Daily Note

THE 'BUYSIDE BUBBLE'

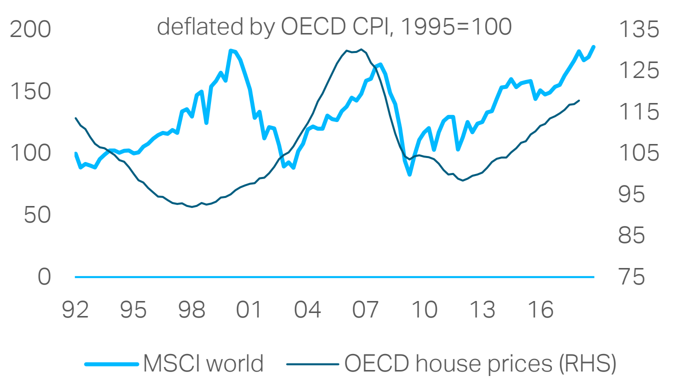
Dario Perkins

- **Global markets have experienced a long sequence of bubbles since the 80s**
- **Policymakers becoming increasingly anxious about corporate debt markets**
- **Could it be the 'buyside' rather than the 'sellside' that prompts the next crash?**

There is a fun narrative that blames everything that has happened in financial markets over the past 30 years on central banks, specifically their "asymmetric" response to bubbles and the Federal Reserve's infamous "put". Officials, particularly at the world's most powerful monetary authority, tend to ignore the emergence of bubbles - in fact they actively encourage them – and then ease policy aggressively when the exuberance ends. In doing so, they simply replace one bubble with another. You can see the sequence: 1987 stock market crash – early 1990s Savings and Loan (banking) crisis – mid 90s various EMs blow up – 1998 LTCM crash – 2000s Dotcom – the 2008 subprime mortgage collapse – 2018? Maybe a coincidence but each disaster followed periods of 'easy' monetary policy, with the Fed usually tightening policy as the situation unravels.

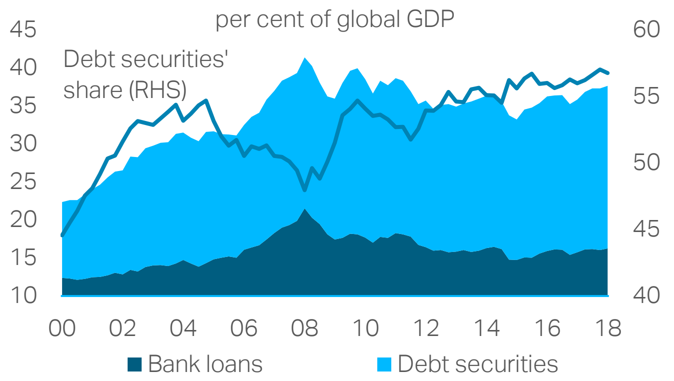
While we should be careful not to assign too much power to central banks, this history of financial calamity highlights the obvious (and perhaps increasing) volatility of financial markets and the world's apparent reliance on a long sequence of bubbles. And with markets misbehaving recently, you can understand why investors are nervous about what happens next. Is another bubble about to burst? Putting aside the world's clearest credit bubble – China – which could continue defying economic logic and market forces, most people are worried about corporate debt. Two features of the corporate debt 'bubble' stand out: (1) it is common to many parts of the world, including a large number of developed nations; and (2) with banks unwilling to lend, capital markets have inflated this bubble - specifically bond markets. These trends suggest it is part of a global 'search for yield'. With interest rates low for a long period, investors everywhere have competed for yield, prepared to buy riskier corporate loans to secure a higher return.

