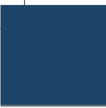

CREDIT RISK

Flying Blind

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into the Next Recession? (Part 5)

Be Alert as the Credit Cycle Grows Old

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THE FIRST THREE parts of this series investigated the key factors often ignored or undervalued by commercial banks—fundamentals that matter regardless of where we sit in the credit cycle. Parts 4 and 5 build on this effort, contrasting the economic, financial, and political environment prior to the Great Recession with where we stand now. Part 4, published in the previous issue, focused on comfort zones for lenders and international trade. Part 5, presented here, examines the impact of rising government, corporate, and household debt.

"Adaptation seems to be, to a substantial extent, a process of reallocating your attention."

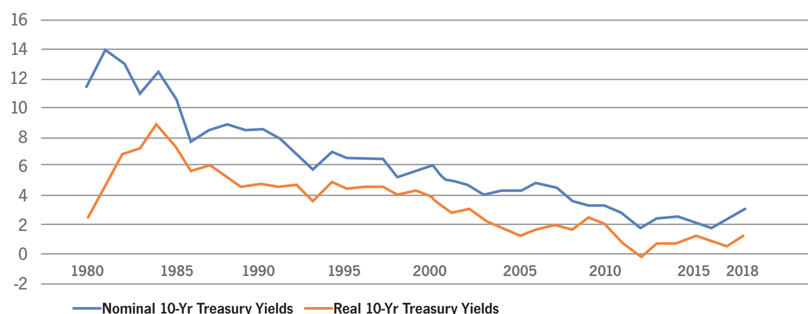
– Daniel Kahneman, 2002 Nobel Laureate in Economics

BY RICK BUCZYNSKI AND DEV STRISCHEK

On all fronts, America's debt has grown exponentially. According to a McKinsey Global Institute report, total worldwide debt, including government, household, and corporate liabilities, exploded from $97 trillion in 2007 to $169 trillion by mid-2017.[1] That report notes that many large corporations have shifted toward bond financing, owing to subdued commercial bank lending, and that non-investment-grade bonds have almost quadrupled over the past decade.

One reason for the mounting debt is that interest rates have been low for decades. As shown in Figure 1, U.S. interest rates have been at historically low levels since well before the financial crisis—and not just because of the Fed's quantitative easing (QE) policies.[2] Low rates preceded former Fed Chair Ben Bernanke and date back well into Alan Greenspan's tenure.

FIGURE 1: UNPRECEDENTED TERRITORY FOR LONG RATES



Source: Federal Reserve Bank of St. Louis

Inflation-adjusted 10-year Treasury rates, often the benchmark for determining other rates such as those for mortgages and C&I loans, actually dipped below zero during the U.S. economic recovery. This zero-rate stratagem was replicated by many central banks worldwide.

The rub? The U.S. economy has been restructured to sustain itself in a world of free money—not unlike Milton Friedman's "helicopter money" story in which the government drops dollars from a helicopter to stimulate the economy. As such, any abrupt change in interest rates, even by a few hundred basis points, would have a significant impact on the economy and the risk profile of every bank.

Unfortunately, this low-rate environment has also helped marginal borrowers qualify for credit as a result of their misleadingly low debt-service and interest-coverage ratios. Borrowers operating in industries subject to volatile revenues, such as contractors, are at even more risk.

Rising Government Debt Puts Upward Pressure on Rates

Earlier this year, the Fed announced it would "be patient" regarding further hikes in interest rates—and in early June even hinted at some easing down the road given obvious concerns

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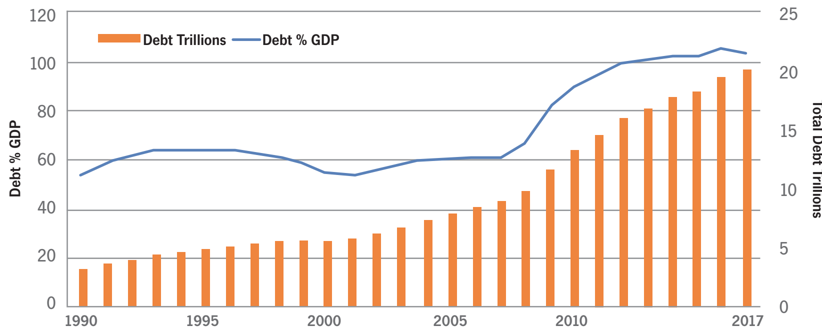
FIGURE 2: U.S. FEDERAL DEBT IS UP, UP AND AWAY!



