Senior Bank Loans

2017 Forecast: The Stage is Set for Another Strong Year

Senior Loan Group

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Investment Outlook

Senior bank loans returned more than 10% in 2016. Looking ahead to 2017, the asset class seems poised for another strong year. Our "base" case for the total return of the S&P/LSTA Leveraged Loan Index in 2017 falls between 4.5–5.0%, i.e., within the range of coupon expectation.

Other than CCC/D-rated loans that we believe are fully valued, most of the Index is trading at or near par. Accordingly, given the general "callability" of loans, we see little in the way of material upside price appreciation. However, that is only one part of the story. Loans continue to offer attractive yields with no material duration risk and offer attractive returns relative to similarly situated alternatives. Additionally, the gap between the LIBOR floor of loans and spot (or actual) LIBOR has essentially disappeared, making loans even more attractive in a year where interest rates are expected to increase.

LIBOR Floors: Then and Now

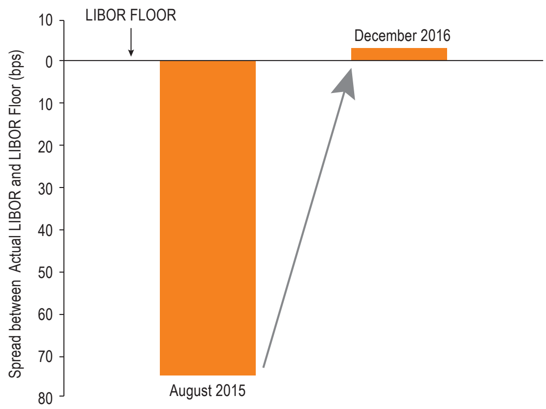
In the aftermath of the 2008 financial crisis, interest rates were brought close to zero to stimulate growth in the U.S. economy. Since then, most senior loans have been issued with what's referred to as a LIBOR floor, i.e., a minimum rate (the "floor") on the base rate component of the overall coupon. As of August 31, 2016, just below 90% of the loans in the Index had a LIBOR floor, with the weighted average of the floor being a yield of approximately 0.99%.

In December 2016, the Federal Reserve increased short-term rates for the second time since the 2008 financial crisis. Additionally, the impact of impending regulatory reform on money market funds and subsequent investor redemptions from prime money market funds since October has lowered demand for short-term commercial paper and resulted in higher yields and a noticeable increase in LIBOR over the last few months. As a result, the LIBOR/LIBOR floor gap for loans has disappeared (Figure 1). As of the end of December, three-month LIBOR stood at approximately 100 basis points (bp), and the weighted average LIBOR floor for the Index was 97 bp.

As a result, the floating rate nature of senior loans can now revert to its historical presentation as an ultra-short duration asset class. Going forward, all (credit-related) things being equal, the overall coupon of loans will reflect changes in short-term interest rates within a typical 45–60 day "reset" period.

For investors seeking protection in a rising interest-rate environment, the diminished impact of LIBOR floors is another compelling reason to consider an allocation to senior bank loans.

Figure 1. LIBOR Floors Have Disappeared



Source: S&P/LCD; Bloomberg

Strong Technical Support

The support of rising short-term rates and the resulting encouragement of positive flows to the asset class from various types of investors is central to our base case argument. Retail investors have already demonstrated renewed vigor for loans, which is likely a function of beginning to see losses in bond investments given the rise in core bond yields. Similarly, institutions such as pension funds and insurance companies already appear to be lining up allocations in 2017, through investments both in funds and segregated accounts.

The collateralized loan obligation segment of the market has reemerged, and while new issuance under risk retention rules is not likely to revert to anywhere near 2013–2014 highs, activity should remain healthy relative to longer-term historical averages.

The question is then whether new loan supply will be sufficient to meet demand and therefore mitigate further spread compression, which could adversely impact gross yields. In our opinion, technical balance, while never at complete equilibrium, should likely remain reasonable through the year. Although we are still in a "wait and see" holding pattern as the new Trump administration sets its policy priorities, we do believe that sound reflationary policies and tax reform measures could set the stage for improved investment confidence, which would likely provide a boost to new loan issuance. That said, should the market remain materially undersupplied, it may lead to new bouts of spread tightening. Important in this context, however, is the fact that loans head into the new year with credit risk premiums (i.e., spreads) above historical averages (Figure 2), and a basic underlying assumption that LIBOR levels should rise enough to offset or overcome most, if not all, of the coupon loss resulting from spread compression. In this scenario, all-in gross yields would remain attractive, particularly relative to underlying risks (Figure 3).

Figure 2. Entering 2017, Loan Spreads are above Historical Averages

Loan Credit Risk Premium and Gross Yields: January 31, 1997 to December 31, 2016*

