Bank Loan Market Update

A Commentary on the US Bank Loan Market

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All references to Invesco refer to Invesco Senior Secured Management, Inc. All data is as of May 31 2009 unless otherwise stated. Source: Invesco, unless otherwise stated.

All data as of 31-May-2009 unless otherwise noted.

"The Rally Continues But How Much Further Can It Go?"

Strong technicals propelled the bank loan market to a 6.10% return in May bringing cumulative year to date gains on the S&P/LSTA Index to 26.3%. Our last commentary contrasted the sharp reversal in technicals between the record sell-off in the fourth quarter of 2008 and the first quarter rally of 2009. This contrast is still relevant but there are several additional factors to help explain May's performance and the strong bid side demand we see across the market.

Direct Inflows – Bank Loan Mutual Funds at $1.6BN through May 30th and an estimated $4 to $5BN into institutional accounts.

High Yield Bond Factor – $9.8BN of positive flows into H.Y. Bond funds being put to work on a cross-over basis (loan baskets heavily utilized) and, $8.8BN of bank loan deals refinanced via new H.Y. Bond issues.

Financial Market Liquidity – Improved liquidity in the financial markets with a TED Spread now at 46 b.p. and evidence that several TRS desks are once again looking to put money to work financing bank loan portfolios.

There is also other evidence that the market is moving back toward normalization and we view this as a healthy sign that supports the rally beyond pure technical factors. Specifically, we note that the new issue market has re-opened for select issuers, typically those that are already well known to investors and/or are perceived to be of higher credit quality. While volume is low at just $7.8BN the average new issue deal for the 2009 vintage is trading above cost suggesting that demand is in fact real. We also note a number of successful amend and extend transactions which are pushing out maturities to alleviate one of the fundamental concerns raised earlier this year – the "refinancing cliff."

Sticking on the fundamental theme, we note a confluence of contradictory macro economic data which has emerged since our April commentary. This is typically indicative of an inflection point in the economy and suggests that we should be nearing a trough in the credit cycle. A material decline in the pace of defaults for the April - May period may be the best evidence that we are in fact nearing a trough in the cycle. The annualized default pace for April - May was 8.4% vs. an annualized pace of 19.5% during the first quarter. We explain this in part by the idea that many of the weaker corporate borrowers capitulated early-on, knowing that they had untenable balance sheets and limited liquidity options - in essence an "early adopter" principle. With these "early adopters" cleared out and some improvement on the economic and liquidity fronts, expectations for defaults and concurrent credit losses for the remainder of 2009 and beginning of 2010 have eased several points.

With technicals and fundamentals providing support for the market, Bank Loans are the top performing corporate asset class on a year to date basis. This is well depicted in the below chart which shows the 2009 performance of Treasuries and various corporate based investments in order of generally perceived risk.

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Sector Returns

	Y-T-D 2009 Returns
10 Year Treasuries	-8.58%
Corporate Bonds	6.01%
Bank Loans	26.3%
H.Y. Bonds	25.4%
S&P 500 (equities)	1.76%

Proxy index for Corporate Bonds is the Merrill Lynch Investment Grade Bond Index, Bank Loans index is the S&P/LSTA and the High Yield Bonds index is The Merrill Lynch High-Yield Master Index.

To the question of whether or not there is still value in the bank loan market at current levels, we believe the answer is yes, albeit with less upside than our prior buy recommendations. We offer several observations to support our view and a continued "buy" on the asset class. First, is an update to the Market Yield Matrix which we have shown in prior commentaries – this continues to show a compelling excess risk premium in the broad market with risk adjusted yields of 8.5 to 10.0%.

Yield to Maturity

	Recovery Rate							
Default Rate	**85.00%**	**80.00%**	**75.00%**	**70.00%**	**65.00%**	**60.00%**	**55.00%**	**50.00%**
5.00%	11.98%	11.73%	11.48%	11.23%	10.98%	10.73%	10.48%	10.23%
6.00%	11.81%	11.51%	11.21%	10.91%	10.61%	10.31%	10.01%	9.71%
7.00%	11.64%	11.29%	10.94%	10.59%	10.24%	9.89%	9.54%	9.19%
8.00%	11.46%	11.06%	10.66%	10.26%	9.86%	9.46%	9.06%	8.66%
9.00%	11.29%	10.84%	10.39%	9.94%	9.49%	9.04%	8.59%	8.14%
10.00%	11.12%	10.62%	10.12%	9.62%	9.12%	8.62%	8.12%	7.62%
11.00%	10.94%	10.39%	9.84%	9.29%	8.74%	8.19%	7.64%	7.09%
12.00%	10.77%	10.17%	9.57%	8.97%	8.37%	7.77%	7.17%	6.57%
13.00%	10.60%	9.95%	9.30%	8.65%	8.00%	7.35%	6.70%	6.05%
14.00%	10.42%	9.72%	9.02%	8.32%	7.62%	6.92%	6.22%	5.52%
15.00%	10.25%	9.50%	8.75%	8.00%	7.25%	6.50%	5.75%	5.00%

Assumptions

Index Spread	2.75
Average Price	73.96
Index Maturity	4.27
3 Month LIBOR	0.65
Market Yield	12.85%
% of Defaulted issuers paying current	50.00%
Current Yield	4.60%
Principal Appreciation	8.25%

Sources: S&P/LCD, Bloomberg, Invesco. For illustrative purposes only. The shaded areas highlight Invesco Senior Secured Management, Inc.'s view of Default and Recovery Rates. These views may not reflect the opinion of other affiliated Invesco Ltd. Investment advisors. The Key Assumptions are on based on current market conditions as of May 31, 2009, and are subject to change. Accordingly, investment results, yields and volatility may differ significantly from those identified.

Second, the market continues to exhibit a number of inefficiencies or "sub-dislocations" for lower rated names, stressed issuers and, issues trading at lower price points. This creates an opportunity for credit specific alpha of up to 500 bp in actively managed strategies. Finally, bank loans continue to offer an attractive current income stream and do it in a format that is duration neutral which provides a hedge against increasing interest rate risk.

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