Leveraged Finance Asset Allocation Insights

PineBridge® INVESTMENTS

2Q **2024**

Issuer Selection Is Key as Loans' Edge Over High Yield Moderates

US inflation was unexpectedly strong in the first quarter, leading to prolonged higher interest rates and halting the rally in risk assets. Real domestic final sales also remained robust due to firm income growth, supported by government employment and easier financial conditions following the Fed's fourth-quarter policy shift. This helped sustain strong service consumption even as excess savings declined.

These demand factors are likely to diminish as the year goes on, however. Notably, the reacceleration of inflation is only partly due to strong demand, while supply-side strength appears more enduring. Manufacturing is now showing signs of recovery, as goods inventories have cleared, ending the rolling recession that started in early 2023.

January's inflation surge was largely due to challenging seasonal adjustments. Overall, the inflation increase in the first quarter seemed less connected to domestic inflationary pressures, which are not expected to persist. In April, consumer price inflation moderated. Core Consumer Price Index (CPI) inflation rose by the expected 0.3%, with the annual figure dropping from 3.8% to 3.6%, the lowest level in three years. Although April's inflation figures are still above the Fed's targets, they are moving in the right direction after previous setbacks. We still expect to see the first Fed rate cut in the second half of this year, but further cooling in the labor market is likely needed for this to happen.

Meanwhile, April retail sales were disappointing, with the biggest decline seen in online sales, which had been a bright spot in prior months. The next move for the Fed is clearly cuts, and while believe this will initially spur a rally, at that point portfolio positioning will depend on which side of the Fed's dual mandate is more prominent: Was it a policy adjustment, or a defense against deteriorating employment trends?

This has been a strong earnings season for leveraged credit, with many more companies beating than missing EBITDA expectations. We have seen a rally so far this month in both the high yield and leveraged loan markets. High yield has outperformed given the rally in Treasury rates.

From here, we favor floating-rate asset classes (bank loans and CLO debt tranches) relative to fixed-rate asset classes (such as high yield bonds) but believe those trends will largely equalize over the remainder of the year. Spread differentials still support bank loans over high yield. However, with a larger portion of the loan market trading above par, repricing activity has increased, and we are more neutral with respect to our asset mix between high yield and loans. We are instead focused on issuer selection and are actively participating in new issues in both markets.

This material must be read in conjunction with the disclosure statement.

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

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	296	376	383	390	7.85	7.93	6.35	6.26
	BB	173	250	252	259	6.59	6.61	4.97	4.87
	B	262	385	389	392	7.58	8.02	6.48	6.29
	CCC	727	826	842	811	12.10	12.61	11.16	10.24
Leveraged Loans	Index	470	505	484	460	9.01	8.72	6.09	5.94
	BB	281	325	320	321	7.12	7.02	4.59	4.99
	B	463	504	475	466	8.92	8.70	6.05	5.95
	CCC	1183	1292	1293	1193	16.47	16.83	16.43	13.57
CLOs	Index	281	271	263	250	7.59	6.50	4.01	4.11
	AAA	103	161	143	143	6.07	5.54	3.01	2.96
	AA	173	225	199	199	6.52	5.98	3.63	3.75
	A	243	291	264	270	6.96	6.60	4.34	4.66
	BBB	381	443	402	393	8.23	8.10	5.70	5.84
	BB	786	875	818	722	12.31	12.36	10.26	8.94
	B	1210	1325	1263	1006	16.66	17.32	15.26	11.88

Bloomberg as of 20 May 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 discount margin 3-year 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

The resilient macro outlook continues to support our expectation for a modest increase (but no spike) in defaults. From a bottom-up perspective, first-quarter earnings results suggest solid fundamentals, with increasing consumer credit stress offset by strong employment trends. Normalization of supply chains is largely complete in the US. Fundamental strength in credit metrics appears to have peaked but from relatively high starting levels, and we believe this strength will persist despite a more restrictive monetary backdrop.

