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Economics Group

Special Commentary

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Leveraged Loans: A Deathknell for the U.S. Economy?[1]

Executive Summary

The leveraged loan market, where the bank debt of non-investment grade companies is traded, has experienced rapid growth over the past few years. But weakness in the market in recent weeks may bring back unpleasant memories of the sub-prime loan debacle a decade ago. Does this recent weakness in the leveraged loan market have negative implications for the macro U.S. economy?

In our view, the leveraged loan market, taken in isolation, is not likely to bring the economy to its knees anytime soon. But its recent weakness may reflect a broader economic reality about which we have been writing. Namely, the overall financial health of the non-financial corporate sector has deteriorated modestly over the past few years. If the Fed continues to push up interest rates and if corporate debt continues to rise, then financial conditions would tighten further, which could eventually lead to a sharper slowdown, if not an outright downturn, in economic growth.

Stress Appears in the Leveraged Loan Market

Prices of leveraged loans have weakened over the past few weeks.

The leveraged loan market in the United States has mushroomed to more than $1 trillion today from only $5 billion about 20 years ago (Figure 1). Growth has been especially marked in the past two years with the amount of leveraged loans outstanding up more than 30% since late 2016. But the market has weakened recently. The amount of leveraged loans outstanding declined by nearly $20 billion between late November and mid-December, while prices of loans fell about 2 points over that period (Figure 2).

Figure 1

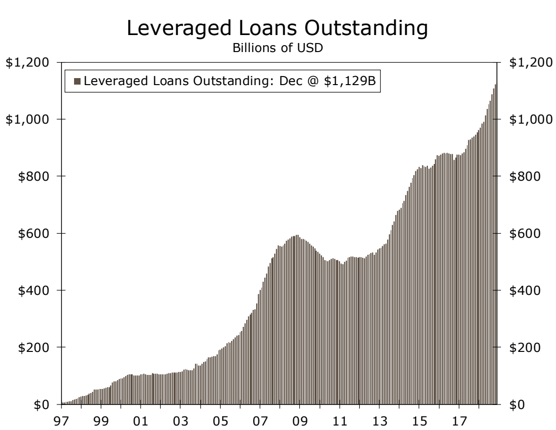
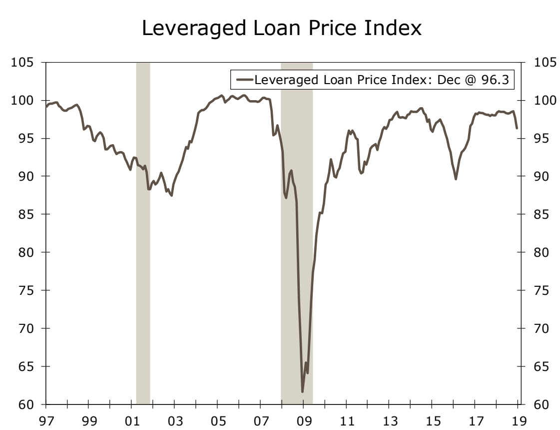


Figure 2



Source: LCD (an offering of S&P Global Market Intelligence) and Wells Fargo Securities

Before discussing macroeconomic implications, we first offer a quick primer on the leveraged loan market. A leveraged loan is a loan that is made to a company with relatively high leverage (i.e., companies with high debt-to-cash flow ratios). Usually, these companies are rated as less-than-investment grade. Years ago, banks would hold these loans on their balance sheets, but in the

[1] **I am grateful to Dave Preston and Mackenzie Miller, from Wells Fargo Securities' Structured Products Research team, for helpful discussions and data sources.**

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past few decades an active market has developed in which these loans are bought and sold. Often, an investment bank will buy leveraged loans from commercial banks to bundle them into structured financial instruments that are known as collateralized loan obligations (CLOs). CLOs trade like bonds, and they improve the liquidity in the leveraged loan market.

Leveraged loans are floating-rate financial instruments.

Leveraged loans are floating-rate financial instruments, so investors piled into the market over the past two years when the Fed was in rate-hiking mode. However, some investors have started to sell their holdings of leveraged loans recently as doubts have risen about how much higher short-term interest rates actually will rise. Moreover, the evident deceleration occurring in the economy could negatively affect the ability of some highly levered companies to adequately service their debt obligations, which has also contributed to some nervousness in the leveraged loan market. Could the recent weakness in the leveraged loan market have implications for the U.S. economy?

Does the Leveraged Loan Market Have Broader Macro Implications?

When banks sell their leveraged loans, they then have room on their balance sheets to make new loans. If weakness in the leveraged loan market negatively affects the ability of commercial banks to offload their leveraged loans, then growth in bank lending could slow. Everything else equal, slower growth in bank lending could lead to slower economic growth, which could then lead to further weakness in the leveraged loan market, etc. In short, a vicious circle could be set in motion. Is there any evidence to support the notion that weakness in the leveraged loan market has led to slower growth in bank lending?

