May 2, 2024

Global Credit Weekly:

Peak rates and patience

BlackRock

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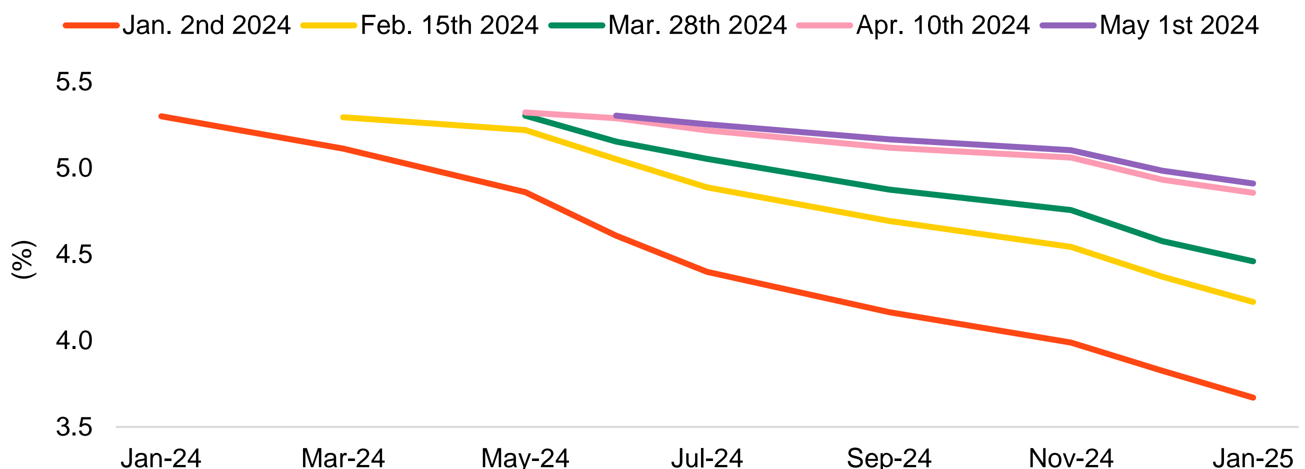
Key takeaways

- Heading into the May 1st FOMC press conference, we were focused on two topics: (1) whether we had reached "peak" monetary policy rates in the U.S., and (2) how patient the Federal Reserve would be in achieving its 2% inflation target. On net, the commentary skewed dovish as Chair Powell said a rate hike was "unlikely". The FOMC's patience also appears to remain intact, despite stalled progress on the inflation front.
- For corporate credit investors, this minimization of "rate hike risk" (at least for now) is positive for sentiment. The relative clarity on the path of U.S. monetary policy – coupled with solid U.S. growth and historically elevated all-in yields – should combine to keep USD credit spreads range-bound. We continue to favor shorter-duration and floating rate exposures – although the relative value vs. fundamental trade-off (and credit selection) is critical for the latter, as many of those firms are navigating sharp increases in debt service costs (via their floating rate debt).
- While not our base case, a *sustained* reacceleration of inflation remains the key downside risk to corporate credit valuations, as it would likely interject significant uncertainty related to the forward path of U.S. monetary policy (and may lend more credence to the potential for *rate hikes*). Additionally, we see a high probability for a shallow rate cutting cycle, once it ultimately materializes (we still expect 2H2024) – a view that is already reflected in market pricing (Exhibit 1). This means investors should be bracing for a "high for longer" cost of capital environment.
- Given this backdrop, market participants are understandably watching for vulnerable pockets of corporate credit. As we outlined in our *2Q2024 Global Credit Outlook*, we see tentative signs of plateauing in default rates, given the (1) receptive capital markets (especially to lower rated borrowers), (2) proactive liquidity raising completed in recent years, and (3) supportive economic activity. Nonetheless, we expect some of the specific drivers of 2023's default activity will remain dominant in 2024, absent material interest rate relief. These include distressed exchanges, "repeat defaulters," and "loan only" capital structures.

Exhibit 1: The market's repricing of rate cut expectations reflects "high for longer"

The U.S. policy rate implied by Fed Funds Futures at various points in time, through early 2025



Source: BlackRock, Bloomberg.

