Credit Market Update

It's All About Housing!

May 2023
Economic update

First Quarter Summary:

Inflation still untamed, benchmark rates will remain elevated, pressuring corporate borrowers as well as consumers.

- Inflation is still running well above the Fed's target, forcing the Fed and its policy makers to keep the federal funds rate higher for longer; and likely higher than markets are anticipating as their actions have not changed the unemployment rate yet
- Higher all-in borrowing costs have increased entities' debt-service burdens and could limit funding especially for lower-rated borrowers
- Companies exposed to unhedged floating-rate debt may feel more liquidity strains
- Consumers' balance sheets have been weakening for some time — mostly due to an increase in credit card debt indicating the economy could see a significant pullback in discretionary spending
- Corporate profits face twin challenges: reduced spending will drag revenue while both borrowing costs and input costs continue to climb
- A delayed downturn or a protracted period of stagnation/ stagflation could prove more harmful than a shallow near-term slump; especially as the maturity wall approaches (late 2023 and early 2024)

Looking Beyond First Quarter:

Even more uncertainty ahead.

- Outlook for a soft landing is complicated:
- Stress in financial markets, highlighted by the SVB, Signature Bank and First Republic Bank issues, may force the Fed to hold off on tightening rates
- Pumping the brakes on interest rates risks allowing inflation to get further ahead, however
- Even if rate hikes are paused, banking sector turmoil continues to result in tighter lending standards, posing a drag on economic growth
- And the last shoe to drop could very well be housing…..and the questions everyone wants to know…..Will a decrease in the equity in homes bring consumer spending to a screeching halt?
- Low mortgage rates over the last ten years fueled home prices
- The recent fast rise in mortgage rates has worsened housing affordability
- Housing prices need to come down and this could further erode consumers wealth and confidence with a decrease in equity in homes
- Consumer spending could take a big hit if the equity in homes gets squeezed. This could be the catalyst that puts the economy into the recession everyone is fearing…..
- Let's dig deeper!

Homes are not affordable!

Low rates during the pandemic created demand in the housing sector.

- Since 2022 the Fed has started to raise rates to fight inflation, with 30 YR Mortgage rates hitting 7% in November of 2022 and now settling in around 6.5%
- Rising interest rates have made a massive difference for homebuyers, for example: a family that could afford a $500k house when rates were 2.7% can now only afford a $325K house with rates at 6.5%
- With the median home sale price in America at $468k, a 20% down payment and a 30-year mortgage with monthly payment is approximately 54% more than it was in early to mid 2021

Home purchasing sentiment has declined significantly.

Consumers have very little confidence in the housing market as the sentiment is near all time lows.

- End of the day, housing prices need to come down as people can not afford homes
- Home prices have barely fallen 1% in recent years and current prices are not sustainable
- The low affordability of homes coupled with the erosion of consumers savings and inflation on all other goods and services will continue to keep the consumer feeling that they need to slow their spending

Loan Market Update:

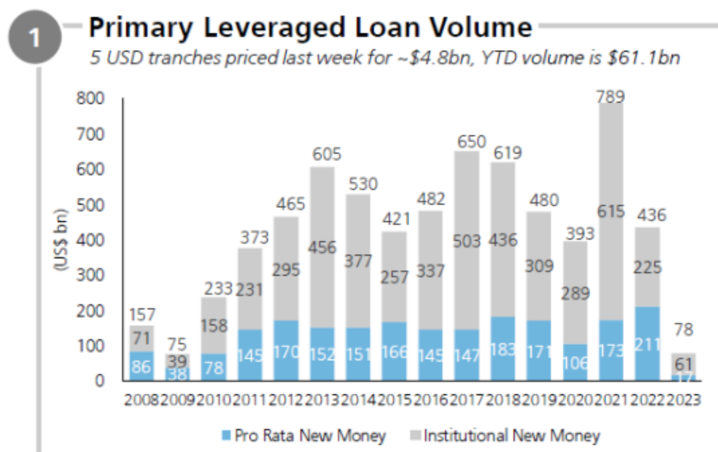
Leveraged loan market seeing signs of life, but volume still down

