Loomis on Loans

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

ONE YEAR INTO A PANDEMIC: THREE LESSONS LEARNED AND THREE QUESTIONS TO ASK

Markets have recently passed the one-year mark for the COVID pandemic in the U.S., and we think it is worth pausing for a moment to reflect on what we have learned (beyond more epidemiology than we ever wished to know), and to pose some questions for the future.

1) Can the Fed solve pandemics too?

Years ago, we used to write in our internal commentary that the loan market was subject to various risks that monetary policy could not solve, including pandemics. 2020 showed that thought was only half-formed. While the Fed clearly did not solve the actual pandemic, their actions, along with fiscal policy, were very effective in assuaging market concerns. Markets turned around far quicker than we expected last March. We believe markets are good at anticipating recoveries six months before they occur, and we imagined vaccines et al would be starting to work in March of 2021 (a good call), so maybe the market would be rebounding in September of 2020 in anticipation. Instead, the market rebounded in April of 2020, and did not significantly swoon again on any number of disappointing developments. That was a very surprising show of faith in policy and science far before it was possible for them to be proven effective.

Lesson: Markets need to be even earlier to be early. The playbook from the Global Financial Crisis (GFC) was fresh enough in the market's and the government's minds that the GFC recovery timeline was accelerated. Investors did not wait to see if it would work this time.

Question: How will markets react if the Fed/fiscal playbook is not quickly effective in a future market panic?

2) We believe market panic is a technical factor, not a fundamental one.

Loan prices plunged in March of 2020, ringing alarm bells across the investment spectrum that default rates would be huge because the market prices were telling us so. But, as so often happens, "implied default rates" were not reflections of analysis, but specious arithmetic in the face of panicked sellers. The sell-side and rating agencies put out breathless thoughts on potential default rates and "smart money" talked doom and gloom. We heard the usual loan market concerns about covenant-lite loans, lower quality issuance, and CLOs potentially causing harm, but then...not too much happened to loans.

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LOAN MARKET QUICK TAKE

S&P/LSTA Index	YTD Return (%)	Price	3-Mo. Price Change	Nominal Spread
"All" Leveraged Loan Index	1.78	97.55	1.35	369.86
BB Index	0.75	99.14	0.21	272.72
B Index	1.60	98.89	0.54	401.93

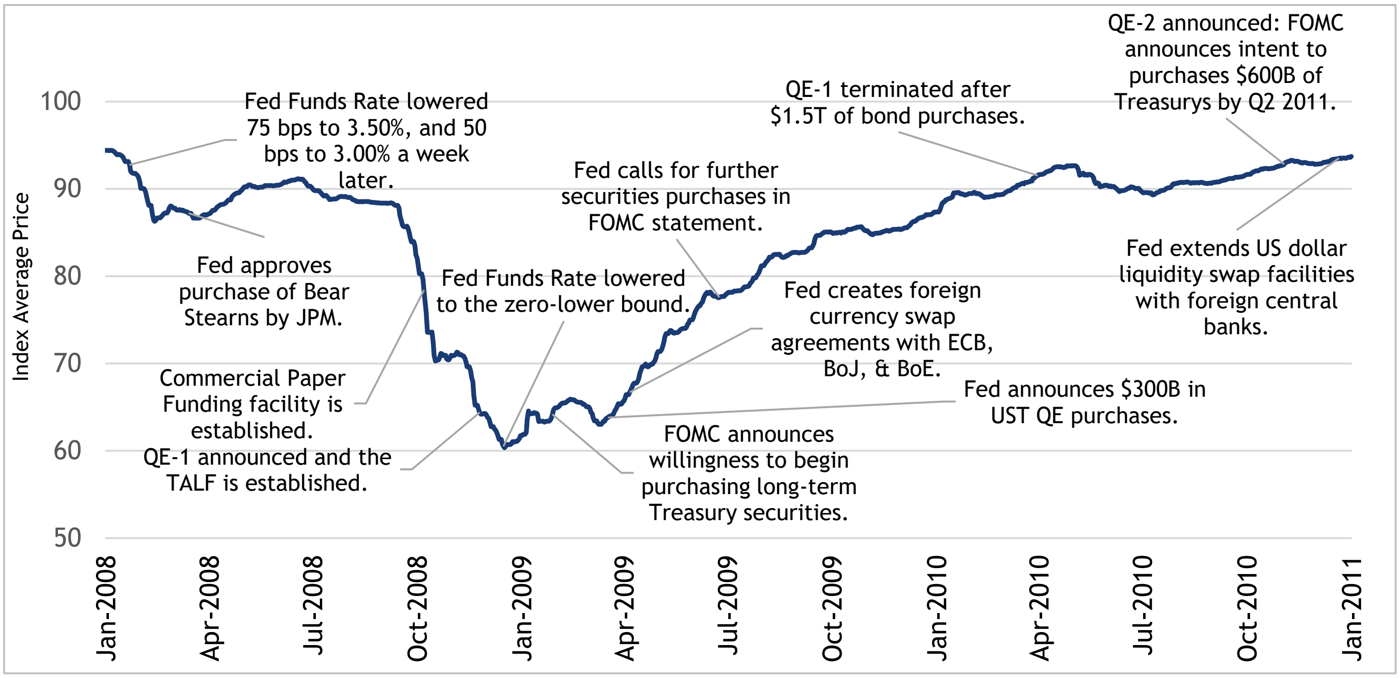
Source : LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index, as of 03/31/21.

