Leveraged Finance Asset Allocation Insights

PineBridge® INVESTMENTS

Returns Will Be Driven by Income and Security Selection

- The US economy remains resilient, with steady GDP growth and inflation expected to trend toward the Fed target (despite a potential temporary rise due to tariffs). Leveraged finance issuer fundamentals likewise remain robust, with earnings largely meeting or exceeding investor expectations.
- We remain constructive on high yield bonds overall, with lower-rated segments in particular continuing to outperform amid support from strong economic data. While changes in federal fiscal priorities could cause disruptions to the economy, we believe defaults will remain stable.
- Leveraged loan issuer fundamentals remain stable despite volatility arising from uncertainty over the new administration's trade policies, and attractive risk-adjusted yields continue to compensate investors.
- We continue to favor selective purchasing of shorter-spread-duration CLO assets across the capital stack, and especially for lower-rated credits. If spreads were to widen, we would support shifting further into lower-rated tranches for portfolios positioned higher up the cap stack overall.

Last year's rally in the bank loan and high yield markets continued through the first two months of 2025. US Treasury rates rose immediately after the Fed's rate cutting, again after the US election, and once more after the Fed adopted a more hawkish stance and reduced rate-cut guidance for 2025. We maintained a preference for floating-rate asset classes through much of this period, based on attractive spread differentials between bank loans and high yield bonds. However, as Treasury rates approached the higher end of our forecasted range, we favored a gradual increase in fixed rate exposure and extending duration. In February, US Treasury rates reversed all of the post-January spike in Consumer Price Index (CPI) inflation as investors grew more confident that US economic growth is moderating and interest-rate reductions will resume, with uncertainty around the Trump administration's policies weighing on business expectations.

The return of Donald Trump to the presidency has brought an unusual blend of policies that combine populist, reflationary initiatives with business- and disinflation-friendly measures. The new administration has focused on policy aimed to support lower interest rates, including workforce reductions, deregulation, and tariff adjustments. Treasury Secretary Scott Bessent stated that economic growth and deregulation – not Federal Reserve intervention – would drive lower rates. The administration has opted to delay terming-out debt issuance, complementing potential Fed quantitative tightening (QT) pauses. Lower long-end rates remain a key strategic focus.

The US economy continues to demonstrate resilience, with steady GDP growth and inflation that, despite a potential temporary rise due to tariffs, is expected to trend toward the Fed target. Leveraged finance issuer fundamentals remain robust, with earnings largely meeting or exceeding investor expectations. With roughly half of issuers reporting so far, the percentage of companies experiencing year-over-year earnings declines has dropped to roughly 39%, from 51% this time last year.[1]

[1] JP Morgan as of 21 February 2025.

1Q **2025**

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 Co-Head of Leveraged Finance

John Yovanovic, CFA
Head of High Yield Portfolio Management and Co-Head of Leveraged Finance

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

Outperforming sectors include services and transportation, while the metals and automotive sectors have lagged. Rating upgrades have generally exceeded downgrades, with retail facing the most downgrades and telecom, real estate, and travel seeing upgrades.

For investors, leveraged finance asset classes remain an appealing option. Although credit spreads are low, all-in yields remain historically attractive, and we would view any potential volatility event – such as sudden Treasury rate spikes or a correction in tech equity valuations – as buying opportunities. We have preferred bank loans over high yield for some time. Despite a large repricing wave in the loan market, discount spreads have moved slightly wider since year-end 2024. High yield has outperformed given both tighter spreads and lower Treasury rates.

With higher spread but little price upside in leveraged loans and investment grade (IG) collateralized loan obligation (CLO) debt, we believe all parts of leveraged finance have a similar risk/return balance for 2025. Given current conditions, mid- to lower-quality rated credit appears to be the best-positioned segment. Yields on CLO debt remain attractive, but spreads have tightened materially over recent quarters, with IG CLO debt being favored. However, we expect low to negative net supply and believe most passive investment demand will keep spreads range-bound, with returns driven by income and security selection themes.

