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Rising rates? Senior loans may be the answer …

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As investors continue to position for higher interest rates, even with growing geopolitical concern, one asset class in particular continues to get a lot of attention: floating rate senior corporate loans. When we consider their fundamental characteristics, this is not surprising.

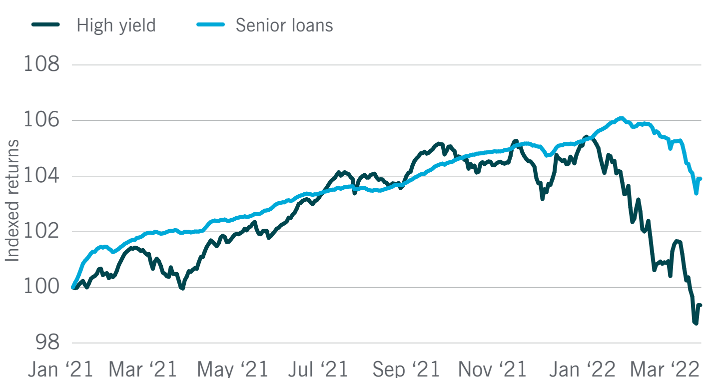
Due to the interest rates on loans being, generally, tied to a 1- or 3-month reference rate, the asset class has effectively zero duration. As our CIO Saira Malik wrote in her recent commentary, in a time of rising rates duration is a key characteristic to consider when examining fixed income asset classes. With their floating rate coupon structure, loans instead are basically a pure form of credit risk. As such, loans are well positioned against a backdrop of continued economic growth and the higher interest rates that are likely to follow. The loan asset class is also nearly entirely dominated by U.S.-based issuers with U.S.-oriented businesses, which may prove beneficial given concerns overseas. As a result, the asset class has seen strong demand since the beginning of 2021, which has continued despite recently elevated volatility. Given that strong demand, valuations in loans make credit selection as important as ever, though the recent volatility has created some new opportunities. In our opinion, for income-oriented investors looking to allocate capital into a rising rate environment loans could well be a powerful part of the solution, if troubled credits and defaults can be avoided.

The steady performance of loans in the face of rising rates has caused continued demand for the asset class from both institutional and retail investors.

LOANS HAVE PROVEN RESILIENT

In 2021, the market saw volatility in both the front and back end of the yield curve. Throughout this period, loans remained remarkably stable considering the volatility seen by other fixed income asset classes. Even high yield bonds, which are less duration sensitive than investment grade bonds, and are close to a hybrid equity-fixed income asset class, have oscillated in response to moves in the rate market.

Loan returns have been steady vs. high yield

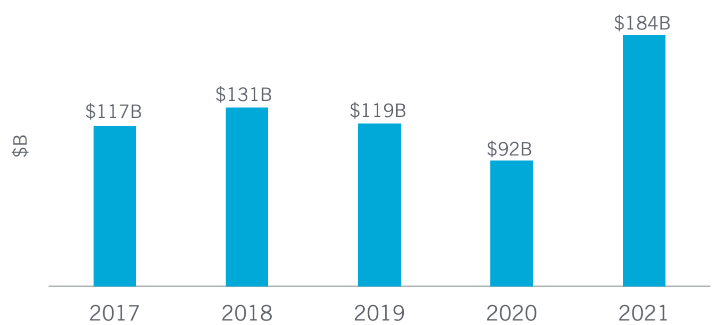


Source: Bloomberg. **Past performance is no guarantee of future results.** As of 17 March 2022.

The stability of senior loans is arguably what investors should be most focused on. Somewhat coincidentally, despite different volatility profiles, loans and high yield bonds ended 2021 with nearly identical total returns. So far in 2022, however, high yield has again seen significant volatility. This time it is being caused by a combination of the threat of higher rates and also geopolitical uncertainty. Loans, again, have been quite resilient.

