JULY CREDIT OUTLOOK

Surging Insolvency and Ballooning Interest Expense

PMI Index & Unemployment

The U.S. manufacturing rate was 46.0% on the ISM Index for June, which decreased by 0.9% from prior month. Any reading under 50.0% is contractionary, marking eight straight months of declines. Furthermore, the five subindexes that are factored into this metric; none were in the growth category signaling a shrinking manufacturing sector. However, the U.S. did add 209,000 jobs in June with wages growing by 0.4% and job cuts fell to an 8-month low. The unemployment rate was unchanged in April at 3.6%, still hovering at a decade low.

Inflation

Inflation for the month of June came in at 3.0%, which is down 1.0% from the prior month, signaling its deacceleration. It has fallen roughly two thirds from a year ago and this marks 12 straight months of declines with its lowest level since March 2021. However, core CPI is still running hot at 4.8% with rent and shelter accounting for 70% of these gains. The Fed will be happy with the direction, but core CPI is a better long-term measure. Given the above, we are expecting a small rate hike by the Fed.

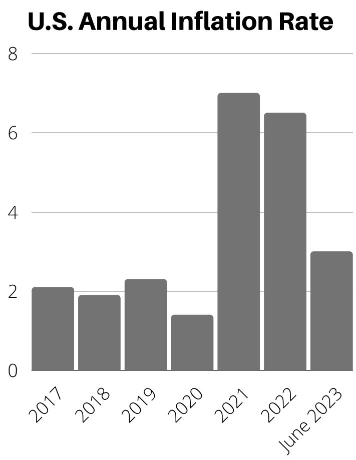
Insolvency

Total filings are up 17% for the first half of the year, when compared to the same period last year. A breakdown shows commercial filings are up 18% and small business filings jumped to 55% when looking at the same time frame. A deeper dive on a monthly basis from the previous year shows commercial filing increased by 12% and small business bankruptcy swelled to 111%. Overall, we believe this trend will worsen as companies try to weather higher rates with limited liquidity options.

CURRENT & EVOLVING CREDIT RISKS

Defaults Climbing

Covenant defaults have risen in the last 5 quarters with loan defaults at 1.86%, surpassing the 10-year average. Defaults are rising at a pace unseen since 2014 and downgrades continue to outpace upgrades for 13 consecutive months. Additionally, selective defaults account for 50% of all defaults this year and a third default again in less than 2 years. Overall, future credit conditions will likely be challenged and progressively worsen.



Debt Challenges

The outlook for debt servicing has taken a pessimistic turn; interest expense has doubled while debt levels remain the same. Additionally, the fixed charge coverage ratio is declining, which is concerning because it measures the ability to pay debt and interest expense. Furthermore, lenders have taken note as they are restricting debt loads through the underwriting process. As performance declines so does risk appetite for lenders and they shift towards risk aversion by tightening up credit policies.

Liquidity

As corporate earnings come under increasing pressure, many face upcoming maturities as well. Companies with lower credit quality may begin to experience tight liquidity. Tightening credit standards will add to the difficulty.