ZAIS Insights

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Corporate credit outlook amid policy uncertainty

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Summary

- The business sector and related credit markets are fundamentally in good shape
- Yields still look attractive to us but policy related risks should be avoided
- We like the risk/reward of CLO debt and equity as well as older CMBS vintages

Financial markets had a rough time during the first two months of the new Trump presidency. The S&P500 dropped 10.1% between February 19 and March 13, the VIX surged more than 10 points and credit spreads have widened across the board.[1] Market volatility appears to be driven by uncertainty over US economic policy, especially trade policy, as well as weaker economic data, summarized in the sudden shift of the Atlanta-Fed GDPNow estimate for 2025-Q1 real GDP growth from +2.3% to -2.8%.[2]

In our view, growth is likely to be soft in the first quarter, but we think the sources of that weakness are temporary special factors (weather effects and tariff frontloading, see footnote 3 for details).[3] Indeed, growth was also weak in early 2022 but that did not lead to a recession (see footnote 4 for detail).[4]

More concerning to us would be a prolonged deterioration in financial conditions and economic sentiment plus signs that policy changes undermine the economic fundamentals that made the US growth performance so exceptional in recent years.[5]

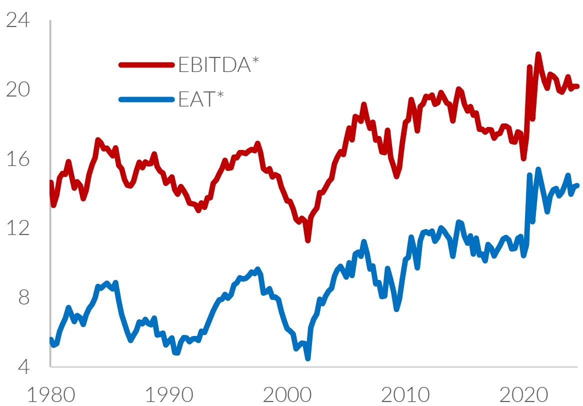
Against that background, we take a closer look at the business sector and the relevant credit markets. Business and credit fundamentals look solid to us and we view yields as still attractive; nevertheless, we have reduced overall and policy-related risks.

Solid business fundamentals

As we outlined in the last issue of ZAIS Insights, US economic outperformance over the last five years was built on strong employment and productivity growth.[6] In our view, the business sector both benefits and contributes to these favorable supply conditions. The strength of the US business sector is most visible in record high profit margins (see Chart 1).

Chart 1: US nonfinancial corporate profit margins

% of gross value added



* EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortizations (net operating surplus); EAT = Earnings After Taxes (and all other non-operating expenses).

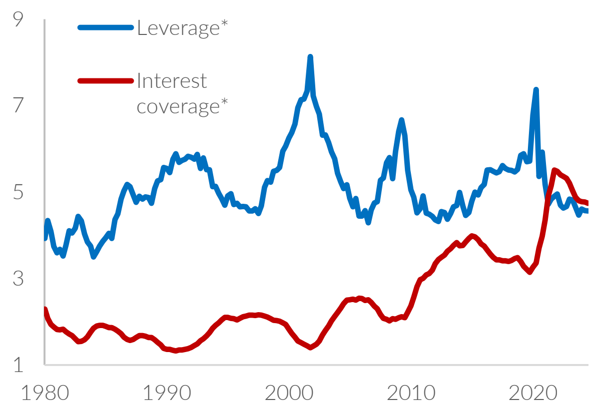
Source: Bureau of Economic Analysis[7]

The biggest lift in profit margins came from productivity gains which more than offset the rise in real labor costs.[8] The narrowing gap between operating margins (EBITDA) and profit margins after taxes (EAT) is noteworthy, mostly driven by the falling share of net interest payments.[9]

We see the strength of the US business sector also reflected in healthy credit fundamentals. Businesses appear overall to have adjusted well to higher interest rates and we see no large operating and balance sheet imbalances. The leverage ratio for nonfinancial corporates is at the low side of the historical range and the interest coverage ratio is near its historical high despite the rise in interest rates (see Chart 2).