The steady performance of loans in the face of rising rates has caused continued demand for the asset class from both institutional and retail investors. Two of the most transparent sources of demand are collateralized loan obligation (CLO) creation, which is driven by institutional investors, and mutual fund and ETF flows, which are largely retail driven. CLOs have been a growing source of loan demand since the CLO industry was reborn in the wake of the GFC. This growing institutionalization culminated in a record $183B of net CLO creation in 2021. That growing demand has resulted in CLOs accounting for around two-thirds of demand for primary market loan issuance.

CLOs are a source of consistent demand

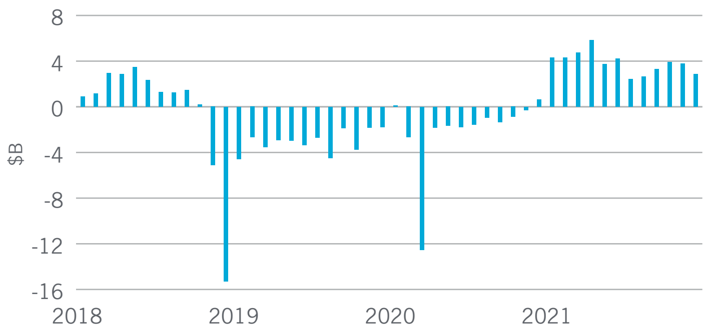


Source: JP Morgan. As of 31 January 2022.

Mutual fund and ETF flows into the asset class, on the other hand, tend to be more tactical in nature and heavily influenced by the sentiment around interest rates. During periods of interest rate volatility, retail investors typically allocate to the loan asset class, and during more benign periods and times of falling rates they are typically sellers of the "floating rate funds" that make up the loan peer group.

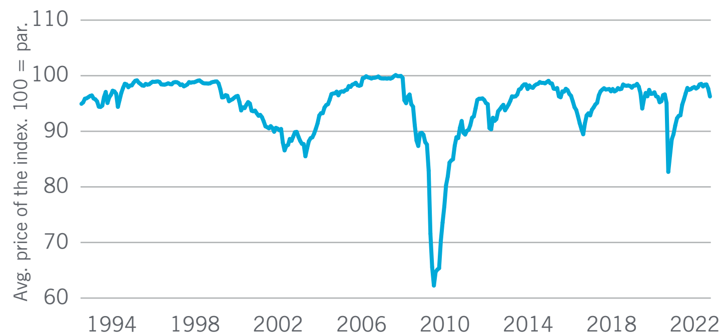
The last several years have been a prime example of that. Between December 2018 and December 2020, with rate risk on the back burner, loans saw heavy outflows that totaled $86B over a two-year period. Beginning in January 2021, however, that trend dramatically changed direction with mutual funds and ETFs seeing $45B of inflows in 2021 and $10B so far in 2022. Inflows have slowed but remain consistent even amid the conflict in Europe.

Loan mutual funds and ETFs have seen recent strong demand



Source: Morningstar. As of 31 January 2022.

Loans trade at a discount to par despite attractive positioning and moves by Fed



Source: Credit Suisse. **Past performance is no guarantee of future results.** As of 16 March 2022.

That recent demand provides a stable backdrop and allows issuers to extend their debt runway post-COVID, as fundamentals continue to improve and issuers take advantage of strong economic conditions. However, consistent demand should keep prices and spreads fairly stable.

