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Households less vulnerable to recession risk than businesses

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Households less vulnerable to recession risk than businesses

- Recession is unlikely in 2022 but risk is rising in 2023 …
- … as monetary and operating conditions tighten
- Household and business credit fundamentals to diverge …
- … making credit selection key

Last year, we published four notes between February and August on the consumer, housing, corporate default risks and commercial real estate (CRE).[1] In this note, we review the outlook for the four sectors given the changes since the middle of last year, especially the sharp rise of inflation, the change in Fed policy and the increasing risk of recession.

In our view, the economy has enough momentum coming out of the Corona pandemic to sustain growth this year. However, we think the risk of recession will rise appreciably in the course of next year as monetary and operating conditions tighten.

We expect that the changing environment will impact all parts of the economy, especially interest-rate-sensitive sectors like housing. From a credit perspective, we believe this environment will create more challenges for the business sector than private households. We also expect more bifurcation between different credits. Finally, with the Fed just starting to hike interest rates, we continue to prefer floating rate products.

As expected and better

We were optimistic on the prospect of economic recovery from the Corona pandemic when we wrote the four sector outlooks earlier last year. In our judgment, the overall performance in the four sectors has been as expected and even better in some parts despite setbacks from new Corona variants and supply shortages.

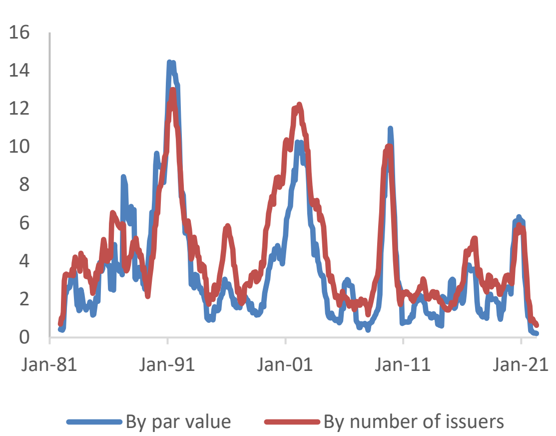
Household finances appeared to us to be in good shape, supporting consumption and housing investment.

Indeed, real personal consumption was in March 4.7% higher than before the Corona Pandemic.[2] Housing activity has moderated from the boom that followed the initial Corona outbreak, but remained strong and above the pre-pandemic level, while house prices continued to rise rapidly.[3]

Our outlook for corporate default risks was more cautious. We thought that corporate default rates were already low in the middle of last year and saw upside risks due to margin pressures and high leverage. So far, this has not happened. In fact, default rates slipped further, to below 1% (see Chart 1).

Chart 1: US high yield default rates

Percent



Source: JPMorgan[4]

Our outlook for CRE was also mixed. We were optimistic on multi-family, industrial and lodging, yet saw difficulties in the office and retail space. Overall, the CRE recovery has met and even exceeded our expectations (see Table). Retail, in particular, has done better than we anticipated and only office space, as shown, lagged behind the overall CRE recovery.

Table: Commercial real estate

Percent

		2019Q4	2020Q4	2021Q4
Office	Rent[1]	3.9	-1.5	0.4
	Vacancy[2]	9.6	11.0	12.2
Retail	Rent[1]	2.4	1.0	3.1
	Vacancy[2]	4.5	5.1	4.7
Residential	Rent[1]	2.4	0.5	11.4
	Vacancy[2]	6.5	6.6	4.8
Industrial	Rent[1]	5.4	4.9	9.3
	Vacancy[2]	5.1	5.5	4.2
Lodging	ADR[3]	1.0	-27.1	42.0
	Occupancy[4]	61.5	41.7	57.9

1) Rent % change over a year ago, 2) % vacancy rate, 3) average daily room rate % change over a year ago, 4) % occupancy rate
Source: Co-Star[5]

Double whammy

The environment has changed significantly since we published last year's four sector outlooks. The two key changes are inflation and Fed policy.

- Headline inflation has more than tripled over the last 12 months, to above 8%.[6] In our view, the rise in inflation is largely driven by Corona-related supply and demand distortions compounded by the recent surge in energy prices due to the Ukraine war. However, the risk is that higher inflation becomes entrenched given tight labor market conditions.

- The inflation surge also has forced a U-turn in Fed policy. In the middle of last year, the Fed expected to maintain its accommodative policy stance for some time.[7] The Fed projected no rate hikes before early 2023.[8] Not even a year later, the Fed has already hiked the funds rate by 75 basis points and will start the balance sheet unwind in early June.[9] In our view, the Fed will likely raise the funds rate to 2.5% by the end of 2022.

