April 11, 2024

Global Credit Weekly:

Stalled progress

BlackRock

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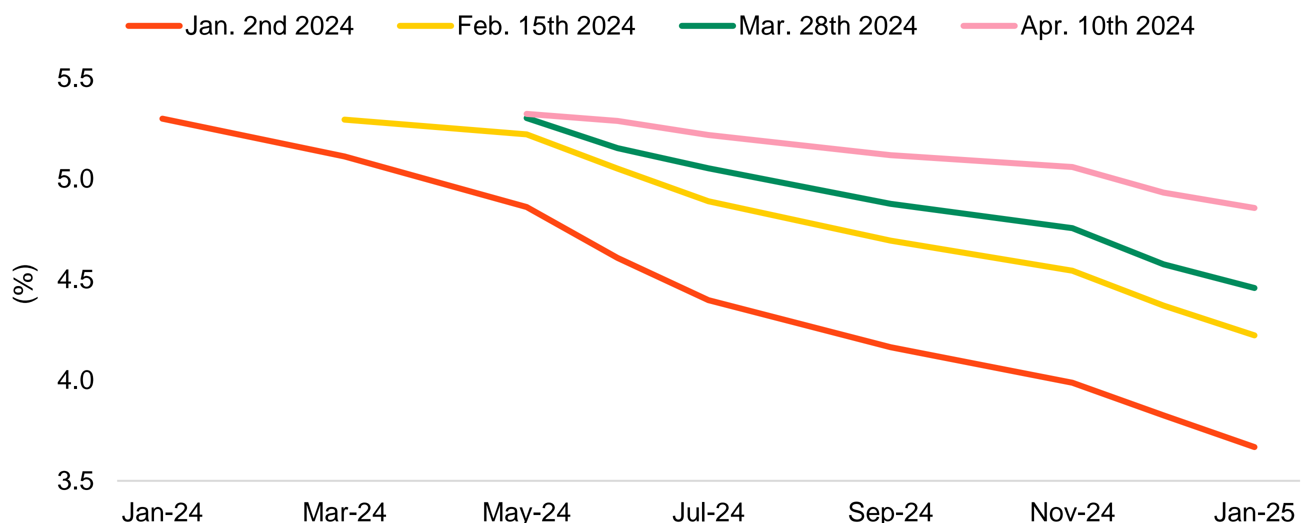
Key takeaways

- For the third consecutive month, March inflation data was above Bloomberg consensus expectations. As it relates to the Federal Reserve's objective to return to 2% (core PCE) inflation "over time," the strength in the March inflation data poses two headwinds, in our view. First and foremost, it follows the elevated inflation readings in January and February of 2024. While one-off seasonal adjustments were previously cited as potential causes of the January strength, the upward pressure on inflation has since been largely persistent. Second, a variety of categories contributed to the March increase – especially in the services sector – suggesting the pressure may be broad based.
- The minutes from the March FOMC meeting already reflected "uncertainty about the persistence of high inflation." They also noted that "recent data had not increased" participants' confidence that inflation was moving sustainably down to 2% - which Federal Reserve officials have outlined as a condition for starting a rate cutting cycle. The March inflation data – coupled with the ongoing strength in the labor market – further reduces the urgency to start monetary policy normalization, in our view. We continue to expect the first Federal Reserve rate cut in 2H2024.
- As we outlined in our *2Q2024 Global Credit Outlook*, this quarter will be critical as corporate credit investors seek confirmation on additional inflation progress (which has recently been elusive) and the (eventual) start of monetary policy normalization. A sustained reacceleration in inflation is the largest risk, in our view, to asset valuations.
- As we detail within, we see two clear implications for asset allocation. First, we expect sector and issuer dispersion to increase as borrowers continue to navigate this "high-for-longer" cost of capital landscape. Second, the tactical case to own floating rate exposures in liquid and private credit should also persist in 2Q2024, given the rates backdrop.

Exhibit 1: The market's repricing of rate cut expectations reflects "high for longer"
The U.S. policy rate implied by Fed Funds Futures at various points in time, through early 2025



Source: BlackRock, Bloomberg.

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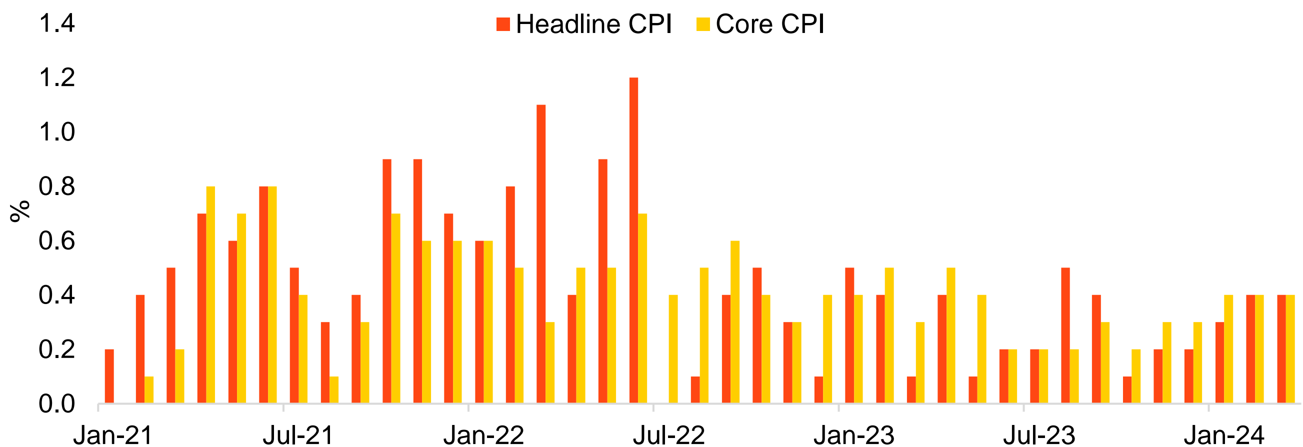
Progress on inflation stalls in early 2024

