Giving leveraged credit the credit it is due

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- The selloff and bounce-back of high-yield bonds and floating-rate loans in recent months followed much criticism of the leveraged-credit sector.
- Contrary to popular perception, the fundamental strength of the leveraged credit sector has been improving.
- In the face of retail-driven price volatility, actively managed loan funds held up better than passive ETFs.
- Loans and high yield are par instruments that historically have well-compensated investors for default risk – something investors should consider before selling in a downdraft.

What is a bond worth? It is such a basic question that you wouldn't think investors would change their minds so dramatically over the span of just a few months, in the absence of any significant change in underlying credit-market fundamentals or interest rates.

But that is exactly what happened in the fourth quarter of 2018 and the first quarter of 2019, when credit markets sold off and then rebounded quickly and sharply. The selloff hit both investment-grade and below-investment-grade credits, and as best as we can tell, due to a combination of factors.

In late October and early November, there were fears of an escalating trade war with China, slower global growth and a hawkish-leaning U.S. Federal Reserve. These concerns were roiling the equities market and traditional interest-rate-sensitive investment-grade bond markets. As "risk-off" sentiment took hold, it was only a matter of time before below-investment-grade credit sectors would feel the impact as well. Significant net outflows occurred in December in retail high-yield and floating-rate loan funds, which were likely exacerbated by year-end tax-loss selling.

The high volatility in below-investment-grade credit sectors followed numerous warnings in the press over the past year or so, which pointed to an alleged bubble of debt in leveraged credit – high-yield bonds and floating-rate loans. Indeed, despite the significant year-to-date recovery in both sectors, the criticism has continued.

For example, on March 18, New York Times columnist William Cohan wrote of floating-rate loan issuers: "Some of those companies will not be able to handle the high level of debt they have taken on, and when they reach the breaking point, corporate bankruptcies will again begin to rise." Cohan cited concerns expressed by Fed Chairman Jerome Powell and former Fed Chair Janet Yellen.

Fundamental strength

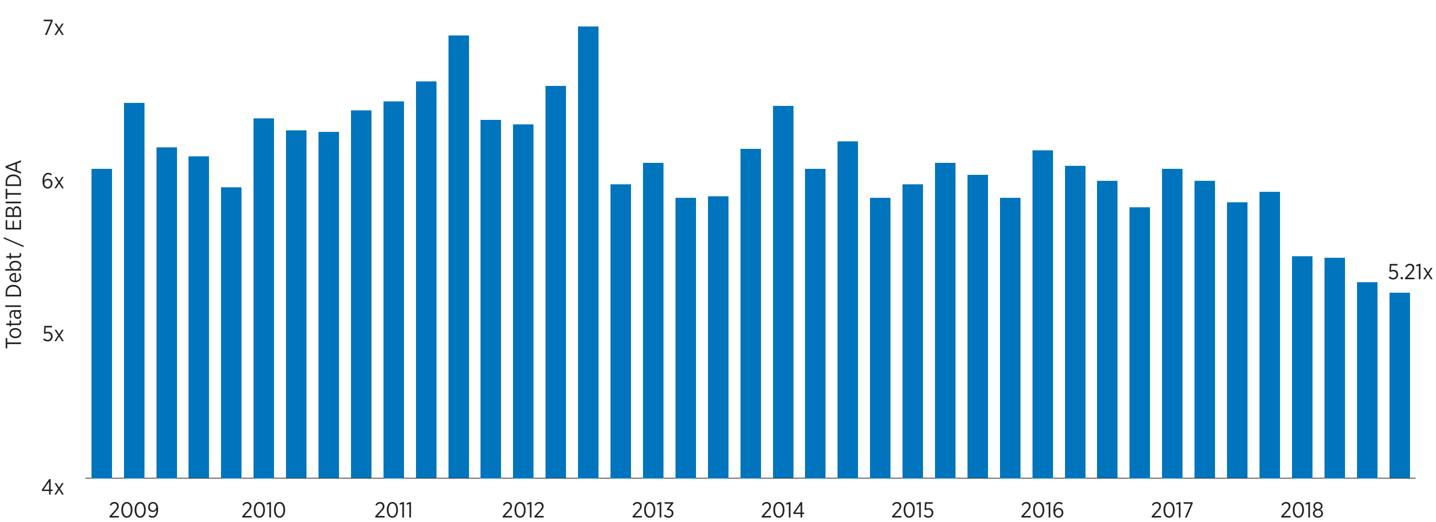
But current corporate credit fundamentals tell a different, more positive story. Exhibit A shows the total leverage of issuers in the S&P/LSTA Leveraged Loan Index, including both their loans and high-yield debt. Total leverage – the ratio of debt to cash flow[1] – has declined for four straight quarters and now stands at its lowest level in 10 years.

