# Leveraged Finance Asset Allocation Insights

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## Markets Embrace Likely September Rate Cuts

- The Federal Reserve appears ready to begin cutting rates at its September meeting, supported by another month of favorable inflation data – a move welcomed by the market.
- High yield price and option-adjusted duration are still historically low, and all-in yields remain attractive. LME risks remain most topical in lower-rated segments and have accounted for most recent defaults, resulting in strong demand for BB/B bonds while spurring volatility in CCCs.
- While leveraged loans currently have better carry relative to bonds, we see attractive total return opportunities in both asset classes at the individual issuer and security level.
- Leveraged loans are positioned to perform well despite expectations for Fed rate cuts, as easing interest burdens will help buttress fundamentals and stable CLO demand underpins a supportive technical environment.
- CLO prices have rallied significantly in 2024, with the average AAA-BBB price ending July above par and the basis between higher- and lower-rated tranches tightening materially. We thus believe now may not be the time to rotate lower in the capital stack.

After a brief period of volatility in early August, several factors are likely to shape the leveraged finance markets as we move into fall.

On the positive side, the Federal Reserve seems ready to begin cutting rates at its September meeting, supported by another month of favorable inflation data – a move welcomed by the market. After a weaker-than-expected ISM Manufacturing Purchasing Managers' Index (PMI) reading followed by a sharp slowdown in payroll gains, subsequent indicators have pointed to improved GDP growth, including retail sales and the ISM Services PMI. Meanwhile, second-quarter earnings have largely met or exceeded elevated consensus estimates, with twice as many leveraged finance issuers beating expectations as missing. We have seen a modest increase in mergers and acquisitions, though M&A has been concentrated in specific sectors such as energy, metals, AI-related technology, and distressed assets.

On the downside, we see growing evidence that US consumers are pulling back. This shift in sentiment is noticeable across various sectors, including food service, airlines, hospitality, home improvement, automakers, and certain retail segments. Another concerning sign is the stagnation in credit creation over the past few months. Corporate credit growth across all categories – investment grade, high yield, bank loans, private credit, and bank lending – is barely in the low single-digits. A strong US economy typically requires robust credit growth, which we aren't seeing.

We're likely transitioning from a period of high growth to either a soft landing or a typical recession. We see no reason to change our default outlook, which calls for a modest increase but no spike. Fundamental strength in credit metrics appears to have peaked, but starting from historical highs, and fundamentals should remain



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### 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.


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strong. From the top down we see a moderation in both inflation and production that points toward a soft landing, giving central banks the space needed to normalize policy. From the bottom up, we see continued solid trends, with signs that the lower half of consumers are feeling stress.

Spreads continue to be at the tighter end of the range but at attractive all-in yields. Liability management exercises (LMEs) remain a market focus, accounting for most recent defaults – and, importantly, signaling such defaults to the market six months or more in advance, thereby crowding investors into BB/B assets. This continues to weigh on CCC spreads and volatility.

Bond and loan scenarios are converging, leaving the asset classes about equally attractive. Loans have better carry for the time being, but we are finding attractive total return opportunities at the individual issuer and security level in both loans and high yield bonds. CLO debt tranche valuations look fair, so higher-quality tranches appear more attractive on the margin.

### 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 | 322 | 376 | 377 | 390 | 7.53 | 7.97 | 7.11 | 6.31 |
| | BB | 190 | 250 | 249 | 258 | 6.20 | 6.63 | 5.67 | 4.95 |
| | B | 301 | 385 | 385 | 391 | 7.38 | 8.01 | 7.32 | 6.34 |
| | CCC | 805 | 828 | 841 | 812 | 12.27 | 12.66 | 11.92 | 10.42 |
| Leveraged Loans | Index | 503 | 544 | 524 | 502 | 8.68 | 9.38 | 7.41 | 6.57 |
| | BB | 279 | 327 | 318 | 315 | 6.31 | 6.99 | 5.33 | 4.90 |
| | B | 459 | 531 | 511 | 507 | 8.10 | 8.96 | 7.24 | 6.61 |
| | CCC | 1320 | 1317 | 1317 | 1235 | 18.11 | 19.43 | 17.96 | 15.36 |
| CLOs | Index | 257 | 272 | 264 | 255 | 6.48 | 6.70 | 5.13 | 4.23 |
| | AAA | 133 | 160 | 143 | 143 | 5.35 | 5.76 | 3.21 | 3.03 |
| | AA | 180 | 223 | 199 | 200 | 5.66 | 6.08 | 4.02 | 3.94 |
| | A | 230 | 289 | 264 | 265 | 6.09 | 6.66 | 4.84 | 4.84 |
| | BBB | 369 | 441 | 401 | 399 | 7.40 | 8.08 | 6.39 | 6.03 |
| | BB | 791 | 861 | 816 | 728 | 11.68 | 12.38 | 11.07 | 9.09 |
| | B | 1233 | 1324 | 1258 | 1012 | 16.22 | 14.14 | 16.05 | 12.04 |

