August 1, 2024

# Global Credit Weekly:

## On track for September

BlackRock

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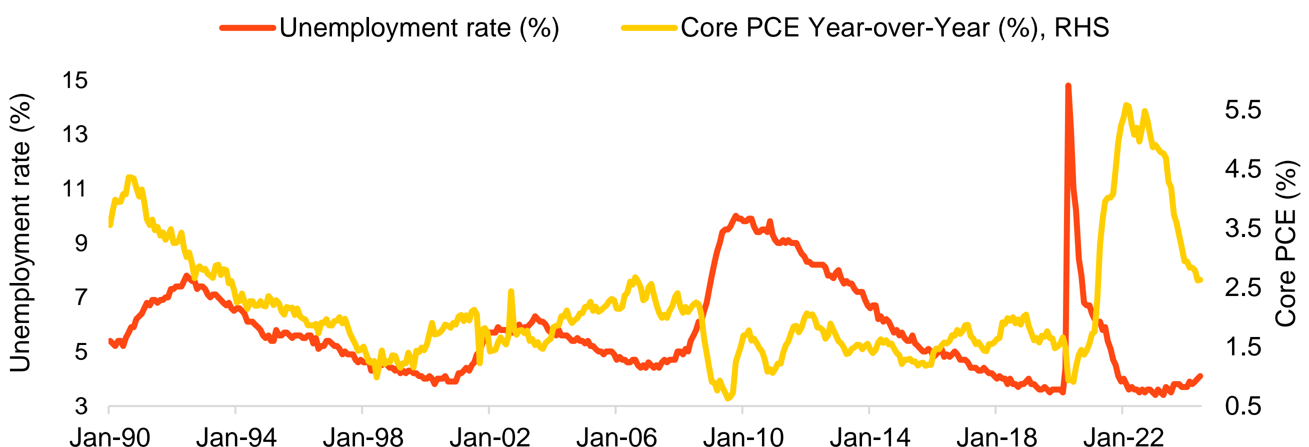
# Key takeaways

- As was widely expected, the FOMC left its monetary policy rate unchanged (at 5.25% - 5.5%) at its July 30th - 31st meeting. That said, Chair Powell's press conference explicitly highlighted a September rate cut as a possibility – *if* the incoming inflation data cooperates. While many market participants are focused on the timing (i.e., start) of a rate cutting cycle, we believe the *depth of* and *reason behind it* are instead more important. For example, "easing" rate cuts in response to unexpected, material weakness in the U.S. labor market (and/or a sharp downturn in growth) would likely be accompanied by much wider spreads and higher risk premiums in growth-sensitive asset classes such as corporate credit (both liquid and private). By contrast, "normalization" rate cuts in response to ongoing declines in inflation would be a much more supportive environment for corporate credit.
- As we outlined in our *3Q2024 Global Credit Outlook*, the liquid and private credit markets have generally been following a trend of "dispersion but not widespread disruption," and have navigated this higher cost of capital backdrop with relative resilience – owing to a supportive growth backdrop. A trend pace of growth (or ideally, above trend) is likely a prerequisite for continued resilience in these liquid and private credit markets, as we do not expect material near-term relief in corporate borrowers' interest costs.
- Alongside the FOMC rate decision, the financial health of the U.S. consumer has been in sharp focus over the past two weeks, as 2Q2024 earnings reports from a wide range of consumer-focused companies emphasized more choiceful, value-seeking, and selective spending patterns. Beyond the importance of consumer spending to the overall U.S. economy, these trends warrant close monitoring for sector- and issuer-specific performance. Indeed, July total return performance does show some additional weakness in certain USD HY consumer-facing sectors, relative to the broader year-to-date trend. Recent data also indicates that the *severity* of consumer delinquencies may be more pronounced in the current cycle.

**Exhibit 1: The Fed's dual mandate of price stability and full employment is now balanced**
U-3 U.S. unemployment rate (monthly, seasonally adjusted) and year-over-year core PCE inflation (seasonally adjusted), RHS




Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Bloomberg, BlackRock. Captures data through June 30, 2024 (most recent as of July 31, 2024).

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## July FOMC recap: On track for September

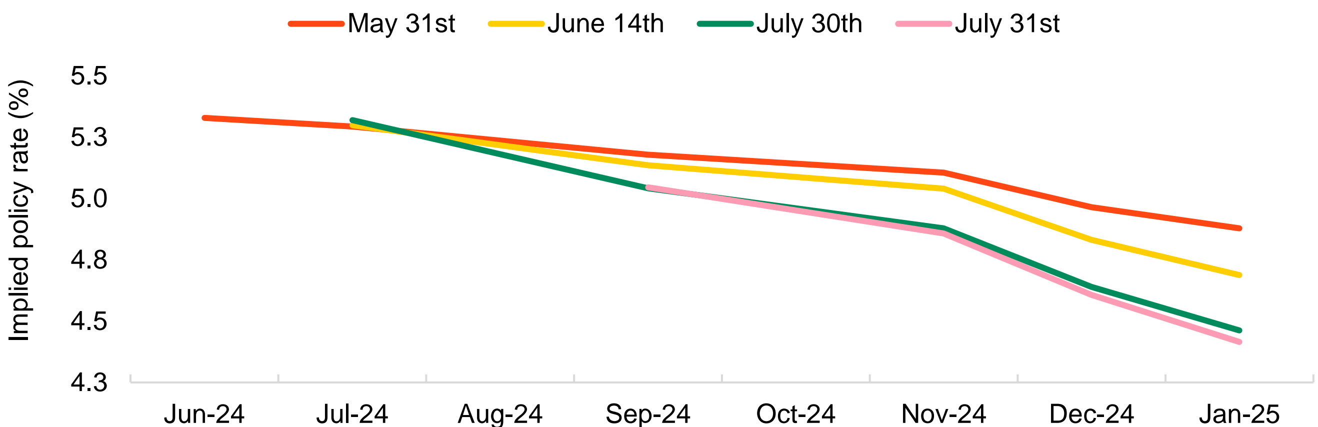
As was widely expected – based on recent commentary from Federal Reserve (Fed) officials and market pricing (Exhibit 2) – the Federal Open Market Committee (FOMC) left its monetary policy rate unchanged (at 5.25% - 5.5%) at its July 30th - 31st meeting. That said, Chair Powell's press conference explicitly highlighted a September rate cut as a possibility – *if* the incoming inflation data cooperates.

