Consumer Dynamics Amid the Credit Crunch

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Anu Rajakumar: Investment grade credit has been an area of particular interest, thanks to attractive yield, robust demand, strong corporate fundamentals, and remarkable resilience in consumer spending but with concerns about the impact of a higher interest rate environment and a potential economic slowdown on the horizon, investors are wondering about how investment grade credit will be affected and where the spending patterns can hold steady as consumers navigate the complexities of higher rates for longer and inflationary pressures. My name is Anu Rajakumar. And joining me today on this episode of *Disruptive Forces* is Kristin Cedja, Co-Director of Investment Grade Credit Research, and a Senior Research Analyst to unpack the dynamics that make investment grade credit an area worth watching. Kristin, welcome to *Disruptive Forces*.

Kristin Cedja: Thanks for having me, Anu.

Anu: Now, Kristin, to get us started, why don't you give us an overview of the current state of credit markets particularly as it relates to the consumer retail space?

Kristin: Sure so, the state of the current credit markets globally spreads are tight. A goldilocks situation is priced in many ways. Spreads are tight for technical and fundamental reasons and justifiably so. The market's pricing a relatively benign outcome for the macro, the election, a smooth exit here of monetary tightness from the Fed and other central banks around the world as rates are presumably cut over the next 6 to 12 months. And all this is very well priced.

Our base case remains the Fed cuts two times inflation comes down in the US and spreads remain tight across the global IG corporate space. From a fundamental perspective, fundamentals are healthy and stable in aggregate, and from a technical perspective, this year, we've seen really robust demand and supply has followed that strong demand for all in yields. So, supply in the US, for example, is up over 30% and we expect this to moderate a bit in the back half, but still end the year up low double digits for the full year.

As it relates to the consumer retail space in IG, it generally skews defensive, Triple B in the case of consumer and up in quality in the case of retail. So, spreads in both sectors look relatively tight to us, and this is partially driven by the high-quality nature of the constituents and their strong fundamentals. There's some bifurcation between your higher quality issuers who have strong balance sheets that in theory they could put to use over the next 12 to 18 months, and then those who are struggling. This feeds into some interesting one-off stories in companies that are having idiosyncratic issues, some spread volatility, and creating some opportunities to trade. Lots of companies coming out of COVID cleaned up their balance sheets. They've enjoyed inflation-driven top-line growth, and they're now facing an inflection point of how to grow from here.

We've been doing a lot of work on how micro-company information feeds into macro, and we work closely with our multi-sector team in relaying any insights from earnings around the consumer, around spending, and around how the consumer is feeling in the current environment. So, we're right in the heart of retail earning season, but McDonald's noted that they're getting pressure to have a national value offering, given that consumers are trying to make their dollar stretch.

Starbucks noted that the occasional consumer is taking less trips to their store. Home Depot noted that large ticket comps are down, and their consumers are adopting what they referred to as a deferral mindset for projects that are large ticket and require financing given the higher rate environment. Walmart also noted better trends for staple goods versus discretionary items and was very keen to highlight that they're gaining market share from the higher-income cohort.

Banks echoed this commentary as well. In fact, our bank analyst has been at a conference with lots of C-Suite execs in this space, and the narrative from there is, again, consumer spending is normalized, lower FICO customers are experiencing more pressures. So, picking up a little bit on that bifurcation between your low-end and your high-end consumer.

Anu: Terrific. That's a great overview and certainly what I think we've been seeing a little bit more in the news over the last few weeks. I'm just curious, has anything surprised you, about the current state of the investment grade market, particularly given some of your comments coming out from earning season?

Kristin: Sure. So, I'd answer that with first, what does not surprise us is tight spreads just given, the background of technicals fundamentals and all in yields. But on the consumer side, during earnings, I would say the resilience and the persistence of the consumer strength has what has surprised me, how long consumers have been able to really sustain that spending power. We've been hearing a lot about the excess savings of the consumer being worked down with different theories as to when that's run out. But in the face of inflation, double-digit price increases for basic goods. The amount of time that the consumer has been able to be resilient has surprised me. All of the companies I cover in food and beverage, for example, have passed through inflation quite easily to the customer because inflation was widespread. It was easy to do. And while the environment has become more promotional, these price increases are really here to stay.

