Loomis on Loans

Man vs. Machine - Risk Timing in the Loan Market

No, this will not be about AI.

Long time readers of Loomis on Loans know that within the loan market, the Bank Loan team believes that the risk bet is the key bet. Most loans trade near par most of the time due to lack of interest rate risk (duration), and because loans are senior, secured, and tend to have short average lives. That par-trending price is regardless of rating, since lower-rated loans have higher coupons to compensate for the additional risk. Therefore, security selection becomes more of a factor in times of stress, when default avoidance becomes more pressing. Under normal market conditions, in order to outperform a loan index, portfolio managers must choose whether to lean toward or away from risk.

The classic indicators of risk timing, spreads and ratings mix have proven not to be very reliable. As discussed in our Loomis on Loans, "Default Rates and Losses: The Big Picture Can Miss a Lot"(9/30/2020), low prices/high spreads often do not correlate well with high defaults. We have also observed that CCC downgrade waves (such as in the pandemic) can be overdone. Given that thinking, many years ago the Bank Loan team at Loomis Sayles developed a proprietary model (constructed with data and observed with human judgment) to help guide us on risk timing. Affectionately, we call it RORO, shorthand for "risk-on, risk-off." When risk is on, bank loan managers might feel more inclined towards riskier portfolios, and vice versa.

After testing a myriad of factors, we decided that factor models are too inconsistent when it comes to loan prices, and that we should focus on loan market internals (relative price movements) instead. We won't give away our special sauce, but from a high level, the point of the model is that loan market participants either feel good or bad about risk. We believe it is useful to know as quickly as possible when the risk tide has turned, regardless of the reason.

At the time of this writing, RORO is strongly signaling risk-on, and it has been for a while. But is it right? All the market has been talking about for 18 months is recession risk. How do we reconcile the risk outlook of humans versus the risk message of our model?

The answer is that we disagree with RORO. We think it is being fooled by market technicals that conflict with loan fundamentals. Specifically, the concern of recession has greatly limited the new issue market for loans since 2022, while rising rates and CLO market technicals have strongly supported loan demand. When demand exceeds supply, prices rise, and that's been the case this year.

LOAN MARKET QUICK TAKE as of September 30, 2023

Morningstar LSTA Index	3Q23 Return	Price	YTD Price Change	Nominal Spread
"All" Leveraged Loan Index	3.46%	95.36	2.57	367.68
BB Index	2.21%	99.06	1.45	292.51
B Index	3.85%	96.95	4.40	392.80

Source: Morningstar LSTA Leveraged Loan Index, as of 9/30/2023

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Past market experience is no guarantee of future results.

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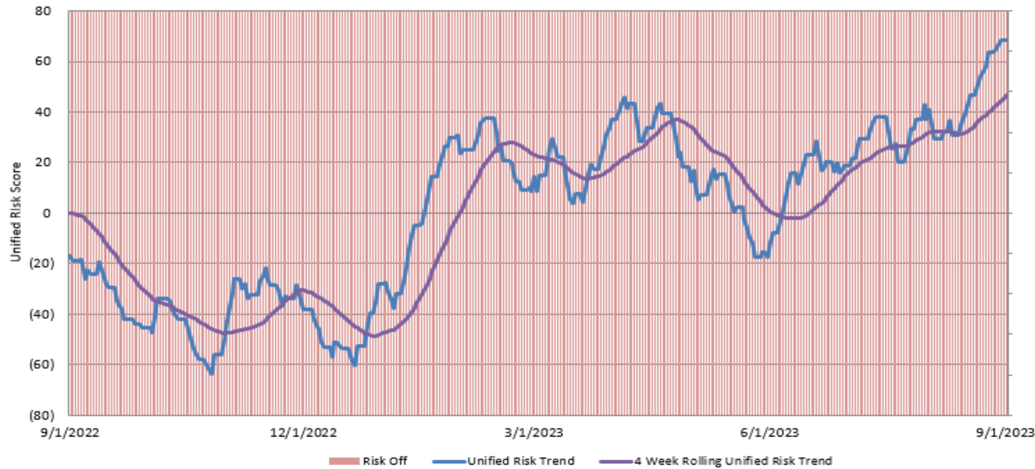
And so RORO is showing us this:



Source: Morningstar Pitchbook LCD

When RORO is showing a result above 28, that has historically indicated a risk-on market. RORO at its current level suggests a very strong risk-on market, and indeed higher-risk loan strategies have strongly outperformed in 2023 after underperforming in 2022 (although still returning significantly more than most other asset classes). But we view this as a technical trading pattern, not a confirmation of fundamental views. The market has performed this way despite the fundamentals, not because of them.

We've observed this scenario before, where the market technicals felt more positive than the investor sentiment around it. Below is what RORO showed in the pandemic. This period of 2020 was very scary as people were dying all over the world and a vaccine was a distant hope. But the market quickly decided that a supportive Fed would be enough to tide us through to vaccines in record time. We think that was due partly to how much money was made from the Global Financial Crisis recovery; aggressive portfolio managers wanted to get to the head of the line this time. But it also reflected what proportion of the loan market did not have a reason to sell, e.g., Collateralized Loan Obligation managers, who do not have flows and make up about 70% of the loan market. After some loan retail investors fled to cash in the spring of 2020, the loan selling was mostly over, and bargain hunters were looking for offers that did not exist. So RORO indicated risk-on in a world that felt very much risk-off, and the model was "right" because the fundamentals came through surprisingly quickly.

Source: Morningstar Pitchbook LCD

We think we are right again now, that RORO is again being fooled by loan technicals. RORO suggests we are wrong and good times are here to stay. In this particular case of man vs. machine, they who have the buttons have the power, but we also have the humility to know we could be wrong. That is the reality of being a portfolio manager.

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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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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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