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Liquidity will still flow to income

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Signs abound that the credit canary's oxygen is thinning; but how much? On June 3, SNL published an article that said C&I delinquencies in the U.S. jumped 50% in 1Q'16 to 1.5%. The chart that accompanied the article told you about all you need to know about commercial credit — the bottom is in. Granted, much of the upturn in past due credits is attributable to the stressed energy sector. Nevertheless, the trend is hard to ignore.

On June 14, the CFO of credit card-focused Synchrony Financial sort of preannounced the next few quarters by noting that net charge-offs would increase 20 to 30 basis points over the next year. The last-12-months net charge-off ratio as of March 31 was 4.40%. The shares sank 13% on the 14th.

Why did the shares crash? It probably was not the pro forma loss rate of upwards of 4.70% for a company with a net interest margin over 15% and a P/E around 10x. CFO Doubles attributed the increase to consumers' growing trouble in paying off their debts rather than a specific event. That is interesting because gas prices, though up lately, are down sharply over the past 18 months. Maybe Doubles' comment was an indirect confirmation of my view that consumer lenders have been extending credit to marginal borrowers to keep the music going the past 20 years or so.

The upturn in credit warnings coincides with other indicators that point to an aging expansion. Retail sales have been sluggish, especially when viewed from the perspective of same-store sales growth (or contraction) for a host of major retailers the past few quarters. The U.S. Treasury yield curve, as measured by the spread between the yield on the 10-year bond and two-year note, narrowed to 88 basis points as of June 14. Historically, the spread has been a good indicator of economic activity and a guide for the Fed in setting the Funds target. While the current spread is just below the 40-year average of 97 basis points, narrowing via the declining yield on the 10-year, rather than narrowing because the two-year yield is trending higher with Fed rate hikes, is not a welcome development. In early 2014, the spread was around 250 basis points. Perhaps that was when a few rate hikes should have occurred.

And then there is corporate credit. Leveraged loans and corporate bonds — "spread product" in the parlance of the fixed income market — were hewing to the slowing script too by undergoing a long decline in price that got underway in mid-2014. Like the past-due C&I loans cited earlier, much of the initial weakness was confined to high-yield energy credits. During late 2015, weakness began to spread to other sectors, ironically as the Fed hiked rates for the first time in nearly a decade. The option-adjusted spread on BB-rated bonds in the BofA Merrill Lynch High Yield Index widened from a cycle low of 232 basis points on June 23, 2014, to 582 basis points on Feb. 11, 2016.

The market then underwent what technicians call a "retracement." Prices rallied hard such that by June 9, the spread narrowed to 367 basis points — a 215 basis-point, or 61% retracement, from the Feb. 11 wide spread (price low). Liquidity flows can do that, especially if shorts are forced to cover in illiquid markets. Since then, the spread widened a bit to 399 basis points as of June 14, which is near the 20-year average of 385 points.

The old bond king, Bill Gross, thinks the move is too much. He is now talking about shorting credit because of the magnitude of the move and his view that central banks will not always have investors' back. The new bond king, Jeff Gundlach, thinks central banks are losing control. After Chair Yellen's shaky post-FOMC meeting press conference on June 15, he offered an Elvis analogy: "The rate hike cycle has left the building."

Intuitively, it is not hard to disagree with Gross and Gundlach. Years of easy money have produced asset inflation that has been financed with easy credit as witnessed by exceedingly tight high-yield spreads in 2014. A lot of marginal borrowers obtained access to funding that otherwise would not have been extended had conditions not been so loose and had investors not been so parched for income. Nevertheless, credit always has been and always will be cyclical. We are transitioning to the other side of the cycle. The declining yield on the 10-year U.S. Treasury, negative rates in Europe and Japan and the underperformance of bank stocks indicates this.

My hunch, however, is that unless there is a nasty recession, losses may not be as severe as hair-trigger selling in Synchrony seems to indicate. I humbly disagree with Gross if I understand his view correctly, and have a nuanced view of control as articulated by Gundlach. Central banks are all in. I do not think they can pull away from markets unless a new paradigm emerges that allows them to do so. The degree of their control may be fading, however. The bond market seems to have forced the Fed's hand in terms of implementing a series of rate hikes. And risk assets are no longer solely riding the up escalator. Equities seem to be repricing to reflect little earnings growth or prospects for lower earnings for some industries. Credit underwent a repricing in 2015 and 2016 vis-à-vis 2014 as investors began to show more sensitivity to potential losses and valuation. Nevertheless, I think income producing assets will remain reasonably well bid other than during periodic air pockets, as long as the borrower's underlying business has not imploded. Well bid credit means some marginal credits will be able to refinance. How many? That depends on the economic trajectory.

As for bank stocks, they are living up to their reputation as early market cyclicals by turning before the economy does. The market, in effect, has been cutting 2017 estimates before the Street will do so. That probably will occur during the third quarter to reflect higher provision expense and lower NIMs than currently modeled. Analysts may find it hard to avoid the rinse and repeat exercise of cutting near-term estimates while hiking the out year (soon to be 2018) in the hope that the stars will align the following year. That is not an impossible scenario, but it appears flat is the new up scenario for now.

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