CIFC Asset Management

# CIFC Portfolio Intelligence

## Seeing beyond the headlines

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# Credit Markets: Keeping you informed

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Mr. Sokolowski has 33 years of credit, portfolio management and trading experience. He is the lead portfolio manager for CIFC's Corporate Credit Loan Funds and a member of the firm's Investment Committee. Mr. Sokolowski has a broad range of investment management skills and experience in private and public credit markets. He has invested and traded across the spectrum of credit from high yield to investment grade as well as distressed and stressed credit, fixed and floating rate instruments, bonds, loans, CDS and index products.

The higher-for-longer rate regime has brought with it an onslaught of pervasive pessimism surrounding the credit markets. Many articles out there possess bombastic clickbait headlines and end with erroneous conclusions. While a number of forecasts paint a bleak picture of widening spreads, decreased prices, and escalating defaults, it is essential for investors to scrutinize these viewpoints and maintain a balanced perspective. Even more so, it is vital to discern the validity of these claims and understand what is priced into the market today. As we often remind headline readers, beware and remember the words attributed to Mark Twain: *"If you don't read the newspaper, you are uninformed, if you do read the newspaper you are misinformed."*

In the realm of credit investing, negative sentiment persists even as equity markets soar to new all-time highs. Regardless, it is imperative to avoid a generalized view of credit and, more importantly, understand the more nuanced details of credit fundamentals and risk compensation. Credit markets are not homogeneous. Not all sectors and issuers are equally impacted by economic shifts, and understanding these distinctions is vital in navigating the credit landscape successfully. Despite natural concerns about potential defaults and downgrades, there needs to be first and foremost acknowledgement that the credit market is inherently diverse. Problems associated with the impact of higher interest rates and over-levered capital structures have been well identified over the past two years of rising interest rates. While certain segments may face challenges due to their reliance on low interest rates or high growth projections (similar to equity markets...), a significant portion of the credit market is resilient and has proven itself to be highly adaptable.

Looking at recent data from Moody's, it is evident that a large proportion of industry sectors remain stable or positive, indicating a heightened level of preparedness among a wide variety of corporations to weather further economic uncertainties. As another data point, this year alone, the active repricing of outstanding leveraged loans has resulted in substantial interest savings for borrowers, highlighting an ability to manage risks and generate additional cashflow in a higher-rate environment.

More granularly, enough CIFC-owned loan issuers have reported Q1 earnings for us to conclude that the favorable patterns from 4Q continue: 1Q median revenue growth was 6.4% versus our expectations of 3.8% for the same companies; median EBITDA growth was 8.8% versus expectations of 2.4%; and median FCF to debt was 3% versus 3.5% expected.

Not surprisingly, approximately half of our reporting issuers beat our expectations in both 4Q23 and 1Q24 and beat, plus inline reporters, exceeded 85% of issuers in both quarters. Of the subset of issuers that commented explicitly on guidance, the vast majority offered no change in both quarters; 20-25% raised guidance; fewer than 10% lowered it.

Importantly, a still strong consumer has been evident in most retail, home improvement, consumer, and leisure results. The relative weakness of the low-income consumer showed up in certain products and retail formats but is not dominating. Building products is benefiting from strong new home demand and infrastructure spending. Sectors that exhibited generally strong results include software, power, healthcare, and aviation. In healthcare, positive healthcare utilization trends were evident in both quarters, and labor inflation has begun to normalize to historical levels. Aviation has been supported by strong demand in corporate and leisure travel, and growth in revenue is expected throughout 2024. On the other hand, weakness persists in enterprise telecom, consumer broadband has been mixed, and the pet category generally is soft.

Overall, evidence of positive corporate earnings trends and clear differentiation remain on display. Nevertheless, in times of macroeconomic and policy uncertainty, investors should focus on prudently balancing risks and rewards and ensure they are being paid for the risk they are taking.