March U.S. headline and core CPI figures (released April 10th) were above Bloomberg consensus expectations on a month-over-month and year-over-year basis, representing the third consecutive upside surprise for the data set. With these most recent data, the inflation progress in place for much of 2H2023 has now shown signs of plateauing. For context: the March core CPI reading of +0.36% month-over-month brings the year-over-year rate to +3.8%, which is essentially flat with the February level. This also marks the third consecutive month of +0.4% (rounded) readings (Exhibit 2). March headline CPI of +3.5% year-over-year is now above vs. February's +3.2% reading (Exhibit 3).

As it relates to the Federal Reserve's objective to return to 2% (core PCE) inflation "over time," the strength in the March inflation data poses two headwinds, in our view. First and foremost, it follows the elevated inflation readings in January and February of 2024. While one-off seasonal adjustments were previously cited as potential causes of the January strength, the upward pressure on inflation has since been largely persistent. Second, a variety of categories contributed to the March increase – especially in the services sector – suggesting the pressure may be broad based.

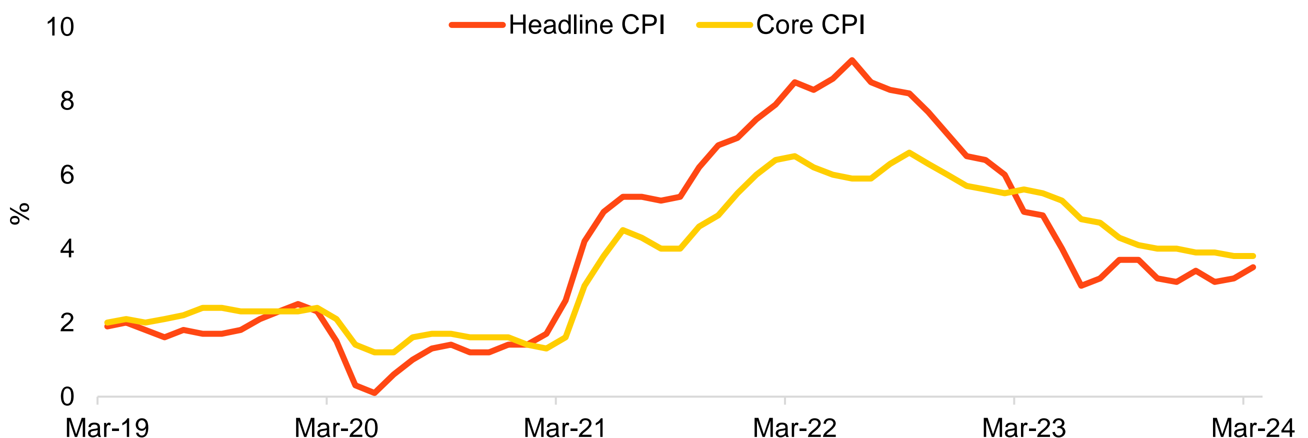
The minutes from the March 19th-20th FOMC meeting (released April 10th) already reflected "uncertainty about the persistence of high inflation." They also noted that "recent data had not increased" participants' confidence that inflation was moving sustainably down to 2% - which Federal Reserve officials have outlined as a condition for starting a rate cutting cycle. The March data will likely further fuel that stance.

Exhibit 2: March marked the third consecutive month of above consensus inflation
Month-over-month % change in headline and core U.S. CPI (seasonally adjusted)



Source: BlackRock, Bureau of Labor Statistics, Bloomberg. Captures data through March 31, 2024.

Exhibit 3: Year-over-year inflation rates have either stalled or increased, as of late
Year-over-year % change in headline and core U.S. CPI (not seasonally adjusted)



Source: BlackRock, Bureau of Labor Statistics, Bloomberg. Captures data through March 31, 2024.

