BARINGS

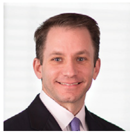
PUBLIC FIXED INCOME

The (Still) Compelling Case for Broadly Syndicated Loans

INSIGHTS

Even as the rate-hiking cycle looks close to its end, loans look well-positioned for strong performance in the year ahead, due largely to the high contractual income on offer.

Natalie Heawood, CFA
Managing Director
European High Yield



Casey McKinney
Managing Director
U.S. High Yield

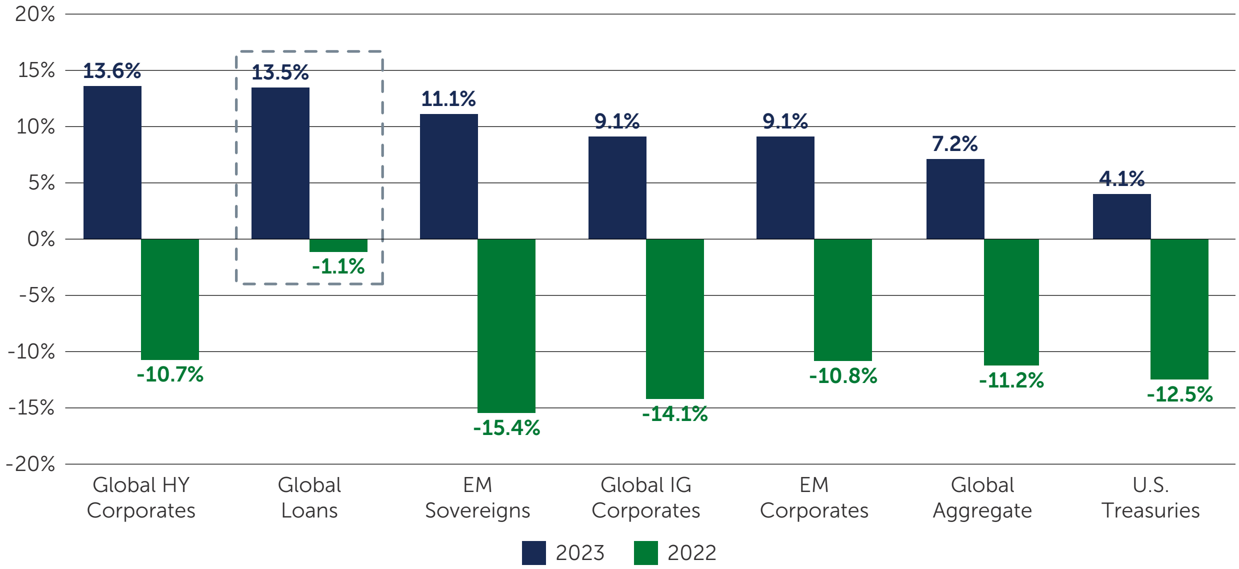
"While yields across all fixed income markets are elevated, the loan asset class stands out not only for being at the top of the list, but also because the bulk of its yield is coming from contractual income that is being paid today rather than awaiting price recovery."

As an asset class that pays investors a floating-rate coupon, broadly syndicated loans have historically outperformed in rising-rate environments—and the asset class certainly benefitted from that backdrop over the past two years. Now that the rate-hiking cycle may be reaching its end, however, there are questions as to whether this strength can continue. We believe it can, due largely to the contractual income currently on offer, which continues to hover around its peak post-financial crisis highs.

Strong Performance Amid Rising Rates

The loan market outperformed other fixed income asset classes in each of the last two years, as central banks steadily increased rates to combat inflation. In 2022, while performance was negative—which had previously only happened twice in the U.S. and three times in Europe—the loan market showed significant resilience relative to other fixed income markets due to its lower price sensitivity to increases in interest rates **(Figure 1)**. Heading into 2023, the asset class was armed with a much higher coupon which, along with some modest price recovery, allowed it to quickly recapture the negative results of 2022 and outperform other markets for a second consecutive year.

