UBS

High yield bonds

US senior loans: Attractive floating yield

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- The yield pick-up of US senior loans against higher quality bonds remains attractive and the default rate outlook is benign. We see limited price upside from current levels, however. We remain overweight US senior loans.
- As a floating-rate asset class, a rising US LIBOR rate should support coupon income. This is somewhat offset by a drag on coupon income from ongoing loan repricing.
- We recommend USD senior loans to investors who have a multi-year investment horizon and can tolerate some illiquidity.

We are positive on US loans based on their attractive yield of 5.4%, low default risks and resilience to higher short-term rates. Over the next 12 months, we expect total returns of around 4%, driven mostly by carry. We maintain an overweight in US loans in our Fixed Income Strategist (FIS) moderate and aggressive portfolios.

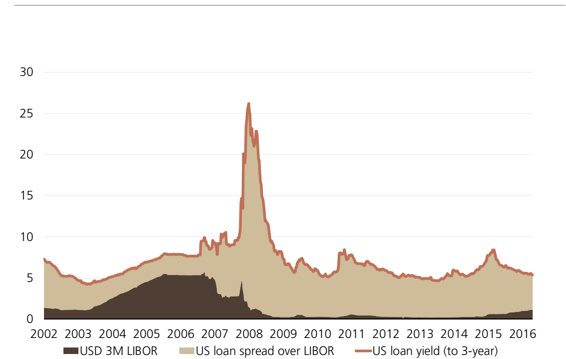
Strong market conditions supporting US loan prices

Loan coupons are variable and consist of a base rate such as LIBOR and an interest margin charged to reflect the credit risk of the borrower. Their variable nature results in rates durations close to zero. We think the Fed is likely to raise rates twice before the end of the year, and three times in 2018. The US 3m LIBOR is thereby set to further increase towards 2.0% over the next 12 months, from 1.2% currently. Given the floating rate nature of loans, the expected rise in US LIBOR should support higher coupon income.

In anticipation of further US rate hikes, retail demand for US senior loans has increased recently and has outpaced new loan supply. Cumulative retail fund inflows have reached USD 7bn since September 2016. CLO demand has also remained steady, with CLO volume running at an average monthly pace of USD 32bn since September 2016. At the same time, there has been a lack of new money deals as most of the 1Q17 supply came from the repricing of existing loans.

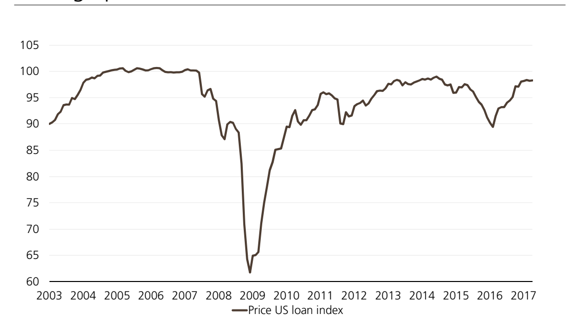
New money transactions made up only 24% of leveraged issuance in 1Q17 vs 63% in 1Q16. Such market conditions have helped push spreads lower and prices higher. The average price has been higher than the prior peak in prices seen in May 2015, with the index currently trading at an average price of USD 98.3. The percentage of loans in the US leveraged loan index trading at par (i.e. USD 100)

Fig. 1: Attractive floating yield
Yields in %



Source: Bloomberg, S&P LCD, UBS, as of 17 April 2017.

Fig. 2: US senior loan price
Average price in USD



Source: Bloomberg, S&P LCD, UBS, as of 17 April 2017.

Fig. 3: Callability of US loans

The majority of loans are immediately callable, meaning that companies can call a loan at par at any time to take advantage of better funding conditions. Some have a USD 101 "soft call" where the issuer has to pay a USD 1 penalty to refinance at a lower rate for the first six months or one year following issuance. As a consequence, prices rarely rise much above par ($100).

Source: UBS, as of 17 April 2017.

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or above stands at 67%, slightly down from 72% in February 2017. We see limited US loan price upside from current levels due to their callability (see Fig 3).

