# 2021 Senior Loan Outlook

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## 2020 Review

A long list of unprecedented events made 2020 a year unlike any other in modern history. The devastating impact of the COVID-19 pandemic took an immense toll on public health infrastructure, severely disrupted global supply chains and shuttered economic production. The degree to which economic activity contracted and unemployment swelled was only paralleled by the Great Depression. Justifiably, the virus' unprecedented impact prompted a massive response by governments and central banks around the globe. In the United States, Congress and the Federal Reserve (the "Fed") provided support including an historic stimulus package, both to individuals and businesses, as well as credit buying and lending programs, which provided a much-needed liquidity backstop for corporate credit markets. Across the Atlantic, the European Central Bank enacted similar measures.

The apex of the market dislocation occurred in March, as historically high volatility poured into virtually all risk markets, leading to massive declines across the board. Perhaps most surprisingly, investors were caught off guard by the speed at which valuations fell, with most if not all the damage occurring over the course of only a few weeks. During the month of March, the S&P 500 index (including dividends) lost 12.35%, and high-grade corporates, as measured by the Bank of America Merrill Lynch High-Grade Corporate index, fell by 7.47%. High yield bonds and senior loans lost 11.76% and 12.37%, as measured by the Bank of America Merrill Lynch High Yield Master index and the S&P/LSTA Leveraged Loan index (the "index"), respectively, near record monthly lows for both asset classes.

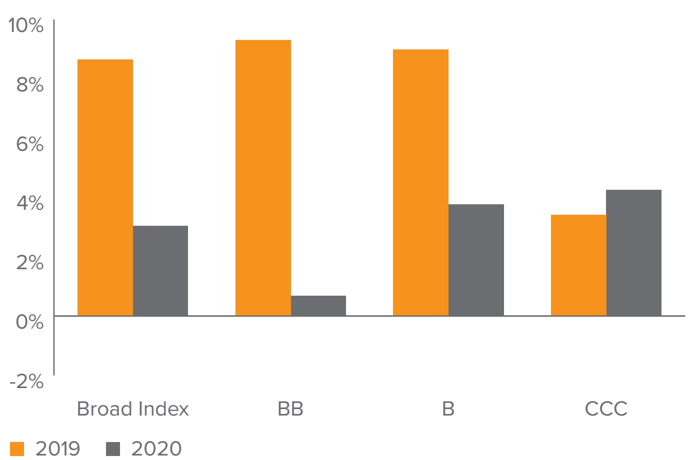
To provide further context, the loan market witnessed four of its five worst performing days on record in just an eight-day period. Swift policy responses from government leaders in April calmed investor sentiment at least initially, prompting strong price recoveries in risk markets. In the months that followed, the slow and gradual reopening of regional and local economies, coupled with promising advances in coronavirus treatments and vaccines, provided additional support to investor optimism. The path to the recovery faced many challenges along the way as surging virus infections introduced episodic bouts of volatility. By the end of the summer, however, the macro picture had materially improved, and many asset classes virtually erased all of the losses experienced in March.

While performance improved across capital markets, the speed at which prices recovered varied greatly between asset classes. The dispersion among asset class performance can, to some extent, be attributed to the level of support – direct or indirect – by the Fed and Congress. Some of the variance was a byproduct of changing rate dynamics, as floating rate products typically underperform during periods of decreasing rates. Clearly, this dynamic played out in 2020. Specifically, within senior loans, full-year returns were 3.12%. The floating rate asset class trailed behind its credit counterpart in high-yield bonds, as well as investment grade corporates and equities, with returns of 6.17%, 9.81% and 18.40%, respectively.

The Fed's firmly accommodative stance following its early assessment of the pandemic paved the way for the yield buyer to aggressively pursue fixed-rate products. In addition to the change in rate expectations, bond markets received further tailwinds from the fiscal support that primarily targeted corporate bonds, as evidenced by relative fund flow dynamics between loans and high yield. Despite the various structural and secular challenges, the loan market ended 2020 in positive territory once again – for the 22nd time in the 24-year history of the asset class.