Source: Federal Reserve Bank of St. Louis

over the impact of renewed trade tensions. Moreover, it was considering an earlier-than-expected end to the runoff in Treasuries accrued during QE. Regardless, there are other factors putting upward pressure on interest rates—perhaps the most notable being a burgeoning federal debt that has more than doubled since 2007, as shown in Figure 2.

There have been significant shifts in fiscal policy, including bipartisan support for highly stimulative government spending at a time when the economy is growing rapidly and unemployment is extremely low. This shift, coupled with the 2018 tax cuts, is why the Congressional Budget Office (CBO) estimates that the national debt will more than triple in the next 30 years. By 2028, the debt-to-GDP ratio would be the largest since the end of World War II.

According to the CBO's report of January 28, 2019, the federal budget deficit will be roughly $900 billion in 2019 and will exceed $1 trillion in each year beginning in 2022. Because of persistently large deficits, federal debt is projected to grow steadily. To quote the CBO:

> *The average deficit over the next 10 years equals 4.4% of GDP. That average deficit is not only large but also unusual for times of low unemployment—in contrast to times of high unemployment, when the government sometimes implements policies aiming to stabilize the economy, causing deficits to be larger.*

What does this mean? While the government issues Treasury securities to finance the growing debt, the supply of bonds increases, driving bond prices down and market interest rates higher. Regardless of Fed policies, don't disregard the possibility of higher costs of credit.

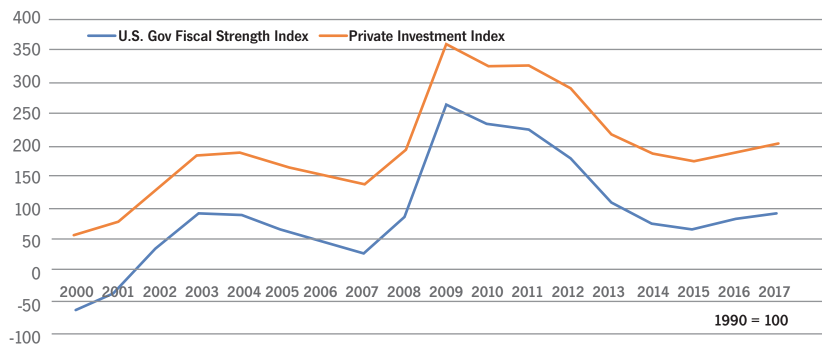
Higher interest rates attract depositors, but paying higher interest rates for deposits also raises the cost of funds for lenders. At some point, the spread between deposits and loans narrows so much that banks face diminishing marginal returns on incremental loan production, a point that actually tends to occur on the brink of recession.

There's much more to consider, including the "crowding out" effect. Crowding out occurs when capital expenditures by businesses (CAPEX or private nonresidential investment)—on items like machinery, industrial infrastructure, software, training, and R&D—are supplanted by increases in government spending and deficit financing. The result is competition for available financial resources, which puts upward pressure on interest rates.

Figure 3 shows the link between federal government deficits and CAPEX. The Fiscal Strength Index is calculated

THERE HAVE BEEN SIGNIFICANT SHIFTS IN FISCAL POLICY, INCLUDING BIPARTISAN SUPPORT FOR HIGHLY STIMULATIVE GOVERNMENT SPENDING AT A TIME WHEN THE ECONOMY IS GROWING RAPIDLY AND UNEMPLOYMENT IS EXTREMELY LOW.

FIGURE 3: FEDERAL DEFICITS IMPEDE PRIVATE NONRESIDENTIAL INVESTMENT



Sources: Bureau of Economic Analysis, Office of Management and Budget, IBISWorld

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as the reciprocal of the federal government deficit. The higher the index, the greater/smaller the federal surplus/deficit. The correlation is uncanny and undeniable. And then add another 10% (estimated at $2 trillion) to the debt figures for state and local governments that aren't included in the chart.

Another CBO quote from July 2016 is appropriate:

High and rising federal debt would reduce national saving and income in the long term; increase the government's interest payments, thereby putting more pressure on the rest of the budget; limit lawmakers' ability to respond to unforeseen events; and increase the likelihood of a fiscal crisis.

