



Private Markets

June 6, 2024

Global Credit Weekly: Beyond the first cut

BlackRock

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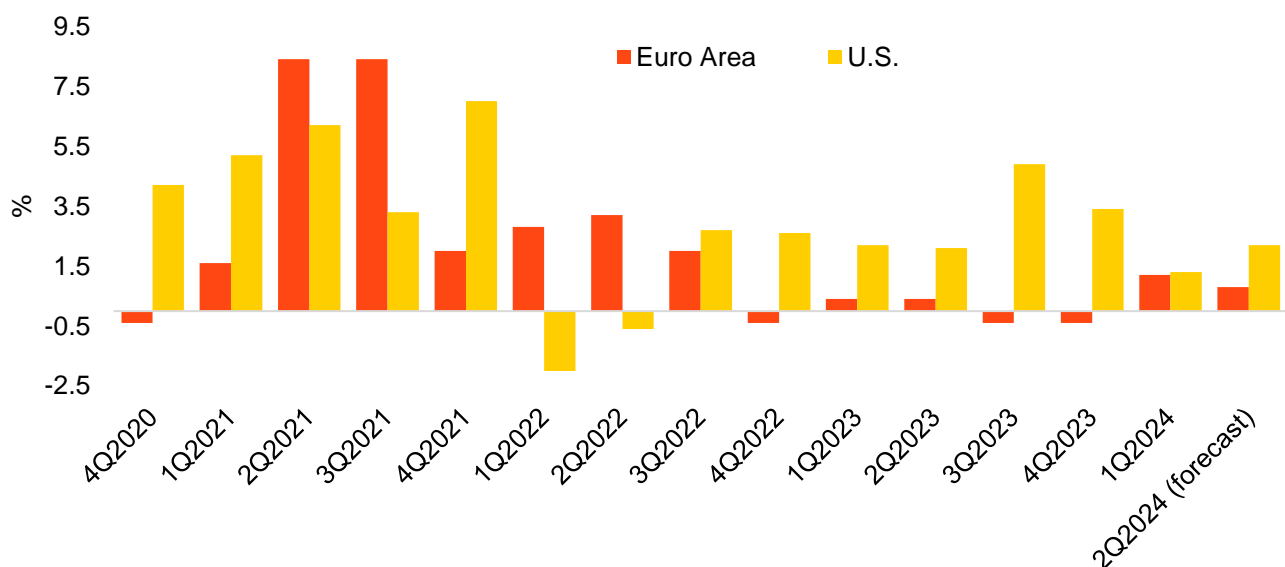
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Key takeaways

- Looking ahead to next week’s Federal Reserve decision on June 12th, we are most focused on the following three areas: (1) incremental insight into the central bank’s reaction function, now that the dual mandate of maximum employment and price stability is in better balance; (2) an updated Summary of Economic Projections, which will likely show fewer rate cuts in 2024 and a higher “long run dot”; and (3) commentary on the neutral rate, which should help inform the “depth” of the (eventual) rate cutting cycle. Given the recent softer-than-expected economic data, Friday’s (June 7th) non-farm payrolls report will be especially important, in our view, since the Federal Reserve has noted that it remains ready to respond to “unexpected” weakness in the labor market. That said, consensus estimates suggest a solid print.
- As outlined previously, we are not expecting significant, near-term interest rate relief in the form of Federal Reserve rate cuts. Rather, we believe a “shallow” rate cutting cycle (once it eventually begins) is more likely. This means limited prospects for swift interest rate relief for many credit market borrowers, which will drive dispersion. It also leaves income and yield as the key considerations when deploying capital into corporate credit (as opposed to total returns) – especially since spreads are still hovering near the tight end of the post-financial crisis range.
- The “high for longer” interest rate backdrop that we expect in the U.S. also extends to the Euro Area. Commentary from European Central Bank officials over the past several weeks guided towards a first rate cut at the June 6th meeting, which materialized. That said, members of the Governing Council have also expressed a desire to preserve optionality regarding the pace of any additional actions beyond that point, due in part to a “bumpy” path for domestic services inflation (driven by elevated wages).

Exhibit 1: U.S. growth has moderated vs. 2H2023, while Euro Area growth has improved

Quarter-on-quarter real GDP growth (%), seasonally adjusted at an annualized rate



Source: BlackRock, Bureau of Economic Analysis, Eurostat. 2Q2024 forecast uses the Bloomberg Contributor Composite as of June 3, 2024.

