



Uncovering Opportunities in Noninvestment-Grade Credit

Credit analysis can reveal value in bank loans, high yield bonds.

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KEY INSIGHTS

- High yield bonds and bank loans have various benefits and risks in the current environment of ongoing economic recovery and ultralow interest rates.
- The credit quality of the broad bank loan market has trended lower, but fallen angels have boosted the overall quality of the high yield bond market.
- We work closely with our global team of credit analysts to find selective opportunities in both segments of noninvestment-grade credit.

High yield bonds and bank loans (or leveraged loans) represent two forms of noninvestment-grade credit exposure. Both sectors have various strengths and risks in the current environment of economic recovery and ultralow interest rates. The loan and high yield bond markets are meaningfully larger in the U.S. than in Europe, although the two regions have broadly similar credit quality characteristics. Our global fixed income portfolio managers are finding select opportunities in some European high yield bonds in out-of-favor industries as well as U.S. high yield bonds and bank loans from companies that can benefit from a gradual reopening of the economy.

Floating Interest Rate on Bank Loans

Like all investments, fixed income instruments entail several risks, with

credit risks and interest rate risk among the most prominent. While both high yield bonds and leveraged loans have more credit risk than investment-grade bonds, they have less interest rate risk than their investment-grade counterparts. Higher income and lower interest rate risk are defining characteristics of the high yield bond and leveraged loan segments, making both options attractive in a low rate environment.

Similar to high yield bonds, bank loans have noninvestment-grade credit ratings and, therefore, higher coupons to compensate for their higher credit risk. However, loans are generally secured and senior to bonds in the issuer's capital structure, giving them repayment priority if the issuer defaults. The coupon of a leveraged loan equals a benchmark or base rate, typically the three-month London interbank offered rate (LIBOR),¹ plus a fixed credit spread. The overall



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¹ Bank loan markets are transitioning away from using LIBOR as a benchmark rate in favor of other short-term rates that may more accurately reflect market conditions.

“Higher income and lower interest rate risk are defining characteristics of the high yield bond and leveraged loan segments....”

coupon resets at regular intervals—often every 90 days—based on the changing base rate. Some bank loans have floors to provide a minimum interest rate if LIBOR or the benchmark rate reach low levels.

Because of their floating rate feature, bank loans have relatively low duration,² which is a unique feature in fixed income markets. While an increase in rates is not currently our base-case forecast, an unexpected pickup in inflation triggered by a stronger-than-expected recovery from the recession could push rates somewhat higher. In that environment, loans would likely suffer less than fixed rate bonds. Although noninvestment-grade bonds have a longer duration than leveraged loans, they have a lower duration than investment-grade notes with similar maturity, giving them some degree of insulation from higher interest rates.

U.S. Loan and High Yield Bond Markets Much Larger Than in Europe

The U.S. bank loan market, at about USD 1.2 trillion as of September 30, is far larger than the approximately USD 320 billion European loan market.³ However, the overall credit quality of both markets is in the B rating category, according to J.P. Morgan. The U.S. high yield bond market stood at about USD 1.6 trillion, again much larger than the European noninvestment-grade market, at approximately USD 600 billion.

While the average credit quality of both high yield bond markets was BB, energy-related issuers make up a larger percentage of the U.S. market than in Europe, which historically gave European noninvestment-grade bonds a marginal quality advantage over their U.S. peers. Leveraged loans have even less energy exposure than the European high yield bond market, contributing to

the segment’s comparatively low overall cyclical exposure.

Loan Market Credit Quality Trending Lower

We have observed that the average credit quality of the broad bank loan market has generally declined as the underwriting by the banks that provide the loans has become less stringent over the past few years, due largely to strong demand for the asset class when rates were rising. The degree of creditor protection provided by periodic maintenance covenants⁴ has also decreased so that loan covenants today are more consistent with those of high yield bonds. Now, coupled with the pressure on some businesses resulting from the pandemic and recession, these trends have made rigorous credit analysis even more essential for investors in loans and noninvestment-grade bonds. This environment is well suited for active portfolio managers.

High Yield Bond Market Quality Improving

In contrast, the credit quality of high yield bonds has generally been improving. The recession has resulted in many “fallen angels”—companies with BBB ratings (the lowest rung of investment grade) being downgraded to BB (the highest noninvestment-grade category). The addition of these higher-quality issuers, many of which are large, well-established corporations that can obtain funding on relatively easy terms, has lifted the overall credit quality of the noninvestment-grade universe.