Relative to the June meeting, some adjustments were made to the July FOMC statement to reflect that job gains have "moderated", the unemployment rate has "moved up but remains low", and inflation has eased over the past year but remains "somewhat" elevated. The statement also noted that there has been "some" further progress toward the FOMC's 2% inflation objective.

The most significant change to the statement, in our view, was a reference that the FOMC "is attentive to the risks to both sides of its dual mandate." This sentence had previously been focused on inflation risks but was changed now that the dual mandate of price stability and maximum employment has moved into better balance (Exhibit 1).

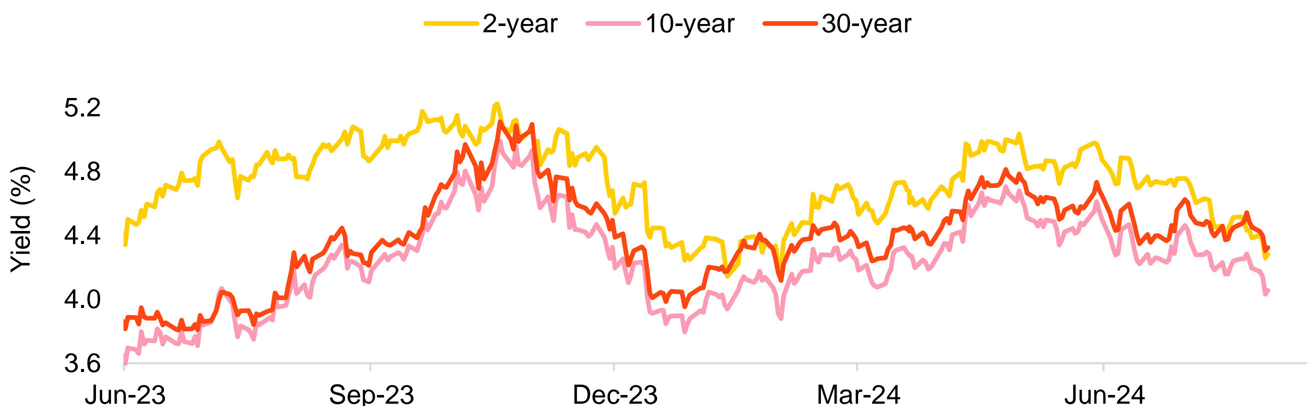
Finally, there was an indication that the encouraging inflation data from 2Q2024 is not yet sufficient to begin normalizing monetary policy, as this sentence was left unchanged: "The Committee does not expect it will be appropriate to reduce the target range until it has gained greater confidence that inflation is moving sustainably toward 2%."

**Exhibit 2: Market pricing implies roughly 90bp of rate cuts by early 2025**
The U.S. monetary policy rate implied by Fed Funds Futures, through early 2025




Source: BlackRock, Bloomberg. As of May 31, June 14 and July 30, and July 31, 2024. **There can be no guarantee any forecasts may come to pass.**

**Exhibit 3: Rates rallied this week, due in part to some geopolitical headlines on Wednesday**
Yield-to-worst of the 2-year, 10-year and 30-year U.S. Treasuries (on-the-run securities, mid levels)




Source: BlackRock, Bloomberg. As of July 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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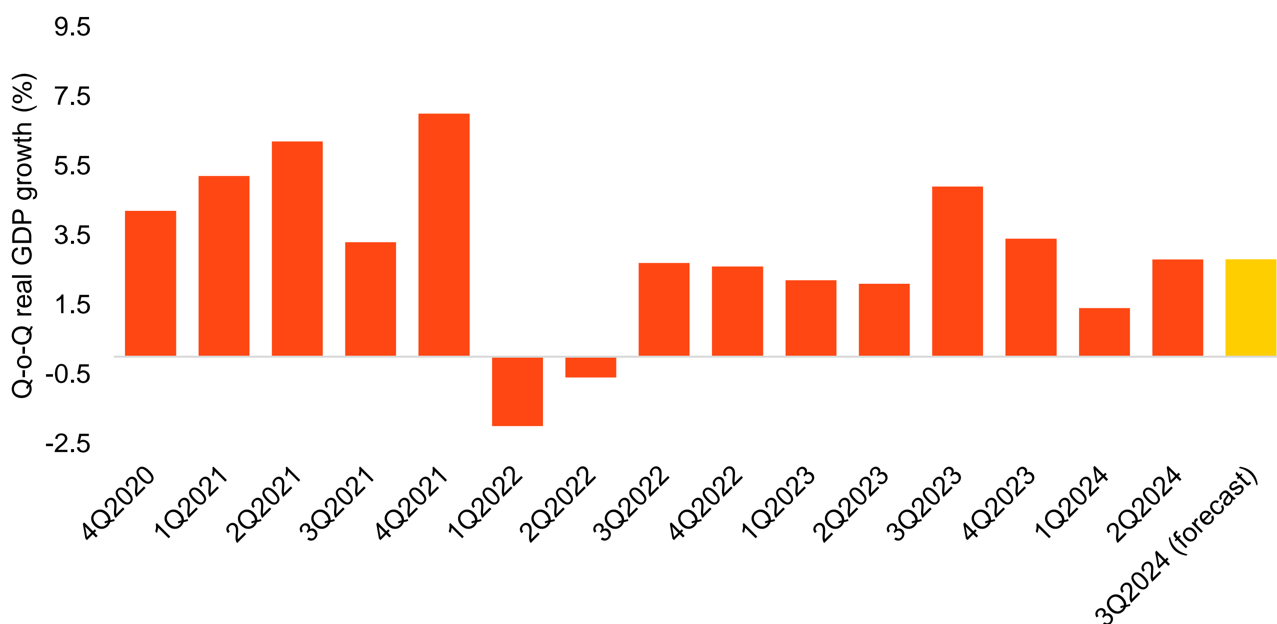
## Key takeaways from the July FOMC, for corporate credit investors:

- **Timing: September is on the table.** When asked if a rate cut was possible in September, Chair Powell said that while no decisions have been made on future meetings, the "broad sense" of the FOMC is that "the economy is moving closer to the point at which it would be appropriate to reduce the policy rate". He added that a reduction of the policy rate could occur as soon as the September meeting if the future inflation data is consistent with their expectations, but that the Committee was "not quite there yet."
- **Data dependent, not data point dependent.** Similar to the language used recently by European Central Bank President Christine Lagarde, Chair Powell said the FOMC would look at the totality of the data (inflation, balance of risks, employment) – not a single data point – in making future monetary policy decisions.
- **No guidance on the pace of future cuts.** While acknowledging that the Fed can likely afford to "dial back" the level of restriction in the policy rate, Chair Powell declined to give specific guidance on the pace of future cuts (stating that this would be highly dependent on the economy). He added that the Committee is not thinking about a 50bp cut at this time.
- **Economic activity: Slowing, but not slow.** Chair Powell noted that economic activity continued to expand at a solid pace in 1H2024 but moderated vs. 2H2023 (Exhibit 4). While acknowledging that there are some pockets of weakness in the economy, he pushed back on the idea (during the Q&A) that the anecdotal data was uniformly downbeat. Rather, he described it as "mixed." Chair Powell added that the Fed was "well equipped" to respond to any economic weakness, if it were to materialize, given the current level of the policy rate (5.25% - 5.5%, which leaves room to cut).
- **A potential cut *was* discussed.** While the decision to hold rates was unanimously supported by the members of the FOMC, Chair Powell said that there "was a real discussion back and forth" about the potential case for cutting rates at this meeting. Chair Powell reiterated the message (from various forums over the past several weeks) that he believes policy is "clearly restrictive", but not extremely restrictive.
- **The U.S. election.** During the Q&A, Chair Powell said the FOMC "would never try to make policy decisions based on the outcome of an election that hasn't happened yet."

**Exhibit 4: U.S. economic activity has moderated vs. 2H2023, but remains solid**
Quarter-over-quarter U.S. real GDP growth (%), seasonally adjusted at an annualized rate




Source: BlackRock, Bureau of Economic Analysis. 3Q2024 forecast uses the Atlanta Fed "GDPNow" estimate as of July 26, 2024 (which is the most recent available as of July 31, 2024). **There can be no guarantee any forecasts will come to pass.**

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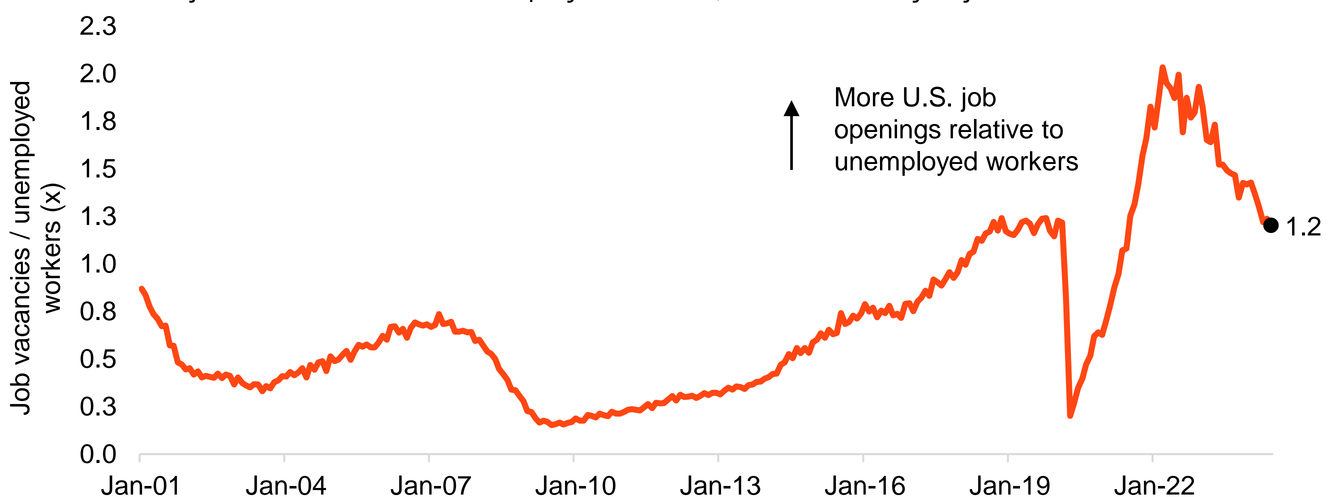
- **The risks to the dual mandate are balanced.** The risk of cutting too soon (which would undermine inflation progress) must be weighed against the risk of cutting too late (which would put the economic recovery at risk).
- **Inflation progress in 2Q, but "we need to see more."** The 2Q2024 inflation data gave the Fed some confidence that inflation is on a path toward the 2% target, and the "quality" of this data was also encouraging as it showed "broader disinflation" progress in all three core PCE categories (goods, services, and non-housing services). That said, Chair Powell added that "the job is not done on inflation" and that "we need to see more" good data to have confidence that inflation is on a path toward 2%.
- **The labor market warrants close monitoring.** Chair Powell characterized the labor market as showing an ongoing, gradual normalization (from a period of overheated conditions) – not outright weakness. That said, he acknowledged "the downside risks to the employment mandate are real now." Now that the labor market has reverted to its pre-pandemic (i.e. late 2019) conditions (Exhibit 5), Chair Powell said he "would not like to see material further cooling." He added that the Fed will be watching a broad range of data (wages, participation, surveys, quits, hires, etc.) very carefully for signs of a sharper downturn, but that many metrics (including job creation, wages, vacancies, the unemployment rate, layoffs, and initial claims) suggest normalization and not outright weakness.
- **Hard landing risk and the typical recession indicators.** Chair Powell was asked during the Q&A if he would be concerned if the "Sahm rule" – a recession indicator based on the change in the unemployment rate – were to be triggered. He said he viewed the metric as more of a "statistical regularity" and not an "economic rule" and added that other typical economic relationships (such as the link between an inverted U.S. Treasury yield curve and recession) have not held in this unique economic cycle (so far). Chair Powell characterized the chances of a so-called "hard landing" as "low."

More broadly, while many market participants are focused on the timing (i.e., start) of a rate cutting cycle, we believe the *depth of* and *reason behind it* are instead more important. For example, "easing" rate cuts in response to unexpected weakness in the U.S. labor market (and/or a sharp downturn in growth) would likely be accompanied by wider spreads and higher risk premiums in growth-sensitive asset classes such as corporate credit (both liquid and private). By contrast, "normalization" rate cuts in response to ongoing declines in inflation would be a much more supportive environment for corporate credit.

