Global Credit Weekly:

The final stretch

BlackRock

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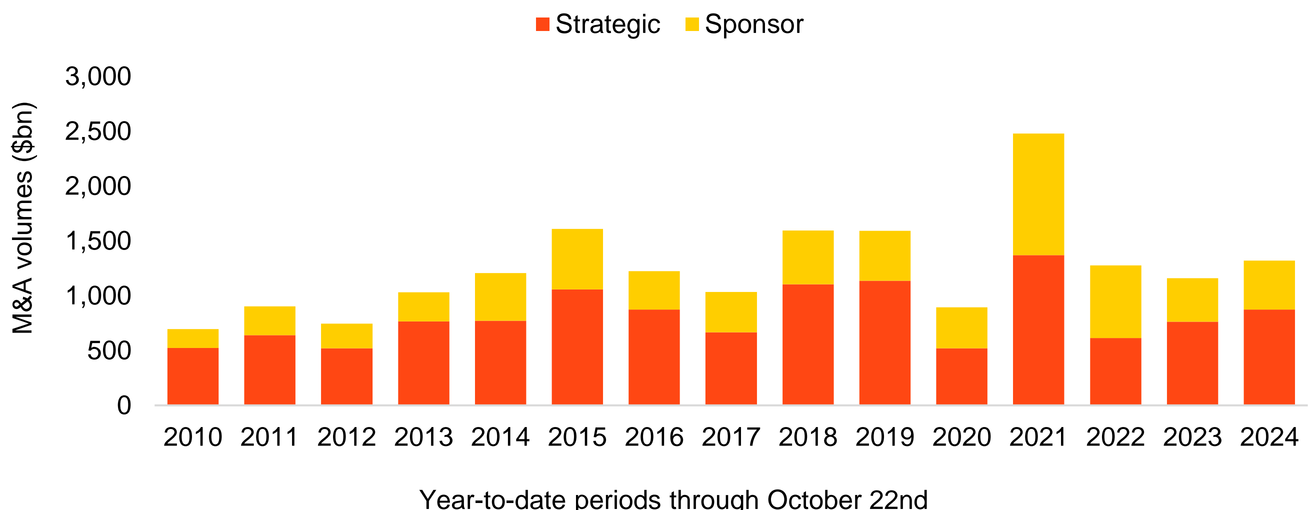
Key takeaways

- The November 5th U.S. election is now less than two weeks away, and polls point to a close race. We believe investors should focus on the themes that are likely to prevail in *most* scenarios, while preserving flexibility for granular investment selection once additional policy details materialize through early 2025.
- In most scenarios we see potential for (1) higher fiscal spending and deficits, (2) structurally higher inflation and interest rates relative to the post financial crisis era, (3) ongoing investment in artificial intelligence and related infrastructure (among other structural trends) funded by public *and* private markets, and (4) a continuation of strategic competition with China. Additional clarity on the macro landscape may also result in increased M&A volumes (Exhibit 1), in our view. For corporate credit investors, the funding mix of this activity (i.e., debt vs. equity) will be key.
- Outcomes on taxes and trade/tariffs are more uncertain, in our view, but have the potential to impact credit fundamentals significantly. This will likely drive more sector and issuer dispersion – underscoring the importance of granular credit selection.
- For corporate credit (liquid and private), the overall macroeconomic backdrop – irrespective of the U.S. election outcome – will be a key driver of valuations. For example, the above-trend pace of growth, which has prevailed in the U.S. for much of 2023 and 2024, has been a significant contributor to the resilience of corporate credit spreads.
- The growth backdrop is also a key input for the forward path of monetary policy, in our view. For example, slower – or fewer – Federal Reserve (Fed) rate cuts (relative to market pricing) because of strong economic activity can likely be easily digested by corporate credit. By contrast, slower – or fewer – Fed rate cuts because of reaccelerating inflation would be a much less favorable backdrop for credit, in our view, especially if coupled with weaker economic activity.

Exhibit 1: Clarity on the macro backdrop may result in increased M&A volumes, in our view
Strategic and sponsor M&A announced by North American acquirers, by year-to-date period. Captures deals valued at $100 million or more, at announcement. Excludes cancelled and withdrawn deals.



Source: Dealogic (ION Analytics), BlackRock. As of October 22, 2024.

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The U.S. election: the final stretch

The November 5th U.S. election is now less than two weeks away, and polls point to a close race. In this *Global Credit Weekly,* we revisit some of the areas most relevant for corporate credit investors. Given current polling, we have limited conviction on large, directional bets ahead of the event. Rather, we believe investors should focus on the themes that are likely to prevail in *most* scenarios, while preserving flexibility for granular investment selection once more policy details materialize through early 2025.

In *most* scenarios we see potential for (1) higher fiscal spending and deficits, (2) structurally higher inflation and interest rates (at least relative to the post financial crisis era), (3) ongoing investment in artificial intelligence and related infrastructure (among other structural trends) funded by public *and* private markets, and (4) a continuation of strategic competition with China.

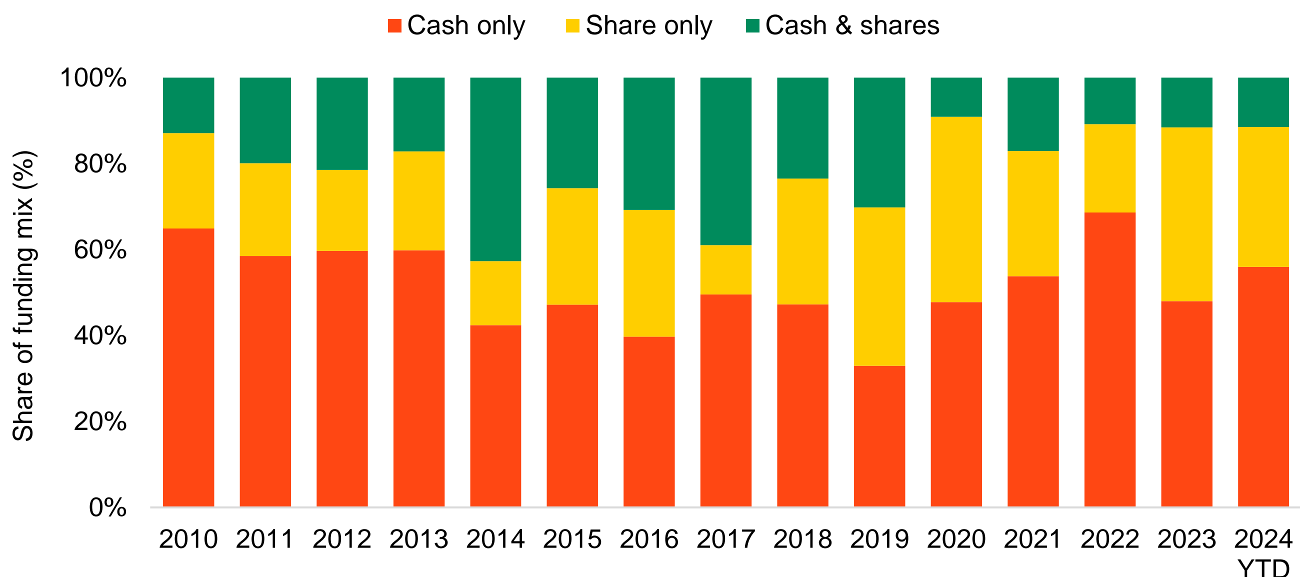
Additional clarity on the macro landscape (broadly speaking) may also result in increased M&A volumes (Exhibit 1), in our view. For corporate credit investors, the funding mix of this activity (i.e., debt vs. equity) will be key. As illustrated in Exhibit 2, 56% of strategic M&A announced by North American acquirers has been funded solely with cash (which, in practice, can often be replaced with debt). This ranks at the high end of the range over the past several years (although is notably behind 2022's "cash only" share).

