Loomis on Loans

A quarterly look at data and topics in the syndicated loan market

IT'S A VOLATILE WORLD: WHAT YOU NEED TO KNOW

The first six months of 2022 have been volatile for financial markets. Increased inflation and rising interest rates coupled with geopolitical events have brought greater volatility and generally negative returns. The bank loan market has been pressured by broad market sentiment, ending the first half of the year with performance of -4.55%. While this compares very well to almost all fixed income and equity indices (see table as of 6/30/22), bank loans haven't been immune to market stresses of their own. Retail funds, the marginal buyers of bank loans, showed strong growth to start the year, and inflows persisted into May before taking a turn. With rates still likely to rise, a direct benefit to the bank loan category, why is the market seeing redemptions, and why are prices thus declining? What do we expect the default rate to look like for loans? Where will loans go from here? Let's take a look at some of those dynamics.

Loan prices held up better, so loans are being sold in order to buy assets that have declined more.

Expectations of rising interest rates tend to lead investors to bank loan funds. As loans are floating rate, the base rates used in calculating coupon rates for loans, LIBOR and SOFR, also increase, leading to higher coupon payments. This differentiates loans from other types of fixed income investments, and fund flows therefore generally benefit. As we said above, that's how 2022 began, but that shifted as the first half of the year went on, and steep price declines were seen in other asset categories. We believe that because loan prices held up so well, only dropping a handful of points from the start of the year, investors redeemed their bank loan holdings to redeploy that cash into other categories they believed were cheaper. That has translated into lower prices for the bank loan market, and those who need to sell are forced to accept those lower prices. While CLO demand is most often a stabilizing force for most of the loan market, they don't want to buy before prices have hit their lows, and so the market lingers in a waiting game. When the balance tilts back, loan prices often recover very quickly, as we've seen time and again in the loan market.

Rates are still likely to go up from here.

We believe loan buyers will come back to the market because we also believe Federal Reserve interest rate hikes are going to continue from here. The need to tame the effects of inflation through higher interest rates could go on for much of the next year. The value of higher interest income is very attractive for some investors, and so they are incentivized to come back to loans again and again. For other fixed income investments, the effect of duration could depress bond prices even further from current levels, making those categories less desirable as well. Finally, for those investors who fear a recession is on the horizon but are still willing to take some risk, many loans are preferable to high yield bonds given their senior and secured status in default scenarios, leading to better recovery of principal in many cases. Which is a good time to remember that…

RETURNS BY ASSET CLASS as of June 30, 2022

	Year-to-Date	Last Twelve Months
S&P/LSTA Leveraged Loan Index	-4.55%	-2.78%
BAML HY MASTER (H0A0)	-14.04%	-12.66%
10-Year Treasury (GA10)	-11.34%	-10.94%
S&P 500, Including Dividends (SPX)	-19.96%	-10.62%
BAML High-Grade Corp (C0A0)	-13.93%	-13.83%

Source : LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index, as of 6/30/22.

Past market experience is no guarantee of future results.

LOAN MARKET QUICK TAKE as of June 30, 2022

S&P/LSTA Index	2Q 2022 Return	Price	YTD Price Change	Nominal Spread
"All" Leveraged Loan Index	-4.45%	92.16	-6.48	351
BB Index	-3.11%	94.47	-4.78	276
B Index	-4.91%	92.05	-7.04	377

Defaults have to be triggered by a non-payment event.

