Strategy

Perspectives

February 2024

2024 Loan Market Outlook

Supported by high interest rates, syndicated bank loans had a stellar 2023 and are currently providing a historical level of income. With higher borrowing costs persisting in 2024, we anticipate an increase in default rates and periodic volatility, but the technical setup remains favourable. When paired with the high level of current income offered in the loan market (~9.3% current yield), the loan asset class continues to look attractive. We believe credit selection will be essential to generating highly competitive risk-adjusted returns.

2023
Total Returns

US Loans
(USD)
13.3%

EUR Loans
(USD Hedged)
15.9%

"Brief periods of volatility created short-lived buying opportunities"

Last Year in Review

- **Strong total returns**
- **Lower quality outperformed**
- **European loans outperformed US loans**

2023 was an impressive year for loan market returns, fueled by high levels of income and secondary price appreciation. As the chart below shows, the US loan market returned 13.3% (in USD) while the European index returned 15.9% (USD hedged).[1]

With interest rates rising across the globe, the current yield associated with US and European loans steadily increased throughout the year. Outside of March (US regional banking concerns), May (recession fears rising) and October (geopolitical tensions rising), 2023 was very much a risk-on year.

These brief periods of volatility created short-lived buying opportunities. As inflation moved from peak levels and recession fears/probabilities declined, lower quality loans outperformed across the board. US CCC rated loans outperformed all other rating categories globally, returning 17.5%. CLO demand was more than enough to meet an underwhelming new issue calendar.

While fundamental borrower performance was stable overall, pockets of weakness emerged on an idiosyncratic basis. Industry and borrower-specific challenges pertaining to margins and cash flow caused the default rate to move up 70 bps in the US (to 1.5% at year-end) and 100 bps in Europe (1.4%).[1] Despite the rise, these default rates still remain below long-term averages.

2023 Total Return by Asset Class (USD Hedged)

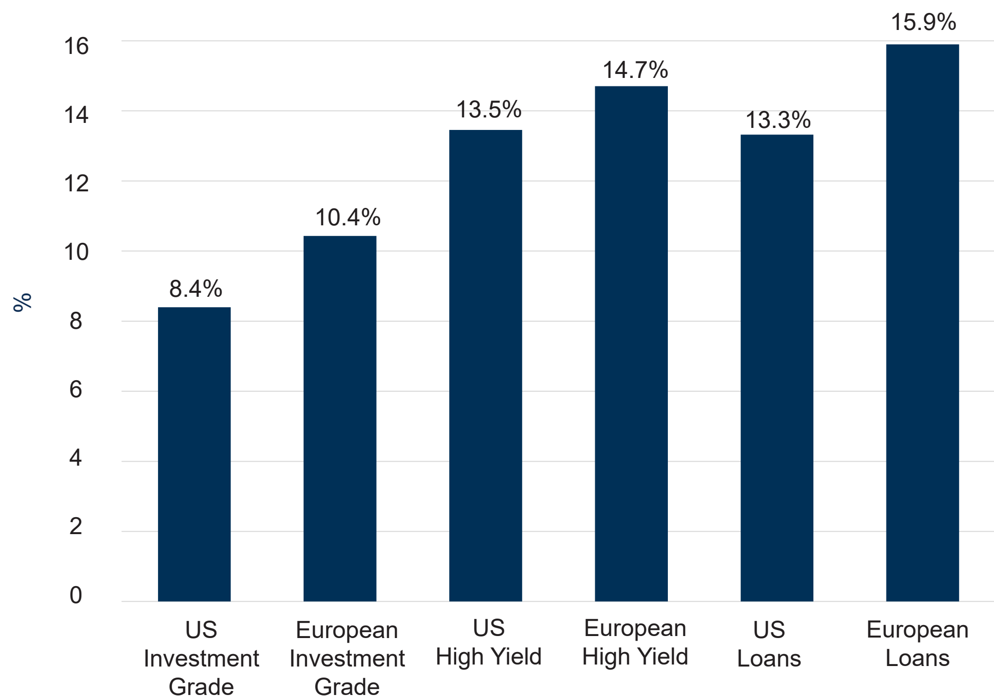


Chart Source: CQS, ICE and Morningstar LCD as at 31 December 2023. Indices used include C0A0, ER00, H0A0, H9PC, LLI and ELLI. Please refer to the end of this document for index descriptions. This document includes historic returns and past performance is not a reliable indicator of future results. The value of investments can go down as well as up.

