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Is it time to consider leaving leveraged loans?

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Leveraged loan prices have begun to decline, and the sector faces liquidity headwinds. This prompts the question of what investors in leveraged loans can do to protect themselves from the challenges the sector will face as quantitative tightening (QT) takes hold. Hurdles include valuations inflated by quantitative easing (QE), credit issues and substantial supply/demand imbalances. We think the solution is to diversify this exposure from corporate-focused credit risk to a consumer-focused asset class that has not been as distorted by capital flows driven by QE, namely securitized credit.

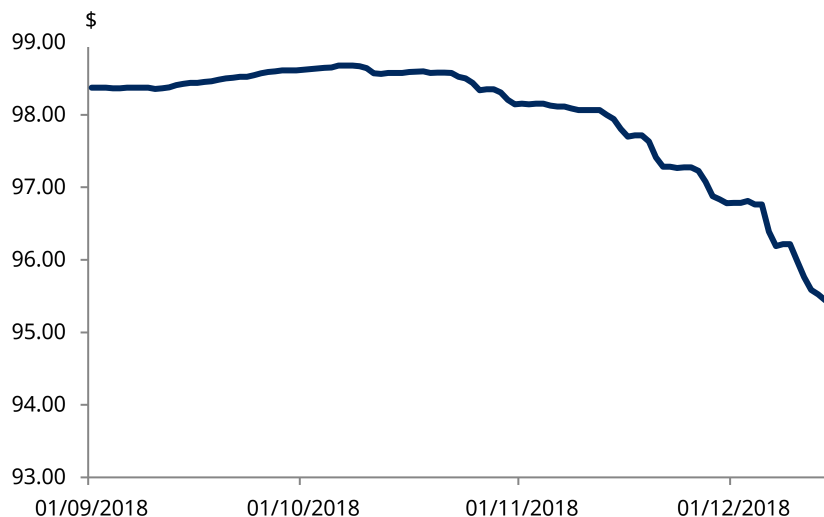
Below we have provided the three key dynamics that may lead to stress in the leveraged loan market this time around.

QE transition to QT

Global QE reduced the supply of higher quality and liquid investments and created an environment for corporations to lever up; resulting in corporate leverage reaching all-time high levels. Lower global yields caused by QE drove investors to other assets in the search for yield. This yield-seeking led to substantial inflows into US credit, including significant flows from overseas.

With QE moving to QT, we are seeing these trends reverse. As they do, loan spreads are widening and loan prices are falling. Investors may not have anticipated this price volatility prior to a recession.

Figure 1. Average bid prices have dropped sharply in recent weeks



Source: S&P Global, September 1, 2018 to December 14, 2018.

Change in demand

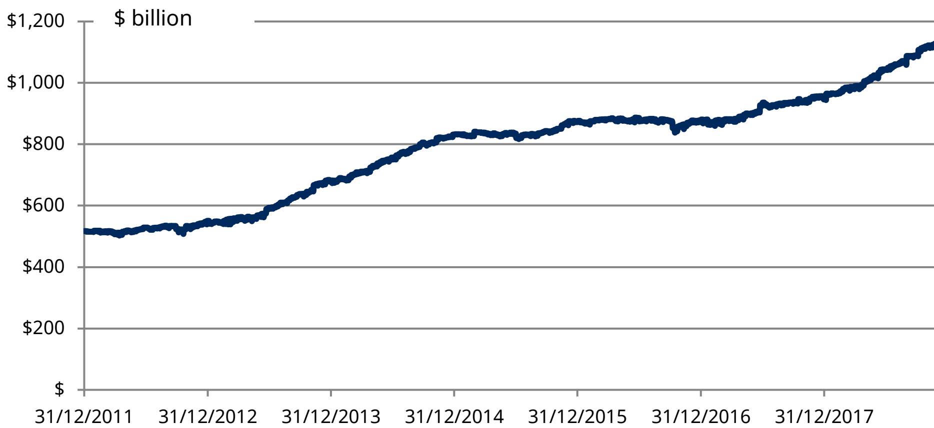
Leveraged loans received substantial demand from yield-seeking investors, particularly as they are floating-rate securities and therefore offer price protection against future increases in interest rates. Demand for floating-rate loans has been strong domestically and internationally, as well as from collateralized loan obligation (CLO) managers. Given the high demand, leveraged loan pricing is likely to be sensitive to declines in demand from any of these sources.

