Voya Perspectives Series | Talking Points | January 6, 2017

Voya Senior Loan Group – 2016 Recap and 2017 Outlook

2016 in Review

- For the U.S. senior loan market, 2016's strong total return story effectively started in March, when the price of oil rebounded and investor sentiment took a sharp upward turn from its late February lows. With little change in overall credit fundamentals, lopsided market technicals, driven by demand in excess of new loan issuance, drove loan prices back toward par. As a result, the loan market, as represented by the S&P/LSTA Leveraged Loan Index (the "Index"), posted an impressive full-year return of 10.16% (Figure 1), despite ongoing macro volatility, which included a brief Brexit hiccup. A notable divergence in returns by ratings cohort (Figure 2) further underscored the dramatic shift in risk tolerance and yield-seeking over the past two years.

Figure 1. 2016 Monthly Index Returns

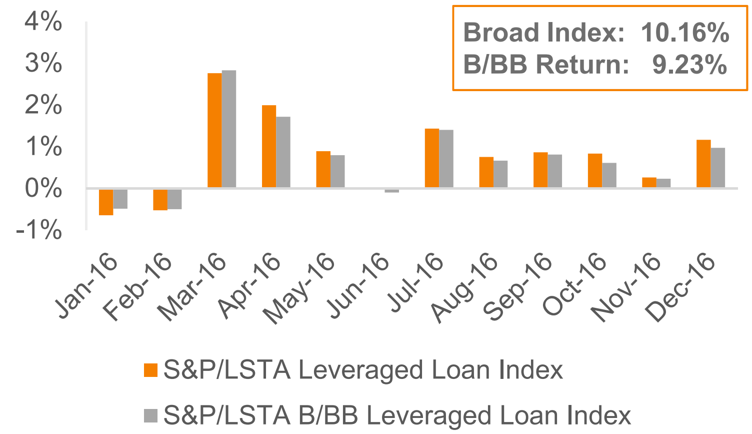
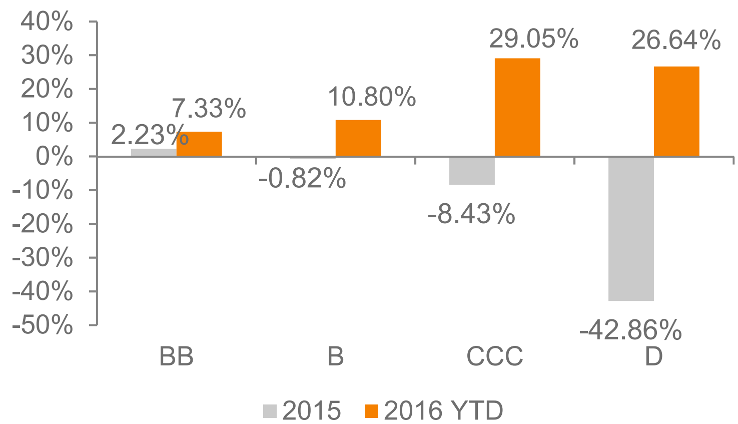


Figure 2. Return by Rating



- As the market rallied, new issue volume and terms followed the technicals, moving more firmly in favor of issuers post-first quarter as demand picked up from an array of sources. Institutional loan issuance exceeded $336 billion, up from nearly $257 billion in 2015 (Figure 3). Refinancing activity made up 37% of the 2016 volume by purpose.

- Demand, which was generally disjointed for much of 2015, grew markedly as 2016 unfolded (Figure 4). Staging a remarkable turnaround from a moribund first two months of the year, 2016 CLO issuance came in just shy of $72 billion, spurred on in the latter part of the year by strong demand and the impending December effective date for new risk retention rules. Retail fund investors, who had been notably absent as a demand source since the beginning of 2014, re-entered the mix with a steady stream of positive flows in 23 of the last 26 weeks of the year, bringing 2016 inflows for loan funds to $6.25 billion (per Lipper's report of ETFs and mutual funds). Although difficult to track, non-CLO institutional demand, at least anecdotally, was healthy in 2016.

