Leveraged Loans and Systemic Risk (Third of a Series)

THE LEAD | March 14, 2019

What's in a name? A lot, apparently, if it's the name of a very large number.

According to a WSJ piece last week, as the world of big data grows, so does the problem of keeping track of it. In a decade or so, the amount of information will exceed 1 yottabytes. That's 1 with 24 zeros after it. 1 with 27 zeros? Well, there's the rub.

No official names exist for larger byte sizes. One scientist employed the classics to propose *ronnabytes*, and *queccabytes* for 1 with 30 zeros. After that, it's Greek to us.

Though not as multi-zeroed, $1.2 trillion is a pretty large number. It's also the size of the leveraged loan market. In the last five years, that market has doubled. Such stellar growth has been used as a case against it. If so much money is being poured into an asset class, the argument goes, there must be a bubble. Which could put the economy at risk.

Certainly $1.2 trillion is well-numeraled, but it pales in comparison to US equities ($32 trillion) or bonds ($37 trillion). And while loan growth has been appreciable, outstandings only recently passed the high-yield bond market in size. Yet few are calling out junk bonds as a threat to GDP.

So what's the connection between leveraged loans and the economy? Can loan problems infect the greater financial system (as one critic has warned), "tightening credit [that] will feed into the real economy, setting off losses"?

Because CLOs represent the lion's share of leveraged loan buyers, they attract the most attention from regulators. To the uninitiated, C-L-O sounds like C-D-O, the securitized bond equivalent that housed sub-prime mortgages. But as we covered last week, loans performed well through the downturn.

To be sure, structural issues such as mark-to-market valuations when asset prices fall are challenging for managers. They can impact availability under warehouse lines used to ramp to permanent vehicles. But as with covenants in middle market loans, these metrics are integral to a functioning system protecting lenders and investors.

December's volatility was something of a test run for this thesis. Secondary prices for liquid loans dropped more than five points that month, putting some warehouses "under water." When prices recovered in January, much of that value returned, mirroring the restoration we saw beginning in the first quarter of 2009. (See *Chart of the Week*).

Public loans, however, are only the most transparent neighborhood in this asset suburb. Private credit too has mushroomed since the credit crisis, though it's tougher to put a number on the size of that universe. (*Lead Left* subscribers can access our study – "How Big is the Middle Market?"). It's likely less than $1 trillion.

Defects in private credit are unlikely to lead to widespread domino-falling. Loan losses in direct lending funds held by asset managers can hurt their investors and shareholders, but most analysts agree would have limited systemic impact.