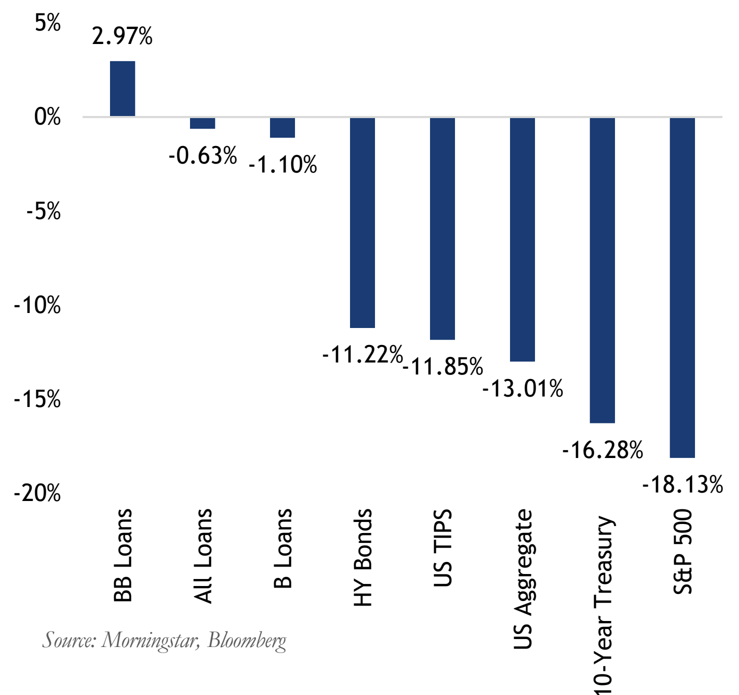
Loomis on Loans

Bank Loans: If 2022 Was the End of an Era, What's Next?

Loan returns crushed the returns of most other major asset classes in 2022. In 2021, we were telling internal and external clients that loans should do relatively well as the Fed started raising rates, but even we did not think the relative outperformance would be so strong. What happened, and why did so few investors have a meaningful allocation, or any allocation, to loans?

More than a decade of interest rate suppression by central banks since the Global Financial Crisis (GFC) may have lulled many investors into complacency about rate risk. Ironically, markets have frequently feared such a failing for credit discipline, but many may have been asleep at the switch on rate discipline. We have spent years trying to reassure investors outside our asset class that "cov-lite" and "loan-only" are scare terms without significant teeth when examined thoughtfully, and we suspect such fears persisted long enough for many to miss the outperformance of loans in 2022.

As the year unfolded, arithmetic and macro nerves collided in a way rarely seen in markets over the last few decades: Treasurys and stocks both went down hard, while high yield managers learned that duration risk is very real when coupons are low and rates are rising well after the economy improves. Loans started the year with positive flows on higher interest rate bets from retail investors (who have proven more inclined than institutions to hedge against rate concerns with loans in recent years, from our vantage point), but turned negative on fear that the Fed would go too far and drive the US into a recession. CLO formation was strong early but weakened as liability spreads widened on macro concerns and capital rules later in the year. Within loans, CLO managers sold lower-rated loans to manage their future CCC buckets, driving strong outperformance for higher-rated loans.



Source: Morningstar, Bloomberg

LOAN MARKET QUICK TAKE as of December 31, 2022

Morningstar LSTA Index	2022 Return	Price	YTD Price Change	Nominal Spread
"All" Leveraged Loan Index	-0.63%	$92.79	-$5.85	+358
BB Index	2.97%	$97.61	-$1.64	+280
B Index	-1.10%	$92.55	-$6.53	+382

Source : Morningstar LSTA Leveraged Loan Index, as of 12/31/22

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MALR030251

As we look forward to 2023, we are looking at a significant chance of a recession. Many investors, who missed having an allocation to loans during 2022, may be thinking about beefing up their Treasury allocation to capture some potential Fed rate cuts down the line, or increasing their stock allocation to capture a risk rebound, or some of each. Asset allocation is a multi-year decision for most investors, not a game of 'Frogger' as markets shift endlessly beneath their feet. That is why we are asking investors to consider whether 2022 was the end of an era rather than just an anomaly.

Below is a return quilt ranking calendar year returns of major asset classes since shortly after the GFC. The effect of rate suppression is evident in how loans performed year-by-year. While we strongly disagree, we believe many investors view loans only as a bet on-higher interest rates, and so it was difficult for loans to show up near the top of the quilt during a decade of rate suppression. That loans did so anyway, several times, is a testament to their value in a broad asset allocation over time. We believe the vast majority of asset allocations would benefit from some loan exposure in most environments, with greater exposure when rates are expected to rise.

