LORD ABBETT

MARKET VIEW

BANK LOANS: WHAT'S THE STATE OF FLOATING RATE?

In light of the recent volatility, we address key questions for investors in U.S. bank loans.

CHART 1. BANK LOAN COUPONS HAVE CONTINUED TO CLIMB

AVERAGE COUPON RATE IN THE CREDIT SUISSE LEVERAGED LOAN INDEX, JUNE 30, 2013–JANUARY 10, 2019

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

IN BRIEF

- Like most asset classes, bank loans experienced elevated volatility in late 2018. Nonetheless, the asset class, as represented by the Credit Suisse Leverage Loan Index, was positive for the year.
- While there are no guarantees, we believe continued low default rates and expected growth in the U.S. economy should provide a supportive backdrop for bank loans over the next 12 months.
- The price declines in the fourth quarter created more potentially attractive valuations in the asset class.

CONTRIBUTING STRATEGIST

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The fourth quarter of 2018 brought a surge in volatility across equity and credit markets. Against that backdrop, we wanted to address common questions we have been hearing from investors about bank loans. When *Market View* last focused on floating-rate bank loans on November 19, 2018, we highlighted the fact that bank loans had held up reasonably well compared to most other major asset classes. As 2018 came to a close, however, bank loans came under increased pressure.

What caused the market volatility in the fourth quarter?

After a long period of relative calm, market sentiment turned in early October, following comments from U.S. Federal Reserve (Fed) Chairman Jerome Powell that created uncertainty about the future path of Fed policy. This initially caused a jump in interest rates, with the 10-year U.S. Treasury bond approaching a 3.25% yield in early November. Equity markets began to stumble, as investors weighed uncertainty about interest rates, along with projections of slowing U.S. corporate earnings growth, some weakness in U.S. economic data, and ongoing trade tensions, particularly between the United States and China.

The high yield market initially was little affected by the tumult, but the negative sentiment toward risk assets, less rosy U.S. economic backdrop, and a 30% fall in oil prices led to significant credit spread widening in the quarter. After reaching a post-financial crisis low point of 316 basis points (bps) over Treasuries in early October, high yield spreads widened by over 225 bps, peaking at more than 540 bps in early January 2019.

What led to the decline in loan prices?

While bank loans avoided much of the volatility witnessed across most other asset classes in the first half of the fourth quarter, loans came under significant selling pressure over the last six weeks of the year. Given the large move experienced in high yield spreads, it should be expected that loans would see wider spreads—and lower prices—as well. As high yield spreads widened, multi-sector investors with flexible mandates to invest across asset classes may have taken the opportunity to sell loans in favor of the higher yields on high yield bonds, based on relative value.

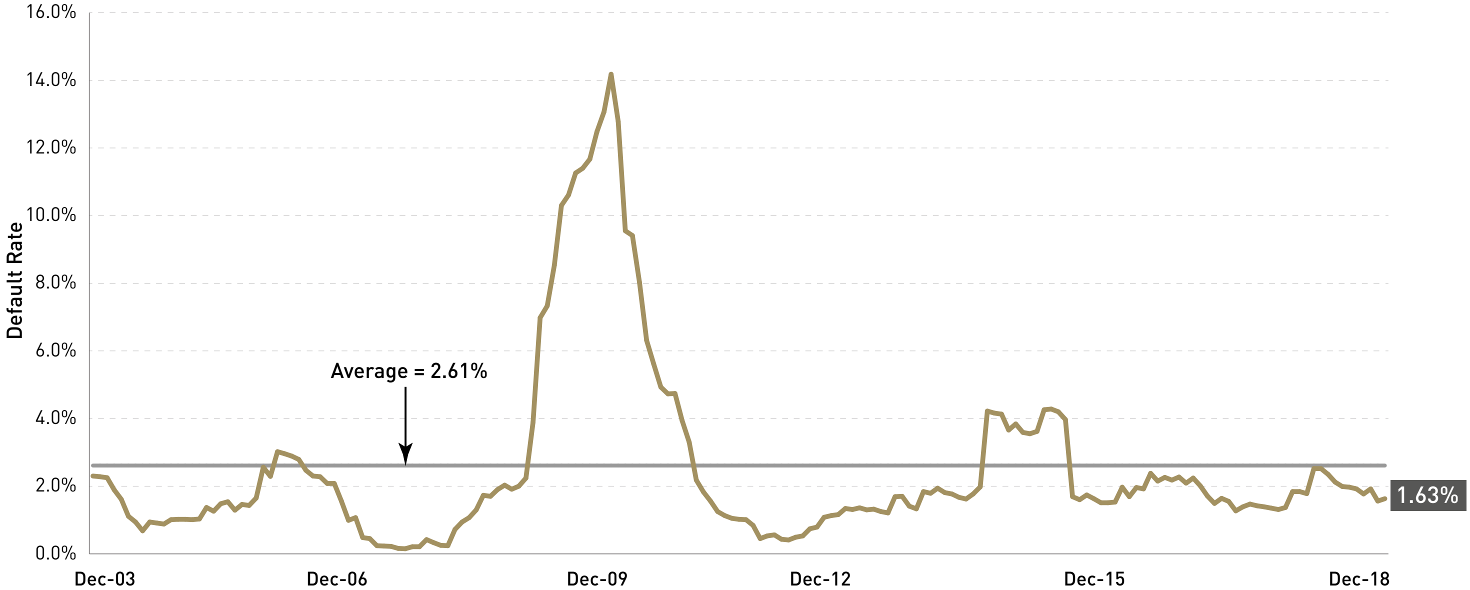
Then, as sentiment weakened and the market consensus for the path of future interest rates changed, retail mutual fund flows reversed. Over the last seven weeks of the year, loan funds experienced approximately $16 billion in outflows, according to Lipper. While bank loan mutual funds account for a relatively small portion of the loan asset class (less than 15% of a $1.2 trillion market), large flows can have an impact on pricing. While this selling pressure led to a loss of 3.1% in the quarter, the Credit Suisse Leveraged Loan Index (the benchmark index) remained positive for the full year, outperforming major high yield bond, investment grade bond and equity indexes (see Chart 3).