Real asset prices



Source: OECD, TS Lombard

Non-banks the marginal lender



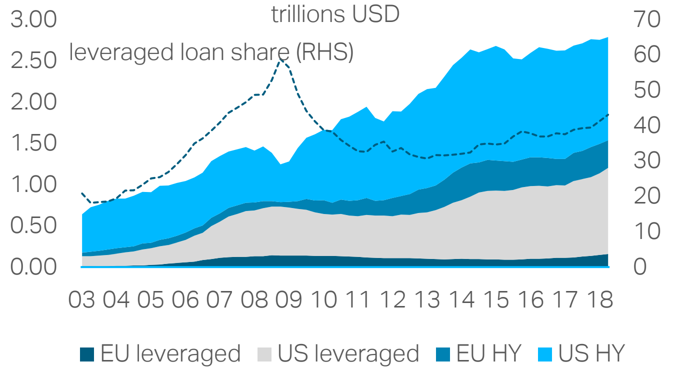
Source: BIS Quarterly Review

Here I want to focus on one particularly 'hot' area of DM corporate debt – leveraged loans. Policymakers everywhere have issued warning in recent weeks, highlighting similarities with subprime loans. Leveraged loans are commercial loans to non-investment grade borrowers who already have large amounts of debt. The main difference with high-yield debt is that these loans are secured, usually against a company's assets. Combining these two types of corporate lending, we are looking at a market that has grown rapidly in recent years, roughly doubling to $2.5 trillion. Not only is the growth rate disturbing, but lending standards have deteriorated – a classic marker for being late in the credit cycle. In recent years, around 85% of these loans have been covenant-lite, meaning investors have given up various controls on corporate governance in order to generate these loans. While this doesn't necessarily increase the risk of default, it means recovery rates are likely to be significantly lower during the next recession.

The other red flag for policymakers is that many of these loans have been repackaged into collateralized loan obligations (CLOs), which are bought and sold by investors. Policymakers are worried that if interest rates keep rising and some of the weaker companies run into problems, this could set up a dangerous subprime-style feedback loop. But does the comparison with 2008 really stand up? For one thing, banks are not funding these securities by borrowing in short-term money markets, which is a clear improvement. More important, the banks are not keeping these securities on their balance sheets by using them as repo collateral. This is a hugely important difference. If there is another crash, it is unlikely to bring down the large systemically important banks. Good news for tax payers. In fact, to the extent there is another "bubble" in markets, it seems to have been the buyside – not the sellside – that is responsible. At least that is the view of the Bank of England, according to a paper it published recently.

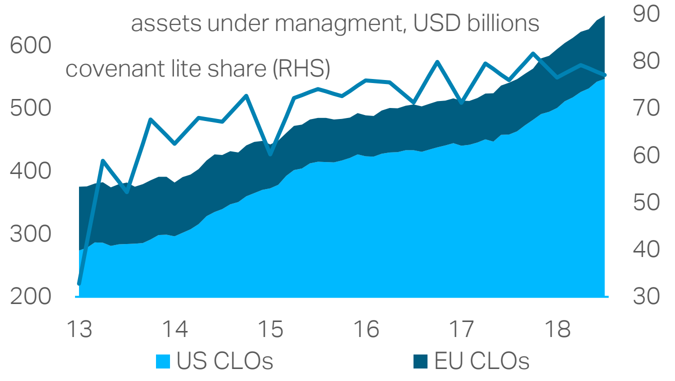
The Bank of England argues that the systemic consequences of a problem in the asset management industry are less dangerous than a problem in the banks. But a crisis in debt markets could still damage the global economy, particularly as buyside institutions are likely to dump these securities, which could lead to 'firesales' and an 'overshooting' in asset prices. The biggest problems would occur in funds that have invested in illiquid securities such as leveraged loans, but have very liquid liabilities. And a big decline in asset prices, while not necessarily a systemic issue for the global economy, would still destroy wealth and make it harder for more traditional lenders to operate, adding yet more spillovers. Companies that shouldn't have had access to cheap funding in recent years, particularly the 'zombies', would need to cut costs, or go out of business. In short, if the panic of recent weeks were to become materially worse and asset prices kept falling, corporate debt and leveraged loans are an obvious amplifier, turning market volatility into a macro event. But we would be talking Dotcom II rather than subprime II.

Leveraged loan boom



Source: BIS Quarterly Review

Leveraged loan CLOs



Source: BIS Quarterly Review