Another concern that has been voiced is that leveraged-credit issuance has reached "bubble" levels, but the data does not bear that out. Floating-rate issuance indeed has grown in the past few years, in large part because it was viewed as a hedge against rising rates, as the Fed began its tightening policy. However, much of that issuance came at the expense of high-yield volume, which declined slightly over the same period (Exhibit B). The net result is that since the end of 2013, leveraged credit has grown by just 0.5% per year – hardly the tsunami of issuance implied by press accounts.

Exhibit A

Contrary to popular perception, below-investment-grade leverage has fallen.

Total leverage: High-yield bonds and floating-rate loans



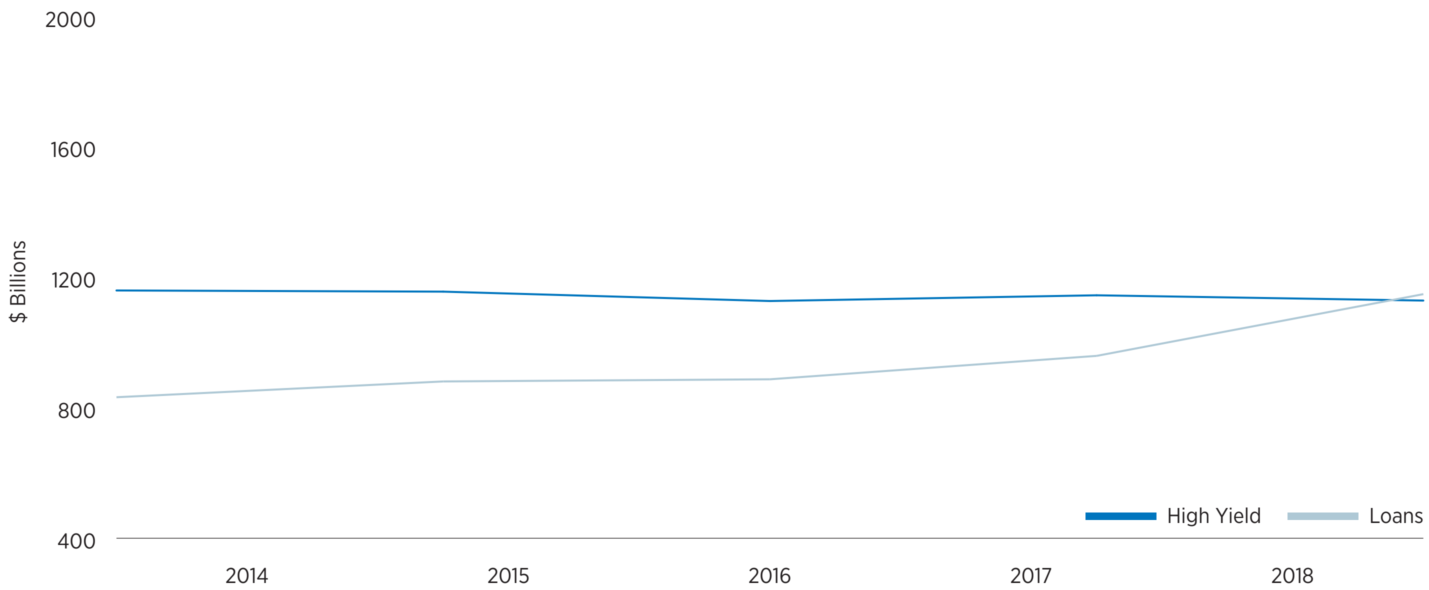
Source: LCD, an offering of S&P Global Market Intelligence, as of 12/31/18. Includes issuers in the S&P/LSTA Leveraged Loan Index, an unmanaged index of the institutional leveraged loan market.

