

# Bank loans in the time of higher for longer

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Invesco's Global Market Strategy Office

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# In Focus: Bank loans in the time of higher for longer

Markets welcomed 2024 with expectations of six rate cuts in 2024 from the US and eurozone, five cuts from the UK, and a belief that most major economies would see a period of slow growth. Now, markets are looking for just one or two cuts in the US, UK, and Eurozone, yet these economies appear to be undergoing a cyclical recovery. With prospects of a soft landing in sight, investors are assessing opportunities in risky assets in an environment of already-lofty valuations.

In fixed income, rates have taken a significant leg higher since their post-GFC days, the US yield curve has been inverted since mid-2022, and yet credit spreads on high yield bonds remain at their tightest levels in years. In this environment of elevated rates and tepid but resilient growth, we favor risk assets but with selective risk exposure. In particular, we see an attractive return profile in bank loans with zero duration risk, meaningful credit protections, and attractive valuations. Issuer fundamentals also remain solid (and have even improved in the latest Q1 2024 data), though some deterioration is likely as the lagged effects of restrictive monetary policy take hold.

Despite our view that disinflation should continue, we anticipate central banks are likely to keep rates “higher for longer”, well above recent history. The fundamental outlook calls for an extension of the current cycle, in our view, but credit spreads on most bonds are unlikely to rally further from here. We believe bank loans offer diversification and a bright spot for credit investors, as the floating rate nature of these assets adjusts according to market interest rate changes, offering protection from inflation and an attractive source of income. In this piece, we review bank loans in the time of higher for longer policy and interest rates.

– Invesco, Global Market Strategy Office

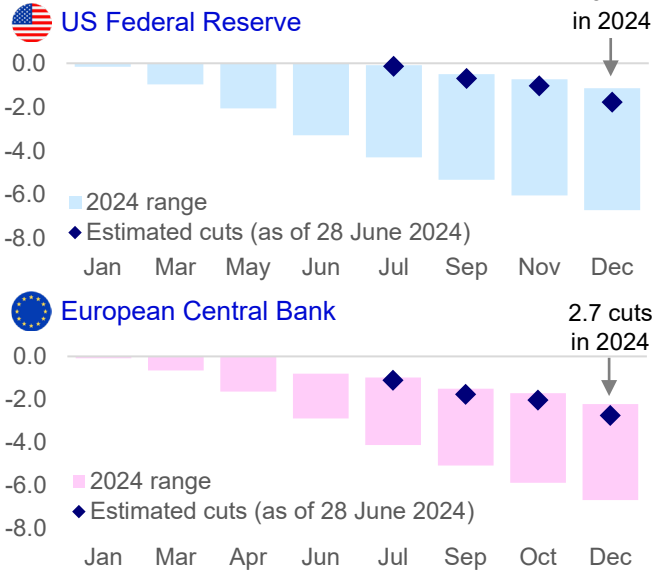
Data as at 28 June 2024 unless otherwise specified. Sources: Bloomberg and Invesco.

## In Focus

- 1 Rates are expected to remain higher for longer
- 2 Despite elevated rates, US and European growth remain resilient
- 3 Solid or improving activity are good for bank loans
- 4 Loan spreads are attractive on a relative basis, and near-zero duration looks appealing in higher for longer environment
- 5 Ultra-short duration component of bank loans has helped make it a leader versus high yield
- 6 Default cycle looms, but historically, implied default rates have overshoot actual defaults
- 7 Bank loan fundamentals still look solid

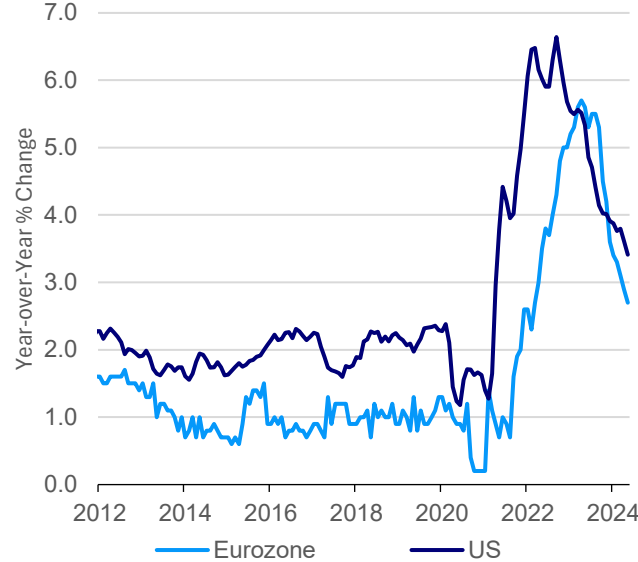
# 1 Rates are expected to remain higher for longer

