RISING RATES REINFORCE CONVICTION IN LEVERAGED LOANS

KEY TAKEAWAYS

- Loan funds experienced positive flows in 2017, and this trend is likely to continue as investors gravitate toward the protection from higher rates offered by the floating rate feature of bank loans.
- Although resilient demand has allowed companies to lower their borrowing costs on existing loans, the rise of LIBOR has outpaced the growth of refinancing transactions, meaning that the rate reset feature of the asset class helped mitigate the loss of coupon for investors.
- Bank loans are a true floating rate asset again because the benefits of resetting bank loan coupons have come to fruition as LIBOR has risen above floor levels.
- Although troubled market segments such as retail are likely to experience more bankruptcies in 2018, we believe the default rate will remain comfortably below the long-term average, as earnings growth and mostly favorable macro conditions should be supportive for borrowers.

Leveraged loans are a compelling option for fixed income investors seeking a low-duration, higher-yielding asset class and who are willing to accept the credit risk associated with owning below investment-grade issuers. In the current environment, many fixed income sectors have come under pressure due to growing concerns about rising rates and inflation. Unlike most other fixed income alternatives where prices fall as rates rise, the floating rate feature of bank loans results in a low-duration profile because their coupons reset higher as rates rise. Additionally, the senior secured status of loans typically results in less volatile performance relative to high yield bonds.

The Federal Reserve’s decision to reduce its balance sheet and continue gradually raising interest rates has led to higher Treasury yields. The passage of U.S. tax reform and a federal budget agreement that is expected to increase deficit spending have also placed upward pressure on rates. In February, the yield on the 10-year Treasury note climbed to its highest level since early 2014, peaking mid-month at 2.94%. After having raised rates three times in 2017, the Fed is projecting up to four rate hikes this year. Leveraged loans have historically outperformed other fixed income asset classes during periods of rising Treasury rates and monetary policy tightening. Notably, leveraged loans advanced in the first two months of 2018, while most other fixed income segments posted losses.

SUPPORTIVE TECHNICAL ENVIRONMENT

Steady demand and a dearth of new supply have created favorable technical conditions for the asset class. Demand for loans exceeded supply over the last 12 months, with a significant portion of total issuance consisting of repricing/refinancing transactions rather than new loans coming to the market. Collateralized loan obligations (CLOs) have been a key source of demand. According to J.P. Morgan, CLO volume for calendar year 2017 reached the highest annual total on record. Loan funds also experienced positive flows last year versus outflows from high yield bond funds. This trend is likely to continue as investors gravitate toward the protection from higher rates offered by the floating rate feature of bank loans. It must be noted, however, that robust demand has led to elevated valuations in the loan market. The percentage of loans trading above par has risen steadily, and we have modest expectations for capital appreciation in the year ahead.
STRONG DEMAND DRIVES REPRICING TRANSACTIONS

While resilient demand has supported the asset class, it has also fostered a surge in repricing activity. This occurs when companies return to the market to take advantage of benign credit conditions to lower their borrowing costs on existing loans. According to J.P. Morgan, repricing activity accounted for nearly half of all issuance over the previous 12 months through February. However, the rise of LIBOR has outpaced the growth of repricing transactions, meaning that the floating rate feature of the asset class helped mitigate the loss of coupon for investors.

LIBOR RISES ABOVE FLOOR LEVELS

A loan’s coupon equals the credit spread plus LIBOR, the interest rate at which banks lend money to each other in the London wholesale market. The total coupon typically resets every 90 days based on the LIBOR level, while the spread remains unchanged. Importantly, the benefits of resetting bank loan coupons do not come to fruition until LIBOR increases above floor levels. Three-month LIBOR ended February at 2.02%, making floors largely unnecessary. LIBOR floors today typically range from 0.75% to 1.50%. With LIBOR above these levels, bank loans are a true floating rate asset again. Still, a development of note for the asset class is that the percentage of loans in our index with LIBOR floors has declined, as a growing number of loans are coming to the market without floors.

FAVORABLE LONG-TERM OUTLOOK

We remain constructive on the long-term prospects for the loan market. Steady economic growth, favorable employment trends, healthy corporate fundamentals, and modest default levels should bolster the performance of the asset class. According to J.P. Morgan, the 2017 default volume was the lowest annual total since 2013. The number of defaults is likely to increase in 2018 due to more bankruptcies in troubled market segments such as retail. However, we believe the default rate will remain comfortably below the long-term average, as earnings growth and mostly favorable macro conditions should be supportive for borrowers. Moreover, the defaults we are likely to see this year have been well telegraphed or are widely expected by the market, thus the impact on the broader asset class should be contained.
Relative Value Short-Term Outlook

<table>
<thead>
<tr>
<th>Sector</th>
<th>One-Mo. Return</th>
<th>YTD Return</th>
<th>One-Yr. Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Treasuries</td>
<td>0.94%</td>
<td>-1.18%</td>
<td>0.43%</td>
</tr>
<tr>
<td>U.S. Treasury Inflation Protected Securities (TIPS)</td>
<td>1.05</td>
<td>-0.79</td>
<td>0.92</td>
</tr>
<tr>
<td>Global Sovereign ex-U.S.†</td>
<td>1.43</td>
<td>3.62</td>
<td>11.75</td>
</tr>
<tr>
<td>U.S. Municipals</td>
<td>0.37</td>
<td>-1.11</td>
<td>2.66</td>
</tr>
<tr>
<td>Mortgage-Backed Securities (MBS)</td>
<td>0.64</td>
<td>-1.19</td>
<td>0.77</td>
</tr>
<tr>
<td>Commercial Mortgage-Backed Securities (CMBS)</td>
<td>0.39</td>
<td>-1.32</td>
<td>1.12</td>
</tr>
<tr>
<td>Asset-Backed Securities (ABS)</td>
<td>0.18</td>
<td>-0.39</td>
<td>0.62</td>
</tr>
<tr>
<td>Global Investment-Grade Corporate</td>
<td>0.25</td>
<td>-2.32</td>
<td>2.70</td>
</tr>
<tr>
<td>Global High Yield Corporate</td>
<td>-0.54</td>
<td>-0.69</td>
<td>4.53</td>
</tr>
<tr>
<td>Bank Loans</td>
<td>0.31</td>
<td>1.53</td>
<td>4.63</td>
</tr>
<tr>
<td>Emerging Markets (EM) Dollar Sovereigns</td>
<td>0.38</td>
<td>-1.78</td>
<td>3.34</td>
</tr>
<tr>
<td>EM Corporates</td>
<td>-0.19</td>
<td>-1.12</td>
<td>3.66</td>
</tr>
<tr>
<td>EM Local</td>
<td>1.02</td>
<td>4.44</td>
<td>12.99</td>
</tr>
</tbody>
</table>

Sources: T. Rowe Price, Bloomberg Barclays, J.P. Morgan, and S&P/LSTA.


†European corporates are included in this sector.

Past performance is not a reliable indicator of future performance.
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