BC Partners' Quarterly Credit Check

What to watch out for in an unambiguously bullish market

Ted Goldthorpe
Head of BC Partners Credit

Mike Terwilliger, CFA
Managing Director, Credit

BC PARTNERS

In this quarterly macro-commentary from the BC Partners' Credit team, Ted Goldthorpe and Mike Terwilliger, CFA, examine why they believe markets are at risk of overlooking certain fissures in the U.S. economy, as public investors embrace an unambiguously bullish outlook.

Given divergent signals in the market, we view this as an opportune time to share our views about the macroeconomic backdrop. Public investors have unambiguously embraced a bullish outlook. The S&P 500 has delivered the strongest rolling year to date performance of the 21st Century in 2024.[1]

Similarly, corporate credit spreads continue to push lower, with spreads for Investment Grade the narrowest since March 2005 and the non-financial sub-index the tightest since 2000. Hight Yield spreads have collapsed to post-GFC lows.[2]

While there are some merits to the optimistic viewpoint, we nevertheless believe markets risk overlooking certain fissures in the U.S. economy.

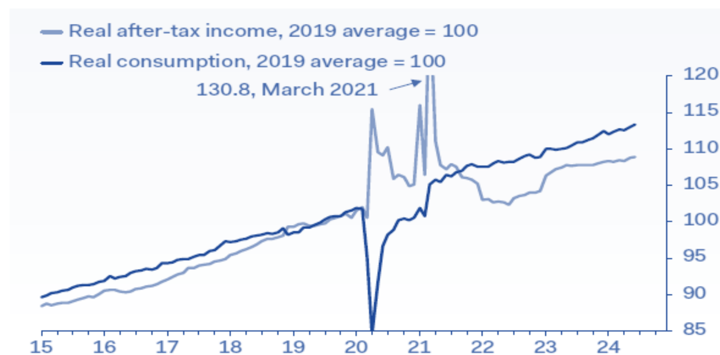
Macro Backdrop: The Concerning

With U.S. manufacturing in prolonged contraction (as reflected by ISM data), U.S. GDP will live and die with the consumer. Fraying by certain segments, particularly economically sensitive households, represents an underpriced risk, in our view.

For perspective, the fiscal and monetary response to COVID was roughly four times greater than the stimulus provided during the Great Financial Crisis.[3] The resulting wage and balance sheet growth have helped drive our post-pandemic recovery.

The fading impact of stimulus support and inflation have combined to erode real wages. Nevertheless, consumers have maintained their elevated pace of spending — now far outpacing real income:

Chart 1: Real after-tax income vs. Real consumption



Source: Pantheon Macro (8/7/2024)

In short, this dynamic is not sustainable. Consumers can fund this income/spending gap through lower savings rates and/or borrowing, but there are limits to both. After those thresholds have been reached, households will be forced to cut spending, which, in time, will drag on GDP.

Consumer credit stress presents a further risk. With credit card rates roughly 23% higher than historical levels, St. Louis Fed data reflects that delinquencies have risen dramatically across income cohorts.[4]

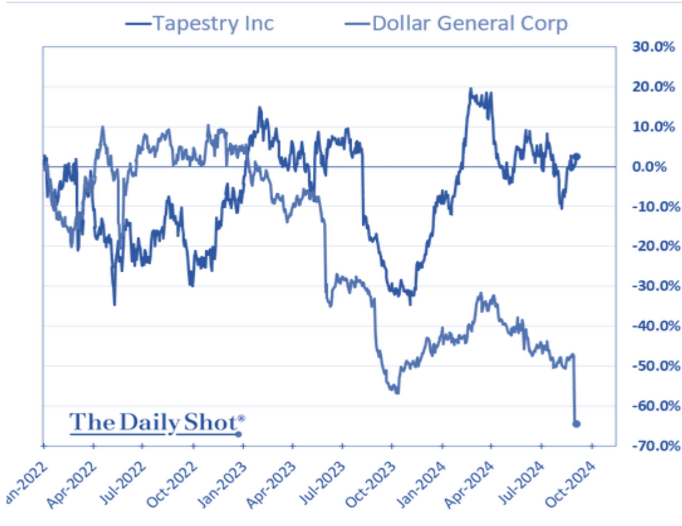
Further Fed analysis shows that serious delinquencies for auto loans and credit cards (+90 days) have reached the highest levels of the post-GFC era.

