High loan yields signal a buying opportunity

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- Loans are currently the highest-yielding major credit asset class – the first time in many years it has eclipsed both emerging-markets debt and high-yield bonds.
- A close look at loan performance in the last three Fed-cut environments shows that they performed comfortably in line with their long-term historical average.
- The loan market appears strong, based on credit and technical factors, though close attention to issuer strength is warranted in the late stages of the credit cycle.

In this Q&A, the Eaton Vance floating-rate loan team offers its perspective on today's loan market.

Recently, the U.S. Federal Reserve lowered the federal funds rate by 25 basis points (bps) – its first cut since the financial crisis. What are the implications for the floating-rate loan market?

Predicting the course of interest rates has rarely proven to be productive, and it is important to keep in mind that every rate-cut cycle is different, based on the particular economic environment of the time. In 2001 and 2007, for example, prolonged and deep cuts were made as risks of serious recession unfolded, while in 1998 the Fed made modest and short-lived adjustments. It was similar in 1995, though that cycle preceded the inception of the loan Index.

It appears that the Fed's recent cut is more of a pre-emptive "insurance"-type policy adjustment for an economy on decidedly solid footing – albeit facing some growing risks, such as trade uncertainty and cooling business investment.

Given that rates are already very low, the Fed may be poised to save its monetary "bullets" – i.e., additional rate cuts – for further down the road, should economic conditions take a turn for the worse. At the same time, the Fed claims to be "ready to act." As of July 31, 2019, the yield on the S&P/LSTA Leveraged Loan Index (S&P/LSTA Index) was 6.55% — the highest-yielding major domestic credit sector, 53 bps higher than the ICE BofAML US High Yield Index (U.S. High Yield). And because Libor tends to be anticipatory, it had already eased markedly on expectations of the Fed's cut. In other words, today's loan yields appear to already incorporate much of the recent cut, so loan yields may prove resilient unless expectations materialize for even further rate cuts beyond what the market currently expects. Even still, wider new-issue credit spreads may provide an offset of sorts, and this has been on display in recent months.

How have loans performed in prior Fed-cut cycles?

