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December 2024

Floating Rate Loans: Attractive Income Potential in an Expensive Market

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We believe floating rate loans may be attractive for investors seeking income with moderate correlation to inflation.

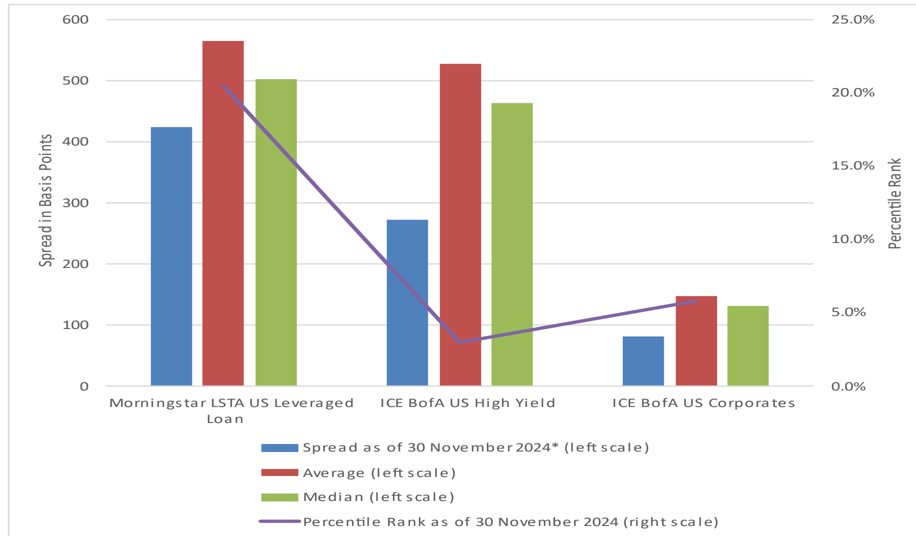
Executive summary

- *Spreads have tightened due to investors' optimism regarding economic growth and issuers' ability to repay debt. While loan spreads currently are tight, the spreads are relatively wider than High Yield and Investment Grade spreads.*
- *The credit quality of the loan universe may be improving, which may reduce credit costs over time.*
- *Loan yields may benefit if the US Federal Reserve cuts rates slowly, which we believe is likely as inflation is proving to be sticky.*

US corporate debt spreads are tight in general, but loan spreads are relatively wider

Corporate debt spreads have tightened to near-record levels as the US economy has continued to expand and the Fed has begun to decrease its short-term interest rate target. Looking at the three main categories of traded corporate debt (Investment Grade bonds, High Yield bonds, and Leveraged Loans), Investment Grade and High Yield bond option adjusted spreads[1] have fallen to the 3rd percentile and 6th percentile since 1997, respectively. The loan three-year discounted spread, the metric which we believe best represents loan spreads, is trading in the 20th percentile for the same period.

Exhibit 1: US leveraged loans, high yield bonds and investment grade corporate bonds: current and historical spreads show spreads as lower than long-term averages



Sources: ICE BofA US High Yield index, ICE BofA US Corporate Index, Morningstar LSTA US Leveraged Loan Index. From 1/31/1997.

[1] Spread data for loans reflects the 3-year discounted spread of the Morningstar LSTA US Leveraged Loan index. Bond spreads are represented by the option-adjusted spread of the ICE BofA US High Yield and US Corporate indices. From 1/31/1997.

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Investors should be aware that the overall credit quality of the loan universe has weakened over the last decade; in contrast, high yield credit quality has improved. Qualitatively, we believe the loan universe is more diversified than the high yield universe, with a smaller weight of cyclicals and a lower weight of securities rated CCC and below[2]. Collateralized loan obligations (CLOs) dominate the loan market; these structured vehicles are not concerned with total return relative to a benchmark and liquidity but instead focus on meeting their covenanted compliance ratios that indicate the credit quality of a portfolio, such as the weighted average ratings factor (WARF). Compliance ratios are the mathematical tests CLOs must pass to maintain distributions to the equity holders and interest payments to junior creditors. CLOs' compliance ratios are calculated on par value, which can contribute to price stability for performing loans as managers are incented to purchase loans from stable credits trading at market discounts.

