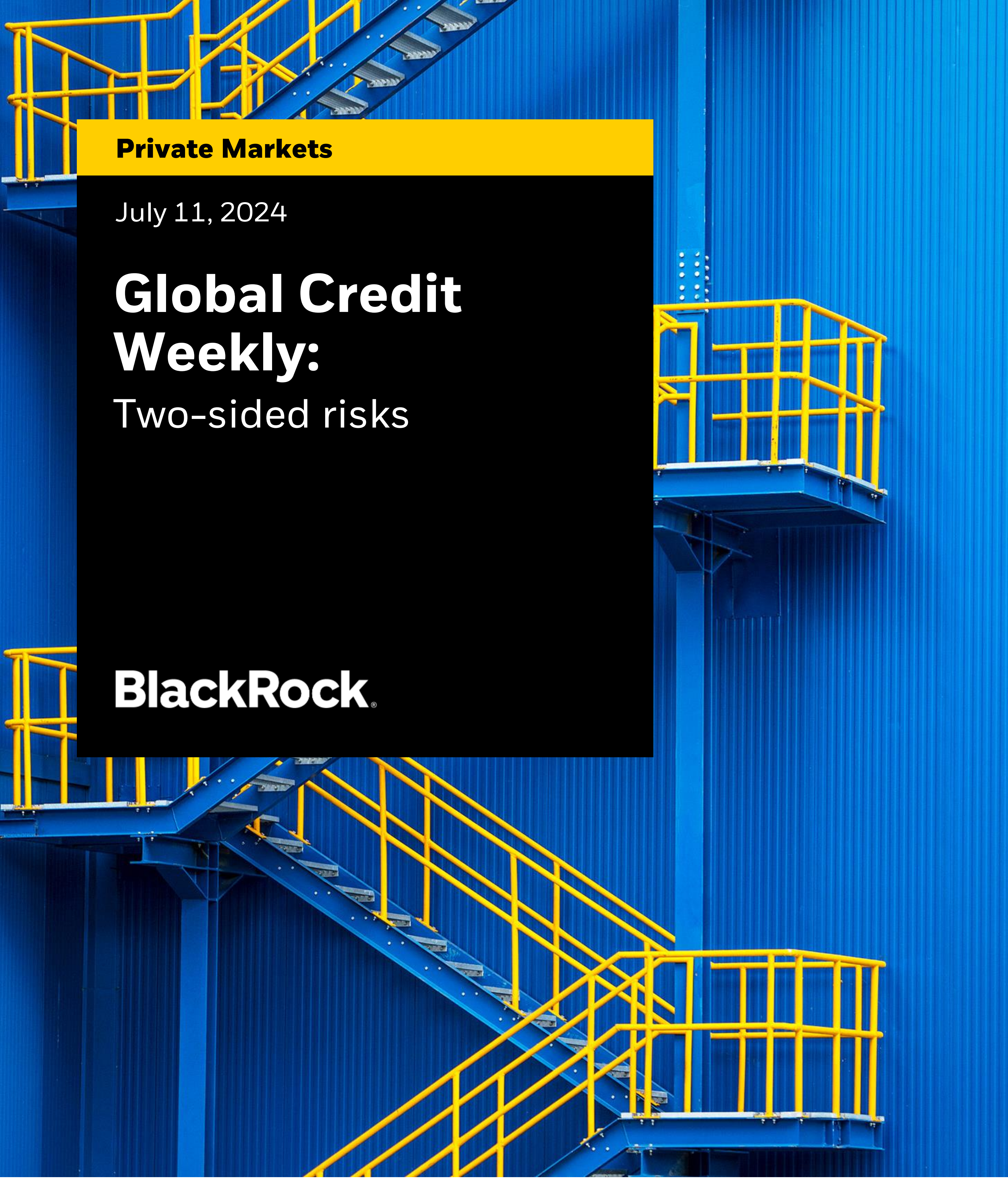

Private Markets

July 11, 2024

Global Credit Weekly:

