KDP ASSET MANAGEMENT, INC.

High Yield Bond and Senior Secured Bank Loan Outlook

March 2020

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High Yield Observations

Fundamentals

- The Moody's global speculative grade issuer default rate ticked up to 3.1% in February from 3.0% in January.
- Defaults are projected to rise to 3.6% by December 2020 primarily in the energy and retail-related industries, however, a prolonged Covid-19 economic shutdown of the economy will like cause the rate to rise more sharply.
- Near-term maturities are low given the magnitude of ongoing refinancings taking advantage of low interest rates.
- Earnings for HY companies have been credit supportive, but we expect that first half of 2020 will be severely depressed
- HY credit metrics continue to show solid EBDITA and coverage, and with moderate leverage on balance.
- KDP analysts continue to see supportive fundamentals in higher quality credits.

Technicals

- HY weekly fund flows were -$2.2B (including -$4.2B the last week of the month). Flows were +$253MM in January despite a -$2.8B outflow the last week of the month.
- The HY market posted a negative -1.6% return in February following a flat 0.0% return in January. The HY market felt the impact of Coronavirus fears all month. Full year 2019 returns amounted to a robust +14.4%. February's negative performance was led by several important sectors posting outsized negative returns including the Energy sector -7.5%, Airlines -4.8%, Automotive -2.8% and Gaming -2.3%.
- February's returns by rating reflected the risk off environment as BBs posted a -1.4% return. Bs were -1.5% and CCCs led the downdraft at -2.4%.
- HY bond issuance totaled $29.7B in February compared with $42.8B in January and $18.7B in December. Full year 2019 issuance amounted to $296.8B.
- Net HY issuance remains below historical monthly averages and proceeds have been primarily destined for refinancings, providing a positive technical tailwind.

Valuations

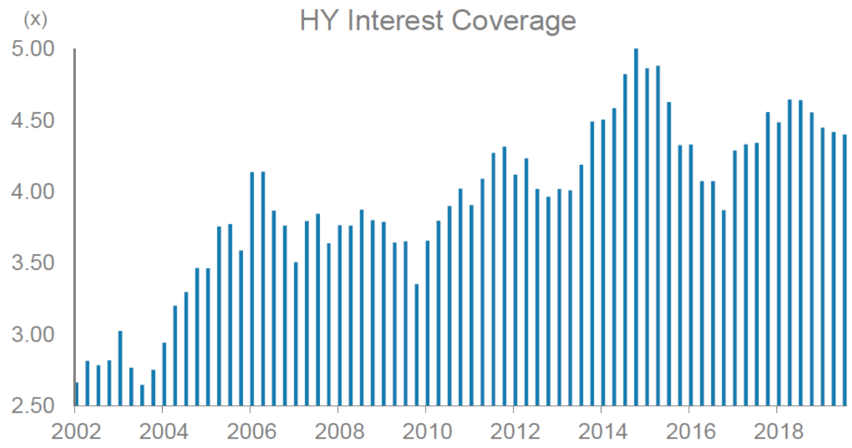
- Market performance is more dependent on economic activity and stimulus programs going forward, given the low level of interest rates reflecting the current extreme volatility associated with the global pandemic.
- Higher-quality carry has risen to compelling levels during the current sell-off.
- Risk/reward for CCCs will continue its significant decline as economic activity is poised to slow significantly over at least the near-term.

Macro

- High yield returns will remain volatile over the near term as countries and issuers come to terms with the current health crisis.
- KDP believes that higher-quality credits will continue to offer attractive risk/return opportunities compared to other fixed income classes given their:
    - Significant spread advantages
    - Relative shorter duration
    - Lower correlation when interest rates rise
- KDP reiterates and maintains its up-in-quality preference.