The credit quality of the loan universe has recently shown signs of improvement

Although CLOs are able to hold low-rated loans, their compliance ratios make holding too high a proportion of loans rated CCC and below problematic. CLO managers are also wary of B- rated loans which appear likely to be downgraded to CCC. Therefore, we believe it is useful to monitor the loan universe's aggregated weight of loans rated B- and below.

As Exhibit 2 displays, the weight of B- and below loans expanded from 14.6% in January 2013 to a peak of 33.6% in July 2023. Recently, the weight of loans rated B- and below has fallen, reaching 30.6% in November 2024. We believe this happened for two primary reasons, both of which may prove to be beneficial to returns going forward: defaults and refinancings by private credit funds.

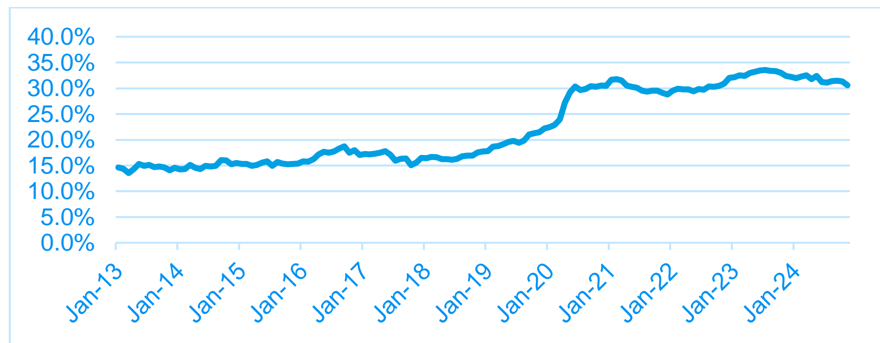
Loan defaults

Loan defaults have been high this year, with J.P. Morgan reporting the default rate, including distressed exchanges, by par amount at 4.04% as of November 2024[3]. J.P. Morgan projects defaults will moderate to 2.75% in 2025 and 2.5% in 2026. Although the current default rate is high, we believe the loan universe may be burning through its most likely default candidates, which will ultimately produce a less risky cohort.

Refinancings

Additionally, we believe private credit funds have been refinancing many of the more aggressive loans in the leveraged loan universe. As noted above, loans rated B- and below are problematic for CLOs, which hold an estimated 68% of the loan universe[4]. Private credit funds are not constrained by ratings and seek higher spread loans in order to cover their higher fees and meet their investors' higher return expectations, which has led to weaker average interest coverage for private credit compared to publicly traded loans[5].

Exhibit 2: Weight of loans rated B- and below in the Morningstar LSTA US Leveraged Loan index has grown over time: B- and below weight grew from 2013 to July 2023 but has recently fallen



Source: PitchBook LCD "US Leveraged Loan Index Factsheet" as of November 30, 2024. "B- and below" loans include all loans rated B-, CCC+, CCC, CCC-, CC, C, D and NR.

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[2] Sources: ICE BofA US High Yield index and Morningstar LSTA US Leveraged Loan index. Weights of CCC and below: 12.3% for high yield and 7.5% for loans.

[3] Source: J.P. Morgan, "Default Monitor," Dec 2, 2024.