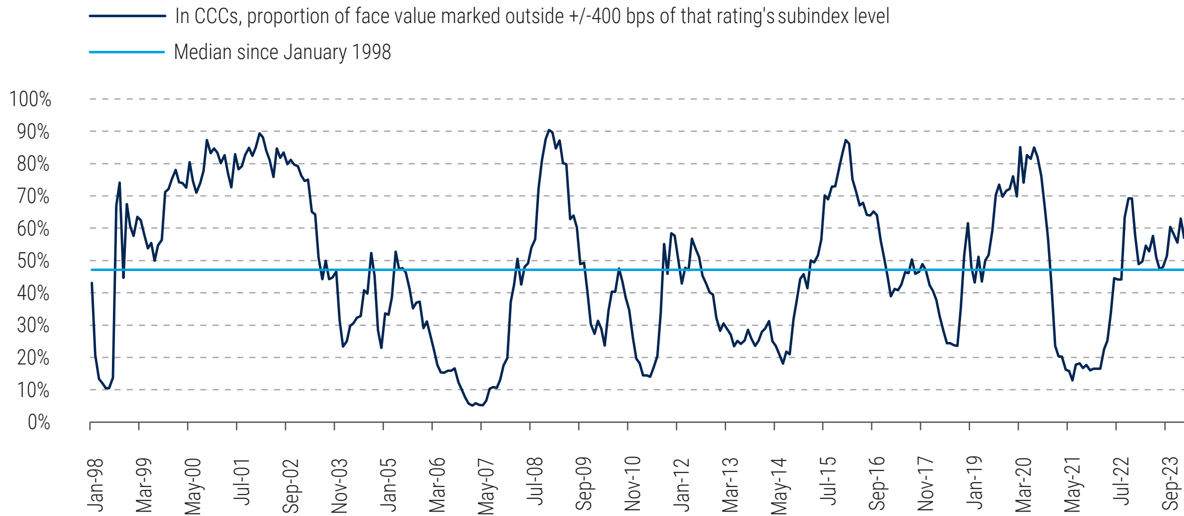
From a valuation standpoint, average spreads at the index level continue to be at the tighter end of our fair-value range. For most issuers, the market is pricing in a soft- to no-landing scenario, with little material probability of a hard landing. However, the lowest-quality segment (CCC rated and below) is bifurcated, with many issuers cut off from new capital in both the private and public markets. Their balance sheets require significant improvement, with half the segment experiencing negative free cash flow and debt-to-enterprise value ratios of 85% or higher. Many of these issuers are already engaged in liability management exercises (or are rumored to be). As a result, we favor a selective approach to CCC and lower-rated issues.

Nonetheless, while spreads are toward the tighter end of our fair valuation range, with higher all-in yields, a lower average dollar price, and solid issuer fundamentals, we believe the high yield market presents an attractive total return option for longer-term investors.

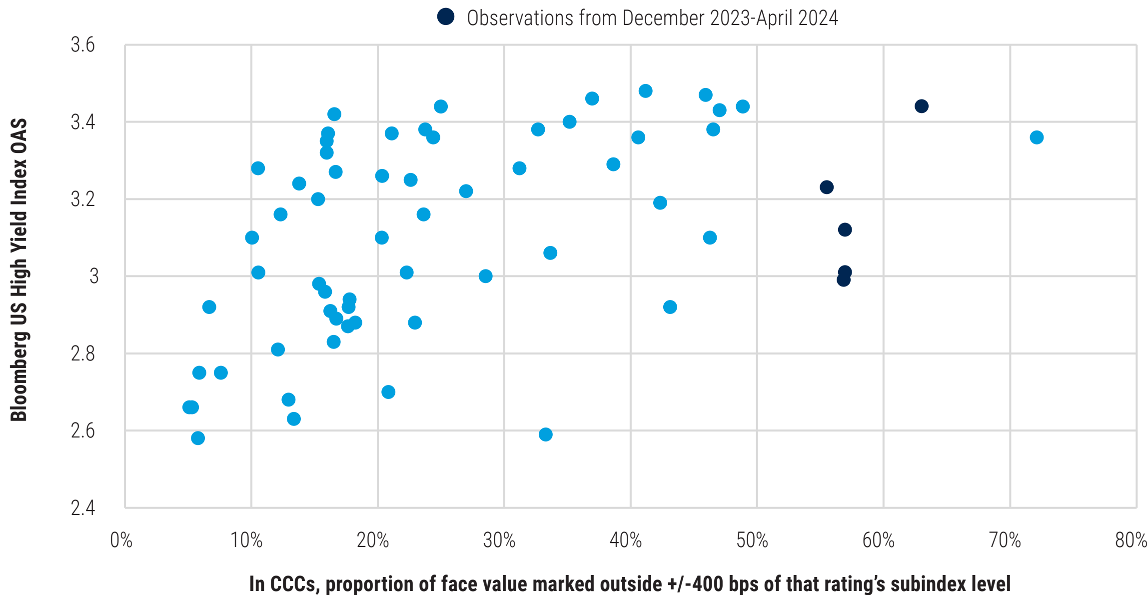
The CCC and below segment shows elevated dispersion, as measured by the proportion of bonds with spread levels more than 400 basis points above or below average index spreads. This historically has not been the case when index spreads are trading relatively tight. The first chart below shows the level of dispersion relative to all monthly time periods since 1998. The second chart focuses on time periods when the index OAS was trading at or inside of 350 basis points. On the second chart, the y-axis indicates the option-adjusted spread on the Bloomberg

