

Home a Loan

Since the prior market peak in 2007, the U.S. leveraged loan market has more than doubled in size, growing from \$550 billion to roughly \$1.3 trillion. Globally, this universe now exceeds \$2.6 trillion and has coincided with investors' unrelenting search for yield. However, and unsurprisingly, the exponential growth trajectory of leveraged loans has been accompanied by a notable deterioration in average credit quality, increasing leverage, and more "loan-only" capital structures with little-to-no debt cushion. Given the length of the current economic expansion and demand for the asset class, investors may not be adequately assessing the risk and return profile of this alternative to traditional fixed income.

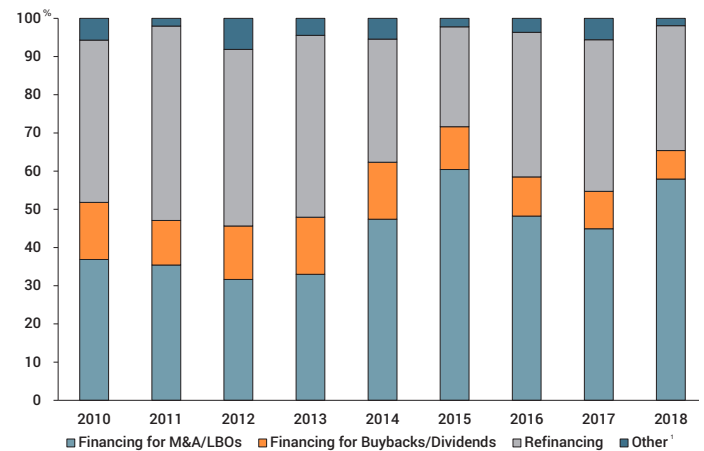
To understand leveraged loans, it's important to also understand the context and construct of the leveraged finance market, which consists of assets with ratings below investment grade (Ba1/BB+ or lower as rated by Moody's and S&P). Generally, this market is used to fund leveraged buyouts, mergers and acquisitions, capital expenditures, or refinancings. Leveraged loans, specifically bank loans, are one of the major types of investment vehicles within the leveraged finance market, alongside high yield "junk" bonds. Leveraged loans are commonly utilized by companies with either large liabilities or a weak credit history, are generally floating rate in nature, and are secured by a first or second lien on physical assets. Conversely, junk bonds are largely unsecured, fixed-rate debt instruments, and typically subordinate to secured loans in the capital structure.

Historically, highly levered companies seeking debt preferred junk bonds over bank loans because of the

lack of borrower covenants. On the other side of the trade, high interest rates and the spread over Treasuries made the fixed nature of junk bonds acceptable to investors. However, with the demand for yield, expectation of rising interest rates, and loosening covenant standards, leveraged loans have become the preferred debt structure for lower credit quality companies to access capital, causing this market to balloon to the size of the junk bond market.¹

EXHIBIT 1

The World Share of Leverage Loan Issuance by Purpose



Sources: Bank of England Financial Stability Report Data through 2010-2018
¹Other includes general corporate purposes, financing of capital spending and bankruptcy-related finance

While leveraged loans and junk bonds are used by similar types of borrowers, recent leveraged loan issuance has shifted to now fund riskier mergers and acquisitions or leveraged buyouts – typical of private equity transactions – as opposed to sustaining dividends or share repurchases (Exhibit 1). Investors have partially addressed this increasing risk by bundling bank loans

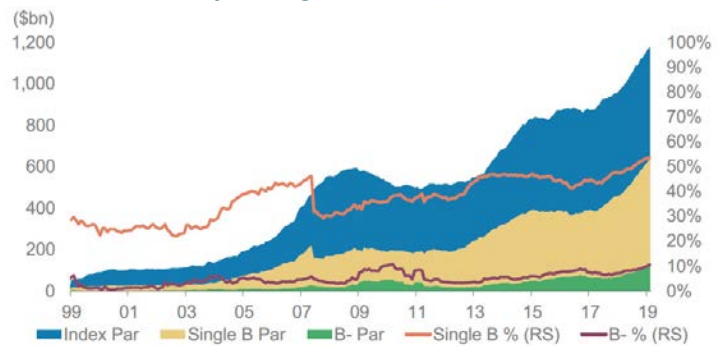
¹ Bloomberg Businessweek, "How Leveraged Loans Are (and Aren't) Like Junk Bonds"

