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State of the Loan Market (First of a Series)

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The French are running out of butter. *C'est impossible!*

Bad weather, falling milk production, and revived global demand for the dairy product have left bare shelves in France, particularly Brittany. This in a nation where consumers eat three times as much butter annually (18 lbs. per capita) as in the US.

L'affaire du beurre (a.k.a. *BeurreGate)* has caused stockpiling, pushing butter prices up sharply from $2,800 per ton in April 2016 to $8,000, according to the NY Times. A ton of butter is challenging to wrap your brain around. Unless you've eaten a croissant.

Issues of supply and demand were also much on the minds of attendees of the 22nd Annual LSTA Conference. The Loan Sales and Trading Association is the industry's marketing and advocacy organization. Its members represent the breadth and depth of the loan market, with an emphasis on liquidity, tradability and documentation.

A number of themes arose in the primary market discussion, none surprising. Loan volume has continued at a record pace, with activity so far this year at $436 billion for the overall market (per S&P LCD). A significant share of these transactions are refinancings, though that share declined from 80% at the start of 2017 to just below 30% today.

All-in loan spreads have also tightened, particularly since January 2016 when single-B's were in the neighborhood of L+550. At this writing they stand at L+375.

Much of the panel conversation centered around supply/demand dynamics; specifically; what's driving the supply of new deals, and is it enough to satiate the appetite of the growing number (and capacity) of institutional accounts?

Overall institutional lending related to M&A transactions is up smartly from last year. Year-to-date volume is a hair under $200 billion compared to about $160 billion for all of 2016. And while buyout financings are also on the rise – $40 billion for the third quarter vs. $35 billion for 2Q – these numbers pale in comparison with pre-crisis levels.

Two drivers rule the roost on the demand side of the equation for broadly syndicated loans: mutual loan funds and new CLO formation. Investor cash related to the former has been leaking out of retail accounts since August. That coincided with the growing view that the Fed might ease up on rate hikes; a belief that also led to the reversal of cash out-flows from high-yield bond accounts.

Thanks to lower spreads on their liabilities, new CLO formation has been on a relative tear. That's one of the more surprising developments of 2017. Given the capital demands of risk retention, it was thought vehicle growth would slow. Instead, it seems top-tier managers with deep pockets realize that CLOs still represent a cost-effective way to finance leveraged loans. More on CLOs later in this special series.

As our *Chart of the Week* depicts, there is a growing gap between loan supply and demand. In short, the market environment is creating conditions in which it’s too easy to create first-lien term debt capacity and too challenging to buy companies. Leaving asset managers little margarine for error.