Loomis on Loans

A quarterly look at data and topics in the syndicated loan market

Keep Calm and "Carry" On

Interest income, or carry, is the anchor of bank loan returns. These floating rate instruments adjust alongside short-term interest rates, which can provide a steady level of income, generated by a spread over a short-term reference rate (for now, typically 3-month LIBOR). Bank loans are regularly refinanced and repaid for all kinds of reasons; therefore, loans tend to have a three-year average life. This short average life supports the loan market's general price stability in most market environments. Since loans pay off at par, there is a natural tendency for their prices to gravitate back to this level. Because loan prices are often around par, price action does not tend to have a large influence on returns. While average annual loan total returns have been 4.60% since 1999, average annual interest returns have been 5.78%, making up most of the return each year.

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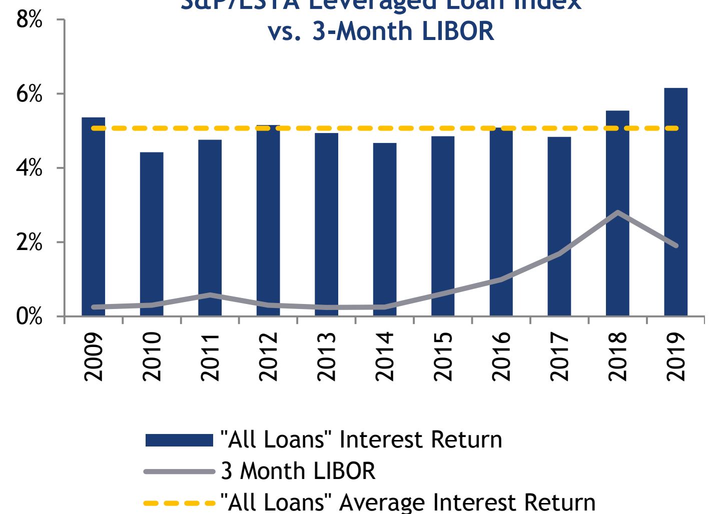
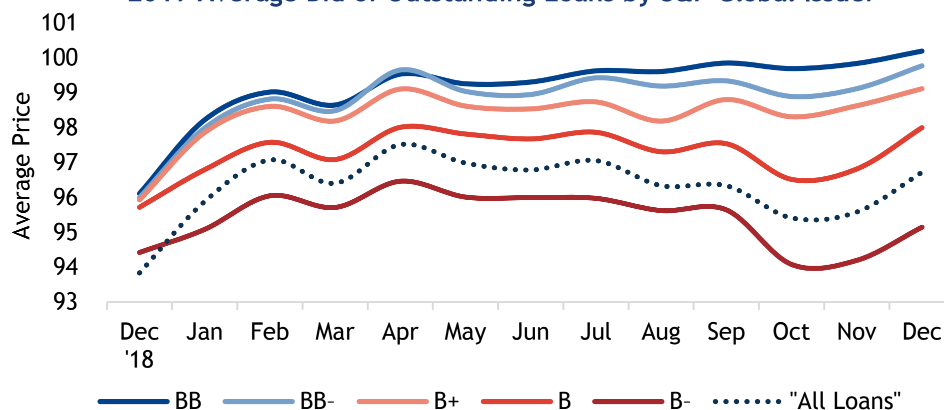


Source: LCD, an offering of S&P Global Market Intelligence ; Bloomberg as of 12/31/19

LOAN MARKET QUICK TAKE

S&P/LSTA Index	2019	Price	12-Mo. Price Change	Spread
"All" Leveraged Loan Index	8.64%	96.72	3.07%	L+352
BB Index	9.31%	99.65	4.58%	L+267
B Index	8.99%	97.70	3.25%	L+383

Source: S&P Capital IQ, as of 12/31/19



Source : LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index as of 12/31/19

Price Bifurcation

In 2019, the price gap between double-B and single-B rated loans widened. The environment for loans has been "liquidity-on" this year in contrast with the risk-on tone of equity markets. Many loan investors have placed a premium on quality and liquidity rather than on yield. Factors influencing this trend include persistent retail loan fund outflows and more cautious CLO buying.

Bid prices of B-rated loans have risen following the Fed's decision to put short-term rates on hold in October. If we move into a period of flat interest rates, retail outflows may abate and could possibly change direction.