into a vehicle called a collateralized loan obligation (CLO). CLOs are intended to diversify the risk of bank loans over multiple issuers, transactions, and investors, not dissimilar to the collateralized debt obligations (CDOs) that pooled mortgage-backed securities before the 2008 financial crisis. CLOs are structured in tranches of differing credit quality and rating and have structural features that protect debt versus equity investors. A CLO buys its underlying loans using money raised from selling debt in tranches of varying risk and return and a piece of equity to investors.²

CLOs became an attractive alternative to junk bonds because of their intent to diversify in tranches. These securitized pools of leveraged bank loans accounted for 60% of leveraged loan issuance in 2017 (Exhibit 2). Demand for the asset class has caused all ratings categories to grow in size, pushing the overall ratings profile of the S&P/LSTA Leveraged Loan Index lower. Issuance by single B-rated entities (highly speculative) has grown precipitously since 2007. In fact, single B-rated entities have increased from 29% to 54% of the index, and even the worst rated credits, B3, rose from 2.9% to 10.5% of the index. This deterioration in credit quality has continued to intensify and bears close attention (Exhibit 3).

EXHIBIT 3

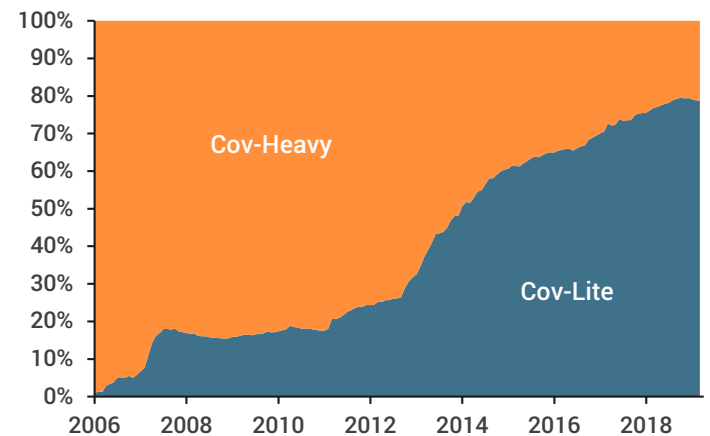
A much larger and lower-rated loan market Loan Index Par by Rating



Sources: Morgan Stanley Research, S&P LCD. Note: June 2007 \$59bn decline in single B par is related to an S&P ratings methodology change

EXHIBIT 4

Cov-Lite loans now represent roughly 80% of loan market

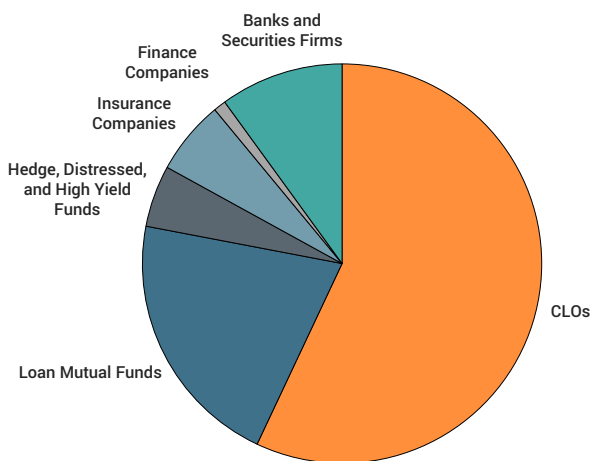


Sources: Bloomberg Barclays Indices and S&P LCD
Above is for the S&P LSTA Leveraged Loan Index

Perhaps more concerning, this growth has accelerated alongside loosening underwriting standards. “Covenant lite” loans which lack the traditional protective investor covenants constitute an increasingly large portion of new issuance (Exhibit 4). Bank loans comprised roughly 30% of the leveraged finance market in 2006, all of which was considered “covenant heavy” and contained a substantial amount of investor protection. However, today bank loans are nearly half of the leveraged finance market but only 20% are considered covenant heavy, or about 10% of the overall market.³