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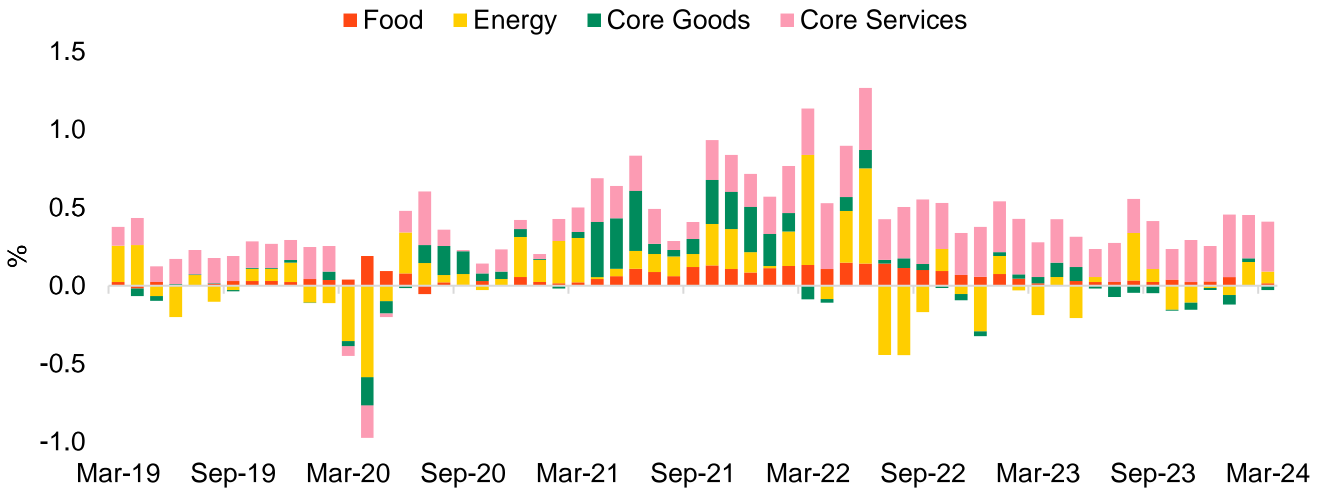
The services category continues to drive the inflation strength

As shown in Exhibit 4, the services category was a key driver of the strength in March CPI – extending the trend in place over the past few quarters. Under the surface, a range of categories contributed, including motor vehicle insurance and repair costs, medical care/services, and pet/veterinarian services. These same components helped push "supercore" CPI (i.e., core services ex-housing) to a +0.65% monthly increase (Exhibit 5).

The shelter category (36% of CPI) also demonstrated ongoing stickiness, with the rent and owners' equivalent rent subcomponents each increasing by 0.4% month-over-month. Gasoline, apparel, personal care, education, household furnishings and food away from home also registered increases for the month, per data from the Bureau of Labor Statistics.

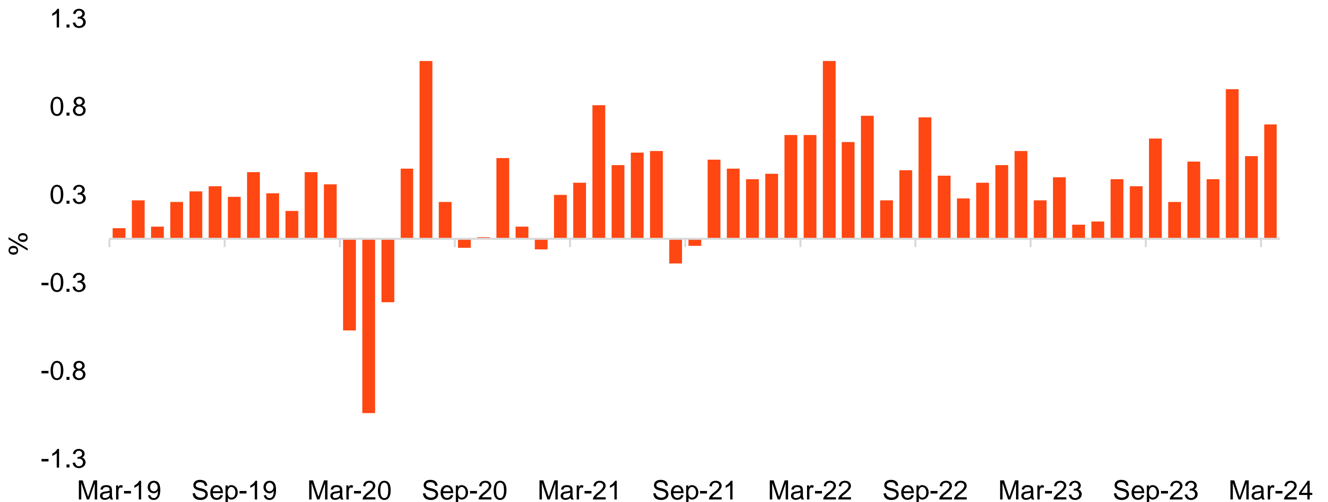
On the positive side, core goods resumed its trend of disinflation, which was briefly interrupted in February (again, Exhibit 4). Used cars and trucks reported a notable decline in March, with a smaller decline for new vehicles.

Exhibit 4: The services category remains the key driver of inflationary pressure
Contributions to month-over-month headline U.S. CPI (seasonally adjusted)



Source: BlackRock, Bureau of Labor Statistics, Bloomberg. Captures data through March 31, 2024.

Exhibit 5: "Supercore" CPI accelerated in March
Month-over-month change in U.S. CPI services ex-housing ("Supercore" CPI)



Source: BlackRock, Bureau of Labor Statistics, Bloomberg. As of March 31, 2024. Bloomberg estimate of "supercore" CPI excludes Rent of Primary Residence and Owners Equivalent Rent of Residences from Services ex-Energy Services. Estimate reflects Bloomberg's calculations following consultation with the Bureau of Labor Statistics (BLS) https://www.bls.gov/opub/hom/cpi/calculation.htm.

