



FIXED INCOME

## Three Reasons Loans May Be Poised for Strong Performance

### BARINGS INSIGHTS



**Chris Sawyer**  
Managing Director,  
Global High Yield



**Tom McDonnell**  
Managing Director,  
Global High Yield

It's not as simple as 'when rates rise buy loans; when rates fall buy bonds.' Indeed, a combination of several factors has set the stage for loans to potentially deliver attractive total returns going forward.

Since the onset of the pandemic, a combination of technical factors has slowed the recovery of the loan asset class, while at the same time providing a tailwind to other fixed income asset classes, such as high yield bonds. As a result, we believe loans now offer compelling relative and absolute

value, and—as the technical backdrop begins to improve—present a potentially attractive total return opportunity going forward. In particular, there are three reasons we believe loans represent attractive relative value, even in what looks likely to be a lower-for-longer rate environment.

## 1. Loan and Bond Yields Are Comparable

As central banks provided unprecedented stimulus following the initial onset of COVID-19, high yield bonds in particular experienced a strong resurgence. Retail funds saw significant inflows—the U.S. high yield bond market, for instance, has experienced more than \$60 billion<sup>1</sup> of inflows since April—and spreads have tightened substantially. The rebound for loans, which did not benefit as much from the stimulus measures, has been slower to materialize—and fund flows have remained largely negative in a continuation of the last two years, when expectations for lower rates drove many investors out of loans, which are floating rate, and into fixed rate assets. As a result, the global loan market, on average, continues to trade at a discount to par, with an average price of roughly 95<sup>2</sup>—versus the global high yield bond market, which is trading above par with an average price of 102.<sup>3</sup> These technical factors, and the sentiment-driven shift from loans to bonds, have caused the yield differential between the two asset classes to remain compelling for loans despite the decline in short-term rates in the U.S. (FIGURE 1). Of note, one recent trend that has been supportive of yields in the U.S. loan market has been the reemergence of new issue loans with improved terms for the minimum level of interest income paid. Essentially, a floor level is set—for instance, 0.50%–1.00%—on the floating rate component of the coupon in addition to the stated credit spread.

FIGURE 1: Loan and Bond Yields Currently Comparable (%)



SOURCES: BAML; Credit Suisse. As of November 30, 2020.

This is within the context of loans being senior in the capital structure, meaning they are typically paid back ahead of subordinated debt and equity. Loans are also secured by some or all of a borrower’s assets—ranging from real estate and equipment to intangible assets like software and trademarks—providing additional credit risk protection in the event of default. Given this seniority and security, loans have historically offered high recovery rates relative to other asset classes. While recovery rates can vary as they tend to be influenced by the sectors and businesses that default during any given period, to put this in perspective, average recovery rates for loans over the last 30+ years have been between 60%–80%, versus 30%–50% for unsecured high yield bonds.<sup>4</sup>

1. Source: J.P. Morgan. As of November 30, 2020.

2. Source: Credit Suisse. As of November 30, 2020.

3. Source: Bank of America Merrill Lynch. As of November 30, 2020.

4. Source: Moody’s Corporate Default and Recovery Data. As of February 2020. Approximate ranges provided for historical recoveries between recoveries based on trading prices and those measured by ultimate recoveries.

## 2. Spreads Appear to be Compensating for Default Risk

On an absolute basis, while loan spreads have regained material ground since the onset of the pandemic, they remain wider than they were pre-crisis—suggesting there is room for further tightening as the pandemic begins to recede. While past performance is not necessarily indicative of future results, when we have seen similar spread levels in the past, the subsequent 12-month total returns have been strong (FIGURE 2).

