Global Credit Weekly:

Moving toward neutral

BlackRock.

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Market insights contributors

Amanda Lynam, CPA

Head of Macro Credit Research, Portfolio Management Group

Dominique Bly

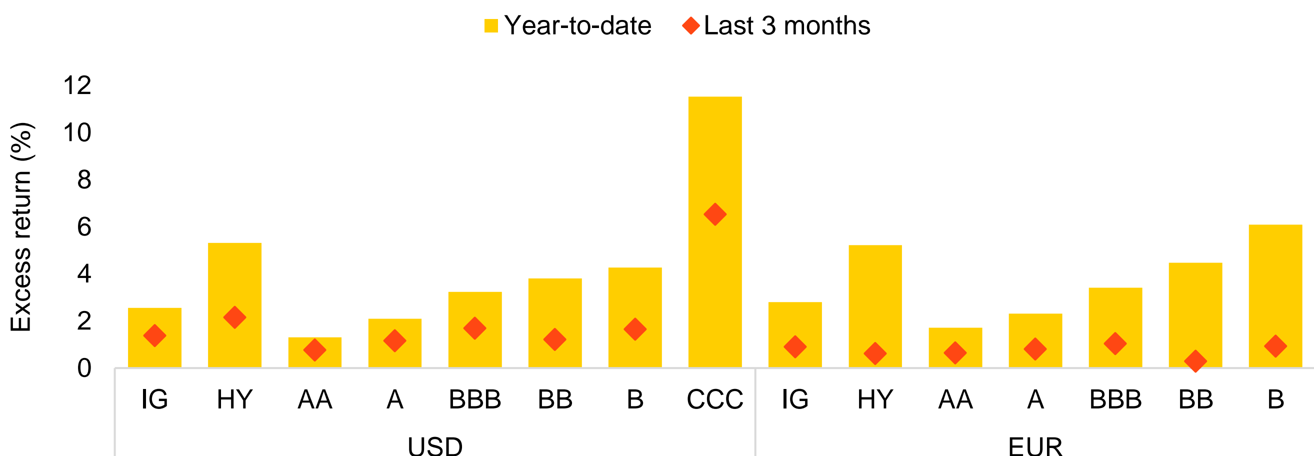
Macro Credit Research Strategist, Portfolio Management Group

Key takeaways

- Federal Reserve Chair Jerome Powell's remarks this week (Dec. 4th) acknowledged the stronger than anticipated U.S. growth momentum vs. what the FOMC expected when it last provided quarterly economic projections in September. Chair Powell's remarks were closely watched following Fed Governor Chris Waller's comments earlier in the week, where he noted the current level of monetary policy is "significantly restrictive". With 4Q2024 U.S. real GDP tracking at an above-trend pace of 3.2%, many market participants have questioned: is the current stance of monetary policy really *that* restrictive? And is the "neutral" rate of policy higher than believed? In his remarks, Chair Powell specifically referenced the economic pressures facing low-income consumers – reflective of the persistent pattern of bifurcation we have flagged in recent quarters.
- We still expect the FOMC to cut by 25bp at the December meeting. But in 2025, the forward path for monetary policy is much more uncertain, given the potential for significant policy shifts. For corporate credit, growth is key. Fewer – or slower – Fed rate cuts in response to strong economic growth can likely be easily digested by credit spreads (this is reflected in current valuations). By contrast, fewer – or slower – Fed rate cuts because of reaccelerating inflation would be a much less supportive backdrop for risk assets, especially if coupled with weaker growth.
- In this week's *Global Credit Weekly*, we take stock of the most recent company commentary on the topic of potential tariffs. Key takeaways from our review of 26 U.S. companies' transcripts (across 16 subsectors) include: (1) despite trade policy uncertainty, many businesses feel well-equipped to accommodate tariffs, should they be implemented; (2) over the past few years, many businesses have invested in supply chain resilience (over efficiency); further, some sectors actually see a potential *benefit* from broader supply chain disruptions; and (3) certain sectors (i.e., energy and materials) expressed confidence in the next administration's sector-specific policy views and noted this clarity supports their willingness to expand business investment.

Exhibit 1: Lower-rated credit has outperformed this year

Excess returns (which exclude interest rate fluctuations) for the Bloomberg USD and EUR Corporate indices



Source: Bloomberg, BlackRock. As of Dec. 2, 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. USD and EUR excess returns exclude the impact from interest rate fluctuations on U.S. Treasuries and German Bunds, respectively. We exclude USD AAA, EUR AAA, and EUR CCC due to small sizes.

Chair Powell signals some patience in the search for "neutral"

Federal Reserve (Fed) Chair Jerome Powell provided remarks on the U.S. economy at the NY Times/DealBook Summit on December 4th. The timing of his remarks was notable as they were given ahead of (1) a highly-anticipated non-farm payrolls report (December 6th) and (2) the start of the Fed's "quiet period" heading into its December 17th-18th Federal Open Market Committee (FOMC) meeting.

Chair Powell's remarks were also closely watched following Fed Governor Chris Waller's comments earlier in the week (December 2nd), where he noted in a speech (titled *Cut or Skip?*) that "I believe the evidence is strong that policy continues to be significantly restrictive and that cutting again [in December] will only mean that we aren't pressing on the brake pedal quite as hard."

