Insights
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Why Credit Market Should Prefer a Recession Now vs. Later

Credit Research Update

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Since our last update, there has been the widespread downgrade of global growth forecasts-including by our own Chief Economist, Simona Mocuta, whose global forecasts have been lowered by five-tenths for 2022 and by eight-tenths in 2023. That is a significant downgrade in just a quarter's time, and it is perhaps the latter change that is even more disappointing as it removes the previous expectation of improvement in the medium term.[1] The downgrades were driven by the expectation of a more protracted stagflationary shock, due to the persistence of a combination of factors that are tailwinds to inflationary conditions (supply chain disruptions, the Russia-Ukraine war, COVID restrictions in China), as well as by the concurrent pivot of global central banks to a far more aggressive monetary policy tightening stance.

We have no doubt that the determination of global central banks to combat inflation will weaken global demand and growth impulses. The question is if central banks can pull off "soft landings" and avoid causing recessions. However, as a credit research team, and in the context of the global credit cycle, we aren't as concerned about whether global economies are pushed into a "technical recession", as we are with the potential depth and scope of the growth downturn, which we view as inevitable. In fact, given this inevitability we believe that the "sooner the recession, the better". Let us explain.

We know that global central banks will continue to tighten policy until inflation is on a clear, downward trend, and demand destruction will be a key factor on how quickly this goal is accomplished. If a material growth slowdown occurs in the near term, the ultimate damage in the credit markets during the downturn should be relatively shallow and short-lived, in our view. A driving factor of this view is the current lack of material imbalances in the financial system. Developed market economy consumers and corporations would enter a near-term recession in relatively strong shape. For example:

- Households have been deleveraging for more than a decade (especially in the US and Europe), compared to rising debt to income levels leading up to the 2008/2009 global recession. While household debt has increased relative to incomes in recent quarters, the debt burden is still quite small in a historical context, and smaller than it was prior to the pandemic.[2] The mortgage debt-burden is particularly contained by the fact that the super-majority of mortgages originated in recent years have low, fixed rates.

- While household net worth in major economies has taken a hit with significant stock price declines, it is still at historically high levels, and well above pre-pandemic levels in most developed countries, further buoyed by significant house price gains.[3]

- Consumer liquidity is still strong (in aggregate). For example, in the US, consumers have 7–7.5x more cash ($1–$2.5k account cohorts) and 5x more cash ($2.5–$5k account cohorts) in their bank accounts relative to pre-pandemic levels.[4] Labor markets have been quite strong in major developed economies. While we certainly expect softening, low unemployment and strong wage growth have put global consumers in a strong position at the start of this downturn.

- Corporate credit quality is past its peak condition, but balance sheets remain in strong shape by many measures. For example, interest coverage ratios and net leverage ratios for US High Yield firms remain near their highest levels in history, due to still-high levels of cash on balance sheets, and the low cost of debt that has been locked in during the many years of low rates.[5] Overall, these features should lead to a benign corporate default picture if a recession occurs in the near term.

- At the midpoint of 2022, momentum in credit ratings migration remains positive in the USD bond market and while migration is more mixed in the EUR bond market, the volume of bonds on "outlook positive" in both markets still largely outnumber bonds on "outlook negative".[6]

Overall, households and corporations in developed market economies look well-placed to handle a near-term recession, without causing material fundamental damage in the credit markets.

We have published many quarterly updates in recent years which have emphasized the enhanced resiliency of the fundamental credit profiles of major global banks, largely due to the significant regulatory reforms that were put in place after the 2008/2009 Global Financial Crisis (GFC). We are confident of that resiliency for the global banks on our credit approval list going into this downturn, but would certainly expect some threat to credit profiles and investment restrictions for banks on our approval list through a global recession. That said, if we "get our wish", and the worst of the central bank-induced downturn occurs in the near term, we'd expect a recession that is only modest (at worse), with minimum impacts on the fundamental credit profiles of the global banks on our credit approval list. After all, the banks in our coverage universe enter this downturn in exceptionally strong position:

- Many banks in our coverage universe have loan loss levels and delinquency levels that are at or near all-time low levels.

- Heading into earnings releases for 2Q, expectations for profits at many banks in our coverage universe (especially in the US) were exceptionally high, due to expected net interest margin expansion and accelerating loan growth.

- Banks have generally spent the past decade repairing their balance sheets and undergoing numerous rounds of capital raising, better preparing them for downturns in the economy. For example, the Fed released its US Bank Stress Test results on June 23 and reported that all banks remained well above their risk-based minimum capital requirements despite undergoing a hypothetical severe global recession accompanied by a period of heightened stress in commercial real estate and corporate debt markets.