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FOMC recap: Peak rates and patience

Heading into the May 1st FOMC press conference, we were focused on two main topics:

(1) the likelihood that the current level of monetary policy represents "peak rates" for this cycle, and

(2) commentary related to the Federal Reserve's patience in reaching its 2% inflation target

Related to the first topic of "peak rates," Chair Powell's May 1st FOMC remarks notably *omitted* the language from the March 20th FOMC that monetary policy was "likely at its peak for this tightening cycle and…it will likely be appropriate to begin dialing back policy restraint at some point this year." But while the removal of this language might have been interpreted as hawkish at face value, the comments during the ensuing Q&A skewed more dovish. Indeed, Chair Powell outlined two potential paths for cutting rates, as well as one potential path for maintaining rates at their current level (all detailed later). Notably, he did *not* offer a path for hiking rates until pressed further, at which point he called a hike "unlikely" and added clarification that "the policy focus has been on holding the current level of restriction."

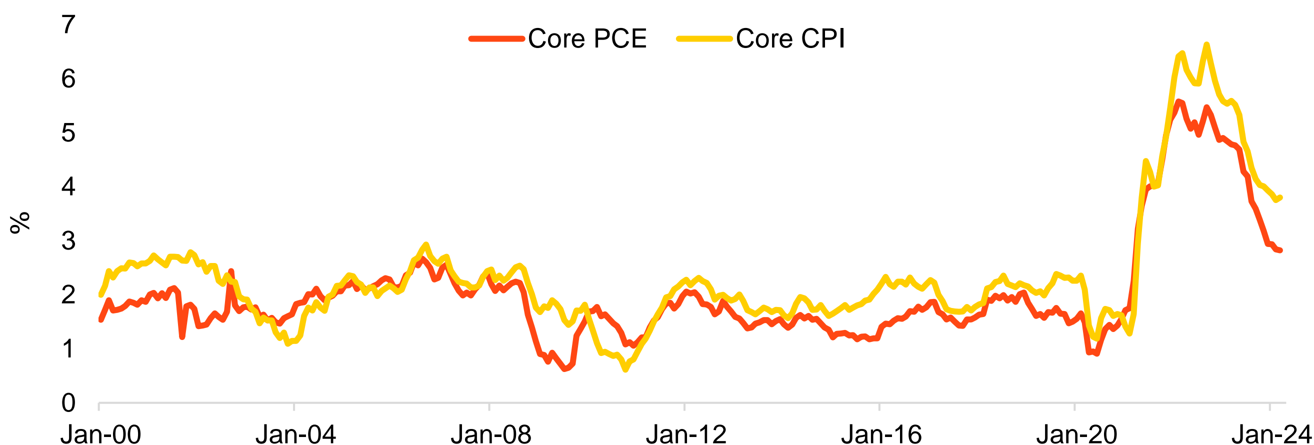
On the second point of "patience," Chair Powell noted during the Q&A that "clearly, restrictive monetary policy needs more time to do its job" but "how long that will take and how patient we should be" will depend on the totality of the data and how the outlook evolves. When asked about the potential for divergence in monetary policy across regions and other major central banks, he again noted that "we can be patient," in waiting to cut rates because of the solid U.S. economic growth. By contrast, other countries with weaker growth may opt to cut rates sooner.

Several other notable takeaways include:

- **An acknowledgment of stalled inflation progress.** The May 1st FOMC statement was updated to reflect stalled progress on the effort to reduce inflation, by adding: "in recent months, there has been a lack of further progress toward the Committee's 2% inflation objective" (Exhibit 2).
- **Policy is restrictive, but time will tell if it is "sufficiently restrictive."** Chair Powell said the current level of monetary policy (5.25-5.5%) is "restrictive" and is weighing on certain areas of the economy, namely: (1) the demand for labor, and (2) interest sensitive spending (housing, investment). That said, when pressed during the Q&A if policy was "sufficiently restrictive" he noted "we believe over time, it will be sufficiently restrictive" but "that will be a question the data will have to answer."
- **The reaction function favors holding or cutting – *not hiking*.** Chair Powell said explicitly during the Q&A that "it is unlikely that the next policy rate move will be a hike." The Chair said he did not want to get into "complicated hypotheticals" regarding future policy actions but noted that the FOMC is "committed to retaining our current restrictive stance of policy for as long as appropriate."

