Unlocking the Credit Cycle

By Tom Fahey, VP, Senior Global Macro Strategist, Associate Director of Macro Strategies, Portfolio Manager

KEY TAKEAWAYS

- Borrowing and spending help sustain global demand and feed credit creation.
- The ebb and flow of credit creates boom and bust asset price cycles.
- A well-developed credit cycle framework is integral to tracking the interaction between credit and asset prices.

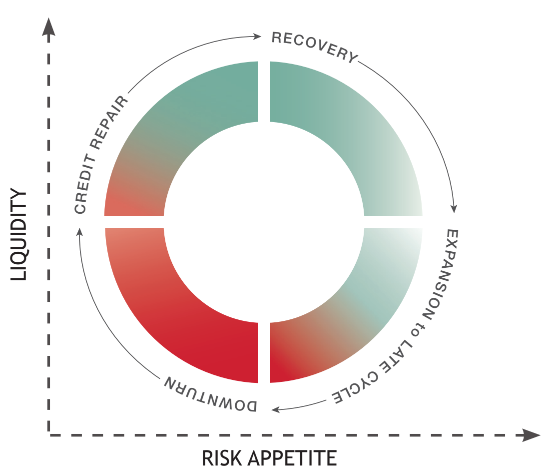
Credit, profits, liquidity and risk appetite are always in motion and can meaningfully impact asset prices. For an investor to identify attractive investment opportunities, a view on the complex global credit cycle is critical.

At Loomis Sayles, we developed our top-down credit cycle framework to analyze changing credit conditions, provide a common language and boundaries for credit cycle phases and furnish practical insights to our investment teams. We break the credit cycle into four phases—downturn, credit repair, recovery, and expansion to late cycle—informed by our measures of risk appetite and liquidity.

Our Definition of the Credit Cycle

At its core, our credit cycle framework analyzes who in the global economy is borrowing and spending, and who is saving and deleveraging. Borrowing and spending is expansionary and helps sustain economic growth, while the mirror image, saving and deleveraging, is contractionary and a headwind for growth. The ebb and flow of credit interacts with the business cycle and creates a familiar pattern of boom and bust asset price cycles.

PHASES OF THE CREDIT CYCLE



Pinpointing where we are in the credit cycle is difficult. Many factors drive the cycle, such as who is borrowing and spending, access to credit, financial intermediary balance sheet management, risk appetite, profits, incomes and liquidity. Unpredictable human behavior, such as fear and greed, influences these variables and further frustrates analysis. Moreover, countries, sectors and companies are simultaneously moving through different credit cycle phases, which increases complexity but can help identify relative value investment opportunities. Given the challenges in identifying where we are in the credit cycle, a well-developed framework is integral to tracking the interaction between credit and asset prices.

Borrowing, Spending and Balance Sheets

Before examining the complexities of each credit cycle phase, an overview of how balance sheets link the credit cycle to saving, borrowing and spending is vital. For us, an important question is: Are companies managing their balance sheets to entice equity shareholders or credit investors?

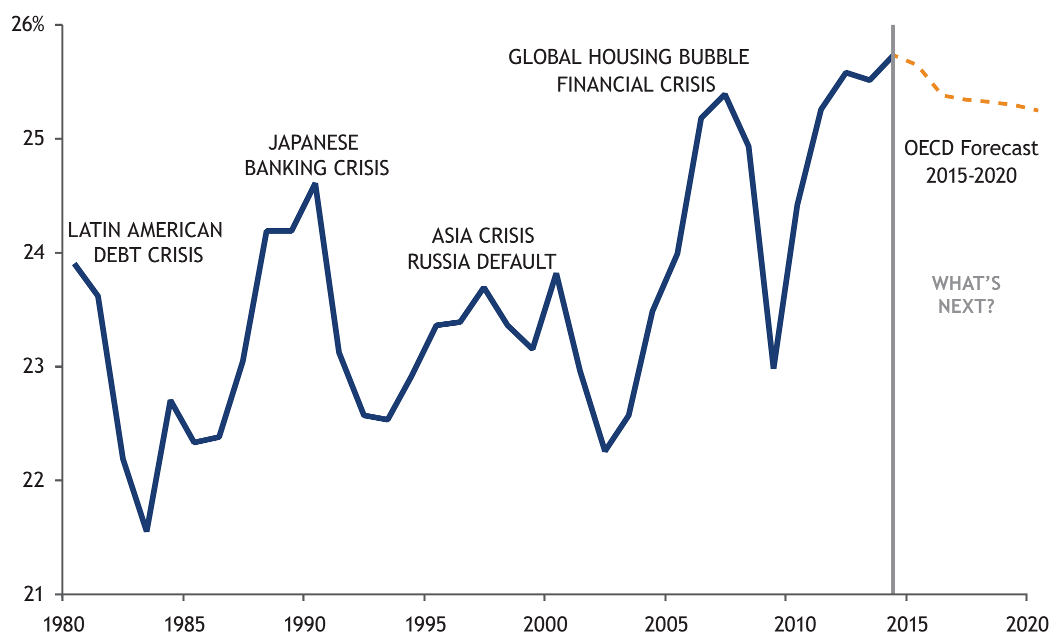
The chart below shows global savings, as estimated by the International Monetary Fund (IMF), and helps bring the borrowing, spending, and balance sheet dynamics to life. Peaks in the savings cycle correspond with economic or financial crises; that is no accident. When savings are plentiful, borrowing is easier, and equity shareholders hold more sway over balance sheets. Investor exuberance and risk-taking stoke asset prices and feed shadow banking, which uses short-term deposits to fund long-term loans. Eventually, asset prices overshoot fundamentals. Often, company, household and government balance sheet leverage looks relatively stable as the credit cycle progresses. But when asset or collateral prices correct from overvalued levels or earnings collapse, balance sheets can quickly turn to trash. With savings declining and financial stress rising, creditors become more important, and companies tend to enforce capital discipline.