With a more dovish tone from the Federal Reserve (Fed), and with market consensus suggesting that there are possibly only two interest rate hikes remaining, it seems demand for rising rate protection is poised to decline. With recent spread widening in CLOs, it is also possible CLO demand for loans will be lower. This will have an impact on loan prices that may have been unanticipated by investors.

Credit issues

Given the strong demand, since 2011, the market for leveraged loans has more than doubled from roughly $500 billion to over $1.1 trillion.

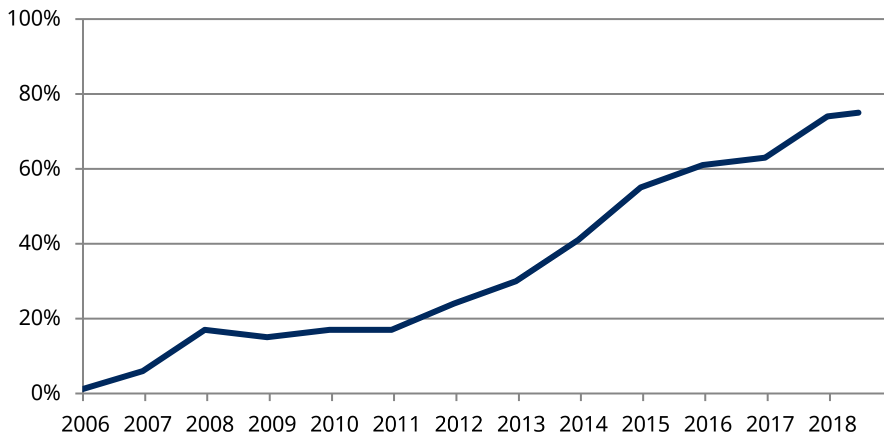
Figure 2. The leveraged loan universe has grown considerably since 2011



Source: S&P Global to December 14, 2018.

Along the way a material deterioration in quality has occurred, as indicated by the rising percentage of Covenant Lite loans; loans issued without some of the more traditional loan covenants (which is the legal agreement between the issuer and loan/bond holder) used to protect investors.

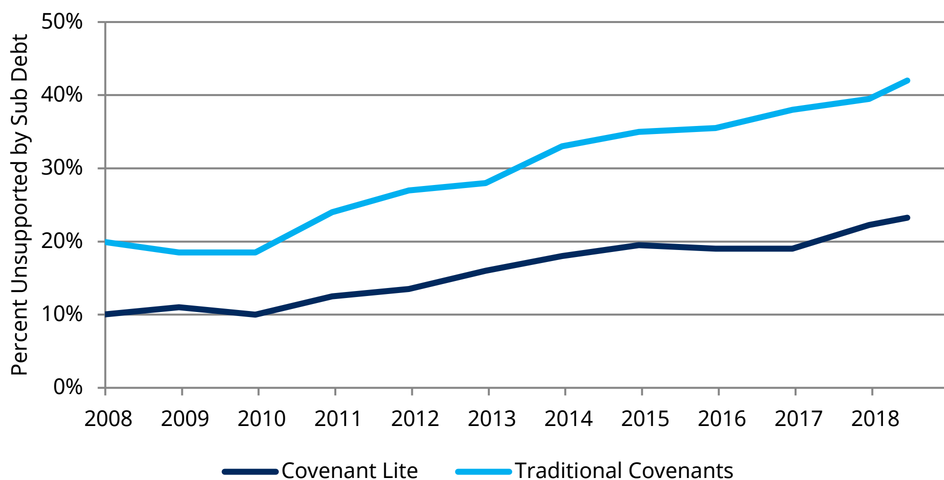
Figure 3. Leveraged loans are less investor friendly; "Covenant Lite" is now the norm



Source: LCD, August 2018.

Along with fewer loan covenants, loan leverage has risen, and the leverage levels likely reflect weaker underwriting with more significant EBITDA adjustments.

