Flavor of the Month

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Turns out there's nothing plain about vanilla.

Back in March a huge storm – cyclone Enawo – struck Madagascar, a major grower responsible for supplying 80% of the world's vanilla pods. That crop devastation caused pod prices to hit a record high this year of $600 per kilogram. "It has been ridiculous," said the chief of one major UK "healthy alternative" ice cream company.

The trickle-down effect of this commodity crisis has been felt all year long as producers searched for other alternatives. The good news is that just 1% of all vanilla flavoring comes from pods themselves. Other non-food sources include coal tar, wood, and petroleum. Makes us think differently about that ice cream cone we had last weekend.

As summer winds down, the fate of the most popular ice cream flavor echoes what investors may forget about the leveraged loan market. Similar to pre-cyclone vanilla prices, middle market loan spreads have been in a steady state for over four years.

In part that's because sponsors and issuers have traded potential spread tightening for higher leverage. It's also due to the lowest-cost producers – namely, commercial banks – having exited (with some exceptions) from non-investment grade credit.

Spread tightening has been more of a feature in the broadly syndicated loan market. Single-B first lien all-in spreads, according to S&P LCD, have declined from roughly L+450 a year ago, to L+375 today. Supply/demand technicals are mostly responsible for that trend.

What some market participants may not remember is what can happen to spreads (or prices) when an exogenous event hits the shore. In the case of the China and commodities twister that roiled US markets in August 2015, large cap spreads widened out almost 100 bps. By March of 2016 all-in single-B yields had topped out at 589 bps, sliding down to 420 bps twelve months later (per LCD; see our *Chart of the Week*).

To achieve more yield today for senior secured debt, investors are being tempted to taste-test loans offering unlevered high-single or low-double digit yields. These loans do not carry the same risk profile as those with 5-7% yields.

Though it's hard to imagine in today's eternally "low-vol" market, where hurricane and nuclear war jitters have a half-life of three days, things can change quickly. When that happens investors will wake up to the cold reality that issuers who may have thrived in a low-rate, modest growth economy, can struggle mightily in a downturn.

What if the exogenous event becomes something more systemic than the correction two years ago? Memories are short, but 2008-09 didn't just result in gapping spreads. Financing came to a grinding halt. Lenders without permanent capital were washed away. And all but the most adventurous investors fled to cash and safety.

The lesson learned back then by experienced managers is that even plain vanilla deals can go awry. And that for investors, substitute flavorings may not be so sweet.