Advisory Blog

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

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Floating rate | Income | Inflation | Rates

EV Forward: Help Counter Inflation with Short-Duration, Multi-Sector Strategies and Floating-Rate Loans

By: EV Forward | April 29, 2022

Boston - Income markets are experiencing a challenging 2022. Heightened volatility in interest rates and credit spreads have driven returns lower across the yield curve and most sectors.

Bond markets are reacting to a pivot by central banks toward a much earlier and quicker pace of monetary policy normalization than initially expected. That pivot is in response to inflation, which is proving persistent and poses risks to the upside. More recently, the geopolitical developments unfolding in Ukraine have added to economic uncertainty and volatility.

In our view, actively managed multi-sector strategies — particularly those with a focus on higher-yielding, short-duration securities — and floating-rate loans can provide opportunities to reduce interest-rate risk and potentially improve returns.

Bond market repricing quickly

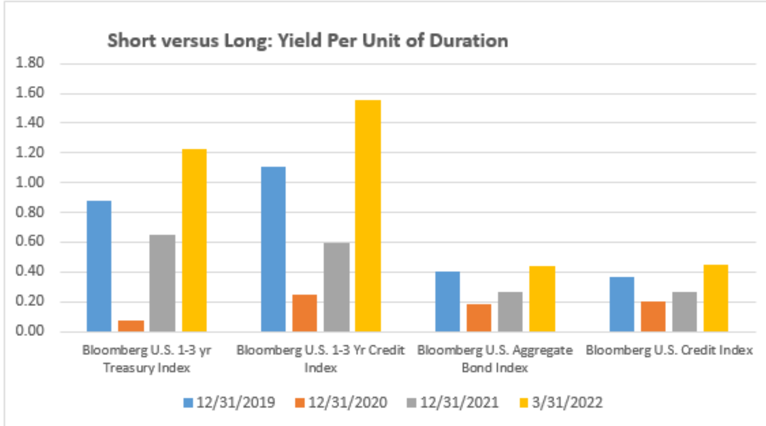
At the beginning of the year, market pricing implied the Federal Reserve would deliver three 25-basis-point interest-rate hikes in 2022. After the Fed began the rate-hiking cycle at its March 15-16 meeting, market pricing moved to suggest more than nine hikes for the year, implying moves in increments of 50 basis points. As a result, interest rates have risen across the yield curve, most noticeably at the front end. The two-year Treasury note is 189 basis points higher since the start of 2022. Such steepness at the front end of the yield curve is highly unusual at the beginning of a rate-hiking cycle, which could boost the draw of these securities for investors.

Consider risk-reward profiles of short-duration securities

We believe opportunities on the front end of the yield curve are now more attractive than on the long end, given the rapid repricing in the bond market:

- A significant number of rate hikes have already been priced in. Starting yields matter, as they cushion the impact of rising rates.
- Yields at the front end of the yield curve (1-3 years) look attractive relative to the longer end (10-30 years). Indeed, the flattening of the curve has left the front end providing considerably more yield per unit of duration risk — a measure of sensitivity to interest rates — than the intermediate and longer ends.
- Yields on many short-duration sectors are now materially higher than yields on longer-duration sectors — giving investors another reason to reexamine the risk-reward trade-off of short strategies.

Short-duration yields rise sharply in 2022 relative to long



Source: Bloomberg as of 3/31/2022.

Applying a multi-sector approach

Actively managed multi-sector strategies can provide further opportunities to reduce interest rate risk and potentially improve returns in a rising rate environment. To capture the best opportunities, we see value in overweighting certain securities typically not held in benchmark indexes, including:

Floating-rate securities: These securities feature coupons that reset higher as short-term rates rise — a feature that offers some principal protection, given their inherently very short duration. We find significant opportunities in the investment-grade part of this market, including U.S. money center banks and AAA-rated senior tranches in the non-agency commercial mortgage-backed securities (CMBS) sector.

Securitized assets: Asset-backed securities (ABS), such as consumer and auto loans, offer short durations and often amortize, paying down a portion of their principal each month alongside their coupons. In a rising rate environment, this allows investors to reinvest these proceeds at higher yields and can potentially reduce volatility, given the "pull-to-par" nature of the securities.

Short-duration high yield: Given our expectations for a strong economy and low default rates in 2022, we continue to focus on high-yield "rising star" candidates — issues moving from high yield to investment grade. We believe spreads on select BB-rated securities are attractive and should help mitigate interest-rate volatility with their higher yields. The potential for spread tightening on ratings upgrades could further enhance total returns.

Fundamentals favor companies and consumers

The sharp rise in interest rates has been accompanied by wider credit spreads in many sectors. We attribute this to broader market volatility and elevated bond supply in the market, rather than a deterioration in credit fundamentals. Corporate and consumer balance sheets are coming into this hiking cycle from a position of strength. Continued strong earnings growth and net cash positions built during the recovery should benefit corporations, while leverage in the consumer sector has declined. Strong employment and wage growth should help to at least partially offset the impacts of higher inflation.