As we outlined in our *3Q2024 Global Credit Outlook*, the liquid and private credit markets have generally been following a trend of "dispersion but not widespread disruption," and have navigated this higher cost of capital backdrop with relative resilience – owing to a supportive growth backdrop. A trend pace of growth (or ideally, above trend) is likely a prerequisite for continued resilience in these liquid and private credit markets, as we do not expect material near-term relief in corporate borrowers' interest costs.

**Exhibit 5: The U.S. labor market has rebalanced to its pre-pandemic level**

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




Source: BlackRock, Bureau of Labor Statistics. Captures data through June 30, 2024 (most recent).

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## A growing divide: Bifurcation in the U.S. consumer

Over the past few quarters, one prevailing investing theme has been elevated dispersion, but not widespread market disruption. Recent performance in high yield credit offers an example of such dispersion, with credit spreads hovering near the low end of the post-financial crisis (GFC) range (and for some rating cohorts, reaching new post-GFC lows), while subsets of the market – such as CCCs – have lagged the overall tightening at the index level.

The U.S. consumer is no exception to this trend of dispersion. Indeed, as we've highlighted previously, the U.S. consumer is bifurcated, as evidenced by somewhat mixed data over the past several months. While this bifurcation isn't new, we believe it matters more in the current market backdrop of elevated interest rates, higher home prices and rent costs, and gains in the equity market.

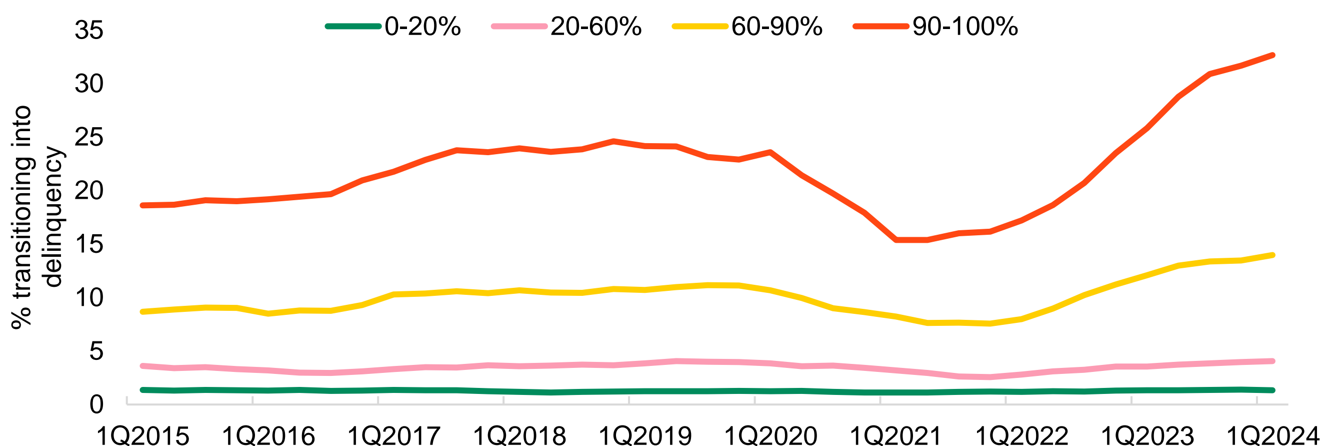
A variety of corporations have suggested on recent 2Q2024 earnings calls that subsets of the U.S. consumer are becoming increasingly discerning and cost-conscious (i.e., making tradeoffs on spending, prioritizing certain purchases, or purchasing in smaller quantities). The health of the U.S. labor market will be critical in keeping this trend contained and preventing it from materializing into a concerning circle of decreased consumer spending, lower corporate profits, and corporate headcount reductions. Despite some recent cooling, the unemployment rate remains low at 4.1% (versus the local trough of 3.4% in April 2023 and an average of 6.2% from 2010-2019; again, Exhibit 1).

Consumer sentiment in the U.S., according to the University of Michigan consumer sentiment index, has moderated from local highs at the beginning of the year, but still hovers near the last two-year average. Meanwhile, the Conference Board's consumer confidence measure ticked up slightly in July, though remains below its highs at the beginning of the year, as well as the two-year average.

## Watching the frequency and *severity* of delinquencies

In May, we analyzed how credit usage highlights the growing divide among U.S. consumers. Indeed, a NY Fed analysis[1] revealed that a greater share of "maxed-out" credit card balances (defined as those utilizing at least 90% of their available credit) were transitioning into delinquency status (Exhibit 6). The data also showed that roughly one-third of the balances associated with maxed-out borrowers became delinquent in the past year (vs. less than one-quarter of balances in the pre-pandemic period; again, Exhibit 6). In our view, this indicates that the *severity* of delinquencies may be more pronounced in the current period.

**Exhibit 6: A greater share of "maxed out" balances are transitioning into delinquency**
Percent of balances transitioning into delinquency by borrower utilization rate




Source: New York Fed Consumer Credit Panel / Equifax, BlackRock. As of 1Q2024. Note: The chart shows a balance-weighted transition to 30-day credit card delinquency among borrowers who were current on all accounts in the previous quarter. A borrower's group is determined by their utilization in the previous quarter. Data is smoothed as four-quarter moving sums to account for seasonal trends.

(1) Andrew F. Haughwout, Donghoon Lee, Daniel Mangrum, Joelle Scally, Wilbert van der Klaauw, and Crystal Wang, "Delinquency Is Increasingly in the Cards for Maxed-Out Borrowers," Federal Reserve Bank of New York Liberty Street Economics, May 14, 2024, https://libertystreeteconomics.newyorkfed.org/2024/05/delinquency-is-increasingly-inthe-cards-for-maxed-out-borrowers/.

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Data from a separate analysis conducted by the Federal Reserve Bank of Philadelphia (Philadelphia Fed) emphasized a similar takeaway related to the frequency vs. severity discussion.

According to the Philadelphia Fed, credit card delinquency rates (by balance) hit their highest levels in 1Q2024 since the data began in 2012. But the *number* of accounts past due fell in the first quarter (partly due to seasonal factors). This divergence – between the nominal (dollar value) of balances and the number (equally weighted, by each individual borrower) – demonstrates that while there are proportionately fewer accounts past due, those behind on payments are accumulating larger unpaid balances (Exhibit 7). (*Note that this is true across all cohorts: 30+, 60+, and 90+ days delinquent*).

Changes in the number of accounts past due also offers some insight into the uniqueness of this current cycle. Pre-pandemic, trends in the number of accounts past due in each cohort showed a relatively consistent pattern. However, post-pandemic, these cohorts have become less consistent, potentially signaling a *higher degree of strain* amongst the most financially stressed borrowers.

