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Risky Loans? Think Again

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For private capital veterans, the recent spate of market volatility is another opportunity to show strength relative to public asset classes.

The threat of higher interest rates, abetted by spiking inflation, is now fully absorbed in the market. After a rocky week for the Dow and Nasdaq, indices firmed. But uncertainty still reigns and investors globally remain hung between Omicron's grip and the hope for resumed growth.

Loan investors are looking at this set of circumstances and voting with their feet. Last week $2 billion flowed into retail funds, bringing to almost $7 billion of in-flows for the new year, according to S&P/LCD and Lipper. Total assets in these funds now amounts to $93.6 billion, double the level from only a year ago. In contrast, $13 billion flowed out of retail high-yield bond funds.

Last Wednesday's WSJ ("Junk Loans Shine Amid Market Rout") highlighted the positive returns leveraged loans have shown so far for 2022, compared to the rout in bonds and stocks (*Chart of the Week*). "It's the one asset class in fixed income that tends to go up in value when rates rise," one manager said. He has increased his loan allocation from 1% in 2019 to 12% today.

Of course many credit investors have been anticipating higher rates for several years. And despite the "junk" or "risky" labels, leveraged loans have performed well during Covid. Indeed, as S&P reported recently, global corporate defaults for 2021 were the lowest since 2014.

Sectors that suffered the most defaults last year were homebuilders/real estate, consumer, media/entertainment, and oil and gas.

Having an active secondary market, broadly syndicated loans – unlike private credit generally, and direct loans, specifically – earn a component of their returns from price changes. Fed rate hike expectations drove loan prices to almost par, before falling back to just over 99.5 in the wake of last week's market turmoil.

While loan investors benefit from upswings in rates, loan borrowers do run the risk of higher interest expenses. However most managers view higher rates being associated, or at least accompanied by, more robust economic growth. Better revenue performance and stronger cash flows will support interest costs. Good businesses with reasonable leverage should manage a 1-2% pop in rates over the next two years, the level economists are suggesting.

Of more concern than growth would be an economic slowdown. Having fretted about the Fed's dovish stance until last month's about-face, observers worry that too much, too quickly could be a drag on commercial activity. Others see too many tailwinds for a slowdown any time soon.

Uncertainty, as one analyst put it, is worse than bad news. For loan investors, though, uncertainty about rates and volatility continues to fuel confidence in the asset class.