TABLE: TOP 40 INDUSTRIES MOST VULNERABLE TO A GOVERNMENT SHUTDOWN

NAICS 6-DIGIT CODE (2017)	IBISWORLD 5-DIGIT CODE	INDUSTRY NAME	DRIVER DESCRIPTION
115310	11531	Forest Support Services	Federal Government Spending (General)
212231	21232	Sand & Gravel Mining	Federal Government Spending (General)
236210	23621	Industrial Building Construction	Federal Government Spending (General)
334511	33451a	Navigational Building Construction	Federal Government Spending (General)
335921	33592	Wire & Cable Manufacturing	Federal Government Spending (General)
511210	51121b	Database, Storage & Backup Software Publishing	Federal Government Spending (General)
511210	51121f	Security Software Publishing	Federal Government Spending (General)
517410	51741	Satellite Telecommunications Providers	Federal Government Spending (General)
517919	51791b	Radar & Satellite Operations	Federal Government Spending (General)
541350	54135	Building Inspectors	Federal Government Spending (General)
541370	54137	Surveying & Mapping Services	Federal Government Spending (General)
541511	54151	IT Consulting	Federal Government Spending (General)
541611	54161	Management Consulting	Federal Government Spending (General)
541690	54171	Scientific & Economic Consulting	Federal Government Spending (General)
561210	56121	Correctional Facilities	Federal Government Spending (General)
562910	56291	Remediation & Environmental Cleanup Services	Federal Government Spending (General)
712120	71212	Historic Sites	Federal Government Spending (General)
512240	51224	Audio Production Studios	Federal Funding for Creative Arts
611610	61161	Fine Arts Schools	Federal Funding for Creative Arts
711130	71113	Musical Groups & Artists	Federal Funding for Creative Arts
711310	71133	Concert & Event Promotion	Federal Funding for Creative Arts
711510	71151	Performers & Creative Artists	Federal Funding for Creative Arts
712110	71211	Museums	Federal Funding for Creative Arts
621420	62142	Mental Health & Substance Abuse Clinics	Federal Funding for Social Services
623990	62399	Orphanages & Group Homes	Federal Funding for Social Services
624110	62411	Adoption & Child Welfare Services	Federal Funding for Social Services
624190	62419	Family Counseling & Crisis Intervention Services	Federal Funding for Social Services
624210	62421	Community Food Services	Federal Funding for Social Services
624221	62422	Community Housing & Homeless Shelters	Federal Funding for Social Services
624310	62431	Job Training & Career Counseling	Federal Funding for Social Services
813311	81331	Conservation & Human Rights Organizations	Federal Funding for Social Services
813410	81341	Civic, Social & Youth Organizations	Federal Funding for Social Services
212311	21231	Stone Mining	Federal Funding for Transportation
237310	23731a	Road & Highway Construction	Federal Funding for Transportation
237990	23799	Heavy Engineering Construction	Federal Funding for Transportation
336510	33651	Train, Subway & Transit Car Manufacturing	Federal Funding for Transportation
485111	48511	Public Transportation	Federal Funding for Transportation
488111	48811	Airport Operations	Federal Funding for Transportation
488210	48821	Rail Maintenance Services	Federal Funding for Transportation
624230	62423	Natural Disaster & Emergency Relief Services	Federal Funding for Homeland Security

Source: IBISWorld

THE NEXT ROLLER-COASTER RIDE IS REMINISCENT OF THE GOVERNMENT INFIGHTING THAT RESULTED IN THE "FISCAL CLIFF" OF HALF A DECADE AGO.