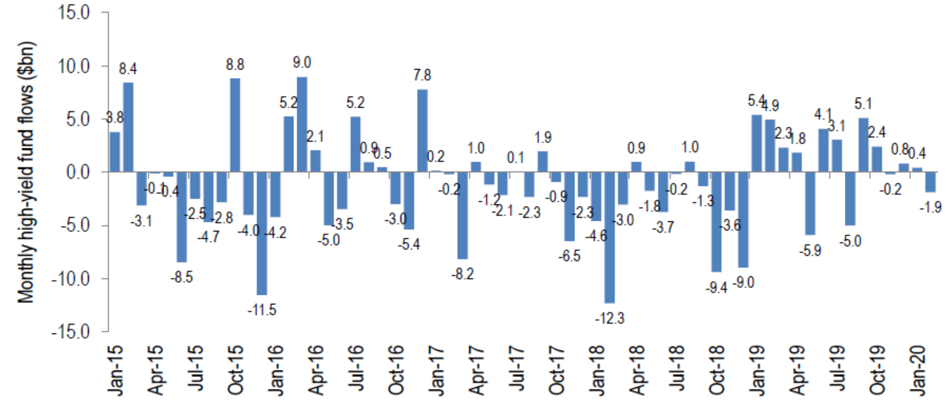
The Case for High Yield

Fundamentals: HY Coverage Lower Over Past Year, But Remains Elevated



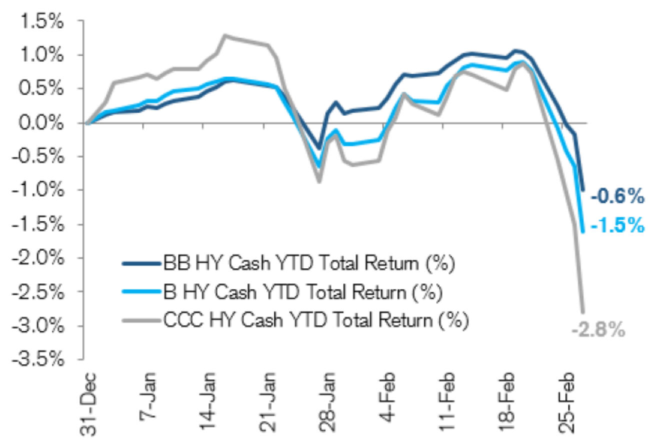
Source: Morgan Stanley, *Corporate Credit Chartbook*, 3/2/2020

Technicals: February Saw Largest Retail Outflows on Virus-Related Market Weakness



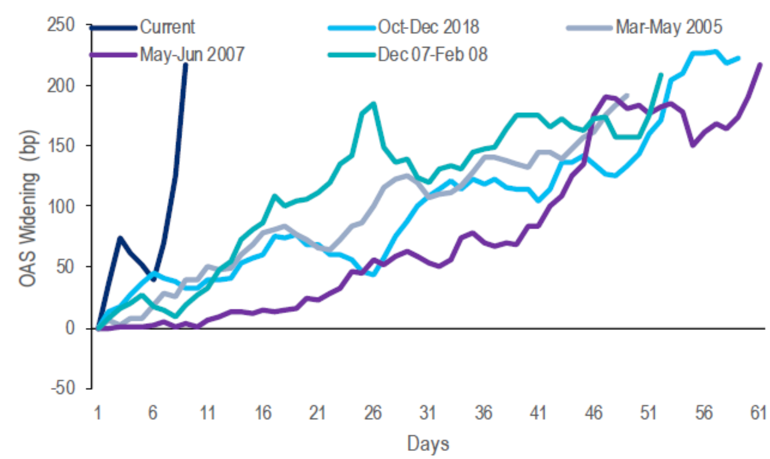
Source: J.P. Morgan, *High Yield Bond and Leveraged Loan Market Monitor,* 3/2/2020

Macro: High Quality High Yield Has Significantly Outperformed in 2020



Source: Credit Suisse, *CS Credit Strategy Daily Comment,* 2/28/2020

Valuation: Current Spread Widening Much Swifter Than Past Periods of Volatility



Source: Citi, *US High Yield Strategy Focus,* 3/10/2020

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Senior Secured Bank Loan Observations

Fundamentals

- The par weighted default rate for leveraged loans was 1.70% in February compared with 1.79% in January.
- Default activity remains well below the average 3.1% historical level.
- The low level of defaults reflected solid economic and credit fundamentals as well as lower overall exposure to Energy, which comprised 41% of total loan defaults.
- No near-term maturity concerns reflect recent record levels of refinancing/repricing.
- Overall leverage is up slightly as leverage in the new-issue market continues to increase primarily due to M&A activity and dividend-payment deals.
- The slight decline in Interest coverage levels predominantly reflects aggressive lower-rated loan only issuance by private equity firms.