Relatedly, the New York Fed's Debt Delinquency Expectation Survey measures consumers' perceived risk of missing a debt payment within the next three months. The September reading of 14.2% (vs. 13.6% in August) is the highest since April 2020 (the peak of COVID panic) and above the ten-year average (2013-2023) of 12.1%[5]

If we could distil the current state of the U.S. consumer in one picture, it would be the following. Below compares the stock performance of Tapestry (the maker of high-end apparel under the *Coach* and *Kate Spade* brands) vs. discount chain Dollar General:

[1] Bloomberg and Deutsche Bank (10/8/2024)
[2] Spread Strategy Spotlight: "'Just Enough' or 'Just Can't Get Enough'" JP Morgan (10/22/2024)
[3] Carola Binder, *Shock Values: Prices and Inflation in American Democracy*, page 263 (New York City, U Chicago Press, 2024).
[4] The Daily Dash (7/9/2024)
[5] Federal Reserve Bank of New York (10/15/2024)

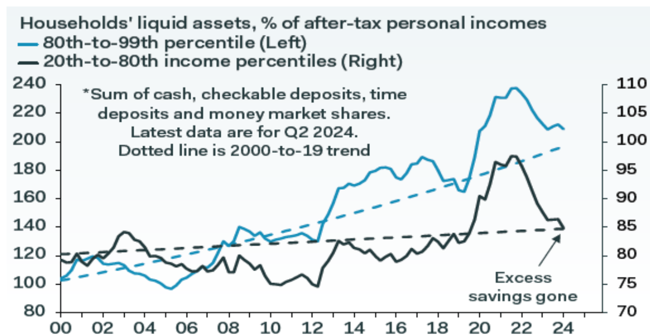
Chart 2: Trading Prices of Tapestry vs. Dollar General



Source: The Daily Shot (9/5/2024)

In short, we have a deeply bifurcated consumer economy right now. Liquid assets (which represent proximal potential spending) have become constraints for the vast majority of households:

Chart 3: Households' liquidity assets (as % of after-tax income), by percentile



Source: Pantheon Macro (10/21/2024)

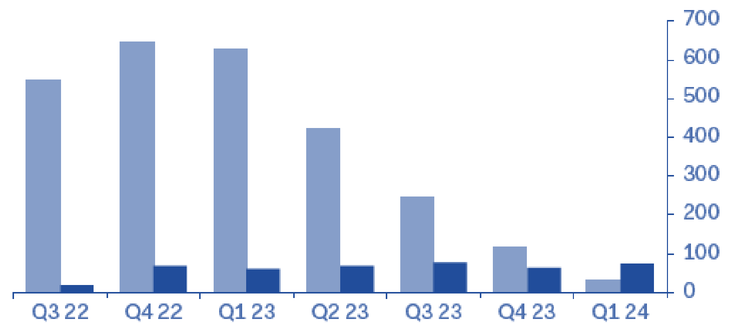
Although (intuitively) wealthy Americans drive most consumption, the bottom 40% of earnings still account for 22% of spending.[6] The vulnerability of this segments presents a threat to our economy writ large.

Bank lending—or rather, the continued lack thereof—represents another overhang for our economy.

As previously highlighted, traditional banks are facing a crush of obstacles: market-to-market losses, CRE uncertainty, depositor flight and Basel III End Game, being the most salient. Amid the shadows of uncertainty, banks, rather than performing their core lending function, have retrenched by hoarding cash. Banks are holding securities on the balance sheet well above historical norms and providing loans well below trend.

