Corporate credit

5 for '21

2020 was a year unlike any other. While many of us may be keen to put it far in our rearview mirror, examining market dynamics from this year can provide clues about where we're headed next year.

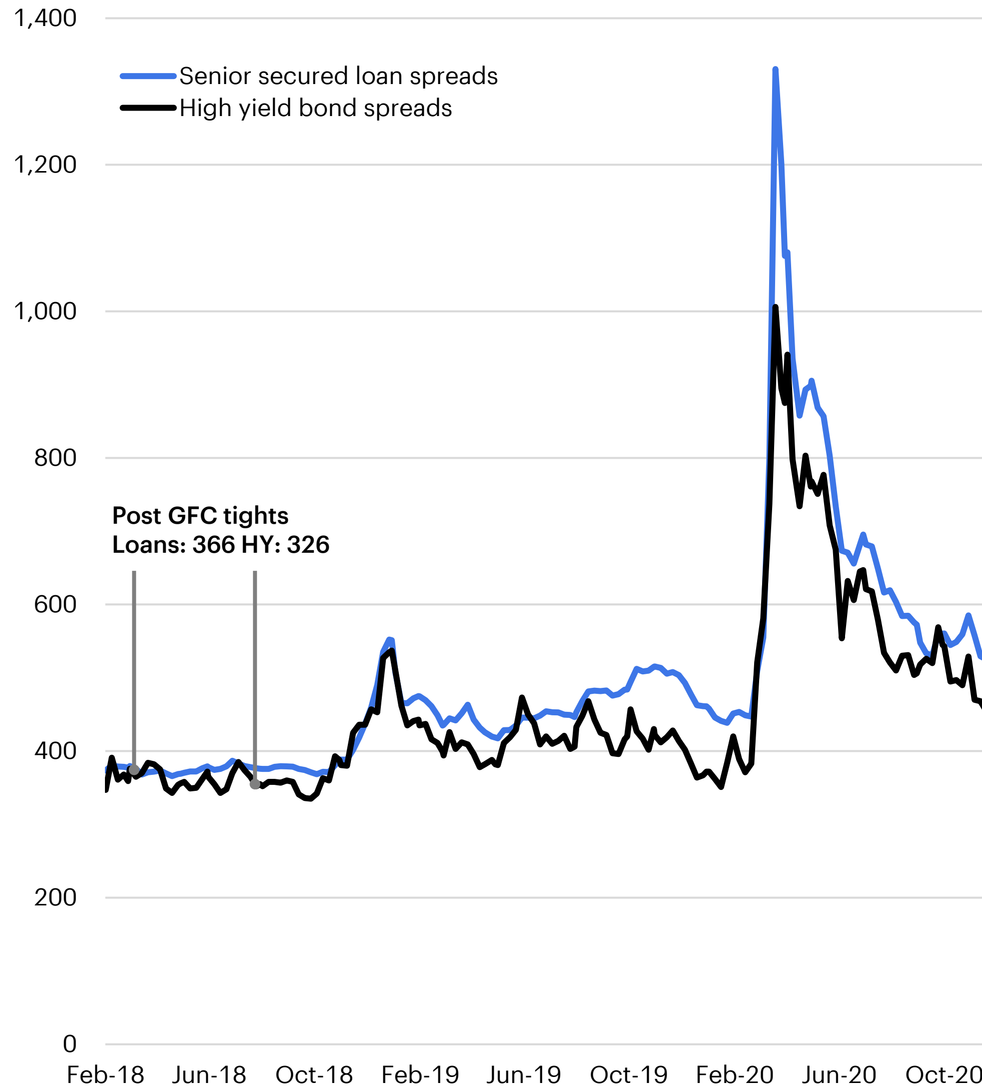
Here are 5 big ideas we'll be watching in corporate credit markets in 2021.

1. Credit spreads
2. Lower-rated assets
3. Loan flows
4. Default rates
5. Loan yields vs. high yield bond yields

1

Credit spreads test post-crisis lows

Senior secured loan and high yield bond spreads (bps)



Source: ICE BofAML U.S. High Yield Index, S&P/LSTA Leveraged Loan Index.