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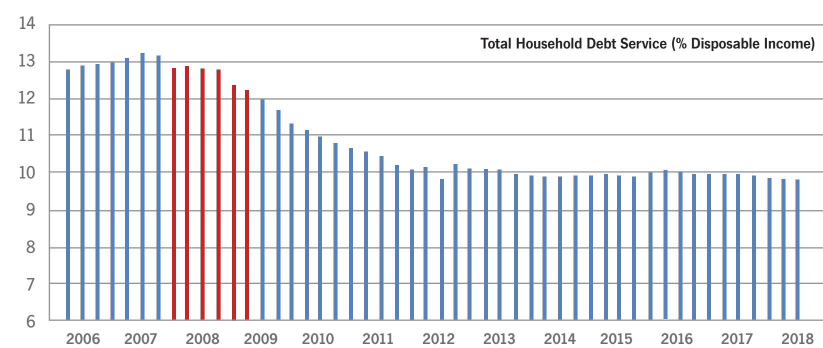
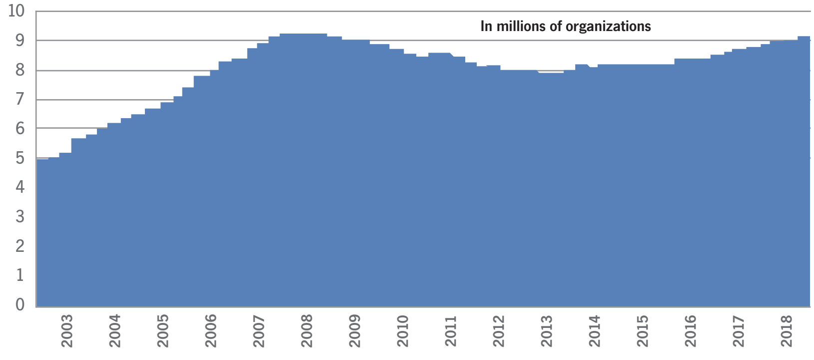
FIGURE 4: HOUSEHOLD DEBT SERVICING HAS BECOME MORE MANAGEABLE—FOR NOW



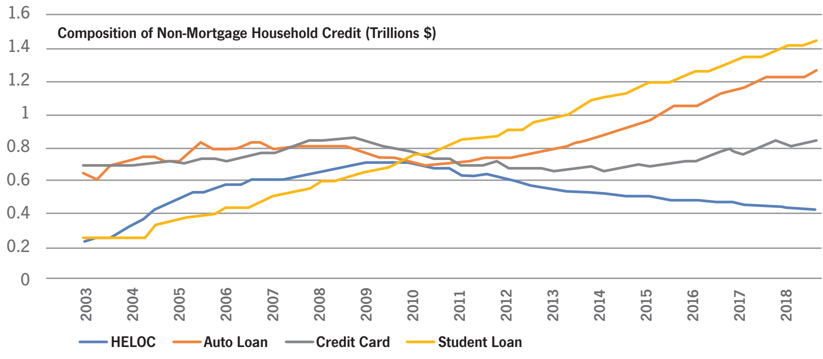
Source: Federal Reserve

FIGURE 5: HOUSEHOLD MORTGAGES FINALLY RECOVER TO PRE-CRISIS LEVELS



Source: Federal Reserve Bank of New York

FIGURE 6: AUTO AND STUDENT LOANS SOAR DURING ECONOMIC RECOVERY



Source: Federal Reserve Bank of New York

Key Takeaway #1

Interest-sensitive industries and those exposed to the crowding-out effect require considerable scrutiny, especially by bank credit committees, as the end of the current credit cycle approaches. Think about construction (CRE and related C&I), CAPEX, and even small retail mom-and-pop shops that are dependent on short-term credit to finance operations or inventories of product.

Inside-the-Beltway Gridlock

The next roller-coaster ride is reminiscent of the government infighting that resulted in the "fiscal cliff" of half a decade ago. The compromise on the government shutdown earlier this year does not preclude future shutdowns, as inside-the-beltway gridlock has sunk to an unprecedented nadir.

The table on p. 20 is drawn from IBISWorld's database of common factors, or "key drivers." It delineates the industries that are most sensitive to key areas of government spending—in particular, to a shutdown. The table provides the industries' six-digit NAICS codes in addition to their IBISWorld five-digit codes, since many banks integrate these into their portfolio management and loan origination systems.

Obviously, some industry-specific impacts are more immediate than others; and who knows if or when the next shutdown will occur? Perhaps more important, what will the impacts be on the households of government employees and contractors? Add to this the farmer households, whose loans and other disbursements are in jeopardy at a time when farm incomes are being stressed by weak prices and the trade dispute with China.

What are the ramifications? And what should bankers be thinking about?