Are lower prices coming as a result of an increase in defaults?

Not necessarily; defaults have remained low. According to JP Morgan research, the trailing 12-month default rate in the loan market declined to 1.6% as of December 2018, below the 1.8% rate reported a year earlier, and well below the long term average (see Chart 2). The recent price declines have been driven by negative sentiment across asset classes, and technical factors. Certainly, if the U.S. economy were to undergo a period of significant weakness, the loan market might face increased credit quality issues. But broadly speaking, with U.S. economic growth forecast to continue, albeit at a more modest pace, the low default environment of the past few years is likely to continue.

CHART 2. U.S. BANK LOAN DEFAULTS HAVE REMAINED LOW

U.S. LEVERAGED LOAN DEFAULT RATE, DECEMBER 31, 2003–DECEMBER 31, 2018



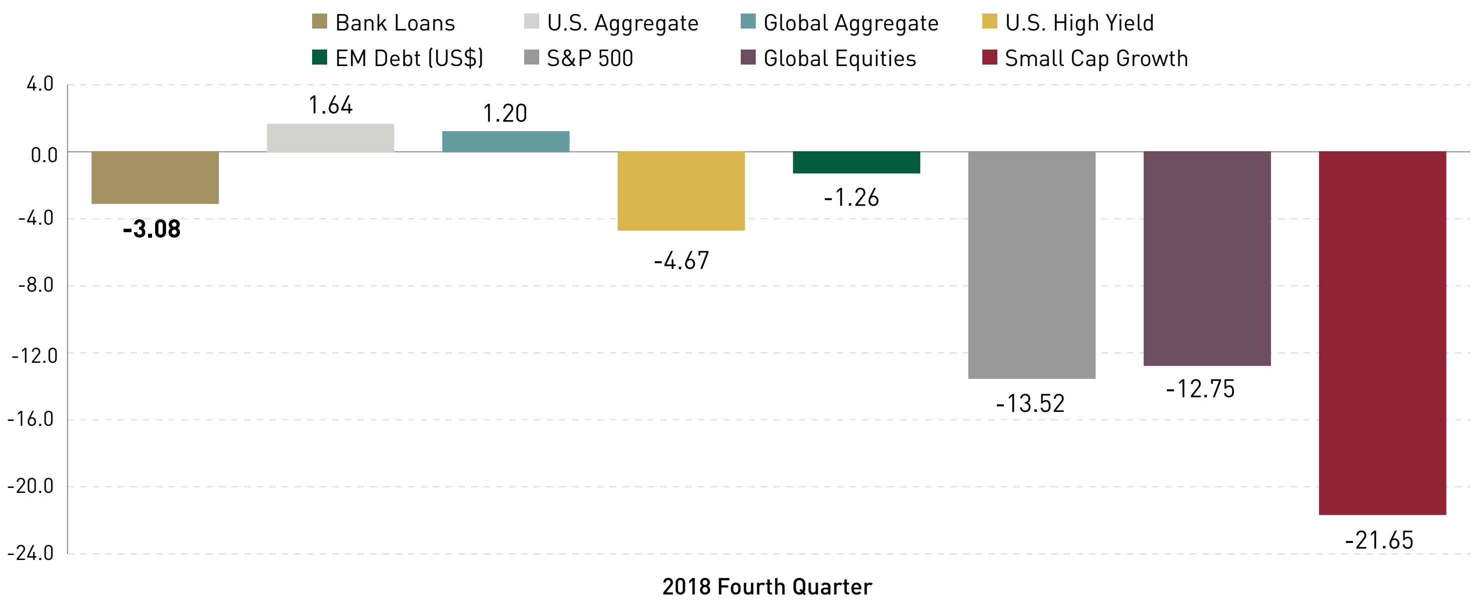
Source: J.P. Morgan and Barclays. Data as of December 31, 2018.