Figure 1: Loans Have Outperformed Other Fixed Income Asset Classes



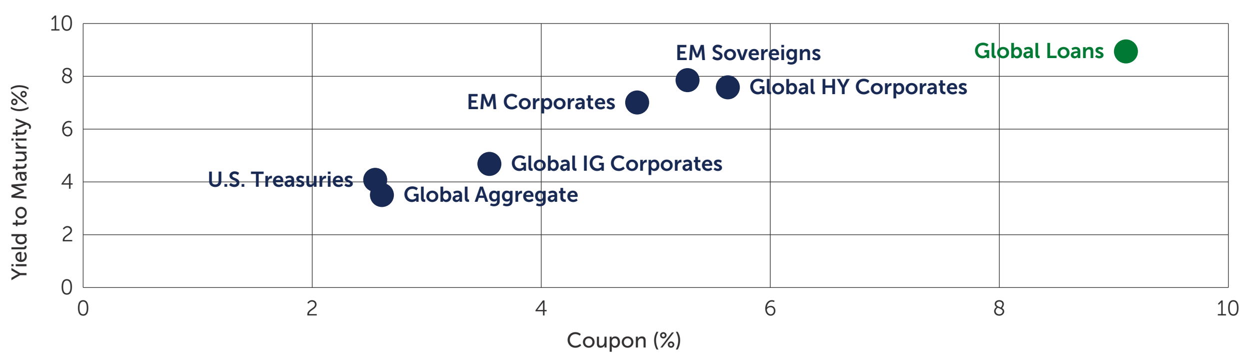
Sources: Credit Suisse; J.P. Morgan; Bloomberg. As of December 31, 2023. Returns are hedged to USD.

Can the Strength Continue?

Even as the rate-hiking cycle looks close to its end, loans look well-positioned for outperformance in the year ahead, due largely to the contractual income on offer. As a result of the increase in short-term rates (which make up the floating-rate portion of a loan's coupon) and the general steadiness in stated spread (the fixed-rate portion) loan coupons today are at elevated levels. The average coupon for the global loan market today is 9.11%, which is well above the long-term average of 5.46%.[1] For a market that has historically provided total returns in the 4%–6% range, coupons at these levels suggest strong potential for above-average total returns. The high starting point also provides a natural buffer for total returns in the face of volatility or temporary periods of price disruption, which may be more likely than not in the months ahead given today's macroeconomic uncertainty.

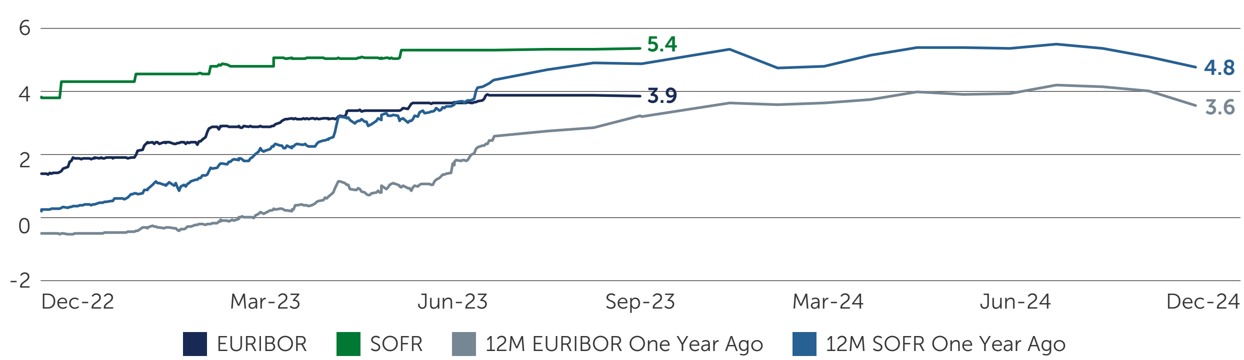
While yields across all fixed income markets are elevated, the loan asset class stands out not only for being at the top of the list, but also because the bulk of its yield is coming from contractual income that is being paid today rather than awaiting price recovery **(Figure 2)**. Further, although short-term rates may eventually decline from current levels, many market participants are expecting rates to remain higher for much of 2024 **(Figure 3)**. Importantly for loans, this likely means that even with a modest pullback in rates, coupons will remain well above historical levels and pave the way for healthy performance.

Figure 2: Elevated Yields, Contractual Income



Sources: Credit Suisse; J.P. Morgan; Bloomberg. As of December 31, 2023.

Figure 3: Rates Expected to Remain Higher for Much of 2024



As of December 31, 2023.