EXHIBIT 2

U.S. Leveraged Loans Share of New Issuance by Investor 2017



Sources: EPFR Global, S&P Leveraged Commentary and Data and IMF staff calculations

² Bloomberg Markets Magazine “The Debt Issue” April/May 2019 (p. 38)

³ Barclays: “Covenant-Lite: An Evolution, Not a Revolution,” 2/20/2019 (p. 7)

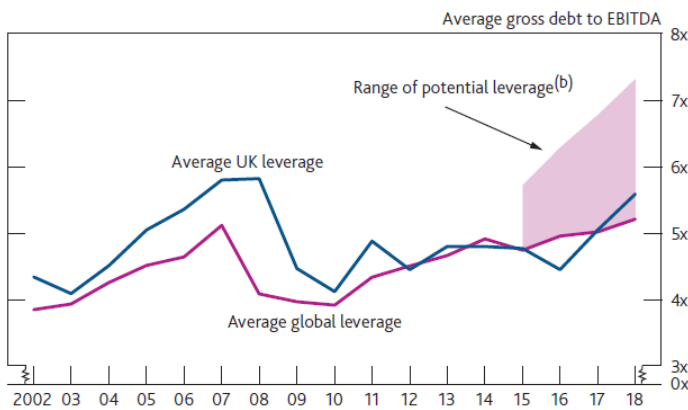
Even the most speculative (B3) loans have seen their covenant lite issuance explode, with the portion of loans with these weaker standards increasing from 28% in 2007 to 90% today,⁴ illustrating how memories of the financial crisis have faded.

These lighter covenant standards have coincided with increasing new issue leverage (Exhibit 5), reaching a record multiple of 4.2 times for B-rated deals and rising significantly above prior cycle peaks.⁵ This leverage has affected estimated recovery rates, with the average first lien loan recovery expected to fall from 77 to 61% and second liens from 43 to 11%.⁶

EXHIBIT 5

The average leverage of issuers has reached pre-crisis levels and could be even higher than reported

Average leverage of global and UK issuers for new leveraged loans^(a)



Sources: Covenant Review, LCD, an offering of S&P Global Market Intelligence and Bank calculations.

(a) Granular data on add-backs only available from 2015.

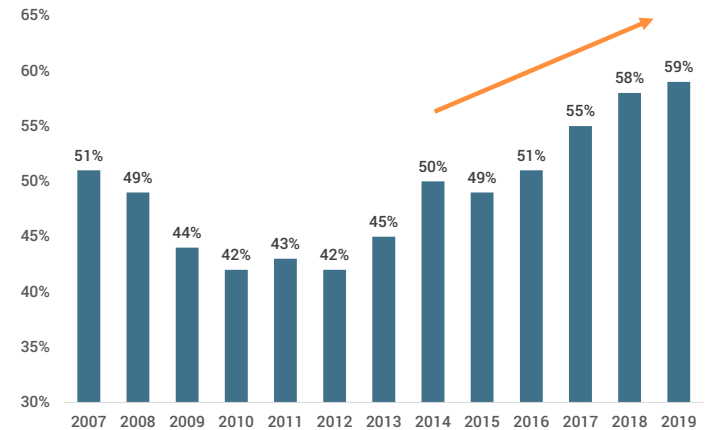
(b) The greater the proportion of add-backs which are not realised, the higher the actual leverage will be relative to the reported leverage. The top range assumes none of the add-backs are realised. The bottom of the range assumes all of the add-backs are realised.

Another concern related to leveraged loans is the increase in loan-only capital structures (Exhibit 6). A firm with loan-only characteristics typically has no subordinate high yield debt, which has typically served as a “debt cushion” and support mechanism in past recoveries. According to Barclays, loan-only issuers represents 60% of the market.⁷ Moreover, according to Moody’s, the prevalence of senior loan-only structures which lack the

cushion of junior debt is expected to be a major factor in recovery rates and produce an extended default cycle.⁸ The combination of loan-only issuers and a movement from junk bond to leveraged loan issuance could further lower potential recovery value in a downturn.