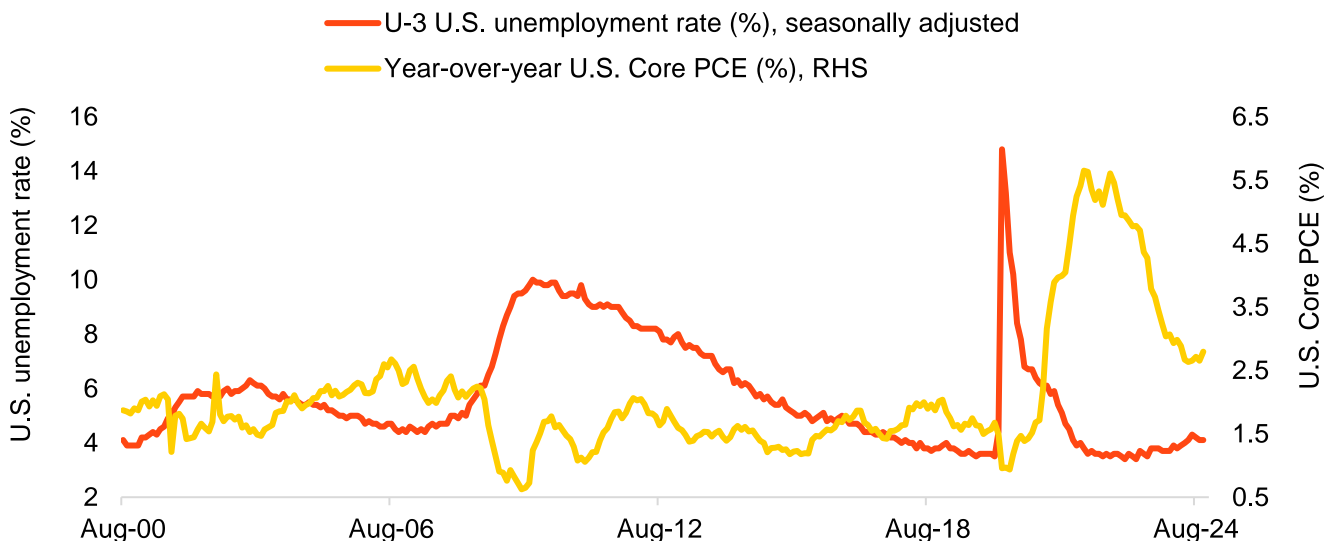
With the Atlanta Fed's GDPNow tool tracking 4Q2024 U.S. real GDP at an above-trend pace of 3.2% (as of December 2nd) many market participants have questioned: is the current stance of monetary policy really *that* restrictive? And is the "neutral" rate of policy higher than believed?

Below are the main takeaways, in our view, from Chair Powell's remarks:

- **The U.S. economy is stronger than anticipated.** Chair Powell stated explicitly that the U.S. economy is "stronger than we thought it was going to be in September." The reference to the September FOMC is noteworthy, as that was when the FOMC last provided a quarterly Summary of Economic Projections (SEP), which is a snapshot of the economic projections of the 19 FOMC members. Chair Powell noted that, relative to September, the downside risks to the labor market are less pronounced, growth is "definitely" stronger than the FOMC expected, and inflation "has come in a little higher."
- **We expect an upward revision to the "longer-run" dot in the December SEP.** In our view, the direct comparison to the September FOMC (as opposed to the most *recent* FOMC meeting, which was on November 7th), paves the way for such growth, inflation, and unemployment revisions to be reflected in the December SEP (which will be released on December 18th). We also expect an upward revision to the FOMC's "longer-run" Federal Funds rate projection, which is a proxy for the "neutral" rate of interest (i.e., the rate which neither stimulates nor restricts growth). We believe neutral is likely higher in this cycle, owing to structural shifts in the economy. Indeed, this longer-run projection – using the median FOMC member's forecast – was 2.9% as of the September 2024 SEP, and has been moving higher over the past several months (it was 2.5% in the December 2023 SEP).

Exhibit 2: The Fed is monitoring both sides of its dual mandate of price stability and full employment

U-3 U.S. unemployment rate (%) seasonally adjusted, and year-over-year U.S. Core PCE inflation (%) seasonally adjusted, RHS



Source: Bureau of Labor Statistics, Bureau of Economic Analysis. Captures data through October 31, 2024 (most recent available as of December 2, 2024).

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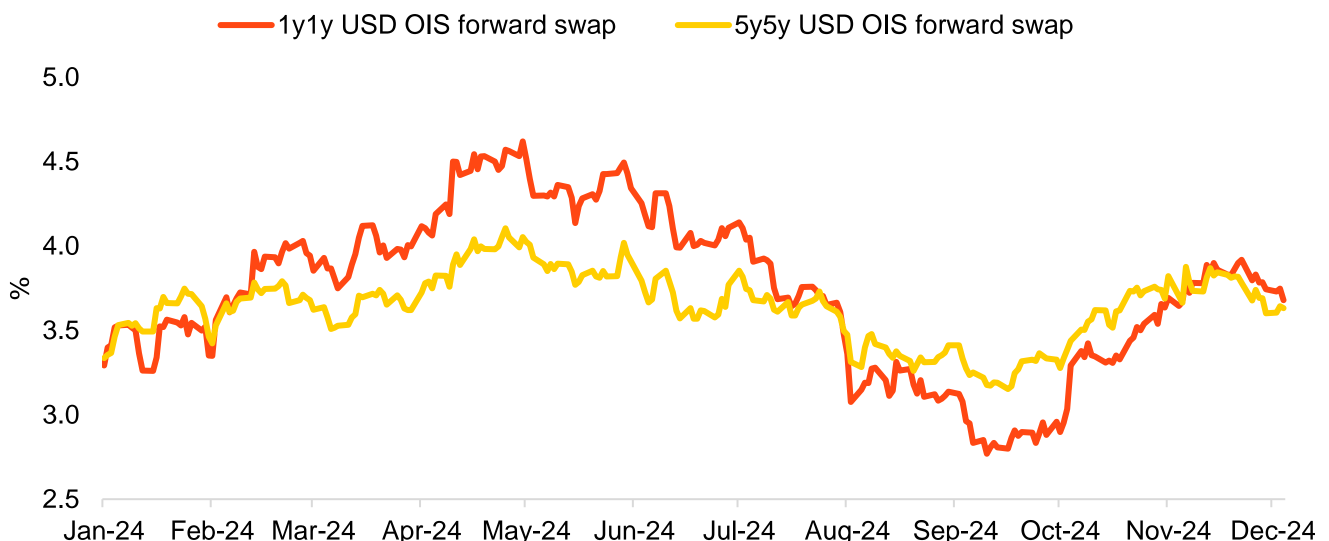
Key takeaways from Chair Powell's remarks (continued):

