Chart of the Week

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U.S. Credit Market Health Check

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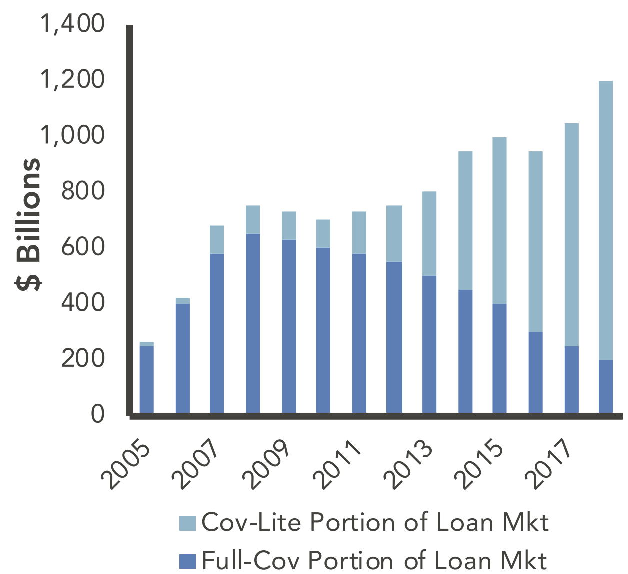
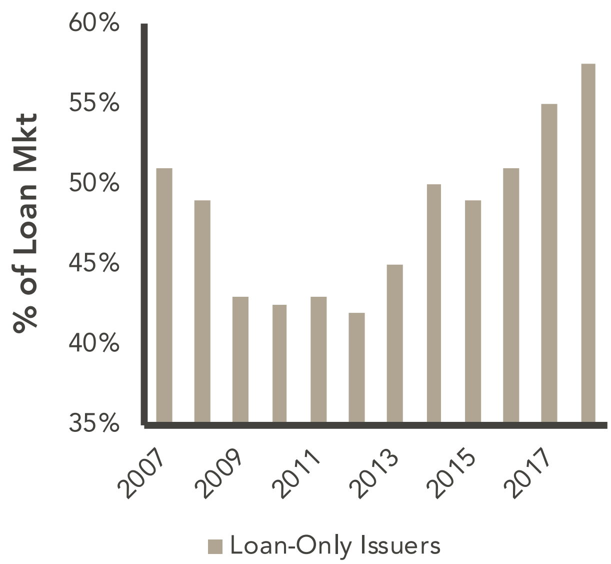
No sign of immediate trouble in the U.S. credit market





Source: Credit Suisse

This week's chart looks at two key indicators of the health of the U.S. credit market. The first, on the left, shows a growing portion of covenant-light ("cov-lite") bank loans relative to full-covenant bank loans. The second indicator, on the right, shows a growing portion of loan-only bank loan issuers, which remove the benefit of a credit cushion for bank loan investors. Recent studies by Credit Suisse show that recovery rates for cov-lite issuers are 10–15% worse than non-cov-lite issuers, and recovery rates for loan-only unitranche issuers are 15% worse than non-unitranche issuers. As such, there is some structural deterioration in the bank loan market, but the general consensus is that this should not be a 2019 story, but 2–3 years out. This means that there is not a very high concern of a credit crunch in 2019, but potentially in 2020–2021 if prices get to frothy levels again by then.

That said, defaults remain low, so at least for now, there is no sign of immediate trouble. And spreads have widened out over the last couple of months to be wider than average excluding 2008 and 2009 levels, showing that there has been some release in pressure and the market is perhaps pricing in some of these concerns. Most bank loan strategies are now focused on quality credit selection, avoiding deals with high leverage and unreliable assets or unreliable earnings. That said, as this cycle wears on, we would certainly want to remember that despite their senior secured nature, bank loans are still sub-investment grade debt and should be balanced with a healthy core bond allocation.

[1] Covenant-light means that the bank loan issuer is subject to few restrictions, also known as covenants, in managing its business. For example, covenants could be maximum leverage (debt divided by cash flows) or minimum coverage (cash flows divided by interest expenses). The rise in cov-lite deals has been a reality since 2005 and they appear to be here to stay. One reason for their rise is due to the standardization and syndication of bank loans as a public security, thereby making them become more like high yield bonds, which have very little covenants, and less like private credit.

[2] This means that, in the event of bankruptcy, the bank loan investors do not have a high yield, junior subordinated debt tranche beneath them for the losses to eat into after the equity tranche. The bank loan investors will see immediate losses right after the equity tranche in this case.

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