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Another repricing of rate cut expectations, to reflect fewer cuts

As shown in Exhibit 1, following the release of the March CPI data the market repriced (again) its expectations for Federal Reserve rate cuts in 2024. As of the time of this writing, the market implied probability of a 25bp rate cut was approximately 50% by the July FOMC meeting and 91% by the time of the September FOMC meeting.

Consistent with this, the policy-sensitive front-end U.S. Treasury (2-year) yield spiked to 4.97% on April 10th – the highest level since mid-November 2023. Similarly, the 10-year U.S. Treasury moved above the 4.5% level for the first time since mid-November (Exhibit 6).

The moves higher in U.S. Treasury yields may also have been influenced by supply dynamics, with two auctions taking place this past week: a $58 billion, 3-year auction on Tuesday (April 9th) and a $39 billion, 10-year auction on Wednesday (April 10th). Both were met with tepid demand, as these auctions "tailed" by 2bp and 3bp, respectively, per data from Bloomberg. As this article from the Dallas Federal Reserve outlines, a large positive tail typically indicates that the yield realized in the auction exceeded market expectations, indicating weaker-than-expected demand.

March FOMC minutes – stale, but still notable vis-à-vis inflation

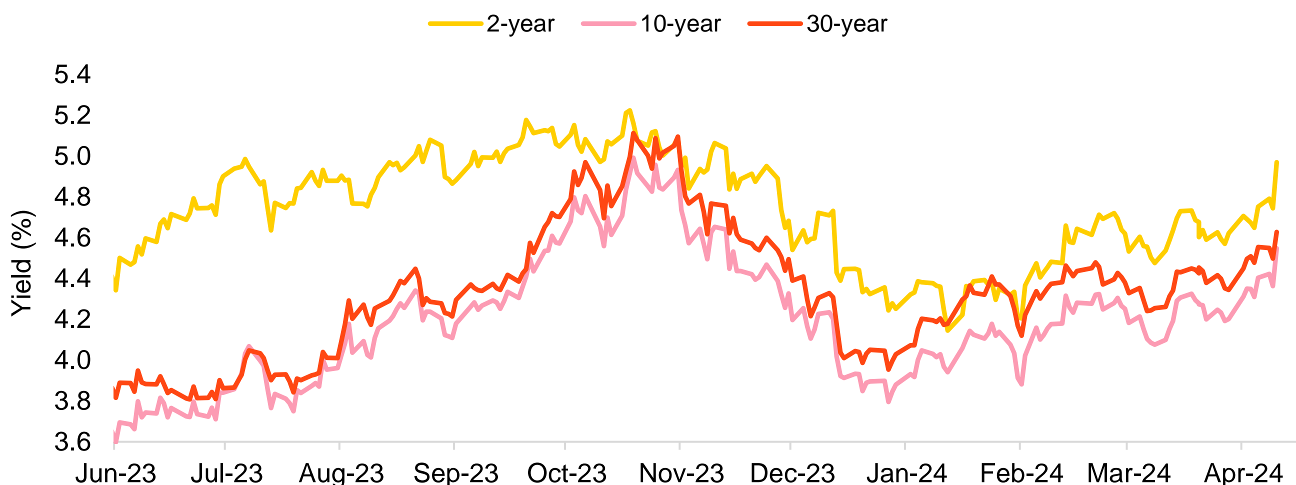
As mentioned earlier, the minutes from the March 19th-20th FOMC meeting (which were released this week) are already relatively stale, as the meeting occurred *prior* to the release of the March CPI data. That said, they do provide some incremental insight, in our view, on the Federal Reserve's reaction function related to inflation. For one, the minutes acknowledged "uneven" and "disappointing" progress on inflation in recent months, as well as risks that were "tilted slightly to the upside" as "unexpectedly persistent inflation dynamics could materialize."

The minutes also reiterated the "possibility of maintaining the current restrictive policy stance for longer should the disinflation process slow," – a message that has been emphasized by a range of Federal Reserve officials in public remarks over recent weeks.

Notably, in our view, the minutes also included the following reference to financial conditions: "Some participants noted the uncertainties regarding the restrictiveness of financial conditions and the associated risk that conditions were or could become less restrictive than desired, which could add momentum to aggregate demand and put upward pressure on inflation." The reference is relevant as Chair Powell noted in the March 20th FOMC press conference (in response to a question on the topic) that he believed "financial conditions are weighing on economic activity."

Exhibit 6: U.S. Treasury yields have climbed back to levels last seen in late 2023

Yield-to-worst of the 2-year, 10-year and 30-year U.S. Treasuries (on-the-run securities, mid levels)



Source: BlackRock, Bloomberg. As of April 10, 2024.

