Take Me Out to the Credit Ballgame

Heritage Quarterly Newsletter – 4Q 2015

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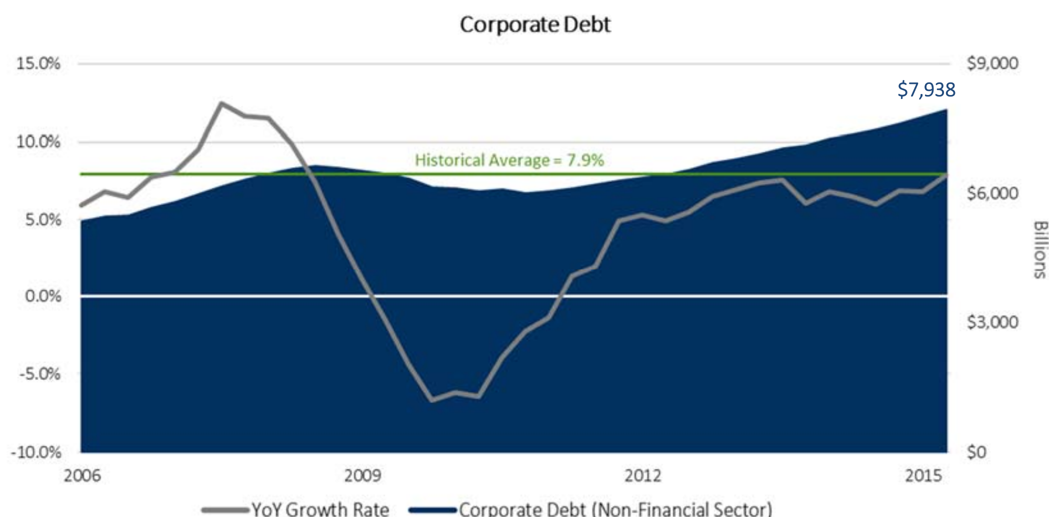
HIGHLIGHTS (Quarterly Focus: Credit Cycle)

- Credit expansion trends in the corporate and household sector do not indicate that the lending cycle is overheating.
- Commercial credit is trending around a normalized rate of growth while mortgage debt has stagnated. Commercial credit growth has not outpaced residential credit growth by this wide a margin in over 30 years.
- Home prices across the country have run up, but unlike the last cycle, mortgage debt has not played as widespread a role in the run up. Despite increased housing completions, demand has exceeded supply, leading to low inventory levels, particularly in metro markets.
- The last time the Fed began to raise rates, credit growth continued to remain strong and did not reverse course.

Given that the Fed has raised the rhetoric on the possibility of a rate increase in December, Heritage thought it would be telling to gauge what inning of the ball game the credit cycle is in, and how it will be impacted in the coming months. It is important to remember, the last time the Fed hiked rates from zero, credit expansion did not reverse trend. Our assessment is that the US credit cycle is somewhere between the halfway point and the last third of the game. If we had to pick an inning, it would be the 6th, which means there is still reasonable runaway before the end of the current expansionary cycle.

CORPORATE DEBT

Coming out of the recession, credit expansion in the non-financial corporate sector has been strong. However, it is nowhere near the perimeter of irrational exuberance, at least not yet. The rate of credit creation in the corporate sector is currently trending around its long term historical average. We examined data dating back to the conclusion of WWII. Growth in corporate debt over that time has averaged 7.9% per annum, roughly where it is now. In modern history (since 1990), growth has averaged a more tepid 5.7% per annum. Even against that backdrop, the pace of balance sheet expansion is more accurately characterized as robust, not *unrestrained*.



Headlines in the popular press would lead one to believe the economy has been on a leverage binge, with companies gearing up on cheap debt. While significant leverage has been extended to some companies, we characterize the lending cycle to be "hitting its stride", rather than "reaching boiling point". Preceding the collapse of the credit bubble in 2008, the US had 4 quarters of double-digit commercial credit growth, on top of what was already an extended period of stout credit creation.

Corporate debt* outstanding totals **$7.9 trillion** or 47% of GDP.

*Seasonally adjusted, nonfinancial sector corporate

Quarters of double-digit YOY credit growth:

Prior to Great Recession: 4

Prior to Dot-com bust: 8

Current Cycle: None

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In the period prior to the dot-com bust, the US had 8 quarters of over double-digit credit growth, again on the tail end of an extended period of strong credit creation. This time around, debt growth in the corporate sector has not even begun to scrape the double-digit threshold.