Chart 2: US nonfinancial corporate leverage and interest coverage

Ratio



* Leverage = Debt/EBITDA; Interest coverage = EBITDA/interest payments.

Source: Federal Reserve Board and Bureau of Economic Analysis [10]

A vibrant business sector is good for labor demand and investment spending, which in turn is supportive for overall economic growth. We see this robust business performance as having benefitted from external developments, notably the immigration boom, the surge in shale-gas exploration and fiscal pump-priming, while much of the productivity gains are concentrated in the IT sector.[11]

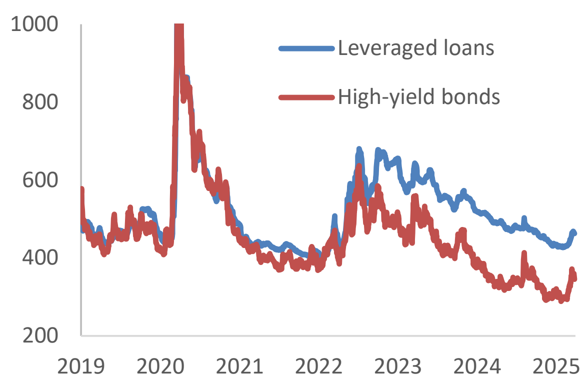
Still, the ability of US firms to persistently innovate and put new technologies and products to wider use suggests to us broad institutional and structural advantages that are unique to the US economy.[12]

Credit markets have normalized

Turning to the relevant ZAIS investment universe, we note that high-yield bonds and leveraged loans have both weathered COVID and Fed tightening well and credit spreads are basically back to pre-Covid levels despite the most recent widening (see Chart 3).

Chart 3: High-yield and leveraged loan credit spreads

Basis points



Source: JPMorgan [13]

However, leveraged loan spreads have tightened less than high-yield spreads since 2022. In our view, leveraged loans have been more impacted by Fed tightening (floating rates) than high-yield bonds (fixed rates), while credit quality has been weaker, especially for loans from private issuers. This is also reflected in higher leverage ratios, lower interest rate coverage ratios and higher default rates of leveraged loans versus high-yield bonds (see Table).[14]

Operating conditions (EBITDA margins) of leveraged loans and high-yield bonds, however, look similar to us and we expect that the gaps (interest coverage, default rates and credit spreads) between high-yield and leveraged loans will narrow in 2025 as most leveraged loan issuers have adjusted to higher interest rates and now benefit from Fed rate cuts in the second half of last year, while many high-yield bond issuers still have to refinance at higher interest rates.

Indeed, higher interest rates for longer means to us more credit quality bifurcations within both high yield and leveraged loans and less differences between the two asset classes.

Table: High-yield bond and leveraged loan credit fundamentals

	High yield bonds		Leveraged loans	
	2019	Latest	2019	Latest
EBITDA marg.	16.3	15.2	16.5	15.6
Leverage	4.1	4.1	4.7	5.0
Inter. coverage	4.5	4.7	4.0	2.9
Default rate	3.9	1.3	2.1	4.4

Latest is 2024-Q3 except default rate is Feb-2025. EBITDA margin and default rate are in % and leverage and interest coverage are ratios.

Source: JPMorgan [15]

CMBS is more bifurcated

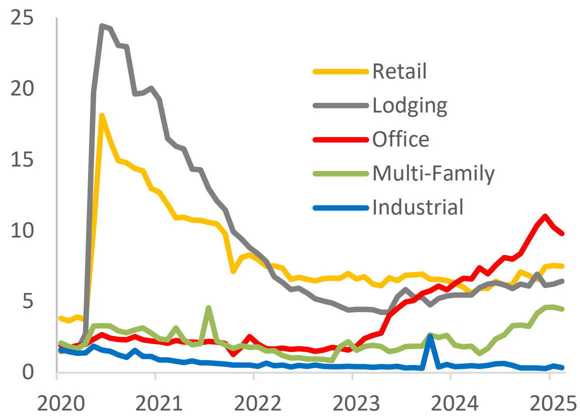
CMBS is the other business-related asset class within ZAIS's investment portfolio that has felt the impact of higher interest rates. Overall, we think CMBS is on a good recovery path but bifurcations between property types and vintages remain significant.