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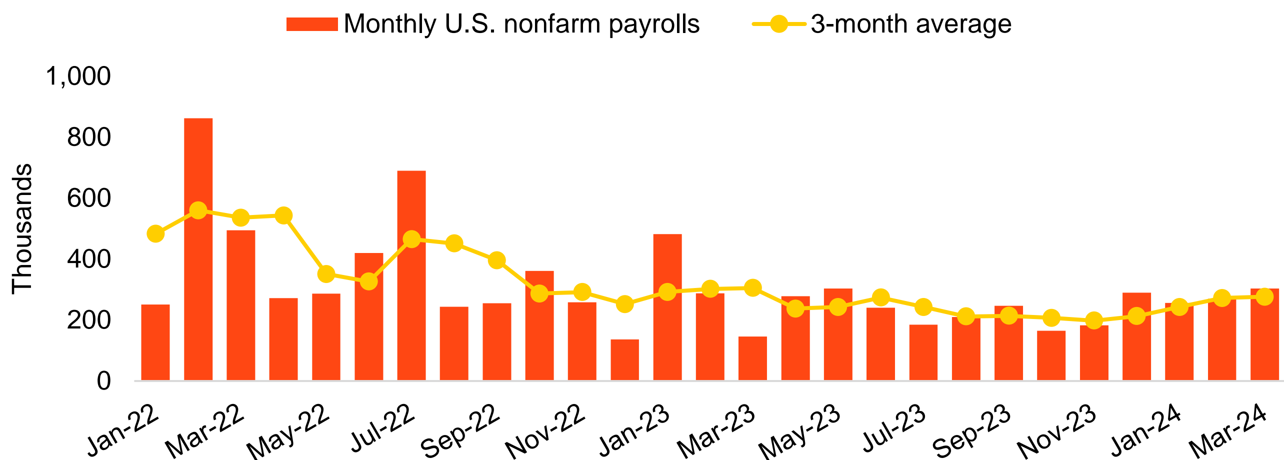
A resilient labor market is another reason to delay cuts, in our view

Beyond the persistently sticky inflation data, the March U.S. nonfarm payrolls report (released April 5th) painted a picture of ongoing resilience in the labor market – further reducing the urgency for the Federal Reserve to cut rates, given its dual-mandate of maximum employment and price stability. 303k jobs were created in March (vs. Bloomberg consensus expectations for +214k), bringing the three-month rolling average of job creation to +276k. This is the highest since March 2023 (Exhibit 7). Job growth was widespread across a range of sectors, including healthcare, government, leisure/hospitality, construction and retail. The unemployment rate remained largely unchanged at 3.8% (Exhibit 8), as labor force participation increased from 62.5% to 62.7%.

Despite the upside surprise in job creation, the year-over-year pace of wage growth (using average hourly earnings) declined modestly to 4.1% (vs. 4.3% in February) – suggesting the labor market can likely sustain a higher pace of monthly "breakeven" job creation than previously thought. As we discussed in our 2Q2024 Global Credit Outlook, elevated immigration has been widely discussed as a factor in the growth of the U.S. labor force. This factor was also acknowledged in the most recent FOMC minutes.

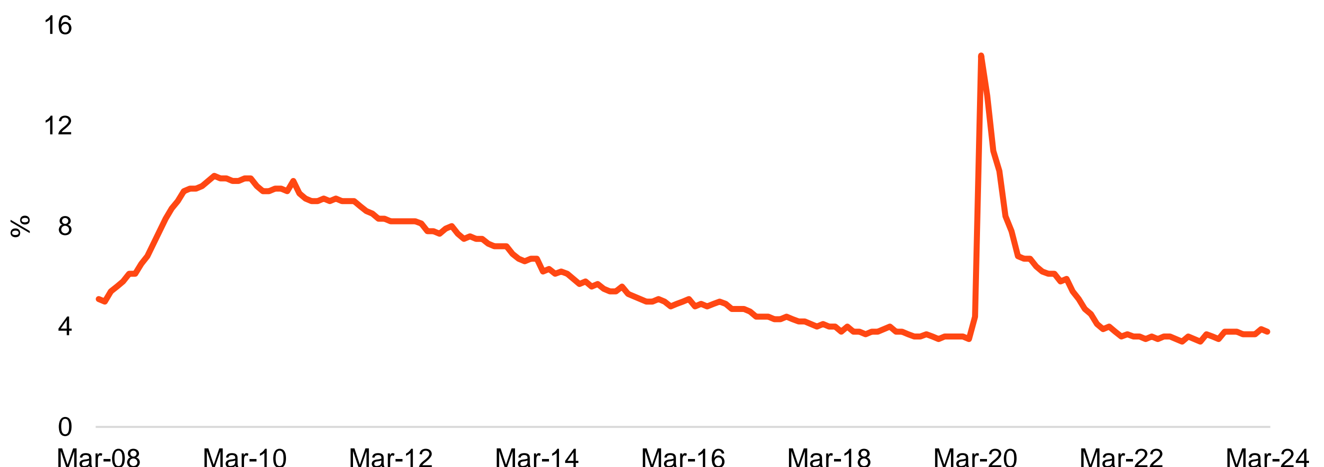
That said, while wage growth has (so far) been relatively contained, a level of +3.0-3.5% is likely ultimately necessary (assuming an approximate +1.0-1.5% contribution from productivity) to be consistent with the Federal Reserve's 2% inflation target.

Exhibit 7: Wage growth accelerated in March, extending the recent trend
Monthly U.S. nonfarm payrolls and the three-month moving average pace of job creation



Source: BlackRock, Bloomberg, Bureau of Labor Statistics. Captures data through March 31, 2024.

Exhibit 8: The unemployment rate has remained below 4% since early 2022
U.S. unemployment rate (%), monthly, seasonally adjusted



Source: BlackRock, U.S. Bureau of Labor Statistics, St. Louis Federal Reserve Bank database (FRED). As of March 2024.

