Pacific Asset Management

Floating Rate Update
June 2022

Year to Date
As we approach mid-year, the floating rate loan asset class has been the shining star within corporate credit in 2022, supported by robust retail inflows and strong fundamentals. The asset class held strong for the first 4 months of the year (excluding a short stint in March that fully recovered in short order) offering investors a hedge from rising rates and an attractive yield profile. In May, the asset class finally experienced weakening. We view the causes of this weakening to be more ancillary effects of sympathetic selling by investors, capital raises to meet cash needs, and some repositioning further out on the risk spectrum. To frame May's historically poor return, May would rank as the third worst monthly return since December 2008 and the ninth worst monthly return since 2000. As a result of the selloff in May, the average price of the index resides slightly below $95 (versus above $98 to start 2022) with yields above 6%.

The comments below address our view on the macro landscape, fundamental and technical support of the asset, and relative value of loans. In summation, we view the floating rate loan asset class as appealing, providing potential for price appreciation, as well as a compelling yield profile.

Macro Landscape
We continue to believe the Fed will move forward with an increase in rates over the coming months. While no one is certain of when the Fed will stop raising rates, we feel comfortable with the assumption the Fed will move at least 100bps higher this year. Taking into consideration the forward guidance and Fed speak, it appears the preference remains to go hard and fast up front in the cycle and reassess toward the end of the year. The Fed must walk a delicate tightrope between fighting sustained inflation and not pushing the economy into a full-blown recession. Inflation prints (lagging CPI) feel "peakish" with the caveat that prices are likely to remain broadly elevated across sectors for some time to come. This will create additional pressure on growth projections (Atlanta Fed GDP tracker now calling for 2Q22 GDP print of 1.3% down from 1.8%). We are convinced that slowing growth is indeed real, but it is NOT our base case for a recession in 2022. While consumers are feeling pressure via price increases at the pump and in stores, we expect demand to be resilient as long as the employment environment holds. The Russia/Ukraine crisis remains challenging and tragic, but is unfortunately likely to continue. Its effects will continue to play havoc on energy, gas, commodities, potash, and other exports and countries reliant upon this centralized region's exports. Overseas in Asia, things appear to be opening up in China from its recent zero-COVID policy shutdown and as they work thru processing the enormous backlog of inventory while maintaining a healthy environment. As China opens, we would expect stress on supply chains to loosen, which is disinflationary in nature.

Floating Rate Fundamentals
Corporate health remains, by and large, strong, with many companies possessing a better balance sheet position than at YE19. That said, of course some corporations are feeling the impact of increased costs that are eroding their (in many cases record setting) profit margins. However, many companies have figured out how to better manage their balance sheets and prioritize streamlining their business to reduce overhead, expenditures, and overall costs. Many corporations tapped the liquidity markets in summer of 2020 to shore up balance sheets and then again in summer 2021 to refi and extend maturity walls so that quickly approaching debt is not a concern at the moment. Additionally, many companies hedge a percentage of their rate exposure to limit the impact of increasing financing rates. While there is no denying companies are seeing margin compression, we still see demand as holding strong in most cases. We do not see a swath of default activity picking up to lead to a massive wave of defaults over the next 12 months. According to the S&P LSTA, the default rate currently resides sub 50bps and the 15yr average default rate for loans is ~3%. There may be some increase over the next 12 months in default activity, but it is likely to remain well below historical averages.