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	261	376	365	381	7.20	7.96	7.42	6.42
	BB	160	249	249	249	6.18	6.63	6.15	5.09
	B	249	382	378	381	7.13	7.98	7.37	6.44
	CCC	530	826	801	805	9.84	12.65	11.91	10.50
Leveraged Loans	Index	397	472	456	436	8.41	9.78	8.38	5.97
	BB	254	316	311	308	6.87	8.05	6.00	4.63
	B	405	485	455	455	8.45	9.78	8.48	6.29
	CCC	1309	1249	1205	1136	18.49	18.71	16.73	13.59
CLOs	Index	190	273	266	253	6.06	6.74	6.03	4.27
	AAA	106	161	143	133	5.21	5.71	5.01	3.05
	AA	155	225	199	188	5.70	6.10	5.53	3.80
	A	186	291	257	256	6.01	6.72	5.98	4.72
	BBB	274	444	398	384	6.90	8.15	7.29	5.92
	BB	708	876	818	742	11.30	12.40	11.68	9.34
	B	1163	1325	1263	1050	16.02	17.32	16.26	12.63

Source: Bloomberg as of 20 February 2025. 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

We remain constructive on high yield overall, with lower-rated segments in particular continuing to outperform with support from strong economic data. While changes in federal fiscal priorities could cause disruptions to the economy, we see no reason to change our stable default outlook.

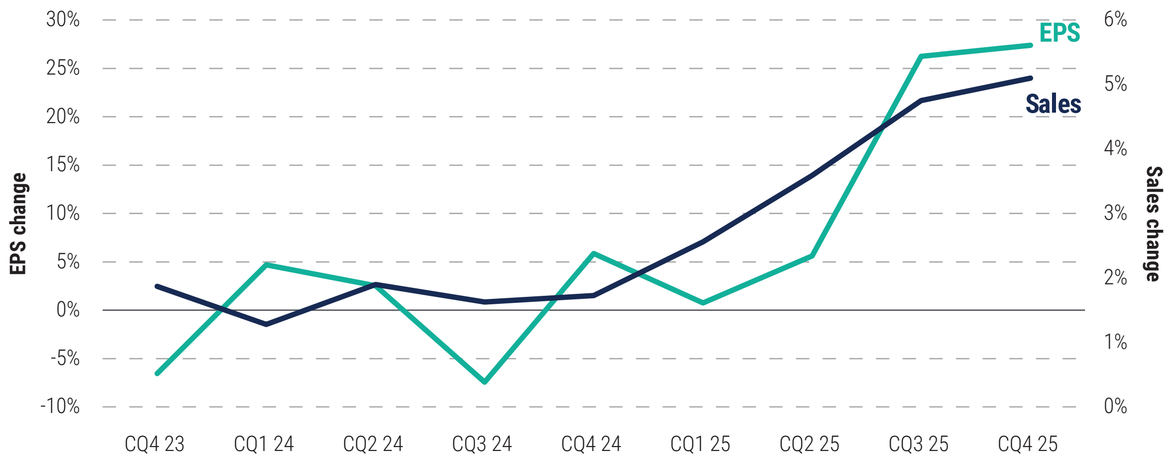
High yield spreads continued to rally in the first two months of 2025, nearing their lowest levels since the post-financial-crisis period. This tightening has been driven by a rally in equity markets, subdued issuance apart from refinancings, renewed retail flows into mutual funds and ETFs, and encouraging macroeconomic indicators. Issuers are again having a positive earnings season thus far. As expected, the Fed has left policy rates unchanged and is projected to keep them steady until at least June. Lower-rated segments of the high yield market continue to outperform, supported by strong economic data.

Spreads for the asset class remain range-bound. Demand remains strong amid prospects for deregulatory and M&A impulses, and the resilient economy and broader risk rally in stressed credit has pushed default rates and upgrade/downgrade ratios in the right direction. Liability management exercises (LMEs) still threaten, but continued strong fundamentals and strong technicals are mitigating the risk. Trailing-12-month par-weighted default rates increased in January to 1.43%/0.30% (with and without distressed exchanges).[2] January saw no defaults and one distressed exchange totaling $0.4 billion par.[3] We expect default rates to remain low in 2025, though we note that LMEs for one major telecom could easily push this number higher, given that this company makes up 2.23% of the market (par weighted).[4]

We remain constructive on the asset class overall, though we note that changes in federal fiscal priorities could cause disruption to the economy. We see no reason to change our stable default outlook. We expect high-single-digit returns from credit that are carry-based with drawdown cases that could potentially be muted by a rally in Treasury rates. Demand for credit remains solid. We expect more issuance in 2025 and anticipate that more lower-rated issuers will need market access into 2026. We remain neutral beta, adding value via credit selection, and expect credit to remain favored due to high current income and continued low default rates until the macro picture darkens, which we do not expect this year.

