Bond Blog

PGIM FIXED INCOME

February 18, 2021

U.S. LEVERAGED LOANS: FROM TREPIDATION TO POTENTIAL REFLATION

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As investors consider the pending transition from virus-related trepidation to a potential reflation scenario as vaccines unlock the potential of significant monetary and fiscal stimulus, U.S. leveraged loans are frequently re-emerging in allocation discussions. They have attributes that fit both sides of the transition: attractive spreads and seniority in the capital structure amid investors' search for yield in a still-uncertain economic environment as well as minimal duration and floating-rate coupons in an environment where inflation expectations and interest rates continue to tick higher.

Although yields across the credit sectors declined during 2020's market recovery amid historically low interest rates and narrowing credit spreads, a yield of about 4.90% on the benchmark leveraged loan index could provide up to 90 bps in additional yield relative to the broader high-yield bond index.[1] A portion of that advantage is derived from the third of the leveraged loan market that has LIBOR floors of 50-75 bps (LIBOR continues to sit at about 25 bps) and spreads that generally remain about 75 bps wide to those in the U.S. high-yield bond market.[2] Room for price appreciation also remains in some of the more COVID-affected names, and about 38% of the market is bid above par.

While some may point to the callability of loans as potentially limiting further price appreciation, the economic uncertainty from the virus, amongst other factors, underscores the importance of loans' first lien status at the top of the capital structure even with credit fundamentals set to improve. And although recovery rates declined with the prevalence of loose documentation and loan-only capital structures, recovery rates ticked higher to start 2021, indicating that a possible trough was set in late 2020. Furthermore, leverage loan default rates are expected to decline from 4.3% in 2020 to 3.5% this year and 2.0% in 2022.[3]

Credit Selection to Drive Alpha Generation

The pending improvement in fundamentals does not lessen the need for credit research. Rather, it only raises the importance of credit selection and risk management in order to capitalize on the attributes mentioned above.

Over the past decades, the loan market's composition has transformed significantly. After comprising slightly more than one third of the market in late 2002, B rated issues now comprise nearly two thirds of the market with the CCC segment comprising more than 10%. Meanwhile, the share of BB issuers has declined by more than half since late 2002 (Figure 1). The shift in credit quality would be a significant concern in an economic downturn amid generally elevated leverage levels and loose documentation standards.

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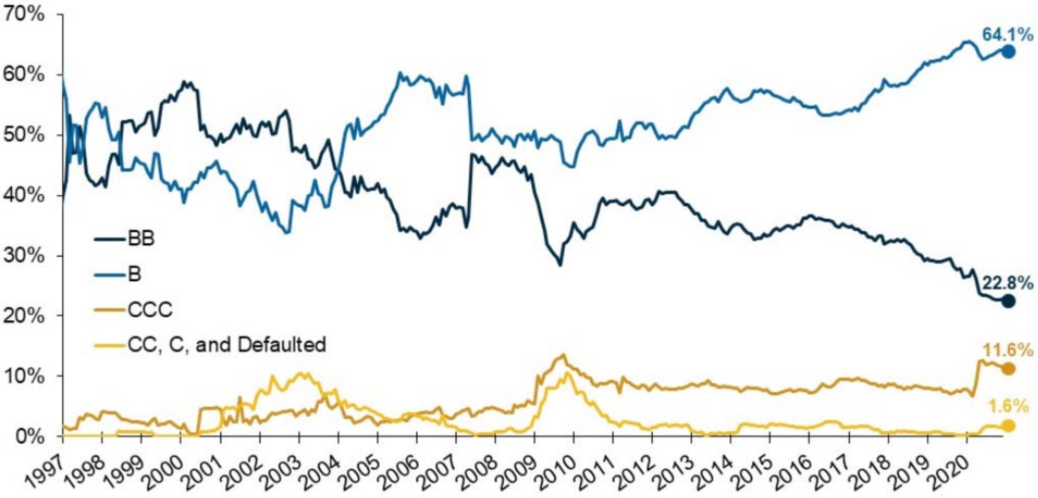
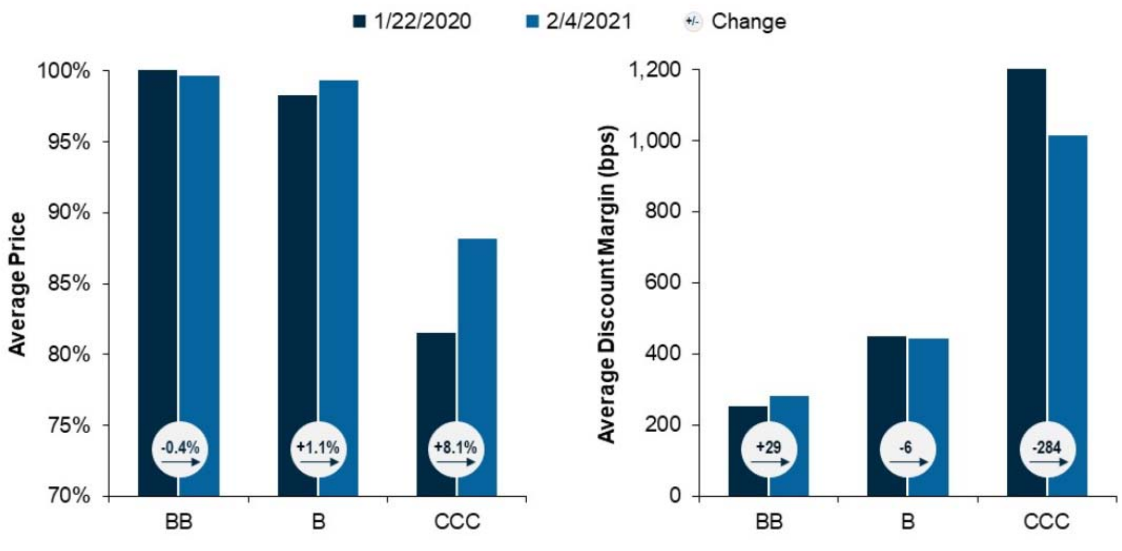
FIGURE 1: THE MARKET HAS SHIFTED TO A HIGHER-RISK COMPOSITION IN RECENT YEARS



Source: Credit Suisse U.S. Leveraged Loan Index. Composition profile is normalized by credit rating excluding the non-rated sector.

