COLUMBIA THREADNEEDLE INVESTMENTS

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LATE CREDIT CYCLE CHALLENGES: A HIGH QUALITY OPPORTUNITY

Market murmurs about the "end of the credit cycle" have grown steadily in volume over the last several years. But the concept of the "credit cycle" is ambiguous—not everyone uses it in the same way, and not all parts of the economy are at the same stage of the cycle at the same time.

What is a credit cycle?

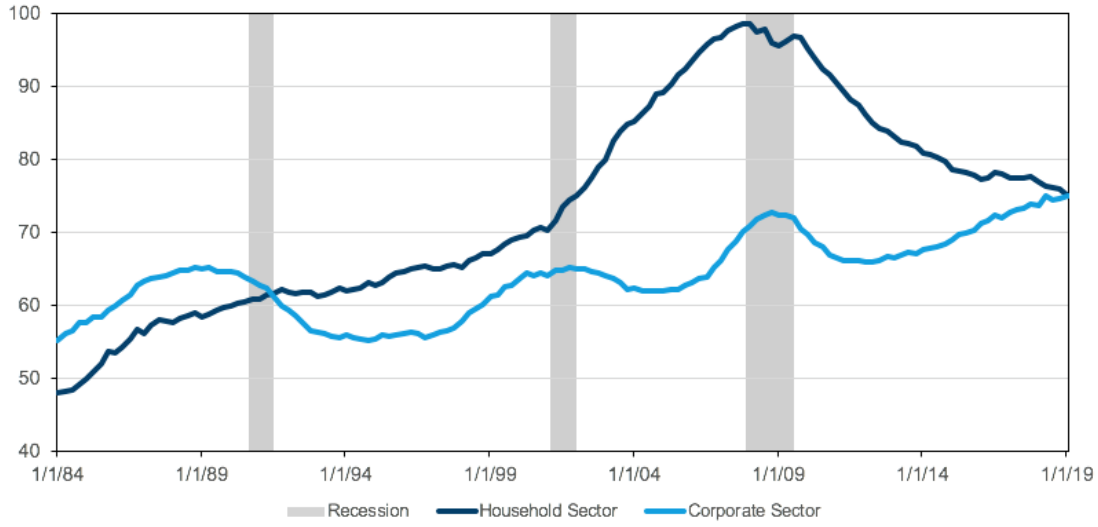
There is no unifying definition of a credit cycle, but in our view, it centers on the vulnerability of borrowers and the compensation that lenders receive for extending credit to those borrowers. At the beginning of a credit cycle, lenders will typically demand higher yield premiums, better collateral, and stricter deal terms. Lenders have the advantage of being selective about their borrowers, as credit is generally less available. Over time, the pendulum of influence swings towards borrowers, deal terms loosen, yield premiums shrink and there's more money available to lend.

When economic shocks hit, whether the shock is industry-specific or broad-based, the likelihood of default increases for more vulnerable borrowers. Therefore, credit cycles matter to bond investors, as bonds and loans become riskier and credit spreads no longer adequately compensate for risk.

So, why are there so many calls for an "end to the credit cycle"? First, we must be more specific: which credit cycle is coming to an end? Different sectors and industries are always at varying points in their cycle, and an end in one sector does not mean an end in all. There is a reason we remember credit bubbles as coming from one sector: residential mortgages in 2008, tech and telecom in 2000 and savings and loans banks in the late 1980s. Sometimes vulnerabilities in a particular sector are so large that they infect other sectors, like in 2008. But this is not always the case. In 2015, the credit cycle ended for energy companies, but that shock didn't spread to other sectors and certainly not to the average household.

At the very least, we must first differentiate between the consumer and the corporate sectors when discussing credit cycle dynamics.

