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In this Issue

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High Yield Credit - Cheaper ≠ Attractive

While often similar, no cycle is exactly the same. In seeking to understand the current macroeconomic climate, one might find parallels with the Q3 2018-Q1 2019 period characterized by a dual monetary tightening in the form of two 25bps rate hikes and a 10% reduction of the Fed balance sheet. Even though a lot has happened since then, very few need reminding of the resulting fall and Christmas crash of 2018. Meanwhile the dynamics may be the same with the Fed tightening into an economic weakness, the particularities and initial conditions of the current days are vastly different and uniformly worse.

First, we are confronted with greater economic fragility today from considerably higher leverage. Together, total US nonfinancial private debt and public debt has risen to 282% of GDP, up 26% over 2018 levels. Next, the dollar is ripping higher and 10% stronger than it was the last time the Fed began tightening into weakness. A strong and rising dollar is further costly to growth through depressed net exports as evidenced by a 22% MoM surge in US trade deficit to a record $110 billion in March. The destabilizing effects on the dollar-based global financial system goes without saying. Third, the level and persistence of inflation driven by core consumption categories like food and energy is invariably killing consumer demand. It is evidenced by the disparity in real vs. nominal retail sales and hastening the deceleration of real growth. Recall, our current market outlook incorporates both slowing and elevated inflation. Lastly, uncertainty in the world underwent a major phase transition from late-night presidential tweets to an unwinding of global order with sporadic shutdowns of the world's second largest economy and a full-scale US proxy war with a fellow nuclear superpower.

In the face of this historically negative setup, the sheer speed and magnitude of monetary normalization is of maximal hawkish caliber: 150bps of rate hikes between May, June, and July and $500 billion in quantitative tightening by year-end. The result? An economic growth slowdown like no other.

Financial market conditions are tightening at a fast pace. Consumers are feeling the pain of higher inflation and companies will be soon too. HY credit may look cheaper, but it sure is not attractive yet. Remember risk happens slowly, then all at once.

Macro, The Big Picture

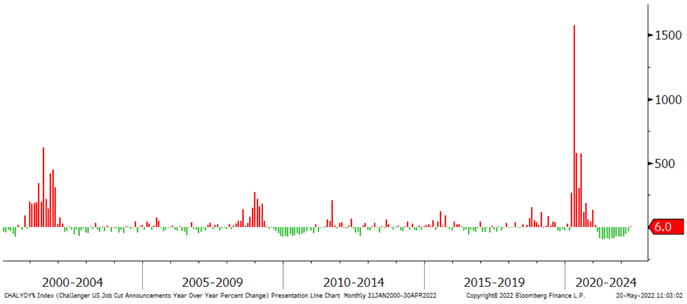
When the Chairman of the US Federal Reserve says that *"I think we have a good chance to have a soft or softish landing. I think we have a good chance to restore price stability without a recession"* you hear him realizing and acknowledging they are behind the curve. The change in tone from *"soft"* to *"softish"* is evidence of that.

The next question is whether we approach a recession? Probabilities are rising. Economic data has begun to roll over and supporting our view of a slowing US economy. Policymakers are focused on one and one thing only. Inflation. To get it under control, the Fed has limited tools (rates and balance sheet). By pulling liquidity out, it inherently looks to slow the economy down.

However, being data dependent, the odds of the central bank overshooting its target are high. We are already starting to see cracks in the economy and the Fed has, to-date, "only" raised rates by 75bps and not begun its balance sheet reduction.

Job cuts turned positive for the first time since January 2021, up 6.0% YoY vs. -30.1% last month. Job cut plans are on the rise as businesses assess market conditions, inflationary risks, and capital spending **(Chart 1)**.

Chart 1. US Job Cut Announcements YoY (Monthly)

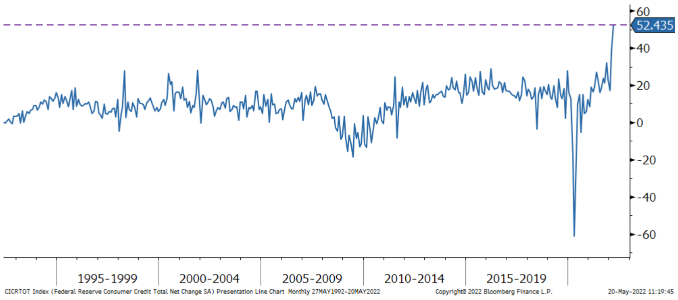


Source. Bloomberg, MAM Research

Consumers are in good shape, right? Well… not really.

