Private Markets

June 13, 2024

# Global Credit Weekly:

## Building confidence

BlackRock

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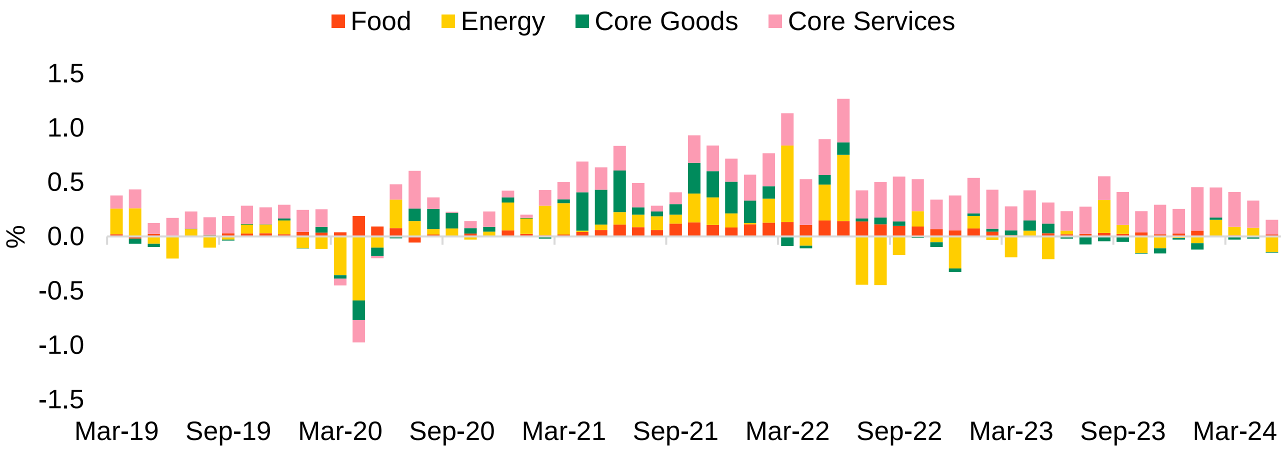
# Key takeaways

- This week's May U.S. inflation data was cooler than expected – a welcome development for Federal Reserve officials, considering the string of upside inflation surprises in 1Q2024. But even with this favorable inflation reading, the June FOMC meeting skewed *slightly* hawkish in our view, as illustrated by the revised "dot plot" in the June 2024 Summary of Economic Projections (SEP), as well as some of Chair Powell's commentary during the press conference (detailed within).
- Nonetheless, after an in-line inflation reading for April, and this better-than-expected print for May, we believe the groundwork is forming for at least one 25bp rate cut in 2024 (either in September, or in 4Q2024). The onus will be on the next few months of inflation data to continue this recent (favorable) pattern, such that the FOMC receives the "greater confidence" it desires before starting to normalize monetary policy.
- For corporate credit investors (in liquid and private markets), the interaction with growth remains paramount for two reasons. The first relates to the "depth" of the eventual rate cutting cycle. So long as U.S. growth remains at or above trend (note: 2Q2024 real GDP is tracking well above trend, at 3.1% per the Atlanta Fed GDPNow), we continue to expect a "shallow" rate cutting cycle. This makes the prospect of significant, near-term interest rate relief (on borrowers' debt service costs) unlikely. But it will also leave "all-in" yields elevated for a range of investors seeking to deploy capital into the credit markets. This will likely keep IG and HY credit spreads range-bound in aggregate (and may even support tightening, as issuance slows through the summer).
- The second reason relates to credit's fundamentals. Solid economic growth should allow most of the corporate credit market to continue to navigate the "high for even longer" interest rate environment with relative resilience – extending the trend of the past few quarters. The exception, in our view, will be capital structures with unsustainably high leverage and an inability to grow in a *capital efficient* way. This underscores the importance of credit and sector selection, in our view, and supports the case for elevated dispersion across asset classes, sectors and issuers.

**Exhibit 1: April and May inflation data have been encouraging**

Contributions to month-over-month headline U.S. CPI (seasonally adjusted)




Source: BlackRock, Bloomberg, Bureau of Labor Statistics. As of May 31, 2024.