Exhibit 2: Additional progress is required on lowering inflation

Year-over-year growth (%) in U.S. Core PCE and U.S. Core CPI



Source: BlackRock, Bureau of Economic Analysis, Bureau of Labor Statistics. As of March 31, 2024 (most recent).

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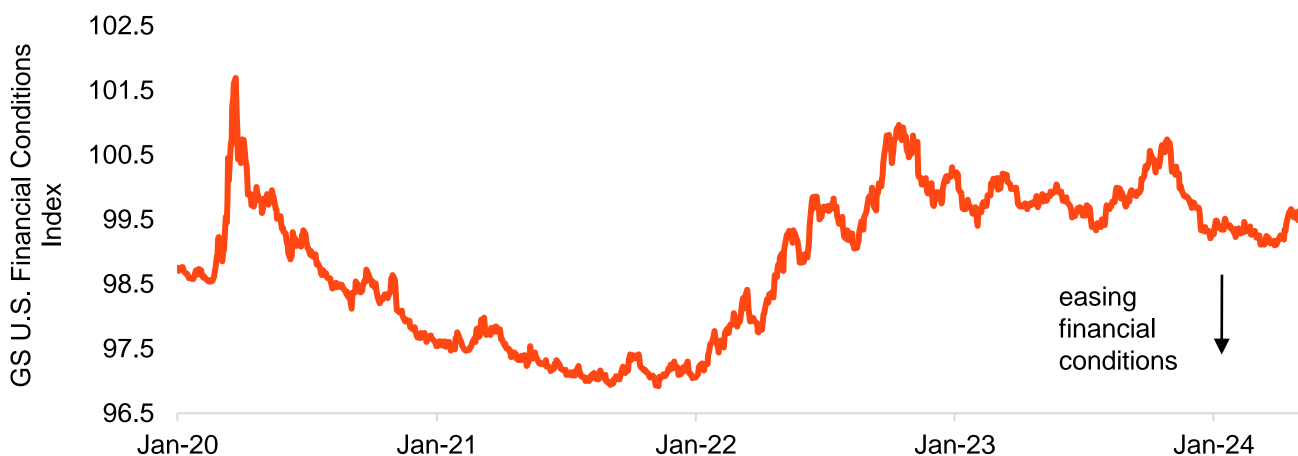
May FOMC takeaways: the policy reaction function

- **Catalysts for a potential rate cut.** If inflation proves more persistent than expected, but the labor market remains strong, Chair Powell said it could be appropriate to hold off on rate cuts. Conversely, if the FOMC gains greater confidence that inflation is moving sustainably down to 2%, *or* if the labor market weakens *unexpectedly*, then rate cuts could be warranted. That said, the weakening in the labor market would need to be "meaningful" for the FOMC to consider responding. While the Chair didn't define such a scenario, he did say that "a couple of tenths" of a percent in the unemployment rate would probably not qualify (although it would ultimately depend on other circumstances).
- **Catalysts for a potential rate hike.** Chair Powell said the Committee would need to see "persuasive evidence" (based on a totality of data) that the current stance of monetary policy is not sufficiently restrictive to bring inflation sustainably down to 2%, over time. He added: "that's not what we think we are seeing."
- **Are we at peak rates for this cycle?** As mentioned earlier, the May 1st FOMC remarks removed specific language (from the March meeting) related to peak policy rates. When asked about that during the Q&A, Chair Powell said the data (including the incoming inflation readings) will have to answer the question as to whether current monetary policy rates represent the peak for this cycle (i.e., a response similar to the above question on "sufficiently restrictive rates").
- **More confidence on inflation is needed…** The statement again noted that "the Committee does not expect it will be appropriate to reduce the target range until it has gained greater confidence that inflation is moving sustainably toward 2%." The Committee "remains highly attentive to inflation risks."
- **…and this is likely to take longer than expected.** Similar to his public comments in mid-April, Chair Powell noted that recent inflation data "have not given us that greater confidence" and it is "likely that gaining such greater confidence will take longer than previously expected."
- **The 2% inflation target was reiterated.** Chair Powell said "of course we are not satisfied with 3% inflation" and "we will return inflation to 2%, over time." He added that the FOMC believes the current stance of monetary policy is appropriate to accomplish that.
- **Are easy financial conditions the cause of the sticky inflation?** Chair Powell said he does not see an "obvious connection" between the easing of financial conditions since late 2023 (Exhibit 3) and the 1Q2024 inflation strength. He also noted that U.S. interest rates are higher vs. the December FOMC meeting, which is "appropriate" given the recent inflation data. While Chair Powell said he expects inflation to decline over the course of the year (citing the lag in housing data, for example), his "confidence is lower" because of the above consensus readings of the last three months.

