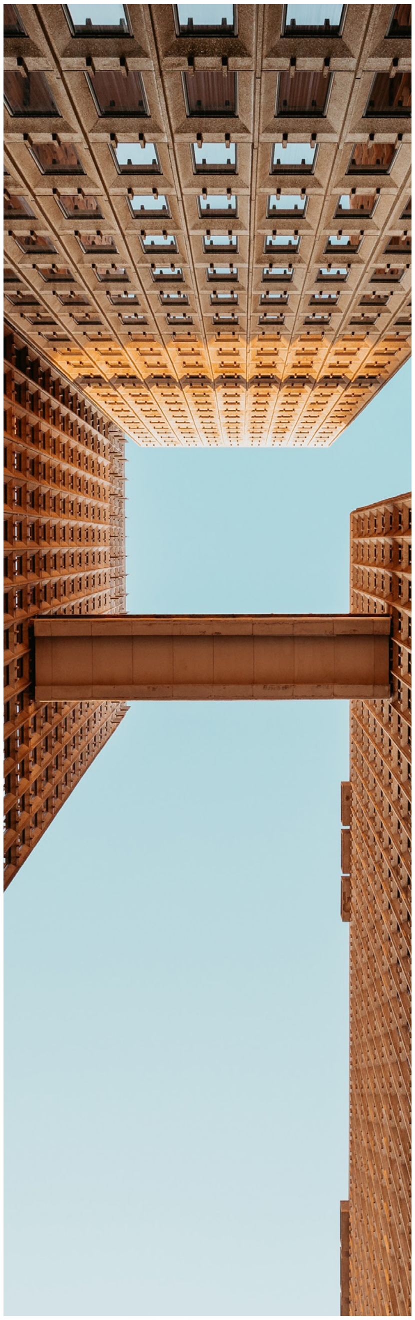
When Hedging Inflation with Loans, Credit Selection Is Still Key

Bank loans remain compelling amid inflation – but, in a rising rate environment, active credit selection will be crucial to maximize return potential.



Key Takeaways

- Bank loans have historically offered more inflation and rate risk mitigation potential than their fixed-rate counterparts.
- Despite strong overall fundamentals, some segments of the loan market may be especially vulnerable to credit risk due to rising interest rates and a decline in credit quality.
- Active managers adept at identifying the most attractive credits have historically generated excess returns, outperforming the Index.

Investors have eagerly piled into bank loans in recent months as they seek protection from inflation and imminent interest rate hikes. These worries show little sign of abating in the near term – Goldman Sachs recently revised its 2022 inflation forecast upward to 3.7%, from earlier expectations of 3.1%. Moreover, economists now cite concerns that Russia's invasion of Ukraine has further exacerbated the issue by spiking energy prices and further disrupting supply chains.

Amid these worries, investors previously reticent to change their core bond allocations might now be looking to alternative assets that may help them pivot to this new reality.

Though it's true that bank loans have tended to outperform traditional core bonds in inflationary or rising rate environments, their performance during such periods also varied widely by credit quality and sector. This is especially relevant when the headlines give mixed messages: elevated consumer spending, strong corporate earnings, and a tight labor market also come with inflation, supply chain shortages, and geopolitical risks.

Moreover, higher interest rates have historically led to slowed economic growth. While higher rates are good for loans from an inflation hedge perspective, they also curb borrowing and spending by passing on higher borrowing costs to consumers and businesses. As those hikes impact growth, they, in turn, may eventually hurt risk assets like high yield bonds and loans. In some cases, when rates run high too quickly, they may spark an increased risk of recession.

Careful credit selection will be critical to help ensure investors are able to seize on the structural advantages of bank loans and the segments of the economy that are still thriving, while avoiding potential credit risks and credits that are impacted by slower growth and inflation.

Inflation and rising rates may expose market winners and losers

Bank loans are well-positioned to act as a potential hedge against inflation compared with longer-duration, fixed-rate instruments because their floating rates, which reset every one to three months, enable their interest payments to increase as rates rise.

