Bloomberg

The Star-Crossed Tale of Junk Loans

Now you love them, now you don't.

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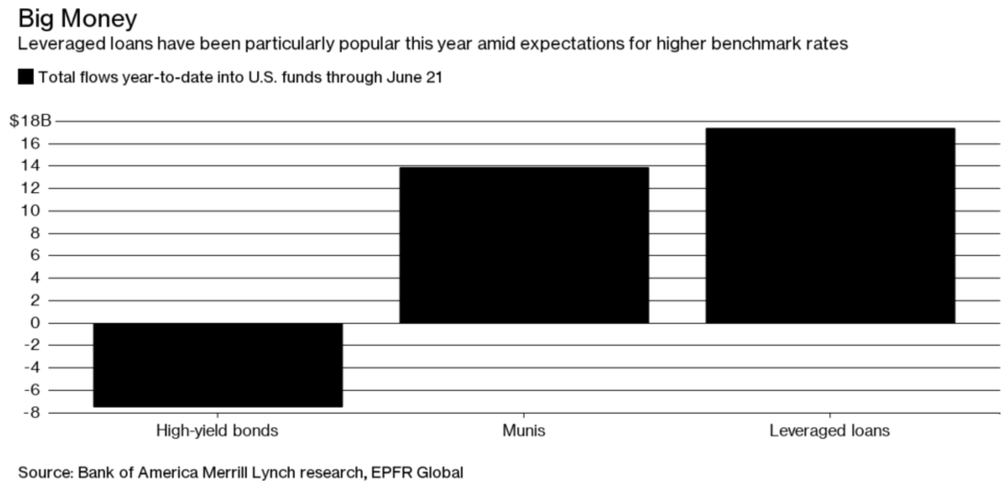
It's a tale as old as time, or least as old as the past few years.

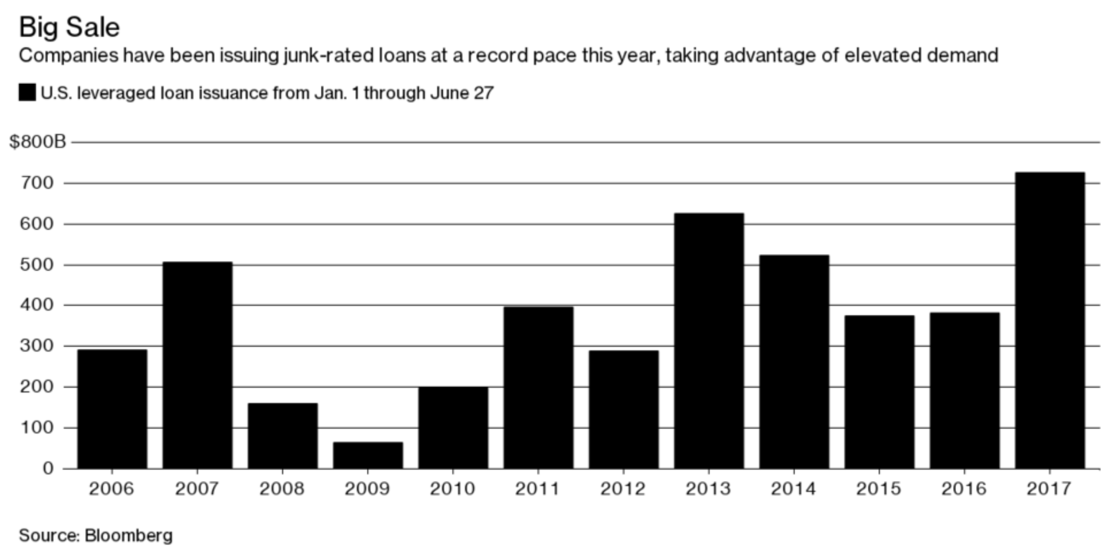
Investors fall in love with leveraged loans as they worry about rising benchmark borrowing costs. Rates don't meaningfully rise. Investors fall out of love with the debt.

This year is no different. U.S. high-yield loan funds have received $17.4 billion of new money, boosting their assets under management by 13.2 percent, according to Bank of America Merrill Lynch research. The demand stemmed from the fact that loans are pegged to floating-rate benchmarks, which rise in tandem with increasing short-term borrowing costs. In contrast, junk-bond funds experienced outflows.