[1]As measured by EBITDA, or earnings before interest, taxes, depreciation and amortization, a common measure of cash flow.

Exhibit B

Leveraged credit has grown modestly, but doesn't look like a bubble.

Outstanding leveraged credit

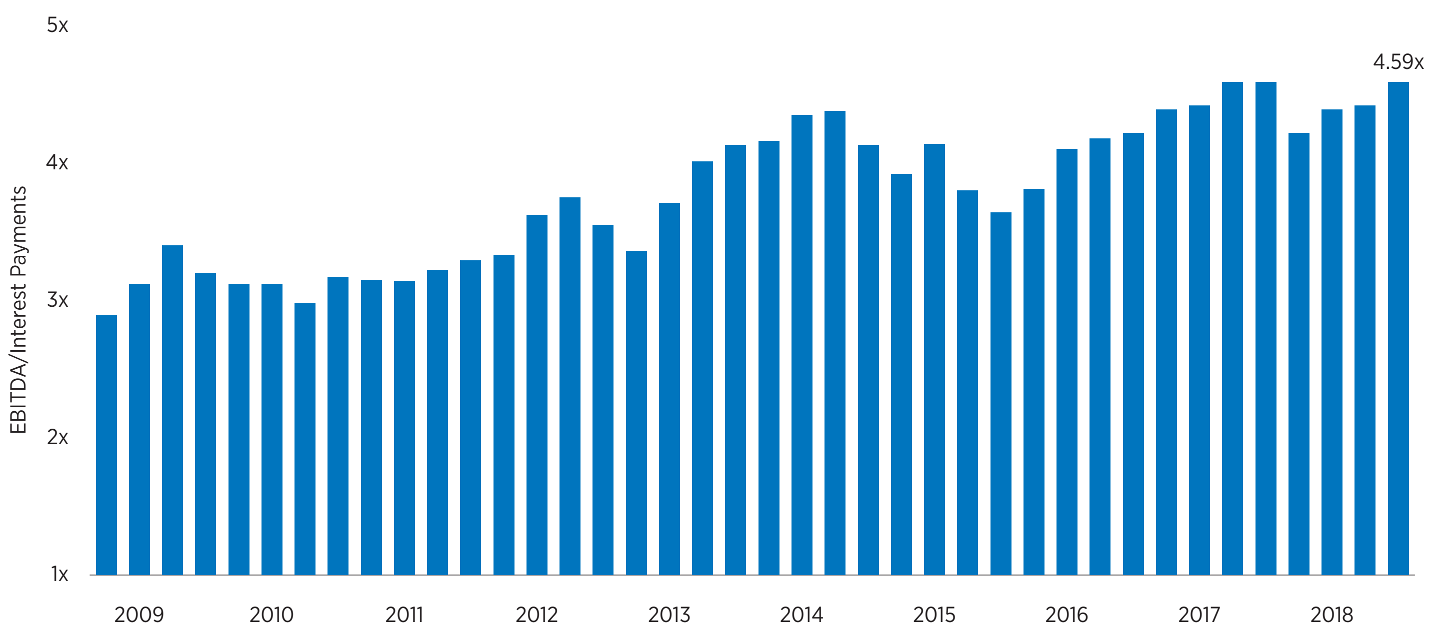


Source: BofA Merrill Lynch Global Research, ICE Data Indices, LLC, S&P LCD, 12/31/18. Based on the ICE BofAML U.S. High Yield Index, an unmanaged index of U.S. high-yield debt, and the S&P/LSTA Leveraged Loan Index, an unmanaged index of the institutional leveraged loan market.

Exhibit C

Interest coverage for loans is the strongest it has been in a decade.

Interest coverage: Floating-rate loans



Sources: LCD, an offering of S&P Global Market Intelligence, as of 12/31/18. Includes issuers in the S&P/LSTA Leveraged Loan Index, an unmanaged index of the institutional leveraged loan market.

Another key metric for the health of leveraged credit is interest coverage – the ratio of cash flow (EBITDA) to interest payments. Exhibit C shows that interest coverage for loans has been largely increasing since the end of the financial crisis in 2009. It declined once the Fed started raising rates in 2015, but soon started tacking back up as economic strength and earnings grew. At 4.6x, the ratio is the highest it has been in a decade, despite interest costs being at their highest level! High yield has followed the same basic pattern: At 4.9x at year end 2018, interest coverage on JPMorgan's high-yield universe is also the highest in a decade.