Banks pulling back has provided more opportunities for non-traditional capital providers, but private markets represent a metaphorical ripple compared to the waves of capital historically provided by banks:

Chart 4: Change in Bank C&I and CRE vs. Change in Non-Bank Lending to Non-Financial



Source: Pantheon Macro Research (7/11/2024)

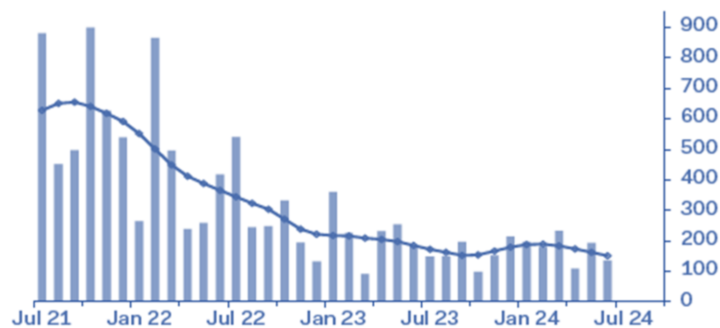
Simply put, the U.S. economy cannot continue to grow without availability and private markets cannot fully replace traditional banks. Recent rate cuts have loosened credit conditions, but that benefit has accrued to larger corporations, not the small and medium-sized businesses reliant on bank funding.

Jobs represent another concern worth noting.

First, layoffs have remained muted, consistent with our expectations. Businesses will be slow, in our view, to fire the workforce they struggled to build post-pandemic. Peak profit margins may further enable companies to delay the reflective layoffs evident in downturns.

Nevertheless, our concern centers on the unambiguous downshift in job creation, as shown in the following graph:

Chart 5: Private Non-Farm payrolls and trends



Source: Pantheon Macro Research (7/11/2024)

---

[6] Pantheon Macro (9/11/2024)

Forgive the cliché, but the "trend is not our friend" when it comes to jobs.

It is historically rare for the job market to regain momentum. Plus, jobs are often strong up until the point of a recession; then, the collapse is both sudden and severe. For example, on the eve of the GFC, U.S. unemployment was just 4.4% in May 2007 before a steady climb to a 10% peak.[7]

Headline job numbers have remained firm — particularly the blockbuster September report — but underlying data portends trouble ahead. Labor Differentials (the difference between "jobs are plentiful" and "jobs are hard to get" as measured by Consumer Confidence surveys) fell to 12.6 in September (from 15.9)—levels not seen since 2017.[8]

Our last concern to highlight relates to AI, which has been a key driver of the market's furious ascent. Guessing the future of artificial intelligence is (thankfully) far beyond our purview, but we note some potentially troubling data related to AI.

Technology newsletter *The Information* reported last month that just 0.1% - 1.0% of Microsoft's roughly 440mn users have subscribed to its AI add-on, Copilot.[9] Further, estimates of total revenue from all LLM (large language model) remains just $10bn.[10] For perspective, that is roughly the annual sales of *Sketchers*. Apple's new "AI enabled phone" has been met with a collective shrug by consumer, with the company cutting orders by nearly 10mn units.[11]

The *New York Times* recently disclosed that market-leader Open-AI is expected to burn $5bn of cash in 2024 on an estimated $3.7bn sales.[12] Relatedly, in a report this summer, tech investor Sequia Capital calculated that AI companies would need to generate revenue of $600bn simply to payback capex spent thus far (including spending on GPU's, energy, building, back-up generators).[13]

As for AI valuations, a recent report heighted that NVIDIA's market cap exceeded the equity capitalization of five G7 countries: Canada, UK, France, Germany and Italy.[14] For perspective, these countries generated GDP in 2023 of $2.1T, $3.3T, $3.0T, $4.5T and $2.2T, respective, compared to NVIDIA's trailing twelve-month revenue of ~$96bn.[15] Clearly something is amiss…

It is far too early to characterize AI as the next Oculus or Google Glasses, but roughly two years into its investment cycle, AI has yet to demonstrate a mass market application despite massive investment by market titans including Amazon, Apple, Google and Microsoft.

We are not doubting the long-term path of AI per se, but the hype cycle is in jeopardy. Again, math always wins in the end. AI's "rounding error" revenue having captured cultural zeitgeist and despite massive capital investment echoes of the Dot.com era.