- The risks are clustered locally. Look out for the geographic areas in your footprint that have

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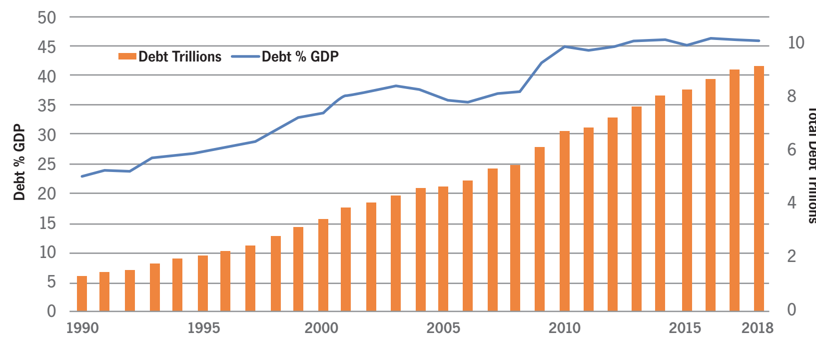
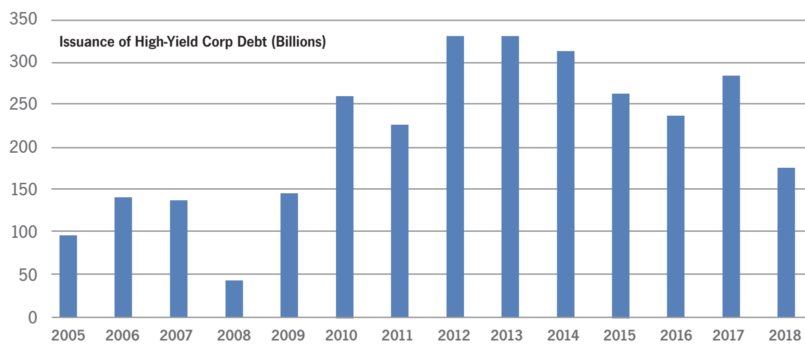
FIGURE 7: U.S. BUSINESSES DOUBLING DOWN AND BUBBLING UP ON DEBT



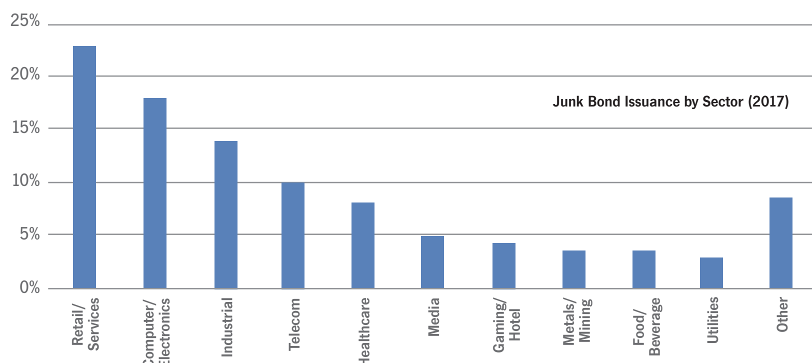
Sources: SIFMA, Bureau of Economic Analysis

FIGURE 8: HIGH-YIELD (SUBPRIME) BOND ISSUANCE SLOWING…BUT REMAINS HIGH



Source: SIFMA

FIGURE 9: JUNK BOND ISSUANCE CONCENTRATED IN RETAIL/SERVICE INDUSTRIES



Sources: SIFMA, IBISWorld

significant government offices or concentrations of government workers and contractors. Uncertainty and furlough-reduced incomes blunt consumers' appetite to spend.

- The impacts will be felt the most in retail establishments where these clusters exist. Upscale restaurants located near government agency hubs are particularly at risk.
- In vulnerable locations, mom-and-pop shops that survive on small margins or sell high-end luxury goods face very strong and, for many, life-threatening headwinds. This type of borrower is already under fire given the "Amazon effect" (more on that later).
- Last but not least, think of your consumer lending exposures in vulnerable locations.

Key Takeaway #2

Understand and map your concentrations of client exposures to government workers and contractors. Don't assume this issue will go away anytime soon.

The Changing Composition of Household Debt

The state of household finances is vastly different now compared to pre-recession levels. Consumer debt, including mortgages, credit cards, auto and student loans, and personal loans, is on pace to top $14 trillion this year. The recent high point—during the deleveraging post-recession period—was $11.2 trillion in 2013.

Nonetheless, low interest rates, government assistance under the Home Affordable Refinance Program, and private refinancing have helped lessen household debt servicing. See the effect in Figure 4, where the recession period is highlighted in red.

The chief reason for lower household debt-servicing costs is the smaller number of aggregate outstanding mortgages, which have slowly returned to pre-crisis levels—an artifact

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of the limping U.S. housing recovery and sales of new and existing homes. Figure 5 illustrates the recovery in home mortgages outstanding.