Source: Bloomberg as of 15 August 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 economy has pushed default rates and upgrade/downgrade ratios in the right direction, but liability management exercises remain a risk. Overall growth continues, albeit at a slower pace and with a greater dispersion of results. In addition to the persistent headwinds buffeting certain industries, such as cable and telecom, we are also seeing indications of mixed results in financials, leisure, and building materials. Last-12-month par-weighted default rates declined further to 1.78%/1.16% for high yield (with and without distressed exchanges).[1] Average leverage stands at 4.0x and coverage at 4.9x, both better than long-term averages.[2]

[1] Source: J.P. Morgan as of 31 July 2024.
[2] Source: J.P. Morgan, based on 1Q financials as of 12 June 2024.

Recent indicators of economic growth have improved following a disappointing payroll report, with stronger retail sales, jobless claims, and ISM Services PMI data. Meanwhile, inflation has eased sufficiently to justify a Fed rate cut in September. The key question now is whether the Fed will opt for a 50-basis-point cut or a smaller 25-bp cut. The decision will likely hinge on the strength of the August payroll report, which is set to be released on 6 September.

The high yield market remains undersupplied from a technical standpoint, with total demand exceeding total supply by roughly $25 billion so far in 2024. Spreads on high yield bonds are now significantly tighter than the 381-bp monthly peak on 8 August. CCC to BB/B spread ratios tightened materially as well, with the rally in a few "left for dead" CCC credits. Notably, price and option-adjusted duration are still historically low, and all-in yields remain attractive.

Liability management exercises have accounted for most recent defaults and, importantly, have signaled them to the market six months or more in advance. This has resulted in strong demand for BB/B bonds but has weighed on CCC spreads and spurred volatility. The ratio of the option-adjusted spread on the Ba/B rated segment relative to CCC rated segment reached an all-time-high of 384% on 23 July. The ratio has since come down, but LME risks remain most topical in the lower-rated segments of the high yield market.

**Ratio of CCC OAS to Ba/B OAS**


Source: Bloomberg Indices calculated as the ratio (in percentage terms) of the option-adjusted spread on the Bloomberg CCC High Yield Index relative to the option-adjusted spread on the Bloomberg Ba/B High Yield Index as of 19 August 2024.

## Leveraged Loans

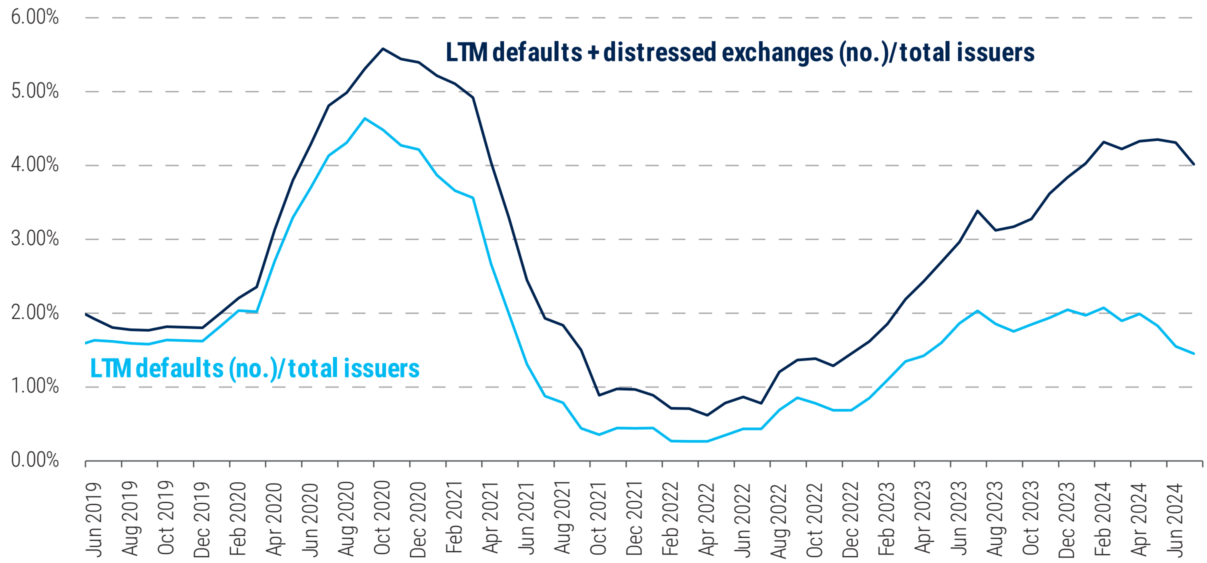
Despite expectations that the Fed will soon begin cutting rates, leveraged loans are positioned to perform well, as easing interest burdens should help buttress fundamentals and stable CLO demand underpins a supportive technical environment. Loan yields are expected to decline when rate cuts begin, but coupons should remain elevated on a historical basis for now, as the Fed is likely to ease into the rate-cut cycle and evaluate the evolving economic data to avoid a resurgence in inflation. In addition, the asset class should continue to offer a haven from interest rate volatility, as markets remain vulnerable to shifting expectations on the magnitude and speed of rate cuts.