For example, in 1Q2024, the share of delinquent accounts that are 30+ and 60+ days past due showed improvement, declining at a rate of 6% and 4%, respectively (Exhibit 8). This is consistent with seasonal first-quarter patterns, in which the number of delinquent accounts generally declines. However, the 90+ days delinquent cohort diverged from historical patterns (and the other cohorts), with the number of delinquent accounts declining by only 1% (again, Exhibit 8). This suggests that consumers further behind on payments (i.e., 90+ days delinquent) are less able to become current, compared to (1) past patterns of this specific cohort and (2) the 30+ and 60+ days delinquent cohorts.

**Exhibit 7: Balance-based delinquency rates reached new highs in 1Q2024**
Percent of credit card balances and accounts 60+ days past due

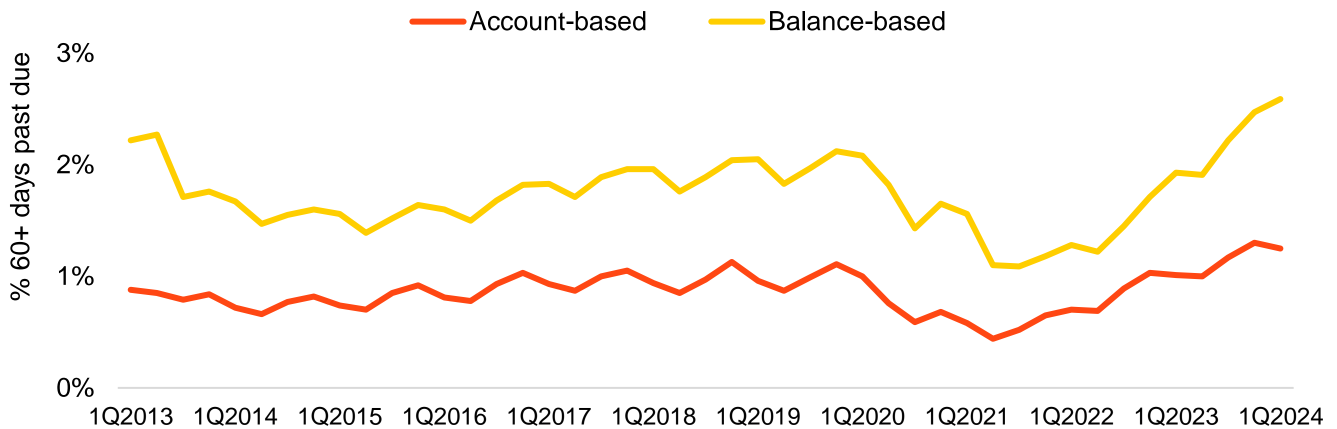
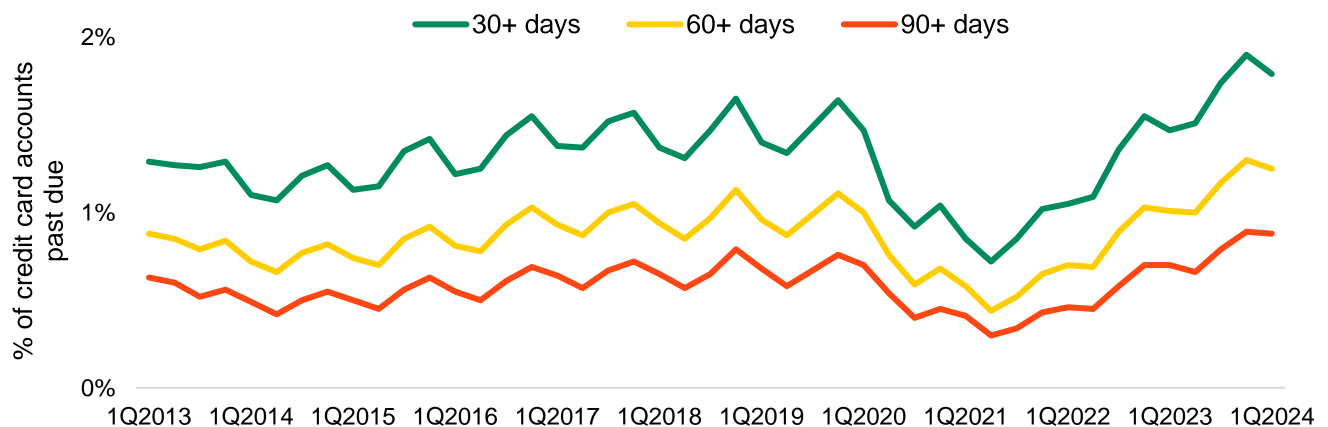



**Exhibit 8: Credit card delinquency activity has been less consistent across cohorts in the post-pandemic era**
Percent of credit card accounts (equally weighted) past due, by days past due




**For both charts:** Source: FR Y-14M Data, Federal Reserve Bank of Philadelphia, BlackRock. As of 1Q2024. Note: Credit card data include consumer bankcards only and exclude small business, corporate, and consumer charge cards. Credit card balances in the aggregate FR Y-14M data are estimated to represent roughly four-fifths of total U.S. bankcard balances.

## The sector read-through

For corporate credit investors, the obvious question is: how does this materialize in market and sector performance? At the macro level, trends in the U.S. consumer warrant close monitoring given its significant contribution to U.S. GDP. In 2Q2024, quarter-over-quarter real U.S. GDP grew 2.8%, which was above Bloomberg consensus expectations for 2.0%. Notably, personal consumption expenditures were the largest contributor (Exhibit 9). At the micro level, we see potential for additional dispersion in sector and issuer performance.