Outcomes on taxes and trade/tariffs are more uncertain, in our view, but have the potential to impact credit fundamentals significantly. This will likely drive more sector and issuer dispersion – underscoring the importance of granular credit selection.

For example, widespread tariffs would likely result in higher risk premiums in corporate credit, due to the uncertainty related to implementation, and the potential for certain industries and firms to encounter higher input costs. Exclusions for certain sectors and/or items will be important to watch. Should additional tariffs be enacted, we expect further bifurcation in credit markets based on borrower size, geographic exposure (for sourced inputs *and* end market sales), and supply chain positioning, among other factors.

Changes to corporate taxes, if they materialize, could also create further dispersion in credit markets, in part because the impact of tax policy is likely to be far from uniform. For example, a 2023 working paper from the Federal Reserve economists highlighted how trends in effective tax rates – and exposure to the 2017 Tax Cuts and Jobs Act's main provisions – varied substantially for public, private, multinational and domestic firms, as well as firms across the size spectrum.

Exhibit 2: M&A can significantly influence a corporate balance sheet, depending on funding
Funding mix of strategic M&A announced by North American acquirers (by transaction value). Captures strategic deals valued at $100 million or more, at announcement. Excludes transactions that involve a financial sponsor as a buyer or a seller. Excludes cancelled and withdrawn strategic deals.



Source: Dealogic (ION Analytics), BlackRock. 2024 is as of October 22, 2024.

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Growth will be paramount

Ultimately, for growth and interest rate sensitive asset classes such as corporate credit (liquid and private), the overall macroeconomic backdrop – irrespective of the U.S. election outcome – will be a key driver of valuations. For example, the above-trend pace of growth, which has prevailed in the U.S. for much of 2023 and 2024, has been a significant contributor to the resilience of corporate credit spreads (Exhibit 3). Favorable market technicals have also played a role, as we have discussed recently.

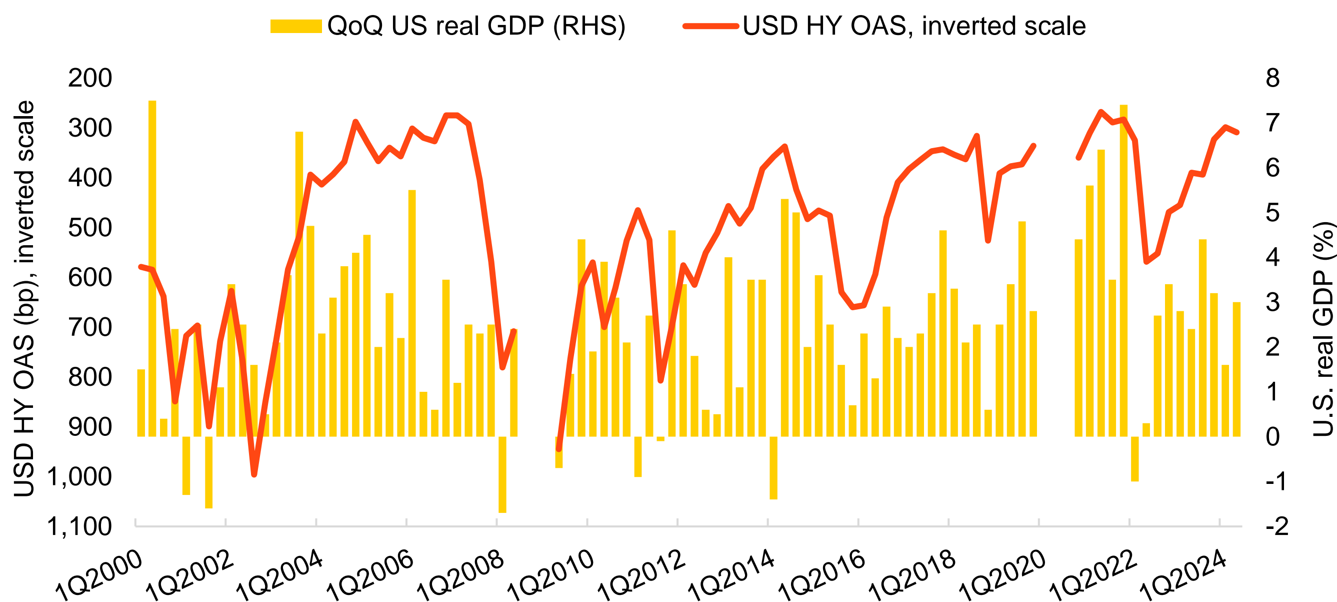
As a result, maintaining an above-trend pace of growth will be important for (1) validating the current level of spreads, and (2) corporates' ability to navigate structurally higher interest rates and borrowing costs (again, relative to the post-financial crisis era).

The growth backdrop is also a key input into the forward path of monetary policy, in our view. For example, slower – or fewer – Fed rate cuts because of strong economic activity can likely be easily digested by corporate credit. By contrast, slower – or fewer – Fed rate cuts because of reaccelerating inflation would be a much less favorable backdrop, especially if coupled with weaker economic activity.

