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Floating-Rate Loans | Leveraged Credit

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

By: Andrew N. Sveen, CFA | & Christopher Remington | June 2, 2021

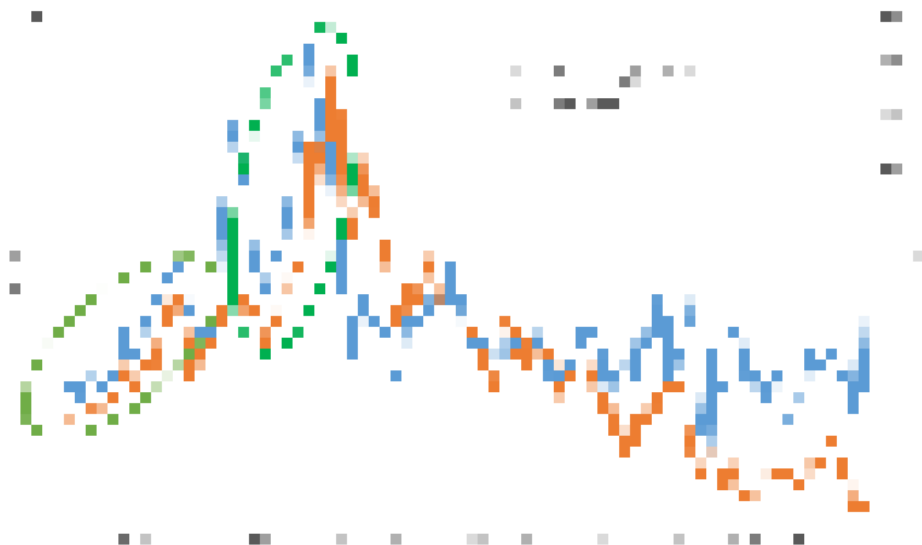
Boston - For most of the year, prospects for a new, post-COVID inflationary surge have only strengthened. In our view, so too has the case for the floating-rate loan asset class, both as a hedge against possible rising rates and a potential beneficiary of a resurgent economy.

Most recently, the April inflation report released on May 12 showcased higher-than-expected results. The Consumer Price Index (CPI) jumped 0.8% month over month (including food and energy) — well above the market consensus for a monthly increase of just 0.2%. That would be an annual rate of 4.2%.

For bond investors, the big question is how much upward pressure inflation could put on interest rates. 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 overall), 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

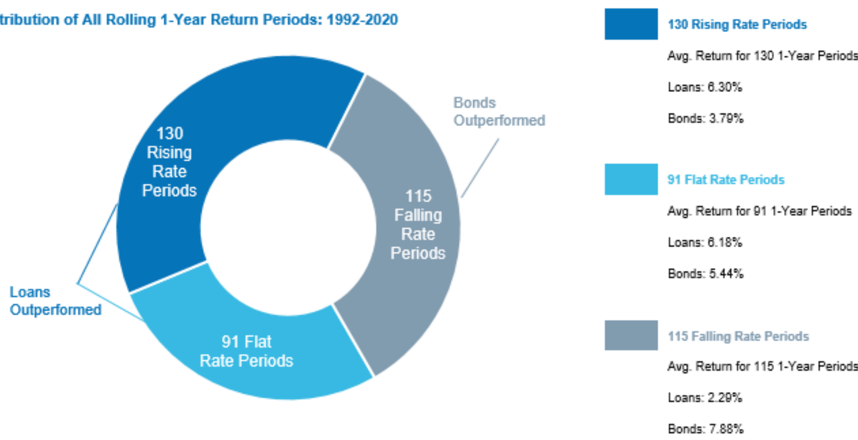


Sources: Federal Reserve Bank of St. Louis, Eaton Vance, 05/28/2021.

Of course, the corporate loan asset class was only in its infancy during those long-ago inflationary decades. But its performance during more recent rising rate environments, aided by its "floating-rate" feature, has been well established. As the latest example, the S&P/LSTA Leveraged Loan Index outperformed the Bloomberg Barclays U.S. Aggregate Index by more than 500 basis points (bps) during the first quarter of this year, when the yield on the 10-year U.S. Treasury almost doubled to 1.74%.

Looking back further, ample performance data allows for useful comparisons. 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. Of course, there are 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.

1Q21 was no fluke: Since 1992, loans have outperformed bonds when rates are rising



Sources: 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.

The other side of the bullish coin for loans is a strengthening economy. As credit instruments, improvement in the strength of the underlying issuers has typically been supportive of loan valuations. That's because better fundamentals tend to draw greater investor demand.

The trailing 12-month default rate on issuers in the S&P/LSTA Leveraged Loan Index peaked at 4.6% in September 2020. That would be impressive on its own in the context of the coronavirus pandemic and one of the sharpest recessions ever recorded. But the default rate has also fallen precipitously for the past seven months as the economy and issuer balance sheets have healed. Based on secondary-market trading, investors appear to be optimistic that the current default rate of 2.5% could be headed lower. The distress ratio, which is the percentage of loans trading below $80, is just 1%.

Bottom line: Much current debate centers on whether renewed inflation is likely to be "transitory," as the U.S. Federal Reserve maintains, or a more enduring consequence of massive COVID stimulus. Regardless of which scenario prevails, we believe loans can play a role in helping investors prepare for it. And in our view, the year-to-date performance of loans versus bonds may be the proof in the pudding.

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

Credit Suisse Institutional Leveraged Loan Index is an unmanaged index of the institutional leverage loan market.

S&P/LSTA Leveraged Loan Index is an unmanaged index of the institutional leveraged loan market.

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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