US High Yield Index, while the x-axis shows the proportion of CCC rated bonds trading more than 400 basis points outside of average index spread levels, with the darker blue dots indicating observations from December 2023-April 2024. Typically, when overall index spreads are tight, dispersion among CCC rated issuers is relatively low. However, this is currently not the case. Again, the elevated dispersion underscores the need for a highly selective approach.

For CCC Issues, We Favor a Highly Selective Approach



Source: ICE BofA as of 30 April 2024.



Source: OAS is from Bloomberg as of 30 April 2024; dispersion of CCC rated bonds is from ICE BofA as of 30 April 2024.

Leveraged Loans

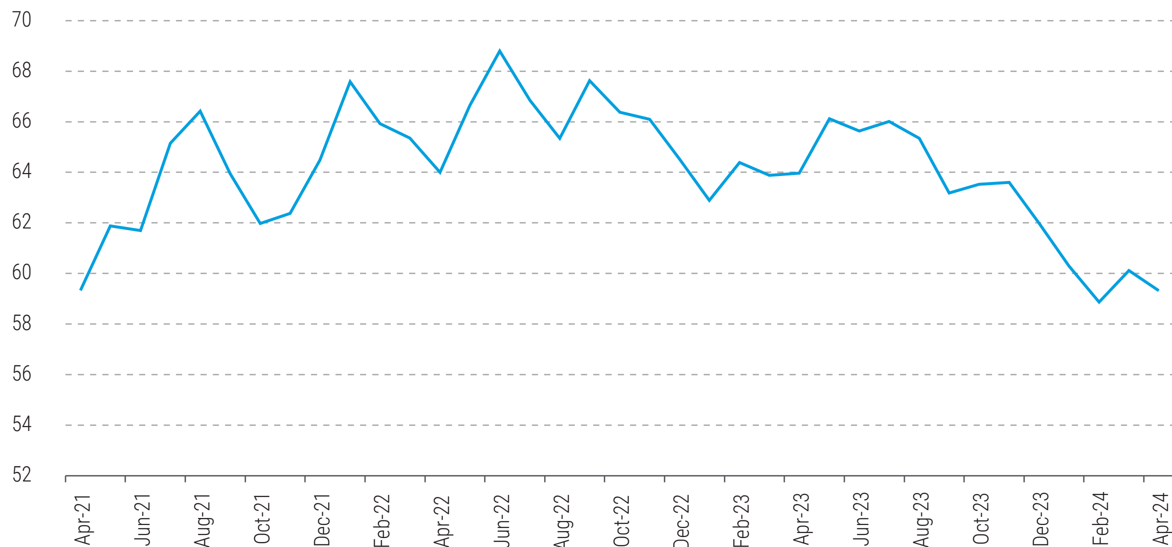
Leveraged loans should continue to perform well over the next six to 12 months as issuer fundamentals benefit from the resilient economic backdrop and technicals provide support for loan prices. For investors, a higher-for-longer rate environment should keep loan yields well above the historical average.