While the road to recovery is unlikely to be linear, and there is potential for further volatility going forward, most companies appear fairly well-equipped to withstand near-term shocks. Indeed, companies have continued to successfully raise capital as evidenced by recent months' elevated issuance. Supportive monetary policy and stimulus have, of course, played a large role in this. But more specific to the loan market, there has also been support from private equity sponsors, who have been willing to help good businesses preserve liquidity and navigate this short-term revenue disruption rather than pushing them toward a potential restructuring. This is in addition to healthy primary market conditions in recent years, which have allowed businesses to refinance their debt and push out maturities, leaving limited near-term maturities in the loan market.

As a result, defaults have remained largely manageable. Although they have risen year-over-year, defaults in the loan market are

well below the double digits that some sell-side forecasts were calling for at the height of the crisis—hovering around 4.5% in the U.S. and just over 1% in Europe.<sup>5</sup> Of these, a significant portion have come from identifiable areas of the market such as the retail and energy sectors, which had already faced headwinds prior to the pandemic.

While defaults do entail a potential loss of principal, as mentioned above there are typically opportunities to recover a portion of that through a restructuring process. Although past recovery rates do not indicate future results, factoring in long-term recovery assumptions for loans can provide an idea of how current spreads compare with loss given default scenarios. For example: on a global basis, loans are currently offering an average spread of roughly 511 basis points (bps) over the risk-free rate.<sup>6</sup> If an investor assumes the aforementioned recovery rate of 60%–80%, a spread of 511 bps would imply that it would take a default rate of over 10%—which is well-above current expectations and also above historical peak levels—in order to fully erase any excess spread that should be required over a risk-free opportunity (FIGURE 3).

While there is still much uncertainty on the horizon, we believe these scenarios may be overly pessimistic given the liquidity that has been injected into the markets and the expectation for a more manageable default environment going forward.

**FIGURE 2:** U.S. and European Spreads Relative To Past Widening Events

Market	Global Financial Crisis		European Sovereign Debt Crisis		Commodity Crisis		4Q 2018		12/31/2019	11/30/2020
	Spread Wides	12-Month Total Return	Spread Wides	12-Month Total Return	Spread Wides	12-Month Total Return	Spread Wides	12-Month Total Return	Pre-COVID	Current Spread
U.S. Loans <sup>1</sup>	1859 bps	45.4%	757 bps	10.7%	700 bps	12.5%	552 bps	8.2%	461 bps	522 bps
European Loans <sup>2</sup>	1987 bps	48.1%	901 bps	10.6%	584 bps	9.5%	458 bps	7.5%	423 bps	465 bps

Spreads represented by the 3-year discount margin. Returns for European loans are shown hedged to USD. Returns represent the total return for the 12-month period following the widest daily 3-year discount margin during a past widening event. **PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.**

1. SOURCE: Credit Suisse Leverage Loan Index, Hedged to USD.

2. SOURCE: Credit Suisse Western European Leverage Loan Index (Non-USD denominated), Hedged to USD.

**FIGURE 3:** Loss Given Default Scenarios

Recovery Rate Scenarios	Default Rate Scenarios									
	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
80%	20 bps	40 bps	60 bps	80 bps	100 bps	120 bps	140 bps	160 bps	180 bps	200 bps
70%	30 bps	60 bps	90 bps	120 bps	150 bps	180 bps	210 bps	240 bps	270 bps	300 bps
60%	40 bps	80 bps	120 bps	160 bps	200 bps	240 bps	280 bps	320 bps	360 bps	400 bps
50%	50 bps	100 bps	150 bps	200 bps	250 bps	300 bps	350 bps	400 bps	450 bps	500 bps
40%	60 bps	120 bps	180 bps	240 bps	300 bps	360 bps	420 bps	480 bps	540 bps	600 bps
30%	70 bps	140 bps	210 bps	280 bps	350 bps	420 bps	490 bps	560 bps	630 bps	700 bps

SOURCE: Barings. Loss given default calculated as the default rate multiplied by one minus the recovery rate. For illustrative purposes only. **PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.**