EXHIBIT 6

Loan-only Capital Structures



Source: Credit Suisse

Data through 3/31/2019

The fourth quarter of 2018 also highlighted market risks for leveraged loans. For example, after the dovish reversal by the Federal Reserve in November of 2018, demand for floating rate loans from CLOs dramatically dissipated. With accommodative monetary policy essentially capping rates, the expectation of higher yields in CLOs and their underlying bank loans diminished given the floating rate nature of asset class, creating a supply and demand imbalance. While liquidity isn’t an issue when prices are rising, the fourth quarter of 2018 also demonstrated the risk of settlement mismatch, as bank loans can take an average of 11 days to settle.⁹ For investment vehicles that promise daily liquidity, such as mutual funds, investments in bank loans and CLOs could be problematic in times of stress.

It’s not all bad news. There are several factors that could mitigate the risks associated with leveraged loans. While the asset class has grown substantially, bank loans seem to be realistically rated for their respective credit

^{4,5} Morgan Stanley: A Loan at the Bottom 4/5/2019

^{6,8} Reuters, “Lower recovery rates to haunt U.S. leveraged loans”, 8/17/18

⁷ Barclays: “Covenant-Lite: An Evolution, Not a Revolution,” 2/20/2019 (p. 7)

⁹ Loan Syndications & Trading Association, “1Q18 Secondary Trade Data Study”

quality unlike the pristine and questionable ratings that CDOs enjoyed pre-crisis. The below investment-grade ratings of these securities are appropriate for cyclical businesses which carry significant debt. Lower ratings should indicate to investors the higher risk profile of these investments as opposed to the lack of transparency and oversight that was experienced pre-financial crisis in the sub-prime mortgage market.

Global banks also have better reserves to counter leveraged loan weakness thanks to Basel III regulations developed after the financial crisis which require banks to hold increased capital. As a result, U.S. and Pan-European banks' Tier 1, or core capital, has increased from \$1.2 trillion to \$4 trillion since 2007.¹⁰ Moreover, while loans have become more bond-like and the fundamental credit deterioration is concerning, loans are still deemed secured and therefore superior in the capital structure to unsecured bonds.

In addition, unlike the global financial crisis when bank exposure to subprime mortgages in CDOs served as a catalyst for market volatility, bank ownership in CLOs is actually muted in comparison to the depth of institutional ownership in the asset class. In fact, despite their rapid growth, CLOs comprise only 30% of the \$2.6 billion leveraged loan market with only a third of this total, or 10% of the aggregate, held by banks.¹¹ The other types of leveraged loans banks are exposed to are less risky in comparison and include amortizing term loans or drawn credit facilities which generally have stronger covenants and seniority in the capital and repayment structure (Exhibit 7).

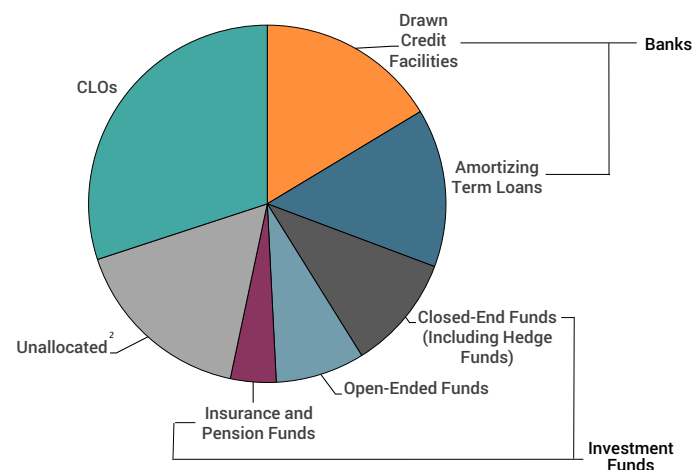
This institutional ownership structure where the primary investors use committed capital should help any weakness from becoming systemic. Since the last crisis, CLOs have been restricted in what they can purchase and are considered more diversified than their CDO or subprime mortgage counterparts. While the institutional buyers and sustained demand contributed

to driving down covenant standards, these investors may also provide insulation from a stressed leveraged loan market given their independence from the financial system. Per the Bank of England, contingent liquidity lines are not being provided by the banking system and the leveraged loan market is much less reliant on short-term wholesale funding.¹² Despite uncertainty as to what both default and recovery rates could look like, institutional ownership could lower risk of contagion.

