Creditflux
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Global credit funds & CLOs

Record fiscal stimulus provides pick-me-up

Credit markets had a mini bounce-back in the second quarter as central banks poured cash into the economy. But there is great uncertainty about the effects of a second wave of coronavirus

European loans

Loans have disconnected from equity markets

David Allen
Chief Investment Officer,
AlbaCore Capital Group

Bullish
Globally, loans are cheaper now than 92% of the history of the market

Bearish
On how companies will fare as economies reopen

Greatest challenge
Credit selection with materially higher defaults

Now is a great time to invest in leveraged loans, despite the rally since the lows of March, says David Allen, CIO at AlbaCore. "Since 1992, the average spread has been 4.5%. Today that number is closer to 6.5%," he says. "Loans are cheaper than 92% of the history of the leveraged loan market."

Dispersion is also about as significant as the market has ever seen, with Allen noting that the top quartile loans yield, on average, over 30%, while the bottom quartile yield just over 3%. He says the 10:1 ratio presents a huge opportunity for creditors investing in the top quartile loans — if they don't default. Even the second quartile of loans yield 7.5%.

The huge disconnect between levered loans and equities is also making the former more attractive. "When you had the drawdowns in levered loans in previous recessions, equities were a lot lower (down around 50%). It's a very cheap loan market relative to history now but many equity markets are at all-time highs," says Allen.

> **Lower revenues and margins will likely lead to materially higher default rates**

He says that, given low interest rates, many strategists believe equities won't return the 7-8% they have delivered historically. "Levered loans pay 650 basis points over risk free rates, are secured and have less risk than equities. From a CIO's perspective, levered loans are great."

Still, the biggest risk is that defaults will be materially higher than they are today. AlbaCore has estimated a 10% default rate versus 2-3% average. "Many companies today are facing an uncertain and more difficult operating environment with dramatically lower revenues and margins, which will likely lead to materially higher default rates."