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U.S. growth fears resurface, driving a rally in rates

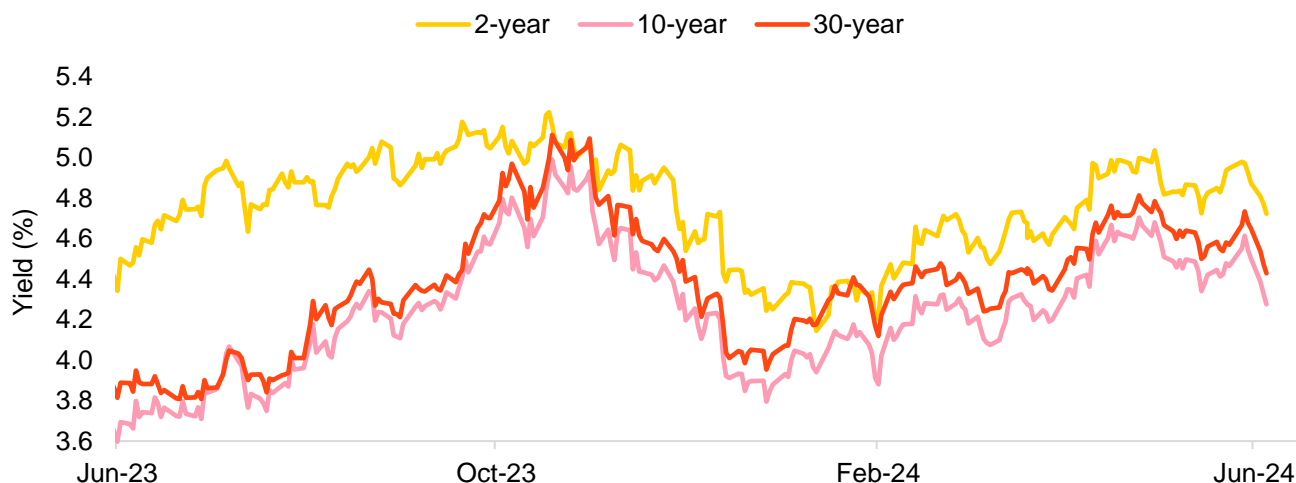
Softer-than-expected economic data this week (i.e., ISM Manufacturing, Job Openings and Labor Turnover Survey (“JOLTS”), and ADP private sector employment) sparked a sharp retreat in U.S. Treasury yields over the past few sessions (Exhibit 2) – which remained in place despite a stronger-than-expected ISM Services reading later in the week.

Looking ahead to next week’s Federal Reserve (Fed) decision on June 12th, we are most focused on the following three areas:

- **Incremental insight into the Fed’s reaction function.** At the [May FOMC press conference](#), Chair Powell characterized a rate hike as “unlikely” and said the Committee’s focus was on holding the current level of restriction until it gained more confidence that inflation is moving sustainably toward 2%. We expect Chair Powell to reiterate his prior message that an “unexpected” weakening in the labor market could expedite the start of a rate cutting cycle. While the pace of U.S. job creation has moderated (Exhibit 3) and the “jobs-workers gap” has narrowed (Exhibit 4), the labor market remains quite strong by historical standards. Friday’s non-farm payrolls reading will be key to watch, in our view (as of June 5th, Bloomberg consensus expected +185k jobs for May, and an unemployment rate of 3.9%). While not our base case, we continue to view a *sustained* reacceleration of inflation as the key downside risk to corporate credit valuations, as it may lend more credence to the potential for rate *hikes* and would interject uncertainty related to the forward path of U.S. monetary policy.
- **The updated Summary of Economic Projections (SEP), which we expect will show fewer cuts in 2024.** In addition to the FOMC decision and press conference, the June 12th meeting will also feature a revised SEP. We expect the “dot plot” to be updated to show fewer cuts relative to the [March 2024 SEP](#), which implied 75bp of cuts by year-end 2024 (i.e., a Fed Funds rate of 4.6%). We believe two cuts is most likely for 2024 in the June SEP, although one cut may be possible given the recent “Fed speak.” As of June 5th, market pricing (based on Fed Funds Futures) implied approximately two 25bp cuts by year-end 2024.
- **Commentary on the neutral rate, which should help inform the depth of the eventual cutting cycle.** As we have outlined previously, barring a major growth setback we expect a shallow Fed rate cutting cycle, once it eventually materializes. The [minutes from the May 2024 FOMC meeting](#) reflected some “uncertainty regarding the degree of restrictiveness” of current financial conditions. And during the [May press conference](#), Chair Powell said that while he believes the current policy rate is “restrictive,” time will tell whether it is “sufficiently restrictive.” We see scope for the “longer-run dot” (a proxy for the longer-term Fed Funds rate) in the June SEP to move somewhat higher vs. the 2.6% shown in the [March 2024 SEP](#) (for context the [December 2023 SEP](#) level was 2.5%).