Source: [1]Morningstar LCD as at 31 December 2023.

2024 Outlook

- **Elevated current income**
- **Idiosyncratic credit and macro dispersion**

"Idiosyncratic credit decompression indicates a market in which credit selection will be critical"

As broadly syndicated loans enter 2024, both the US and European markets find themselves with elevated yields on an index level. The US has a current yield of 9.9% (94th percentile post Global Financial Crisis, "GFC") and Europe has a current yield of 10.7% (96th percentile post-GFC).[1] This level of income serves two important functions:

1) Provides a strong base for 2024 returns

2) Acts as an insulating effect for any single name or mark-to-market volatility

With the higher cost of borrowing persisting into 2024, we do anticipate an increase in defaults throughout the year. Idiosyncratic credit decompression indicates a market in which credit selection will be critical to delivering performance. Our expectation is for continued periodic volatility throughout the year. The geopolitical backdrop remains tenuous, with conflict in the Middle East and the upcoming US Presidential election in November. A proactive and nimble approach to managing macro risk will be critical.

Loan spreads have continued to trend upwards in both Europe and the US over the last twelve months, as illustrated by the below chart. Given elevated base rates versus recent history, we believe that loans remained positioned to deliver exceptional current income versus the broader fixed income universe. Current yields (reflecting that income) are registering in the top decile of levels since the GFC.

US Versus European Leveraged Loan Spreads

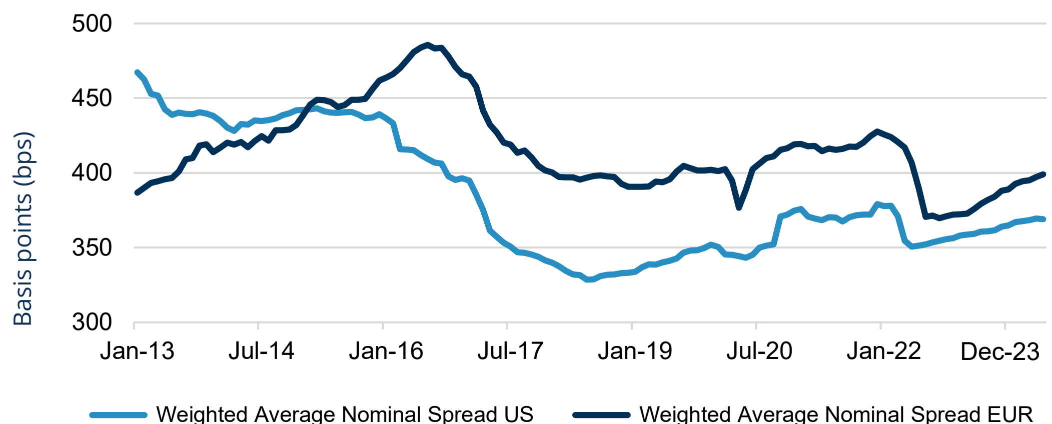


Chart Source: Morningstar LCD as at 31 December 2023.

Source: [1]Morningstar LCD as at 31 December 2023.

How CQS is Positioning for 2024

- **High quality income**
- **Credit selection**
- **Geographic diversification**

Our goal is to continue our strategy from last year: maintain high levels of quality income while rotating into high conviction loans which we anticipate will outperform on a fundamental basis.

