FLOATING-RATE LOANS | LEVERAGED CREDIT | MULTI-ASSET CREDIT

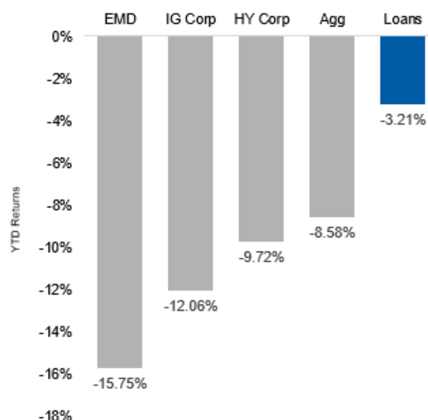
Floating-Rate Loans: Forward Return Prospects Appear Bright

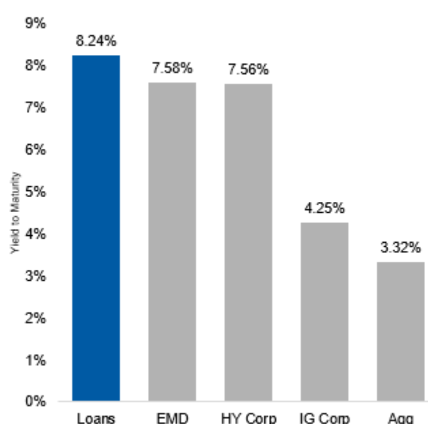
By: Andrew N. Sveen, CFA | & Christopher Remington | May 27, 2022

Boston - In our view, it remains a compelling time for floating-rate loans, with the current bout of weakness only improving the forward return potential for this specialty asset class. Here are a few observations about how loans are performing this year and how we see the situation in the asset class now.

They say a picture is worth a thousand words, and we think these two charts speak volumes. Notwithstanding the marked outperformance of senior loans in the global capital markets so far this year (left panel), their forward return prospects appear just as bright (right panel).

Loans continue to shine in a difficult environment





Sources: Eaton Vance, ICE Data Indices LLC, JPMorgan, Credit Suisse as of May 25, 2022. **Past performance is not a reliable indicator of results.** The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. 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.

Loans maintained notably positive year-to-date returns through the opening four months of the year, delivering all-important ballast to fixed income portfolios during a painful bout of rising interest rates. Returns across a range of bond benchmarks experienced double-digit percentage declines.

Circular loop of weaker loan technicals in May

Weakening investor sentiment in May and ongoing volatility in capital markets at large have finally caught up with loans to some degree, and loan prices have dipped about three points month to date. There are a variety of driving factors, all somewhat circular.

For example, rather than selling battered bond holdings, many high yield and multi-sector bond funds have met growing redemptions by selling loans, which have held up well. This has weakened the technical picture for loans, driving loan prices lower. That may have tilted the well-established loan fund inflow regime to outflows more recently, which in turn has weakened the technical picture, thus driving loan prices still lower.

It's easy to see how a loop like this can build on itself. Indeed, we've seen the cascade and its rebound many times over the decades.

High degree of pain already priced in

Fundamentally, there may be real questions about the credit cycle and whether policymakers can or cannot deliver a soft landing. Whatever the outcome, the important point for loans is that a remarkably high degree of pain is now "priced in."

Consider that the average loan price in the market stands at 93 to 94 as of May 26. Assuming a typical 70% recovery in cases of default, these levels equate to a 20-percentage-point cumulative default —well in excess of anything this asset class has ever endured in 30+ years. That includes the tech wreck of the late 1990s, the global financial crisis of 2008-2009 and the more recent COVID recession — among many others.

In the meantime, the actual 12-month default rate in the loan market is approximately zero. While default rates are backward-looking to be sure, leading indicators paint a supporting picture as well. Consider that the percentage of the asset class trading below a dollar price of 80 — a level considered to be "distressed" or more likely to experience credit trouble —was under 2% at the beginning of May and still remains in this range. We view that as a benign reading.

Keeping focus on discipline and defensiveness

As active managers, we remain as focused as ever on our loan portfolios and the underlying credits we own on behalf of our clients. We've always maintained discipline at the weaker end of the market, recognizing that recession-proofing portfolios is something best done when times are good.

We're maintaining that defensiveness now, as well as looking for swap candidates where value opportunities may present themselves. And we're busy engaging with our clients who naturally have questions or concerns in this environment. We trust that clients have largely been comforted by our continued high conviction in this space.

Darker side of high rates and inflation mitigated by key factors

Most conversations seem to center around the perceived darker side of higher interest rates and inflation — and the degree to which loan issuers can withstand these. For the *investor*, loans have showcased a history of effectively hedging these risks in portfolios. For the loan *issuer,* on the other hand, high rates and inflation are generally credit negatives, but the marginal degree is what's important. That's modest in our view, overwhelmed by key mitigating factors and of course the high starting yield.

For starters, the economy is strong and the EBITDA (earnings before interest, taxes, depreciation and amortization) measure of issuer financial performance sits markedly higher than pre-pandemic levels. Loan issuers entered this period with record high interest coverage levels, so they begin from a good place with a "cushion." Meanwhile, the closest maturity wall isn't until 2025.

What's more, loan issuers are less exposed to rising rates than one might think: More than 60% of issuers also have bonds in the capital structure, while street estimates suggest some 50% to 75% of loans outstanding have been swapped by issuers to fixed rate. Together, these are meaningful rate hedges.

In the final analysis, one of the most reliable forward return indicators in fixed income investing is starting yield. On that measure, we think loans are shining bright.

Bottom line: A little market indigestion is normal at times of heightened uncertainty. Investors are processing a new paradigm of higher inflation and rates — factors that favor investing in this asset class, by the way. The market ebbs, the market flows... buying on the ebbs has historically been rewarding.

Investing entails risks and there can be no assurance that any strategy will achieve profits or avoid incurring losses. Active management attempts to outperform a benchmark index and assumes considerable risk should managers incorrectly anticipate changing conditions.

Loans are traded in a private, unregulated inter-dealer or inter-bank resale market and are generally subject to contractual restrictions that must be satisfied before a loan can be bought or sold. These restrictions may impede the strategy's ability to buy or sell loans (thus affecting their liquidity) and may negatively impact the transaction price. It may take longer than seven days for transactions in loans to settle. Due to the possibility of an extended loan settlement process, the strategy may hold cash, sell investments or temporarily borrow from banks or other lenders to meet short-term liquidity needs. Loans may be structured such that they are not securities under securities law, and in the event of fraud or misrepresentation by a borrower, lenders may not have the protection of the anti-fraud provisions of the federal securities laws. Loans are also subject to risks associated with other types of income like high-yield bonds described above. Investments in foreign instruments or currencies can involve greater risk and volatility than U.S. investments because of adverse market, economic, political, regulatory, geopolitical, currency exchange rates or other conditions. Changes in the value of investments entered for hedging purposes may not match those of the position being hedged.

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