GUGGENHEIM

Bank Loans

The Loan Dilemma of Higher Interest Rates

The pros and cons of short-term interest rates going deeper into restrictive territory.

Average prices declined by 0.4 percent in the third quarter, but coupon income helped total returns for the bank loan sector to bounce back with a return of 1.2 percent. This partially reversed the 4.4 percent loss in the second quarter, bringing the Credit Suisse Leveraged Loan Index return to -3.3 percent as of Sept. 30.

Demonstrating that loans are not immune to the Fed's rate hikes, discount margins tightened 100 basis points from June through mid-August and then widened 100 basis points from mid-August through September as the Fed prepped the market for, and then delivered, its second 75 basis point rate hike at the end of the quarter. Three-year discount margins, the conventional way to express risk premium in loans, ended the quarter at 668 basis points, the 92nd percentile of historical valuations dating back to 1992, and 200 basis points above the historical average. Part of the reason that discount margins are wide versus history is due to the sector's weakening credit profile (i.e. more single Bs than ever before), but even controlling for ratings, we find risk premiums are wide. As the Fed goes further into restrictive territory, the negative credit impact to loan issuers will worsen as interest payments rise.

Our analysis finds that the median loan interest coverage ratio (the ratio between annual cash flow and interest expense) could fall to less than 3.0x if the fed funds rate rises to 5 percent and earnings growth slows to 5 percent. A near threefold increase in the loan market default rate, from 1.3 percent to 3.5 percent in the next 12 months, is our base case expectation. Looking through the full cycle, we believe defaults could peak around 6-7 percent of the market in 2024 based on the lagged effects of tightening financial conditions and a U.S. recession. This would exceed the COVID peak default rate of 4.6 percent and would be comparable to the 2008 default cycle in terms of length. Since investors typically recover about 60 percent of their loan value in default situations, we estimate the cumulative credit loss rate in loans to be around 4 percent in the next two years. Discount margins at 668 basis points, some of which compensates for limited market liquidity, exceed our loss estimate.

We believe loans remain a compelling place for credit exposure due to attractive yields and discounted prices. We are increasingly selective on new purchases as recession risks rise heading into 2023, and look to make defensive allocation adjustments as the end of this cycle comes more clearly into view.

By Christopher Keywork and Maria Giraldo

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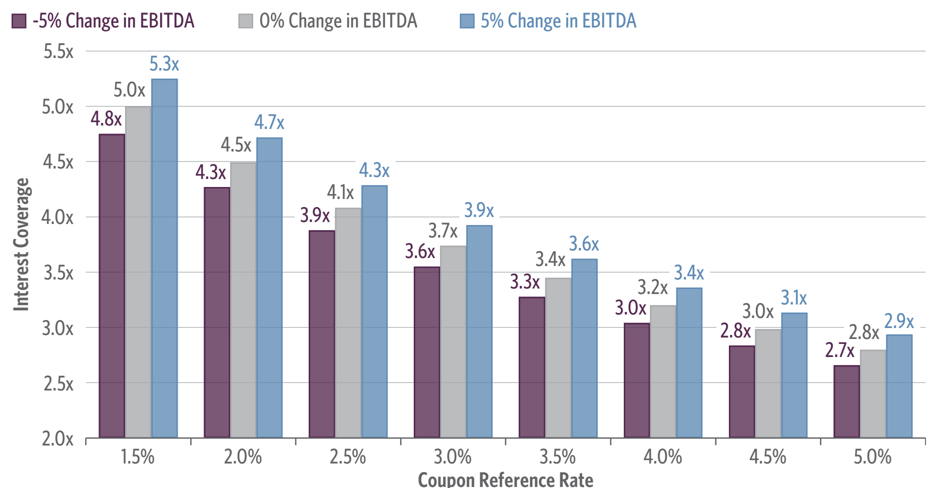
Bank Loan Interest Coverage Ratios

Interest Coverage for Given Coupon Reference Rate



Source: Guggenheim Investments, S&P LCD. Data as of Q2 2022. EBITDA - earnings before interest, taxes, depreciation, and amortization.

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