July 3, 2024

Global Credit Weekly:

Watching for an inflection point

BlackRock

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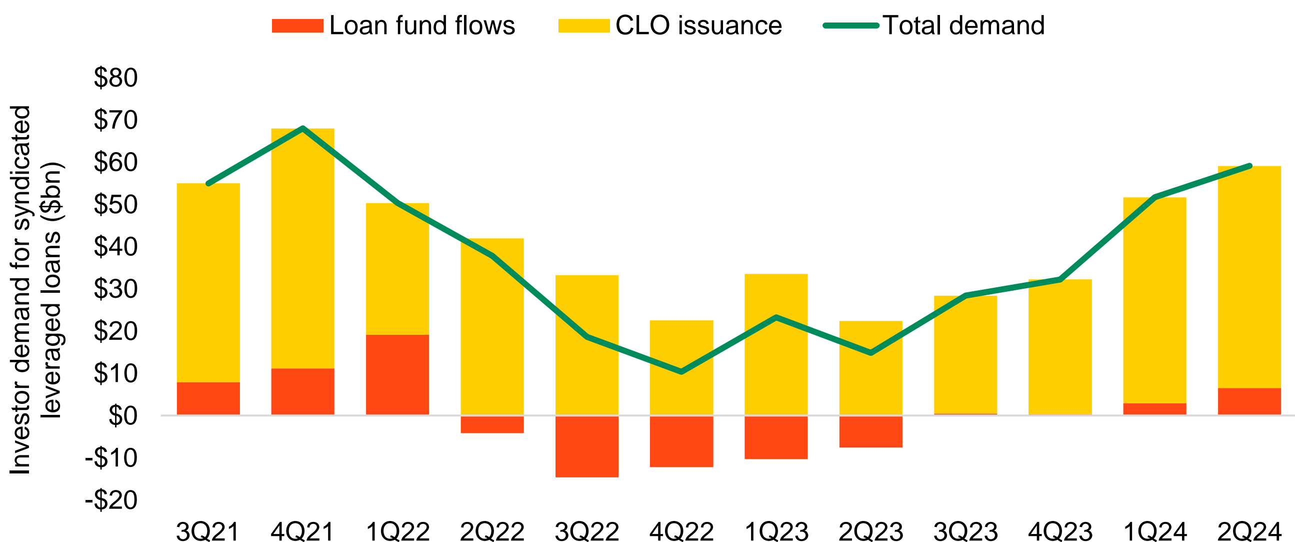
Key takeaways

- With progress on inflation becoming clearer, and the downside risks to growth more pronounced, central banks in the U.S., Europe and the U.K. have increasingly discussed (or started) rate cuts. But as we outlined in our *3Q2024 Global Credit Outlook*, our base case calls for gradual and "shallow" rate cutting cycles, relative to the post-financial crisis era. As we discuss within, this week's commentary from European Central Bank (ECB) President Christine Lagarde and Federal Reserve Chair Jerome Powell (at the ECB Forum in Sintra, Portugal) largely supports this view.
- Under our baseline assumption, consumer, corporate, and commercial real estate borrowers are unlikely to see material, near-term interest rate relief on their debt costs – at least not in 2H2024. For investors across these asset classes, the interaction between higher rates and economic activity will be paramount, as supportive growth (and a solid labor market) would help mitigate the headwind from persistently elevated debt service costs.
- While not our base case, a key risk for 2H2024 is that the moderation in U.S. growth and rebalancing in the U.S. labor market reaches an "inflection point" and turns into outright deterioration and weakness. Friday's (July 5th) U.S. non-farm payrolls report will be important to assess the pace and velocity of the ongoing rebalancing in the U.S. labor market (Exhibit 4).
- Away from these macro areas of focus, in this *Global Credit Weekly*, we also take stock of record-setting issuance volumes in two distinct pockets of corporate credit: (1) the syndicated leveraged loan market (related to Exhibit 1), and (2) cross-border issuance in the USD IG universe (from European borrowers). Finally, we revisit the five policy areas most relevant for corporate credit investors, considering persistent uncertainty related to the U.S. election.

Exhibit 1: CLO creation has driven demand for new leveraged loans

USD syndicated leveraged loan market measurable investor demand, as captured by Pitchbook LCD



Source: BlackRock, Pitchbook LCD, Morningstar Direct. Data through June 24, 2024. Pitchbook LCD measures investor demand as the aggregate of collateralized loan obligation (CLO) issuance and retail cash flows to U.S. loan funds. Fund flows include monthly reporters.

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Election uncertainty persists

Uncertainty related to the U.S. election persists. President Biden and former President Trump faced off in their first presidential debate on June 27th. National polls such as 538 showed a slight lead for former President Trump (+1.6 points, as of July 2nd) relative to President Biden, but nevertheless remain close.

As we outlined in early May, we believe five policy areas are most relevant for corporate credit investors: (1) taxes; (2) trade and tariffs; (3) fiscal spending; (4) regulation and anti-trust; and (5) immigration. That said, some of these areas would also be influenced by the outcome of the House and Senate races in November.