Exhibit 3: Financial conditions have tightened slightly, but remain looser vs. late 2023

Goldman Sachs U.S. Financial Conditions Index



Source: BlackRock, Bloomberg, Goldman Sachs Global Investment Research. As of April 30, 2024.

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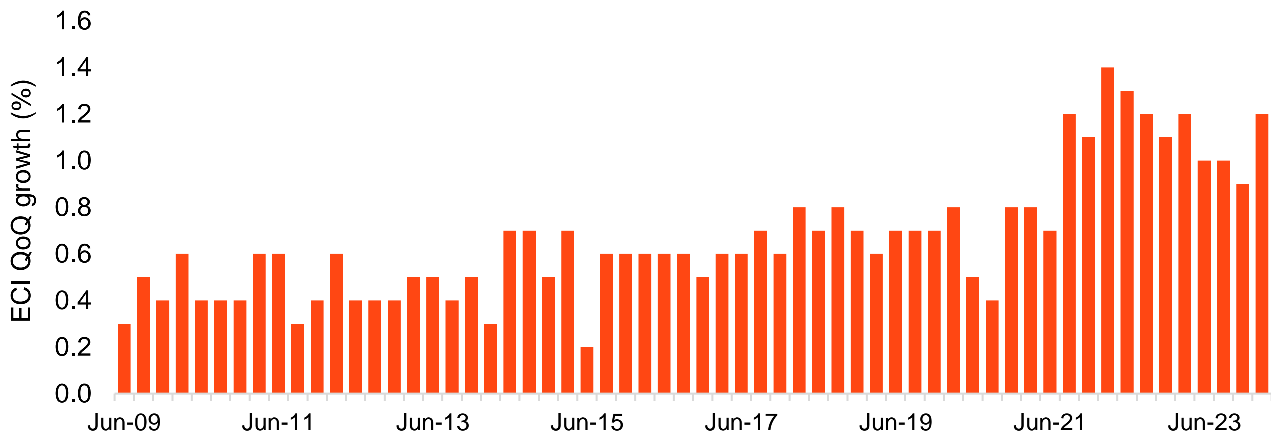
May FOMC key takeaways (continued)

