Market Insight

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More Tailwinds for Senior Loans?

The Federal Reserve, Money Market Funds and LIBOR

An increase in short-term interest rates typically translates to a pick-up in yield for senior loan portfolios. As a result, investors have always paid much attention to the actions of the U.S. Federal Reserve (the "Fed") and movements in LIBOR, the base rate over which loan spreads float. In fact, LIBOR and the fed funds rate have historically had a very tight relationship, with the former typically trading about 25 basis points (bp) above the latter. Recently that has changed, as LIBOR has been moving up, but without any short-term rate changes from the Fed since its first 25 bp lift at the end of 2015. What many investors may not have expected was that, although not as common, other market pressures on short-term commercial paper can also impact LIBOR and, ultimately, the yield they receive from investing in senior loans.

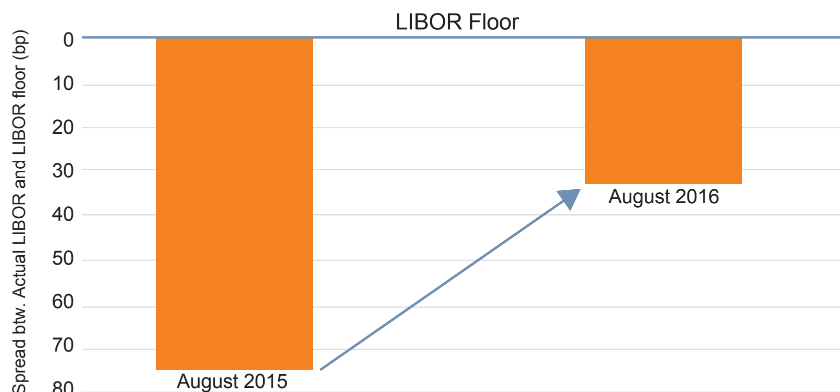
Money Market Reform is Driving LIBOR higher

On October 15, 2016 , as a result of impending regulatory reform, money market ("MM") funds will move from a fixed to a floating NAV and will be able to implement redemption gates and charge liquidity fees to investors. As a consequence, investors have begun redeeming from prime MM funds and investing in government MM funds. The result has been less demand for short-term commercial paper, leading to higher yields and a noticeable increase in LIBOR. As of the end of June, 60 day LIBOR stood at approximately 55 bp; by the end of August, it had increased to 66 bp. While MM reform does not explain 100% of the movement in LIBOR, most market observers view it as the main proponent.

What Would a Fed Rate Hike Mean for LIBOR Floors?

In the aftermath of the Global Financial Crisis, interest rates were brought close to zero to stimulate growth in the U.S. economy. Since then, most senior loans have been issued with what's referred to as a LIBOR floor, i.e., a minimum rate (hence the "floor") on the base rate component of the overall coupon. At August 31, 2016, just below 90% of the loans in the S&P/LSTA Leveraged Loan Index had a LIBOR floor, with the weighted average of the floor being approximately 0.99%. The recent increase in 60 day LIBOR reduces, as of August 31, the gap between spot (or actual) LIBOR and the LIBOR floor to 33 bp — a notable change from the 75 bp gap seen about a year ago (Figure 1).

Figure 1. Senior Loan Rates May Soon Break through LIBOR Floors



Source: S&P/LCD; Bloomberg

So, if the Fed does move at least once in 2016 (an assumed 25 bp), and should the upward creep in LIBOR related to MM reform continue, there exists a good possibility that the gap will dissipate in short order. It's important to remember that, once that occurs, the income from loans will again float according to the effective reset period.[1] The reset period will vary from loan to loan, but a large, diversified portfolio of senior loans can be expected to have a weighted average reset period of 60 days or fewer.

Of course, we're not there yet, but the recent increases in LIBOR remind us that the LIBOR floor influence on loan coupons is very likely a temporary one. Yield-wise, that would be a positive tailwind for loan performance. But a move higher in short-term rates cannot be taken in complete isolation. Coupled with strong 2016 performance of the asset class, on both an absolute and risk-adjusted basis, and recent, more hawkish Fed dialogue, we believe that increasing LIBOR rates would boost demand for floating rate loans. Should that happen, as we've stated before, and if that increased demand isn't met with sufficient new loan supply, prices would likely move incrementally higher. While a positive for total return, it could crimp distribution yields a bit.

Additionally, a material jump in demand may result in credit spread compression on new loans coming to market and thus increase the probability of an up-tick in "re-pricing" activity (i.e., a voluntary resetting lower of the borrower's credit spread) on existing loans. In this scenario, weighted average credit spreads for the asset class could begin to narrow while short-term rates are increasing, potentially pushing back a bit the point at which materially higher yields for loans would materialize. While there are a few moving parts to this equation, the eventual outcome will be dictated in large part by the extent to which short term rates rise, as the LIBOR component has, over longer periods of time, contributed the lion's share of the coupon in the world of floating rate senior loans.

From a credit risk perspective, while materially higher borrowing costs could have an adverse impact on the most leveraged issuers in the market, we believe that the recent lift in LIBOR — all the way through the Fed's terminal level, i.e., the peak for this cycle — is not materially concerning for the majority of borrowers, as average cash coverage ratios relative to debt service obligations remain well above historical means.

The Broader Investment Thesis for Loans Remains Intact

Global market risk is likely to remain high amid continued and unpredictable macro headwinds. While investment markets will likely remain choppy as the Fed struggles to right-size its policy rate, we believe that the investment thesis for loans is fully intact. In our opinion, senior loans continue to be an attractive investment in today's environment and offer favorable prospects for generating income now and with further upside potential once actual short-term LIBOR exceeds the average LIBOR floor within a given portfolio. We also believe the senior and secured position of the asset class will continue to set it apart as a volatility-dampening portfolio diversifier for yield-oriented investors with a mid- to longer-term investment profile.

[1] Loans typically pay a two-part coupon — a market-driven base rate (30-60 day LIBOR in most cases) plus a contractual credit spread which serves as a risk premium. When short-term market interest rates go up, the LIBOR component of the coupon also rises. This lifts the overall interest rate paid by the borrower, as well as the income to a portfolio invested in senior loans. Conversely, when short-term market interest rates decline, the income from senior loans will duly follow. The period of time between an increase in market rates and the resulting rise in the interest rate on a senior loan is referred to as the interest rate "reset period."

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