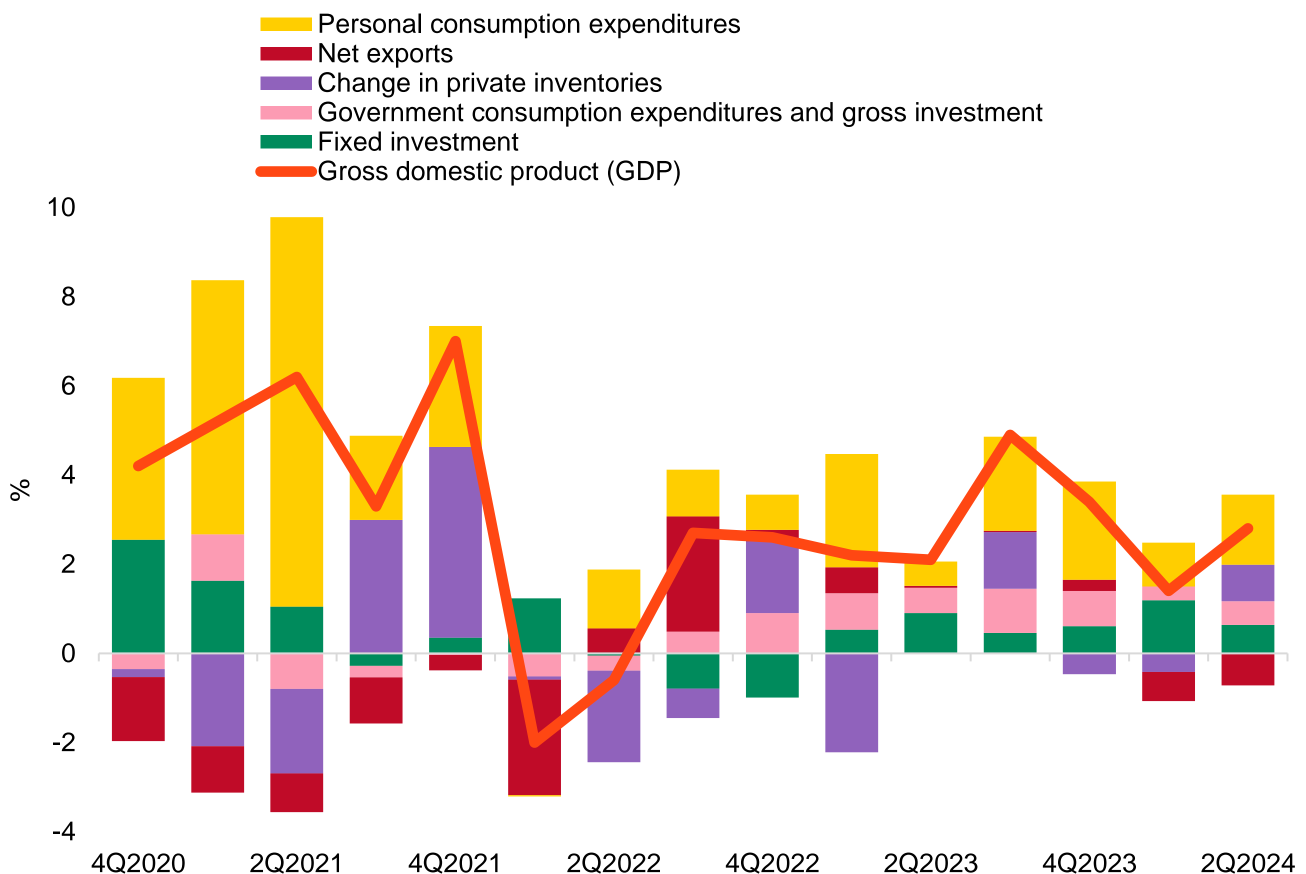
Exhibit 10 (next page) illustrates some of the recent shifts at the sector level. Indeed, month-to-date (MTD) returns for consumer-focused sectors generally lagged the broader USD Corporate High Yield Bond Index in July, suggesting that a deliberate and cost-conscious consumer is weighing on the performance of consumer-focused sectors.

For some sectors, this is a reversal from stronger year-to-date (YTD) performance. For example, retailers, gaming, and leisure all underperformed the broader index in July, but have outperformed it YTD. The shift in (more recent) performance suggests that corporate pricing power may be waning as consumers become more value-seeking. This trend will warrant close monitoring, in our view, over the coming quarters.

By contrast, some sectors, such as restaurants, lodging, supermarkets, and consumer products, have underperformed the index in both July MTD and YTD returns. This (more sustained) underperformance is likely nuanced and may be due to a confluence of macro and micro headwinds (i.e., company/sector specific challenges, capital management decisions, moderating but still elevated input cost and wage inflation, narrowing profit margins, loss of pricing power, a cost-conscious consumer, etc.).

**Exhibit 9: Personal consumption expenditures supported solid GDP growth in 2Q2024**

Contributions to quarter-over-quarter real U.S. GDP growth (%), seasonally adjusted at an annualized rate




Source: Bureau of Economic Analysis, Bloomberg, BlackRock. As of June 30, 2024 (most recent available).

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**Exhibit 10: The underperformance of certain consumer-focused sectors has become somewhat more pronounced in July**

July month-to-date (MTD) and year-to-date (YTD) total returns by sector for the Bloomberg USD Corporate High Yield Bond Index

| | Total MTD index return (%) | Total YTD index return (%) |
|---|---|---|
| *USD HY Index* | 1.7 | 4.4 |
| | **Total MTD return by sector (%)** | **Total YTD return by sector (%)** |
| Wirelines | 4.5 | 3.2 |
| Cable Satellite | 3.3 | -1.7 |
| Office REITs | 3.3 | 0.8 |
| Media Entertainment | 2.8 | 0.7 |
| Wireless | 2.4 | -3.7 |
| Healthcare | 2.2 | 6.7 |
| Technology | 2.1 | 5.3 |
| Natural Gas | 2.1 | 2.6 |
| Pharmaceuticals | 2.1 | 13.3 |
| Other Financial | 2.0 | 7.4 |
| Other REITs | 2.0 | 4.9 |
| P&C | 1.7 | 4.1 |
| Home Construction | 1.7 | 4.7 |
| Health Insurance | 1.7 | 3.1 |
| Finance Companies | 1.7 | 5.1 |
| Banking | 1.7 | 5.1 |
| Leisure | 1.6 | 5.5 |
| Midstream | 1.6 | 5.6 |
| Retail REITs | 1.6 | 6.9 |
| Metals and Mining | 1.5 | 4.5 |
| Consumer Products | 1.5 | 4.1 |
| Consumer Cyc Services | 1.5 | 4.4 |
| Transportation Services | 1.5 | 3.4 |
| Building Materials | 1.4 | 4.5 |
| Tobacco | 1.4 | 7.7 |
| Oil Field Services | 1.4 | 5.8 |
| Electric | 1.4 | 3.3 |
| Life | 1.4 | 7.2 |
| Diversified Manufacturing | 1.3 | 5.2 |
| Supermarkets | 1.3 | 3.4 |
| Automotive | 1.3 | 4.6 |
| Lodging | 1.3 | 4.0 |
| Food and Beverage | 1.3 | 4.4 |
| Construction Machinery | 1.3 | 3.0 |
| Restaurants | 1.2 | 3.3 |
| Aerospace/Defense | 1.2 | 4.8 |
| Environmental | 1.2 | 4.8 |
| Other Industrial | 1.2 | 5.9 |
| Gaming | 1.2 | 4.6 |
| Brokerage Assetmanagers Exchanges | 1.2 | 6.2 |
| Independent | 1.2 | 5.7 |
| Healthcare REITs | 1.1 | 6.2 |
| Paper | 1.0 | 6.4 |
| Chemicals | 0.9 | 4.8 |
| Refining | 0.9 | 4.2 |
| Retailers | 0.8 | 7.2 |
| Railroads | 0.8 | -0.8 |
| Packaging | 0.6 | 2.2 |
| Airlines | 0.4 | 3.8 |