Credit selection will focus on three key factors:

1) Resilient free cash flow in the face of higher rates for longer; margin stability and growth

2) Demand in an uncertain economic environment

3) Geographic relative value will also come into play in 2024 with the potential for differing central bank behaviour and macroeconomic backdrop

"The ability to navigate seamlessly between the US and European markets will be a useful tool"

The ability to navigate seamlessly between the US and European markets will be a useful tool to help deliver performance. We believe that European loans will continue to be outperformers in the sub-Investment Grade corporate credit space.

Asset Class Spreads

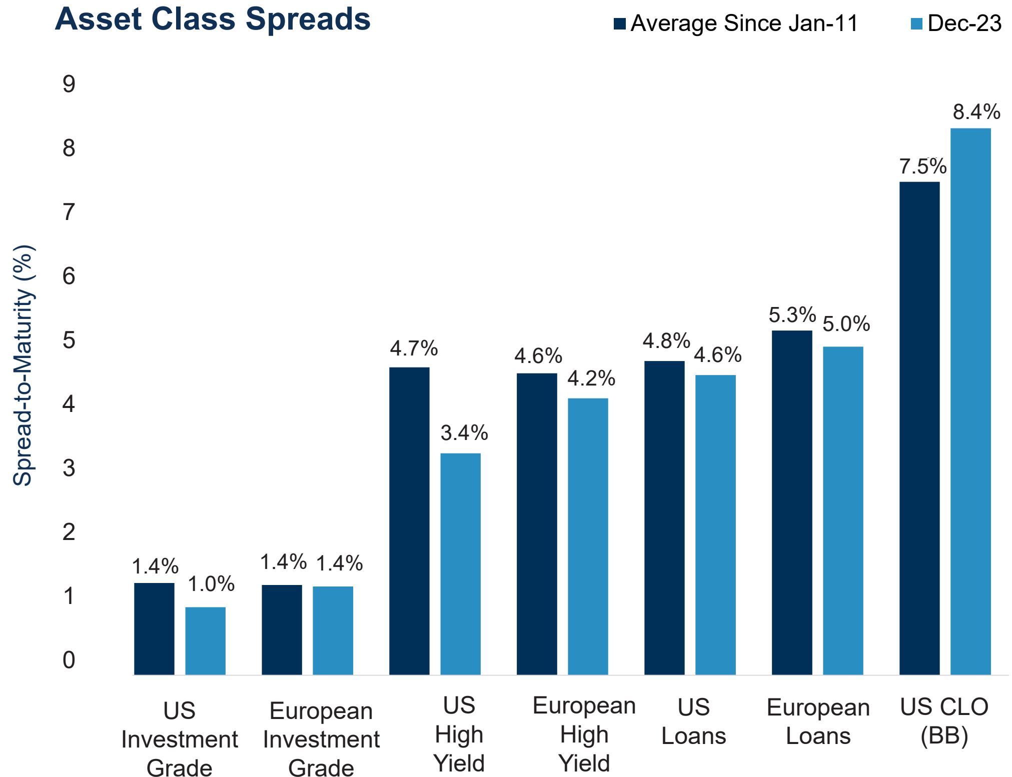


Chart Source: CQS, ICE, BBG and Morningstar LCD as at 31 December 2023. Indices used include ER00, C0A0, H9PC, H0A0, ELLI, LLI, and the J.P. Morgan CLO BB Index. Please see the end of the presentation for index descriptions. US CLO BB index data taken since its inception on 3 January 2012.

European Loans as a Diversifier

- **Outperformance as an asset class**
- **Sound fundamentals**
- **Stable buyer base**

"European loans have been the best performing asset class in sub-investment grade corporate credit"

While roughly a quarter the size of the US market, European loans have been the best performing asset class in sub-Investment Grade corporate credit over the last 10 years. The below chart illustrates the respective sizes of the US and European loans market by notional USD value over the past 10 years. European loan performance has been due to a combination of factors including: lower default rates; higher spreads; and a buyer base with a longer investment horizon which is less sensitive to mark-to-market movements.