With 3Q2024 U.S. real GDP growth estimated at an above trend pace of 3.4% per the Atlanta Fed's GDPNow (as of October 18th), we expect monetary policy *normalization* as opposed to *easing*. Our base case is for the Fed to cut rates into early 2025, to the 3.5% area. Once the Fed Funds rate starts to approach that territory, however, we believe conversations around the neutral rate of interest will become more important in determining the ultimate destination of monetary policy. The 3.5% area we identified could shift higher or lower, depending on how the U.S. growth backdrop evolves from here.

Given the close nature of the race, and the binary outcomes related to certain provisions (discussed within), we expect some near-term volatility in corporate credit markets. That said, over the medium term, a backdrop of supportive U.S. growth, reduced monetary policy restriction, solid credit fundamentals, and technical tailwinds (such as yield-based demand and limited net supply) would allow spreads to remain in their narrow (and tight) ranges. That said, as referenced above – the clear downside risk for corporate credit, in our view, is an environment of deteriorating economic activity and reaccelerating inflation.

Exhibit 3: The USD HY index has responded to the pace of U.S. growth, over time
Average index-level option adjusted spreads for the Bloomberg USD HY Corporate Index at each quarter-end (inverted on axis), and quarter-over-quarter (QoQ) U.S. real GDP (seasonally adjusted at an annualized rate), RHS; Excludes 3Q2008 – 1Q2009 and 1Q2020 – 3Q2020.



Source: Bloomberg, BlackRock. **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. For ease of visualization purposes in the chart, we exclude three quarterly periods during the Global Financial Crisis (3Q2008 – 1Q2009) and the COVID-19 pandemic (1Q2020 – 3Q2020). For context, the associated spread and GDP figures for each period were: 3Q2008: 1,020bp / -2.1%; 4Q2008: 1,662bp / -8.5%; 1Q2009: 1,514bp / -4.5%; 1Q2020: 880bp / -5.5%; 2Q2020: 626bp / -28.1%; 3Q2020: 517bp / +35.2%.

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Fiscal spending is projected to grow

We see scope for fiscal spending (and relatedly, the U.S. budget deficit) to grow, regardless of which presidential candidate takes office, as neither party has outlined plans for tackling the budget deficit. For example, Vice President Harris has largely adopted President Biden's tax plan, such as higher corporate taxes, with some key differences including the capital gains tax on wealthy households. Former President Trump plans to fully extend the provisions of the Tax Cuts and Jobs Act expiring in 2025 and propose new cuts, including to corporate taxes. Former President Trump says he will boost revenues by levying tariffs on a broad range of U.S. imports.

As discussed previously, the U.S. annual budget deficit as a share of GDP remains elevated relative to the unemployment rate (Exhibit 4). And data from the Congressional Budget Office (CBO) suggests that the U.S. government will continue to run a budget deficit over the next ten years.

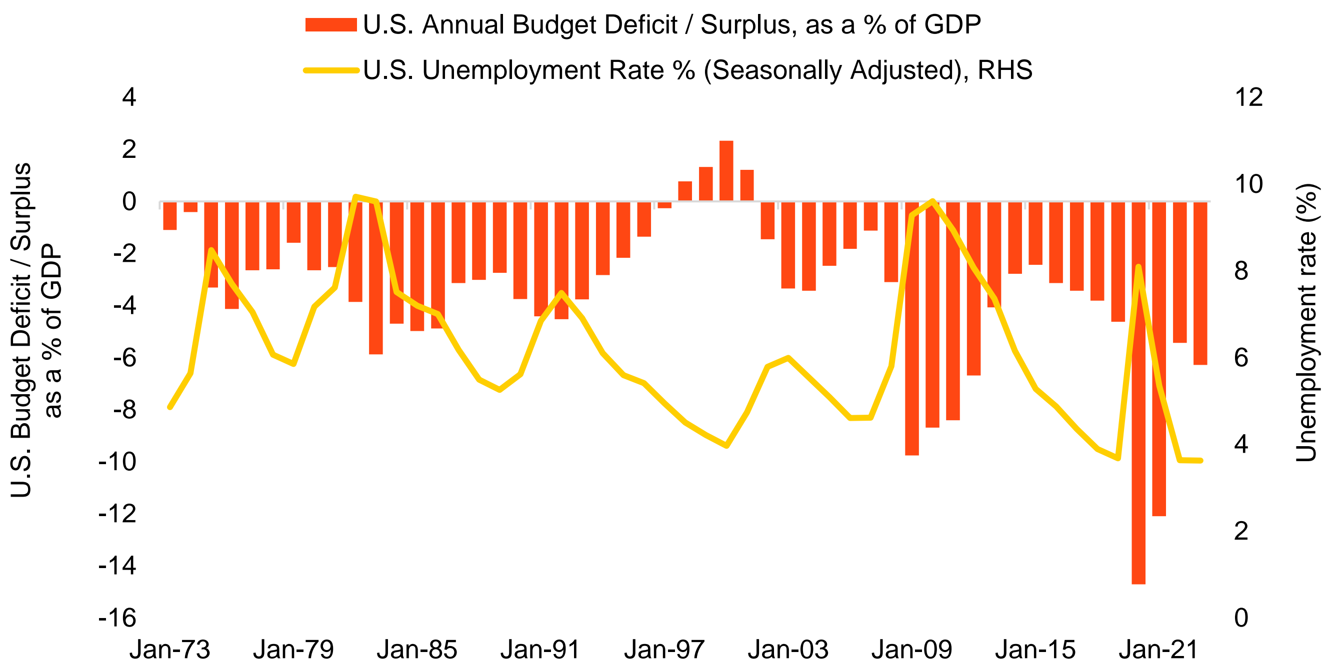
Exhibit 5 (next page) illustrates the expected trajectory of interest payments, with respect to the annual deficit. Indeed, in 2023, net interest expense represented 39% of the total deficit. This share is projected by the CBO to grow to 62% by 2027. Currently, there is a wide range of uncertainty related to the impact of both candidates' policy proposals on the budget deficit.

This backdrop for the deficit has two major implications for credit investors, in our view. First, at a macro level, it will likely inform curve positioning (i.e., front, intermediate or long-end) as well as fixed vs. floating asset allocation decisions. For example, we see potential for structurally higher long-end interest rates, and additional term premium, to reflect the overhang from expected U.S. Treasury supply to fund the deficit. A September 2024 analysis by Moody's noted that the U.S. "debt dynamics would be increasingly unsustainable and inconsistent with an Aaa rating if no policy actions are taken to course correct." Moody's rates the U.S. sovereign Aaa/Negative Outlook, while S&P and Fitch rate it AA+/Stable.

Second, at a more micro level, higher U.S. budget deficits could provide some incremental support to sectors and firms that have been (1) historically reliant upon government spending, or (2) may benefit from some of the policies recently proposed. So far, a wide range of sectors have been referenced in policy proposals, including housing, infrastructure, healthcare, education, childcare, manufacturing, energy, and defense, among others.