Analysts Expect Steady Earnings and Revenue Growth Throughout the Year

Below-investment-grade issuers with publicly listed equities: analyst sales and earnings-per-share estimates



Source: Data as of 20 February 2025. Bloomberg for analyst sales and earnings per share estimates. PineBridge Investments identified the cohort of below-investment-grade issuers with publicly listed equities.

Leveraged Loans

Leveraged loan issuer fundamentals remain stable despite volatility arising from uncertainty over the new administration's trade policies, and attractive risk-adjusted yields continue to compensate investors.

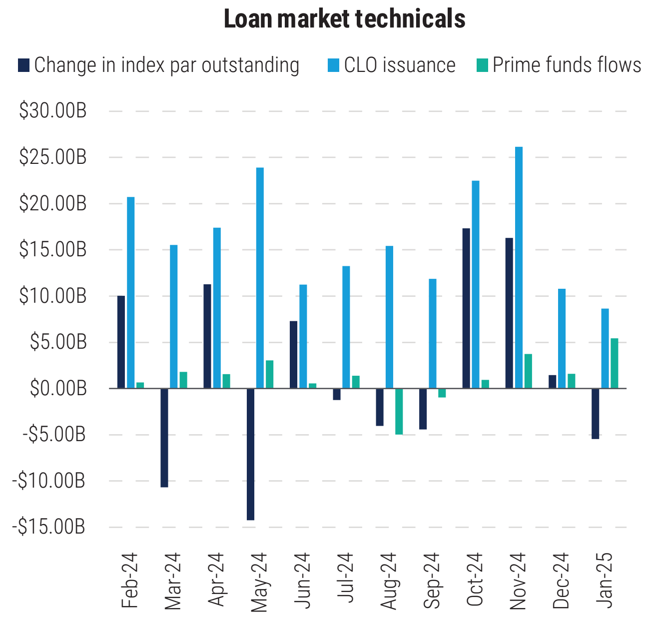
With the fourth-quarter 2024 earnings season underway, early indications reflect a continuation of the positive momentum from recent quarters, with low-single-digit revenue and earnings growth on average. While tariff-related headlines have created uncertainty for loan issuers within selective sectors, the main concern for the loan market is at the macro level. Greater clarity on the new administration's trade policy as well as more detail in terms of planned tax and spending cuts will be required to better gauge the potential impact on economic growth and financial conditions. In the interim, loan issuers have taken advantage of borrower-

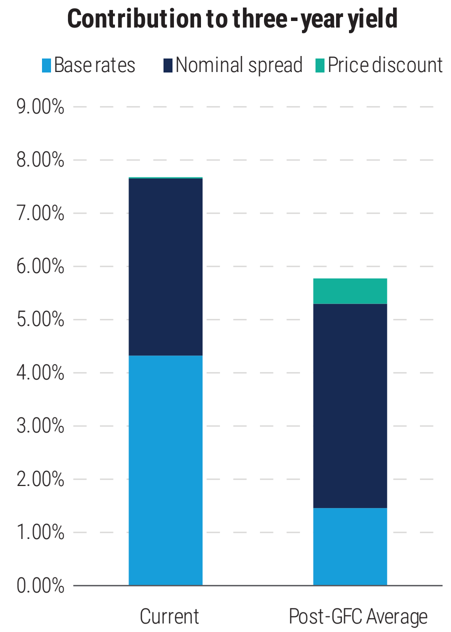
[2] JP Morgan as of 31 January 2025.
[3] Ibid.
[4] Bloomberg, 20 February 2025.

friendly capital markets to address near-term debt maturities and reduce borrowing costs. Leverage metrics among loan issuers have remained relatively stable for performing credits, and we expect distressed activity, including defaults and LMEs, to trend lower over the course of the year.

