LORD ABBETT

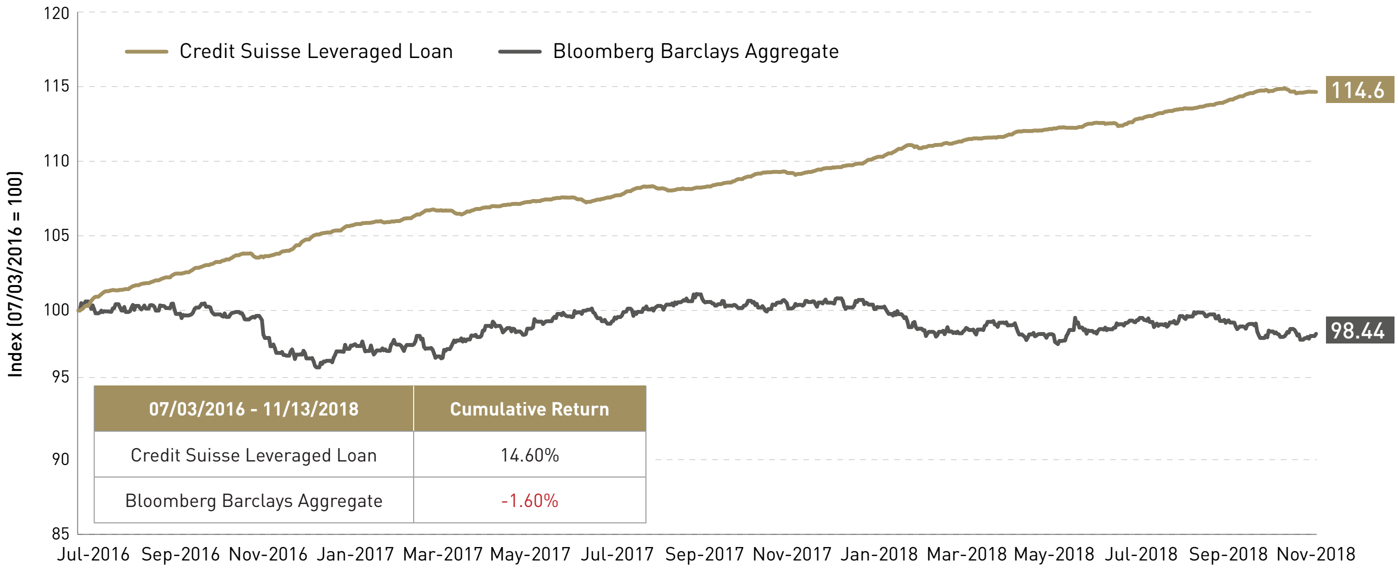
MARKET VIEW

BANK LOANS: A SOURCE OF STABILITY IN A VOLATILE MARKET

Floating-rate bank loans have weathered the recent tumult comparatively well, and, in our view, continue to be favorably positioned in the current economic environment.

CHART 1. BANK LOANS HAVE OFFERED POSITIVE RETURNS IN A NEGATIVE BOND MARKET

NORMALIZED INDEX LEVELS FOR THE CREDIT SUISSE LEVERAGED LOAN INDEX AND THE BLOOMBERG BARCLAYS U.S. AGGREGATE BOND INDEX, JULY 3, 2016–NOVEMBER 13, 2018



07/03/2016 - 11/13/2018	Cumulative Return
Credit Suisse Leveraged Loan	14.60%
Bloomberg Barclays Aggregate	-1.60%

Source: Credit Suisse and Bloomberg Barclays Indices.

Past performance is not a reliable indicator or guarantee of future results. Due to market volatility, the asset classes depicted in this chart may not perform in a similar manner in the future. For illustrated purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

IN BRIEF

- Since our last review of floating-rate bank loan securities, U.S. equity and fixed-income markets have been whipsawed by volatility.
- How have bank loans fared against other asset classes? Quite well, posting stable returns while key equity and fixed-income benchmarks have suffered losses.
- Looking further back, since the low point in 10-year U.S. Treasury yields in July 2016, the primary bank loan benchmark has provided positive returns, while the broad bond market proxy has posted losses.
- Despite the recent weakness in the credit markets, we believe the current economic environment may continue to provide a favorable backdrop for floating-rate loans going forward.