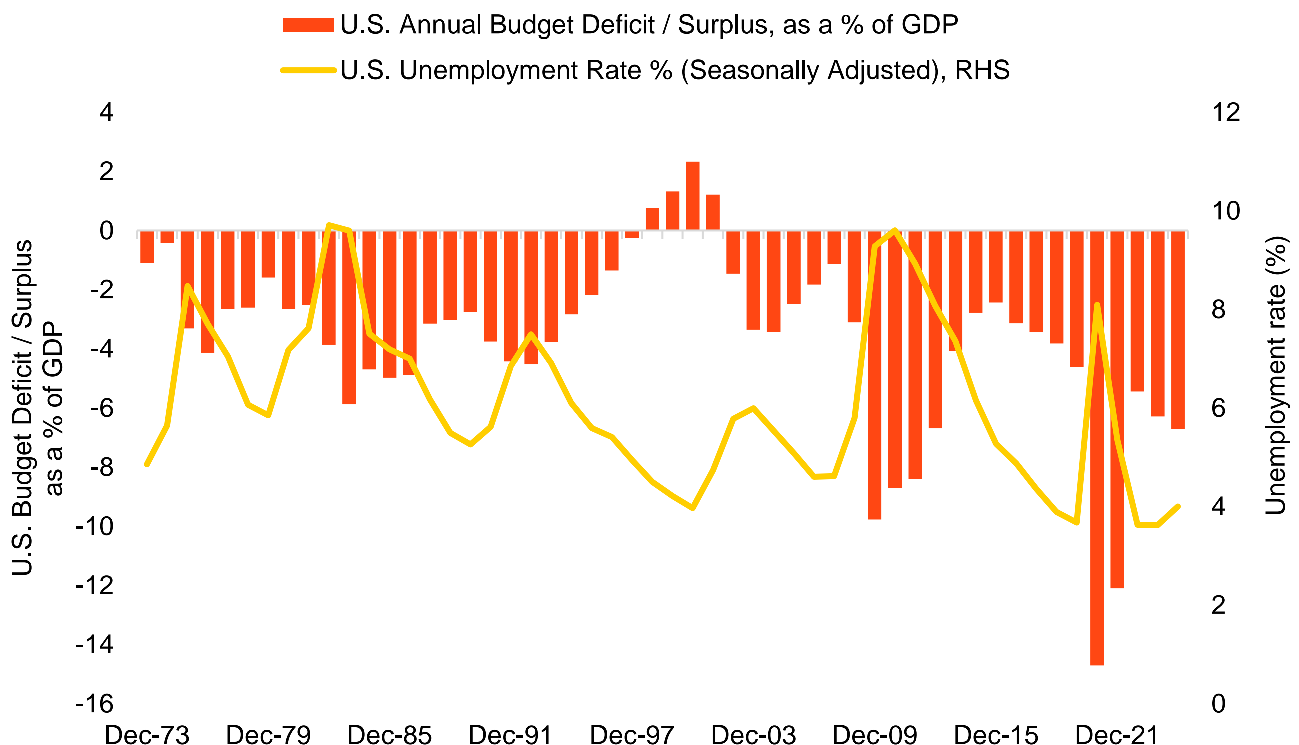
We see more scope for significant policy shifts (relative to the status quo), in a Republican sweep scenario – especially in areas such as taxes. Other potential policy shifts, such as those related to trade and tariffs are also in focus for many investors, given former President Trump's public commentary on the topic.

Budget deficits are expected to remain large regardless of which party wins the U.S. election (Exhibit 2). Such ongoing deficits reinforce our expectation for higher-for-longer interest rates (beyond the policy-sensitive front-end), as well as the potential that investors may demand additional compensation for holding longer-term U.S. Treasuries.

Investors are focused on upcoming milestones in July and August that will provide additional clarity on formal nominations, such as the Republican ticket's Vice-Presidential selection and the Republican and Democratic National Conventions (which begin July 15th and August 19th, respectively) and policy priorities from both parties. Additionally, the next presidential debate is scheduled for September 10th.

Exhibit 2: The U.S. budget deficit is elevated, despite relatively low unemployment

The U.S. annual budget deficit (or surplus, if positive) as a percent 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 (CBO), Bureau of Labor Statistics, Bloomberg. Historical data (including deficit as a percentage of GDP and unemployment rate) is as of each annual period through 2023. Year-end 2024 unemployment rate projection is per the June 2024 Federal Reserve Summary of Economic Projections. Year-end 2024 budget deficit projection is per the CBO, as of July 2, 2024. **There can be no guarantee that any projections will come to pass.**

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ECB Forum in Sintra: Key takeaways

The ECB held its annual Forum on Central Banking in Sintra, Portugal this week – the theme of which was titled "Monetary policy in the era of transformation."

ECB President Christine Lagarde provided remarks on July 1st, and she was joined by Federal Reserve (Fed) Chair Jerome Powell and Governor of the Central Bank of Brazil, Roberto Campos Neto on July 2nd.