Repricing activity eroding coupon income

Companies have taken advantage of strong market conditions to call and "reprice" their loans at lower rates by negotiating a lower interest margin. Lenders accept the lower rate rather than receive no allocation if the company were to pursue a full refinancing in the primary market. Since September 2016, a total of USD 342bn of loans have repriced, equivalent to roughly 40% of the outstanding value of the S&P US leveraged loan index. While repricing is advantageous for companies, it tends to erode coupon income for investors. Investors wishing to remain invested in the asset class have to accept lower coupon income and reduced returns. The current repricing wave that started in mid-2016 is estimated to have wiped out 25bps thus far, which compares to an average coupon decline of 60bps during the last repricing wave in 2013. With many issuers having already taken advantage of favorable rates, we expect repricing activity to decelerate over the coming months. The positive impact of rising US LIBOR rates should offset the negative impact of repricing over the next 12 months and result in rising coupon cash flows for investors. For loan issuers, the benefits of repricing offsets some of the higher interest burden caused by rising US LIBOR.

Fundamentals are improving

Default risks remain low, in our opinion. The trailing 12-month default rate has fallen from 2.2% in July 2016 to 1.5% in March 2017, below its long-term median of 2%. Most of the defaults over the last 12 months have been in the energy sector. With the weakest companies having largely defaulted by now, and as the oil price has recovered to USD 53 (WTI), we expect to have passed the peak of the energy-related default cycle. We see the loan default rate as remaining near current low levels, with the most likely source of future stress occurring within pockets of the energy and the retail sectors. One of the additional benefits of loans is that recovery rates are higher than for senior unsecured debt, with the average loan recovery since the financial crisis being about 70%.

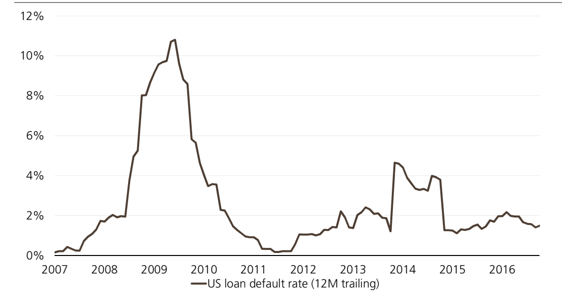
Companies are benefiting from improving US economic fundamentals and benign lending conditions. The average earnings of US leveraged loan issuers increased in Q4 by 5.2% YoY (8.3% YoY ex-commodities), up from 4.3% (5.8% YoY ex- commodities) in Q3. This is leading to improving leverage and cash flow coverage ratios. The average leverage ratio declined to 5.0x in Q4, from 5.3x in Q3 and cash flow coverage rose to 3.3x in Q4 from 3.2x in Q3. We believe these positive fundamental trends should continue as the US economy grows modestly, consumer and business sentiment remains strong, and most commodity issuers continue to recover.

Liquidity risk

Senior loans are originated by banks and then traded "over the counter" (OTC) between different banks and mostly collateralized loan obligations (CLOs) and loan fund managers. One inherent

Fig. 4: US loan default rate

Trailing 12-month default rates, in %



Source: S&P LCD, UBS, as of 31 March 2017.

feature of loans is their limited secondary market liquidity, as they were originally designed as buy and hold investments. The specifics and mechanics of loan trades limit their trade execution speed. The average loan settlement time was 18.4 business days in 2016, compared to three business days for bonds.

Longer settlement times become an issue when there is increased market volatility, as a longer outstanding trade implies a higher price risk. Liquidity risk is more pronounced in periods of market stress, when investors want to withdraw their funds, as was the case during the 2008 financial crisis.

In light of the liquidity risk, we recommend investors to invest in loans as part of a well-diversified portfolio, to have an investment time horizon of at least 12 months and to be comfortable with some illiquidity risk. In general, illiquid securities have to offer an illiquidity premium to compensate investors for the lower liquidity. A hold to maturity investor, who does not have to be overly concerned with loan market price fluctuations, can benefit from this return component over time.

Summary

We remain constructive on US loans based on an attractive yield of 5.4%, low default risks and a resilience to higher short-term rates. We maintain an overweight in US loans in our moderate and aggressive FIS portfolios.

Appendix

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