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When *Market View* last focused on floating-rate bank loans on September 10, 2018, we highlighted the strong risk-adjusted returns that the asset class had delivered relative to most areas of fixed income. Despite this strong performance, we have continued to field questions from investors about the potential risks of declining underwriting standards, and potential losses in a difficult credit environment.

What has happened since our last update? The broad U.S. fixed-income market has gone through a significant bout of volatility. The yield on the 10-year U.S. Treasury note jumped by more than 40 basis points between late August and early November, peaking at near 3.25% on November 8, based on Bloomberg data. This led to negative returns across most investment-grade fixed-income sectors. Equity markets stumbled, with the S&P 500® Index suffering a 10% pullback from its peak in early October.

High-yield bonds initially held up reasonably well, although spreads have widened recently, perhaps reflecting a spillover of "risk-off" sentiment from the equity market. After reaching their post-financial crisis low point in early October, high-yield spreads have since widened by nearly 100 basis points, leading to a 2.5% loss quarter to date, and pushing the average yield in the index to the highest levels in 2 years. The ICE BofAML U.S. High Yield Index has been led lower by its 16% weighting in the energy sector, which has been hurt by a sharp fall in oil prices (note that the sector has weathered the current decline better than during the previous high-yield energy correction in 2014–15).

Amid the tumult, how have bank loans fared? As illustrated in the quarter-to-date performance in Chart 2, the asset class has been remarkably stable, remaining flat versus sharply negative returns in many segments of the equity and fixed-income markets.

Given the sharp credit spread widening in the high-yield market, it should not be surprising to see recent price weakness in bank loans. But on a year-to-date basis, bank loans have been one of the best places to be in U.S. asset markets, outperforming most investment-grade bond, high-yield bond, and equity indices.

Chart 1 takes a slightly longer-term view, showing how bank loans can play a vital role in diversifying a core bond portfolio. Since the low point in the 10-year Treasury yield (1.36%) in early July 2016, the Credit Suisse Leveraged Loan Index has greatly outperformed the broad bond-market benchmark, the Bloomberg Barclays U.S. Aggregate Bond Index (Aggregate Index). During that time, loans have generated a cumulative return of 14.6%, versus a 1.6% loss for the Aggregate Index, as rising yields created a negative environment for rate-sensitive investments.

This is a real-world example of negative correlation at work: a difficult environment for core bonds can be a positive environment for bank loans.

Our Outlook

In our view, the recent market volatility has largely been an equity story. After major stock indexes reached all-time highs, supported by strong earnings growth, some are questioning whether corporate profits can maintain that strength. Equity investors are also worried about the impact of higher interest rates, potential trade skirmishes, and other factors. While credit spreads have widened from very low levels, we believe the fundamentals for credit remain sound. There may be some signs of softening economic data, but we think that overall, the U.S. economy is in good shape, as are U.S. consumers and businesses. While earnings may slow, default rates on both high-yield bonds and loans are near historically low levels, and are widely expected to remain low at least through 2019.

Of course, there may be a chance of recession at some point, but for now the greater risk to worry about still appears to be the prospect of a sustained move higher in interest rates and inflation. In that scenario, the biggest risk in many investors' portfolios is undue exposure to duration. In traditional core fixed-income allocations (as typified by the construction of the Aggregate Index) investors are not getting compensated for interest-rate risk.

By contrast, as short-term rates have risen, the average coupon in the bank loan index has continued to increase (to 5.89% as of November 15). (See Chart 3.) Bank loans can provide a source of attractive income, without the duration risk of traditional fixed income.

But the recent price movements may remind investors that loans have exposure to credit. We believe the current environment, in which the U.S. economy continues to grow and the U.S. Federal Reserve seems to be on a path of gradual rate hikes, should continue to provide a positive backdrop for floating-rate bank loans.

