RBC Global Asset Management

Leveraged finance's exponential rise and its future in uncertain rate markets

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"Today, leveraged finance has grown to a market of over $5 trillion and offers a robust range of investment options for a wide range of investors."

The leveraged finance market has seen tremendous growth since its humble beginnings in the 80s and 90s of non-rated assets and fallen bonds. Today, leveraged finance has grown to a market of over $5 trillion and offers a robust range of investment options for a wide range of investors. Lending markets have evolved considerably, but with credit spreads tighter than recent years and interest rate movements still uncertain, understanding the complexities and opportunities in this vast market is crucial for investors seeking resilience in challenging times.

Defining Leveraged Finance and Market Evolution

The definition of leveraged finance is often left ambiguous, as the breadth of the market includes several types of assets that fall under the loan/bond bucket. "The most common types of asset classes categorized as global leveraged finance today are leveraged loans, non-IG private market debt, high yield corporate bonds, and broadly syndicated loans, " says Tim Leary, Blue Bay Senior Portfolio Manager at RBC Global Asset Management.

"We're talking about corporate bonds and corporate loans, the debt of companies as opposed to sovereign debt. That line can become blurred sometimes depending on how you define emerging markets and global high yield. Some global high yield managers would include sovereign debt in that as well; but sticking purely to lending money to corporations and generating alpha relative to that benchmark based on their ability to return that capital and have spreads tighten, is how I would define this massive market," Leary adds.

The depth of debt markets has evolved considerably, with the U.S. high yield market hovering around $300 billion in size around the year 2000, to about $3.3 trillion currently, "and that's just on the face amount," Leary explains. This accounts for about a 300-400% growth in the last 25 years, with private debt in the U.S. alone almost tripling in size over the last 5 years.

"At one point in time, you could only buy fixed income or corporate fixed income in the highest-quality cohort. Now, the universe has changed, and there's a larger offering where an investor can decide whether they want to be in the high-yield market, broadly syndicated loans, and so forth. Large, liquid, multibillion dollar enterprises are now involved in these markets whereas in the past, it was smaller businesses that would have, at one point, only been financed in the mezzanine or junk bond market," Leary says. An improved liquidity profile has expanded the investor base for these asset classes, as retail and institutional investors can now trade in and out of different risk levels and allocate to places that in the past was almost impossible.

This growth has brought about changes in credit quality and market dynamics, with a substantial portion of high-yield bonds now rated BB. Leary says the private debt market of today and the period of 2015-2020 is more akin to what the bond market used to look like in the past, and that "the high yield market is almost like a hybrid for that crossover universe. 50% of the high yield market is BB rated for example," he says.

This expansion, and volatile markets coupled with uncertain interest rate forecasts, has developed unique market dynamics for the leveraged finance world. Certain sectors have become more resilient than others, while opportunities emerge in the form of companies with strong fundamentals who might not have weathered the COVID-19 era well and now need financing help, but still have much to offer.

Sector-Specific Risks and Credit Spreads

As traditionally said, Leary also states the importance of "time in the market more than timing the market," and that the specific industries that will be challenged moving forward will be those with a combination of an absence in protective covenants in loan agreements and challenges due to high leverage. In the leveraged finance world, defining the nature of the risk marks the difference in opportunity and holistic understanding of the investment. "There are always good businesses with bad capital structures that are a function of leverage and credit," Leary says, pointing out that some businesses might be sound, profitable businesses but have made poor financial choices along the way and taken on too much debt, or have unfavorable terms in their credit agreements. This puts the companies at financial risk - but might still present as an opportunity for the right investor.

"If you look at Moody's and S&P and simply look at the average rating in loan markets versus the average rating in the bond market, you're going to see that loans are a lower-rated group of cohorts," Leary adds. Loans typically have lower credit ratings compared to bonds, indicating higher risk, but not necessarily lower underlying quality. Leary also urges investors to look at the type of risk associated with these loans. "Loans might have lower ratings because there are often more good businesses with bad capital structures within these asset classes. They're also often smaller businesses with less of a footprint – but that doesn't mean it's bad risk, it just means a different type of risk, so an investor will be compensated accordingly" Leary explains. These fundamentals are having an impact on certain sectors.

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Enjoying a meteoric rise during and shortly after the pandemic, tech and software companies found easy funding during periods of low interest rates and booming equity markets. Leary points out significant exposure to software risk in the leveraged loan market. "The tech stock market is selling off a little bit, but there's also a possibility it bounces back. It's been pretty volatile and experienced thin trading throughout the summer, but there is an incredible amount of software risk in the leveraged loan and high yield market," Leary points out.

Conversely, he highlights the strong performance of the energy sector, which has seen improved balance sheets and M&A activity driving bonds prices higher. Part of the reason for this, Leary says, is due to a period of stress the sector underwent before the pandemic. "Many people see the Great Financial Crisis as a default cycle, but I disagree. The proper default cycle was within the energy space in 2016. Many U.S. upstream oil and gas companies filed for bankruptcy and had different iterations of 'amend and extend, amend to protect the different liens' and so on. The balance sheets were restructured before they filed for bankruptcy. The net impact of that is that they stayed in the private markets under the radar and are now emerging with less debt on their balance sheets," Leary explains, offering an interesting consideration for bond investors.

Additionally, falling Treasury yields have led many to believe that spreads will increase, but Leary says this might not be a bad thing. "Spreads will likely widen as Treasury yields decrease, but this doesn't necessarily mean a loss for investors", he explains. He emphasizes the importance of understanding the potential benefits for fixed income investors in a potentially high interest rate environment, especially as the U.S. population ages.

"While the concept of lending to companies and getting your money back plus interest is not rather exciting, it is certainly a good source of income. As we see a demographic in the United States that is aging, you're going to see people having more familiarity with the types of bonds they own and how to best use them in retirement," Leary says.

Leary also notes the importance of understanding defaults within the high-yield market. "Defaults can spike, and it's crucial to have an active manager who can navigate these waters," he says. He stresses the significance of recovery values in liquidity and managing defaults effectively. "The key is to understand the rating profiles and the risk associated with each asset class within leveraged finance," he adds.

Steepening of the Treasury Curve and Short-Duration High Yield

Many have given their predictions as to where the curve will land amidst the market volatility of the last few months, and Leary predicts a steepening and normalization of the Treasury curve in the coming months. "I think the two-year Treasury is going to yield less than the five-year and ten-year Treasury in the next six months. This is just normalization as we start cutting rates," he explains. As far as a rate forecast, Leary anticipates that the Federal Reserve will cut rates in September, leading to a normalization in credit and Treasury curves.

The anticipation that investors should prepare for a market environment that is markedly different than the past few years seems to have finally materialized. "Your front-end paper, like CDs and money markets yielding 5%, is going to underperform short-duration high-yield," he states. According to Leary, short-duration high-yield bonds, with maturities in 2025 through 2028, offer attractive yields between 6% and 8%.

Additionally, there is a unique combination of high-yield market dynamics currently in play. "The high-yield market has a combination of recent new issues with big coupons and low-coupon bonds trading at a discount to par," he explains. This bifurcation creates opportunities for investors to capitalize on both high yields and potential price appreciation as interest rates start to decline.

Ultimately, these market movements and uncertainties create pockets of opportunity.

"Most people don't really understand the ins and outs of fixed income, but if you're not paying attention to it, you could miss the opportunity to lock in some income and lower the volatility of your portfolio," Leary concludes.

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