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Float like a butterfly



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Expectations for rising rates are taking hold globally as policymakers react to a synchronized and sustained global expansion and abandon emergency levels of policy accommodation. See our [Global investment outlook: Midyear 2017](#) for details. Rising rates boost the appeal of floating rate assets. Yet there are risks. Our approach is best captured by Muhammad Ali's famous quote: "Float like a butterfly, sting like a bee." In a floating rate context, this means staying nimble to avoid being stung.

Highlights

- Floating rate notes have a built-in hedge against monetary tightening; rate rises are passed on through regular coupon resets. The market-implied path of future Fed tightening points to a restoration of yields on floating rate and short-term debt, and this is already quietly underway.
- It is critical to distinguish between different types of floating rate debt. Bank loans, for example, offer relatively attractive yields but come with prepayment and credit risk. Low default rates of late and a positive economic backdrop support the asset class, but tight valuations and declining investor protections are challenges.
- We see selected opportunities in bank loans but our stance is defensive. Within high yield we prefer bonds over loans. Our overall stance within and across credit markets is up-in-quality. We also like selected emerging market debt (EMD).

Risk rewarded

U.S. Treasury yields have drifted lower again after a sharp climb in late June. The overall market tone remains risk-on, with higher-risk sectors such as EMD and high yield leading year-to-date returns, as the table below shows.

Bond market summary

Sector	View	YTD return	Yield	Sector	View	YTD return	Yield
U.S. aggregate	—	2.71%	2.51%	U.S. municipal bonds	—	4.40%	2.17%
U.S. government bonds	▼	2.04%	1.87%	U.S. investment grade	▲	4.56%	3.12%
Short (1-5 years)	— ↑	1.08%	1.51%	U.S. high yield	—	6.09%	5.41%
Intermediate (5-10)	— ↑	2.55%	2.08%	Bank loans	—	2.63%	4.98%
Long (10+)	▼ ↓	4.76%	2.82%	Securitized assets	▲	2.70%	2.60%
U.S. inflation protected	▲	1.30%	2.24%	Euro credit	▼	1.41%	0.80%
Agency mortgages	—	1.81%	2.82%	Emerging markets	—	7.08%	5.32%
Non-U.S. developed	▼	8.96%	0.81%	Asia fixed income	—	4.38%	3.84%

▲ Overweight — Neutral ▼ Underweight ↑ Upgrade ↓ Downgrade

Source: Bloomberg, as of July 31, 2017. Notes: Performance and yields are represented by the S&P Leveraged Loan Index (bank loans); J.P. Morgan EMBI Global Diversified Index (EM hard-currency debt), J.P. Morgan Asia Credit Index (Asia fixed income), and the respective Barclays Bloomberg indexes for the remaining sectors. Yields are yield to maturity, except U.S. high yield and municipal bonds (yield to worst). Performance is measured in total returns and in U.S. dollars, except for Euro credit (euros). Our TIPS view reflects relative performance vs. nominal U.S. Treasuries. Indexes are unmanaged and used for illustrative purposes only. They are not intended to be indicative of any fund or strategy's performance. It is not possible to invest directly in an index. Past performance is no guarantee of future results.

Expanding options

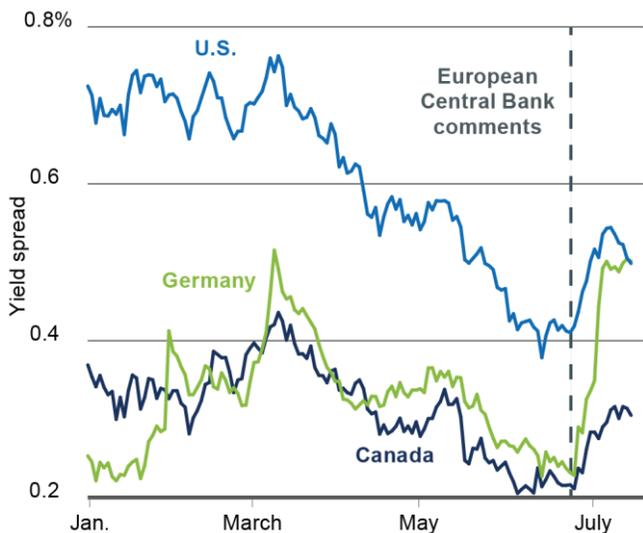
The Federal Reserve appears poised to raise rates again in December, with the central bank’s “dot plot” pointing to a median expectation of three more hikes to follow in both 2018 and 2019. Its endgame: a terminal “neutral” rate of 3%. The Fed isn’t alone. The Bank of Canada in July increased rates for the first time in seven years. And the European Central Bank (ECB) is expected to announce later this year it will begin scaling back asset purchases in 2018, before eventually raising rates in the eurozone.

