DIAMOND HILL

INVESTED IN THE LONG RUN

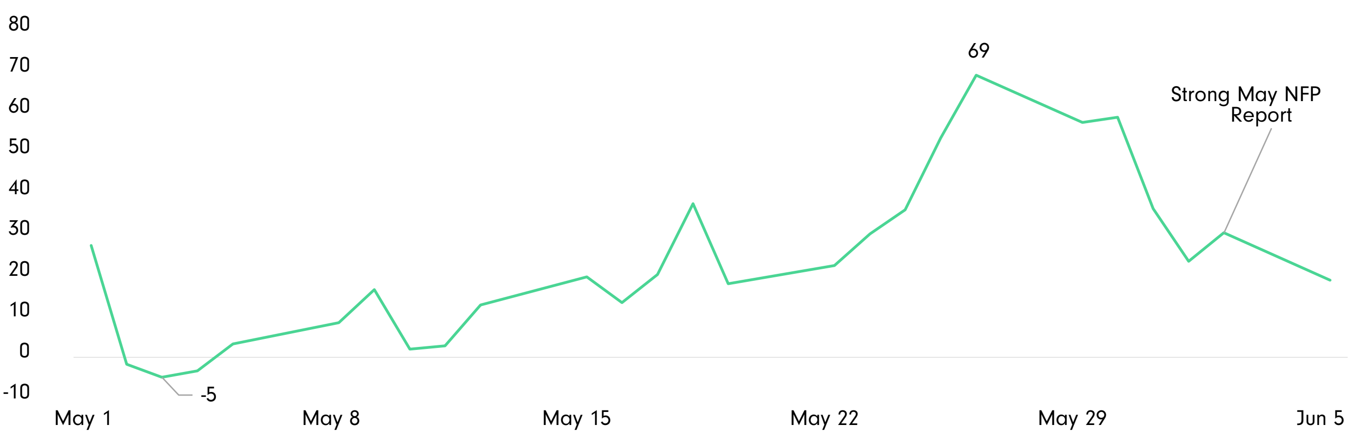
Rate Hikes, Regional Bank Failures, Debt Ceiling. How Is the Consumer Holding Up?

Jun 2023

It's been a tumultuous time in financial markets since the beginning of the year as investors digest the seemingly never-ending tightening cycle from the Federal Reserve, a mini-banking crisis and the ongoing debt ceiling debacle.

The Federal Reserve has continued its assault against inflation that began in the Q1 2022 by raising interest rates 25 basis points (bps) on three separate occasions since the beginning of 2023. Given Fed Chairman Jerome Powell's comments immediately following the most recent meeting (early May), expectations for a pause in the path of interest rates grew. But market expectations for the upcoming June meeting ran the full gamut throughout May, as shown in Exhibit 1, which tracks the percent chance of a 25-bps rate hike in June using fed fund futures.

Exhibit 1 — Market Expectations for 25-bps Hike at June 2023 Meeting (%)



Source: Bloomberg.

Earlier in the year, expectations for Fed action plunged on March 13 as concerns around potential contagion and a redux of the global financial crisis reverberated throughout the economy. The market volatility came to a head with the most anticipated and uncertain FOMC meeting since the global financial crisis. Given the stronger economic data and stubbornly resilient labor market, pre-regional bank crisis expectations had been growing for a potential 50-bps hike at the March 22 meeting, but on the heels of the banking events, uncertainty loomed. Jerome Powell announced a 25-bps hike and, despite the Summary of Economic Projections (SEP) showing a terminal rate for 2023 holding fast at 5.125%, the market continued to show a lower terminal rate as well as rate cuts before year end. The early days of May provided us with what is hopefully the final piece of the regional bank trouble as First Republic Bank was seized by regulators, with JPMorgan acquiring most of its assets.

Finally, the traditional game of financial chicken between the political parties came to a head at the end of May as President Biden and House Speaker Kevin McCarthy reached an eleventh-hour agreement to suspend the debt ceiling through the end of 2024. At the beginning of the month, when negotiations appeared to be going nowhere, yields on T-bills maturing around the expected x-date (early June) were trading with a 7-handle, illustrating the extra compensation demanded by investors to hold the bills most likely to be the cause of default.

The deal was passed by both the House and the Senate in the first days of June with expectations of Biden signing the bill into law and once more avoiding the financial catastrophe that would be brought on by a US government default. It remains to be seen how the major rating agencies process this near-calamitous event and whether any action will be taken as Fitch announced that the US will remain on negative watch despite the debt ceiling agreement. Once more, the US has succeeded in kicking the can down the road with the next showdown coming in 2025.

Along with discussing these major headlines and financial markets gyrations, one question we continually hear from clients is, "How is the consumer holding up?" So, let's look at the consumer and see where they stand.

Labor Market and Inflation

Despite the Fed's best efforts to slow down the labor market and inflation, it has only been marginally successful in bringing down inflation while the labor market remains quite strong.