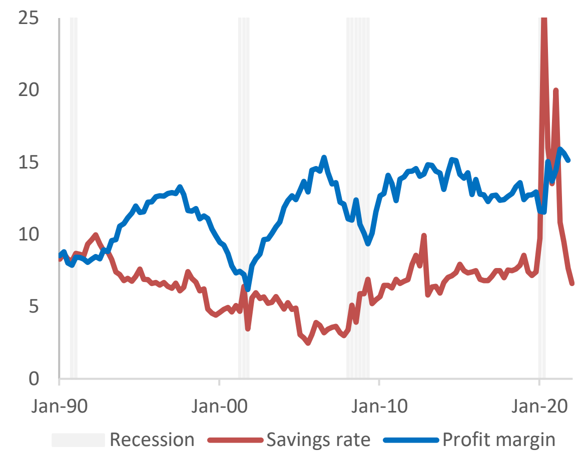
Lower growth but no recession in 2022

High inflation and monetary tightening have negative implications for businesses and households (margin pressure, reduced real spending power, tighter funding conditions). We expect these pressures will reduce growth in 2022 but not result in the kind of operating and financial stress that typically leads to recession.

- First, we do not believe the recovery from Corona is complete, especially in services.[10] As a result, we expect continued strong catch-up momentum as social and economic mobility continue their return to normalcy.
- Second, we view business and household fundamentals as sufficiently strong to absorb adverse pressure from rising prices and interest rates in 2022. Households have put aside a large cushion of additional savings during the pandemic and aggregated profit margins are near record highs (see Chart 2).
- Third, the Fed is just starting to adjust policy, moving away from its previous accommodative stance. Financial markets are adjusting to Fed policy changes (e.g., rising mortgage rates), but there are no signs of acute stress.[11] The rise in mortgage rates has led to a decline in mortgage applications (see Chart 3, although primarily in refinancing). Thus, we do not foresee the full impact of Fed tightening before next year.

Chart 2: Savings rate and profit margin

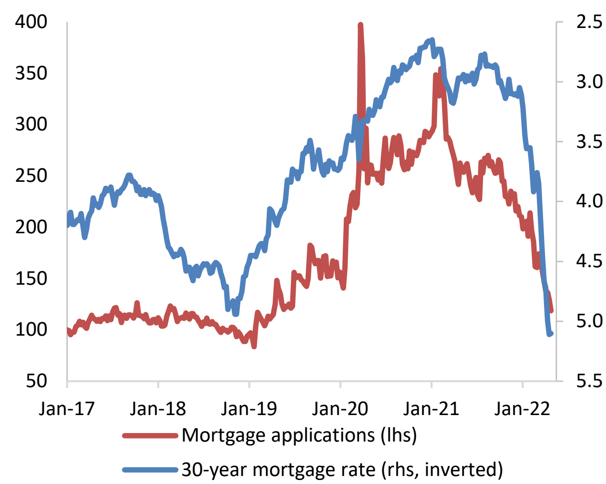
Percent



Source: US Bureau of Economic Analysis[12]

Chart 3: Mortgage rate and applications

Index Jan-2017=100 (lhs) and % p.a. (rhs)



Source: Freddie Mac and MBA[13]

The first quarter GDP report was disappointing, but not a sign of weak demand.[14] We believe the main risk of recession in 2022 is not inflation or Fed policy but, rather, from outside the US, notably from Europe due to the war in Ukraine, and from China, which struggles to overcome Corona and a housing bubble.

Recession risk to rise in 2023

We expect the risk of recession to rise appreciably in 2023, especially if inflation remains stubbornly high and the Fed is forced to tighten more than currently projected. The pressure is likely to be felt in all parts of the economy and undermine growth, with recession risks likely to be highest in the business sector.

In our judgment, the combination of slowing economic activity, heightened inflationary pressures and full employment will squeeze profit margins. This should become more visible as the impact of Corona-related government support fades. Based on our estimates, government support currently still accounts for about one eighth of the aggregate business sector profit margin.[15] We believe this support will be gone by 2023 and consequently will expose the firms with weak operating fundamentals.[16]

We expect that falling profit margins plus tighter debt and equity market conditions will force more companies to cut production, lay off staff and, in some cases, declare default. The economy may still avoid recession as it is, in or view, less vulnerable than before the financial and the dot-com crises, but we expect the risk will be much higher.