The Active Approach

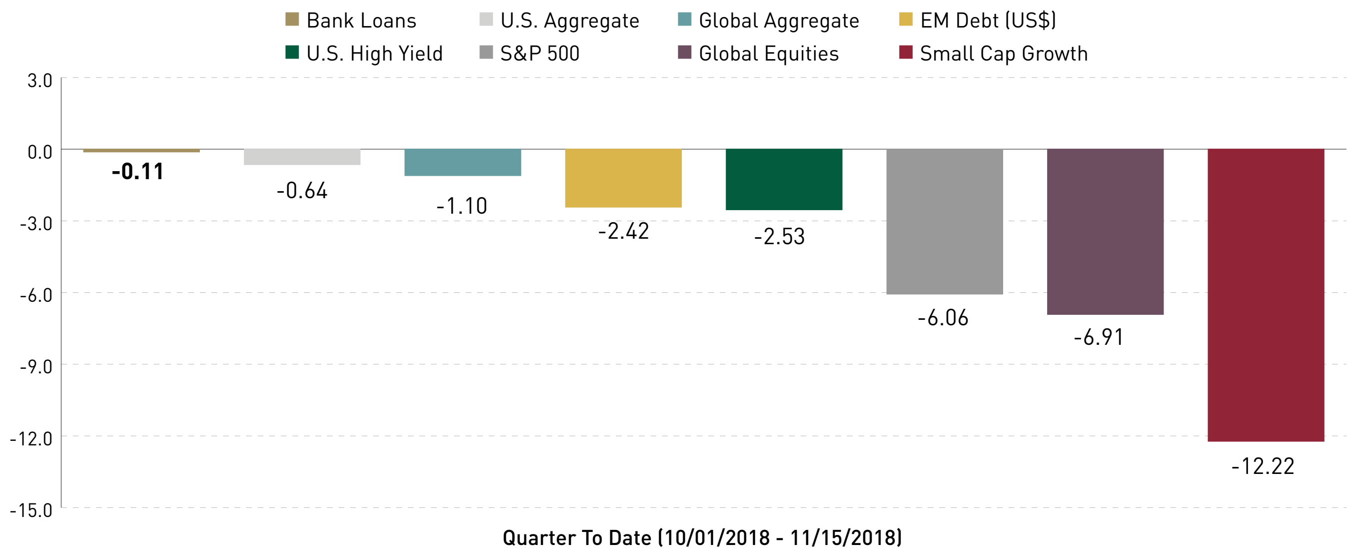
As we emphasized in September, floating rate is not an asset class conducive to passive investing. We believe successful investment in bank loans requires rigorous credit research by experienced analysts with a deep understanding of the issuers and industries in which they compete. That analytical rigor should extend to individual issues; covenant analysis, collateral analysis, and a strong knowledge of deal structures are vital to understanding your protection as a lender. At Lord Abbett, we believe an active approach provides our investment team with the agility to adjust the portfolio for the market environment, moving across the credit-quality spectrum, identifying those industries and individual issuers that present the best risk/reward opportunities, while avoiding those issuers and deal structures that pose risks to lenders.

In the next *Market View*, we'll show how a strategic combination of bank loans with other lower-duration asset classes may offer the potential for attractive income while mitigating volatility.

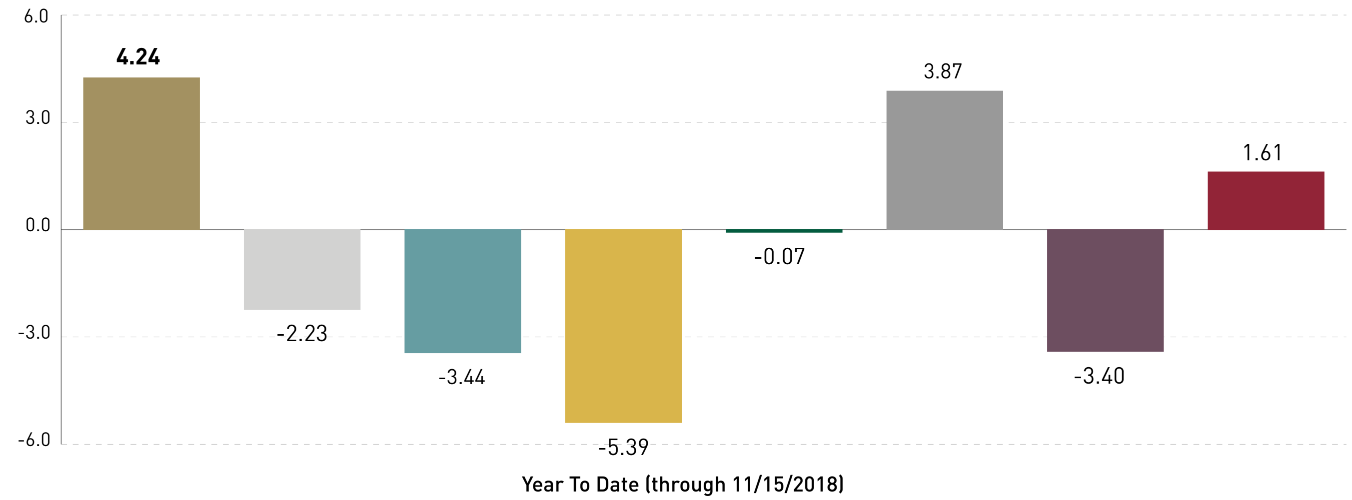
CHART 2. BANK LOANS HAVE REMAINED STABLE AMID VOLATILITY IN EQUITIES, RATES, AND CREDIT

