Why Volatility Matters (Part Two)

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Leveraged loans occupy a unique position in the credit asset class. Like high-yield bonds they boast an active secondary market, but unlike junk they reside at the top of the capital structure.

Also, like high-yield, these loans are extended to non-investment grade issuers so enjoy higher returns than their investment grade cousins. But unlike bonds, they are secured by the assets of the borrower.

These features make the loan asset class particularly favored by experienced investors during times of volatility, as we currently are enjoying. Over the course of three decades, institutional buyers of loans have stepped up when other markets have closed.

As we discussed last week, despite dramatic public equity swings witnessed over the past month, the loan market has generally brushed off Fed rate confusion and China growth rate consternation. Loan prices for broadly syndicated deals have generally stayed within a band very close to par – in the 98-99 range.

Primary loan spreads have similarly demonstrated reasonable discipline. A single B issuer can still expect to pay an all-in coupon of 5.3% (per S&P/LCD), almost exactly where borrowing costs were two months ago.

What has been governing buy-side activity, to some extent for both mid and large cap transactions, has been supply/demand pressures. For institutional funds flush with cash, keeping fully invested in loans, regardless of environmental noise, is critical.

While there has been a decent pipeline of new issue, there has been a notable absence of mega-buyout activity on which buyers typically feast. That has created downward pressure on spreads and an upward bias on prices, in the face of economic uncertainty.

Not to say loan investors have on their happy hats at all times. One sector that continues to be punished is energy. As our *Chart of the Week* depicts, energy-related names have traded down significantly as analysts worry oil prices show no signs of recovery.

Another area of dislocation is second liens. Market volatility (as it always does) is putting a premium on credit quality, creating "haves" and "have-nots." Higher risk names are attracting fewer buyers. And less liquidity means lower prices and higher spreads. Of course, at some point yield players will step in, but they seem to be in no hurry.

In the middle market, linkage to external events is even further removed. Arrangers are coming out with a relatively robust post-Labor calendar of deals for both new buyouts and refinancings.

Not to say that experienced mid cap debt investors are ignoring current events. The uncertainty on the Fed rate hike adds to the overall unease about market stability. But whether a boost comes this week or not, the overall direction is clear: keep putting money to work in good quality loans.

Next week we look at what middle market arrangers are doing to prepare for a rising rate environment.