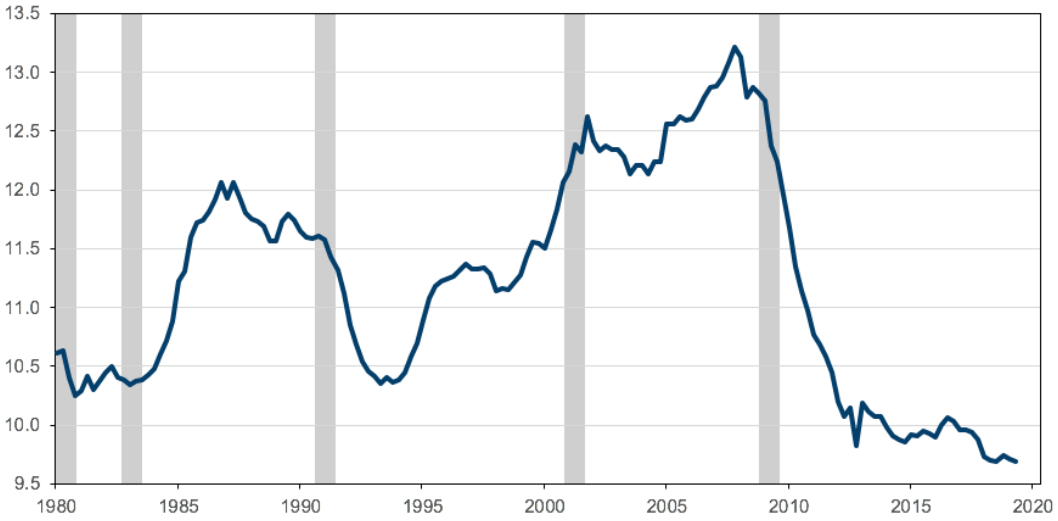
Exhibit 1: Private sector U.S. debt/GDP ratio, households vs. non-financial corporations



Source: Bank for International Settlements; and Columbia Threadneedle Investments

The graph above shows the evolution of private sector leverage over time in the U.S. Financialization and globalization have led to increased leverage since the beginning of the 1980s, especially in the household sector where home prices have risen faster than GDP. What's also clear above is how much the U.S. consumer has been forced to de-lever since the 2008 financial crisis, as access to and availability of consumer credit tightened considerably. And because the vast majority of consumer debt is mortgage debt, which has been right-sized and refinanced at low interest rates, and wages have grown over the past decade, the overall debt burden on Households has fallen to the lowest levels in the last 40 years (Exhibit 2 below).

Exhibit 2: Federal Reserve U.S. household debt service ratio, seasonally adjusted



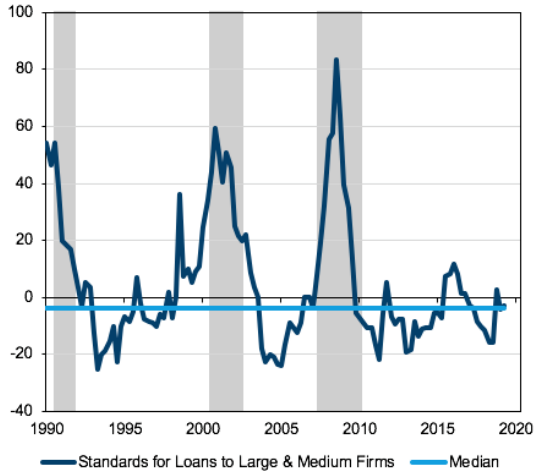
Source: Federal Reserve; Columbia Threadneedle Investments; through July 31, 2019

The same cannot be said for corporate credit. While consumers have shed debt more recently, corporate debt has continued to expand, as CEOs and CFOs have taken advantage of open capital markets and re-levered company balance sheets beyond pre-financial crisis levels on a % GDP basis. Given the historical relationship between corporate leverage and recession risk shown in Exhibit 1 above, it's understandable why the business cycle and the credit cycle are often considered the same—corporate leverage increased into each of the last three recessions. But credit cycles are ebbs and flows in vulnerabilities, and not all credit cycles end in recession—the recent energy cycle being a good example. There must be a large enough shock on a large enough vulnerability, plus a confluence of other events, to result in recession.