RISK CONSIDERATIONS

Limited ability to move above par

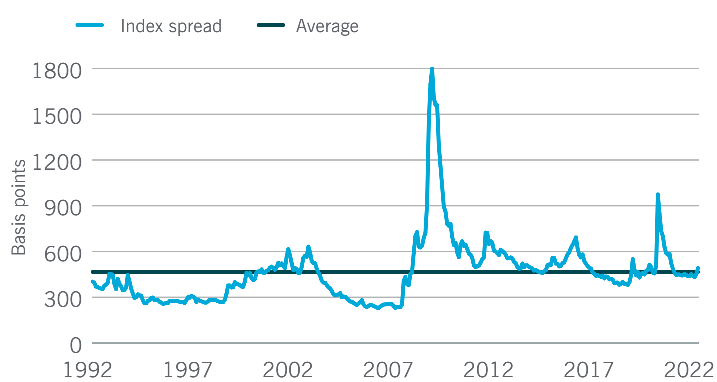
Although prices have backed up somewhat in recent weeks, leaving some upside potential, loan investors should recognize that loan returns are likely to be driven heavily by current income. With a lack of call protection, loans have limited ability to move above par. However, navigating a market where risk is asymmetric to the downside is not an unusual scenario for loan investors. In fact, the only time the loan asset class traded at a material discount to par was during periods of acute dislocations: the technology bubble, the Global Financial Crisis, the Energy Crisis, and COVID. In fact, seeing loans at a meaningful discount to par with the expectation for Fed rate hikes is unusual.

In a more normal environment, in particular one with defaults expected to be below average, investors should expect to find performing loans trading near par. As such, performance going forward will largely be a function of avoiding deteriorating credit situations, as opposed to picking winners.

Spreads

While investors often look at prices when considering valuations, it is our opinion that looking at spreads versus Treasuries is a better way to assess risk/reward. While spreads have certainly narrowed considerably in loans, driven partly by strong demand, investors are often surprised to hear that loan spreads are not at all-time tights. In fact, loan spreads today are actually slightly above long-term averages following some recent widening, and well outside of the levels seen in the tights of previous credit cycles. Again though, some of what is keeping credit spreads slightly wide of where we would expect is the aforementioned higher risk of loans versus the long-term historical context.

Spreads to Treasuries remain above average



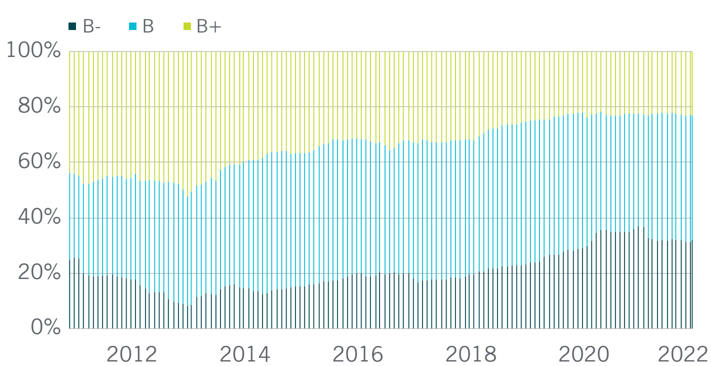
Source: Credit Suisse. As of 16 March 2022.

Shift to lower-rated issuance

Although loans seems well positioned for an environment with higher rates and continued economic growth, they are not without their risks. With a floating rate coupon and below investment grade credit rating, loans are effectively a pure form of credit risk.

At a high level, the market has seen a gradual but persistent shift in a higher proportion of lower-rated B rated loans. Since 2011, the percentage of BB loans has decreased from 39% to 24%. This shift has been occurring since the GFC but has become more pronounced over the last few years. At a more granular level, the market has seen a meaningful increase in the amount of debt rated B-, the last rung above CCC. One driver of that has been CLO buyers. CLOs have limited ability to buy or own CCC rated debt, but have more flexibility to own loans rated B-. CLOs are also hungry for yield and spread. So, as CLOs are looking for yield but constrained from looking at CCCs, it perhaps isn't a surprise that the specific notch one level above CCC is seeing so much growth. In many ways this growth is similar to the growth seen in the BBB and BBB- market within investment grade corporate bonds.

Riskier B- loans climbing as a percentage of the index



Source: Credit Suisse. As of 31 January 2022.

