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Relative Value in the Loan Market (Part Two of Two)

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Last week's June CPI report showed inflation running at 9.1%, higher than May's number, dashing hopes that consumer prices had peaked. Data drivers were also broad-based, including energy, food and housing, challenging the Fed's rate hike pace.

Would 75 bps be enough, or will the Fed kick it up to a previously unimagined 1% later this month? Equity markets seem to be buying the notion that longer-term inflation is still headed lower, so the smaller hike is expected. Credit markets have less conviction.

No surprise that more cash has exited high-yield bond accounts this year than for the same 2021 period ($18 billion vs. $14 billion, per Lipper), with fixed income returns taking big hits. More surprising perhaps is the exodus from retail loan funds. In the past two months almost $10 billion has departed, a reversal from prior in-flows.

Recessions aren't helpful for non-investment grade credit, and a higher, quicker Fed ramp clearly troubles BSL buyers. But as discussed last week, lower leveraged loan prices means higher yields. That's attracting attention from loan buyers, not to mention a higher benchmark rate (see our *Chart of the Week*).

Indeed the price reset in liquid strategies has the effect of lowering their AUM in portfolios, overweighting allocations to alternatives. This has the unintended consequence of pressuring managers to reduce the very asset that provides healing properties for market volatility.

As the risk-free rate is repriced, whether by 75 or 100 bps, leveraged loan prices will likely be pressured down and yields up. Middle market loan yields will also rise, though at a more measured pace. Both outcomes are beneficial to loaners.

The big question looming is where economic data heads relative to slowing consumer and commercial demand. While the default rate for the S&P/LSTA leveraged loan index is at record lows (0.28%), the rating upgrade-to-downgrade ratio has swung to the negative for the first time since early 2021. This could foreshadow a higher default rate if the economy softens.

The flip side of higher all-in coupons is fraught primary issuance as large corporate and sponsored borrowers delay going to market. BSL volume has declined, leaving fewer opportunities for managers and buyers. Those in the secondary market are at steeper discounts, implying more risk.

While direct lending volume is also off, MM spreads are more issuer-favorable; private credit buyers can deploy cash more quickly at higher yields. Larger MM structures are also more investor-friendly now; cov-lite going cov-heavy, and with lower leverage.

All of which means assessing relative value between asset classes isn’t just about pricing. It’s also how each performs through cycles and adapts to protect investors along the way.