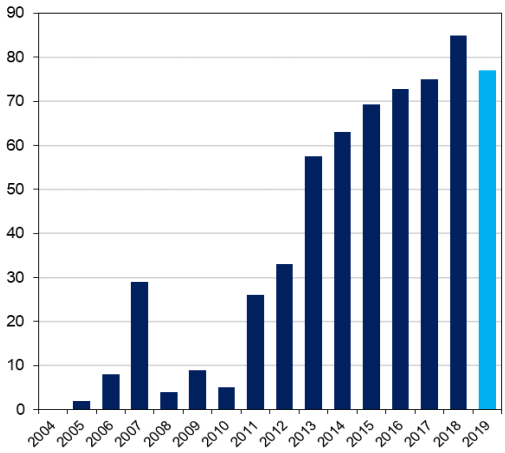
A credit cycle isn't just about leverage, however: it's also about the terms of new debt getting less restrictive for borrowers. There has certainly been a trend in the last several years for easing in corporate borrowing standards outside of the short oil collapse in 2015–2016, as seen in the chart below on the left. Covenant-lite bank loan issuance (loans that have looser standards for the borrower) has also surged over that time period (see the chart on the right). This is widely cited as a sign that the credit cycle is mature: lower quality companies that borrow in the bank loan market are getting easier credit. The combination of easier borrowing and higher leverage has made both the quality and quantity of debt less favorable for fixed income investors.

Exhibits 3 and 4: Lending standards

Net % of domestic lenders tightening loan standards



Covenant-lite loans: Percent of all new bank loan issuance



Source: LH chart - Macrobond; Federal Reserve; and Columbia Threadneedle Investments. RH chart - Macrobond; S&P Global Intelligence; and Columbia Threadneedle Investments

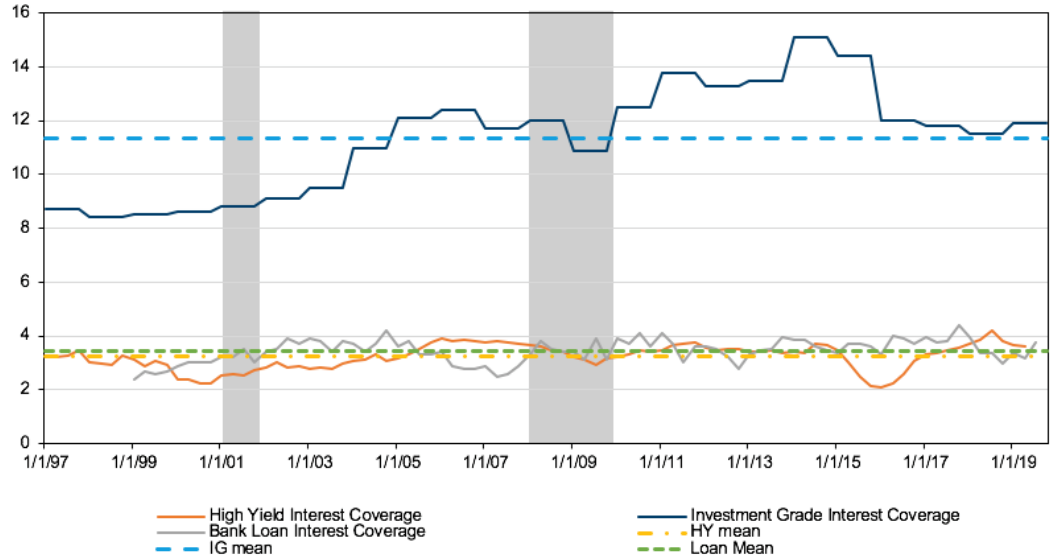
In contrast, when it comes to terms on consumer debt, the terms on mortgages remain relatively restrictive. Mortgage availability has just marginally loosened from post-crisis tights, meaning creditors have been careful not to extend too much debt or impose unsustainably expensive debt for borrowers over time. This leaves the aggregate U.S. household sector in its strongest position in a long time to weather a minor recession or period of tighter financial conditions.

