Leveraged Loans (Senior Loans) Could Be One Of The Beneficiaries Of Higher Interest Rates

Floating-Rate Corporate Debt Indicators

Year-End	Net New Cash Flow (In Billions)*	3-Month LIBOR Rate (USD)	10-Year Treasury Note Yield
2015	($22.63)	0.61%	2.27%
2014	($22.23)	0.26%	2.17%
2013	$59.58	0.25%	3.03%
2012	$10.63	0.31%	1.76%
2011	$10.16	0.58%	1.88%
2010	$15.04	0.30%	3.30%
2009	$4.36	0.25%	3.84%
2008	($8.17)	1.43%	2.21%
2007	($2.45)	4.70%	4.03%
2006	$5.45	5.36%	4.70%
2005	$2.20	4.54%	4.39%
2004	$7.45	2.56%	4.22%
2003	($0.31)	1.15%	4.25%
2002	($5.79)	1.38%	3.82%
2001	($5.11)	1.88%	5.05%

Source: Bloomberg and the Investment Company Institute.
**Net new cash flow pertains to Floating-Rate High-Yield Bond mutual funds.*

View from the Observation Deck

1. Conventional thought says that it is prudent to shorten the duration of one's bond holdings when interest rates are on the rise. With respect to pricing, fixed-rate bonds are particularly vulnerable to rising interest rates.
2. Today's post seeks to illustrate that investors may shift capital in and out of floating-rate corporate securities based on the rise or fall of either short-term or longer-term interest rates.
3. For example, the income distributed by leveraged loans, which are issued by corporations and tend to be speculative-grade in quality, floats with the direction of short-term interest rates. Loans are typically indexed to a benchmark such as the 3-month LIBOR rate. Over time, if short-term interest rates rise the amount of interest income distributed by the loans can potentially rise, making the loans potentially more attractive to investors, and vice versa. (See net flows from 2004-2006)
4. In 2013 (shaded blue in table), however, investors funneled a net $59.58 billion into Floating-Rate High-Yield mutual funds, likely in response to the 127 basis point increase in the yield on the 10-year Treasury note between the end of 2012 and 2013 (1.76% to 3.03%), in our opinion. Short-term interest rates were down slightly in 2013. Notice the net outflows in 2014 and 2015, likely in response to the drop in the yield on the 10-year Treasury note, in our opinion.
5. The S&P/LSTA U.S. Leveraged Loan 100 Index closed at 92.28 on 9/12/16, or a 7.72% discount to par value, according to Bloomberg. The index's yield to maturity stood at 5.20%, according to S&P Dow Jones Indices.