Figure 3. Cumulative Leveraged Loan Volume

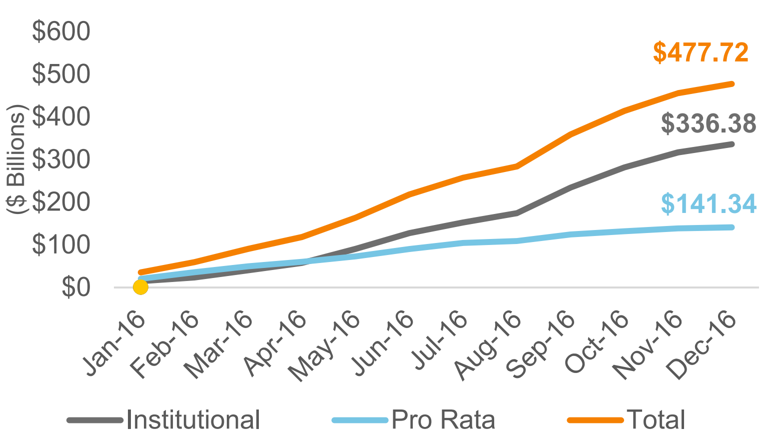
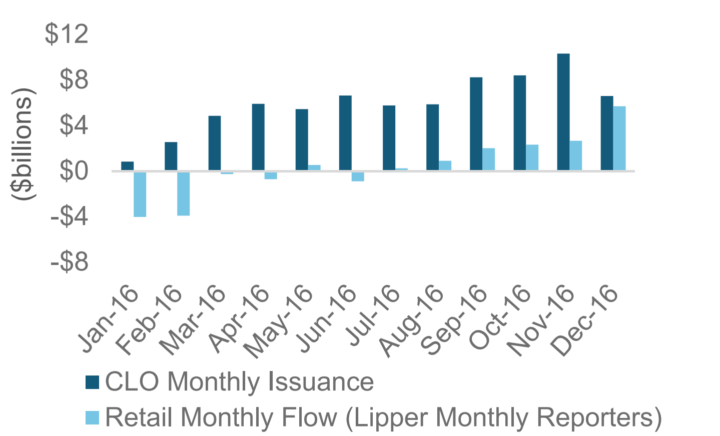


Figure 4. CLO Issuance and Monthly Retail Fund Flows



Source charts: Fig 1. S&P/LSTA Leveraged Loan Index; Fig 2. S&P/LSTA Leveraged Loan Index; Fig 3. and Fig 4. LCD, an offering of S&P Global Market Intelligence, as of December 31, 2016.

Voya Senior Loan Group: 2016 Recap and 2017 Outlook

- Fundamental credit risk, as measured by actual default activity and Index shadow default rates*, remained mostly stable during the year and, excluding commodities-related sectors, historically low. Trailing default rates closed out 2016 below the long-term average of 3.09%, with a default rate of 1.58% by principal amount and 2.06% by issuer count (Figure 5). Not surprisingly, Metals & Mining and Oil & Gas made up the majority of the year's Index defaults (Figure 6), comprising 11 of the Index's total of 20 defaults. For comparison, there were 11 Index defaults in 2015.

- The ever-important shadow default rate also remained relatively low during the year, effectively mirroring the sectoral skew detailed above. Following the large number of energy and commodities-related defaults over the year, the figure currently stands at just 0.37%, down from 0.87% at the end of 2015, though this does not include issuers trading at distressed levels that would indicate default risk.

Figure 5. Lagging 12-Month Default Rate
December 31, 1998 to December 31, 2016

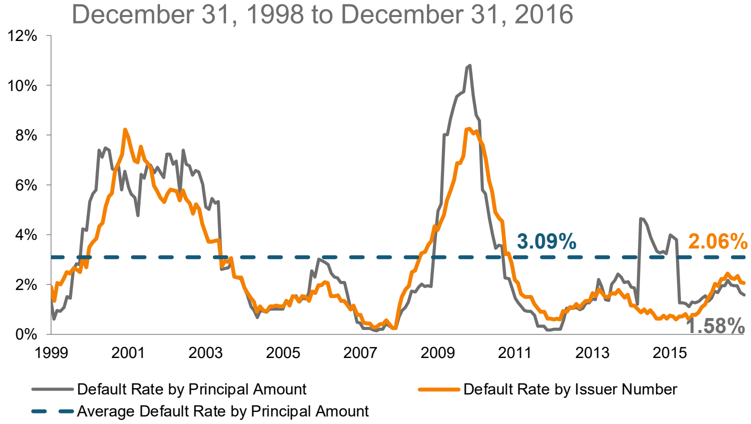
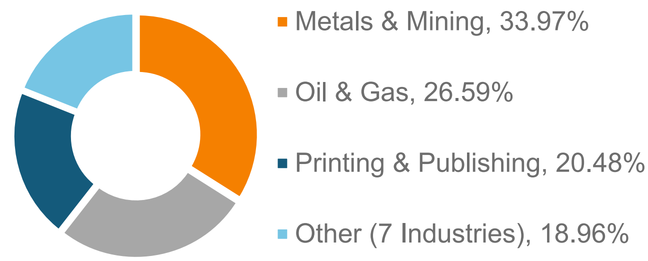


Figure 6. Composition of Defaults by Industry**
As of December 31, 2016



- In December, the Federal Reserve increased short-term rates for the second time since the Global Financial Crisis. Additionally, the impact of impending regulatory reform on money market funds and subsequent investor redemption from prime money market funds since October has lowered demand for short-term commercial paper and resulted in higher yields and a noticeable increase in LIBOR over the last few months. As a result, the LIBOR/LIBOR Floor gap for loans has all but disappeared. As of the end of December, three-month LIBOR stood at approximately 100 basis points (bps), and the weighted average LIBOR floor for the Index was 97 bps. Fortunately, for loan managers and investors alike, the conversation around the floating rate nature of senior loans can now revert to its historical presentation: an ultra short duration asset class in which the overall coupon will – all (credit-related) things being equal – reflect changes in short-term interest rates (LIBOR, in this case) within a typical 45-60 day "reset" period.