However, the fallout from COVID and the resulting Fed stimulus has had an outsize impact on supply chains, labor markets, and consumer behavior within certain industries.

For example, hospitals and airlines are especially hurt by tight labor markets. Hospitals face chronic labor shortages as roughly one in five healthcare workers quit their jobs during the pandemic. Meanwhile, airlines continue to struggle to rebuild their workforce post-COVID, offering costly signing bonuses to entice new workers.

On top of these challenges, the disruption of global supply chains caused by the pandemic – particularly the string of factory lockdowns in China – has revealed vulnerabilities around companies' reliance on specific suppliers to procure critical materials. As companies move to restructure these bottlenecks, some market winners and losers may emerge.

Inflation-impacted sectors like autos, packaging, food and beverage, and retail are more at risk of being affected by these ongoing issues – particularly companies that largely depend on sourcing in Asia. Sectors that rely less on supply chains, such as gaming and technology, may fare better.

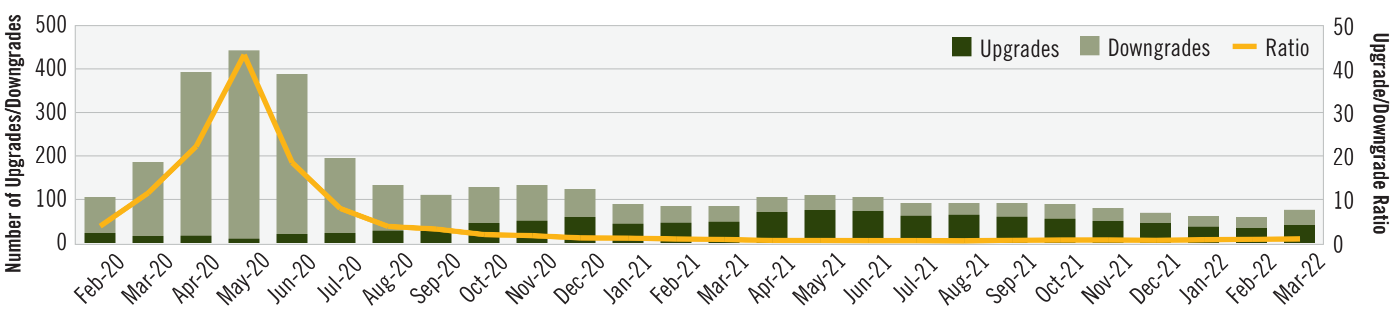
Identifying industries more insulated from inflationary pressures may help give investors a distinct advantage over a passive strategy linked to the loan Index.

Amid strong fundamentals, warning signs point to potential volatility in certain sectors

Despite current challenges with inflation, there is evidence to suggest that loans will benefit from a relatively strong macroeconomic backdrop. Thus far, economists have forecast above-average GDP for the year, and because bank loans are enjoying both strong demand from investors and strong supply from issuers, the technical environment is expected to remain supportive. Leveraged loan default rates are also at close to record lows, at 0.19%.

Nevertheless, the positive momentum propelled by strong Fed support, the post-COVID reopening, and a strong macroeconomic backdrop may be showing signs of slowing down.

UPGRADE/DOWNGRADE RATIO – ROLLING 3-MONTH



Source: LCD (Leveraged Commentary & Data). As of March 31, 2022.

As the Fed signals a pivot to tightening, wage inflation persists, and the macroeconomic backdrop grows more volatile, the credit upgrade/downgrade ratio, which was positive for 12 straight months, is starting to incline more towards 1-to-1 parity (see above).

