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US Bank Loans – Attractive Yield without the Rate Risk

Summary

Due to their floating rate coupons that move directionally with short term interest rates, bank loans are used as a hedge against rising interest rates in addition to a source of yield. When US economic growth began slowing in late 2018, prospects for US Federal Reserve (Fed) easing prompted investors to flee bank loan funds. From July, 2019 to March, 2020, the Fed slashed rates five times bringing the lower bound of the Fed Funds rate from 2.25% to 0%, extending the exodus from loan funds. As of November 30, floating rate loan funds experienced 26 consecutive monthly net outflows totaling over $84 billion. However, with short term rates currently near zero, bank loans have little remaining downside to falling rates due to their imbedded floors. Meanwhile, credit fundamentals have started to rebound and should continue to improve in 2021 on receding COVID-19 risk and rebounding economic growth. At an average price below par and 5.1% yield, we believe loans offer attractive absolute and relative value while providing insurance against future rate increases.

Declining Rates Created a Headwind for Loans

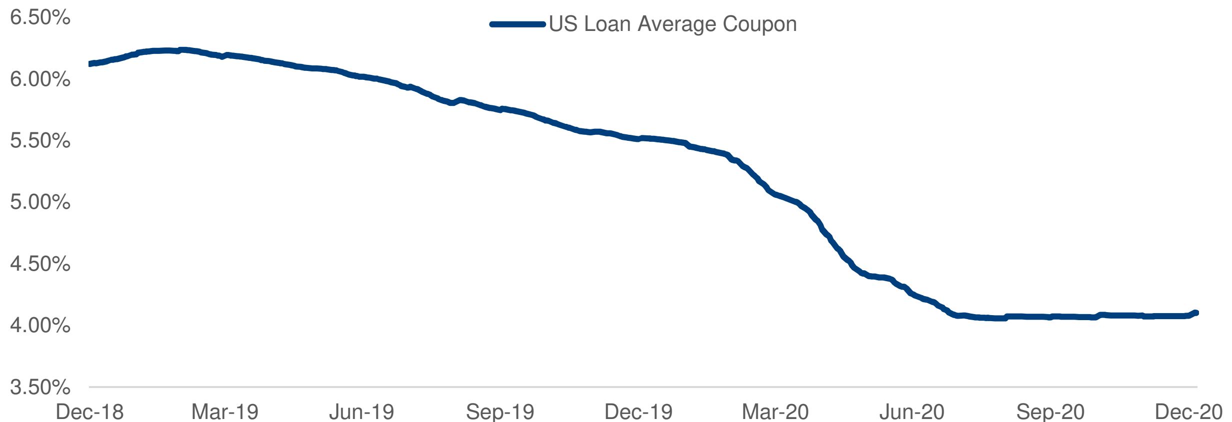
The waning effects of the 2017 tax cuts coupled with a government shutdown and rising global trade tensions contributed to slower US economic growth in the second half of 2018. Dimming growth prospects prompted the Federal Reserve to cut the Fed Funds Rate by 0.25% in July 2019. This was the first of five cuts, including the dramatic 1.00% cut in March 2020 which lowered the Fed Funds rate from 2.25% to 0%. Other short term US dollar rates experienced similar declines. From December 2018 to November 2020, three-month LIBOR, the base rate for most bank loans, fell 2.58% to 0.23%.

Chart 1: Fed Funds Rate and 3-Month LIBOR Declined in Recent Years

Source: Bloomberg, as of December 31, 2020

As the financial press reminds us on a regular basis, fixed coupon assets such as Treasuries, Investment Grade corporate bonds, and High Yield bonds are characterized by an inverse relationship between yield and price. All else equal, declining interest rates benefit the prices of fixed coupon assets by making their future coupon streams more valuable to investors. However, the floating rate nature of bank loans creates the opposite effect. Declining short term rates translate directly into lower coupons for loan investors, albeit with a few months lag. From February 2019 to November 2020, the average bank loan coupon fell 2.1% from 6.2% to 4.1%.