Exhibit 4: The current U.S. budget deficit exists against a backdrop of low unemployment

The U.S. annual budget deficit (or surplus, when positive) as a percentage of U.S. annual gross domestic product (GDP), compared to the U.S. unemployment rate at each calendar year-end (RHS)



Source: BlackRock, Congressional Budget Office, Bureau of Labor Statistics. As of each annual period, through 2023.

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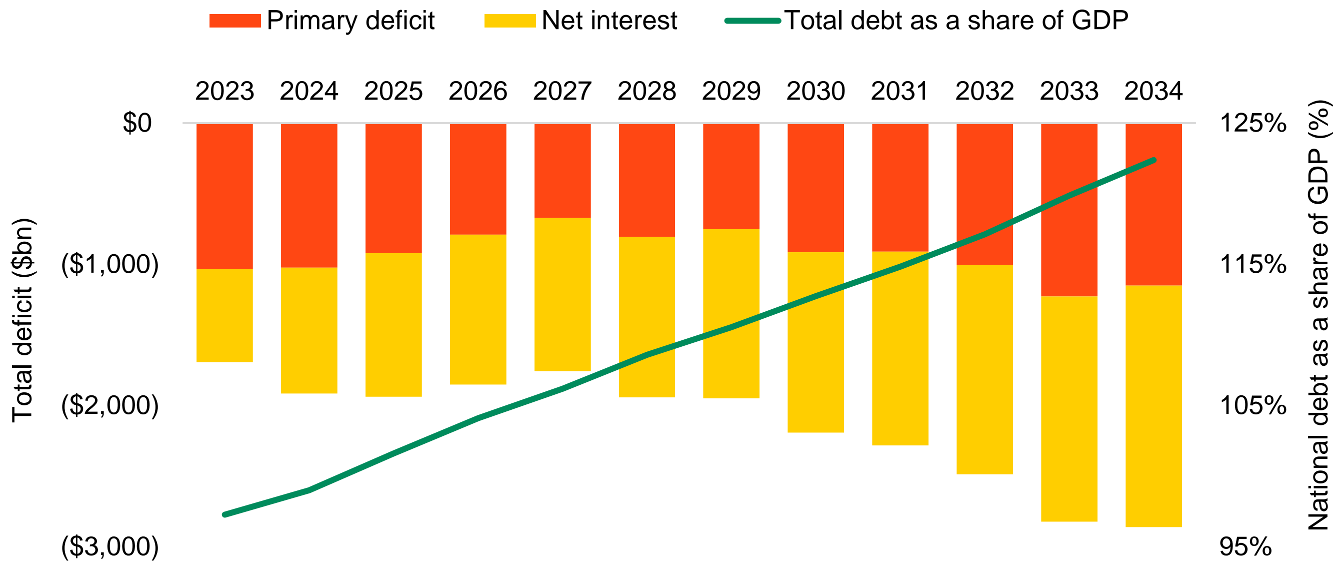
Exhibit 5: Net interest expense is expected to become a larger share of the U.S. deficit in coming years

Actual (2023) and expected (2024-2034) total time-adjusted U.S. government deficit (including primary deficit and net interest expense), and total national debt as a share of GDP (RHS)



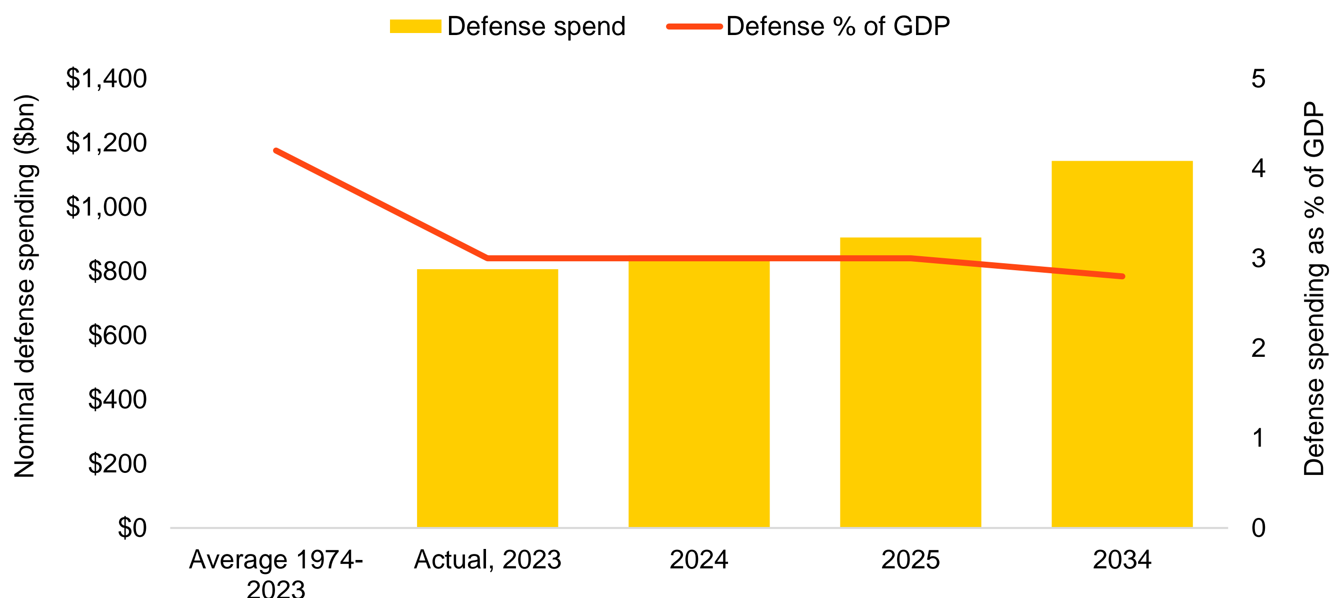
Source: Congressional Budget Office (CBO), BlackRock. As of June 2024. A deficit is when annual outlays exceed annual revenues, so negative values indicate a deficit. The total deficit is the sum of the primary deficit (mandatory and discretionary spending) and the net interest. **There is no guarantee any forecasts may come to pass.**

Higher defense spending

Data from the CBO suggests continued increases in defense spending, which is expected to grow from $806 billion in 2023 (actual) to $1.144 trillion in 2034. Over that same period, defense spending is expected to decline as a share of U.S. GDP, from 3.0% in 2023 to 2.8% in 2034 (Exhibit 6). In addition to supporting the aerospace & defense industry directly, suppliers and other tangential products are also likely to capture additional revenues from government contracts, in our view.