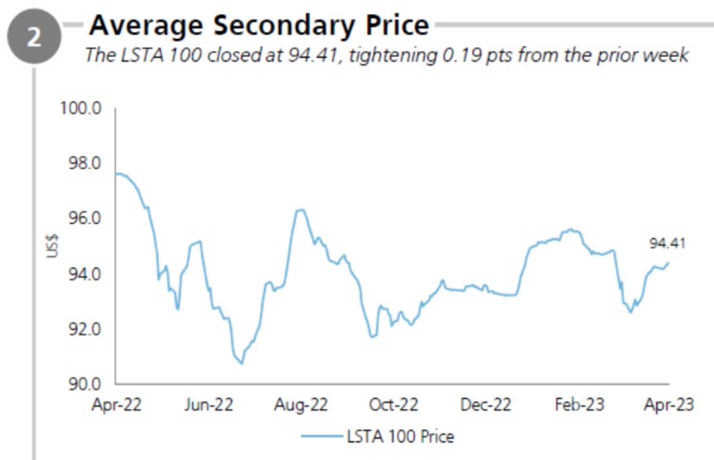
- Loan book is still largely refinancings and amend/extend transactions, with some M&A activity emerging
- Amend-and-extend volume reached $46.5B in Q1'23, compared to $12.3B for the same period in 2022
- Qualtrics (B1/B) completed its $1.2B first lien term loan, backing its buyout by Silver Lake and CPP Investments
- First LBO transaction to price since February
- Priced at S+350 at 99.00 with no floor, compared to talk at S+375-400 at 98.00 with a 0.5% floor
- While pricing appears to be stabilizing, volume is still down
- The secondary loan market remained stable in early April coming off a late-March rally; LSTA 100 index rose 0.19 pts to close at 94.41 on April 14 compared to 94.22 seen the prior week
- However, YTD institutional loan volume is at ~$61.1B, compared to ~$131.3B last year YTD (-53.0%)
- Combined new LBO volume across Q4'22 and Q1'23 totals $5.5B, lowest level for consecutive quarters in 13 years
- Volume will remain under pressure as leveraged loan retail funds continue to see outflows
- Over the first half of April, leveraged loan retail funds saw more than $1B in net outflows
- YTD, there has been only one weekly net inflow; outflows now total $9.2B, already greater than the $8.5B net outflow for all of 2022
- In 2021, leveraged loan retail funds took in net inflows of $33.9B; cumulative outflows since then have already reversed half of that, and are on pace to give it all back by the end of 2023, a stunning reversal

Pandemic stimulus has set us up for an intense correction;

loan issuance has already stalled

- As of the week ended April 14, 2023, primary leveraged loan value has still not rebounded
- The secondary loan market has remained intact with little to no volatility as of late. Having said that, with interest rates expected to remain high and likely go higher, secondary loan prices are still far from par
- YTD volumes in the leverage loan market are well below last year levels and market sentiment is that banks continue to tighten lending standards