## Fewer rate cuts expected in 2024...



Sources: Invesco and Bloomberg L.P., as of 28 June 2024. Based on market-implied path of the respective policy rate over the remainder of 2024, measuring the total number of cuts to take place over 2024. US federal funds rate is based on federal funds futures. European Central Bank deposit rate is based on overnight index swaps pricing. Each cut or hike is assumed to be 25 basis points.

## ...yet disinflation continues



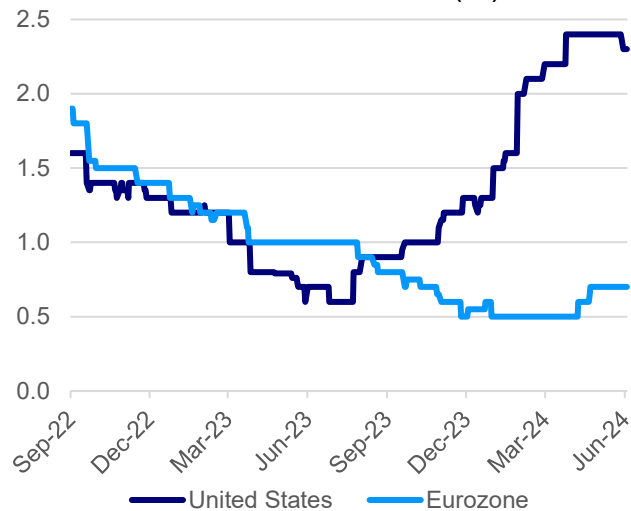
Based on monthly data from January 2012 to May 2024 (as of 28 June 2024). Eurozone data is for HICP indices. Core inflation is for all items less food & energy, except the Eurozone which also excludes alcohol & tobacco. Source: LSEG Datastream and Invesco Global Market Strategy Office

- Markets entered the year expecting a slew of rate cuts from major Western developed economy central banks. Today, market pricing indicates just a handful of cuts in 2024 following hotter-than-expected first-quarter inflation data.
- Disinflation appears to have slowed after a relatively rapid descent from 2022-23 highs, particularly in the US. Services inflation has especially remained well above targets. This has delayed market expectations for when central banks may begin to ease their hawkish policy stances.
- With yield curves still inverted, we expect that rates are likely to remain elevated for the foreseeable future, though central banks should begin to cut in the second half of 2024.
- Even marginally lower rates should be a boon for borrowers and may help stimulate demand for new issuances. We also anticipate lower rates to help improve debt serviceability, which can enhance credit performance.

## 2 Despite elevated rates, US and European growth remain resilient

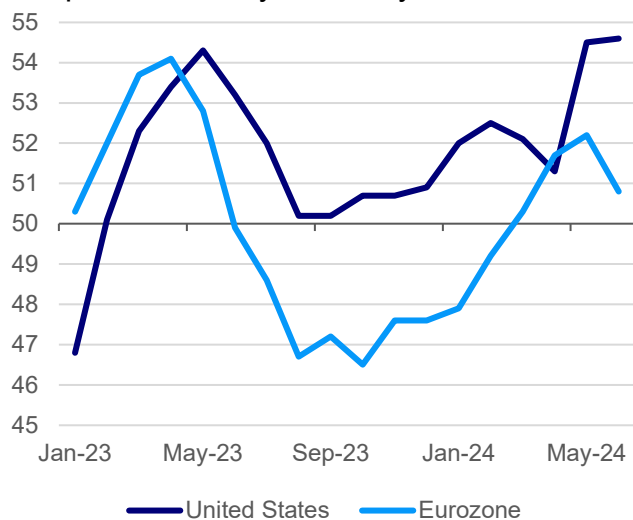
### 2024 growth estimates climbing

Consensus 2024 GDP forecast (%)