Exhibit 6: Defense spending is projected to increase nominally, but decline slightly as a share of GDP by 2034

Actual and expected defense spend, and as a share of total U.S. GDP



Source: Congressional Budget Office (CBO), BlackRock. As of June 2024. **There is no guarantee any forecasts may come to pass.**

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Structurally higher inflation

Related to the point on deficit spending, we expect the U.S. to experience structurally higher inflation in the coming years, regardless of election outcomes. Indeed, research from the BlackRock Investment Institute (BII) highlights this anticipated shift in the macroeconomic regime, driven by some longer-term, structural shifts in the economy. In many instances, we see potential for the private debt markets to play a role in financing these longer-term trends.

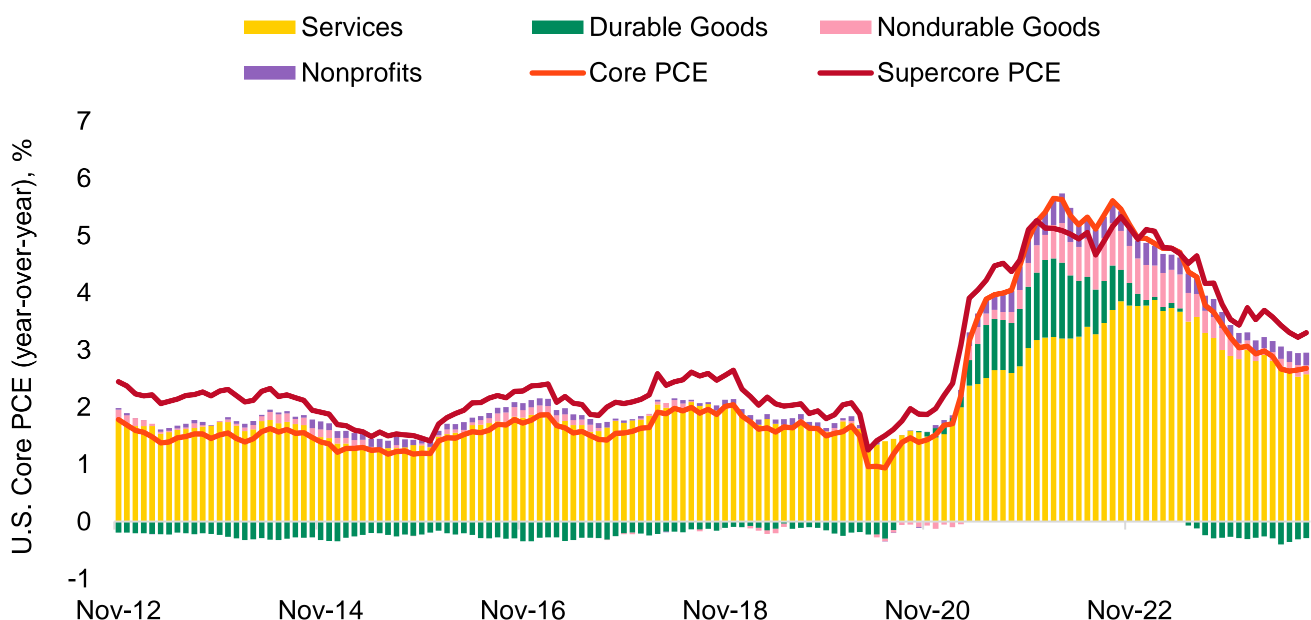
- **Rewiring of global supply chains:** Pandemic era disruptions have encouraged companies to enhance the resilience and durability of their supply chains in recent years. This rewiring of global supply chains is driving demand for infrastructure investment.
- **Aging population:** An aging population has the potential to be inflationary because fewer workers in the workforce can reduce production capacity. Data from the National Transfer Accounts suggests that an older population generally maintains demand by spending their savings (even if the *type* of consumption evolves as they age). We believe this demographic shift can lead to inflationary pressures as the population continues to consume, while production decreases.
- **Low-carbon transition:** Transitioning to a low-carbon economy may contribute to inflationary pressures in the near to medium term. Indeed, research by BII suggests that the low-carbon transition could raise energy costs (and thus, inflation) over the next decade, due to increased capital expenditures and government spending. Beyond the next decade, the inflation outlook is uncertain, as energy prices may fall with the shift to cheaper renewables.

Structurally higher inflation, if it does indeed prevail, will have implications for monetary policy. As noted previously, Federal Reserve Chair Jerome Powell acknowledged that the neutral rate of interest is likely "significantly higher" vs. the ultra low rates which prevailed for much of the post-financial crisis era. Indeed, the September Summary of Economic Projections (SEP) reflected a median longer-run Fed Funds estimate of 2.9% vs. a 2.5% forecast as of December 2023 and an average effective Fed Funds rate of less than 1% from 2010 - 2019.

We expect that the impact of structurally higher inflation will vary across credit markets, sectors, and borrowers – allowing the trend of "dispersion but not widespread market disruption" to persist. In our view, larger borrowers with pricing power (e.g., industry leaders), robust profit margins, and the ability to scale efficiently (including by utilizing technology) will be best positioned to succeed in this environment.

Exhibit 7: Structural shifts may influence longer-term inflation trends

Contributions to the year-over-year U.S. Core Personal Consumer Expenditure (PCE) Price Index



Source: Bureau of Economic Analysis, Bloomberg, BlackRock. Captures data through August 31, 2024 (most recent available as of October 23, 2024). Core PCE excludes Food and Energy. Supercore PCE also excludes Housing.

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Artificial Intelligence (AI) optimism and investment

We also expect optimism surrounding – and investment in – AI to continue, regardless of election outcomes. In addition to the direct impact in the technology sector, we also expect tangential sectors related to the AI infrastructure build out to benefit, such as power and utilities.

Here too, we see a role for investment from the private sector – including through private debt financing – to fund this longer-term, structural shift.

In recent years, legislation such as the Creating Helpful Incentives to Produce Semiconductors (CHIPS) Act of 2022, and to a lesser extent, the Inflation Reduction Act (IRA) of 2022 have bolstered investment in AI infrastructure and certain utilities (which are used to power the AI data centers).