Two-sided risks

BlackRock

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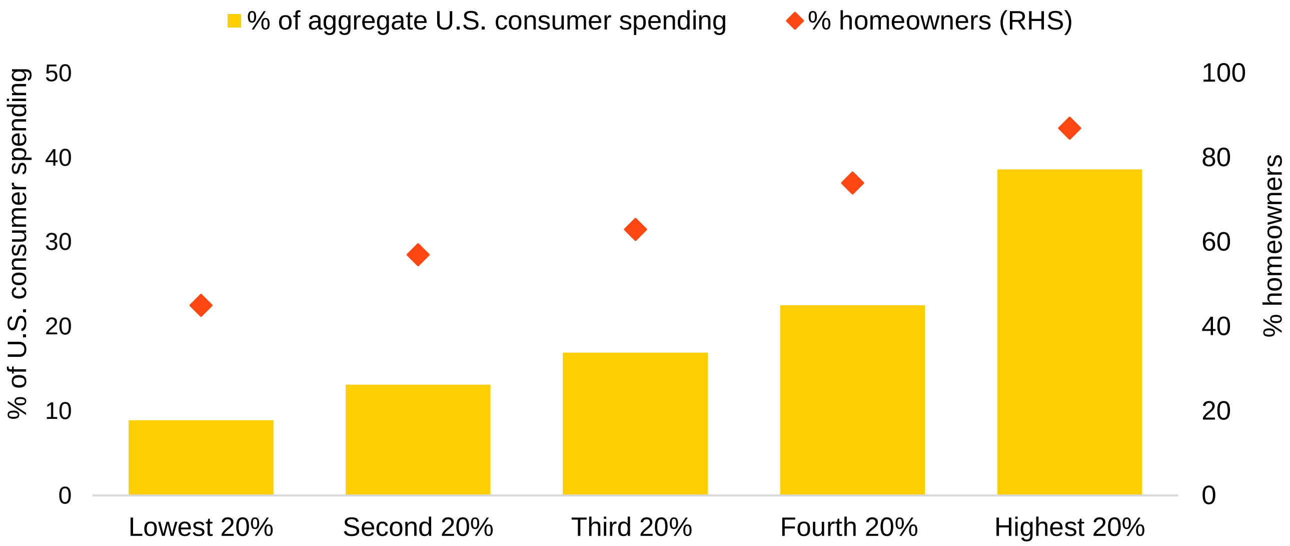
Key takeaways

- During his two-day testimony to Congress, Federal Reserve Chair Jerome Powell emphasized the two-sided risks facing the central bank's dual mandate of price stability and maximum employment. Among notable takeaways (detailed within) were comments related to the "considerable cooling" in the U.S. labor market, the (likely higher) neutral rate, manageable commercial real estate risks for most banks, and anticipated revisions to Basel III endgame.
- We continue to expect the start of monetary policy normalization in either September or 4Q2024, and still anticipate a shallow rate cutting cycle (barring a sharp downturn in growth). This leaves floating rate and shorter duration credit well positioned, in our view, given the persistent inversion of the U.S. Treasury curve. It also makes the interaction with economic growth critical for corporate borrowers' ability to navigate the higher cost of capital environment.
- Away from monetary policy dynamics, the health of the U.S. consumer remains a focus. In May, we highlighted the bifurcation across the various U.S. consumer income cohorts (Exhibit 1). At the time, we noted that while the idea of differentiation across the income spectrum is not new, such dispersion likely matters more in the current market backdrop of elevated interest rates, higher home prices and rent costs, and gains in the equity market.
- Indeed, a recent report from Pew Research Center illustrates that this pattern of bifurcation *has* become more pronounced over the past few decades. This has two implications for corporate credit investors. Beyond the importance of consumer spending to the overall economic picture (it represents 68% of U.S. GDP), the variation in the degree of consumer strength will likely contribute to dispersion in the corporate credit market – especially across (and *within*) sectors exposed to discretionary spending and consumer credit availability for large-ticket items.

Exhibit 1: The high-end of the U.S. consumer drives spending, more likely to own a home
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 (September 2023 - most recent available).

Two-sided risks to the Fed's dual mandate

In his prepared remarks and subsequent comments to the Senate Committee on Banking, Housing and Urban Affairs (July 9th) and the House Financial Services Committee (July 10th), Federal Reserve (Fed) Chair Jerome Powell highlighted the two-sided risks facing the central bank's dual mandate of price stability and maximum employment.

While the risks for much of the Fed's hiking cycle (since March 2022) were tilted in the direction of inflation, progress on that front – coupled with a rebalancing in the U.S. labor market – has left the risks more balanced, as of late.