1) CLOs represent 70% of the European loan buyer base which are cash flow arbitrage and longer maturity vehicles. This has led to more stable secondary prices and higher spreads.

2) The European Loan market has had a default rate consistently below the US Loan, and US and European High Yield markets.

3) Stronger legal documentation and more stringent directors' liability has also led to fewer incidents of lender versus lender negative restructuring outcomes.

We continue to view the European loan market as an important opportunity set within both our Global Loan and Multi-Asset Credit capabilities.

Annualised Returns (USD Hedged)[1]

	US IG	EUR IG	US HY	EUR HY	US Loans	EUR Loans
3-year	(3.2%)	(1.0%)	2.0%	2.8%	5.8%	6.6%
5-year	2.6%	2.0%	5.2%	5.3%	5.8%	6.4%
10-year	3.0%	3.0%	4.5%	5.2%	4.4%	5.8%

Loan Market Sizes

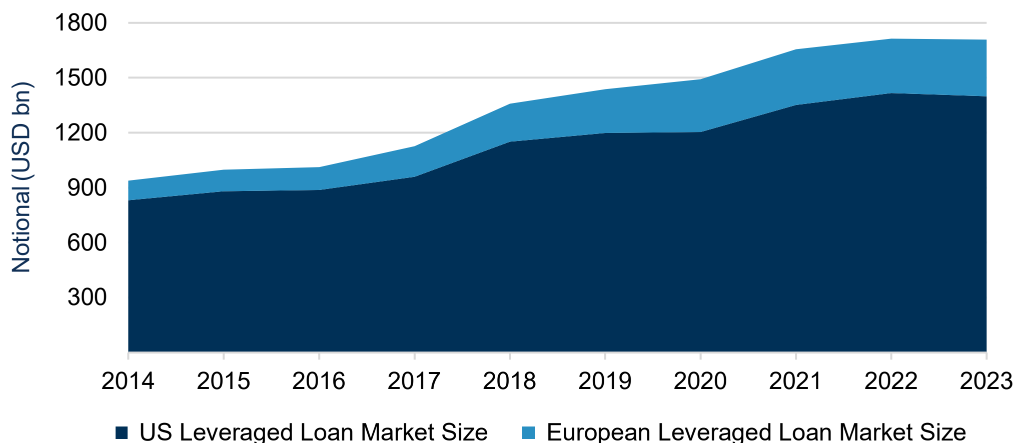


Chart Source: Morningstar LCD as at 31 December 2023. This document includes historic returns and past performance is not a reliable indicator of future results. The value of investments can go down as well as up.

Source: [1]CQS, ICE and Morningstar LCD as at 31 December 2023. Indices used include ER00, C0A0, H9PC, H0A0, ELLI and LLI. Please see the end of the presentation for index descriptions.

Why Invest in Loans Today?

- **Higher income, lower duration**
- **Portfolio diversification**
- **Consistency of returns**

Current income levels stand well above the 90th percentile (post-GFC).[1] Looking at the chart below, with a base rate in excess of 5.2% in the US and nearly 4.0% in Europe, the opportunity to generate considerable current income from the loan asset class remains. Even if the US Federal Reserve begins a period of rate cuts this year, base rates will be in line with pre-GFC levels as opposed to post-GFC levels (Zero Interest Rate Policy).

In addition to high levels of income, bank loans provide diversification benefits to fixed income portfolios due to their low correlation to other assets.[2] Bank loans have also been a very consistent asset class, over the past 10 years, US Loans have experienced only two negative years[3] (averaging -0.73%) and European Loans only one (-1.37% in 2002).

With a still uncertain macroeconomic environment lingering, returns must be protected through fundamental credit analysis. Broadly syndicated US and European loans comprise a total market size of roughly $1.75 trillion, providing a credit alpha-focused manager sufficient opportunity to differentiate on a credit selection basis.

