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Take-offs and Landings

THE LEAD | September 24, 2019

Bastille Day is a French national holiday in July with fireworks and parades. This year it was also celebrated in Paris by a “dazzling” test of the *Flyboard Air* – a jet-powered hoverboard. Its inventor, Franky Zapata, hoped to become the first to cross the English Channel on such a vehicle.

So hopes were riding high a week later when Monsieur Zapata – on the 110th anniversary of France’s first successful plane crossing – took off from Sangatte, France. Unfortunately his flight lasted only fifteen minutes, crashing at about the halfway point in an attempt to refuel.

“We should have done a takeoff and landing test,” the unharmed pilot told reporters.

Keeping things airborne is also much on the minds of private debt investors. As we highlighted last week, much of the global world is beset with negative rates. Even in the US, Libor’s contraction since the Fed began easing rates last December has, for the first time in years, put floating rate assets in the crosshairs.

Yet those loan investors who managed money in the pre-credit crisis era, recall an interesting phenomenon: when Libor comes down, spreads go up. And vice versa.

This makes sense intuitively. As the lending base rate decreases, investors seek to maintain all-in yield equilibrium by demanding higher spreads. Conversely, when the base rate rises, borrowers push for lower spreads.

That’s the theory, anyway. The historic data is not definitive. As our *Chart of the Week* from Refinitiv LPC shows, Libor and middle market spreads moved inversely from 2002 through the Great Recession. But except for a brief period in 2017-18, that precise negative correlation fell apart. Large liquid loans show the same pattern.

In part this is because of competition. While market technicals may argue for higher spreads, there are always lenders who will try to go low to win business. The broadly syndicated loan market toggles with high-yield bonds. Junk can provide issuers with an attractive fixed rate alternative, regardless of directional rate movement.

In today’s environment, signals are mixed. The Fed is working hard to lower rates, but the persistent strength of the economy is pushing back. And credit managers are keenly aware of where we are in this ten-year old cycle.

For the loan buyer, there’s solace to these uncertainties. Per the *Chart*, through all cycles, all-in yields for middle market loans remained in the 6-8% range. Despite all the capital flowing generally into private debt, yields are actually up since 2017.

Experienced investors know rewards await those who persist through unknowns. In a related footnote, on August 4, ten days after his first attempt, Franky Zapata succeeded in piloting Flyboard Air across the English Channel, and into history.

Bon voyage!