As Chair Powell noted again this week, cutting rates "too soon or too much" could allow progress on inflation to stall (or worse, reverse), while cutting rates "too late or too little" could weaken economic activity and cause deterioration in the labor market. (Chair Powell made similar remarks in recent weeks, including at the June FOMC press conference and the ECB Forum on Central Banking).

Other key takeaways from the two days of Congressional testimony are outlined below. On net, the commentary appears consistent with the potential start of monetary policy normalization in either September or 4Q2024. That said, the drivers and depth of the (eventual) rate cutting cycle are more important for corporate credit investors, in our view, as opposed to the start timing.

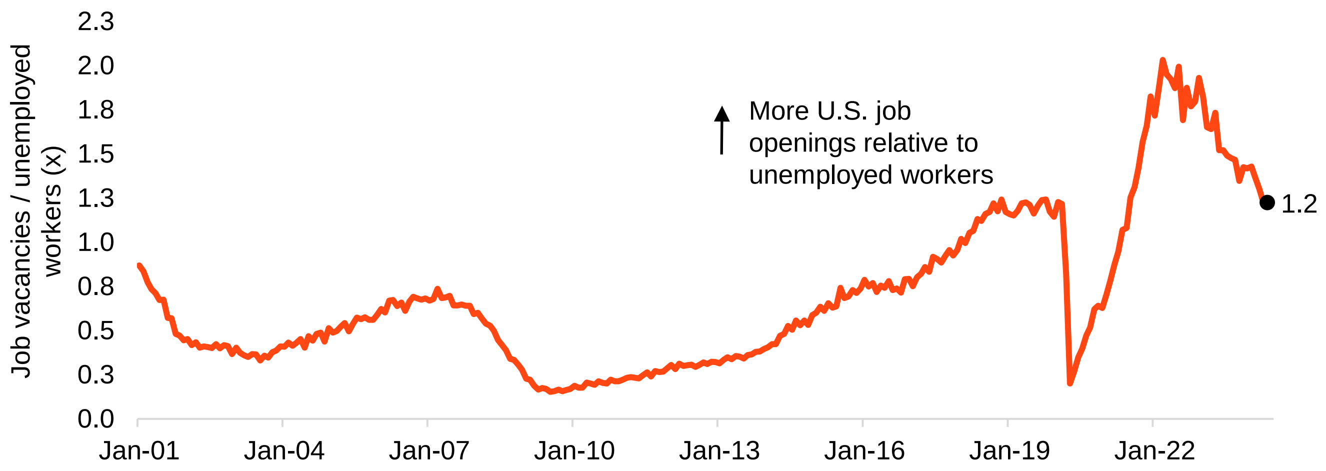
Our base case remains for a shallow rate cutting cycle (barring a sharp deterioration in growth). Chair Powell's comments on the neutral rate of interest (discussed later) also seem to support this view – at least for now. As we outlined in our *3Q2024 Global Credit Outlook*, the economic growth backdrop will be critical in determining corporate borrowers' success in navigating the higher cost of capital environment.

Takeaways from Chair Powell's Congressional testimony:

- **"Considerable cooling" in the U.S. labor market.** Chair Powell highlighted "considerable cooling" in the U.S. labor market, as the jobs-workers gap has narrowed to the pre-pandemic level (Exhibit 2). While the June non-farm payrolls (released July 5th) gain of +206k jobs was solid, the two previous months were revised lower by 111k. The breadth of job creation in the most recent payrolls report was also relatively narrow, driven by the government and healthcare sectors.
- **"Some confidence" on inflation progress, but not yet "sufficient confidence".** Chair Powell said that the FOMC has "some confidence" that inflation is moving sustainably on a path to 2%, but he made sure to highlight that "sufficient confidence" will be needed before cutting rates. He also reiterated the messages (from previous, recent FOMC press conferences) that a rate hike is unlikely (although he said it is "not taken off the table"), and that an unexpected weakening in the U.S. labor market could warrant a policy response (i.e., lower rates).