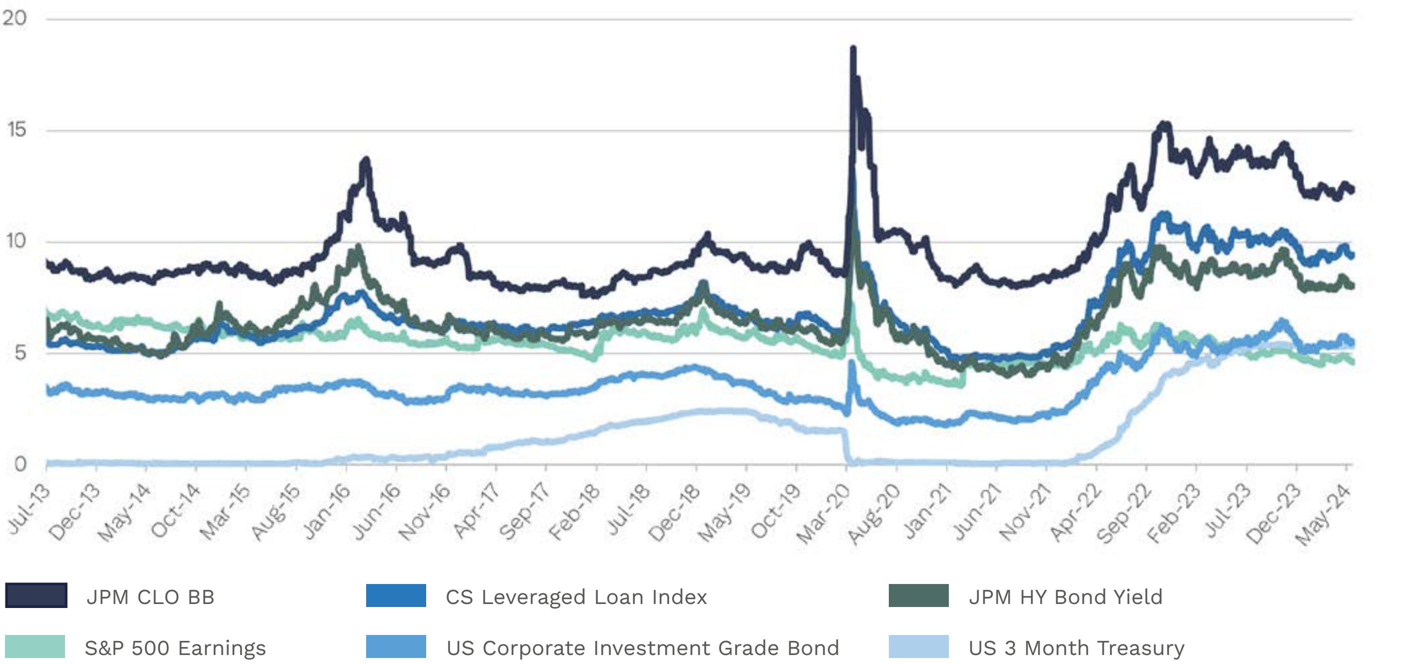
Below we outline the risks and rewards available from various sectors of the credit market today.

"Sectors that exhibited generally strong results include software, power, healthcare, and aviation."

## Broadly Syndicated Loans

When investing in leveraged loans, it is essential to assess the drivers of revenue, asset quality, and overall value proposition while prioritizing stability, resiliency, and liquidity in investment decisions. It is equally important to understand the risk / reward equation for the asset class. At current prices, spreads and yields, we believe that broadly syndicated loans are pricing far and wide-ranging default and loss outcomes. In fact, constant annual default rates and associated losses would have to exceed Great Financial Crisis levels for investors not to break even today. Furthermore, broadly syndicated loans are among the highest yielding fixed income cohort these days.

### Yields Across Assets[1]




1. Source: Bloomberg. Data as of May 22, 2024. Please see the disclaimer for a description of the indices. Past performance is not an indication of current and future returns.