Monetary tightening expectations shifted upward globally in June after a speech from ECB President Mario Draghi was seen as a prelude to normalization. This was reflected in a sharp rise in the gap between five- and two-year yields – a key gauge of monetary policy expectations. See the *Great (rising rate) expectations* chart below. Soft inflation data and a more dovish interpretation of central bank comments have recently tempered these moves, but we still see rates heading higher over time.

Cumulative increases in rates as the Fed – and eventually other central banks – normalize policy mean investors may, over time, be able to satisfy more of their core income needs through lower-risk sectors in the bond market. This could curb appetite for riskier fixed income sectors, as detailed in [Normalizing normalization](#) of March 2017. The shift in global monetary policy expectations also validates the appetite for floating rate securities, which pass on rate rises in the form of higher coupons. And alternatives for investors to manage rising rates have increased. The U.S. [Treasury began issuing](#) short-maturity floating rate notes in 2014 to diversify its cash funding needs. These bonds sport two-year fixed maturities and quarterly coupon resets.

Great (rising rate) expectations

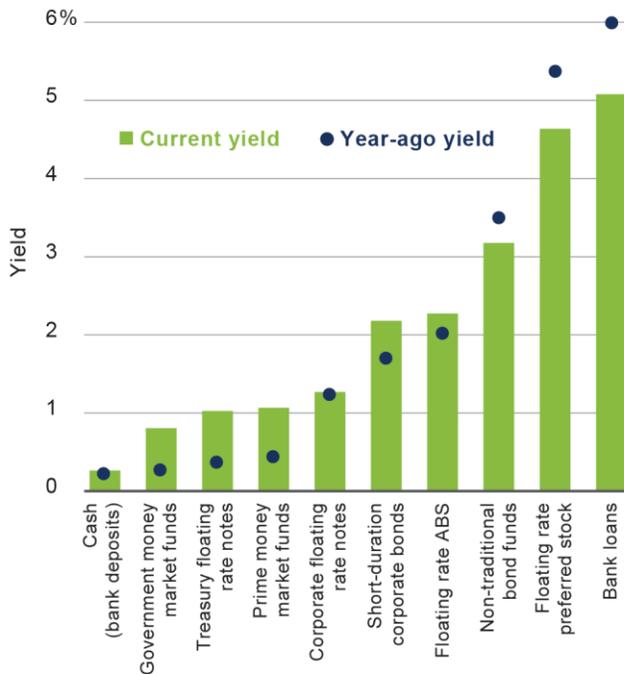
Difference between five- and two-year yields, 2017



Source: BlackRock Investment Institute, with data from Thomson Reuters, July 2017. Notes: The lines show the difference between benchmark nominal five- and two-year government bond yields for each country in percentage points. European Central Bank comments refers to Mario Draghi’s comments at the central bank’s annual policy forum on June 27 in Portugal.

