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WEEKLY ECONOMIC COMMENTARY

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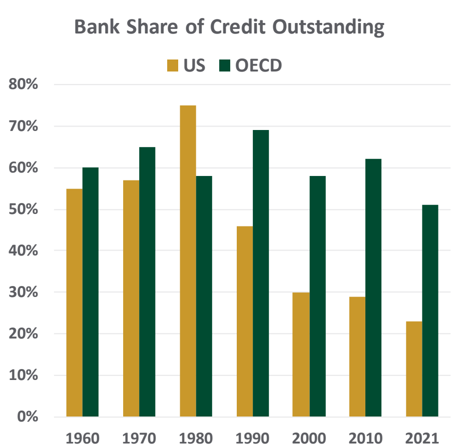
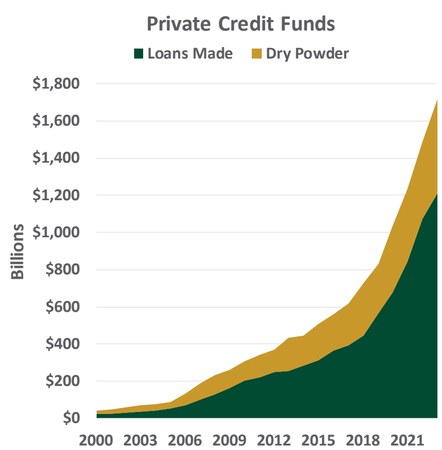
In the old days, there weren't very many places you could get a loan. If a bank wasn't willing to extend credit, you'd be thrust into the murky world of payday lenders and pawn shops. If you were really desperate, you get funds from a "shark," who charged you 5%...per week.

Today, nonbank lending is much more respectable. Known as private credit, this sector of finance is growing very quickly. To its adherents, private credit is a channel that gets capital to borrowers more efficiently and one that offers attractive returns to investors. To its detractors, it is a potential source of systemic risk that needs to be better monitored and controlled.

Following is some background on how private credit came to its current standing, and where it might progress from here.

Bank lending has been losing its dominance for several decades. In the United States, very high interest rates in the 1970s led depositors to shift into investment products, limiting the ability of banks to make loans. Scores of bank failures in the 1980s prompted heightened regulation for traditional intermediaries, raising costs for borrowers. These developments created fertile ground for the growth of new credit channels.





Sources: World Bank, Prequin, Moody's

Corporations began to raise capital more frequently in the financial markets. Short-term needs were met through the issuance of commercial paper, which was purchased by money market funds. Long-term needs were covered by bond issuance; according to the Securities Industry and Financial Markets Association (SIFMA), the American corporate bond market has expanded from a little over $1 trillion in 1990 to almost $11 trillion in the third quarter of 2023.

Household finance has also been transformed over the past 40 years. Mortgages once held by banks are bundled, guaranteed and sold as mortgage-backed securities. Consumer loans have also been “securitized.” Banks earn fees for originating these types of loans, but they have become waystations, not warehouses.

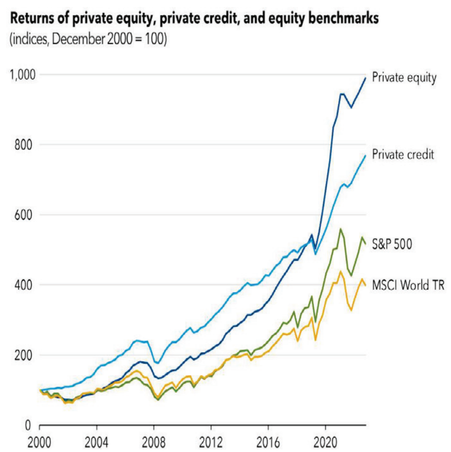
Amid this transformation, asset managers have become more and more central to the flow of capital. They create vehicles that sell shares to investors and invest the proceeds in a wide range of asset classes. The sector is not entirely unregulated, but it certainly does not face the same kind of capital and liquidity constraints that banks do. Asset returns are passed directly to investors; liabilities are uninsured.

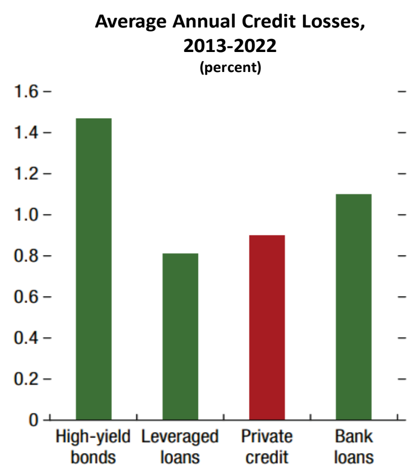
As banks have retreated, private lending has advanced.

Private credit is a natural extension of this trend. Mid-sized companies are typically not large enough to issue debt in the marketplace; many of them do not issue public financial statements. For these reasons, middle-market firms still rely on banks for the bulk of their financing.

