



The Game of Loans | October 2019

“If you think this has a happy ending, you haven’t been paying attention.”

Ramsay Bolton

In the game of thrones, you win, or you die. In the game of loans, death is unlikely, but great pain and suffering could be in store for some players.

Fuelled by strong investor demand, the leveraged loan market has doubled over the last decade, and by some estimates, has reached USD 1.4 trillion. The rapid growth of this space has led to fears of excess and imprudence. Such concerns even garnering the attention of global leaders at the October G20 meetings.

As risk appetite for lower-quality debt wanes and cracks appear in what is suspected to be a fragile market, should we be heeding the choruses of ‘winter is coming’?

For the unindoctrinated, leveraged loans might sound like an esoteric Wall Street invention, but they are simply loans. The leveraged aspect comes from the borrowers: companies encumbered with lots of debt or poor credit history, and private equity firms financing leveraged buyouts, share purchases, and dividends.

Given the riskier nature of these debtors, the loans are typically rated BB- or lower and pay a relatively high spread over a benchmark interest rate (i.e. LIBOR). And in a world of ultra-low yields, this extra return potential has enticed investors and spurred parabolic growth in loan issuance.

Behind much of this demand are Collateralized Loan Obligations (CLOs), home to over half of the outstanding issues. CLO managers bundle loans together and then slice and dice them into various tranches. The seniority of the tranches dictates the order in which investors get paid from the underlying loans, thus offering different risk/reward profiles.

This structuring process and the term itself might sound eerily similar to the much-maligned CDOs of the Great Recession. But unlike their notorious cousins, CLOs outperformed most sectors of the high-yield market and skated through 2008 with relatively few losses.

The ‘winter is coming’ crowd will point to many reasons as to why this time it will be different.

Not only has the loan market grown considerably, but there has also been a loosening of underwriting standards or covenants. Of the over \$700 bn of new loans issued in each of 2017 and 2018, estimates have over 80% being covenant-light, compared to less than 20% in 2007. This means fewer restrictions on the borrowers and fewer protections for the lenders.

The concerned camp will also add that the credit quality of the issuers has decreased. Pre-crisis, over 50% of loans were rated BB, whereas today, the majority are single-B or lower. Perhaps most concerning is that almost a third of outstanding loans are rated B-. The particular relevance of this rating is that it is only one notch above CCC, with most CLOs contractually limited to holding no more than 7.5% of CCC debt.

With fears of slower growth (if not a recession) ahead, there is a rising concern that downgrades will hit the sector, pushing more loans over the CCC cliff, resulting in forced selling by CLO managers. The problem then becomes identifying potential buyers. The usual cast of characters is money managers without onerous constraints on what type of debt they can own. But these folks are seeing outflows, as ‘hot money’ becomes weary and leery of low-quality credit.



With the buyers of last resort in retreat, a rise in defaults and restructurings is imminent. While this may seem ominous, in and of itself, it is a healthy and long-overdue process of trimming the excess fat. For most of us, the big question is the impact this could have on other parts of the market (i.e. high-yield).

Given the complexity and opacity of the space, it is difficult to assess the risk of contagion. If the rest of the economy holds up, the defaults and restructurings could occur over longer periods. In such a case, the pain can be contained. However, if some other exogenous shock or crisis unfolds, causing capital to flee to safety, then the risk of an unleashed dragon-like scenario grows significantly.

The Fund

October often sees a bifurcation in temperatures between Canada and our neighbours to the south. Last month, credit markets followed the weather pattern with a much colder climate north of the border. While US investment-grade spreads were tighter by 5 bps, the domestic market was broadly unchanged, with BBB spreads widening a few basis points.

US credit was supported by a light amount of issuance combined with strong inflows into investment-grade funds (likely some of the cash flowing out of lower-quality investments). In Canada, the new issue supply was more robust as large deals from RBC, CCDJ, Fortified Trust, Enbridge Inc, and ENMAX came to market. There were also plenty of infrastructure-related deals from the likes of Vancouver Airport, BC Ferries, Brookfield Infrastructure, and CN Rail. Finally, there were small but interesting deals from Sienna Senior Living and Allied REIT. By Hallowe'en, the tally was over CAD 8 bn, making it the second busiest October on record.

In issuer-specific news, Allied REIT was upgraded to Baa2, as Moody's rewarded the company's progress in deleveraging and strong operational performance. Moving in the other direction was Ford, which was downgraded to BBB- and sits on the cusp of falling to high-yield. Despite the restructuring issues that face the auto sector from declining sales, Ford spreads actually rallied on the downgrade as investors were relieved that the company maintained an investment-grade rating.

With weak economic data and geopolitical tensions (Brexite, Syria) to start the month, the Fund was defensively positioned and relied largely on the carry portion of the portfolio to generate a conservative return of 0.39% (F Class 0.32%).

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2019	2.03%	1.15%	0.36%	1.54%	0.15%	1.04%	0.80%	(0.83%)	1.02%	0.39%			7.88%
2018	1.19%	(0.45%)	(0.35%)	0.77%	(0.25%)	0.26%	0.46%	0.52%	0.47%	(0.34%)	(1.57%)	(0.81%)	(0.13%)
2017	1.73%	1.30%	0.44%	1.03%	(0.22%)	0.53%	0.94%	(0.09%)	0.70%	0.83%	0.45%	0.50%	8.46%
2016	0.19%	1.49%	5.32%	3.51%	0.60%	0.54%	1.73%	1.63%	1.01%	1.86%	1.60%	1.62%	23.15%
2015	-	2.29%	2.51%	1.27%	2.46%	0.25%	0.73%	(0.25%)	1.68%	1.71%	1.37%	0.87%	15.86%

The Algonquin Debt Strategies Fund LP was launched on February 2, 2015. Monthly returns are based on 'Series 1 X Founder's Class' NAV as calculated by SGGG Fund Services Inc. and are shown in Canadian dollars, net of all fees and expenses.



Credit

November should see a reasonable spike in new supply south of the border, as companies get past quarterly earnings and rush to get deals placed before US Thanksgiving. Canadian issuance should also pick up, but the forward calendar looks very manageable, with the market in a position to digest the new deals.

Demand for investment-grade credit, especially BBBs, remains very strong. The domestic market also has a significant number of corporate bond maturities and coupon payments due, with roughly CAD 10 bn/month in November and December. With dealer inventories sitting at moderate levels, portfolio managers will rely on the new issues as a means of putting this cash to work.

Typically, the run to year-end provides a seasonal tightening of credit as issuance pauses from December to mid-January, and dealer inventories get depleted. Also, with the odds of a no-deal Brexit now very low, and the US and China playing 'nice', the backdrop for credit into the new year is constructive. But with the scars still fresh from last December's massacre in risk assets, there is the possibility of increased volatility on any late-year macro surprises.

Rates

Bond traders were treated to a rare event with both the Bank of Canada (BoC) and Federal Reserve (Fed) having rate-setting meetings on the same day.

The BoC got things going in the morning by opening the door to lower rates. They expressed concern that global trade tensions were negatively affecting the economy and barring an improvement in data, monetary stimulus would likely be required. As such, we think that unless GDP improves, the odds are good the BoC cuts rates by 25bps in January 2020. Sovereign bond yields responded by moving 15 bps to 20 bps lower over the last two days of the month.

The Fed, on the other hand, delivered another 25 bps cut (bringing the total cuts to 75 bps) but signalled that a pause was in order.

Both central banks maesters have done an admirable job in anchoring rate expectations for the next quarter or two, which means yields will ebb and flow in a rather narrow range.

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