SEPTEMBER CREDIT OUTLOOK

Credit Risk to Remain Elevated in Q3 as Optimism Fades

Economic Update

The U.S. manufacturing rate remained in contraction for the 10th straight month ending August with PMI at 47.6%. Unemployment rose to 3.8% from 3.5% with 187,000 jobs added, which was above expectations. Inflation rose to 3.7% marking a .6% increase month over month, which marks two straight months of increases along with the largest jump in over a year. The increases are attributed to gasoline prices remaining elevated due to production cuts and sanctions. It's highly likely the Fed will raise rates to continue its tightening to lower inflation. Overall, growth is slowing, and labor demand has declined, signaling a cooling economy. Given this, it's still widely believed the economy will grow around 2% in 2023 and just above 1.0% in 2024 with potential rate cuts rates in the first half of 2024 to stimulate economic growth if we tip into recession.

Insolvencies

Total bankruptcy filings continued to trend upward in August as they increased by 18%, when compared to the same month last year. A breakdown shows commercial filings are at 54% and small business filings continued to stay elevated at 43% within this same timeframe. August shows all filings moving upward when compared to the previous month and it marks 13 consecutive months of total commercial bankruptcy filings increasing on a year-to-year basis. Bankruptcy is becoming more of a reality as companies find it more difficult to find their financial footing amid these turbulent macroeconomic conditions.

State of Corporate Credit

Credit risk continues to trend up as challenging macro conditions persist. Changes in consumer preferences to services from goods are pressuring demand and earnings overall. We continue to see downside risks, especially in metals, chemicals, packaging, plastics, and transportation. All these factors spell higher potential for payment slowness and credit losses as companies grapple with a new normal.

CURRENT & EVOLVING CREDIT RISKS

Maturity Problem

This year has proven to be the weakest for loan issuance in ten years based on heightened rates. While maturities heading into 2024 are the highest with a $2.0 trillion debt wall that needs to be addressed over the next two years. It's clear, impact of aggressive rate hikes will be felt in the future and refinancing risk will continue to plague credit ratings.

Default Forecast

The 2023 default rate will be just above 3.0% and in 2024 at around 5.0%. Furthermore, if the economy takes a nosedive the worst-case scenario would be roughly 6.0% or more. Overall, it's widely believed defaults will rise as August defaults were the highest since 2009. Liquidity, cash flow generation, and debt service coverage will remain in focus.

High Leverage

As leverage becomes more of a credit concern, a greater emphasis is being put on a company's ability to pay its debt and interest. Although overall interest coverage ratios are better now than before 2020, we continue to see erosion of this cushion.