Much as the gravitational pull of artificial intelligence has lifted asset prices, doubts about the technology, should they emerge, would weigh like an anvil on markets.

Macro Backdrop: The Good

Reversing gears, there are many positive economic signals underpinning the public markets cheery outlook.

As noted, economically sensitive consumers are struggling, but aggregate household balance sheets are remarkably healthy. Lifted by post-pandemic wealth effects, U.S. net worth and the growth of net worth as measured by Oxford Economics' consumer health monitor are nearing all-time highs.[16]

Much of these gains are concentrated, however. Affluent households disproportionately benefit from wealth effects; those without assets, see none. Aggregate data may therefore overstate their potential economic benefit, but the figures remain noteworthy.

Corporate balances sheets are also strikingly strong, with interest payments plumbing modern era lows:

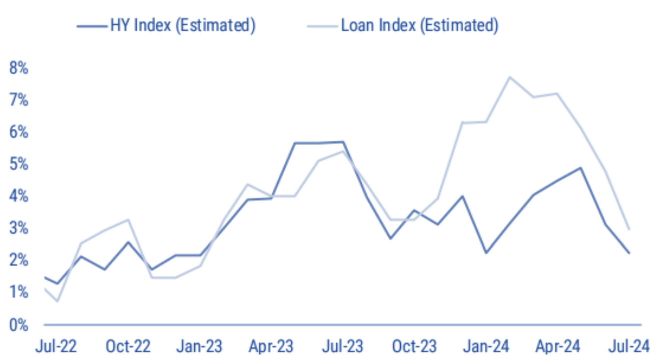
[7] U.S. Bureau of Labor Statistics
[8] Pantheon Macro Research (9/11/2024)
[9] "Hail Mary," MacroStrategy Partnership (10/11/2024)
[10] "Hail Mary," MacroStrategy Partnership (10/11/2024)
[11] "Apple Cuts Back iPhone Orders. Why Demand Fears Are Mounting," *Barron's* (10/24/2024)
[12] "OpenAI Is Growing Fast and Burning Through Piles of Money" *New York Times* (9/27/2024)
[13] Sequia, "AI's $600B Question." (06/20/2024)
[14] Apollo Chief Economist (10/24/2024)
[15] https://data.worldbank.org/indicator/NY.GDP.MKTP.CD and *Bloomberg*
[16] Oxford Economics (10/17/2024)

Chart 6: Non-Financial Corporate Interest Payments

Source: Oxford Economics (10/17/2024)

The low interest burden has, in turn, contributed to declines in default rates as well:

Chart 7: Trialing three-month default rate, U.S. High Yield and Levered Loans



Source: Moody's S&P, LDC, Bloomberg, Morgan Stanley (8/14/2024)

No conversation about markets would be complete without a discussion of interest rates.

First, the Fed's 50bps cut in September may, in time, provide an economic boost. However, much like the lagging impact of hikes, cuts will take time to flow through to the economy. Importantly, the long end of the curve (which mortgage rates closely track) is higher since the September cuts (reflecting bullish expectations), which may mute the near-term benefit of lower Fed Funds.

More notably, the Fed's cuts may accelerate a global easing cycle.

The recent surge in the dollar, in part, reflects market expectations that global easing may outpace the U.S.

Adding fuel, China recently announced a range of measures to jumpstart its economy, specifically trying to raise asset prices to lift consumer confidence. The size of these programs is larger than any Chinese government stimulus of the previous two years.[17] The country also cut its one-year rate to 3.1% from 3.35%, the largest reduction ever.[18]

Highlighting the global connectedness of easing, China timed these moves in the wake of the Fed's cuts to minimize the risk of capital flight. Herein lies the potential flywheel of stimulus as U.S. cuts beget easing around globe.

