How Loans Can Help Investors as Economy — and Perceived Inflation Risks — Grow

- With a yield to maturity for the S&P/LSTA Leveraged Loan Index of 4.23% as of June 30, loans are the highest-yielding major U.S. fixed-income sector, notable for clients concerned about income generation as well as total return potential.

- As investor concerns over inflation have grown over the course of the first half of 2021, the need for fixed-income diversification has become increasingly timely. Loans have again proven their potential as diversifiers this year, as the absence of duration has helped boost relative loan returns 488 basis points (bps) ahead of the broad U.S. fixed-income market, through June 30.

- As credit instruments, loans have also benefited from the improving economy, as issuer fundamentals like cash flow and interest coverage have surged. Market stress has faded and upgrades are surpassing downgrades.

- The attractive profile of the asset class is feeding a “virtuous circle,” as loans are drawing investor demand from both sides of the retail and institutional buyer base; this, in turn, is feeding new deal flow with ample issuer access to the capital markets.

An imbalance in supply and demand in the market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads and a lack of price transparency in the market. There can be no assurance that the liquidation of collateral securing an investment will satisfy the issuer’s obligation in the event of non-payment or that collateral can be readily liquidated. The ability to realise the benefits of any collateral may be delayed or limited. Investments in income securities may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer’s ability to make principal and interest payments. Borrowing to increase investments (leverage) will exaggerate the effect of any increase or decrease in the portfolio’s investment value. Investments rated below investment grade (typically referred to as “junk”) are generally subject to greater price volatility and illiquidity than higher-rated investments.
The first half of 2021 presented fixed-income investors with an all-too-familiar problem coupled with a rather unfamiliar risk. Investors still struggle with historically low yields, as they have since the 2008 financial crisis. But now they also face the possibility that resurgent inflation could put upward pressure on rates and inflict losses on bonds that surpass any gains from income.

Floating-rate loans can be a valuable tool for helping diversify fixed-income portfolios in this environment because they offer an attractive level of income while minimizing interest-rate risk. As of June 30, loans offered the highest yield among major U.S. income sectors (Exhibit A).

Moreover, corporate issuers are gaining strength in the post-COVID surge. As such, loans can be both a potential beneficiary of a resurgent economy as well as a hedge against possible rising rates. This paper outlines the supporting case for that view — why we see economic forces converging in a favorable environment for the asset class.

**Eyeing Inflation’s Return**

For most of the year, prospects for a new, post-COVID inflationary surge have only strengthened. In May, the CPI increased 0.6%, on the heels of the 0.8% rise in April. Over the 12 months ended May 31, the CPI has increased 5% — the largest 12-month surge since the period ended August 2008, according to the U.S. Bureau of Labor Statistics.

Until its June 16 meeting, the U.S. Federal Reserve had been stressing the likely “transitory” nature of the inflation metrics as a consequence of postpandemic factors, and it hasn’t disowned that view. But the Fed delivered a bit of a hawkish surprise at the meeting, as the consensus projection for new rate hikes moved forward to 2023; two days later, St. Louis Fed Bank President James Bullard indicated the first rate hike could come as soon as late next year.

Whether or not inflation expectations continue to rise, it’s clear that investors’ collective mindset has turned from “if it happens” to “how high for how long.” As a result, we think the need for diversification of traditional fixed-income portfolios becomes especially timely — and for that reason the loan asset class should remain in the spotlight for some time.

**Loans as Diversifiers**

The case for loans as a diversifier against inflation risk has been on display in dramatic fashion in 2021. For the year to date through June 30, the S&P/LSTA Leveraged Loan Index (the Index) had a total return of 3.28% compared with a loss of 1.60% for the Bloomberg Barclays U.S. Aggregate Index. In other words, loans outperformed the broad U.S. fixed-income market by 488 basis points (bps) — performance that would have benefited fixed-income portfolios with a loan allocation.