Exhibit 2: U.S. Treasury yields retreated following a mix of softer economic data in recent days

Yield-to-worst of the 2-year, 10-year and 30-year U.S. Treasuries (on-the-run securities, mid levels)



Source: BlackRock, Bureau of Labor Statistics. Captures data through June 5, 2024.

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The case for corporate credit revolves around yields

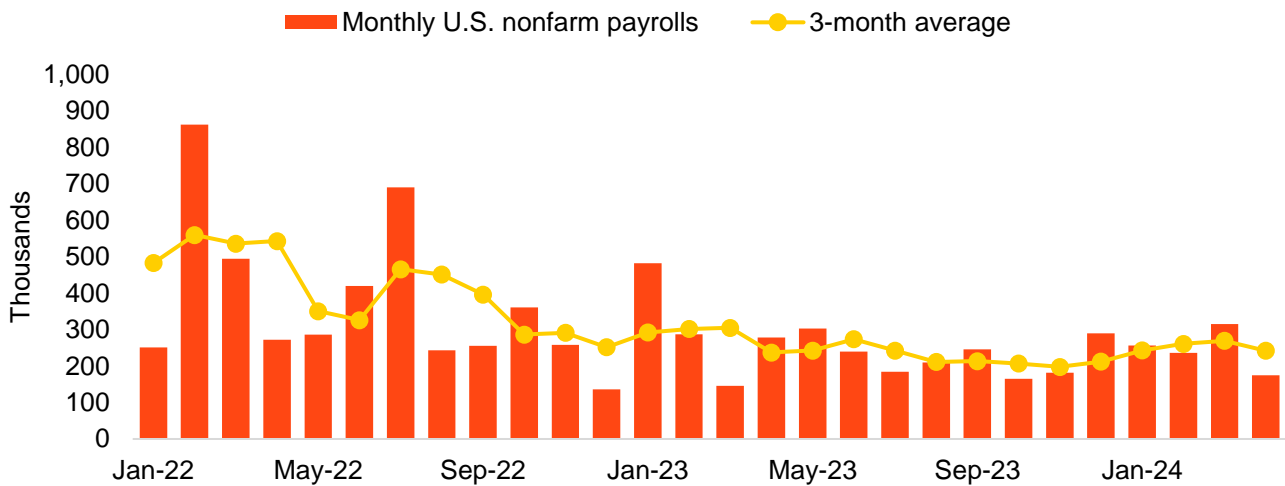
As outlined earlier, we are not expecting significant, near-term interest rate relief in the form of Fed rate cuts. Rather, we believe a “shallow” rate cutting cycle (once it eventually begins) is more likely. Absent a sharp and unexpected deterioration in the U.S. labor market (which is not our base case), we struggle to identify a sense of urgency for the Fed to cut rates significantly – sentiment that has been echoed by various Fed officials in recent weeks (via public comments).

This “high for longer” interest rate environment – at least relative to the post-financial crisis era – has two implications for USD corporate credit investors. First and foremost, capital allocated to USD corporate credit should primarily be based on income and yield, not total return. Material and *sustained* additional declines in interest rates (at the policy-sensitive front-end, as well as at the long-end) are not our base case, due to the interaction of solid growth, sticky inflation, patient monetary policy and fiscal deficit considerations.

Similarly, given the current valuations of most corporate credit spreads (Exhibit 5), we are not expecting significant absolute spread tightening from here – another constraint limiting the scope for sizable absolute total returns. But there is still an attractive opportunity for yield-based buyers to capture attractive all-in yields, as Exhibit 6 illustrates.

