

# DBRS Canada Newsletter

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## WILL HIGH-YIELD BONDS DISPLACE BANK LOANS AS THE POST-RECESSION FINANCING OF CHOICE?

Not so long ago – i.e., before the Great Recession – it had become almost commonplace in the leveraged finance market to regard high-yield bonds as somewhat passé, compared to leveraged loans. Ever since loans began to migrate off the books of the banks that made them, and became underwritten, syndicated and distributed – much like bonds – to a wide variety of investors, their volume grew at a far faster pace than loans. In recent years – pre-recession – the absolute volume of leveraged loan issuance has exceeded high-yield bond issuance by a substantial margin.

When the credit crunch and subsequent recession hit, both loan and bond issuance came to a screaming halt, and the market prices of both dropped significantly, with healthy, performing loans routinely selling below 70 cents on the dollar, and similar high-yield bonds selling below 60 cents. Now both markets have come back strongly – in terms of market pricing – but in terms of new issuance the bond market is way out in front, having reclaimed its traditional lead over loans. For the first eight months of this year, high-yield bond issuance was just under \$90 billion, while leveraged loan issuance was less than half of that.

### Disappearing Loan Investors

Investors have returned to the high-yield bond market in droves, which is not the case in the loan market. While typical high-yield bond investors are mutual funds and other traditional institutional investors, typical leveraged loan investors were structured vehicles (mostly collateralized loan obligations, or CLOs) and closed-end funds, with CLOs by far having been the larger of the two. Considerable new money has flowed into high-yield bond funds, and the market prices of closed-end bond and loan funds have made a considerable comeback, but the market for new CLOs is still largely closed. This means that most issuers that need to refinance debt have found a more receptive market in high-yield bonds than they would have had in the leveraged loan market. Many of those issuers that have refinanced in the loan market have actually provided their own investor base, so to speak, by doing “amend and extends” (A&Es), where the loan is extended to a future maturity date in return for which the investors are compensated by increasing the interest rate spread.

### Temporary or Permanent Shift

Of course the big question in the market is whether this shift back to high-yield bonds is just a temporary phenomenon, or whether it represents a permanent shift. There are plenty of arguments on both sides of the question, and some of them are used by supporters of either side:

One is the CFO “peace of mind” issue. After a year in which liquidity was often hard to come by at almost any price, many borrowers are delighted to lock up funding at a fixed rate for ten years or so. Those who believe credit markets will snap back to normal quickly see this as merely a temporary factor. Those who see a longer-term liquidity crunch believe this will tilt the ground toward bonds more permanently.

Another is the fear of inflation. Even though the high-yield bond market yield of 9% or 10% may seem high in the current low-rate environment, borrowers anticipating inflation once the effect of deficit spending and monetary growth kicks in may view it as a prudent long-term interest rate bet. If this view is correct and we end up in a high-inflation environment for years to come, then this is a one-time opportunity to lock in relatively low rates. Once rates are high (and expected to stay there), the playing field between fixed and floating rate lending will be level again, since the high rates will be built into the entire yield structure. In fact, if high inflation becomes a constant, then eventually the long-term fixed rate market will likely atrophy and short-term floating rate will become the only real alternative for most borrowers. That has been the case throughout economic history in high-inflation economies, as the risk of inflation scares away long-term fixed-rate investors.

Those arguing for the long-term dominance of the loan market point to many of the factors that caused it to grow so much in recent years:

- The attractiveness of the product to issuers: floating rates, the ability to prepay, flexibility regarding structure and term, legal simplicity (no bond registration requirements)
- The attractiveness of the product to investors: collateral security, covenants and closer scrutiny of the borrower throughout the loan term

But still unclear are questions about the loan market's long-term investor base:

- Will the securitized vehicles – primarily CLOs – that represented the core of the growth in institutional loan investment in recent years return in some form or another? There is a good argument that they will since, unlike many of their cousin collateralized debt obligations (CDOs) that were chock-full of sub-prime mortgage debt and other toxic waste, CLOs are relatively straightforward investments for which there is a natural market of investors seeking an “equity-like” return from a debt-based vehicle. But a lot of dust has to settle in the structured finance markets before they can be properly evaluated and appreciated.
- Will the equity risk associated with investing in closed-end funds (which are the primary vehicles for retail investors to access the loan market) scare off potential loan investors? Will additional open-end funds, which appear more user-friendly to many smaller investors, enter this market?

Finally, will the increase in loan spreads, which pre-recession had become so low that the loans no longer fit the investment return guidelines of the banks that were originating them, remain at levels high enough to make bank loans an asset that banks themselves will want to hold once again? Much of the excess that led to the recent credit crash was an attempt to create yield through leverage because underlying credit spreads were not great enough to entice traditional investors into the loan asset class. Time will tell whether the markets and/or their regulators have learned enough from the near-disaster of the past two years to know this time when (or how) to moderate growth when an equilibrium point is reached.

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