Following a banner year in 2019, both high yield bond and senior secured loan markets entered 2020 with spreads nearing the lows seen after the Global Financial Crisis (GFC). Even after the rout in March, the remarkable market recovery has left spreads looking relatively tight once again. This begs the question: How much more room does credit have to run? We think spreads will continue to compress during 2021 and are likely to test or surpass the post-crisis lows last seen in 2018.

A solid economic backdrop, the likelihood of widespread vaccine distribution, and implicit Federal Reserve support should serve to maintain the current bullish sentiment. Technical conditions should remain supportive as we believe issuance will remain steady and high yield inflows will continue. We expect the CLO market to continue to thaw, and the possibility of moderately higher interest rates could reignite demand for floating rate assets, providing key support for loans. Lastly, the relatively low level of global interest rates, even with a moderate increase in the U.S., will likely continue to create demand for fixed income asset classes that provide the highest absolute yields, like high yield bonds and loans.

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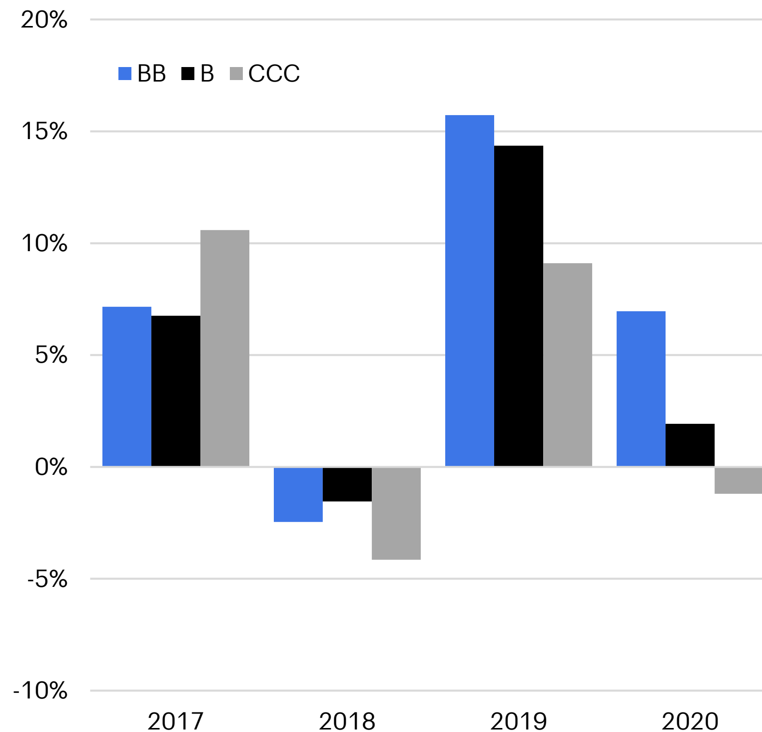
2