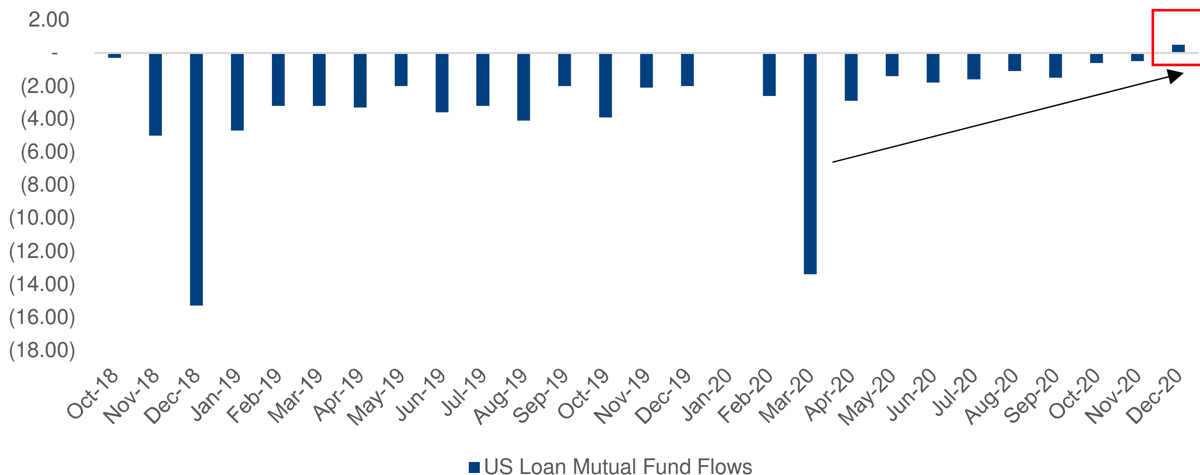
Chart 2: Loan Coupons Fell Alongside Declining Short-Term Rates



Source: Credit Suisse Leveraged Loan Index, as of 5 January 2021

The negative effect of lower rates on floating rate bank loans was not lost on investors. Fund flows into bank loan mutual funds came to an abrupt end in October 2018. For the final three months of 2018, loan fund investors withdrew a massive $21 billion from loan funds, including over $15 billion in December alone. Outflows continued through 2019 and 2020 with retail investors pulling an additional $38 and $25 billion, respectively, from the market. As of November 2020, the loan market witnessed 26 consecutive monthly outflows totaling a combined $84 billion. This streak of outflows was finally broken in December as investors poured a modest $521 million into loan funds for the month. For context, loan mutual funds comprise less than 8% of the $1.2 trillion US bank loan market while collateralized loan obligations (CLOs) are the largest loan holders at about 60%.

Chart 3: US Loan Funds - First Month of Inflows in over Two Years ($B)



Source: JP Morgan

Loans Have Little Downside to Further Rate Declines

With short term rates near zero, we believe loans are now largely insulated from additional rate declines due to their LIBOR floors. A LIBOR floor creates an absolute minimum base rate. The base rate for any loan with a floor is the higher of LIBOR or the floor. For example, with 3-month LIBOR at 0.24%, a loan with a 0.50% floor will have a base rate of 0.50%. As of December 31, 2020, 99% of the US bank loan market has an imbedded LIBOR floor. Most loans (58%) have a floor of zero meaning they would be susceptible to declining LIBOR only until that rate reaches zero. For these loans, there is only 24 basis points of potential additional coupon erosion should LIBOR fall to zero or below. Meanwhile, 41% of loans have LIBOR floors that are currently "in the money". Their floors are higher than LIBOR, protecting them from any additional rate decline.

