JUNE CREDIT OUTLOOK

Manufacturing Weakness, Higher Borrowing Costs, Defaults Rising

PMI Index & Unemployment

U.S. employers added 339,000 jobs in May, surpassing forecasts. However, the unemployment rate rose to 3.7% (slightly higher than April's 3.4%). We also note that employers appear to be feeling some of the effects of higher interest rates. Layoffs in May reached 80,089, a 20% increase compared with layoffs in April. Employers so far this year have cut 417,500 jobs, the largest amount in this time period since 2020, and have largely been concentrated in the tech sector. As for manufacturing data, PMI surveys are showing readings below 50 (indicative of declining activity) in many countries. U.S. PMI registered 46.9 percent in May, which is the seventh consecutive month of contraction. Tightening credit conditions and slowing macroeconomic activity continue to weigh on manufacturing.

Inflation

Inflation slowed in May, rising just 0.1% from April. This is the smallest monthly increase since March 2021 and brings the 12-month inflation rate down to 4.0%. The Federal Reserve is unlikely to raise interest rates at its June meeting, after raising rates at its last 10 meetings. However, we expect the Fed to keep rates high through at least the rest of the year, as both the job market and inflation remain stronger than expected.

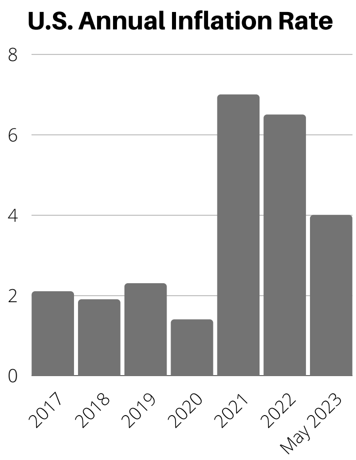
Insolvency

Commercial Chapter 11 filings continue to surge, as May data showed Chapter 11 filings doubled over the same period last year. Overall commercial filings increased 31% as businesses deal with elevated borrowing costs and sustained economic pressure. Small business filings were also up 31% year over year. Cheap money is a thing of the past. We expect the default rate to climb through the rest of the year.

CURRENT & EVOLVING CREDIT RISKS

PE-Backed Debt Hangover

Bankruptcies of PE-owned businesses in the United States are starting to rise, already doubling 2022 filings through the first five months of 2023. PitchBook data shows at least 18 PE-backed companies filed for bankruptcy in the U.S. during the first five months of 2023. This is a sign that many of these businesses are struggling to service their debt. One reason for the increase in bankruptcies is that many PE-backed companies have floating-rate debt. Floating-rate debt means that the interest rate on the loan can change over time, based on market conditions. As interest rates have risen in recent months, the cost of debt has also increased.



Cause for a Pause?

Cooling inflation has relieved some pressure on the Federal Reserve. It appears that the Fed will leave rates unchanged at its June meeting today, but additional tightening is still possible in the months ahead according to some analysts. Either way, elevated interest rates continue to weigh on corporate credit.

Strict Lending Standards

Banks are implementing stricter lending standards following the recent banking sector turmoil. This clamp-down will make for more difficult financing options. Higher-risk borrowers could also find themselves with no access to financing. Given this, we can expect more liquidity strains for the remainder of the year.

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