April 2018

First Half 2018 Insurance Highlights

Real Estate

Commercial Real Estate

- Commercial Real Estate has continued to perform well
  - There is still a supply/demand balance with the exception of urban multi-family segment.
- Abundant liquidity for multi-family development – however, this does not equate to overbuilding across the board.
- Development is still restricted due to "not in my back yard" sentiment regarding multi-family development in the suburbs. By contrast, cities want development in the urban core to relieve traffic issues, which has resulted in overbuilding.
- Affordability is also becoming problematic, the cost to build has gotten expensive and therefore development only makes sense on the high ends of the market. Urban multi-family rents have made it unaffordable for middle class renters. We believe renters who cannot afford to live in newly developed urban apartments and the increase in properties potentially can cause a bubble.

Sector Outlook

- While attention is on retail, there is more "noise" around the asset class. Big box retail and malls will continue to struggle and better located properties will transform to their highest and best use. Grocery anchored and local strip retail is preferred but investors need to be cautious. Proper cap ex needs to be considered to account for any transformation or required upgrades to effectively compete.
- We favor real estate assets that benefit from demographic changes such as self-storage, mobile home parks and senior living.

CMBS

- While CMBS has effectively lived with risk retention rules, big banks were the beneficiaries. Many of the smaller CMBS originators have been pushed out of the market, which continues to put a cap on the amount of CMBS originated. Single borrower/ Single Asset remains efficient.
- Regulations continue to hamper bank lending especially in the construction loan space. This has given insurance companies and debt funds the opportunity to lend in the construction loan and bridge loan space at proper risk-adjusted rates. While there is potential relief in regulation, there will still be challenges in the banking space. Regulators still understand that small and regional banks create many of the real estate bubbles.

Collateralized Loan Obligations

Strong issuance

- 212 new U.S. CLOs were priced in 2017 totaling $118 billion.
- ~$166 billion in U.S. re-set/refinancing volume activity.
- This was a record year topped only by 2014 when $124 billion of CLOs were issued.
- Forecasts for 2018 are in the $100-$115 billion range.

Sector Outlook

- Potential for further spread tightening.
- Steady loan fundamentals, increased CLO demand and a risk-on sentiment.
- Improving CLO arbitrage expected to continue in the medium term due to deceleration in loan repricing activity and further tightening in liability spreads.
- From a CLO manager's perspective, the focus is on managing retail sector exposure, developing sub-sector trends and idiosyncratic credit issues. CLO managers have to be more proactive in how they manage around any increased CCC levels and pick-up in default activity so as to minimize par erosion.
- CLO equity distributions, after declining for almost a year due to reduced LIBOR floor benefits and collateral spread compression, are expected to remain relatively stable and start increasing again (given the expectations for increasing LIBOR in 2018) in the medium term.

Relative Value

- AAA and BB tranches appear favorable using comparable asset classes and historical basis differential.
- CLO equity in newer vintage deals (2018, 2017 and some longer dated re-sets from prior vintages) also look attractive. This is attributed to longer reinvestment periods, equity friendly indenture docs, clean portfolios and, most importantly, tighter liability costs.

Defaults

- Muted CLO default activity in 2017 has resulted in stabilization and improvement of OC and interest diversion cushions. Downgrades in the U.S. loan space have stabilized, with the median percentage of CCC assets in U.S. CLO portfolios decreasing. In 2018, loan default activity is expected to remain inside of historical averages which provide a stable backdrop for CLOs.

Private Credit Investment Grade

Market Growth and Anticipated Supply

- The Private Credit Investment Grade (PC IG) market grew significantly in 2017.
- Volume was up 24% in 2017 driven by continued strong domestic issuance from borrowers.
- Both the number of deals and size of deals increased over 10%.
- The PC IG market typically experiences the first wave of issuance in late February through early June as companies complete year-end financials and gain better insight into capital plans.
- The second wave of issuance typically comes between September through the end of November.
- Guidance from the broker community suggests that these issuance trends will continue this year. New issuance for 2018 is expected to be similar to 2017 with approximately $55-60 billion in issuance as companies continue to capture low absolute yields.
- Domestic issuance is expected to continue to dominate new production, while flow from Europe continues to decline.
- Issuers refinancing needs in 2018 and 2019 are expected to be high because of 10-year maturities coming due from companies issuing pent up debt needs after the global financial crisis in 2008 and 2009.

Sector Outlook

- As absolute rates are anticipated to rise gradually in 2018, companies will likely continue to lock in long-term fixed rate debt and reduce floating rate bank exposure prior to rate increases.
- ~50% of investors are looking to invest more capital in private credit with interest in the asset class because of the low interest rate environment and need for institutional clients to invest.
- Excluding energy and business services, credit quality of issuers remains stable.
- Spreads are anticipated to be attractive in relative value terms. While spreads have compressed versus historical averages, spreads to comparable publics are favorable relative to risk-free rates.
- Selectivity in the marketplace with credits and focus on negotiating deal structure continues.

Private Credit High Yield

The Impact of Strong Demand

- Record sums of Private Equity dry powder have continued to grow valuations and purchase multiples in the Private Credit High Yield markets. We expect this to continue in the near term given substantial fund-raising in 2017 and positive tailwinds resulting from the tax reform.
- Leverage levels in credits have risen across the board and will likely remain elevated in 2018.
- Despite the higher leverage at companies, middle market spreads have tightened considerably relative to other more liquid asset classes. We expect this to continue given the demand for paper and inflow of capital in the middle market space.
- The rising Libor environment will likely benefit investors by offsetting the spread tightening; however, it also has the potential of creating liquidity pressure on businesses that are over-levered or have weaker cash-flow profiles at some point later on in 2018.
- During 2017, middle market participants overlooked structural protections and this trend accelerated in deals completed at the end of the year. Voya PCHY has exercised discipline in its selection of credits that have highly defensible business models and tight structures with special emphasis on second way home, which we believe will serve us well in the long term.

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