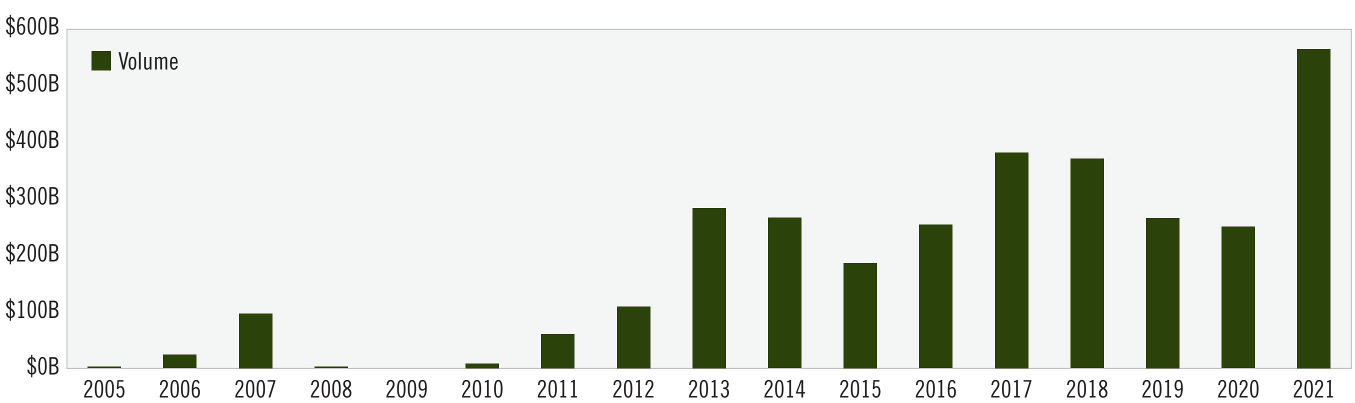
Additionally, a higher portion of total leveraged loan volumes are now made up of B- or CCC-or-below rated credits than before, making the market riskier than it was a year ago. Covenant-lite deals that set looser restrictions on borrowers have also become a larger share of the total outstanding volume.

COVENANT-LITE AND SINGLE-B LOANS HAVE BECOME A LARGER PORTION OF THE MARKET

Date	March 2010	March 2015	March 2022
Total Outstanding ($b)	$510.76	$837.86	$1,390.45
Market Value Outstanding ($b)	$467.49	$812.54	$1,357.06
Number of Facilities	731	938	1191
% of Cov Lite Loans (at Par)	17.85%	61.31%	88.02%
Breakdown by Facility Rating (at Market Value)			
A	0.00%	0.00%	0.00%
A-	0.00%	0.00%	0.00%
BBB+	0.21%	0.00%	0.00%
BBB	2.11%	2.58%	0.48%
BBB-	3.10%	5.51%	5.79%
BB+	8.02%	8.96%	6.31%
BB	13.08%	11.86%	5.50%
BB-	12.94%	15.05%	11.58%
B+	19.83%	20.07%	12.97%
B	8.24%	21.02%	27.56%
B-	10.68%	5.58%	22.91%
CCC+	2.32%	3.93%	2.91%
CCC	1.29%	0.69%	1.77%
CCC-	1.12%	0.00%	0.17%
CC	0.34%	0.00%	0.06%
C	0.03%	0.00%	0.00%
D	6.18%	2.11%	0.18%
NR	10.53%	2.64%	1.80%

As of March 31, 2022. Source: Leveraged Commentary and Data (LCD), S&P LSTA Leveraged Loan Index.

