The Great Stay-In (Eighth of a Series)

THE LEAD | April 29, 2020

"The GFC was a crisis that began on Wall Street and spread to Main Street. COVID-19 is a crisis that began on Main Street and spread to Wall Street."

That's how the capital markets head of a leading private credit firm contrasted the origins of the two worst downturns since the Great Depression. And with the financial effects of the coronavirus in its early stages, this pandemic might end up worse in some respects than the crash of the 1930's.

Another difference between the Great Recession and the Great Stay-In? The former began with too much leverage in the system. It took all the resources of central banks to pump enough liquidity into members to deleverage and recapitalize that system.

This time around the Fed employed a variant of the 2008 tool kit, lowering interest rates to zero, spending $trillions on commercial paper and overnight repo programs, and supporting the Treasury to subsidize and incentivize the nation's businesses.

COVID, of course, is a health crisis. Enforced lock-downs and shut-ins precipitated the near-cessation of commercial activity. But the financial system, particularly banks, is in much better shape in 2020. The volume of hung underwritings, for example, was a fraction of the level than when the music stopped over a decade ago.

One veteran credit consultant tried this comparison: Most recessions are caused by misallocation of capital, he told participants at a recent webinar, whether mortgages, high tech, or emerging market debt. The current situation found capital markets generally in sound shape, with no significant bubbles of unsustainable value.

Other GFC lessons learned? Non-banks haven't relied on short-term lines, spending the past decade raising plentiful long-term capital. Once the virus runs its course, credit providers are well-positioned to address issuer illiquidity or growth needs.

What about the behavior of liquid loans? We noted an excellent analysis by Rachelle Kakouris at content partner S&P LCD. As the *Chart of the Week* shows, while secondary prices have recovered since cratering last month, the resulting volume deemed "distressed" outweighed the universe of *all* 2008-09 loans.

Twelve years ago CLOs represented about 50% of the leveraged loan market. Those CLO 1.0 vehicles were mark-to-market, which exaggerated the downdraft of loan values. Today CLOs are over 70% of loan buyers. While not MTM, triple-C limitations (7.5% of total collateral) create a similar challenge; under stress, assets either need to be sold to or capital invested to remain in compliance.

That risk is heightened given how many more single-B names are in the S&P/LSTA Leveraged Loan Index now (58%) than there were in the midst of the GFC (31%).

? Next week: We conclude our special COVID-19 series with a look ahead.