Advisory Blog

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Floating-Rate Loans | Leveraged Credit | Multi-Asset Credit

Floating-Rate Loan Investors to Powell: "Thanks"

By: Andrew N. Sveen, CFA | & Christopher Remington | June 17, 2022

Boston - Things are looking up in loan land. In this "fixed" income asset class that floats, coupon streams are about to sweeten.

That's thanks to Jerome Powell's historic rate hike of 75 basis points. What's more, the Federal Reserve has plenty more in store for the front end of the yield curve. It projects continued hikes that will boost its policy rate to more than 3% by year-end and as high as 3.75% in 2023. That will carry yields on adjustable-rate investments higher.

Take our floating-rate corporate loan market: Rates in this asset class have an average reset period of just over 30 days, so watch for rising yields in this space between now and mid-July. Looking ahead from there, the Fed has four more FOMC meetings on the books — late July, then September, November and December — the Fed projects the cumulative effect of these will about double its policy rate from today's level. Rising yields should be a continued theme for floating-rate products well into next year.

Of course, the Fed is aiming to thread the needle. They hope that raising rates sharply will stave off inflation, but it also raises the specter of overcooling the economy and thus recessionary risks are now higher. Here in our market, we think of these risks in terms of probabilities and degree, assessing what's likely from what's already "priced in." Whether the Fed might deliver a soft landing or something harder remains up for debate, and well-reasoned investors make cases on both sides. We come out somewhere in the middle, and time will of course tell — it always does.

Meanwhile, let's start with what we know: How much damage is priced in? Take the average loan price of 94 and calculate the default rate needed to permanently erase 6 points of capital —which is the discount priced into today's market.

Using S&P's Global Loss Stats database, which tracks defaults and recoveries for high-yield bonds and loans over 34 years since the dataset's creation in 1987, our universe of first-lien term loans has realized an average recovery of 75% in default situations over the long run. This same figure for term loans issued post-GFC is 77%. Meanwhile, the number over the most recent trailing 12 months is a notably higher 84% (granted, a small sample set given the very low default environment) and last, we'll mention that recoveries during the 2020 pandemic period were 72%.

Working backwards from the 75% long run recovery figure, it would take a cumulative default rate of 24% to account for the 6 points of discount priced into today's market:

24% default rate x 25% loss given default = 6 points capital loss = today's discount to 94

For context, the default rate in the loan market peaked at 8%, 10% and 4% in the 2001-2002 tech wreck, 2008-2009 Global Financial Crisis and 2020 COVID periods, respectively. In other words, today's market is pricing in a multiple of the GFC and

over five times the COVID recession.

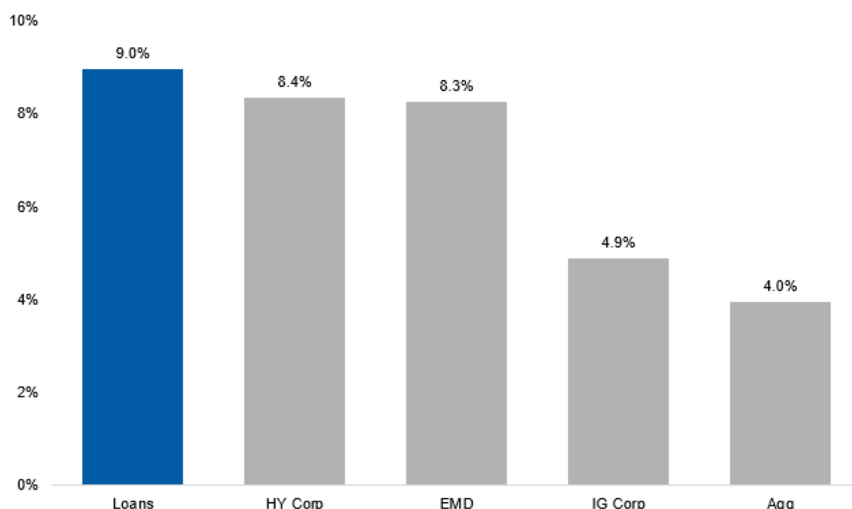
Meanwhile, the actual default rate (which is backward looking) is roundly 0. And the under-80 "distressed" bucket (which tends to look forward) is only 2% to 3% of the market. Loan manager surveys show expectations for defaults rising, but only modestly and into the low single digits. If defaults were to rise to 5% (more than the COVID experience), consider that they would need to rise five times more to breach the 24% already priced in. If defaults did rise that much, remember — it's already priced in. And in that environment, portfolios would almost certainly have bigger problems than their senior/secured broadly syndicated corporate loan portfolio.

No one can make perfect sense of the uncertain environment in which global capital markets find themselves. We do know that loan coupons are poised to rise, and by quite a lot. That part is easy. We also know that it would take an incredible amount of credit carnage to justify today's discounted price levels in permanent impairment terms. We see value in this asset class, and we believe the forward return potential from these levels is bright.

The yield to maturity chart below seems to agree. Consider the 9% YTM for the loan market presently. The build to this figure includes the sum of the credit spread, expectations for the short end of the curve and the accretion of the 6-point discount back to par. Subtract your own assumptions for defaults, and off you go with a reasonable baseline.

Bottom line: Inverted yield curves don't cause recessions, just like wet streets don't cause rain. So much is priced in, and for that reason we see the floating-rate corporate loan market as a buy. This is the very time and these are the very set of circumstances to own it.

Yield to Maturity: Loans' Prospective Returns Shine



Past performance is not a reliable indicator of results. Sources: Eaton Vance, ICE Data Indices LLC, JPMorgan, and Credit Suisse, as of June 15, 2022. Agg represents the Bloomberg US Aggregate Bond Index. IG Corp represents the ICE BofA US Corporate Index. HY Corp represents the ICE BofA High Yield Index. EMD represents the JPMorgan EMBI Global Diversified. Loans represents the Credit Suisse Leveraged Loan Index.

Credit Swisse Leveraged Loan Index tracks the investable market of the U.S. dollar denominated leveraged loan market.

ICE BofA U.S. High Yield Index is an unmanaged index of below-investment grade U.S. corporate bonds.

J.P. Morgan Emerging Markets Bond Index (EMBI) Global Diversified is an unmanaged index of USD-denominated bonds with maturities of more than one year issued by emerging markets governments.

ICE BofA US Corporate Index is an unmanaged index of investment grade U.S. corporate bonds.

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

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

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