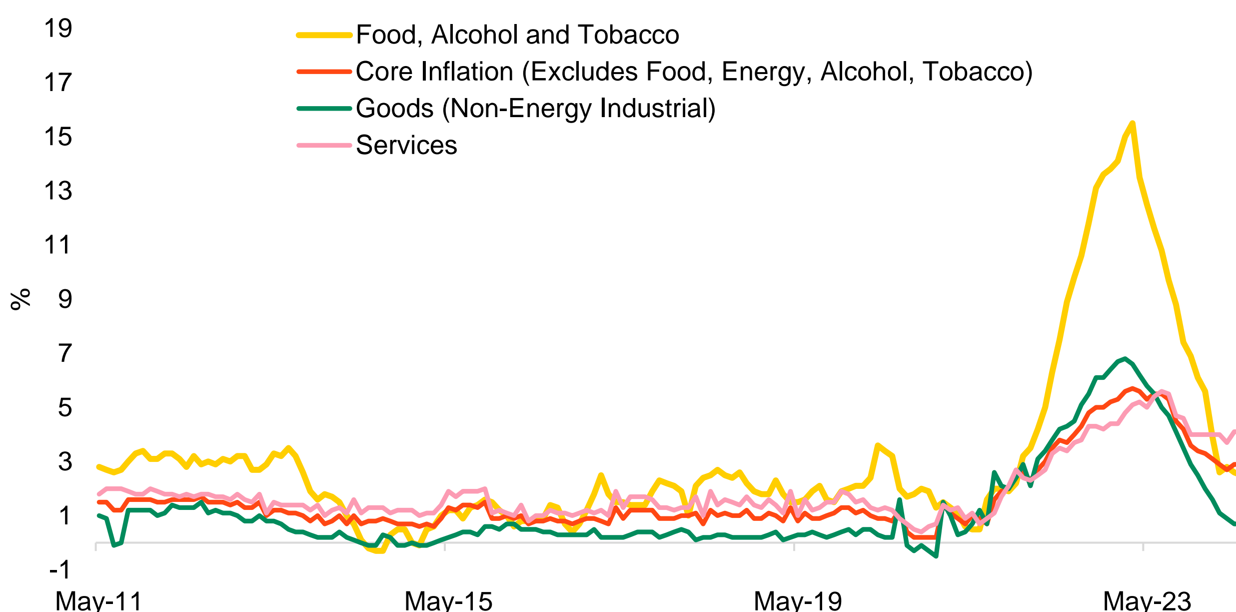
As it relates to developed market economies, the commentary from President Lagarde and Chair Powell each acknowledged improvement on fighting inflation but nonetheless stressed a data-dependent approach to policy normalization. For corporate credit investors, the messaging was consistent with our expectation for a gradual, shallow policy rate cutting cycle in both regions.

We outline some of the key takeaways below.

ECB: A "bumpy" path, with services inflation in focus

- President Lagarde's commentary coincided with the release of inflation data for the Euro Area, which showed persistently elevated services costs (Exhibit 3). She noted that the ECB continues to face "uncertainties" regarding inflation and that "it will take time for us to gather sufficient data to be certain that the risks of above-target inflation have passed."
- The ECB will be watching the interaction of profits, wages and productivity closely, per President Lagarde. Key to understand, in her view, is whether the stickiness of services inflation represents a permanent change, or the lagged effects of other components which are now "finding their way more slowly and gradually into services."
- President Lagarde noted that labor shortages are encouraging employers to "hoard" labor, and she believes higher profits and lower real wages are encouraging them to do so. President Lagarde also addressed the unique nature of labor negotiations in the Euro Area – some of which are conducted on a multi-year basis (implying an element of "catch up" working its way through the system).
- For inflation, President Lagarde anticipates a "bumpy road until the end of 2024." That said, she reiterated that services inflation doesn't need to reach 2%, as it will be the balance between services and goods inflation that is most relevant for the path of monetary policy.

Exhibit 3: Services inflation in the Euro Area remains elevated, driven in large part by wages
Year-over-year inflation (not seasonally adjusted) for the Euro Area, by category



Source: BlackRock, Eurostat, Bloomberg, European Central Bank. Captures inflation data through June 30, 2024 (latest available).

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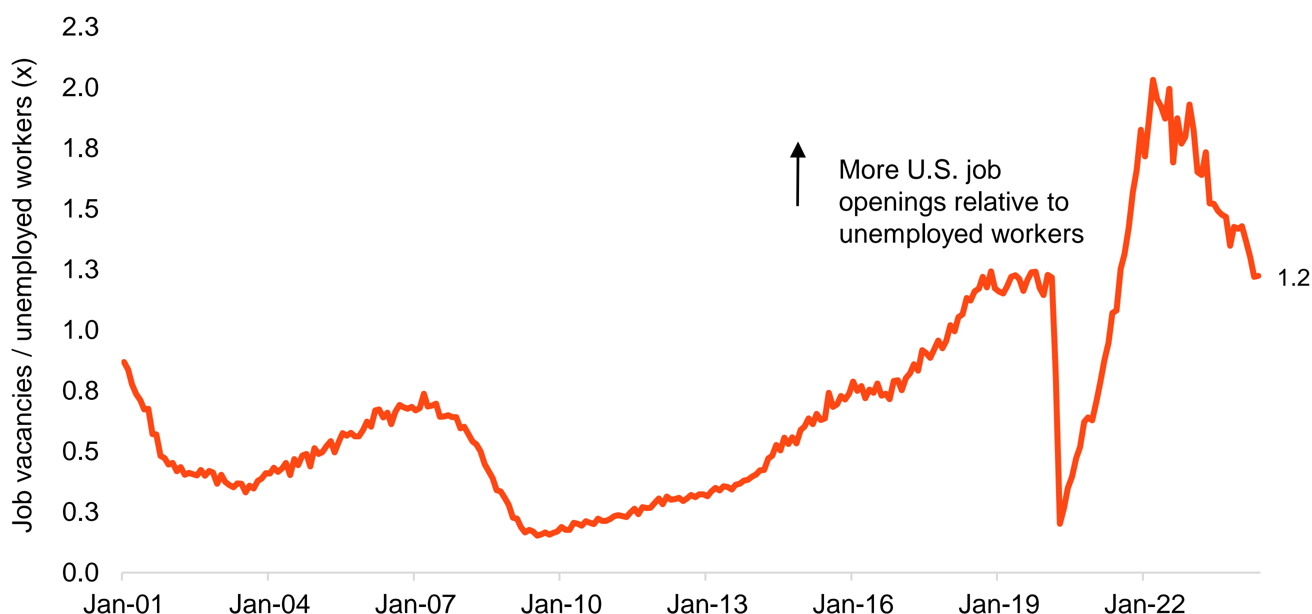
Fed: Still looking for more confidence

