2016 – A Look Ahead in the Middle Market (Last of a Series)

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"We're waiting to see what happens."

For many credit investors, and to some extent investors of all stripes, this oft-heard remark captures well the market's view of 2016 as we enter its second month.

In the world of broadly syndicated loans, arrangers are like auto mechanics working in a dark garage. Operating by feel rather than sight, the sell-side is struggling with what wrench to use and how much torque to apply to meet buyer demand.

For add-ons to good credits (e.g. *Central Security*), it's a quick tune-up. For more complex financings (e.g. *Staples*), it's more like a new transmission. This cautionary tone makes visibility on deal pricing and structure a challenge.

Middle market players are less anxious, but the picture is no less clear. Arrangers report a "slow pipeline" and "quiet on the deal front" so far this year. 2016 has started off looking less like an episode of *Top Gear* and more like *Overhaulin*'.

So what are investors waiting for? For one thing, the Fed has left many wondering where interest rates are headed next. "One and done" is the view of many observers, as shaky markets make a second hike unlikely over the next few months. Indeed, surveys indicate the expectations of two or three more hikes this year are low.

Another question mark is the price of oil. It seems as if $30/barrel oil is here to stay for the foreseeable future. That means energy-related borrowers are in for a long period of retrenchment, with the more leveraged credits borrowers at risk of restructuring.

Default rates, accordingly, are expected to edge up. As our *Quote of the Week* suggests, some investors are poised to take advantage of this opportunity. Others worry that energy woes will leak over into other sectors. Regardless, experienced drivers have one eye on their portfolios and one eye on the economy.

Institutional investors are also looking closely for signs of returning liquidity. Reversing fund flows or improved CLO formation would be a start. Higher secondary prices on the most liquid loans would be another good indication. Until then, buyers remain (as one trader put it) "defensive."

What's making mid cap participants more confident? Liquidity is very much present in their market. This is coming in the form of new funds raising capital as well as existing ones adding pockets. In combination with over $500 billion of uncommitted cash in the pockets of private equity, this points to a health supply/demand dynamic.

These elements suggest that while exogenous factors will lower the froth factor for 2016, the investing climate will be constructive. Spreads will remain at or above current levels, leverage will stay with a band around historic highs (mitigated by high equity contributions), and deal volume will be a repeat of last year’s reasonably productive numbers.