If you listen to JPM and AMEX, they will tell you rising consumer credit is evidence of consumer confidence. In our view however, consumers are tapped out and rely more on credits. Consumer credit ballooned by most on record in March 2022 to $52.4 billion (est. $25.0 billion) **(Chart 2)**. Revolving credit including credit card rose by $31.4 billion. Non-revolving credit including auto and school loans jumped by $21 billion. The 35.3% YoY surge in consumer revolving credit is the largest since 1998.

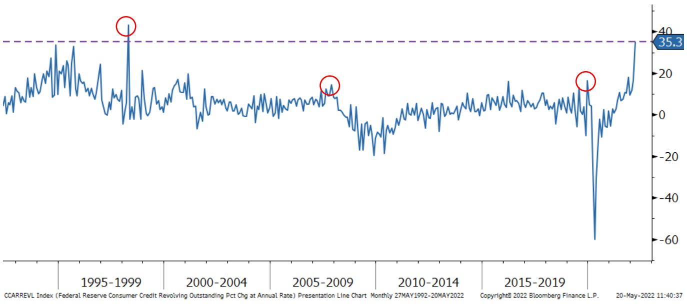
Chart 2. US Consumer Credit Net Change (Monthly)



Source. Bloomberg, MAM Research

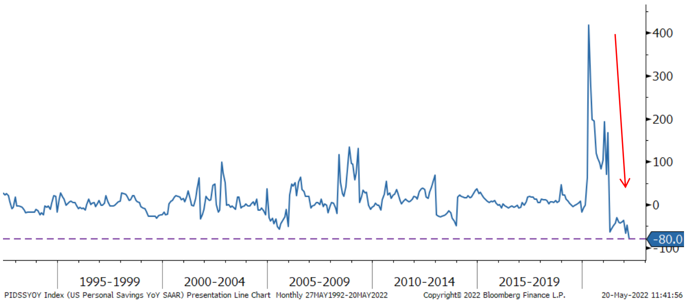
Interestingly, before each of the past three recessions, the next change in consumer credit jumped to a cycle high **(Chart 3)**. Q1 2022's jump was the largest reading, ever! Let's also not forget that the US savings rate just hit a post-pandemic low **(Chart 4)**. As inflation has risen, consumers spent stimulus check money from Q1 2021. Then, they spent their savings. Today, they are taking on credit (at much higher rates than a few months ago) to manage purchases. This is NOT a healthy trend.

Chart 3. Revolving Credit Outstanding Pct. Δ Annualized



Source. Bloomberg, MAM Research

Chart 4. US Personal Savings YoY (Monthly)

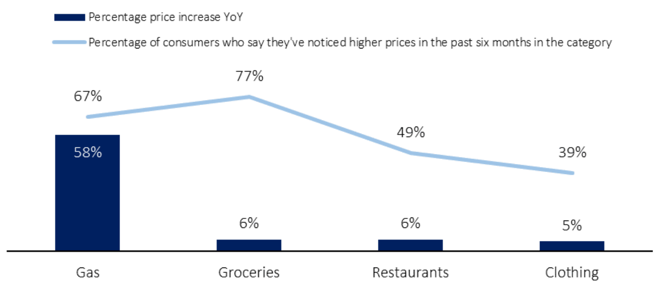


Source. Bloomberg, MAM Research

Consumers generally do not change spending behavior. Yet, we are starting to see signs of change in spending habits through the lens of staples. Food at home price inflation hit 4.5% in September and accelerated every month since, hitting 10.8% in April. Simply looking at the base effects, it is fair to project at least one or two more months of accelerating food inflation given the current supply shocks. But then what? Slowing inflation over the summer would be great on a sequential basis, but it is not much comfort for consumers looking to put food in their pantry. Consumer spending will have to come out of something. It takes outside forces like a pandemic to cause brand switches or shopping at new stores. Once started, habits become sticky. Companies do not have the same pricing power or cost pressures and as such there will be losers and winners.