Liquidity

While mutual funds control a smaller portion of the loan market than they have in previous periods, they continue to gather assets. And, for many retail investors, mutual funds are one of the easiest ways to get access to the asset class. As assets have ballooned in many of these funds, so have the number of holdings. Today, some of the largest funds in the category have over 900 line items in their portfolios.

That raises two important issues. One, how well do they know the companies they've lent money to, and how well can they monitor them. And, two, what is their exposure to assets with lower liquidity, as there are fewer than 900 loans in the market that trade with any type of regularity. As the credit cycle begins to turn, whenever that might be, the price discovery process within these less-liquid names could prove onerous. That is particularly problematic for funds offering daily liquidity to their investors.

RESILIENT CHARACTERISTICS, BUT DON'T FORGET THE RISKS

Loans have seen strong demand from investors for obvious reasons, as they remain a helpful option for investors looking to position for higher interest rates. However, any time we see such strong demand for an asset class, it can impact both risk and returns. While loans still appear fairly priced, in particular relative to other assets, investors should fully understand the opportunities, as well as the risks. Investors should also ask the hard questions of their fund managers regarding how they intend to add value above and beyond just giving broad exposure to the asset class, as beta exposure becomes less attractive as spreads continue to tighten.

For more information, please visit nuveen.com.

Endnotes

Sources

Gross Domestic Product: U.S. Department of Commerce; **Treasury Yields and Ratios:** Bloomberg (subscription required); **Municipal Bond Yields:** Municipal Market Data; **ICI Fund Flows:** http://www.ici.org/research/stats; **Municipal Issuance:** Seibert Research; **Defaults:** Municipals Weekly, Bank of America/Merrill Lynch Research, July 7, 2017; **State Revenues:** The Nelson A. Rockefeller Institute of Government, State Revenue Report, June 2017; **State Budget Reserves:** Pew Charitable Trust. **Global Growth:** International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD); **Standard & Poor's and Investortools:** http://www.invtools.com/; **Flow of Funds, The Federal Reserve Board:** http://www.federalreserve.gov/releases/Z1/Current/z1.pdf; **Payroll Data:** Bureau of Labor Statistics; **Bond Ratings:** Standard & Poor's, Moody's, Fitch; **New Money Project Financing:** The Bond Buyer; **Consumer Price Index:** http://www.bls.gov/cpi/ http://research.stlouisfed.org/fred2/series/CPIAUCNS; State of Connecticut Fiscal Year 2017 Comprehensive Annual Financial Report; State of Connecticut Annual Information Statement; State of California Official Statement dated March 6, 2018; Moody's Analytics, California, April 2, 2018; BLS.gov; State of California, Comprehensive Annual Financial Report, FYE June 30, 2017; New Fiscal Plan for Puerto Rico, Restoring Growth and Prosperity, April 2018; Puerto Rico's Financial Oversight and Management Board hearing on April 19, 2018; The Bond Buyer, Governor's opposition to Puerto Rico fiscal plan could end up in court, April 20, 2018

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Glossary

One **basis point** equals .01%, or 100 basis points equal 1%. The **Municipal Market Data AAA scales** are compilations of the previous day's actual trades for AAA-rated insured bonds. The **personal consumption expenditures (PCE) deflator** indicates the average increase in prices for all domestic personal consumption.

A word on risk

All investments carry a certain degree of risk and there is no assurance that an investment will provide positive performance over any period of time. Investing in municipal bonds involves risks such as interest rate risk, credit risk and market risk, including the possible loss of principal. The value of the portfolio will fluctuate based on the value of the underlying securities. There are special risks associated with investments in high yield bonds, hedging activities and the potential use of leverage. Portfolios that include lower rated municipal bonds, commonly referred to as "high yield" or "junk" bonds, which are considered to be speculative, the credit and investment risk is heightened for the portfolio. Bond insurance guarantees only the payment of principal and interest on the bond when due, and not the value of the bonds themselves, which will fluctuate with the bond market and the financial success of the issuer and the insurer. No representation is made as to an insurer's ability to meet their commitments.

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