What Inning Are We In? (Last of a Series)

THE LEAD | June 7, 2018

Confusion over where we are in the cycle was clarified a bit last week. The chief of JP Morgan Chase, Jamie Dimon, said at a NYC investor conference, "We're probably in the sixth inning. It's very possible you're going to see stronger growth in the U.S."

Mr. Dimon's bullish view was supported by Friday's job report, the highlights of which included a further improvement in the unemployment rate (to 3.8%), more hiring in May than had been expected, and better wage growth.

He also weighed in on the current market comparison to the pre-crisis period. "I've heard people say, well, it's looking like 2007. Completely untrue. There's much less leverage in the system. The banks are better capitalized."

That's not to say there aren't potential headwinds. He identified trade policy as one area of concern. And that was before this week's headlines of pushback from some of America's largest and most durable global trading partners.

In a joint interview on CNBC today, Dimon and Warren Buffett reiterated their bullish views. Extending the baseball metaphor, the Sage of Omaha said of the economy, "It's feeling really strong. I mean, if we're in the sixth inning, we have our sluggers coming to bat right now."

On the earnings front, though, analysts are now pointing to signs of a peak in corporate profit margins, which rose to a record level of 11.6% in the first quarter. Hard to see where this could go directionally except down. Higher interest rates and oil prices look to be a drag on this trend as the year progresses. This could explain why the Dow has traded in a band most of the year, despite the corporate tax cut that passed in December.

S&P LCD also reported on strong performance from its Leveraged Loan Index borrowers. Ebitda growth hit 9.25% for the first quarter, the highest reading since 2014. Yet anecdotally bankers worry about things like rising freight costs.

To-ing and fro-ing about cycle life hasn't slowed down leveraged lending. The institutional loan universe just passed $1 trillion – a record. At the current rate of issuance, outstanding loans will soon pass high-yield bonds. Is this the beginning of the end, or just confirmation of the widespread popularity of a stable asset class?

Positioning yourself optimally in the capital structure is one undisputed lesson of the last downturn. All other things being equal, it's preferable as a senior lender to have some kind of capital below you, whether bonds, mezzanine, or second lien.

As Pimco's bank loan portfolio manager, Beth McLean, noted in a recent FT article, "In the next credit cycle you will have the 'haves' and the 'have notes'. And the 'have notes' are likely to be in these loan-only capital structures."

As we head to the second half of 2018, the end of this game looks to be (as we keep saying) two innings away. Or maybe (as Dimon and Buffett are saying), three. Barring a cataclysmic event, as rates rise, there's a chance the Fed could truly engineer a credit manager's dream – a soft landing. That would skim off loan market froth, and cap liquidity in the system. It could also reset yields, thus valuations, to more appropriately risk-adjusted levels.

Of course, a mild recession might not eliminate all the bad market behavior out there. But at least it would send us to the first inning of a whole new ball game.