Bank Loans

A Borrower's Market

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Credit performance has been strong, but the erosion of investor protections raises risks in the next downturn.

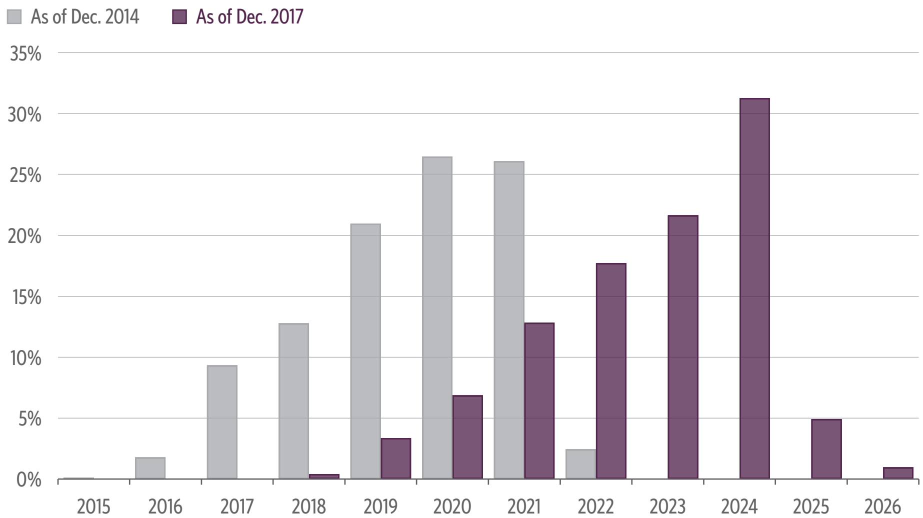
Low loan defaults and muted volatility in 2017 created a favorable credit environment for loan investors and borrowers alike. We saw another year of strong refinancing and repricing activity, which tightened contractual spreads by 6 basis points quarter over quarter and 34 basis points year over year. Refinancing activity also helped borrowers push the maturity wall out to 2024, when over 30 percent of loans are expected to mature (see chart, top right). Just three years ago, half of outstanding loans were expected to mature in 2020 or 2021. We expect much of the same for 2018. Refinancing and M&A activity should drive healthy supply, which we expect to be met with strong demand from investors looking for floating-rate assets in an environment in which the Fed is continuing to raise interest rates.

The Credit Suisse Leveraged Loan index posted a gain of 1.2 percent in the fourth quarter, bringing 2017 returns to 4.2 percent. CCC-rated loans were the best performers with an 8.0 percent total return, outperforming the high-yield corporate bond index, but not CCC-rated corporates. BB-rated and B-rated loans returned 3.5 percent and 4.5 percent, respectively, significantly underperforming CCCs for the year.

We expect 2018 will see further loosening of credit standards. The covenant-lite issuance trend continues to strengthen, representing 74 percent of the par amount of loans outstanding (see chart, bottom right). In addition to the removal of financial maintenance covenants, we saw a weakening of negative covenants in credit documents as borrowers and sponsors continue to push the envelope to preserve their options in a downturn. We believe these actions will likely reduce lenders' recoveries when defaults rise. Lastly, we have seen first-lien BB-loans issued with 0 percent London interbank offered rate (Libor) floors (or in a few cases, no Libor floor), reversing the post-crisis trend of 0.75–1.25 percent Libor floors. We categorize such activities as late-cycle behavior. The credit health of individual companies will likely remain strong for now, but loosening covenants and weakening credit documents remain a source of concern for our credit team as they will likely reduce recoveries when defaults rise. In response, we remain defensive in our credit selection, focusing on investments that we believe can survive the next downturn and allow us to comfortably hold them until maturity.

Bank Loan Maturity Wall Gets Pushed Out

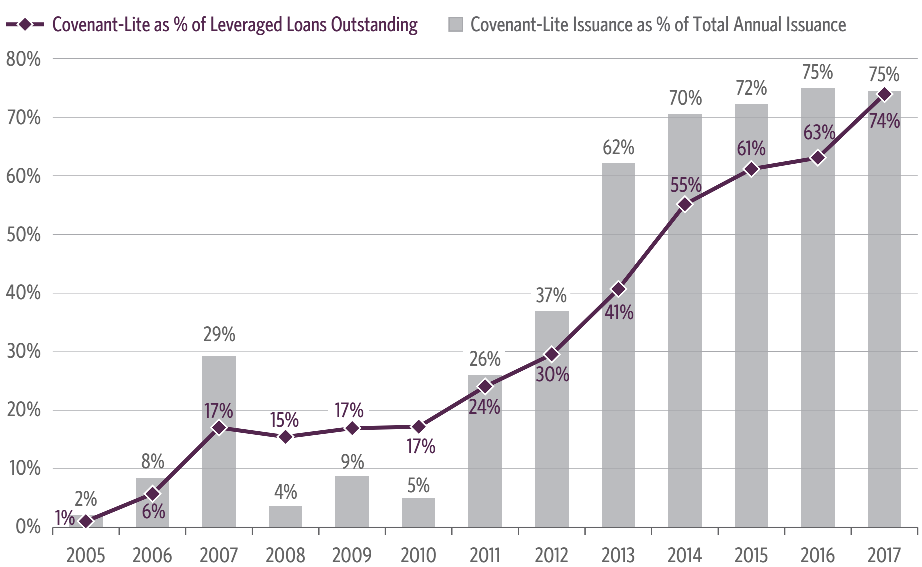
Percentage of Loans Due to Mature



Source: Credit Suisse, Guggenheim Investments. Data as of 12.31.2017.

Another year of strong refinancing and repricing activity caused contractual spreads to tighten by 6 basis points quarter over quarter and 34 basis points year over year. Refinancing activity also helped borrowers push the maturity wall out to 2024, when over 30 percent of loans are expected to mature.

Covenant-Lite Trend in Bank Loans Continues to Strengthen



Source: Bank of America Merrill Lynch, S&P LCD, Guggenheim Investments. Data as of 1.19.2018.

We expect 2018 will see further loosening of credit standards as we have seen over the past several years. The covenant-lite issuance trend continues to strengthen, representing 74 percent of the par amount of loans outstanding.