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The read-through to credit: supportive for floating-rate allocations

As we outlined in our 2Q2024 Global Credit Outlook, this quarter will be critical as corporate credit investors seek confirmation on inflation progress and the start of monetary policy normalization. Despite the "delayed" prospect of rate relief, liquid and private corporate credit has been resilient – a trend we expect to continue in 2Q2024. Indeed, even with the rates and equity market volatility surrounding the March CPI release, aggregate average spreads for the Bloomberg USD IG and HY Corporate indices closed their respective sessions either unchanged (IG at 87bp) or tighter (HY at 292bp), as yield-based demand remains a tailwind.

That said, there are two clear implications for asset allocation. First, we expect sector and issuer dispersion to increase as borrowers continue to navigate this "high-for-longer" cost of capital landscape. Second, and as we detailed in the outlook, the tactical case to own floating rate exposures in liquid and private credit should also persist in 2Q2024, given the rates backdrop.

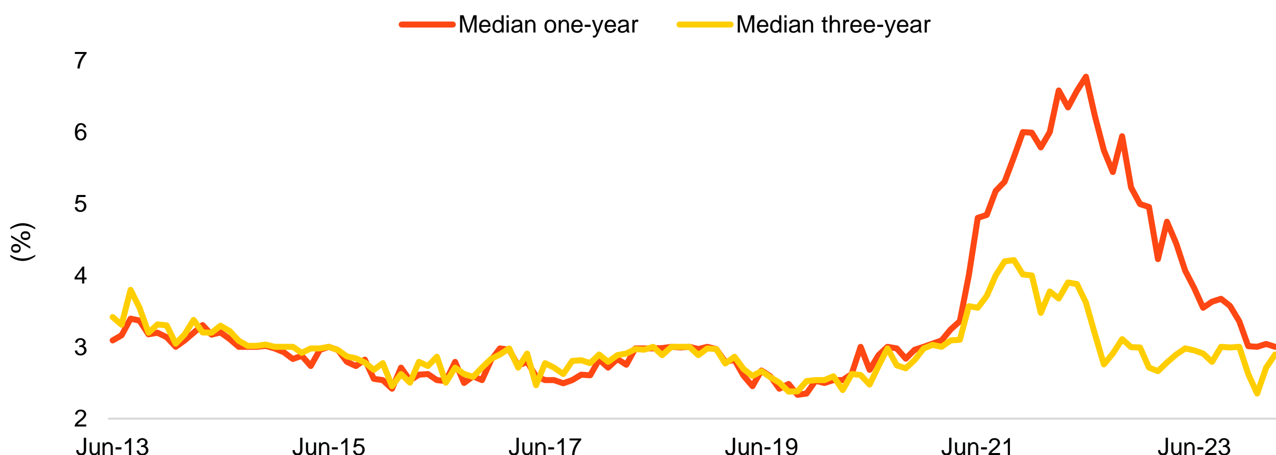
Our base case remains for the first Federal Reserve rate cut to begin in 2H2024, with the risks skewed earlier within that timeframe. As it relates to investor sentiment, however, the exact timing of the start of rate cuts is likely not the primary consideration for corporate credit investors. Rather, we view the following factors as critical for investor risk appetite to remain supportive: (1) a high likelihood that the current Fed Funds rate represents the peak for this cycle (i.e., no more rate hikes are expected), (2) the expectation that rate cuts will begin eventually in 2024, and (3) the reason for the eventual rate cuts will be eventual improvement on inflation, as opposed to a sharp growth downturn.

Consumer expectations of inflation and the job market

Given the current backdrop, monitoring consumer expectations related to inflation and the job market will likely be especially important over the coming quarters. With that in mind, we take stock of the Federal Reserve Bank of New York's March 2024 Survey of Consumer Expectations, which is a monthly survey engaging 1,300 household heads (on a rotating panel) across the U.S. The survey monitors changes in consumer expectations of inflation, the labor market, and household finances, over time.

The March 2024 survey illustrates how consumer expectations for inflation rates (over different time horizons) have narrowed the gap to align more closely, after a period of divergence (Exhibit 9). While median inflation expectations for the short-term (one-year horizon) remained unchanged at 3.0%, median inflation expectations over the medium-term (three-year horizon) increased from 2.7% in February to 2.9% as of March. And while not shown in Exhibit 9, median inflation expectations for the long-term (five-year horizon) decreased from 2.9% to 2.6%, per the survey.

Exhibit 9: Inflation expectations have converged over short and medium-term horizons
Median one-year and three-year ahead expected inflation rate



Source: BlackRock, New York Federal Reserve Bank Survey of Consumer Expectations. As of March 2024.