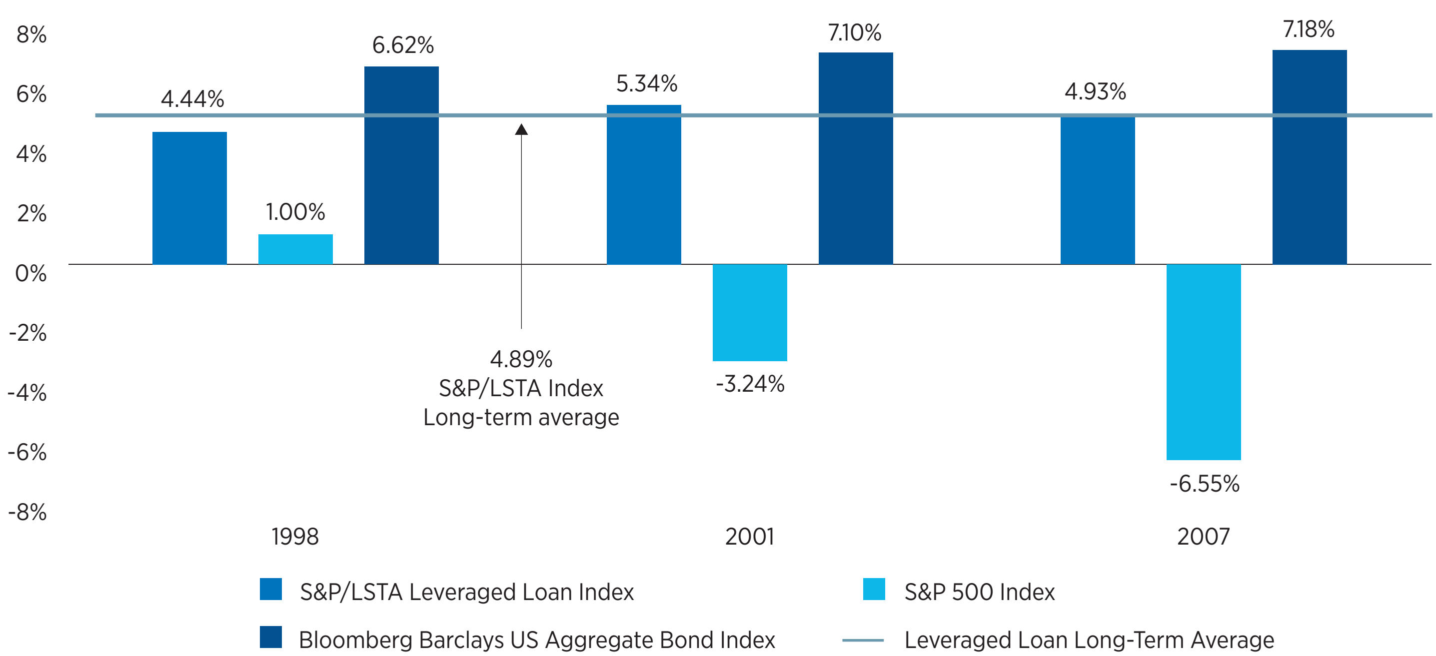
Exhibit A offers an informative framework for addressing that question. It compares loans, the Bloomberg Barclays US Aggregate Bond Index (the Agg), and stocks, based on the average annual total return over the three years following each initial cut by the Fed. For the periods following each of the past three cuts, starting in 1998, loans have returned 4.44%, 5.34% and 4.93%, respectively. For comparison, loans have had a long-term average annual return of 4.89% since the S&P/LSTA Index began keeping track in 1997 – that exact figure also happens to be the average of the three periods cited. In other words, facts show that loan performance in rate-cut environments is broadly quite similar to the asset class's long-term profile, not worse as popular belief would have it.

This relative consistency shouldn't be too surprising, because an accommodative Fed that's cutting rates is generally stimulative for the underlying economy and

Exhibit A

Following prior rate cuts, loans performed in line with long-term average.

Three-year average annual returns following initial cut to fed funds target rate.



Sources: Federal Reserve Bank of St. Louis, Morningstar, June 30, 2019. Returns shown are the average annual 3-year period that followed the Federal Reserve's initial cut to the federal funds target rate, which occurred on September 29, 1998, January 3, 2001 and September 18, 2007, respectively. Data provided is for informational use only. Past performance is not a reliable indicator of future results. You cannot invest directly in an index. See index disclosure below for more information.

thus supportive of corporate issuers. Additionally, falling short-term rates can be "credit positive" in terms of a company's ability to service its debt. What's more, a Fed that's "ready to act" can boost investor confidence and by extension, can be good for asset prices. So while falling rates have the potential for lower coupon income, there are a variety of other factors that can serve as a positive offset in terms of total return.

Exhibit A also shows how the Agg has outperformed loans over the past three periods, notably by a wide margin. Importantly, such environments have favored the Agg, because it has longer duration than loans, and bonds' market values have increased amidst falling rates.

However, in the previous three periods when the Fed began lowering rates, the key concept is that the initial yields on the Agg were all greater than 5%, compared with just 2.5% on July 31, 2019. There is simply less coupon income to juice returns today. And by extension, there is less "room" for rates to fall – and prices to appreciate – compared with the yield compression that characterized the three high-coupon periods summarized in Exhibit A.