2017 Outlook and Expectations

- Following a year when total returns outstripped even our "bull" case, our "base" case for the ***total return for the Index in 2017*** falls between 4.5-5.0%; *i.e.*, within the range of coupon expectation. As most of the Index is trading at or near par, other than CCC/D-rated loans that we believe are fully valued, and given the "callability" of loans generally, we see little in the way of material upside price appreciation. However, that is only one part of the story. Loans continue to offer attractive yields with no material duration risk and offer attractive returns relative to similarly situated alternatives.

*Shadow default rate is a measure of performing Index issuers that have missed a bond payment, missed a loan payment but remain in the cure period, entered a forbearance agreement, received a D rating on at least one debt facility, publicly stated they are contemplating bankruptcy or an out-of-court restructuring, or received a going-concern qualification from their auditors.

**As a % of face value at time of original syndication.

Source charts: Fig. 5 and Fig. 6, S&P/LCD Leveraged Loan Index

- Diving a little deeper, the support of ***rising short-term rates*** and the resulting encouragement of ***positive flows to the asset class from various types of investors*** is central to our base case argument. Retail investors have already demonstrated renewed vigor for loans, which is likely a function of beginning to see losses in bond investments given the rise in core bond yields. Similarly, institutions like pension funds and insurance companies already appear to be lining up allocations in 2017, through investment both in funds and segregated accounts. As for CLOs, again, this part of the loan market has really re-emerged, and, while new issuance under risk retention rules is not likely to revert to anywhere near 2013/2014 highs, activity should remain healthy relative to longer-term historical averages.

- The question is then whether ***new loan supply*** will be sufficient to meet demand and therefore mitigate further spread compression, which could adversely impact gross yields. In our opinion, technical balance, while never at complete equilibrium, should likely remain reasonable through the year. Although we are still in a "wait and see" holding pattern as the new Trump Administration sets its policy priorities, we do believe that sound reflationary policies and tax reform measures could set the stage for improved investment confidence, which would likely provide a boost to new loan issuance. That said, should the market remain materially undersupplied, it may lead to new bouts of spread tightening. Important in this context, however, is the fact that loans head into the new year with credit risk premiums (*i.e.*, spreads) above historical averages (Figure 7), and a basic underlying assumption that LIBOR levels should rise enough to offset or overcome most, if not all, of the coupon loss resulting from spread compression. In this scenario, all-in gross yields would remain attractive, particularly relative to underlying risks (Figure 8).

- With respect to those risks, we expect ***default activity to moderately increase***, as the remaining problematic oil and gas exposure in the Index is cleansed and the market digests what is bound to be a flaring of idiosyncratic credit stress. A recent S&P/LCD buy-side survey shows that loan managers put their year-end 2017 forecast for trailing default activity by principal amount at approximately 2.44%, which is still inside the long-term asset class average of 3.09%. We believe that this generally supports a limited downside total return scenario for the year, but, as always, it is difficult to temper the impact of macro headwinds, particularly as a new presidency commences this month. We will likely face continued volatility as the new administration begins to clarify and implement proposed policies around taxes, infrastructure spending, trade, energy, and healthcare. The potential negative impact of these unknowns puts our "bear" case scenario at around 2-3%.

- Ultimately, we believe the ***structural aspects of loans*** (*i.e.*, their position in the capital structure and ability to repay at par) in combination with an inherent hedge on – finally, albeit slowly – rising rates, are positive catalysts to support demand and help smooth some of the volatility other asset classes might experience more acutely as changing economic, monetary, and fiscal policies become more clear. If we are correct, the result should be a year that highlights senior loans as potentially offering one of the more attractive risk-adjusted yields available to investors.