Earnings season for loan issuers is underway, and broadly speaking, results are pointing to a continuation of revenue and EBITDA growth. However, loan performance is still bifurcated. Issuers with over-leveraged balance sheets or that are facing shifting secular trends are seeing their loan prices gap down in response to disappointing results.

Defaults and distressed exchanges picked up slightly in April, but absent a broader economic downturn, this activity will likely remain concentrated among weaker credits that do not have access to traditional capital markets. For loans trading below 80, a typical threshold for distress in the loan market, the weighted average bid price has continued to trend lower, highlighting both the difficult operating environment for these issuers and expectations for lower recoveries. In contrast, the average bid price for the broader loan market has trended higher year to date, with approximately 65% of the Morningstar Leveraged Loan Index trading at par or higher as of 16 May 2024.

The Weighted Average Bid Price Is Trending Lower for Distressed Loans

Average bid price: loans below 80



Source: Morningstar as of 16 May 2024.

The technical backdrop for loans remains strong, with no signs that supply/demand dynamics will shift in the near term. Demand for loans continues to outpace new issue supply. Net loan supply will remain limited as elevated financing costs continue to sideline mergers/acquisitions and leveraged buyouts. Loan issuers are still focused on liability management, with opportunistic transaction activity including repricings and refinancings setting a record pace year to date. In terms of demand, collateralized loan obligation (CLO) formation remains steady; April was the second-busiest month for CLO issuance in roughly two-and-a-half years. CLO issuance continues to be supported by tighter CLO liability spreads as well as healthy demand for the asset class. Retail loan funds, another source of demand for leveraged loans, have also seen net inflows accelerate in recent weeks.

With much of the loan market trading near par in the current environment, bottom-up credit selection based on a credit research-intensive process will remain paramount. However, loan yields are still in the 9%-10% range, which is attractive on a risk-adjusted basis, with superior relative value in the B-flat and B+ rating segments. In addition, interest rate futures are pricing in less than two 25-basis-point rate cuts from the Federal Reserve in 2024, which would leave base rates just below 5% and keep loan yields elevated on a historical basis for the next several quarters.

CLOs

CLO new issuance has continued at a record pace as managers take advantage of tighter liability spreads, with AAA secondary spreads at the tightest levels since April 2022. CLO prices in the secondary market have increased dramatically so far this year, with the average price of AAA to A rated CLO paper now trading above par. Loan prices are also elevated, with over 60% of the loan market now trading above par. Amid tight spreads and high asset prices, refinancing and reset volumes have continued at a torrid pace, with $56.1 billion pricing through April, already exceeding the volume in four of the past five full years.

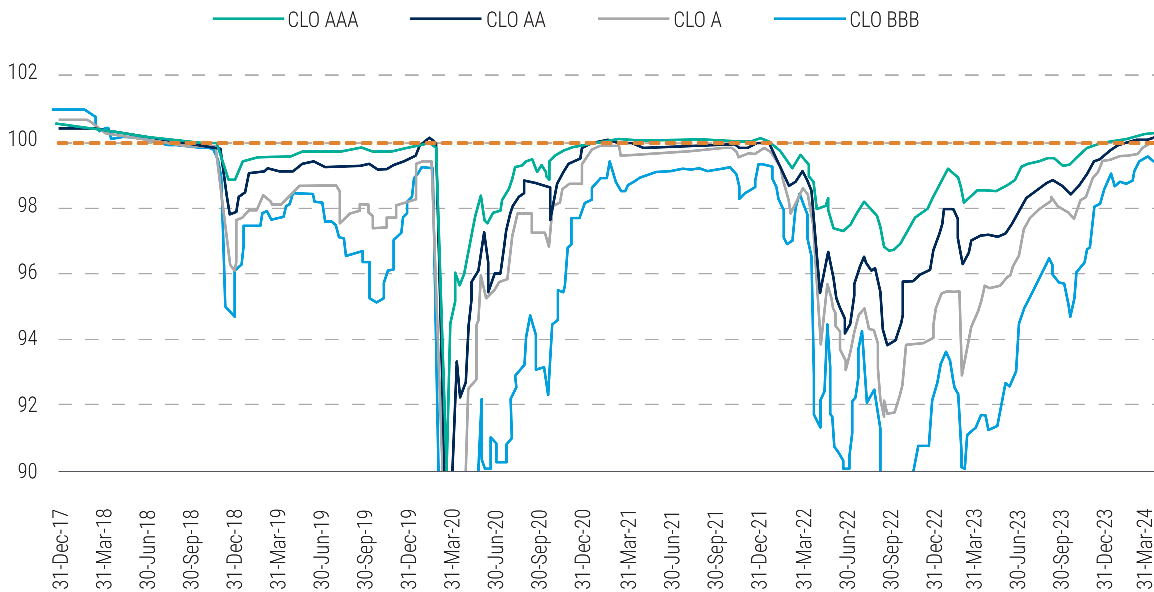
Although the potential universe of refi/reset candidates has shrunk materially given the level of activity already this year, should the loan and CLO markets continue to rally, we would expect to see more portfolios benefit from the significant redemption optionality in CLOs. However, given the dispersion we're seeing in the loan market, certain CLO portfolios holding weaker credits, particularly deals that are out of their reinvestment periods, could eventually experience impairments to the lowest-rated debt tranches, even if the majority of the loan market continues to rally. As a result, vintage, portfolio, and manager selection remains key.