Base Rates Have Risen

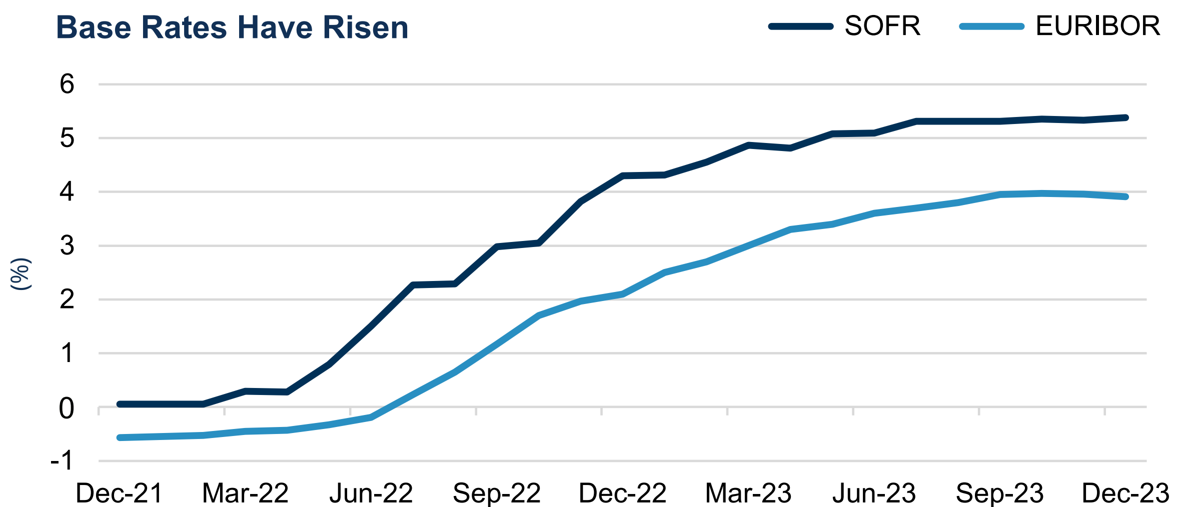
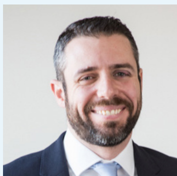


Chart Source: Bloomberg as at 31 December 2023. SOFR: Secured Overnight Financing Rate, EURIBOR: Euro Interbank Offered Rate.

Why CQS for Bank Loans?

We believe that credit selection is the key to generating highly competitive risk-adjusted returns in managing loan portfolios. CQS is a nimble, boutique asset manager and does not simply “buy the market.” CQS manages portfolios in a benchmark agnostic way, seeking total returns. Our detailed, fundamental investment process focuses on individual credit selection to produce a selective, high conviction loans portfolio with a history of low default rates.

We seamlessly combine our rigorous credit selection process with top-down sector allocations, actively trading loan portfolios to select the best-risk adjusted investments for both global and US-focused strategies.



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Source: [1]Morningstar LCD as at 31 December 2023. [2]Bloomberg as at 31 January 2024. Correlation analysis measured against market indices from 1 January 2013 to 31 January 2024. [3]Morningstar LCD as at 31 December 2023.

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Index Descriptions: It is not possible to invest directly in an index.

ICE BofAML Euro Corporate Index (ER00) tracks the performance of EUR denominated investment grade corporate debt publicly issued in the eurobond or Euro member domestic markets.

ICE BofAML US Corporate Index (C0A0) tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market.

ICE BofAML European Currency Fixed & Floating Rate Non-Financial High Yield Constrained Index (H9PC) contains all non-financial securities in ICE BofAML European Currency Fixed & Floating Rate High Yield Index but caps issuer exposure at 3%.

ICE BofAML US High Yield Index (H0A0) tracks the performance of US dollar-denominated below investment grade corporate debt publicly issued in the US domestic market.

S&P European Leveraged Loan Index (ELLI) covers the European market back to 2003 and currently calculates on a weekly basis.

S&P/LSTA Leveraged Loan Index (LLI) covers the US market back to 1997 and currently calculates on a daily basis.

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