## Better inflation data, yet a more hawkish "dot plot"

This past week was unique as it featured the release of U.S. May inflation data and the Federal Reserve's June rate decision on the same day. On net, the inflation data was cooler than expected – a welcome development for Federal Reserve officials, considering the string of upside inflation surprises in 1Q2024. But even with the favorable inflation readings, the June FOMC meeting skewed slightly more hawkish, as illustrated by the revised "dot plot" and Chair Powell's commentary.

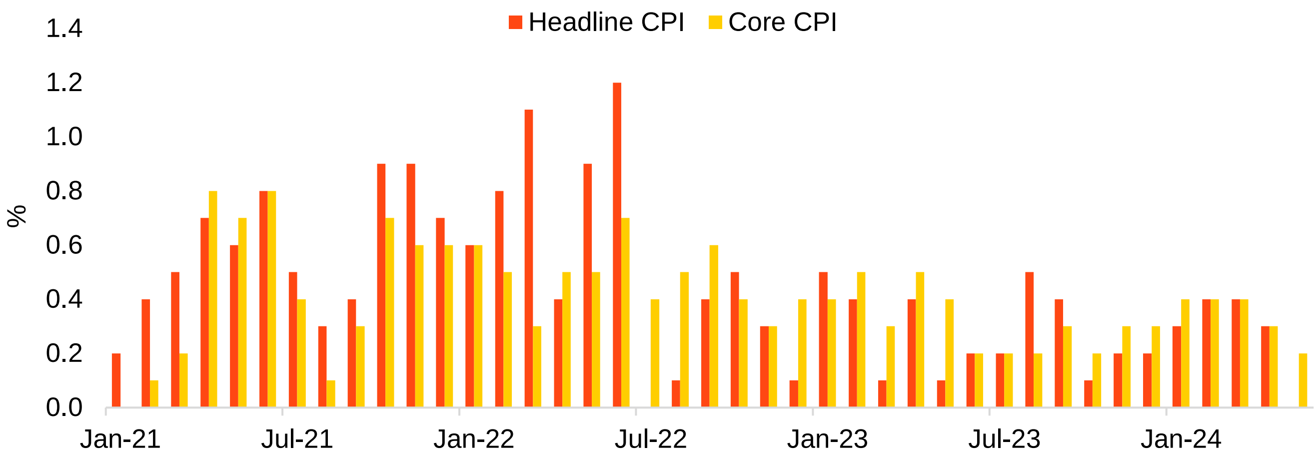
### May inflation data: so far, so good

The May 2024 Consumer Price Index (CPI) data (released June 12th) was more benign than anticipated. Headline CPI was flat month-over-month – a sharp decline from the pattern of the past few months (Exhibit 2), and below Bloomberg consensus estimates for +0.1%. On a year-over-year basis, headline CPI decelerated to +3.3% as of May (from +3.4% in April; Exhibit 3).

Similarly, core CPI (which excludes food and energy) increased 0.2% month-over-month (again, Exhibit 2) – the lowest reading since August 2021's +0.1% and below Bloomberg consensus estimates for +0.3%. Year-over-year core CPI was +3.4%, compared to +3.6% in April (again, Exhibit 3).