Often forgotten is that, ultimately, the housing market depends on household formation, which is generated by immigration in the near term and birth rates in the long run. Both factors are teetering at this time. And simple demographics (an aging population) and ever-morphing preferences (millennials preferring to rent) are also in play. Your guess is as good as ours. Regardless, this is fodder for analysis by your bank.

The changing composition of U.S. household debt since the housing meltdown is extraordinary. In the world of outstanding household credit excluding mortgages, auto and student loans are the flavor of the decade. Both have soared during the recovery, as indicated in Figure 6.

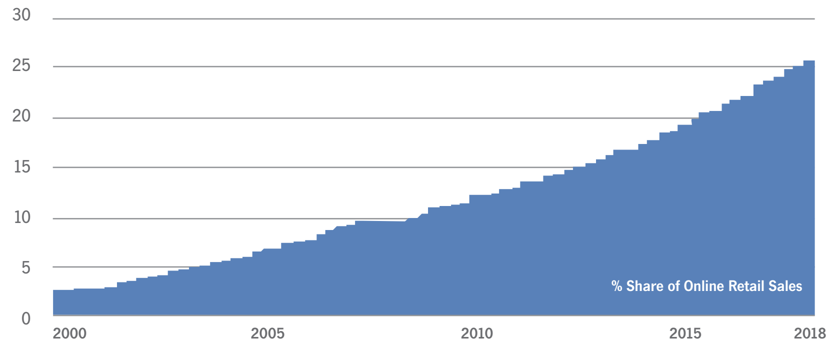
With an uptick in average credit scores for vehicle financing across the board, the percentage of subprime loan originations reached its lowest level in 11 years, according to a recent report by Experian.[3] By the third quarter of 2018, subprime and deep-subprime lending made up 21.19% of the market, down 1.5 percentage points from a year earlier. Nonetheless, there are some significant risks here, particularly as the economy approaches a downturn.

Moreover, it is well known that more than 33% of parents and grandparents are helping to pay off student loans. Think about this in terms of your consumer portfolio risks.

Key Takeaway #3

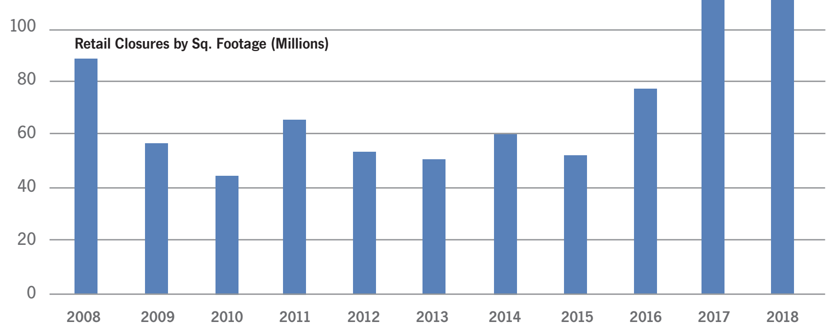
Pay attention to your auto loan portfolios. As consumers shift toward more expensive vehicles and lenders lengthen loan terms and raise LTVs, more marginal borrowers with lower credit scores are locking themselves into longer car loans with higher rates. How likely is it that an eight-year car loan to a borrower with a credit score of 550 will mature? How will these

FIGURE 10: THE "AMAZON EFFECT" IS PAVING THE WAY FOR RETAIL'S CONTINUED RETREAT



Source: U.S. Census

FIGURE 11: THE RETAIL APOCALYPSE EXERTS ITS TOLL



Sources: CoStar, IBISWorld

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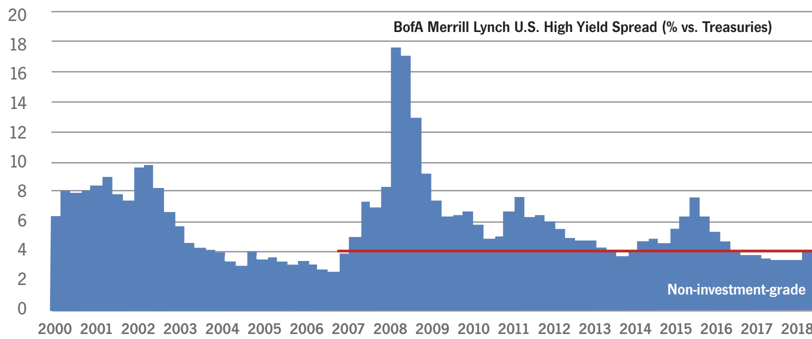
FIGURE 12: RISK TAKING IS NARROWING SPREADS (DÉJÀ VU ALL OVER AGAIN?)



