Bank Loans

A Double-Edged Sword

Thomas Hauser
Senior Managing Director

Christopher Keywork
Managing Director

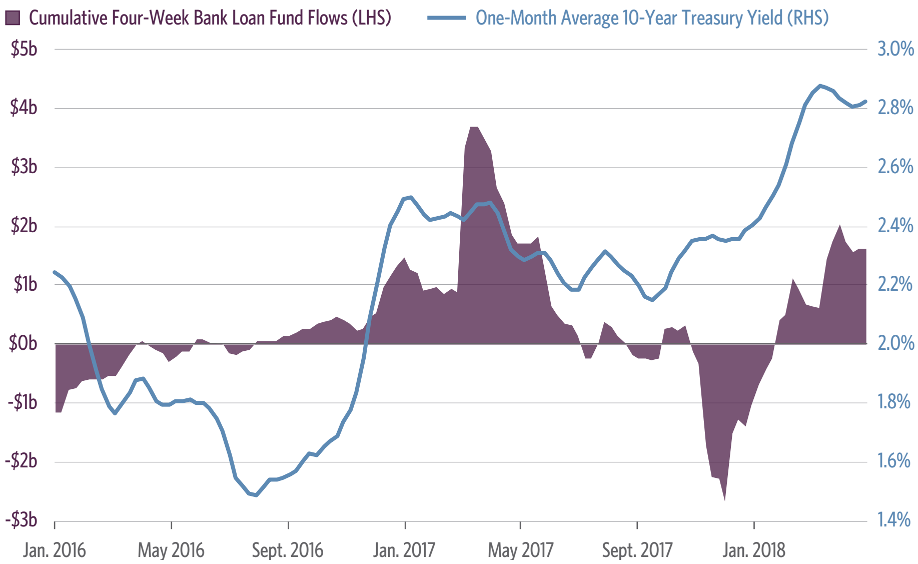
Concerns about inflation and a steeper path for Fed rate hikes buoyed investor demand for floating-rate assets, but defaults are ticking higher.

Loan mutual funds and exchange-traded funds have seen net inflows of almost $4 billion year to date through April, compared to net outflows of over $15 billion for high-yield corporate bond funds. We saw similar activity in mutual fund flows in late 2016, when a 127 basis point backup in 10-year Treasury yields—from a low of 1.36 percent in July 2016 to 2.63 percent in March 2017—was accompanied by cumulative net loan fund inflows of $23 billion over the same period (see chart, top right). Bank loans outperformed high-yield corporate bonds for the second quarter in a row on the back of strong investor demand.

The Credit Suisse Leveraged Loan index posted gains across all ratings. On average, leveraged loans returned 1.6 percent for the quarter, with CCC-rated loans delivering the strongest gains of 3.6 percent, compared to 1.2 percent for BB-rated loans, and 1.6 percent for B-rated loans.

The significant increase in rates may attract investors to floating-rate loans, but it will have negative consequences for some borrowers. This is highlighted in the recent uptick in default activity, with both the 12-month trailing par and issuer-weighted default rates going up in the first quarter of 2018 (see chart, bottom right). Nevertheless, the loan market continues to look healthy, with no widespread deterioration at this stage. Loan interest coverage stands at 3.8x compared to the 15-year average of 3.5x and historical low of 2.6x. This is largely the result of heavy refinancing activity last year, which helped drive loan spreads tighter and kept the increase in borrowing costs contained. But with refinancing activity taking a backseat to mergers and acquisitions activity this year, borrowing costs have been increasing. We do not expect meaningful deterioration in loan interest coverage until Libor reaches 3 percent or more, but as recent default activity shows, we could see some early casualties from the steady rise in borrowing costs.

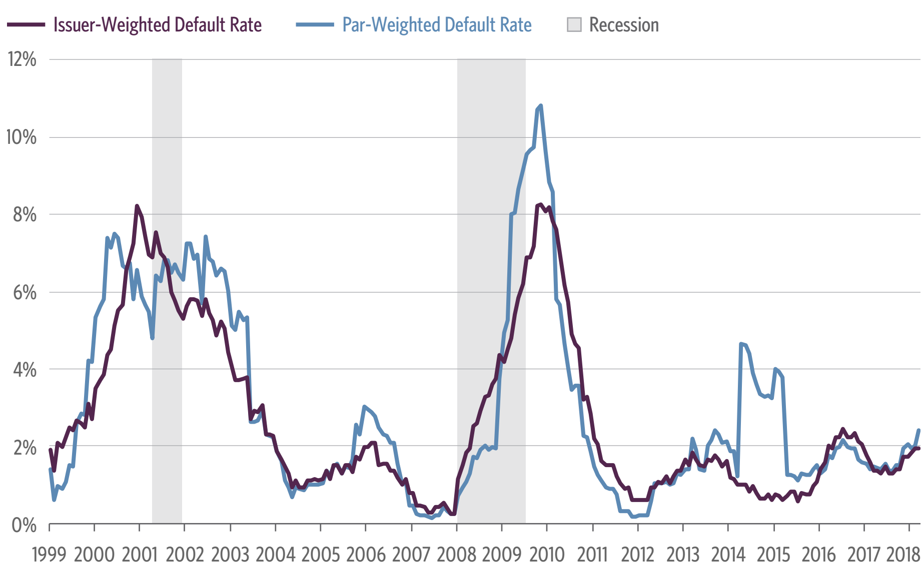
Loan Fund Flows Turned Positive as Treasury Yields Rose



Source: Bloomberg, Lipper, Guggenheim Investments. Data as of 4.27.2018. LHS = left hand side, RHS = right hand side.

Bank loan mutual funds and ETFs saw inflows of $4 billion year to date through April. We saw similar activity in mutual fund flows in late 2016, when a 127-basis point backup in 10-year Treasury yields—from a low of 1.36 percent in July 2016 to 2.63 percent in March 2017—was accompanied by cumulative net loan fund inflows of $23 billion over the same period.

Loan Defaults Are Ticking Higher in 2018 as Rates Rise



Source: S&P LCD, Bloomberg, Guggenheim Investments. Data as of 3.31.2018. Gray areas represent periods of recession.

Rising rates will have negative consequences for some borrowers. This is highlighted in the recent uptick in default activity, with both the 12-month trailing par and issuer weighted default rates going up in the first quarter of 2018.