Brompton Insights

Historic Yield Advantage for Senior Loans

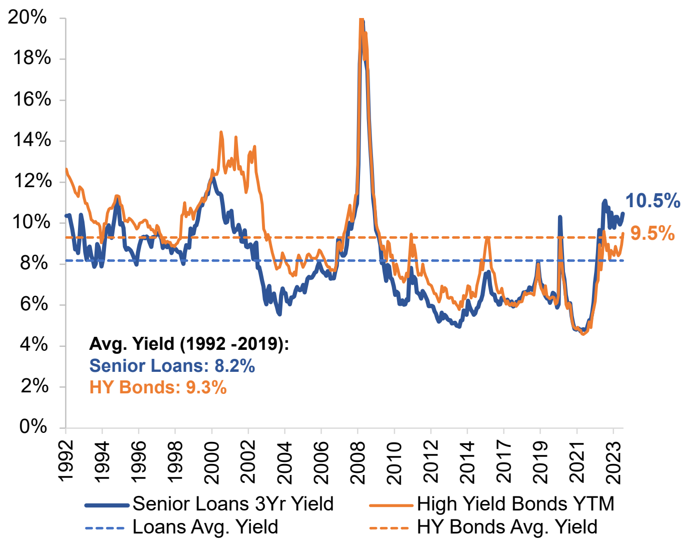
November 23, 2023

Fund in focus: Symphony Floating Rate Senior Loan Fund (SSF.UN)

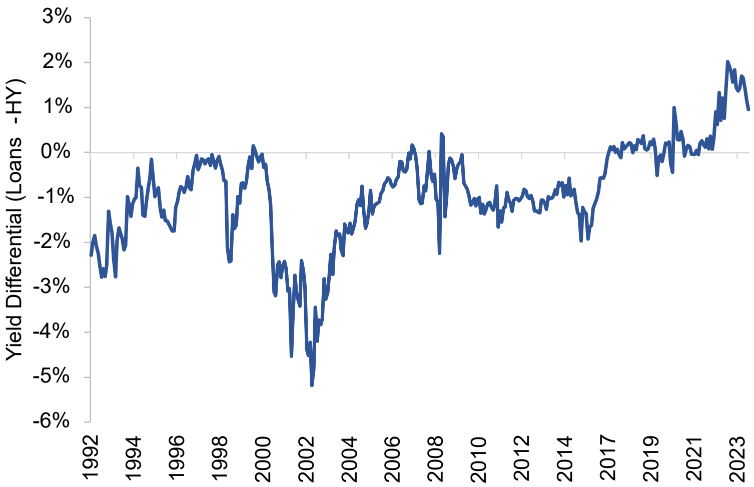
In our May 2023 Brompton Insights publication on Senior Loans, we highlighted the potential for Senior Loans to deliver equity-like returns given their high current yield and the opportunity for discounted loan prices to return to par. Year-to-date, Loans have returned 9.9% and have continued to outperform high yield bonds (4.7%) and investment grade corporate bonds (-1.4%).[1] With the Fed expected to keep rates at an elevated level into 2024, the loan market will continue to benefit from higher yields, setting up a supportive backdrop for returns.

Today, the yield-to-maturity of the Senior Loan Index is 10.5% with a cash yield of 9.8%.[2] This continues to imply a forward return profile for Loans that is similar to long-term equity return expectations. Senior Loan yields are currently +228 basis points (bps) higher than their pre-COVID average, while High Yield bond yields have returned to their average level.[1] In addition, Loans currently offer a historic yield pick-up relative to High Yield bonds as the differential between Loan and High Yield bond yields is close to the highest it has been since the inception of the Senior Loan Index in 1992.[3]

Loan Yields More Attractive Relative to History



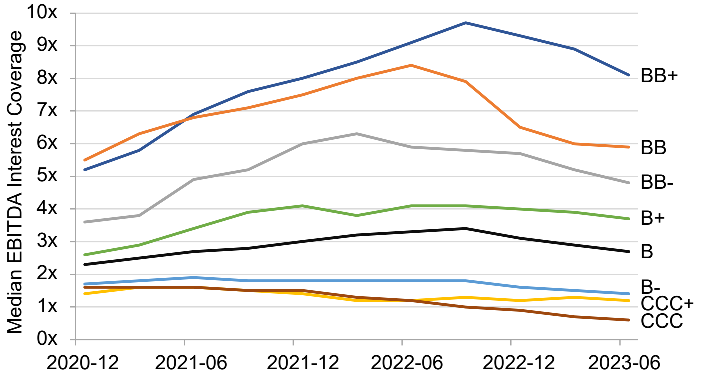
Historic Yield Pickup for Loans vs. High Yield Bonds



Source: Credit Suisse (a UBS Group Company), LSEG Datastream, as at October 31, 2023.