Within the loan market, rating cohort outperformance was skewed towards riskier segments. While BB-rated loans outperformed in the initial recovery, their stay at the top of the leaderboard was rather short-lived. Single-B-rated loans, in particular, quickly closed the gap as the year went on. Similarly, CCC-rated loans also gained ground but at a much more measured pace, as improving outlooks on vaccine development helped ease investor concerns of further downgrade risk within COVID-linked issuers. By year-end, CCCs were the dominant performers (Figure 1). However, we would highlight that many issuers within this cohort began the year in single-B territory and subsequently fell into the CCC bucket due to aggressive rating agency downgrades, discussed in more detail below. In fact, a large segment of the COVID-related issuers fell into this category. As a result, CCCs in many ways were positioned to benefit the most from any sort of strong technical tailwind that would emanate from an improving vaccine timeline.

**Figure 1. Rating cohort returns, 2019 and 2020**




Source: S&P/LCD, data as of December 31, 2020.

In this report, we offer our views on what 2021 may bring to the loan market. After the unforeseen and unprecedented events of this past year, our underlying theme going into next year will be nuanced around the reversal of the many trends that dominated the headlines in 2020.

## Market Technical Factors: Drivers of Supply and Demand

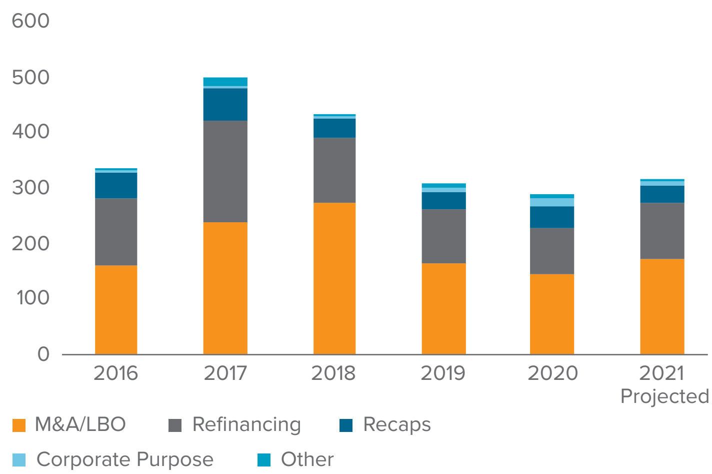
Pandemic-driven uncertainties had a material impact on the loan market's technical balance between supply and demand. At the end of 1Q20, both sides of the equation virtually cratered as the early impact of the virus immediately killed most risk-taking. As the macro backdrop gradually improved, the subdued technical overhang slowly lifted, paving the way for the recovery of both aggregate supply and investor demand.

### Supply

Loan issuance understandably slowed from the torrid pace it had set in prior years. Total issuance was $287.8 billion, down roughly 7% from 2019. The use of proceeds was dispersed across a healthy mix of mergers and acquisitions (M&A) and leveraged buyout (LBO) related transactions, refinancings and dividend recapitalizations (Figure 2). The onset of falling interest rates also contributed to the supply lull as corporate issuers were incentivized to tap into the high-yield bond market for financing. Illustrating this dynamic was the robust prevalence of bond-for-loan take-outs during 2020, particularly in the first half of the year.

For 2021, we expect a solid bounce-back in loan supply and estimate a range of $300–350 billion in aggregate, in line with market consensus expectations. Reflective of the uptick is a healthier backdrop for corporate M&A activity, which was put on pause for the larger part of 2020. Other notable drivers will be the relative ease with which corporates can access favorable financing, the deployment of sponsor dry-powder, and a recovery in corporate earnings stemming from recovery-related economic growth.

**Figure 2. Annual institutional loan issuance by purpose, $ billions**




Source: S&P/LCD, data as of December 31, 2020.