1. Source: Credit Suisse Global Leveraged Loan Index. As of December 31,2023.

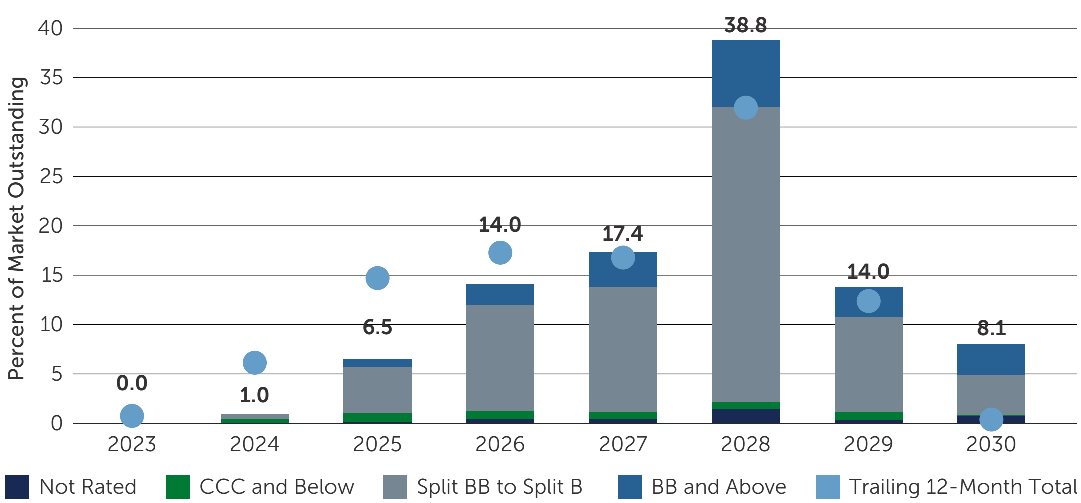
Resilience in the Face of Risk

The loan market consists of credits that are rated below investment grade, which means a primary risk is the potential of principal loss from a default. While investors in loans certainly benefit from the higher income component today, elevated rates are somewhat of a double-edged sword, as borrowers are faced with higher borrowing costs. Although many borrowers have interest rate hedges or other fixed-rate financing sources in place, there will be some that do not. These borrowers could face liquidity pressures in the months ahead—particularly if earnings see elevated volatility in response to a weaker economic backdrop—and be forced to either seek additional capital or default.

Unsurprisingly, increased borrowing costs, among other factors, have contributed to an increase in the default rate for U.S. loans, from 1.6% in 2022 to 3.2% for the trailing 12-month period ending December 31, 2023.[2] However, it is important to highlight that this level is in line with the market's long-term average default rate of 3.1%. Therefore, while it has risen, the default rate remains in manageable territory and looks unlikely to increase significantly from here.

As we look ahead to the next year, we expect to see similarities to 2023. Defaults are likely to remain at a similar, manageable level, particularly for actively managed portfolios focused on prudent credit selection. This is partly due to the fact that management teams have been proactively addressing capital structure needs through the primary market, refinancing debt and pushing out maturities **(Figure 4)**. It is also a result of pockets of stress being fairly well telegraphed, which means the market has already priced in discounts for many credits facing near-term headwinds or potential liquidity events. Therefore, while defaults are certainly worth monitoring closely in the months ahead, we do not believe they will materially offset the strong returns generated by elevated income.

Figure 4: Maturities Remain Manageable



Source: Credit Suisse. As of December 31, 2023.

2. Source: J.P. Morgan. As of December 31, 2023.

It is also worth noting that loans are fairly resilient by nature. In addition to typically being senior in a company's capital structure, they are secured by a borrower's assets—which has contributed to loans' higher recovery rate over time versus both junior debt and equity. Broadly syndicated loans also have an active secondary market that provides liquidity, even in uncertain market environments. Finally, the asset class offers sector diversification relative to other fixed income allocations, which helps it weather the ups and downs of market cycles. Specifically, while many fixed income markets offer exposure to energy, homebuilders and hospitals, loans offer the opportunity to diversify into the technology and services sectors.

Key Takeaway

Following two years of relative outperformance, and with the rate-hiking cycle likely at or near its peak, there are questions around whether the time is right to shift out of loans and into other areas of fixed income. In our opinion, this view overlooks one of the key benefits of the rising-rate environment for the asset class—the higher contractual income currently being generated. Not only are broadly syndicated loans beginning the year with a higher coupon than in the last two years, but there is greater attention among managers to potential pockets of stress—some of which have already been addressed. To that end, we believe loans are well-positioned to deliver attractive relative performance in the year ahead.

Barings is a $347+ billion global investment manager sourcing differentiated opportunities and building long-term portfolios across public and private fixed income, real estate and specialist equity markets. With investment professionals based in North America, Europe and Asia Pacific, the firm, a subsidiary of MassMutual, aims to serve its clients, communities and employees, and is committed to sustainable practices and responsible investment.*

LEARN MORE AT BARINGS.COM

**As of September 30, 2023*

23-3291107