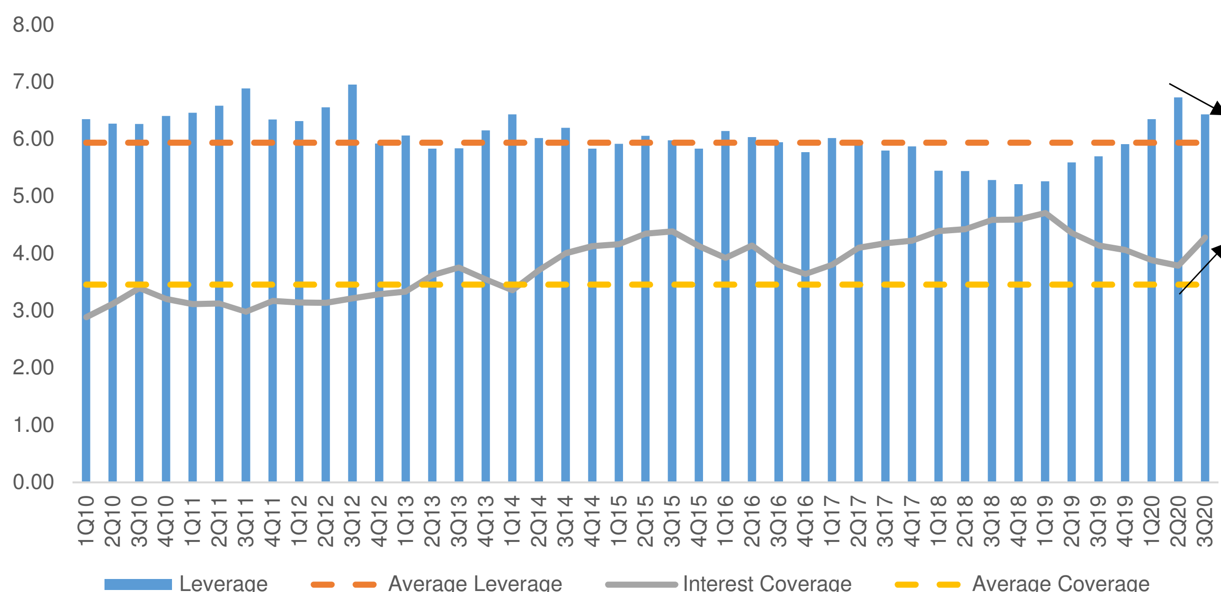
Floor	Loan Count	Market Weight
No Floor	26	1.2%
Zero Floor	808	58.1%
0.25% - 0.50%	22	1.4%
0.75% - 1.00%	821	39.1%
> 1.00%	12	0.3%

Source: Credit Suisse Leverage Loan Index as of December 31, 2020

With Upside from Rebounding Fundamentals

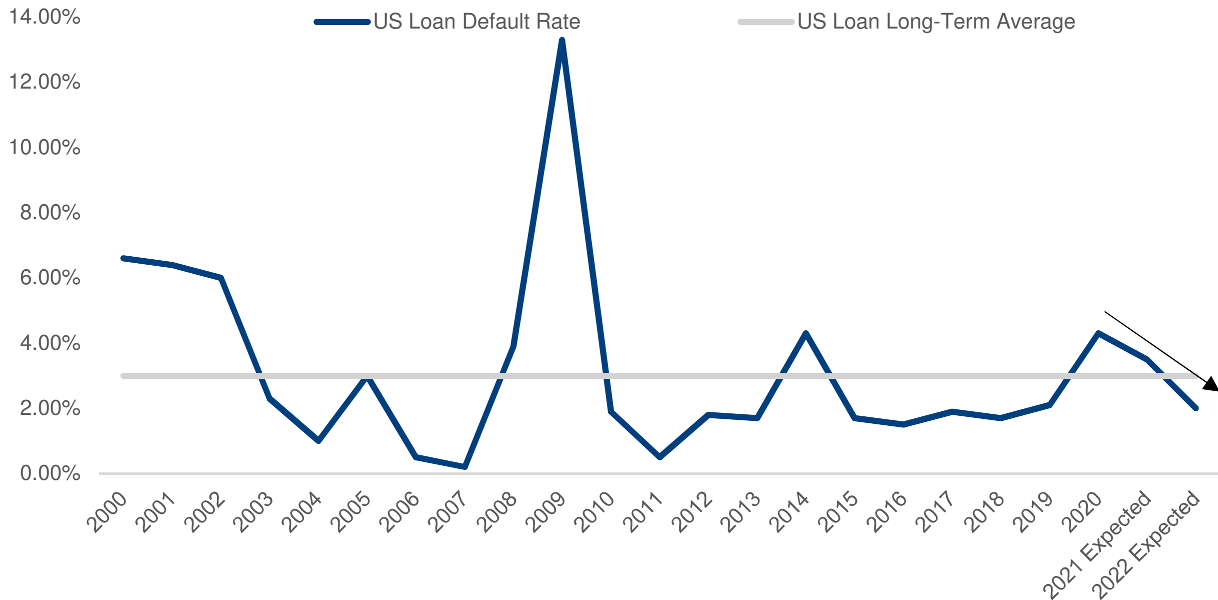
Meanwhile, loan fundamentals, which troughed in Q2 2020, have begun to rebound. Leverage and interest coverage showed improvement in Q3 and we expect additional credit repair in Q4 and over the course of 2021. Defaults, which jumped from 1.6% in 2019 to a 5-year high of 4.26% in September, have receded to 3.95% as of December 31. JP Morgan expects the default rate to fall to 3.5% in 2021, in line with historical average, and further improve to 2.0% in 2022.