Chart 4 (on next Page) suggests that the office sector is most strained, due the structural reduction in demand caused by hybrid work models, elevated improvement costs and refinancing pressures due to higher rates, while industrial properties continue to benefit from the e-commerce trend.

Multifamily has come under pressure due to a wave of new deliveries in certain sunbelt locations but we expect that continued strong housing demand will absorb the extra capacity in relatively short time.

Chart 4: CMBS delinquency rates

Percent

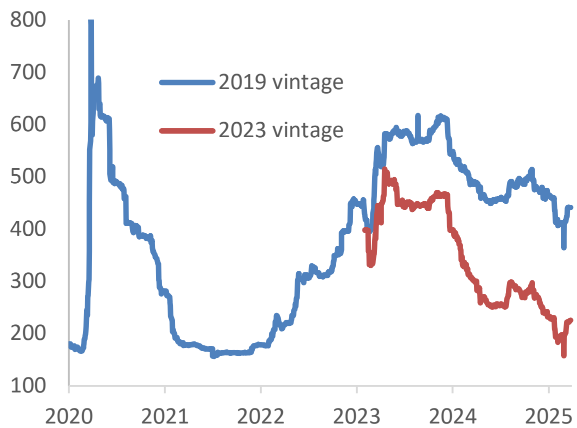


Source: Trepp [16]

The differences are also visible between vintages. Seasoned vintage mezzanine tranches with loans underwritten at lower interest rates and looser credit standards have underperformed more recent vintages as market participants expect declining payoff rates and increased loan workouts. (see Chart 5).[17]

Chart 5: Single-A CMBS conduit spreads

Basis points



Source: JPMorgan [18]

Creative versus harmful disruption

Whether the good times for US business and related credit markets will keep on rolling depends significantly on the impact of the new administration's policy agenda. In our view, the policy rollout is a dynamic process and it will take time until the full impact becomes clear. We see positive aspects but are concerned that the balance of all policy measures could be more harmful than beneficial for the business sector.

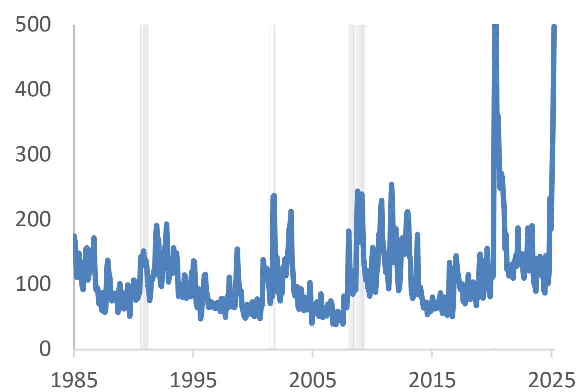
We agree that cutting back red tape and regulations can improve business efficiency, unshackle the economy, lift growth and lower inflation. But the effects can also be damaging if the framework of prudential standards and institutions that facilitate and safeguard business operations and contributed to the exceptional performance in recent years is undermined.[19]

In our view, a further escalation of the tariff conflict and an aggressive immigration crackdown that strangles the labor supply offset any positive effects for businesses from an extension of the Tax Cuts and Job Act.

And while the direct policy impact may take some time to materialize, we fear that the damage could come faster if ongoing policy uncertainty deteriorates economic sentiment and financial conditions further (see Chart 6).

Chart 6: US economic policy uncertainty

Index



US economic policy uncertainty soared to the highs of the COVID period and far exceeds any prior recession over the last 40 years including the great financial crisis.

