No Signs of Slowing (Except Defaults)

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Since Labor Day we've spent considerable time at conferences and with investors. Nothing focuses the mind better. And what we've found is a disconnect between perception and reality.

Take the economy. Beginning a year ago, there was a growing worry that higher rates were going to plunge the US into a recession. Anyone calling for a soft landing (as we did) was told how rare and unlikely such an event was. Bloomberg's market survey of economists showed expected growth for 3Q 2023 deteriorating, then bottoming at negative 1.5% this past April.

But as employment numbers strengthened and consumers continued to spend, opinions reversed. Predicted 3Q GDP rose each month to over 4%, culminating last week with news that, through September 30, the US economy grew by almost 5%. And to further flout received wisdom, lo and behold, core inflation came in at 2.4% for 3Q – close to the Fed's target.

Analysts rushed to caution that growth would slow from here, bottoming to near-zero in the first quarter of 2024 (see our *Chart of the Week*). But those doubtless some of the same analysts who called for a slowdown for the quarter just past.

Similarly, news on credit quality has defied warnings from rating agencies and investment banks. Despite BofA Global Research predicting private debt defaults could reach 5% next year, worse than 3.0% for BSLs, Proskauer's Private Credit Default Index actually *fell* from 2.15% in the first quarter of 2023, to 1.64% in the second quarter, to 1.41% in 3Q.

KBRA's Van Hesser publishes an excellent podcast, "Three Things in Credit." Last week's installment covered corporate earnings, the Fed's Financial Stability Report, and the default outlook. In it, Hesser said six of the S&P 500's eleven industry sectors had lower earnings so far this year. But "for the first quarter 2024, only three are expected to be negative."

Looking at public credit defaults, KBRA analyst Eric Rosenthal centered on high-profile troubled issuers such as Rite-Aid, Ligado Networks, and WeWork. He said default projections for 2023 remained on track: 3.25% for high-yield bonds and 4.5% for leveraged loans. "Large defaulters can shift the percentages," he reported. For 2024 he expects similar numbers: 3.5% for bonds and 4% for loans, with rates peaking in 2025.

Could defaults reach 5%? Hard to see, they reported. With the BSL universe of $1.5 trillion, 5% would translate to $75 billion in defaulted loans – equivalent to the GFC peak.

KBRA's 2024 direct lending default estimate for 2024 is 1.6%. As supporting evidence, they cited the small number of defaults year-to-date (40) amid their index of 2500 borrowers. Also, "the small club of direct lenders are more willing to work with sponsors as they have substantial skin in the game as buy-and-hold underwriters." Finally, liquid loans trade, so "various types of investors may have opposing agendas, especially when trouble arises."