Surveys show consumers are more sensitive to the price increases of food than any other categories including gasoline **(Chart 5)**. Sprout Farmers Market already sees consumers removing some items from their basket to compensate for food prices up double digits. Grocery Outlet, a discount grocer where consumers can save on average 40% relative to conventional grocery stores, has begun to see an increase in store visits. Conventional grocers are seeing shopping trips being consolidated again. This habit started out of pandemic concerns and reversed as these ebbed, but it has now reverted again on the back of higher gasoline prices.

Chart 6. Consumers Perceived Price Increases



Source. BLS, Forrester's CEI and Retail Pulse Survey, MAM Research

BofA card spending data for April 2022 show consumers were still spending. Total credit and debit card spend was up 13% YoY in April compared to 11% in March. However, look where they spend their money… the IRS! Every year, credit card spending spikes in April as people pay their tax bill. Spending money to the IRS does not stimulate the economy. Then, we are hearing auto loans delinquencies are on the rise. In fact, they are at the highest level since 2007 for subprime borrowers with a credit score below 620, which is 15-20% of borrowers.

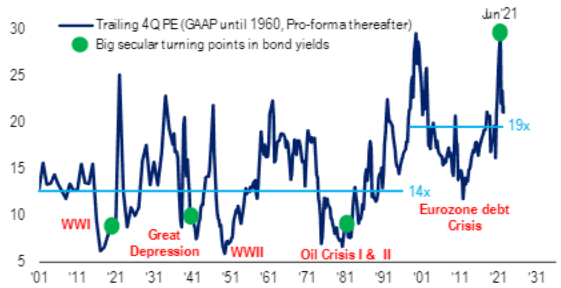
Lastly, small businesses do not like inflation. According to a Bank of America Small Business Owner Report, as much as 88% of small business owners say inflation is impacting their business.

Financial Market Conditions

US Q1 2022 GDP $24.4 trillion. Global equity market cap collapse since the November 2021 peak is $23.4 trillion. The wealth destruction effect is running at full speed.

There have been 19 US equity bear markets in the past 140 years. The average price decline was -37.7% for an average 289 days duration. If repeated today, the bear market would end around October 19, 2022 with the S&P 500 Index at 3,000 and Nasdaq 100 at 10,000. Next, EPS/GDP growth forecasts are rolling over as the debate shifts to multiple correction. Two sides of the tale, some arguing 21st century multiple of 19x P/E still appropriate while others argue 20th century multiple of 14x P/E are more appropriate for a stagflation environment. We can argue for a mix of both applying at around 17x **(Chart 7)**.

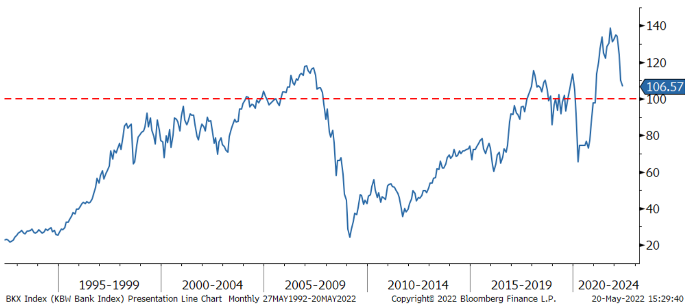
Chart 7. Pre-21st Century Multiple More Appropriate



Source. BofA Research

Wall Street assets are 6.3x larger than US GDP. As seen in 2020, the quickest route to a deep recession is via a market cash. Housing and labour markets are just at the inflection points. US home purchase loan applications are off 35% from the 2021 highs and lowest point since the pandemic. The US 30-Year mortgage rates have skyrocketed towards 5.5% from 3% in November 2021. Banks are now trading below the highs of 2007, 2018, and pre-Covid **(Chart 8)**. A drop below 100 on the BKX Index would be a recession and/or credit event signal.

