FEBRUARY CREDIT OUTLOOK

Conflicting Indicators Complicate the Fed’s Task

PMI Index

United States manufacturing sector contracted for a third straight month with PMI at 47.4% for the month of January. This is down 1.0% from the month of December and below estimates of 48.0%. Also, New Order Index fell by 2.6% to 42.5%. These metrics were expected as manufacturing weakness is tied to consumer demand dropping. Typically, any reading under 50.0% signals a contractionary phase in manufacturing. Overall, the start for 2023 looks to be soft with new orders falling and manufacturing on a steady downward trend.

Unemployment & Inflation

The unemployment rate fell slightly in January to 3.4% from 3.5%, which was the lowest rate since 1969. The U.S. added 517,000 jobs, which was the strongest in the last six months and it was more than anticipated by 185,000. The large increase was led by the service sector specifically in food and beverage. Inflation showed mixed results as it continued to ease for the seventh straight month going to 6.4% on a yearly basis but rose by a half percent monthly. The leading contributors continue to be housing, food, and energy. This data comes as a surprise because the economy and job market continue to show its resilience, which will complicate the Fed’s task of a smooth landing.

Insolvency

All chapters of bankruptcies saw an increase year-over-year in January and a 5% increase on a month-to-month basis. Total commercial filings were up 12% with Chapter 11 increasing by 70% and small business bankruptcies up at 49% when compared to a year ago. Companies continue to grow their debt as they struggle to find favorable financing in this elevated rate environment. As such, we expect bankruptcy to be an increasingly favorable restructuring option for most organizations.

CURRENT & EVOLVING CREDIT RISKS

Further Credit Deterioration

CCC+ and below ratings increased for US and Canadian entities by more than 15% in 2022, with 76% having a negative outlook or on credit watch. Additionally, the debt bubble almost doubled for this group and ended the year at $255 billion. We believe debt will continue to grow and ratings will continue to worsen, which will transition into credit defaults.

Loan Defaults on the Rise

The default rate increased to go over 2% for the fourth quarter of 2022 and marks two straight quarters of increases. The default rate for companies generating under $25 million in EBITDA jumped to 2.7%, an increase of 1.2% for the year. While companies generating over $50 million in EBITDA rose to 1.5%, an increase of .4% for the year. We believe this rate will surge as missed debt payments, distressed financing, restructuring, and bankruptcy filings increase.

Metrics Under Pressure

Rising interest rates and persistent elevated input costs will continue to pressure credit metrics. As financing conditions continue to tighten and demand slows because consumer purchasing power weakens, it will negatively impact the financial standings for most companies. We expect deterioration in margins, sales, cash flow, and debt service to occur as credit metrics become strained

U.S. Annual Inflation Rate