THE LEAD
https://theleadleft.com/third-quarter-report-second-of-a-series/

# Third Quarter Report (Second of a Series)

THE LEAD | October 17, 2018

For two weeks in a row we've been blessed with memorable quotes from top market observers. We wrote in our last column about Fed chair Powell's comment that the current cycle could go on "indefinitely."

This week's nugget comes from our long-time friend, Steve Miller, the chief executive of Fulcrum Financial. "You can't fight the Fed," he said, "except, maybe with loans."

Indeed, that's the beauty of the floating rate asset class in a rising rate environment. Unlike equities – or fixed income, for that matter – that seem increasingly spooked as the Fed persists with its upticks, this climate is tailor-made for loans and their investors.

The combination of a healthy, but not too frothy, economy, and a moderate pace on hikes, has long been considered constructive for loans. High-yield bond funds, by contrast, saw almost $5 billion in outflows last week – the fourth highest exit ever.

One of the most important (and challenging to measure) metrics informing loan demand is how much of it receded amid the post-crisis push for more bank regulation.

As we know, much of the $1 trillion-plus leveraged loan universe is now comprised of CLOs and mutual funds. Back in 1994, 70% of that was held by commercial banks. While it wasn't as large an asset class back then, that's a lot of ground to make up.

For the middle market, it's not clear exactly how much bank capital has withdrawn from direct lending over the past decade. But it likely is a significant amount. There's also no way of estimating how many regional banks have been discouraged by the risk capital (and risk management) required to play competitively in the space.

In their place, non-banks now represent almost 40% of middle market leveraged loans, according to LPC. Those direct lenders are driving loan appetite and activity. Sponsored volume, as one data point, is up year-to-date at around $60 billion. At this rate, 2018 numbers will exceed last year's for senior secured loans.

How much demand for middle market loans is coming on line? LPC's estimate, including BDCs, CLOs, mezzanine, private funds, and SMAs, is $60 billion for this year. Preqin's data shows as much as $130 billion of dry powder, including mezzanine.

So let's call it $100 billion. Even if you add new managers with plans to dive into private credit, or new funds not yet launched from existing managers – $10 billion? $20 billion? – those numbers pale in comparison with future supply.

As we've noted previously, private equity dry powder of $500 billion combined with $500 billion of looming middle market maturities, represent $1 trillion to work on.

Next week, we wrap up our 3Q report with a look at what to expect for the final quarter of 2018.