- **The pace of rate cuts appears likely to slow.** During the November 7th FOMC, Chair Powell stated that "nothing in the economic data suggests that the Committee has any need to be in a hurry to get there [to neutral]." He highlighted a similar message in his most recent remarks this week, noting "we can afford to be a little more cautious, as we try to find neutral." As Exhibit 3 illustrates, the market pricing of (1) the neutral rate and (2) the terminal rate, or magnitude of rate cuts for this cycle, have shifted meaningfully over the past year.
- **We continue to expect normalization, not easing.** Chair Powell noted that the data are "not quite there" on inflation, but "still making progress." He added: "we are now on a path to bring rates back down to a more neutral level over time." Given the two-sided risks which remain (i.e., cutting too quickly vs. cutting too slowly), Powell said the goal is to decrease the level of restriction, over time. As we have outlined previously, we expect monetary policy normalization, not easing. This means rates are likely to be structurally higher (relative to the ultra-low rates which prevailed for much of the post-financial crisis era). For corporate credit investors, this makes granular credit selection important, as borrowers will need to navigate a structurally higher cost of capital environment. It also supports the case for an allocation to floating rate assets, in our view.
- **Growth remains paramount to validate current credit valuations.** Related to the point above, for corporate credit investors, the growth backdrop remains paramount. For example, fewer – or slower – Fed rate cuts in response to strong economic growth can likely be easily digested by credit spreads. This backdrop is reflected in current valuations (Exhibits 10 through 13). By contrast, fewer – or slower – Fed rate cuts because of reaccelerating inflation would be a much less supportive backdrop for risk assets, especially if coupled with weaker growth. In a similar vein, deeper than anticipated rate cuts in response to a sharp downturn in growth or a deterioration in the U.S. labor market would likely be accompanied by much wider credit spreads, to reflect additional required risk premium.
- **The impacts of potential tariffs are too uncertain to be incorporated into current monetary policy decisions.** Chair Powell noted a list of uncertainties related to potential tariffs on imported goods, including the magnitude, timing, duration, goods included/excluded, countries included/excluded, the degree of transmission to prices, the market reaction (financial conditions impact), the extent of any retaliation from other countries, and importantly – what other factors might be influencing the economy in 6-12 months time, when any potential tariffs may have the largest impact. For these reasons, he noted, tariffs are not impacting the Fed's current monetary policy decisions. Please see pages 7 and 8 for more detail on this topic.

Exhibit 3: The market's pricing of the Fed's terminal and neutral rates has fluctuated this year

1y1y Overnight Indexed Swap (OIS) forwards, as a proxy for the terminal rate of this cycle, and 5y5y OIS forwards, as a proxy for the longer-run neutral rate



Source: BlackRock, Bloomberg. As of December 4, 2024. **There is no guarantee any forecasts may come to pass.**

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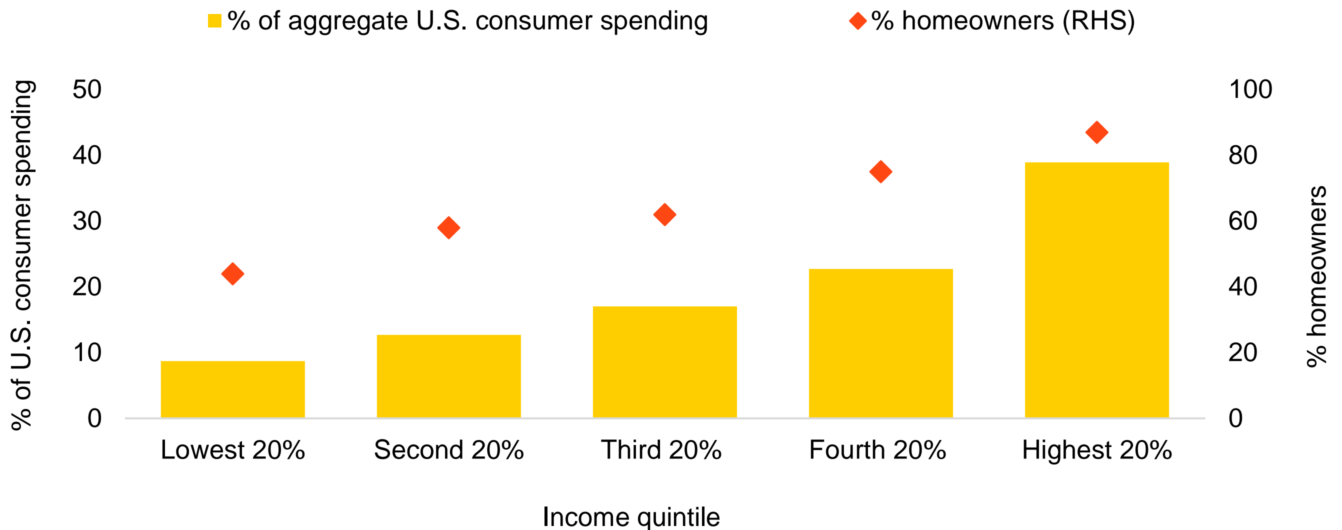
Key takeaways (continued)