Source: Baker, Bloom and Davis [20]

Positioning for policy uncertainty

Looking ahead, we view yield levels as sufficiently high to remain fully invested but we have reduced our risk profile given prevailing uncertainties and still high market valuations.[21]

In leveraged loans, we focus even more on careful bottom-up credit analysis and we strictly limit the exposure in credits below B2/B, especially in sectors that we view as risky for policy or idiosyncratic reasons.

We have pared exposures in sectors and issuers that have large cross-border business operations and are vulnerable to supply-chain disruptions or input-price increases due to tariffs. These include automobile, building materials, chemicals, consumer products, high tech, packaging, and retail.

In the oil & gas sector, we expect that deregulation and a pro-drilling environment will result in supply increases and reduced prices, creating margin pressures for upstream producers but providing opportunities for downstream operators.

We remain cautious on healthcare, which we view as already fragile due to past regulatory changes, aggressive reimbursement policies from health insurers, the strains from COVID, cost inflation and labor shortages.

Against that background and given the complexity of the sector, we think that the impact of any policy changes must be analyzed on a case-by-case basis.

We expect that a prolonged crackdown on immigration that leads to a tightening in labor supply will be felt by issuers that rely on low-cost workers, notably in hospitality and leisure but also healthcare.

Finally, while we think that the business sector as a whole has absorbed interest rate increases well, we are mindful that there are weak credits in any sector (but in particular real estate) that are likely to come under pressure should interest rates rise further because of inflation and crowding-out effects in the capital market.

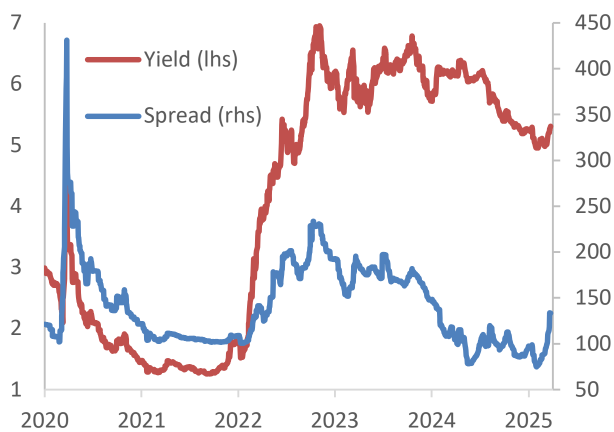
In terms of asset classes, we think that CLOs still offer good value for investors. First, we believe CLOs provide good default protection given the loan diversification across CLO portfolios, structural protections and reinvestment capabilities.

Second, while spreads of CLO debt are tighter than they have been in years, the all-in yield is still attractive up and down the cap stack depending on risk appetite, from mid-single digit returns on the AAAs up to high single / low double digit returns on lower mezzanine tranches (see Chart 7).

We also think that spread tightening has created an attractive entry point for CLO equity, both in the primary market as well as with opportunities to restructure existing CLOs to lock in the tighter financing available in the market today.

Chart 7: AAA CLO spreads and yields

% p.a. (left) and basis points (right)



Source: JPMorgan[22]

In CMBS, we took profit in recent conduit vintages given spread compression over the last 12-18 months.[23] We now prefer more seasoned conduit vintages where spreads have stayed wider due to credit noise (tenant lease events, downgrades, declining payoff rates, etc.).

We are focusing on 2017-2019 vintages which are not immediately maturing and with loans that have not been underwritten during peak valuations periods (notably 2020-21). Furthermore, we prefer structures that we view as loss remote in downside scenarios with 10% to 15% credit support in subordinated tranches. In terms of credit ratings, we see the best risk-reward relationships in A and BBB flat.

Finally, we look for conduit structures with diverse property pools and avoid pools with high concentrations in near-term lease expirations, office properties that have not been updated recently and hotels that have failed to fully recover post COVID.