Source: Bank of America/Merrill Lynch

loans impact loan loss reserves as the industry shifts to the current expected credit loss (CECL) accounting principle in the next couple of years? CECL requires recognition of estimated credit loss based on the term of the loan at its inception.

Corporate Debt, Leveraged Loans, the New Subprime, and Bubbles

A palpable shift in corporate financing has occurred since the financial crisis of 2008. Lending took a hit as banks wrestled to regain profitability, at a time when financial reform legislation required them to adjust to higher capital and liquidity requirements. This change gave way to a massive shift toward corporate bond financing and the so-called leveraged loan market. Sure, these are riskier loans, but in a market with low returns on safer credits, the lower-investment-grade borrowers look more appetizing. And besides, they need to borrow.

With a ferocious appetite for risk, investors gobbled up the new issuance of corporate debt in a low-interest, risk-chasing world. Some of this was destined for start-ups, but much was issued by marquee companies. The implications of this Rubik's cube may be the most puzzling of all the debt factors considered here.

The result? The McKinsey Global Institute report cited earlier has this to say:

> *Over the past 10 years…the average quality of investment-grade issuers has declined. In the United States, almost 40% of all nonfinancial corporate bonds are now rated BBB, just a few steps above noninvestment grade, up from 22% in 1990 and 31% in 2000, according to Morgan Stanley. Overall, BBB-rated U.S. nonfinancial corporate bonds outstanding total $1.9 trillion—almost twice the size of the high-yield (junk) bond market. Issuers are also more heavily indebted than before.*

So America has roughly $2 trillion in barely investment-grade corporate bonds outstanding (with maybe half being leveraged) and another $1 trillion being non-investment-grade—in other words, junk or subprime. Sure, this is considerably less than the $1.4 trillion of U.S. subprime mortgages just prior to the financial meltdown of 2008, and it is more secured and regulated, but it's also bigger than a bread basket. Remember, the loans supporting these bonds are to not-so-creditworthy borrowers—the so-called subprime borrowers.

And think about this quote from a *Washington Post* article by Steven Pearlstein (July 29, 2018):

> *Many of the borrowers in the leveraged loan market are midsize companies that most people have never heard of. But some are large companies you would recognize—Dell, Tesla, Uber, BMC Software, Japan's SoftBank, and office-sharing WeWork. What they all have in common is that they already have so much debt that their credit rating is below investment grade, or "junk" as it is known on Wall Street. In effect, they are "subprime" borrowers in the corporate loan market…. There's also been a shift in how loans are being used…a growing portion of leveraged lending has been used to buy back stock, pay special dividends to private equity firms or to finance richly priced mergers and acquisitions, which are now running at a pace that exceeds the bubbles of 2000 and 2007. In other words, it has been used to reward investors rather than grow the business.*

We submit that "rewarding investors" is tantamount to "succumbing to risk takers" in a low-interest-rate world. Figure 7 summarizes the rapid growth of America's corporate debt, which now exceeds $9 trillion, or about 45% of GDP.

Figure 8 depicts the issuance of high-yield debt—also called non-investment-grade or junk bonds. Junk bond issuance is heavily concentrated in a few key sectors, notably retail, computers, and electronics industries and industrial manufacturing, as shown in Figure 9.

What's the appeal of the retail sector? There are no slow-turning receivables, just credit cards to cash almost instantaneously. The result is a veritable fire hose of cash that attracts lenders and investors who have lost track of the size of the debt fire that the cash hose is trying and will be unable to extinguish.

There is an additional matter related to the concentration of junk bond issuance in retail and food services. It is common knowledge that the weakness