Technicals

- Loans produced a negative -1.45% return in February compared with +0.53% in January and +1.65% December. Indeed, Loan prices were stable for the first three weeks of the month but fell some -1.50% during the last week of the month. Loans outperformed HY bonds in February. For all of 2019 Loans produced a solid +8.64% return.
- February’s performance reflected Coronavirus fears and significant weekly outflows. During February all 21 industry sectors were negative. The Leading decliners included Energy -3.49% and the Metals & Mining sector off -3.28%.
- Weekly loan fund flows were -$1.8B in February compared with -$465MM in January.
- February’s negative performance was led by Split B/CCC with a -1.58% return. BBs rwere-1.24% and Bs -0.76%.
- Gross loan issuance amounted to $71.8B in February with $26.0B net of refi/repricings. Gross loan issuance was $123.0B in January (including a record high $79.0B of repricings and $27.0B of refinancings) compared with $38.0B in December. Gross CLO issuance in February was $30.5B the highest since June 2018. CLO issuance in January was $8.0B compared with $8.5B in December.

Valuations

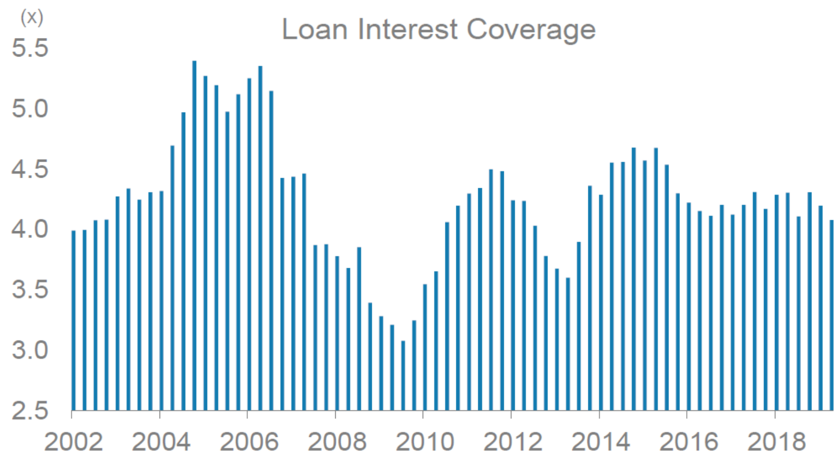
- The average loan price at the end of February was 95.93, down -1.52pts. on the month.
- At the end of February just 2.8% of loans were trading above par compared with 62.0% at mid-month January.
- At the end of February 26.8% of loans traded between 99.0 and 99.9 compared with 28.2% a month earlier.
- The spread to the 3-year takeout at the end of February was 509bp up from 458bp a month earlier.
- At the end of February the yield to the 3-year takeout was 6.05% compared with 5.89% a month earlier and 6.29% at year-end 2019.
- Typically, loan volatility tends to be significantly lower when compared to HY bonds as loans are higher in the cap structure, have higher recovery levels, and are floating with LIBOR rates. The exact opposite has occurred in March.

Macro

- Loans, due to their negative convexity and short duration, are a carry-asset trade.
- High quality secured, floating-rate bank loans are compelling given the attractive risk/reward adjusted returns, and portfolio diversification benefits.
- Negative retail mutual fund flows from leveraged loans have accelerated in March on the downturn in global markets spurred by the health crisis.
- The floating-rate nature of bank loans provides a natural hedge to increasing interest rates and lowers duration risk.
- Loans typically have a negative correlation to Treasuries and low correlation to other asset classes.
- Refinancings and repricings are on hold for an indefinite time given below par prices and market uncertainty.