[4] Sources: S&P, Morningstar LSTA US Leveraged Loan index as of September 30, 2024

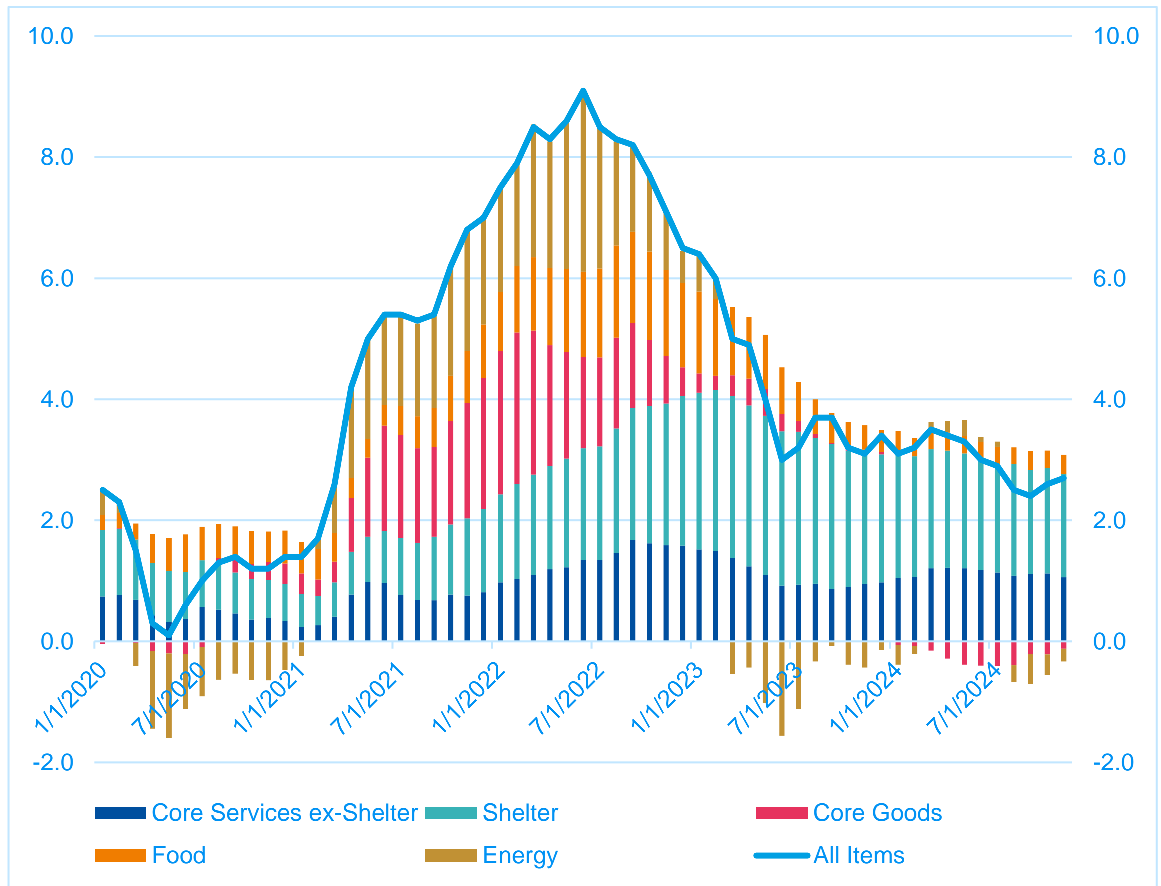
[5] Source: Board of Governors of the Federal Reserve System, "Private Credit: Characteristics and Risks," Feb 23, 2024 https://www.federalreserve.gov/econres/notes/feds-notes/private-credit-characteristics-and-risks-20240223.html

Loan yields may decrease slowly if the Fed cautiously cuts rates

From June 2022 to November 2024, inflation declined dramatically, with the US Consumer Price Index[6] declining from its 9.1% peak in June 2022 to 2.7% as of November 2024. However, inflation remains above the Fed's long-term 2% target. Further, inflation is currently dominated by core services and has been proving to be persistent, or sticky, due to a tight labor market. Average hourly earnings[7] growth near 4% remains well above pre-COVID levels, adding to the inflationary pressures.

Exhibit 3 shows the contributions to CPI of its various subcategories. At November 30, 2024, Shelter's 4.8% inflation rate contributed 1.7% of total CPI, while Core Services ex-Shelter's 4.4% inflation rate contributed 1.1% to total CPI. As can be seen in Exhibit 3, Shelter and Core Services ex-Shelter can be viewed as contributing almost all of current inflation. Although other subcategories of CPI such as Energy and Core Goods have recently generated negative inflation contributions year-over-year, achieving the Fed's 2% target may be difficult without further improvement in Shelter and Core Services ex-Shelter[8].