Exhibit 3: The U.S. labor market has moderated, but job growth remains solid

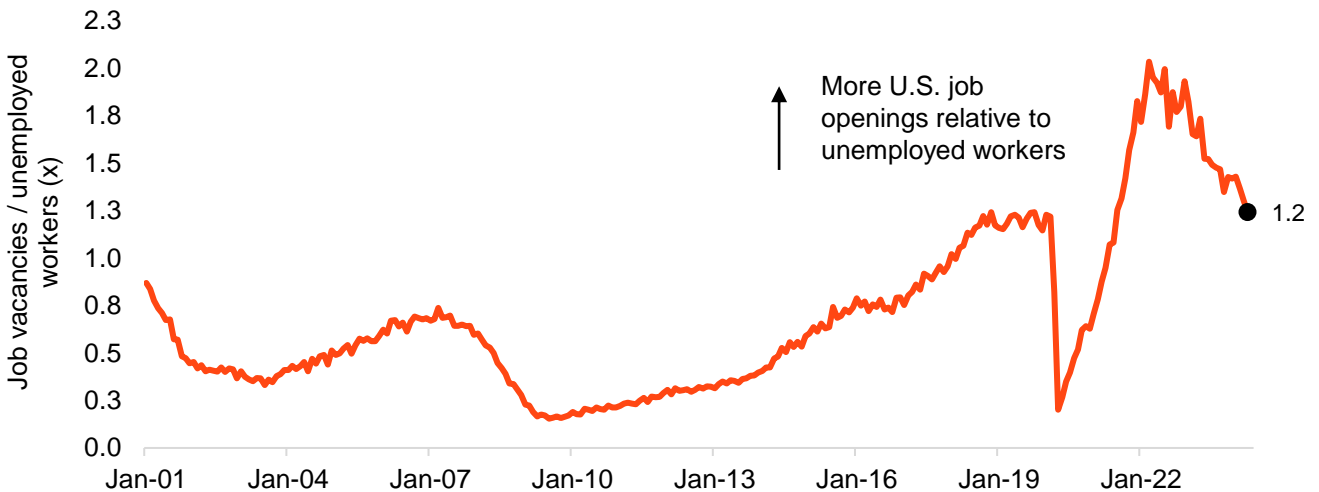
Monthly U.S. nonfarm payrolls and the three-month moving average pace of job creation



Source: BlackRock, Bureau of Labor Statistics. Captures data through April 30, 2024.

Exhibit 4: The U.S. “jobs-workers” gap has now returned to the February 2020 level of 1.2x

The ratio of U.S. job vacancies to U.S. unemployed workers, both seasonally adjusted



Source: BlackRock, Bureau of Labor Statistics. Captures data through April 30, 2024.

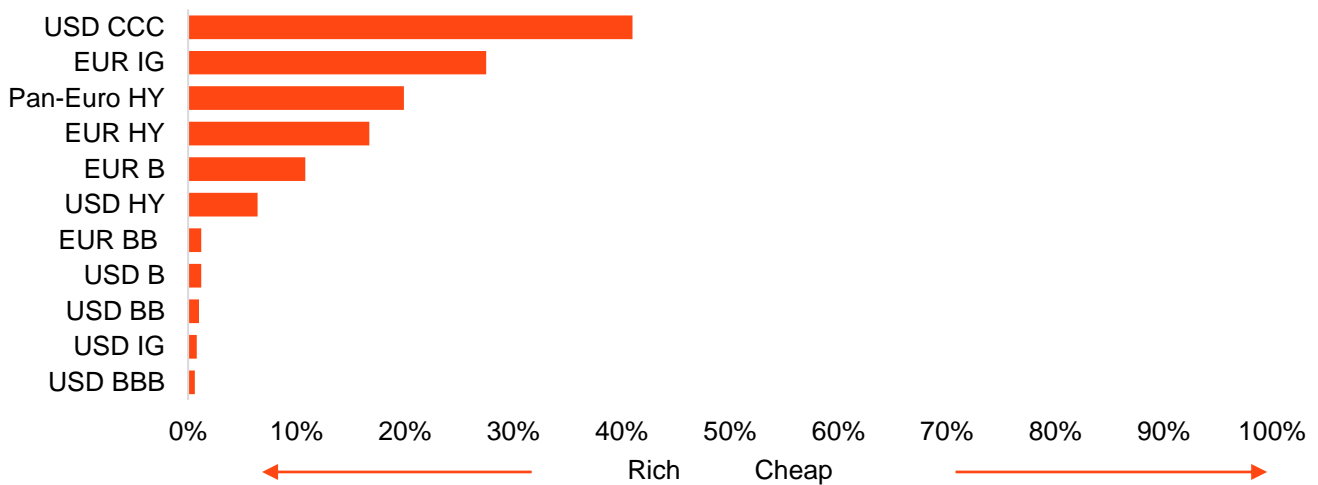
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The second implication from the “high for longer” backdrop is that dispersion (across asset classes, sectors, ratings and issuers) will likely remain elevated – a theme we have emphasized over the past few quarters. This is evident in a few of our relative value views, as just two examples:

- Given the rates backdrop, we still have a preference for floating-rate and shorter-duration exposures, relative to long-end, fixed-rate bonds. For example, using data from Pitchbook LCD, USD leveraged loans offer an approximate 185bp “carry pick-up” vs. USD HY bonds (when controlling for single-B ratings), due in part to the inverted U.S. Treasury yield curve (among other considerations).
- As we noted previously, CCCs have lagged the overall spread tightening at the USD HY index level in recent months. We expect this trend to continue given this (highly idiosyncratic) cohort’s thin financial cushion and sensitivity to a higher cost of capital. We are more comfortable moving down-in-quality within the USD IG universe and prefer BBB-rated exposures vs. their A-rated peers.