- **The level of the deficit cannot factor into monetary policy decisions.** Chair Powell reiterated a message he has given previously: the federal deficit is on an unsustainable path, the U.S. economy needs to grow faster than the debt, and "sooner is better than later." He highlighted the negative implications of – and importance of avoiding – "fiscal dominance", which is a scenario where a central bank is constrained in its monetary policy actions because of the fiscal situation.
- **The Fed is monitoring the risks to low-income consumers.** When asked about some of the most pressing *domestic* risks, Chair Powell flagged the economic pressures facing consumers at the low and moderate ends of the income spectrum (citing commentary from retail industry earnings calls). He added that while the aggregate numbers for the U.S. consumer are still "really good," there are "pressures in the lower income spectrum that we didn't see two years ago." The bifurcation in the U.S. consumer has been a persistent theme over the past few quarters. While wealth creation at the higher-ends of the income spectrum (which tend to own homes and investments) have boosted aggregate wealth, lower-income consumers (which are more likely to rent) are feeling pressure from the cumulative impact of prior inflation (and elevated price levels, relative to pre-pandemic).

Exhibit 4: The U.S. consumer is not "one size fits all"

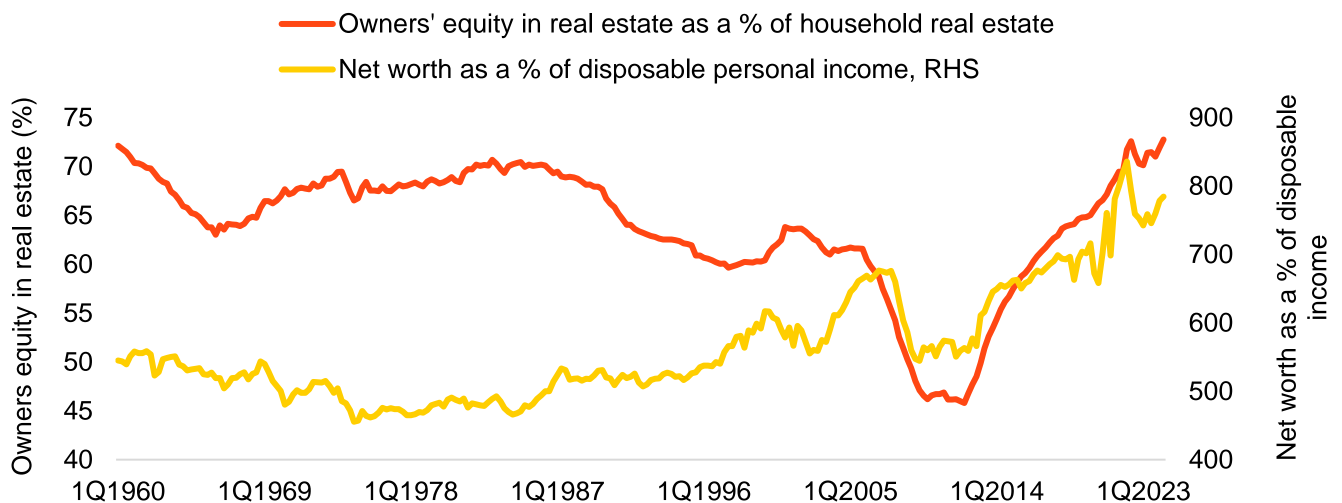
U.S. annual aggregate expenditures by consumer income quintile, and the share of consumers in each cohort that are homeowners (RHS)



Source: BlackRock, U.S. Bureau of Labor Statistics Consumer Expenditure Survey (released September 25, 2024).

Exhibit 5: U.S. households' net worth has benefited from gains in equity and housing markets

Measures of U.S. households' net worth



Source: Federal Reserve Board, Haver Analytics, BlackRock. As of 2Q2024 (most recent as of November 26, 2024).

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Payrolls: An anticipated rebound

We expect the November U.S. non-farm payrolls report (December 6th) will be closely watched by the FOMC and market participants for signals on the health of the U.S. labor market, especially after Tuesday's (December 3rd) slightly stronger than expected job openings reading.

The Bloomberg consensus survey expects a reading of +215k. This would reflect a rebound from October's weak print (+12k), which was distorted by hurricane and labor strike impacts. Beyond the non-farm payrolls reading, we will also be watching the trend in the unemployment rate (in both directions).

While the U.S. labor market has rebalanced (and cooled) from the tight levels of 2022 and 2023, it has done so while keeping layoff rates low by historical standards. This has somewhat mitigated the negative economic effect and has helped to keep the weakness in the U.S. consumer relatively contained. To the extent that corporates increase their layoff rates (perhaps, to protect profit margins), this poses a risk to the broader macroeconomic landscape, and by extension, corporate credit risk premiums, in our view.

