ADVISOR PERSPECTIVES

Corporate Credit, Housing, and the Next Recession

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More than a decade ago, a financial crisis sparked in part by a burst housing bubble plunged the U.S. economy into recession. What might cause the next downturn?

Admittedly, economists have been bad at forecasting recessions, to say nothing of their ability to foresee the trigger. Unexpected events, such as the emergence of the coronavirus, can send markets and the economy into a tailspin.

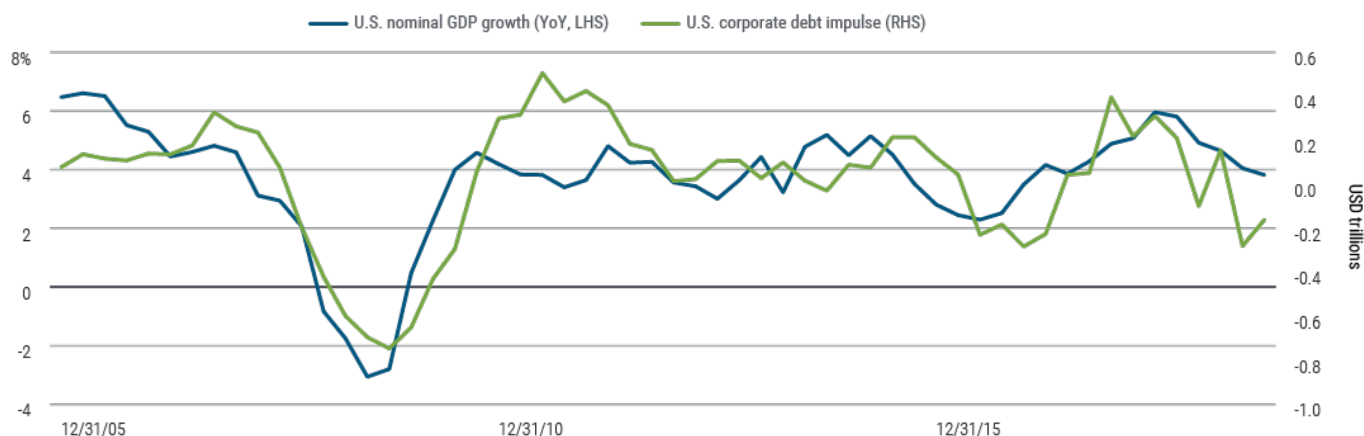
Nevertheless, while our baseline forecast calls for a period of weakness to give way to a moderate recovery during 2020, it is worth asking what might kill the U.S. expansion, now in a record 11th year.

Here, we share two themes – focused on the potential causes of the next recession – from our latest outlook, "Seven Macro Themes for 2020," which distills key points from our recent quarterly Cyclical Forum. We follow a suggestion by PIMCO advisor and Nobel laureate Richard Thaler to engage in a premortem – an exercise intended to mitigate groupthink and overconfidence in a particular baseline scenario.

In doing so, we asked our U.S. team to assume that the economy falls into recession in 2020 and suggest a plausible narrative of how and why this happened. The team zoomed in on vulnerabilities in the riskier segments of the corporate credit market that could exacerbate a slowdown of growth and turn it into a recession. The story goes as follows:

Potential cracks in the corporate credit cycle

In 2017 and 2018, due in part to a notable increase in nonbank loans to U.S. small and midsize firms that couldn't get credit from banks, the corporate credit impulse (i.e., the change in overall credit flows, which is highly correlated with GDP growth – see chart below) accelerated dramatically. These firms benefited from strong global growth and U.S. fiscal stimulus and drove the acceleration in private-sector job growth. However, when GDP growth decelerated during 2019 from 3% to 2%, private credit lending ground to a halt and, in addition, banks tightened standards on commercial and industrial loans.



Source: Haver Analytics, U.S. Federal Reserve, PIMCO calculations as of 30 September 2019. The chart shows the close correlation between GDP and the ebb and flow of overall credit to the corporate sector. The debt impulse is the dollar change in overall corporate debt flows, including bank loans, corporate bond issuance and private credit from the Federal Reserve's flow of funds data.

According to Federal Reserve data, private credit is a roughly $2 trillion market, or 9% of U.S. GDP, which makes a slowdown in this engine of credit growth seem manageable in the context of a robust labor market and healthy consumers.

However, if growth slows further in 2020 rather than picking up during the year as in our baseline, the riskier segments of the credit market would seem vulnerable. Private credit, leveraged lending, and high yield debt have been concentrated in

businesses that are highly cyclical and have riskier credit profiles. Moreover, despite solid bank equity positions, post-crisis regulation creates incentives for banks to ration credit when heading into a downturn. With speculative grade lending currently around 35% of GDP, stress across these sectors would be more than enough to contribute to a recession.

Again, our base case is that growth picks up in the course of 2020 and thus the financial accelerator" does not kick in to propagate a default cycle and recession (note that the term was introduced by current PIMCO advisor Ben Bernanke and co-authors in 1996). However, in our view, these corporate credit vulnerabilities warrant close attention, especially if growth should fall short of our and consensus expectations this year.

Housing and the next recession

In contrast to the 2008–2009 recession, which had its roots in defaults on risky mortgage loans tied to an inflated housing sector, we expect the housing market to be an area of strength in the U.S. economy this year and beyond. The decline in mortgage rates in 2019 has brought buy-to-rent and payment-to-income affordability ratios back to November 2016 levels. Moreover, credit score requirements for new mortgages have eased year-over-year.

Meanwhile, the excess homes built pre-crisis have finally been digested and we are entering a period of overall scarcity across the U.S. Housing vacancies and inventories are at their lowest levels since 2000, while household formations are once again picking up, arguing for an increase in investment needed to grow the housing stock. Our mortgage team expects U.S. home prices to appreciate by some 6% cumulatively over the next two years.

Read PIMCO's latest Cyclical Outlook, "Seven Macro Themes for 2020," for further insights into the 2020 outlook for the U.S. and global economy along with takeaways for investors.

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