Of course, one of the concerns had been that the Fed's tightening policy would push up interest payments on floating-rate debt, and leveraged issuers would have trouble meeting their debt obligations. But now that the Fed is emphasizing "patience" in favor of rate hikes, this concern has abated.

The growth in lowest quality high quality debt

The closest thing to a bubble in the fixed-income market might be the lowest rung of investment-grade corporate debt. Exhibit D shows that Moody's Baa-rated bonds outstanding grew by 50% over the past five years to $2.8 trillion. The other investment-grade credit sectors more or less treaded water in terms of size. Moreover, for the five years ended December 31,, 2018 (the most recent data available) average leverage has increased for all investment-grade issuers, from 1.9x to 2.3x, according to Morgan Stanley, while interest coverage has fallen to 10.7x from 12.0x.

In short, credit quality metrics have actually improved in leveraged credit sectors yet deteriorated in investment-grade quality corporate bonds in recent years. This divergence should be a source of *comfort* for investors. Investment-grade issuers are, on average, better able to handle more debt because, by definition, credit metrics remain more robust than those of below-investment-grade companies. They typically have a capital structure with a greater equity cushion for creditors, which is beneficial in adverse economic conditions. The greatest risk of an overall decrease in the credit quality of investment-grade issuers will likely be borne by equity holders, not bondholders.

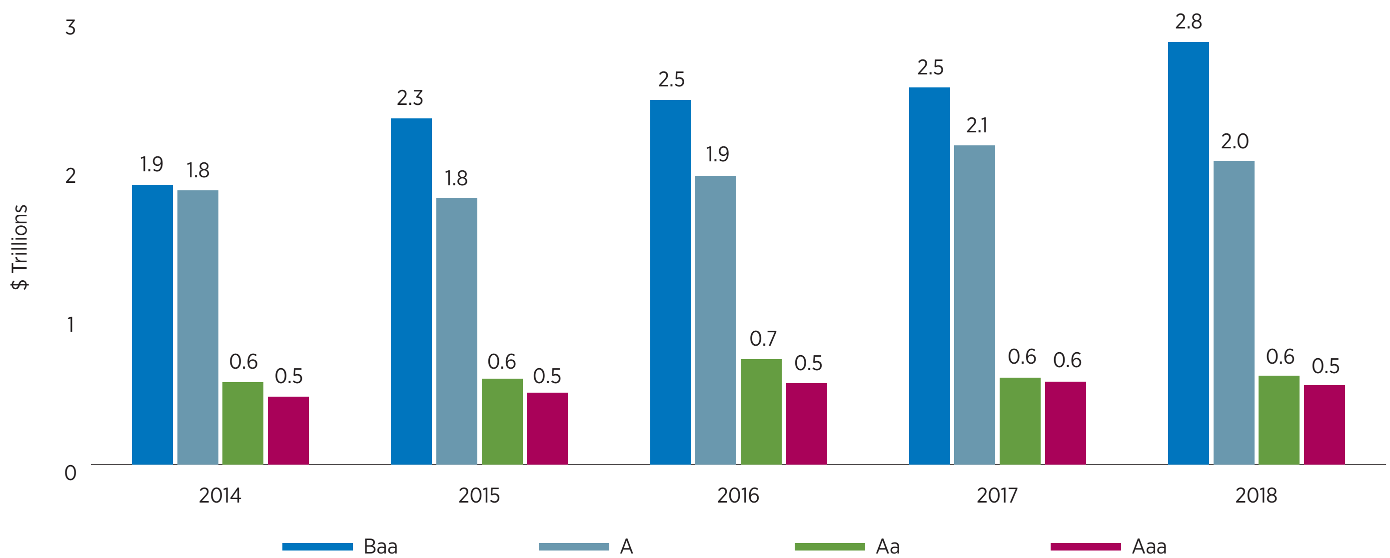
The retail tail wagged the dog

The fourth-quarter selloff was an illustration of how retail sentiment drives price volatility in the leveraged-credit sector. Exhibit E compares loan prices with net retail fund flows, and the correlation is clear. But as of January 31, retail funds represented just 12% of the loan market – it is a case of the tail wagging the dog. Similarly, retail investors comprise only 24% of the high-yield market.

