Leveraged Finance Asset Allocation Insights

PineBridge® INVESTMENTS

4Q **2024**

Balanced Positioning With Targeted Security Selection

- Our base case is that we are entering a rare non-recessionary rate-cutting cycle that should support credit performance in 2025, particularly for leveraged finance asset classes.
- High yield bond spreads are trading at historically tight levels, but all-in yields remain attractive. We favor positioning portfolios with a beta close to index levels while seeking to add incremental outperformance via careful issuer and security selection, especially among lower-rated issuers.
- Leveraged loan issuer fundamentals are still on healthy footing against a supportive technical backdrop, while loan yields appear set to remain elevated on a historical basis.
- We no longer favor broad risk-on shifts down the CLO capital stack and believe vintage, portfolio, and manager selection remain key. We continue to favor selectively purchasing lower-rated credits with shorter spread duration in the primary market.

As 2024 draws to a close, leveraged finance asset classes remain desirable to investors, with strong demand chasing relatively limited supply outside of refinancing activity. The option-adjusted spread on the Bloomberg US Corporate High Yield Index set a fresh post-financial-crisis record tight in November at 253 basis points, just 20 basis points wide of the all-time tight level of 233 basis points reached in 2007. The weighted average discount margin on the Credit Suisse Leveraged Loan Index (assuming a three-year takeout) is at its lowest level since the first quarter of 2022.

Risk asset classes had already rallied sharply going into the November US presidential election, with economic data supporting a narrative of receding labor market concerns and robust consumer spending. Third-quarter earnings results were generally positive, albeit with softer guidance from some leveraged finance issuer segments. Donald Trump's presidential election victory caused a further rally in spreads as investors bet on lower corporate taxes, deregulation, and a more active environment for mergers and acquisitions (M&A).

From here, several factors are likely to shape leveraged finance markets as we move from the end of 2024 into the first quarter of 2025.

On the positive side, the Federal Reserve has already cut rates by 75 basis points, and fed funds futures markets are pricing in another 75 basis points of cuts in the next 12 months. This is coming at a time when GDP growth is still at a solid 2.8% pace and unemployment is relatively low. A lower cost of capital is bullish for leveraged finance issuers, particularly those with floating-rate debt in their capital structures. We also expect to see increased M&A and capex amid the new administration's pro-growth policies. And despite relatively tight spreads for both high yield bonds and bank loans, all-in yields are still attractive for both asset classes. We see the potential for relatively high equity valuations and attractive all-in yields to bring investors out of money market funds, where an all-time record $6.5 trillion of cash is currently parked (see chart).

About This Report

This is a quarterly publication which encapsulates insights of PineBridge Investments' Leveraged Finance Team. Our global team of investment professionals convenes in a live forum to evaluate, debate and establish top-down guidance for the leveraged finance investment universe. Using our independent analysis and research, driven by our Fundamentals, Valuations and Technicals framework, we assess the pulse of high yield, leveraged loans and CLOs.

Contributors:

Steven Oh, CFA
Global Head of Credit and Fixed Income and Head of Leveraged Finance

John Yovanovic, CFA
Head of High Yield Portfolio Management

Kevin Wolfson
Portfolio Manager, US Leveraged Loans

Laila Kollmorgen, CFA
Portfolio Manager, CLO Tranche

Jeremy Burton, CFA
Portfolio Manager, US High Yield and Leveraged Loans

Andrew Karlsberg, CFA
Portfolio Risk Manager and Investment Strategist, Leveraged Finance

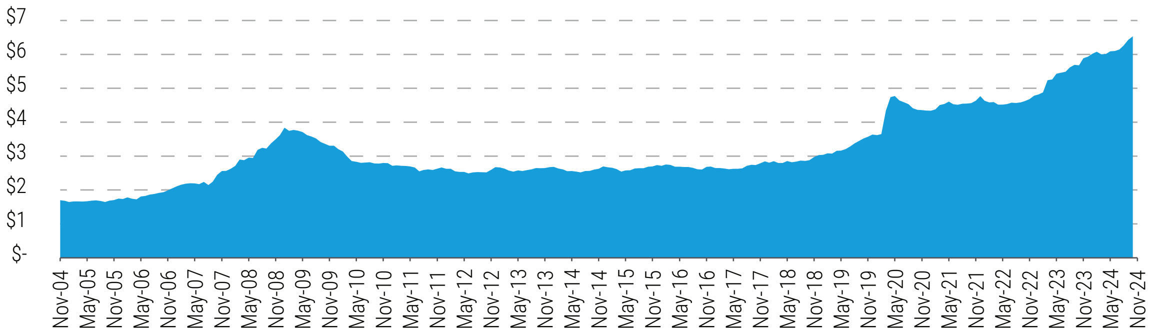
Jonathan Kramer, CFA
Fixed Income Product Specialist, Leveraged Finance

