature in 2024, leaving little refinancing risk in the market.

Borrower leverage across the loan market



Source: JP Morgan as of December 31, 2023.

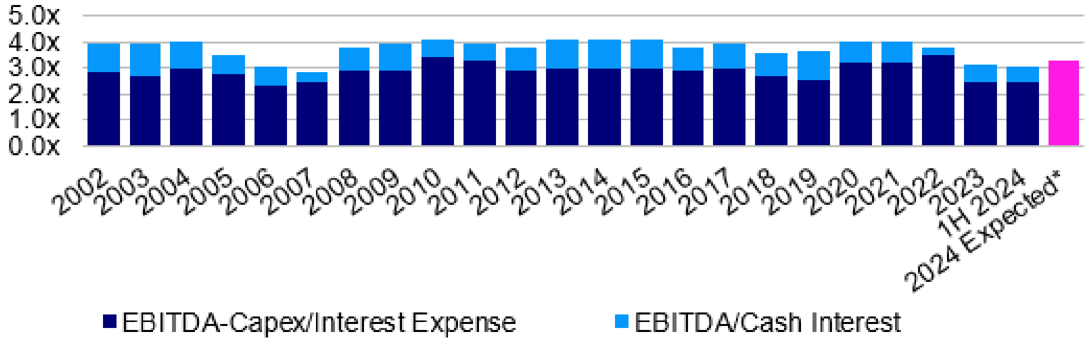
Years of strong refinancing activity have kept maturity wall at bay



Source: CS LLI as of June 30, 2024.

Another important investor concern is how current rates will impact issuers' ability to service their debt. As highlighted in the table below, the average borrower has entered this cycle with a very strong ability to service their debt. Interest coverage ratios have still been robust, leaving companies with sufficient ability to absorb higher rates. Additionally, we expect interest coverage ratios to improve as rates start to decrease, lowering interest expense as illustrated in the pink bar.

Interest coverage across the loan market



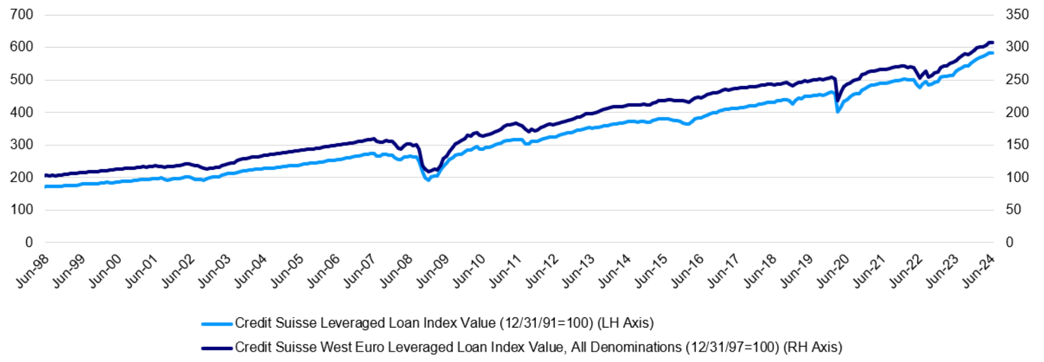
Source: PitchBook Data, Inc. as of June 30, 2024. *Based on Barclays research stating a 1% rate cut equates to a positive 3/8 turn impacting interest coverage ratios.

Conclusion

As shown above, we believe there is likely still ample opportunity in the loan asset class to generate higher than historical average returns. We expect 8% loan returns in 2024[4], again powered by strong carry partly offset by expected price erosion at the lower end of the credit quality spectrum. An aggressive interest rate easing cycle is certainly possible based on historical experience, but that is not our base case.

In conclusion, the loan asset class has consistently proven to be a reliable source of returns for investors, regardless of market fluctuations. As evidenced below, any decreases in loan values have typically been temporary. Regardless of whether interest rates are increasing or decreasing, loans have historically provided investors with a worthwhile return on investment.

Downticks in loan valuation have historically been short-lived



Source: Credit Suisse as of June 30, 2024.

[1]Credit Suisse as of June 30, 2024.

[2]Pitchbook LCD, Intex, Bloomberg, Credit Suisse as of December 31, 2023.

[3]Pitchbook LCD; Morningstar LSTA US Leveraged Loan Index. Data through June 30, 2024.

[4]Invesco. 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.

Investment risks

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. The market for senior loans remains less developed in Europe than in the U.S. Accordingly, and despite the development of this market in Europe, the European Senior Loans secondary market is usually not considered as liquid as in the U.S. The value of investments, and any income from them, will fluctuate. This may partly be the result of changes in exchange rates. Investors may not get back the full amount invested.

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