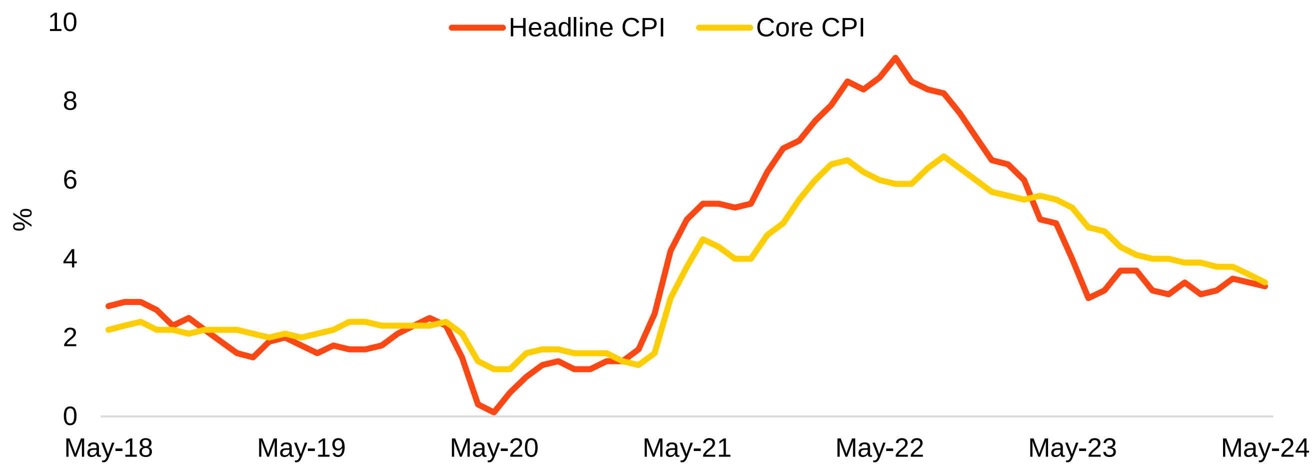
May core Personal Consumption Expenditures (PCE) – the Federal Reserve's preferred inflation gauge – will be released on June 28th.

**Exhibit 2: May CPI data represented a sharp decline vs. the recent pattern**
Month-over-month % change in headline and core U.S. CPI (seasonally adjusted)




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

**Exhibit 3: Headline and core U.S. CPI decelerated on a year-over-year basis in May**
Year-over-year % change in headline and core U.S. CPI (not seasonally adjusted)




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

The closely watched "supercore" metric – which represents core services excluding shelter – also generated a sharp decline in May, as illustrated in Exhibit 4. Detail released from the Bureau of Labor Statistics showed the index for airline fares fell 3.6% in May, following a 0.8% decrease in April. Over the month, the new vehicles index fell 0.5%, the communication index decreased 0.3%, and the recreation index declined 0.2%. The indices for apparel, household furnishings and operations, motor vehicle insurance, and personal care also declined in May.

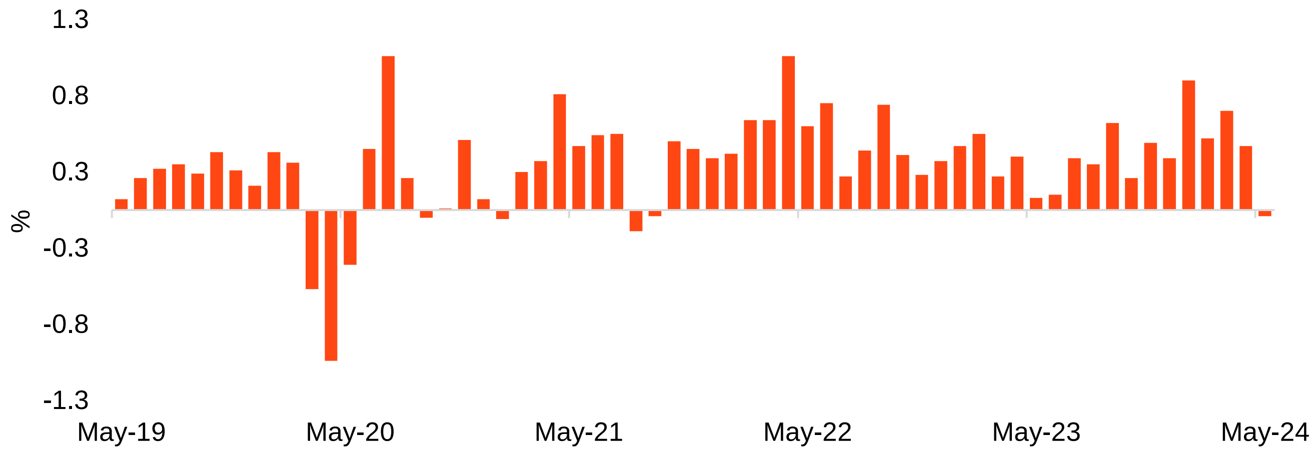
By contrast, the index for shelter (which represents 36% of the CPI basket) increased 0.4% for the fourth consecutive month. Other indices which increased during May include medical care, used cars and trucks, and education.