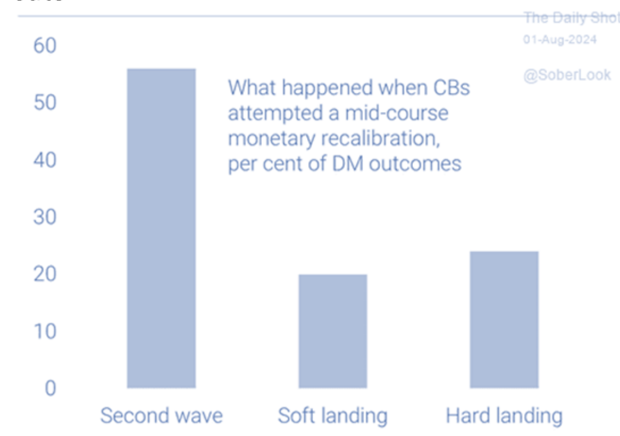
While lower global rates may prolong the current cycle, we note that U.S. 5-year inflation swaps have jumped in recent weeks.

Ironically, if lower rates reignite inflationary pressures, it may force the Fed to recalibrate the path and magnitude on its easing cycle.

Macro Backdrop: The Opportunity

Lofty public values suggest investors have put their faith in a soft landing. However, as reflected below, a benign outcome from mid-cycle cuts by global Central Bank have been historically rare:

Chart 9: Central bank track-record of mid-cycle cuts



Source: Fed study and TS Lombard (8/1/2024)

To be clear, we are unambiguously cheering for a soft landing. If the Fed arrests inflation without recession, Chair Powell would join Paul Volker in the conversation of greatest Chair ever. (The GFC has de-throned the once lauded Greenspan, in our view).

Nevertheless, with banks sidelined, certain consumers slowing, jobs creation likely having peaked, we remain skeptical. Geopolitical uncertainty represents yet another overhang.

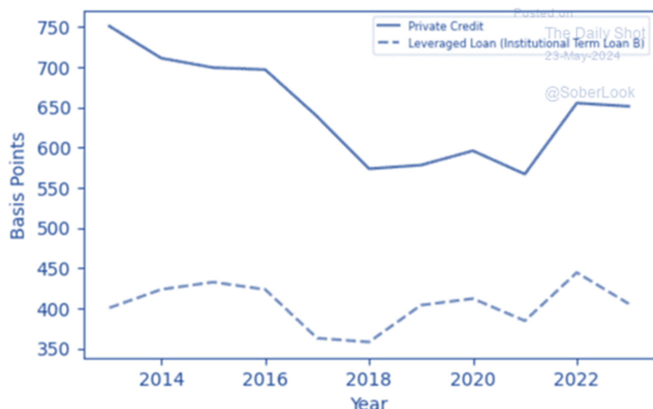
With public markets having priced the bull-case across many variables, we have a simple response: God Bless the Private Market.

[17] "How This Time is Different," Deutsche Bank (9/30/2024)

[18] The Financial Times, (10/21/2024)

As reflected in the following graphs, middle market private credit continues to command a meaningful yield premium:

Chart 10: Private Credit Spreads vs. Leverage Loan (Term Loan B)



Source: Debtwire (7/11/2024)

As for why private credit enjoys this advantage, I highlight the following passage from the Fed's study, "Private Credit: Characteristics and Risks:"

> *"Given the absence of a liquid secondary market for many private credit instruments, lenders typically hold these loans until maturity or a refinancing event. As a result, these loan contracts can include features uncommon to traditional bank loans, such as a structured equity component, high prepayment penalties, or a role in oversight or management of the company."[19]*

Don't fight the Fed when it comes to private market premium…

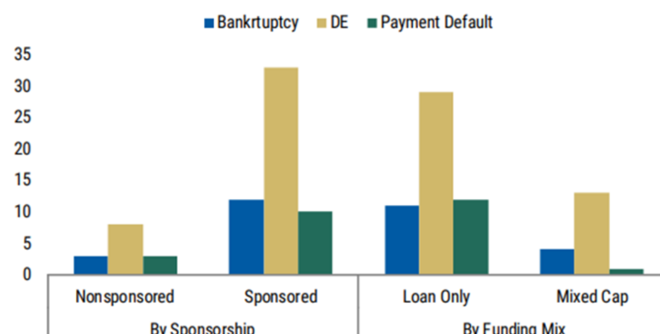
Again, not all private credit solutions deliver the same benefit. The dawn of monster funds by monster firms has seen a degradation in segments of this market. Platforms forced to chase large deals must compete against public markets to win deals, resulting in lower yields and fewer investor protections.

