CQS Insights

January 2023

Global Loans: Alpha Opportunities in 2023

Global Loans

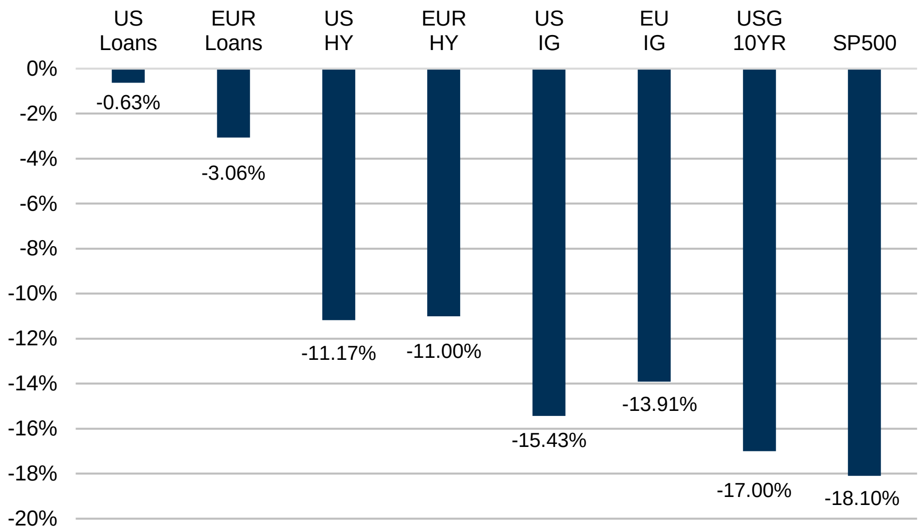
After outperforming major asset classes last year, the global loan market appears well positioned to provide alpha opportunities to active managers.

- Resilient performance in 2022, despite periods of volatility, demonstrated the importance of income in the asset class
- Elevated levels of current income, given the higher rate environment, provide an attractive investment opportunity
- High income levels are expected to more than offset potential capital losses
- Defaults, while expected to increase to c. 4%, will only be slightly above historical averages
- Last year's volatility is expected to continue as central banks remove record levels of support. Valuations are expected to be more reflective of true fundamentals
- At CQS, our highly selective and active approach has taken our current risk-adjusted income to 8.99% in the US and 6.94% in Europe
- Loans are a natural short-duration asset class, which mitigates interest rate risk

A Resilient Asset Class

Last year was challenging for most asset classes, yet Broadly Syndicated Loans (BSLs) were resilient in Europe and the US. The total return for the asset class compared favorably to other risk assets, with the US returning -0.63% and Europe, -3.06%. A difficult first half of 2022 was followed by a bounce back in the second half, largely driven by a favorable supply-demand dynamics and broader market stability. Default rates remained low, finishing the year at 0.72% in the US and 0.42% in Europe. Spreads (on a 3-year basis) finished 2022 at 645 basis points (bps) in the US and 705bps in Europe.

Figure 1: 2022 Total Return by Asset Class



US Loans	EUR Loans	US HY	EUR HY	US IG	EU IG	USG 10YR	SP500
-0.63%	-3.06%	-11.17%	-11.00%	-15.43%	-13.91%	-17.00%	-18.10%

Source: CQS and Bloomberg as at 31 December 2022.

2023 Loan Market Outlook

In our view, broader risk markets will experience continued volatility in 2023, more acutely felt in the first half. The loan market will not be entirely immune in this environment. This is based on several factors:

- Uncertain inflation path/outlook
- Uncertain central bank action/unknown terminal rates
- Recession/fundamental fears rising
- Market liquidity in the absence of a central bank buyer
- Geopolitical dynamics

However, this potential mark-to-market volatility should be more than offset by elevated levels of current income.

From a fundamental perspective, operating margins have contracted across a number of industries and rising borrowing costs have added pressure to corporate cash flows. Less robust financial conditions have contributed to an increasing default outlook. CQS is assuming a 2023 loan market default rate of 4% in the US and a 3% default rate in Europe.

Despite this backdrop, the loan market presents reasons for optimism

The loan market offers a large and diverse investment opportunity set. The US Broadly Syndicated Loan market totals $1.4 trillion, with Europe adding another EUR278 billion. A boutique approach to investing in the loan market opens avenues for outperformance. The ability to be discerning on credit remains present. Taking a selective and proactive approach to investing in the loan market can help mitigate idiosyncratic downside credit risks. The market size provides sufficient flexibility for managers to shift portfolios up in quality, into counter-cyclical industries, and towards less inflation-sensitive business profiles. This positioning reflects our current portfolio construction.

Market yields remain attractive and current income is robust. The rising base rate environment has provided a boost to loan investors' income. The senior secured nature of the loan asset class has historically provided a floor for recoveries in the event of default. Taking the current market income, less anticipated credit loss, the income dynamic for the market looks compelling:

Market	US	Europe
Current Income	8.92%	6.96%
Less:		
Expected Credit Losses	-1.40%	-1.05%
Current Risk-adjusted Income	**7.52%**	**5.91%**

A boutique approach to investing in the loan market opens avenues for outperformance

It is our belief that our approach to investing in the loan market will bring 2023 returns in excess of the market.

CQS: Taking Advantage of 2023 Market Dynamics

Our approach to the market involves carefully selecting a portfolio of assets that deliver high levels of current income. These assets are high conviction investments. We have focused on yield-to-call instruments, discounted single B assets and selective BB loans. Our focus remains on a borrower's cash flow, with a view to navigating potential downgrade and default risk. These extensive levels of due diligence and proactive monitoring have enabled CQS to consistently deliver default rates which are below market. We constantly re-underwrite credit risk at an individual asset level.

Earnings, company and industry news flow, and conversations with management teams allow us opportunities to re-assess probability of default and loss given default and trade accordingly.

CQS also utilizes a well-articulated top-down view to proactively position portfolios from a geographic, industry and ratings perspective. Our internal and external resources allow us to be uniquely placed to deliver this proactive style of management.

Based on CQS' ability to deliver higher current income than the market with less fundamental risk, we view our current risk-adjusted income as:

Market	US	Europe
Current Income	9.34%	7.29%
Less:		
Expected Credit Losses	-0.35%	-0.35%
Current Risk-adjusted Income	**8.99%**	**6.94%**

Source: CQS calculations.

The loan market is broad and big enough for active managers to find alpha opportunities; this should help them outperform passive strategies

While the challenges risk markets are facing appear elevated, we believe this market dynamic creates opportunities for BSL loan managers who are:

- Highly selective on individual credits
- Proactive in their approach to investing
- Focused on delivering attractive current income
- Able to invest with a global (US/EUR) opportunity set

In short, we believe a credit alpha and proactive management approach to investing in the loan market should outperform a market beta and passive approach.

Important Information

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