Evan Burke
Assistant Portfolio Manager, US Leveraged Loans

Komal Shahzad, CFA
CLO Tranche Analyst

Attractive Leveraged Finance Yields Could Bring Investors Out of Record-High Money Market Allocations

Total AUM in US money market funds (in US$ trillions)



Source: Morningstar Direct as of 31 October 2024.

On the downside, we are seeing some signs of a weaker consumer in certain discretionary segments of the economy. Consumer spending has been the growth engine in the US, and any slowdown could hamper GDP growth. We also believe certain initiatives from the new administration – including an emphasis on new tariffs and a significant crackdown on immigration – could have inflationary side effects.

Overall, our base case is that we are entering a rare non-recessionary rate-cutting cycle that should support credit performance in 2025, particularly for leveraged finance asset classes. Amid a backdrop of higher Treasury yields, high yield bond and bank loan total return scenarios have been converging. Loans are providing higher current income but with an expectation that SOFR rates will come down somewhat over the next year. As a result, we favor a balanced approach to overall portfolio risk positioning, which calls for constructing portfolios with overall beta risk similar to market indices and targeting security selection opportunities to take advantage of idiosyncratic issuer outcomes.

Key Data

		Spread (bps)				Yield (%)			
		Current	3-year median	5-year median	10-year median	Current	3-year median	5-year median	10-year median
High yield	Index	264	376	371	386	7.21	7.97	7.31	6.39
	BB	157	250	249	254	6.13	6.63	6.02	5.03
	B	250	384	379	386	7.13	8.01	7.32	6.43
	CCC	527	826	821	812	9.79	12.65	11.92	10.52
Leveraged Loans	Index	403	471	456	471	8.79	9.78	7.30	5.87
	BB	262	316	311	310	7.27	8.04	5.58	4.59
	B	412	485	460	460	8.85	9.78	7.55	6.21
	CCC	1243	1240	1195	1118	18.16	18.68	15.10	13.43
CLOs	Index	219	273	266	256	6.37	6.74	5.57	4.26
	AAA	109	161	143	136	5.31	5.71	4.62	3.06
	AA	154	225	199	195	5.70	6.10	5.30	3.88
	A	192	291	260	261	6.06	6.72	5.77	4.83
	BBB	309	443	398	393	7.21	8.15	7.29	6.04
	BB	756	875	818	744	11.67	12.39	11.66	9.23
	B	1199	1325	1263	1031	16.18	17.32	16.20	12.23

Source: Bloomberg as of 21 November 2024. High yield represented by the Bloomberg US Corporate High Yield Index; spread is OAS and yield is yield-to-worst. Leveraged loans represented by the Credit Suisse Leveraged Loan Index; spread is spread-to-maturity and yield is yield-to-maturity. CLO represented by the JPM Post-Crisis CLOIE; spread is discount margin to worst and yield is yield-to-worst.

High Yield Bonds

Spreads are trading at historically tight levels, but all-in yields are still attractive. We favor positioning portfolios with a beta close to index levels and seeking to add incremental outperformance via issuer and security selection. We are especially selective among lower-rated issuers.

With a second Trump administration forthcoming, concerns have turned toward how aggressively Trump will advance his campaign promises on immigration and trade. On immigration, it seems highly likely that Trump would quickly end the asylum programs established during the Biden administration. Over time, this could bring job growth back to pre-pandemic levels of about 100,000 jobs per month, which is expected to have a minimal inflationary impact. While large-scale deportations are a possibility, they would likely happen further down the road.