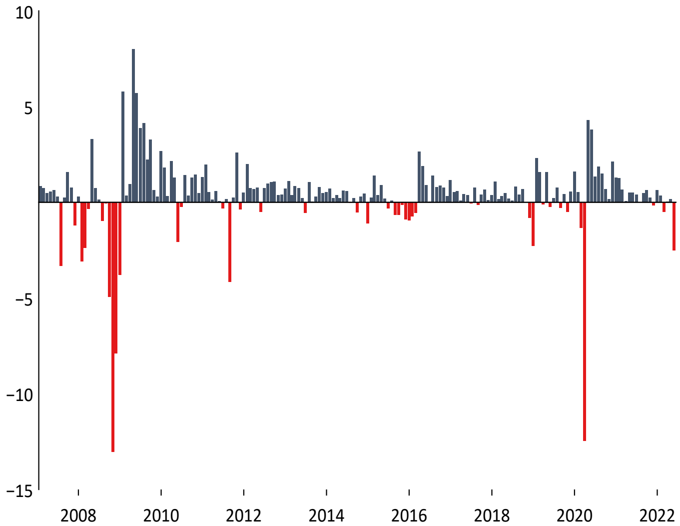
Floating Rate Technicals
From a support perspective, the asset class is largely supported by CLOs (approx. 2/3 of the buyer base). Per JPM, CLO origination was resilient at $13.5bn in May which has year-to-date activity totaling $63bn year-to-date, down less than 10% yoy ($64.6bn YTD21). 2021 was a record year in CLO origination. For additional context, we broadly assume CLO origination in a calendar year in excess of $100bn as being healthy. If we annualize the CLO run rate thus far, it will handily exceed $100bn. Additionally, the retail buyer base is about 10-15% of the asset class support. While loan funds have seen some modest outflows in recent weeks, loan funds YTD have seen inflows totaling +$21.7bn (+$1.3bn ETF) which follow +$46.5bn of inflows in 2021. Reference rates continue to move higher with the Fed hiking regardless of using LIBOR or SOFR – which given the floating rate nature of the asset class is a positive support.

Floating Rate Relative Value
While the loan asset class has sold off in May, we attribute this largely to a few main drivers: sympathetic pressure to other asset classes as loans had not really gotten "hit" prior to the month of May; investors selling to meet liquidity needs (selling their best performing asset class vs the S&P 500 ETF that is approximately -15% YTD); and investors selling to move into more risk-based assets. This has resulted in a drop in the average price of the loan index to now approx. $94-95. The loan asset class is asymmetric (meaning it is capped at par). There is now a potential for not only a yield opportunity, but also the ability for price to move higher, thereby increasing the total return potential. Per JPM, with the Fed expected to ratchet rates higher in the months ahead and attempt to engineer a soft landing for the economy, they do not expect loan prices to reach the $90-$91 level as was the case during the 2016 and 2011 non-recessionary declines. If we use 2018 as potential roadmap (where the Fed was moving rates higher then stopped), loans were priced closer to par than they are today – there is always the possibility that loan prices can move higher as we move later into the year. Additionally, loans are currently yielding in excess of 6% on a 4yr effective yield basis and over 8% when factoring in the forward curve, making the yield opportunity rather intriguing. Also, based on the forward curve, the loan asset class is expected to have a coupon in excess of 6% by year end, up from 4.5% currently.

Interestingly, per JPM, buying leveraged loans as yields breach 8% and/or prices cross below $94, has translated into strong forward returns over the past decade plus. For example, the average 3, 6, and 12 month forward return for leveraged loans as yields breach 8% is 3.2%, 6.3%, and 10.7%. Spreads tightened an average 181bp over the next 12 months during this time frame. Notably, March 2020, December 2018, August 2011, and May 2010 were great opportunities to buy loans at 8% with solid returns over the next 6 months of 7.9%, 5.2%, 6.6% and 5.3%, respectively. Albeit not obtainable yet today, the average 3, 6, and 12 month forward return for leveraged loans as prices breach $94 is 1.1%, 4.4%, and 9.1%. Note, the average 6 month forward return for leveraged loans as prices cross $96, $95, $94, $93, and $92 is -1.0%, 3.0%, 4.4%, 4.8%, and 5.9%, respectively.