Default data published by S&P indicates that the number of corporate defaults have increased, and that 2015 may see the highest number of defaults since 2009. However, when cited in most articles, the numbers are taken out of context because one would expect the number of defaults to naturally increase as credit expands. The truth of the matter is that the absolute number of defaults is still far below previous peaks. At this point, we've not yet observed symptoms of a credit bubble. The hubris seems to imply that "every company is overstretched on their debt", but we think the only thing overstretching is that statement.

S&P Global Defaults

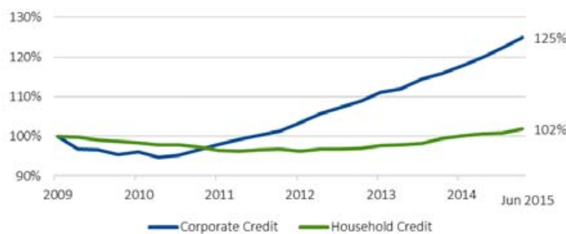
YTD:	99
2014:	60
2013:	81
2012:	83
2011:	53
2010:	83
2009:	268

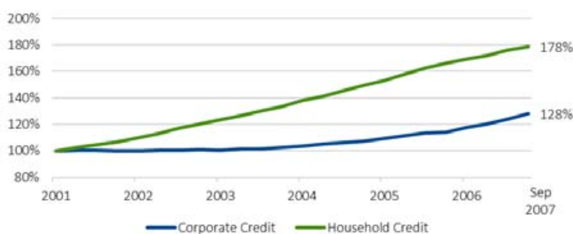
2001:	226
2002:	229

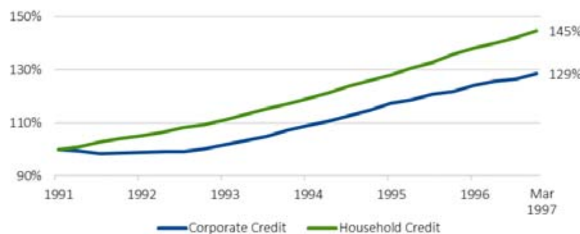
*YTD data as of November

COMPARING CORPORATE TO HOUSEHOLD

We found it useful to juxtapose corporate credit creation alongside household credit creation as these often go hand in hand. Since the start of the current bull cycle (post Great-Recession), growth in household debt has been subdued, and quite a few innings behind the corporate sector. Household debt measured $14.0 trillion at the end of June 2015, roughly equal to the $14.3 trillion peak in 2008. Residential mortgage debt (the largest constituent of household debt) has actually shrunk, as we'll elaborate upon in the next section. While consumer household debt (auto loans, revolving credit) has expanded, it's a smaller piece of the pie than mortgage debt.







It is unusual for commercial credit to outgrow household credit by such a wide margin. Following the introduction of more onerous regulatory requirements, banks and credit unions tightened their residential mortgage underwriting standards, clamping down on the debt spigot. If one only examined household liabilities, one could misconclude the credit game has barely thrown its first pitch. In the charts above, we looked at relative credit expansion over a 6-year period in the current cycle and the last two cycles. Over the very long run, one would expect secular growth in personal debt to match corporate debt. While this is broadly the case when viewing over a multi-decade window, there are periods of time when one widely outpaces the other. The last time commercial credit has outpaced household mortgage by this magnitude and for this extended period of time was in the early 1980s. While other factors play into the health of an individual or corporation's balance sheet, it would be fair to deduce that individuals have not been aggressive about leverage and are in good shape to withstand rate increases.

