Eaton Vance Management

Timely insights from portfolio managers and industry experts on key financial, economic and political issues.

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Floating-Rate Loans | High Yield | Leveraged Credit

Credit market valuations imply improved fundamentals in 2021

Boston - High-yield corporate bond and floating-rate loan markets ended 2020 on the up, with a strong rally following news of vaccine efficacy in November. The loan market closed the year with a 3.1% total return, while the bond market was up just over 6%, aided by higher sensitivity to falling interest rates.

Default rates rose throughout the year, but they did not come close to the most pessimistic forecasts made in March and April. In bonds, we saw the trailing 12-month default rate finish 2020 north of 6%, while in loans it was touching 4%.

Two competing forces in 2021

Credit markets feel like they are starting 2021 in something of a tug-of-war between two competing forces:

1. Developed markets are in the midst of a significant additional wave of COVID-19 cases with increased restrictions in place across much of the U.S. and lockdowns once again in force in Western Europe.
2. Against this, rock-bottom interest rates, additional fiscal stimulus and the start of vaccination programs around the world have given financial markets much to be optimistic about.

More broadly for debt investors, we suspect credit feels like one of the only games in town for keeping yield in a portfolio. Historically, investors would not get excited about yields between 4% and 5%, but those yields are significant improvements on what's available in investment-grade markets. We have only to look at the European experience of the last decade for evidence of demand for sub-investment grade credit at these all-in yield levels.

With the loan market coming into 2021 at an average price just over $96, we think there is some capital appreciation to supplement the coupon income available in this market. In high-yield corporate bonds, we believe the rebound in economic activity has the potential to drive spreads a little bit tighter. However, both markets are susceptible to volatility as the pandemic continues.

Significantly, we saw net inflows return to the loan market in December after a year mostly dominated by outflows. The results of the Georgia Senate run-off have brought the theme of reflation back into focus, which may provide a technical tailwind for the floating-rate loan markets. With increased demand for the asset class, we expect a busier year for supply.

Looking across both markets, we think relative value is more finely balanced at the start of 2021, with opportunities for positive total returns. Though current valuations across credit markets imply an improved fundamental situation, they also point to the potential for higher prices ahead.

Picture of

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"For debt investors, we suspect credit feels like one of the only games in town for keeping yield in a portfolio."

Whatever appreciation potential exists is probably modest. Yet that's not likely to diminish the attractiveness of credits, as yields and spreads outshine much of what's on offer in today's yield-starved fixed income environment. In particular, we still see opportunities to lend to companies in some more challenged sectors such as leisure and gaming, focusing on those with both sufficient liquidity to weather the current economic disruption and a clear reason to exist in a post-pandemic world.

Bottom line: For our credit mandates with the most flexibility, we continue to look to collateralized loan obligations (CLOs) as a great place to pick up some extra yield and total return potential. And we believe that emerging markets — both sovereign and corporate bonds — are offering opportunities.

High Yield — About Risk: *The value of investments may increase or decrease in response to economic, and financial events (whether real, expected or perceived) in the U.S. and global markets. Investments in debt instruments may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. Investments rated below investment grade (sometimes referred to as "junk") are typically subject to greater price volatility and illiquidity than higher rated investments. As interest rates rise, the value of certain income investments is likely to decline.*

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