### PMI data has been improving

Composite PMIs by economy



- In our view, the global economy remains in a soft patch, driven by a restrictive monetary policy backdrop that translates into below-trend but still resilient growth. US growth has softened from 2023's pace, while European growth appears to be undergoing a cyclical rebound, albeit a bumpy one. Going forward, we anticipate growth in both the US and Eurozone to be further supported by rate cuts.
- US growth has been relatively more resilient despite elevated policy rates. Over the remainder of 2024 we expect growth to gravitate towards trend rates.
- In the eurozone, we anticipate relative softness in growth performance compared to the US, but at rates that are also picking up towards (low) potential growth rates.

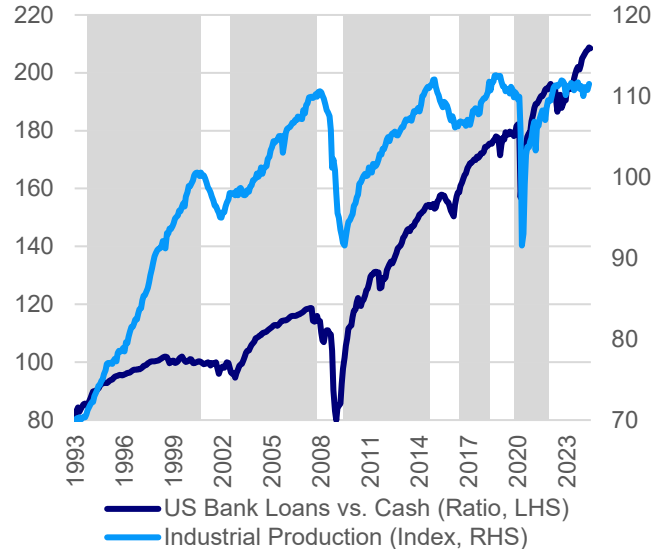
Sources: Bloomberg and Invesco, as of 28 June 2024. Consensus GDP forecasts are based on the median economist consensus estimate from Bloomberg for 2024 annual real GDP growth. PMI data is based on S&P Global/Hamburg Commercial Bank purchasing manager indices. Readings above 50 indicate expanding activity, and readings below 50 indicate contracting activity.