Lower-rated assets outperform

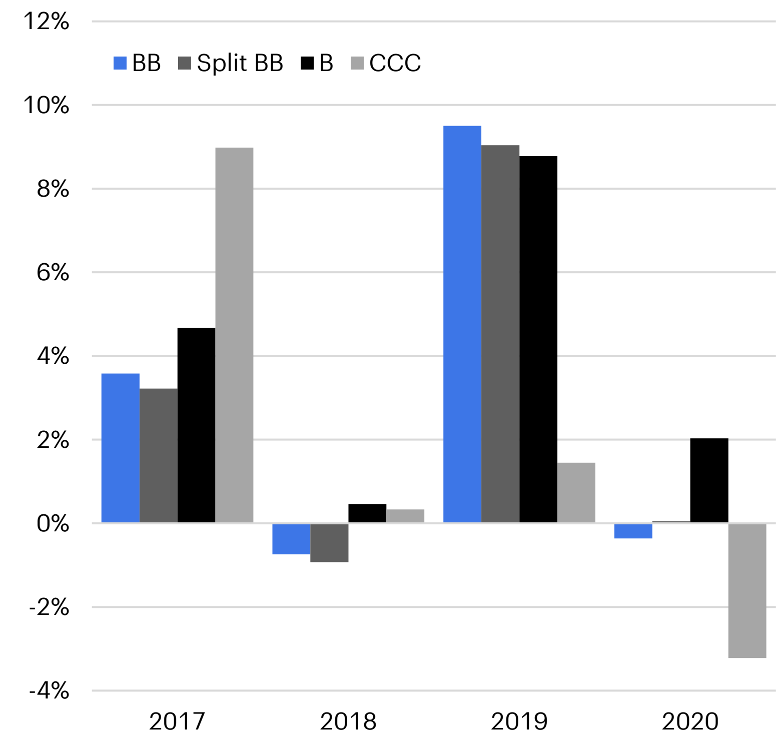
High yield bond returns



Source: ICE BofAML U.S. High Yield Bond Index.

Typically, we'd expect to see lower-rated assets outperform their higher-rated counterparts in times of market strength and underperform in weak markets. 2019 was an exception to this pattern, with investors showing a clear preference for higher-rated assets over fears of late-cycle macroeconomic dynamics. 2020 continued this trend, as a late recovery for lower-rated assets is unlikely to make up for significant underperformance during the downturn and early stages of the recovery in Q2.