Euphoric growth, reduced protective covenants, increasing debt levels, and liquidity concerns have all contributed to the heightened sense of a potential downturn for leveraged loans. However, the expectation and understanding that this asset class is risky, has higher bank capital reserves, and exhibits isolated ownership could alleviate the widespread effects of any strain. Given the substantial change in the Fed's outlook for interest rates, it feels prudent to continue to monitor this asset class for any signs of credit deterioration as the magnitude of potential losses remains difficult to model with any degree of certainty.

EXHIBIT 7

The World Estimated Holdings of Leveraged Loans by Investor Category¹



Sources: Bank of England Financial Stability Report November 2018.

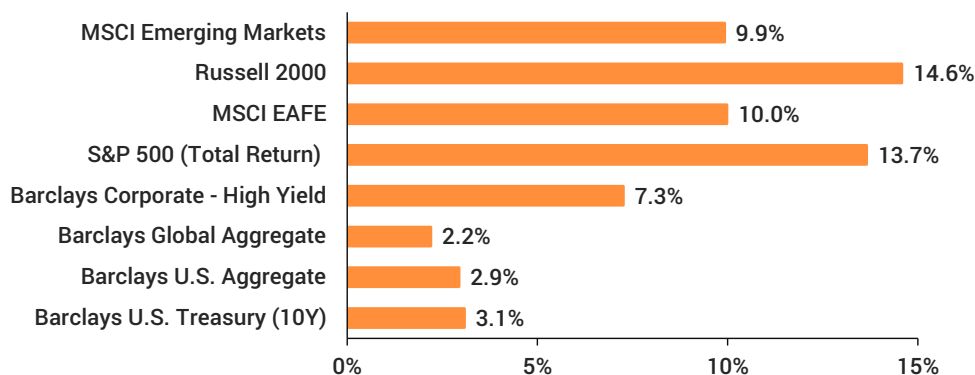
¹ The work by the Bank of England is based on Bloomberg's definition of leveraged loans. Undrawn bank credit facilities are excluded.

² Holdings of institutional investors are bottom-up estimates based on various sources, hence a significant amount of loans remain unallocated. In practice, banks may hold some of this amount.

^{10,11} Empirical – "Corporate Debt, It's Private (p. 8)

¹² Bank of England Financial Stability Report, November 2018, (p. 48)

Market review: First Quarter 2019



Sources: Glenmede Investment Management L.P. and FactSet

Data through 3/31/2019

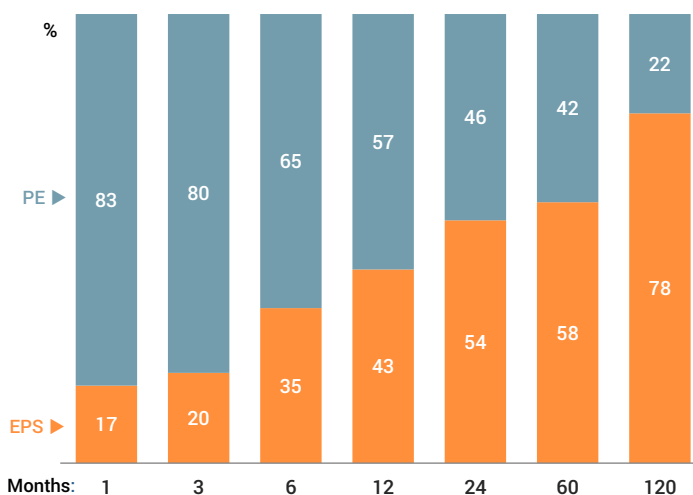
The beginning of 2019 marked a swift recovery from December's systemic lows. In the U.S., the S&P 500 rebounded +20.6% from December's trough, while internationally the MSCI ACWI Ex-U.S. rallied over +11.5% by quarter-end. The decade-old domestic equity bull market applauded the Federal Open Markets Committee (FOMC)'s about-face regarding the future trajectory of interest rates and the unwinding of its balance sheet. On the geopolitical front, hopes of a U.S. and China trade deal and a delayed BREXIT spurred the market rally to continue. While yield curve inversion between the three-month U.S. T-bill and 10-year Treasury near quarter-end sparked softness, the S&P 500 still finished the quarter just 3.3% away from September's record highs. With the FOMC putting further interest rate increases on hold, fixed income investors flocked to longer-dated maturities and credit. In fact, corporate bonds returned +5.1% during the quarter and high yield generated around +7.4%. International markets also benefited from the dovish pivot of global central banks, with the Barclays Global Aggregate producing +2.5%.