In addition, as loan prices rise, their callability creates a more asymmetric return profile. Therefore, in order to capture the sector's attractive carry opportunities, a conservative, well-researched approach is warranted and supports our preference for BB rated names - particularly given the relative value profile compared to Bs and CCCs (Figure 2) - as well as some select B rated names. The desired portfolio profile may also involve a relatively concentrated set of about 225 issues (from a market of nearly 1,700 credits) as well as attractively priced high yield bonds and/or perpetual preferred securities. Accurate issue selection in a concentrated portfolio also indicates the possibility that its default rate could be notably less than what is recorded in the broader market.

FIGURE 2: BB LOAN PRICES REMAIN BELOW THE 2020 HIGHS, AND DISCOUNT MARGINS REMAIN WIDE OF RECENT TIGHTS



Source: Credit Suisse and PGIM Fixed Income.

The current point in the economic transition demonstrates why active credit selection and risk management - as opposed to a passive approach restricted to the largest names in an index - will likely be the most significant contributors to sector outperformance and alpha generation going forward.

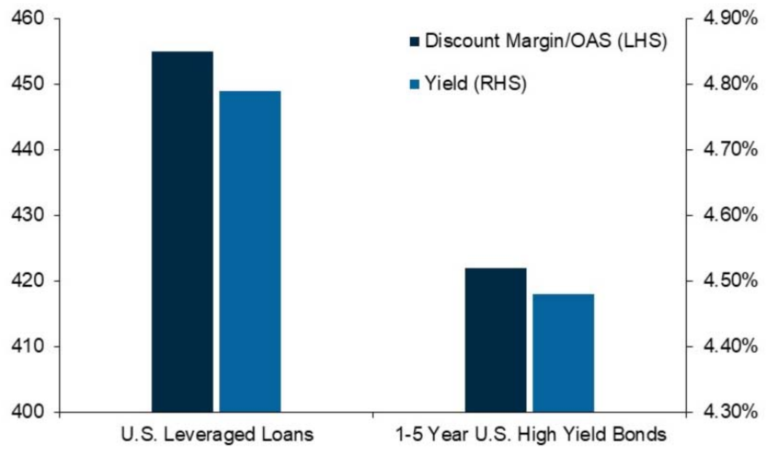
Shifting to Reflation

Investors' anticipation of an economic recovery has been reflected across markets. While the most recent comments from the Federal Reserve indicate an accommodative policy stance for the foreseeable future, market activity has firmly pointed to a reflation scenario as the 10-year Treasury yield has jumped more than 70 bps off the lows to 1.30% and 10-year breakevens have surged 170 bps off the lows to 2.2%. As investors concerned about rising inflation and/or rates have sought principal protection as well as attractive spreads, technicals in the loan market have improved as well. Renewed inflows have surpassed $4.0 billion year-to-date after more than $20 billion of outflows in 2019 and in 2020 as the Fed curtailed its rate hikes and returned the Fed funds rate to the zero-lower bound as the pandemic spread. We anticipate CLO formation will also maintain a consistent bid under the loan market.

While the primary market remains active with more than $114 billion in gross issuance through early February, much of the recent activity pertains to repricing or refinancing activity. Therefore, net issuance is expected to decline by 10% over the course of the year.[4] Furthermore, we remain highly selective in the primary market and are adding only one out of four to five primary offerings.

Estimates for returns in the leveraged loan sector in 2021 range between 4%-5%, which could compare well to longer-duration asset classes as the reflation theme continues. And for investors seeking shorter-duration options, leveraged loans' aforementioned yield and spread pickup pertains to short-duration high yield bonds as well (see Figure 3).

FIGURE 3: LEVERAGE LOANS COULD PROVIDE AN ATTRACTIVE WAY TO PLAY THE REFLATION TRADE



Source: Credit Suisse and ICE BofA Indices as of February 2, 2021.

Our longer-term base case continues to call for low interest rates and inflation that generally remains below central bank targets. However, for reference, the Fed's last rate hike of the prior cycle in late 2018 coincided with a leveraged loan yield of 6.29% as LIBOR reached nearly 2.80% even as spreads were less than 10 bps wider than in early February 2021.

As investors consider the shift from trepidation to potential reflation, the nuances of the coming recovery may warrant potential allocation adjustments. At this point, the attractive spreads on leveraged loans, as well as the value of seniority in the capital structure, may appeal to investors. Yet, active credit research and risk management are needed to capitalize on these attributes. Looking ahead, the exact shape of the recovery remains unclear given the potentially significant tailwinds from an unprecedented combination of global monetary and fiscal stimulus. Limited duration and floating-rate coupons may support the performance of leveraged loans in a scenario where the reflation narrative gains momentum. And as investors monitor the fits-and-starts of this progression, an allocation to leveraged loans may provide a suitable way to navigate the period of transition.

[1] Based on the Credit Suisse U.S. Leveraged Loan Index and the ICE BofA U.S. High Yield Index.

[2] Spreads in the leveraged loan market refer to a discount margin on a loan with a three-year average life.

[3] Information from J.P. Morgan as of February 1, 2021.

[4] Estimate from J.P. Morgan.

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