We are finally starting to see some of the cracks as it relates to private brands taking share from branded which is typical during a time of consumer trade down. We've seen the consumer finally exercising some discretion as evidenced by some of the lower discretionary spending with a focus on staple goods instead of discretionary items. And as I noted, Walmart noting that the high-income cohort is what's driving market share gains in the Walmart store.

So, this resilience theme that has taken me aback a bit is currently being tested in real time and data is coming out to support that claim. I'd say the other piece of surprise is just wage growth is still strong, and nominal wage growth is still running above inflation. So perhaps the consumer is coming to the tail end piece of that savings from the past couple of years but given the wage growth situation, they still have some spending power and money left to spend. That being said, it feels like we're in the very late innings of that equation and the cracks are starting to emerge like we're seeing so far in earning season.

Anu: Yeah. Sure. Absolutely. And so now, I guess another question for you then is how are the companies responding to these shifts in consumer retail and economics? Particularly you said they must be looking at when, or thinking about when excess savings are going to be coming to an end and what that means for their businesses.

Kristin: Sure. So, companies are seeing a backdrop where they need to start thinking about what other levers they can pull to grow their top line other than price. So how can we offer value to a consumer? How can we drive traffic to our store? We've really been able to rely on price to grow our top line but now we need to assess the conundrum now of the consumers digested these price increases and now is looking for value, flexibility, convenience which was a nice way Walmart put it on their earnings call.

So, one way to grow is to buy it. So that enters in the theme of M&A. So, M&A has been robust this year. We tend to think about M&A in four buckets around what's the motivating factor behind the transaction. In our view, the four buckets are buying growth, cost, savings, and scale, regulatory changes, and the new interest rate regime. And then finally, industry disruption. So, in the consumer space, we've seen companies' growth benefit from the extra money in the consumer's pockets to spend on goods during COVID that obviously with reopening shifted to services, we saw companies pass through the inflation in the form of price increases. And these have been very sticky. So, the price part of the top-line revenue equation drove most of the growth. But again, that's all in the rearview mirror now. Companies need to think about how to grow and where to find it and a lot of times it's turning to inorganic opportunities in the M&A space. In the situation where companies are deciding to buy growth instead of growing organically from a creditor's perspective, one of the first things you want to look at is how these deals are being financed. So, a large portion of the deals this year actually have been all equity. So, in some cases, not adding debt to the balance sheet can provide an opportunity to capitalize on a lower-rated entity being purchased by a higher-rated entity.

In other cases, we are seeing companies use a mix of cash and stock, and in the case of the cash portion, a lot of the times that comes in the form of debt. So, we have seen some M&A transactions as well where companies are putting debt back on the balance sheet, even at these higher interest rates, given that they've cleaned up their balance sheet, they've kind of cleared a runway to accommodate that debt. And they think that even at higher rates, sort of the longer-term strategic nature of making the acquisition is going to overrule perhaps the higher interest expense they'll incur for the financing. A good example of that is what Home Depot recently did, so they are acquiring SRS distribution. Their credit ratings were affirmed at mid-single A. The company has had a very strong balance sheet through many economic cycles and a conservative history, so ratings were affirmed, and the company will be in our market with new bonds and that could present an opportunity in the name.

One of the more high-profile examples in that cost savings and scale bucket would be the Kroger Albertsons deal in the retail space. So, this is a deal happening in a structurally low-margin, highly competitive grocery industry. And Kroger is notorious for leveraging up for M&A to grow, paying down their debt, and then going right back to their M&A playbook. At the heart of a host of issues wrapped into this deal are--will this result in higher prices for the consumer who's already been feeling a lot of pain at the grocery store? What does it mean for the jobs, many of which are unionized, when this transaction goes through? Is the divestiture plan the company is put in place to try to get regulatory approval set up for success or failure?

In addition, it's interesting because this is an instance where we have a mid to high Triple B investment grade company buying a high-yield company. So that's presented a variety of investment opportunities, whether it was avoiding Kroger bonds ahead of the leveraging deal, being tactical in Albertsons bonds, and now, on our end, waiting to see what happens with the deal with potential new issuance from Kroger to fund it. The FTC in several states are suing to block the deal so, this one's headed to court, but it's a good example I think that incorporates a lot of the key themes that we've been talking about.

Anu: Yep. And as you say, you know, there's been a robust M&A activity this year, but as you highlight in that example, there are some risks and issues, they're not all going through. Talk about that a little bit more. What are some of the other potential headwinds to the M&A space right now?