Absent a sharp contraction in the economy, pressure on revenue and earnings for loan issuers should be offset in part by lower interest burdens as short-term rates fall. In the interim, performance within the loan market will remain bifurcated between performing and stressed credits. Loan issuers continue to report stable, low-single-digit revenue and earnings growth, and the latest economic data has assuaged fears of a sharp economic contraction. The default rate in the Morningstar US Leveraged Loan Index has declined in recent months amid relatively stable economic conditions (see chart), and the pace of distressed activity (including LMEs) likewise has fallen from the recent peak. Lower interest burdens should further ease pressure on loan issuer fundamentals, which have already seen organic improvement as rising earnings benefited both leverage and interest coverage metrics in the absence of leverage-accretive LBO and M&A transactions.

It remains to be seen whether the early signs of a thaw in LBO and M&A activity in the loan market will gain momentum and contribute to meaningful improvement in net loan supply. In the meantime, steady demand from CLO issuance should continue to outstrip net supply and support loan prices, even as net retail loan fund flows continue to be susceptible to shifts in investor sentiment.

**Leveraged Loan Defaults Have Dropped in Recent Months**

Default/distressed activity: Morningstar US Leveraged Loan Index




Source: Pitchbook as of 31 July 2024. Data for the Morningstar US Leveraged Loan Index.

## CLOs

CLOs generated positive total returns across the capital stack in July, the 16th consecutive month of positive returns at the overall index level and the ninth consecutive month of positive returns for all rating tiers.[3] Carry continues to drive strong returns given high base rates, while price returns were relatively flat. The CLO primary market remains robust, with issuance volume in 2024 to date now 82% higher than in the same period last year and at the fastest pace on record. Meanwhile, refinancing and reset activity continued at a rapid pace, with activity for the year now at $140.8 billion compared to just $2.5 billion year-to-date in 2023. Year-to-date total issuance of $254.5 billion is now 291% higher than in the same period last year.[4]

Despite limited net loan issuance, CLO new issuance has continued at a record pace as managers take advantage of tighter liability spreads. We expect this to continue in the near term, given that AAA spreads are at the tightest levels since early 2022, though this pace may be unsustainable unless M&A and LBO activity picks up.

Despite the higher-than-expected supply, CLOs continue to see strong demand given high all-in yields, which we expect to persist through year-end. In addition to the traditional investor base of insurers, banks, and money managers (among others), the CLO market has also benefited from the growing presence of CLO exchange-traded funds. Japanese banks, traditionally big buyers of AAA rated paper, are also expected to make additional allocations to CLOs, which could serve as a tailwind for further spread compression and ultimately additional CLO creation over the back half of the year and into early 2025. The increase in refinancing and reset activity in recent months has also bolstered demand for new paper and led to tighter spreads as investors put proceeds back to work. Should the loan and CLO markets continue to rally, we would expect to see more portfolios benefit from the significant redemption optionality in CLOs, although that potential universe has shrunk given the level of activity already witnessed this year.