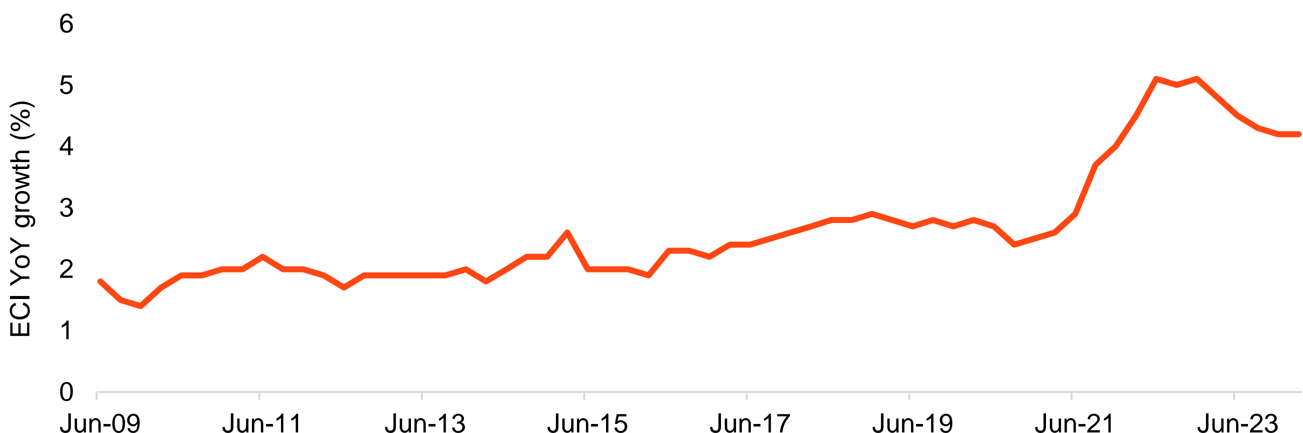
- **Is a strong labor market a problem?** Chair Powell said that strong growth or a strong labor market "in and of itself" would not "automatically" create an inflation problem – in part because supply-related improvements are still possible. He also stated that the FOMC does not target wage growth, but rather targets *price inflation*. That said, he said wage increases will probably need to move down incrementally to levels that are more sustainable (Exhibits 4 and 5).
- **A rebound in labor productivity? Too early to tell.** Related to a question on the U.S. economy's "neutral" rate of interest, Chair Powell said it is too early to know whether productivity will be able to run persistently above its longer-run trend. That said, he does see the case for *higher potential output* of the U.S. economy, due to increased labor supply in 2023 (from higher labor force participation as well as immigration) which should also create more demand (via spending) over the long-term.
- **The widely anticipated taper was announced.** As was anticipated based on the minutes from the March 19th-20th FOMC, an adjustment to the taper of the balance sheet was announced. It was done to "slow the pace of decline" in order to approach the "ultimate level more gradually" while "reducing the possibility that money markets experience stress." Effective June 1st, the monthly redemption cap on Treasury securities will decline from $60 billion/month to $25 billion/month. The cap on agency debt and agency mortgage-backed securities at $35 billion/month remains unchanged.

Exhibit 4: The Employment Cost Index (wages, benefits, etc.) increased in 1Q2024
U.S. Employment Cost Index (ECI) quarter-on-quarter growth, seasonally adjusted (%)



Source: BlackRock, Bureau of Labor Statistics. Captures data through March 31, 2024.

Exhibit 5: On a year-over-year basis, the 1Q2024 Employment Cost Index was flat vs. 4Q2023
U.S. Employment Cost Index (ECI) year-on-year growth, seasonally adjusted (%)



Source: BlackRock, Bureau of Labor Statistics. Captures data through March 31, 2024.

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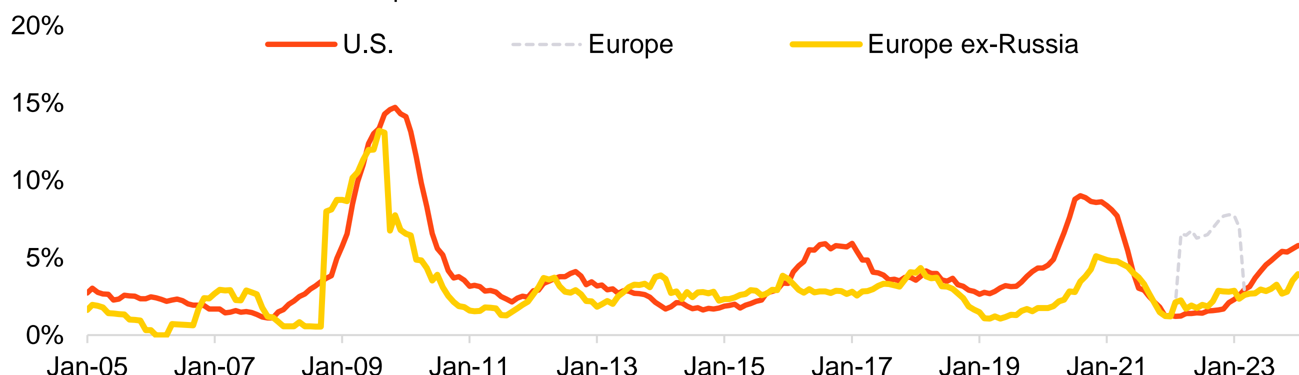
Defaults and distressed credit amid “high for longer”

