Advisory Blog

Timely insights on the issues that matter most to advisors and their clients

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Floating-Rate Loans | Income

EV Forward: Floating-Rate Loans

By: EV Forward | July 11, 2022

Boston - Just as the loan market has proved its resiliency over several decades and business cycles, today we see value in this asset class, and we believe the forward return potential from these levels is bright.

What we are seeing

The historic 75 basis points (bps) hike by the Federal Reserve on June 15 signifies a major boost for floating-rate loans — literally. Rates in this asset class have an average reset period of just over 30 days, and the two key loan benchmarks — Libor and Sofr[1] — both closely track the fed funds rate that the policymakers control.

The Fed has four meetings on the books through the end of the year, and is projecting that its policy rate will be boosted to more than 3% over that period, and as high as 4.00% next year. So rising yields will likely be a continuing theme in the loan market for the balance of 2022.

What we are doing

The Fed is aiming to thread the needle, in hopes that raising rates sharply will stave off inflation without tipping the economy into recession. We think of these risks in terms of probabilities and degree, assessing what's likely based on what's already "priced in."

The loan price of $94 on the S&P/LSTA Leveraged Loan Index as of June 17 means that investors are predicting $6 in losses over the five year nominal maturity of typical loans. Our universe of first-lien loans has had an average recovery rate of 75%, based on the S&P Global Loss Stats database. Applying some basic arithmetic, the loan pricing and recovery rates imply that investors expect a 24% default rate.

That default rate allows us to gauge how fairly priced loans are, if we assume that a recession is likely, based on relevant comparisons. The default rates in the loan market peaked at 8% in the 2001-2002 tech wreck, 10% in the 2008-2009 Global Financial Crisis (GFC) and 4% in the 2020 COVID pandemic. In other words, today's market is pricing in a multiple of the GFC and over five times the COVID recession.

More recently, the trailing 12-month default figure rounds to zero. The distressed ratio of loans trading under $80, which has been a good indicator of where investors see defaults trending, remains a low 2% to 3% of the market.

What we are watching

The implied default rate of 24% based on current loan pricing appears to be a very large cushion against the most likely

economic downturns. Moreover, it suggests that the 9% yield to maturity on loans, as of June 17, offers attractive value — it is the highest of major fixed-income asset classes.

For investors assessing the current environment, two key factors stand out: First, courtesy of the Fed, loan coupons are poised to rise, and by quite a lot. Second, the discounted price on loans anticipates far more credit carnage than we believe is remotely justified.

Just as the loan market has proved its resiliency over several decades and business cycles, today we see value in this asset class, and we believe the forward return potential from these levels is bright.

Andrew Sveen, CFA
Head of Floating-Rate Loans

[1] Libor and Sofr are short-term benchmarks commonly used in the pricing of short-term and variable-rate instruments such as bank loans.

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EV Forward

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