The pandemic-induced flood of fallen angels only accelerated a long-running upward trend in the credit quality of the high yield bond market. Before the global financial crisis (GFC) of 2008–2009, the noninvestment-grade bond market was predominantly B rated.

² Duration measures a bond’s sensitivity to changes in interest rates.

³ Data source for market sizes: Credit Suisse. © 2020 CREDIT SUISSE GROUP AG and/or its affiliates. All rights reserved.

⁴ Covenants provide legal protection for debt holders against a deterioration in the borrower’s fundamental credit metrics.

In the era of falling interest rates after the GFC, fixed income investors searched for yield, leading many to the high yield market. Many of these investors typically focused on investment-grade debt, so they saw BB rated bonds as a way to add yield by “crossing over” into noninvestment-grade bonds. Particularly in Europe, higher-rated (BB) issuers in the high yield universe came to market to meet this demand.

The U.S. high yield market has expanded by over 70% since the GFC as demand for yield enabled companies to issue debt. Default waves removed lower-quality companies from the market, and some issuers shifted from leveraged loans to secured high yield bonds, pulling the quality of the overall market toward BB.

CLO Issuance Supports Bank Loans

Almost USD 68 billion in bank loans came to market during the third quarter of 2020 according to J.P. Morgan, an increase from the second quarter but well under half of the new issue volume in the first quarter, most of which occurred in January and February. Issuance of collateralized loan obligations (CLOs)⁵ has continued to increase since the March market turmoil following the onset of the pandemic, providing a reliable source of demand for bank loans. CLOs are by far the biggest buyers of leveraged loans, providing notable technical support. In the third quarter, loan funds industry wide also reported the lightest redemption levels of the past eight quarters.

Supply of New High Yield Bonds Surges

Noninvestment-grade companies tapped the U.S. bond market with significant issuance in April and May as they pushed to fortify balance sheets against the effects of the pandemic

and recession. The rush of new supply continued through the summer, giving the second and third quarters of 2020 the highest-ever quarterly levels of issuance, according to J.P. Morgan. The U.S. high yield bond market has a meaningful base of dedicated institutional investors that specialize in the asset class, and their demand for the new issues supported the market.

Participants in the European high yield bond market tend to move in and out of the segment, depending on their views of relative value, so issuance in Europe has been much lighter than in the U.S. However, the European Central Bank (ECB) has been buying investment-grade corporates for years, pushing yields lower and encouraging investors to move into noninvestment-grade bonds to add yield. Somewhat similarly, the Federal Reserve initiated support for high yield exchange-traded funds this year as part of its bond-buying programs.

Select Opportunities in Both Loans and High Yield Bonds

While we are aware of the heightened credit risk and less liquid conditions in high yield bonds and bank loans, we are working closely with our global team of credit analysts to find selective opportunities in both segments of noninvestment-grade credit. In particular, we are looking closely at some European high yield bonds in out-of-favor industries related to travel and transportation to locate credits that may be mispriced. High yield bonds and leveraged loans from companies that can benefit from a gradual reopening of the economy or from therapeutic treatments and vaccine development are also producing some opportunities. In addition, we have been finding value in price-dislocated fallen angels in the U.S. high yield market.

⁵ Collateralized loan obligations are securitized portfolios of bank loans structured into slices, or tranches, of varying credit risk.



WHAT WE'RE WATCHING NEXT

The ECB's quantitative easing programs have included investment-grade corporate bonds for years, supporting European noninvestment-grade credit by keeping yields in investment-grade sectors at unattractively low levels. The Fed launched a corporate bond purchase program in March. We are monitoring central bank policy sentiment for signs that the central banks will expand or extend their corporate debt purchases.

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Debt securities could suffer an adverse change in financial condition due to ratings downgrade or default, which may affect the value of an investment. Fixed income securities are subject to credit risk, liquidity risk, call risk, and interest rate risk. As interest rates rise, bond prices generally fall. Investments in high yield bonds involve greater risk of price volatility, illiquidity, and default than higher-rated debt securities. Investments in bank loans may at times become difficult to value and highly illiquid; they are subject to credit risk, such as nonpayment of principal or interest, and risks of bankruptcy and insolvency.

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