As the inflation threat grows, so does the case for floating-rate loans

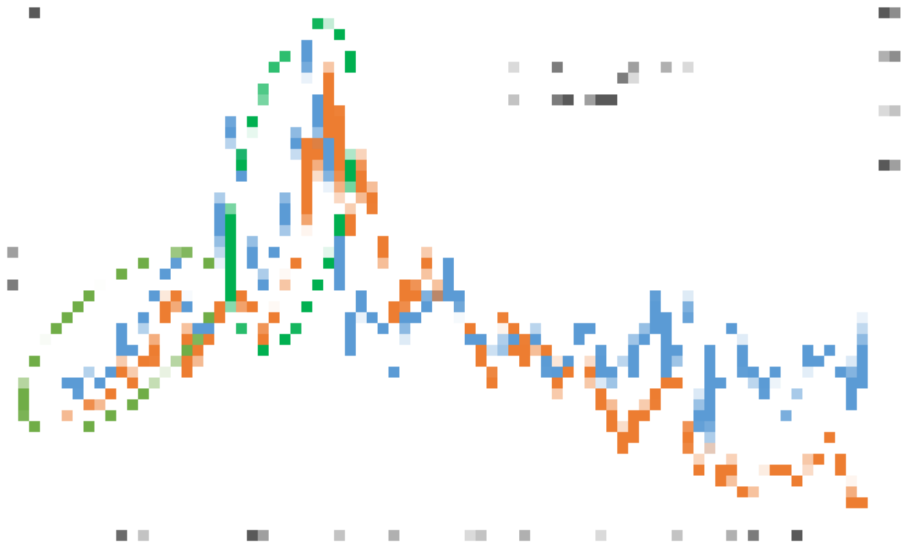
Floating-rate loans represent senior/secured obligations of a wide range of corporate issuers, with interest payments that float along with a short-term index such as Libor or Sofr. Because those indexes are highly correlated with the fed funds rate, and have a near-zero duration, loans can be a highly attractive asset as the U.S. Federal Reserve begins its tightening cycle.

In our view, today's market environment has only strengthened the case for the floating-rate loan asset class. The key for loan investors in this environment is to focus on issuers that are well-positioned to cover increased debt servicing costs, including companies with solid free cash low and flexible business models. In this kind of market, we believe investors will be better served by active loan managers, who can assess which companies are likely to thrive in an inflationary environment.

The relationship between the CPI and rates over the past six decades tells an interesting story. Overall, the relationship between the two has been close over much of that period (with a positive correlation of 0.66), though it has loosened in recent years as both rates and inflation have hovered near historical lows.

Note that during the inflationary decades of the 1960s and 1970s, however, the relationship was quite tight, with correlations of 0.96 and 0.83, respectively. Both decades were characterized by loose monetary policy and massive fiscal stimulus, reminiscent of the mix of policy conditions today.

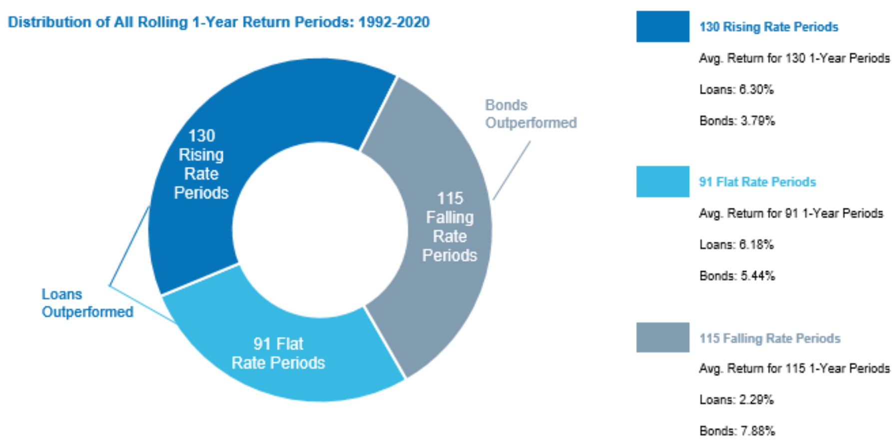
Inflation and rates were tightly linked in the 1960s and 1970s



Source: Federal Reserve Bank of St. Louis, Eaton Vance as of 5/28/2021.

Of course, the corporate loan asset class was only in its infancy during those long-ago inflationary decades. But in the 336 rolling one-year periods since 1992 (the inception of the Credit Suisse Institutional Leveraged Loan Index), loans have outperformed bonds, on average, during the 130 periods characterized by rising interest rates. That's because higher rates weigh on bond prices. There can be no assurances that rates will keep rising, so it is equally notable that loans outperformed bonds during the 91 periods in which rates remained range-bound. That's a function of the power of the loan asset class to generate potentially higher yields.

Since 1992, loans have outperformed bonds when rates are rising



Source: Eaton Vance, Credit Suisse, Bloomberg, U.S. Federal Reserve as of 12/31/2020. Data provided is for informational use only. Past performance is no guarantee of future results. It is not possible to invest directly in an Index. Loans are represented by Credit Suisse Institutional Leveraged Loan Index and bonds are represented by the Bloomberg Barclays U.S. Aggregate Index. Analysis includes all rolling one-year periods since inception of Credit Suisse Institutional Leveraged Loan Index in February 1992.

Bottom line: As both inflation and rates are likely to move higher in the foreseeable future, we believe floating-rate loans and short-duration securities within an active multi-sector strategy offer many investors an attractive opportunity to reduce interest-rate risk and potentially improve returns.

Bloomberg 1-3 U.S. Treasury Index measures the performance of U.S. Treasury bonds maturities of 1-3 years.

Bloomberg U.S. 1-3 Year Credit Index measures the performance of investment-grade U.S. corporate securities and government-related bonds with maturities of 1-3 years.

Bloomberg U.S. Aggregate Bond Index is an unmanaged index of domestic investment-grade bonds, including corporate, government and mortgage-backed securities.

Bloomberg U.S. Credit Index measures the performance of investment-grade U.S. corporate securities and government-related bonds.

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EV Forward

> Rising inflation, less accommodative central bank policies and heightened geopolitical risks have created significant market volatility in 2022. In this series, our investment teams offer their views on the opportunities and risks present for their strategies. As always, our goal is to seek fundamental value that helps build client wealth over the course of many business cycles.