Demand has kept pace despite the strong overall supply, with investors largely looking past tight spreads and continuing to seek out high all-in yields provided by CLOs, which we expect to remain at attractive levels given more muted rate-cut expectations. Demand for new paper has also been bolstered by investors who need to reinvest proceeds from amortizing, called, refinanced, or reset deals. The rapid increase in the size of the CLO ETF market was another tailwind, growing from roughly $2 billion at the start of 2023 to over $11 billion today. This has led to even tighter spreads and should limit the potential for any extreme near-term spread widening in a downside scenario.

Overall, we expect CLO spreads to trade in a range for the next three to six months given the supportive technical backdrop, and we view spreads and yields as attractive in most market scenarios over the next 12 months. Given tighter valuations and risks that are tilted to the downside, we remain positioned higher in the capital stack overall, with more selective exposure to A and BBB credits. Should prices increase further above par for A and BBB credits, we would expect to begin derisking portfolios, looking for opportunities to once again add exposure to lower mezzanine tranches once spreads begin to widen.

Average Price of AAA to A Rated Tranches Rose Above Par for the First Time Since June 2018

CLO average price by rating



Source: JP Morgan CLOIE Index as of 16 May 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 31 March 2024, the firm managed US$168.2 billion across global asset classes for sophisticated investors around the world.

pinebridge.com

MULTI-ASSET | FIXED INCOME | EQUITIES | ALTERNATIVES

Investing involves risk, including possible loss of principal. The information presented herein is for illustrative purposes only and should not be considered reflective of any particular security, strategy, or investment product. It represents a general assessment of the markets at a specific time and is not a guarantee of future performance results or market movement. This material does not constitute investment, financial, legal, tax, or other advice; investment research or a product of any research department; an offer to sell, or the solicitation of an offer to purchase any security or interest in a fund; or a recommendation for any investment product or strategy. PineBridge Investments is not soliciting or recommending any action based on information in this document. Any opinions, projections, or forward-looking statements expressed herein are solely those of the author, may differ from the views or opinions expressed by other areas of PineBridge Investments, and are only for general informational purposes as of the date indicated. Views may be based on third-party data that has not been independently verified. PineBridge Investments does not approve of or endorse any republication of this material. You are solely responsible for deciding whether any investment product or strategy is appropriate for you based upon your investment goals, financial situation and tolerance for risk.

Disclosure Statement

PineBridge Investments is a group of international companies that provides investment advice and markets asset management products and services to clients around the world. PineBridge Investments is a registered trademark proprietary to PineBridge Investments IP Holding Company Limited.

Readership: This document is intended solely for the addressee(s) and may not be redistributed without the prior permission of PineBridge Investments. Its content may be confidential, proprietary, and/or trade secret information. PineBridge Investments and its subsidiaries are not responsible for any unlawful distribution of this document to any third parties, in whole or in part.