Chart 8. Banks trading below highs of '07, '18, pre-Covid



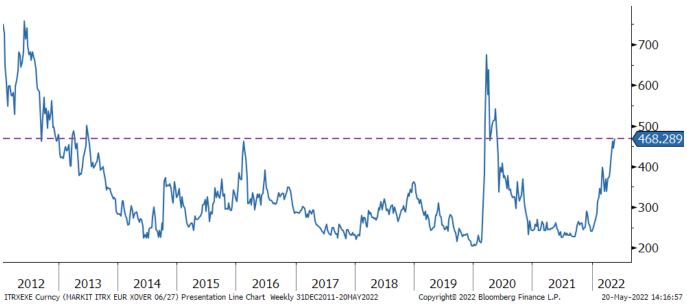
Source. Bloomberg, MAM Research

High Yield Credit Implications

Credit markets faced a number of challenges this year such as sharp rise in yields, extraneous inflation shocks, record drawdown, and cross-asset pricing relationships divergence to name a few. The silver lining for markets, however, was that the challenges were largely external in nature. Balance sheet fundamentals meant credit was relatively resilient in the early innings of a rates induced correction. Wider spreads and loans outperformance kept with the narrative of mid-cycle correction. Yet, the disconnect between the Fed's reaction to inflation and what markets were pricing then was one of our primary concerns. We expected lagging policy and uncertainty as a source of volatility and credit weakness.

In the five months since, the macro stress points have clearly pivoted from rates and inflation risk to growth and credit risk. The magnitude of slowdown, soft versus hard landing, etc. will continue to be debated but the Fed's compromise on growth to curb inflation is clear. In turn, this compromise increasingly entails challenges for credit markets from within. HY Credit spreads **(Chart 9)** will continue to widen incrementally driven by both growth-sensitive and lower quality pockets.

Chart 9. US High Yield Credit Spreads (Weekly)



Source. Bloomberg, MAM Research

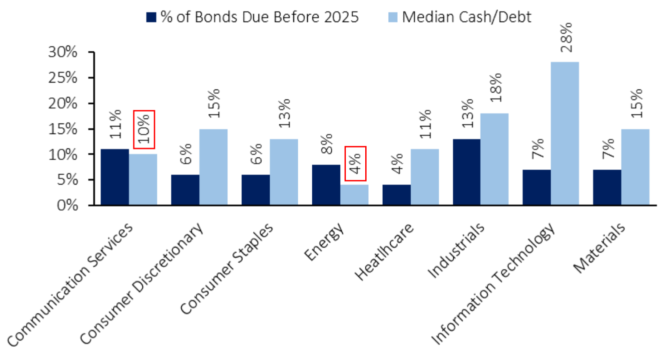
High yield stress usually arrives in four stages. (1) Higher costs of hedging which are already largely behind us. Implied volatility in equities and rates jumped to very high levels. US credit volatility is in top 90^{th} percentile looking back ten years. (2) Primary markets dysfunction. High yield issuance is now in its fourth month of very low volumes, and its recent pace resembles the lowest point in the last decade (2018, 2016, and 2011). The market is turning away from viewing this as a positive technical to funding concerns. (3) Wider dispersion. As hedging gets expensive, it makes more sense to sell excess bonds rather than buying puts. Dispersion surged from 45% late last year to 63.4% today and could easily go into the 70-80% range. (4) Outright distress, which is just getting started. The BofA distress ratio has moved out from a low of 1% in February 2022 to 3.7% today.

Applying a top-down framework we look to identify the sectors with heightened sensitivity to inflation, margin pressure, and higher rates. However, given the current macro outlook, we expanded this screen for industries with near-term liquidity constraints, relatively sizeable tail cohorts, and increased exposure to rising rates.

The Result

Near-term maturities liquidity constrains are modest for most sectors with Communication Services and Energy most constrained on lower cash buffers and 8-11% of index-eligible bonds to mature before 2025. Meanwhile, Tech and Consumer Discretionary have back-ended maturity distributions and higher cash/debt **(Chart 10)**.

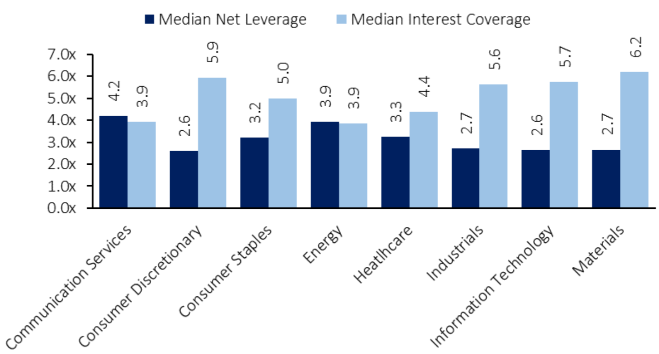
Chart 10. HY Key Metrics



Source. Bloomberg, MAM Research

Energy and Consumer Staples represent a large share of issuers with excessive leverage, but they remain better positioned on interest coverage **(Chart 11 & 12)**.