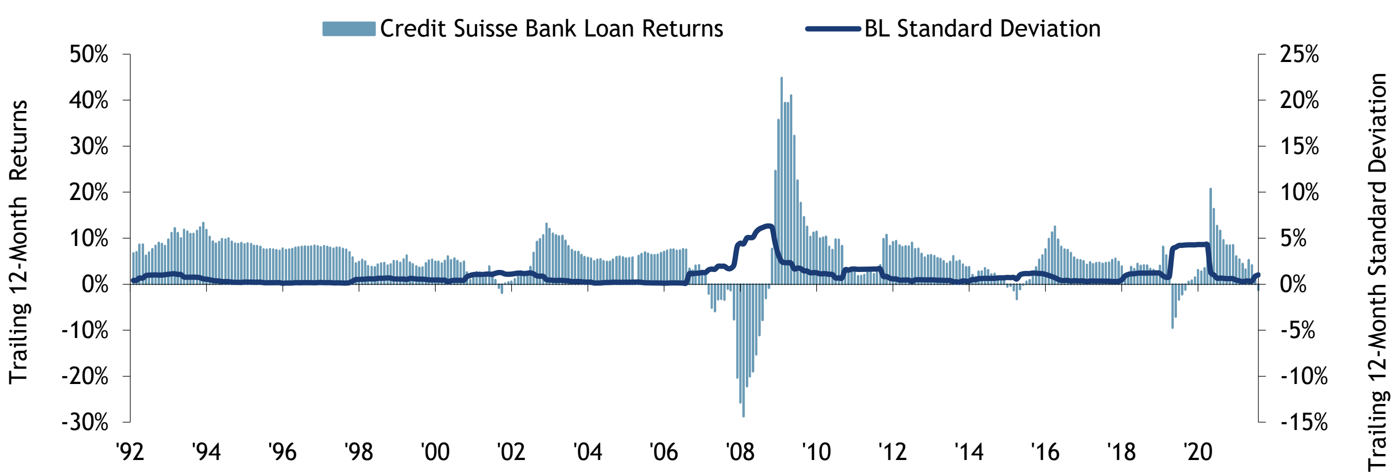
While there are reasons to fear the economy is headed for a downturn, there aren't many indicators that a recession will also cause a massive increase in default rates. Loans default mostly due to an inability to pay interest expense or a missed maturity payment. As we detailed in last quarter's Loomis on Loans, properly leveraged companies can weather many interest rate hikes under a variety of circumstances, so the likelihood of default due to missed interest payments is generally low. A loan maturity is a much larger bill to pay, but over 90% of loans in the index are scheduled to mature in 2025 and beyond. Without near-term maturities for most loans, they will likely have plenty of runway to refinance even if we should encounter a recession in the next couple of years. Therefore the bank loan market could get through a modest downturn without a significantly high default rate.

The "pull to par" is well tested over time.

While loan prices have drifted lower amid the technical volatility and recession fears in the market recently, historical events that have caused one-year returns to turn negative tend to be relatively short-lived for the bank loan space. In fact, there have only been two negative annual return years for the bank loan market, 2008 and 2015 (see below), both of which were followed by robust returns in 2009 and 2016. That phenomenon is partly driven by the need for loans to be repaid for many different reasons. Loans not only have quarterly principal paydowns crafted into the terms of the loan, but there are also excess cashflow sweeps that require further repayments, and many standard business reasons that cause loans to be refinanced and repaid. These factors help drive loans to have short average lives (we assume three years). So along with the natural march of time is a likely progression back towards higher prices for loans.

Trailing 12-Month Bank Loan Returns and Standard Deviation Since Credit Suisse Senior Loan Index Inception

As of June 30, 2022



The combination of macroeconomic and geopolitical events we've witnessed over the last six months is unlike any prior period in the bank loan market's history. It's impossible to say with much certainty that we know what will happen next. However, likely higher coupon income is among the loan market's inherent characteristics that suggest there is value for investors in multiple scenarios versus other fixed income assets.

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LET'S CHAT

Questions or concerns about the bank loan market?

Email Cheryl Stober to learn more.
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DISCLOSURE

KEY RISKS

Credit Risk, Issuer Risk, Interest Rate Risk, Liquidity Risk, Derivatives Risk, Leverage Risk, Counterparty Risk, Non- US Securities Risk, Prepayment Risk, Extension Risk and Management Risk.

Investing involves risk including possible loss of principal.

Diversification does not ensure a profit or guarantee against a loss.

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