Why Volatility Matters (Last of a Series)

THE LEAD | October 1, 2015

With the passing of Yogi Berra, the position of sports legend/philosopher is now vacant. While no obvious candidates have stepped forward, we offer to nominate Cam Newton, star quarterback of the Carolina Panthers. Second-guessed on a play call by a reporter at a press conference last October, he replied with a shrug, “Hindsight is always 50/50.”

This notion resonated with us given the challenge of anticipating buyer behavior in today’s credit markets. With the Fed’s stance on raising rates oscillating between “not now” and “maybe tomorrow,” managers wonder if their next move will be decided by a coin toss. Are we headed for a downturn, or for an era of improved yields and growth?

Retail cash, meanwhile is still headed for the exits. Though floating rate assets are likely beneficiaries of a Fed move, the nine-week string of cash outflows from mutual funds (see *Chart of the Week*) is likely to be extended. That totals about $8.2 billion year-to-date (per Lipper); high-yield outflows ($2.8 billion) are comparatively more modest.

One friend on a money-center trading desk, exasperated at the contrariness of these buyers, echoed the Zen of Cam: “Don’t these investors remember how well-behaved loans were through the credit crisis? Don’t they understand the relative value?”

This steady leak of demand impacts liquidity in the broader markets. Ongoing volatility has created what one observer termed a “bifurcation” between “stressed” and “sleep at night” loans. The latter performed through the cycle and have a strong institutional following, while the former – “story” credits in cyclical sectors – struggle to find buyers.

The dearth of distressed investors is blamed on flight to quality. But continued volatility means no one knows when prices of out-of-favor loans will see another leg down. As public equities have demonstrated since mid-August, it’s hard to call a floor.

Meanwhile in the land of middle market credit, the story for the rest of the year will remain one of supply and demand. Private equity sponsors care less about macro trends and more about value creation around specific investments. While toppy purchase price multiples have dampened investment activity, firms are still putting money to work.

And middle market lenders are lined up to help them. Thomson Reuters LPC reports middle market institutional volume has increased gradually each quarter so far this year: from $5.7 billion, to $6.8 billion, and (so far this quarter), $8.3 billion. These numbers are down overall compared to 2014’s levels, but the trend is decidedly positive.

Middle market managers are encouraged as well with what one firm’s CEO calls “the stability of loan metrics” – meaning pricing and leverage. To wit, mid cap all-in spreads continue to hover around 6.25%, at least a 100 bps premium to large cap spreads.

Leverage has been steady at around 5.5x total debt to Ebitda this year, but that may be changing. LPC reports this week that middle market LBOs have seen leverage spike just over six times. While this may reflect the size of the data set, there's no question that non-bank arrangers are able to push beyond where regulated banks can go.

There are no signs volatility will ease anytime soon. But disciplined mid cap lenders know how to create asset value whether the market shows heads or tails.