Senior secured loan returns

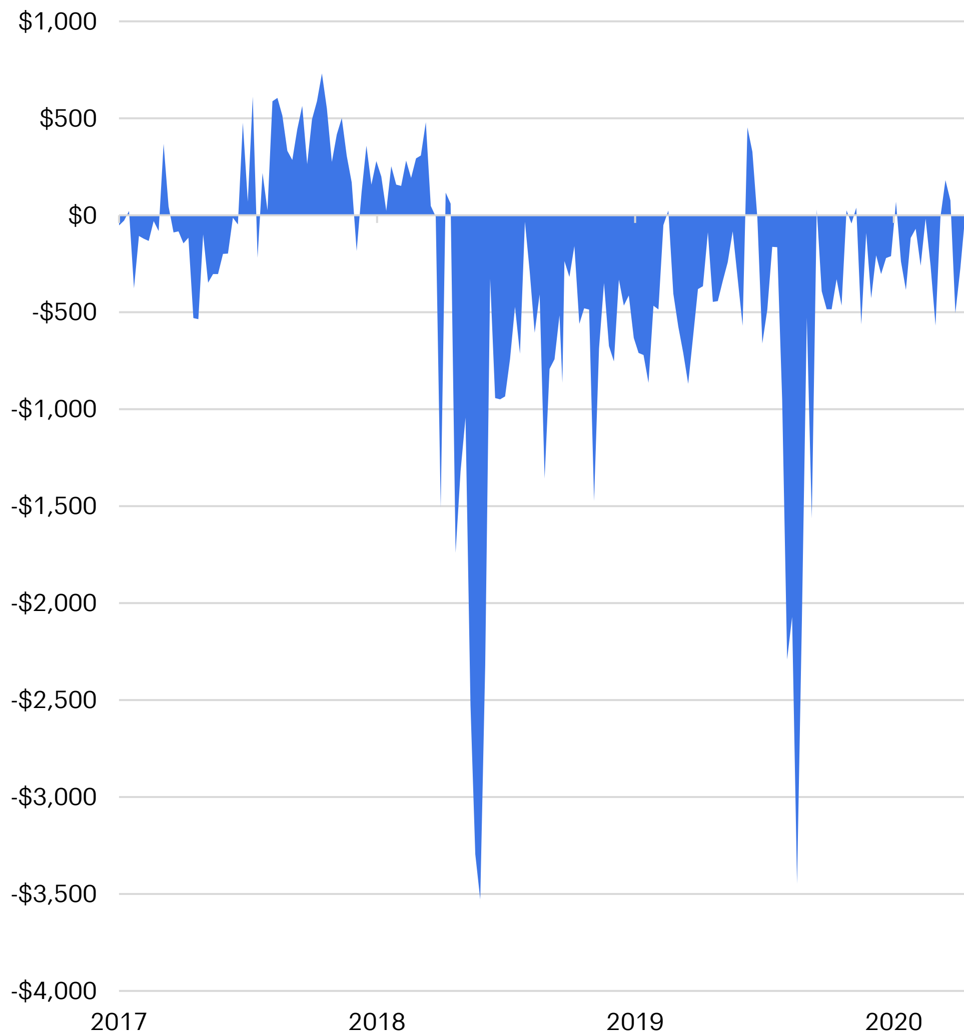


Source: J.P. Morgan Leveraged Loan Index

We believe vaccine-related euphoria, a continuing economic recovery and the search for yield may result in assets rated CCC and below outperforming in both bond and loan markets in 2021. If realized, this would be the first time since 2017 (for high yield bonds) and 2018 (for senior secured loans) that the lower-rated segment of the market led the broader indexes.

3 Loans see consistent inflows for the first time since 2018

Weekly loan fund flows ($M)



Source: J.P. Morgan.

Loan funds have seen near-continuous outflows for the past two years. We think that may change in 2021.

The last time loan funds saw sizable inflows was during the latest Fed rate-hike cycle, which began slowly in 2015 and culminated in four rate increases in 2018. Investors tend to gravitate towards floating rate assets during times of rising rates as the higher base rate brings the prospect of higher income and the low duration dampens price volatility. While we do not expect the Fed to raise rates in 2021, rising U.S. Treasury rates combined with above-market income may be enough to encourage inflows by retail investors into loan funds. We've already seen loans stymie the bleed a bit in recent weeks—November saw the second-lightest outflows in two years—as the reflationary trade has been in full force and Treasury rates have edged higher. The prospect of rising long-term rates and a steeper yield curve could drive flows back into the asset class consistently for the first time in years.

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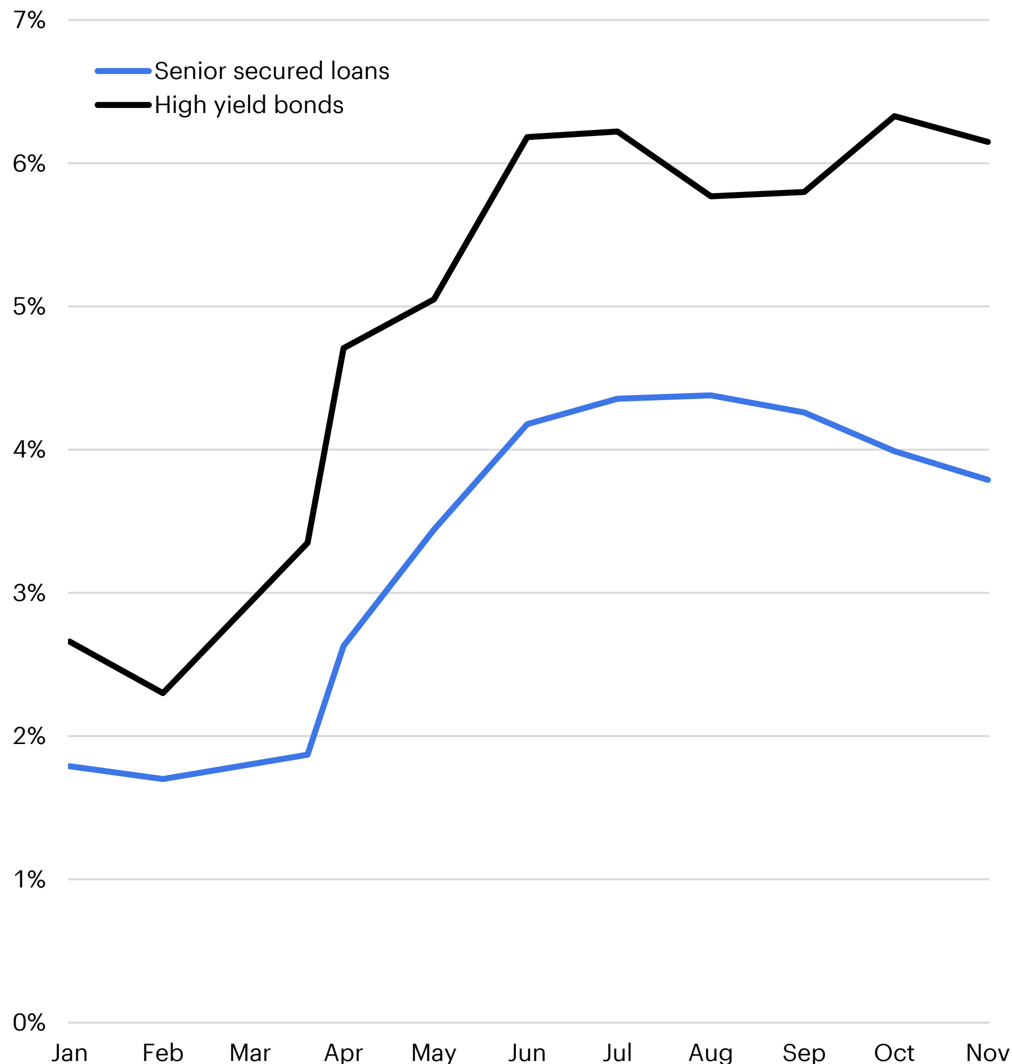
4 Default rates trend lower

