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The Great Unwind (Third of a Series)

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Our characterization of the current economic picture as a "precession" took into account the second quarter's negative GDP data. But last week's "blowout" labor report for July – 528,000 jobs added – combined with unemployment edging down to 3.5%, hardly depict the prelude to a recession. The number of jobs now stands where it did before the pandemic.

Of course this good news carries with it the bad news of higher inflation. A hot job market means higher wages which will add to the witches' brew of upward price pressures the Fed will consider before September's meeting. So far there's nothing to suggest that another 75 bps isn't likely, but plenty of data between now and then will be available to cinch it.

We asked a good friend with an informed economic view where he stood on the chance of a recession. "It looks unlikely anytime soon," he told us. "But right now markets are paying more attention to the Treasury rebound and corporate earnings.

"My own worry is quantitative tightening," he continued. "No one talks about it much, but the Fed announced early this year (and began in June) its plan to take liquidity out of the system by reducing its balance sheet. Next month it will allow an increased $95 billion per month of Treasuries to run off, including agency debt and MBS.

"Along with rate hikes, which have been well anticipated," our friend concluded, "QT is adding to market instability by raising the costs of top-rated securities for non-Fed buyers. That impacts all asset prices along the risk chain. And unlike rate hikes, QT won't pause in the fall."

As our *Chart of the Week* shows, the previous QT in 2017 lasted two years and reduced the Fed balance sheet by $850 billion. It was also conducted in a much less volatile environment with inflation under control and rates having been raised for over a year. This time it will aim to shrink reserves by about $2 trillion, twice the drawdown five years ago.

Unlikely as a recession is, based on current market and economic conditions, the possibility of one looms large in the minds of credit investors. That has played out in liquid markets with loan prices remaining depressed and all-in yields elevated.

Direct lenders are seeing higher spreads, 25-50 bps for first-lien term loans and 50-100 bps for unitranches. We have also observed risk-off behavior in lower hold levels (by half), use of proceeds (fewer dividend recaps), and leverage (staying below 6x). Industry concentrations, where certain sectors may be more cycle-prone, are also being monitored closely.

Repricing of the risk-free rate has highlighted the difference between technical risk (prices hurt by fund flows), a hallmark of BSL, and real credit risk of defaults and losses. The latter is at an all-time low, while the former could ease if recession worries abate.

Next week: We conclude our series with a look ahead at 4Q and 2023 in credit.