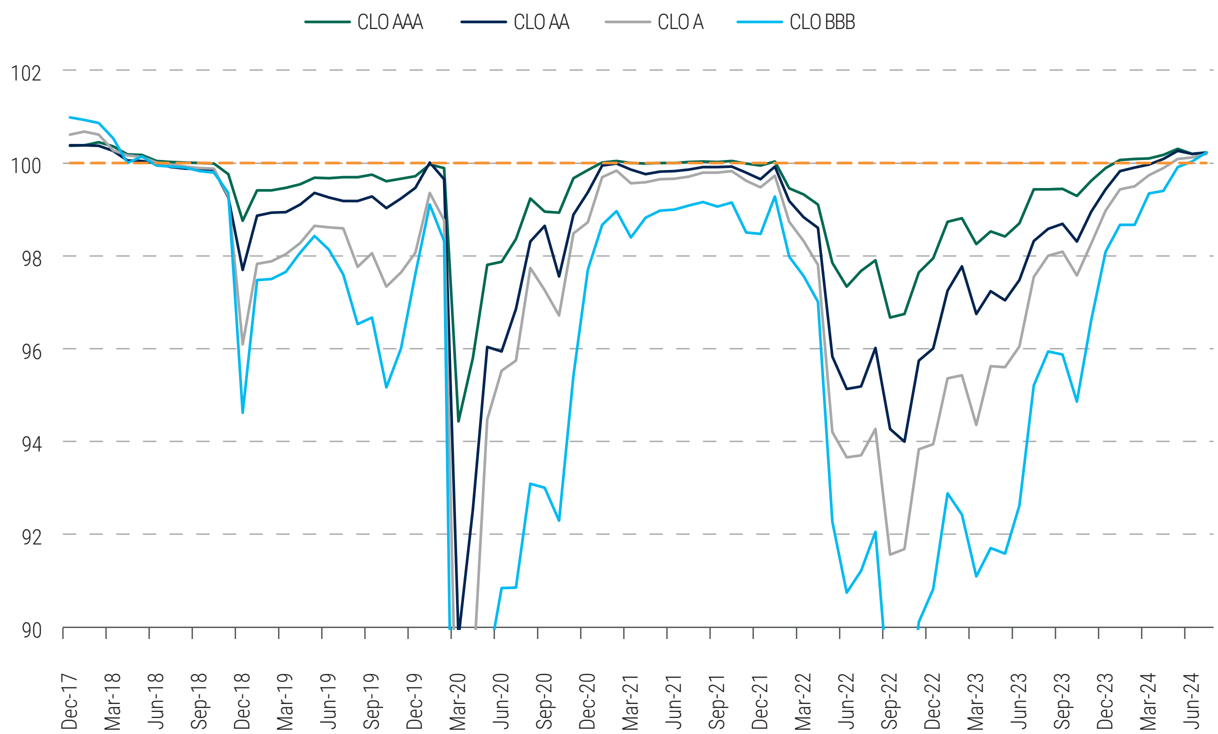
[3] Source: J.P. Morgan CLOIE index as of 31 July 2024.
[4] Source: Issuance data from Barclays, Finsight, OpenFIGI, and LCD as of 31 July 2024.

CLO prices have rallied significantly in 2024, with the average AAA-BBB price ending July above par and the basis between higher- and lower-rated tranches tightening materially. As a result, we believe now may not be the time to rotate lower in the capital stack, as the relative value opportunities have begun to shift. While prices remain well above the five-year median, if spreads widen, we think it's prudent to maintain the ability to shift further into lower-rated tranches. With the majority of CLO paper trading above par, investors may continue to realize gains in securities that are trading above par in favor of credits that offer more positive price convexity or spread in the primary market.

The supportive technical environment will likely keep CLO spreads range-bound for the next three to six months and allow for attractive returns under most market scenarios over the next 12 months, but the rally won't last forever. Notwithstanding shorter-term technical tailwinds, we believe expensive valuations and a fundamental picture that is bifurcated between vintages – and, relatedly, between deals that are in and out of their reinvestment periods – calls for a robust bottom-up approach to security selection for long-term investors. We believe investors would be well served to be more selective about the CLO portfolios and managers they choose.

**AAA and AA Tranche Prices Stayed Above Par for the Seventh Straight Month**

Average US CLO price ($) by rating




Source: JP Morgan CLOIE Index as of 16 August 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 June 2024, the firm managed US$169.7 billion across global asset classes for sophisticated investors around the world.

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