MANAGER INSIGHT

DECEMBER 31 2021

Loomis on Loans

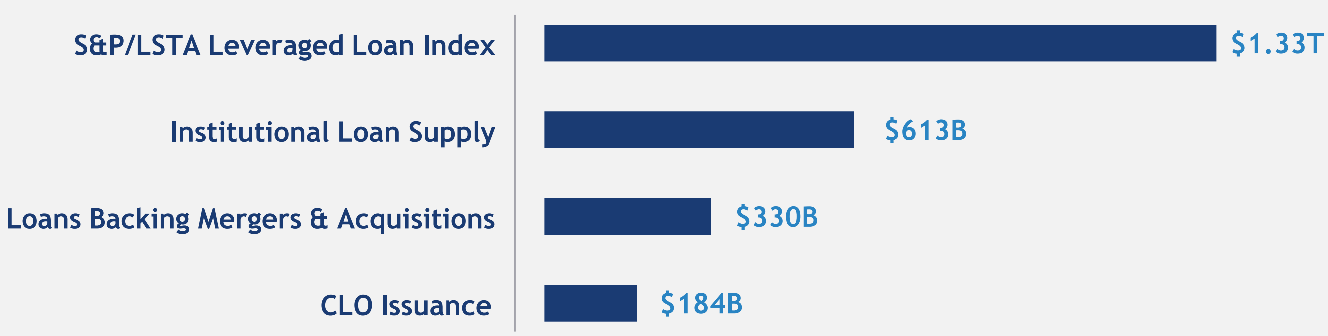
A quarterly look at data and topics in the syndicated loan market

INFLATION, DURATION AND LOANS: WHAT YOU NEED TO KNOW

With the depths of the pandemic recession likely behind us, but the economy struggling with supply chain disruptions and wage pressure, inflation has arrived and taken up residence of unknown "duration" in our lives. The Federal Reserve has targeted 2% inflation but market participants seem to be pricing in higher inflation rates for years to come. So how is that view of sustained inflation likely to affect the loan market and its participants? We'll explore that topic in this edition of Loomis on Loans.

As we look across our loan portfolios, we see an overwhelming proportion of borrowers in very good economic shape. They rationalized costs during the pandemic, built liquidity, and generally did quite well on the top line, since we did not have high exposure to companies most harmed by lockdowns and lack of travel. That means most of our credits appear well positioned to handle the initial twin effects of potentially higher interest rates and higher cost inflation. We have been reading lots of management commentaries and analyst reviews on the effects of inflation in recent earnings reports. The general takeaway is that a lot of prices are being raised, sometimes multiple times over months, to offset cost headwinds. That is the leap-frogging nature of inflation, and we do not know when it will settle down, though the longer it continues the more likely it is that the Fed raises rates to slow its roll.

In 2021, **STRONG CORPORATE FUNDAMENTALS, LOW DEFAULTS AND ROBUST DEMAND** Combined To Create The Right Conditions For Several Records In The Loan Market:



Data Source: S&P Capital IQ LCD through 12/8/21

LOAN MARKET QUICK TAKE

S&P/LSTA Index	2021 Return (%)	Price	3-Mo. Price Change	Nominal Spread
"All" Leveraged Loan Index	5.20	98.64	0.02	372.03
BB Index	3.12	99.25	-0.12	293.07
B Index	5.22	99.08	-0.25	400.93

Source : LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index, as of 12/31/21.

Past market experience is no guarantee of future results.

Rising rates have generally created more demand for the bank loan asset class. Once a loan's base rate (formerly LIBOR and going forward Sofr) surpasses its rate floor[1], the full coupon floats with the base rate, and so rate increases are passed along to investors while the price of the loan typically remains unaffected by rate moves. This relationship does not apply to fixed coupon securities, for which the concept of duration estimates the arithmetic sensitivity of bond prices to interest rates. For example, a hypothetical bond priced at par with a 5% coupon and a 3-year duration could see a price drop of 3% if rates were to increase by 1%. That would mean the bond's price would fall to 97, offsetting more than half of the bond's annual coupon income. Because loans lack duration their prices do not typically move up or down due directly to interest rate changes, allowing investors to get a better return potential than bonds at an equal coupon when rates rise.