Exhibit 2: The U.S. labor market has rebalanced to its pre-pandemic level

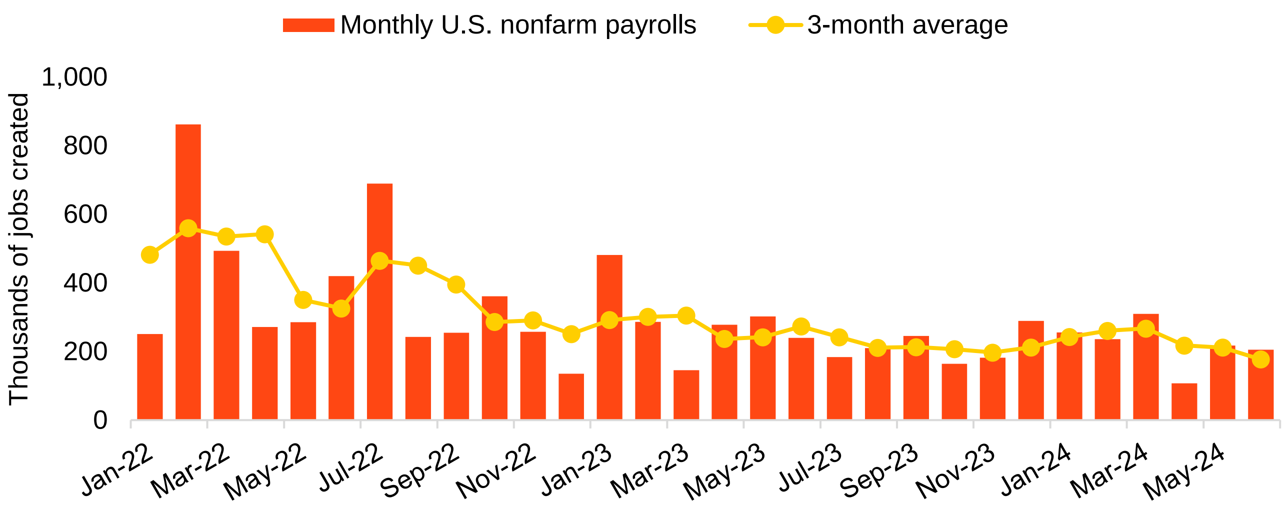
The ratio of U.S. job vacancies to U.S. unemployed workers, both seasonally adjusted



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

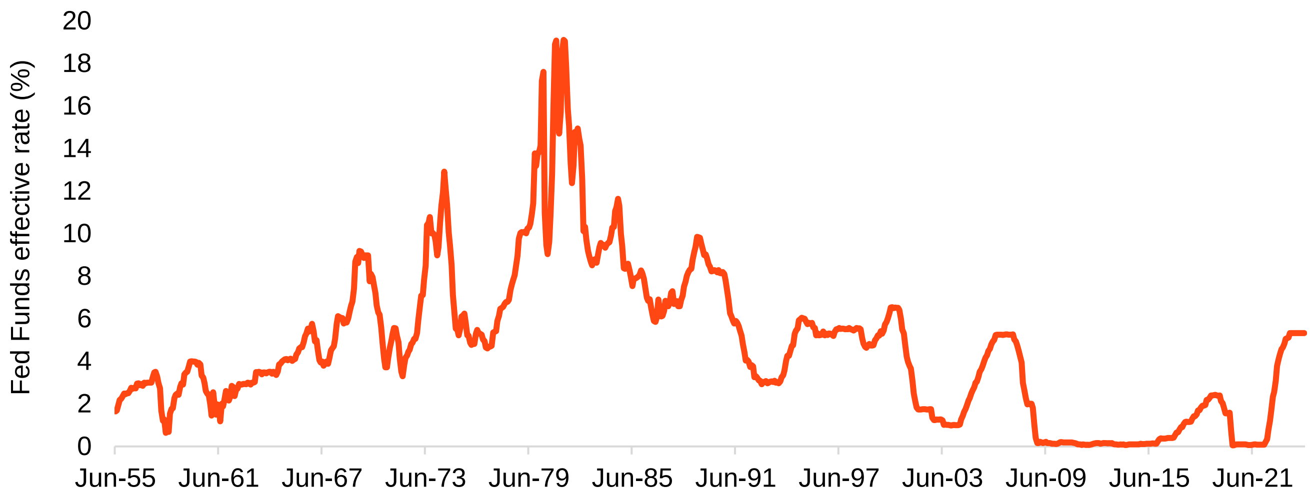
- **The (higher) neutral rate and the (moderate) degree of restriction.** Chair Powell said "[monetary] policy is restrictive, but not intensely restrictive." He added that this suggests the "neutral interest rate must have moved up" at least in the short-term. Chair Powell believes it is unlikely that the U.S. will return to the very low interest rates of the post-financial crisis period (Exhibit 4; which was characterized by very low inflation). The Fed's monetary policy framework review will begin in late 2024.
- **Commercial real estate (CRE) risks – not systemic.** When asked about risks stemming from CRE, Chair Powell noted that certain downtown office and retail exposures are likely to be a threat to the profitability of some smaller banks (with local concentrations), but not a systemic risk to broader financial stability. He expects the overhang to persist for a few years and mentioned that bank supervisors are working with impacted firms to make sure they have the appropriate levels of capital and liquidity, as well as a realistic assessment of potential losses.
- **Basel III endgame revisions are expected.** The various bank regulatory agencies are close to agreeing on the substance of proposed changes to Basel III endgame, and a 60-day public comment period may be warranted (according to Chair Powell), given the materiality of the expected changes.