Exhibit 5: On a spread basis, USD corporate credit trades tight vs. its history...

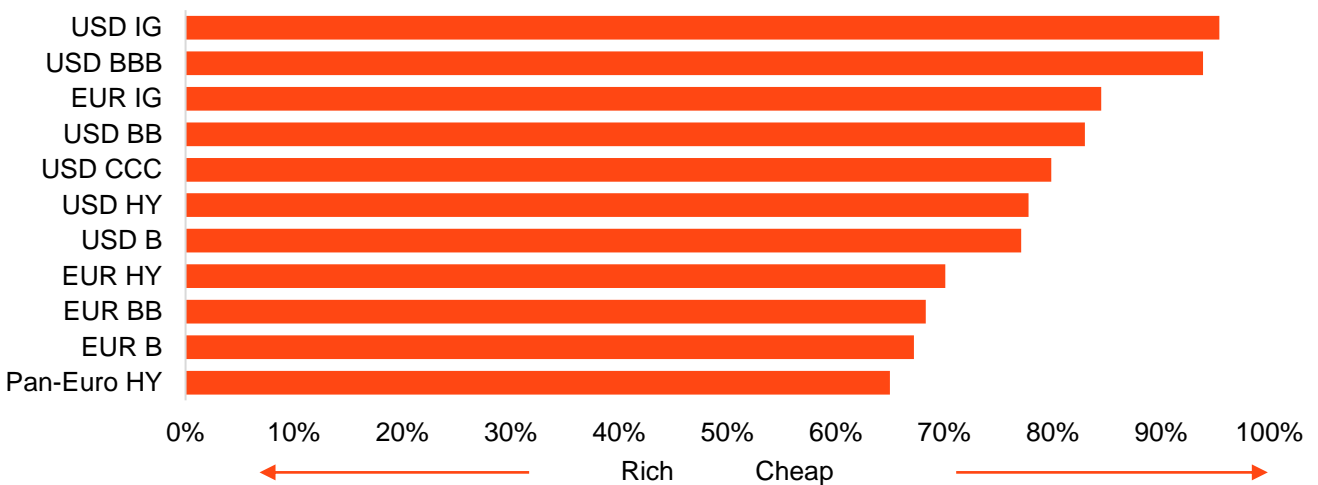
Percentile rank of daily index-level corporate bond spreads since January 1, 2010



Source: BlackRock, Bloomberg, ICE-BAML. Captures option adjusted spread data through May 31, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

Exhibit 6: ...but yields are more appealing (due to an elevated risk-free rate)

Percentile rank of daily index-level corporate bond yields since January 1, 2010



Source: BlackRock, Bloomberg, ICE-BAML. Captures yield-to-worst data through May 31, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

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ECB: The “last mile of disinflation”

The “high for longer” rate backdrop that we expect also extends to the Euro Area. Commentary from European Central Bank (ECB) officials over the past several weeks – as well as the [official account](#) of the April 2024 Governing Council meeting – guided towards a first rate cut at the June 6th meeting, which was confirmed. That said, members of the Governing Council have also expressed a desire to preserve optionality regarding the pace of any additional actions beyond that point.

As ECB Executive Board Member Isabel Schnabel highlighted in a May 17th [interview](#) with Nikkei, the current policy cycle is unique “in the sense that rate cuts are not meant to counter a looming recession, but rather to gradually withdraw restriction without reigniting inflation.”

Schnabel noted that while “a rate cut in June may be appropriate” the “path beyond June is much more uncertain” owing to difficulties related to the “last mile of disinflation.” She went on to explicitly state that “a rate cut in July does not seem warranted” owing to a “global phenomenon” of “bumpy” inflation (especially domestic services inflation) and the potential for second-round (i.e., indirect) inflationary effects (Exhibit 7). Uncertainty related to where the “natural rate” of interest is in “real time” further underscores the need for a cautious approach, according to Schnabel.