# High Yield Bonds

U.S. high yield market technicals remain firm owing to inflows to the asset class, two years of lackluster new issue and $257.3 billion of rising stars since the beginning of 2022. The size of the U.S. high yield market stands at $1.32 trillion, down from a peak of $1.53 trillion in November 2021[2]. In addition, many institutions are increasing exposure to fixed income now that all-in yields have increased.

On current valuations, while the spread to worst is tight relative to historical periods, the high yield market is higher in quality than it has been in the past[2,3]:

| | Current | Average since 2004 |
|---|---|---|
| % BB | 46% | 41% |
| % CCC | 12% | 17% |
| % Secured | 33% | 19% |
| Years to maturity | 4.8 years | 6.7 years |
| Leverage | 3.9x | 4.3x |
| Interest Coverage | 5.0x | 4.5x |

More importantly, our view remains that the market convention of focusing on spread-to-worst is not the appropriate metric to use today. We are in a unique period because the average dollar price is well below par in a non-stressed environment. As a result, we focus on the spread-to-expected redemption as we do not expect most bonds to remain outstanding to maturity, which is what the yield-to-worst assumes for all bonds trading below par (currently 76% of the market). The earlier redemption means that discounted bonds will accrete to par at a faster rate than assumed by the yield to worst. As a result, while the spread-to-worst is near its tightest level since January 2022, we feel the spread-to-expected redemption is more attractive at roughly 450 bps. The following data give us confidence in our thought process[4]:

- Historically (over past 20 years), only 10% of U.S. high yield bonds have matured[5].
- We assume the average high yield bond comes out 1.5 years before maturity versus the 3.5 year average since 2001.
- Since September 30, 2023, $95 billion of bonds have been called or tendered for at an average of 2.1 years before maturity (with another $11 billion of bonds of companies targeted for M&A that average 5.5 years to maturity).

Our view is that high yield investors are not focused on the yield-to-expected redemption and that the benefits of bonds being retired early will accrue to bondholders over time.

"Our view remains that the market convention of focusing on spread-to-worst is not the appropriate metric to use today."

2. Source: Bloomberg, data as of April 30, 2024.
3. Source: Barclays and JPM Research Team data as of April 30, 2024.
4. Source: JPM Credit Strategy week of May 17, 2024.
5. Source: CITI, data as of March 31, 2024.

# Private Credit

In the middle market, borrowers have effectively navigated the pressures of a prolonged higher rate environment. This is partly due to conservative deal structures. In response to higher interest rates, lenders in the middle market reduced leverage to preserve free cash flow and interest coverage metrics.

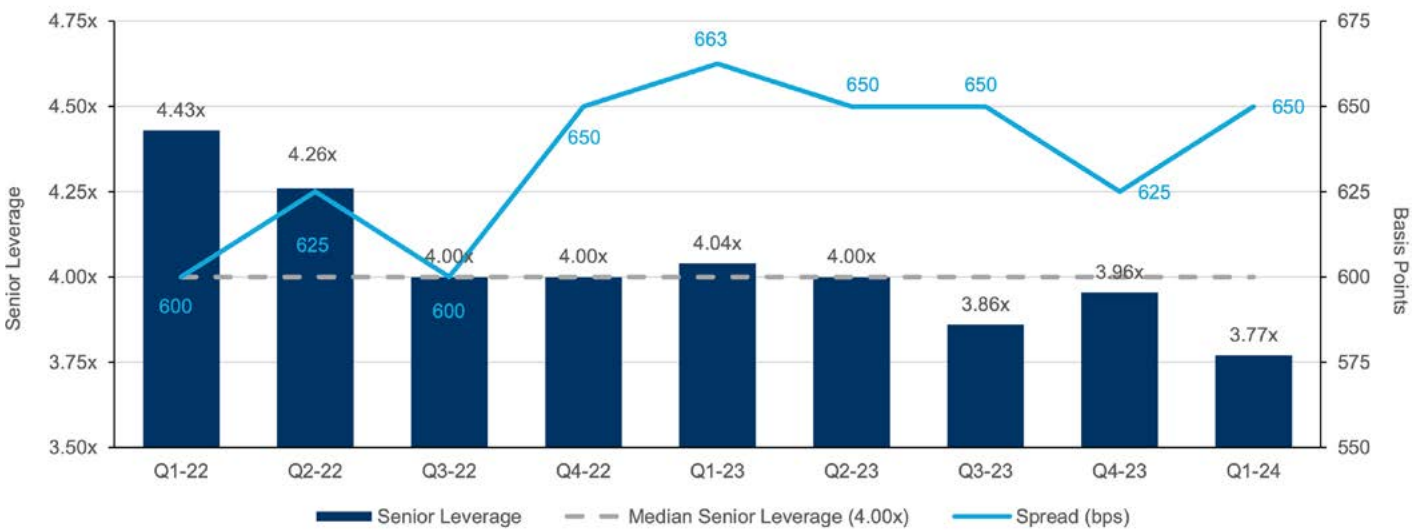
Despite the more conservative deal structures, middle market pricing spreads have remained resilient, sustained by less price competition on new loans and fewer repricing events on existing loans. For deals reviewed by our firm, we track the spread per unit of leverage as a measure of compensation for a unit of risk, which is currently at highly attractive levels compared to other asset classes and the middle market historically.