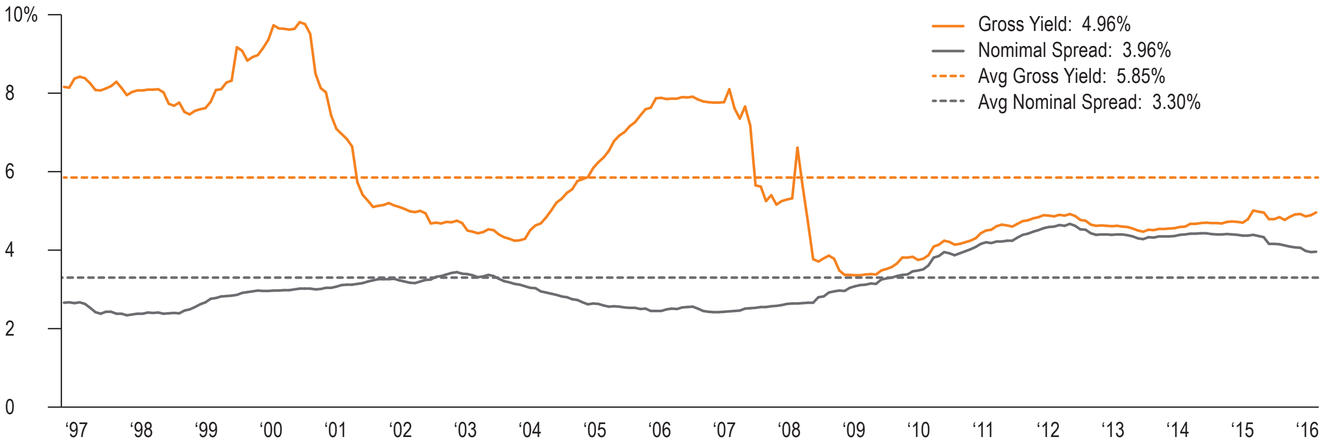
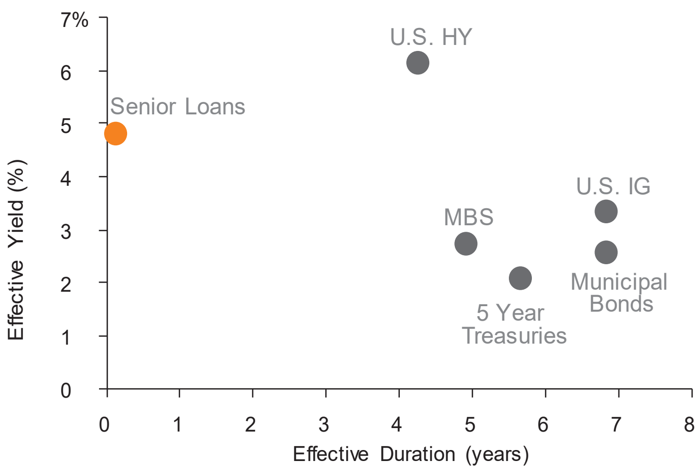


Figure 3. Gross Yield for Loans Remains Relatively Attractive

Effective Yield and Effective Duration as of December 31, 2016



Source: S&P/LSTA Leveraged Loan Index, BAML and Bloomberg

*Nominal spread data excludes all facilities in default. Nominal spread shows the excess spread over LIBOR, and includes LIBOR floors (where applicable). Gross yield reflects the nominal spread plus three-month LIBOR.

We expect default activity to increase moderately in 2017, as the remaining problematic oil and gas exposure in the Index is cleaned up and the market digests what is bound to be a flaring of idiosyncratic credit stress. A recent S&P/LCD buy-side survey shows that loan managers put their year-end 2017 forecast for trailing default activity by principal amount at approximately 2.44%, which is still inside the long-term asset class average of 3.09%.

We believe that this generally supports a limited downside total return scenario for the year, but, as always, it is difficult to temper the impact of macro headwinds, particularly as a new presidency commences. We will likely face continued volatility as the new administration begins to clarify and implement proposed policies around taxes, infrastructure spending, trade, energy, and healthcare. The potential negative impact of these unknowns puts our "bear" case scenario at around 2–3%.

Conclusion

Ultimately, we believe the structural aspects of loans (i.e., their position in the capital structure and ability to repay at par) in combination with an inherent hedge on rising rates, are positive catalysts to support demand and help smooth some of the volatility other asset classes might experience more acutely as changing economic, monetary and fiscal policies become more clear. If we are correct, the result should be a year that highlights senior loans as potentially offering one of the more attractive risk-adjusted yields available to investors.

2017 Expectations Dashboard

Potential Total Return

In the range of 4.5–5.0%, with upside stemming from potentially higher short-term rates. With average loan prices at or near par, market value gains are not expected to be a material contributor.

Defaults

Late cycle evidence appears to be accumulating, but expectations for 2017 default activity are reasonably benign. Managing idiosyncratic risk will be the challenge.

Technicals

Given the expected direction of rates, investor demand should be quite good. The market will need new issue supply to keep pace in order to ward off unwanted consequences, such as credit spread compression.

Volatility

Many markets are currently priced to perfection; any major disappointment could leave risky assets vulnerable. Loans should fare better than most, but would not be immune.

Fed Policy

The Fed appears to have taken on a decidedly hawkish tone. Should they follow through without being overly aggressive, floating rate loans will likely be one of the most visible beneficiaries.

Macro Headwinds

All eyes have shifted to the potential impact of a Trump administration. The uncertainties run the board, from fiscal and economic policies to geopolitical considerations. Any and all negative surprises could impact risk-taking.

The S&P/LSTA Leveraged Loan Index is an unmanaged total return index that captures accrued interest, repayments, and market value changes. The Index does not reflect fees, brokerage commissions, taxes or other expenses of investing. Investors cannot invest directly in an index.

General Risks for Floating Rate Senior Bank Loans

Floating rate senior bank loans involve certain risks. Below investment grade assets carry a higher than normal risk that borrowers may default in the timely payment of principal and interest on their loans, which would likely cause the value of the investment to decrease. Changes in short-term market interest rates will directly affect the yield on investments in floating rate senior bank loans. If such rates fall,the investment's yield will also fall. If interest rate spreads on loans decline in general, the yield on such loans will fall and the value of such loans may decrease. When short-term market interest rates rise, because of the lag between changes in such short term rates and the resetting of the floating rates on senior loans, the impact of rising rates will be delayed to the extent of such lag. Because of the limited secondary market for floating rate senior bank loans, the ability to sell these loans in a timely fashion and/or at a favorable price may be limited. An increase or decrease in the demand for loans may adversely affect the loans.

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