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US credit tightens ahead of Federal Reserve policy shift

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Signs of impending downward spiral appear even before policy move

Dear future historians: Janet Yellen did not cause the late-2010s recession.

If a Federal Reserve interest rate rise in December is followed in short order by an economic slowdown, the temptation will be to blame the central bank and its chair for a premature tightening of monetary policy. But there are a growing number of red flags that suggest the US credit cycle has already turned, with consequences for the real economy next year, even before the Fed makes its move.

Smart money investors have positioned themselves for a rise in corporate defaults, a pullback in lending, and contagion across asset classes. The question is whether this is the start of a self-reinforcing downward spiral.

The answer depends in part on the complex chain that links the deepest recesses of the credit markets to the real economy.

A booming leveraged-loan market has fuelled the mergers and acquisitions mania of the past few years, boosting the stock market and the economic feelgood factor in the process — but it is in sharp reverse.

A majority of leveraged loans find their way into investment vehicles called collateralised loan obligations (CLOs); so investors who buy the riskiest parts of a CLO — the so-called equity tranche, which takes the first losses if the loans start to default — are therefore pivotal players in the availability of corporate credit and in underwriting standards. They have been pulling in their horns most of this year.

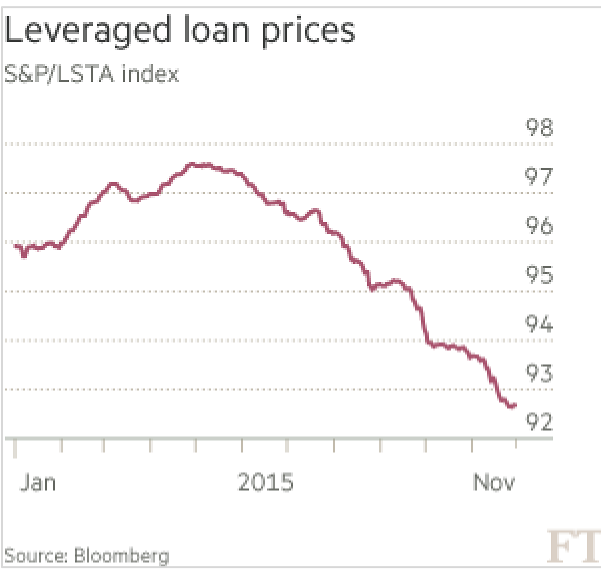
It is not just that defaults are expected to rise from current historically low rates. Loans do not have to stop paying to cause problems for CLO equity holders; credit agency downgrades have an impact, too, since there are limits on how many of the riskiest kinds of loans CLOs can hold. Some CLOs, such as a recent vehicle created by Guggenheim Securities, are building in higher limits on ultra-high risk, CCC-rated loans, to give them a cushion. Downgrades are already on the rise.

With CLO investors expressing so much more caution, CLO issuance is down, and the effect is already visible in the disappointing performance of the loan market. An S&P/LSTA index that showed the average loan selling for almost 98 cents on the dollar in the secondary market in May now sits below 93 cents.

As recently reported by the Financial Times, banks are having trouble finding buyers for loans they have already promised for the financing of some recent takeovers. With losses looming, they will have to be more cautious in the future. This threatens to do more to raise the cost of financing M&A deals than any little move the Fed might make, acting as a drag on activity next year.

Of course the loan market is not the only place that corporate America can go to raise money, but there are signs that other sources of credit may also be getting harder to come by. Spreads on high-yield bonds have widened, particularly for the riskiest borrowers, and trading has become more skittish, as befits a market with more retail investor involvement than ever before. Anomalies have also opened up in the pricing of credit default swaps and high-yield indices, suggesting some market stress.

In a "run-for-the-hills" investment note that Ellington Management, run by credit maven Mike Vranos, circulated to its clients this month, the hedge fund said investors were underestimating the probable losses in high yield because in previous cycles falling interest rates have limited the damage.



Meanwhile, there has been a modest but clear change in the tone of the Federal Reserve Board's regular surveys of US banks' loan officers. Last month, among the modest number of banks that indicated they had changed their commercial lending standards, reports of tightening were more frequent than reports of easing, especially for large and middle-market borrowers.

The backdrop to these changes is a US economy where risks seem to be rising, whether they be from a global slowdown led by emerging markets or from the shrivelling of the domestic shale oil industry. Revenues from S&P 500 companies were down 4 per cent on average in the third quarter while earnings, buoyed for so long by the availability of credit to finance share buybacks, are also contracting.

It is too early to predict a downward spiral where caution begets more caution and deleveraging begets more deleveraging, but the emerging dynamics in credit markets are worrisome. Credit seems to be tightening, Fed or no Fed.

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