

Easy Money

THE LEAD | January 31, 2018

“The world is going up in a straight line, but for how long?” Such was one Euro banker’s query from the lofty aerie at the Davos World Economic Forum. Despite potential global worries including terrorism, nationalism, and bubbliism, the mood was buoyant. “There’s always things to worry about,’ said another, “but not a lot until the middle of 2019.”

We’ll put that on the calendar. Still, boisterous bankers give us pause. What are we missing?

Global synchronization – the new watchword – means the world’s economies are headed together in the same direction – from weakness to strength. But behind the scenes central banks are either tightening monetary policy, or prepping to do so. The WSJ reports the Fed, ECB, BofJ, and BofE will pull back on asset purchases 70% by the end of the year.

The likelihood of more volatility and price corrections down the line seems obvious, yet markets are taking this in stride. Nor does the prospect of higher rates seem to be fazing investors. Debt to ebitda over six times when Libor is 1% is one thing. But at 3-4% you’ve got a bit different credit story.

One indicator that Mr. Market doesn’t believe inflation will catch fire anytime soon is the flat yield curve. Despite a 3000 point rise in the Dow since October, 10-year Treasury yields have risen only modestly.

And though US growth at 3.3% (per 4Q GDP) is higher than most economists believe can be sustained over the long run, inflation has barely moved at 1.5%. Goldilocks indeed.

On monetary policy, the Fed has signaled three rate hikes this year and two next. Assuming ¼ point jumps that would leave Fed funds at 2.75%. Compare that to the 5.5% level we saw in the summer of 2007. At this pace we won’t reach that pre-crisis benchmark until 2022.

Europe is a couple years behind the US on ending QE, but it’s catching up. The ECB recently stated its intention to wind down bond buying, thanks to an improved economic outlook. Germany and the UK are also seeing some market rates rise. Even Japan, where deflation has reigned historically, is witnessing higher consumer prices.

Market observers are closely monitoring central bank activities. Since 2009 the world has lived in a close-to-zero rate environment. If inflation suddenly takes hold and interest rates spike back towards a 4-5% range, a number of interesting things could happen.

At the borrower level, higher interest expenses will carve out a greater share of operating income. For highly leveraged issuers that means tightening coverage ratios and (at high enough levels) more covenant and payment defaults.

As our [Chart of the Week](#) illustrates, when interest rates rise, Libor spreads compress to keep all-in spreads for sponsors and issuers in line. While we don’t expect middle market yields to follow the broadly syndicated market, it’s a trend credit managers will track closely. Bond prices will also be pressured and issuance could take

a hit with more fixed income investors seeking the safety of floating rate instruments.

Down the road, credit managers see clear benefits to central bank hawkishness. As a Lincoln International report put it last month, “The end of quantitative easing and additional interest rate hikes may constrain liquidity in the private debt markets.”

That constraint, it is hoped, will siphon off excess liquidity that has weakened structures and created risk/reward imbalances in the leveraged loan market. We don’t expect straight lines up. But less easy money would be an excellent start.