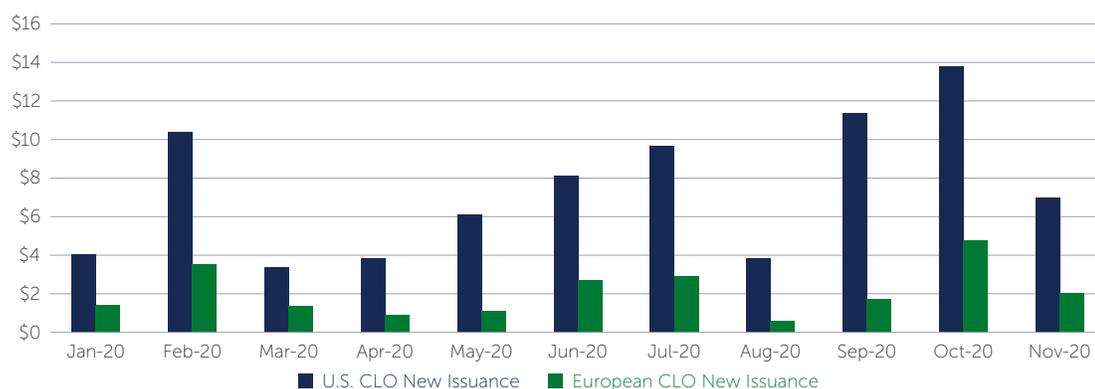
5. Source: Credit Suisse. As of November 30, 2020.

6. Source: Credit Suisse (3-year discount margin). As of November 30, 2020.

### 3. Technical Picture is Improving

Over the last few years, as interest rate expectations moved down materially, investor sentiment shifted notably toward bonds and away from loans—a dynamic that, as mentioned above, was exacerbated by the pandemic. Going forward, however, the compelling yield profile for loans, coupled with the notion that spreads appear to be providing adequate compensation for defaults, may help restore demand for the asset class and further improve the technical picture. This is in addition to stable demand from ramping collateralized loan obligation (CLO) portfolios, which saw issuance slow considerably earlier this year but pick back up in recent months—a further sign of improving conditions (FIGURE 4).

FIGURE 4: U.S. and European CLO Issuance (\$Billion)



SOURCE: J.P. Morgan. As of November 30, 2020.

Combined with a lack of primary supply in the loan market and moderate retail outflows in recent months, this renewed demand is providing a technical tailwind for loans—even before any improvement in the ‘real economy’ is fully priced into fundamentals. As a result, we believe there is room for further spread compression as we move through the pandemic, potentially resulting in an attractive total return opportunity from here.

### Conclusion

As we look across the markets today, we believe there is an interesting opportunity in loans, for three key reasons:

- Loans are currently offering **comparable yields to bonds**, despite loans being senior in the capital structure and secured by some or all of a borrower’s assets
- Current loan **spreads appear to be fairly compensating investors in the context of defaults**, which due to capital market support have remained more manageable than originally forecast
- Loans could experience a **technical tailwind** going forward as demand returns, potentially resulting in further spread tightening

While there are plenty of risks on the horizon—whether from the virus, political unrest, or other factors—the economy and markets will recover. However, just as the economic slowdown has been more severe for some industries and companies than others, the recovery is likely to be uneven. While some companies will inevitably default, we believe most should be able to continue to meet their debt obligations and will eventually see their trading levels normalize, or move back closer to par. In our view, active management, combined with a steadfast focus on corporate fundamentals, will be key to capitalizing on the resulting upside.

**RISK PROFILE:** While we see many benefits to investing in loans, it is also important to consider the potential risks. Although this asset class is senior in the capital structure, investors may still be exposed to losses in the case of issuer defaults. Credit rated below-investment grade may have a greater risk of default and investors should consider such risks in the context of their overall investment portfolios. Investors may also be exposed to price fluctuations and/or losses, which can result from changes in overall market conditions or issuer specific fundamentals.

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