2021: The Great Reception (Second of a Series)

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We continue our special series on the outlook for the year ahead with a look at the capital markets. What are the moving parts impacting funds flow, asset characteristics (volume, prices, and yields), and quality of deal issuance?

With each passing day, the prospect for lower infection rates improves. Investors expect vaccine distribution to reach a tipping point soon with the US adult population, perhaps earlier than expected if logistical hurdles are overcome. Commercial activity could then resume “normal” levels.

The result of that newfound optimism has been further pressure on interest rates. As our *Chart of the Week* shows, the ten-year Treasury has stepped up 70 bps or so. At the same time, investors are moving up the Fed’s first anticipated hike date to mid-2024.

Higher rates have had a chilling effect on high-yield fund flows. Reversing from in-bound cash last year, there have been $4 billion of redemptions six of the past seven weeks, per S&P LCD. Bond volume has also eased, from $60 billion last June to $24 billion so far this month.

Still, yields remain issuer friendly. For the first time ever, the ICE BofA High-Yield Index fell below 4%. That’s less than 1% higher than the 10-year yield in late 2018. Some have even suggested renaming the asset class “Higher-Yield” or “More-Yield.”

This climate change of rates, along with growing confidence in the US economic recovery, has swung loan fund flows around. Since January 1 over $6 billion has returned to funds, compared to outflows of $17 billion through March 31 of last year.

Better technicals are feeding more bullish activity in the broadly syndicated loan market. S&P LCD reports loan repricings, all but absent after COVID hit last March, are $102 billion this year. That activity exceeds new deal volume by $14 billion. And 80% are for single-B names, compared with just over half for lower-rated issuers in 2020.

Other evidence of market froth is large cap dividend deals. Through early February dividend volume was about $6.5 billion. This continued a trend begun in the third quarter of 2020 when recaps hit $13.4 billion from zero in 2Q. Fourth quarter was just under $13 billion.

Mirroring bonds leveraged loan spreads have also declined. Refinitiv LPC data showed average first-lien yields sinking below 4.5%. Prices for the S&P/LSTA Index, having bottomed out at 76 last March, recently weighed in at 93.30.

The next month or so will be telling for the direction of liquid credit. If momentum on higher rates and herd immunity accelerates, expect to find ourselves in a very robust market indeed.

Next week: We wrap our special series with a prediction for private capital.