Note: In April 2014, the trailing 12-month default rate increased by 2.6% due to the default of Energy Futures Holdings (formerly known as TXU Energy). As of April 30, 2015, this default was no longer included in the 12-month rate. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.

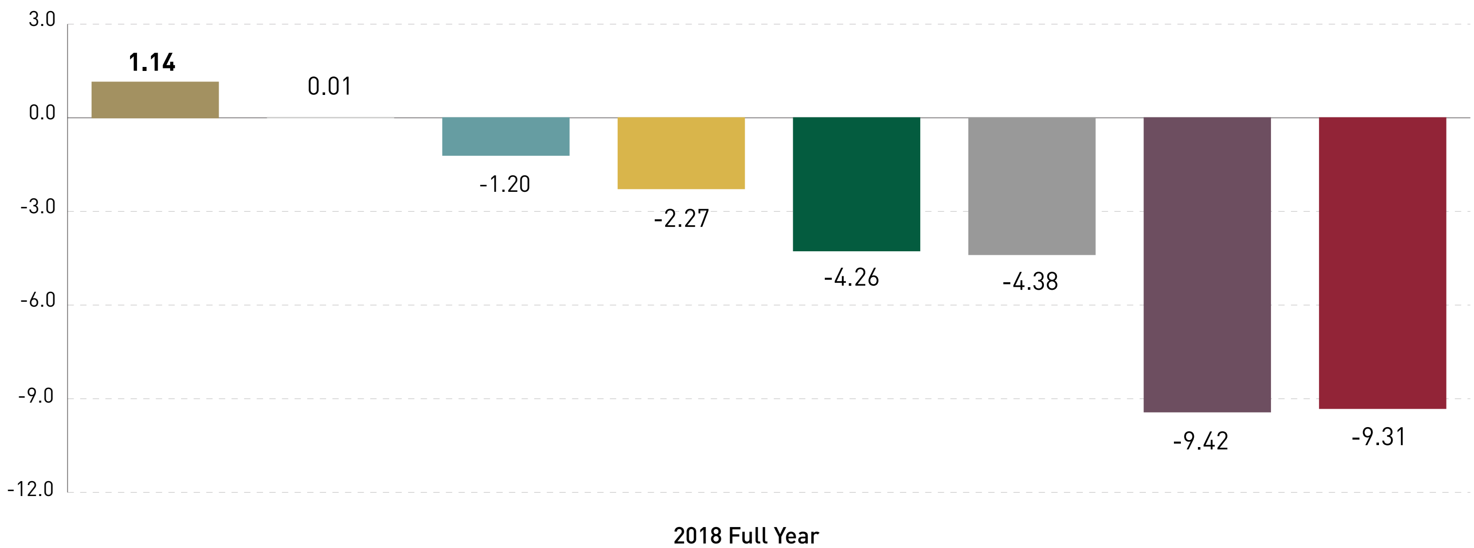
CHART 3. HOW DID BANK LOANS FARE VERSUS OTHER INVESTMENTS IN 2018?

PERCENTAGE RETURNS BY CATEGORY FOR THE INDICATED PERIODS

Even after the late-year volatility ...



... bank loans were one of the best performing asset classes in 2018



Source: Morningstar. Data as of December 31, 2018. Bank Loans=Credit Suisse Leveraged Loan Index. U.S. Aggregate=Bloomberg Barclays U.S. Aggregate Bond Index. Global Aggregate=Bloomberg Barclays Global Aggregate Bond Index. U.S. High Yield=ICE BofAML U.S. High Yield Constrained Index. EM Debt=J.P. Morgan Emerging Markets Bond Index Global. Global Equities= MSCI ACWI Index. U.S. Small Cap Growth= Russell 2000® Growth Index.

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Has the loan market gone through a similar period in the recent past?

Prior to the last six weeks of 2018, the U.S. loan market had experienced a long period of relative calm. The decline in the fourth quarter broke a string of 11 consecutive quarters of positive returns, dating back to the end of 2015. The credit market had suffered significant spread widening in late 2015 into early 2016, driven by concerns over global growth and a sharp correction in energy and commodity prices.

