ClearBridge Investments

Credit Quality Suggests Cycle Not Over Just Yet

May 1, 2019

Key Takeaways

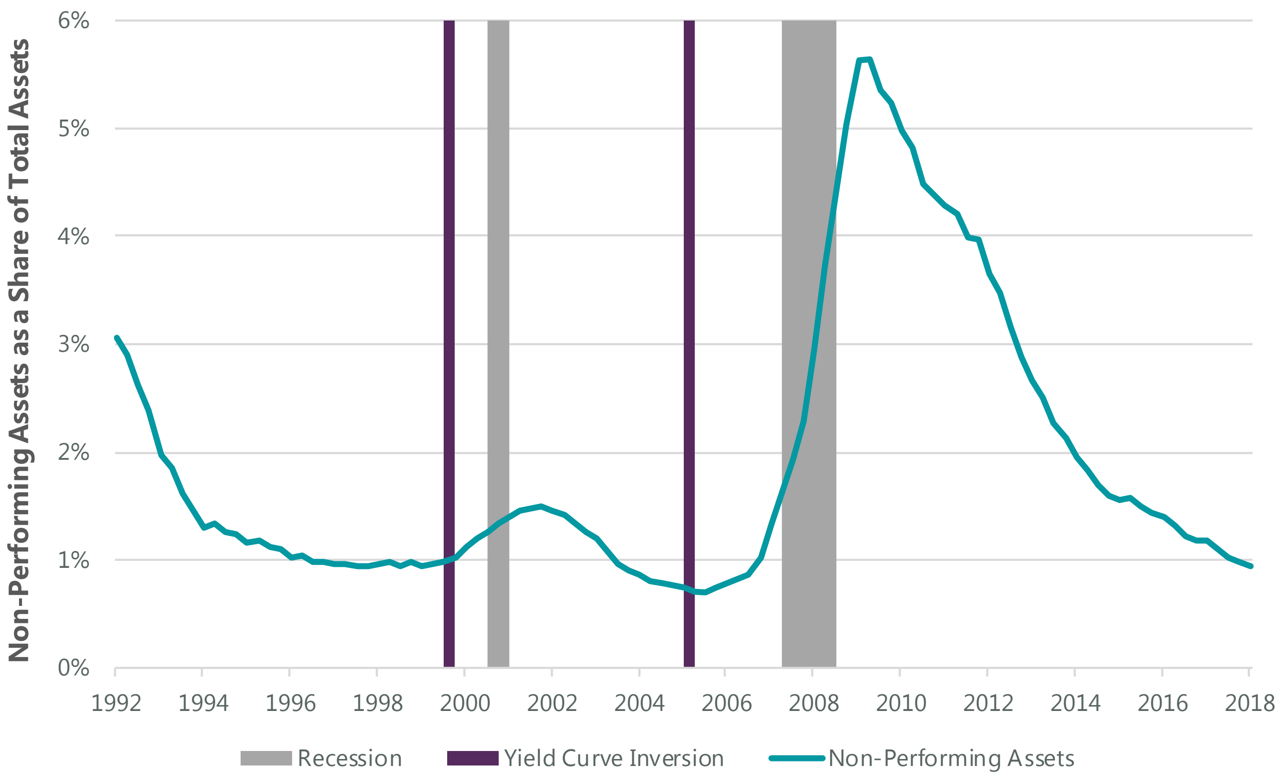
- The non-performing assets ratio (NPAs) can help give investors important clues about credit quality, which tends to worsen ahead of recessions. NPAs appear to be rising modestly but remain at low levels.
- Higher debt levels are less worrisome than they might appear, given higher corporate profit margins and low interest rates. Comparing debt to corporate profits shows that aggregate corporate leverage is within its historical range.
- With corporate leverage levels not at extremes, NPAs remaining healthy, and the overall signal for the ClearBridge Recession Risk Dashboard still in "green" expansionary territory, we believe the current economic cycle still has room to run.

Non-Performing Assets Ratio Tends to Rise Ahead of Recessions

With the yield curve briefly inverting in March, many investors are looking for additional data points that can help confirm (or deny) if a recession is indeed on the horizon. In addition to the 12 signals on the ClearBridge Recession Risk Dashboard, we also monitor credit conditions. Some investors have pointed to the rapid growth in debt since the last financial crisis as a harbinger of bad things to come. Our analysis finds that higher debt levels are less worrisome than they might appear, given higher corporate profit margins and low interest rates. Most importantly, credit conditions remain healthy at present, leaving us optimistic about the economy over the balance of the year.

