Overview

After an historic and extraordinary 2009, loan investors are naturally focused on what may lie ahead in 2010. We look at what some market observers are saying about potential senior loan returns in 2010, and share with you ING's views about the key drivers for this asset class in 2010.

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ING INVESTMENT MANAGEMENT

Senior Loans: Outlook for 2010

Market predicts 7-10% returns in 2010

Reprinted below are relevant excerpts from three 2010 market forecasts from respected investment banks that predict senior loan returns in the 7% to 10% range in 2010.

"For the current cycle, default rates have peaked and refinancing risk is minimal since the capital markets have reopened. Corporate fundamentals are improving, though leverage in many sectors remains high…For 2010, we project the US leveraged loan total return to be 7% - 10%."
Credit Suisse – 2010 Leveraged Finance Outlook and 2009 Annual Review, 22 Jan 2010

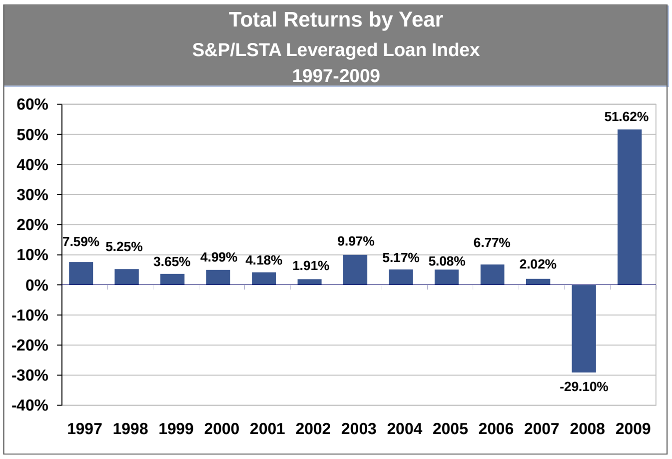
"The loan market should normalize further, as technical pressures have subsided and Libor floors, amendment fees, and prepayments support valuations. We expect loans to produce solid returns of 8-9%".
Barclays Capital – U.S. Credit Outlook 2010: The Hunt for Yield, Dec 2009

"The most likely scenario would see total [high yield] returns nearer to 9-10%...on a total return basis, [senior loans] could deliver similar returns to the fixed rate HY market given that their floating rate nature automatically hedges them for the rate risk."
Deutsche Bank – Global Credit Outlook 2010: Stay Invested, 2 Dec 2009

Historical Senior Loan Returns

The senior loan asset class is represented by the S&P/LSTA Leveraged Loan Index[1] (the "Index"). This index had an enviable history of consistent positive returns for more than a decade from 1997 through 2007. These returns were comprised of two components, a base rate (typically LIBOR), and a return over LIBOR (comprised of a spread over LIBOR plus any change in market value).

This history of consistent positive returns was upset in 2008 with the onset of the worldwide liquidity crisis, and the Index experienced its first negative return that year at -29.1%. The primary driver of this negative return was an unprecedented drop in the market value of loans, which reached an all time low in late 2008. In 2009 we saw a complete reversal of this trend. The senior loan asset class had a record return of 51.62%, and loan prices ended the year at 87.35% to par value. This trend has continued in 2010, with loan prices rising to a current value of 89.34% of par.



The S&P/LSTA Leveraged Loan Index is an unmanaged total return index that captures accrued interest, repayments, and market value changes. **Investors cannot invest directly in an index.**

Source: Standard and Poor's LCD and S&P/LSTA Leveraged Loan Index

2010 Return Components

Those unfamiliar with the senior loan asset class might find a 7% to 10% total return prediction difficult to support, especially on the heels of 2009 where the market delivered returns over 50%. It is important to note, however, that loans have a different set of performance drivers than equities and bonds. We will explore the key components of a senior loan total return. These are:

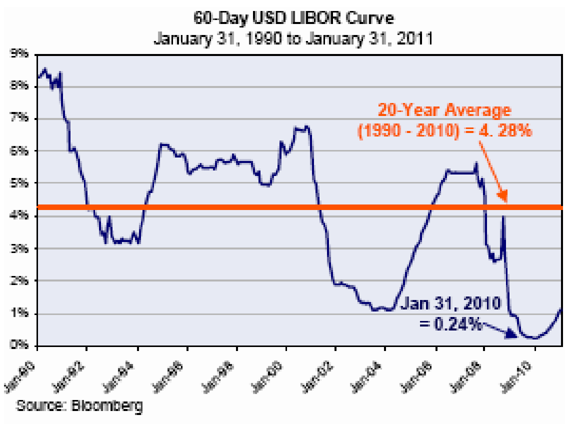
- short-term interest rates;
- nominal spreads;
- capital gains;
- credit losses; and
- the impact of inflation.

[1] The S&P/LSTA Leverage Loan Index is a total return index that tracks the current outstanding balance and spread over LIBOR (London Interbank Offered Rate) for fully funded term loans in the index.

SHORT-TERM INTEREST RATES: ON THE RISE?

Because of their floating-rate nature, senior loan prices are generally insensitive to movements in short-term interest rates. In fact, in a rising rate environment, all things being equal, floating rate secured corporate loans actually experience increased yields, without the concomitant decline in value suffered by fixed rate bonds in the same situation. This unique reaction by senior loans to changes in short-term interest rates can mitigate a good deal of the fear surrounding a potential jump in either short or long term rates.

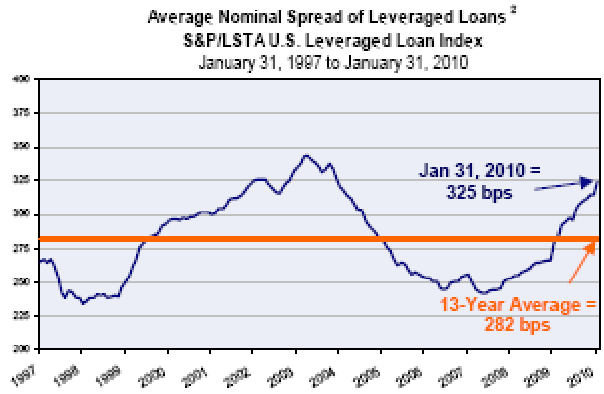
With interest rates at all time lows – 60-day LIBOR is currently around 0.24% – the prospect of interest rate increases is a major concern in virtually all markets. This is well illustrated by the forward curve that shows LIBOR rates steadily increasing throughout 2010 and reaching 1.11% within 1 year. The chart below shows the 60-day LIBOR curve from January 1990 through January 2011.



NOMINAL SPREADS ARE ON THE RISE

The current difficult economic climate has led to a deterioration in business fundamentals and financial performance for many borrowers. As a result, these borrowers have, as anticipated, breached financial covenant tests embedded in their credit agreements. These covenant breaches provide an opportunity for lenders to increase nominal spreads on existing loans as a part of negotiations with borrowers seeking to avoid being placed in default.

In addition, new loan transactions appearing in the market are being priced at higher nominal spreads in concert with the overall repricing (higher) of the market. As the chart below demonstrates, nominal spreads have been moving higher since mid-2007 (i.e., just before the onslaught of the global liquidity crunch), and we expect this trend to continue, with year-end 2010 nominal spreads near the high end of the market's historical range.



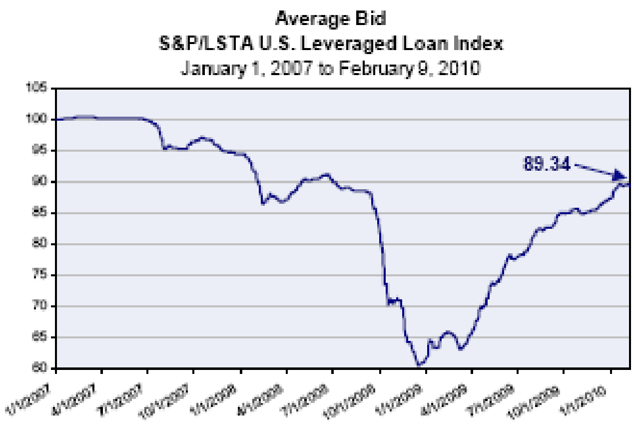
Note: Excludes all facilities that are currently in default.