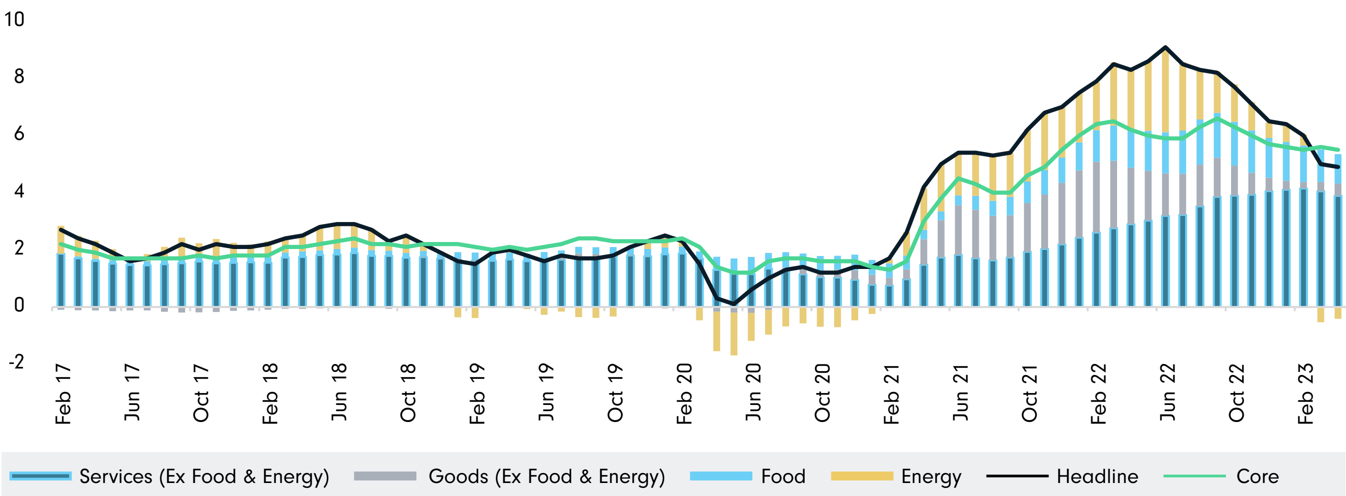
Consider that since the onset of COVID in March 2020, job creation is net positive more than 3.3 million jobs. Yes, there were disastrous months of March and April in 2020 (1.4 million and a mind-boggling 20.5 million month-over-month decreases in non-farm payrolls (NFP), respectively, but since that historic period, the economy has added 25.2 million jobs. Even if we exclude the early exacerbated recovery months and only look at the past 24 months ending in May 2023, the US economy has added 455,000 jobs per month on average over that period to get back on its feet. And while the May unemployment level stepped up from 3.4% to 3.7% in the most recent NFP report released on June 2, the economy added 339,000 jobs, well ahead of the consensus estimate of 195,000, with a revision of an additional 41,000 jobs for the previous month's report (253,000 up to 294,000). This marks the thirteenth consecutive month in which the NFP report exceeded the consensus forecast on the day of the release, illustrating the ongoing dislocation between reality and expectations.

The unemployment rate continues to hover in historic territory between 4.0% and 3.4% since the beginning of 2022 while the participation rate (percentage of the population that is either working or actively looking for work) has returned to pre-pandemic levels. The most recent reading of the participation rate (62.6%) is only slightly behind the final pre-COVID level in February 2020 (63.3%).

Average hourly earnings, a measure of pay, rose by 0.3% in the May report and wages are now up 4.3% from the same period a year ago. Combine these statistics with the fact that, according to the Federal Reserve Economic Data (FRED), there are roughly 10 million job openings currently in the US, the job market is proving to be incredibly resilient in the face of an aggressive Federal Reserve.

While the inflation battle appears to be succeeding, we must consider that victory could come at a steep cost. Upper- and middle-income consumers have been able to weather the inflation storm by adjusting spending habits and reconfiguring budgets. Lower income families, faced with higher prices at the pump and the grocery store, are facing some difficult choices. We could be seeing a bifurcation in the idea of a recession: some segments of the economy are faced with painful choices when it comes to their budgets while others are trimming habits but still spending.