Exhibit 3: Inflation rates: Consumer Price Index, Shelter and Core Services ex-Shelter sectors, in percentage terms



Source: US Bureau of Labor Statistics, Amundi US. Last data point November 30, 2024.

[6] Source: US Bureau of Labor Statistics, US CPI Urban Consumers year-over-year Index

[7] Source: US Bureau of Labor Statistics, US Average Hourly Earnings All Employees data as of November 2024

[8] Source: Amundi, US Bureau of Labor Statistics US CPI Urban Consumers year-over-year Index. The Fed's preferred inflation measure is the US Bureau of Labor Statistics US Personal Consumption Expenditures (PCE) Price Index YoY%.

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In response, the market has recently adjusted to the potential for sticky inflation by returning to the "higher for longer" narrative for Fed policy. The year-end 2025 federal funds contract now trades at 3.97%, above the Fed's "Dot Plot" reference point of 3.875% for the same period.

Regarding loans, the Secured Overnight Funding Rate (SOFR) is the index that replaced LIBOR. This rate generally trades several basis points over the federal funds rate. With year-end 2025 Fed Funds futures contracts trading at 3.97% as referenced above[9], this implies that SOFR at the end of 2025 will be approximately 4.02%. The credit spread of each loan is then added to this base rate to produce each loan's yield. Assuming that loan spreads remain at current levels with the Morningstar LSTA US Leveraged Loan Index Discounted Spread at 343 basis points[10], the index yield at year-end 2025 could be as high as 7.45%.

Exhibit 4: US Federal Funds December 2025 contract rate: last yield to convention

Sources: Amundi, Chicago Board of Trade, Bloomberg. Last data point December 18, 2024.

Conclusion

We recognize that loan spreads are not particularly attractive, except relative to other fixed income asset classes. However, we believe the improving credit health of the loan universe, the fact that loan coupons are priced off the front end of the still-inverted curve and the strong possibility that the Fed will be unable to cut rates quickly due to sticky inflation, support the inclusion of loans in income-oriented portfolios.

Further, considering the likely continuing stickiness of core services inflation, we believe floating rate assets such as loans are currently an attractive option to add diversification[11] to investors' fixed income portfolios, which are generally weighted in favor of fixed rate instruments. In effect, loan allocations represent hedges against continuing high inflation.

[9] Fed Funds (30-day Fed Funds) futures contracts on the Chicago Board of Trade trade-in dollar prices; the Yield-to-Convention converts these dollar prices into yield equivalents.

[10] Pitchbook LCD "US Leveraged Loan Index Daily Spreads_17-Dec-2024.xlsx" as of December 17, 2024.

[11] Diversification does not guarantee a profit or protect against a loss.

Index and Term Definitions

- A collateralized loan obligation (CLO) is a single security backed by a pool of debt. CLOs are often composed of corporate loans with low credit ratings or loans taken out by private equity firms to conduct leveraged buyouts. The investor receives scheduled debt payments from the underlying loans, assuming most of the risk if borrowers default.
- Option-adjusted spread: The yield spread that must be added to a benchmark yield curve to discount a security's payments to match its market price, using a dynamic pricing model that accounts for embedded options.
- Morningstar LSTA US Leveraged Loan Index: A market-value weighted index designed to measure the performance of the US leveraged loan market.
- Tight credit spreads: Indicate that investors are more confident in an issuer's ability to meet its debt obligations and are willing to accept a lower yield.
- US Consumer Price Index: a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.
- Weighted average ratings factor: A measure used by credit rating companies to indicate the credit quality of a portfolio.
- Wide credit spreads: Indicates that investors perceive a higher risk of default for a corporate borrower, and are demanding a higher yield to compensate for that risk.

Important information

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RO ID# 4085762

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