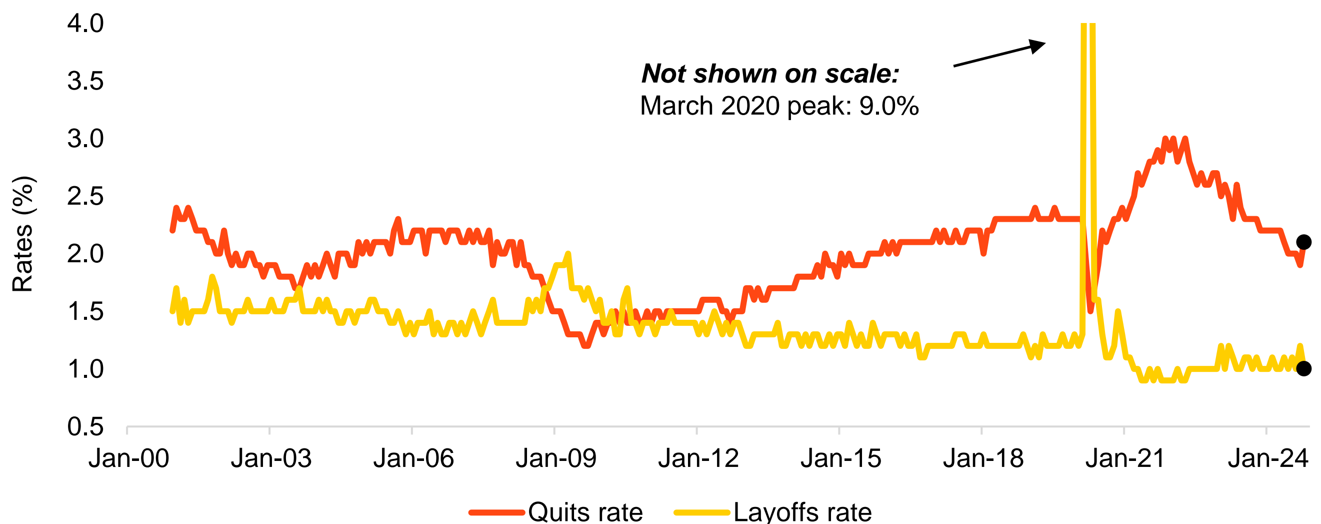
Exhibit 6: The U.S. labor market has rebalanced to the pre-pandemic level

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

Source: BlackRock, Bureau of Labor Statistics. Captures data through October 31, 2024 (most recent available as of December 3, 2024).

Exhibit 7: Layoffs remain muted by historical standards

U.S. Layoffs & Discharge and Quits rates (%), both seasonally adjusted



Note: The Layoffs & Discharge Rate tracks involuntary job separations initiated by the employer, while the Quits Rate tracks voluntary job separations initiated by the employee. Source: Bureau of Labor Statistics, Bloomberg, BlackRock. Captures data through October 31, 2024 (most recent as of December 4, 2024).

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Examining the impact of potential tariffs

A month after the U.S. election, President-elect Donald Trump has begun to define his vision for the next four years. As our colleagues in the *BlackRock Investment Institute* have highlighted, significant policy shifts are on the horizon – including those related to tariffs. We see potential for certain tariff related policies to have meaningful impacts on both the domestic and international macroeconomic landscape, as well as on credit markets at the aggregate, sector, and borrower levels. This is generally consistent with our expectation for "dispersion but not widespread market disruption," although the range of outcomes and uncertainty is unquestionably wide.

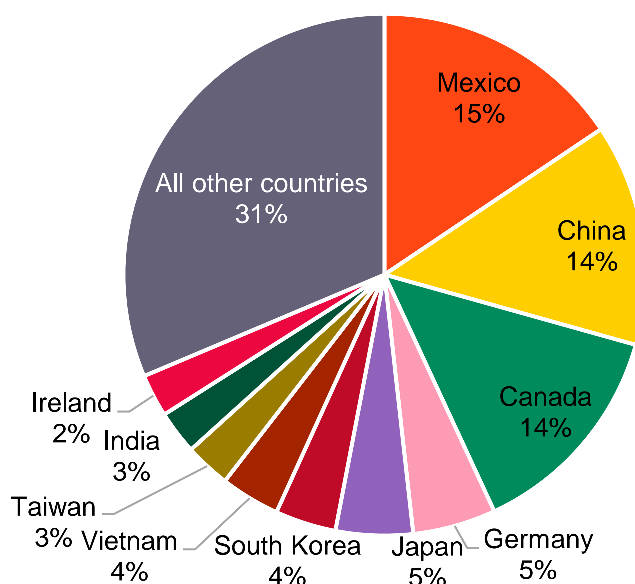
On November 25, 2024, President-elect Trump provided incremental details related to his planned tariff approach. He suggested a 25% tariff on all products imported from Mexico and Canada could be possible, contingent on select objectives. This proposal was accompanied by others, including a potential, additional 10% tariff on imports from China. That said, and as referenced earlier, significant detail related to any potential tariff policy remains to be finalized. Additionally, the United States-Mexico-Canada Agreement's (USMCA) review is slated for mid-2026. During Trump's previous presidency, a tariff on Mexican imports was proposed but never implemented because an agreement was reached.

Should the proposed tariffs be implemented, the impacts on U.S. markets and the economy could be significant. A recent paper by the Federal Reserve Bank of New York[1] found that 2018-2019 tariffs of 10%-50% on more than $300 billion of Chinese imports led to negative effects on the U.S. stock market. On days when the tariffs were announced, the U.S. stock market fell a cumulative 11.5%, leading to an aggregate $4.1 trillion in equity value losses, per their analysis. In our view, a portion of any additional risk premia required by the equity market is likely to extend into corporate credit, as well. And as we highlighted recently, even the *uncertainty* related to tariffs – prior to any implementation – may be enough to weigh on global growth – especially Euro Area investment.

U.S. imports are heavily exposed to Mexico, Canada, and China, with the three countries representing a cumulative 43% of goods import volume in 2023 (Exhibit 8), per the Bureau of Economic Analysis. But imports from each country represent different sector exposures. For example, automotive vehicle imports represented the largest segment of U.S. imports from Mexico in 2023, vs. mineral fuels from Canada and electronic equipment from China (Exhibit 9 – next page). This variety in exposure, in our view, underscores the importance of nuance and active credit selection when evaluating the impacts of various policies.