But wait...there is more nuance in the corporate credit sector

Once we differentiate between household and corporate credit cycles, we can dive deeper into various components of the U.S. corporate sector. Looking at the main corporate credit markets—investment grade, high yield bond, and bank loans—we note that the credit cycle has matured at different paces during the current cycle. The composition of these sectors has also shifted.

Exhibit 5: Corporate credit balance sheet health

Interest coverage ratio by sector (EBITDA / interest expense)

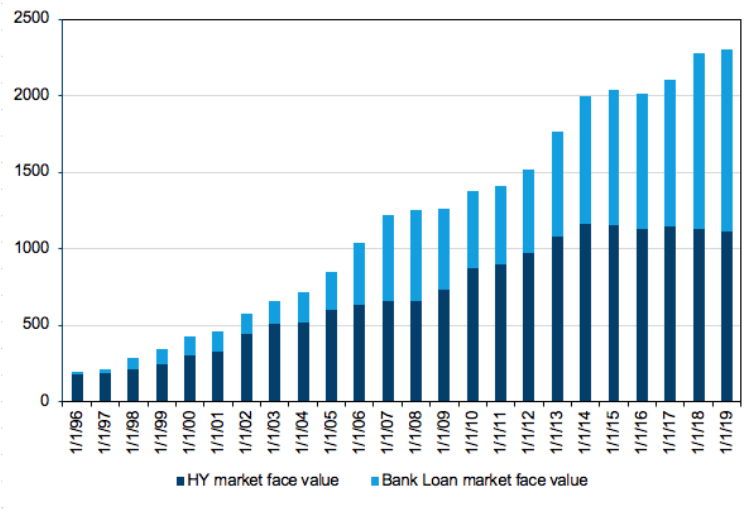


Source: Bloomberg Barclays; Bank of America Merrill Lynch; and Columbia Threadneedle Investments.

While a credit cycle can't be distilled into one indicator, one of the better indicators is interest coverage: how does the burden of a company's debt servicing costs compare to its cash flow generation? The chart above shows the evolution of interest coverage in the three main corporate credit sectors. The investment grade bond market experienced rapid and significant healing that outpaced the high yield and bank loan sectors after the financial crisis, but it has since settled back to longer-term averages. Is that cause for concern when compared to the high yield bond market, which is currently pacing well above longer-term averages at 3.5x? While trends are important, the absolute level is also instructive as investors construct their portfolios. Using interest coverage as a proxy, the high yield bond market is more than three times as vulnerable than investment grade. And not coincidentally, high yield bond spreads have typically been 3–4x more volatile than investment grade bonds.

Another nuance to consider when determining valuation versus vulnerability is the composition of various sectors. For example, more recently, the lowest quality rung of the high yield bond market, CCC-rated bonds, has declined as those issuers migrated to the bank loan sector, primarily into second liens. Conversely, the investment grade bond market has witnessed an increase in BBB-rated bonds.

Exhibit 6: The bank loan market vs. high yield market



The bank loan market has grown rapidly to become larger than the high yield market.

Source: high yield: ICE BofAML US Cash Pay High Yield Constrained Index; bank loan: S&P/LSTA U.S. Leveraged Loan 100 Index; and Columbia Threadneedle Investments.

As companies shift how they fund themselves, sector vulnerabilities also shift. The high yield market, for example, is higher quality as companies fund themselves solely with bank loans and the level of CCCs declines. But the other consequence of this is that bank loan market has potentially become more vulnerable. This is the point of differentiation: not every sector evolves the same way through a credit cycle.

Navigating the cycle and the choppy waters near the end

The end of a credit cycle doesn't come quickly—but the reaction in markets can be abrupt and jarring. The time for investors to be defensive is when risks rise, asset valuations are elevated, and risk premia are low—which is pretty much how things look today. As active fixed income investors, we're focusing our portfolios on those sectors more closely tied to the strength of the U.S. consumer. And we've migrated up in quality to minimize exposure to more vulnerable sectors and industries where the risk outweighs the potential reward.

There are risks associated with **fixed-income** investments, including credit risk, interest rate risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer term securities.

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