The US credit cycle: how much should it concern us?

In 2019, the US will reach the longest economic expansion in its modern history if, next July, it surpasses the record of 40 quarters held by the expansion of 1991-2001. That said, it is likely that over the coming quarters economic activity will slow down due to the very maturity of the economic cycle and the fading of the fiscal stimulus implemented in late 2017. Thus, the economy may find itself in a context in which, due to the conjunction of lower income growth among households and firms and higher interest rates implemented by the Fed, financial vulnerabilities that have accumulated over the last few years may be uncovered. Among them is the indebtedness of households and firms, the state of which we analyse below.

Debt and credit follow cyclical trends similar to those of the business cycle, with phases of expansion and recession. In the former, there is an increase in the volume of credit and an improvement in the conditions under which families and businesses can borrow (for example, with lower interest rates or fewer collateral requirements). The latter are characterised by a tightening of access to credit, an increase in the rate of non-performing loans and a contraction in the volume of debt. Later, as firms and households clean up their accounts and manage to improve their risk profile, credit begins to flow once again and the cycle reenters the expansionary phase.

Where does the US credit cycle stand at present? The non-financial private sector (i.e. families and non-financial corporations) has reduced its indebtedness from 170% of GDP in 2008 to below 150% in 2018. However, we must look beyond these figures to distinguish between household and corporate indebtedness, since they often follow different trends,[1] as well as analysing its evolution in comparison with other expansionary phases.[2]

On the household side, in the current expansionary phase, mortgage debt and consumer debt are following different paths. While, on the one hand, the burden of mortgage debt on households' disposable income has fallen by more than 40% from its peak in 2007, the burden of debt for consumption purposes has risen steadily since 2012 and at an average annual rate of 0.6% (see second chart). Even so, given that mortgage debt is a significant part of total household debt, the household debt service as a whole lies below 10% (compared to a high of 13.2% in 2007) and at an all-time low since the data series began (1980). The decline in the debt burden not only reflects a reduction in debt, but it has also been facilitated by the low interest rates that have prevailed in recent years (much of the debt has been contracted at a fixed rate, while old debt contracted at higher rates has been maturing). Finally, another noteworthy trend is the sharp decline in the use of home equity lines of credit (consumer loans in which the home is used as collateral). Therefore, as a whole, household debt represents

1. For example, at present, the credit-to-GDP gap is negative for households and positive for the non-financial corporate sector.
2. We analysed economic expansions according to the classification of the NBER (1983-1990, 1991-2001, 2002-2007 and 2009-present).

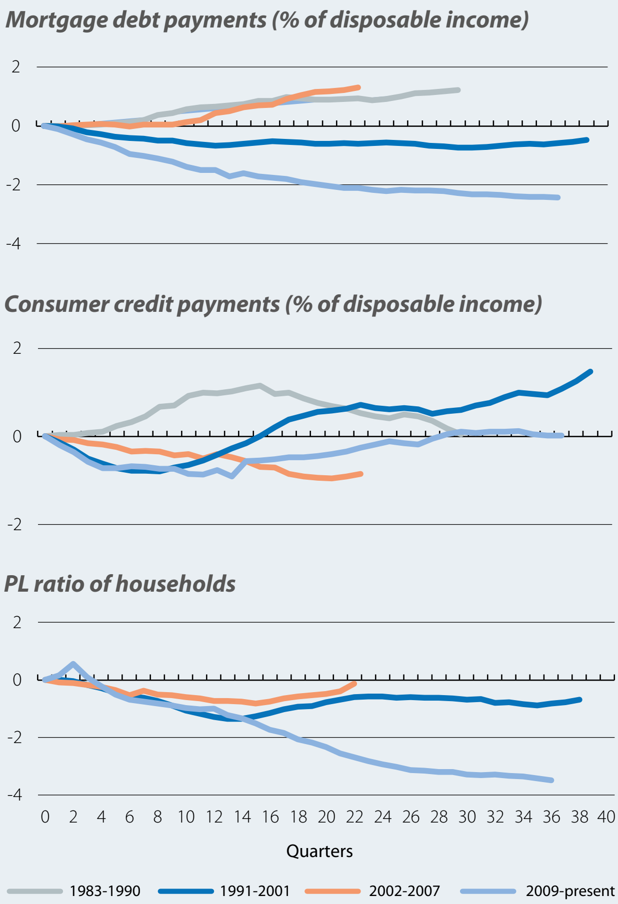
US: private debt

Indicator	Current	High-point of the financial crisis	Average of the current cycle
Non-financial private debt (% of GDP)	147.6	171.1	152.3
Household debt (% of GDP)	75.0	98.6	83.0
Mortgage debt (% of GDP)	49.7	73.5	57.8
Household NPL ratio (%)	2.5	6.6	4.1
Non-financial corporate debt (% of GDP)	72.6	72.5	69.3
Corporate sector credit spread *	274	1,165	369

Note: * Differential between the interest rates on corporate bonds with a BBB rating or above and those with a BB rating or below.
Source: CaixaBank Research, based on data from the Federal Reserve and the Federal Reserve Bank of St. Louis.

The credit cycle: households *

Cumulative change in pps vs. the beginning of the cycle



Note: * All series are standardised to 0 at the beginning of the expansionary phase determined according to the NBER. The non-performing loan ratio of households includes both consumer loans and mortgages, weighted according each one's relative importance.
Source: CaixaBank Research, based on data from the Federal Reserve Bank and the Federal Reserve Bank of St. Louis.

a clearly more moderate source of risk than in the previous expansionary phase. Furthermore, looking ahead to the next few quarters, the strength in the labour market should allow the non-performing loan rate to remain at low levels.