Kristin: Sure. So, the way I think about it is, first and foremost are the regulatory issues and the highly scrutinizing FTC. We've seen the concerns raised by the agency, not only in consumer retail but across sectors. It's also an election year, which will have implications for key appointees and policy stance as it relates to kind of big M&A. And the Kroger Albertsons deal heads to court this summer and so I think the outcome of that will really set the tone for other corporates who are looking at some of these larger scale, high profile transactions that undoubtedly will run into some market share and FTC pushback.

Given these risks and issues as bond investors, I'd say we need to do our due diligence and be cognizant that whenever a bond is issued in association with an M&A transaction, we need to make sure we're really aware of some of the special terms that get put into these deals because companies can issue bonds before the deal actually closes. So in our market, that means looking at some of the special mandatory redemption language in the actual bond documents, thinking through deal probabilities, upside downside scenario analysis because in some cases the language that gets put into some of the bond deals is such that your bonds will get put back to you at 101 if for some reason the merger is not completed, one company may owe the other company money. In the case there's a breakup fee, that's got to somehow be funded that will have implications for the credit profile. So, from an investor seat, it's being aware of some of these provisions and how they can impact valuations and scenario planning.

From a company perspective, I would say 12, 18 months ago, a lot of companies given the macro backdrop at the time, there was lots of chatter around a recession, and a lot of companies I think we're a little bit hesitant given the uncertainty on the horizon to do much. As that abated, I think there's more comfort and appetite for making decisions and doing M&A, which is what we've really seen play out this year. But I would say that that macro piece, so the broader enthusiasm on the goldilocks macro that could change consumer labor jobs, a weaker consumer feeds into risk to inflation. The fed's ability to cut rates over the next 12 months, all of these risks feed into the macro environment. And I think that will feed into the outlook of CFOs and CEOs and boards who are considering the next strategic step for their company.

The last important piece would be valuations. So, the last thing companies want to do is overpay for an asset and then have to write down the value later. So, attempts to innovate business models just for the sake of innovating by putting two different businesses together could be something to watch out for. We have seen this happen where two companies combine and then five to seven years later, you hear that they're breaking the businesses back up. So, I think companies are very cognizant about the valuation environment and being careful to make sure they're not overpaying for an asset in this environment.

Anu: Great. You know, as you were talking about being aware of the various different scenarios and talking through some of the potential outcomes that you might see, one thing I wanted to ask you about is, are there any additional items that you think are underappreciated, in the market or, you know, not being spoken about quite so much? Whether that's M&A type of deals or just broadly across investment grade credit?

Kristin: Sure. So broadly across investment grade credit, a couple things come to my mind. One is the speed and pace of disruption. So, our team spends a lot of time doing sector and industry research, trying to pick up on key trends and themes and industries and identify cyclical trends versus secular versus structural changes in industries that are going to impact all of the issuers in a particular industry. So, I would say we are seeing business models changing quickly due to the fast pace of disruption and innovation. And on the flip side of that, there are certain balance sheets that perhaps are not set up properly for that environment. We think a lot about forces like artificial intelligence, some of the drug innovations that have recently become more mainstream, and some of the evolving regulatory backdrops when we think about this kind of broad bucket of different disruptive forces for business models.

In addition, we've spent a lot of time thinking about the Triple B portion of the market, given it is very large in the industrial corporate credit space globally. And one of the things on our minds is looking out for historically defensive sectors that have had strong cash flow streams that have enabled them to perform well through a cycle and support certain capital structures. We like to think about if any of the sectors that fit into that bucket are undergoing any structural business model changes that could impact future cash flow generation and therefore perhaps expose inappropriate capital structures. In IG, the healthcare pharma space is historically defensive sector that is transforming, and it is on our radar. There have been lots of regulatory changes, vast innovation, leveraging M&A, evolving cost structures, evolving business models.

A lot of what I just spoke about, and this is one we're closely watching and it's one we're getting the sector trends and issuer credit picking is going to matter more and more in our view going forward. This really ties into a bit as rates move higher here, over-levered balance sheets have been exposed, not as much in the IG space, but perhaps there's more to come and it is something we're continually asking ourselves, what is the prolonged low-rate environment masked or hidden that perhaps is yet to reveal itself?

So, our team spends a lot of time trying to think about some of these disruptive forces' impacts on sectors and business models and perhaps what is structurally different going forward that is something new that perhaps was not the case 10, 20 years ago.