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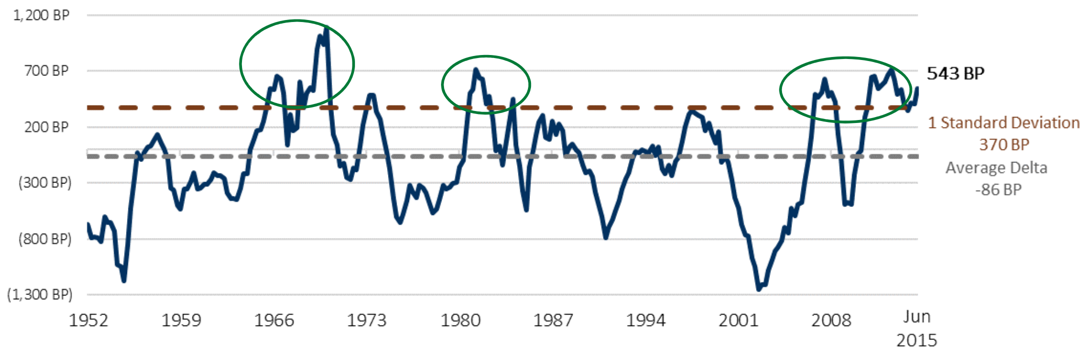
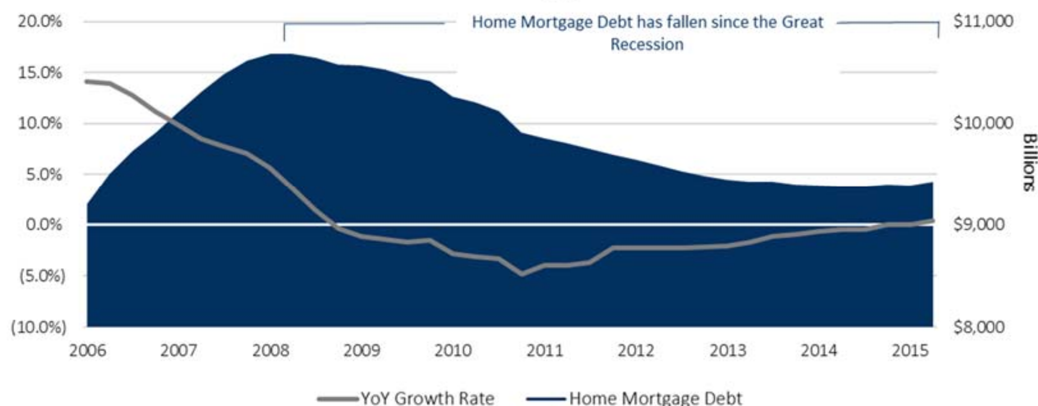


HOUSEHOLD CREDIT

The majority of household credit in this nation consists of mortgage debt. The country has over $9.4 trillion of home mortgages outstanding, down from the peak of $10.7 trillion in 2008. While corporate debt halted its contraction in mid-2011, mortgages have continued to contract, albeit at a slower pace.



Unlike the housing boom in the last upturn, the increase in home prices have NOT been debt-fueled. The last run up was a broad base phenomenon driven by credit-enhanced purchasing power. This time around, leverage enhancement is absent from many home purchase equations. Nonetheless, home prices, particularly in urban areas, have appreciated considerably. So what gives?

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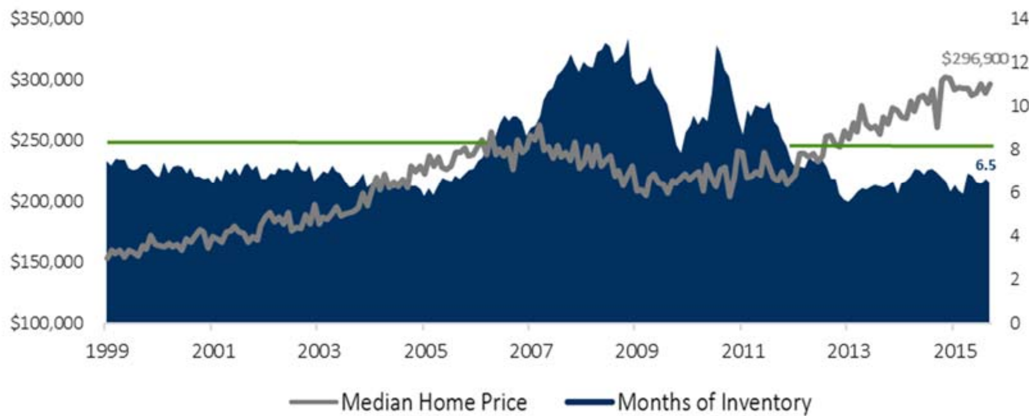
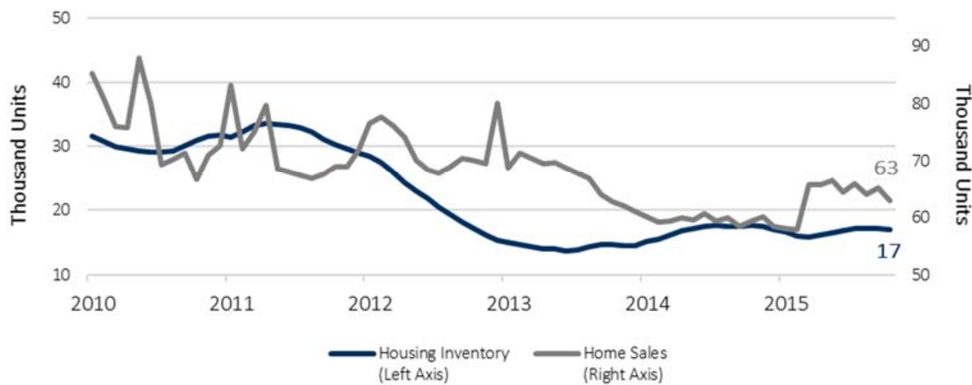
It's still a supply and demand imbalance issue. The demand side, however, is driven by a different profile of buyers this time around. Anybody who has a less-than-pristine credit score and has attempted to purchase an abode in one of the major metropolitan cities in the last five years has likely found themselves frustrated by competition stemming from cash-rich (often international) and institutional investors. A major impetus for these buyers when they began to move into the asset class was the perceived safety of a US-domiciled hard asset and its attractive yield relative to other yield investments.

