

Are We Back to 2007? (First of a series)

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What is the scariest sentence in the English language? If you're a parent dropping off your four-year old at summer camp (as we did last Friday), a good candidate is, "Daddy, today we're learning archery!"

For bankers monitoring leveraged markets these days, it seems like the equivalent phrase of fear is, "We are back to 2007." The concern, of course, is not just topy markets, but extreme behavior that leads to another credit apocalypse.

Unlike our daughter's revelation, this worry has been bruited about for a while.

Loan bubble-phobia originates as far back as 2011. That was the second full year of recovery after the credit crisis. It also marked the return of leveraged volume to nearly pre-crisis levels. New-issue institutional loans totaled \$376 billion (all data courtesy S&P/LCD), then the third-highest year in market history after 2006 (\$475 billion) and 2007 (\$529 billion).

2011 was also the year mega-deals made a comeback. Eleven leveraged transactions between \$2-5 billion were completed, compared with only two the year before. Finally, covenant-lite deals, always a bull market's canary in the coal mine, jumped from \$8 billion in 2010 to \$57 billion in 2011.

However, in reviewing your correspondent's columns back then, we recalled one key difference. Four year ago, sovereign debt downgrades or government shutdowns roiled markets every few months, sending investors scurrying back to their caves.

Today that volatility is a distant memory. Fed officials worry now that the *absence* of volatility is a bad thing. Unlike 2011, risk-takers can get a head of steam with less fear that an exogenous shock (at least a familiar one) will derail them.

Over the next few weeks, we'll examine the question that seems to be on everyone's mind: Are leveraged markets behaving like the pre-crisis years of 2006 and 2007, or do we have a ways to go before we need to fret about heading over the cliff?

As a backdrop, let's first look at historic comps. As we said, volatility is low; the VIX stands at 12, versus an average of 17.5 in 2007 and 24.2 in 2011. Central banks have been pumping liquidity into the global system for six years. As importantly, they're ready to inject more if even the hint of a liquidity event raises its ugly head.

Then there's the economy itself. The period between 2001 and 2007 was characterized first by rapid recovery from the telecom crisis, then by slower growth. Since the Great Recession, GDP has gone mostly sideways – an uninspiring rebound to say the least.

Finally, in the biggest contrast to 2007, interest rates remain at historic lows. Today our faithful 90-day interbank offered rate is 0.23%. Seven years ago? It was 5.36%.

Next week, we take a closer look at market liquidity – now and back in 2007.