Exhibit 8: 43% of all goods imports in 2023 were from Mexico, China, and Canada

Share of 2023 United States goods import volume, by country



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

[1] Mary Amiti, Matthieu Gomez, Sang Hoon Kong, and David E. Weinstein, "Using Stock Returns to Assess the Aggregate Effect of the U.S.-China Trade War," Federal Reserve Bank of New York Liberty Street Economics, December 4, 2024, https://libertystreeteconomics.newyorkfed.org/2024/12/using-stock-returns-to-assess-the-aggregate-effect-of-the-u-s-china-trade-war/.

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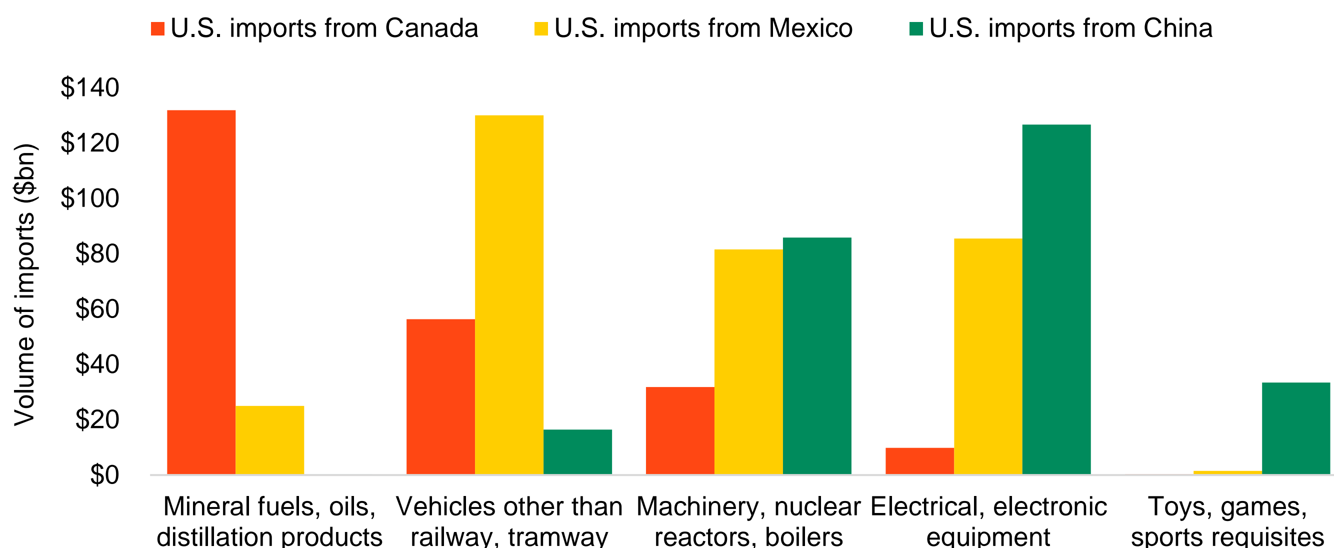
Exhibit 9: Imports from each country represent a different sector mix
Three largest U.S. import categories from Canada, Mexico, and China



Source: Comtrade, Trading Economics, BlackRock. As of 2023 (data was last updated in December 2024).

Company perspectives on navigating trade policy uncertainty

We expect the impact of trade policy uncertainty (and tariffs, if implemented) will vary across regions, sectors, and issuers. Should 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. In our view, these insights generally underscore the likelihood of dispersion, but not widespread disruption – barring certain "tail" scenarios.

To better understand how businesses are managing this uncertainty, we reviewed recent earnings calls (focusing only on those following the November 5th U.S. election), for 26 U.S. publicly listed companies across 16 sectors. From this analysis, there were three key takeaways, in our view.

(1) Despite the uncertainty surrounding tariffs, businesses feel well-equipped to accommodate them in most scenarios. Across sectors, there was a broad acknowledgment of the uncertainty around future tariff policy. Even so, many businesses, especially those with international supply chain exposure, felt prepared for the implementation of tariff policies, with some referencing "tool kits" developed during President elect Trump's first term. Further, some noted strong supplier relationships as a potential mitigation tool, believing that they can collaborate with suppliers to achieve better outcomes should tariff policies come to fruition.

(2) Businesses have focused on supply chain resilience (over efficiency) in recent years. A movement toward protectionist policies in the U.S., unforeseen events such as the COVID-19 pandemic and geopolitical tensions have focused businesses on establishing resilience in their supply chains (even when a higher cost may be required). For example, many businesses proactively shifted supply chain exposures onshore or diversified away from certain regions such as China. That said, various home improvement and electronics retailers cited challenges with implementing supply chain diversification. Off-price retailers also offered a unique perspective, noting that trade policy uncertainty has the potential to *benefit* them, as it can disrupt traditional retail inventory strategies.

(3) The new administration has sparked (cautious) optimism across different sectors. Despite trade policy uncertainty, businesses in certain sectors (namely, energy and materials) expressed confidence in the next administration's sector-specific policy views. Some noted that this increased their comfort in ramping business investment. For example, various oil companies signaled increasing willingness to expand capital expenditures. A materials company noted that they view potential tariffs as a means to create a more level international playing field.