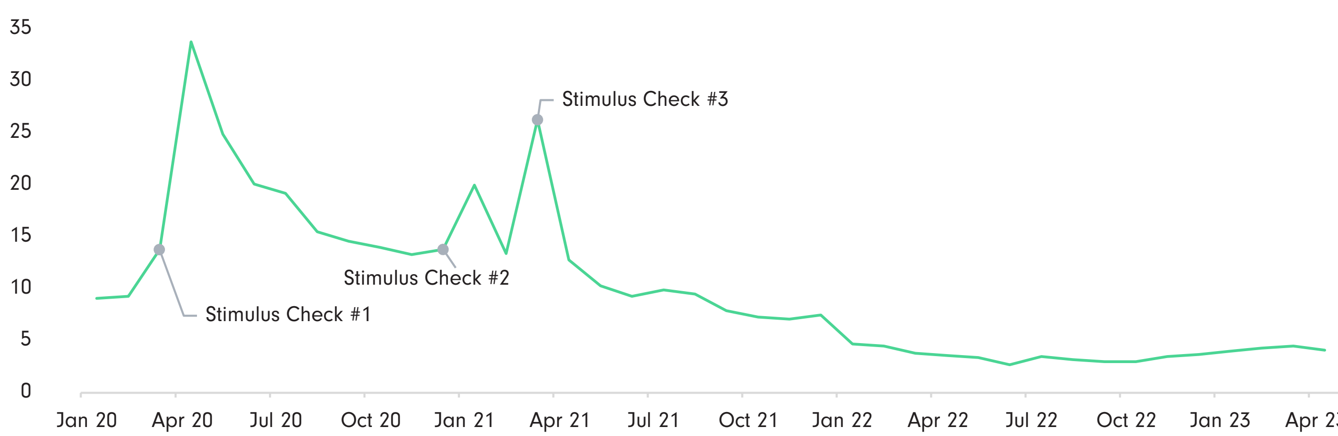
Exhibit 2 — Ongoing Inflation Battle Succeeding (%)



Source: Bureau of Labor Statistics.

There is some good news regarding the consumer's financial position. After an expected drop in the savings rate as the benefit of stimulus checks faded into the background, consumer savings levels have rebounded slightly in the past several months. The savings rate bottomed out in mid-2022 at 2.7% but has since pushed above 4% — still a far cry from the levels heading into and during the early days of the pandemic but trending in the right direction.

Exhibit 3 — US Savings Rate (%)



Source: FRED, Federal Reserve Bank of St. Louis.

Consumer Debt Performance and SLOOS Report

Credit Card Debt — While 60+ day delinquencies have risen over the past couple of months, they appear to be stabilizing and remain well below the historic 10-year average. As with all consumer-related debt, there is traditionally a nice uptick in performance in the early part of the year as tax returns help consumers meet their ongoing obligations. Charge-offs for both retail and bank credit cards are well below their 10-year average but have increased over the past few months.

Auto Asset Backed-Securities (ABS) — As referenced earlier about the bifurcation in the consumer financial position, prime auto ABS have held up quite well recently while subprime auto ABS have seen some cracks beginning to emerge.

Prime auto deals are below trend levels in 30+ day and 90+ day delinquencies and nearly half of the historic default rate. And while non-prime auto ABS have seen 30+ day and 90+ day delinquencies holding up well relative to historic averages, default levels have stubbornly remained above the historic average for the past nine months, though recent months have seen some improvement.

There is also a divergence based on vintage year. The loosening of underwriting standards in the non-prime auto ABS space in late 2021 and early 2022 has led to higher-than-expected delinquency levels when compared to other vintages. The industry's reversal of that loosening in subsequent months has led to much better relative performance. The other good news in the auto space? Recovery levels on reclaimed cars sold at auction have increased, and while not at the historic levels of the summer of 2021, they remain strong.

Consumer Unsecured — Regardless of origination type (marketplace/online or in-person branch), delinquencies have stabilized after trending higher the past several months. Net losses remain elevated but have come down from peak levels with similar differentiation in vintage performance to what has been seen in the auto ABS space.

Senior Loan Officer Opinion Survey (SLOOS) — Not surprisingly, lending standards tightened across residential real estate loans outside of government-sponsored enterprise (GSE)-eligible and government residential mortgages. Coinciding with this and most likely due to rate levels, demand for residential loans contracted albeit more slowly than in previous quarters. Banks reported tightening standards for home equity lines of credit as well as consumer loan categories, including autos and credit cards.

Student Loan Payment Restart — As part of the debt ceiling deal, the Biden administration has agreed to restart repayment on Federal Direct and federally held Federal Family Education Loan Program (FFELP) student loans after August 29, regardless of how the Supreme Court rules on the administration's forgiveness plan, which is expected in June. This ends a three-year long pause on repayments and could be a negative credit event for consumer ABS but should not be viewed as a widespread event.

Takeaways and Thoughts

So where does this leave investors when considering exposure to the consumer as we potentially head into a recession?

At Diamond Hill, we have always focused on a bottom-up approach to investing in fixed income markets and now, more than ever, it is important to remain focused on detailed due diligence and in-depth stress testing when considering investments. Due diligence can range from meeting with issuers (virtually or in-person) to running scenario analysis for the underlying loans to determine how they might perform in difficult economic environments. Stress-testing various environments helps reaffirm our conviction in an individual bond, as well as build a portfolio designed to protect client assets in a variety of environments by diversifying risk. We believe careful selection of undervalued securities and spread sectors offering incremental yield and total return relative to the index is the best way to generate successful long-term investment outcomes.

Learn more about our investment approach in our in-depth philosophy and process.