RETURNS BY CATEGORY FOR THE INDICATED PERIODS

Bank loans have been resilient during the recent bout of volatility ...



... and one of the best-performing asset classes year to date.



Source: Morningstar. Bank Loans=Credit Suisse Leveraged Loan Index. U.S. Aggregate=Bloomberg Barclays U.S. Aggregate Bond Index. Global Aggregate=Bloomberg Barclays Global Aggregate Bond Index. U.S. High Yield=ICE BofAML U.S. High Yield Constrained Index. EM Debt=J.P. Morgan Emerging Markets Bond Index Global. Global Equities= MSCI ACWI Index. U.S. Small Cap Growth= Russell 2000® Growth Index.

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CHART 3. BANK-LOAN COUPONS HAVE FLOATED HIGHER

AVERAGE COUPON RATE IN THE CREDIT SUISSE LEVERAGED LOAN INDEX, NOVEMBER 15, 2013–NOVEMBER 15, 2018

Source: Credit Suisse. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. **Past performance is not a reliable indicator or guarantee of future results.** Due to market volatility, the asset class depicted in this chart may not perform in a similar manner in the future. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

Bank Loans: The Technical Picture

Recent articles in the financial press have commented on the growth of the loan market, and the strong retail demand coming from floating-rate mutual funds and exchange-traded funds (ETFs). Once again, we believe some context is required.

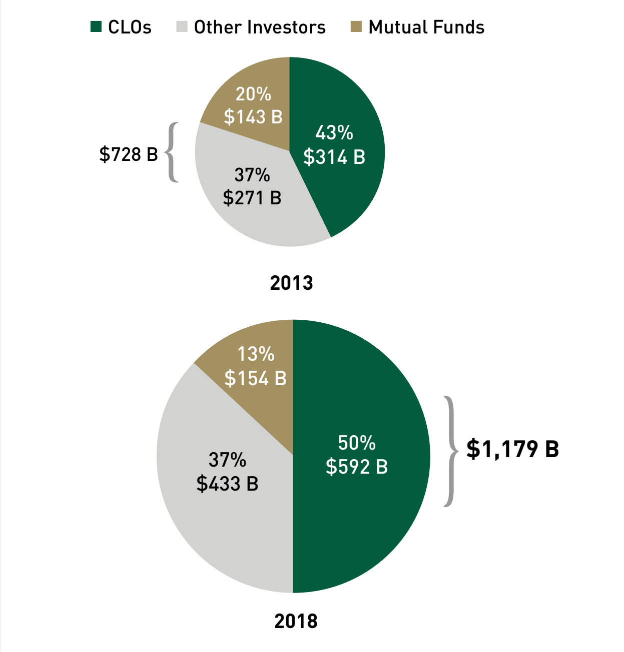
Yes, the U.S. bank loan asset class has seen significant growth in recent years, and, at approximately $1.2 trillion, is approaching the size of the high-yield bond market. In terms of new issuance, there has been approximately $670 billion in gross new issuance of loans this year. While that is a very large number, much of that issuance has been for refinancing older debt, so on a net basis, new issuance has been approximately $277 billion, an increase of about 20% over last year. However, net issuance of high-yield bonds has declined by 35%, on pace for the lightest year since 2009, as many issuers have chosen to bypass the bond market in favor of the loan market. Thus, total leveraged credit borrowing (net issuance of high-yield bonds plus loans) has been flat, year over year, and well below the peak levels seen in 2014.

