Leveraged Loans

Be Careful of Falling B's

While we prefer single-Bs in 2020, our expectations are somewhat tempered by continued elevated volatility. Rating agency action will likely continue to skew to the downside, with elevated price declines as a result. Both should be headwinds to returns for the cohort.

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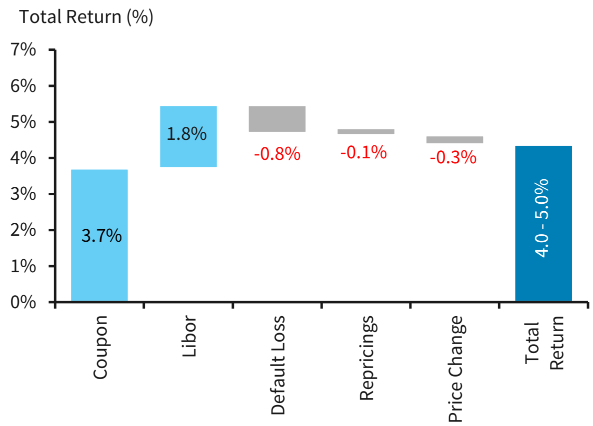
As noted in our 2020 outlook, we hold a slight preference for single-Bs relative to BBs as the former have, on average, a materially higher coupon and almost $2.5 lower price (*Enthusiasm curbed by tail risks*). Despite this upside, we believe this cohort will remain the most topical in 2020 and exhibit continued volatility, tempering our enthusiasm somewhat. Specifically, we expect a continuation of two trends that should place increased importance on credit selection:

1. Downgrade rates to outpace upgrade rates, especially for lower-rated credits
2. Price declines as a result of these downgrades to remain elevated

Despite total returns of nearly 8% for the loan market, this year has been marked by underperformance to high yield bonds. As a whole, we expect total returns of 4.0-5.0% for the leveraged loan market next year, slightly above our expectation of 3.5-4.5% for bonds. This forecast is a result of stable Libor expectations, a slight price decline for the loan index, and a modest rise in default loss (Figure 1). We forecast the price of the loan index to end the year in the low $95 range. Additionally, we expect default rates to increase slightly, to 1.5-2.5% (par-weighted), while recovery rates worsen, resulting in a modestly higher default loss.

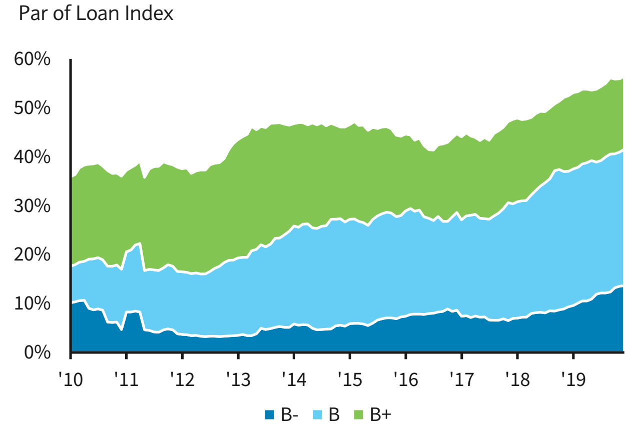
The market as a whole, especially the single-B portion, has had increased volatility this year, with the standard deviation of weekly loan returns at the highest level since 2011. We expect this pressure to remain, especially for the lower-rated portions of the market, particularly driven by potential CCC constraints in CLOs if downgrades were to increase beyond our expected rate. As a result, investors must remain selective within the B-rated bucket, given almost 42% of all loans in the index are B or B- rated, the highest percentage on record (Figure 2). With such a high portion of the index either one or two notches from the CCC cliff, the single-B cohort should remain the focus in 2020.

FIGURE 1. Components of 2020 Total Return Forecast



Source: Barclays Research

FIGURE 2. B Rated Loans Represent a Growing Portion of the Loan Index



Source: S&P LCD, Barclays Research

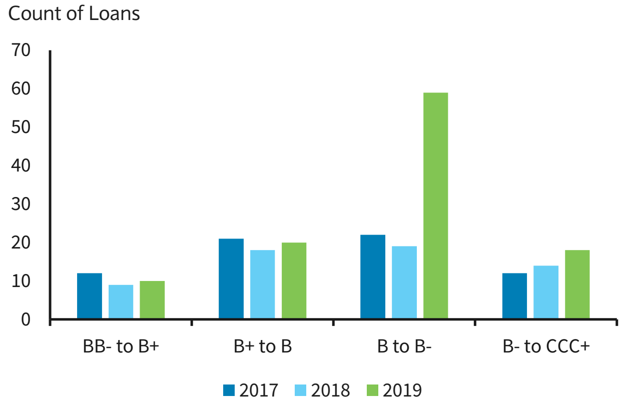
Figure 3 shows the number of loans beginning the year in one ratings category and ending one notch lower using S&P ratings. Throughout 2019, there have been 59 loans downgraded from B to B-, which is over 8x the number of loans upgraded from B- to B. This highlights the continued pressure ratings migration has placed on the market, with migration rates skewed more towards downgrades (*Loan Downgrades on the Rise: Implications for CLOs*).

Beyond the increased frequency of loan downgrades in the lower single-B space, the effect is exacerbated by the more punitive price declines this year. In Figure 4, we show the average dollar price change during the year for loans downgraded one notch (S&P rating) relative to the change in price of the loan index, using the same buckets as Figure 3. This year, loans downgraded from B- to CCC+ have declined by over $10 on average relative to the index since the start of the year, three times the price decline for the same ratings move in 2018. The downgrades from B to B- and B- to CCC+ have had the greatest change, suggesting that investors are increasingly cautious about lower-rated loans. We evaluated similar price changes for upgrades, but found it difficult to draw conclusions, given the limited number of instances for each migration bucket.

Breaking down the price declines, we find that a majority of the underperformance occurs prior to the date of the rating downgrade. Furthermore, the average downward price change becomes greater as one moves down in quality, both before and after the downgrade date.

Ultimately, while we believe the upside for single-B loans is attractive, especially relative to current BB levels, our enthusiasm is tempered by the increased downside risk stemming from ratings migrations. If elevated downgrade rates continue, and price declines remain greater, a few credits could weigh on returns for the entire single-B cohort. We believe this places an increased focus on credit selection for investors, with the ability to boost returns with attractive Bs, but the main focus remaining on avoiding single-name pitfalls.

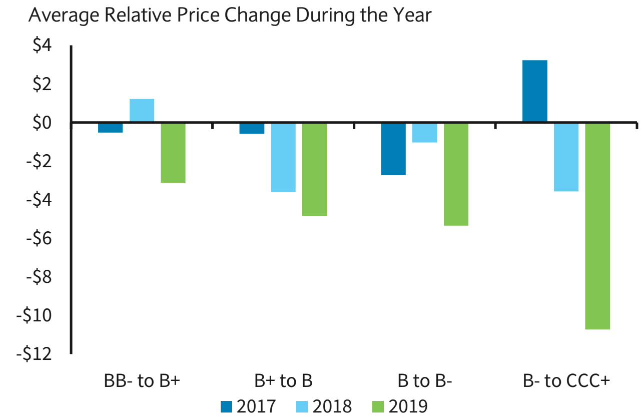
FIGURE 3. B to B- Downgrades Have Spiked this YearT



Note: Based on S&P rating

Source: S&P LCD, Barclays Research

FIGURE 4. Price Actions of Downgrades Have Been More Punitive



Note: Based on S&P rating. Average year-end price change over the course of the year relative to the price change in the index over the same period.
Source: S&P LCD, Barclays Research

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