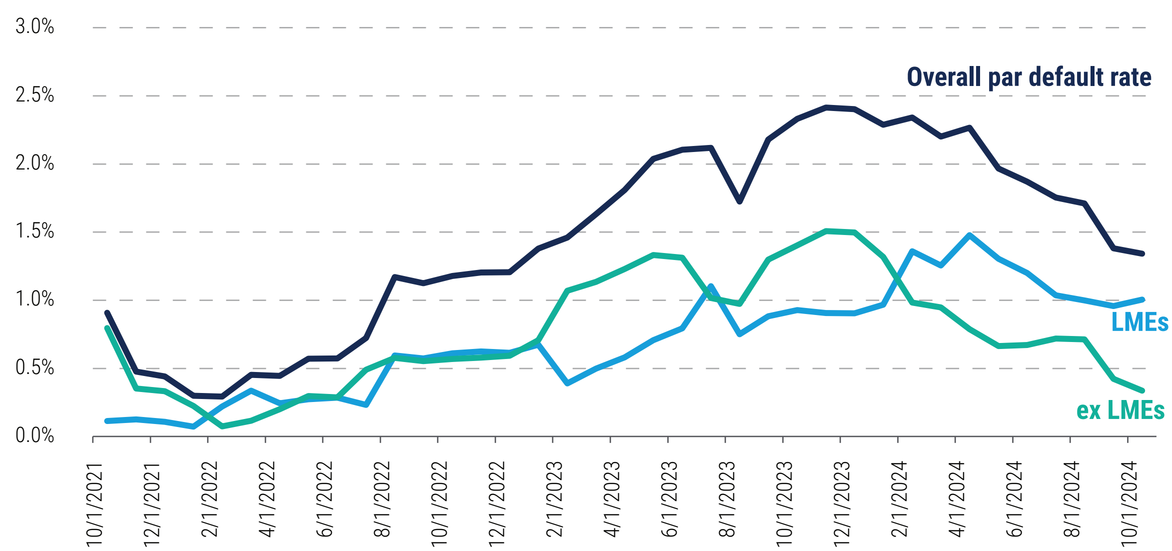
The bigger uncertainty revolves around how swiftly and forcefully Trump will implement trade restrictions, including significantly higher tariffs on China. In the first Trump presidency, higher import prices led to only a modest rise in consumer prices and slightly slower economic growth. A looser regulatory environment may somewhat offset these concerns, leaving the overall growth outlook for next year relatively unchanged despite the shifting variables.

Jobs data suggest that the base-case economic scenario is still leaning toward a soft landing. We continue to believe that defaults will remain relatively stable – trending higher but still remaining below 3%. Fundamental strength in credit metrics appears to have peaked, but started at a high level and should remain strong. Spreads remain at the tighter end of what we would consider fair value, though October's backup in Treasury rates has provided for attractive all-in yields.

Liability management exercises (LMEs) continue to be a market focus. In fact, so far in 2024, LMEs have accounted for the majority (75%) of default activity (see chart). Return scenarios continue to favor lower-quality credits, though that outcome assumes that favorable economic conditions will persist. Potential drawdown cases are not concerning except in the lower-rated bucket, where getting it wrong could be painful. We have been particularly selective among CCC rated issuers and have favored underweight portfolio positioning relative to market indices in general. We are in a market environment of limited convictions across somewhat overvalued credit markets. Therefore, we favor positioning portfolios with a roughly neutral beta and expect that high current income and continued low default rates will lead to attractive total returns for longer-term investors.

LMEs Have Dominated Defaults in 2024

US high yield LTM par amount default rate: LMEs vs. ex-LMEs



Source: Bank of America as of 31 October 2024.