# 3

## Solid or improving activity are good for bank loans

### Improving activity is good for US loans

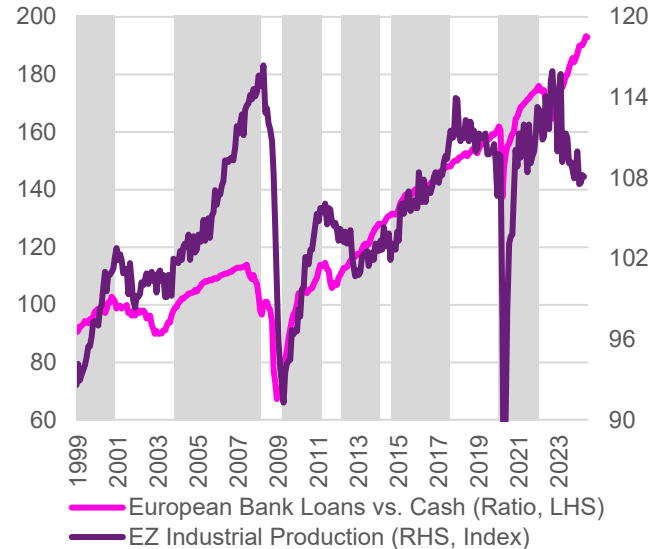
Bank loans versus cash, USD



Periods of expanding activity

### Evidence is less clear in Europe

Bank loans versus cash, EUR



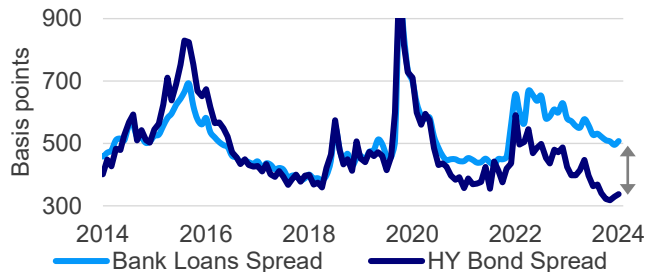
- Across credit assets, improving economic activity is typically good news, reducing default rates and improving debt serviceability as company fundamentals improve.
- We note that, within bank loans, US assets have historically tended to respond more to cyclical shifts in the economy, as documented in the left-side chart. In Europe, meanwhile, we find the relationship is less strong.
- Continued economic resilience in the US should help support credit risk, including bank loans performance.

Based on monthly data from December 1992 to June 2024 for the US, and December 1998 to June 2024 for Europe. Bank Loans vs. Cash shows the total return index for bank loans (Credit Suisse Leveraged Loan Index for the US; Credit Suisse Western Europe Leveraged Loan Index for Europe) divided by the total return index for cash (ICE BofA 0-3m Treasury Total Return Index for the US; ICE BofA 1-6 Month Euro Government Index for Europe), rebased to 100 at the average of 2000 levels. Sources: Credit Suisse, ICE BofA, Bloomberg, and Invesco, as of 28 June 2024. **Past performance is no guarantee of future results.**

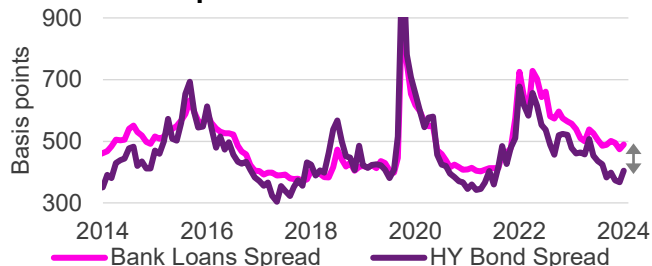
# 4

## Loan spreads are attractive on a relative basis, and near-zero duration looks appealing in higher for longer environment

### Loan spreads look attractive vs. HY bonds United States

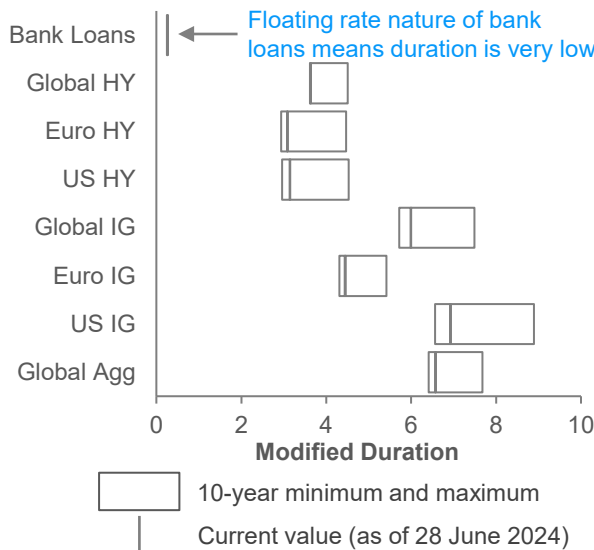


### Western Europe



Sources: Bloomberg, Credit Suisse, and Invesco. Based on Credit Suisse US Leveraged Loan Index & Credit Suisse High Yield Index for US and Western Europe, as of 28 June 2024.

