Harry's Take

June 23, 2020

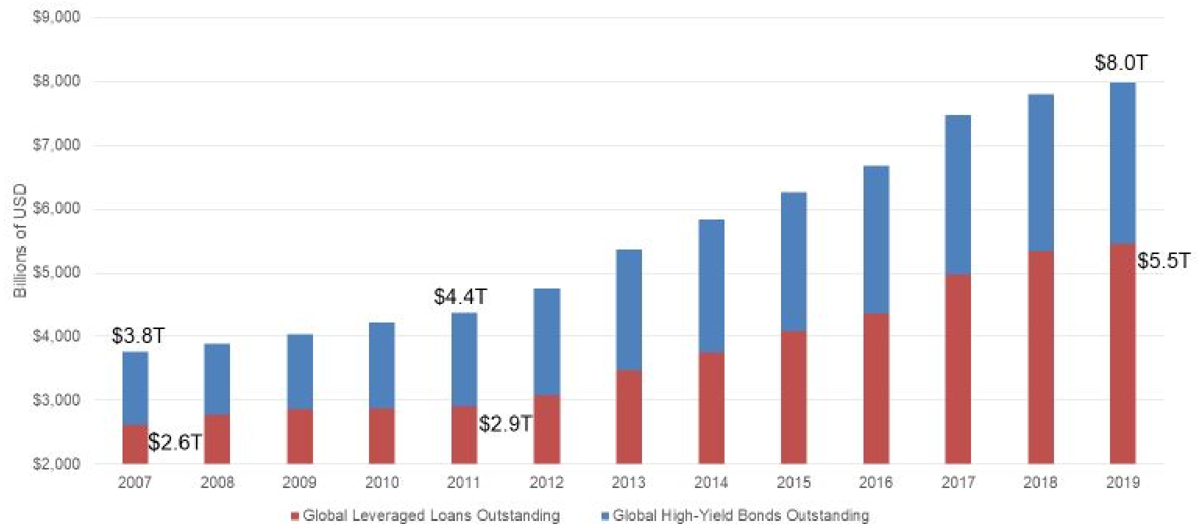
Leveraged Loans Are the New Time Bomb, The Virus Is the Match

Coming into the last financial crisis (GFC), U.S. mortgage lending standards went to zero: no-down, no-doc loans increasingly were given to subprime borrowers. With housing going up forever, who cared if they defaulted? The house would be worth more and the bank could cover the loan easily… until housing crashed 34%, further than in the Great Depression, down 26%.

This time around, my unique Net Demand housing indicator says it's overvalued by 40% in the US, vs. 20% in 2006; hence, I see a 40% to 50% crash this time.

But that's not the most imminent problem in a housing market that has had tight supply as a result of low construction since the GFC and now the temporary lockdown began.

The new game is leveraged loans. These are loans made to companies already in trouble on leverage. Hence, they are worse than high-yield bonds, which are made to companies with low credit ratings.



These loans have exploded 112%, or 2.1 times, from $2.6T at the top of the last boom in 2007 to $5.5T now. The global total of leveraged loans plus high-yield bonds also rose 2.1 times since 2007, from $3.8T to $8.0T. These business loans and bonds are the ones most likely to trigger the next, larger wave of debt and bond defaults, during a boom in which corporate debt rose the fastest, not consumer and financial sector debt like last time.

In the mortgage lending bubble, Wall Street came up with a clever way to package these into diversified portfolios with "low-default correlation" combined with fake insurance through credit-default swaps on high leverage with no collateral. The problem was, they did all start defaulting together once a severe crisis hit (like now), and those derivatives on leverage failed and caused their own financial crisis in the most overleveraged financial sector of debt.

CLOs Becoming the New Version of CDOs That Triggered the 08 Crash

Source: SIFMA

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In this chart, the structured finance vehicles (blue) and the CDOs (green) are similar and totaled $760B in 2007. CLOs (red) were up to $680B as of 2019. All of these leveraged loan packages dressed up to look like A+ rated bonds are at $871B, vs. $1057B in 2007.

China and the global real estate bubble are the epicenter of this unprecedented bubble, which also includes the greatest stock bubble in history. It’s just that stock crashes don’t cause the debt deleveraging problems that real estate and business loans do.

It’s these leveraged loans, high-yield bonds, and especially the CLOs and CDOs that are the big setup for this crash, and the coronavirus, again, is the perfect trigger to set off such defaults.

I'll have much more on the unprecedented financial asset and debt bubble in the July issue of *The HS Dent Forecast*.

Harry

Got a question or comment? You can reach us at info@hsdent.com.