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

- **Vulnerabilities in the US credit cycle will probably not be the trigger for the next recession. However, they could amplify the slowdown in the US economy.**
- **Specifically, we estimate that if these vulnerabilities are activated, they could result in a tightening of financial conditions that would subtract between 0.3 and 0.7 pps from GDP growth in 2020.**

Having analysed the state of private credit in the US in two previous articles,[1] we close the series by answering the most frequently asked questions regarding the business cycle and the US credit cycle.

What is the current situation of the US economy?

Since this July, the US economy has been in the longest expansionary phase in its history, with the unemployment rate at its lowest in 50 years and inflation close, though slightly below, the target rate of 2%. Due to the very maturity of the business cycle and the fading of the fiscal stimulus of late 2017, economic growth is expected to fa decelerate towards its potential over the coming quarters. In fact, the most recent indicators suggest that this slowdown is already gradually occurring. However, in recent quarters the downside risks (especially those of a geopolitical nature) have intensified, and this is undermining economic sentiment at present.

What is the current situation of private debt?

On the one hand, households have undertaken a major deleveraging process, led mainly by mortgage debt. In addition, new issuance of mortgages has fallen and has been steered towards households with a reasonably solvent credit profile. Thus, the situation is much less worrying than in the years leading up to the Great Recession and the vulnerabilities are to be found in areas that are quantitatively of less importance (such as student debt).

As for non-financial corporations, debt has increased substantially in recent years and has surpassed the levels seen prior to the Great Recession. Normally, significant debt growth is associated with greater risk-taking and a deterioration in the quality of the debt, which can lead to vulnerabilities. Indeed, the current case of the US is no exception. Based on our prior analyses, we can highlight three vulnerabilities: the increase in debt with a BBB rating, the reduction in the use of covenants that protect the investor and the increase in lending to companies that are already highly leveraged.

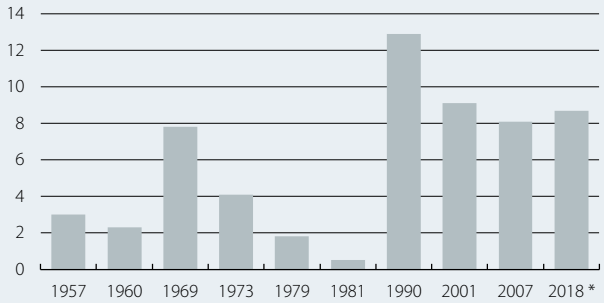
1. See «The US credit cycle: how much should it concern us?» in the MR04/2019 and «The US credit cycle: how much should it concern us? Part II» in the MR06/2019.

Will private credit be the trigger for the next recession in the US?

Several factors suggest that, at present, the trigger for the next recession is less likely to be the credit cycle itself than on prior occasions. On the one hand, as we have discussed, the status of household debt is relatively comfortable. On the other hand, the increase in non-financial corporate debt has been significant but, nevertheless, relatively more moderate than in previous episodes (and supported by an environment of low interest rates that makes the debt burden more bearable). As an example, the ratio between non-financial corporate debt and GDP has risen by 8.7 pps between 2009 and 2018, whereas it increased by 9.1 pps between 1991 and 2001 (see first chart). In addition, the regulatory changes motivated after the financial crisis have forged a financial system that is more robust and has more liquidity, making it better prepared to deal with episodes of stress. Finally, despite having highlighted some vulnerabilities in specific sectors, a very large portion of the corporate sector is enjoying somewhat healthier finances.

US: growth of non-financial corporate credit prior to recessions

(pps)



Notes: *Cumulative growth of non-financial corporate debt as a percentage of GDP between the minimum and maximum point of the business cycle, as defined according to the NBER.*
** Latest available data for Q4 2018.*
Source: *CaixaBank Research, based on data from the Bank for International Settlements and the National Bureau of Economic Research.*

So how can private debt determine the economic outlook?

Of the 33 recessions that have occurred in the US since 1857, few have been triggered by private debt. Nevertheless, this class of debt tends to have a significant

role in most of them: there is consensus in the economic literature that private debt amplifies adverse shocks. In this regard, the risks surrounding US corporate debt should be considered sources of vulnerability that could be activated by the economic slowdown, such that they could accentuate the moderation of growth.[2]

How does the amplifying role work?

