What's Ahead for 2015? (Last of a Series)

THE LEAD | January 7, 2015

As oil prices continue to drop, taking other asset values with them, capital markets are beginning the new year sorting through what this all means for them.

In high yield land, while secondary prices for energy credits took it on the chin in early December, the overall theme is "recovery." As junk guru Martin Fridson points out in an S&P note yesterday, energy-related issues were the *best* performing of all industry sectors for the latter half of the month.

This schizophrenic behavior is reflected in broader equity indices. The Dow rose almost 1000 points from December 16 (17,068) to December 26 (18,054), since falling off a bit. Investor sentiment toggles back and forth between "Consumers will carry us through" and "Europe will drag us down."

Even the best and brightest seem torn. Byron Wien, in his 30th annual list of predicted surprises for the year, says *"…the momentum of the economy has begun to flag and a short-term slowdown has started,"* yet two paragraphs later forecasts: *"A growing economy, fueled by housing and capital spending and favorable earnings, enables the S&P 500 to increase 15% during the year…"* [link]

Speaking of hedged bets, the leveraged loan market ran hot and cold to close out the year. On the one hand, Thomson Reuters reported overall syndicated loan volume of $2.1 trillion, the second best on record. But fourth quarter deal flow lost momentum as market volatility and the weight of regulatory pressures created headwinds for arrangers.

A quick survey of loan players this week showed these concerns are expected to worsen. Regulators apparently met with top bank officials after Christmas to underline their "We're not kidding" message regarding the Leveraged Lending Guidance as reaffirmed back in November.

These spank-a-bank provisions are having an effect. As shown in our *Chart of the Week*, both senior and total leverage for 4Q 2014 fell from the previous quarter's levels for all loans. This is the case for middle market loans as well, where total leverage (for LBOs) declined from 5.3x to 5.0x, according to S&P/Capital IQ.

Pricing has widened amid this uncertainty. All-in institutional yields rose for the overall market from 503 bps to 581 bps from 3Q to 4Q. Similarly, middle market LBO yields improved to 654 bps from 609 bps over the period (per S&P).

We expect these buy-side friendly trends to be a feature of the leveraged market at least for the balance of 1Q 2015, and probably beyond.

As we kick off 2015, an intriguing question is whether shadow banks – all the non-regulated credit that's been raised over the past several years – will simply replace banks in providing sponsor clients with increasingly aggressive (and arguably, irrational) deal terms?

Or will these BDCs, hedge funds, finance companies, and other credit shops take the opportunity to finally move the market to a more sensible footing.