Bank Loans

Rising Carry Continues to Attract Flows

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Rising net supply of institutional loans has weighed on performance, but rising carry attributed to higher Libor continues to attract inflows.

The percent of loans trading above par declined to only 15 percent of the market as of the end of the second quarter of 2018, down from over 60 percent at the end of the first quarter. This has caused a shift in primary activity as issuers lost some of their incentive to refinance existing loans. Filling this void is a resurgence in volume related to M&A and leveraged buyouts (LBOs) since tax reform was passed (see chart, top right). Year to date through July, over 55 percent of loans issued were for M&A and LBO activities. This trend, accompanied by increasing leverage ratios, is something we typically see toward the end of the business cycle (see chart, bottom right).

The Credit Suisse Leveraged Loan index gained 0.8 percent in the second quarter of 2018, making it the 10th consecutive quarter of positive returns in the loan market. This brings year-to-date return to 2.4 percent, with loans outperforming high-yield and investment-grade corporate bonds as investors sought duration protection amid rising rates.

Supply dynamics have not significantly weighed on returns because rising carry income continues to support loan returns this year relative to other fixed-rate sectors. One-month and three-month Libor have risen by 90 basis points and 100 basis points, respectively, since June 2017. Over the same period, average current yields on institutional loans have risen from 5.1 percent to 5.9 percent. Given our Macroeconomic and Investment Research Group's view that the Fed will raise rates two more times in 2018 and four times in 2019, higher short-term rates are likely to continue to attract inflows to loans over the next 18 months, but it will be important to monitor demand dynamics as CLO spreads have widened since the beginning of the year. This makes it difficult for CLOs to maintain an attractive asset-liability spread and could weaken demand from the loan market's largest investor base. We thus believe that some technical headwinds lie ahead for the loan market, but rising coupons may cushion any negative price impact.

M&A and LBO Loans Have Risen, Filling the Refi Void

Quarterly M&A- and LBO-Related Institutional Loan Issuance

Source: S&P LCD, Guggenheim Investments. Data as of 6.30.2018.

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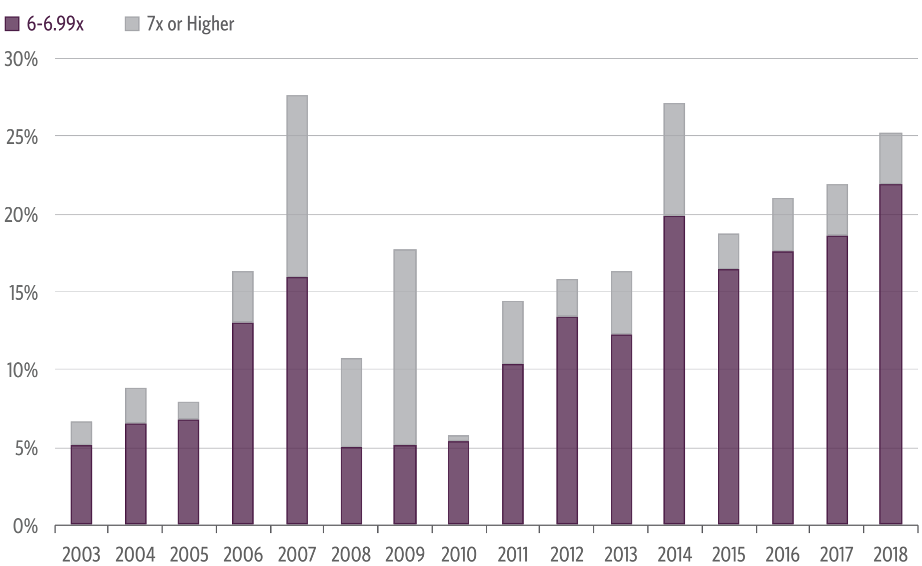
Increasing Share of New Leveraged Loans Have Debt Ratios Greater than 6x

Share of Large Corporate Loan Transactions by Debt / EBITDA Ratio



Source: S&P LCD, Guggenheim Investments. Data as of 3.30.2018.

Increasing leverage ratios, accompanied by decline in loan refinancing, is a phenomenon we typically encounter toward the end of the business cycle.