## The path from here

After an in-line inflation reading for April, and this better-than-expected reading in May, we believe the groundwork is forming for at least one cut in 2024. That said, the onus will be on the inflation data to continue this recent pattern, such that the FOMC receives the "greater confidence" required to begin normalizing policy. So long as U.S. growth remains above trend, we continue to expect a "shallow" rate cutting cycle. This leaves the prospect for significant, near-term interest rate relief as unlikely.

**Exhibit 4: Core services ex-housing declined sharply in May**

Month-over-month change in U.S. CPI core services ex-Housing ("supercore" CPI)




Source: BlackRock, Bureau of Labor Statistics, Bloomberg. As of May 31, 2024. Bloomberg estimate of "Supercore" CPI excludes Rent of Primary Residence and Owners Equivalent Rent of Residences from Services ex-Energy Services. Estimate reflects Bloomberg's calculations following consultation with the Bureau of Labor Statistics (BLS) https://www.bls.gov/opub/hom/cpi/calculation.htm.

## June FOMC: A *slightly* more hawkish tilt – at least in the near-term

Heading into the June 12th FOMC meeting, the Federal Reserve was widely expected to leave the monetary policy rate unchanged at 5.25% – 5.5%, as the Committee previously guided to a need for more "confidence" that inflation was on a sustainable path toward 2%. That said, we were focused on three main areas away from the formal policy decision:

- **Incremental insight into the central bank's reaction function**, now that the dual mandate of maximum employment and price stability has moved into better balance (i.e., inflation is no longer far above the 2% target, and the unemployment rate has increased 60bp from the early 2023 local trough of 3.4%)
- **An updated Summary of Economic Projections (SEP)**, which we expected to show fewer rate cuts in 2024 and a higher "long run dot" (indictive of the "shallow" rate cutting cycle we have been expecting)
- **Commentary on the neutral rate**, which may help to inform the degree of restrictiveness embedded in the current stance of monetary policy, as well as the impact of structural shifts in the economy on interest rates (including higher U.S. government deficits and spending related to infrastructure investment and artificial intelligence)

The June FOMC (and accompanying SEP) skewed *slightly* hawkish on a few fronts, in our view. Key takeaways include:

- **Two fewer cuts in 2024, but one more in 2025.** The median "dot" in the June 2024 SEP showed just one 25bp cut for 2024, relative to three 25bp cuts as of the March projection (Exhibit 5). Market pricing as of June 11th (i.e., heading into the June 12th FOMC decision) implied close to two 25bp cuts for 2024, rather than just one. That said, some of the shift in the June SEP's median "dot" represented a "postponement" of sorts: 2025 now shows four 25bp rate cuts, compared to three as of March. During the press conference, Chair Powell reiterated that the projections shown in the quarterly SEPs are not an official forecast from the Committee. Moreover, he cited a range of plausible outcomes which are "very close calls." (For example: eight FOMC participants expect two cuts in 2024, seven expect one cut, and four expect no cuts). There is not, according to Chair Powell, "a really strong commitment" to a particular rate path. Rather, it is and will be subject to the totality of incoming data.
- **Higher inflation forecasts.** The median projection now calls for core PCE inflation of 2.8% by year-end 2024, compared to 2.6% as of March (again, Exhibit 5). When asked why the bias on inflation was for a higher figure in the SEP, Chair Powell referred to this as a "fairly conservative" estimate for "good, but not great" inflation data, which may cause the year-over-year figures to remain elevated as the low readings from 2H2023 fall out of the calculation. Inflation of "2.6% or 2.7% …is a really good place to be" according to Chair Powell.
- **A higher long-term rate, and residual questions on "sufficiently restrictive."** The "longer run" Federal Funds rate is now 2.8% per the median "dot" in the June SEP. This represents an increase from 2.6% as of March 2024, and 2.5% as of December 2023 (again, Exhibit 5). While Chair Powell pushed back against the relevance of the long-term rate for setting near-term monetary policy, he acknowledged that this drift higher reflects a "view that rates are less likely to go down to their pre-pandemic levels" which were low by historical standards. Chair Powell also reiterated his prior messaging that while he views the current stance of monetary policy as "restrictive," the question of whether policy is "sufficiently restrictive" is one that will be known over time.

