Fixed Income Perspectives

CALAMOS INVESTMENTS

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The Credit Market Is Sending Mixed Signals

People use the word credit in a lot of different contexts. We use our credit cards to make purchases. Maybe we received extra credit from teachers in school. We hate it when other people take credit for our work. But credit, in an economic or financial sense, is an often misunderstood and sometimes demonized aspect of both domestic and global economies. Many people think about taking on debt and being in debt as negative, but that is not necessarily true. Taking on a mortgage to purchase a home is not the same as using a credit card to finance a vacation. The quality of debt should and does matter, and access to credit at both the micro and macro-economic level is the oil that keeps the financial engine running.

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One of the lenses through which one can view the quality of corporate debt is that of American economist Hyman Minsky, who classified corporate debt in terms of the source of its repayment. If debt will finance a project that pays off the principal and interest out of its own cash flows, that is a positive. If debt will finance a project that covers the interest cost but requires regular refinancing to extend the repayment of principal, it falls into a second tier. If debt is issued in the hope that eventually assets will appreciate to cover the cost of the debt, it falls into a category that Minsky classified as "Ponzi" borrowing and is viewed as the lowest quality.

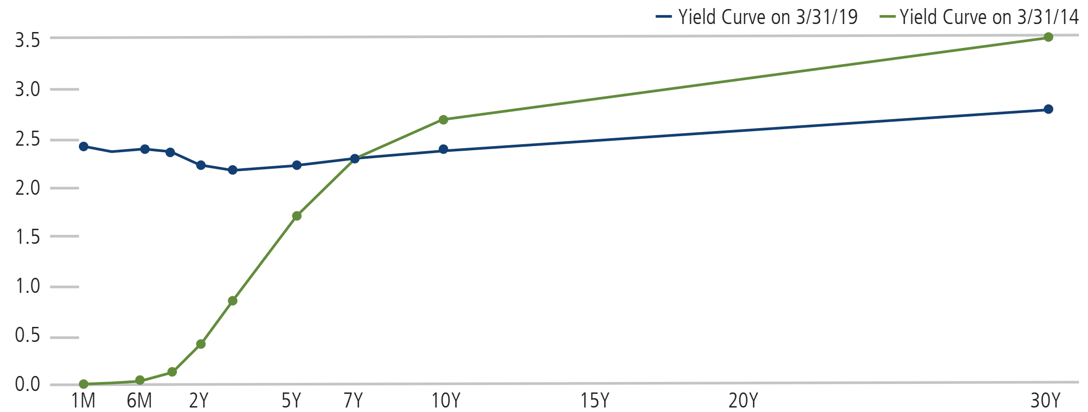
Availability of credit, to both business and consumers, is an important source of liquidity and impacts purchasing decisions. For instance, it may impact a business' decision to invest in a new plant. It might also influence the decision of a family to buy a new home or car. Those decisions, whether to move forward or hold off on investments and expenditures, drive the amount of aggregate spending in the economy. Gross domestic product, the primary measure of economic activity, is simply the total value of goods and services produced. So, you can see how credit conditions have direct implications for economic growth in a given cycle or year.

What is the yield curve telling us?

One of the most important sources of credit for businesses and consumers alike is the banking system. After all, the primary functions of a bank are to take deposits and make loans. Banks make decisions about whether or not to lend based on what level of profits they anticipate earnings from loans. Financial institutions favor positively sloped yield curves and provide a greater availability of credit to borrowers in that environment because they are incentivized to do so. A positively sloped yield curve generally improves bank profitability because banks typically borrow at lower, short-term rates and lend at higher, long-term rates. This is part of the reason the slope of the yield curve has had value as a leading indicator of recessions.

FIGURE 1. FLATTENING CURVE POINTS TO BUILDING PRESSURE

Yield curve: now (3/31/19) vs. five years ago (3/31/14)

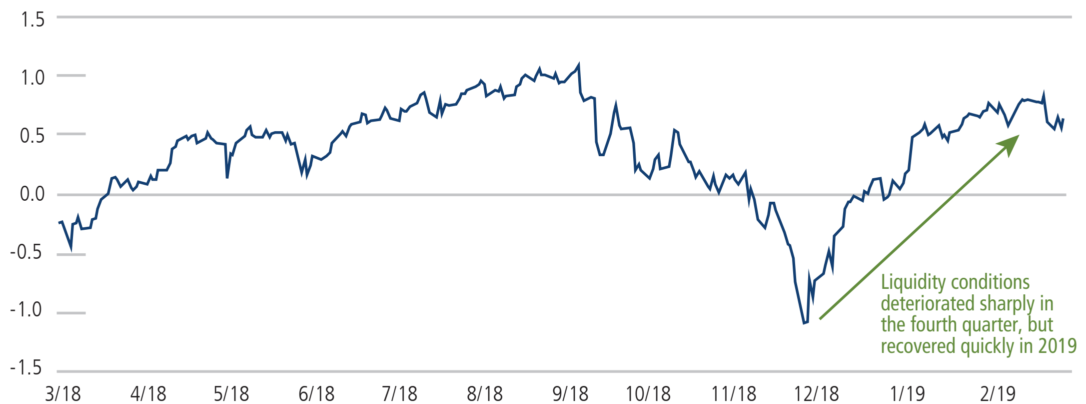


Source: Bloomberg.