Increasingly, private equity (PE) firms are raising funds from investors, hiring credit underwriting teams (some of which are former bankers) and making loans to smaller businesses. PE firms have long been leaders in financing start-ups, so private credit is a natural graduation for them.

The attractions of private credit to borrowers include tailoring of terms and conditions, speed of execution and flexibility in working through defaults when they occur. The attraction to investors are returns which have exceeded listed equity indices over the past 15 years with lower levels of volatility. And losses on loans originated through private credit have been lower than those originated by banks.





Sources: IMF, Prequin

It is important to note that while the growth of private credit has been more pronounced in the United States, other markets are following along. According to credit rating agency Moody’s, Europe’s private lending market has doubled over the past five years, to $448 billion. The practice in Asia is also growing quickly.

Observers and overseers of financial stability have significant concerns about private credit. For one thing, it is hard to gauge what is going on in this space.

Banks are heavily regulated by a range of overseers. As public companies, they are required to file financial statements. Banks file broad information on credit portfolios with regulators each quarter. By comparison, private credit funds are lightly regulated, have no public disclosure requirements and provide their investors with very little portfolio information. The opacity of this sector has prompted some owners (pension funds and insurance companies, for example) to consider holding larger buffers against prospective losses.

There are several layers of leverage surrounding private credit that would have to be peeled back under adverse conditions. Sponsors of private credit products often have lines of credit from the banking system, both for contingencies and to enhance returns. Owners of private credit products may have leveraged their holdings to gain additional yield. Because shares in private credit funds are generally illiquid, owners may seek liquidity from banks should a correction occur. The channel has grown substantially since the last significant credit downturn, which leaves room for doubt over how it would fare under adversity.

There is concern over how private credit will fare under stressful conditions.

Further, revelations of trouble in the private credit arena might trigger psychological contagion that would spread more broadly through financial markets. For all of these reasons, systemic supervisors and observers have expressed apprehension over the rapid growth in non-bank lending. Analyses published by the Federal Reserve, the Bank of England and the International Monetary Fund have highlighted the vulnerability that might be latent in this area.

The industry defends itself by noting that private capital can be a source of stability in bad environments. Distressed debt funds step in to acquire loans which are faltering, placing a floor under debt prices and providing price discovery amid illiquidity.

Private lenders are certainly not sharks preying on unsuspecting borrowers, but they could leave a trail of unsuspecting victims in a worst-case scenario. Better to know what's going on beneath the water line before trouble surfaces.

Myriad Metrics

Last week, we discussed the ways that inflation measures can be selectively interpreted to fit a narrative. Readers of that article raised an even simpler question: Why are there multiple readings of inflation in the first place?

In the U.S., there are two leading gauges. The consumer price index (CPI), published by the Bureau of Labor Statistics, garners attention (in part) because it is more timely, usually published two weeks after the end of the month. The Bureau of Economic Analysis follows a fortnight later by issuing a price index based on personal consumption expenditures (PCE).

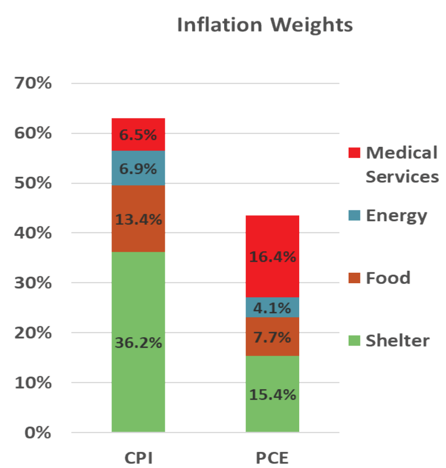
A major distinction between the two is their treatment of substitution. Price indices reflect a weighted average of goods and service costs which aim to reflect the spending of a median household. The CPI basket is rebalanced only annually (a recent upgrade from a cycle of every two years). The PCE weights are adjusted every month, based on actual spending. When consumers change their behavior, PCE rebalances quickly.

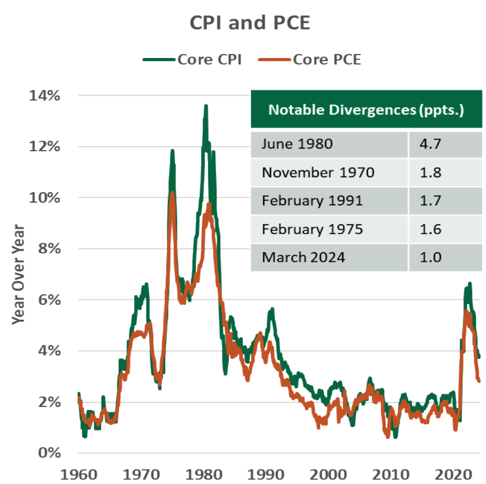
The Federal Reserve also prefers PCE because it is more comprehensive, capturing a wider set of prices paid by more consumers. PCE can be restated as more information is collected, while CPI is only revised to account for seasonal factors.