GLOBAL SAVINGS AS A PERCENT OF GLOBAL GDP

Source: Thomson Reuters Datastream, as of 12/31/2015, and Lombard Street Research.

Gross National Savings as a Percent of Global GDP

Forecast of Gross National Savings as a Percent of Global GDP



Because financial intermediaries are the engines of credit creation, they often play a key reinforcing role in the cycle. In contrast to company and household balance sheets, financial intermediaries' balance sheets are procyclical, helping inflate asset valuations. When funding in debt markets is plentiful, leverage constraints are loose, and financial intermediaries have abundant capacity to extend credit; aggressive lending supports the expansion. Conversely, when debt funding conditions deteriorate, credit spreads widen, and intermediaries are forced to save and deleverage. The supply of credit becomes constrained, causing a chain reaction of saving and deleveraging that brings down overvalued asset prices and impairs balance sheets.

Dismantling the Credit Cycle

The interconnected relationship between borrowing, spending, saving and deleveraging is fluid, a result of the collective behavior of governments, companies and consumers. The power of our credit cycle framework rests in the granularity it provides as various cycle phases progress toward tipping points. As we have indicated, pinpoint accuracy is impossible, but boundaries and common language are invaluable.

OUR FRAMEWORK

The complexities of the credit cycle make pinpoint accuracy impossible, but boundaries and a common language are invaluable.

DOWNTURN

As the bust phase of the cycle, we think downturns are the easiest to comprehend. In late cycle, rapid economic growth and high inflation typically force central banks to raise interest rates, eventually tipping economies into recessions and credit cycles into downturns. Downturns reveal just how the rot in the system built up over time and was concealed by easy credit conditions and financial engineering. Investors who were buying less liquid, risky assets often run for the small exit door, seeking relative safety and liquidity. The supply of credit tightens, debt growth slows, but profits and incomes collapse. Financial intermediaries shrink their balance sheets. Credit spreads blow out. Risk appetite and liquidity fall to low levels. Eventually, central banks recognize credit conditions have become too tight, start to cut interest rates and commit sufficient liquidity to restore order.

CREDIT REPAIR

In credit repair, companies are forced to improve their balance sheets. Desperate for liquidity, they offer lenders high interest rates. This is the sweet spot for credit investors as companies focus on liability management and survival. To improve their balance sheets, companies typically shed workers, sell assets, reduce capital expenditures, build up cash and lower debt. Essentially, businesses are forced to deleverage because of an economic contraction. For some companies, deleveraging is not enough, so defaults tend to rise. Meanwhile, central banks open the credit spigots in an attempt to reflate the economy. As a result, liquidity starts to rise from very low levels and can become quite abundant. Liquidity is also high because investors exited risky assets in the downturn and piled into relative safe havens. Risk appetite begins to improve in credit repair as investors anticipate the worst of the downturn is behind them. Credit spreads can tighten dramatically, supporting corporate bond returns.

RECOVERY

In recovery, profits grow faster than debt, and defaults usually peak. Corporate deleveraging is now well underway, especially as asset prices rebound. Shareholders and creditors are equally important to managements. Credit spreads are tighter, and equities start to outperform. Economic growth is stronger, and central banks begin dialing back easy policies. Investors start to rebalance portfolios and take more risk. Risk appetite continues to improve as economic and profit recoveries become well entrenched. Lending standards are easing, and credit supply is improving. Borrowing and spending is fun; these are the good times, and asset prices get bid up with liquidity generated from increased credit and profit growth.

