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# Relative Value in the Loan Market (Part One of Two)

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In our series on portfolio construction [link] we looked at how liquid and illiquid loan managers assemble quality all-weather assets. Because of the contrasting characteristics and behaviors of BSL and middle market, PMs work differently to extract and maintain value.

In recent months, thanks to market volatility caused by higher interest rates, toppy inflation, and the perceived higher probability of a recession, large cap loan prices have traded down sharply. S&P/LCD's leveraged loan index has dropped from 98.5 in February to 92 last week.

While an economic downturn would certainly increase the probability of loan defaults and losses, history shows that BSL *default rates* barely amounted to 8% in the Great Recession, let alone losses. So at this stage in the credit cycle, 92 represents the "worry discount" from perceived higher credit risks, particularly in sectors such as energy, food and commodities.

But that discount has real impact on primary issuance. To compete for buyers in the secondary market, the resulting average yield of a new single-B term loan has doubled from 4% to 8% since last fall. What's good for BSL investors, of course, is a drag for issuers. Large cap volume, per S&P/LCD, is off about 50% from last year. High-yield bond issuance has dropped off 75%.

Meanwhile, middle market loan yields have also risen, but modestly. Being less subject to in-and-out-flows of retail cash or CLO capacity, direct lenders with long-term capital can respond more to supply-demand technicals and competitive dynamics.

At year-end 2021, a plain vanilla middle market term loan was issued at SOFR plus 475 bps spread. Today that same loan would be S+500-550, depending on leverage. Including the benchmark rate and OID, the all-in yield is around 7.5%.

A lower cost of capital is one reason PE firms are increasingly going the private credit route to finance buyouts and acquisitions. But credit investors see higher large cap yields and wonder why not take advantage of this rare opportunity?

The spread differential between BSL and midcaps – the so-called illiquidity premium – has averaged 100-200 bps in favor of smaller loans for the past two decades (see our *Chart of the Week*). Exceptional market volatility occasionally pushes BSL yields close to MM, but that trade never lasts.

How long it takes for order to be restored depends on when the Fed signals its battle with inflation is being won. June's 9.1% CPI report pushes that day even further into the future.

*Next week: What's the longer-term outlook for relative BSL and MM spreads?*