Wages are on a “multi-year adjustment process”

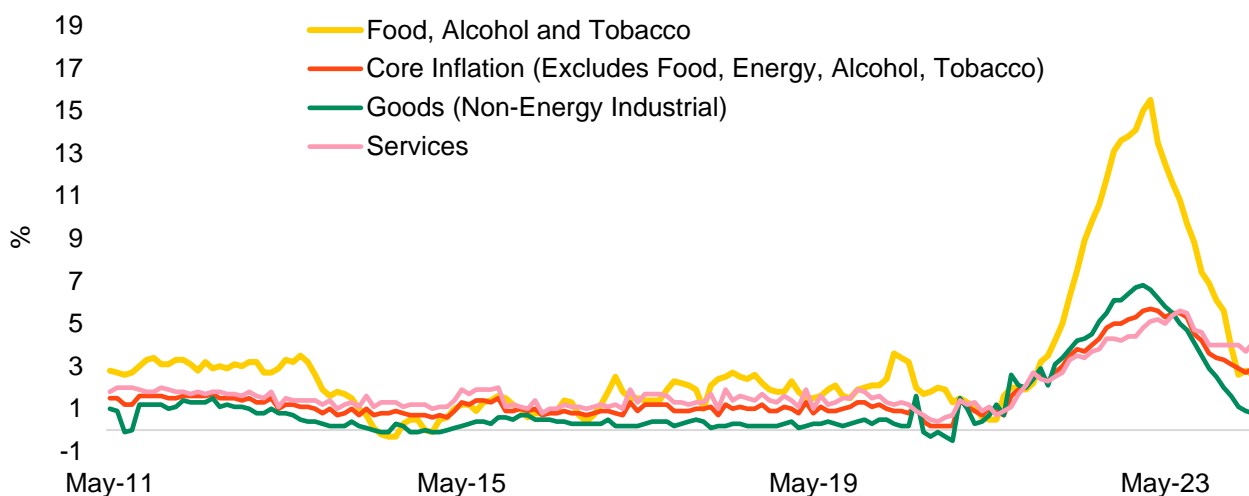
The ECB’s Executive Board Member and Chief Economist Philip Lane also emphasized the importance of taming services inflation in a separate (May 24th) [interview](#) with the Financial Times, when he acknowledged the [impact of still-elevated wage costs](#) (Exhibits 8 and 9). Lane said that while “the overall direction of wages still points to deceleration” this “does not necessarily mean an immediate return to steady state.” Indeed, Lane noted that the ECB does not expect wages to normalize until 2026, [consistent](#) with a “multi-year adjustment process for wages” highlighted by staff economists.

Lane also noted that once the ECB acts “to remove the top level of restriction, being at 4%”, the speed at which the ECB removes restrictiveness will be determined by the data flows over the coming months – echoing Schnabel’s comments from the week prior.

Importantly, in our view, Lane said that the “bumpy and gradual” improvement on domestic services inflation means that the ECB will “need to be restrictive all year long,” such that “firms will think twice about trying to pass on cost increases” (again referencing the potential for second-round inflation effects). That said, he acknowledged that “within the zone of restrictiveness we can move down somewhat,” as lower inflation provides some flexibility to decrease the nominal rate while preserving a degree of restriction.

Exhibit 7: Services inflation in the Euro Area has been range-bound in recent months

Year-over-year inflation (not seasonally adjusted) for the Euro Area, by category



Source: BlackRock, Eurostat, Bloomberg, European Central Bank. Captures inflation data through May 2024 (latest available).

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Framing the current cost of wages

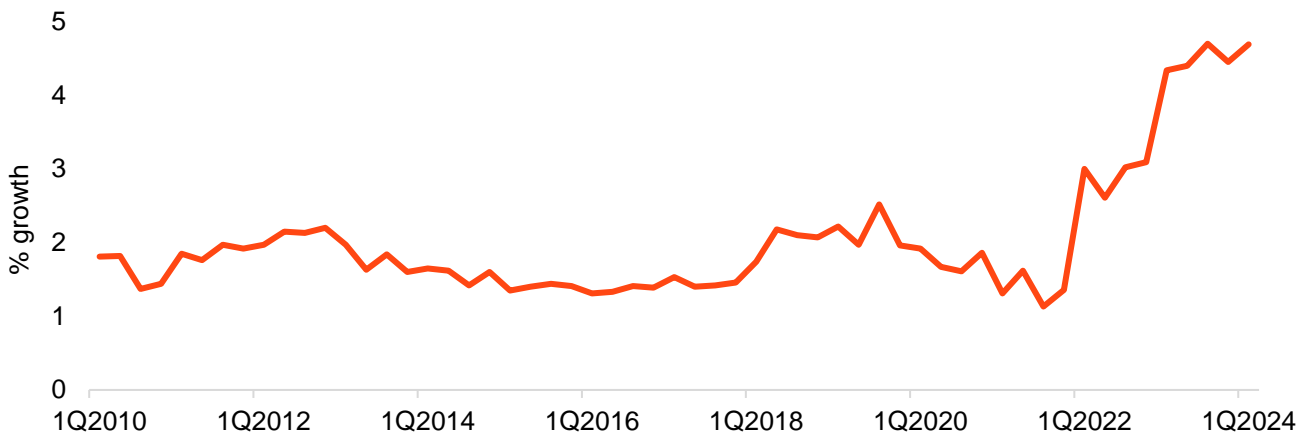
Growth in compensation per employee has been elevated in the Euro Area since 2021 and reached 5.2% in 2023 – the highest annual rate since the start of the Euro (December 1999). Wages can impact inflation through boosting demand (i.e., if consumers earn more, they may spend more) and the input cost channels (i.e., firms may need to raise prices to “pass through” a higher cost of labor, otherwise margins could deteriorate).