We at Pacific Asset Management remain positive on the loan asset class and believe much of the negative news is priced in the with average loan price around $95. Within our floating rate loan strategies, we believe our differentiation is our focus on larger companies, selectivity, and downside risk management. We focus on the larger issue/facility sizes with no exposure to middle-market or mezzanine type issuers. Our process screens out issuers that are less than $300m in facility size or $100m in EBITDA and we do not invest in non-USD securities. We remain highly selective in our portfolio construction (approx. 80-150 issuers) and we focus on holding meaningful positions in companies with a fundamental catalyst for outperformance. Lastly, our investment process has led to strong historical performance and downside risk protection relative to peers, as measured by downside market capture, default rates, standard deviation, and performance during 2008, 2015, and 1Q 2020. We expect to perform well if there are further episodic times of volatility and believe our process is time tested. We remain in favor of the asset class and the benefits it offers.

Leveraged Loan Monthly Returns (%)



Source: Credit Suisse, as of May 31, 2022

10 Worst Monthly Returns (2000-2022)

Rank	Period	Return
1	October 31, 2008	−13.03%
2	March 31, 2020	−12.46%
3	November 28, 2008	−7.89%
4	September 30, 2008	−4.93%
5	August 31, 2011	−4.16%
6	December 31, 2008	−3.78%
7	July 31, 2007	−3.32%
8	January 31, 2008	−3.10%
9	**May 31, 2022**	**−2.51%**
10	February 29, 2008	−2.39%

Source: Credit Suisse, as of May 31, 2022

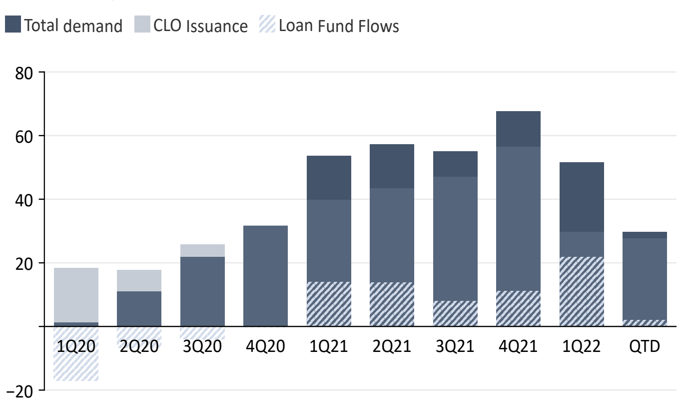
CS Leveraged Loan Index

Source: Credit Suisse, as of May 31, 2022

4-Year Discount Margins (bps)

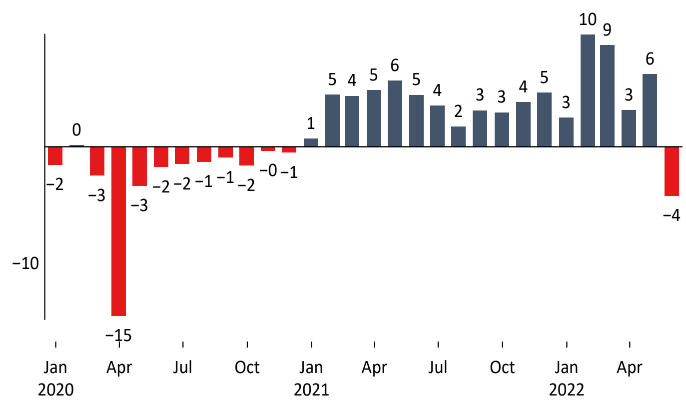
Source: Credit Suisse, as of May 31, 2022

US Leveraged Loan Market Demand ($bn)



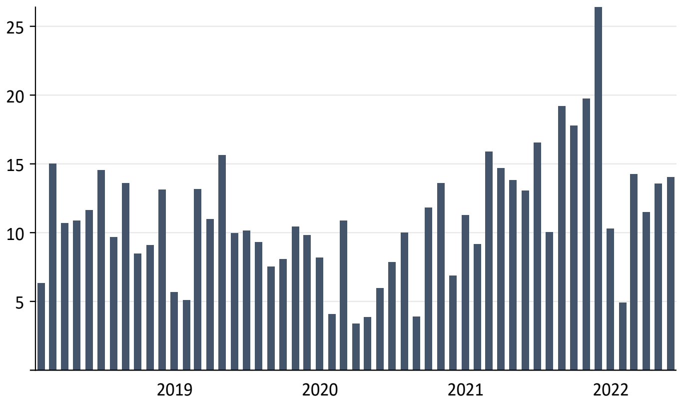
Source: LCD Research, Lipper, as of May 31, 2022