### Low duration versus major fixed income



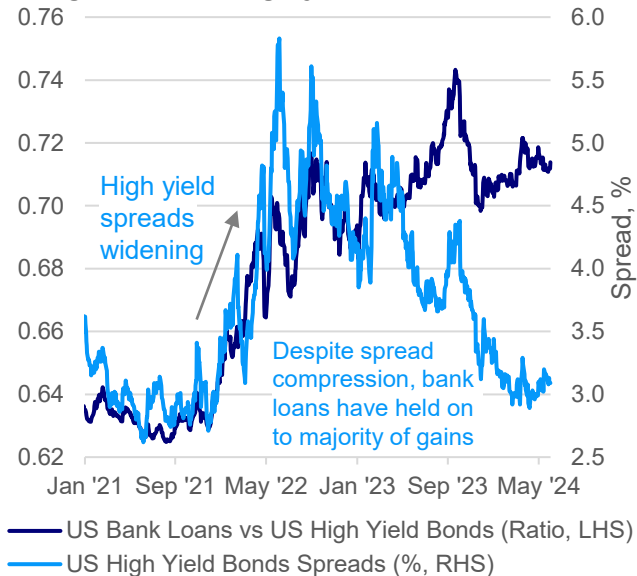
Sources: Bloomberg and Invesco, as of 28 June 2024. Global High Yield = Bloomberg Global High Yield Index; Euro HY = Bloomberg Pan-European High Yield Index; US HY = Bloomberg US Corporate High Yield Index; Global IG = Bloomberg Global Aggregate Credit Index (USD); Euro IG = Bloomberg Euro Aggregate Corporate Index; US IG = Bloomberg US Corporate Bond Index; Global Agg = Bloomberg Global Aggregate Bond Index (USD).

- In addition to a supportive macro backdrop, we believe bank loans are attractively priced. While spreads in both US and Eurozone high yield and investment grade bonds have compressed meaningfully, bank loans remain near decade highs.
- Meanwhile, with rates expected to remain higher for longer, we like the near-zero duration characteristic of bank loans. In our view, recent outperformance has been driven in large part by its duration characteristics (see point #5).
- In addition, many issuers in bond markets have shortened their duration profile (see right-side chart). In a higher for longer environment, they are likely to be forced to increase issuance to roll over maturing debt and lock in higher rates. Bank loans, in contrast, have already reflected much of these changes.

