Thomas Majewski

Founder & managing partner

Eagle Point Credit Management

2020 was the year of fixed-rate bonds, but treasury curves are steepening and demand for loans is heating up

While loans enjoyed their 28th year of positive total returns over the past 30 years, the first-place trophy in the fixed income non-structured products category last year went to holders of fixed rate securities. The Barclays Aggregate Bond Index delivered a total return of 7.5% — integer multiples of the Agg's coupon — as rates dropped sharply and credit concerns waned.

We enter 2021 with the US Fed continuing to flood the market with liquidity. A new round of stimulus money will likely soon find its way into many Americans' pockets. The Fed says it wants to run the economy a little hot. It's hard not to see inflation picking up throughout the year.

The bull case for 2021 is that we are in the early stages of a new expansionary period. The rates market is already beginning to reflect an inflationary view. After last year's rally, as of the time of writing, 10-year treasury notes have widened by 20 basis points this year and it's hard not to see that trend continuing.

With the rates tide having turned, the Agg has given back about 10% of last year's return so far this year. If rates keep moving the way they have so far in January, it's quite conceivable that we will see the Agg deliver a total return of negative 5% or worse in 2021.

Investors flock to loan funds

The solution, of course, for many investors is to move into floating rate loans. We have seen strong inflows into retail loan exchange-traded bonds. Although there can continue to be some additional increases in loan prices, it is difficult to see much rate-based upside in loans — this year, at least.

Other investors, particularly those which prefer investment grade ratings, are moving into CLO debt. While not to the same extent as a typical loan issuance, the debt tranches of many CLOs today are oversubscribed at syndication and investors are jockeying for allocations.

If the steeper curve and increasing inflation outlook is correct, how will CLOs be impacted?

Borrowers will face higher operating costs as the price of many of their inputs rise. Depending on a borrower's competitive position, they may be able to pass those increased costs on to their customers. Or they may not and margins will be squeezed. Many companies have ample liquidity, so we don't anticipate many inflation-driven defaults this year. In our view, a bear case for 2021 could see the market ending up with a few more zombie companies — where the companies are not worth the face amount of their debt, but where they have enough cash flow to service it.

The CLO market is similar to 2018

With strong demand, better quality loans are already beginning to reprice. Some loans issued in the second half of 2020 are paying their 101 'call pro' to refinance early. 2018 was a year of significant spread compression in the loan market. Will 2021 be a replay of that? We hope not, but there are certainly some eerie similarities.

> The tide has turned… the solution for investors is to move into floating rate loans

funds already this year and have observed other institutional money shift into floating-rate paper. There is plenty of demand for loans. The market is up over 1% already this year, comfortably outpacing the Agg and high yield bonds.

There is a phrase from half a decade ago that we suspect some returning loan investors may have forgotten: "floaters that don't float". While the long end of the curve is moving up, with the Fed's stated goals, it's more difficult to see much movement at the short end of the curve this year.

Perhaps the goal for loan investors this year is simply to earn the coupon — and to avoid rate-based losses in long-dated fixed rate

What is different from 2018, however, is the type of capital driving the CLO market. Whereas we estimate that about half of CLOs issued in 2018 were supported by captive equity capital (which in some cases might be less return sensitive), we expect that number to be much lower this year. That might slow CLO formation a bit, but we believe it will help keep CLO liability levels more in line with the trends in the loan market.

We think lower defaults and a symmetry in the demand for loans and for CLO debt could auger well for another good year for CLO investors.