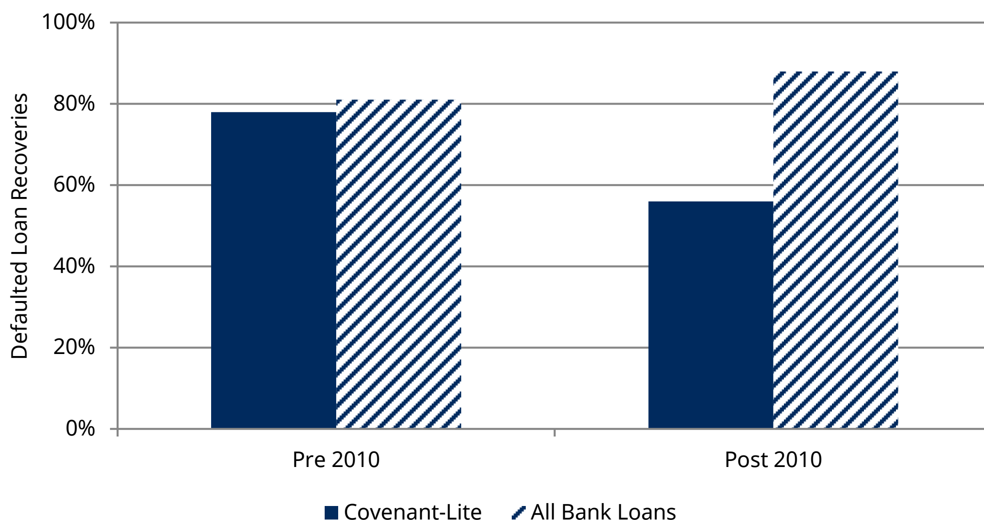
Figure 4. More and more borrowers going "loan only"



Source: LCD, August 2018.

Further, the debt cushion beneath the average loan has gotten smaller throughout this latest cycle, which should translate directly into higher loan losses in the event of default, especially given the increasing prevalence of loan-only deals.

Figure 5. Covenant Lite recoveries have already been weaker



Source: LCD, August 2018.

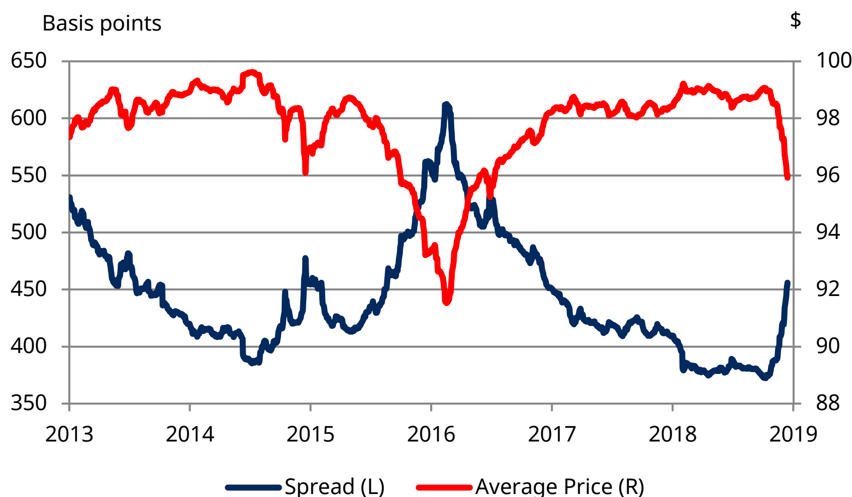
One more issue…market structure

More than 50% of leveraged loans outstanding are held by CLOs, and another 20% are held in mutual funds. It's important to remember that leveraged loans typically settle with a 30-day convention; this is a settlement period not matched for a daily liquid investment. As such, daily liquid funds would need to have some source of liquidity in short settling securities to meet the need for daily redemptions.

Recently, we have seen some of these liquid mutual funds own some securities, such as CLO securities, with a shorter settlement period (2 days), and we are now seeing some selling of these securities with little notice. We believe this is indicative that these funds are getting redemptions, and in turn, reducing their "liquidity holdings." This, we believe, will widen CLO spreads, creating a less attractive arbitrage for CLOs and put additional pressure on many of these loan funds. As the liquidity buffer is eroded, we think many of these funds will be challenged in their ability to generate cash for daily liquidity.

Price declines for leveraged loans have occurred in the post Global Financial Ccrisis period. The last period of loan price declines occurred as recently as 2016 and was centered on the energy crisis. Defaults for energy company's loans pressured prices, with the result being a decline from near par ($100) to near $92, as shown in the middle of Figure 6. However, this time around, the price declines have come quickly and are not yet linked to rising default rates.