According to the ECB, collective wage bargaining in the Euro Area covers approximately 80% of total employees. As a result, negotiated wages (again, Exhibit 8) are an important input into the overall compensation per employee calculation. By extension, negotiated wages are also a key driver of wage growth trends in the Euro Area over the medium term.

So far, EUR corporate credit fundamentals have remained somewhat resilient despite the higher cost of capital and the elevated wage backdrop. For example, Exhibit 10 illustrates median leverage for EUR IG and HY issuers which remains below the peak of the past few years. And while EUR IG coverage ratios have declined over the past several quarters (Exhibit 11), EUR HY metrics have been range-bound.

Exhibit 8: Negotiated wages are a key driver of Euro Area services inflation

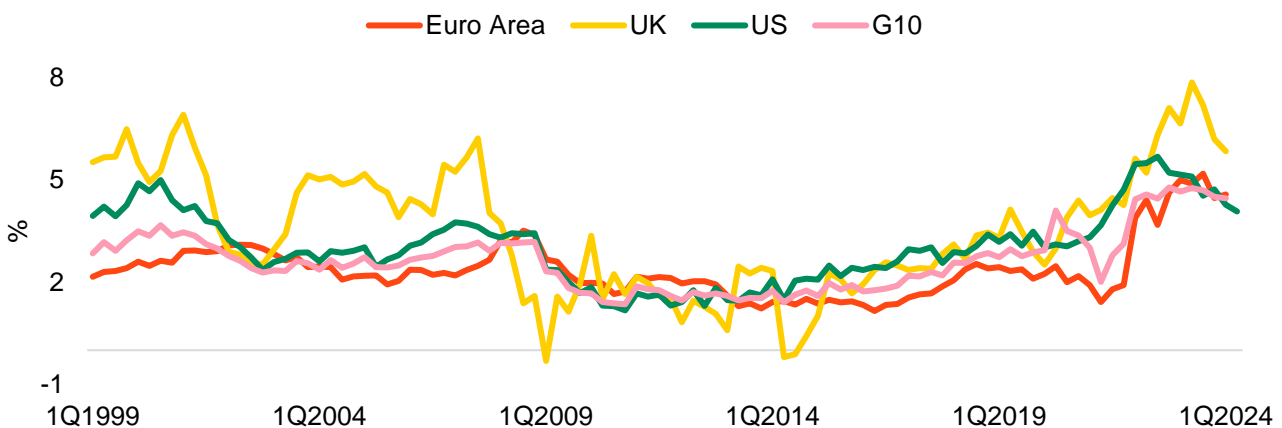
Percentage change in Euro Area negotiated wages



Source: European Central Bank, BlackRock, Bloomberg. As of 1Q2024 (most recent). Note: Developments in negotiated wages can be monitored by the ECB’s indicator of Euro Area negotiated wage growth, which has been compiled since 2001 and is based on data from nine countries: Belgium, Germany, Spain, France, Italy, Netherlands, Austria, Portugal and Finland. The indicator is published on a quarterly basis and includes structural wage increases as well as one-off payments.

Exhibit 9: The pace of wage growth has moderated but is still somewhat elevated

Underlying pace of wage growth in certain key G10 economies, as measured by the Goldman Sachs Global Investment Research Wage Trackers