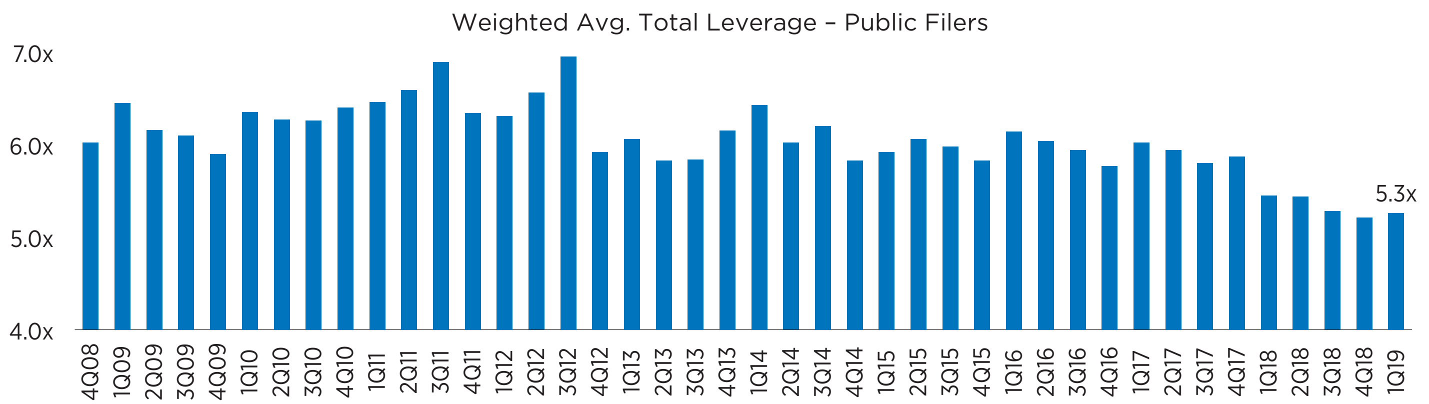
In our view, the takeaway from this brief review is that loans should be viewed as a strategic allocation rather than a tactical one when rates are rising, given that in falling rate environments, on average, they have proven to produce returns comparable with their long-term record.

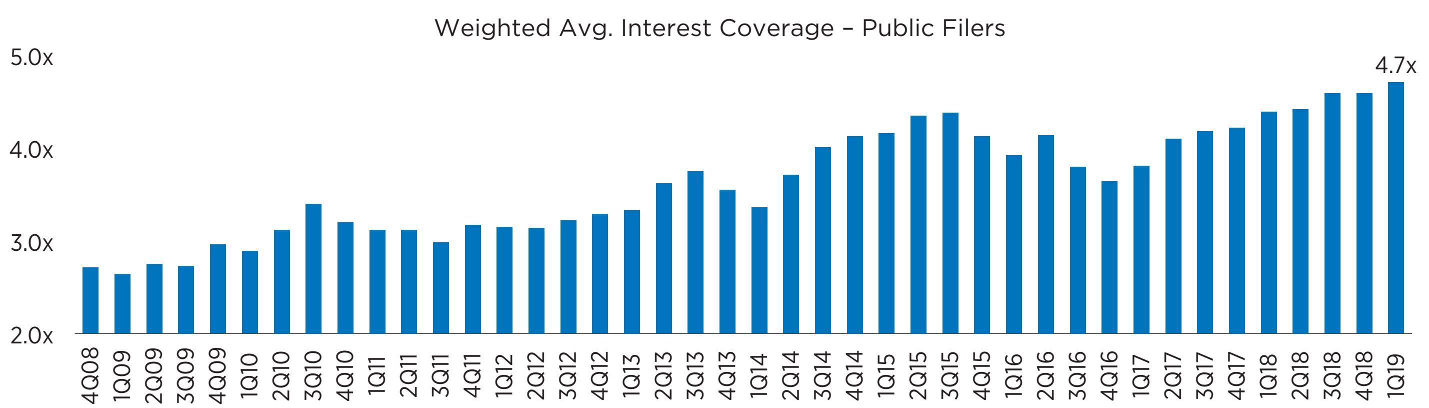
As of July 31, 2019, the yield on the S&P/LSTA Index was 6.55%, compared with 6.02% for U.S. high yield. Typically, high yield has a greater yield. What accounts for the change?