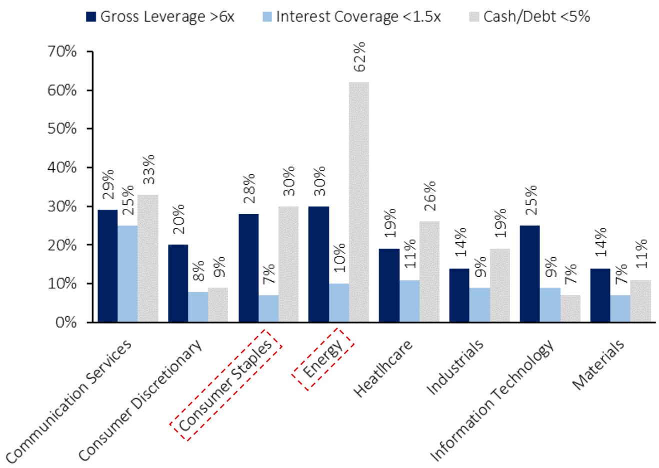
Chart 11. HY Key Metrics



Source. Bloomberg, MAM Research

Industrials and Consumer Discretionary have higher tail exposure given exposure to several air and cruise lines which have yet to stage a proper post-Covid recovery. We recognize the median cash/debt ratio, even for the weaker names, is close to record highs. However, tail cohorts **(Chart 12)** deserve closer attentions as we enter a macro environment of slowing earnings growth and margins compression.

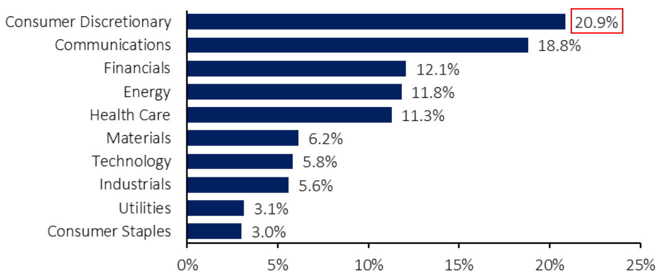
Chart 12. HY Stressed Tail Cohort



Source. Bloomberg, MAM Research

Consumer discretionary and other cyclical sectors such as energy and industrials weigh heavily in the universe **(Chart 13)**. Decelerating growth, lower revenue growth, and margins compression makes it tougher for these names to service debt moving forward.

Chart 13. High Yield ETF Sector Exposure



Source. Bloomberg, MAM Research

We strike the recession threshold for high yield credit at around 800bps. In the case of a global downturn, credit spreads on high yield would touch these levels before settling around 650-700bp. If the economy did slip into a mild recession in the next 12 months, healthy in-place fundamentals should limit the risk of more extreme outcomes. We also see the default wave being on the milder side as long as the recession is short-lived.

The later point is critical. If inflation does not subdue or the Fed does not pivot its strategy to continue to fight elevated price levels then we could see a more severe recession. The outcome? Credit spreads would widen materially more than our original estimates. In terms of weak links, we are particularly cautious on segments of the market with cyclical exposure, restricted pricing power (typically smaller companies), and areas tied to consumer goods. These sectors weigh more heavily in the high yield credit benchmarks.

Investment Implications

We continue to recommend an underweight allocation to developed market credit and most notably US HY. The macroeconomic environment is a strong source of headwinds for the asset class. A stronger than expected, or longer than anticipated, recession would drive credit spreads wider and lead to higher default rates. Cyclical sector overrepresentation is also a negative attribute in today's market. In the recent past, we implemented a put spread on the iShares IBOXX HY Corporate Bond ETF to benefit from wider credit spreads.

As always, please feel free to reach out to us if you have any questions.

Kind regards,

MAM Investment Team

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