Exhibit 3: The pace of job creation has moderated in recent months
Monthly change in U.S. nonfarm payrolls and the three-month moving average pace of job creation



Source: BlackRock, Bloomberg, Bureau of Labor Statistics. Captures data through June 30, 2024.

Exhibit 4: Rates are unlikely to revisit the "zero lower bound" of the post-global financial crisis era, in our view
Federal Funds effective rate (%), monthly series



Source: BlackRock, Federal Reserve Bank of St. Louis. As of July 10, 2024.

A bifurcated U.S. consumer

One prevailing investing theme over the past few quarters – in the corporate credit and commercial real estate markets – has been elevated dispersion. The U.S. consumer is no exception to this trend and remains notably bifurcated.

As we last highlighted in May, higher-income consumers (which tend to be asset owners) have benefited from gains in the housing and investment markets over the past few years. On the other hand, lower-income consumers (which are more likely to rent and carry debt balances) have experienced a headwind from higher inflation and elevated borrowing costs. This helps explain, in our view, some of the "conflicting" data points released about the financial health of the U.S. consumer in recent months (per widely tracked economic data and various financial, consumer and retail sector earnings commentary).

A shrinking middle class, and gains for higher income earners

In May, we noted that while the idea of differentiation across U.S. consumer income cohorts is not new, we believe the bifurcation matters more in the current market backdrop of elevated interest rates, higher home prices and rent costs, and gains in the equity market. A recent report from Pew Research Center, a nonpartisan "fact tank", illustrates that the pattern of bifurcation has indeed become more pronounced over the past few decades.

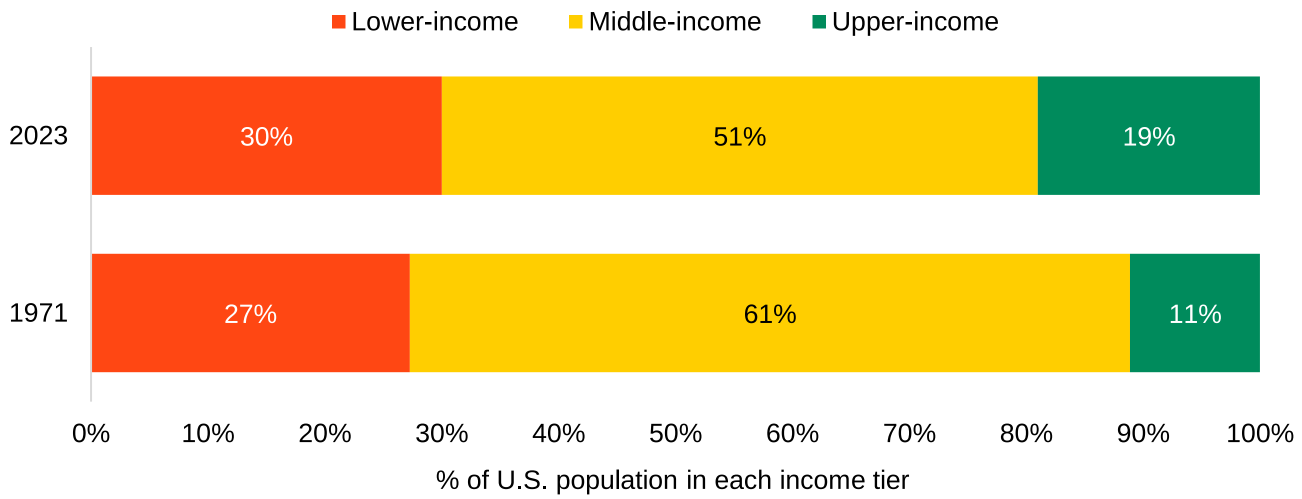
Per the Pew analysis – which uses a range of data including the U.S. government's Current Population Survey (CPS) – the middle class has declined as a percentage of the U.S. population, falling from 61% in 1971 to 51% in 2023 (Exhibit 5). Of those consumers that 'left' the middle class (i.e., shifted to another income category), a larger portion moved into the upper-income bracket.

