Following a strong year for loans, it’s back to the (floating) future

- In 2016, floating-rate loans rebounded from two subpar years with a total return of 10.2%, or about twice the long-term average, as nearly two years of retail fund redemptions abated.

- Strong performance in 2016 was underpinned by solid fundamentals: a stable and improving economy, reasonable corporate cash flow, contained leverage and below-average default rates.

- We see 2017 as having strong potential for loans, with credit conditions largely in check and income predominantly driving returns. The stage is set for upward adjustment in loan yields, now that Libor has advanced to the level of the Libor floors on many loans.

- With signs of both stronger growth and inflation, retail and institutional investors may continue to be drawn to the sector, helping to keep the market’s technical balance strong, looking ahead.
In this Q&A, Craig Russ and Ralph Hinckley discuss their perspective on the market, and what they see ahead for 2017.

In 2016, the floating-rate loan market reversed course from two subpar years in 2014 and 2015, with a total return of 10.2% for the S&P/LSTA Leveraged Loan Index\(^1\), or about twice the long-term average. Ralph, can you give some perspective on what drove these outsized gains?

Floating-rate loans are by-and-large “par instruments,” with average maturities of about three years and historical long-term repayment of principal at more than 99% (including recoveries). So the kind of relatively large capital gains experienced in 2016 usually are the result of a historically consistent pattern: Negative sentiment and/or uneven technical factors result in large (but temporary) discounts from par. Those factors abate, discounts shrink and gains ultimately follow.

In this case, the pattern began in 2014 and 2015 with mutual fund investors exiting the asset class. Having poured $75 billion into the sector in 2013 in search of yield, fund investors then pulled out $51 billion in the next two years. Loan funds fell from a peak market share of 25% in 2014 to just 16% at year end 2016. In contrast, institutional loan investors – who have been and remain the bulk of the market – provided a relatively constant source of demand during these past few volatile years. Weighed down by the flight of retail investors, the floating-rate loan market began 2016 trading at an average price of around $91.

Outflows persisted through mid-year. However, positive flows began in July and picked up steam in the fourth quarter, with cumulative second-half net inflows to mutual funds of about $17 billion (Exhibit A). Investors were buoyed by a firming economy, greater confidence in the credit outlook and the prospect of rising rates. Institutional demand (represented in Exhibit A by CLO formation) remained steady. On the supply side, most issuances in 2016 were repricings and refinancings that added little to outstandings – the market started and ended the year at about $870 billion and $880 billion, respectively.

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Exhibit A 2016 saw the return of retail investors to the loan market.
Visible sources of demand

![Exhibit A](source-image)

**Source:** BofA/Merrill Lynch, 1 December 2016.

\(^1\)The S&P/LSTA Leveraged Loan Index is an unmanaged index of the institutional leveraged loan market. Data provided are for informational use only. Past performance is no guarantee of future results.
By year-end, the favourable supply/demand imbalance helped push up the price of the S&P/LSTA Leveraged Loan Index to 98.2, as of 31 December 2016, while spreads compressed to below their long-term average (Exhibit B). At the margin, the rebound in commodity prices also benefited the floating-rate market: The oil & gas and metals & minerals sectors were up 44.9% and 42.2%, respectively. When the dust settled for 2016, the overall 10.2% return came from income and capital appreciation in roughly equal measures.

Libor floors have helped maintain income for loan investors during the post-financial crisis period of ultralow rates. Craig, are rates reaching the point where they will exceed the floors and start to float higher again?

In all likelihood, yes. About two-thirds of outstanding floating-rate loans have a floor of 100 bps, a level that until recently three-month Libor had not touched since May 2009. Libor hit bottom in May 2014 at 22 bps, and began advancing with the first U.S. Federal Reserve hike in...
December 2015 (Exhibit C). Libor’s rise accelerated in July 2016 – even before the Fed’s second hike in December – as new money market fund regulations had the indirect effect of pushing up banks’ short-term borrowing costs. (Libor’s level is determined by those costs.)

Libor floors have served a valuable role in providing a minimum rate for investors in addition to the credit spread that is negotiated at loan issuance. They have had the paradoxical effect of creating floating-rate loans that haven’t floated in several years – a paradox that may end for most loans in 2017, assuming the likely scenario of continuing Fed rate hikes.

Ralph, how did the fundamentals of loans and issuers contribute to 2016 performance?

The strong performance of loans in 2016 was underpinned by solid fundamentals among issuers in the S&P/LSTA Index. Total leverage remains contained – down from peaks in 2011 and 2012, and mostly in a range around 6.0x since 2014. Interest coverage still remains near all-time highs – a reflection of both the low interest-rate environment and conservative deal structures (Exhibit D).