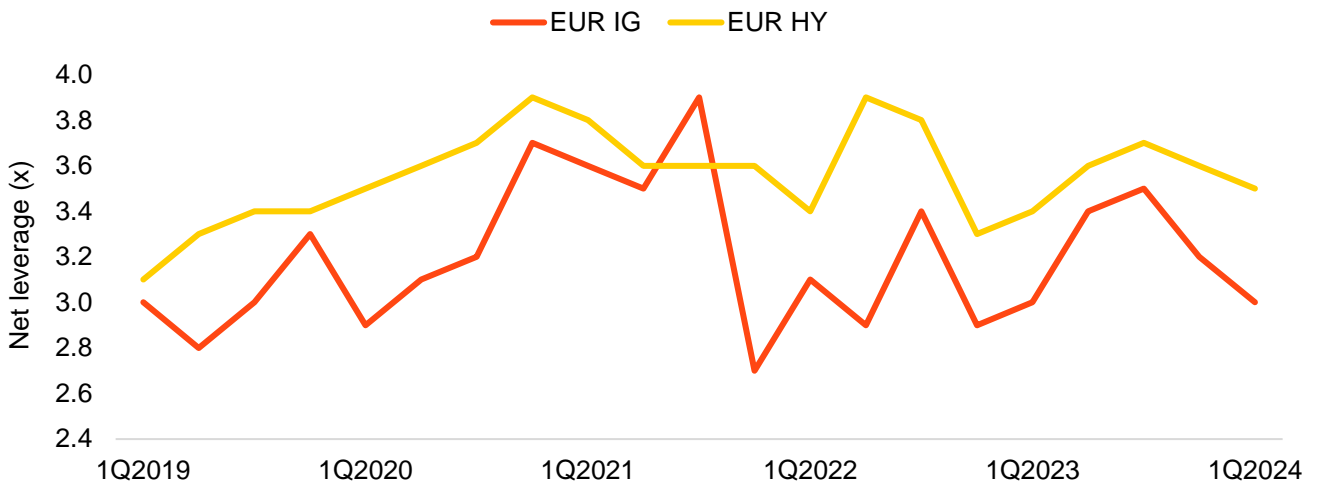


Source: Goldman Sachs Global Investment Research, BlackRock. As of 1Q2024, except for the U.S. which is as of 2Q2024.

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Exhibit 10: Median leverage in the EUR corporate credit market improved in 1Q2024

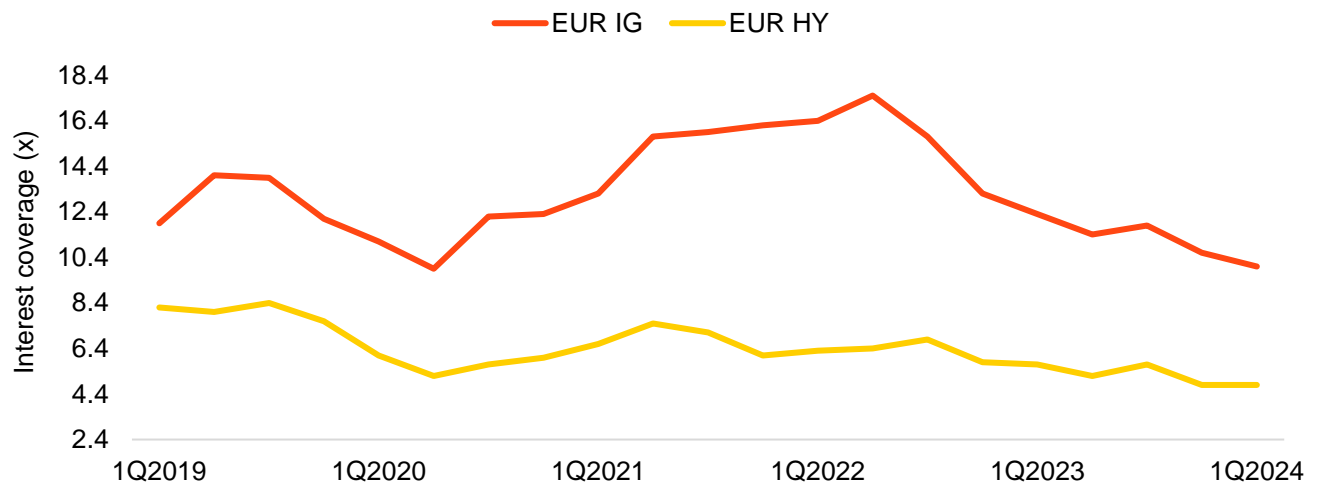
Trimmed mean (excludes top and bottom 10%) net leverage for the issuers in the Bloomberg EUR IG and HY Corporate indices



Source: Bloomberg, BlackRock. As of 1Q2024. Net leverage = (Debt - cash) / trailing 12-month EBITDA.

Exhibit 11: Coverage has moved lower, especially for EUR IG

Trimmed mean (excludes top and bottom 10%) interest coverage for the issuers in the Bloomberg EUR IG and HY Corporate indices



Source: Bloomberg, BlackRock. As of 1Q2024. Interest coverage = trailing 12-month EBITDA / interest expense.

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