Figure 7. Loan Credit Risk Premium and Gross Yields*
January 31, 1997 to December 31, 2016

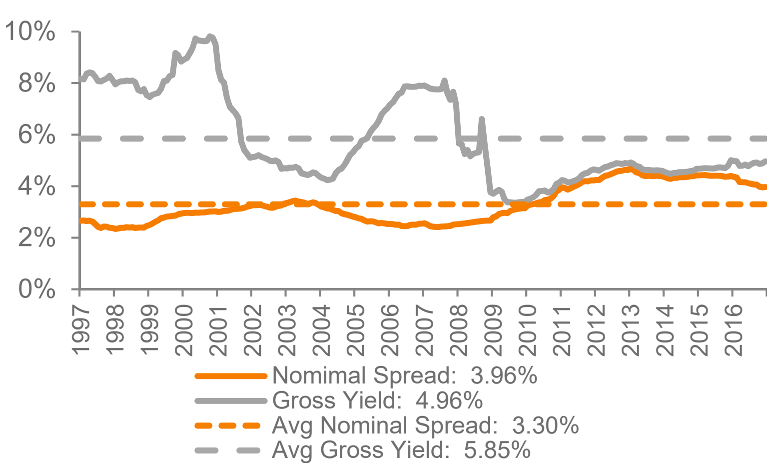
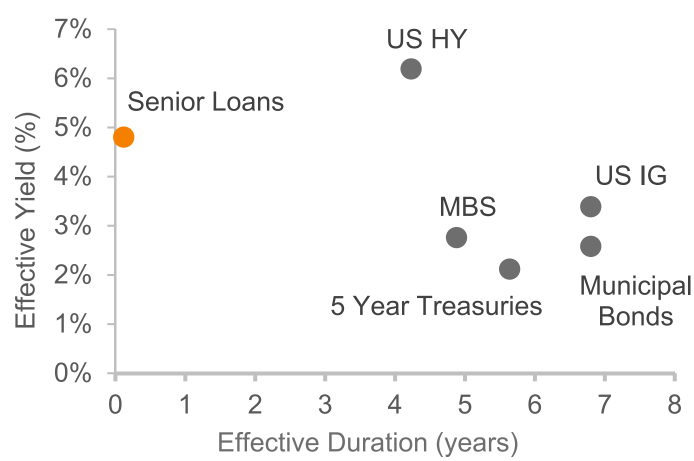


Figure 8. Effective Yield and Effective Duration
Data as of December 31, 2016

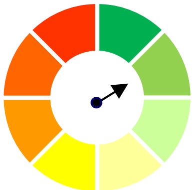


*Nominal spread data excludes all facilities in default. Nominal spread shows the excess spread over LIBOR, and includes LIBOR floors (where applicable). Gross yield reflects the nominal spread plus 3 month LIBOR.

Source charts : Fig. 7 S&P/LSTA Leveraged Loan Index; Fig. 8 S&P/LSTA Leveraged Loan Index, BAML and Bloomberg

2017 Expectations Dashboard

Potential Total Return

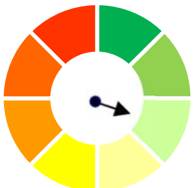


In the range of 4.5-5.0%, with upside stemming from potentially higher short-term rates. With average loan prices at or near par, market value gains are not expected to be a material contributor.

Defaults

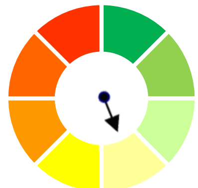
Late cycle evidence appears to be accumulating, but expectations for 2017 default activity are reasonably benign. Managing idiosyncratic risk will be the challenge.

Technicals



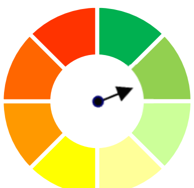
Given the expected direction of rates, investor demand should be quite good. The market will need new issue supply to keep pace in order to ward off unwanted consequences, such as credit spread compression.

Volatility



Many markets are currently priced to perfection; any major disappointment could leave risky assets vulnerable. Loans should fare better than most, but would not be immune.

Fed Policy



The Fed appears to have taken on a decidedly hawkish tone. Should they follow through, without being overly aggressive, floating rate loans will likely be one of the most visible beneficiaries.

Macro Headwinds

All eyes have shifted to the potential impact of a Trump administration. The uncertainties run the board, from fiscal and economic policies, to geopolitical considerations. Any and all negative surprises could impact risk taking.

The Voya Senior Loan Group

Dan Norman
Group Head

Jeff Bakalar
Group Head

Dan Norman
Telephone: 480-477-2112
dan.norman@voya.com

Jeff Bakalar
Telephone: 480-477-2210
jeff.bakalar@voya.com

The Voya Senior Loan Group is a part of Voya Investment Management. The team is comprised of 28 investment professionals and 27 dedicated support staff. There are five portfolio management teams in Scottsdale, each of which is responsible for particular industries, and a team located in London that is responsible for sourcing overseas loans.

The Voya Senior Loan Strategy is an actively managed, ultra-short duration floating rate income strategy that invests primarily in privately syndicated, below investment grade senior secured corporate loans. Senior loans are floating rate instruments that can provide a natural hedge against rising interest rates. They are typically secured by a first priority lien on a borrower's assets, resulting in historically higher recoveries than unsecured corporate bonds.