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2022 Capital Markets Outlook (Second of a series)

THE LEAD | February 24, 2022

Churchill's Kelli Marti and Jessica Nels continue their commentaries related to the firm's 2022 Capital Markets Outlook [link]:

From loan issuance, to LBO and M&A activity, to record CLO volume, 2021 was an unprecedented year in many forms. Coming off that record-breaking activity, we consider what lies ahead in 2022. In December 2021, our content partner S&P / LCD surveyed buy-side, sell-side and advisory professionals to gauge sentiment for the year ahead.

Here's a summary of its findings:

- Issuance will continue at record levels due to demand for floating rate debt from fixed income investors;
- The loan market does not expect a correction in 2022, but instead anticipates periods of "mini volatility";
  o 61% said a correction would be unlikely to occur within the next 12 months;
- The loan default rate will linger near post-crisis lows (below the current <1%) for at least the next 13 months;
- Inflation is most likely to impact the performance of credit portfolios in 2022, along with supply chain and labor shortages which are also contributing to the overall price inflation of goods;
  o 93% believe inflation will be at, or above, the Fed's 2% policy target;
- 85% of respondents called for rate hikes in 2022 [Polling for LCD's survey took place Dec. 1-13 — before the Fed signaled three rate hikes by the end of this year];
- Leverage levels on new deals are unlikely to fall, supported by robust enterprise values.

Besides these topics, one critical issue on the minds of market participants is the transition from LIBOR to SOFR. LSTA representatives compare the pre-transition focus to "Y2K" at the turn of the millennium, though with more tangible impact. Uncertainty surrounding SOFR has motivated credit managers to create task forces and generated much market chatter about this new benchmark rate.

Market participants expected the SOFR transition to be led by the BSL managers with the middle market following. This expectation was driven by banks, the prime arrangers of broadly syndicated loans, who were required to issue loans in SOFR beginning on January 1, 2022. Many direct lenders are not subject to the same banking regulations and so may convert to SOFR during the course of the year.

We've observed, however, that many middle market lenders opted to issue new SOFR loans now rather than waiting. With a new benchmark inevitable, why not jump in? SOFR, being considered a risk-free rate, carries with it the concept of a Credit Spread Adjustment, or CSA. This compensates lenders for the difference between SOFR and LIBOR, a market-based rate. The market quickly adopted a standard 10bps CSA for 1 month borrowings, 15 bps for 3 months and 25 bps for 6 months. While the CSA is standard course, some larger issuers have instead opted to build the CSA into the spread itself.

The resilience of the loan market has been evident during this transitional period, with the SOFR rate being seamlessly introduced. Perhaps not a Y2K non-event, but one that bodes well for another year of strong, non-controversial loan issuance.