A WORLD IN DEBT | MACRO STRATEGY

ABS: Normalizing Delinquent Behavior

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MetLife Investment Management

Introduction

A World in Debt

Governments, businesses, and consumers all took advantage of a decade of free money. Bond markets are now multiple times larger than before the Great Financial Crisis (GFC), having soared to record levels. Economic activity and most financial markets benefited. As central banks around the world swiftly raised interest rates to fight inflation, significant challenges are emerging, especially concerning the ability to refinance or repay substantial volumes of maturing debt.

Looking ahead, 'debt overhang' may act as an on-going economic headwind to GDP and productive capacity. As government debt servicing costs rise as a percentage of GDP, political tensions could rise further especially given the rapidly shifting geopolitical landscape. The shift in the cost of capital may also impact business decisions, R&D, social spending, government deficits, supply and demand of securities, the shape of the yield curve and central bank policy decision making.

Our ongoing series "A World in Debt" will continue to examine significant trends across various sectors of the financial markets. In this latest report, we focus on the consumer and auto asset-backed securities (ABS) markets, exploring how rising delinquency rates may stabilize in the coming quarters. This analysis delves into the impact of tightening lending standards, moderating inflation, and resilient consumer balance sheets, offering key insights for discerning investors. Stay tuned for further in-depth analysis on other areas of the credit markets, providing guidance on how these trends may influence your investment strategies moving forward.

Key Takeaways

- We believe recent increases in delinquency rates for consumer and auto asset-backed securities (ABS) should stabilize over the next few quarters due to tightened lending standards, moderating inflation, looser monetary policy and a stable labor market.
- The end of the federal student loan “on-ramp,” during which missed payments were not reported and interest was not capitalized, may make it harder for some to balance student loans with other debt, pressuring other types of consumer ABS.
- Consumer balance sheets remain strong in aggregate, and consumers still have spending capacity.

Economic uncertainty and recession fears, combined with deteriorating metrics for consumer ABS, have given some investors pause, but we are relatively optimistic.

We expect steady 2% GDP growth for 2024 and 2025 owing to strong consumption and investment. Robust corporate profits also provide security against recession as the Fed cuts rates. The foundation of sound growth, along with monetary policy changes, healthy household balance sheets and goods disinflation, should support resilience in the ABS market. This implies that the delinquency rate increases experienced over the past few quarters in consumer loan ABS are a normalization from prior lows rather than a negative trend.

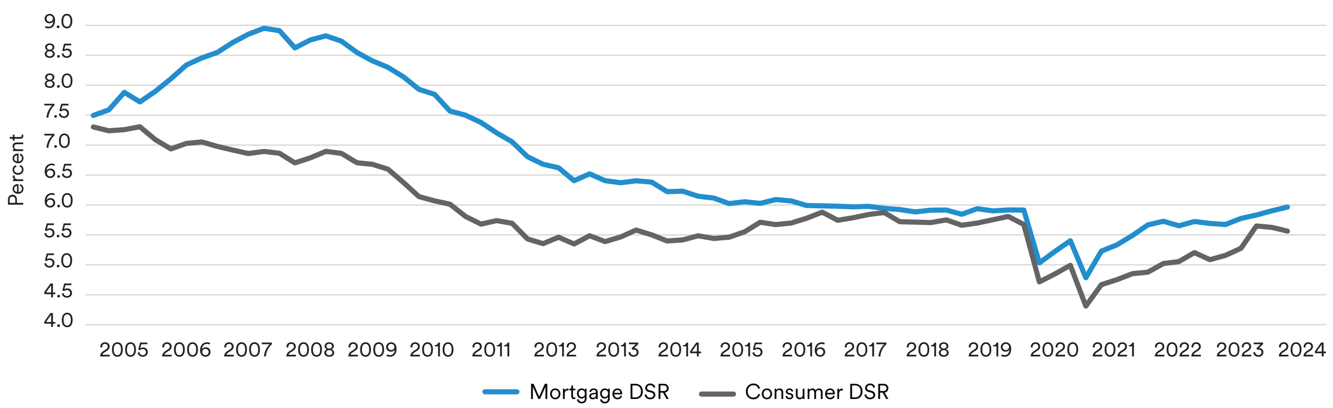
A Still Strong Consumer

Recent increases in the unemployment rate and weakness in consumer confidence have made some observers worried about consumer health and the state of consumer spending.

