

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.

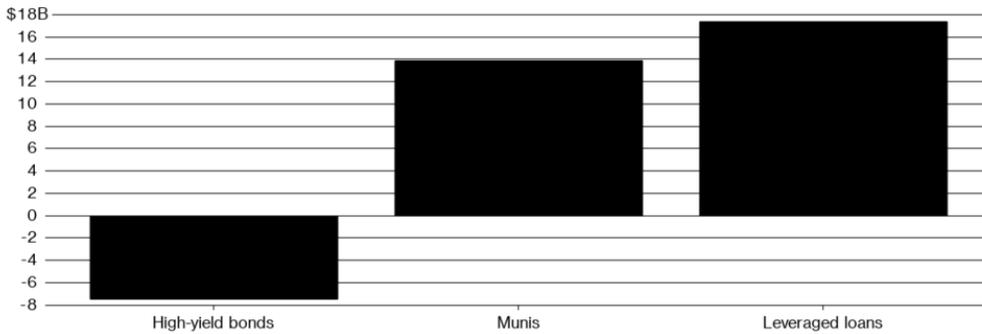
Investors fall in love with leveraged loans as they worry about rising benchmark borrowing costs. Rates don't meaningfully rise. Investors fall out of love with the debt.

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.

Big Money

Leveraged loans have been particularly popular this year amid expectations for higher benchmark rates

■ Total flows year-to-date into U.S. funds through June 21



Source: Bank of America Merrill Lynch research, EPFR Global

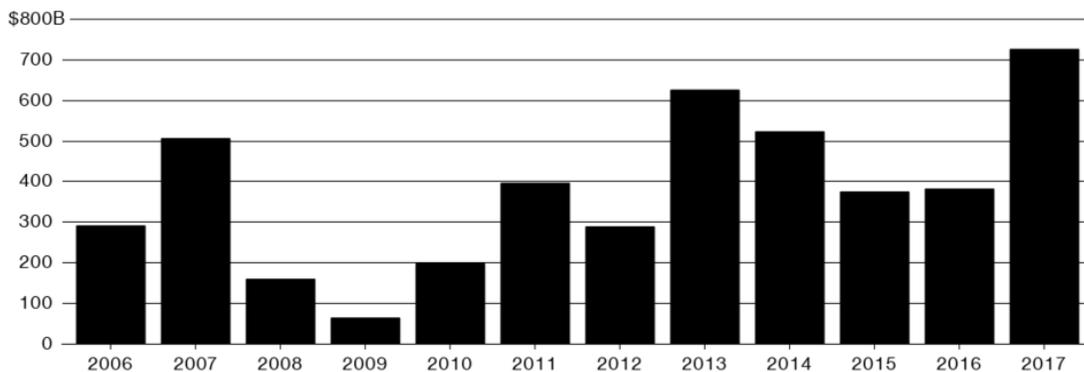
Indeed, these loan flows corresponded with a groundswell of optimism about the American economy and prospects for higher inflation.

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.

Big Sale

Companies have been issuing junk-rated loans at a record pace this year, taking advantage of elevated demand

■ U.S. leveraged loan issuance from Jan. 1 through June 27



Source: Bloomberg

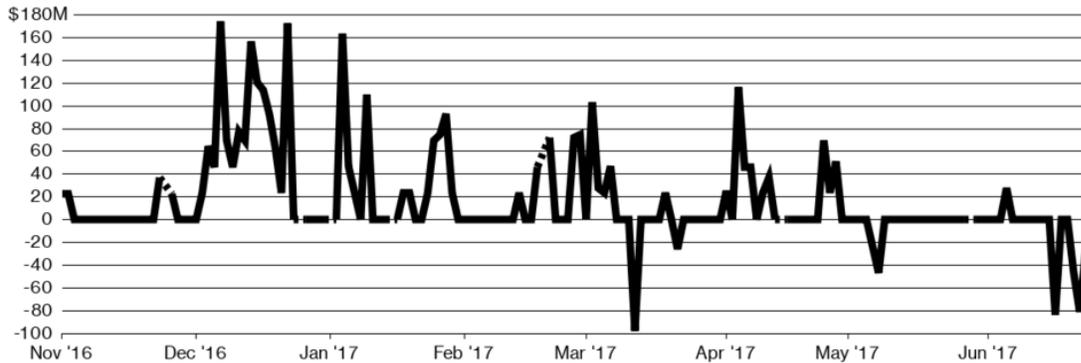
But something happened on the way to the new leveraged-loan dawn: Investors lost faith in the prospect of higher benchmark rates and faster economic growth. Economic data consistently came in below expectations. Oil prices fell. President Donald Trump,

who came into office trumpeting grand promises of lower taxes and fewer regulations, made a lot of noise but has accomplished little so far.

Waning Demand

While investors piled into leveraged loans following the November U.S. election, their appetite for the debt is waning

■ Flows in the \$9.1 billion PowerShares Senior Loan Portfolio ETF



Source: Bloomberg

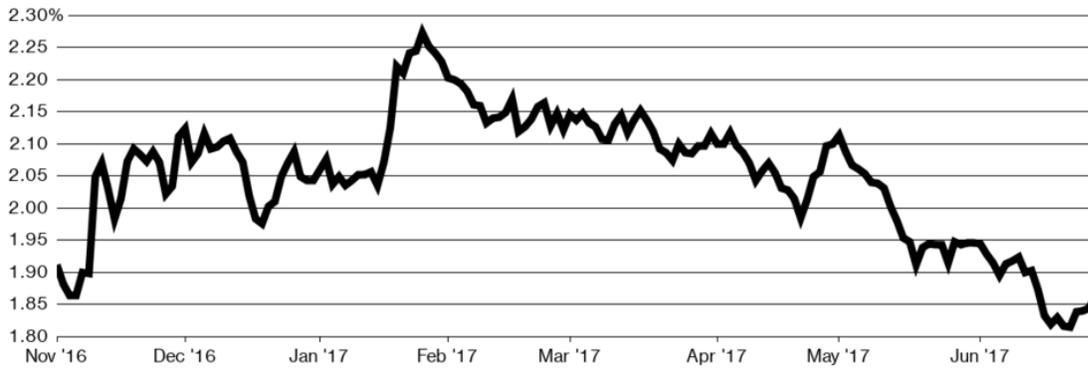
And suddenly, sentiment is reversing. U.S. loan funds experienced their first weekly outflow last week since November, Bank of America research shows. Two deals, from Berry Plastics and Virgin Media, were pulled from syndication. The debt is losing more this month than its sister asset class, junk bonds. 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.

Lower Expectations

Derivatives traders are pricing in a lower long-term inflation rate now than before the November election

■ U.S. 5-year 5-year forward breakeven rates



Source: Bloomberg

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.