But while the "mix shift" of the population (by income level) was net positive in aggregate, an examination of the overall *income* distribution suggests higher-income consumers may have made disproportionate gains.

For example, the share of total U.S. household income held by the middle class (which accounts for approximately half of the U.S. population) fell from 62% to 43% between 1970 and 2022 (Exhibit 6). Over that same time, the share of total U.S. income held by the upper-income class increased from 29% to 48% - representing a disproportionate expansion relative to growth in the population.

Exhibit 5: The lower-income and upper-income "tails" of the U.S. population distribution have increased over the past few decades

Share of U.S. population in each income tier



Source: Pew Research Center analysis of the Current Population Survey, Annual Social and Economic Supplement (IPUMS), 1971 and 2023 (as published in "The State of the American Middle Class" report on May 31, 2024), BlackRock. Note: People are assigned to income tiers based on their household incomes in the calendar year prior to the survey year, after incomes have been adjusted for the number of people living in each household. Shares may not total 100% due to rounding.

Also notable: the lower-income cohort held just 8% of total U.S. household income in 2022 (relative to 10% in 1970), despite this segment *growing* as a share of the U.S. population.

Somewhat unsurprisingly, the Pew analysis found a vast differentiation in consumer income levels, based on factors such as education level, occupation/industry, and metropolitan area (among many others) – again underscoring the pattern of bifurcation.

The implications for corporate credit

The bifurcation in the financial strength of the U.S. consumer has two implications for corporate credit investors. First and foremost, the consumer (in aggregate) is a major engine behind the U.S. economy, generating 68% of U.S. GDP. The resilience of the U.S. consumer (which will be determined by the strength of the labor market) will be critical to the U.S. economy's ability to avoid a sharp growth downturn.

Second, the variation in the degree of "financial cushions" available across the U.S. consumer cohorts will likely contribute to dispersion in the corporate credit market – especially across (and *within*) sectors exposed to discretionary spending and consumer credit availability for large-ticket items.

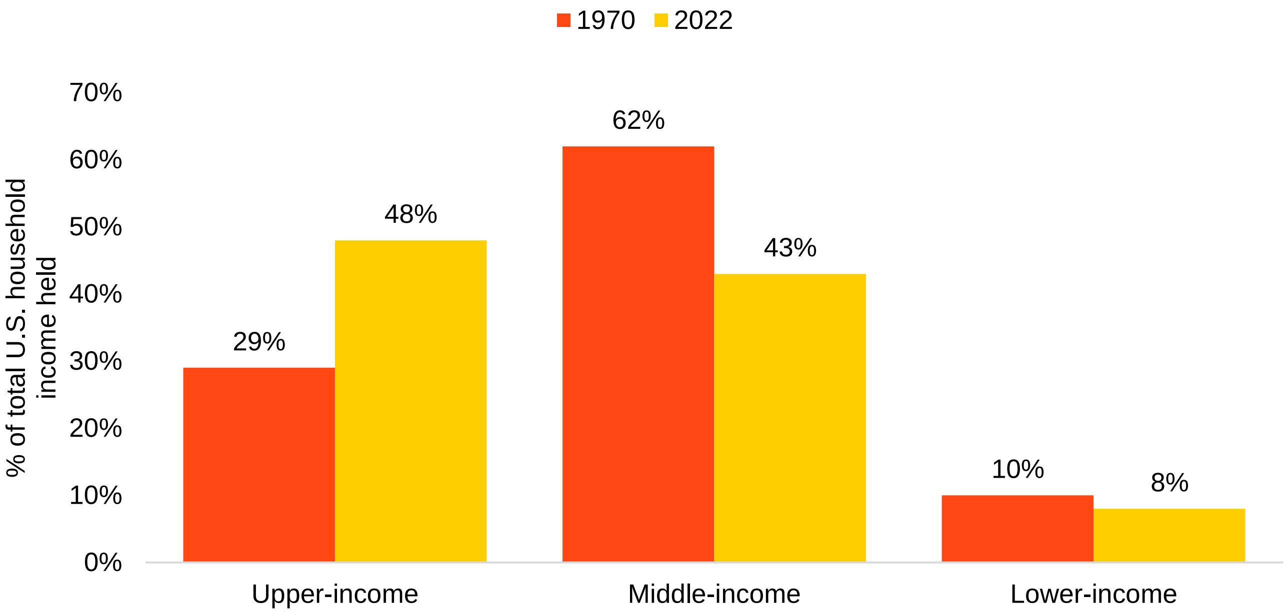
Using the Bloomberg USD Corporate High Yield Bond Index as just one example, year-to-date (YTD) total return performance for certain consumer-facing sectors such as Retailers, Leisure, Airlines, and Gaming has been relatively resilient (as shown in Exhibit 7).