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Corporate credit performance

Exhibit 10: USD corporate credit spreads are tight…

Option adjusted spreads (OAS, bp) for the Bloomberg USD IG and HY Corporate indices

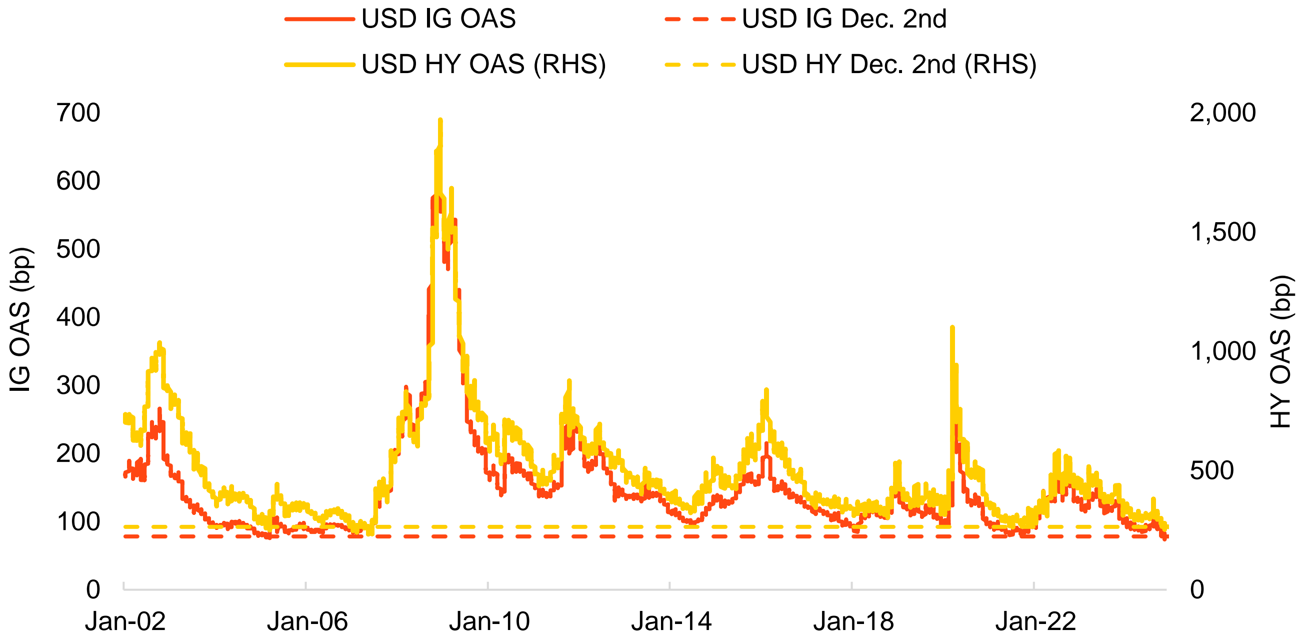

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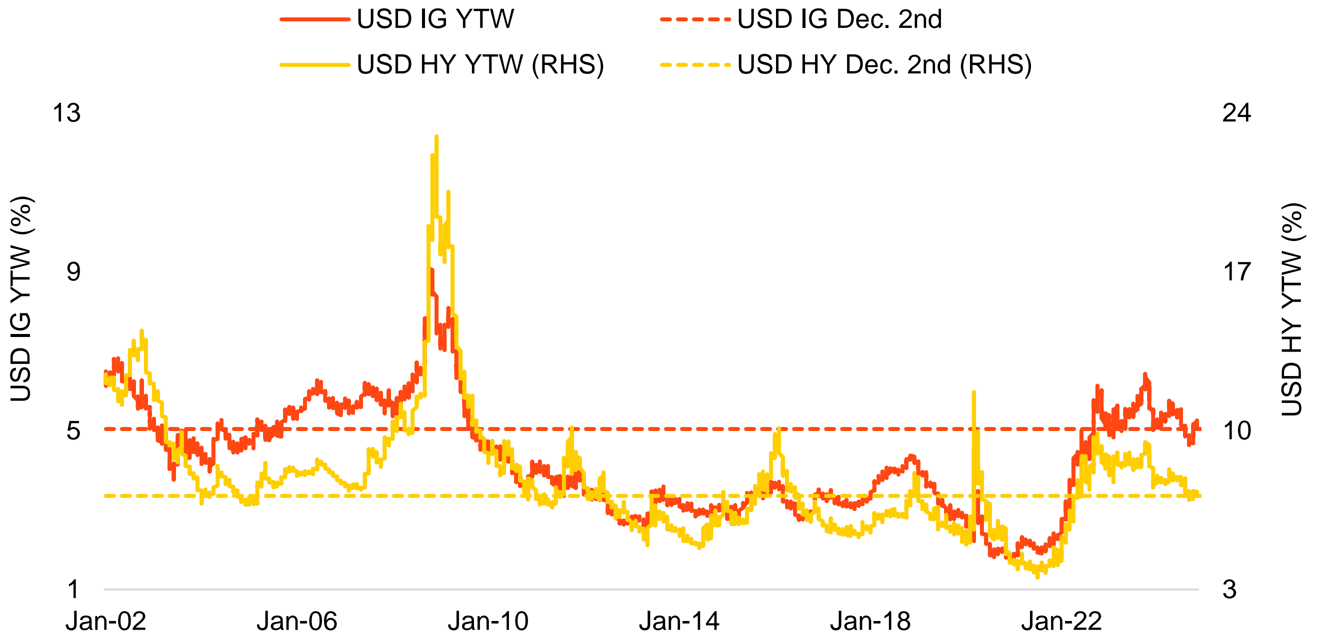
Exhibit 11: …but yields are still elevated

