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Credit investors and issuers are becoming more aggressive

Highlights:
-Credit investors and issues are both becoming more aggressive
-Equity investors are worried about loan prices and ratings, but those are proving to be buying opportunities for credit investors
-The profit margins for shadow banking remain near 4-year highs
-The increased aggressiveness should lead to more stock buybacks designed to boost equity prices

The credit boom appears to be intensifying again. As we head into year-end, both credit investors and issuers seem to be becoming more aggressive. This stance should lead to more debt-fueled stock buybacks designed to boost equity prices.

Insurance company shadow banking

After our nation's public pensions, insurance companies are the second most important group of participants in the shadow banking community. AIG was the most vivid illustration of that in the last credit cycle.

Yesterday Reliance Standard Life came to the credit market looking to issue $300 million for 5 years to leverage up a subsidiary's funding agreement. The lightly regulated cash funds love to buy these illiquid agreements because they yield more than the products that the highly regulated money market funds can buy. Insurance companies love to issue them because they can take the proceeds and investment in lower quality bonds, giving themselves a yield spread over what they owe to the cash fund. We view them as levered insurance products that contributed to the last two boom and bust cycles that began in 1991 and 2003.

Just over two years ago, we noticed a number of insurance companies, starting with the noted shadow banking insurance company MassMutual, coming into the credit market to lever up their funding agreements, essentially **levering up a levered insurance product.** Since then, we have seen a half-dozen insurers do the same thing. This is the first time we have seen a deal from Reliance, so **the list of shadow banking insurers has just grown.**

The initial price talk for this deal was 110 basis points over Treasuries, but investor demand was so strong that it priced at just 95 basis points. That is a large move in a short time, and it allows the insurer to earn a wider than expected spread on their investments.

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Lending to a cash burner

The day before, Netflix came to the credit market looking to borrow $2 billion for 10 years, split between the US and the EU.

In the U.S., the initial price talk was a yield of about 5.125%. Demand was so rabid that it actually priced at just 4.875%. That is a super-sized move, indicative of how aggressive credit investors have become.

Netflix is junk rated, has new competition, and has burned more cash this year than WeWork. Yet, it was able to issue debt at less than 5% in the US. Of course, since yields in Europe are lower, the EU part of the deal came at a yield of just 3.625%!

Give me Liberty or give me debt

Also on Tuesday, Liberty Cable Puerto Rico came to the credit markets for $2.2 billion in bond and loan financing to partly fund its purchase of AT&T's operations in the region. Investors showered the firm with money, so our heading's play on Patrick Henry's words should actually be "give me Liberty AND give me debt."

This company is deeply into junk territory, with just a single-B rating. It is run by the legendary John Malone. In our October 10 column in which we discussed this deal, we noted that "He is one of the most famous borrowers in the history of the credit market, and is well-known for extracting value for shareholders, often at the expense of credit investors."

And yet, credit investors showered him with money. The 8-year bond deal was upsized from $1 billion to $1.2 billion, yet the deal priced at the low end of the 6.75%-7.00% price talk.

Demand for the deal was so rabid that it popped more than 2 ½ points in price after it was freed to trade (that's a stock-like move) and its yield is now down to just 6.12%!

A bond from a deep junk company run by a bond-unfriendly manager only yields a little more than 6%, nowhere close to the 7.5% that our nation's public pensions need!

What loan market problem?

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The September credit issuance surge resulted in the loan market being overserved with low-quality deals. So, loan yields have come up a little, and loan prices have come down a little. Every time this has happened in this decade-long credit cycle, it has been a buying opportunity, even though some equity investors are worried about this price drop.

Since loan yields are up, Liberty Cable reduced the size of their loan by $200 million and increased the size of their bond by the same amount.

Lenders still threw money at the company, giving them a $1 billion term loan for 7 years at a spread of only 500 basis points over Libor.

If there was really a problem with the loan market, a deal this junky would not be getting done.

Another new worry of equity investors is that if the economy slows more, enough loans will be downgraded to triple-C that the caps that CLO's have on triple-C debt will bust and be a negative for the whole lending and CLO market.