Exhibit D

The lowest rung of investment grade issues has grown the most.

Investment-grade credit: $ outstanding



Source: Bloomberg Barclays U.S. Corporate Investment-Grade Index, as of 12/31/18. Credit ratings are categorized using Moody's Ratings, which are subject to change. Credit ratings measure the quality of a bond based on the issuer's creditworthiness, with ratings ranging from Aaa, being the highest, to C, being the lowest based on Moody's measures. Ratings of Baa or higher by Moody's are considered to be investment-grade quality. Credit ratings are based largely on the ratings agency's analysis at the time of rating. The rating assigned to any particular security is not necessarily a reflection of the issuer's current financial condition and does not necessarily reflect its assessment of the volatility of a security's market value or of the liquidity of an investment in the security.

The dramatic growth of retail open-end funds in recent years in leveraged credit has provided significant benefits to investors in terms of diversification, daily redemptions (for open-end funds) and intraday trading (for ETFs). But high-yield bonds and loans may not be as liquid as high-quality investment-grade debt or stocks, particularly in "risk-off" periods. During these periods, net outflows in open-end retail funds can create significant price volatility, which discerning investors should put in perspective if the underlying credit fundamentals and outlook remain intact.

The active advantage

Eaton Vance research has shown that passive floating-rate loan ETFs are especially vulnerable during sell-offs. We examined relative performance of the Morningstar active open-end loan funds versus passive ETFs in the same category, since loan ETFs came to market in 2011, measuring return over 58 three-year rolling periods beginning in March 2014 and ending in December 2018. Over that period, active open-end funds held a relative return advantage of 86 bps over passive ETFs, comparing asset-weighted averages of both categories (Exhibit F).

However, when volatility peaked in December 2018 – the end of the last rolling three-year period – the active-funds advantage widened to 134 bps. Much of this widening occurred because passive ETF share prices fell to a greater discount relative to their NAVs. Open-end funds are priced each day based on their NAVs and are not subject to a potential market price discount.