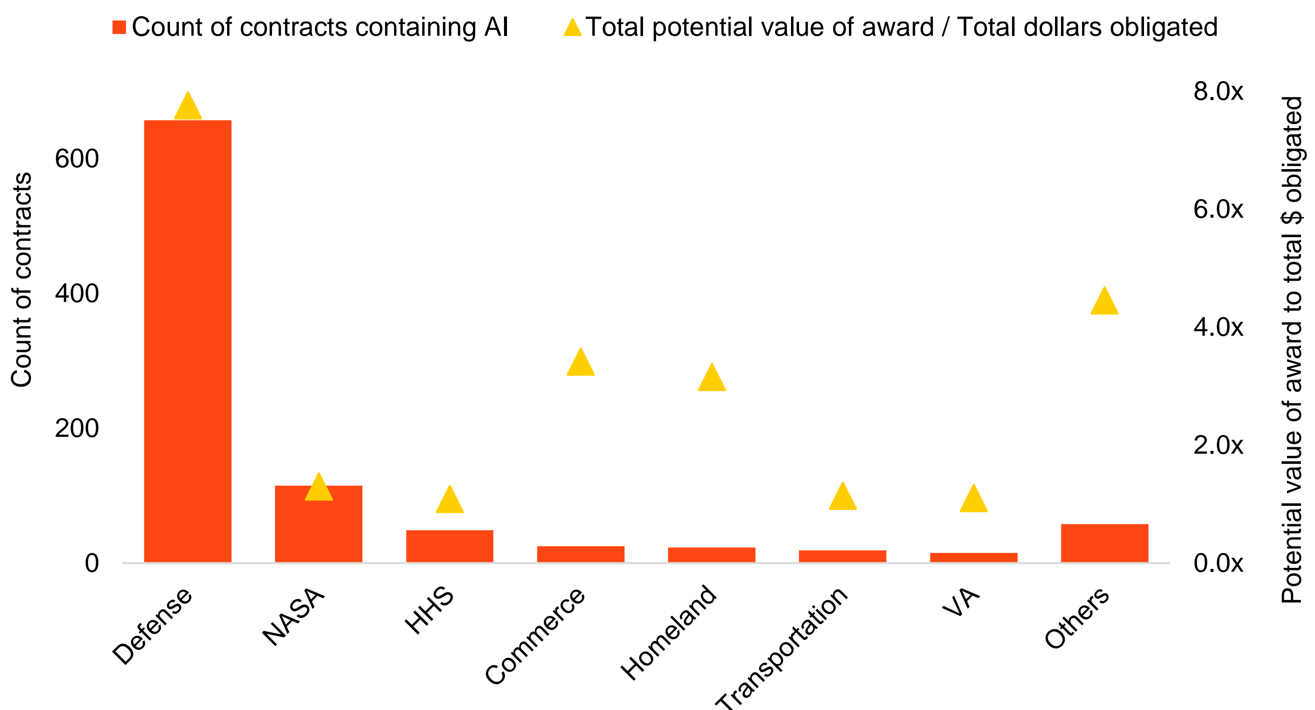
In March 2024, The Brookings Institution refreshed a previous study, highlighting an increase in U.S. government contracts referencing AI and an expected increase in AI investment. According to the study, from August 2017 to August 2022, there were 17 federal agencies with new contracts mentioning AI. From August 2022 to August 2023, six *additional* federal agencies established new contracts that mentioned AI, suggesting that AI adoption is becoming broader-based across government agencies. The Department of Defense holds most of these contracts (Exhibit 8).

Further, data from the study suggests that the government's investment in such AI infrastructure is set to expand. For example, the value of funding obligations from August 2017 to August 2023 (including part 1 and part 2 of the study) reached $675 million in aggregate, while the potential value of awards is $4.56 billion.

In our view, this demonstrates a longer-term optimism and commitment to further investing in AI, from one subset of the economy. Spending related to AI could boost economic growth but may also be somewhat inflationary, as demand for building and retooling AI will likely precede supply-side or productivity benefits.

Exhibit 8: The share of agencies with contracts including AI has broadened, suggesting widespread investment and adoption in the US government

Count of contracts established between August 2017 and August 2023 that include AI and the ratio of total potential value of award versus total dollars obligated, by government agency (RHS)



Source: Leadership Connect, The Brookings Institute, BlackRock. Count of contracts established between August 2017 and August 2023 that include AI.

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Ongoing strategic competition with China

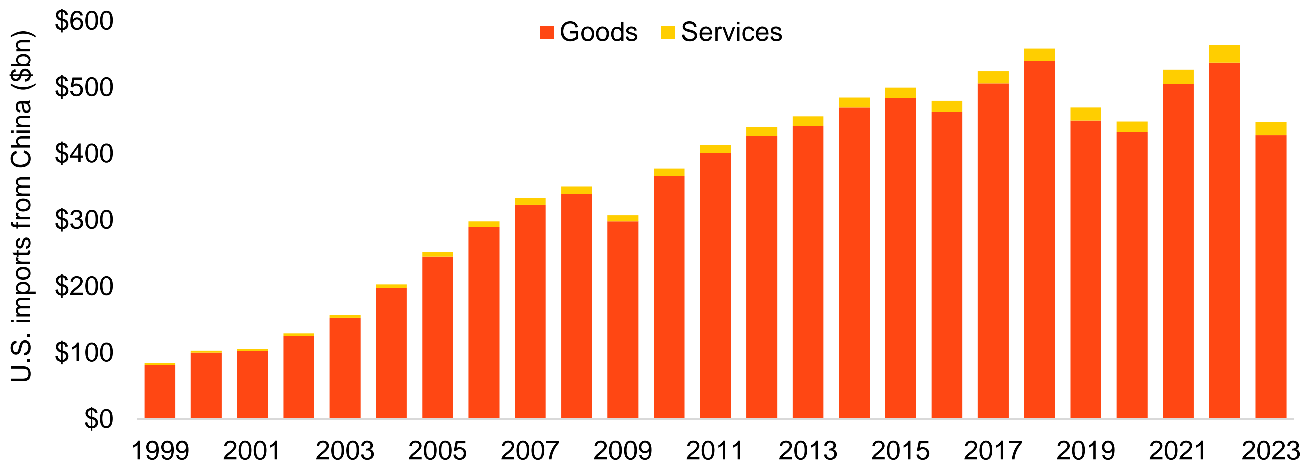
A September report from BII details the strategic competition embedded in the current U.S.-China relationship. A "targeted decoupling" of advanced technologies – such as AI, semiconductors, and technologies with military applications – is central to this. We expect this backdrop between the U.S. and China to persist following the election, as both candidates have leaned toward protectionist policies. For example, the Biden administration left many tariffs imposed on China (during the Trump administration) in place. That said, we expect tariffs to be broader-based under a potential Trump administration.

