NASHVILLE NOTES

Market depth depends on price too

Wednesday, February 27, 2019 6:01 AM CT

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Bob Farrell, Merrill Lynch's long-time chief market technician, had 10 rules about the market that remain widely quoted today, years after his retirement. No. 7 states that markets are strongest when they are broad and weakest when they narrow to a handful of blue-chip names. Stated differently: a market is on thin ice when participation is limited.

The press is filled with stories about an economic expansion that is long in the tooth and lots of musings about when the corporate debt market will crack given increased leverage in the years since the financial crisis. *The Wall Street Journal* ran one variant on this theme recently when it profiled Tokyo-based Norinchukin Bank as a key investor in collateralized loan obligations and thereby a key investor in the leveraged loan market because CLOs — along with mutual funds, ETFs and other credit funds — absorb most of the leveraged loans underwritten and distributed by banks.

Not surprisingly, I had never heard of Norinchukin, which collects deposits from Japanese farmers and fisherman, until this article. There is no branch office in Nashville, but there is one in New York that allows its investment professionals to keep close tabs on the U.S. CLO market. Norinchukin accounted for 23% of U.S. and European CLO originations in the second, third and fourth quarters of 2018, according to S&P Global. Its $62 billion CLO portfolio was nearly as large as that of JPMorgan Chase & Co. and Wells Fargo & Co. combined and is significant in the context of an estimated $700 billion global market.

If the *WSJ* is correct, the CLO market for new issuances was on hold or maybe even frozen early this year as the bank evaluated new investments that it eventually made. Farrell's adage about market strength applies to the CLO market and by extension to the leveraged loan market, where CLOs purchase a sizable amount of originations.

As credit and equity investors debate whether the credit cycle is near an inflection point, Norinchukin is a testament to what roughly two decades of the Bank of Japan's zero interest rate policy (ZIRP) has done to the bond market and Japanese banks; ZIRP may have already destroyed both. Norinchukin's net interest margin has steadily declined from a pathetic 0.51% in fiscal year 2015 to a microscopic 0.06% in the nine-month period ended Dec. 31, 2018. Not surprisingly its ROA is woeful too. Norinchukin and the Japanese banking system may portend the future for Europe's already sick banking system given the negative interest rate policy employed by the European Central Bank.

Norinchukin also highlights how ZIRP creates a reach for yield among investors and thereby access to cheap capital by companies that may not be worthy of it. Zombie companies that should go out of business do not because they can roll over maturing obligations. A play on Farrell's rule is that ZIRP and near-ZIRP conditions create an artificially deep and broad market that otherwise would not exist.

Overlooked in the commentary over CLOs is a broader point about structured credit. The meme I often see in the press and quoted by politicians is the dishonesty, if not implicit criminality, of banks that packaged crud assets like subprime mortgages into AAA-rated securities in the years leading up to the financial crisis. While there is a grain of truth in the idea about the shenanigans that occurred in the pre-crisis years, it totally misses the point that the capital structure employed in a securitization to finance the assets is not same thing as the assets themselves. Investors choose where in the capital structure to invest based on risk and return parameters.

Norinchukin reportedly invests mostly in the top-rated tranches of CLOs that have first dibs on the cash flows produced by the leveraged loans. The risk is less than the subordinated tranches that are lower rated, but the yield is lower too.

The final point is not one of Farrell's 10 rules for investing, but it is a widely quoted maxim on Wall Street: there are no bad bonds, only bad bond prices. No matter how bad a bond (or CLO) may look, price paid is a key factor in determining the return. That Norinchukin is a critical investor in the CLO and therefore the leveraged loan market is surprising; however, Norinchkin may be very good at paying the right price for the right CLO tranche because even if the leveraged loan market implodes in the next downturn, most AAA-rated tranches may perform perfectly fine.

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