**Exhibit 5: The June SEP median forecast noted higher inflation and fewer rate cuts for 2024**

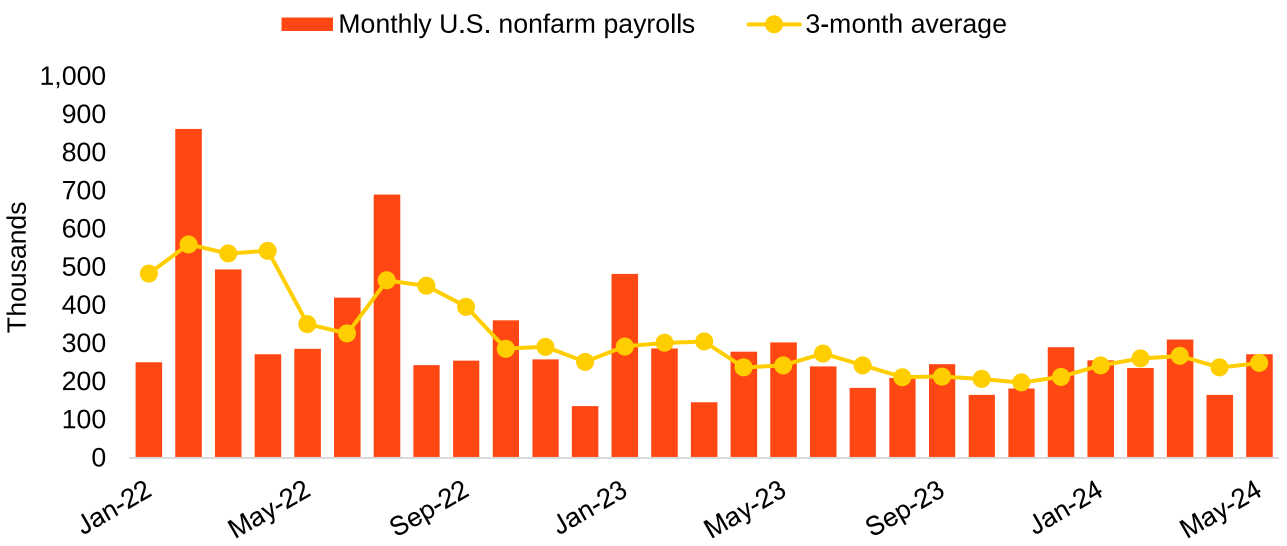
Median economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, under their individual assumptions of projected appropriate monetary policy, as of June 2024

| | 2024 | 2025 | 2026 | Longer run |
|---|---|---|---|---|
| **Real GDP growth** | **2.1** | **2.0** | **2.0** | **1.8** |
| *March 2024 projection* | *2.1* | *2.0* | *2.0* | *1.8* |
| *December 2023 projection* | *1.4* | *1.8* | *1.9* | *1.8* |
| **Unemployment rate** | **4.0** | **4.2** | **4.1** | **4.2** |
| *March 2024 projection* | *4.0* | *4.1* | *4.0* | *4.1* |
| *December 2023 projection* | *4.1* | *4.1* | *4.1* | *4.1* |
| **PCE inflation** | **2.6** | **2.3** | **2.0** | **2.0** |
| *March 2024 projection* | *2.4* | *2.2* | *2.0* | *2.0* |
| *December 2023 projection* | *2.4* | *2.1* | *2.0* | *2.0* |
| **Core PCE inflation** | **2.8** | **2.3** | **2.0** | |
| *March 2024 projection* | *2.6* | *2.2* | *2.0* | *not given* |
| *December 2023 projection* | *2.4* | *2.2* | *2.0* | |
| **Federal funds rate** | **5.1** | **4.1** | **3.1** | **2.8** |
| *March 2024 projection* | *4.6* | *3.9* | *3.1* | *2.6* |
| *December 2023 projection* | *4.6* | *3.6* | *2.9* | *2.5* |

Source: BlackRock, Federal Reserve June 2024 Summary of Economic Projections.