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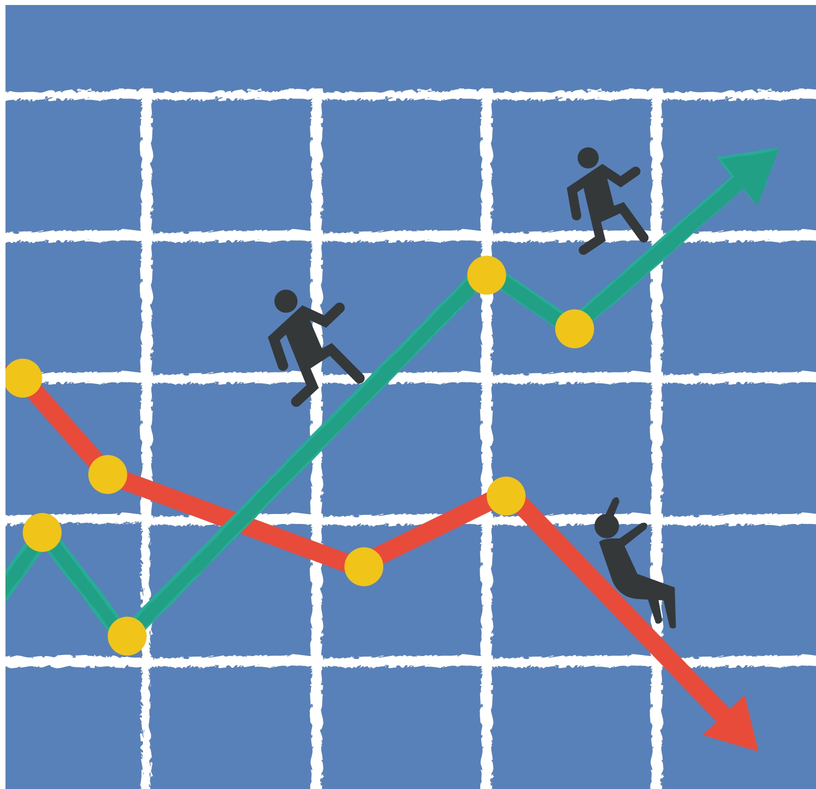

and growing riskiness in retail is due to the "Amazon effect" as the share of online sales has surpassed 25%, as indicated in Figure 10. This trend shows no sign of slowing.

The onslaught of online sales and the inroads made by big-box stores like Walmart and Home Deport contributed to the large number of major U.S. retailers that filed for bankruptcy or announced liquidations in 2018. This trend has been underway for years and is not expected to abate. Many of the vanquished are anchor stores, while others are franchises that rely on traffic generated by anchors, as do countless mom-and-pop shops. The list includes Sears, Toys R Us, Nine West, Brookstone, Bon Ton, Southeastern Grocers, Tops Markets, and Bertucci's—the so-called Retail Apocalypse depicted in Figure 11.

Consider that big-box retailers are on long-term leases, and the malls and strip shopping centers where they are located often have restrictions that prevent a closing store from easily subletting to another. As the Financial Accounting Standards Board's new lease capitalization principle rolls into effect, think about lessees asking for shorter leases to lessen the amount of lease debt that has to be recognized on their balance sheet. But how many lenders are going to feel comfortable extending 15-year CRE mortgages on commercial office buildings filled by tenants on five-year, three-year, or annual leases?

Conclusion

Abe Lincoln said of the future, "The best thing about the future is that it comes one day at a time." Our days may not be numbered, but we are clearly running out of time to prepare for the next recession. CECL and lease capitalization are going to exacerbate the credit risk.

As investors continue to undervalue risk and purchase non-investment-grade bonds, the spreads of these assets in relation to Treasuries has dipped to levels similar to those seen just prior to the financial crisis. Figure 12 shows how leveraged lenders have bid down the price of junk bonds.

Parts 4 and 5 of this series refuted the myth that the U.S. is a declining manufacturer and exporter. On the other hand, they revealed that certain industries are highly sensitive to downturns. And even without the ups and downs of the business cycle, U.S. trade wars with the rest of the world have increased the nation's economic vulnerability to international competition and, especially, to China.

So prepare for the worst and hope for the best. As President Calvin Coolidge once observed, "Business will be better or it will be worse." ®

Notes

1. See "Rising Corporate Debt: Peril or Promise?" by Susan Lund, Jonathan Woetzel, Eckart Windhagen, Richard Dobbs, and Diana Goldshtein, McKinsey Global Institute Discussion Paper, June 2018. Available at https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/rising-corporate-debt-peril-or-promise.
2. For more on QE, see "The Fed's Quantitative Easing and C&I Lending Opportunities" by Rick Buczynski, *The RMA Journal,* May 2013.
3. See "Subprime Lending Hits 11-Year Low Across the Automotive Loan Market," Experian news release, December 6, 2018. Available at https://www.prnewswire.com/news-releases/subprime-lending-hits-11-year-low-across-the-automotive-loan-market-according-to-new-experian-study-300761110.html.

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