China has been one of the largest trading partners with the U.S. in recent years, with the total value of goods imports in 2023 totaling $427 billion (Exhibit 9). We expect this backdrop of strategic competition (and any resulting policies) will impact industries with meaningful exposure to China via inputs, including (but not limited to) electronics, manufacturing, and those that utilize various raw materials (such as textiles, chemicals, metals, plastics, and rubbers; Exhibit 10).

That said, the impacts will likely be nuanced. Those industries and firms with domestic manufacturing capabilities would likely be more insulated, for example, while those that rely on production in China may face headwinds. In certain scenarios, U.S. companies' end market sales exposure to China may also be important to monitor.

Exhibit 9: U.S. imports from China totaled $427 billion in 2023

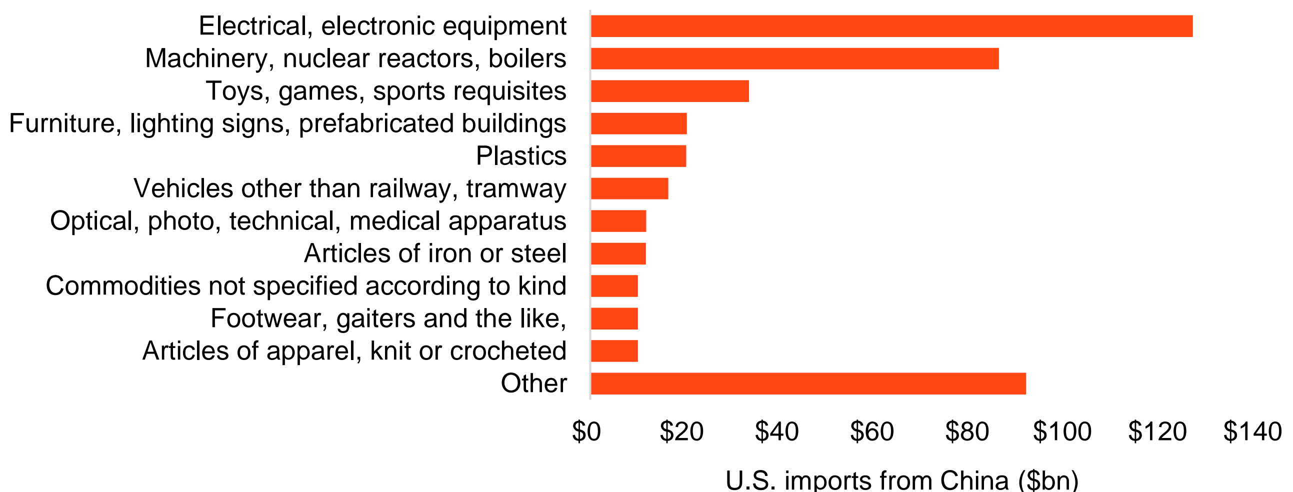
Annual United States goods and services imports from China



Source: Bureau of Economic Analysis U.S. International Trade in Goods and Services Data, BlackRock. Data as of year end 2023.

Exhibit 10: Electronic equipment represented the largest import category from China in 2023

2023 United States goods and services imports from China, by import category



Source: Comtrade, Trading Economics, BlackRock. As of 2023 (data was last updated in October 2024). "Other" includes 86 additional categories.

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Tariffs and trade: significant uncertainty

Tariffs and trade represent policy areas that may not require control of Congress to enact significant change. This is because a President has considerable executive authority to impose tariffs on imports.

Both presidential candidates will likely maintain or strengthen the existing U.S. tariff policy, though former President Trump's proposal represents a more material change to the current policy. Mr. Trump has proposed a 10-20% across-the-board tariff and a 60% tariff on all Chinese imports. Vice President Harris is broadly expected to maintain tariffs enacted by the Biden administration earlier this year, with the potential for more targeted tariffs against China.

Widespread tariffs would likely result in higher risk premiums in corporate credit, due to the uncertainty related to implementation, and the potential for certain industries and firms to encounter higher input costs. Exclusions for certain sectors and/or items will be important to watch, as it would contribute to sector and issuer dispersion. Widespread tariffs could also exacerbate price pressures, and would be included in inflation measures, in the year of enactment.

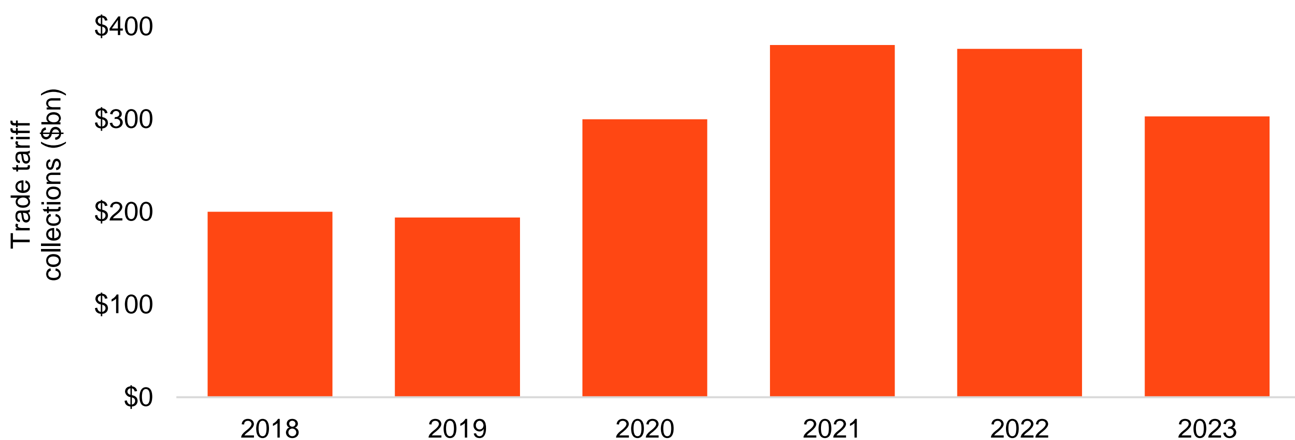
Should additional tariffs be enacted, we expect further bifurcation in credit markets based on borrower size, geographic exposure (for sourced inputs *and* end market sales), supply chain positioning, and other issuer- and sector-specific factors. As one counterintuitive example: HY firms may be better positioned from a business model perspective, as they tend to be more U.S.-focused relative to their IG peers (which are often multi-national). That said, the financial flexibility enjoyed by many large IG firms can be a powerful mitigant to any higher input costs.

Additionally, sectors exposed to international manufacturing and importing commodity raw materials may face headwinds, while sectors exposed to domestic commodity *production* may benefit. And firm-level characteristics such as supply chain resilience and supplier concentration may move to the forefront, as was the case during the 2018 trade tensions between the U.S. and China. Here too, this underscores the importance of active credit selection.