Technicals should be supportive of loan prices in the near term, with robust CLO formation and positive retail inflows. However, technicals could become more balanced, as it appears spread tightening on CLO liabilities may have plateaued while loan spreads continue to compress. If this trend persists, we could see CLO equity arbitrage become challenged, potentially slowing CLO issuance. In addition, retail loan funds could see net outflows at the margin as economic forecasts are adjusted for the rollout of the new administration's policies. Net loan supply will continue to be limited in the near to medium term, as the pipeline for M&A and LBO transactions has yet to meaningfully thaw. In terms of valuations, despite tighter nominal spreads, all-in yields remain attractive due to the attractive carry component, with base rates likely to stay elevated versus historical levels.

Loan Demand Will Likely Outstrip Supply, While Base Rates Support Attractive Carry





Source: Loan market technicals, Pitchbook as of 31 January 2025. Yield data based on the Morningstar LSTA US Leveraged Loan Index as of 21 February 2025.

CLOs

We continue to favor selective purchasing of shorter-spread-duration CLO assets across the capital stack, and especially for lower-rated credits. If spreads were to widen, we would support shifting further into lower-rated tranches for portfolios positioned higher up the cap stack overall.

In January, CLOs generated positive total returns across the capital stack for the 15th consecutive month, and the rally in prices continued, with the basis between higher- and lower-rated tranches remaining tight.[5] The average AAA-BBB price ended January well above par, as has been the case for the past five months, and BBs are trading just shy of 98, a level not reached since late November 2018.[6] Primary and secondary

[5] JP Morgan CLOIE as of 31 January 2025.
[6] JP Morgan CLOIE as of 31 January 2025.

spreads tightened throughout 2024 and into January, with secondary AAA and AA spreads ending the month at the tightest levels since January 2022.[7] However, buying in the primary market continues to allow for wider spreads on a relative basis, even when taking spread duration into account. Against this backdrop, we continue to favor selective purchasing of shorter-spread-duration assets across the capital stack, and especially for lower-rated credits. If spreads were to widen, we would favor shifting further into lower-rated tranches for portfolios positioned higher up the cap stack overall.

CLO demand remains strong due to high all-in yields. The prospects for lower corporate taxes, deregulation, and a more favorable M&A environment also support the outlook. Following a new annual record in 2024, CLO issuance remains healthy as managers take advantage of tighter liability spreads. We expect strong issuance to continue as spreads remain tight. Despite that, high levels of amortization and call volumes resulted in marginally negative net AAA supply for 2024. This theme continued in 2025, with net AAA supply negative $8 billion so far this year.[8] Demand from CLO ETFs is also helping drive a demand imbalance. In 2024, CLO ETFs saw $16 billion of inflows, which have accelerated in 2025 with an additional $7 billion of inflows. CLO ETF assets under management now represent 2%-3% of the total CLO market.[9] Refinancings and resets also continue at a rapid pace following record activity in 2024, as portfolios constructed with purchases in the secondary market take advantage of higher loan prices and tighter CLO spreads. We expect this trend to continue for at least the first half of the year. This has bolstered demand for new paper and led to tighter spreads as investors put proceeds back to work.

Amid the supportive technical environment, we expect CLO spreads to remain range-bound given strong demand and heavy primary supply. That said, we view spreads and yields as attractive under most market scenarios over the next 12 months. Notwithstanding shorter-term technical tailwinds, we believe expensive valuations and a fundamental picture bifurcated 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. As a result, vintage, portfolio, and manager selection remain key.

CLO Technicals Remain Supportive

	US (BSL)	
	2024	2025
Gross Issuance	161	18
AAA supply	105	12
Deal Amortization	82	17
AAA amortization	79	16
Deal Call	46	7
AAA call	30	4
Net Supply	33	**(5)**
AAA net supply	**(4)**	**(8)**
CLO ETF Inflows	16	7
AAA ETF inflows	14	7
Non ETF Investors (change)	17	**(12)**
AAA holdings (change)	**(19)**	**(15)**

Source: BofA Global Research, Intex, "CLO Weekly", as of 21 February 2025.

[7] J.P. Morgan as of 31 January 2025.
[8] BofA Global Research, Intex, "CLO Weekly," as of 21 February 2025.
[9] Ibid.

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 31 December 2024, the firm managed US$190.3 billion across global asset classes for sophisticated investors around the world.

pinebridge.com

MULTI-ASSET | FIXED INCOME | EQUITIES | ALTERNATIVES