Past Is Prologue: Revisiting the Use of Corporate Loans to Manage Rate Sensitivity

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BREAKING THROUGH THE FLOOR, FROM BELOW

Lost amid the consternation surrounding record equity valuations and the focus on the amount of developed market debt trading with negative yields was a milestone in the corporate loan universe. For the first time since May 2009, 3-Month LIBOR, the benchmark rate for floating rate corporate loans, is above 75 bps. Regardless of whether this historic move represents a temporary shift or a lasting trend, there are a number of both near- and long-term effects of this rate level on the loan market, from changes to deal structures to potential benefits to investors in leveraged loans.

Central bank intervention in the post-crisis era forced benchmark yields across the globe to the zero bound; in response, many corporate loans incorporated a structural enhancement of a LIBOR floor to entice buyers. As global monetary policy morphed into the now familiar "lower for longer" mantra, this structural enhancement became a common feature and now a full 91% of the leveraged loan index has a LIBOR Floor.

LIBOR Floor Level	Index Market Value (%)
No Floor	9%
75 bps	21%
100 bps	64%
125 bps	5%

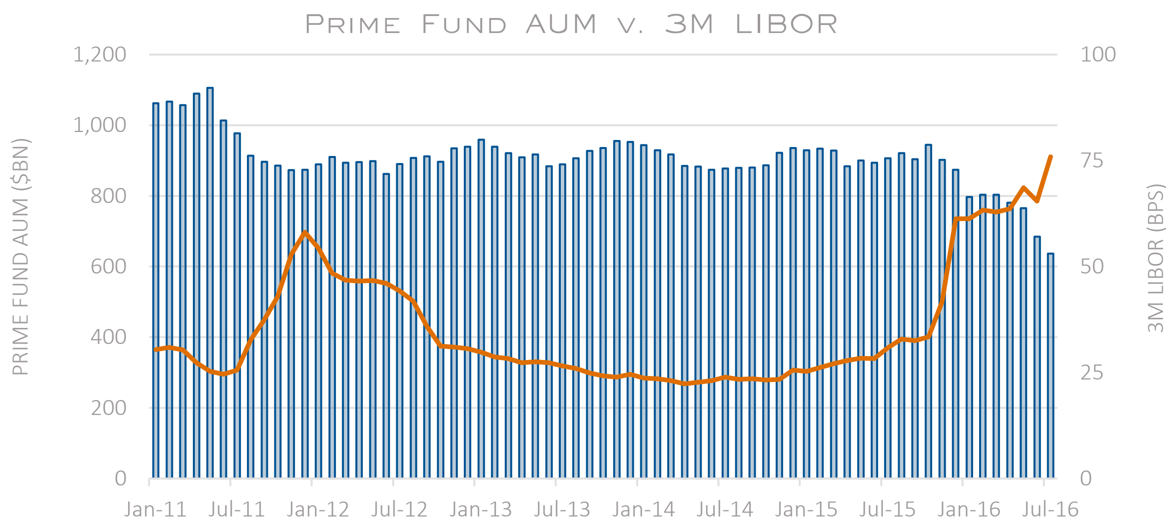
Source: Credit Suisse Leveraged Loan Index as of 7/31/2016

As the adjacent table demonstrates, a full 30% of the bank loan index may reflect its floating-rate origins. A move in 3-Month LIBOR above 100 bps, or 20 bps above today's level, will make that number nearly 94%.

STRUCTURAL INEFFICIENCIES IN ONE MARKET MAY BENEFIT INVESTORS IN ANOTHER

LIBOR rates reflect a myriad of factors, not the least of which is the influence of short-term rates by central bank targets. While the Fed is running out of excuses for delaying a rate hike, the culprit for the recent move higher in LIBOR rates does not appear to be the expectation a hike is imminent, as Fed Fund Futures are implying only a 40% chance of a rate hike by year-end 2016. Instead, the catalyst of the move

higher is most likely the impending reform of money market funds, specifically institutional prime funds, which will be required to float their NAVs beginning October 14th. These funds are a big source of demand for bank issued commercial paper and certificates of deposit. In anticipation of the impending change, investors have been pulling money from these funds at a furious pace in favor of government funds. This migration is triggering a spike in the cost of borrowing for financial firms, which in turn will be transmitted to the corporate loan market in the form of higher borrowing costs for issuers. Should the trend persist, loan investors stand to benefit from higher coupon payments due to the floating rate features of their securities—an attractive feature in the current yield starved world.