Monthly Bank Loan Fund Flows ($bn)



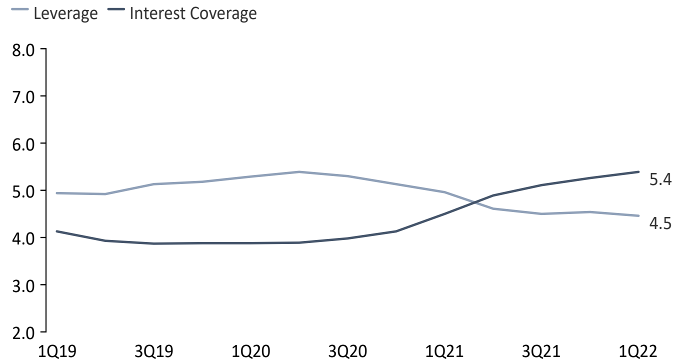
Source: S&P/LCD Research, as of May 31, 2022

US CLO Issuance ($bn)



Source: LCD Research, Lipper, as of May 31, 2022

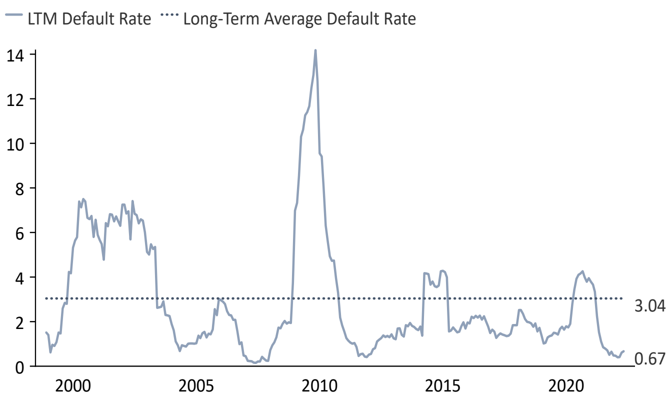
Leverage Loan Issuer Fundamentals



Leverage Loan Issuers ex-Gaming/Transportation

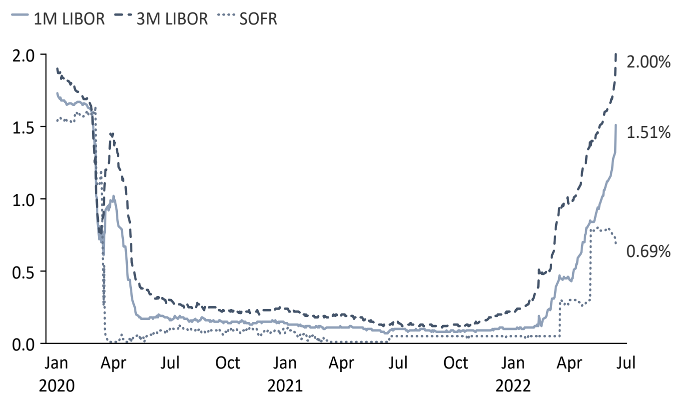
Source: JP Morgan, as of June 15, 2022

Bank Loan Par-Weighted Default Rate (%)



Source: JP Morgan, as of May 31, 2022

Leveraged Loan Reference Rates (%)



Source: Bloomberg, as of June 15, 2022

ABOUT PACIFIC ASSET MANAGEMENT

Founded in 2007, Pacific Asset Management LLC, specializes in institutional fixed income management. As of March 31, 2022 the firm managed $20bn across bank loan, high yield, corporate, and CLO strategies.

IMPORTANT NOTES AND DISCLOSURES