Source: Bloomberg, BlackRock. As of July 30, 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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## Bank lending standards for consumers are more selective

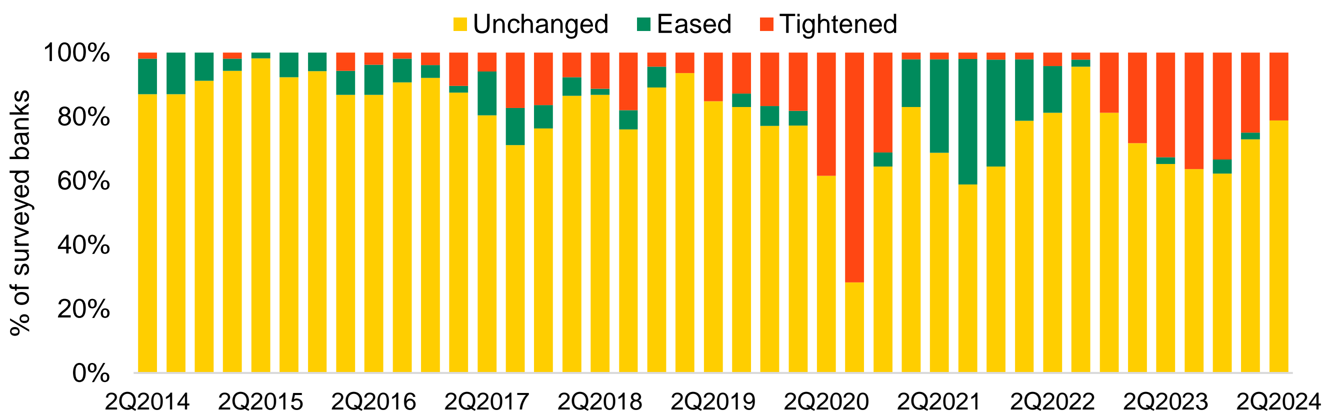
As this consumer bifurcation persists, more U.S. banks are focusing on underwriting higher-quality borrowers and are demonstrating more selectivity. According to the April 2024 Senior Loan Officer Opinion Survey (SLOOS), 21% of banks surveyed reported tightening lending standards for individual or household credit card applications over the past three months, versus 79% remaining unchanged and 0% easing (Exhibit 11).

This trend of more banks tightening lending standards than easing them coincides with the timing of the Federal Reserve's rate hiking cycle, which began in March 2022. (For context, April 2022 marks the most recent SLOOS where more banks *eased* lending standards than tightened them.)

Exhibit 12 further illustrates this point, by showing a modest increase in the 25th and 50th percentile credit scores for new credit card originations during 1Q2024. Credit scores across each percentile increased by an average of 14 points from 1Q2022 to 1Q2024, indicating that changes in bank lending standards over the last two years may have favored borrowers with higher credit scores for new credit card originations. (It may also reflect, to some extent, the trend of "credit score migration" we previously discussed in March 2024).

**Exhibit 11: More U.S. banks reported tightening of credit card lending standards (vs. easing) over the past 7 quarters**

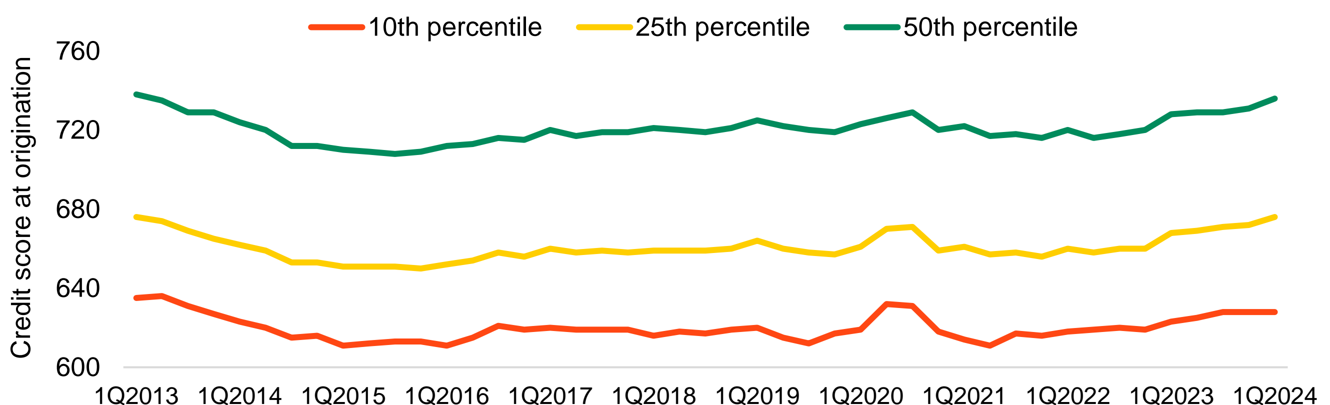
Percentage of surveyed U.S. banks making changes to credit card application standards for individuals or households over the past three months




Source: Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS), Haver, BlackRock. April 2024 SLOOS (signaled by 2Q2024 on exhibit) was released on May 6, 2024, and captures activity from 1Q2024. Survey respondents include only banks that originate credit card loans to individuals or households. In the April 2024 SLOOS, 20% of respondents (13 of 65 total respondents) abstained from responding to this question because their bank does not originate credit card loans to individuals or households.