A CAPITAL GAIN OPPORTUNITY STILL EXISTS

Assuming a corporate borrower is performing reasonably well, in a technically balanced market, where there is no material excess supply or demand, loans will typically carry a "par" (i.e., 100% face value) or near-par valuation. This is the case because a loan can usually be repaid by the borrower at any time without penalty. As such, loans are not innately prone to the type of excessive absolute valuations that can occur in both stocks and bonds. While this was not the case in 2008, the market returned to a more normalised technical position in 2009.

Fundamentally, it is intuitive that a stronger economic backdrop and stable-to-increasing asset prices will prompt an increase in merger and acquisition activity, both financial (i.e., private equity driven) and strategic (i.e., corporate-to-corporate) in nature. An increase in merger and acquisition activity, in turn, should lead to increased prepayment velocity and an accelerated capture of the discount to par.

Additionally, from a technical standpoint, senior loan managers are currently fairly liquid and looking to acquire assets. Importantly, renewed demand and an increase in prepayments are working to lift secondary prices, a trend that is exhibited in the chart below. The average bid of the S&P/LSTA Leveraged Loan Index (the "Index") closed 2009 at 87.35. It is currently at 89.34, and we expect that 2010 will continue to close the gap to par. The chart below shows the bid price history for the Index since 2007.



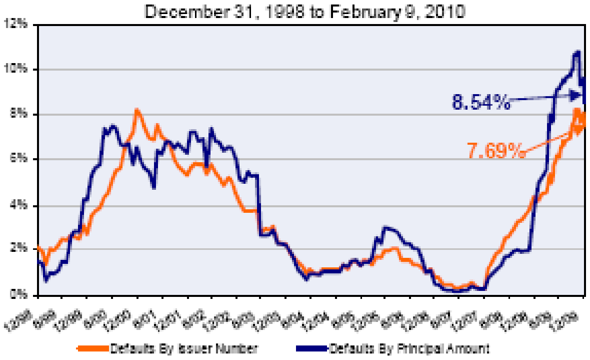
INFLATION AND ITS IMPACT ON SHORT-TERM RATES

LIBOR has historically been highly responsive to inflation due to the interaction between interbank lending rates and monetary policy. Most central banks, particularly in developed economies, use monetary policy as a tool to control inflation. Generally speaking, policymakers raise target rates to combat rising inflation and, conversely, reduce rates to stoke economic growth. Therefore, interbank rates will usually be higher than the rate of expected inflation and will correlate well with realised inflation. Further, given that monetary policymakers are unable to set nominal rates below zero even in a shrinking economy, LIBOR-based returns can be attractive in both inflationary and deflationary environments.

Interbank lending rates typically outperform realised inflation, have lower volatility than other inflation hedging instruments and have high and stable correlations with realised inflation. These factors make LIBOR-based investments an excellent inflation hedging vehicle. Nevertheless, while LIBOR-based strategies may reliably produce a return in excess of inflation, this spread alone is most likely insufficient to satisfy the return objectives of most investors. Hence, the interest in a LIBOR plus spread strategy (i.e.,senior loans).

