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MARCH 5, 2021

Floating-Rate Loans | Leveraged Credit

Value of loans as inflation hedge looms large amid bond market volatility

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Boston - *After a dramatic backup in U.S. Treasury yields in late February and early March, are we entering a new bear market in bonds? Our fixed income investment experts present their views on the market environment in a series of blogs, starting with floating-rate loans.*

For many fixed income investors, February 2021 was quite a wake-up call. The yield on the 10-year U.S. Treasury gained 45 basis points (bps) to 1.46% during the month — its largest one-month rise since 2016 — as concerns about the impact of stronger economic growth, massive stimulus and higher inflation expectations all came to the fore.

Though the short end of the yield curve weakened over the month as well, the real drama came on February 25, when the yield on the five-year U.S. Treasury note spiked by almost 40%, from 22 bps to 81 bps — the largest-ever one-day jump on record.

As we turned the corner into March, yields subsided modestly and the Treasury market calmed down. On March 4, however, stocks and bonds sold off again, following remarks by U.S. Federal Reserve Chair Jerome Powell.

"Recent bond market volatility should underscore that the ultra-low rate environment which has prevailed for so long can no longer be taken for granted — not even at the short end of the yield curve. Loans may offer an excellent tool for investors to prepare for the changing risk profile of today's bond market."

Possibility of renewed growth and reflation

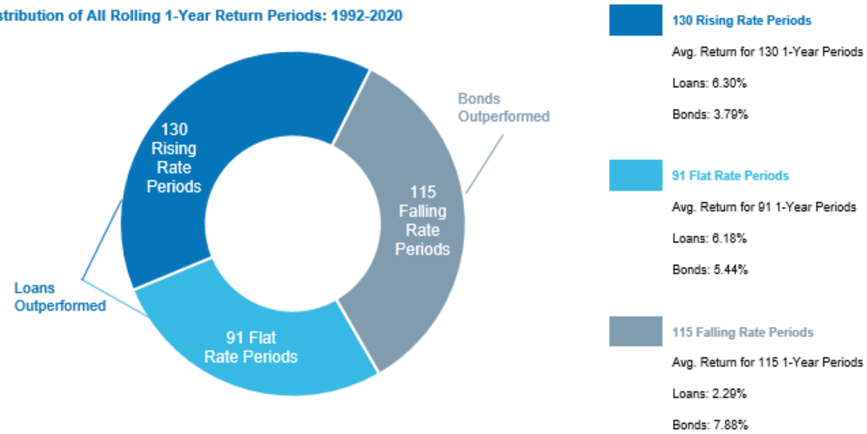
Despite recent volatility, we believe it's too soon to declare that the inflationary scenario is indeed the most likely one, given the many uncertainties surrounding the recovery's path. Nonetheless, we think one thing is clear: Investors may want to make sure that their portfolios are prepared for the possibility of renewed growth and reflation ahead.

One answer is the floating-rate senior loan asset class. These corporate loans offer investors a unique tool to prepare for an environment such as the one that appears to be unfolding. An improving economy boosts the financial strength of loan issuers, making it a conducive backdrop for allocating to corporate credit strategies.

At the same time, loans' adjustable coupon structure translates to virtually no interest-rate duration (price sensitivity to interest-rate changes), which is why loans have been one of the only asset classes spared amid the recent bond market volatility. The exhibit shows how loans have outperformed bonds in 221 of 336 rolling one-year periods since 1992.

Loans have outperformed bonds in rising-rate and flat markets alike

Distribution of All Rolling 1-Year Return Periods: 1992-2020



All these factors have helped push up inflation expectations over the past 12 months, as measured by the five-year breakeven inflation rate[1] now at 2.43% — its highest level since 2008.

To be sure, the jury is still out on whether rising rates and inflation will continue their march higher. There are indeed counterpoints — a weaker labor market, for example — but it will take time to know.

Bottom line: Recent bond market volatility should underscore that the ultra-low rate environment which has prevailed for so long can no longer be taken for granted — not even at the short end of the yield curve. Loans may offer an excellent tool for investors to prepare for the changing risk profile of today's bond market.

1. The breakeven inflation rate is a common metric for inflation expectations, and represents the difference between the nominal five-year U.S. Treasury rate and the real (adjusted for inflation) rate on five-year U.S. Treasury Inflation Protected Securities (TIPS).

Bloomberg Barclays U.S. Aggregate Index is an unmanaged index of domestic investment-grade bonds, including corporate, government and mortgage-backed securities.

Credit Suisse Institutional Leveraged Loan Index is an unmanaged index of the institutional leverage loan market.

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

All investing involves risk, including the risk of loss.

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.