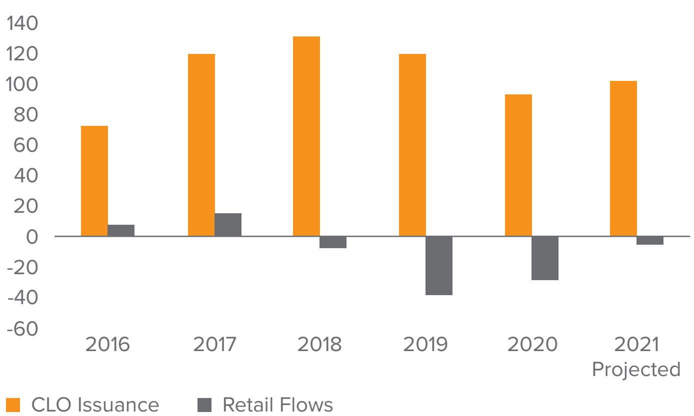
### Demand

Investor demand dynamics were similarly pressured for much of 2020. With increased volatility in 1Q20, combined with multiple rate cuts, the retail fund investor segment of the loan market withdrew investments at an aggressive clip. In March alone, total outflows were $14.7 billion; total for the year were $27.8 billion. Since the change in rate expectations in late 2018, the presence of retail buyers has diminished dramatically, now constituting only about 8% of the loan market by index outstandings. We don't expect this figure to increase until we see more hawkish posturing from the Fed. That said, we think outflow activity is likely to stabilize next year — should some opportunity arise for reversal of relative value trades, or if the market begins to price in expectations of rising short-term rates.

In contrast, collateralized loan obligation (CLO) ownership within the loan market continued to expand and now accounts for about two-thirds of all loan outstandings (Figure 3). CLOs were under immense pressure during 2020 as the structural safeguards that underpin these vehicles, namely interest diversion (ID) and overcollateralization (OC) ratios and CCC concentration limits, were materially challenged. Following the deluge of loan downgrades in April and May, CCC exposure in CLO portfolios reached double digits. OC and ID ratios were triggered in a large number of CLOs, prompting rating agencies to downgrade most mezzanine tranches (those rated BB/B). When these ratios are breached, it can result in cash flow cut-offs to equity and subordinate tranches.

As macroeconomic conditions improved and downgrade activity slowed, loan prices found stronger bid support and CLO liability spreads (the spread CLO managers pay to tranche holders) tightened. These conditions allowed new CLO formation to resume, and more important, allowed CLO portfolio metrics to improve considerably. For the full year, CLO issuance totaled roughly $92.1 billion, largely in line with general Street expectations heading into 2020. Most market participants would agree that the fiscal year 2020 figure is a respectable, albeit surprising, amount considering the challenges to CLOs during the market drawdown. For 2021, we expect CLO issuance of roughly $90–100 billion. Our view is based on additional tightening of liabilities, a stronger supply pipeline that will give managers plenty of collateral for new deals and an attractive carry opportunity for yield-hungry buyers relative to other securitized products.

### Figure 3. Annual CLO issuance and retail fund flows, $ billions




Source: S&P/LCD, data as of December 31, 2020.

## Credit Fundamentals, Earnings Outlook and Default Expectations

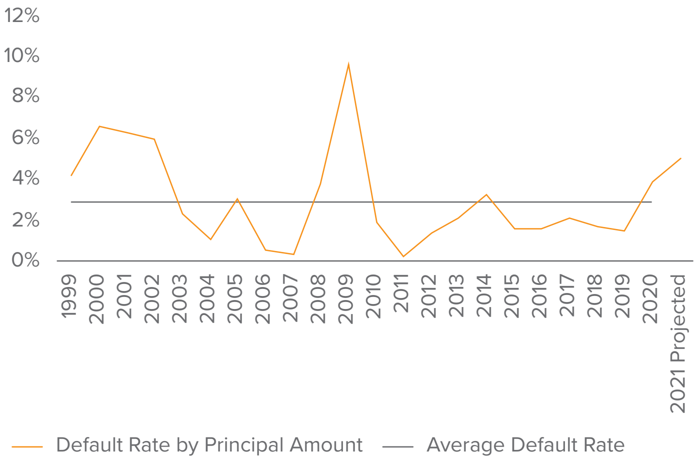
It goes without saying that 2020 was a tough year for leveraged loan issuers. The damage brought by the sudden disruption in economic activity starkly impacted virtually every measure of credit health. Revenue growth and cash generation deteriorated; leverage and interest coverage ratios worsened. With the Fed providing less direct support to the loan market than to bond markets, leveraged loan issuers managed liquidity needs mainly through tapping available credit lines and facilities and, where possible, implementing aggressive cost-cutting measures or furloughing workers. Business activity faltered within the travel, leisure and entertainment-oriented sectors, as social distancing measures and lockdowns severely challenged existing revenue models.

