Why Volatility Matters (Third of a Series)

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In the classic 1962 film, "*Lawrence of Arabia*," two British officers watch the unfolding chaos as Arab tribes vie for control of Damascus. Eager to keep events from spiraling out of control, the colonel pleads with his commanding officer, "We can't just do nothing." The general, savvy to the political reality, replies calmly, "Why not? It's usually best."

Doing nothing neatly sums up the position the Fed took at the close of their much-awaited September meeting last week. Some kind of hike seemed a foregone conclusion only weeks ago. Janet Yellen and her board elected instead to focus less on the US economy and more on the risk of slower growth in China and emerging markets.

While some economists expected the no-hike scenario, few predicted the associated dovish commentary that accompanied it. Clearly policymakers have been spooked by what they see in global markets and how that might affect growth and inflation at home.

What concerns many observers now is that by choosing to focus on the situation abroad, the Fed has essentially become hostage to forces out of its purview and control. What is the likelihood EM economies will stabilize or improve over the next few months? Does this reluctance to take a step towards US interest rate normalization foster continued uncertainty? And does the resulting volatility thus become a self-fulfilling prophecy by sending a message to global economies that things are worse than they appear?

The wisdom of the Fed's inaction will be hard to measure in the near-term. In the meantime, investors will continue whatever strategies they are employing to stay ahead of the ripples that have coursed through public markets since early August.

In the case of loan buyers, as we are detailing in this series, that strategy is buying good performing loans in both primary and secondary markets. As our *Chart of the Week* portrays, loans have carved out for themselves an enviable position; they are producing reasonable returns with very low volatility, compared with many other asset classes.

Middle market credit asset managers meanwhile will view this rate news as business as usual. Certain lead arrangers had begun to take into consideration the possibility of higher rates as part of their overall funding strategy.

For those whose platforms are fueled by CLO vehicles, the risk is that their liabilities – priced as a spread against Libor – would cost more as rates increased. Their assets, mostly with Libor floors, would not offset the higher cost until Libor rose above the level of the floors. Since most floors are set around 100 bps, the time lag until that happens might be considerable, particularly now that the Fed has set such a glacial pace.

When a rate hike seemed imminent, some arrangers considered offering loans with reduced Libor floors, or even eliminating them entirely. While this theoretically should be offset with a wider Libor spread, t competitive environment might make that difficult.

Now that the do-nothing phase has been ratified for the time being, floors are likely to remain. What credit buyers must now consider is whether the Fed's decision signifies further volatility amid a continued low rate environment.

Next week we conclude our series on volatility with an outlook for the rest of the year.