The loan index decline of 2.29% in December 2018 was the largest monthly pullback since the 4.16% loss in August 2011. Back then, in addition to dealing with concerns over global growth and the threat of European debt contagion, Fed Chairman Bernanke pledged to keep the Federal Funds target rate near zero until at least mid-2013. This led to many investors turning negative on bank loans.

While past performance is no guarantee of future results, both of these episodes created attractive entry points. For the 12 months ended August 2012, the benchmark index returned 9.8% (without any Fed rate hikes); in 2016, the index generated a 9.9% return, with only one 25 basis point hike by the Fed.

How has the market responded so far in 2019?

The high yield and bank loan markets have rallied in the opening days of 2019. A strong December U.S. jobs report and comments from Powell which suggested the possibility of a pause in the Fed's rate-hike campaign have eased some of the concerns hanging over the market. Some of the technical factors facing the credit markets at year-end also dissipated as the calendar turned. As of January 9, high yield spreads had tightened by about 80 basis points year to date, and the benchmark index was up 2.4%, wiping out December's loss in a few days.

Where are bank loan valuations today?

As of January 11, 2019, the average loan price in the benchmark index was $96.01, off recent lows but still well below the $98.6 level in early October (see Chart 4). But given the rise in short term-rates, the average coupon in the index is now over 6.1%, levels not seen since before the financial crisis in 2008. The high current income generated by loans can be a large component of total returns.

CHART 4. WHILE BANK LOAN PRICES HAVE RALLIED, THEY REMAIN WELL BELOW RECENT HIGHS

CREDIT SUISSE LEVERAGED LOAN INDEX AVERAGE US$ PRICE, JANUARY 11, 2013–JANUARY 11, 2019

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

If expectations for future Fed rate hikes have been declining, should I avoid loans?

We believe loans do not need further rate hikes to generate attractive returns in 2019. With a recent coupon of 6.1% (see Chart 1), and an average price of $96.01, the current income alone is enough to generate attractive returns over the next year.

Many investors focus only on the "protection from rising rates" aspect of bank loans. But as we have noted over the past few years, we believe there are many reasons to include loans in a diversified portfolio:

The opportunity for high income with low duration exposure

- Lower volatility than high yield bonds: the benchmark index has had less than two-thirds of the volatility of the ICE BofAML U.S. High Yield Bond Index over the trailing three, five, and 10 years
- The potential for attractive risk-adjusted returns: the benchmark index has had a higher Sharpe ratio than both the ICE BofAML U.S. High Yield Bond Index and the Bloomberg Barclays U.S. Aggregate Bond Index over the trailing three, five, and 10 years
- Diversification benefits: loans historically have had a negative correlation with the Bloomberg Barclays U.S. Aggregate Bond Index

Given that bank loans have exposure to below-investment grade credit, the asset class may experience times of volatility when the markets turn negative on risk. While there will certainly be individual credits that face difficulties, defaults are low and are broadly expected to remain low over the next year. While the U.S. economy may show some signs of slowing, we expect continued economic growth, which should provide a supportive backdrop for the credit markets over the next 12 months. ■

Want to learn more about our investment strategies?

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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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GLOSSARY

Basis point is a financial unit of measurement that is 1/100th of 1%.

A **coupon** is the annual interest rate paid on a bond, expressed as a percentage of the face value.

Correlation is a statistical measure that describes the strength of relationship between two variables. It can vary from 1.0 to -1.0.

Duration is the change in the value of a fixed-income security that will result from a 1% change in market interest rates. Generally, the larger a portfolio's duration, the greater the interest-rate risk or reward for underlying bond prices.

Sharpe ratio is a way to examine the performance of an investment by adjusting for its risk. It is the average return earned in excess of the risk-free rate per unit of volatility or total risk.

Treasuries are debt securities issued by the U.S. government and are secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes.

A **yield spread** is the difference in yield between two bonds, usually of similar maturity but different credit quality.

The **Bloomberg Barclays Global Aggregate Bond Index** is a broad-based measure of the global investment-grade, fixed-income markets.

The **Bloomberg Barclays U.S. Aggregate Bond Index** is an unmanaged index composed of investment-grade securities from the Bloomberg Barclays Government/Corporate Bond Index, Mortgage-Backed Securities Index and the Asset-Backed Securities Index.

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

The **ICE BofAML U.S. High Yield Constrained Index** is a capitalization-weighted index of all US dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market.

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The **J.P. Morgan Emerging Markets Bond Index** Global ("EMBI Global") tracks total returns for traded external debt instruments in the emerging markets

The **MSCI ACWI Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 46 country indices comprising 23 developed and 23 emerging market country indices.

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The **Russell 2000® Growth Index** measures the performance of those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values.

The **S&P 500® Index** is widely regarded as the standard for measuring large cap U.S. stock market performance and includes a representative sample of leading companies in leading industries.

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