CALENDAR YEAR ASSET CLASS RETURNS RANKINGS

2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
REIT	S&P 500	REIT	REIT	HY	EM Equity	LLI	S&P 500	EM Equity	REIT	BB Loans
EM Equity	World Equity	S&P 500	BB Loans	S&P 500	World Equity	US Agg	REIT	S&P 500	S&P 500	LLI
EM Agg	HY	IG	S&P 500	EM Equity	S&P 500	BB Loans	World Equity	World Equity	World Equity	HY
World Equity	LLI	US Agg	EM Agg	LLI	Global Agg	US TIPS	EM Equity	US TIPS	US TIPS	US TIPS
S&P 500	BB Loans	World Equity	US Agg	EM Agg	REIT	Global Agg	HY	Global Agg	HY	US Agg
HY	REIT	EM Agg	World Equity	REIT	EM Agg	IG	IG	IG	LLI	EM Agg
IG	IG	US TIPS	IG	World Equity	HY	HY	EM Agg	US Agg	BB Loans	IG
LLI	US Agg	HY	LLI	BB Loans	IG	EM Agg	BB Loans	EM Agg	IG	World Equity
BB Loans	EM Equity	LLI	US TIPS	IG	LLI	REIT	US Agg	HY	US Agg	S&P 500
US TIPS	Global Agg	BB Loans	HY	US TIPS	US Agg	S&P 500	LLI	LLI	EM Agg	Global Agg
US Agg	EM Agg	EM Equity	Global Agg	US Agg	BB Loans	World Equity	US TIPS	BB Loans	EM Equity	EM Equity
Global Agg	US TIPS	Global Agg	EM Equity	Global Agg	US TIPS	EM Equity	Global Agg	REIT	Global Agg	REIT

1/1/2012 through 12/31/2022

Source: Bloomberg and Morningstar/LCD. Asset classes at the top indicate higher returns than those at the bottom

Indexes used : S&P 500 Index, MSCI World Index, MSCI Emerging Markets Index, Bloomberg US Treasury Inflation-Linked Bond Index, Ice BofA US Corporate Index, Bloomberg US Aggregate Bond Index, ICE BofA High Yield Index, Bloomberg Global Aggregate Ex-US Bond Index (unhedged), Bloomberg Emerging Markets USD Aggregate Bond Index, Morningstar/LSTA Leveraged Loan BB Index, Morningstar/LSTA Leveraged Loan Index, and FTSE Nareit All Equity REITS Total Return Index. Indices are unmanaged. It is not possible to invest directly in an index. Data and analysis does not represent the actual, or expected future performance of any investment product managed by Loomis Sayles.

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In the wake of 2022, a key question is whether we are going back to another long period of rate suppression or whether the world has transitioned to more turbulent times with rates that can go up and down more frequently, as they did before the GFC. And should anyone make a 100% bet that rate suppression is our path from here? Because having no loans seems like a 100% bet to us.

We believe an important point should be made: "loans" are not a monolithic asset class, any more than "stocks" or "bonds" are. Loan portfolios can be constructed to be conservative or aggressive or anywhere in between. The relative performance of BB loans in 2022 within the loan category makes that point. Risk has been on more than off historically, so more aggressive portfolios should "win" in the end, but investors wary of default risk in a recession or who just do not like volatility can choose to get their rate bet (and potentially a nice yield!) with more conservative loans without facing many of the technicals on lower-rated loans that CLO managers create.

That said, the Loomis Sayles Bank Loan Team does not expect a high default rate in its loan portfolios in 2023. That's because in order to default, in general, a borrower needs to miss a payment of some kind, be it interest or a maturity. There are about 1,500 loans in the Morningstar LSTA Leveraged Loan Index, and at Loomis Sayles we own about a third of them. Our analysts see companies that are in relatively good shape coming out of the pandemic, and even though interest expenses have been elevated, we don't think they are beyond what properly levered companies can handle. That leaves maturing debt as a potential cause of default. Looking again at the index, less than 1% is scheduled to mature in 2023. Even if all of those maturity payments were missed – and we don't think that will happen – that would still be a very mild default rate. With the bulk of maturities pushed out to 2025 and beyond, we believe it would take a severe recession to trigger high defaults even in more aggressive loan portfolios.

Was 2022 the end of an era of suppressed rates, or are we heading back to another decade like the 2010s? We read many theories about the endurance of inflation factors. We see supply chains changing, energy prices fluctuating, geopolitics heating up, and more. The simple fact is we do not know if inflation will come, go, and stay gone or whether we will see fluctuations over the next few years. But we do know we would not make a 100% bet on a quiet decade in rates. Loans were never at the bottom of the returns quilt in a suppressed interest rate decade; they were near the top in a rising rate year. We believe loans would have value in almost everybody's strategic allocation at some weight, which can be moved around tactically as the facts change.

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LET'S CHAT

Questions or concerns about the bank loan market?

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Sources: Morningstar, Bloomberg

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