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Floating-Rate Loans | Leveraged Credit

2022 Outlook: Loans Take Center Stage as the Inflation Threat Grows

Boston - For the floating-rate loan asset class, 2021 was a year of superlatives, with any number of metrics at or near record levels, like issuance volume, demand, absence of defaults, and total loans outstanding. For us, the most important message from last year's buoyant market is that loans have been living up to the expectations of both investors and issuers.

In 2022, we expect many of the same positive dynamics to prevail, against a backdrop of generally positive credit conditions. While the Omicron variant highlights how the pandemic remains a major economic variable, we don't believe it will overcome the sweeping economic tailwinds and ongoing policy support.

Inflation concerns are also likely to persist in 2022, which moves loans — and their floating-rate capability — onto center stage for investors seeking to hedge the possibility of rising rates.

Over the course of 2021, as news of tightened monetary policy, rising rates and inflation periodically wracked the markets, and the Bloomberg Aggregate Index lost 1.54%, loans returned 5.20%, as measured by the S&P/LSTA Leveraged Loan Index. In a nutshell, this explains the advantage of the near-zero interest-rate duration of loans in today's environment (Exhibit A).

Exhibit A

Floating-rate loans and high-yield bonds rose to the top as other sectors sold off in 2021

	Total Return	Duration (years)	Yield on 12/31/21
High-Yield Bonds	5.36%	4.0	4.3%
Floating-Rate Loans	5.20%	0.0	4.2%
Municipal Bonds	1.52%	5.1	1.1%
Mortgage-Backed Securities	-1.04%	4.8	1.9%
U.S. Corporate Investment Grade	-1.04%	8.7	2.3%
Bloomberg U.S. Aggregate	-1.54%	6.8	1.8%
Emerging Markets Debt (hard currency)	-1.80%	8.0	5.3%
U.S. Treasury	-2.32%	7.1	1.2%

Sources: Eaton Vance, S&P/LSTA, Bloomberg, as of 12/31/21. 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 the S&P/LSTA Leveraged Loan Index, an unmanaged index of the institutional leveraged loan market. High-yield bonds are represented by the ICE BofA U.S. High Yield Index, an unmanaged index of below-investment-grade U.S. corporate bonds. Municipal bonds are represented by the Bloomberg Municipal Bond Index, an unmanaged index of municipal bonds traded in the U.S. Mortgage-

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"Loans can be not only an attractive source of income, but also a unique tool for portfolio diversification — especially when inflationary forces are building and the long duration of many bond sectors is a growing risk factor."

backed securities are represented by the Bloomberg U.S. Mortgage Backed Securities (MBS) Index, which measures agency mortgage-backed pass-through securities issued by GNMA, FNMA and FHLMC. The Bloomberg U.S. Aggregate Index is included as a broad measure of U.S. investment-grade bonds, and an unmanaged index comprising domestic investment-grade bonds, including corporate, government and mortgage-backed securities. U.S. Treasury is represented by the Bloomberg U.S. Treasury Index, which measures public

borrowing has extended maturities for issuers, while also lowering borrowing costs, both of which are credit positive.

For some idea of the magnitude of issuer enthusiasm, institutional loan volume for 2021 was a record $615 billion, topping the previous peak of $503 billion set in 2017, according to LCD.

Looking ahead

Earlier we noted that current yield is likely to provide most of the return — a "coupon clipping" environment. As of December 31, the yield to worst stood at 4.20%. While at the lower range of historical yields, that still makes loans the second highest yielding U.S. fixed income sector, next to the 4.32% on U.S. high yield bonds. And of course the yield on loans can float if short-term rates rise.

The challenges to growth prospects from the ongoing pandemic and continuing supply chain bottlenecks may also have an impact on credit conditions — pressure that will likely vary by sector and issuer. Loans are below-investment-grade assets, and even during strong parts of the business cycle we typically turn down about 75% of the deals we review.

Thus, our view is that the 2022 environment will be especially supportive of active management in the loan space. We believe that the credit exposure of an actively managed loan portfolio offers a better risk/reward profile than the interest-rate risk embedded in long-duration indexes like the Bloomberg Aggregate.

Regardless of what 2022 brings, loans have proven to be a remarkably resilient asset class over several decades of changing markets —since 1997, the Leveraged Loan Index has posted an annual total return of 4.9%.

Bottom line: With inflation playing a starring role as a major risk factor, we believe loans belong on center stage, deserving consideration for helping to conserve fixed income portfolios in rising rate environments.

RISK CONSIDERATIONS

Investing entails risks and there can be no assurance that any strategy will achieve profits or avoid incurring losses.

Floating-Rate Loans *- 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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