Neither measure is a full account of all spending. They are built from different Census Bureau aggregations that approximate total economic activity. The PCE is derived from business surveys such as the Monthly Retail Trade Survey and Quarterly Services Survey. This gives the PCE a more complete view of business transactions. The CPI utilizes the Consumer Expenditure Survey, which polls a sample of households. Assembling the CPI requires interviews and self-monitoring that are prone to under-reporting of activity.

The differing approaches yield different component weights, which can lead to widely different trends. The cost of shelter is notoriously difficult to approximate, and CPI is more sensitive to that category. The sources also differ in some of their methods and assumptions. Several of CPI's more volatile categories stand out for having a different approach than PCE:

- Healthcare: PCE includes all medical goods and services purchased by employer-provided health insurance to approximate the cost of healthcare. CPI reflects households' out-of-pocket purchases of medical goods and uses sector profits as a proxy for insurance costs.
- Airfare: CPI examines a fixed set of air routes, while PCE uses airline passenger revenues and miles traveled.
- Used vehicles: CPI tracks auto dealers' reported sale prices of a sample of used vehicles, while PCE uses dealers' wholesale and retail sales data to impute price trends.





Sources: Bureau of Labor Statistics, Bureau of Economic Analysis, Haver Analytics

Inflation measures take different journeys to arrive at similar conclusions.

In normal times, the two indices track each other closely. In intervals of high inflation, however, they diverge. Inflationary bouts change our behavior; as an example, high cattle costs motivate consumers to buy less beef and more pork and poultry. PCE reflects this kind of substitution, leading to a more subdued outcome.

At present, core (ex-food and energy) PCE of 2.8% stands much closer to the 2% inflation target than CPI's 3.6%. Both show inflation in a better state now than it was in 2022. But by any measure, the journey to stable prices still has a long way to go.

Drop The Check

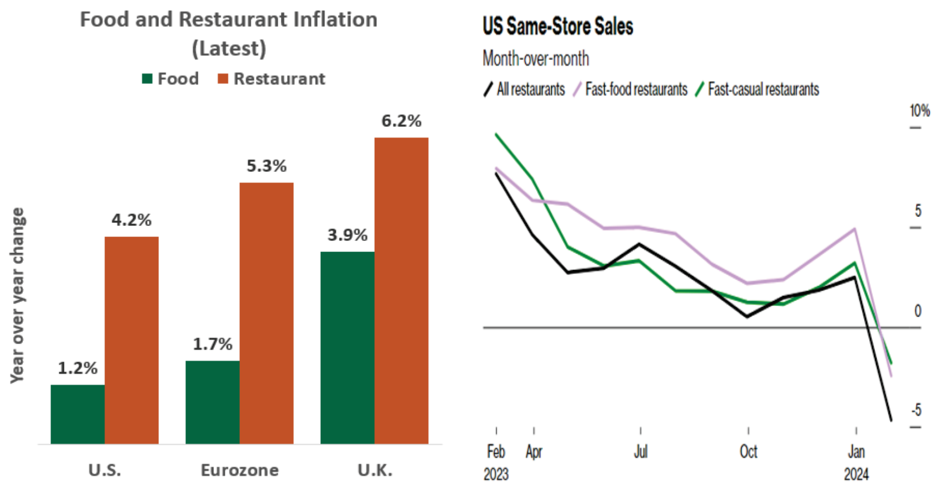
Restaurateurs faced severe interruptions during the pandemic, amid social distancing and supply chain disruptions. While these problems have receded, another has advanced: eateries are facing lower demand due to higher prices.

Eating out has always cost more than cooking at home, but the price gap between the two has been growing. Even as grocery inflation ebbed from the double-digit increases observed a couple of years ago, the cost of dining out is still rising briskly. Food inflation has dropped below 2% in the U.S. and the eurozone, but the cost of meals at restaurants and cafes are increasing at over 4% year over year.

The central difference between the two channels is the cost of labor, which absorbs (on average) about 30% of a restaurant's revenue. Wages for cooks, servers and clean-up crews are rising strongly and persistently. Pay in the hospitality sector in the U.K. is growing by around 8% year over year, higher than the national average of 6%. Food service salaries in the U.S. are rising by 5.1% compared to a 3.9% increase for all employees in the private sector.

Despite some attempts to automate, restaurants have made little headway in their efforts to insulate themselves against labor costs. Businesses must either pass on the burden to patrons or take a hit on margins.

Diners and restaurateurs are still coping with elevated inflation.



Sources: Haver Analytics, Bloomberg

Resilient household incomes offer restaurateurs some pricing power in the U.S., but that leverage is dependent on price points. Top American fast food chains, often synonymous with affordability, are starting to feel the pain as low-income consumers visit less frequently and pare back their orders. According to a survey by Revenue Management Solutions, about half of low-income consumers are making fewer trips to fast-casual and full-service dining establishments.

Meals eaten out account for a little over 5% of the consumer price basket in the U.S. and 11% in the U.K. As diners escape high restaurant prices by returning to their kitchens, they should help in the fight against inflation. The menu won't be as interesting, but it will be affordable.

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