By contrast, other sectors such as Restaurants and Supermarkets have lagged behind the broader market. Additionally, certain pockets of the Telecommunications/Media/Cable sectors – which are also exposed to shifts in consumer spending – have also meaningfully underperformed the overall index.

That said, for corporate credit borrowers, the consumer is just one driver of overall performance. Factors such as pricing power and capital structure management are also paramount to monitor.

Exhibit 6: The distribution of total U.S. household income has been more heavily weighted to the upper-income consumer, as of late

Share of total U.S. household income held by lower-, middle- and upper-income households



Source: Pew Research Center analysis of the Current Population Survey, Annual Social and Economic Supplement (IPUMS), 1971 and 2023 (as published in "The State of the American Middle Class" report on May 31, 2024), BlackRock. Note: Households are assigned to income tiers based on their incomes in the calendar year prior to the survey year, after incomes have been adjusted for the number of people living in each household. Their unadjusted incomes are then summed to compute the share of total U.S. household income held by each income tier. Shares may not total 100% due to rounding. Category definitions: All are based on incomes adjusted for household size. Upper-income households have incomes that are more than double the U.S. median household income. Middle-income households have incomes that are two-thirds to double the median. Lower-income households have incomes less than two-thirds of the median.

Exhibit 7: There has been notable dispersion among sectors with consumer exposure

Total YTD return by sector for the Bloomberg USD Corporate High Yield Bond Index

		Total YTD index return (%)
USD HY Index		3.1
	Sector weight (as % of total index)	**Total YTD return by sector (%)**
Pharmaceuticals	1.7	12.1
Retailers	4.8	7.0
Tobacco	0.1	6.5
Life	0.3	6.2
Other Financial	1.2	5.7
Paper	0.5	5.5
Brokerage Assetmanagers Exchanges	0.8	5.5
Retail REITs	0.1	5.5
Other Industrial	1.4	5.0
Healthcare	5.4	5.0
Independent	4.0	5.0
Oil Field Services	1.8	4.8
Leisure	3.5	4.4
Midstream	5.7	4.3
Diversified Manufacturing	1.9	4.3
Chemicals	2.5	4.1
Banking	0.9	4.0
Aerospace/Defense	2.0	4.0
Environmental	0.7	3.8
Healthcare REITs	0.4	3.7
Airlines	1.6	3.7
Gaming	3.4	3.7
Food and Beverage	1.8	3.7
Automotive	2.2	3.7
Finance Companies	3.7	3.7
Technology	7.8	3.7
Refining	0.3	3.7
Metals and Mining	2.5	3.5
Building Materials	2.2	3.3
Consumer Cyc Services	3.6	3.3
Home Construction	1.1	3.3
Other REITs	1.4	3.2
Lodging	0.9	3.0
P&C	2.3	2.9
Consumer Products	1.7	2.9
Supermarkets	0.6	2.5
Restaurants	1.3	2.5
Transportation Services	0.9	2.4
Electric	2.5	2.3
Construction Machinery	1.3	2.0
Health Insurance	0.2	2.0
Packaging	2.4	1.6
Natural Gas	0.0	0.9
Wirelines	2.9	-0.2
Railroads	0.2	-1.3
Media Entertainment	3.4	-1.5
Office REITs	0.3	-1.9
Cable Satellite	6.1	-4.0
Wireless	1.4	-5.9

Source: Bloomberg, BlackRock. As of July 10, 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.