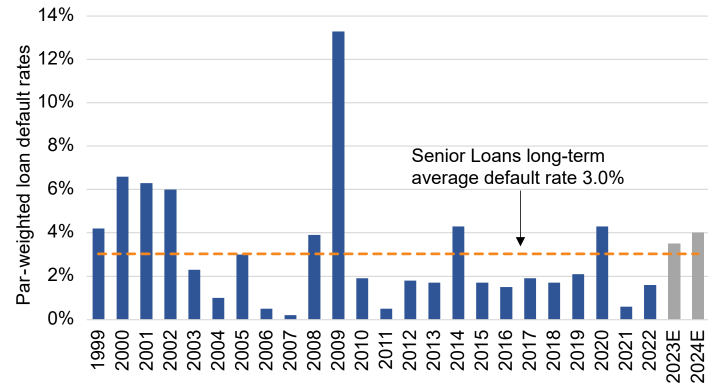
Higher financing costs pose a challenge for borrowers, however a resilient U.S. economy has so far helped borrowers weather the impact. A number of refinancings this year have significantly reduced near-term maturities in 2024 and 2025, which is positive for fundamentals as a lower number of near-term maturities should limit the need for most borrowers to access capital in a potentially tighter credit environment.[4] Interest coverage levels for higher-rated loans are generally strong, but lower-quality borrowers face greater risk from higher debt payments, as shown in the chart below (left). According to J.P. Morgan, the average default rate for loans is forecasted to be 3.5% in 2023 and rise to 4.0% in 2024, slightly higher than the long-term average default rate of 3.0%, as shown in the chart below (right). However, loans appear to already be pricing in a meaningful amount of default risk. Conservatively, assuming 50% of defaulted loans are recovered, the discount in the market today with Loans priced at 95% of par value, implies a 10% cumulative default rate. Only in the Great Financial Crisis of 2009, did actual defaults rates get to double digit figures over the past 25 years, so current market pricing is somewhat disconnected from historical default averages.

Overall loan market well positioned to weather higher rates and slowing economy, but risk rises in lower rated issuers



Source: S&P Global, US Leveraged Finance Q3 2023 Update, November 9, 2023.

Loan Defaults Expected to Rise to Long-Term Average



Source: J.P. Morgan as of October 2, 2023.

An easing in the U.S. inflation rate in October has increased expectations that the Federal Reserve is done raising rates. Historically, Senior Loan performance has been strong following the start of the pause phase, as shown in the chart below. In the last 30 years, there were four times when the FOMC paused rate increases, and pauses lasted about nine months on average before a rate cut. At the end of the June 2006 rate hiking cycle, the Federal funds rate peaked at 5.25%, a similar level to the current 5.25%-5.50% range. In the twelve months following, Loans returned 7.6%. Since the Loan Index was trading at 99% of par at the time of the pause, this return was comprised primarily of coupon income. Today, the average coupon rate on Loans is 9.2% (1.5% higher than it was in June 2006) with loans priced at 95% of par, offering the potential for additional upside from a return to par from current price levels.[2]

Senior Loan Returns After End of Rate Hike Cycle

			Loan Forward Returns			
Last Hike	Fed Funds Rate	Cut Date	3 Months	6 Months	9 Months	12 Months
18-Dec-18	2.25-2.50	30-Jul-19	3.3%	4.7%	5.7%	7.1%
28-Jun-06	5.25	17-Sep-07	1.6%	3.4%	5.9%	7.6%
15-May-00	6.50	02-Jan-01	2.2%	3.1%	4.7%	5.2%
31-Jan-95	6.00	05-Jul-95	2.4%	5.2%	7.2%	8.8%
Average			**2.4%**	**4.1%**	**5.9%**	**7.2%**

Source: Federal Reserve, Credit Suisse Credit Suisse (a UBS Group Company). Loan performance is represented by the Credit Suisse Leveraged Loan Index.

Senior Loans continue to offer a very attractive level of income for investors. In a higher-for-longer rate environment, the loan market should continue to benefit from higher yields with the potential to deliver equity-like returns. Even if a recession materializes, high current yields provide a meaningful cushion to offset price declines and careful credit selection through active management can help manage risk.

Symphony Floating Rate Senior Loan Fund (SSF.UN) invests in an actively managed, diversified portfolio consisting primarily of Senior Loans and other senior debt obligations of North American non-investment grade corporate borrowers. Nuveen Asset Management LLC, sub-advisor to the fund, specializes in the management of debt and equity strategies including senior loan portfolios, with a 40+ investment professional team dedicated to leveraged finance.

1. Source: Credit Suisse (a UBS Group Company), LSEG Datastream, as at October 31, 2023. Senior Loans: Credit Suisse Leveraged Loan Index, High Yield Bonds: ICE BofA US High Yield Index, Investment Grade Bonds: ICE BofA US Corporate Index.

2. Source: Credit Suisse (a UBS Group Company), as at October 31, 2023. Loans are represented by the Credit Suisse Leveraged Loan Index.

3. Source: Credit Suisse (a UBS Group Company), LSEG Datastream, as at October 31, 2023. Senior Loans: Credit Suisse Leveraged Loan Index, High Yield Bonds: ICE BofA US High Yield Index.

4. Source: S&P Global, US Leveraged Finance Q3 2023 Update, November 9, 2023.

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