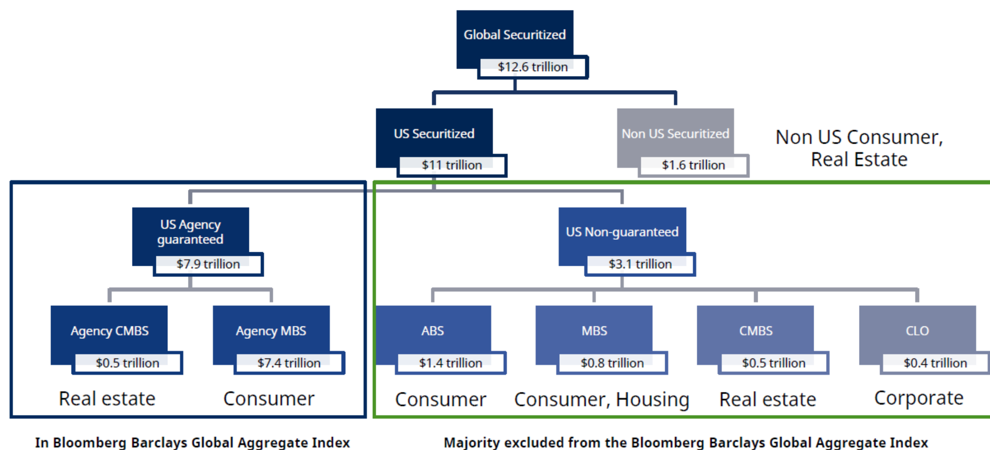
Figure 6. Sharp price declines, widening spreads, problematic for leveraged loans



Source: JP Morgan to December 14, 2018.

Wall Street versus Main Street – the case for securitized as the alternative to leveraged loans

With this backdrop, we suggest investors look at securitized credit, which is principally non-guaranteed asset backed securities (ABS), mortgage backed securities (MBS) and collateralised mortgage backed securities (CMBS). The majority of loans backing these securities are consumer, housing or real estate related (within the green box, below), which we believe offer much better fundamentals when compared to leveraged loans.



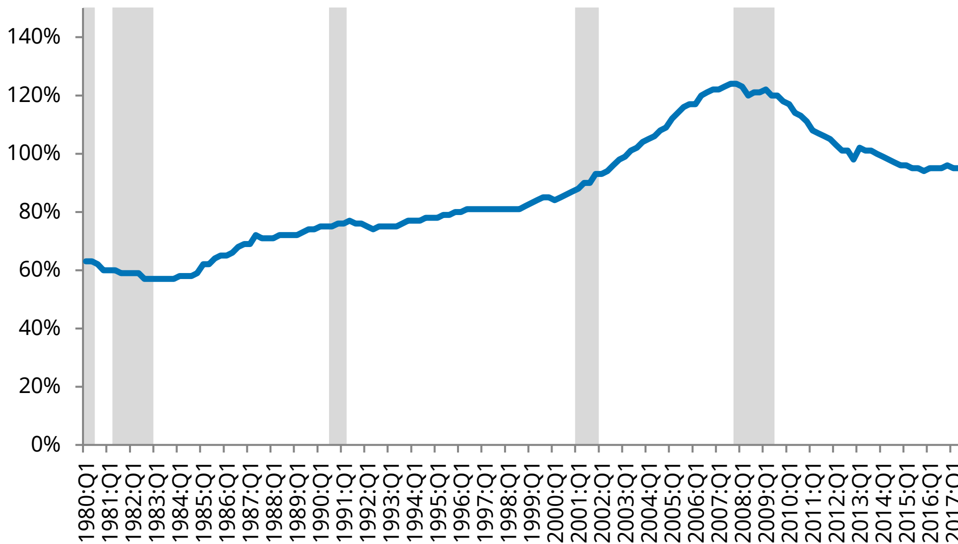
Source: Schroders. For illustration only.

Here, too, we see three main reasons which support our belief:

Lending has not been aggressive

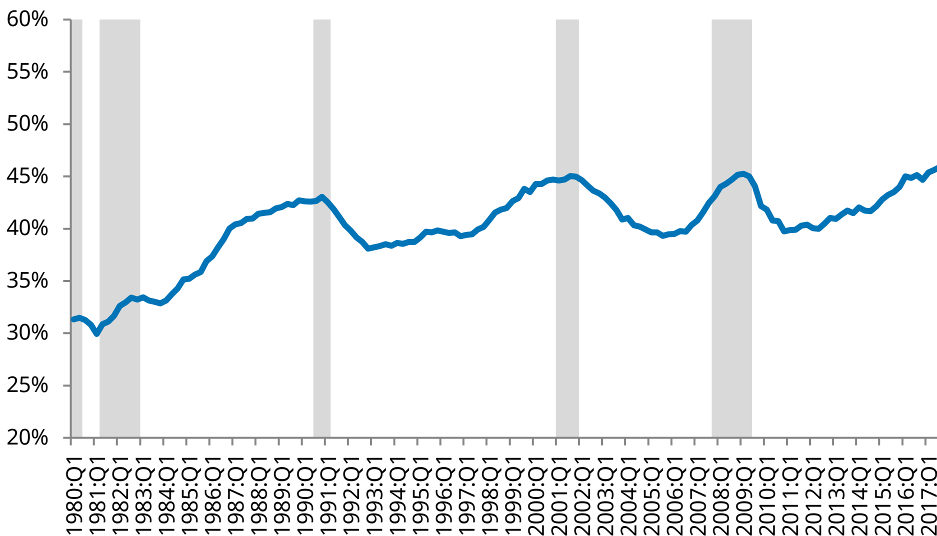
Substantial regulation such as Basel III, the Dodd Frank Financial Reform Act and monitoring by the Consumer Financial Protection Bureau (CFPB) has limited lending expansion. As seen below the consumer/household has deleveraged (Figure 7) while corporations have releveraged (Figure 8).

