Bank loan market: Caution warranted due to softer credit quality

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Bank loans (also known as "leveraged loans") have become an increasingly popular investment choice in recent years due to relatively high yields, low sensitivity to rising interest rates and strong performance in the current credit cycle. However, deteriorating loan quality relative to history, and also when compared to high yield bonds, may warrant investor caution. In our view, risks are rising in high-yield and bank loan investment strategies. Investors should exercise moderation when implementing these strategies, especially if they are used at the expense of high-quality, lower credit risk fixed income investments, such as U.S. Treasuries, which typically provide better defensive characteristics for diversified portfolios.

Advantages and risks of bank loans

Unique and changing characteristics of bank loans are important factors to consider.

- **Floating rate features are likely to continue acting as a tailwind to loans.** Bank loans tend to be floating rate in nature, which can provide potential advantages in rising interest rate environments when compared to traditional fixed interest rate bonds. We expect this tailwind to continue due to our expectation for interest rates in the coming year. For every 1 percent increase in interest rates, we anticipate that the price of loans will drop by 0.2 percent to 0.3 percent when compared to high yield bonds of a similar maturity (which we believe are likely to lose around 4 percent in price).

- **Loan quality has deteriorated relative to high yield bonds**. Bank loans are often senior in issuers' capital structure, meaning they are amongst the top priorities for repayment in a bankruptcy, and often have a first lien on assets as collateral for the loan. This is one reason why bank loans have historically represented a lower risk, though lower return alternative, to high yield bonds. Declining loan covenant quality and reduced subordination over the past several years has eroded investor protections. As a result, average bank loan credit ratings have deteriorated relative to high yield bonds, and rating agencies have begun to raise concerns. According to Moody's credit rating agency, "[Weaker] credit agreements are creating the potential to upend or dilute the position of first-lien loans at the top of the capital structure."

- **Riskier use of loan proceeds is a cautionary flag**. On a year-to-date basis, 52 percent of the use of proceeds from bank loan issuance was for higher-risk activities, such as mergers and acquisitions (M&A) or leveraged buyouts (LBO). In contrast, only 19 percent of recent high yield bond issuance has been for M&A or LBO purposes while 79 percent has been for refinancing maturing debt or general corporate use. In times of market stress, companies that have used debt for core business needs instead of growth or expansion have typically fared better.

- **High yield and bank loan yield spreads to Treasuries are tight by historical measures**. The incremental yield received by high yield bond and bank loan investors is well below median levels over a range of various time frames. This indicates repricing risk if investor sentiment or the economic environment deteriorates. While the economic backdrop continues to be supportive and defaults remain low for now, we urge avoiding overreliance on lower-quality securities when valuations are rich by historical measures.

Conclusion

We believe that the primary component of fixed income portfolios should be comprised of bonds with low credit risk and strong portfolio diversification properties, such as U.S. Treasuries and high grade corporate or municipal bonds. Growing risks in the loan market warrant caution, despite strong recent performance. Rich valuations indicate bank loans and high yield bonds should be utilized in moderation. Our positioning remains neutral, with a cautious bias on the high-yield category (which includes bank loans). If you have questions or need additional information, please talk to your advisor.

Definitions:

- **Bank loan market:** Also known as "leveraged loan market," comprises debt from companies with below investment grade credit ratings. Bank loans are typically secured with a lien on the company's assets.
- **Leveraged buyout (LBO):** The acquisition of another company using a significant amount of borrowed money to meet the cost of acquisition. The assets of the company being acquired are often used as collateral for the loans, along with the assets of the acquiring company.
- **Mergers and acquisitions (M&A):** A general term that refers to the consolidation of companies or assets through various types of financial transactions. M&A can include a number of different transactions, such as mergers, acquisitions, consolidations, tender offers, purchase of assets and management acquisitions.