EXPANSION TO LATE CYCLE

As we move into expansion, shareholders dominate and encourage a higher return on equity. The profit boom is fading, and debt growth starts to accelerate. Risk appetite remains high, but central banks are actively reversing their easy money policies and raising interest rates. Financial intermediary balance sheets start to expand, supporting the cycle. Importantly, when the economic expansion moves toward late cycle, there are often new forms of money and credit that extend beyond the traditional deposit-funded credit creation process. We get innovative liquidity transformations that have at their heart borrowing in short-term liquid markets and lending in longer-dated less liquid markets. These innovative liquidity transformations include securitization, repo markets, derivatives and other shadow banking activities. This form of transactional money implies less liquidity and more risk, and it can be more susceptible to potential panics and runs.

ATTRIBUTES OF THE CREDIT CYCLE

	DOWNTURN	CREDIT REPAIR	RECOVERY	EXPANSION TO LATE CYCLE
ECONOMIC GROWTH	Weak, Deteriorating	Stabilizing	Moderate, Improving	Strong, Plateauing
CREDIT GROWTH	Falling	Weak	Accelerating	High
CENTRAL BANK POLICY	Easing	Easy	Starting to Tighten	Tightening
INFLATION PRESSURE	Moderate, Falling	Low, Stabilizing	Moderate, Rising	High, Rising
VOLATILITY	Above Average, Rising	Above Average, Falling	Below Average, Stable	Below Average, Rising
RISK APPETITE	Low	Low, Improving	High	High
LIQUIDITY	Low	Improving, High	High	Declining
YIELD CURVE	Steepening	Steep	Flattening	Flat/Invert
FUNDAMENTALS	Profit Contraction	Debt Contraction	Profit > Debt Growth	Debt > Profit Growth
ASSET VALUATIONS	Falling to Below Average	Below Average, Rising	Near Average, Rising	Above Average, Rising
CREDIT VS. EQUITY	Credit & Equity both down	Credit Preferred	Credit & Equity both up	Equity Preferred

Source: Loomis Sayles and Morgan Stanley.

Late in the cycle, corporate profits are increasingly under pressure. As profits contract, corporate balance sheets begin to deteriorate, and leverage rises. Stocks may continue to perform well despite slowing profit growth, but corporate bonds begin to underperform Treasurys. Credit spreads leak wider. As firms struggle to generate profits, managements may boost earnings per share with activities like issuing debt to purchase their stock. So long as the expansion continues, this behavior tends to be good for shareholders but bad for creditors. Balance sheets are deteriorating and vulnerable to a sudden stop in profits, incomes or credit. If the lending stops, who doesn't have the liquid assets or profits to fill the hole? This starts the downturn, and we repeat.

Where Are We Today?

After the global financial crisis and housing bust, many developed market balance sheets were trashed and forced into credit repair. Borrowing and spending was weak in developed markets, but many emerging markets (EM) came to the rescue. Their balance sheets were relatively healthy, and they had the ability and willingness to borrow and spend, which helped sustain global demand. China went on its well-known credit-fueled investment binge, and credit-to-GDP rose about 80% from 2008 to 2015.[1] That helped lift many boats in EM, and they became part of the global growth engine. Investors became excited about EM and exuberantly assumed China would grow at around 10% in perpetuity. Capital flows kicked into overdrive, and borrowing and spending took off.

Energy, metals and mining companies also participated in the latest borrowing-and-spending boom, driving about 39% of global capital spending in 2014.[2] As we highlighted, company balance sheets usually look relatively stable until asset prices, collateral or earnings collapse. This was the case for commodity producers; investment spending was fine, and balance sheets were relatively stable until oil and other commodity prices collapsed, trashing their balance sheets.

But now the tides have shifted. Developed markets are currently in more constructive phases of the cycle, having saved and delevered since the financial crisis. In our view, US non-financial sectors are in late cycle, but the US consumer is in the recovery phase. Europe is also generally in recovery, while the Japanese corporate sector seems to be in a perpetual state of credit repair. EM countries, led by China, are late cycle or in the downturn phase. Many emerging market balance sheets are increasingly impaired. To sustain global demand, a new, healthy balance sheet needs to borrow and spend. Otherwise, high savings, which have contributed to disappointing global growth over the last 18 months, will cause demand to fall short. US consumers are generally in great shape; can they resume borrowing and spending and become the next great growth engine?

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Endnotes

[1] *Haver Analytics from 9/30/2008 to 9/30/2015.*

[2] *"Global Corporate Capex Survey 2015," Standard & Poor's Ratings Services, Corporate Credit Research, 8/3/2015.*

Disclosure

Past market experience is not a guarantee of, and not necessarily indicative of, future results.

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