## Current Middle Market Trends[6]

### Recent Market Observations – Q1-2022 to Q1-2024

| Q1-22 | Q2-22 | Q3-22 | Q4-22 | Q1-23 | Q2-23 | Q3-23 | Q4-23 | Q1-24 |
|---|---|---|---|---|---|---|---|---|
| 135 | 147 | 150 | 163 | 164 | 163 | 168 | 158 | 172 |

Spread per Unit of Leverage (bps)




6. Reflective of new middle market investment opportunities reviewed by LBC during the relevant period, excludes upsizes and irrespective of LBC's final decision as to whether to fund such opportunities. No guarantee that assets contemplated will be available for investment in the future. Past performance is not indicative of future results.

We believe middle market lending also provides unique protections for lenders during borrower underperformance. Financial covenants are a standard protection on middle market transactions, providing lenders with an opportunity to react quickly and negotiate better outcomes. Tighter cushions and more conservative EBITDA definitions in documentation make these covenants more meaningful in the middle market.

Overall, we continue to see encouraging signs of strength, which combined with conservative deal structures and downside protections, leads us to believe that middle market direct lending is well positioned to weather the current rate environment and other potential headwinds.

## Structured Credit

Within structured credit, we believe that CLO equity may be one of the best performing asset classes in 2024.

Contrary to 2022-2023, a significant portion of our everyday conversations with market participants this year have been on the topic of CLOs getting called, reset or refinanced. When that happens, it is likely that the CLO equity class is having a great year. The reason being, the option to execute a call, reset, or refi a CLO is at the discretion of the control CLO equity investor. That investor will generally only exercise this option if such a transaction can materially improve the current market price (sometimes to the tune of 10-30%) of their investment. We have not seen this high of volume of CLOs getting called, refinanced or reset since 2021.

For context, CLO equity generated a total return of 31% in 2021.[7] We expect this trend to continue throughout the year as more CLOs exit their non-call period in the second half of 2024.

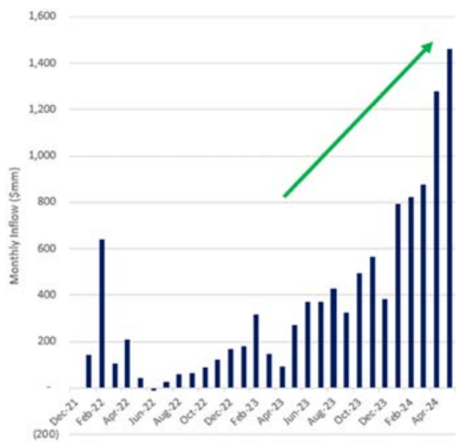
We also anticipate further spread tightening of CLO debt liabilities, which may further boost the performance of the CLO equity asset class. CLOs are no stranger to clickbait headlines and the relative risk/reward of the asset class can often be underestimated.

