Bank Loans

Watch Refi Risk as Prices Improve

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We believe loans offer attractive value to income seekers, but refinancing risk could resurface in 2021.

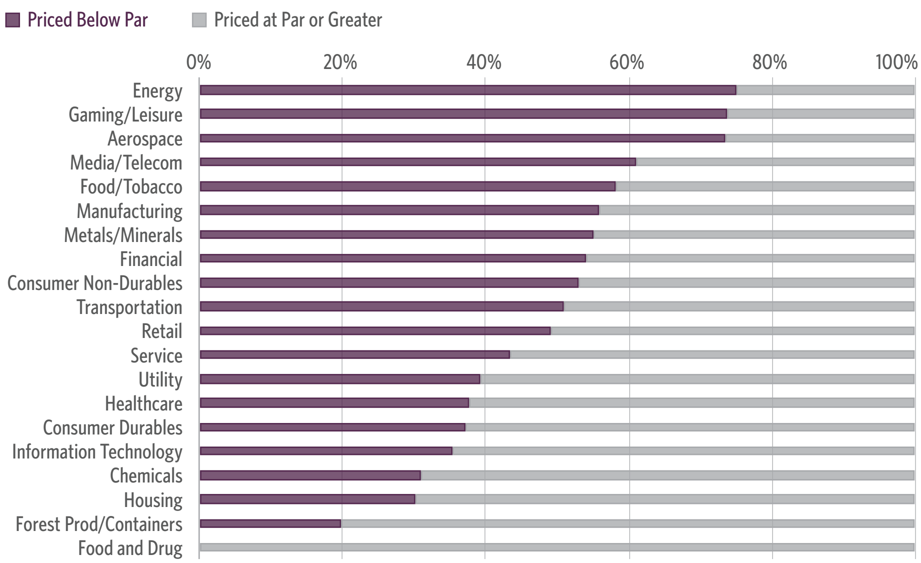
The leveraged loan sector delivered a total return of 2.8 percent in 2020 as Fed rate cuts lowered coupon rates and downgrades pushed prices lower. Bank loans should be better positioned for stronger performance this year with price discounts in some industries (see chart, top right), and the recent increase in Treasury yields renewing interest for duration protection among investors. Issuance in the collateralized loan obligation (CLO) market is also forecast to be a robust $100 billion, not including refinancing and reset volumes.

Loan investors will need to watch out for refinancing risk in favored industries such as healthcare, technology, and food and drug, where most loans are trading at or above par. There is a strong correlation between refinancing activity and the share of loans trading above par (see chart, bottom right). By comparing secondary loan spreads and pricing in the new issue loan market over the last four months, we found around $90 billion of single B loans that are “in the money” to be refinanced later this year, with 101 basis points in potential spread savings to the borrower. The aforementioned favored sectors comprised roughly $40 billion of this refinancing risk.

Downward credit migration has notably eased. The three-month ratio of loans downgraded versus upgraded fell to only 1.1x in the fourth quarter, compared to 43x earlier in the year. In its wake, negative rating migration left behind a loan market with the highest exposure to CCCs or below since 2010, and 19 percent of loans rated B-, the highest ever. This credit profile presents some downside risk given that the average CLO portfolio rating profile is worse than before the pandemic, which gives them less room to absorb more downgrades. But a strong economic recovery should buoy corporate earnings, and possibly restore some ratings to their previous level. Barring an unexpected economic shock, we believe the current rating profile will not weigh on the market’s performance. And while discount margins have tightened from a March 2020 peak of 1,275 basis points to only 455 basis points , we see more room for further spread compression as spreads remain above the post-2008 tights of 381 basis points and pre-2008 tights of 230 basis points.

Discounted Loans Mostly Found in Energy, Leisure, Aerospace

Share of Index Trading at a Discount to Par, by Industry Loan Outstanding



Source: Guggenheim Investments, Credit Suisse, Bloomberg. Data as of 1.27.2021.

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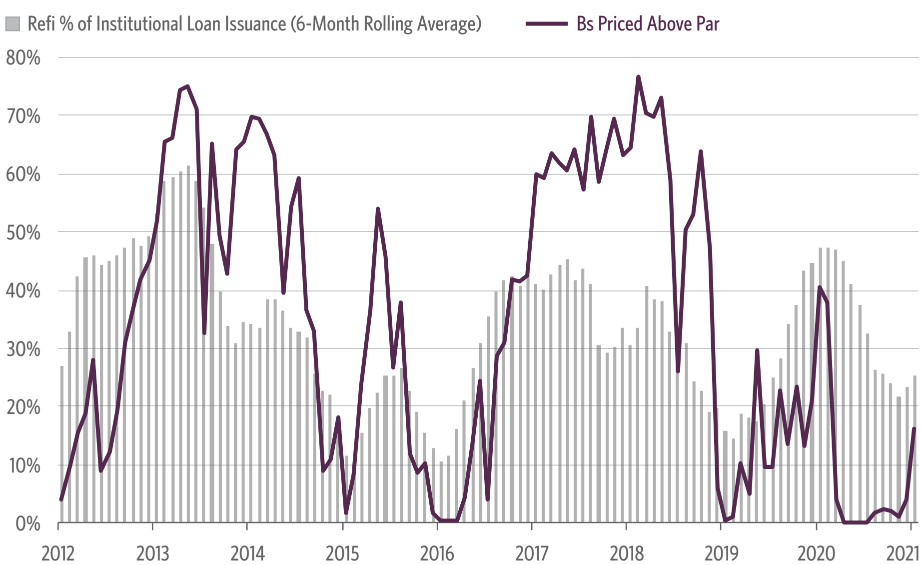
Market Is Heating Up as Investors Bid Loans to Par or Above



Source: Guggenheim Investments, S&P LCD, Credit Suisse. Data as of 1.27.2021.

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