Flavors of floating rate

Floating rate asset yields, 2017 vs. 2016



Source: BlackRock Investment Institute, with data from Bloomberg, Morningstar, S&P and bankrate.com, July 2017. Notes: Current yield (green bar) as of June 30, 2017. All yields in U.S. dollars. Yields for Treasury and corporate floating rate notes, floating rate asset-backed securities (ABS) and short-duration bonds based on respective Bloomberg Barclays indexes; yield for bank deposits based on the national average three-month CD rate from bankrate.com; yields for non-traditional bond funds, government and prime money market funds based on the weighted average yield of the largest funds (those making up 80% of the total AUM of the funds in their respective Morningstar categories); yield for floating rate preferred stock based on the aggregated yield of the non-fixed-rated preferred equities in the S&P preferred stock index; and yield for bank loans based on the yield to worst from S&P LCD. Floating rate preferred stock is not truly floating rate; it has either a coupon floor well above current interest rates or a fixed-to-float coupon structure.

In the opposite corner ... bank loans

The expanded menu of options for investors seeking shelter from rising rates spans an array of income and risk. Short-term debt is not floating rate but can fit the bill by rolling over maturing debts at new yield levels. Indeed, short-duration funds have posted positive returns even amid rising short-term U.S. rates. Floating rate bank loans occupy the other end of the risk spectrum. Their higher income potential reflects greater credit risk. Yields have narrowed across the risk continuum over the past year, a trend we see as unsustainable in the medium term. See the *Flavors of floating rate* chart. The narrowing reflects increases in the Fed’s rate path and investors’ pursuit of higher yields.

Taking on bank loan risk has been rewarded, as seen in the recent spread compression illustrated in the chart above. And just 1.6% of U.S. bank loan issuers defaulted in the 12 months through June, after a spike to 4% last year due to commodity- and energy-related defaults, Moody’s data as of July show. Low rates, refinancing and economic growth supporting company cash flows are helping issuers maintain solid interest coverage ratios – even as many have become more leveraged. Bank loans feature stronger recovery rates than high yield bonds in the event of default; recent experience bears this out. We do, however, see some future challenges. See the next page.

Less to lien on

Cumulative hikes in Fed policy rates are set to increase the attractiveness of all short-term and floating rate debt, including bank loans, in the years ahead. The Fed’s policy rate path points to steady rises in three-month rates through the end of the decade, though they are set to remain below pre-crisis levels. See the *Short rates on the upswing* chart.

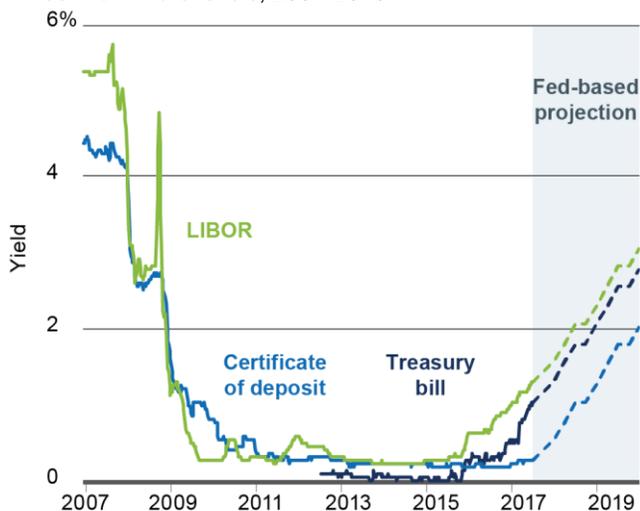
The prospects for higher interest rates supporting rising loan coupons – amid an outlook for low credit losses – supports the longer run outlook for loans. Yet we see a couple of challenges, for which today’s high loan prices, coupled with prepayment risks (as discussed at right) leave little room for further price appreciation. Loan spreads were trading around the tightest levels since January 2008 as of late July, the S&P/LSTA U.S. Leveraged Loan Index shows.

One key challenge: an apparent structural shift away from the use of covenants that historically served to mitigate credit risk. Banks typically demanded these covenants – legal restrictions on borrowers that helped banks limit credit losses through early intervention when performance metrics such as cash flow and interest coverage tests were breached. A more recent shift toward so-called “covenant lite” loans comes amid a greater desire for flexibility by issuers. It also reflects investors’ willingness to trade protection for slightly higher income in a low-rate world.