Even though there is evidence of a bifurcation in consumer spending where higher-income consumers are still able to spend, and lower income consumers are facing more difficulty, we believe the consumer is still strong in aggregate. Layoffs have not been rising, and consumers have continued spending even as sentiment moves sideways.

Additionally, the aggregate debt service ratio (DSR) for consumer debt is at pre-pandemic levels, meaning that households, as a whole, have a relatively healthy balance sheet even though rates remain high.

Figure 1 | Consumer Debt Service is at Pre-pandemic Levels



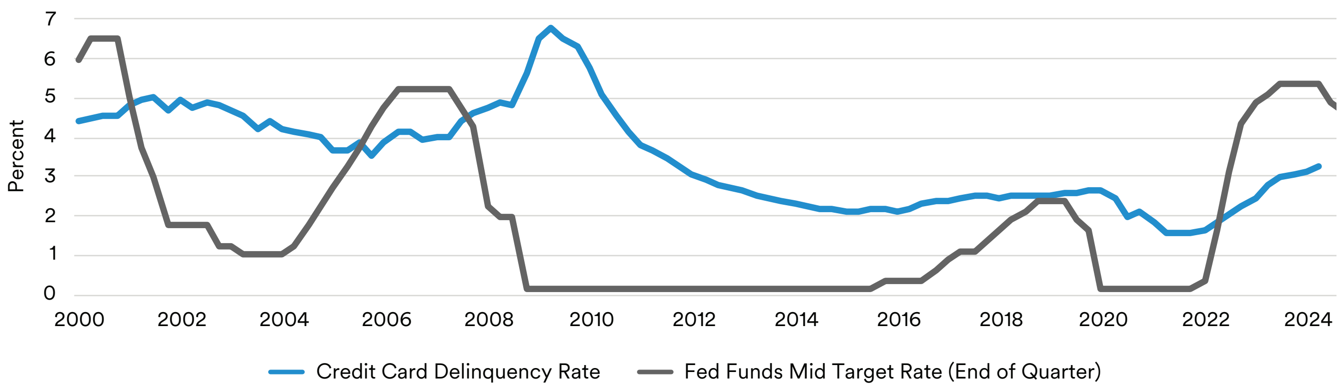
Source: Federal Reserve, MIM. As of 10/15/2024.

Rising Credit Usage and Delinquencies

New York Fed data show that credit card balances increased by $27 billion in the second quarter, reaching a level of $1.14 trillion. At the same time, the delinquency rate climbed to 3.3%, a rate not seen since 2011. Outside of affordability challenges pushing consumers to use credit, usage was also facilitated by a post-COVID-19 loosening of lending standards.

Other data show similar patterns. According to ABS trust reports, aggregate performance metrics of the underlying receivables for U.S. credit card trusts exhibit increasing charge-offs and delinquencies on a year-over-year basis.

Figure 2 | Credit Card Delinquencies Fall with Rates



Source: Federal Reserve. As of 10/22/2024.

We expect stabilization of credit card performance going forward due to tighter underwriting standards, followed by a gradual decline in delinquency rates next year as interest rates fall.

Our forecast calls for 75 basis points of cuts in the policy rate this year. The 0.5% cut in September may only make a small difference to the marginal consumer. But as the Fed continues to cut rates further through the end of the year and next year, the economic easing should allow consumer loan delinquency rates to improve with a lag, as they have in previous cutting cycles.

Lastly, the expected stabilization of inflation should continue to improve affordability of goods and services for consumers, lessening the burden of credit card payments and improving payment rates.

Our view on credit card ABS is constructive, but one concern we have is the “on-ramp period” for student loans ended on September 30, 2024. During that period, missed student loan payments were not reported to credit bureaus, and accrued interest was not capitalized. The expiration of this benefit may make it harder for student loan borrowers (especially younger borrowers facing a higher unemployment rate) to prioritize and balance student loan payments with other debt obligations, negatively affecting other types of ABS.

