JANAURY CREDIT OUTLOOK

Mounting Pressures and Uncertainty Kick Off 2023

Inflation

Inflation continued to ease in December with the consumer price index coming down to 6.5% from 7.1%, compared to prior month. This marks 6 months of straight declines from its peak in June, which was attributed to gas and fuel. The inflation report will be welcomed by the Fed, but the target of 2% inflation is still far away. We expect continued monetary restrictions with smaller rate hikes of 50 basis points or less going forward. Additionally, manufacturing output continues to decline because of drops in new orders. Manufacturing contracted in the U.S. for the second straight month and Canada has seen 5 straight months of decline. The data signaled the sharpest decline since May 2020.

Unemployment

The unemployment rate fell to a half century low at 3.5% and the U.S. added 223,000 jobs, which was down by 38,000 from the prior month. Canada had similar results with the same unemployment rate and surprisingly strong demand for labor. There were 4.5 million jobs added in the U.S. in 2022, the second-highest annual total on record after 2021's 6.7 million. Overall, 2022 was a strong labor market, but the last 6 months showed a considerable slowdown. At the beginning of 2022, monthly payroll growth was averaging about 600,000 jobs but decelerated to finish the year averaging less than 250,000. Moreover, the second half numbers are likely inflated due to large influx of seasonal and part time hires. We expect added jobs will trend downward as seasonal hires exit, and layoffs continue because of economic uncertainty and weakness.

Insolvencies

December showed Commercial Chapter 11 filings were up just 2% while small business subchapter V bankruptcies were up at 13% when compared to a year ago. All bankruptcy filings increased in December when compared to last year, but subchapter V had the most sizable increase of 51%. Canadian business insolvencies for the 12-month period ending November 30, 2022, increased 37.8% compared the same period last year. The sectors hit most were mining, oil and gas extraction, and finance/insurance. Companies are facing large economic pressures in 2023 with raising interest rates, inflationary pressures, and growing debt loads. We expect bankruptcies to continue to trend upward as companies utilize it as a financial reset.

CURRENT & EVOLVING CREDIT RISKS

Default Rates

U.S. loan default rates for the year ended at 0.72%, which is low and under the historical average. However, this indicator is misleading as downgrades continue to outpace upgrades and loans are becoming more distressed. Most credit managers agree defaults were low this past year, but 88% agree and expect increasing defaults going forward. It's clear, credit defaults are on the radar entering 2023 as financial conditions tighten, with default rates expected to triple towards the 2.0% to 3.0% range.

2023 Outlook

Rating agencies forecast North America credit losses for banks at $138 billion combined for the current and following year. Additionally, the other forecast calls for roughly 43% deterioration across all sectors in 2023, which is a significant when it was only 1% for 2022. The post pandemic recovery is vanishing with governmental assistance fading, consumer demand eroding, and tighter refinancing conditions. We expect this trifecta to plague credit conditions for the rest of the year.

U.S. Annual Inflation Rate