Past market performance is no guarantee of future results.

Our view: Federal Reserve actions taken in 2020 led to a quicker recovery than in the GFC.

Fed Actions during the GFC

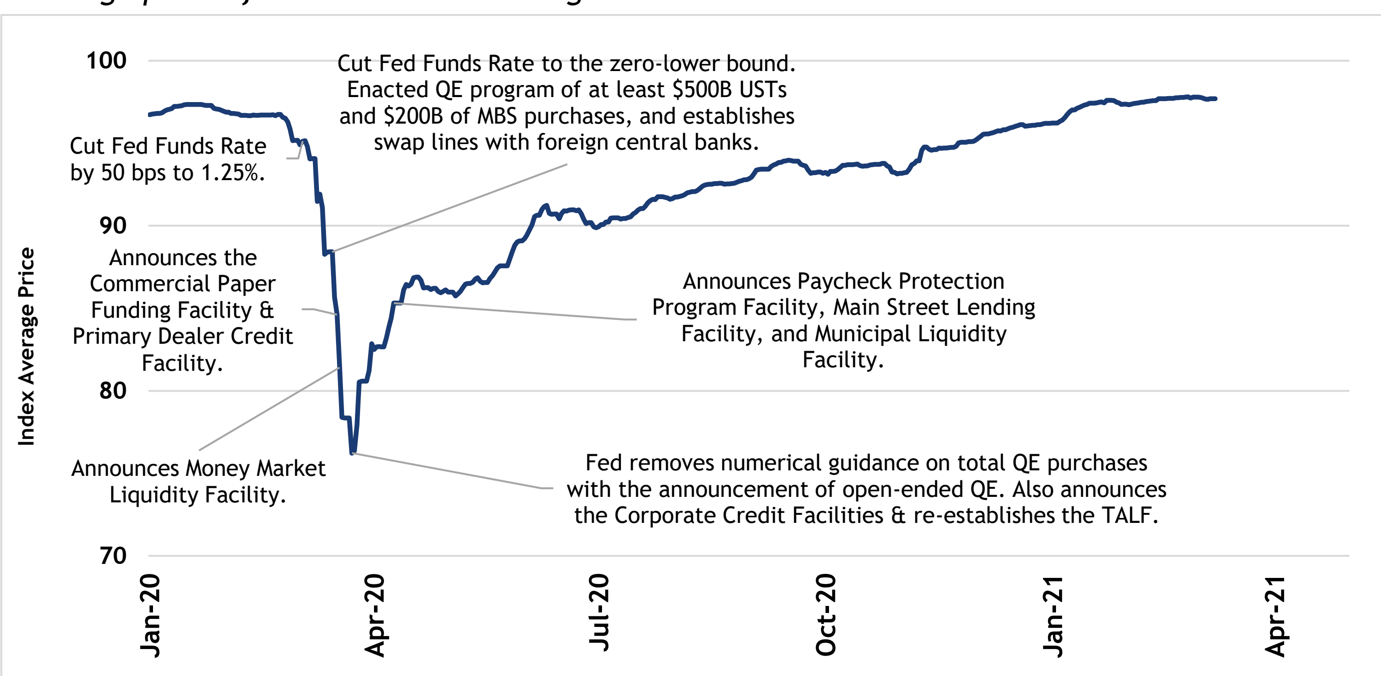
Average price of the S&P/LSTA Leveraged Loan Index



Source : Federal Reserve; LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index, for the period 01/01/08 through 01/01/11.