- In our view, Chair Powell's remarks at the 2024 Sintra conference reiterated much of what he has emphasized in recent FOMC meetings. Namely, that the risks to the Fed's dual mandate of price stability and full employment are now largely two-sided, the FOMC would like to be more confident that inflation is sustainably moving down to 2% before it lowers interest rates, and that an *unexpected* weakening in the U.S. labor market could warrant a policy response.
- Chair Powell said he doesn't see inflation returning to 2% in 2024 or 2025 (at least not before late 2025). This direction of travel is largely consistent with the median projection outlined in the Fed's June 2024 Summary of Economic Projections.
- When asked about the *level* of restrictiveness embedded in the current stance of monetary policy, Chair Powell said that was an "empirical question." He reiterated, however, that he *does* view policy as restrictive, pointing to lower demand for workers (as evidenced by the "jobs-workers" gap highlighted in Exhibit 4), as well as the impact on activity in certain rate-sensitive markets such as housing.
- Chair Powell outlined three drivers of the long-run neutral rate of interest – i.e., the rate of interest that would keep an economy at equilibrium – including demographics, technology, and productivity. That said, he again noted (as he has done previously, in other public forums) that such a concept is not relevant to the monetary policy rate that is appropriate for the economy *right now* – because the U.S. economy is still recovering from pandemic-related distortions.
- That said, Chair Powell acknowledged that the discussion on the long-term neutral rate of interest is indeed somewhat relevant for the ultimate *depth* of the rate cutting cycle. Here, he reiterated previous remarks that it is unlikely the U.S. will revert back to the "very low levels of neutral rates" that defined much of the post-financial crisis era. (For her part, President Lagarde agreed with this).

In our view, the remarks leave the door open for a potential rate cut in September or 4Q2024, presuming the forthcoming U.S. inflation data resembles the pattern seen in April and May. That said, and as we have outlined previously, the *reason* for – and *depth* of – the rate cutting cycle (once it materializes) are more relevant for corporate credit investors than the *timing*. Given that we expect a shallow rate cutting cycle in the U.S., the interaction with growth will remain key for corporate credit borrowers to navigate this elevated cost of capital backdrop with fundamental resilience.

Exhibit 4: The U.S. labor market has rebalanced to the pre-pandemic level by some aggregate metrics, such as the "jobs-workers" gap

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



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

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USD leveraged loan supply: A strong skew towards refinancing

Syndicated USD leveraged loan issuance in the first half of 2024 (1H2024) was uniquely strong. But beyond the headline figures, we would highlight three key themes: (1) the syndicated leveraged loan market was open to lower rated borrowers; (2) activity was heavily skewed toward refinancing (similar to the trend in the USD high yield bond market), and (3) the limited amount of "new money" did not keep pace with investor demand (including from CLO creation).

"New" loan issuance has not kept pace with demand

Syndicated USD leveraged loan primary market activity reached a record-breaking level of $727 billion in 1H2024 (through June 24, 2024), surpassing the previous post-financial crisis record of $584 billion in 1H2017 (Exhibit 5). For context, the average activity over the last ten years (1H2015 – 1H2024) was $347 billion, less than half the 1H2024 level. Both quarters in 1H2024 contributed to this strong result, though the second quarter tracked a record high of $396 billion (Exhibit 6).

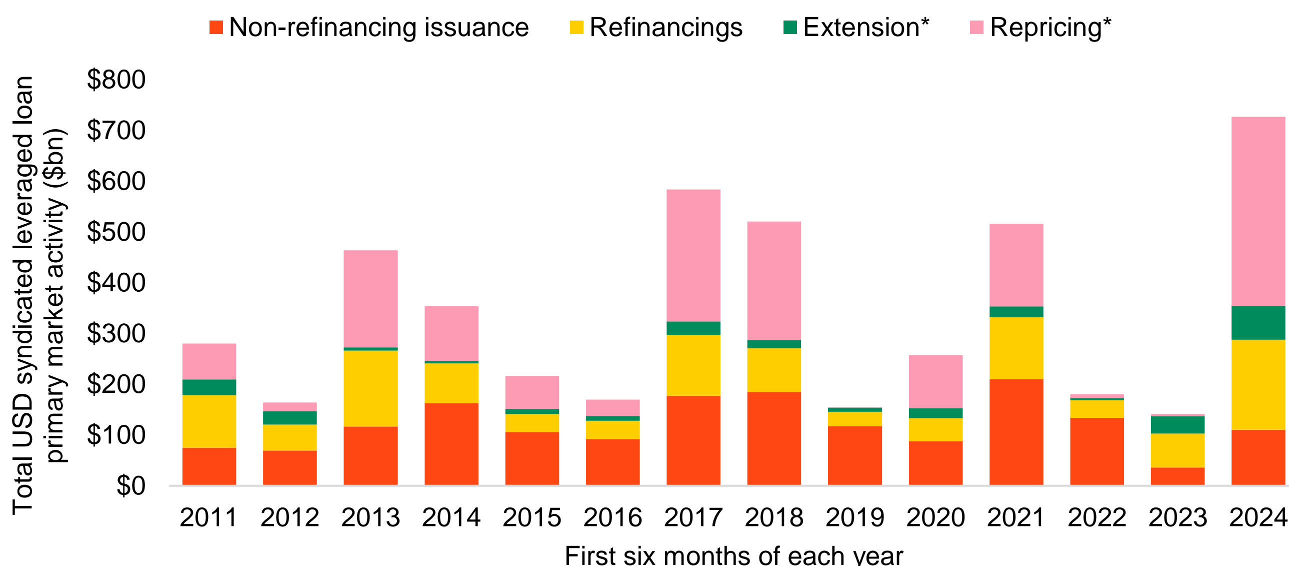
That said, beneath these large headline figures, the amount of "new" loan supply has been minimal, at just 15% of total 1H2024 activity (vs. 25% in 1H2023 and 74% in 1H2022). This is because the bulk of the 1H2024 activity has been related to repricings and refinancings (again, Exhibits 5 and 6).

