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Back to School

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The thirteen-hour drive back from our North Carolina beach retreat afforded plenty of time to conjure up snappy post-Dodd Frank tourism slogans (“Welcome to the Outer Non-Banks!”) and spot amusing bumper stickers (“My Other Car is Driverless”).

In general, though, our thoughts last week kept drifting back to the state of the capital markets as participants prepared to return from the Labor Day break.

One recurring theme in the financial news that did manage to penetrate our vacation brain was the Fed’s effort to convince investors of its genuine desire to raise rates. Communiques from the Board’s mid-month conference in Jackson Hole, as well as supporting interviews with the usual governors, reiterated that “the case for an increase in the federal funds rate has strengthened.” This time we’re serious!

The problem, of course, is that we’ve heard this all before. No sooner were the rounds of Fed jawboning over, when August’s labor report came out. It showed just over 150,000 jobs added – below economists’ expectations and well below the 255,000 recorded for July. That sent rate hike prognosticators scurrying back to their holes once again. According to the CME Group, there is only an 18% likelihood of a rate increase at the next FOMC meeting in September.

Credit markets have long ago baked whatever rate expectations they have into their models. The result is that, regardless of the Fed’s actions, investors don’t see much in the way of higher rates for as far as the eye can see.

That plus a relatively benign credit environment, ex-energy and commodities, has boosted high yield issuance year-to-date. Indeed, as our *Chart of the Week* highlights, high-yield spreads have contracted during 2016, as the risk of defaults has lessened.

But lower junk spreads carry their own risk. Do mid-single digits provide enough return for this particular asset class?

As a WSJ article pointed out last week, the recent bond rally has pushed yields to levels that bump up against other asset classes with more protection should rates begin to rise. For example, the differential between junk and Treasurys is just above 5%. Leveraged loans still are offering north of 6% all-in spreads, and with security.

The real challenge for credit investors is figuring out how well the economy is actually doing. Data is mixed, with some positive signs (housing and consumer spending), and some negative (durable goods shipments). Still, as one analyst remarked, credit does well “when the economy is growing not too hot and not too cold.”

As the post-Labor Day period begins, this “Goldilocks” environment should provide a beneficial backdrop for the leveraged loan pipeline. Indicators from the leading arrangers are that September will be a busy month with a variety of financings ready to launch. We hope this is a indicative of the outlook for the rest of 2016.