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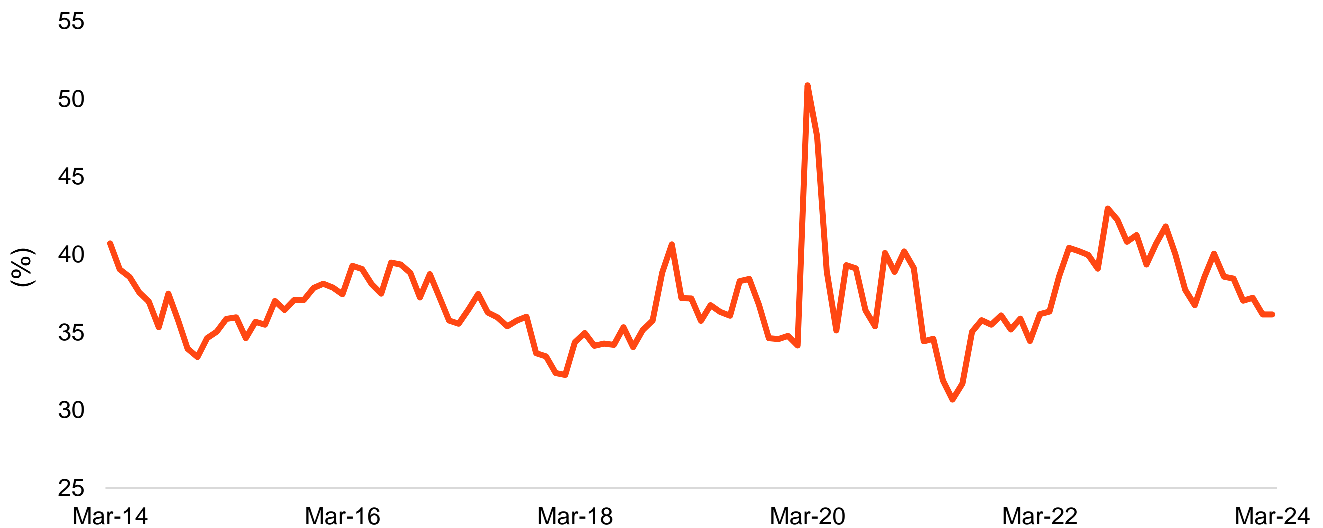
Consumer expectations of the job market are mixed

The survey revealed mixed consumer sentiment on the job market. For example, the perceived probability that U.S. unemployment will be higher one year from the survey is 36%, the lowest level since early 2022, indicating consumer confidence in the economy's ability to create and sustain job growth (Exhibit 10). This confidence is echoed by stable earnings growth expectations, with consumers anticipating 2.8% growth in their earnings over the next year - a level that is consistent with the 12-month trailing average.

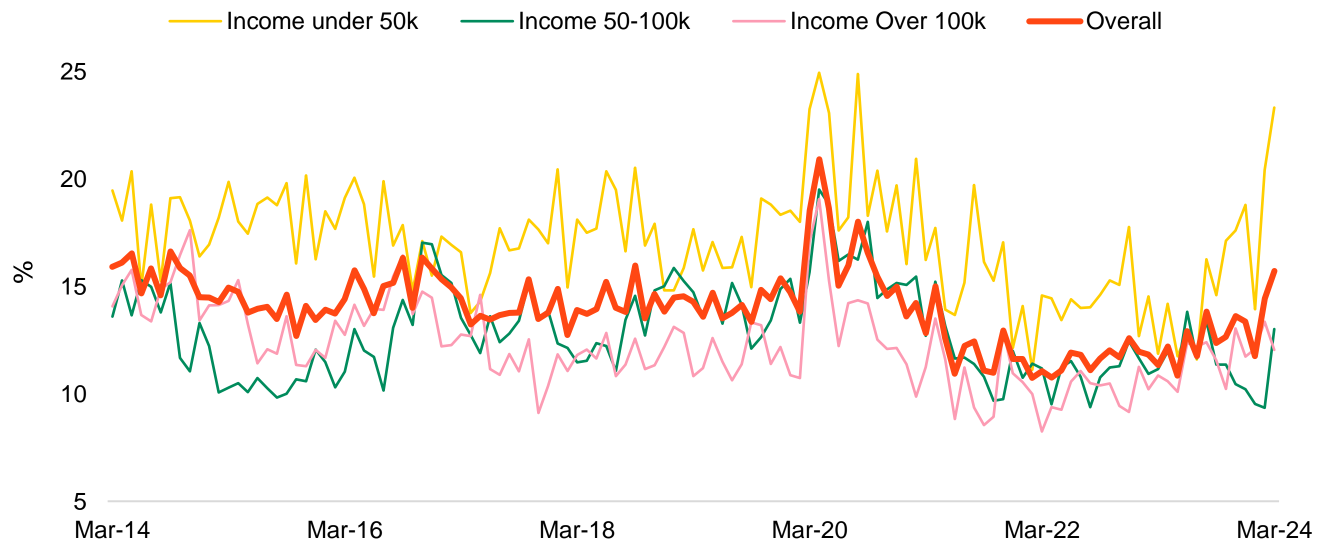
That said, under the surface, there are signals that consumers may feel less confident about their ability to remain employed. For example, the perceived probability of losing a job in the next year increased to its highest level since September 2020 in the March survey (Exhibit 11). This concern was especially evident in the lowest income cohort (consumers with annual income under $50k) – underscoring that the theme of dispersion extends into the consumer credit landscape, as well.

Exhibit 10: Consumer expectations for the labor market have improved since late 2023
Mean probability that the U.S. unemployment rate will be higher one year from now



Source: BlackRock, New York Federal Reserve Bank Survey of Consumer Expectations. As of March 2024.

Exhibit 11: Consumer expectations of losing a job over the next 12 months have increased
Mean probability of losing job over the next 12 months, overall and by income cohort



Source: BlackRock, New York Federal Reserve Bank Survey of Consumer Expectations. As of March 2024.