Repricings (which do not represent "new" supply but rather a decrease in the spread paid – in addition to a base rate – on an existing loan) have been especially prevalent. This is perhaps unsurprising, as borrowers seek to capitalize on the firm tone to help mitigate the sharp increase in borrowing costs (alongside the Federal Reserve's rate hiking cycle). Repricings represented 51% of total activity in 1H2024, versus 3% and 4% in 1H2023 and 1H2022, respectively. As of July 1st, data from Pitchbook LCD shows that 30% of the $1.4 trillion Morningstar LSTA USD Leveraged Loan Index has been repriced. The average spread reduction for borrowers that repriced in 1H2024 was 54bp. In aggregate, this translates into $2.2 billion of annual interest expense "savings", according to Pitchbook LCD.

Investor demand for leveraged loans rose to $59.1 billion in the second quarter, the highest reading since 4Q2021, according to Pitchbook LCD (Exhibit 1). Nearly 90% of this demand was driven by CLO issuance. While fund flows and CLO creation both moderated in late June, the year-to-date supply shortfall (relative to measurable demand) in the USD leveraged loan market nonetheless stood at $115 billion, per Pitchbook LCD (as of July 1st).

Exhibit 5: Repricing activity represented 51% of total activity 1H2024

1H USD syndicated leveraged loan primary market activity (for the first half of each year shown) by use of proceeds



Source: Pitchbook LCD, BlackRock. Values shown are for the first half of each year (e.g., 2023 is 1H2023). Data through June 24, 2024. *Reflects repricings and extensions done via an amendment process only.

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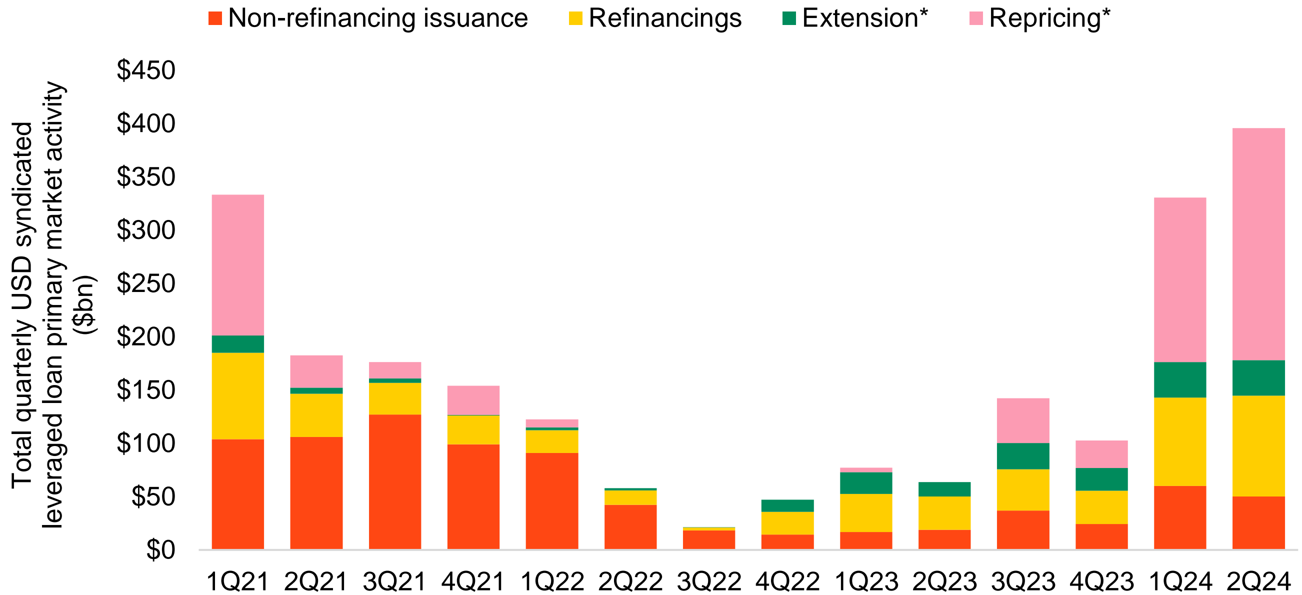
Exhibit 6: Repricing activity was elevated in 1Q2024 *and* 2Q2024
Quarterly USD syndicated leveraged loan primary market activity, by use of proceeds