Senior secured loan and high yield bond default rates, 2020



Source: J.P. Morgan.

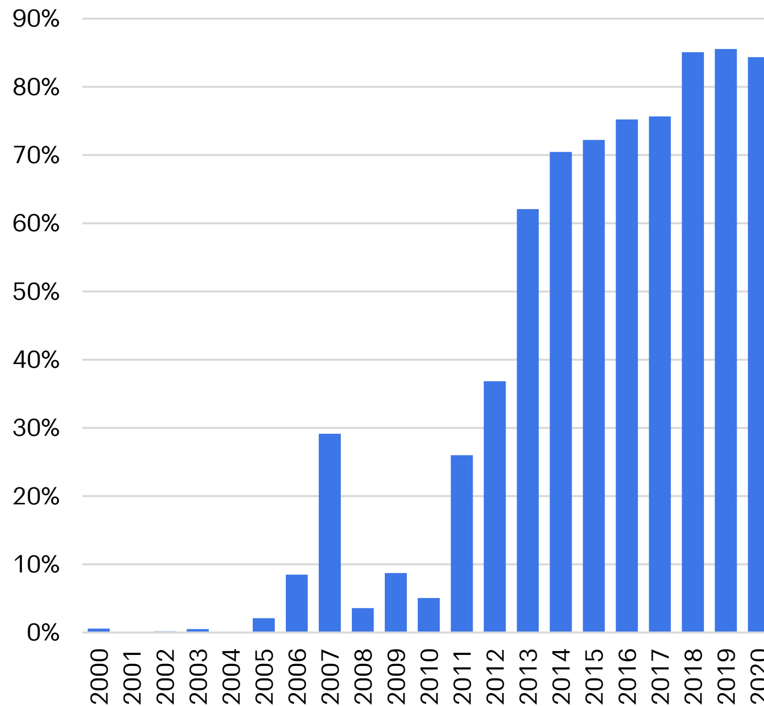
The virtual halt in economic activity earlier this year all but guaranteed rising default rates. Historically, default rates have tended to lag peak credit spreads by roughly one year, meaning if the typical pattern holds, we'd expect to see default rates peak in early 2021. But like most things in 2020, this cycle has been unusual.

