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Heads and Tails

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News reached us last week of a two-headed snake found in the Pine Barrens of southern New Jersey. The young timber rattlesnake(s?), nicknamed Double Dave, was discovered by two environmentalists, Dave Schneider and Dave Burkett.

Co-headedness, known as polycephaly, happens rarely in nature, and occasionally in finance. Double Dave's brains operate independently. But two heads aren't always better than one: They fight for food and can't react quickly to predators. So these oddities don't last long in the wild. "We'll take care of it," said one of the Daves.

In some cultures two-headed animals are seen as bad luck. Certainly the leveraged loan market is beginning to feel snake bit. On the one hand, public markets remain buoyed by hopes that trade talks will eventually be resolved constructively. Yet on the other, interest rates ratcheting lower signal a recession could be around the corner.

Hear a rattling sound? That's the serious coinage exiting retail loan funds – $36 billion in the past 42 weeks (see *Chart of the Week*). No one's partying like it's 2006. Yes, deals are getting done, but the buy-side remains cautious.

"We have seen more investors decline transactions perceived as over-levered or loosely structured for issuers in less-predictable sectors of the economy," Refinitiv quoted one veteran capital markets head. Others weighed in similarly.

The perception of an impending recession, or whatever's theoretically at the tail end of the current cycle, has investors of two minds: Stick with our search for yield, even if that brings greater risk? Or go to cash and wait until things become clearer, even though that may not be any time soon?

It could be a coin toss. Interest rates are low, and likely headed lower. That's generally constructive for credit. Default rates also continue to improve – 1.29% at August's end, down from 1.32% in July, per S&P LCD.

But as a more forward-looking perspective, LCD offers the share of performing BSLs trading at or below 80 cents. This "distressed" share rose to 4.03% last month, up from 2.81% in July. That's the highest level since 2016.

With smaller, unrated loans less correlated to market swings, value comes down to portfolio performance. An informal survey of middle market shops reveals few signs of systemic weakness; rather, select borrowers with idiosyncratic problems.

The post-Labor Day midcap deal pipeline, arrangers report, is healthy. Sponsors continue to raise and deploy capital which ensures a steady supply of buyouts and associated financings between now and year end.

With BSL demand constrained, and the forward calendar building, will that create a floor on yields? If so, does the middle market (as usually happens) follow suit? Only time will tell if credit investors then take the

opportunity to double down.