And, yes, bank loan mutual funds have seen strong inflows, with nearly $17 billion in net new flows into the Morningstar Bank Loan Fund category, year to date through October 31. Some observers have raised concerns that large outflows can have a negative impact on the market. However, total assets under management in the category of $154 billion have only recently recovered to the peak levels of 2014, before the market suffered $60 billion in outflows in 2014–15. As illustrated in Chart 4, bank loan mutual funds make up a relatively small component of the market. And given the large growth in the overall market, their share of the market has been reduced from 20% five years ago to only 13% today.

Large retail fund flows can have an impact on the market, but it is important to understand that 87% of the loan market is held by collateralized loan obligations (CLOs), and other institutional investors such as insurance companies and pension plans, entities which tend to exhibit different behavior than the retail fund buyer.

MUTUAL FUNDS ACCOUNT FOR A SMALL PORTION OF U.S. LOAN DEMAND

Bank loan assets by investor type, as of December 31, 2013, and September 30, 2018



Source: JP Morgan.

Mutual funds include bank loan mutual funds and ETFs. Other Investors include institutional investors (pensions, insurance companies), hedge funds, and other entities.

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IMPORTANT INFORMATION

A Note about Risk: The value of an investment in fixed-income securities will change as interest rates fluctuate and in response to market movements. As interest rates fall, the prices of debt securities tend to rise. As interest rates rise, the prices of debt securities tend to fall. High-yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, interest-rate, and general market risks. Lower-rated bonds carry greater risks than higher-rated bonds. The principal risks associated with bank loans are credit quality, market liquidity, default risk and price volatility. While bank loans are secured by collateral and considered senior in the capital structure, the issuing companies are often rated below investment grade and may carry higher risk of default.

Moreover, the specific collateral used to secure a loan may decline in value or become illiquid, which would adversely affect the loan's value. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer maturity of a security, the greater the effect a change in interest rates is likely to have on its price. No investing strategy can overcome all market volatility or guarantee future results.

Neither diversification nor asset allocation can guarantee a profit or protect against loss in declining markets.

There is no guarantee that the floating-rate loan market will perform in a similar manner under similar conditions in the future.

Forecasts and projections are based on current market conditions and are subject to change without notice. Projections should not be considered a guarantee.

This *Market View* may contain assumptions that are "forward-looking statements," which are based on certain assumptions of future events. Actual events are difficult to predict and may differ from those assumed. There can be no assurance that forward-looking statements will materialize or that actual returns or results will not be materially different from those described above.

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Glossary

A **coupon** is the annual interest rate paid on a bond, expressed as a percentage of the face value.

Correlation is a statistical measure that describes the strength of relationship between two variables. It can vary from 1.0 to -1.0.

Duration is the change in the value of a fixed-income security that will result from a 1% change in market interest rates. Generally, the larger a portfolio's duration, the greater the interest-rate risk or reward for underlying bond prices.w

Treasuries are debt securities issued by the U.S. government and are secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes.

The **Bloomberg Barclays Global Aggregate Bond Index** is a broad-based measure of the global investment-grade, fixed-income markets.

The **Bloomberg Barclays U.S. Aggregate Bond Index** is an unmanaged index composed of investment-grade securities from the Bloomberg Barclays Government/Corporate Bond Index, Mortgage-Backed Securities Index and the Asset-Backed Securities Index.

The **Credit Suisse Leveraged Loan Index** is designed to mirror the investable universe of the U.S. dollar-denominated leveraged loan market.

The **ICE BofAML U.S. High Yield Index** tracks the performance of U.S.-dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market.

The **ICE BofAML U.S. High Yield Constrained Index** is a capitalization-weighted index of all US dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market.

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The **J.P. Morgan Emerging Markets Bond Index Global** ("EMBI Global") tracks total returns for traded external debt instruments in the emerging markets

The **MSCI ACWI Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 46 country indices comprising 23 developed and 23 emerging market country indices.

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The **Russell 2000® Growth Index** measures the performance of those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values.

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