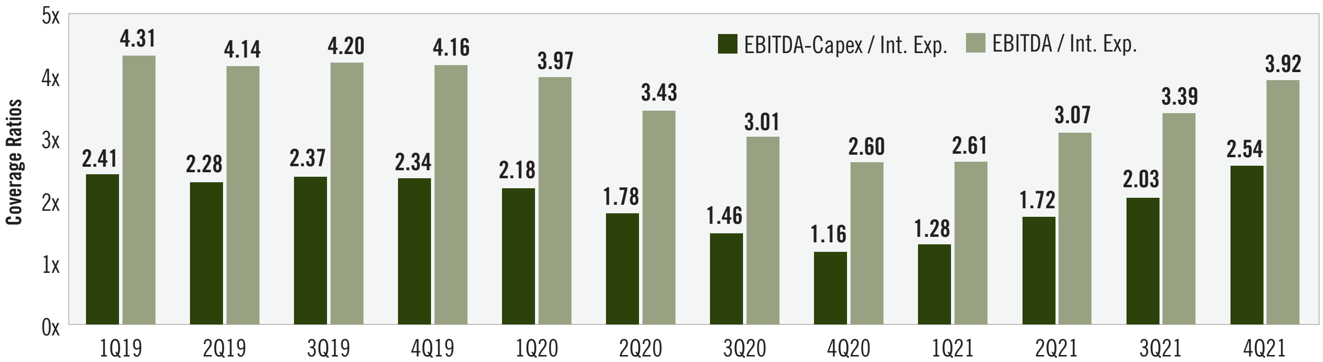
VOLUME: NEW-ISSUE COVENANT-LITE LOANS



As of December 31, 2021. Source: Leveraged Commentary & Data (LCD).

And though most leveraged loan borrowers still maintain adequate interest rate coverage and retain the ability to service their debts, borrowers at the margin, comprising 15% of the market with less than 1.5x interest coverage, may be negatively impacted as interest rates rise and growth starts to slow.

INTEREST COVERAGE RATIOS



As of December 31, 2021. Source: J.P. Morgan; Capital IQ.

THE IMPACT OF 50 BPS INCREMENT RATE HIKES ON INTEREST COVERAGE BUCKETS

No Change in EBITDA	0 bp	100 bp	150 bp	200 bp	250 bp	300 bp	350 bp	400 bp
<1.5x	12.9%	16.5%	17.9%	21.1%	24.7%	27.2%	29.0%	31.5%
1.5x to <3x	17.6%	23.7%	27.6%	28.3%	28.7%	31.2%	32.3%	33.0%
3x to <4.5x	16.8%	19.7%	19.0%	21.9%	20.1%	18.6%	19.4%	19.0%
4.5x to <6x	15.1%	13.6%	13.6%	11.5%	11.8%	10.8%	8.6%	6.8%
>6	37.6%	26.5%	21.9%	17.2%	14.7%	12.2%	10.8%	9.7%
Market	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

Source: J.P. Morgan; S&P Capital IQ.

THE IMPACT OF FED RATE HIKES ON COVERAGE RATIOS ASSUMING DIFFERENT EBITDA GROWTH SCENARIOS

Changes in EBITDA Scenarios	0 bp	100 bp	150 bp	200 bp	250 bp	300 bp	350 bp	400 bp
No change in EBITDA	3.9x	3.1x	2.8x	2.5x	2.3x	2.1x	2.0x	1.9x
+5% change in EBITDA	4.1x	3.2x	2.9x	2.7x	2.4x	2.3x	2.1x	2.0x
+10% change in EBITDA	4.3x	3.4x	3.1x	2.8x	2.6x	2.4x	2.2x	2.1x
+15% change in EBITDA	4.5x	3.5x	3.2x	2.9x	2.7x	2.5x	2.3x	2.1x
+20% change in EBITDA	4.7x	3.7x	3.3x	3.0x	2.8x	2.6x	2.4x	2.2x

Source: J.P. Morgan; S&P Capital IQ.

Still, the loan market continues to price in very low default risk – meaning investors are still anticipating that the overall outlook for risk assets remains relatively benign.

Loans continue to remain a compelling option for investors, but given that higher rates impact growth, credit selection – and, more specifically, targeting companies with strong earnings that can service their debts and successfully deleverage – will be critical to sidestep industries that are vulnerable to future potential volatility.

Credit selection remains key to effectively navigating the current market environment

Loans remain an attractive potential hedge to combat inflation and rate risk given their floating rate structure, relatively high yield, and low duration. Strong demand within the loan market, coupled with a relatively positive outlook, make loans an attractive risk-adjusted source of potential yield for investors.

