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# Rates Take Their Toll on Yields

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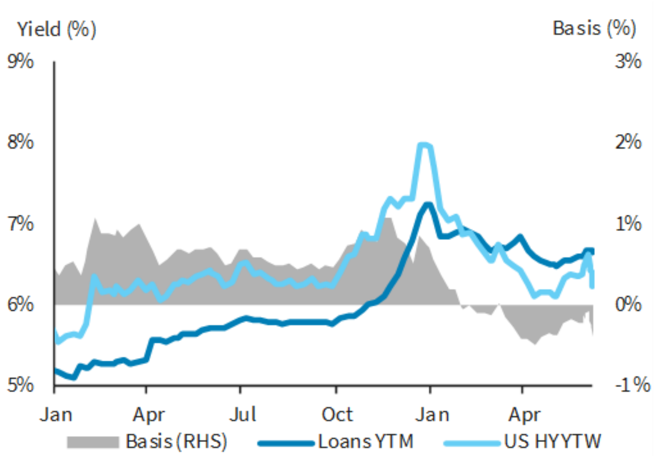
The shifting rates outlook has clearly weighed on loans this year, as expectations are now for rates cuts in 2019, compared with the expectation of hikes a few months ago. One of the most significant results of this changing environment has been seen on the demand front, with loan retail outflows of more than $23bn thus far in 2019, roughly 18% of the retail fund assets at the start of the year. While CLO demand has remained supportive, the shifting outlook has weighed on valuations, with loan total returns for the year well below high yield bond returns (at 5.7% and 8.8%, respectively).

Because of this performance differential, bonds now trade with a yield to worst inside of the loan market (Figure 1). On the face of it, this makes loans appear cheap relative to bonds (before adjusting for market-specific factors such as quality and duration). However, the yield level most frequently use for loans is based on spot Libor and does not factor in the forward curve expectations for lower rates.

When the forward Libor curve is taken into account, the actual yield of the loan market can be significantly different from the stated numbers. The variance between the two is much less meaningful when forward Libor curves are fairly flat, but matters more when the curve is materially upward sloping or inverted. Given the current level of inversion in the forward curve (Figure 2), the stated yield for the loan market significantly overestimates the actual yield that investors would receive if the forward curve is realized.

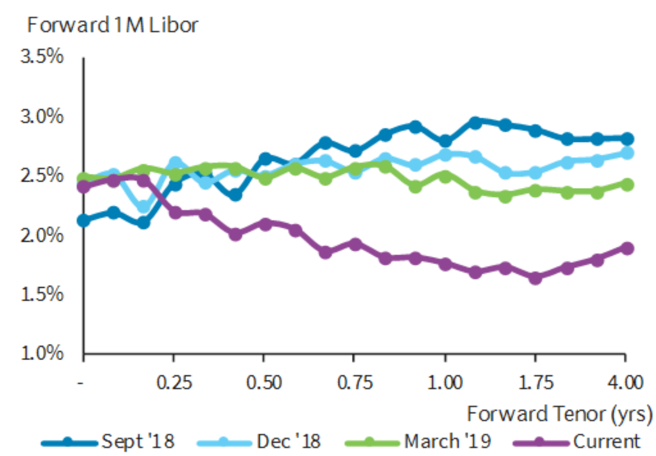
Figure 3 plots the 1m Libor spot rate against the 1y forward 1m Libor rate. While some loans use 3m Libor as a reference, roughly 75% currently use 1m Libor, and more important, the basis between 1m and 3m Libor has been fairly small and tells the same story. The Libor curve was upward sloping for most of 2018 but is now significantly downward sloping, implying that future loan coupons will decline. As a result, current yields are not fully representative of future return expectations.

FIGURE 1
**Loan Index Yield to Maturity Is Now Greater Than the Bond Index Yield to Worst**




Source: Bloomberg Barclays Indices, S&P LCD

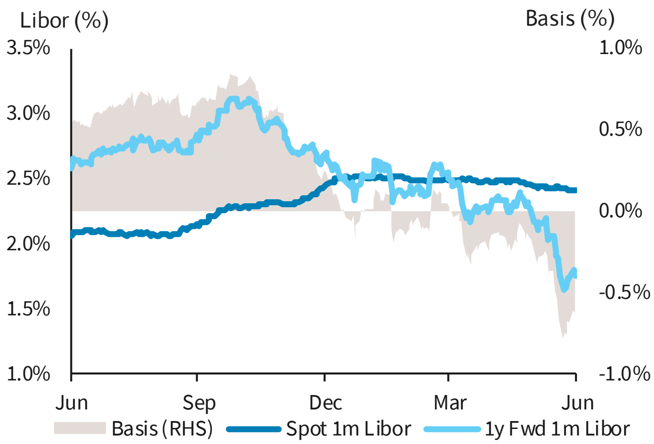
FIGURE 2
**The Forward Libor Curve Has Flattened Significantly in Recent Months**




Source: Bloomberg

FIGURE 3

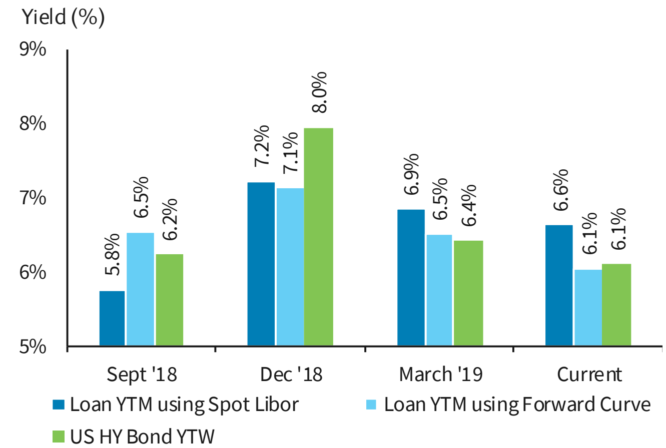
**The 1y Forward Libor Rate Is Now Well below Spot Libor**




Source: Bloomberg

FIGURE 4

**Loan Yields Will Be Lower If the Forward Curve Is Realized**




Source: Bloomberg, S&P LCD

To estimate the effect of the increased basis between spot and forward Libor, we use the forward Libor curve to calculate the yield to maturity for the loan market. For a hypothetical loan with the same terms – weighted average maturity, price, coupon spread – as the overall loan market, we estimate future cash flows using the forward curve to calculate the effective yield. We compare this with the historical stated yields – Figure 4 shows the comparison on a quarterly basis going back to before the end of the 2018 sell-off. Because of the inversion of the forward curve, the current index yield now exceeds the implied yield by roughly 60bp, a reversal of the relationship between the two in September 2018.

We believe this is a good representation of the yield that investors will earn if the forward Libor curve is realized. Given the current basis between the two, we think that the apparent cheapness of the loan market is mitigated by rates expectations. We also expect the negative demand technical to continue for the loan market if the forward curve is realized.

This analysis obviously assumes that the rate cuts priced into the forward curves materialize. The realized loan yield will be much higher if there are fewer (or even delayed) cuts. In that scenario, we would expect the demand technical to improve, providing a tailwind for loan valuations.

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