Looking forward, earnings growth has become a major source of concern. Analysts expect S&P 500 earnings to contract -3.9% in Q1 after five consecutive quarters of double-digit earnings growth. The setup for earnings comparisons was destined to be difficult given the one-

time boost from corporate tax reform, but the shift from such robust earnings growth has called in to question the impact of lower earnings growth on market returns. Interestingly, earnings appear to contribute less to short-run equity returns but comprise a larger portion of long-run returns (Exhibit 8). This research supports the widely touted view of Benjamin Graham and Warren Buffet that likens the market to a voting machine in the short-run and a weighing machine in the long-run.

EXHIBIT 8

Return decomposition - EPS vs. PE



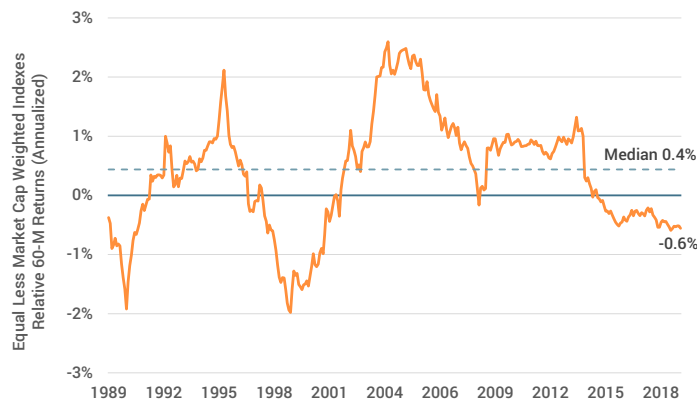
Note: NTM P/E and NTM EPS; Median contribution to return; Since 1964
Source: Standard & Poor's, Thomson Financial, FactSet, Credit Suisse - U.S. Equity Strategy
Data through 3/31/2019

Another factor which has been closely monitored during this economic expansion has been the dominance of growth over value stocks. The Russell 1000 Growth has outpaced the Russell 1000 Value nearly +5.8% per annum over the past 5 years. With such strong momentum behind growth stocks, cap-weighted indices have become increasingly concentrated as we noted last quarter ([Exhibit 1 of 4Q18 quarterly](#)). Exhibit 9 demonstrates the cyclical nature of equal- versus cap-weighted indices over a rolling 5-year time frame. In developed international markets, this disparity isn't as extreme but reflects outperformance of +3.3% per year over the same period.

EXHIBIT 9

Large Cap Equal vs. Market Cap Weighted Indexes

Relative 60-Month Total Returns (Annualized)
December 31, 1984 Through March 31, 2019

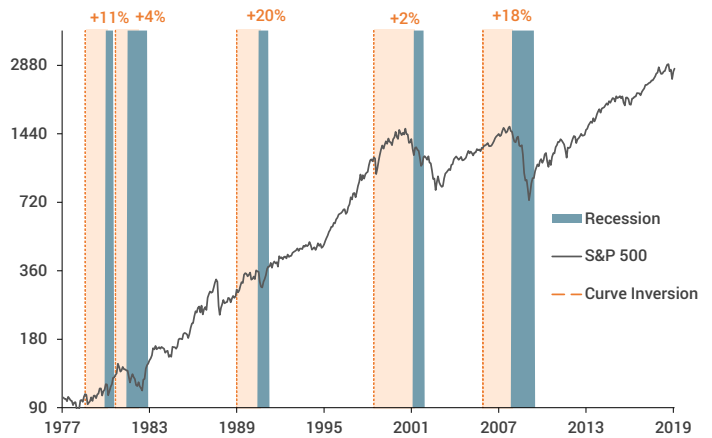


Sources: FactSet (Equal Weighted=Russell 1000 Index Equal Weighted, Market Cap Weighted=Russell 1000 Index) Data through 3/31/2019

