Private credit

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Investment opportunities

Nuances in consumer credit

Inflationary pressure

Investment opportunities and US consumer credit

Navigating uncertainty

Amidst the prevailing tariffs-related uncertainty in the market and the first quarter GDP turning negative in the US, market participants are undoubtedly questioning the impact on and resilience of consumers. This policy uncertainty could ultimately lead to a weaker labor market, wider credit spreads to account of a higher recession probability, and more dispersion.

This is a meaningful shift in the market regime compared to prior years. So, we believe that at a minimum, it will likely lead to higher dispersion in the coming quarters. Our position allows us to engage with various credit strategies and offer a valuable perspective.

Recent headlines highlight rising consumer delinquencies in credit cards, raising concerns about the US consumer's financial health.

Joe Sciortino

Head of Unified Global Alternatives – Private Credit

Adapting to shifts in a dynamic market

This article explores the current trends and strategic investment opportunities within the US consumer credit sector.

Entering the current rate hiking cycle, US consumers were generally in good shape due to several factors:

- Low household balance sheet leverage, compared to previous crises like the Great Financial Crisis (GFC)
- Historically low unemployment rate
- Elevated savings rates, initially following the pandemic

However, since 2021, inflationary pressures have built up, leading to a substantial interest rate hiking cycle. As the impacts of inflation and higher interest rates were felt, credit card and unsecured consumer delinquency rates began to rise. This increase in delinquency rates has sparked concern and uncertainty among investors and analysts.

While credit card delinquency rates are higher today, part of this increase, in fact, is attributable to changes in the borrower universe.

These factors include:

- Credit score inflation, which occurred partially due to the stimulus that was available during the pandemic
- Growth of credit card balances
- Increased credit availability to lower FICO (Fair Isaac Corporation) score borrowers

In addition to the above-mentioned factors, credit cards and unsecured consumer underwriting standards were loose in the years following the pandemic. Consumers, especially those with lower credit scores, were negatively impacted by the strains of higher inflation in recent years. Ultimately, the impacts of looser underwriting standards, credit score inflation, higher interest rates, and higher inflation created increased pressure on the lower end segment of the consumer credit market, which has exhibited rising delinquency rates, resulting in higher levels of debt and subsequent delinquencies, while not necessarily true for asset-rich borrowers.

Since 2022, we believe that there has been a notable divergence in consumer credit performance:

- Higher earning, higher FICO homeowners have generally outperformed
- Lower earning, lower FICO renters have generally underperformed

This divergence highlights the importance of understanding the nuances of consumer credit behavior and identifying the segments in the credit market that are most vulnerable to economic fluctuations. By focusing on these distinctions, investors can better navigate uncertain times and adjust their strategies accordingly.

Capitalizing on potential

As a result of these trends, we're targeting investments in the higher quality, more defensive segment of the borrower universe with an emphasis on asset-backed oriented opportunities, at the expense of potentially slightly lower yields. These include currently:

- US residential credit: Tighter underwriting standards and borrowers are benefiting from low fixed-rate mortgages and the decade-long undersupply of new homes in the country provides attractive tailwinds to benefit from this particular theme within credit and…

- US small business lending: Due to tighter underwriting standards since 2022 and the ability to exclude sectors negatively impacted by rising inflation and interest rates in close partnership with our managers

In our view, focusing on these higher-quality segments may allow investors to mitigate risks associated with deteriorating credit performance among lower quality borrowers. By emphasizing residential credit and small business lending, we aim to leverage the stability and potential growth prospects of these sectors.

Final thoughts

The US consumer credit sector is experiencing significant changes due to inflationary pressures and elevated interest rates, leading to a bifurcation among the consumers. By focusing on higher quality segments of the borrower universe and asset-backed strategies, investors can navigate these challenges and capitalize on strategic investment opportunities. Understanding these trends and leveraging expert insights is crucial for making informed investment decisions.

As we move forward, it's essential to continuously monitor the evolving landscape of consumer credit and adjust investment strategies to align with the latest developments. By doing so, investors can enhance their resilience and adaptability, equipping them to navigate uncertainties and a potential economic slowdown more effectively.

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