More information

As always, we are available to discuss our views with you. Please contact your Client Relations representative at +1 732 978 9722 or zais.clientrelations@zaisgroup.com

[1] S&P Dow Jones Indices LLC, S&P 500 [SP500], retrieved from FRED, Federal Reserve Bank of St. Louis; March 19, 2025.

https://fred.stlouisfed.org/series/SP500

Chicago Board Options Exchange, CBOE Volatility Index: VIX [VIXCLS], retrieved from FRED, Federal Reserve Bank of St. Louis; March 19, 2025.

https://fred.stlouisfed.org/series/VIXCLS

Ice Data Indices, LLC, ICE BofA US Corporate Index Option-Adjusted Spread [BAMLC0A0CM], retrieved from FRED, Federal Reserve Bank of St. Louis; March 19, 2025.

https://fred.stlouisfed.org/series/BAMLC0A0CM

Ice Data Indices, LLC, ICE BofA US High Yield Index Option-Adjusted Spread [BAMLH0A0HYM2], retrieved from FRED, Federal Reserve Bank of St. Louis; March 19, 2025.

https://fred.stlouisfed.org/series/BAMLH0A0HYM2

[2] Baker, Scott R., Bloom, Nick and Davis, Stephen J., Economic Policy Uncertainty Index for United States [USEPUINDXD], retrieved from FRED, Federal Reserve Bank of St. Louis; March 19, 2025.

https://fred.stlouisfed.org/series/USEPUINDXD

The GDPNow real GDP growth estimate for 2025Q1 dropped from 2.3% on February 26 to -2.8% on March 3. Federal Reserve Bank of Atlanta; GDPNow; March 18, 2025.

https://www.atlantafed.org/cqer/research/gdpnow

[3] The table below shows actual real GDP growth for 2024Q4 and the Atlanta Fed Nowcast for 2025Q1 from March 3. The two big drivers of the negative growth estimate for Q1 are the sharp decline in private consumption growth and the huge negative contribution from trade.

Real GDP growth and contributions (% q/q saar)

	2024Q4 actual	2025Q1 Nowcast
Real GDP	2.4	-2.8
Private consumption	2.8	0.0
Business investment	-0.5	0.2
Housing	0.2	-0.2
Inventory	-0.8	0.4
Trade	0.1	-3.6
Government	0.5	0.3

In our view, the weakness in private consumption, which is based on January data, is primarily weather related. We expect that February and March data will be better. Indeed, February car sales have been stronger. We think that the large drag from trade reflects mostly tariff frontloading. Since the rise in imports is so far not reflected in higher private consumption, business investment or government spending, we expect that the estimate for inventory accumulation will rise as more data becomes available.

Bureau of Economic Analysis; Gross Domestic Product, 4th Quarter and Year 2024 (Second Estimate); February 27, 2025.

https://www.bea.gov/data/gdp/gross-domestic-product

Federal Reserve Bank of Atlanta; GDPNow; March 18, 2025.

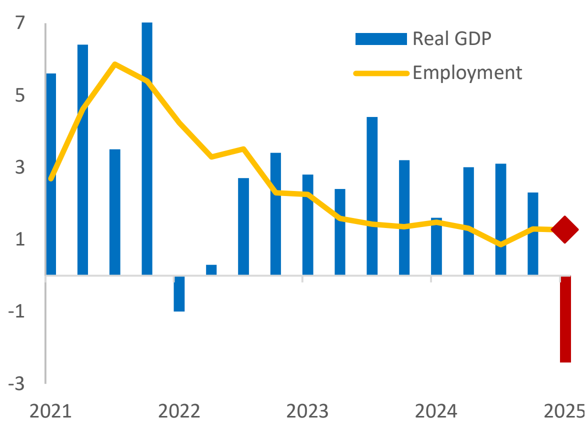
https://www.atlantafed.org/cqer/research/gdpnow

U.S. Bureau of Economic Analysis, Light Weight Vehicle Sales: Autos and Light Trucks [ALTSALES], retrieved from FRED, Federal Reserve Bank of St. Louis; March 18, 2025.

https://fred.stlouisfed.org/series/ALTSALES

[4] Real GDP contracted in the first quarter 2022 and nearly stagnated in the second quarter of 2022, but other coincident indicators like employment remained solid and a recession was avoided (see chart below). Employment in January and February 2025 also remained solid, limiting the risk of actual recession.