- We continue to believe that the industry's de-risking since the GFC is underappreciated across the major banking jurisdictions that we cover. Credit cycles are usually preceded by exuberant lending, but there is little evidence of such lending in the banking systems we follow. As examples, in the UK and across Europe, there's been little loan growth in the banking systems since the 2008/2009 recession, and what growth there has been is primarily in low risk mortgages, while commercial real estate lending is materially lower. Essentially, system-wide stress testing exercises have squeezed out the preponderance higher-risk loans across jurisdictions in our coverage universe.[7]

If recession materializes in the near future, either locally or globally, we would not anticipate a significant phase of balance sheet adjustment in the banking sectors in our credit approval universe. The most concerning scenario for us would be a failure of global central banks to suppress inflation and aggregate demand, in the near term. In this scenario, there is a far greater chance that imbalances can build within economies, and the eventual recession will then be longer, deeper, and have more far-reaching damage to the credit markets. So, yes, now does seem like a good time to have a recession — all things considered — because we believe the scope of a near-term recession would be quite modest, as would its repercussions for the credit markets.

Financial Institutions

United States

Despite headwinds related to the Russia-Ukraine war, high/accelerating inflation, and rising interest rates which saw bank debt spreads underperform, credit profiles generally held firm in 2Q21. Reported earnings results in April were principally in-line with or above expectations as strong commercial loan growth was driven by inventory building, automation and reintermediation away from capital markets. Looking ahead, interest rates and loan growth should continue to benefit revenue growth but a slowdown in mortgage banking, volatile capital markets and ongoing unrealized securities losses are headwinds. On asset quality, banks forecast a gradual pace of normalization with trends having remained stable at historically benign levels, but degradation could become a new narrative if recession looms, even as private sector balance sheets appear robust. On capital, while the Fed's late June stress test show that industry levels are broadly very well-placed, excess capital is trending lower and we expect the largest money-center banks to be especially protective of capital in 2H22 due to economic uncertainty, higher unrealized securities losses and the need to meet regulatory requirements.

Overall, while it is difficult to handicap the damage that inflation and Fed hikes/QT will have on the economy and on banks, the sector continues to be well-placed to combat challenges, should they occur. For now, there is a bit of a disconnect between sentiment around banks and fundamentals with revenue growth accelerating, banks maintaining pricing power (on deposits) and pre-tax margins expanding (a feat not widespread in other industries). While demand destruction could eventually cause the labor market to soften, banks are not yet seeing the full extent of pain given the cross-currents tied to inflation, re-opening momentum, inventory rebuilding and high consumer savings. As well, it remains unclear to which extent asset quality will be a differentiator this cycle given the strength of private sector balance sheets, post-GFC de-risking and tighter lending standards during the pandemic.

Europe

Russian exposures triggered isolated, elevated loan losses in 1Q22. However, this was an earnings issue; not a material capital loss event. Excepting SocGen and RBI, the indirect impact to the global economy of the Russia-Ukraine war will likely be far worse than direct exposures for European banks. Banks are still performing adequately, as rate hikes (UK, US, Central and Eastern Europe) boosted revenues and aggregate loan losses are well below historical averages. Investment banking revenues also outperformed in rates and FX trading. Bank management did downgrade their expense guidance this quarter. Inflation means they will not achieve the cost targets they gave earlier at year-end. However, they view that the revenue tailwinds will still allow them to hit 2022 full year earnings guidance.

Post-earnings in late May/June, market volatility increased as the economic outlook deteriorated further. With inflation failing to recede and recession fears weighing on the markets, peripheral country credit spreads re-widened. However, the ECB committed to preventing fragmentation, opting to reinvest the pandemic emergency purchase programme (PEPP) dividends and promises of further action if spreads threaten effective monetary policy transmission. These actions reaffirm the trend of EU solidarity, which was strongly solidified post-COVID with the NextGen EU grants and loans skewed to peripheral states.

European banks are treading a thin-line of rate hikes providing net interest margin relief vs. deteriorating economic growth and inflation pressuring the consumer. Going forward, unemployment is the lynchpin for these banks. The low unemployment in both developed and emerging markets so far allowed them to post good current results in the face of surging inflation.

Canada

Canadian banks reported solid 2Q22 results in late May with aggregate net income trending up on the back of robust loan growth and growing margins, which benefitted from higher rates. Revenue diversification across business lines and geography remains a point of differentiation from a credit standpoint. Loan growth was up at a double-digit pace YoY across both retail and commercial, the latter of which is particularly outsized. Credit costs overall remain low though they did increase from the year-ago period and are likely to weaken due to the macroeconomic outlook. Note that forward-looking provisions generally remained contained and that reserve levels, while trending lower, are still above pre-pandemic levels. While regulatory capital levels remains a point of strength, there is an expectation for an eventual decline due to deployment including shareholder returns as well as pending M&A (two banks expanding into the US market).