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Bank lending standards in Europe: slightly tighter with less demand

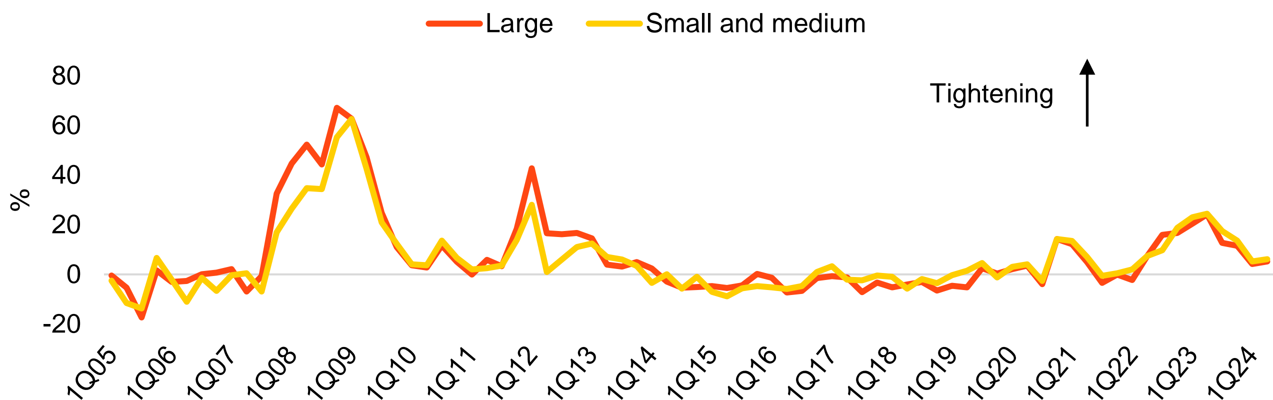
Away from the U.S., this week also delivered incremental information on bank lending in the Euro Area. The most recent ECB Bank Lending Survey (released April 9th) demonstrated a modest tightening of credit standards for business loans to large and small/medium firms during 1Q2024 (Exhibit 12). Still, the directional trend over the past few quarters suggests the peak was likely in mid-2023.

Exhibit 13 illustrates that overall terms/conditions and pricing on “average loans” continued to moderate. Pricing on “riskier loans” modestly increased, however. Notably, according to the banks surveyed, “loan demand from firms declined substantially,” as higher interest rates and lower fixed investment exerted downward pressure on loan demand. Banks surveyed are expecting a moderate net decrease in demand for loans to firms in 2Q2024, as well as a moderate net tightening of credit standards.

Separately, survey respondents noted that access to funding improved substantially for debt securities and improved somewhat for money markets and securitization. Over the same period, access to short-term retail funding tightened. Surveyed banks expect access to debt securities, money markets, and securitization to continue improving over the next three months and expect access to retail funding to remain largely unchanged.

Exhibit 12: European banks’ credit standards for loans modestly tighten

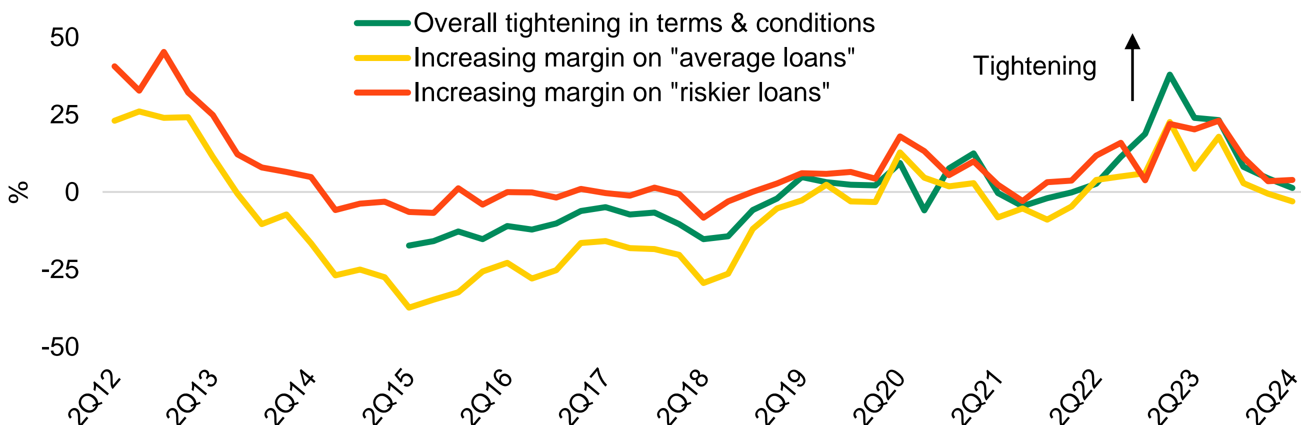
Net percentage of respondents to the ECB Bank Lending Survey increasing credit standards for business loans to large and small/medium firms



Source: BlackRock, European Central Bank, Haver Analytics. As of April 2024 (most recent available).

Exhibit 13: Pricing for “riskier loans” slightly increased

Net percentage of respondents to the ECB Bank Lending Survey tightening overall terms and conditions (and specifically, pricing) for business loans to large and small/medium firms



Source: BlackRock, European Central Bank, Haver Analytics. As of April 2024 (most recent available).

For both charts: The April 2024 Bank Lending Survey was conducted between February 29, 2024, and March 15, 2024. A total of 157 banks were surveyed, with a response rate of 100%.

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