With an expectation of a “high for longer” cost of capital, investors continue to watch for vulnerable pockets of the corporate credit market. As we outlined in our *2Q2024 Global Credit Outlook*, we see tentative signs of plateauing in default activity (Exhibits 6 and 7) given the (1) receptive capital markets, (2) proactive liquidity raising and (3), and supportive economic activity. Nonetheless, we expect these specific drivers of 2023’s default activity to remain dominant in 2024, absent material rate relief:

- **Distressed exchanges.** According to Moody’s Annual Default Study, 60% of 2023’s global defaults (across HY and leveraged loan issuers) were in the form of distressed exchanges (DE). This is the highest share (as a percentage of default count) on record and compares to a 35% DE share in 2022. DEs can be favored by private equity sponsors (which are active in the leveraged loan market) to preserve value and avoid the costs associated with a bankruptcy.
- **“Repeat defaulters”.** According to data from JP Morgan Research, 26% of 2023’s USD HY and leveraged loan defaults (combined) were repeat defaulters – a record high annual share. Per Moody’s, distressed exchanges are more vulnerable to “re-default risk” (vs. bankruptcies), as they are less likely to materially improve leverage and liquidity on a long-term basis.
- **“Loan-only” capital structures.** Of the 159 defaults tracked by Moody’s in 2023 (across global HY and leveraged loan issuers), 53% were in “loan only” capital structures. And per JPM, USD “loan only” defaults represented 56% of USD market defaults in 2023 – the highest share in 16 years. The lack of subordination in “loan only” capital structures can have a negative impact on recoveries. According to Moody’s, the global issuer-weighted average recovery rate for first-lien bank loans declined to 59.6% in 2023 from 69.5% in 2022 and the long-term average of 65.0% since 1983.

Exhibit 6: Early signs of plateauing in default activity

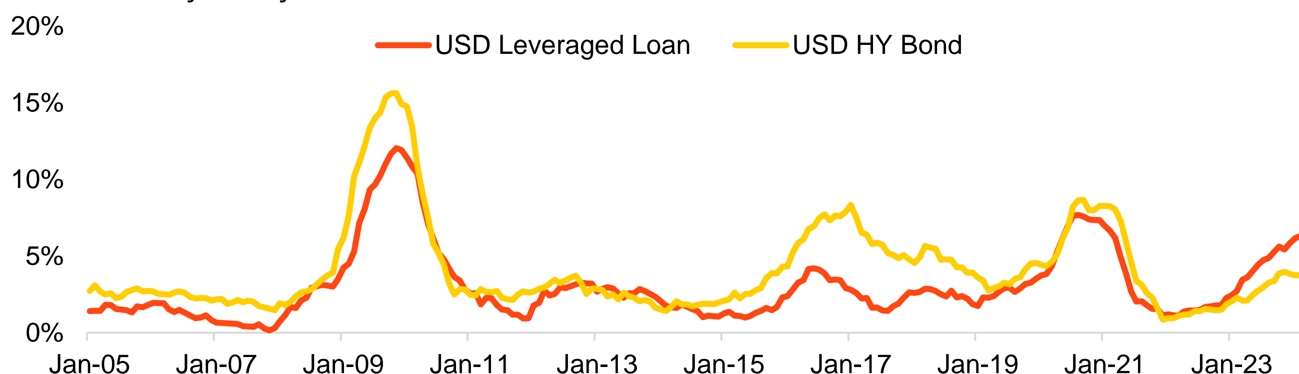
Speculative-grade, issuer-weighted, trailing 12-month default rates for HY and leveraged loan issuers (combined) in the U.S. and Europe



Source: BlackRock, Moody’s. As of March 31, 2024. The increase in defaults in the EUR market in early 2022 reflects the defaults of Russian issuers following the onset of the Russia-Ukraine war.

Exhibit 7: Loan defaults should continue to outpace their HY bond peers

Trailing 12-month, issuer-weighted default rates (%) for the universe of USD HY bonds and leveraged loans tracked by Moody’s



Source: BlackRock, Moody’s. As of March 31, 2024.

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