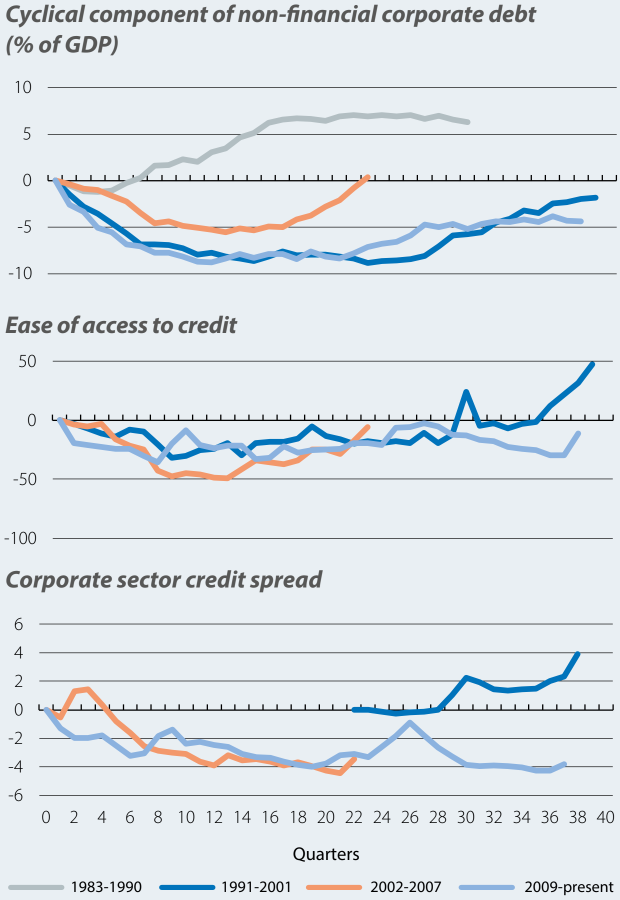
On the side of non-financial corporate debt, the picture is less rosy. Standing at 73% of GDP, corporate debt is currently around its all-time highs, although, as noted in the last chart, the cumulative increase in the current phase of the cycle has occurred more slowly than in previous expansionary phases. Nevertheless, in view of these levels, indicators such as the ease of access to credit can help us to clarify whether the increase in this debt might signal the beginning of a later phase in the credit cycle.

As the second panel of the third chart shows, expansions begin with an improvement in the ease of access to credit[3] (for example, because the positive economic outlook improves borrowers' credit profile). In contrast, in the final stages of the expansion, the deteriorating growth outlook and lower risk tolerance tend to tighten conditions for access to credit. In this regard, the latest data show that in Q4 2018 there was a tightening of credit conditions. On the one hand, this could be a temporary blip (it is the first tightening of conditions in almost three years) as a result of the financial turmoil experienced in the closing weeks of the year. However, some analysts suggest that this is already a sign of greater caution in lending to the corporate sector, due to an anticipation of the possible deterioration in borrowers' credit profile and in the value of collateral.[4]

On this note, the third panel of the third chart shows that, in Q4 2018, there was a slight increase in the risk premium on the debt of companies with a worse credit profile,[5] although it remains at historically low levels. In fact, the same chart indicates that, in the last two expansions, this differential has tended to contract over the course of the business cycle. In other words, the maturity of the expansion has been accompanied by a reduction in the cost of financing for companies with a low credit score. However, this can lead to a deterioration in the quality of the total debt that exists in the market, given that companies with a riskier credit profile can be financed at a relatively lower cost. In this regard, both the IMF and the Fed have warned about the increase in new lending to companies that are already heavily in debt. In particular, they highlight the fact that, in the US, new debt issued by highly leveraged companies has gone from representing slightly more than 20% of the total in 2010 to over 60% in Q3 2018.[6] The concern is that, faced with a tightening of credit conditions (such as a deterioration in the macroeconomic outlook), these companies could find themselves facing difficulties servicing its interest and principal payments, which could amplify the effects of the economic slowdown.

The credit cycle: non-financial companies *

Cumulative change in pps vs. the beginning of the cycle



*__Note:__ * All series are standardised to 0 at the beginning of the expansionary phase determined according to the NBER. In the first panel, the cyclical component is estimated using the Hodrick-Prescott filter. The second panel shows the percentage of financial institutions that tighten access to credit, according to the responses to the survey by the Federal Reserve. Higher values correspond to a tightening of access to credit, while lower values indicate greater ease of access to credit. In the third panel, we show the differential between the cost of financing for companies with a rating equal to or greater than BBB and for companies with a BB rating or below. Data for this indicator are only available from 1998.*

__Source:__ CaixaBank Research, based on data from the Federal Reserve and the Federal Reserve Bank of St. Louis.

All in all, the credit cycle is at a point at which some signals indicate that the expansionary phase still has some way to go, while others point towards pockets of vulnerability. In particular, the increase in the indebtedness of firms that are already highly leveraged poses a risk that could be activated either in the case of a more sudden-than-expected slowdown in economic activity or in the event of signs of overheating that force the Fed to increase interest rates.

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3. According to the data from the Senior Loan Officer Opinion Survey, a survey in which financial institutions indicate whether they are tightening or relaxing conditions for access to credit compared with the previous quarter.
4. Capital Economics (2019), «Tighter lending standards point to further slowdown».
5. In particular, the differential between bonds issued by companies with a rating of BBB or above and those with a rating of BB or below.
6. Highly leveraged companies are considered to be those with an EBITDA ratio (earnings before interest, tax, depreciation and amortisation) greater than 5. For more details, see L. Brainard (2018). «Assessing Financial Stability over the Cycle». Federal Reserve Board.