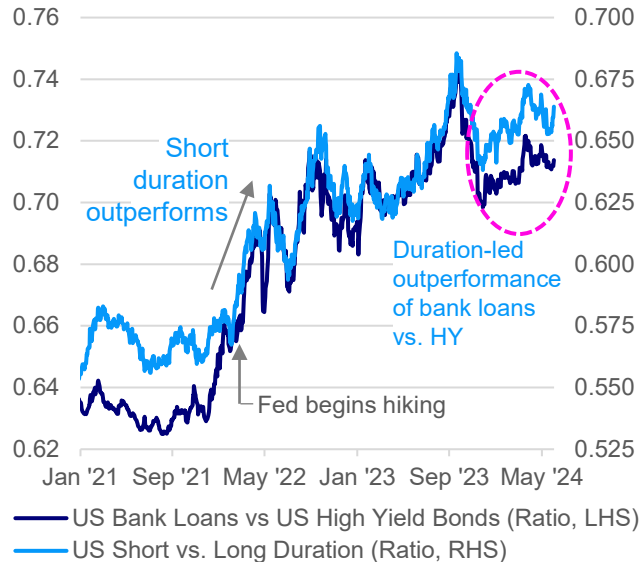
# 5

## Ultra-short duration component of bank loans has helped make it a leader versus high yield

### Recent credit spread tightening hasn't been enough to boost high yield performance



### Ultra-short duration of bank loans has shaped year-to-date outperformance



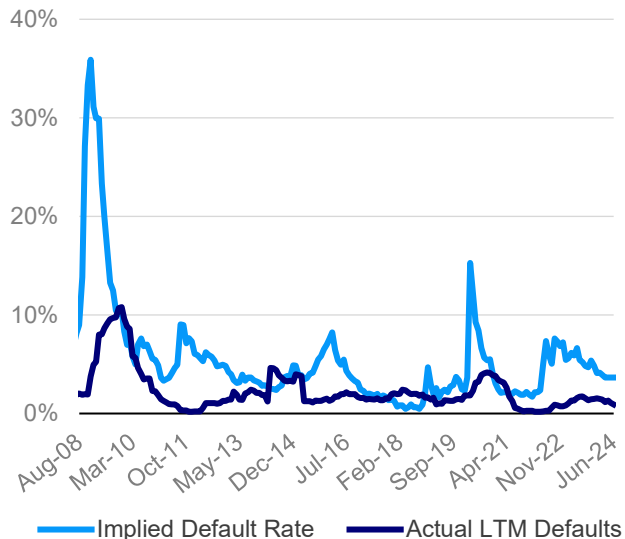
- In our assessment, bank loans share qualities of both cash and high yield. In other words, they are both ultra-short duration due to their floating-rate design, but they are also exposed to the economic cycle and the credit worthiness of borrowers, similar to high yield bonds.
- Because of this, we analyze bank loan performance by comparing their performance against high yield bonds in periods where credit premia and duration are being repriced.
- Particularly relevant to the bank loans outlook has been the higher rates environment that kicked off in March 2022, when the Federal Reserve began an aggressive hiking cycle.
- With rates expected to remain higher for longer—and with rates pricing pushed further out into the future—we see room for bank loans to continue their outperformance that kicked off in 2022.

Note: US Bank Loans measured by Credit Suisse Leveraged Loan Index. US High Yield Bonds measured by Bloomberg US Corporate High Yield Index. US Short Duration and US Long Duration are measured by ICE BofA 1-3 year Treasury bond indices and 7-10 Treasury bond indices. Sources: Bloomberg, Credit Suisse, ICE Bank of America, and Invesco, as of 28 June 2024. Bank loans are represented by the Credit Suisse Leveraged Loans Index. High Yield is represented by the Bloomberg High Yield Index. All indices are based on total returns in USD. **Past performance does not guarantee future results.**

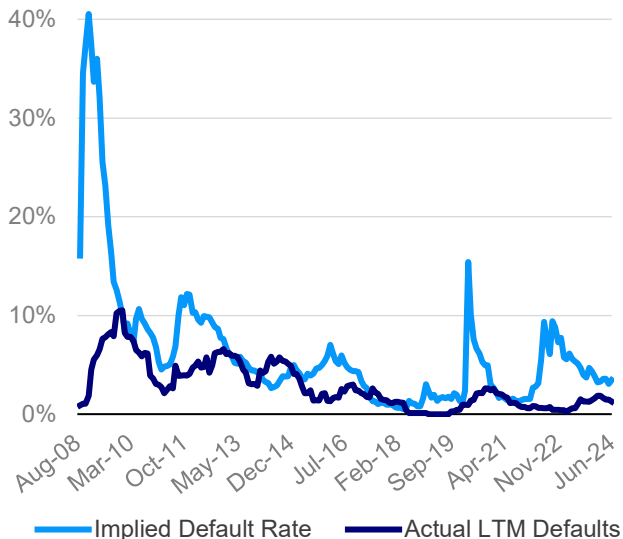
# 6

## Default cycle looms, but historically, implied default rates have overshoot actual defaults

Historical US actual vs implied defaults



Historical Europe actual vs implied defaults



- With the credit risk inherent in bank loans, we also are watchful of the default cycle. Indeed, we anticipate defaults to rise as restrictive monetary policy exerts downward pressure on activity.
- However, we note that implied defaults has frequently overestimated the extent of realized defaults. With this in mind—combined with our view of resilient economic momentum—we anticipate that bank loans are unlikely to be significantly affected by our view of a below-trend growth in economic activity.

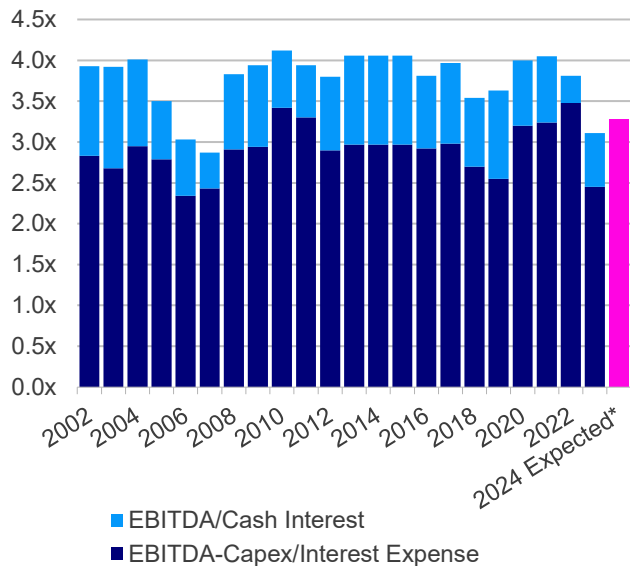
Source: CS Leveraged Loan Index (US), CS Western European Leveraged Loan Index (Europe), PitchBook Data, Inc. as of June 30, 2024. Implied default rate calculated by taking implied default loss (current spread – historical risk premium) and dividing by loss given default of 40%.