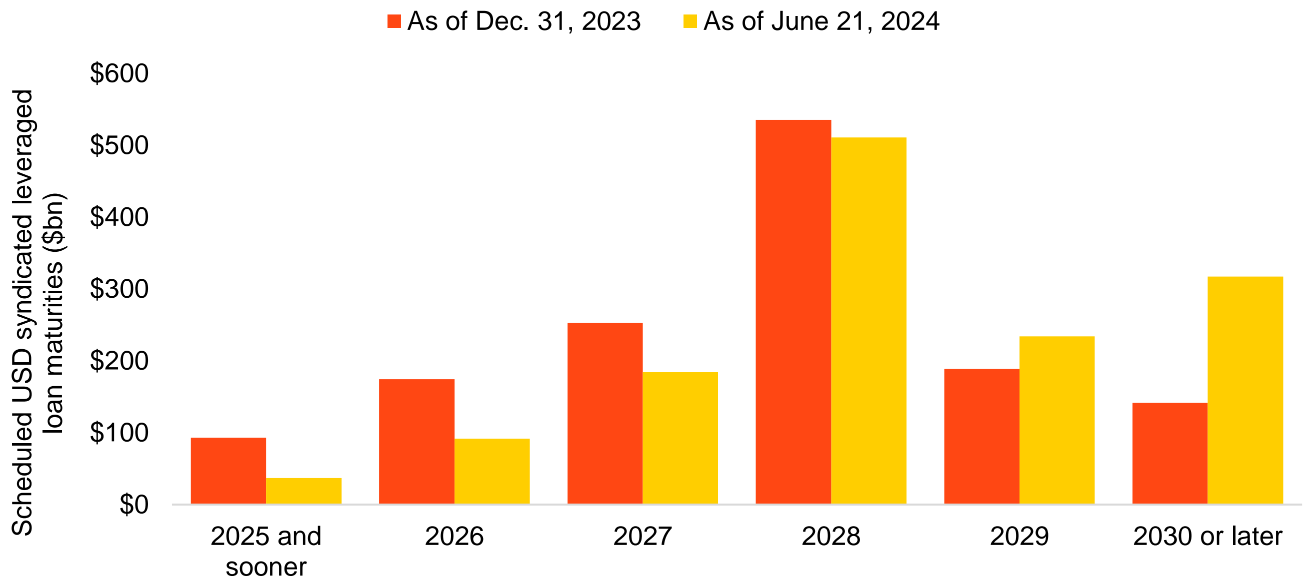
Source: Pitchbook LCD, BlackRock. Data through June 24, 2024. *Reflects repricings and extensions done via an amendment process only.

The loan primary market has been receptive to lower-rated issuers

In 1H2024, the syndicated leveraged loan market was receptive to lower-rated issuers (which we define as those rated B-) – both for repricing and refinancing activity. As we outlined in our *3Q2024 Global Credit Outlook*, this has been important for credit market sentiment as it has allowed borrowers some flexibility to manage interest costs (via repricing) and maturity walls (via refinancing) in the context of the elevated base rate environment.

Starting with refinancing activity, Exhibit 7 illustrates the progress leveraged loan issuers have been able to make in addressing upcoming maturity walls. Since year-end 2023, maturities in 2025 or sooner have declined by 60%, while maturities in 2026 have declined by 48%.

Exhibit 7: Leveraged loan borrowers have made progress on maturity wall management
USD syndicated leveraged loan scheduled maturity wall, by year



Source: PitchBook LCD, Morningstar LSTA US Leveraged Loan Index, BlackRock. As of June 21, 2024.

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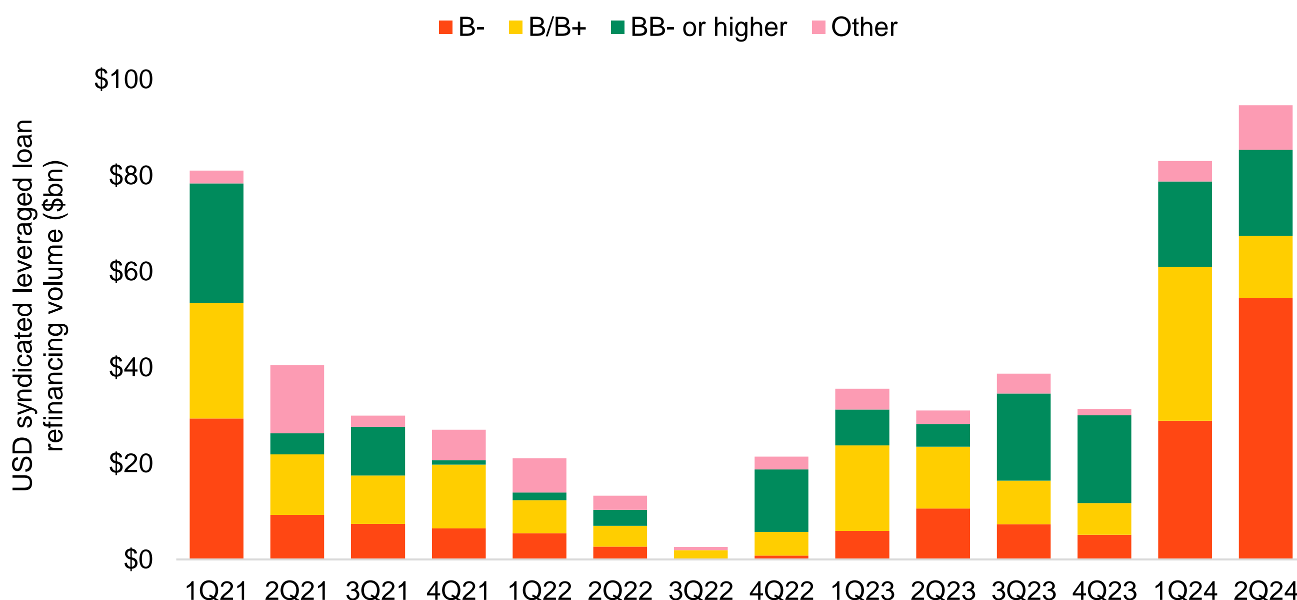
From 1Q2023-1Q2024, refinancings for higher-rated borrowers (i.e., issuers rated BB- and B/B+) averaged 67% of total refinancing volume (Exhibit 8). However, as "new" money activity remains minimal, lenders have seemingly become more willing to refinance lower-rated borrowers. In 2Q2024, B- refinancings represented 58% of total refinancing activity. This marks the highest share of B- rated borrower refinancing since 2008, according to Pitchbook LCD.