**Exhibit 12: Credit scores for credit card originations have increased since the Federal Reserve began hiking rates in March 2022**

Original credit scores for credit card originations during the quarter, by percentile




Source: FR Y-14M Data, Federal Reserve Bank of Philadelphia, BlackRock. As of 1Q2024. Note: Credit card data include consumer bankcards only and exclude small business, corporate, and consumer charge cards. We estimate that credit card balances in the aggregate FR Y-14M data represent roughly four-fifths of total U.S. bankcard balances.

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## Mortgage originations and delinquencies remain low, while home values soar

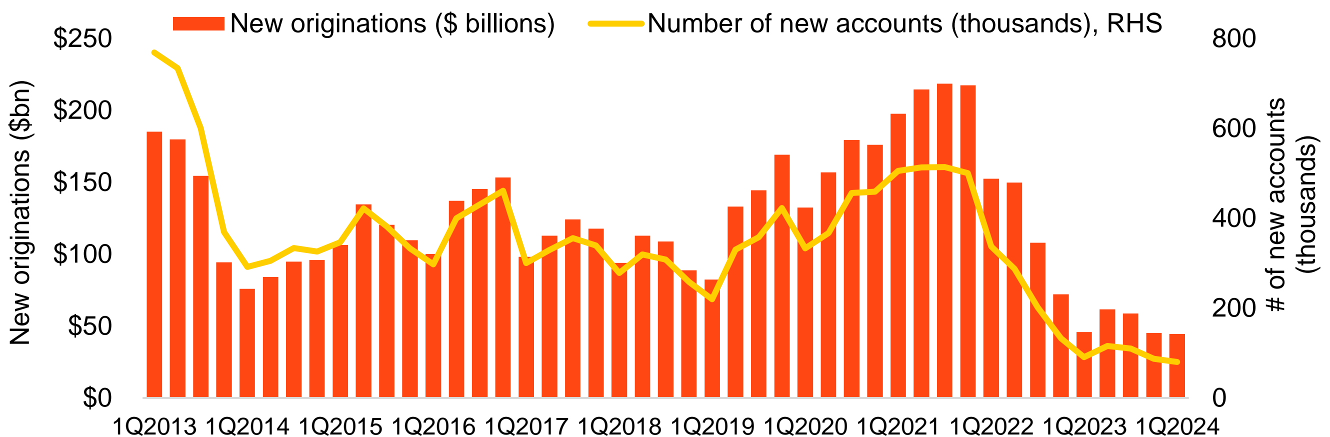
Another factor accentuating consumer bifurcation is asset and home ownership. For example, 87% of U.S. consumers in the top 20% of the income distribution are homeowners, according to data from the September 2023 U.S. Bureau of Labor Statistics Consumer Expenditure Survey (most recent). Many of those owners likely benefited from home price appreciation over the past few years. (Note: the S&P CoreLogic Case-Shiller U.S. National Home Price Index has increased by over 50% between December 2019 and May 2024). Meanwhile, the bottom 20% of the income distribution is more likely to rent (and thus, miss out on the chance to build equity via home price appreciation and, at the same time, encounter higher rent costs).

As rates have risen off post-GFC lows, new mortgage originations have fallen. In 1Q2024, new originations were at their lowest levels since the Philadelphia Fed began tracking the data in 2012 (Exhibit 13). The reasons behind the subdued activity are likely multi-faceted, including seasonality and a slowdown in both supply and demand. The April 2024 SLOOS echoed this, with banks reporting weaker demand across all residential real estate loan categories.

Strong home price appreciation has likely supported low mortgage delinquency rates (Exhibit 14), because homeowners who have benefited from the appreciation likely want to protect their value in the home. We expect this pattern to persist. That said, the strength of the U.S. labor market will remain a critical ingredient to this view.

**Exhibit 13: Mortgage originations hit a series low in 1Q2024**

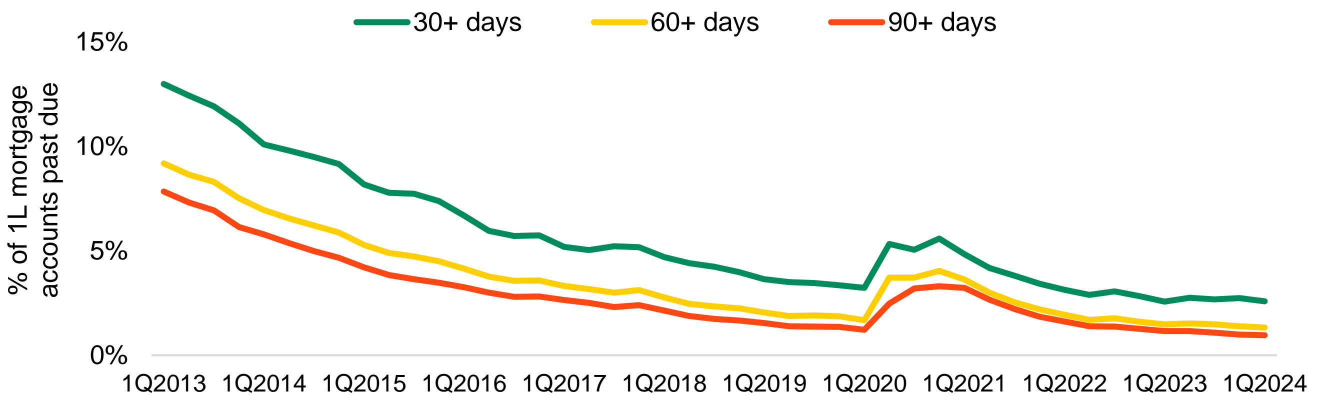
New first lien mortgage originations, by total dollar value and number of accounts




Source: Federal Reserve Y-14M Data, Federal Reserve Bank of Philadelphia, BlackRock. As of 1Q2024. Note: Data includes total bank loans originated and held in portfolio in quarter, including those that will later be sold/securitized. First lien mortgage portfolio loans in the aggregate FR Y-14M data are estimated to represent approximately one-eighth of total U.S. residential mortgage market debt.

**Exhibit 14: Mortgage delinquency rates were at or near record lows in 1Q2024**

Percentage of first lien mortgage accounts (equally weighted) with past due balances, by days past due




Source: Federal Reserve Y-14M Data, Federal Reserve Bank of Philadelphia, BlackRock. As of 1Q2024. Note: Past-due rates include foreclosures. First lien mortgage portfolio loans in the aggregate FR Y-14M data are estimated to represent approximately one-eighth of total U.S. residential mortgage market debt.

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