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Floating-Rate Loans | Leveraged Credit

Senior loans are off like a startled filly


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Boston - A positive and nearly coupon-clipping year for senior loans was remarkable in light of all the asset class endured in 2020. The S&P/LSTA Leveraged Loan Index finished with a calendar-year total return of 3.12% as loans overcame a viral pandemic, the ensuing forced shutdown of the global economy and a sharp technically driven selloff in the secondary market — a comeback that marks the latest test of this asset class's mettle.

Positives toward the end of 2020 included increasingly optimistic news on the vaccine front, receding questions on the U.S. political situation and expectations for greater fiscal stimulus and a reopening economy. As a result, the market's technical condition stayed strong through year end, with structured product creation remaining robust, while in December, retail funds experienced their first net monthly inflows since last January.

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Consistent with prior-month themes, higher-risk credits outperformed throughout the final quarter of the year, as lower-quality CCCs and the harder-hit COVID sectors rallied the most on the improving fundamental picture. Every one of the index's sectors was positive in December, with year-to-date losses pared significantly in challenged spaces such as leisure, oil & gas and retailers.

Coincident with the rising tide of prices across the asset class, levels of market stress continued to recede materially and at the close of the year were all but erased. To be sure, the percentage of loans trading below 80 fell to just 2.2% — its lowest reading in nearly two years. Meanwhile, the default rate fell to 3.83% on a trailing 12-month basis, less than a point above long-term averages.

Outlook for 2021

The loan market has entered the new year on a strong footing, benefiting from an accommodative Federal Reserve, a high probability of continued fiscal support, retreating shutdown risks (given the positive vaccine news) and the availability of relatively attractive yield potential in a global bond market largely devoid of this. We believe these factors taken together should be supportive of both fundamentals and the supply/demand balance for the asset class.

The availability of new vaccines notwithstanding, fundamental questions remain surrounding the speed and the degree to which populations can be inoculated. That will have important impacts on economic reopening and business results, and it could be months until the picture becomes clearer. We will be watching closely as developments unfold.

In the meantime, the capital markets appear to be discounting better times ahead, and the senior loan asset class is no exception. As an indicator, the average loan price for the index entered 2021 at 96.2, just 50 basis points short of pre-COVID levels in late February 2020. And now in January 2021, loan inflows are off like a startled filly as investors seek out not only yield producers, but also loans that have tended to fare well in periods of rising interest rates and higher inflation.

Though current loan valuations imply an improved fundamental situation, they could point to the potential for higher levels ahead. Whatever appreciation potential exists, we would underscore that it is modest. However, that's not likely to diminish the attractiveness of loans, as their yields, spreads and anti-bond characteristics outshine much of what's on offer in today's yield-starved fixed income environment.

Bottom line: Focusing on long-term investment goals and risk management is the best course to navigating this market in our view, which is why it's the centerpiece of our approach. With that lens, we think this asset class appears poised to benefit in the years ahead.

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

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