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Important to pick spots carefully in bifurcated loan market


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Boston - *Eaton Vance and its affiliates seek to actively capitalize on opportunities presented by volatile investor sentiment, while ensuring that the portfolio risk profile remains appropriate for the specific strategy. The following are excerpts from a recent conversation with Andrew Sveen, CFA, and Craig P. Russ, Portfolio Managers, Co-Directors of Floating-Rate Loans for Eaton Vance Management.*

What we are seeing: With still a month to go in the second quarter, the senior corporate loan market is en route to one of its best quarterly marks ever. After rallying 4.5% in April, the S&P/LSTA Leveraged Loan Index has gained another 3% in May — a 7.5% quarter-to-date mark reflecting the optimism across capital markets that COVID-related lockdowns will soon come to an end. If the quarter ended today, Q2 of 2020 would go down as the fourth-best calendar quarter for loans, ever — outpaced only by Q1, Q2 and Q3 of the banner 2009 rebound. This quarter could unseat one or more of these when all is said and done, and June performance will obviously be the key.

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Signals from nearby asset classes paint a hopeful picture: Equity markets are clearly discounting a strong economic rebound upon reopening. To be sure, the S&P 500 Index has rallied to now just 5% from its lofty start-of-year levels. Meanwhile, the bulls have returned to bonds as well, with credit spreads for many investment-grade issuers approaching their pre-COVID tights.

Here in the loan market, levels of stress have indeed receded as well. Yet the asset class remains at a still-deep discount: The average bid price of the loan index is approximately 88 at the start of June. This level is at stark odds with the rosy outlooks offered by other asset classes, as noted. Both extremes can't be "right." The loan market is currently priced for a forward cumulative default rate of roundly 40%. That's not a typo: A 40% default rate with 70% realized recoveries would equal a 12-point loss, or 88. Impairments at this level would be two to three times those of the financial crisis. If this were to actually play out, it's easy to imagine the peril for stock prices in such an environment, yet for loan investors today, it's already "priced in." Conversely — and much more likely in our view — if credit outcomes are less extreme, then loans could present continued upside potential. We view this as a "heads you win, tails you don't lose much" proposition for the loan investor.

What we are doing: The loan market remains bifurcated, with haves and have-nots whether by quality, by size or by sector. It's important to carefully pick one's spots, and that's precisely what we're focused on. On the new-issue front, we're taking the opportunity to participate where we see value. This is occurring at both ends of the spectrum: high-quality companies offering strong ratings and yields higher than would be typical (compared with issuances, say, three months ago), as well as some of the juicier double-digit yields on offer. We're also entertaining add-ons to existing portfolio loans, including some of the secured bonds just noted. As always, additions to our portfolios are weighted congruently with our assessment of risk.

Elsewhere in the secondary market, our analysts are squarely focused on their credits, working closely with portfolio managers to right-size positions. We continue to stress test our portfolio companies, assessing liquidity both in the near term and further out. We remain in touch with issuer management, and we are keeping our credit assessments fresh as we digest first-quarter business results and probable business impacts (and again, liquidity) looking ahead. Value determination is our main focus.

What we are watching: New-issue loan activity has continued to be muted — only a few deals here and there — and investor demand (for loans) has been similarly blasé, with retail funds remaining in modest net redemption mode and structured product creation relatively stalled at present.

In the meantime, there's been plenty to watch in the nearby high-yield bond market. A flood of investor money has returned to the high-yield space, and bond issuances have followed fast and furious. A good amount has taken the form of secured paper, and with shorter maturities too (i.e., a clear replacement for loans). The Fed's support and involvement is likely at play in the high-yield rebound, either directly (through buying) or indirectly (by bolstering investor confidence). We think it's largely the latter. Rates at zero and the Fed's massive pumping of liquidity into the markets have sent all sorts of risk assets higher. All considered, we think the loan market may be one of the best values out there.

Final word: We believe today's loan valuations adequately compensate for the inherent risks involved. The market is now pricing in default levels several times those seen during the financial crisis. If less than that sort of carnage materializes, loans may have inherent upside potential. And if that sort of carnage does materialize, the key today is that it's largely already in the price.

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

S&P 500 Index is an unmanaged index of large-cap stocks commonly used as a measure of US stock market performance.

It is not possible to invest directly in an index. ***Past performance is not a reliable indicator of future results.***

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