This translated into an onslaught of downgrades by rating agencies. For context, the trailing three-month downgrade to upgrade ratio reached a historic 43.2x, far exceeding peak levels during the global financial crisis. Likewise, an uptick in bankruptcies pressured the index default rate, which breached historical averages for the first time in nearly five years. Fortunately, as economies began to inch closer to pre-pandemic production, credit fundaments improved, as did 3Q20 earnings results.

For 2021, we expect corporate fundamentals to improve on the back of a macro rebound and related GDP growth, and a return to more normal underlying activity, supported by vaccine dissemination and continued fiscal and monetary support. The expected recovery will boost top-line growth closer to pre-pandemic levels, which will bode well for stressed credit ratios. Although, we expect the effects of the pandemic to linger well into 2021, borrowers with less exposure to COVID are much more likely return to pre-pandemic growth estimates sooner rather than later. For those that are directly impacted by the pandemic, a lot will hinge on the availability and efficacy of the vaccine. Any delay or setback in either of the two variables could jeopardize the recovery story. Given these uncertainties, we expect some pockets of the leveraged loan space to remain under stress despite a mean-reversion in economic production expected to play out in the broad macro picture.

Our 2021 forecast calls for a peak default rate of roughly 5% before moving closer to the historical average of 2.91% before year-end (Figure 4). The near-term uptick is reflective of the lingering effects of COVID, which eventually will spill over into the remaining pockets of credits under substantial stress. As it stands now, the liquidity profile of the typical issuer points to reasonable room to run in the short term. Therefore, the high, single-digit default estimates that represented consensus in the early part of 2020 will likely not materialize, provided the path to recovery is not met with any unforeseen challenges.

**Figure 4. Historical default rate of S&P/LSTA index**




Source: S&P/LCD, data as of December 31, 2020.

## Election Outcome Impact, Sector Views

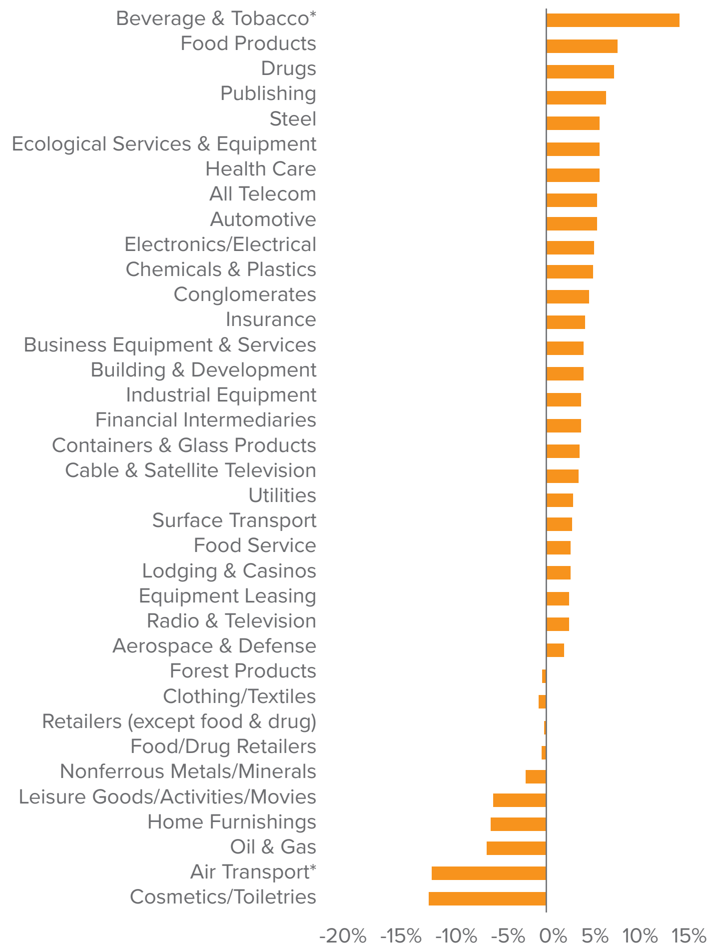
The 2020 U.S. election was highly polarized leading up to and after election day. While the markets reacted well to Joe Biden's election as President, it was largely due to the increased likelihood of a split Congress, with Democrats in control of the House and Republicans presumably still controlling the Senate. However, the recent outcome from the Georgina runoff election has given Democrats a slim majority in the Senate, and essentially full control of Congress. As such, we expect an easier path for the new administration to advance any legislative reform, although the policy path has yet to be meaningfully discerned at this point. At the least, increased regulatory pressure is widely expected on sectors such as energy, financials and certain pockets of healthcare. Cabinet appointments will likely have a bearing also, insofar as assessing the aggressiveness of any policy actions.