Real GDP and employment (%q/q saar)



The red bar is the Atlanta Fed GDPNow estimate for 2025Q1 and the red diamond is average employment for January and February.

U.S. Bureau of Economic Analysis, Real Gross Domestic Product [GDPC1], retrieved from FRED, Federal Reserve Bank of St. Louis; March 19, 2025.

https://fred.stlouisfed.org/series/GDPC1

U.S. Bureau of Labor Statistics, All Employees, Total Nonfarm [PAYEMS], retrieved from FRED, Federal Reserve Bank of St. Louis; March 19, 2025.

https://fred.stlouisfed.org/series/PAYEMS

[5] ZAIS GROUP; News and Insights; US exceptionalism revisited; November 2024.

https://www.zaisgroup.com/us-exceptionalism-revisited.html

[6] See footnote 5.

[7] U.S. Bureau of Economic Analysis, Net value added of nonfinancial corporate business: Net operating surplus [W326RC1Q027SBEA], retrieved from FRED, Federal Reserve Bank of St. Louis; March 18, 2025.

https://fred.stlouisfed.org/series/W326RC1Q027SBEA

U.S. Bureau of Economic Analysis, Net value added of nonfinancial corporate business: Corporate profits with IVA and CCAdj: Profits after tax with IVA and CCAdj [W328RC1Q027SBEA], retrieved from FRED, Federal Reserve Bank of St. Louis; March 18, 2025.

https://fred.stlouisfed.org/series/W328RC1Q027SBEA

U.S. Bureau of Economic Analysis, Gross value added of nonfinancial corporate business [A455RC1Q027SBEA], retrieved from FRED, Federal Reserve Bank of St. Louis; March 18, 2025.

https://fred.stlouisfed.org/series/A455RC1Q027SBEA

[8] U.S. Bureau of Labor Statistics, Nonfinancial Corporations Sector: Labor Productivity (Output per Hour) for Employees [PRS88003093], retrieved from FRED, Federal Reserve Bank of St. Louis; March 18, 2025.

https://fred.stlouisfed.org/series/PRS88003093

U.S. Bureau of Labor Statistics, Nonfinancial Corporations Sector: Real Hourly Compensation for Employees [PRS88003153], retrieved from FRED, Federal Reserve Bank of St. Louis; March 18, 2025.

https://fred.stlouisfed.org/series/PRS88003153

[9] Net interest payments as a share of gross value added of nonfinancial corporates has declined by more than 2 percentage points. This suggests to us that businesses have been able to lock in low funding rates during the COVID period and earning more interest on their cash assets as the Fed tightened.

See also ZAIS GROUP; News and Insights; Resilient but not invincible; April 2024.

https://www.zaisgroup.com/resilient-but-not-invincible.html

U.S. Bureau of Economic Analysis, Net value added of nonfinancial corporate business: Net operating surplus: Net interest and miscellaneous payments [B471RC1Q027SBEA], retrieved from FRED, Federal Reserve Bank of St. Louis; March 18, 2025.

https://fred.stlouisfed.org/series/B471RC1Q027SBEA

U.S. Bureau of Economic Analysis, Gross value added of nonfinancial corporate business [A455RC1Q027SBEA], retrieved from FRED, Federal Reserve Bank of St. Louis; March 18, 2025.

https://fred.stlouisfed.org/series/A455RC1Q027SBEA

[10] Board of Governors of the Federal Reserve System (US), Nonfinancial Corporate Business; Debt Securities and Loans; Liability, Level [TCMILBSNNCB], retrieved from FRED, Federal Reserve Bank of St. Louis; February 18, 2025.

https://fred.stlouisfed.org/series/TCMILBSNNCB

Board of Governors of the Federal Reserve System (US), Nonfinancial Corporate Business; Interest Paid, Transactions [BOGZ1FA106130001Q], retrieved from FRED, Federal Reserve Bank of St. Louis; March 18, 2025.

https://fred.stlouisfed.org/series/BOGZ1FA106130001Q

U.S. Bureau of Economic Analysis, Net value added of nonfinancial corporate business: Net operating surplus [W326RC1Q027SBEA], retrieved from FRED, Federal Reserve Bank of St. Louis; March 18, 2025.

https://fred.stlouisfed.org/series/W326RC1Q027SBEA

[11] See footnote 1.