Sources: Bloomberg Barclays, JPMorgan, ICE BoFA, and LCD, an offering of S&P Global Market Intelligence, as of 6/30/21. EM Debt (USD) is represented by the JPMorgan Emerging Markets Bond Index (EMBI) Global Diversified Index. Loans are represented by the S&P/LSTA Leveraged Loan Index. U.S. High-Yield is represented by the ICE BoFA U.S. High-Yield Index. U.S. Inv Grade is represented by the Bloomberg Barclays U.S. Corporate Investment Grade Index. US Aggregate refers to the broad U.S. investment-grade bond universe. Data provided is for informational use only. It is not possible to invest directly in an Index. Past performance is not a reliable indicator of future results. See end of report for index definitions and important additional information. Diversification does not ensure a profit or eliminate the risk of loss.
Exhibit B illustrates the relative loan-to-bond performance relationship. The experience of 2021 is no fluke: Since 1997 loans have outperformed bonds when rates have risen, and have underperformed as they have fallen. Of course, there’s no guarantee this pattern will persist in the future, but it is solid historical evidence of the diversification potential of loans in a bond portfolio.

Exhibit C tallies up the loans-versus-bonds comparison over a time frame stretching back to 1992 (the inception year of the Credit Suisse Leveraged Loan Index). In 342 rolling one-year periods since 1992, loans have outperformed bonds two-thirds of the time, including 130 rising rate periods. Just as importantly, loans also outperformed during the 95 periods in which rates remained range-bound. The former is a function of loans’ negative correlation with interest rates, while the latter is explained by the higher relative coupon income on loans.

Exhibit B
Loans Have Outperformed Bonds During Rising Rate Periods

Exhibit C
Loans Have Outperformed in Range-Bound Rate Environments Too
To summarize, markets may be on cusp of another inflation and rate surge, or perhaps one that is more modest. Whatever the degree, we feel strongly that the current environment favors the loan allocation. That’s because if inflation and rates stall instead of surge, loans have historically prevailed in similar flat rate periods. And historically, we know the most painful (rising rate) periods for bonds have been those in which the loan asset class has had the best relative performances.

**Fundamental Surge**

There’s another compelling facet to the story of loans in the postquarantine world: The fundamentals of corporate loan issuers have been improving in parallel with surging economic growth. Credit strength is important as it can help support loan values.

In terms of fundamental strength, cash flow has now improved markedly for the two quarters ended 1Q21, with gains of 5% and 16%, respectively.¹ In the first two quarters of 2020, at the peak of the pandemic’s influence on the economy, cash flow tailed off by -9% and -23%, respectively. So absolute levels haven’t returned to prepandemic marks, but the snapback has been quicker and greater than many had anticipated.

The cash flow resurgence has helped push interest coverage — a common measure of debt serviceability — to an all-time high, since records started in 2000 (Exhibit D). This is a function of both the low rate environment as well as reasonable leverage on balance sheets. As of the end of the first quarter, the interest coverage ratio for public Index issuers stood at 4.77x, comparing cash flow (as measured by earnings before interest, taxes, depreciation and amortization, or EBITDA) with interest expense. After the pandemic-driven downturn of 2020, the coverage ratio sharply rebounded this year, with borrowing costs staying low and cash flow again starting to grow.

The rebound in cash flow is also reflected in lower default rates, which stood at 1.25% for the trailing 12 months ended June 30, compared with the median level of 2% since 2000. June marked the ninth consecutive monthly decline in the default rate, and levels are now barely half of long-term averages.

Similarly, the distress ratio, or the par value of Index loans trading under $80, is just 1.02%, compared with the median of 3.5% since 1997. The distress ratio is considered a good indicator of likely troubled credit situations in the market, as well as investor sentiment.

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¹Data is based on the approximately 180 companies in the S&P/LSTA Leveraged Loan Index who file public information, as identified by S&P/LCD.
A 1% distress ratio is about as positive of a reading as the asset class has ever experienced. Ratings agencies have taken notice of these factors, and upgrades have begun to outpace downgrades by a notable margin, as shown in Exhibit E below.

**A Relative Value, Loans Remain a Spotlight in Fixed-Income Markets**

As of June 30, the Index was trading at around $98 — what we would consider a fair or full value. Because loans can be prepaid by the issuer, they rarely trade above par, as most fixed-income sectors do in today’s environment. As a result, we believe forward total returns in loans will consist primarily of income, as there is little room for price appreciation in market prices.

Relative to other bond sectors, we see loans as showcasing attractive value. Consider the “Yield to Worst” column in Exhibit F. Not only does the loan asset class outyield most other areas of fixed income, the absence of traditional bond duration makes for the favorable environment we alluded to at the outset of this paper.