Yield-to-worst (%) for the Bloomberg USD IG and HY Corporate indices



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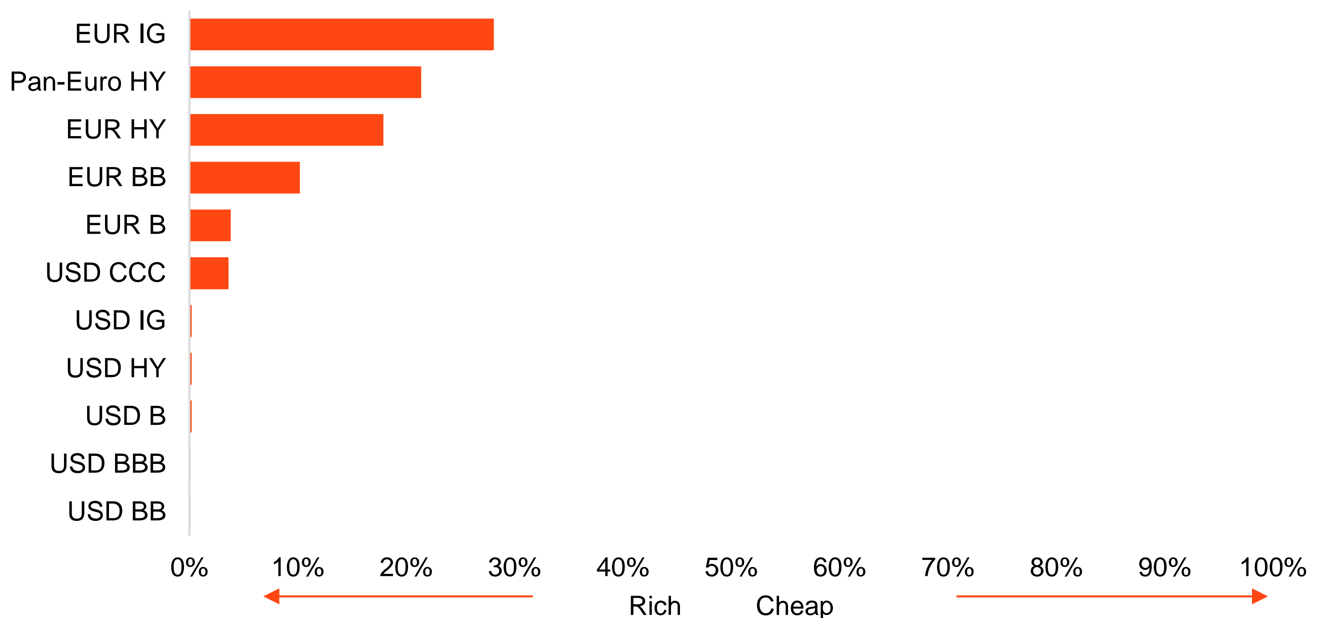
Corporate credit valuations

Exhibit 12: EUR spreads trade at a discount to USD peers

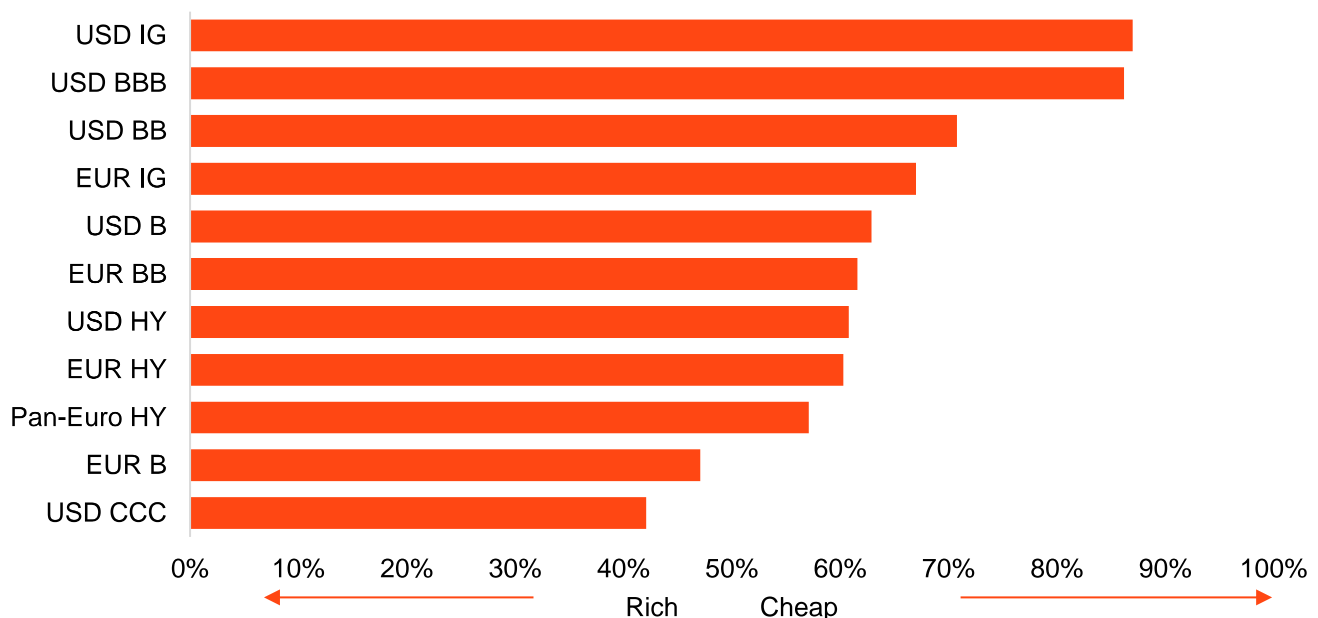
Percentile rank of daily index-level corporate bond spreads since January 1, 2010



Source: BlackRock, Bloomberg, ICE-BAML. As of December 2, 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. We exclude USD AAA, EUR AAA, and EUR CCC due to their small size.

Exhibit 13: The valuation gap between USD and EUR credit is less pronounced when evaluating all-in yields

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



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