Source: Bloomberg as of 8/9/2016

RISK-FREE RATES ARE ANYTHING BUT

The end of the bond super-cycle has been rumored for some time. With the yield on the 10-year Treasury still firmly entrenched below the yield on the S&P 500 and within 15 bps of its cycle low of 1.36%, long-term prospects for fixed income returns are paltry. Though rates here in the U.S. are still upward sloping and offer a premium to other sovereign issuers, any further compression of the curve only serves to front-load returns for long-term investors. This reality lies at the heart of the recent warnings by notable members of the bond market "monarchy" that bond valuations are unattractive.

Stepping back to assess the risk-adjusted returns of high quality bonds, we must ask what has to occur in order to sustain the current rate regime. The answer is that we must believe the following:

I. Monetary policy makers will continue to believe in the efficacy of quantitative easing to battle deflationary trends and anemic global growth

2. Fiscal policy makers will either remain impotent and unwilling to utilize additional deficit spending to stimulate nominal GDP, or their late attempts will fall short

3. Any subsequent inflation from current or future policy changes can be contained

4. Investors will maintain their faith in each of these aforementioned assumptions

With all of this in mind, asset allocators everywhere should revisit their strategies for insulating portfolios from rate sensitivity. The critical problem with reducing rate sensitivity is that it typically comes at the expense of accepting assets with higher volatility and more equity sensitivity. Bank loans, with their senior position in the capital structure and floating base rate coupon mechanisms, are worth considering as a means of reducing rate sensitivity while maintaining portfolio yields, without accepting too much additional volatility in return.

THE MIDDLE CHILD OF CORPORATE CREDIT MARKETS

The corporate credit markets resemble siblings in the way they evoke the stereotypes of birth order. Investment grade corporates, like stereotypical first children, are reliable, conscientious, and cautious. High yield corporates, like the youngest child, are fun-loving attention seekers with a bit of self-centeredness that stems from over-indulgent parents. Corporate loans then are like the middle child: while somewhat rebellious, they thrive on their role of creating stability across the family and avoid standing out too far in either direction. As a result, they are, as the stereotype of middle children goes, often overlooked. Evidence of this oversight is apparent when comparing the valuation and risk profiles across asset classes.

Cross Asset Comparison | Post Crisis (2010 — Present)

					P/E (LTM)	Percentile	Volatility
				S&P 500	20.5x	100%	16%
	DURATION	PERCENTILE	SPREAD	PERCENTILE	YIELD	PERCENTILE	VOLATILITY
U.S. AGGREGATE	6.04 yrs	100%			2.41%	73%	2.87%
U.S. HIGH GRADE	7.30 yrs	87%	181 bps	35%	3.52%	93%	3.95%
U.S. HIGH YIELD	4.24 yrs	93%	681 bps	22%	7.91%	25%	6.24%
U.S. CORPORATE LOANS			***527 bps***	***52%***	***6.30%***	***45%***	***3.31%***
EUR HIGH YIELD	3.79 yrs		532 bps	62%	5.50%	84%	6.74%
EM DEBT (SOV)	8.05 yrs	88%	355 bps	37%	5.20%	86%	7.41%
EM DEBT (CORP)	4.81 yrs	19%	331 bps	64%	4.65%	89%	5.29%

Sources: J.P. Morgan U.S. Aggregate Bond Index; J.P. Morgan U.S. Corp Index; J.P. Morgan U.S. Domestic High Yield Index; J.P. Morgan leveraged Loan Index; Bloomberg; volatility values as of 7/31/2016, annualized; all other values as of 8/9/2016

As noted in the table above, corporate loans offer nearly the same level of spread and yield compensation as their high yield counterparts, despite exhibiting nearly half the historical volatility. Meanwhile, investment grade corporates look especially unattractive in comparison, due to both historically low yields and historically high interest rate sensitivity, as measured by duration.

CONCLUSION

Whether the Fed's attempt to pursue a modicum of policy normalization is well-timed or not remains to be seen. But what is certain is that the prospective returns for securities whose primary risk premia is duration are asymmetrically distributed around today's yield levels. With this in mind, investors will need to be more vigilant in managing the interest-rate and credit-spread sensitivities of their portfolios in a manner that allows for maintaining market rate current income without suffering potential principal losses. An actively managed portfolio of corporate loans, with adjusting coupons and attractive spread compensation, is a good tool to have at the ready. Further, corporate loans typically enjoy a senior position in the capital structure due to their secured claims on the assets of the firm. This seniority may provide additional protection in the event the policy makers were to "flop".

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