While there are certainly risks to all asset classes should a recession become the base case, we believe the technical backdrop for the CLO asset class remains as robust as we have seen in recent history. For the first time ever, year-to-date CLO net issuance is negative, despite the highest Q1 CLO new issuance volume ever[8].

The negative net issuance the CLO market has seen year-to-date can be attributable to the below factors:

- Record high CLO amortizations.
- The resurgence of the refinancing/reset market.
- Increase CLO liquidations.
- The growth of CLO ETFs

**CLO ETF Monthly Inflows ($mm)**




Source: Bloomberg as of April 2024

7. Source: Citigroup
8. Source: Pitchbook

We believe the technical environment will remain constructive for CLO tranches. We expect new CLO issuance to become constrained due in part to a less attractive CLO arbitrage. CLO arbitrage, or the excess spread that the leveraged loans in the CLO collateral pool earn after paying CLO liabilities, is an important driver of CLO issuance volumes.

"Limited new issue CLO supply would be a positive technical for CLO tranches, especially when coupled with higher demand."

As the CLO arbitrage increases, CLO equity is more motivated to issue new CLO transactions. Conversely, when the CLO arbitrage declines, CLO new issuance is limited as equity is less incentivized to invest in new transactions.

We believe CLO new issuance volumes for the remainder of the year may be muted due to the lower CLO arbitrage, driven by higher loan prices as a result of limited new loan supply without a corresponding move tighter in CLO liabilities. While loan prices have increased to early 2022 levels, current liability levels, particularly in AAA rated tranches, have remained wide of trading levels at that time.

While CLO issuance year-to-date has been fueled by existing warehouses that were able to ramp the leveraged loan collateral pool at lower dollar prices at beginning of the year, new transactions will be forced to purchase loans at elevated levels, making the CLO arbitrage less attractive. Limited new issue CLO supply would be a positive technical for CLO tranches, especially when coupled with higher demand.

## Conclusion

As we navigate through this period of uncertainty, it is essential to approach the credit markets with a discerning eye and a balanced outlook. There are always potential risks posed by an exogenous shock lurking in the background. However, by reframing the narrative and emphasizing the potential for growth and resilience within the broader credit markets, we aim to offer a more nuanced and optimistic view. Moreover, we hope that we have demonstrated compelling opportunities that many may be missing as a consequence of homogenously negative views.

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ICE BofA US High Yield Index tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the US domestic market. To qualify for inclusion in the index, securities must have a below investment grade rating (based on an average of Moody's, S&P, and Fitch) and an investment grade rated country of risk (based on an average of Moody's, S&P, and Fitch foreign currency long term sovereign debt ratings).

US CLO Equity Return is published monthly by Citigroup. The return methodology calculates actual CUSIP-level CLO equity total returns using month-end prices from the Citigroup CLO trading desk and takes the average total return after excluding the outliers (top and bottom 5% percentile).

Credit Suisse Leverage Loan Index tracks the investable market of the U.S. dollar denominated leveraged loan market. It consists of issues rated "5B" or lower, meaning that the highest rated issues included in this index are Moody's/S&P ratings of Baa1/BB+ or Ba1/BBB+. All loans are funded term loans with a tenor of at least one year and are made by issuers domiciled in developed countries.

JPM CLO Composite consists of equal weighted JP CLO BBB, JP CLO BB, JP CLO B Indices.

The J.P. Morgan Leveraged Loan Index is designed to mirror the investable universe of USD institutional leveraged loans, including US and international borrowers.

The S&P 500 Index, or the Standard & Poor's 500 Index, is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies. The S&P is a float-weighted index, meaning company market capitalizations are adjusted by the number of shares available for public trading.

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