Figure 3 plots the leveraged loan price index which was shown in Figure 2 along with the year-over-year growth rate in commercial and industrial (C&I) loans. The price of leveraged loans collapsed in 2008, and C&I loan growth subsequently nosedived as well. But the U.S. economy at that time was beset by the deepest financial crisis and recession it had experienced in more than 70 years. The weakness in the leveraged loan market in 2008 may have contributed to the swoon in C&I lending that transpired in 2008-2009, but there probably were more important factors that were causing the sharp drop in C&I lending at that time.

Weakness in leveraged loans does not appear to lead to significantly slower growth in C&I lending.

Indeed, over the past two decades there have been two episodes of weakness in the leveraged loan market that have not been associated with marked deceleration in C&I lending. Between early 1997 and late 2000, prices of leveraged loans fell about 10 points. But growth in C&I lending held up reasonably well during that period, before turning negative as the economy fell into recession in early 2001. More recently, leveraged loan prices fell 8 points between May 2015 and February 2016. Growth in C&I lending edged down a bit, but we would not characterize that episode as one of "significant" deceleration in C&I lending. In short, there does not appear to be overwhelming evidence to support the notion that weakness in the leveraged loan market leads to significantly slower growth in C&I lending.

Figure 3

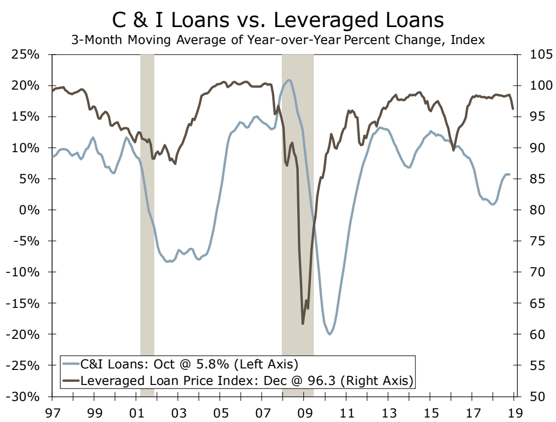
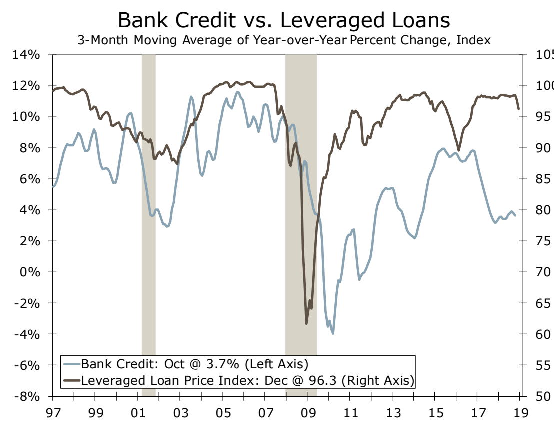


Figure 4



Source: LCD (an offering of S&P Global Market Intelligence), Federal Reserve Board and Wells Fargo Securities

C&I lending accounts for less than 20% of total bank credit. Perhaps other components of bank credit, such as the securities holdings of banks, residential and non-residential real estate lending or other types of consumer lending, may show more sensitivity to the leveraged loan market than C&I lending. However, Figure 4 shows that growth in overall bank credit generally has had a low degree of correlation with prices of leveraged loans as well. Although we acknowledge that the weakness in the leveraged loan market has the potential to eventually weigh on bank credit, there appears to be very little fallout thus far. Indeed, the amount of C&I loans outstanding as well as total bank credit have both risen in recent weeks.

In our view, the weakness in the leveraged loan market at present reflects a broader economic reality about which we have been writing in recent months. That is, the overall financial health of the non-financial corporate sector has deteriorated over the past few years.[2] The phenomenal growth in the leveraged loan market since 2016 reflects both demand-side and supply-side factors. In terms of demand, investors have been attracted to the relatively high returns that leveraged loans and CLOs offer. On the supply side, the marked increased in leveraged loan issuance over the past few years speaks to the steady rise in non-financial corporate debt, especially among non-investment grade businesses, that has occurred.

Taken in isolation, the leveraged loan market is not likely to bring the economy to its knees anytime soon.

Taken in isolation, the leveraged loan market is not likely to bring the economy to its knees anytime soon. But recent weakness in the leveraged loan market may be symptomatic of rising concerns that investors may be having about the outlook for the financial health of the business sector. Spreads on speculative-grade corporate bonds have widened in recent weeks, and investment grade spreads have also pushed out.[3] As we have written previously, we do not view the overall financial health of the American business sector as "poor" at present. But investors apparently are starting to react to its modest deterioration. If the Fed continues to push up interest rates and if corporate debt continues to rise, which would put upward pressure on spreads, then financial conditions would tighten further, which could eventually lead to a sharper slowdown, if not an outright downturn, in economic growth.

[2] See "U.S. Corporate Sector Health: Should We Worry?" (September 27, 2018).

[3] A widely followed index of high-yield corporate bond spreads (over U.S. Treasury securities) has widened by 25 bps since late November. The investment grade index is about 20 bps wider.

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