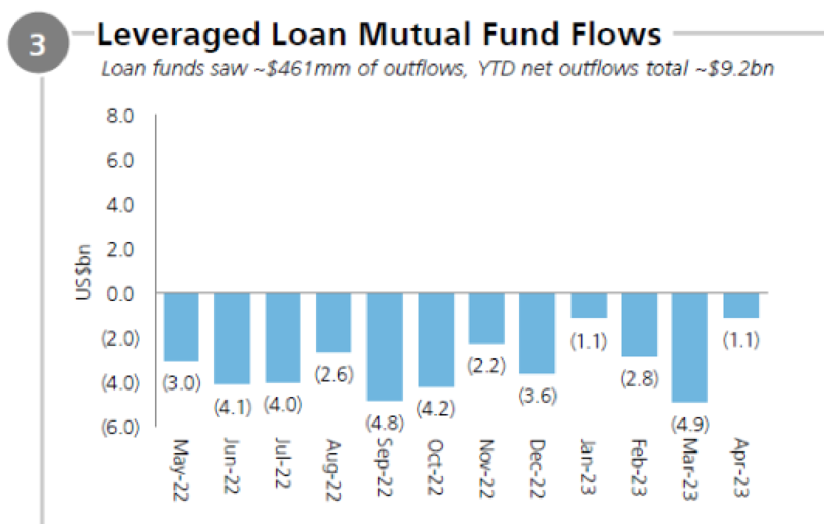


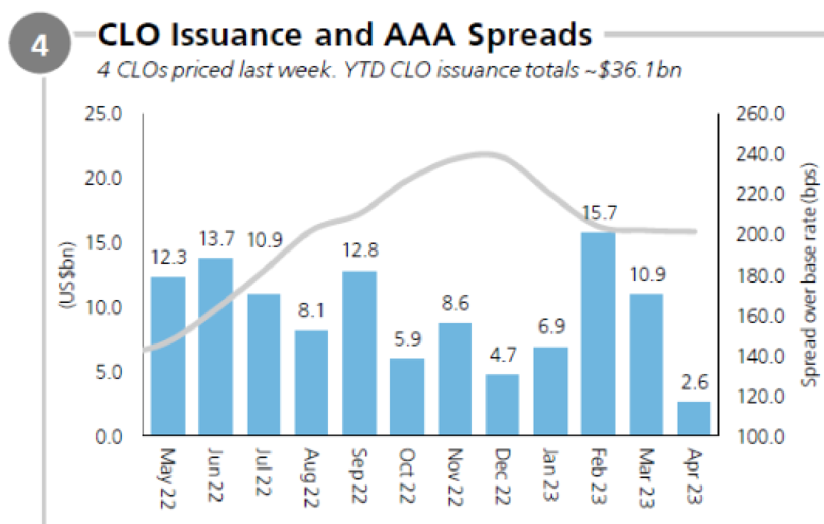


Sources: UBS, Factset, Federal Reserve, LCD

And yet,

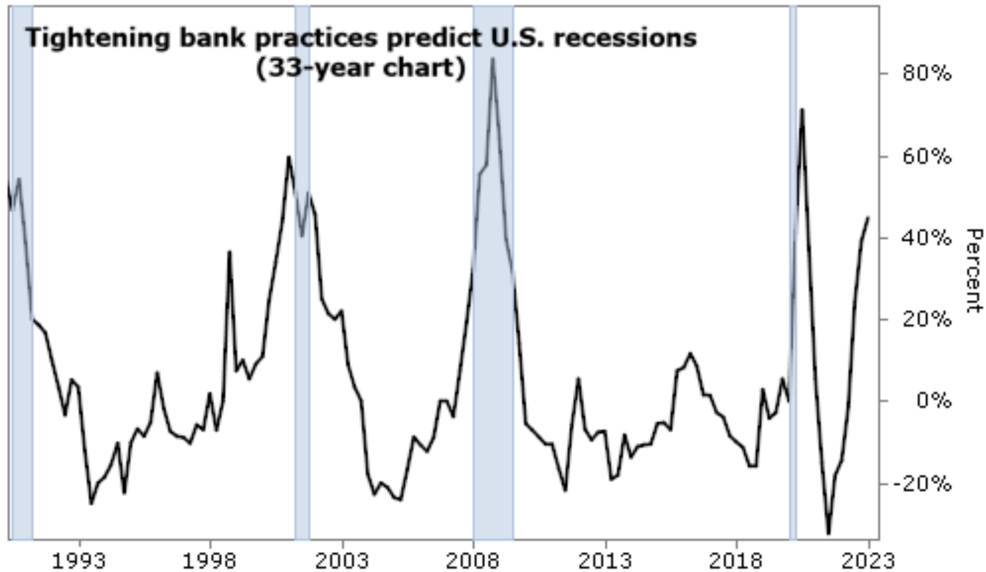
As much as spreads have widened, liquidity is still draining out of the credit market as of April 14th





Sources: UBS, Factset, Federal Reserve, LCD

Restructuring work should increase as banks tighten credit



SUMMARY

- Although credit markets are seeing some activity, lending standards are expected to tighten further
- Borrowers interest costs have doubled
- Refinancing lenders looking to reduce leverage by half requiring equity sponsors to inject equity or find other capital to fill gap
- Meanwhile, second half of 2023 has a significant amount of loan maturities that continue into 2024

CONCLUSION

- With lending standards tightening and liquidity draining out of the credit markets,
- Borrowers will have trouble refinancing and be forced to address their fundamental business challenges
- Lenders and bondholders will have fewer opportunities to trade out, creating “accidental owners”

Source: Federal Reserve Bank of Saint Louis

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