Again, BC Partners views companies with EBITDA between \$10mn to \$50mn as our "wheelhouse" — an advantage conveyed by our "Goldilocks" size.

BC Partners also focuses on lending to companies without private equity ownership, which often provides greater opportunity to dictate terms.

Sponsor-based transactions often entail aggressive structures (e.g. higher leverage, less amortization and no covenants) that have led, as reflected below, to higher instances of bankruptcy, default and debt exchanges:

Chart 12: Last Twelve-Month Loan Index Defaults



Source: Moody's S&P, LDC, Bloomberg, Morgan Stanley (8/14/2024)

Firms that measure their AUM in the \$10s of billions cannot participate in the most attractive segments of the private market — smaller and non-sponsored deals — which we consider our playground.

The outlook for large cap private credit appears even more ominous going forward. Lower interest rates have enabled public markets to claw-back market share, as *Bloomberg* underscored in their recent article "Banks Reclaim \$30bn of Debt Deal from Private Credit."[20] For clarity, none of those deals came at the expense of BC Partners.

Conclusion

The S&P 500 has gained 20% year to date through the third quarter. From this starting point — and with myriad risks in the subtext of our economy — equity markets feel like treacherous waters for investors.

This provides an opportune time to revisit a theme we have been hammering for several quarters: investors must reexamine portfolio construction.

The turbo-charged equity returns that propelled accounts post-GFC will not repeat in the years ahead. Reshoring, energy transition, shifting geopolitical order, aging demographics, non-zero inflation, "just in case" rather than 'just in time" inventories, persistent deficits and higher interest rates represent just some of the obstacles that will weigh on markets.

Goldman Sachs recently released a 10-Year forecast for annualized S&P 500 returns of just 3.0% (nominal).[21]

[19] Board of Governors of the Federal Reserve System, "Private Credit: Characteristics and Risks," 2/23/2024

[20] Bloomberg, "Banks Reclaim \$30bn of Debt from Private Credit." (10/03/2024)

[21] Goldman Sachs, Global Strategy Paper #71: (10/18/2024)

This represents but one of many market projections, but this outlook could undershoot by 4x and still trail the 16% per annum S&P return from 2009 to 2021.[22] Starting valuation and market concentration feature among the largest contributors of the bank's projections.

With higher returns likely available on a nominal basis, we think fixed income must become a larger share of investors' assets. From a risk adjusted perspective, the case for fixed income becomes overwhelming.

The demise of small and medium banks has tilted the opportunity towards private markets. Within private credit, investors should seek the most attractive lower middle market and non-sponsored segments.

---

[22] *"Cost of Capital and Capital Allocation, Investment in the Era of 'Easy Money" Morgan Stanely (2/28/2024)*

Important information

All information contained herein has been sourced from BC Partners Advisors L.P. (the "Advisor"), unless otherwise noted. Certain information contained in this Presentation may have been obtained from published sources prepared by other parties. Such information is believed to be reliable, but has not been independently verified or audited. The information presented herein is for illustrative purposes only and should not be considered reflective of any particular security, strategy, or investment product. It represents a general assessment of the markets at a specific time and is not a guarantee of future performance results or market movement. The information contained herein does not constitute financial, legal, tax or other advice, and is intended solely for the person(s) to which it has been delivered. It may not be reproduced or transmitted, in whole or in part, by any means, to third parties without the prior consent of the Advisor. Nothing herein is or should be construed as an offer to enter into any contract, investment advice, a recommendation of any kind, a solicitation of clients, or an offer to sell or an offer to invest in any particular fund, product, investment vehicle or derivative. The information contained herein is not complete, may not be current, and is subject to change. The Adviser is under no obligation to update such information. This material is not directed at, nor is it available for distribution to, U.S. investors or any persons in any jurisdictions in which the Adviser or its affiliates are prohibited by law from making this information available.