Loomis on Loans

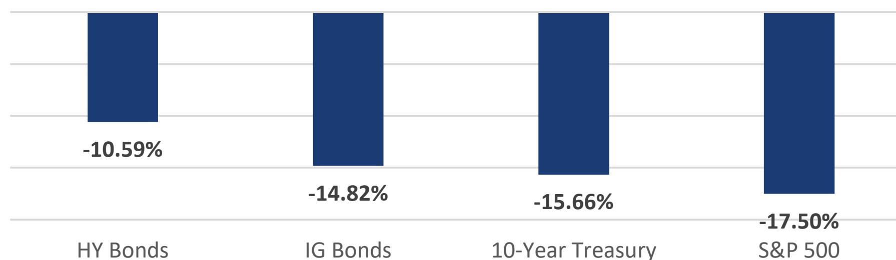
Turning Down the Static: Owning Loans in a Stable Rate Environment

The Fed has paused its rate-hiking cycles and the market is only pricing in 1-2 more interest rate increases this year. Some strategists even suggest that the Fed may be finished with altering interest rates for the rest of the year. Loans are typically seen as an asset class to own when rates are on the rise, but what is the case for owning loans when rates are static, staying at this level without much possibility for subsequent hikes? The answer here is yield.

What do we believe makes leveraged loans different?

Loan coupons are tied to short term interest rates, so they adjust up or down when those rates rise or fall. This makes them an efficient place to help shield against duration, or interest rate risk, when rates are rising. Fixed rate products like High Yield, Investment Grade, and US Treasury bonds all have varying levels of duration, so as rates go up, prices on these fixed coupon instruments go down (based on the rate differentials and putting aside credit thoughts). 2022 was a great example of this; the Fed raised interest rates over 4% last year, which raised rates down the curve, and this was seen in the performance of fixed coupon instruments. HY, IG, and US Treasury bonds' annual performance were all down relative to loans, which were the among the highest returners for the year.

2022 Relative Outperformance of Leveraged Loans



Source: Morningstar Pitchbook LCD, Bloomberg as of 12/31/2022

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Past performance is no guarantee of future results.

LOAN MARKET QUICK TAKE as of June 30, 2023

Morningstar LSTA Index	2Q23 Return	Price	YTD Price Change	Nominal Spread
"All" Leveraged Loan Index	3.15%	95.16	2.37	363.93
BB Index	2.81%	98.47	0.86	285.26
B Index	3.25%	95.68	3.13	390.31

Source : Morningstar LSTA Leveraged Loan Index, as of 6/30/23

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What do we believe could happen if interest rates remain at these levels?

If the Fed is close to finished with this cycle of interest rate increases, how should one think about loans? We still think loans are a good place to invest while we wait out the current economic uncertainty. Why is that? With rates at the level they are today, even with little possibility of future increases, the floating rate component of loan coupons gives the holder a good base rate (at this writing, the 1 month term SOFR base rate is 5.14%[1]) return in addition to the fixed portion of the coupon (the "spread"). The economy is proving to be more resilient than most had predicted, resulting in a constructive environment for risk assets like stocks, HY bonds, and loans. All are having a very strong YTD period return. This also means rates are expected to stay higher for longer.

At the beginning of this year, the market had been predicting a couple of rate cuts by year end, but the strength in the economy and stickiness of inflation mean those expected rate cuts have been pushed out into 2024. The market currently thinks year-end short-term rates will be higher than they are today. What does that mean for loans? The average coupon of the loan index (base rate plus average spread) is 8.78%[2]. With the currently available price discount from par on loans, this puts the current yield above 9% before factoring in potential price appreciation. Current yield is what an investor would earn if the price didn't change. That is compelling on a relative basis considering these loans do not have the duration pressure other instruments have, and considering they are senior and secured (versus high yield which are often not senior and rarely secured).

Index	Yield
Morningstar LSTA US Leveraged Loan Index	9.22%
ICE BofA US High Yield Index	8.35%
ICE BofA US Corporate Index	5.55%

Source: Morningstar Pitchbook LCD, Bloomberg as of 6/30/2022

What do we believe could happen if rates come down?

The real question is: why would the Fed cut rates? The Fed may cut rates to help facilitate a "soft landing." In this event, risk assets would most likely see prices increase (as a soft landing is a positive sign for risk assets). In this scenario, loan prices should likely go up from here, which means that loans would potentially earn more than the 9% previously noted, as there would now be a price appreciation component not previously considered. In this scenario, loans' floating portion of the coupon would go down with each rate cut, but the total return could go up due to price appreciation, thus leaving loans with a still attractive return.

The Fed may also cut rates because the economy is experiencing economic distress. In this scenario, risk assets' prices would most likely be under pressure (loans, HY bonds, equities). We have often observed that whatever happens in the HY market also happens to loans, only less-so for loans given their senior and secured place in the capital structure. Loans' floating portion of the coupon would be diminished by the rate cut and prices of loans would also go down, thus leading to a lower total return for loans than we see today. However, in this case, the prices of HY bonds would typically also go down and should go down more than the price of loans given that HY bonds are often unsecured. In this rate cut scenario, loan returns would shrink but HY returns should shrink relatively more. Equity direction is more uncertain.

The takeaway here is that, even with flat rates and little to no possibility of hikes, loans can provide a good yield, even without factoring in any price appreciation. With a rate cut, loans would still provide a good yield and, depending on the reason for the rate cuts, may fare relatively better than HY.

While we can't know what the future holds, we think rates will stay higher for longer, and we think there is good value in owning loans that are trading with a 9% current yield and at a discount to par.

[1]*Source: Bloomberg as of 6/30/2023*

[2]*Source: Morningstar Pitchbook LCD as of 6/30/2023*

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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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Sources: Morningstar, Bloomberg

IMPORTANT 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.*

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