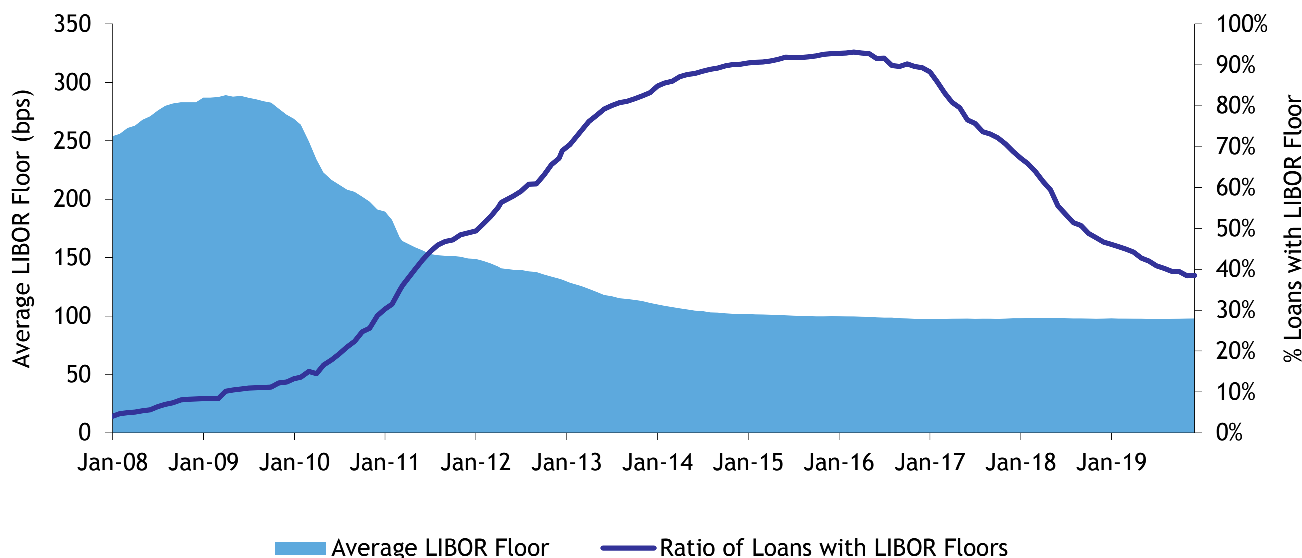
KEEP CALM AND "CARRY" ON (Continued)

When building our loan portfolios, we carefully assess each individual company's interest coverage, the amount the company earns in relation to its required interest payments. Interest coverage is currently very healthy in the loan universe, despite a period of prolonged interest rate increases since 2008. While individual companies vary, we estimate that average interest coverage is north of four times for the types of companies we follow. Strong interest coverage creates a cushion, lessening the chance of a loan missing an interest payment.

Another factor supporting stable interest payments is LIBOR floors. LIBOR floors were created following the Global Financial Crisis (GFC) when short-term interest rates approached zero. Loan spreads based on such low rates were unattractive to lenders given the risk entrenched in the market. As markets recovered, floors were written into many loan agreements, enticing lenders to once again lend. These floors set a minimum level of income to which a loan's spread was added. For example, a loan paying LIBOR + 200 bps with a 100 bps floor would pay an annualized rate of 300 bps even if LIBOR fell below 100 bps (100 bps floor + 200 bps spread).

LIBOR floors exist in many loan contracts today, typically at the level of 75 or 100 bps. After three short-term interest rate cuts in 2019, the discussion of floors has become relevant again; and, we have observed an increase in the number of new loan issues containing floors. We believe floors could come back in a big way if markets demand higher sustained income levels than short-term rates plus loan spreads provide.

History of LIBOR Floors



Source: LCD, an offering of S&P Global Market Intelligence as of 12/31/19

The main components of a loan portfolio's return are each loan's all in rate (LIBOR + spread) plus or minus the price movement in the underlying portfolio of loans, less any default loss. Some short-term periods of volatility (GFC, 2015-2016, 2019) have demonstrated more pronounced price action for bank loans. However, historically investors have been able to rely on loans to produce attractive income while mitigating the impact of interest rate risk (by being floating rate) and credit risk (by being senior and secured). To loan investors concentrating solely on short-term price movements, we say, "keep calm and carry on."

Investing involves risk including possible loss of principal.

Please see Key Risks on the next page.

Past market performance is no guarantee of future results.

John Bell, VP
Portfolio Manager

Michael Klawitter, VP, CFA
Portfolio Manager

Heather Young, VP, CFA
Strategist

Christos Maniatis, VP
Senior Portfolio & CLO Analyst

Emily Sweet, VP, CFA
Associate Product Manager

Cheryl Stober, VP
Product Manager
cstober@loomissayles.com

Questions or concerns about the bank loan market? Email Cheryl Stober to learn more.

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