Bank Loans

Ratings Migration Signals Trouble Ahead

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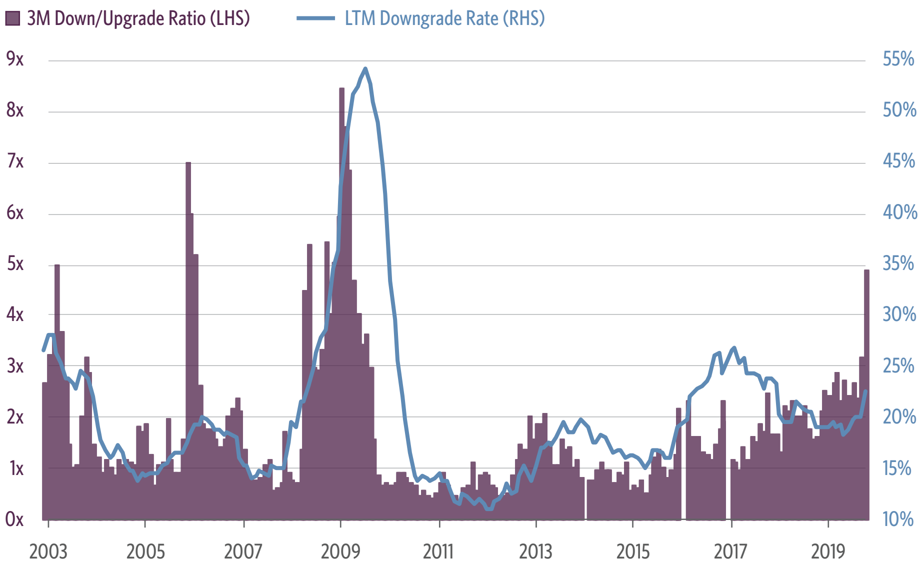
The worrisome pace of downgrades in the leveraged loan market is likely to continue.

Some 102 loans were downgraded between June 2019 and September 2019, according to S&P LCD, representing 7.2 percent of the LSTA Leveraged Loan index. Only 21 loans in the index were upgraded over the same period, resulting in a downgrade-to-upgrade ratio of 4.9x—the highest since 2009 (see chart, top right). The downgrades are not focused on any specific industry. Companies operating in commercial services, retail, technology, healthcare, consumer products, media, energy, and several other subindustries have seen loans downgraded, leaving loan investors few places to hide.

Amid the accelerating pace of downgrades and rate cuts by the Fed, the Credit Suisse Leveraged Loan index delivered a total return of 0.9 percent, losing steam from the second quarter, which delivered a return of 1.6 percent. Lower-rated loans weighed on index performance, with split B and CCC loans losing 3.2 percent and 1.3 percent, respectively. Higher-quality BB loans held on to positive returns of 1.6 percent for the quarter as many fewer BB-rated loans were downgraded compared to the single B or below category. Unfortunately, with a weighted average rating of approximately B+, the market is comprised of more single B loans and fewer BBs (see chart, bottom right). More specifically, the rising share of single B- loans is of concern given that a one-notch rating downgrade drops them to CCC+.

Heavy CCC-rated volume, whether due to downgrades or issuance, would likely be met with very limited demand. Collateralized loan obligations (CLOs), a large buyer of loans, have a limit on their exposure to CCC-rated loans. Intex data suggest that CLOs may be able to absorb about $25–30 billion in CCC loans in aggregate before reaching their limit. Within the Credit Suisse Leveraged Loan index alone, $175 billion par value, or 266 loans, are rated single B- by S&P, of which $28 billion also have a negative outlook. Among the remaining buyers of loans—retail funds, banks, and hedge funds—only the hedge fund group may have appetite for CCC loans. But loans may have to clear at lower prices and wider spreads for hedge funds to absorb the potential volume of single B loans that could get downgraded to CCC. As such, we continue to emphasize an up-in-quality theme.

The Number of Downgrades Far Outweighed Upgrades in Q3



Source: Guggenheim Investments, S&P LCD. Data as of 9.30.2019.

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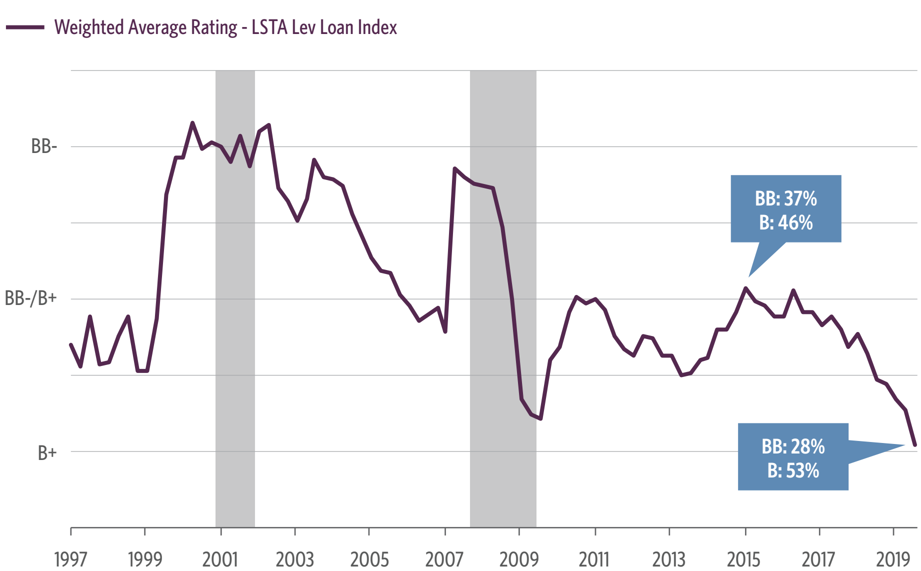
Lower-Rated B Loans Flood the Market



Source: Guggenheim Investments, Loan Syndications and Trading Association. Data as of 9.30.2019. Percentages reflect leveraged loan market composition.

Higher-quality BB loans held on to positive returns of 1.6 percent for the quarter as far fewer BB-rated loans were downgraded compared to the single B or below category. Unfortunately, with a weighted average rating of approximately B+, the market continues to be comprised of more single B loans and fewer BBs.