Increased credit usage may signal a weakening consumer

Market participants have been watching closely for signs of weakening in the consumer, given the ongoing rebalancing in the U.S. labor market and signs of moderation in U.S. retail sales in April and May.

One area of potential concern is increased credit usage to finance consumption. Preliminary measures of outstanding consumer credit signal a 2.7% increase in May (seasonally adjusted and annualized), with total credit outstanding reaching $5.06 trillion, according to the most recent data released by the Federal Reserve.

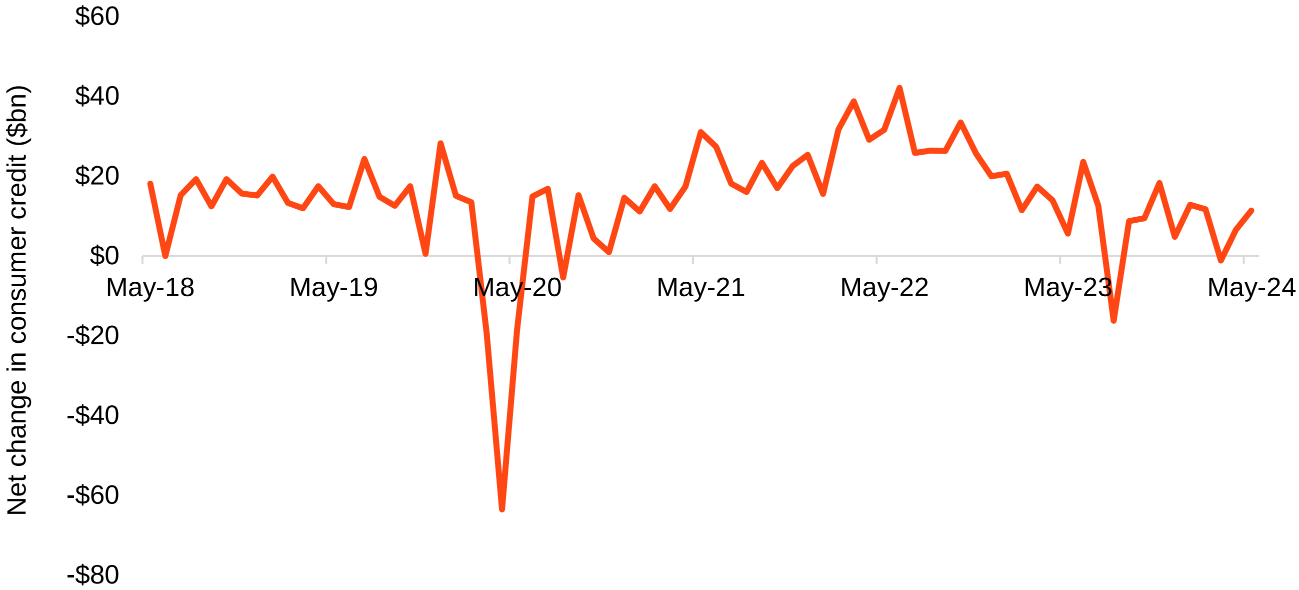
The majority of this growth can be attributed to revolving credit (this category includes credit cards), which grew 6.3%, or by $7 billion, in May (again, seasonally adjusted and annualized). This increase marks the highest nominal level on record for revolving consumer credit outstanding. In comparison, nonrevolving credit (which includes consumer motor vehicle loans and education loans) grew only 1.4% in May.

While it is likely premature to confirm whether this expansion is a long-term trend or a short-term fluctuation, it may suggest that consumers are relying more heavily on credit cards as a tool to support their spending. Still, Exhibit 8 illustrates that nominal net growth levels remain largely below those in 2021 and 2022.

Notable too, borrowing rates on credit cards that have incurred interest charges (i.e., carried a balance to the following month, for example) reached 22.76% in May, according to the Federal Reserve's consumer credit report, marking the second-highest rate on record (after August 2023).

Our review of recent earnings call transcripts from a selection of U.S. retail- and restaurant-focused companies suggests an ongoing emphasis on consumers seeking value, as they look to offset headwinds related to inflation. This includes consumers *outside* of the lower-income cohort.

Exhibit 8: Consumer credit ticked up over the past two months
Month-over-month total net change of consumer credit outstanding (including revolving and nonrevolving credit)



Source: Federal Reserve, BlackRock. As of May 2024. Note data excludes consumer loans secured by real estate.

Unless otherwise stated, all reference to $ are in USD.

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