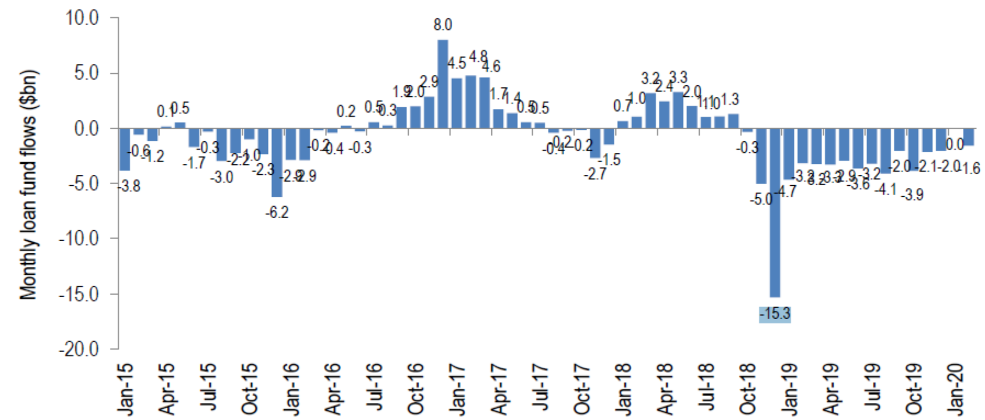
The Case for Senior Secured Bank Loans

Fundamentals: Loan Coverage Ticks Down Slightly Primarily On New Issuance, But Remains Just Off Recent Highs



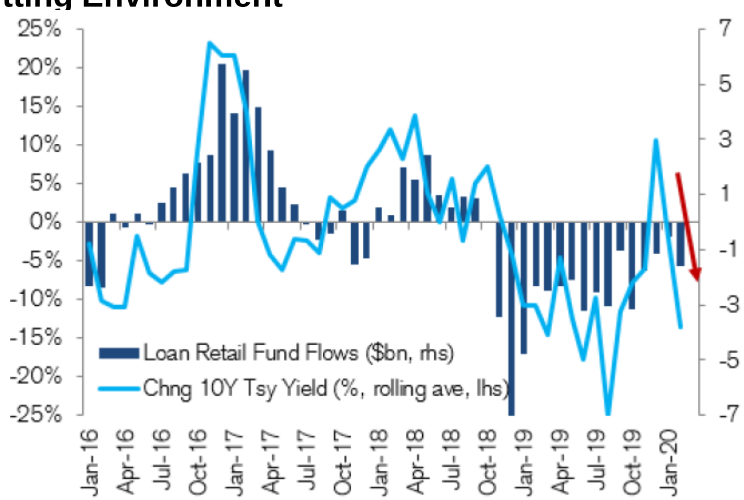
Source: Morgan Stanley, *Corporate Credit Chartbook*, 3/2/2020

Technicals: February Sees a Continuation of Loan Outflows



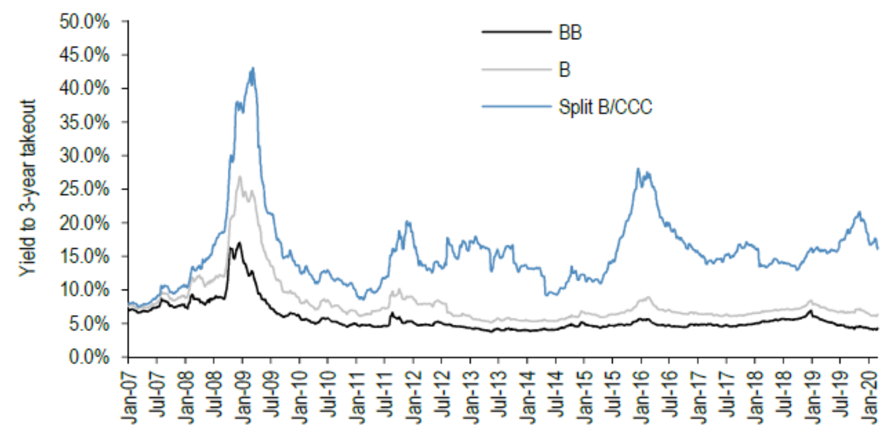
Source: J.P. Morgan, *High Yield Bond and Leveraged Loan Market Monitor,* 3/2/2020

Macro: Retail Loan Flows Remain Under Pressure in Rate Cutting Environment



Source: Credit Suisse, *CS Credit Strategy Daily Comment,* 3/4/2020

Valuation: Wide Credit Quality-Based Yield Disparity Persists in 2020



Source: J.P. Morgan, *High Yield Bond and Leveraged Loan Market Monitor,* 3/2/2020

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