Opinions: Any opinions expressed in this document represent the views of the manager, are valid only as of the date indicated, and are subject to change without notice. There can be no guarantee that any of the opinions expressed in this document or any underlying position will be maintained at the time of this presentation or thereafter. We are not soliciting or recommending any action based on this material.

Risk Warning: All investments involve risk, including possible loss of principal. If applicable, the offering document should be read for further details including the risk factors. Our investment management services relate to a variety of investments, each of which can fluctuate in value. The investment risks vary between different types of instruments. In making an investment decision, prospective investors must rely on their own examination of the merits and risks involved.

Performance Notes: Past performance is not indicative of future results. There can be no assurance that any investment objective will be met. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment. PineBridge Investments often uses benchmarks for the purpose of comparison of results. Benchmarks are used for illustrative purposes only, and any such references should not be understood to mean there would necessarily be a correlation between investment returns of any investment and any benchmark. Any referenced benchmark does not reflect fees and expenses associated with the active management of an investment. PineBridge Investments may, from time to time, show the efficacy of its strategies or communicate general industry views via modeling. Such methods are intended to show only an expected range of possible investment outcomes, and should not be viewed as a guide to future performance. There is no assurance that any returns can be achieved, that the strategy will be successful or profitable for any investor, or that any industry views will come to pass. Actual investors may experience different results.

Information is unaudited unless otherwise indicated, and any information from third-party sources is believed to be reliable, but PineBridge Investments cannot guarantee its accuracy or completeness. All information is sourced from PineBridge Investments unless otherwise noted.

This document and the information contained herein does not constitute and is not intended to constitute an offer of securities or provision of financial advice and accordingly should not be construed as such.

The securities and any other products or services referenced in this document may not be licensed in all jurisdictions, and unless otherwise indicated, no regulator or government authority has reviewed this document or the merits of the products and services referenced herein. This document and the information contained herein has been made available in accordance with the restrictions and/or limitations implemented by any applicable laws and regulations. This document is directed at and intended for institutional and qualified investors (as such term is defined in each jurisdiction in which the security is marketed). Before acting on any information in this document, prospective investors should inform themselves of and observe all applicable laws, rules and regulations of any relevant jurisdictions and obtain independent advice if required.

Where applicable, the Manager may determine to terminate any arrangements made for marketing the Shares in one or more jurisdictions in accordance with the AIFM Directive and UCITS Directive respectively, as may be amended from time to time. Investors and potential investors can obtain a summary of investor rights and information on access to collective redress mechanisms at www.pinebridge.com/investorrights.

Certain Geographic Disclosures:

Australia: PineBridge Investments LLC is exempt from the requirement to hold an Australian financial services license under the Corporations Act 2001 (Cth) in respect of the financial services it provides to wholesale clients, and is not licensed to provide financial services to individual investors or retail clients. Nothing herein constitutes an offer or solicitation to anyone in or outside Australia where such offer or solicitation is not authorised or to whom it is unlawful. This information is not directed to any person to whom its publication or availability is restricted.

Bermuda: PineBridge Investments Asia Limited is registered as a Class A Registered Person with the Bermuda Monetary Authority pursuant to the Investment Business Act 2003 (as amended).

Hong Kong: The issuer of this document is PineBridge Investments Asia Limited, a company incorporated in Bermuda with limited liability, licensed and regulated by the Securities and Futures Commission (SFC). This document has not been reviewed by the SFC.

Malaysia: PineBridge Investments Malaysia Sdn Bhd is licensed and regulated by Securities Commission of Malaysia (SC). This material is not reviewed or endorsed by the SC.

Singapore: PineBridge Investments Singapore Limited is licensed and regulated by the Monetary Authority of Singapore (MAS). In Singapore, this material may not be suitable to a retail investor. This advertisement or publication has not been reviewed by the MAS.

Taiwan: PineBridge Investments Management Taiwan Ltd. Is licensed and regulated by Securities and Futures Bureau of Taiwan (SFB). In Taiwan, this material may not be suitable to investors and is not reviewed or endorsed by the SFB.

Last updated 7 February 2024. For additional legal and regulatory disclosures including other cross border information, please refer to https://www.pinebridge.com/en/regulatory-disclosure.