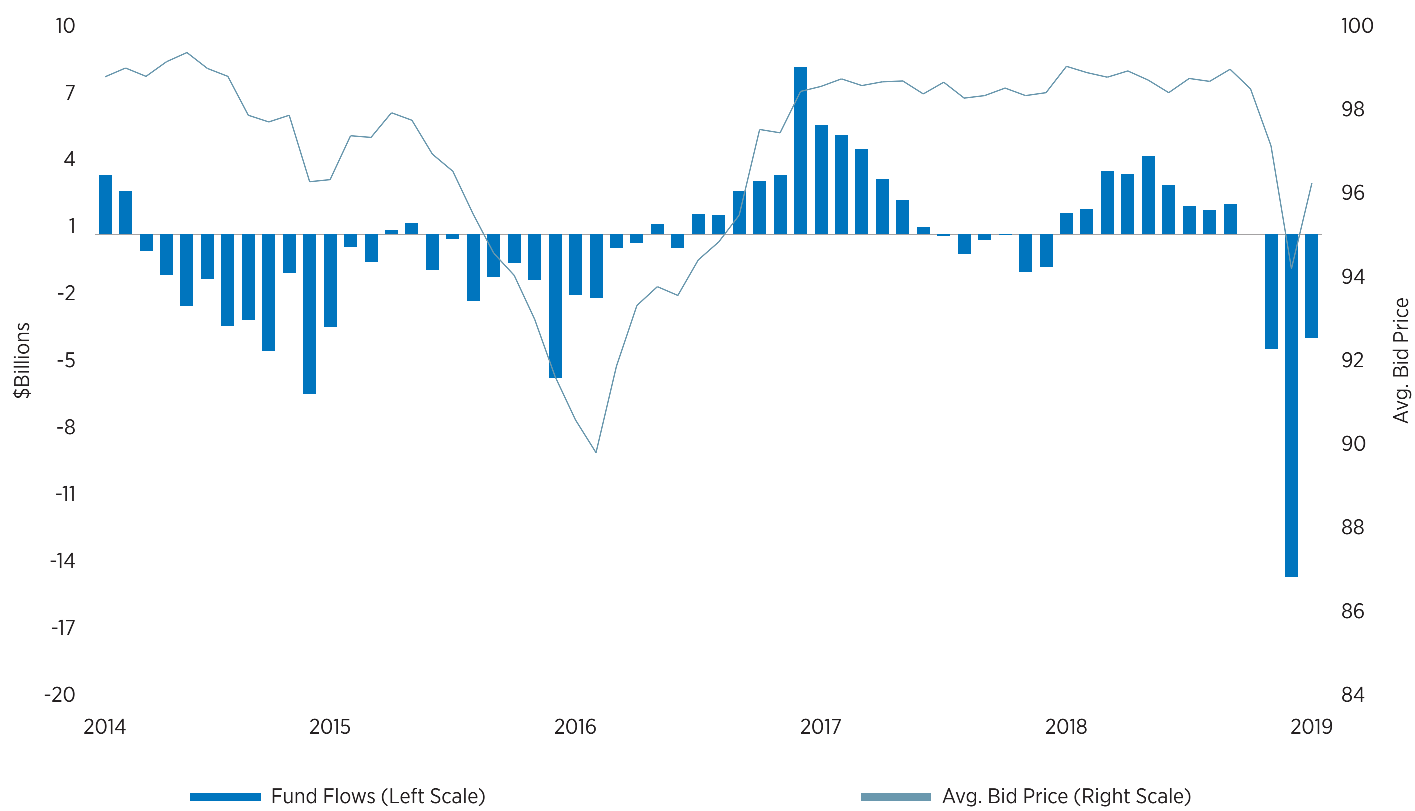
Giving credit to leveraged credit

My discussion began with the question of what a bond is worth. The most straightforward answer is that the vast majority of issuers pay off their debt obligations at par, even for below-investment-grade issuers. While defaults are a fact of life in the below-investment-grade sector, both loans and high-yield bonds have histories that offer some perspective on what defaults have cost investors.

Exhibit E

For loans, retail fund flows drive secondary market pricing.