Many investors believe fixed income markets lead equity markets, although this is not always the case. We monitor several credit metrics we believe can help investors garner a better picture of the economic and market environment. These include leverage and interest coverage ratios, lending standards and other early warning signs from banks such as NPAs. While the historical dataset is somewhat limited, in the past two market cycles NPAs started to rise well before the onset of each recession, as borrowers began to encounter difficulty making debt payments as the economy softened. Further, the "low" in NPAs has historically aligned with the inversion of the yield curve. As a result, we believe that monitoring NPAs (and credit conditions broadly) can help investors looking for clues about the future path of the economy.

Exhibit 1: Non-Performing Assets Lows Align with Yield Curve Inversions



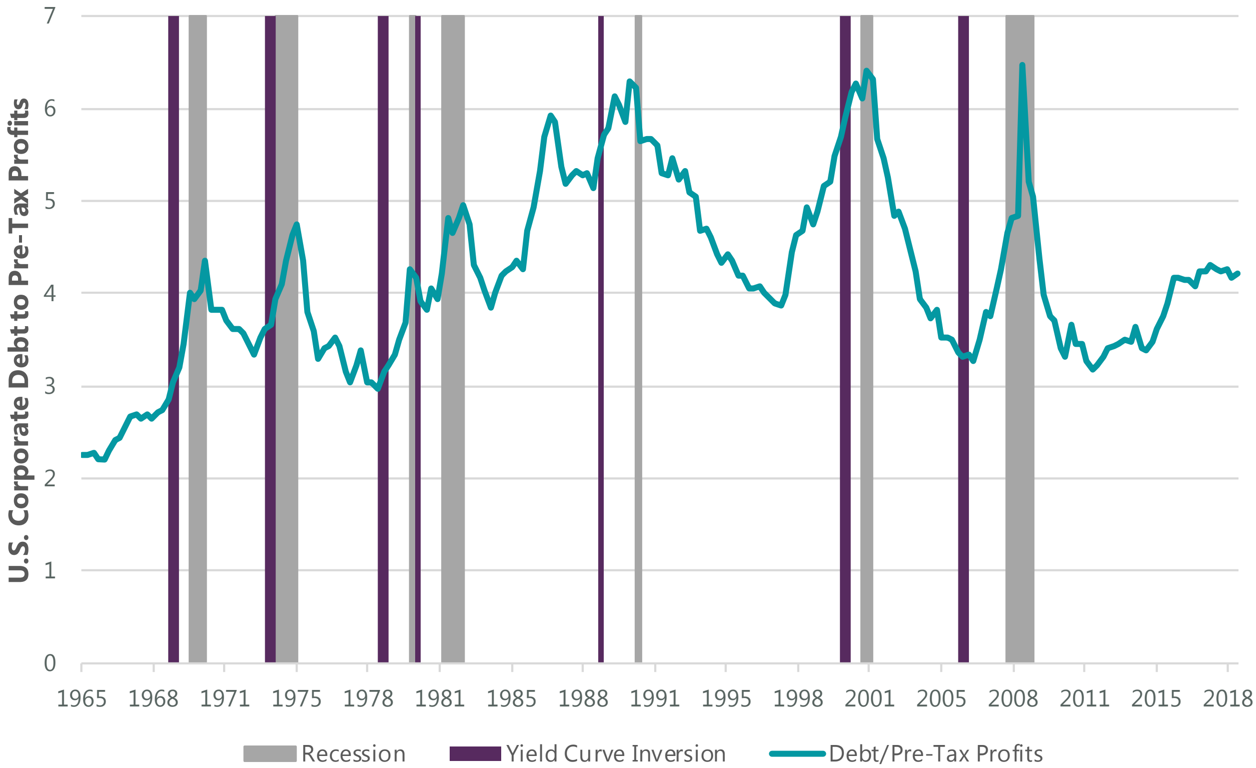
As of Dec. 31, 2018. Source: Federal Reserve, NBER, and Bloomberg.

While we are still in the midst of the first-quarter reporting season, 21 publicly traded large banks have reported results so far, with 13 showing an increase in NPAs and the industry-wide trend on pace for a modest increase. This marks only the third quarter in the last seven years where NPAs have risen. While it remains to be seen if this will mark the turning point or just a hiccup, we believe it is important to continue to monitor credit quality broadly as we move later into the economic cycle.

Corporate Leverage Within Historical Range

While NPAs may not be showing signs of stress just yet, the overall amount of borrowing in the system has risen tremendously in recent years. Many prognosticators point to record-high leverage ratios such as government and corporate debt/GDP ratios and suggest this could indicate turbulence on the horizon. However, we believe these fears may be misplaced because leverage levels — as would be typically measured by an investor — are actually within their historical range. Investors typically look at debt (net of cash on the balance sheet) relative to some measure of profits, such as earnings before interest, taxes, depreciation and amortization (EBITDA). They do so because things like corporate margins impact a company's capacity to borrow. As margins rise or fall, the company has more (or less) profit per dollar of sales and thus can manage varying amounts of debt. Debt/GDP ratios — which are somewhat akin to debt/sales — miss this dynamic by looking at the very top of the income statement. While no EBITDA measure exists on a national level, the chart below measures debt/pre-tax profits and shows that aggregate corporate leverage is within its historical range.