Generally speaking, we see the likely policy backdrop as neutral for most sectors. We enter 2021 with a positive bias towards sectors that will benefit from broader recovery in economic activity, such as cyclicals (versus defensives) and COVID-related sectors that will exhibit recovery in earnings and valuation: travel, hotels, gaming, restaurants, leisure/entertainment and airlines – business models that require in-person/group interaction. Of course, this view is predicated on a successful vaccine rollout and economic reopening. Any deviation from this outcome could push out the recovery for the higher-beta industries to 2022. Even with a successful vaccine, a return to activities such as flying or movie theater viewings may take longer than anticipated, which could further delay mean-reversion in the airline and leisure sectors.

As with most economic recoveries, cyclical sectors tend to perform well in such environments, and we expect the list of beneficiaries to include industrials, autos, energy and financials. In contrast, sectors which have performed well in 2020 may have more limited upside, particularly defensive sectors or those with rich valuations due to having business models relatively insulated from the pandemic or having benefited from structural tailwinds (Figure 5). Topping this list would include pharmaceuticals, technology, consumer products, food and beverage and utilities.

It's also worth mentioning that the commodities backdrop, in particular, looks constructive from multiple angles with a rebalance in oil markets, constructive views on base/precious metals and a China-led recovery. Sectors that stand to lose the most include those that were the primary beneficiaries of the work-from-home environment this year such as cable, food producers and online retail.

**Figure 5. Senior loan sector returns, 2020**




*Has limited observation.

Source: S&P/LCD, data as of December 31, 2020.

## Market Opportunities and Relative Value

A notable theme from 2019 was the bifurcation between the BB-rated and single-B segments of the loan market, as a growing number of issuers were downgraded into the single-B bucket, and in many cases into the CCC category. In 2020, the COVID-19 pandemic only accelerated this trend given how aggressively rating agencies downgraded issuers during the period of market stress. As we noted above, the rolling three-month ratio of downgrades to upgrades reached the previously unimagined level of 43.2x. This figure materially improved as the year went on, but still left the loan market in an elevated concentration to B- and CCC-rated borrowers. For context this figure is now roughly over 27%, having expanded from an historically elevated level in 2019.

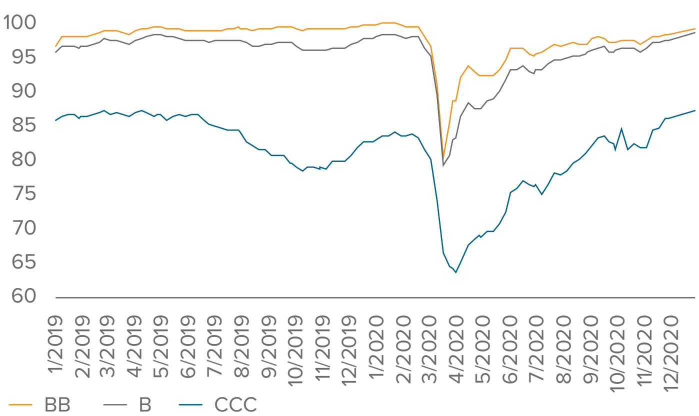
Given how the rally by cohorts took shape in 2020, we see some opportunities for market appreciation across the investable loan universe. At their current trading levels, it could be argued that single-B loans are fairly valued (Figure 6). However, this bucket has a higher beta to the economic recovery; therefore, we do see some opportunities for alpha generation but at a higher risk-premium than in the past due to heightened default probability. As a function of their pronounced weighting within the loan market and strong buying from CLO managers, single-Bs will still be the dominant rating category in most loan portfolios, albeit with potentially greater volatility than previous years.