Also important, in our view, is *how* the proceeds of any new tariffs might be used (i.e., to fund tax cuts or reduce the deficit). As a reminder, the U.S. consumer generates two-thirds of U.S. GDP, so any material shifts in consumer spending (in either direction) may influence corporate credit performance at the macro level, as well as for certain consumer-exposed sectors. And as discussed earlier, the trajectory of the U.S. deficit is also relevant for corporate credit investors to monitor.

For context, using U.S. Customs and Border Protection data, the Tax Foundation estimates that tariffs have generated more than $233 billion of U.S. tax revenues as of March 2024. The Tax Foundation also estimates that existing tariffs (enacted during previous periods of trade tensions) have increased annual tax collections by an average of $200-300 per U.S. household (Exhibit 11).

Exhibit 11: Tariff collections average $200-$300 annually per household
Total duties assessed under Section 201, Section 232, and Section 301 trade tariffs divided by the number of U.S. households, 2018-2023



Source: Tax Foundation (calculations based on US Customs and Border Protection "Trade Statistics" and US Census Bureau "Total Households [TTLHH]" and retrieved from FRED), Federal Reserve Bank of St. Louis, BlackRock. Captures data through year-end 2023.

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Taxes: a nuanced impact, based on prior experience

Unlike tariffs, a change to U.S. tax policy *would* require Congressional approval in some capacity.

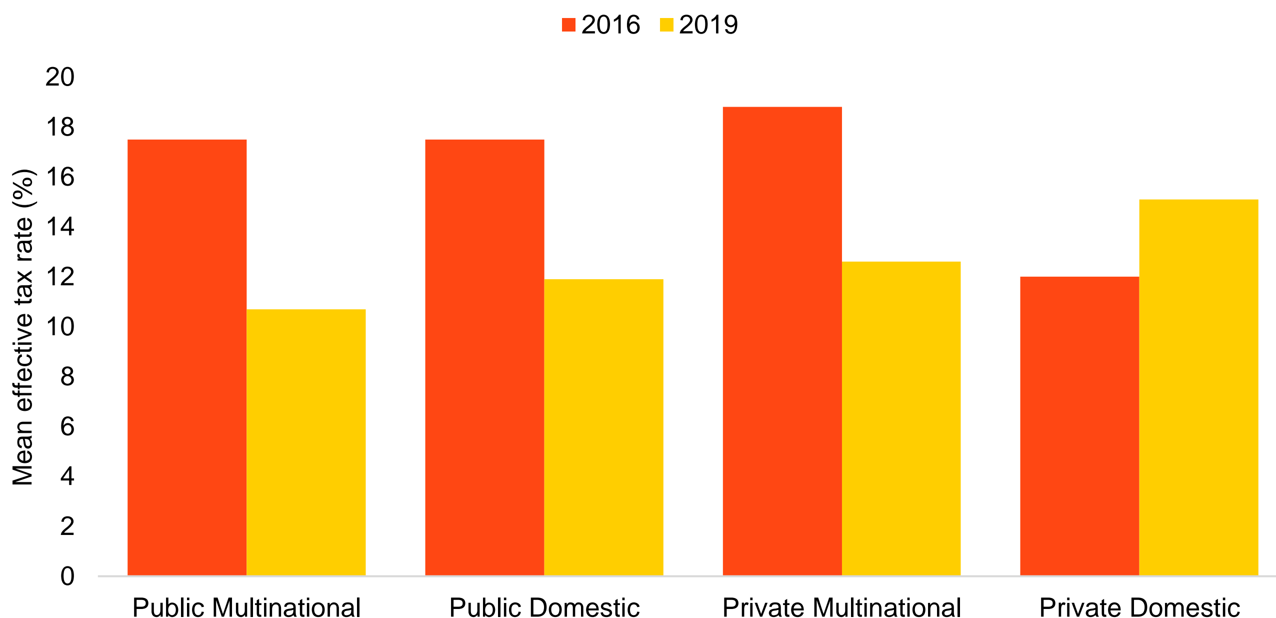
For context, the 2017 Tax Cuts and Jobs Act (TCJA) significantly changed multiple areas of the U.S. tax code, including lowering the top statutory corporate tax rate from 35% to 21%. This cut brought the corporate income tax rate broadly in line with other industrialized peers, according to data from the Tax Foundation. For example, the G7, which includes the world's seven largest advanced economies, has an average statutory corporate income tax rate of 27%, per the Tax Foundation.

Personal provisions were also included in the TCJA and are scheduled to expire at year-end 2025. However, broad-based political support for preserving certain personal tax cuts could result in an extension of these provisions. And should personal provisions be extended, the opportunity to change corporate taxes may re-emerge as part of a broader tax package. These changes could have meaningful implications for some firms' credit fundamentals and capital management priorities.

While campaigning, Vice President Harris has (most recently) outlined a 28% corporate income tax rate, and former President Trump has outlined a 15% or 20% corporate income tax rate. Because changes to tax policy generally require Congressional and Presidential consensus, we view meaningful changes to the corporate tax rate as more likely to come to fruition in a sweep scenario. That said, the statutory tax rate is just one of the potential provisions impacting corporate borrowers. As we outlined previously, the impact of the 2017 TCJA was far from uniform, owing to the myriad of other provisions of the legislation which impacted credit metrics, such as those related to interest expense deductibility, capex bonus depreciation, taxation on overseas profits, repatriation of overseas cash, and expensing of R&D.

For this reason, we expect that changes to the corporate tax rate could create further dispersion in credit markets, in part because the impact of tax policy is likely to be nuanced. For example, a 2023 working paper from the Federal Reserve economists highlighted how trends in effective tax rates – and exposure to the TCJA's main provisions – varied substantially for public, private, multinational and domestic firms (Exhibit 12), as well as across the size spectrum. For most of the corporate credit landscape, however, we believe an increase in the tax rate could be absorbed as a moderate headwind to earnings – especially if growth remains supportive (at a trend pace, or above).

Exhibit 12: The impact of the TCJA was far from uniform across the corporate landscape
Mean effective tax rates for cohorts of U.S. companies: 2016 vs. 2019



Source: BlackRock, Federal Reserve Board of Governors. For specific details on methodology please see: Dobridge, Christine L., Patrick Kennedy, Paul Landefeld, and Jacob Mortenson (2023). "The TCJA and Domestic Corporate Tax Rates," Finance and Economics Discussion Series 2023-078. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2023.078.

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