Credit can amplify adverse shocks through a reduction in new lending, which in turn restricts consumption and investment. For instance, if the deterioration in the economic outlook is accompanied by a reduction in the price of assets, it will also decrease the value of the guarantees that borrowers can use to back their borrowing and, therefore, their borrowing capacity will be reduced. On the other hand, in the final stages of economic expansions credit conditions tend to be tightened, since there is a reduction in growth expectations and, therefore, a higher likelihood of default is expected.

How can the vulnerabilities identified affect the financial conditions of the economy as a whole?

On the one hand, a widespread reduction in the valuation of corporate debt driven by the loss of investment grade status (a common phenomenon during economic recessions) tends to provoke forced sales of this type of debt. Among other consequences, this increases risk premiums and the cost of debt for firms.[3] On the other hand, the rise in the debt of firms that are already highly leveraged, as well as the reduced use of clauses that protect the investor, can accentuate defaults.

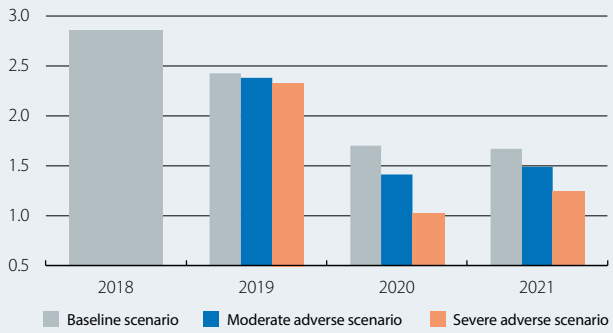
With these two mechanisms in mind, we built two scenarios involving a tightening in the financial conditions, based on the historical relationship between the Federal Reserve Bank of Chicago's National Financial Conditions Index (NFCI), on the one hand, and the percentage of debt with a BBB rating and the delinquency rate of the corporate sector, on the other. In particular, if we assume that the BBB ratio and the delinquency rate will follow a similar path to those seen in other episodes of financial stress, the NFCI would increase by around 0.4 and 0.8 pps in the moderate and adverse scenarios, respectively. To put these figures into context, they are similar to those of the Asian crisis of 1997, in the first case, and half as severe as the Great Recession, in the second.

2. Jorda, Schularick and Taylor show that recessions that have been preceded by sharp increases in non-financial corporate debt have proved to be more severe and longer. See 0. Jorda, M. Schularick and A. Taylor (2013). «When Credit Bites Back», Journal of Money, Credit, and Banking 45(s2): 3-28. And J. Bridges and C. Jackson (2017), «Down in the Slumps: The Role of Credit in Five Decades of Recessions», Bank of England Working Paper n° 659.

3. See S. Çelik, G. Demirtas and M. Isaksson (2019). «Corporate Bond Markets in a Time of Unconventional Monetary Policy», OECD Capital Markets Series, Paris.

US: GDP growth scenarios

Annual change (%)



Note: *In the «moderate adverse» scenario, a 0.4-pp tightening of financial conditions is estimated, derived from a 4-pp drop in the BBB-rated debt ratio and a 1-pp increase in the delinquency rate. The «severe adverse» scenario contemplates shocks of approximately twice the magnitude. The shock begins in Q3 2019.*

Source: *CaixaBank Research, based on data from the Federal Reserve Bank of Chicago, the Federal Reserve and the Bureau of Economic Analysis.*

How much would a tightening of financial conditions undermine economic growth?

Assuming these shocks in the NFCI, and based on the historical sensitivity of US GDP growth to financial conditions, the resulting tightening of financial conditions could subtract between 0.3 and 0.7 pps from GDP growth over the next year (see second chart) and accentuate the slowdown in the economy. Although these figures alone do not seem sufficient to drag the US economy into a recession, if they were to interact with other risks threatening the economy (such as trade tensions),[4] we could end up seeing negative growth rates.

Finally: how much should the US credit cycle concern us?

We should not be complacent with the current levels of private credit. However, our analysis suggests that, rather than being the trigger for the next recession, we should consider them a vulnerability that could amplify the slowdown in the economy. In other words, this role as an amplifier of adverse shocks makes the US economy less resistant to a potential deterioration in the economic outlook. Such a deterioration could be triggered, for instance, by an intensification of the trade tensions or further US government shutdowns. It is this last point that represents the main source of concern for the credit cycle.

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4. See «The threat of protectionism in the global economy» in this same *Monthly Report*.