Defaults ticked up throughout the summer, reaching 10-year highs in both bond and loan markets. Since then, however, rates have moderately receded in both markets for three out of the last four months. Default rates may stay elevated throughout the year compared to historical averages, but we believe they will trend lower throughout 2021. As quickly as markets sold off in March, they recovered. This meant that access to funding for many high yield bond and loan issuers was restored much more quickly than in past recessions. Companies raced to issue and refinance debt, shoring up liquidity. While risks in the form of stricter lockdown measures this winter could cause unforeseen problems, we believe many issuers are well positioned to make it through to the vaccine-lit end of the tunnel.

Like most things in 2020, this default cycle has been unusual. We think we'll see default rates continue to trend lower throughout 2021.

5 Loans continue to out-yield bonds

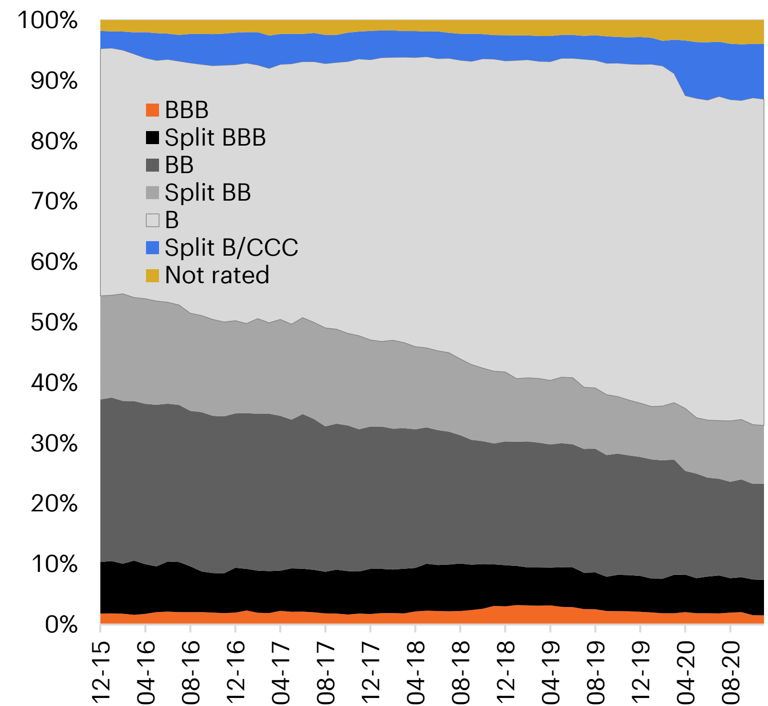
Rise of covenant lite issuers



Source: S&P/LSTA. Represents share of covenant lite leveraged loan issuance.

Historically, the high yield bond market has traded with higher yields than loans, offering investors compensation for bonds' subordination and the fact that they are often unsecured. In late 2018, however, this dynamic changed. Since then, loans have consistently yielded more than high yield bonds. We believe this change is not a temporary market phenomenon but rather a more permanent dynamic that can be attributed to structural changes in the loan market.

Loan market composition



Source: J.P. Morgan Leveraged Loan Index.

The ratings composition of the loan and high yield markets has drifted over the past 10 years, with each taking a markedly different path. The high yield market has seen an improvement in credit quality—with BB rated bonds now representing approximately 56% of the market. The loan market, however, has seen the quality of its credit mix steadily decline, with BB rated loans making up just 25% of the market and single B issues now comprising over 60%. Issuance trends and deteriorating structural protections, such as the rise of covenant lite loans and loan-only issuers, have also caused investors to demand higher yields. As a result of the combination of these factors, we believe this dynamic is here to stay.

Robert Hoffman
Managing Director, Investment Research

As Managing Director of Investment Research, Robert leads the team that analyzes the fundamentals behind market movements, macroeconomic trends and the performance of specific industries—as well as their potential impact on investors. His nearly two-decade tenure in the financial services industry includes experience as a loan portfolio manager and senior credit analyst focused on corporate loan issues. Robert serves as the firm's primary subject matter expert on the corporate credit markets and select alternative investment solutions, developing targeted communications and educational resources.

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All data is as of November 30, 2020.

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