One major reason is the inverted yield curve. Loans are generally priced off of 3-month Libor, which yielded 2.27% on July 31, 2019, while high-yield bonds are priced off comparable-maturity U.S. Treasury bonds. As of July 31, 2019, both the 10-year U.S. Treasury (yielding 2.02%) and the 5-year U.S. Treasury (yielding 1.84%) had yields lower than Libor. So in the unusual environment of an inverted yield curve, loans were being priced off of a higher-yielding benchmark than high-yield bonds – that's

Exhibit B

Loan leverage and interest coverage are at or near best levels in more than a decade.





Source: LCD, an offering of S&P Global Market Intelligence, as of Q1 2019. The data are based on approximately 180 public issuers included in the S&P/LSTA Leveraged Loan Index.

a big factor in the atypical loan/bond spread.

Also, loans have experienced large net outflows from the retail sector – more than $20 billion this year, following $18 billion in December 2018, which puts upward pressure on loan yields. Retail loan investors represent approximately 10% of the market, but at times can have an inordinate impact on loan prices.

Do the retail redemptions represent a red flag for the loan market?

Quite the contrary. From both technical and fundamental perspectives, the market is on solid footing. This year's exodus by retail investors doesn't seem any more complicated than the historical fact that they have always exited loan funds when it appears that rates are falling. In contrast, institutional demand, which is the mainstay of the loan market, continues to chug along. Year-to-date issuance of collateralized loan obligations (CLOs), which are a proxy for institutional demand, is about $65 billion – just shy of the $69 billion issued in the first half of 2018, which was a record year.

Prices have also been buoyed by a reduction in supply from mergers and acquisitions (M&A) and leveraged buyout (LBO) volume, which is down about 50% versus the first half of 2018. When we add it all up, the technical factors are roughly in balance, and the price of the S&P/LSTA Index has remained around 97 with modest drift around small fluctuations in supply and demand. At the same time, this figure was as high as $98.6 as recently as September of last year, suggesting further price firming from here is possible.

How are the market's fundamentals holding up?

Issuer fundamentals remain strong, even though we saw a slowdown in revenue and EBITDA growth in Q2, based on loan issuers that are also public filers (about 20% of the market). Fundamental strength is reflected in key metrics such as interest coverage and leverage – both are at or near the best levels (high for interest coverage, low for leverage) that we've seen in more than 10 years (Exhibit B).

The default rate for the past 12 months entered Q3 at 1.34%, down from 1.63% at the start of the year though up from just under 1% at the close of Q1 – but remains substantially below its long-term average of around 3%. A more forward-looking metric, the distress ratio, is comparably strong – just 2.81% of performing loans in the S&P/LSTA Index are trading below 80, compared with the average of 6.66% for the past 20 years (Exhibit C).