Chart 4: Loan Fundamentals Improved in Q3



Source: S&P Global Market Intelligence, Credit Stats as of 3Q 2020

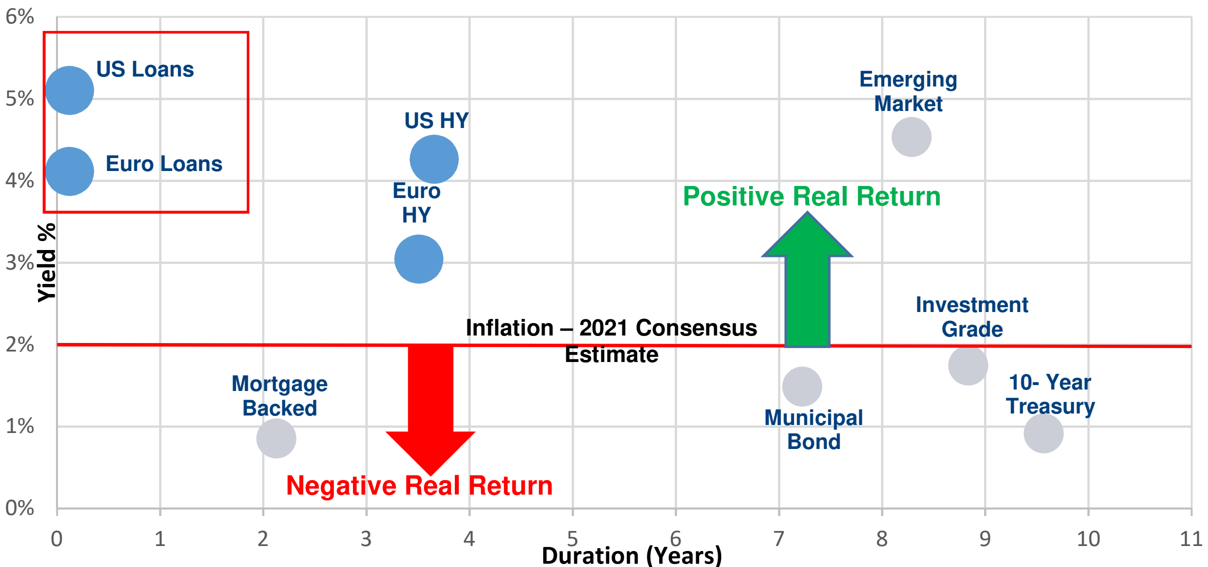
Chart 5: Loan Defaults Expected to Moderate in the Coming Years



Source: JP Morgan

As of year-end, the average bank loan price is $95.7 with a 3-year yield of 5.1%. We believe at these levels bank loans offer attractive value relative to both fundamentals and especially compared to other fixed income assets which have significantly higher duration. Although we do not expect short term rates to rise anytime soon, rising rates are not necessary for loans to perform well in 2021 and beyond. Bank loans offer an attractive yield today while also providing insurance against future rate hikes.

Chart 6: Loans offer Attractive Yield with Low Duration Risk



Source: ICE BofA U.S. High Yield Constrained Index (YTW); Credit Suisse Leveraged Loan Index (3yr Yield); ICE BofA European High Yield Constrained Index (YTW); Credit Suisse Western European Leveraged Loan Index (3yr Yield); JP Morgan EMBI Global Diversified Index, Barclays US Corporate Index; ICE BofA US Insured Bond Municipal Securities Index; ICE BofA US Mortgage Backed Securities Index. As of December 31, 2020. Inflation estimate represented by Consensus 2021 CPI YOY Change from Bloomberg.

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