Another critical source of potentially higher risk in the future is a change in today’s bank loan capital structures. A reduction in the amount of subordinated debt – which acts as a cushion against losses to first-lien bank loans – means recovery values in the case of default may end up lower than in the past. Thinner subordinated debt cushions and a lack of covenant protections could mean significantly lower recovery values (and higher losses) in the next down cycle.

Short rates on the upswing

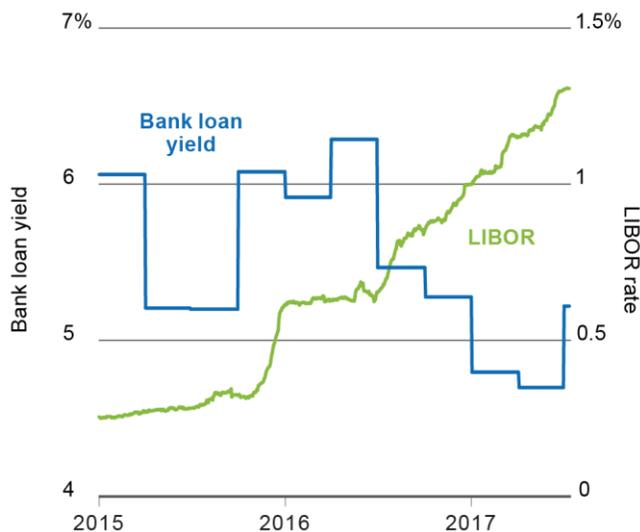
Three-month rate levels, 2007-2019



Source: BlackRock Investment Institute, with data from Bloomberg and bankrate.com, July 2017. Note: The lines show yields for three-month Treasury bills, LIBOR and certificates of deposit. UK regulators in July announced a gradual phasing out of LIBOR; we expect the benchmark rate to remain in use over the period shown in the chart. Projected yields are based on the median level of Federal Open Market Committee (FOMC) participants’ assessments of the “appropriate” federal funds rate over time as of the June 2017 FOMC meeting, as laid out in the Fed’s [Summary of Economic Projections](#).

Opposing paths

Bank loan yields and LIBOR rates, 2015-2017



Source: BlackRock Investment Institute, with data from Bloomberg and S&P LCD, July 2017. Notes: The blue line shows the average yield to maturity of new loans in the first-lien term loan B market (the primary investor market for bank loans) on a quarterly basis. The green line is three-month U.S. LIBOR.

The prepayment punch

Despite these risks, it is prepayments that have been a drag on bank loan returns this year. The ability to prepay a bank loan is a plus for issuers, offering them greater flexibility to manage the cost and structure of their borrowings. But it delivers a blow to investors: Any premiums paid for the expected higher coupon levels are lost. A replacement coupon that is lower than originally expected results in a lower-than-expected return.

Bank loans have returned 2.6% year-to-date, below the performance implied by coupon accrual, with prepayments accounting for a large part of those missing returns. And we are set to see the largest wave of prepayments in the market’s history, with virtually the entire non-distressed bank loan market on pace to refinance in 2017, according to S&P LCD.

A persistent imbalance of investor demand relative to supply in the bank loan market has shifted the risk/reward to favor issuers over investors. Issuers can refinance their bank loans and demand tighter spreads to the base floating rate. The result: diminished returns for investors. Even as base LIBOR rates have gone up, the all-in rate issuers are paying has been going down. This is due to a combination of LIBOR floors (minimum base rates) and issuers’ ability to tighten spreads by more than the increases in LIBOR. See the *Opposing paths* chart.

Bottom line: The evolution of risks and rewards in the loan market means investors need to be even more selective in managing a bank loan portfolio, we believe. Given elevated valuations relative to the risks, we see this credit sector as fully valued. Overall, we see better value in equity exposures and prefer an up-in-quality stance in corporate credit. In high yield we prefer bonds over loans. And we see selected opportunities in EMD.

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