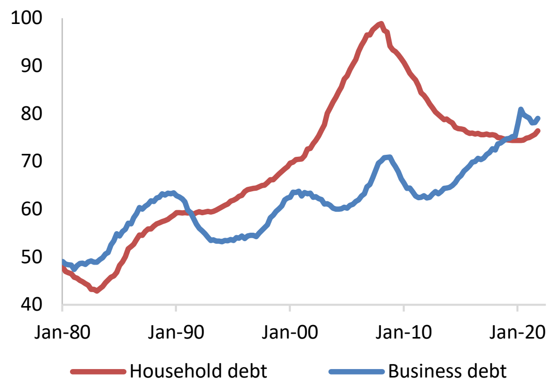
Different credit implications

No matter whether the economy slows or goes into recession, we think implications for household and business debt will be different for three reasons.

- First, we believe the business sector will experience more income pressure than households. Given tight labor market conditions, we expect the losses to fall more on business profits than household employment and income.
- Second, while the household sector has been deleveraging by more than 20% of GDP since the financial crisis, the business sector has been expanding leverage by nearly 20% of GDP (see Chart 4).

Chart 4: Business and household debt

% of GDP

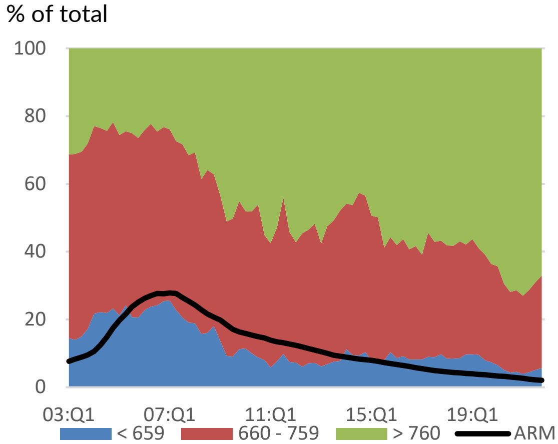


Source: Board of Governors of the Federal Reserve System and US Bureau of Economic Analysis[17]

- Third, households have significantly improved their credit quality. The share of subprime housing loans (risk score <659) and adjustable rate mortgages (ARM) has declined to low single digits (see Chart 5). In contrast, the credit quality of outstanding business debt has deteriorated, with lower-grade debt accounting for roughly 63% of marketable debt (see Chart 6 below).

Chart 5: Mortgage origination by risk score

% of total



Source: New York Fed Consumer Credit Panel/Equifax (ARM is the share of adjustable rate mortgages)[18]

Chart 6: Lower-grade business debt*

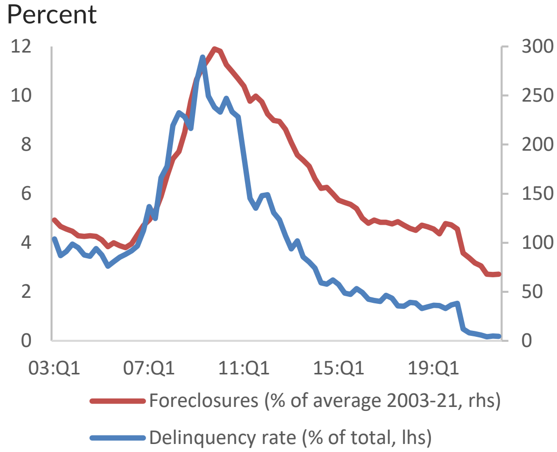
% of marketable business debt

Source: JPMorgan; *) Lower-grade business debt is BBB and HY debt plus leveraged loans[19]

As a result, we think delinquency and default risks are higher for the business sector than for the household sector. We expect delinquencies and foreclosures of household debt will remain on the low side of the last 20-year range (see Chart 7), while we think business defaults will return toward the historical average (roughly 2.5% for high yield) and, in case of a recession, to rise well above that average.

Chart 7: Household credit status

Percent



Source: New York Fed Consumer Credit Panel/Equifax[20]

Credit selection becomes more important

From an investment perspective, we think our outlook for the economy and credit fundamentals heightens the importance of credit selection, as tightening financial conditions will likely encourage increased credit dispersion. As a result, we expect tail credits to be most vulnerable. Further, as the Fed has just started to hike interest rates, we see continued value in floating rate structures.

We are constructive on credit fundamentals for securities backed by residential assets (**RMBS)** despite the expected moderation in home price appreciation. We think RMBS has repriced meaningfully into this volatile macro back drop. Floating rate products like GSE credit risk transfer and SFR continue to offer attractive risk adjusted returns, in our view, but recommend picking credits selectively and analyzing structural leverage carefully (for example, looking at equity cushions built up in homes).