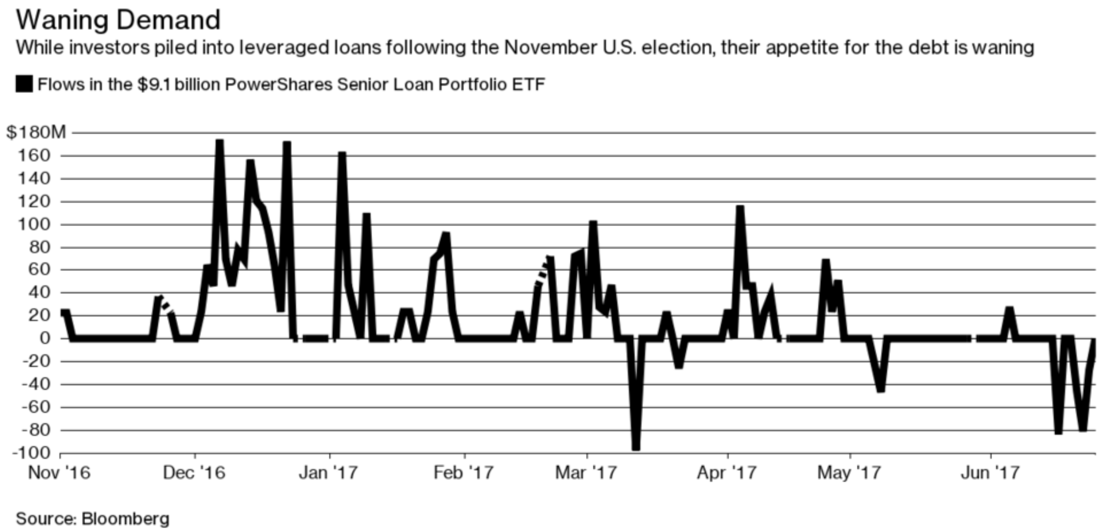


Indeed, these loan flows corresponded with a groundswell of optimism about the American economy and prospects for higher inflation.

Leveraged companies fully took advantage of this environment, with a record pace of loan issuance. Not only did they borrow as much as they thought prudent and then some, but they simply lowered the rates they agreed to pay investors on existing loan agreements through repricings.

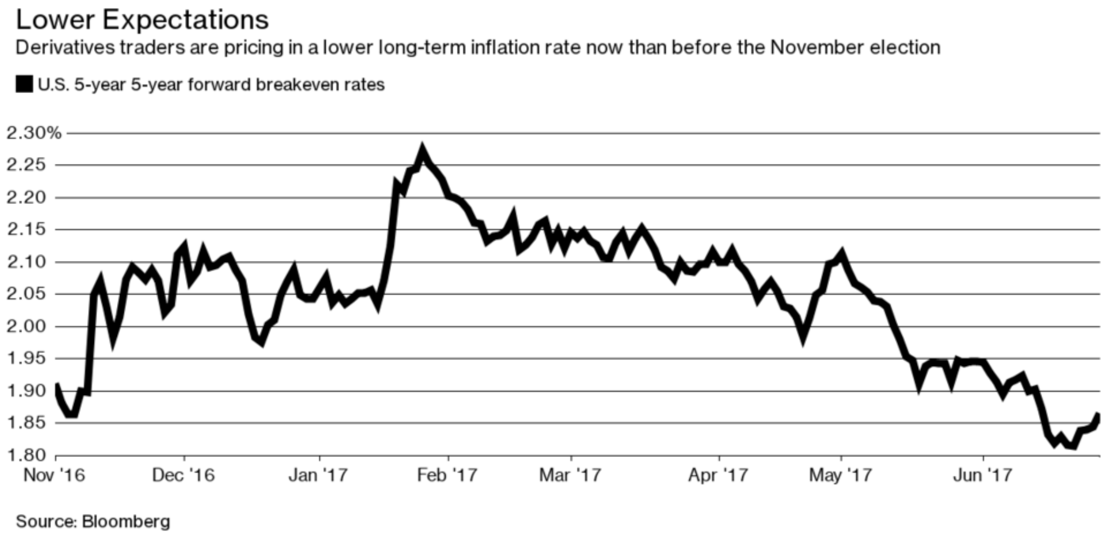


But something happened on the way to the new leveraged-loan dawn: Investors lost faith in the prospect of higher benchmark rates and faster economic growth. Economic data consistently came in below expectations. Oil prices fell. President Donald Trump, who came into office trumpeting grand promises of lower taxes and fewer regulations, made a lot of noise but has accomplished little so far.



And suddenly, sentiment is reversing. U.S. loan funds experienced their first weekly outflow last week since November, Bank of America research shows. Two deals, from Berry Plastics and Virgin Media, were pulled from syndication. The debt is losing more this month than its sister asset class, junk bonds. This is unusual because loans are ranked higher in the capital structure, meaning they typically get repaid before bonds in an insolvency, ostensibly making them more resilient in weaker patches.

Now, investors are highly skeptical about whether overnight rates can really rise that much after years of unfulfilled promises about faster growth and price increases. They don't think the credit cycle is about to crash and burn, but they also aren't optimistic about a reprieve from this profoundly unexciting market. They'd rather the higher yields that junk bonds or stocks offer over a hedge against something that seems less likely.



All this shows how loans serve as the poster children for the rising -- and quickly falling -- expectations for both inflation and growth in the U.S. The more debt traders expect the status quo, the more they'll gravitate to the higher yields on junk bonds and forgo the rate-hedge promise of loans.