Since the FOMC has reversed course, additional interest rate hikes in 2019 seem highly unlikely. One byproduct of this reversal has been the much publicized yield curve inversion between the three-month T-Bill and 10-year Treasury during the quarter. However, this focus appears misplaced as the standard term structure between two and 10-year Treasuries remained intact, albeit low, at a spread of 14 bps at quarter-end. Further, equity market performance following yield curve inversion appears not to be predictive in timing recessions, but rather seems to indicate a recession could occur at some point in the intermediate future (Exhibit 10).

EXHIBIT 10

Equity market performance between inversions and recessions



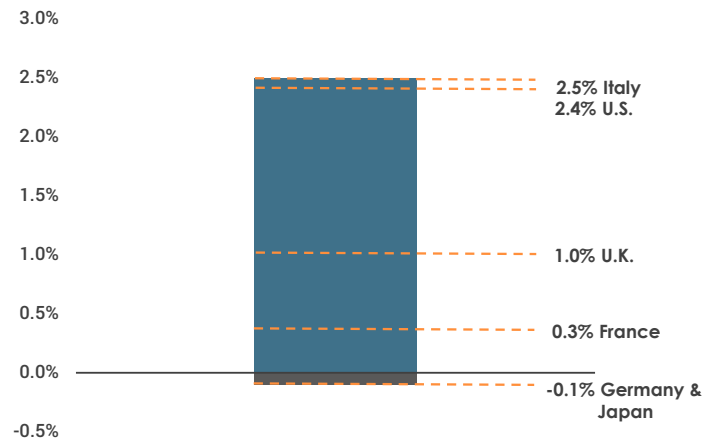
Sources: Cornerstone Macro and Bloomberg

Data through 3/31/2019

On an international basis, fixed income yields moved lower in tandem with U.S. rates and remained paltry (Exhibit 11) as in January of this year the IMF cut its 2019 global growth outlook for the second time in six months. The 10-year U.S. Treasury has remained at range-bound lows since the financial crisis in part due to international demand given its relative attractiveness to other sovereign debt securities (Exhibit 12). This global dynamic of low yields has pushed investors to look elsewhere for income.

EXHIBIT 11

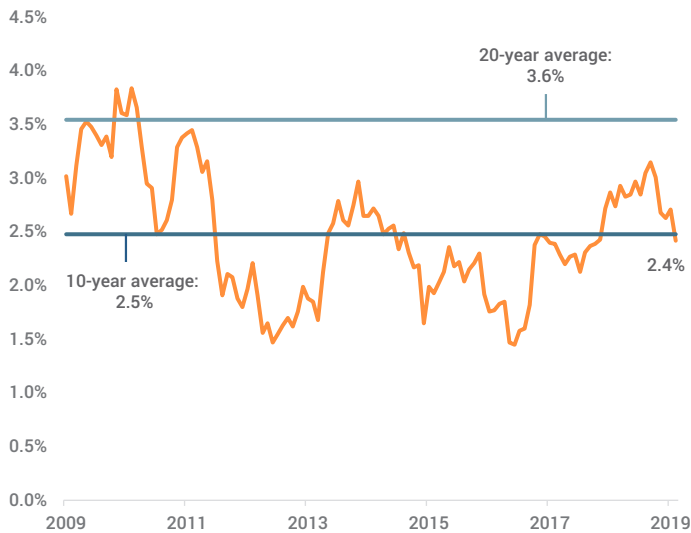
10-Year Sovereign Debt Yields



Sources: Glenmede Investment Management L.P. and FactSet Data through 3/31/2019

EXHIBIT 12

10-Year U.S. Treasury Yield Peak to Present



Sources: Glenmede Investment Management L.P. and FactSet Monthly data, as of 3/31/19

THE QUARTERLY STATEMENT

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