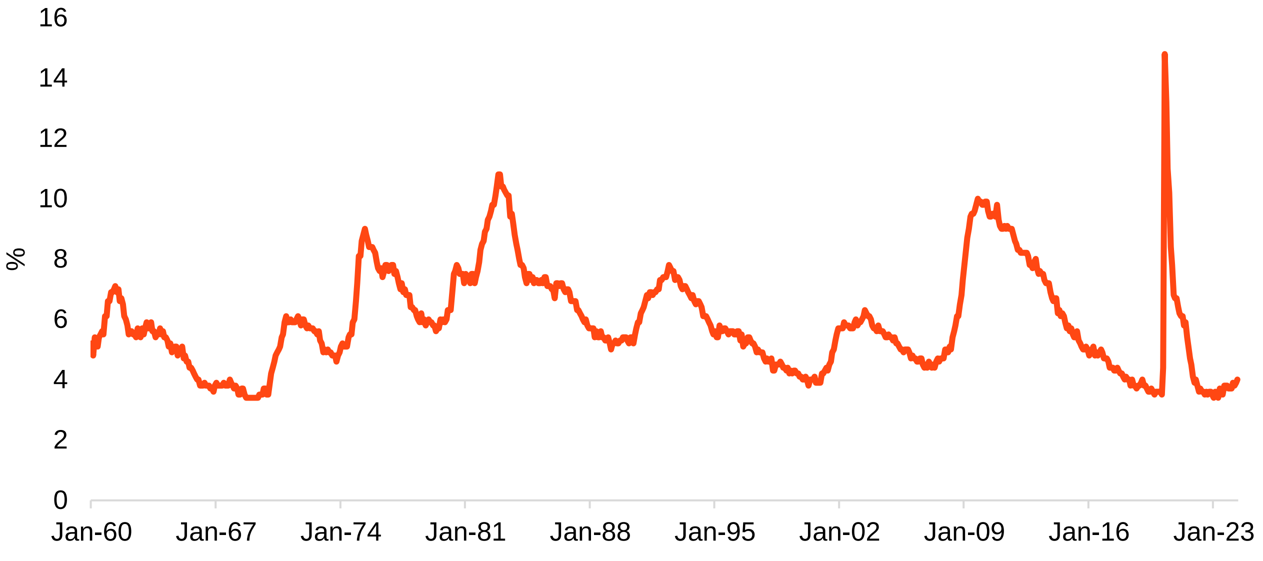
- **Hikes are still not the base case.** In terms of the reaction function, the statement noted: "If the economy remains solid and inflation persists, we are prepared to maintain the current target range for the federal funds rate as long as appropriate. If the labor market were to weaken unexpectedly or inflation were to fall more quickly than anticipated, we are prepared to respond."
- **A more balanced reaction function…** There was a change to the statement to reflect "modest further progress on inflation," instead of the "lack of further progress" that was added previously. Additionally, Chair Powell's prepared remarks acknowledged that "as labor market tightness has eased and inflation has declined over the past year, the risks to achieving our employment and inflation goals have moved toward better balance."
- **…but a somewhat higher bar to react to labor market deterioration.** During the Q&A, Chair Powell noted that it is an "unexpected deterioration in labor market conditions" that would be most likely to warrant a policy response. While the reference to "unexpected" is not new, the June SEP did reflect a slightly higher projection for unemployment in 2025 (again, Exhibit 5).

**Exhibit 6: The Fed said it could respond to "unexpected deterioration" in the U.S. labor market**
Monthly U.S. nonfarm payrolls and the three-month moving average pace of job creation




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

**Exhibit 7: The unemployment rate has risen 60bp vs. the local trough of 3.4% in early 2023**
U.S. unemployment rate (seasonally adjusted)




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

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