Financial media has made most people aware that the yield curve is quite flat at this point. What some probably do not realize is the yield curve is a function of both higher short-term interest rates and lower long-term interest rates. Given the shape of the yield curve and the fact that it has been flattening quickly for several months, one might expect data to begin showing pressure on credit conditions. However, credit conditions are a major component of most financial conditions indices, which still indicate that liquidity is ample and borrowing conditions are favorable.

FIGURE 2. BROAD FINANCIAL CONDITIONS AND LIQUIDITY AREN'T YET SHOWING SIGNS OF STRESS

Bloomberg US Financial Conditions Index



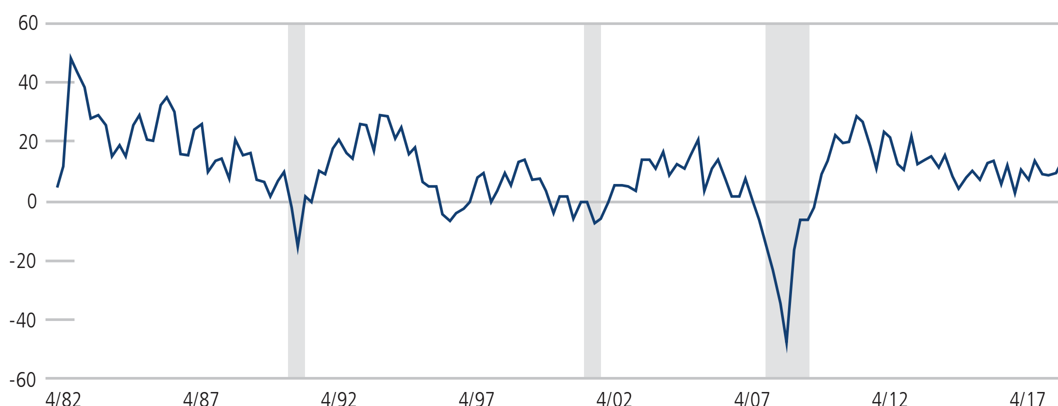
Source: Bloomberg. The Bloomberg U.S. Financial Conditions Index tracks the overall level of financial stress in the U.S. money, bond, and equity markets to help assess the availability and cost of credit. A positive value indicates accommodative financial conditions, while a negative value indicates tighter financial conditions relative to pre-crisis norms.

It's not the price you pay, it's whether you can get it at all!

One data series we track is beginning to show signs of tightening credit conditions for consumers. Each quarter, the Federal Reserve System polls senior loan officers at 80 large member banks as well as 24 U.S. branches of foreign banks. Lenders are asked whether they believe their bank is more or less willing to make consumer installment loans than the previous quarter. The Federal Reserve uses responses to derive a data series that displays the net percentage of domestic banks that are reporting an increased willingness to make consumer installment loans. Negative readings of the data indicate that system wide there is a contraction in the availability of consumer credit. For the reasons we discussed above, these contractions can be troublesome for credit fueled consumer sectors. Given that consumer activity represents 69% of overall domestic GDP, it has a significant impact the overall growth rate of the United States economy. In fact, in each of the past three economic cycles, the measure has turned negative either concurrently or in advance of an economic recession.

FIGURE 3. THERE HAS BEEN WORRISOME TIGHTENING IN CONSUMER BORROWING

US Banks Reporting Increased Willingness to Make Consumer Installment Loans (%). Recessions indicated by shaded areas.



Source: Bloomberg. Survey of up to eighty large domestic banks and twenty-four U.S. branches and agencies of foreign banks.

Conclusion

Availability of credit is vital to economic growth. We currently see mixed signals about credit conditions: The yield curve indicates pressure to the banking system and banks are close to reporting a contraction in the availability of consumer credit, but broader financial conditions indices continue to show favorable borrowing conditions, which contrast the United States with the rest of the world.

We still see no sign of imminent recession, but the sharp drop in this measure of the availability of consumer credit deserves close attention. We continue to search for corroborating signs that we are in the late innings of the economic cycle.

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