Widespread downgrades are always a problem for the credit market. However, we remind people that the ratings agencies are slower to recognize a crisis than even the Federal Reserve! Thus, wholesale ratings downgrades tend to come a year or so after a crisis has begun, and only result in a secondary or tertiary decline in financial asset prices.

Investors gobbled up $2.2 billion of new CLOs in the first three days of this week. That does not sound like a market with a problem to us.

Investors love Libor

Credit investors love Libor because it tends to go up in a crisis while other rates go down, and because it is more stable than the Fed Funds rate, repo or SOFR (which is repo without the Fed as a counterparty).

The Liberty Cable loan floats off of Libor and matures in 7 years. This is just another example of a large loan that floats off Libor well beyond the 2021 date that the Fed and other regulators think Libor will go away.

Thus, Libor will likely continue to be the key rate for shadow bankers in the front end of the curve. Asset spreads off of Libor remain near the high end of their range of the last four years, indicating that shadow banking profit margins remain robust, as shown on our chart on the next page.

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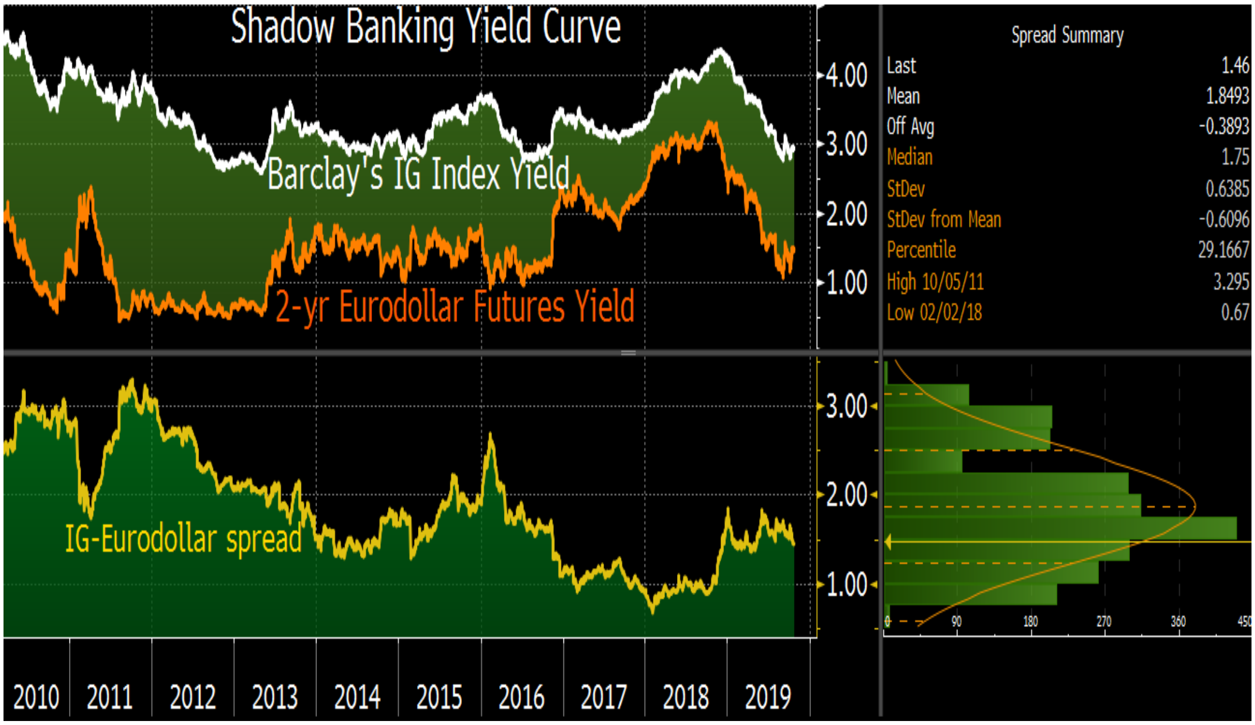

Thus, we continue to believe that this credit boom will persist for far longer than most people think it will, and that it will intensify over time.

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