Leveraged Loans

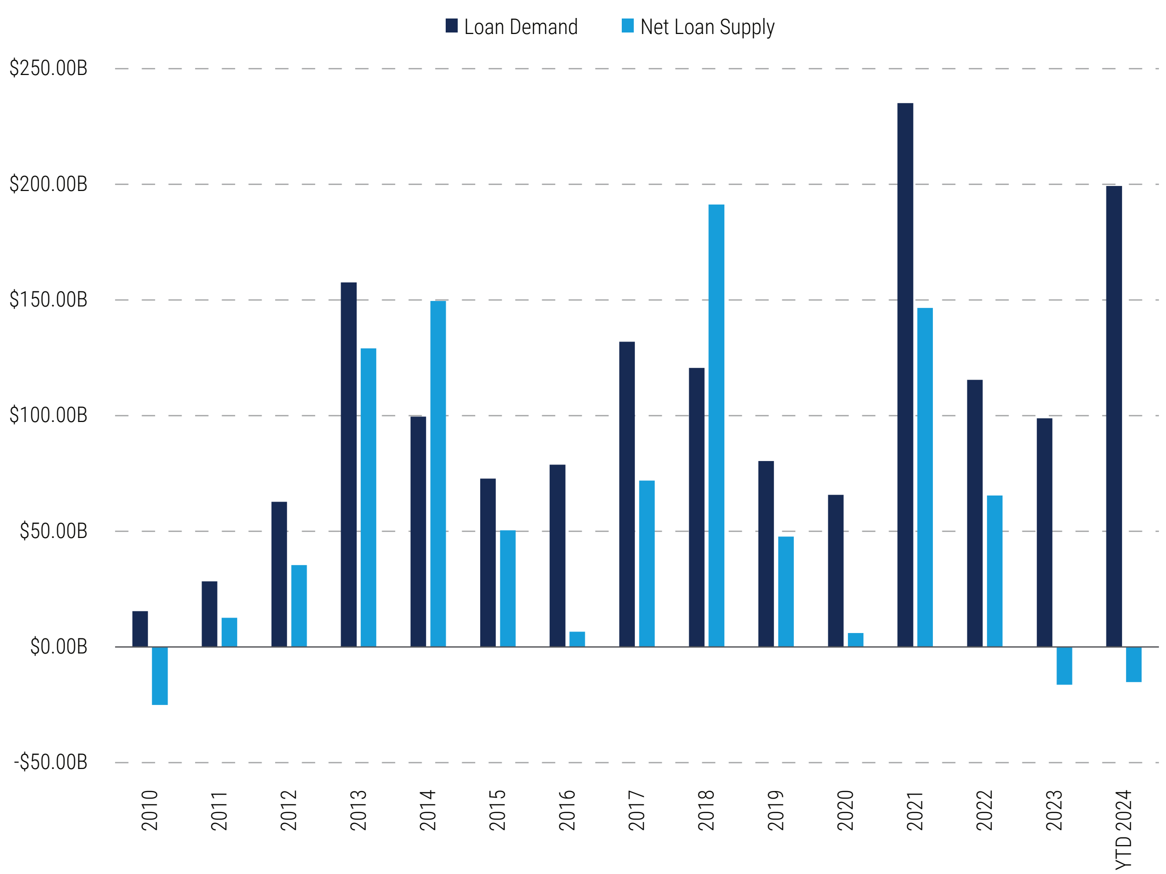
Loan issuer fundamentals are still on a healthy footing amid a supportive technical environment, while bank loan yields appear set to remain elevated on a historical basis.

Current economic forecasts are calling for steady growth in the US, which should support modest revenue and EBITDA growth for loan issuers. And while base rates are now expected to decline at a slower pace than initially forecasted, additional rate cuts will further improve interest coverage and free cash flow metrics over the coming quarters. Loan issuers have also taken advantage of lender-friendly capital markets to push out maturity walls and reduce nominal spreads. As a result, we expect defaults and LMEs to remain concentrated among non-performing credits, and we see the potential for increased trading volatility in certain sectors and companies in response to changes in trade policy and the regulatory agenda for the incoming Trump administration.

In terms of technicals, steady demand growth will outstrip net loan supply in the near term, despite early signs of a recovery in M&A- and LBO-related issuance. Any meaningful increase in net loan supply should be absorbed by demand from new CLO issuance, which has already set a record for annual volume and appears set to continue through year-end. In addition, resilient labor market data and the improved economic outlook, coupled with the less-dovish path for rates, should support modest net inflows for retail loan funds.

Loan Demand Will Likely Outstrip Supply in the Near Term

Loan demand vs. net loan supply



Source: Pitchbook as of 30 November 2024. Data for the Morningstar US Leveraged Loan Index.

Although coupons have been pressured by repricing activity as well as declining base rates, loan yields should remain elevated versus historical levels, especially now that the path for rate cuts has eased. In addition to their attractive risk-adjusted yields, bank loans should continue to offer a hedge against further rate volatility.

CLOs

We no longer favor broad risk-on shifts lower in the capital stack and believe vintage, portfolio, and manager selection remain key. Instead, we are selectively purchasing lower-rated credits with shorter spread duration in the primary market.

