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2023 Investment Outlook: Floating-Rate Loans

By: EV Forward | December 14, 2022

The Paradox of Opportunity

KEY POINTS

1. Loans have outperformed every major equity and bond index, and offer a yield to maturity of about 9.4%, as of mid-November 2022.
2. Thorough credit research, as practiced by MSIM's floating-rate loan team, is especially important in this environment.
3. In 2023, loans offer the opportunity for high income, capital appreciation and participation in the rising rates that may lie ahead.

What We Are Seeing

Floating-rate loans present a bit of a paradox at the end of 2022. Through mid-November, the asset class outperformed every major equity and bond index by a wide margin. Yet there are good reasons to consider the asset class a cheap buying opportunity in 2023.

The core floating-rate feature of loans was highly attractive in a year when the U.S. Federal Reserve raised rates by 300 basis points. Loans escaped the downside peril of duration, while loan fund distributions nearly doubled from the beginning of 2022.

Investors flocked to loans trading at $98 and yielding 4.5%, based on the Morningstar LSTA Leveraged Loan Index. But now, with loans trading at about $93 and a yield to maturity around 9.4%, buyers are harder to find. Call it the paradox of opportunity.

What We Are Doing

We have always maintained that loans are an asset class exposure that benefits from the thorough due diligence of credit research and active management, especially in this environment.

Our investment team of 40-strong has re-underwritten our portfolio companies, gauging how they may be affected by today's set of risks, like higher input and debt service costs.

As part of this effort, we have resized or in some cases exited positions, where appropriate. Despite the spike in inflation and rising rates over the year, our "watch list" of credits — where we are truly concerned in the near term — remains limited.

What We Are Watching

For investors, the important question is whether the prices and yields on loans are compensating for the heightened recession risks in today's market.

We believe the answer is a solid "yes." In mid-November, loans had an approximate seven-point discount from par. Conservatively assuming that 70% of defaults will be recovered (historically, that number has been 75%), the discount in the market today implies a cumulative 23% default rate ahead.

For context, that figure is almost double the great financial crisis of 2008, and about five times the deep (albeit short) COVID recession. By contrast, the current default rate is below 1%. Though we expect annual levels to rise somewhat, it's clear to us that the market is oversold.

Historically, starting yield has been a good guide to total return. With a floating-rate load yield starting at 9.4% in November 2022, we believe returns that include capital appreciation in excess of coupon income may well be in store.

Bottom line: We'll never "call a bottom," and prices may be unpredictable in the near term. That said, we think loans trading at a deep discount elevates the opportunity for investors. It's a chance for high income, capital appreciation and participation in the rising rates that may lie ahead.

Andrew Sveen, CFA
Head of Floating-Rate Loans
Portfolio Manager

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.**

Morningstar LSTA US Leveraged Loan Index is an unmanaged index of the institutional leveraged loan market.

Risk Considerations: *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.*

EV Forward

"With a floating-rate loan yield starting at 9.4% in November 2022, we believe a 'coupon-plus' total return in 2023 may well be in store."

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