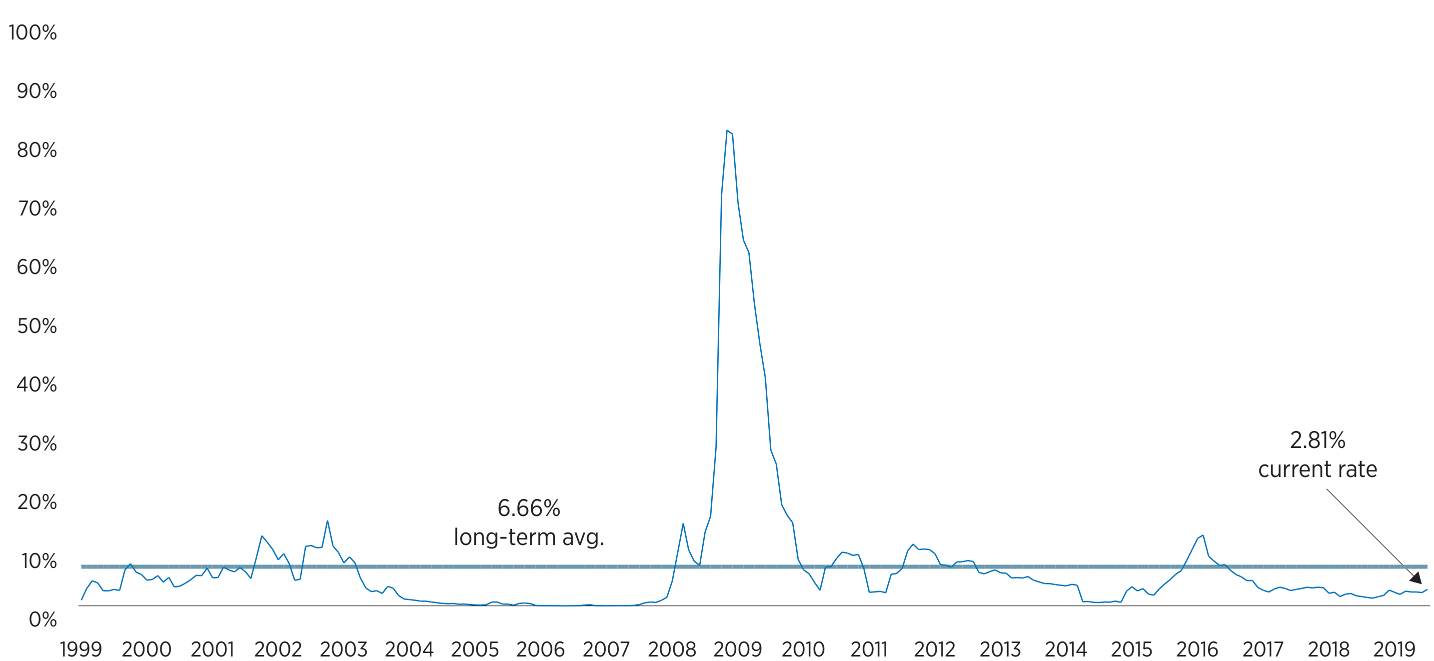
What are the signs of deterioration in credit fundamentals?

From a macro perspective, it's typically when there are two consecutive quarterly declines in GDP, which stress corporate earnings. That is when fundamental analysis and due diligence – the foundations of active management – are put to the test. Well-managed companies don't default from a couple of quarters of

Exhibit C

Low "distress ratio" shows investor confidence in credit quality.

Percentage of S&P/LSTA Index trading under 80



Source: LCD, an offering of S&P Global Market Intelligence, as of Q1 2019. Reflects performing loans within the S&P/LSTA Index, excluding defaulted issues.

declining earnings.

Conversely, in poorly run companies there is often a touch of arrogance in management – arrogance that can catch up with them as they try to work their way out of declining revenue. This shows up as the debt service coverage ratio shrinks and the company runs out of cash and defaults. We are closer to the end of the credit cycle than the beginning — stretching for yield is never a good idea in this sector, but it is especially unwise now.

Is today an attractive entry point for investing in loans?

There are several factors that loans have going for them right now. They are the highest-yielding major asset class, including emerging-markets debt and high-yield bonds. It's not often one can make that statement. With loans, there aren't the currency or political risks of emerging-markets debt and relative to high-yield, loans are senior in the capital structure and secured.

The yield on loans today is also historically high, relative to their long-term average total return – about 6.5% to 4.9%, or a 160-bps advantage. Since we only expect modest drift downward in Libor there appears to be plenty of cushion relative to the long-term average.

With a proper focus on credit quality, as we have discussed, we believe the loan market provides significant opportunities in a global environment where the sources of yield are few and far between.

Index Definitions

Standard & Poor's 500 Index is an unmanaged index of large-cap stocks commonly used as a measure of U.S. stock market performance.

S&P/LSTA Leveraged Loan Index is an unmanaged index of the institutional leveraged loan market.

Bloomberg Barclays US Aggregate Bond Index is an unmanaged index of domestic investment-grade bonds, including corporate, government and mortgage-backed securities.

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Source of all data: Eaton Vance as of June 30, 2019, unless otherwise specified.

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