Net fund flows

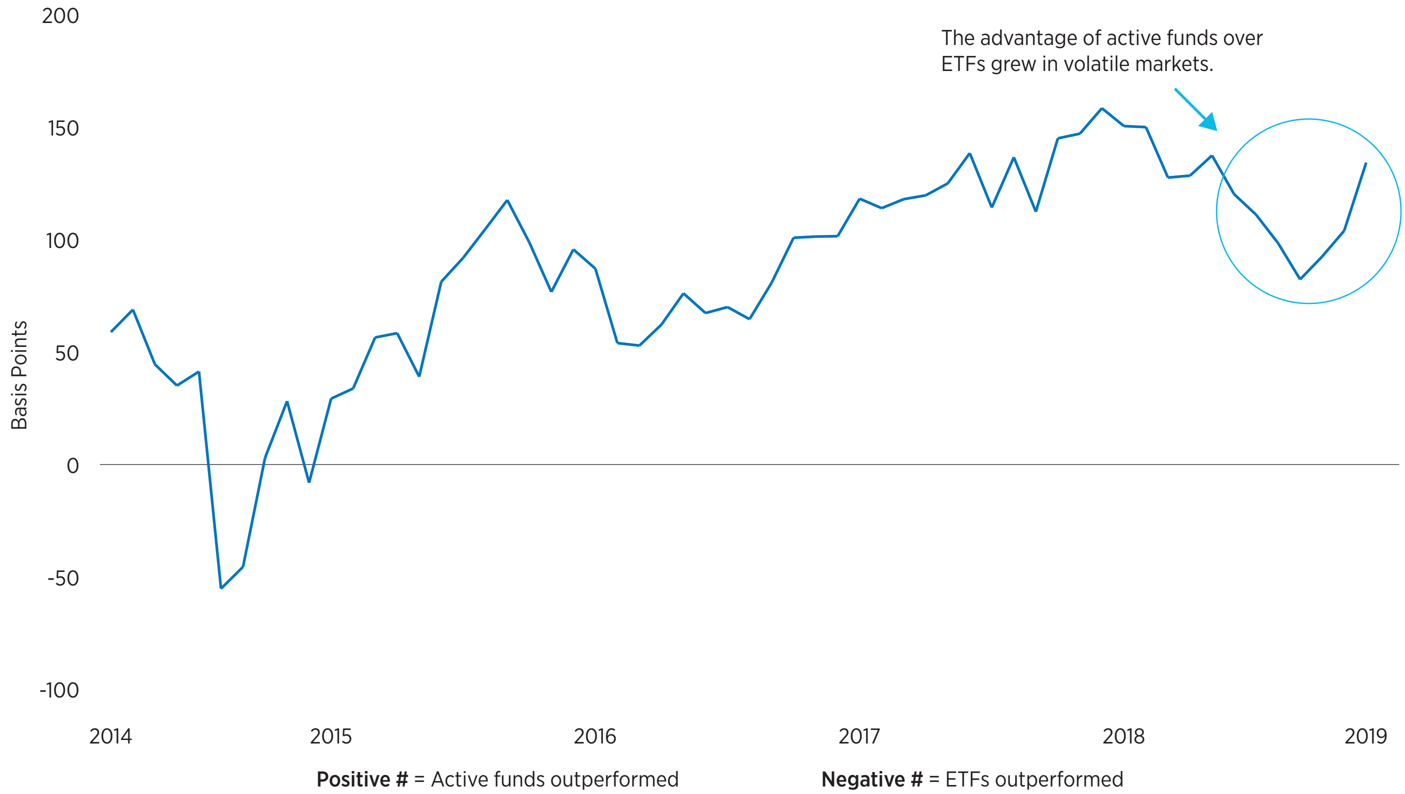


Sources: LCD, an offering of S&P Global Market Intelligence, and Strategic Insight Simfund, as of 1/31/2019. Based on the S&P/LSTA Leveraged Loan Index, an unmanaged index of the institutional leveraged loan market.

Exhibit F

The advantage of actively managed loan funds increased in volatile year-end markets.

Relative performance: Active loan funds vs. loan ETFs



Sources: Eaton Vance Management and Morningstar, as of December 31, 2018. Total return is stated net of fund expenses, reflecting the asset-weighted averages of all funds in the Morningstar Bank Loan category in existence from 4/1/11 through 12/31/18, weighted by beginning-of-period net assets. Performance reflects returns of 58 rolling 3-year periods ended from 3/31/14 through 12/31/18. The Morningstar Bank Loan category comprises U.S. issuers of floating-rate debt, typically secured by corporate assets. For mutual funds with multiple share classes, returns are those of "institutional" or similar (no-load/no 12b-1) share classes, which are most commonly used by financial advisors overseeing discretionary, fee-based client accounts. We exclude funds with incomplete data. Mutual fund returns reflect performance at NAV and ETF returns are based on market closing prices, in each case with fund distributions reinvested. Past performance is not a reliable indicator of future results; performance for different time periods may differ from the results shown.

In floating-rate loans the long-term default rate is about 3%, for the 20 years ended December 31, 2018, according to S&P/LSTA. The long-term recovery rate is about 80%, according to Moody's, so the net credit loss has been about 0.6% (loans are senior and secured obligations, while high-yield bonds are not, which accounts for loans' greater recovery rate). For the 20 years ended December 31, 2018, the S&P/LSTA Leveraged Loan Index has an average annual total return of 4.0%, with only two down years.

In high yield, defaults have averaged 3.2% per year for the 20 years ended December 31, according to JPMorgan. Of those defaults, an average of 42% was recovered, according to BofA/Merrill Lynch, so net credit losses were about 1.9%. Over that period, including defaults, the ICE BofAML High Yield Index had an average annual total return of 6.6%.

And, importantly, though there has been some marginal deterioration in loan and high-yield bond structures recently, default rates in both sectors are below their historical long-term averages. Moreover, JPMorgan estimates that loan and high-yield default rates are likely to stay at 2% through the end of 2020, still below their historical averages.

We believe most investors are better served by viewing leveraged credit as medium- to longer-term investments. Loans and high-yield bonds are par instruments that historically have well-compensated investors for default risk through multiple credit cycles. That's something to consider before selling into a price downdraft that may be more reflective of retail investor jitters than the ability of issuers to pay you back.

Important Additional Information and Disclosures

Source of all data: Eaton Vance, as at December 31, 2018, unless otherwise specified.

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