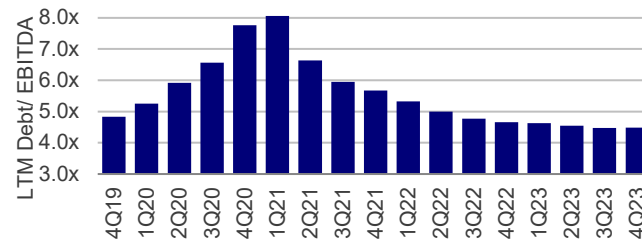
# 7

## Bank loan fundamentals still look solid

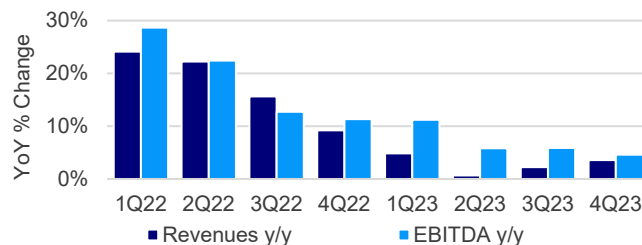
**US Interest coverage across the loan market<sup>1</sup>**



**US Borrower leverage across the loan market<sup>2</sup>**



**US revenue and EBITDA slowing, but positive<sup>2</sup>**



- Encouragingly, credit metrics within the bank loans universe have held up rather well despite elevated rates. Median leverage remains near long-term averages, while coverage ratios remain healthy and have even shown some improvement in the latest data for Q1 2024.
- Indeed, revenue and EBITA growth in the US loans market have remained positive despite the restrictive policy environment. With a handful of rate cuts from central banks on the horizon, we expect some additional relief to be felt in fundamentals, too.
- With spreads and fundamentals attractive, and with short duration still in favor, we see a favorable environment for bank loans.

Sources: <sup>1</sup>PitchBook Data, Inc. Interest coverage ratios of leveraged loans. Data through December 31, 2023. <sup>2</sup>JPMorgan as of December 31, 2023. Data always with a quarter lag. EBITDA = Earnings before interest, depreciation, tax and amortization expenses.

# The Path Ahead:

1

## **Rates likely to remain higher for longer**

Near-zero duration of bank loans indicates that bank loans should continue to outperform in an environment where long duration bets keep reversing or stalling.

2

## **Soft landing is in sight; the cycle continues**

Like high yield bonds, bank loans are exposed to trends in economic activity. Despite elevated rates, US and European growth remain resilient. Our expectations for falling inflation, resilient economic growth, and marginal rate cuts should support bank loan outperformance.

3

## **Valuations remain attractive**

In addition to a supportive macro backdrop, we believe bank loans are also attractively priced. While spreads in high yield and investment grade bonds have compressed meaningfully, bank loans remain at decade highs.

4

## **Fundamentals remain strong**

We anticipate that defaults in bank loans should rise but remain constrained as funding costs and softer growth challenge issuers. Coverage ratios remain in line with long-term averages, and history suggests that realized defaults are likely to remain lower than implied.

Source: Invesco. There is no guarantee that the views expressed here will come to pass.

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Most senior loans are made to corporations with below-investment grade credit ratings and are subject to significant credit, valuation and liquidity risk. The value of the collateral securing a loan may not be sufficient to cover the amount owed, may be found invalid or may be used to pay other outstanding obligations of the borrower under applicable law. There is also the risk that the collateral may be difficult to liquidate, or that a majority of the collateral may be illiquid.

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