Despite overall good household health, we expect more bifurcation between income groups. As a result, we look for markets to tier more visibly between various consumer **ABS** (credit cards and auto loans vs. unsecured consumer loans) as well as among originators of various loan types based on credit performance. The recent move higher both in risk-free rates and risk premiums makes mezzanine asset-backed debt look attractive to us, as well as floating rate asset backed lending.

We view default risks for high yield bonds and leveraged loans as being similar from a macro perspective. However, as outlined in a previous issue of ZAIS Insights, we prefer CLOs over corporate bonds.[21] First, we see the active portfolio management of CLOs as offering better default risk diversification. Second, we expect that floating rate products like leveraged loans and CLOs should continue to benefit from the rising interest rate environment.

Within the **CLO** space, we favor the BB portion of the capital stack. While potentially susceptible to price volatility, we believe CLO BBs are well protected against our expectation for default normalization within the corporate sector and offer strong cashflows. We also believe there is value to be found in longer reinvest CLO equity from high quality managers who have the ability to capitalize on distress through portfolio repositioning.

We do not believe **CMBS** spreads have widened enough to attract more buyers in a rising interest rate environment. We expect capital rate pressure from rising interest rates and anticipate diverging CMBS performance, reflecting the uneven lasting impact from the pandemic as well as the varying ability to withstand inflation by passing costs on to tenants. For example, we believe the office sector has yet to fully rationalize the impact of work from home and now faces the prospect of slowing corporate growth. On the other hand, we think that multifamily should hold in better due to abundant investor capital and strong tenant demand.

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] See also the following ZAIS Insights:

"Consumers to the rescue" February 2021

https://www.zaisgroup.com/consumers-to-the-rescue.html

"No housing bubble yet" April 2021

https://www.zaisgroup.com/no-housing-bubble-yet.html

"New default risks emerging" June 2021

https://www.zaisgroup.com/new-default-risks.html

"CRE – uneven road to recovery"

https://www.zaisgroup.com/cre-uneven-road-to-recovery.html

[2] U.S. Bureau of Economic Analysis, Real Personal Consumption Expenditures [PCEC96], retrieved from FRED, Federal Reserve Bank of St. Louis; May 2, 2022.

https://fred.stlouisfed.org/series/PCEC96

[3] U.S. Census Bureau and U.S. Department of Housing and Urban Development, New One Family Houses Sold: United States [HSN1F], retrieved from FRED, Federal Reserve Bank of St. Louis; May 4, 2022.

https://fred.stlouisfed.org/series/HSN1F

U.S. Census Bureau and U.S. Department of Housing and Urban Development, New Privately-Owned Housing Units Started: Single-Family Units [HOUST1F], retrieved from FRED, Federal Reserve Bank of St. Louis; May 4, 2022.

https://fred.stlouisfed.org/series/HOUST1F

S&P Dow Jones Indices LLC, S&P/Case-Shiller U.S. National Home Price Index [CSUSHPISA], retrieved from FRED, Federal Reserve Bank of St. Louis; May 4, 2022.

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

[4] JPMorgan Default Monitor; May 2, 2022; page 6 and prior issues.

https://markets.jpmorgan.com/#research.na.high_yield

[5] CoStar Realty Information Inc., Analytics Data Export, retrieved Market Rent Index and Vacancy Rate for Office, Retail, Multifamily, Industrial as well as ADR and Occupancy Rate for Hospitality

https://product.costar.com/analyticexport/

[6] U.S. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items in U.S. City Average [CPIAUCSL], retrieved from FRED, Federal Reserve Bank of St. Louis; May 4, 2022.

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

[7] See FOMC statement from July 28th 2021.

https://www.federalreserve.gov/monetarypolicy/files/monetary20210728a1.pdf

[8] See FOMC Summary of Economic Projections, June 16th 2021.

https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20210616.pdf

[9] See FOMC statement from May 4th 2022.

https://www.federalreserve.gov/monetarypolicy/files/monetary20220504a1.pdf

[10] We estimate that real services consumption is still 4% below the pre-Corona trend based on the prior growth rate of around 2% per annum.

U.S. Bureau of Economic Analysis, Real Personal Consumption Expenditures: Services [PCESC96], retrieved from FRED, Federal Reserve Bank of St. Louis; May 4, 2022.

https://fred.stlouisfed.org/series/PCESC96

[11] Financial stress indicators like the VIX, the St. Louis Fed financial Stress Index and the Chicago Fed Financial Conditions Index show some increase in volatility but no signs of stress that typically leads to recession.

Chicago Board Options Exchange, CBOE Volatility Index: VIX [VIXCLS], retrieved from FRED, Federal Reserve Bank of St. Louis; April May 4, 2022.