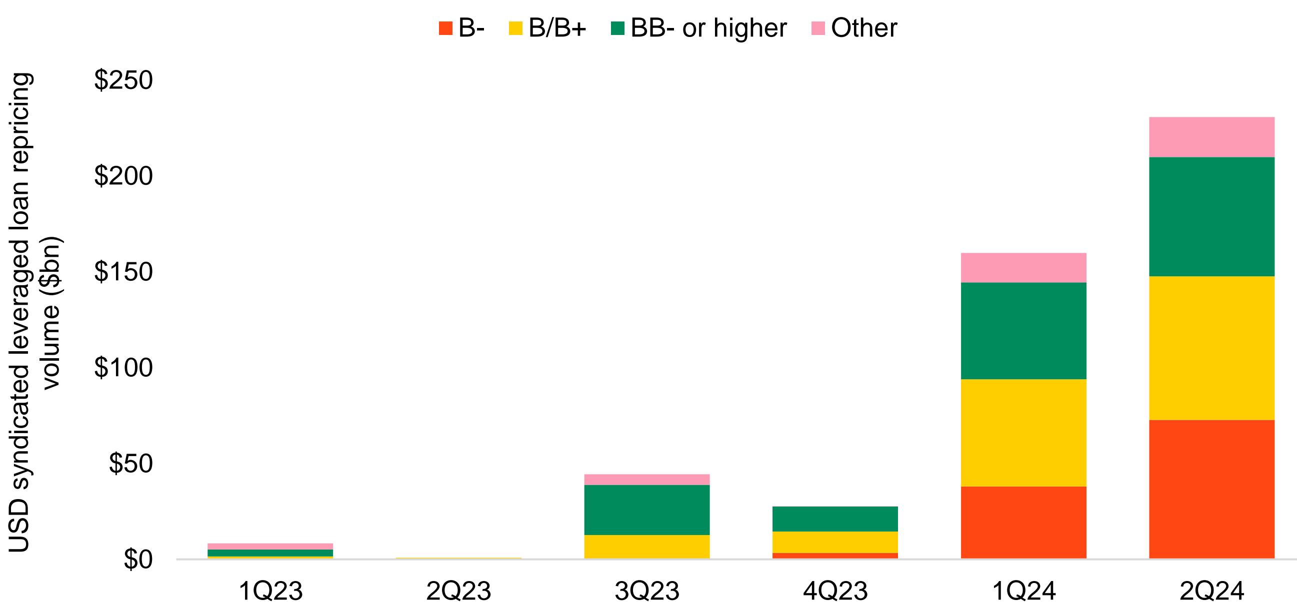
Repricing activity has also included lower-rated borrowers. During the second quarter, $73 billion, or 32% of repricing volume, was attributed to borrowers that are rated B- by at least one rating agency (Exhibit 9). For context, B- borrowers represent 26% of the outstanding USD leveraged loan market as of May 31, 2024, according to Pitchbook LCD.

Exhibit 8: Lower-rated borrowers were active in refinancing activity in 1H2024
USD syndicated leveraged loan refinancing issuance volume by borrower rating



Source: Pitchbook LCD, BlackRock. Data through June 24, 2024. A company qualifies as B- rated if at least one rating agency has rated it as B-.

Exhibit 9: Lower-rated issuers have also participated in the 1H2024 repricing wave
USD syndicated leveraged loan repricing volume by borrower rating



Source: Pitchbook LCD, BlackRock. Data through June 24, 2024. Reflects repricings done via an amendment process and re-syndicated repricings.