POTENTIAL CREDIT LOSS HAS MUCH BETTER VISIBILITY

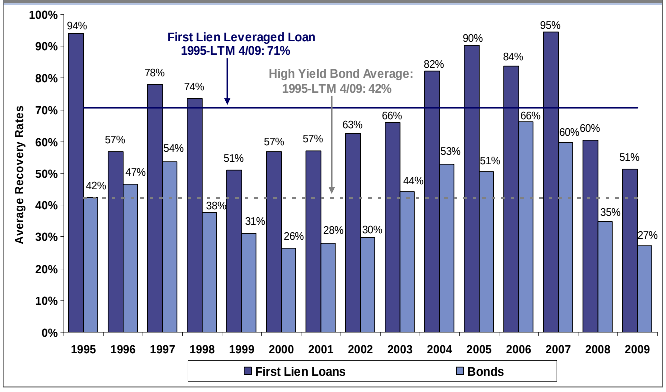
While our strategy emphasises senior secured first-lien corporate loans with generally better credit quality and liquidity than the benchmark, we will not be immune to some degree of credit loss in 2010. The good news regarding defaults is that new activity is clearly trending lower (see chart below).



Lagging 12 Month Default Rate [3]
S&P/LSTA U.S. Leveraged Loan Index
December 31, 1998 to February 9, 2010

Comprises all loans, including those not tracked in the LSTA/LPC mark-to-market service. The vast majority are institutional tranches. The issuer default rate is calculated as the number of defaults over the last 12 months divided by the number of issuers in the Index at the beginning of the 12-month period. Principal default rate is calculated as the amount defaulted over the last 12 months divided by the amount outstanding at the beginning of the 12-month period.

Consensus expectations for year-end 2010 are substantially below the current reading. Fortunately, non-investment grade loans are typically secured by a company's assets, providing historically higher recoveries in the case of a default. The chart below shows historical recovery rates of first lien loans vs. high yield bonds.



First Lien Loan vs. High Yield Bond Recovery Rates
1995 to 2009 (Data as of 31 December 2009)

Current recovery rates, while still developing, are also looking a little better. We think the average recovery for recently defaulted loans will continue to rise if: the economy avoids a double-dip recession; asset values remain stable or rise; and the capital markets remain sufficiently liquid. This should limit the potential credit loss within a well-diversified senior loan portfolio going forward.

Ultimately, we believe that default rates and recovery rates for 2010 will trend towards historical averages. We already know that the dire predictions of 20+% default rates and 50% average recovery rates have not come to pass for this credit cycle. Indeed, there is evidence to suggest that we are well on our way to reaching historical recovery rates already.

A recent S&P/LCD commentary on current recovery rates pointed out that, on a weighted average basis, recovery rates for borrowers exiting bankruptcy are hitting the historical 70% recovery rate. They also explained that defaulted loans are now back to trading at average historical levels.

Specifically, S&P explained:

> *"Since the beginning of 2009, 19 S&P/LSTA Index issuers have either exited from bankruptcy or are approaching an exit. The average price at which the first-lien loans of these issuers went into default was 50 cents on the dollar (excluding the unusual cases of Chrysler and GM). The average price at which they have exited, or are trading at in anticipation of an exit, is 64 cents on the dollar. Weighted for principal amount of the loans, the averages increase to 55 cents at default and 70 cents at exit…*
>
> *[T]he average price of S&P/LSTA Index issuers in default is now 65 cents on the dollar, a two-year high, and just above the long-term average of 64. This suggests the market is pricing recoveries today at the historical levels....*
>
> *For another thing, the mean price at which loans have traded into default since July 2009 is 63 – just inside the cumulative average of 65 – compared to just 37 during the bleak first half of 2009."*

The Bottom Line

The tremendous price recovery in 2009 has, in some cases, served to dampen investor enthusiasm for the senior loan asset class. Upon further dissection of the drivers of total return, we believe educated investors will recognise the important role loans can play in developing a well balanced income-producing portfolio, particularly with an eye toward a higher interest rate environment.

We've noted today's favourable technical positioning and the structural features of the asset category, in addition to a stable to improving fundamental backdrop.

While it's obvious the performance of last year cannot be replicated, we support the consensus estimate of a 7% to 10% return for 2010. As a result, we believe that senior loans represent an attractive risk-adjusted alternative in today's markets.

Finally, we respectfully leave our readers with this important question: ***How will you position your portfolio to both participate in, and defend against, the inevitable increase in interest rates?***

We believe the senior loan asset class can help investors answer that question.

About the Author

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