The leverage picture has remained relatively unchanged for several reasons:
- Guidance from regulators
- Investor aversion to risk
- The predominance of refinancings, which maintain the balance sheet status quo

Cash flow growth (represented by EBITDA) is down from the heady years after the financial crisis (Exhibit E). Since mid-2014, as GDP growth has softened, so has EBITDA growth. However, the prospect of stronger growth and/or higher inflation in 2017 could bode well for a return to larger gains in cash flow, further bolstering fundamentals.

Defaults remain below their long-term average rate. After the spike represented by the large 2014 default of Energy Future Holdings rolled off the trailing-12-month calculation in March 2015, default rates fell below the long-term median of about 2% and finished 2016 at 1.6%, a 10-month low (Exhibit F). Keep in mind that, historically, more than 70% of principal in default has been recovered, so the net credit loss to investors over the past year would have been about half a percentage point, assuming that recovery rate.

**Exhibit D** Credit picture: Interest coverage is near all-time highs and leverage is contained.

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Source: S&P/LCD as of 31 December 2016, based on corporate issuers in the S&P/LSTA Leveraged Loan Index, an unmanaged index of the institutional leveraged loan market.
Ralph, what does market composition tell us about the shape of the asset class going forward?

The composition of the loan market, as represented by pricing tranches, broadly reflects the positive 2016 trends in supply, demand and fundamentals. As shown in Exhibit G, just 1.3% of loans traded at par and above in January 2016; by December 2016, that figure had risen to 68.3%. At the same time, loans trading at 70 and below fell from 7.5% of the market to 1.8%. Because the lowest-priced loans are usually the source of future defaults, their reduced number signals to us that defaults are likely to be contained in 2017.

Craig, how has Donald Trump’s election changed your view of the economy?

Trump’s surprise victory in November 2016 sparked an equity rally, an increase in interest rates and boosted inflation expectations – like a switch being flipped. It’s

Exhibit E  Cash flow growth has cooled, but could improve with stronger GDP.

Sources: S&P/LCD, St. Louis Federal Reserve Bank, as of 31 December 2016, based on the S&P/LSTA Leveraged Loan Index, an unmanaged index of the institutional leveraged loan market.

Exhibit F  Default rates: Below long-term median.

Source: S&P/LCD as of 31 December 2016, based on the S&P/LSTA Leveraged Loan Index, an unmanaged index of the institutional leveraged loan market. Data provided are for informational use only. Past performance is no guarantee of future results.
important to note that the shift in postelection market sentiment didn't change credit fundamentals, which, as we have noted, have remained broadly positive. Fundamentals could further improve if Trump’s growth-oriented policies pan out, including corporate tax cuts, fiscal spending on infrastructure projects and deregulation. In combination, these could deliver a welcome dose of real growth and inflation.

On the other hand, Trump has also engaged in protectionist talk. If his policies go that route, it could invite retaliation by trading partners, which could undermine global (and U.S.) growth, accelerate inflation and weigh on global financial markets. We would assign lower probability to this scenario.

Ralph, could you share your outlook for the loan market in 2017?

The environment in 2017 is likely to be a favourable one for floating-rate loans.

- **Credit risk likely to remain contained.** Defaults are likely to grind modestly higher, in line with the 2.4% estimate for September, based on S&P/LCD’s recent quarterly survey of loan managers. This is modestly higher than the default rate’s long-term average, but it is reasonable for this stage of the credit cycle. Moreover, it may prove to be a conservative estimate if Trump’s growth-oriented policies extend the cycle.

- **Income likely to drive returns.** With loan prices fairly close to par, the potential for price appreciation is modest in 2017 – total return is most likely to reflect the coupon’s level. Keep in mind that the benefit of the floating-rate coupon structure can become particularly compelling in a rising-rate environment – even more so if strengthening prospects for growth and inflation result in more aggressive tightening by the Fed. Over the past 10 years, three-month Libor has been 0.97 correlated with the effective federal funds rate, based on data from the St. Louis Federal Reserve Bank.

- **Investors likely to perceive relative value.** Trillions of dollars are invested in low-yielding, long-duration debt. Given that loans are one of the highest-yielding

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**Exhibit G**  
Growth in par-and-above loans reflects the loan market’s strength in 2016.

![Chart showing growth in par-and-above loans](source)

**Source:** S&P/LCD as of 31 December 2016, based on the S&P/LSTA Leveraged Loan Index, an unmanaged index of the institutional leveraged loan market. Data provided are for informational use only. Past performance is no guarantee of future results.

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domestic sectors, (modestly behind high-yield bonds, with markedly lower risk), we believe that the asset class will continue to attract investors.

**Craig, is this a good time for investors to consider loans?**

Yes. Floating-rate loans are designed to work for investors across the credit cycle. Because they are senior and secured in the issuer’s capital structure, loans can mitigate credit risk in a weakening economy. In a stronger-growth, higher-inflation environment – like the one we may be facing – investors can participate in higher returns as rates rise. This year may be an attractive time for investors to establish – or add to – floating-rate loan positions.

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