Nationally, months of inventory is at 6.5 months, significantly lower than it was during the depths of the recession. While it is not dramatically lower than its long-run historical average of 8.0 months[1], it has remained below that for nearly every month since 2012 despite what has been an increasing supply of new home completions. We can see that when months of inventory is at 8 months or less, prices have tended to increase.



The same supply-demand conclusion can be drawn about metropolitan cities, to an even more pronounced degree. Los Angeles, for example, only has 3.2 months of inventory. Median home prices have skyrocketed 37% in 3.5 years (i.e. since the last time there were over 4 months of inventory). Many buyers have been priced out of the market, despite the relatively moderate use of leverage.



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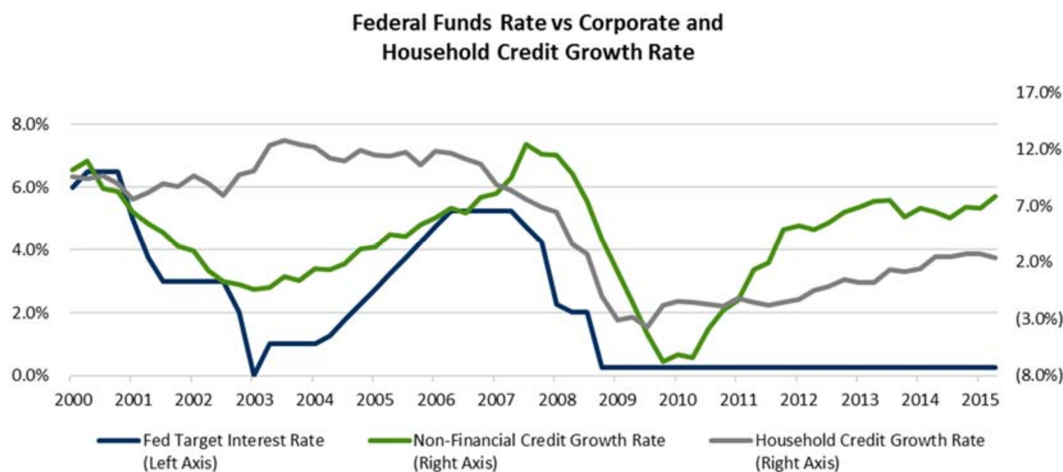
We simply have not detected the symptoms of an irrationally exuberant credit cycle. Based on our findings in the commercial sector, corporations are issuing a healthy degree of debt and defaults are still under control. Households are not relying on the home as a source of cash like they did in the last cycle. The dramatic increase in housing prices, particularly in urban areas, have been because of the large uptick in demand fueled by new segments of buyers. We do not see behavior from corporations or households that are emblematic of a credit bubble.



Many market participants are trying to determine what direction the ballgame will veer following inevitable rate increases. The last time we've seen a series of rate increases, corporate credit did not alter its trend, and we expect a similar result this time around. We believe the market will give us a few more quarters of accelerating credit expansion before we see signs of overheating. At some point we will look to write another letter "sounding the alarm" for our readers.

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Footnotes and Sources

1. HFP's methodology for calculation of months of inventory as follows: (existing home inventory + housing completions) / (existing home sales + new home sales).

   Sources

2. Federal Reserve Board. Flow of Funds.
   Series Z.1: Seasonally adjusted nonfinancial corporate business debt
   Series Z.1: Seasonally adjusted home mortgage debt
   Series Z.1: Seasonally adjusted household debt

3. US Census Bureau
   Housing Completions: seasonally adjusted annual rate
   New Residential Sales: seasonally adjusted annual rate
   Median Sale Price of New Homes: non-seasonally adjusted

4. National Association of Realtors
   Existing home sales: seasonally adjusted annual rate
   Housing Inventory: non-seasonally adjusted

5. Zillow
   LA County (LA-Long Beach-Anaheim)
   Inventory units available
   Building permits
   Residential units sold
   Median home prices

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