On an absolute basis, BBs offer value when looking at pre-COVID tights in spread levels, however, we see less opportunity to capitalize on convexity stemming from a risk-on recovery trade. To that point, CCCs even more than single-Bs have a higher beta to the economic recovery, but at the expense of significantly greater probability of bankruptcy and default. Therefore, an emphasis on credit selection will be as important as ever within this cohort.

From a relative value perspective, the senior loan market is positioned reasonably well going into 2020 and offers an attractive entry point. As noted above, loans underperformed high yield bonds and investment grade corporates in 2020, as three-month LIBOR fell by 167 basis points (bp), which had a negative impact on coupons and pricing, as well as demand for low duration and floating rate products. It's reasonable to believe these dynamics could reverse in 2021 as macro conditions improve. In fact, from a tactical allocation perspective, we are seeing many Wall Street banks recommending an overweight position to loans relative to high-yield bonds. Their main thesis centers around improving technical balance for senior loans with less technical pressure from sharp retail outflows like we saw in the first half of 2020.

Additionally, while less likely, the continued macro recovery could lift rates higher, benefiting floating rate loans and causing potential spread widening in longer duration fixed rate loans. We could see modest compression of loan credit spreads next year, due in large part to the improved technical backdrop. Similarly, the loan market overall could exhibit a higher beta to the economic recovery in 2021 due to a higher concentration of credits rated B+ or below.

**Figure 6. Price by rating cohorts, percentage of par value**




Source: S&P/LCD, data as of December 31, 2020.

## Macro Themes and Total Return Expectations

While not without risks, the main macro theme going into 2021 is a supportive macro/credit backdrop that is likely to usher a new business/credit cycle as we grow to pre-pandemic output levels and corporate fundamentals recover by the second half of 2021. COVID-19 will remain a challenge, but the impact is expected to be much less severe than in 2020, as the worst appears to be behind us. The successful production of a vaccine was the turning point in the global fight versus the pandemic. Now, the focus has shifted to an effective global rollout of the vaccine. Wide availability of the vaccine by the summer of 2021 could allow for substantial economic reopening by 3Q21 and achievement of operational stability by year-end. In this scenario, we would also expect a return to pre-pandemic cadences and a general push towards normalcy.

Beyond the pandemic, another main theme will be policy actions of the new administration, which will undoubtedly have influence on market sentiment. The Senate runoff outcome will likely result in increased fiscal spending along with potential regulatory reform. The Fed, on the other hand, is expected to remain staunchly accommodative. Corporate lending programs could return should liquidity conditions worsen for companies, albeit likely at a fraction of their former size. We don't envision this outcome, however, given the vaccine-propelled growth trajectory. With that said, downside risk would reflect the fact that financial markets have factored in a reasonably straight line to a vaccine-related recovery. A major deviation from that projection would introduce volatility.

Taking everything into consideration, we believe the broad capital markets, including credit, will be buoyed by an improved economic backdrop, recovering corporate growth prospects as output returns to pre-pandemic levels and strong consumer confidence stemming from what is expected to be a successful vaccine rollout. Therefore, our base case for expected 2021 gross total return for senior loans is 4–5%, with the tails of that a range of approximately 3–6% — a range which is highly dependent upon a variety of scenarios that potentially may shift our expectations.

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The **S&P/LSTA Leveraged Loan index** is an unmanaged total return index that captures accrued interest, repayments, and market value changes. The Index does not reflect fees, brokerage commissions, taxes or other expenses of investing. **Investors cannot invest directly in an index.**

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