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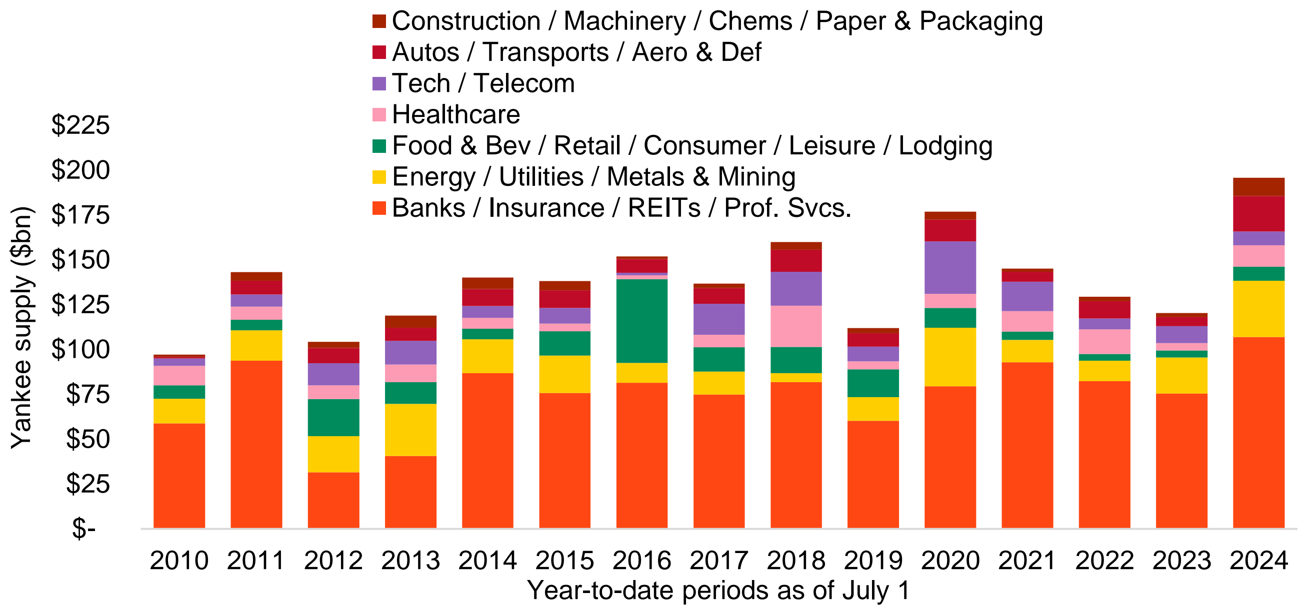
Cross-border USD IG issuance: Another pocket of elevated activity

The receptivity of the USD debt capital markets has not been confined to the leveraged loan market. As we highlighted in our *3Q2024 Global Credit Outlook*, primary market activity in the investment grade (IG) and HY bond markets was also elevated 1H2024 vs. the pace of the past few years (excluding 2020-2021).

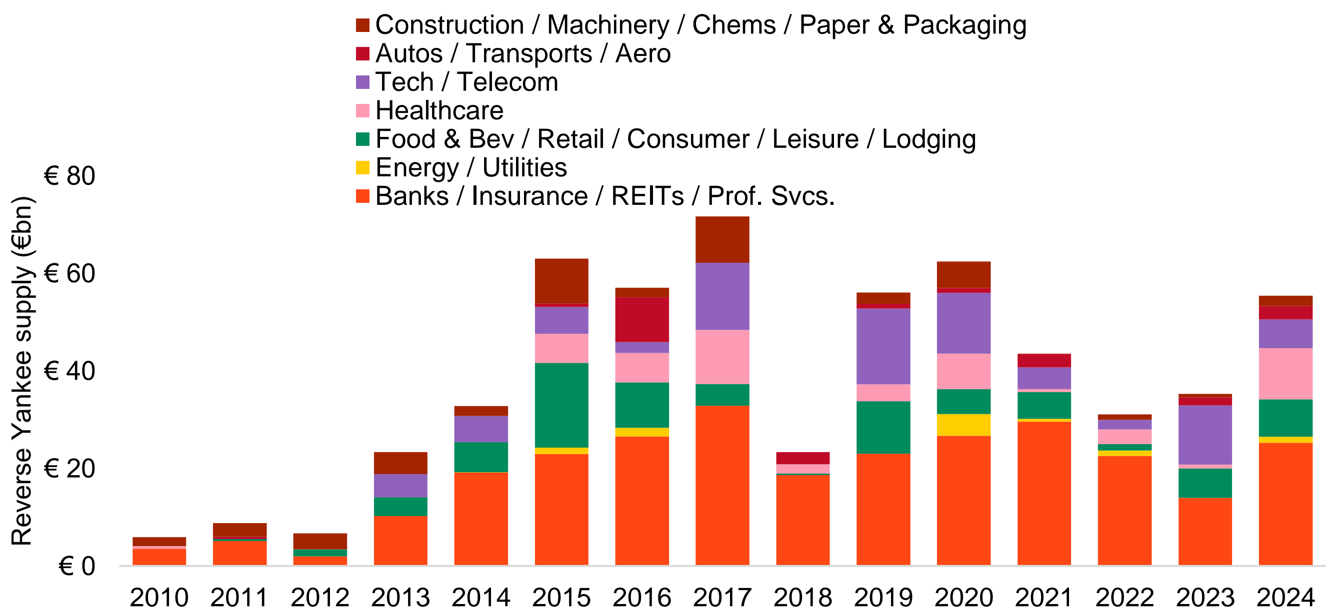
Beyond the headline issuance figures in the IG market, under the surface 2024 has generated a record-setting pace for cross-border issuance (i.e., USD-denominated, IG-rated debt issued by firms domiciled in Europe). So called Yankee issuance in 1H2024 was the strongest of the post-financial crisis era (Exhibit 10), indicating that European firms have been capitalizing on the strong market tone in the USD IG market. Reverse Yankee supply (i.e., EUR-denominated, IG-rated debt issued by firms domiciled in the U.S.) is elevated relative to the past few years, but not by the same magnitude (Exhibit 11).

Exhibit 10: Yankee supply has reached a new year-to-date high
USD-denominated, IG-rated issuance by firms domiciled in Europe, by Dealogic Deal Industry Group



Source: Dealogic (ION Analytics), BlackRock. As of July 1, 2024.

Exhibit 11: Reverse Yankee issuance has been elevated, but not by the same magnitude
EUR-denominated, IG-rated issuance by firms domiciled in the U.S., by Dealogic Deal Industry Group



Source: Dealogic (ION Analytics), BlackRock. As of July 2, 2024.

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