Building Better Outcomes

Loans take center stage as inflation threat grows for 2022

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"In a year when concerns over tightened monetary policy, rising rates and inflation periodically wracked the markets, loans outperformed the Bloomberg Aggregate Index by 6.28 points, gaining 4.70% as bonds lost 1.58%."

Boston – For the floating-rate loan asset class, 2021 has been a year of superlatives, with any number of metrics at or near record levels, like issuance volume, demand, absence of defaults, and total loans outstanding. For us, the most important message from this year's buoyant market is that loans have been living up to the expectations of both investors and issuers.

In 2022, we expect much of the same positive dynamics to prevail, against a backdrop of generally positive credit conditions. While recent news of the Omicron variant highlights how the pandemic remains a major economic variable, we don't believe it will overcome the sweeping economic tailwinds and ongoing policy support.

Inflation concerns are also likely to persist in 2022, which moves loans — and their floating-rate capability — onto center stage for investors seeking to hedge the possibility of rising rates.

Over the course of 2021, as news of tightened monetary policy, rising rates and inflation periodically wracked the markets, and the Bloomberg Aggregate Index lost 1.58%, loans returned 4.70% — the most of any major fixed-income class, in the U.S. or globally, as measured by the S&P/LSTA Leveraged Loan Index (the Index). (See chart below). In a nutshell, this explains the advantage of the near-zero interest-rate duration of loans in today's environment.

Exhibit A

Loans rose to the top as other bond sectors sold off in 2021

	Total Return	Duration (years)	Yield on 11/30/21
Floating-Rate Loans	4.70%	0	4.2%
High-Yield Bonds	4.49%	4.2	4.3%
Municipal Bonds	0.50%	5.2	1.2%
Mortgage-Backed Securities	-0.86%	4.6	1.9%
US. Corp. Investment Grade	-1.02%	8.7	2.2%
Emerging Markets Debt (hard currency)	-1.34%	8	5.1%
Bloomberg U.S. Agg	-1.58%	6.7	1.7%
U.S. Treasury	-2.56%	7.1	1.1%

Table sources: Eaton Vance, S&P/LSTA, Bloomberg, as of 11/30/21. Data provided is for informational use only. Past performance is no guarantee of future results. It is not possible to invest directly in an Index. Loans are represented by the S&P/LSTA Leveraged Loan Index, an unmanaged index of the institutional leveraged loan market. High-yield bonds are represented by the ICE BofA U.S. High Yield Index, an unmanaged index of below-investment-grade U.S. corporate bonds. Municipal bonds are represented by the Bloomberg Municipal Bond Index, an unmanaged index of municipal bonds traded in the U.S. Mortgage-backed securities are represented by the Bloomberg U.S. Mortgage Backed Securities (MBS) Index, which measures agency mortgage-backed pass-through securities issued by GNMA, FNMA and FHLMC. The Bloomberg U.S. Aggregate Index is included as a broad measure of U.S. investment-grade bonds, and an unmanaged index comprising domestic investment-grade bonds, including corporate, government and mortgage-backed securities. U.S. Treasury is represented by the Bloomberg U.S. Treasury Index, which measures public debt instruments issued by the U.S. Treasury. Emerging markets debt is represented by the J.P. Morgan Emerging Markets Bond Index (EMBI) Global Diversified, an unmanaged index of USD-denominated bonds with maturities of more than one year issued by emerging markets governments. U.S. corporate investment-grade is represented by the Bloomberg U.S. Corporate Investment Grade Index, an unmanaged index that measures the performance of investment-grade corporate securities within the Bloomberg U.S. Aggregate Index.

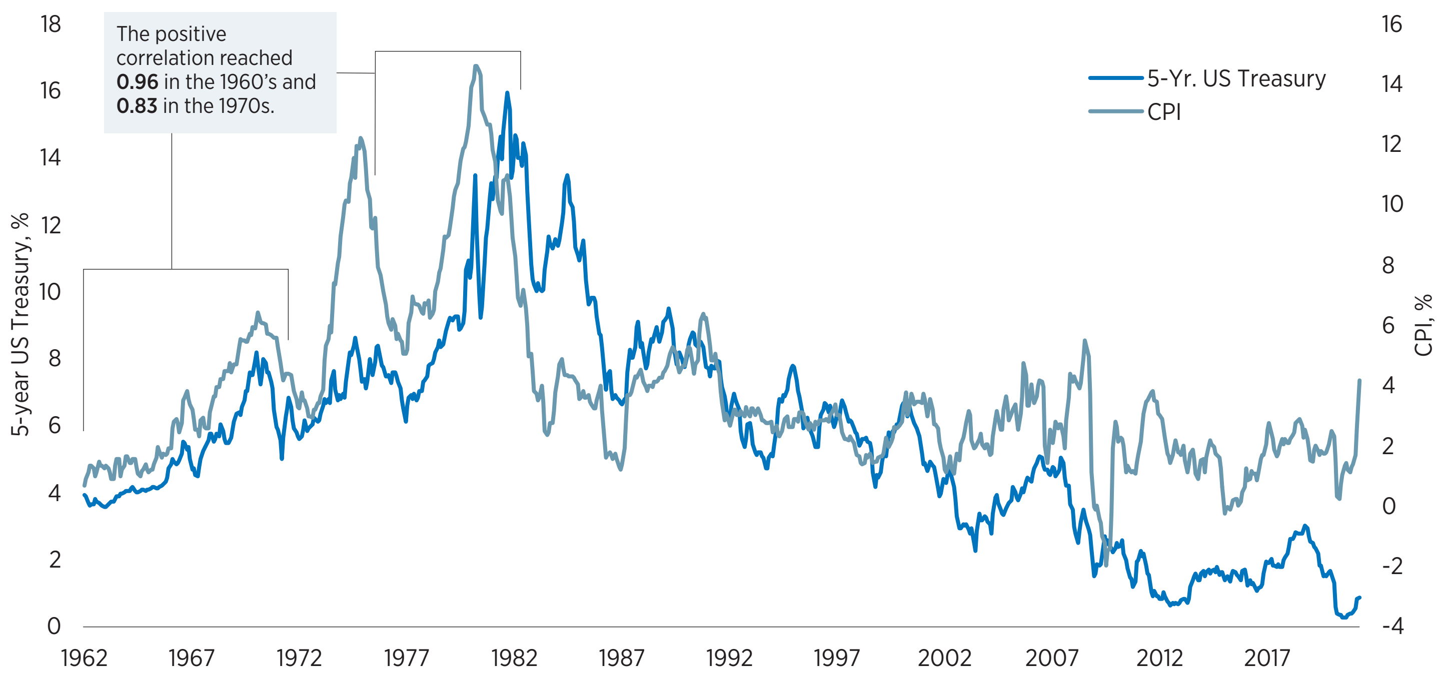
The performance spread of 6.28 points between loans and the Aggregate Index shows why we have long called loans the "anti-bond." Loans have been not only an attractive source of income, but also a unique tool for portfolio diversification, especially when inflationary forces are building and the long duration of many bond sectors is a growing risk factor.

