Bank Loans and High Yield: What One Market Signal May Be Telling Us

From a forthcoming Lord Abbett white paper: How have floating-rate bank loans performed after trading at wider spreads relative to high yield?

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Figure 1. For Bank Loans, History Suggests Current Spreads Versus High Yield Could Be Followed by Outperformance 12 Months Later

Forward 12-month performance difference of loans versus high-yield bonds and spread difference of loans to high-yield bonds, November 2012–July 2020

Spread Difference (Loans - HY)
12 month Performance Difference (Loans - HY)

Spread Difference (Loans – HY), bps: 150, 100, 50, 0, -50, -100, -150

Forward 12 month performance difference (Loans – HY): 6.0%, 4.0%, 2.0%, 0.0%, -2.0%, -4.0%, -6.0%, -8.0%, -10.0%

Nov-12, May-13, Nov-13, May-14, Nov-14, May-15, Nov-15, May-16, Nov-16, May-17, Nov-17, May-18, Nov-18, May-19, Nov-19, May-20

Source: Loans = Credit Suisse Leveraged Loan Index (discount margin). High Yield = ICE BofA US High Yield Constrained Index (spread to worst).
Past performance is not a reliable indicator or guarantee of future results. Due to market volatility, the asset classes depicted in this chart may not perform in a similar manner in the future. For illustrated purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment

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*This Market View is excerpted, in part, from a forthcoming white paper, **"Bridging the Divide Between High Yield and Bank Loans."***

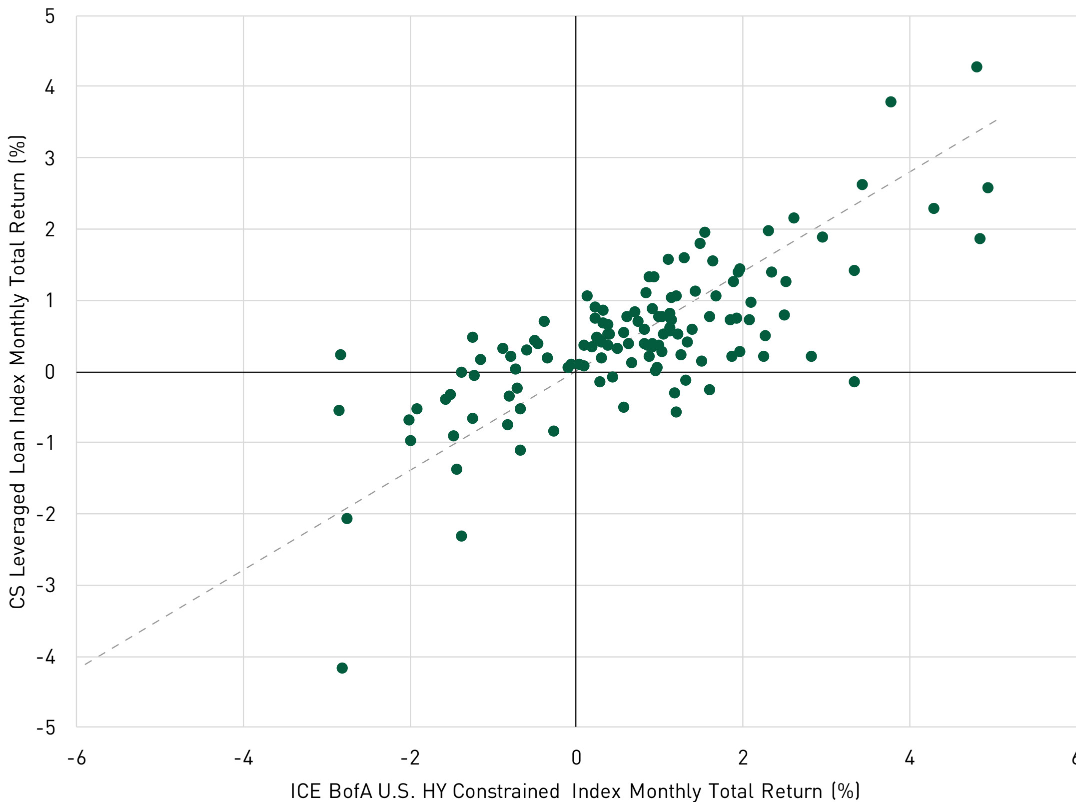
We have long emphasized our view that floating-rate bank loans should not be considered solely as a tactical call on the direction of interest rates; typically, the asset class has offered high income with very little duration and historically attractive risk-adjusted returns. Moreover, bank loans have provided the added benefit of diversification to core bond portfolios by lowering the potential duration risk of holding core bonds on their own. But what is very interesting to us in the current market is the relationship between bank loans and high yield—and what it may signal for loans in the coming months.