With bank standalone credit profiles showing up well in 2Q22, all eyes turn to the macro backdrop as the Bank of Canada continues to aggressively hike rates to tackle inflation. In June, the Bank of Canada released its annual financial system review, which again highlighted high home prices and elevated household debt as key interconnected vulnerabilities. While many households have seen an improvement in net worth and liquid asset holdings over the pandemic, the share of the most highly indebted households has risen. Still, data from 1Q22 indicates that household debt-to-income ratios declined overall. Looking ahead, an important mitigating factor is very strong levels of excess savings and a low unemployment rate, the latter of which is expected to remain low. Still, a very substantial rise in home prices during the pandemic should be watched as financial conditions tighten. Positively, the greatest impact of fixed rate mortgage rates resetting higher from loans taken out during the pandemic will mostly be towards late 2025 and beyond.

Australia

Three major Australian banks reported their half-year results during the quarter. Overall, profitability levels continued to be satisfactory, benefitting from the release of loan loss reserves and positive emerging trends on loan growth. Moreover, since an above-average proportion of the banking sectors revenue is sourced from net interest income relative to fees, a brighter outlook on net interest margins is a key takeaway as the RBA undertakes a more aggressive hiking cycle to tame inflation. From a credit perspective, asset quality maintained a stable or improving trajectory while capitalization remained sound and comparably strong on an international basis, as mandated by domestic regulators. Forward-looking indicators on asset quality are generally encouraging at this stage with high levels household debt offset by record levels of savings and liquidity. While regulatory liquidity/funding metrics also remained solid, the expiration of certain government programs will prompt greater wholesale funding issuance going forward. Nevertheless, the sector's funding profile has improved materially over time and incremental funding needs should be manageable.

The RBA surprized the market with a 50bp rate hike in early June as it contends with inflation dynamics and has pivoted significantly more hawkish, similar to other global central banks. Higher interest rates as the year goes on could serve to curb household consumption and hit home prices, which experienced a substantial run-up during the pandemic. From a broader macro standpoint, it remains encouraging that business leverage is low and has been on a declining trajectory. The focus, of course, remains the housing market and household debt. Encouragingly, household debt to income levels have trended somewhat flat over the last decade and even down net of household deposits and offset accounts. With employment at historically low levels, some weakening is inevitable, but higher rates appear manageable at this point given well below-average debt servicing metrics, large household savings buffers, debt skewed to higher income cohorts (with greater savings), and lending standards having been steadily improved since 2016.

Asia

The major Japanese banks reported improved FY21 results during the second quarter with net income up versus the prior year but profitability, as measured by return on equity, still anemic versus international peers. While the banks saw improved performance over the year in domestic retail and in global corporate banking, this was partially offset by higher credit costs in the domestic corporate business and poor performance from global markets (due to gains booked last year and mark-to-market losses on investments). Russian-related exposures proved manageable, as expected, though they did result in some losses. While rising rates and stock market declines YTD have led to a large fall in unrealized securities gains, these gains remain supportively large and capital ratios ex. gains are within target levels. Overall, the majors continue to have good capitalization and benefit from sovereign support but the operating environment is hampered by structural challenges in the domestic market (rates, population, overbanking, inefficiency). This is pushing the banks towards growth internationally where loans were up double-digit YoY vs. low or negative growth in Japan. This is a trend worth watching carefully.

Looking ahead, guidance for FY23 points to modestly lower profitability. While there would be a benefit to revenue growth from higher rates, it could be offset by lower gains from securities. On the macro front, the lifting of virus-related restrictions in March should support domestic demand near-term but downward growth revisions of major trading partners (EU, US, China) is a drag. The Bank of Japan is committed to easing policy even as other major central banks tighten, buying JGBs with no upper limit and accepting Yen weakness in hopes that stimulus will drive a recovery in the economy and spur faster wage growth to offset rising cost of living. While substantial Yen weakness introduces volatility and could increase risk-weighted assets for banks, it could also boost the yen value of profit denominated in foreign currencies. We remain cognizant of increasing volatility in these markets. Across the sector more broadly, downside risks in credit appear to have been reduced since the pandemic given the benefits of stimulus measures.

Endnotes

1 State Street Global Advisors Economics; Weekly Economic Perspectives Quarterly Edition; 06/17/22.

2 Capital Economics; US Economics Weekly; 06/10/22.

3 Capital Economics; US Economics Weekly; 06/10/22.

4 Barclays Equity Research; 'Jason Goldberg's Bank Brief"; 06/14/22.

5 Goldman Sachs Research: Economics; Global Markets Daily: "Why Defaults Won't Rise, Even If the Economy Slows"; 05/11/22.

6 Goldman Sachs Research: Credit Strategy; Global Credit Tracker; 06/09/22.

7 BoA Global Research; UK Banks; Recession tension; Industry Overview; 05/18/22.

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