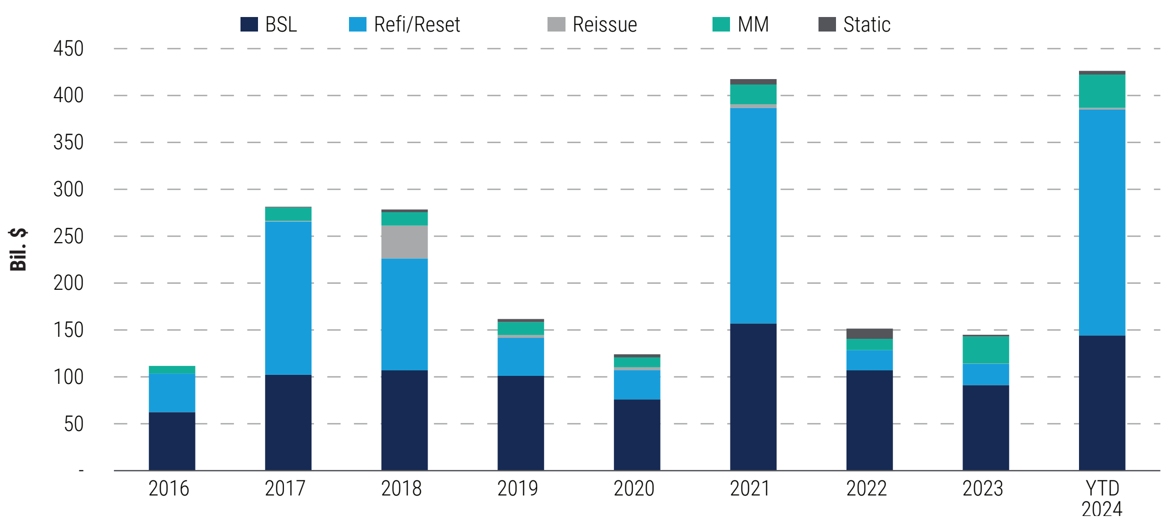
CLOs have now generated positive total returns across the capital stack for 12 consecutive months and at the overall index level for 19 months. Carry continues to drive returns given high base rates. This has occurred amid speculation that the Fed may adopt a more cautious stance on rate cuts due to a strong economy. CLO supply has remained incredibly robust against the current backdrop. In the US, new issue volumes of $184 billion ($148 billion in broadly syndicated loan CLOs and $36 billion in middle market/private credit direct lending CLOs) are set to surpass the prior record of $185 billion in 2021, while refi/reset volumes of $240 billion have already set a yearly record.[1] However, given the levels of amortization and call volumes this year, year-to-date net AAA tranche supply is negative.

Despite the higher-than-expected gross supply, CLOs continue to see strong demand given high all-in yields, which we expect to remain the case through year-end even with the commencement of the Fed's rate-cutting cycle. While valuations remain tight, the recent back-up in Treasury rates has provided for attractive all-in yields. The traditional investor base, including insurers, banks, and money managers, continues to allocate to the asset class, while a newer source of demand in the form of retail CLO exchange-traded funds grows further. CLO ETFs saw the largest monthly inflows in October and November, with total CLO ETF assets under management now surpassing $20 billion. This incremental source of demand, alongside negative net AAA supply, has helped drive spreads tighter and prices higher. The average AAA-BBB price is above par, and the basis between higher- and lower-rated tranches is also tight.

Amid the supportive technical environment and post-election ebullition, we expect CLO spreads to grind tighter. That said, we think spreads and yields will be attractive under most market scenarios over the next 12 months. Notwithstanding the shorter-term technical tailwinds, we believe expensive valuations and a fundamental picture that is bifurcated both between vintages and, relatedly, between deals that are in and out of their reinvestment periods, call for a robust bottom-up approach to security selection for long-term investors.

Given the dispersion seen in the loan market and a moderation in Fed rate cut expectations, certain CLO portfolios holding weaker credits may eventually experience impairments to the lowest-rated debt tranches. Against this backdrop, we have paused any broad risk-on shifts lower in the capital stack, as vintage, portfolio, and manager selection remain key. We continue to selectively purchase lower-rated credits with shorter spread duration in the primary market. If spreads were to widen, we maintain the ability to shift further into lower-rated tranches given our positioning higher up the capital stack.

CLO Issuance Sets a New Record



Source: BofA Global Research, S&P LCD, Bloomberg, Intex as of 26 November 2024.

[1] Source: Bank of America. "2025 Year Ahead Outlook (CLO)," 26 November 2024.

About PineBridge Investments

PineBridge Investments is a private, global asset manager focused on active, high-conviction investing. We draw on the collective power of our experts in each discipline, market, and region of the world through an open culture of collaboration designed to identify the best ideas. Our mission is to exceed clients' expectations on every level, every day. As of 30 September 2024, the firm managed US$203.1 billion across global asset classes for sophisticated investors around the world.

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