By comparison, consider the low yield and high interest-

### Exhibit E

**Upgrades Now Exceed Downgrades, but Overall Credit Quality Has Taken a Hit**

<table>
<thead>
<tr>
<th>Year</th>
<th>Upgrades</th>
<th>Downgrades</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2009</td>
<td></td>
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<td>2010</td>
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<td>2020</td>
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<td></td>
</tr>
<tr>
<td>2021</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Sources: LCD, an offering of S&P Global Market Intelligence, Eaton Vance, as of May 31, 2021. Past performance is not a reliable indicator of future results. All data reflects the S&P/LSTA Leveraged Loan Index. Data provided is for informational use only. It is not possible to invest directly in an Index. Past performance is not a reliable indicator of future results. See end of report for index definitions and important additional information.

### Exhibit F

**Loans are the Only US Income Sector Trading Below Par**

<table>
<thead>
<tr>
<th>Sector</th>
<th>Price ($)</th>
<th>Coupon (%)</th>
<th>Yield to Worst (%)</th>
<th>Duration (Years)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Floating-Rate Loans</td>
<td>98.4</td>
<td>L+3.70</td>
<td>4.23</td>
<td>0.1</td>
</tr>
<tr>
<td>US High-Yield Debt</td>
<td>105.3</td>
<td>5.81</td>
<td>3.86</td>
<td>4.0</td>
</tr>
<tr>
<td>Bloomberg Barclays US Aggregate Index</td>
<td>106.2</td>
<td>2.55</td>
<td>1.50</td>
<td>6.6</td>
</tr>
<tr>
<td>US Corp. Investment-Grade Debt</td>
<td>111.9</td>
<td>3.64</td>
<td>2.04</td>
<td>8.7</td>
</tr>
<tr>
<td>USD-Denominated EM Debt</td>
<td>103.5</td>
<td>5.23</td>
<td>4.89</td>
<td>7.9</td>
</tr>
</tbody>
</table>

Sources: Bloomberg Barclays, JPMorgan, ICE BofAML, and LCD, an offering of S&P Global Market Intelligence, as of June 30, 2021. USD-Denominated EM Debt is represented by the JPMorgan Emerging Markets Bond Index (EMBI) Global Diversified Index. Floating-Rate Loans are represented by the S&P/LSTA Leveraged Loan Index. U.S. High-Yield Debt is represented by the ICE BofA U.S. High-Yield Index. U.S. Corp. Investment-Grade Debt is represented by the Bloomberg Barclays U.S. Corporate Investment Grade Index. The Bloomberg Barclays US Aggregate Index refers to the broad U.S. investment-grade bond universe. Data provided is for informational use only. It is not possible to invest directly in an Index. Past performance is not a reliable indicator of future results. See end of report for index definitions and important additional information.
rate risk of investment-grade debt. With a duration of 8.7 years, a 50-bps rise in rates would knock 4.4% off its value — that’s more than twice its current yield; a rise of 1% is more than four times.

Technical Strength
The economy’s snapback this year has helped light a fire under investors. This credit-friendly environment has drawn flows toward corporate credit asset classes with higher yields, and this, in turn, has fueled deal flow and ample issuer access to capital markets. Total M&A loan volume is at a record pace of $121.2 billion through May 31. This is slightly below the $122.8 billion of volume in the first five months of 2018, a year that set the all-time record for M&A volume. All told, the supply has helped push the Index volume outstanding by $61 billion over the last three months to $1.25 trillion, the biggest growth spurt since the summer of 2018.

The new supply has been easily absorbed by investor demand. After more than two years of net outflows of $94 billion, retail investors changed course and have added a net $24 billion since the start of the year — the steady drumbeat of stories about the rebounding economy, supportive credit environment and inflation’s return have undoubtedly been factors. At the same time, the bedrock institutional support for the loan market, as represented by CLO creation, has remained solid. Indeed, just five months into 2021, CLO buyers have purchased a net $64 billion — already two-thirds of the 2020 figure yet not even halfway through the calendar year.

Bottom line: Loans have shown their value as a diversifier and source of income over many interest-rate cycles. We believe they deserve consideration by investors seeking yield for their portfolios as well as a hedge against the growing threat of inflation.
Index Definitions

J.P. Morgan Emerging Markets Bond Index (EMBI) Global Diversified Index is an unmanaged index of USD-denominated bonds with maturities of more than one year issued by emerging markets governments.

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

ICE BofA U.S. High Yield Index is an unmanaged index of below-investment grade U.S. corporate bonds.

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

Bloomberg Barclays U.S. Corporate Investment Grade Index is an unmanaged index that measures the performance of investment-grade corporate securities within the Barclays US Aggregate Index.

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