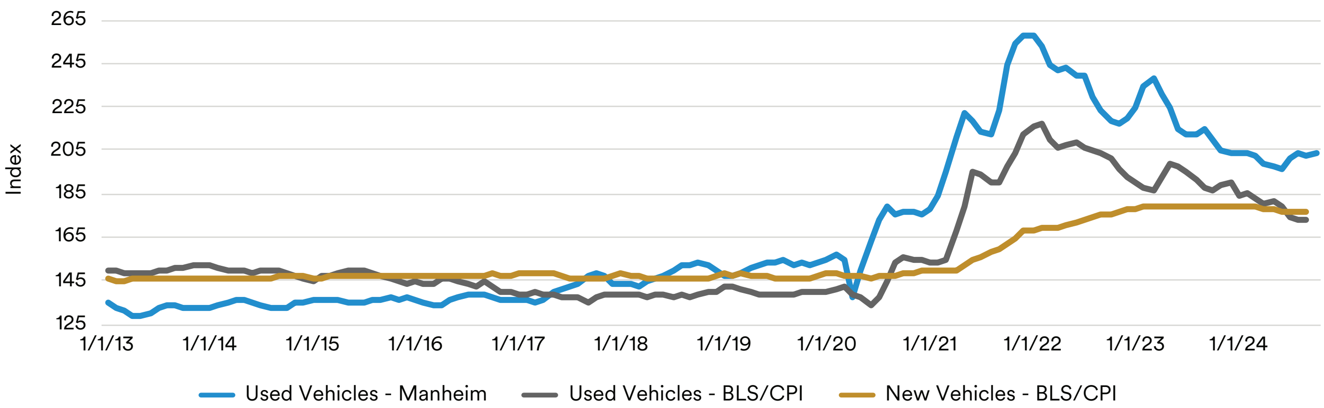
A Similar Story for Cars

Auto loan ABS delinquency rates reached historic lows during the pandemic, but they have trended higher since 2021, with both prime and sub-prime categories showing points of weakness. In July, BofA and Intex data show that the prime auto loan 30+ delinquency rate increased to 1.76%; the subprime delinquency rate was 14.36% in the same period. For comparison, these metrics were 1.4% and 12.5% before the pandemic.

While rate cuts may make less of a difference for existing vintages of auto loans due to their mostly fixed-rate nature, we believe the state of the consumer, the priority of auto loans in consumers' payment hierarchies (which can sometimes be even higher than mortgages),[1] along with a tighter lending environment, will support stabilization of auto loan credit performance by next year.

The 2024 Q3 Senior Loan Office Opinion Survey shows that banks, on balance, did not tighten or loosen lending conditions for auto loans. The stabilization of lending standards, along with healthy household balance sheets, are supportive of credit performance. Much of the recent performance deterioration could be attributed to a rapid post-pandemic loosening of lending standards, but banks started rapidly tightening standards over 2023 and then slowed down tightening over the first three quarters of 2024, which has resulted in better portfolio performance for more recent origination vintages. A slight loosening of standards after the Fed cut rates would also encourage used vehicle demand and sales volume.

Figure 3 | Vehicle Price Inflation is Moderating



Source: BLS, Manheim Consulting. As of 10/22/2024.

Used car prices have been falling throughout 2022 and 2023. Like a rate cut, falling vehicle prices will support sales volume and demand for used vehicles. At the same time, prices remain well above their pre-COVID-19 level. Relative to August 2019, the BLS's used vehicle consumer price index is up 25%, and the Manheim used vehicle value index is up roughly 32%, a plus for residual values and recovery rates.

Risks to Auto ABS credit appear balanced. A re-emergence of inflation—perhaps due to geopolitical issues—would likely mean fewer rate cuts as well as more difficulties in repayments. A recession would also lead to greater difficulties in repayments due to higher unemployment, even as newer vintages of ABS credit come in with tighter lending standards and lower rates.

Overall, our view on Auto ABS credit is constructive, as performance should be supported by tighter lending standards, a relatively strong labor market, strong household balance sheets and the fact that auto debt ranks high in borrowers' payment priority.

Outlook

We believe the economy has safely avoided a recession and will continue to expand as the Fed cuts rates. Moderating inflation and continued stability in the labor market will be supportive of ABS performance and allow delinquency rates to normalize over the next few quarters.

Risks to our outlook include a resurgence in inflation, whether through post-election policy changes or commodity price shocks via escalating geopolitical conflict. Rapid labor market deterioration would also be an obvious detriment to ABS performance as consumers would have difficulty paying back debt. Finally, a renewed focus on student loan repayment may put pressure on consumers' ability to meet their other debt obligations.

Endnote

[1] Consumers prioritize auto over mortgage payments (fico.com) – Consumers (especially higher-income ones) started prioritizing mortgages after the onset of the pandemic as rapid home price appreciation allowed them to build equity in their homes. There is some evidence of this trend reversing, and auto loans rank high for lower-income consumers as their vehicle is essential for getting to work, etc.

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