Learning from past inflation

The last serious inflationary environments in the U.S. were in the 1960s and 1970s, and both decades were characterized by loose monetary policy and massive fiscal stimulus, reminiscent of the mix of policy conditions today. The tight relationship between the consumer price index (CPI) and rates over those periods is shown in the chart below, when the positive correlation reached 0.96 in the 1960's and 0.83 in the 1970s.

Exhibit B

Inflation and rates were tightly linked in the 1960s and 1970s



Sources: Federal Reserve Bank of St. Louis, Eaton Vance, 5/28/21.

Of course, corporate loans as an asset class were only in their infancy during those inflationary times, but performance year to date relative to bonds underscores how valuable they can be if we have anything like a repeat of that era.

Improving credit conditions

The appeal of loans in 2021 has been further strengthened by improving credit conditions. The economic rebound, combined with the easy access to the capital markets provided not just by loans but by the high-yield sector, has powered a remarkable surge of upgrades. Likewise, defaults have plummeted to 0.20%, just three basis points shy of the 0.17% record set in 2011, based on the trailing 12-month average on October 31, compared with the historical average of 2.85% since 1999.

The thriving loan market has helped create what might be called a "virtuous circle" in the economy. It has provided companies with ample access to liquidity, fuel for balance sheet recapitalizations, refinancings and a record wave of acquisition-related activity – all of which is driving the continued economic recovery. The new borrowing has extended maturities for issuers, while also lowering borrowing costs, both of which are credit positive.

For some idea of the magnitude of issuer enthusiasm, by October 31 the loan market has already set a full-year institutional issuance record of $509 billion, topping the previous full-year peak of $503 billion, set in 2017, according to LCD.

Looking ahead

Earlier we noted that current yield is likely to provide most of the return — a “coupon clipping” environment. As of October 31, the yield to worst stood at 4.19%. While this is at the lower range of historical yields, it is still the second-highest yielding U.S. fixed income sector, next to the 4.30% on U.S. high yield bonds. And, of course the yield on loans can float if short-term rates rise.

The challenges to growth prospects from the ongoing pandemic and continuing supply chain bottlenecks may also have an impact on credit conditions — pressure that will likely vary by sector and issuer. Loans are below-investment-grade assets, and even during strong parts of the business cycle we typically turn down about 75% of the deals we review.

Thus, our view is that the 2022 environment will be especially supportive of active management in the loan space. We believe that the credit exposure of an actively managed loan portfolio offers a better risk/reward profile than the interest-rate risk embedded in long-duration indexes like the Bloomberg Aggregate.

Regardless of what 2022 brings, loans have proven to be a remarkably resilient asset class over several decades of changing markets — since 1997, the Index has posted an annual total return of 4.9%.

Bottom line: As inflation works its way onto center stage as a major risk factor, we believe loans deserve consideration for helping conserve fixed-income portfolios in rising rate environments. The floating-rate loan team wishes our clients a safe and happy new year.

Risk Considerations

Investing entails risks and there can be no assurance that any strategy will achieve profits or avoid incurring losses.

Floating-Rate Loans – Loans are traded in a private, unregulated inter-dealer or inter-bank resale market and are generally subject to contractual restrictions that must be satisfied before a loan can be bought or sold. These restrictions may impede the strategy's ability to buy or sell loans (thus affecting their liquidity) and may negatively impact the transaction price. It may take longer than seven days for transactions in loans to settle. Due to the possibility of an extended loan settlement process, the strategy may hold cash, sell investments or temporarily borrow from banks or other lenders to meet short- term liquidity needs. Loans may be structured such that they are not securities under securities law, and in the event of fraud or misrepresentation by a borrower, lenders may not have the protection of the anti-fraud provisions of the federal securities laws. Loans are also subject to risks associated with other types of income like high-yield bonds described above. Investments in foreign instruments or currencies can involve greater risk and volatility than U.S. investments because of adverse market, economic, political, regulatory, geopolitical, currency exchange rates or other conditions. Changes in the value of investments entered for hedging purposes may not match those of the position being hedged.

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Date-of Data: December 27, 2021

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