[12] In our view, these advantages are:

- First-class universities and research institutions that attract top talents from around the world
- Dedicated government support for research and development
- Good funding access thanks to a huge, integrated and efficient financial system
- Effective legal and regulatory infrastructure
- Flexible and open labor market
- Huge and competitive domestic market for goods and services

See also: ZAIS GROUP; News and Insights; US Exceptionalism Revisited; November 2024.

https://www.zaisgroup.com/us-exceptionalism-revisited.html

[13] JPMorgan; High Yield Credit Index and Leveraged Loan Index; Summary spreads to worst; March 25, 2025.

https://markets.jpmorgan.com/#dataquery

[14] Credit workouts in the leveraged loan sector have been accelerated through the use of distressed exchange facilities, which account for three quarters of the par-weighted leverage loan defaults.

JPMorgan; North America Credit Research; Default Monitor; March 3, 2025.

https://markets.jpmorgan.com/jpmm/research.article_page?action=open&doc=GPS-4925254-0

[15] JPMorgan; North America Credit Research; 3Q24 Leveraged Loan Credit Fundamentals; December 23, 2024.

https://markets.jpmorgan.com/jpmm/research.article_page?action=open&doc=GPS-4872605-0

JPMorgan; North America Credit Research; 3Q24 High Yield Credit Fundamentals; December 16, 2024.

https://markets.jpmorgan.com/jpmm/research.article_page?action=open&doc=GPS-4868860-0

JPMorgan; North America Credit Research; Default Monitor; March 3, 2025.

https://markets.jpmorgan.com/jpmm/research.article_page?action=open&doc=GPS-4925254-0

[16] Trepp; CMBS Delinquency Report; February 2025.

https://www.trepp.com/instantly-access-delinquency-report-feb-2025

[17] In October 2023, ZAIS recommended tranches of A/AA conduit CMBS; see ZAIS Insight; Dipping a toe back into CMBS; October 2023.

https://www.zaisgroup.com/dipping-a-toe-back-into-cmbs.html

[18] JPMorgan; Cash Conduit CMBS Index; Single A spread to Swap 2019 and 2023 vintages; March 25, 2025.

https://markets.jpmorgan.com/#dataquery

[19] See footnotes 5 and 11.

[20] Baker, Scott R., Bloom, Nick and Davis, Stephen J., Economic Policy Uncertainty Index for United States [USEPUINDXD], retrieved from FRED, Federal Reserve Bank of St. Louis; March 19, 2025.

https://fred.stlouisfed.org/series/USEPUINDXD

[21] The S&P500 PE ratio (historical earnings) currently stands at 30.5, which is at the top-end of the historical range and similar to the levels seen before the levels seen in the runup of the dot.com bubble in 2000, while high-grade and high-yield bond spreads are at their lowest levels since the financial crisis.

S&P500 PE Ratio; gurufocus; March 19, 2025.

https://www.gurufocus.com/economic_indicators/57/sp-500-pe-ratio

Ice Data Indices, LLC, ICE BofA BBB US Corporate Index Option-Adjusted Spread [BAMLC0A4CBBB], retrieved from FRED, Federal Reserve Bank of St. Louis; March 19, 2025.

https://fred.stlouisfed.org/series/BAMLC0A4CBBB

Ice Data Indices, LLC, ICE BofA US High Yield Index Option-Adjusted Spread [BAMLH0A0HYM2], retrieved from FRED, Federal Reserve Bank of St. Louis; March 19, 2025.

https://fred.stlouisfed.org/series/BAMLH0A0HYM2

[22] JPMorgan; CLOIE; AAA CLO yield and spreads to worst; March 25, 2025.

https://markets.jpmorgan.com/#dataquery

[23] See Chart 5 again.

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