Leveraged Loans and Systemic Risk (First of a Series)

THE LEAD | February 28, 2019

"It is difficult for us to envision a scenario in which the leveraged loan market causes the next financial crisis." – Beth MacLean, loan portfolio manager, PIMCO.

We aren't often torn between which notable Quotes of the Week to feature. This issue, however, presented us with outstanding insights from two long-time credit practitioners. Let's go first to Mr. Mikkelsen's observation regarding Fed policy.

December proved to be a significant turning point in the way the Fed approached rate hikes. Prior to that, the FRB seemed to focus almost exclusively on economic data. Given its dual mandate of price stability and full employment, this made total sense.

But we live in a post-data world. The inflation threat has been chimerical. Higher interest costs, however, were real. So the market had a fit when Chairman Powell appeared to signal he was sticking to a three-ish number of hikes for 2019.

For whatever reasons, the Fed flipped to a very different dovish stance. The likelihood of further immediate rate hikes is now near zero. While that calmed markets, reversing the plunge of asset prices, it raised another question. If economic growth picks up later this year, will this make it tougher to revert to a sounder, more hawkish posture?

Going next to the subject of this special series: leveraged loans and the economy. This topic is getting media attention. FT recently devoted a long piece to the question "Do leverage loans pose a threat to the economy?" In it an economist ("Yes") argued with a global asset manager ("No") whether leveraged lending risks will infect the financial system.

The argument against "risky loans" is well-worn, but remains unconvincing. Comparing leveraged lending to swimming off Cape Cod, the economist wrote,"there are a lot of things to enjoy, but also the danger of sharks."

We checked historic shark-related fatalities in Massachusetts. Turns out a Wellfleet man was attacked last summer. Before that, the last case was in 1936. Not the way we want to go, certainly, but given the millions of swimmers who have safely frolicked in those waters over the past eighty years, pretty reasonable risk.

Then worries were leveled against the credit category, citing its popularity. With so much highly leveraged debt outstanding, if portfolio problems "show up," investors will "stampede out of the asset class."

Advocating for loans, with arguments familiar to readers of *The Lead Left*, the asset manager highlighted the strong performance of loans through the worst downturn since the Great Depression. In the intervening decade, institutional investors have ensured their own financing is diversified, long-term, flexible capital. And they've raised a lot of it.

Over the next few issues, we will explore in detail the ways leveraged lending does and does not relate to the economy and the financial system.