However, given ongoing uncertainties in certain areas of the market, credit selection through active management is critical to capture the potential benefits of the loan market while avoiding its potential pitfalls.

To learn more about Virtus' range of investment solutions for investors concerned about rising rates and higher inflation, please contact us at 800-243-4361 or visit virtus.com

INDEX DEFINITIONS

The **Credit Suisse Leveraged Loan Index** is a market-weighted index that tracks the investable universe of the U.S. dollar denominated leveraged loans. The index is calculated on a total return basis. The index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and is not available for direct investment.

Credit Ratings noted herein are calculated based on S&P, Moody's and Fitch ratings. Generally, ratings range from AAA, the highest quality rating, to D, the lowest, with BBB and above being called investment grade securities. BB and below are considered below investment grade securities. If the ratings from all three agencies are available, securities will be assigned the median rating based on the numerical equivalents. If the ratings are available from only two of the agencies, the more conservative of the ratings will be assigned to the security. If the rating is available from only one agency, then that rating will be used. Default Rate is most commonly referred to as the percentage of loans that have been charged off after a prolonged period of missed payments. Defaulted loans are typically written off from an issuer's financial statements and transferred to a collection agency. In some cases a default rate may also be a higher interest rate charged to a borrower after a specified number of missed payments occur.

A **Basis Point (bp)** is equal to 0.01%. **Credit Ratings** noted herein are calculated based on S&P, Moody's, and Fitch ratings. Generally, ratings range from AAA, the highest quality rating, to D, the lowest, with BBB and above being called investment grade securities. BB and below are considered below investment grade securities. If the ratings from all three agencies are available, securities will be assigned the median rating based on the numerical equivalents. If the ratings are available from only two of the agencies, the more conservative of the ratings will be assigned to the security. If the rating is available from only one agency, then that rating will be used. Ratings do not apply to a fund or to a fund's shares. Ratings are subject to change. **Default Rate** is most commonly referred to as the percentage of loans that have been charged off after a prolonged period of missed payments. Defaulted loans are typically written off from an issuer's financial statements and transferred to a collection agency. In some cases, a default rate may also be a higher interest rate charged to a borrower after a specified number of missed payments occur. **Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA)** is a measure of a company's profitability of the operating business only, thus before any effects of interest, taxes and costs required to maintain its asset base. It is derived by subtracting from revenues all costs of the operating business (e.g. wages, costs of raw materials, services.) but not depreciation, amortization, interest, lease expenses, and taxes. **Interest Coverage Ratio** is a debt ratio and profitability ratio used to determine how easily a company can pay interest on its outstanding debt.

The commentary is the opinion of the Virtus. This material has been prepared using sources of information generally believed to be reliable; however, its accuracy is not guaranteed. Opinions represented are subject to change and should not be considered investment advice or an offer of securities.

IMPORTANT RISK CONSIDERATIONS

Bank Loans: Bank loans may be unsecured or not fully collateralized, may be subject to restrictions on resale, may be less liquid and may trade infrequently on the secondary market. Bank loans settle on a delayed basis; thus, sale proceeds may not be available to meet redemptions for a substantial period of time after the sale of the loan. **Credit & Interest:** Debt instruments are subject to various risks, including credit and interest rate risk. The issuer of a debt security may fail to make interest and/or principal payments. Values of debt instruments may rise or fall in response to changes in interest rates, and this risk may be enhanced with longer-term maturities. **Sector Focused Investing:** Events negatively affecting a particular industry or market sector in which the portfolio focuses its investments may cause the value of the portfolio to decrease. **Market Volatility:** The value of the securities in the portfolio may go up or down in response to the prospects of individual companies and/or general economic conditions. Price changes may be short- or long-term. Local, regional or global events such as war, acts of terrorism, the spread of infectious illness or other public health issue, recessions, or other events could have a significant impact on the portfolio and its investments, including hampering the ability of the portfolio's manager(s) to invest the portfolio's assets as intended.