Exhibit 2: Corporate Leverage at Normal Levels

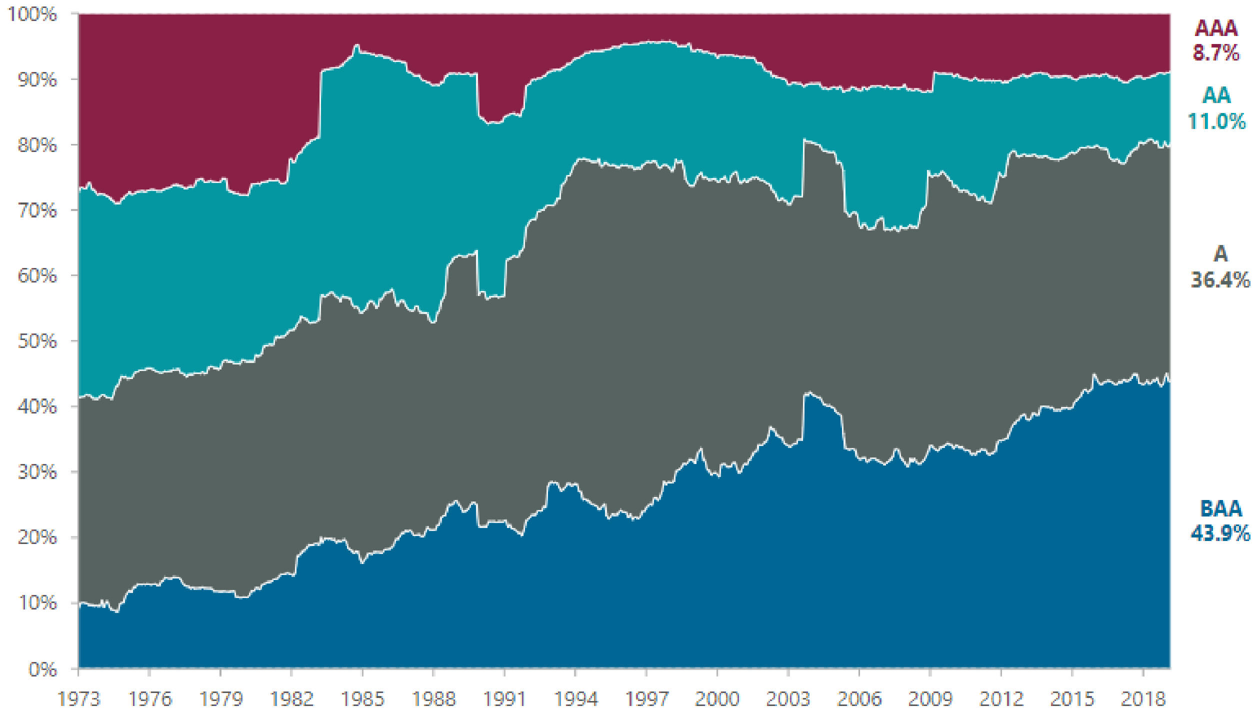


As of Dec. 31, 2018. Source: Federal Reserve, BEA, NBER and Bloomberg.

Expansion of BBB Credit: Risks & Opportunities

Over the last several years, low rates and narrow credit spreads have resulted in a trend toward a greater share of BBB (or Baa as measured by Moody's) credit in the marketplace. In fact, this trend can trace its roots back decades and does not show any sign of abating soon. When the cycle eventually does turn, the increase in lower-quality debt could lead to higher loss ratios and lower recovery rates than seen in past cycles. Additionally, companies that become "fallen angels" — those that fall below an investment grade rating — typically face an increase in funding costs in the smaller and less-liquid high yield market. Further, many of the previous institutional holders of this debt, such as pensions and insurance companies, are precluded from holding high yield debt, leading to additional selling pressure. On the bright side, this presents an opportunity for active equity investors who can distinguish between businesses that can withstand a downturn and those that cannot.

Exhibit 3: U.S. Credit Quality Deterioration



As of March 31, 2019. Source: Strategas Research Partners and Bloomberg Barclays.

However, with corporate leverage levels not at extremes, NPAs remaining healthy, and the overall signal for the ClearBridge Recession Risk Dashboard still in "green" expansionary territory, we believe the current economic cycle still has room to run.

About the Author

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