Fed Actions during COVID

Average price of the S&P/LSTA Leveraged Loan Index



Source : Federal Reserve; LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index, for the period 01/01/20 through 03/08/21.

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That was not because the government bought loans or CLO tranches (they did not, to our knowledge). That was because relatively large companies in the US (and companies in the syndicated loan market are relatively large) typically have levers to pull to survive that small companies do not. Large companies often have lines of credit, which they mostly drew when the pandemic started. They tend to have significant cash balances. They can cut costs. And they are businesses that tend to attract customers across a diverse spectrum, especially from other businesses, not necessarily the lower-income consumers who were most hurt by the pandemic. When we first dove deep into our credits in March and April of 2020 to judge their survivability, we believed that most of them could survive one really bad year, but not two really bad years. A year later, companies have mostly paid back their lines of credit, have more cash, have maintained (or grew!) a surprising amount of revenue, and have figured out costs they do not need to carry, and maybe their margins will be better than before. Now, we think most of our companies could take another bad year.

Lessons: Price action in a panic does not necessarily imply probable default rates. We believe borrowers in the syndicated loan market have levers to pull to survive and have the advantage of size.

Questions: What would it take to prevent companies from successfully using those survivability levers, and would that also undermine the equity market?

3) CLOs came through another downturn well and supported the loan market overall.

Collateralized Loan Obligations, or CLOs, are levered portfolios of bank loans. Investors at the bottom of the leverage stack are subject to major losses if defaults in those portfolios are too high. And yet, in our view, CLOs have come through the 2001 recession, the GFC, and the COVID pandemic without significant losses for investors. Indeed, rating-for- rating, CLO tranches have had better default experience than equivalently rated corporates over time*. Why? Both because CLOs are managed, not static like the GFC's problematic Collateralized Mortgage Obligations, and because the rating agencies were generally wary of credit when they established their ratings criteria. Maybe too wary, if the default experience vs. corporates is an indication. Notably, CLOs do not carry a lot of cash, so they were not immediate buyers of loans sold last year by panicked mutual fund holders in March 2020, but they were steady buyers of discounted value through most of the rest of 2020 and helped provide technical support in a recovering market. Indeed, one of the main annoyances of 2020 for a loan investor was how rarely cheap loans were actually offered. Once mutual funds stopped selling, most holders, including CLOs, were keeping what they owned, so while quotes gradually rose from the trough in March, actual ability to buy near those quotes was very limited. CLO tranche prices plunged in March as one would expect, but they rebounded steadily through the year, and they produced mildly positive returns by year end. Meanwhile, new CLOs were formed looking to buy discounted loans.

Lesson: CLOs have been a stabilizing force in the loan market for years, and have justified the market's belief in their ratings through three downturns.

Question: What would it take to disturb CLO demand for loans? Significant default rates/low recoveries that lead to low equity returns or pierce the lower debt tranches, at least.

**Source: Moody's, Barclays Research; 10-year cumulative issuer-weighted global corporate default rate data for the period 1983-2019.*

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2020 was a very difficult year for the world, but it was mostly a very difficult month for the loan market. Borrowers reacted effectively to the stress, leaving default rates surprisingly low. We believe companies in the loan market are generally emerging as strong or stronger than they were, into an economy that looks ready to grow from here. Market technicals create impressions that have often not come true, as loans have consistently quickly rebounded to near par from their occasional swoons. The Fed, science, and the American spirit all deserve some credit for loan performance in 2020. But the enduring lesson we observe from the last year is that a diverse portfolio of large borrowers in the syndicated loan market should have a strong ability to resist credit stress, and that is the bedrock of their attractiveness to many investors.

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

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Investing involves risk including possible loss of principal.

Diversification does not ensure a profit or guarantee against a loss.

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