THE LEAD
https://theleadleft.com/its-the-dough-not-the-dow/

It’s the Dough, Not the Dow

THE LEAD | February 12, 2019

The oft-quoted baseball legend Yogi Berra once said, “When you come to a fork in the road, take it.” This has been cited as perfectly capturing the futility of some decisions under challenging circumstances. Turns out there was a bit more behind the quote than the Yankee catcher’s famously offbeat wisdom.

According to a 2009 biography, the quote came from actual directions Mr. Berra gave to a visiting friend. His house sits equidistant between two roads. Hence a traveler headed there, upon coming to the fork, can turn either right or left. Either choice leads you successfully to the house.

Read in that light, the mot is even more bon. And for those of us contemplating the world of credit for the coming year, it perhaps highlights ways forward amid otherwise confusing trends and backdrop.

The end of 2018, as we know, saw the unleashing of volatility across public markets. Driven by the Fed’s mixed signals on rate hikes and worries how trade wars might create real drag on economic growth, asset prices tumbled. High-yield bond markets seized up with no new primary issuance in December; the first deal-free month in ten years. Secondary leveraged loan prices fell sharply, while new transactions tailed off and opportunistic re-pricings were shelved.

As the Dow tumbled almost 20% from its high in October, market observers of all stripes, as well as economists, revised their slowdown forecast to the latter half of 2019. The Fed, finally taking note of markets’ reactions, softened their outlook to a more dovish two hikes (vs. three) for the year.

But with the turning of the calendar, another bend in the road appeared. Thanks to the central bank’s new-found sensitivity, and a favorable November jobs report, the Dow lifted off from its Christmas Eve bottom, making up half its December loss by mid-January. Leverage loan prices U-turned to gain 2% from their lows. And the first new junk bond deal since November appeared, for an energy company, no less. Targa Resources Partners issued $1.5 billion of bonds – upsized from $750 million, thanks to higher demand.

Within days, sentiment reversed from doomsday to zoomsday High-yield witnessed $1 billion of in-flows after almost $12 billion of cash exiting since December 1. Loan funds saw a similar about-face, with out-flows slowing to $327 million – a mere trickle from the two-month run on accounts of $16 billion.

What, then, do we believe the road to take is for credit this year? Overall demand remains strong. Issuers still see a strong economy, with rates relatively low. Lenders are supportive; default rates are at a near three-year low. Plenty of private equity (and credit) dry powder has been raised, so supply/demand is balanced.

For loan investors, being senior secured and atop the capital structure is critical as we near the end of the credit cycle. While rates may level off this year, being hedged with a floating rate instrument is also helpful. With financings smaller than the broadly syndicated market, private credit typically requires financial covenants; another significant benefit in the event of an economic downturn.

Private credit adds two significant features. Non-bank midcap lenders are buy-and-hold managers with non-traded loans. They are thus less correlated to the price swings of liquid assets; critical in this environment of heightened volatility. Further, these credit providers have long-term capital whose appetite is governed by fundraising capacity, not retail money that moves with daily market mood. It's about dough, not the Dow.

Since the economy's future path is not as clear as approaches to the Berra residence, experienced asset managers prepare for all eventualities. They steer away from cyclicals such as retail, auto, and housing; towards defensive sectors such as healthcare, software, and business services. They are wary of micro-caps (below $10 million ebitda) with less critical mass and room for error. Finally, they favor investing alongside private equity sponsors with proven track records of protecting both shareholder and lender values.

Of course, with today's market velocity combining with so many unknown unknowns, all this could change tomorrow. But as Yogi might have put it, we'll burn that bridge when we come to it.

This column appeared last week in Creditflux (article link), a leading global information source for the credit trading and investment market.