Given loans' lack of duration risk, the loan market tends to see an increase in demand from many investors leading up to and during a rising rate environment. An increase in overall demand should lead prices to increase. However, as Collateralized Loan Obligations (CLOs) have become the dominant buyers of loans, and CLOs are incentived to buy loans below par, the average price of loans has remained just below par over the last year even as high yield bond prices extended well above par. If non-CLO loan demand rises with rates so that average prices do move towards 101% of par, there may be a repricing wave, where companies are able to lower their interest costs and thus erode some of the benefit of a newly-implemented rate increase. However, even in that scenario, the prices of loans should still be well supported in comparison to the price of bonds with duration.

Inflation and duration tend to be perceived by the markets as negative factors, but bank loans should benefit from extra demand under these scenarios. While higher rates may impact equity valuation models (an additive effect to any pressure on their earnings from cost pressures) and bond prices via duration, unless Fed actions lead to a recession we think default expectations will remain muted and so loans should fare relatively well. We think investors should consider loans as part of their inflation tool kit.

[1]*The majority of new issue bank loans feature a floor above the base rate, whether that is LIBOR or Sofr. Most floors are between 50 and 100 basis points.*

FIXED BONDS CARRY INTEREST RATE PRICE RISK
IF RATES RISE, FIXED-RATE BOND PRICES FALL AND COULD LOWER RETURNS

	AS OF 12/31/2021			25 BPS RATE INCREASE^		50 BPS RATE INCREASE^		100 BPS RATE INCREASE^	
	PRICE	DURATION	YIELD*	POTENTIAL PRICE POINT MOVE	POTENTIAL IMPACT ON TOTAL RETURN	POTENTIAL PRICE POINT MOVE	POTENTIAL IMPACT ON TOTAL RETURN	POTENTIAL PRICE POINT MOVE	POTENTIAL IMPACT ON TOTAL RETURN
INVESTMENT GRADE	109.14	8.34	2.35%	-2.28	-2.08%	-4.55	-4.17%	-9.10	-8.34%
HIGH YIELD	103.31	4.04	4.32%	-1.04	-1.01%	-2.09	-2.02%	-4.18	-4.04%
LOANS	98.64	0.10	4.49%	-0.02	-0.03%	-0.05	-0.05%	-0.10	-0.10%

- While at least one source[1] assumes a duration for floating rate instruments, we have studied this issue and found loans have had a duration of zero consistently over history.

Indexes used: ICE BofA US Corporate Index (C0A0), ICE BofA High Yield Index (H0A0), S&P/LSTA Leveraged Loan Index
^The scenarios shown are hypothetical only and are not predictive of future events. The use of hypothetical scenarios and forecasts has inherent limitations, including but not limited to, their inability to reflect the impact of actual trading on a portfolio or economic and market factors on investment decisions. They rely on opinions, assumptions and mathematical models, which can turn out to be incomplete or inaccurate. These opinions and assumptions are often based on past events and do not consider unforeseen events or developments. They assume that bonds are purchased at current valuations and held throughout the period rather than traded, which would not be the case with an actual portfolio. We make no representation that this is the expected return of any portfolio and you should expect actual performance to differ. Scenarios do not deduct trading costs and other fees and expenses.
[1]The Handbook of Fixed Income Securities by Frank J. Fabozzi
**High yield YTW, Investment Grade effective yield, 36-month loan yield*
Assumptions: Price point changes assume parallel shifts in rates and equal price point changes for equal increases or decreases in interest rates. Assumes interest rate is the only factor influencing price. Assumes yield as of December 31, 2021 remains constant.

Past market experience is no guarantee of future results.

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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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Indices are unmanaged and do not incur fees. It is not possible to invest directly in an index.