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

Federal Reserve Bank of St. Louis, St. Louis Fed Financial Stress Index [STLFSI3], retrieved from FRED, Federal Reserve Bank of St. Louis; May 4, 2022.

https://fred.stlouisfed.org/series/STLFSI3

Federal Reserve Bank of Chicago, Chicago Fed National Financial Conditions Index [NFCI], retrieved from FRED, Federal Reserve Bank of St. Louis; May 4, 2022.

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

[12] U.S. Bureau of Economic Analysis, Personal Saving Rate [PSAVERT], retrieved from FRED, Federal Reserve Bank of St. Louis; May 4, 2022.

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

U.S. Bureau of Economic Analysis, Corporate profits with inventory valuation and capital consumption adjustments: Domestic industries: Nonfinancial [A463RC1Q027SBEA], retrieved from FRED, Federal Reserve Bank of St. Louis; May 4, 2022.

https://fred.stlouisfed.org/series/A463RC1Q027SBEA

U.S. Bureau of Economic Analysis, Gross value added of nonfinancial corporate business [A455RC1Q027SBEA], retrieved from FRED, Federal Reserve Bank of St. Louis; May 4, 2022.

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

[13] Freddie Mac, 30-Year Fixed Rate Mortgage Average in the United States [MORTGAGE30US], retrieved from FRED, Federal Reserve Bank of St. Louis; April 13, 2022.

https://fred.stlouisfed.org/series/MORTGAGE30US

Mortgage Bankers Association, weekly US mortgage applications, retrieved from investing.com, April 14, 2022

https://www.investing.com/economic-calendar/mba-mortgage-applications-380

For a break-down of refinance and purchase applications see Mortgage News Daily.

https://www.mortgagenewsdaily.com/data/mortgage-applications

[14] First quarter GDP declined 1.4% saar with the drag coming from imports and government spending, while real domestic private rose 3.7% saar, the strongest pace since the second quarter of last year.

https://www.bea.gov/sites/default/files/2022-04/gdp1q22_adv.pdf

[15] U.S. Bureau of Economic Analysis, Net value added of nonfinancial corporate business: Taxes on production and imports less subsidies [W325RC1Q027SBEA], retrieved from FRED, Federal Reserve Bank of St. Louis; May 4, 2022.

https://fred.stlouisfed.org/series/W325RC1Q027SBEA

U.S. Bureau of Economic Analysis, Corporate profits with inventory valuation and capital consumption adjustments: Domestic industries: Nonfinancial [A463RC1Q027SBEA], retrieved from FRED, Federal Reserve Bank of St. Louis; May 4, 2022.

https://fred.stlouisfed.org/series/A463RC1Q027SBEA

U.S. Bureau of Economic Analysis, Gross value added of nonfinancial corporate business [A455RC1Q027SBEA], retrieved from FRED, Federal Reserve Bank of St. Louis; May 4, 2022.

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

[16] According to Jeffries Group, small cap firms representing 31% of the Russell 2000 small cap index were loss making at the end of 2021, which is well above the historical average.

https://moneytrainingclub.com/russell-2000-falls-on-lack-of-appetite-for-unprofitable-companies/

[17] Board of Governors of the Federal Reserve System (US), Households and Nonprofit Organizations; Debt Securities and Loans; Liability, Level [CMDEBT], retrieved from FRED, Federal Reserve Bank of St. Louis; May 4, 2022.

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

Board of Governors of the Federal Reserve System (US), Domestic Nonfinancial Sectors; Debt Securities and Loans; Liability, Level [TCMDODNS], retrieved from FRED, Federal Reserve Bank of St. Louis; May 4, 2022.

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

U.S. Bureau of Economic Analysis, Gross Domestic Product [GDP], retrieved from FRED, Federal Reserve Bank of St. Louis; May 4, 2022.

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

[18] New York Fed Consumer Credit Panel/Equifax; Household debt and credit report (Q4 2021); Chart 6; Mortgage origination by credit score.

https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/HHDC_2021Q4.pdf

[19] JPMorgan JULI ex EM Market Value; JPMorgan JULI ex EM BBB Market Value; JPMorgan Domestic HY Summary Market Value; JPMorgan Leveraged Loan Index Summary Market Value.

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

[20] New York Fed Consumer Credit Panel/Equifax; Household debt and credit report (Q4 2021); Chart 11 (Total Balance by Delinquency Status) and Chart 17 (Number of Consumers with New Foreclosures and Bankruptcies).

https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/HHDC_2021Q4.pdf

[21] See ZAIS Insight: Corporate Bond and CLO Spreads to Diverge; February 2022.

https://www.zaisgroup.com/corporate-bond-clo-spreads.html

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