Figure 7. US households/non-profits debt, % of GDP



Source: Federal Reserve, MBER. Shaded areas reflect recessionary periods.

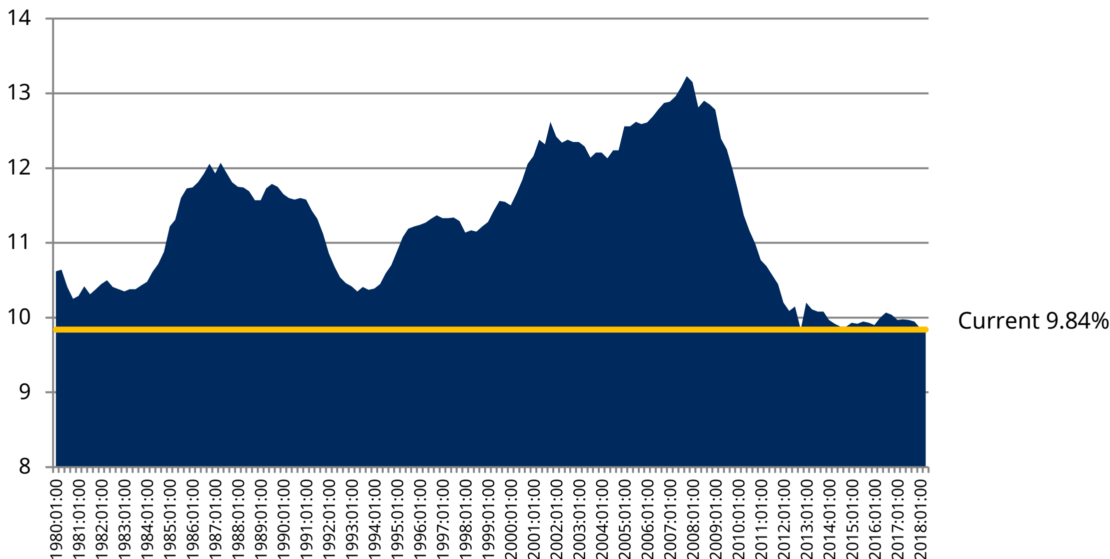
Figure 8. US non-financial corporates debt, % of GDP



Source: Federal Reserve, MBER. Shaded areas reflect recessionary periods.

As well, from a debt-to-income perspective for consumers we are at one of the lowest levels in history.

Figure 9. Current debt-to-income ratio (%) is close to 40-year lows



Source: Federal Reserve, through Q2 2018. Current ratio level reflected by yellow line.

1. **Supply has been contained**. Outside of Agency MBS most sectors within ABS, MBS and CMBS have seen very limited net supply and some sectors have seen negative net supply, post financial crisis. This is in contrast with the expansion in corporate credit and leveraged loans.

2. **These securitized, non-guaranteed sectors are not included in any major global benchmark.** There are no ETFs and only a few mutual funds to provide easy access to the credit markets within the securitized space. As we showed on the previous page, index allocations to the securitized sector principally focus on Agency MBS, which is guaranteed. As such, securitized credit does not sit at the edge of a precipice with respect to valuation, spread or supply.

In summary

We think securitized credit can be viewed as a means to diversify risk exposure away from the QE induced inflations seen in many parts of the corporate credit market, both from a supply and a valuation perspective. As well, it seems there is a catalyst to begin the rotation now as liquidity and redemptions from credit programs begin. In our view, investors wanting to avoid the crowds don't have the luxury of waiting until the next recession begins.

1. Take less credit risk in securitized (improve credit quality/rating) and earn similar return profile
2. Reduce exposure to corporate credit cycle
3. Reduce exposure to QT transition
4. Reduce exposure to flow-driven widening

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