While some differences have emerged between the U.S. bank loan and U.S. high-yield markets over the last several years, long-term monthly return data indicate they are still related, as shown in Figure 2. Over the last 10 years, the correlation between monthly returns of the two assets is about 81%. Year-to-date through August 31, high yield (as represented by the ICE BofA U.S. High Yield Constrained Index, or the HY Index) has returned 0.67%, versus a -1.51% return for loans (based on the Credit Suisse Leveraged Loan Index, or the LL Index).

There are plenty of reasons for this relative performance of late (which we will explore in a forthcoming white paper), but the move lower in risk-free rates has resulted in more intense outflows for U.S. floating-rate mutual funds and exchange-traded funds (based on Lipper data), a technical factor pressuring the bank loan asset class on a relative basis. That has resulted in the LL Index trading at a wider spread—and lower price—than the high-yield market.

Figure 2. Leveraged Loan and High-Yield Returns Have Correlated Over the Long Term

Monthly returns, January 2010 – July 2020



Source: Bloomberg. Data as of July 31, 2020. **Past performance is not a reliable indicator or guarantee of future results.** Due to market volatility, the asset classes depicted in this chart may not perform in a similar manner in the future. For illustrated purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

High Yield

Bank Loans

And that's where the interesting historical trend we alluded to earlier comes into play. Figure 1 shows that typically, when the loan market trades similarly wide of the high-yield market, loans gain ground on high yield over the following 12 months. Indeed, loans outperformed high-yield bonds by 50 basis points (bps) in August 2020 (1.50% vs. 1.00%), just as the two-year to 10-year U.S. Treasury curve steepened by 15 bps on the month.

As experienced investors across the leveraged finance market, we believe both bank loans and high yield provide opportunity over the long term. Nonetheless, history suggests the current trailing performance gap of loans to bonds could narrow, especially if interest rates and investors' inflation expectations move higher over the coming months. Similarly, we believe bank loans can be an attractive complement to a portfolio, if an investor believes the market is underestimating the vitality of a U.S economic rebound.

A Note about Risk: The value of an investment in fixed-income securities will change as interest rates fluctuate and in response to market movements. As interest rates fall, the prices of debt securities tend to rise. As interest rates rise, the prices of debt securities tend to fall. High-yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, interest-rate, and general market risks. Lower-rated bonds carry greater risks than higher-rated bonds. The principal risks associated with bank loans are credit quality, market liquidity, default risk, and price volatility. While bank loans are secured by collateral and considered senior in the capital structure, the issuing companies are often rated below investment grade and may carry higher risk of default. Moreover, the specific collateral used to secure a loan may decline in value or become illiquid, which would adversely affect the loan's value. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer maturity of a security, the greater the effect a change in interest rates is likely to have on its price. No investing strategy can overcome all market volatility or guarantee future results.

Neither diversification nor asset allocation can guarantee a profit or protect against loss in declining markets.

There is no guarantee that the floating-rate loan market will perform in a similar manner under similar conditions in the future.

Forecasts and projections are based on current market conditions and are subject to change without notice. Projections should not be considered a guarantee.

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A **basis point** is one one-hundredth of a percentage point.

A **discount margin** (DM) is the average expected return earned in addition to the index underlying, or reference rate of, the floating-rate security.

Spread-to-worst is the difference between the yield-to-worst of a bond and yield-to-worst of a U.S. Treasury security with a similar duration. The **yield to worst** is the lowest potential yield that can be received on a bond without the issuer actually defaulting.

The **Credit Suisse Leveraged Loan Index** is designed to mirror the investable universe of the U.S. dollar-denominated, leveraged loan market.

The **ICE BofA U.S. High Yield Constrained Index** tracks the performance of U.S. dollar denominated, below-investment- grade, corporate debt publicly issued in the U.S. domestic market.

ICE BofA Index Information:

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