Anu: Yeah, those are certainly important questions to be asking as investors and side note, appreciate throwing in, Disruptive Forces, not once but twice in that response. So, [chuckles] well done, well played. You know, a lot of your comments I believe have been shared with a US lens. Just wondering if you have any comments kind of outside the US and other developed markets. The eurozone economy has been challenged but appears to be turning a corner. Japan's going through a number of critical transitions. What does investment-grade credit look like around the world?

Kristin: Sure. So global credit markets on our team are going to incorporate a Euro and the Sterling IG corporate market and generally, I would say a lot of the trends are similar. Spreads have rallied this year. Heading into the year, there was opportunity on the Euro side, specifically in real estate financials and utilities and spreads have rallied and are tight now. So, we've been able to kind of capitalize on some of those opportunities but now take some chips off the table. I would say on the M&A theme in our market, that's generally a global theme as the companies we follow, and track are global. But, for example, in the European banking space, we think there will be more consolidation and that will present some interesting investment opportunities.

Same for the metals and mining space. We've seen an increase in deal activity there and again, that presents opportunity for trading in certain names. And I would also highlight that we do like to look at opportunities at the sector and the issuer level across currencies. So, to the extent that there's an M&A deal and the transaction involves bonds issued not only in dollars but Euros and Sterling, we will look at those opportunities and do relative value analysis of each company relative to comps within its currency and across currencies and try to capitalize on the best opportunities across the global space. I would say from a demand perspective, it's worth noting that generally, our view on the demand for global IG credit remains strong and that's a global trend we've seen strong flows across the board.

Anu: Terrific. All right well wrapping up here, Kristin, why don't you share some thoughts on the outlook going forward. What are your thoughts on credit market trends and where will they go from here?

Kristin: So, given the dynamics mentioned at the opening, we have a small overweight to credit risk but we're cognizant that spread tightening opportunities are pretty limited here, dispersion is low. So generally, we've been reducing risk and doing some up-in-quality changes in the portfolio given this backdrop that are sector and issuer-specific. Again, spreads are tight, but it's justified so we still are overweight and like the banking space there's still some lingering concerns around regional bank issues.

There was a lot of supply that has hit, that's resulted in spreads being more attractive. We still like Triple Bs and aggregate, however, I would say we're less allocated to some of what we would call the economic cyclicals like energy metals, mining, and chemicals, were more so targeting Triple Bs with less economic cyclicality. The caveat there is not every sector that's viewed as defensive historically will continue to behave that way, as they kind of noted some of the different disruptive forces there coming to play whether it's the healthcare pharma space, the telecom media entertainment space.

So, as the environment changes from low volatility, low dispersion, low spreads, we're hoping we're positioned here where we can capitalize on some opportunities in the market. Perhaps it's going to be in relation to M&A or when we have a differing view of an idiosyncratic situation. So, we've been talking about sector and credit picking, and how that's of the utmost importance in this market and in this tight-spread environment, and we think that that will continue to be of the utmost importance going forward here for the rest of the year.

Anu: All right, Kristin, thank you very much for sharing all of those comments. I can't let you go without a quick bonus question. So since, you focus on consumer retail companies which we've spoken about a little bit in this episode, my question for you is, if you were given $10,000 to do one of those game show shopping sprees to any store that you could choose, which one would you pick and why?

Kristin: So right now, with $10,000 for a shopping spree, I'm probably going to be boring and say that I would pick Walmart, and I would outfit my new nursery for baby number three with all sorts of great baby goods and staple items.

Anu: That sounds like a very very good use of the 10,000 imaginary dollars that we're giving you for shopping spree. Well thank you very much, Kristin, and congratulations, on that exciting news. You know, you've shared a number of great insights today on this episode. It sounds like the investment-grade credit market still being buoyed by strong demand, resilient corporate fundamentals. You know, you've spoken about the extraordinary resilience of consumers, again, evident in that robust spending. It sounds like adaptability to inflationary pressures, but as you highlighted, maybe challenges ahead, from narrow spreads and potential economic slowing but you know, you wrapped up in your comments explaining kind of the focus on high-quality, holdings, security and sector selection, and you know, that constant focus on risk management, which of course will be critical to adding value in investment portfolios. So, with all that said, Kristn, thank you again for coming in the show. We appreciate your time today.

Kristin: Thank you and happy to be here.

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