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Insight INVESTMENT

IS IT TIME TO BACK THE AMERICAN CONSUMER?

OCTOBER 2019

> Investors may be overexposed to corporate risk and underexposed to consumer risks.

BNY MELLON | INVESTMENT MANAGEMENT

EXECUTIVE SUMMARY

Fixed income investors may be relatively overexposed to corporate risk and underexposed to consumer risks.

1. The consumer looks strategically attractive: For decades, corporate margins have risen while real wages have not. However, political developments indicate this trend is becoming stretched.

2. The consumer is performing well as trade wars bite: Unemployment levels are at 50-year lows and wage growth of the lowest earners is higher than for the highest earners. Consumer leverage is falling as corporate leverage rises.

3. Consumer exposure is less crowded: Direct consumer credit exposure can be sourced from the less crowded secured finance market, which offers a complexity premium over comparably-rated corporate debt.

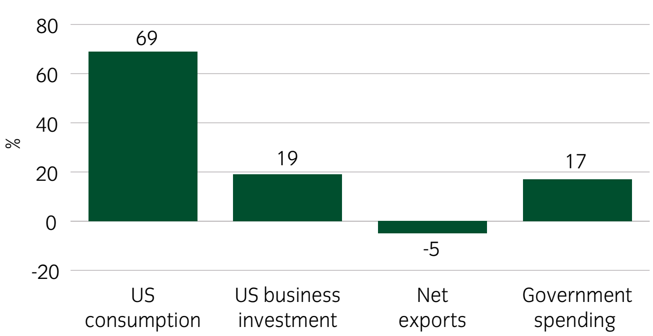
IS IT TIME TO BACK THE AMERICAN CONSUMER?

BACKING CORPORATES OVER THE CONSUMER HAS BEEN BENEFICIAL FOR DECADES

Investors are likely to allocate risk assets to participate in economic growth. Investors' have historically looked to corporate risk assets (particularly equities and corporate bonds) for this purpose.

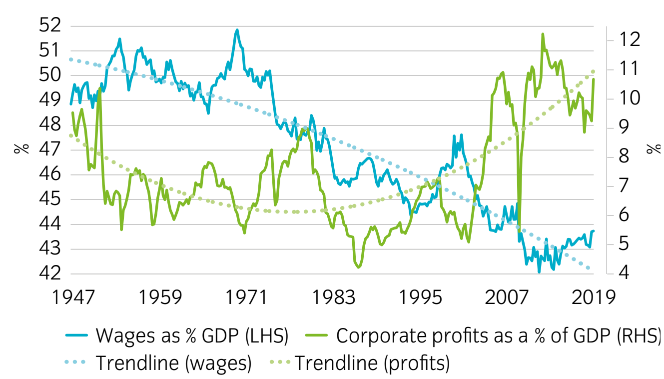
However, corporates only contribute 20% to GDP. By far the largest component – the consumer (at almost 70%) – has been largely ignored .

Figure 1: The US consumer – the main component of GDP has largely been ignored by investors[1]



This has actually arguably been beneficial over the last few decades. The share of economic returns to capital (or corporates) has risen while the share of returns to labor (the largest consumer segment) has fallen (Figure 2).

Figure 2: Corporate profit margins and wages have moved in opposite directions[2]



Many economists cite globalization and technological automation as key secular drivers of these trends. They have increased the supply of labor, reducing the overall bargaining power of workers, squeezing real wages and improving corporate profit margins.

The composition of corporate profits supports this. Over the last cycle, margin expansion has driven more than 60% of corporate profit growth, whereas the main driver historically has been revenue growth[3].

[1] Source: Bureau of Economic Analysis, July 2019. [2] Source: Corporate profits sourced from Bureau of Economic Analysis, wages data from Bureau of Labor Statistics, August 2019. [3] Source: Goldman Sachs, July 2019.

DO POLITICAL TRENDS SIGNAL A TIPPING POINT BETWEEN CAPITAL AND LABOR?

The key beneficiaries of these trends – the owners of capital – represent a slim minority of the voting population. 90% of US corporate equities are owned by the top 10% of the US wealth distribution (whose real net worth has tripled since 1989[4].

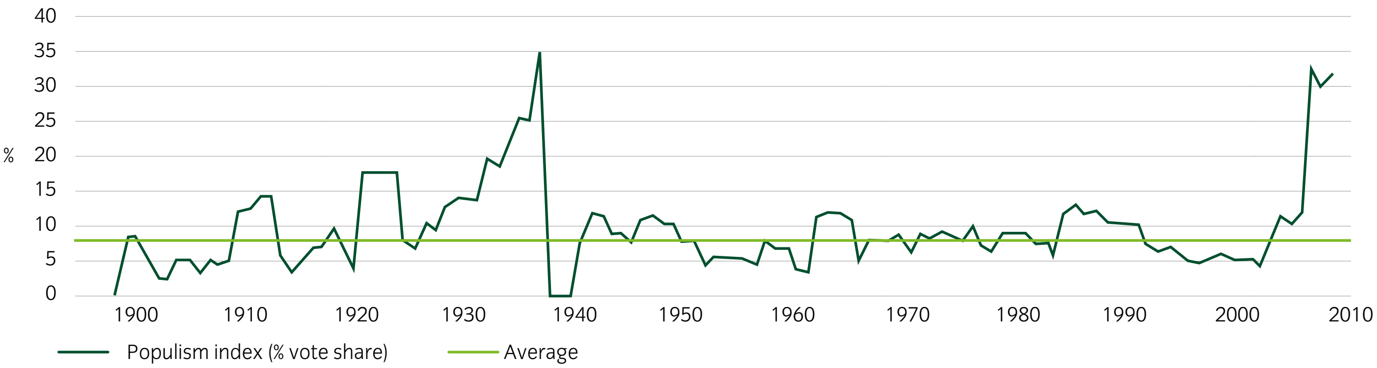
The bottom 50% of the wealth distribution (half the voting population – and most likely to represent labor) own less than 1% of US equities and has seen its net real wealth fall by 24% over the same period.

For many economists and political scientists, this largely explains the recent rise of populist political movements on both sides of the political spectrum across industrialized countries (Figure 3).

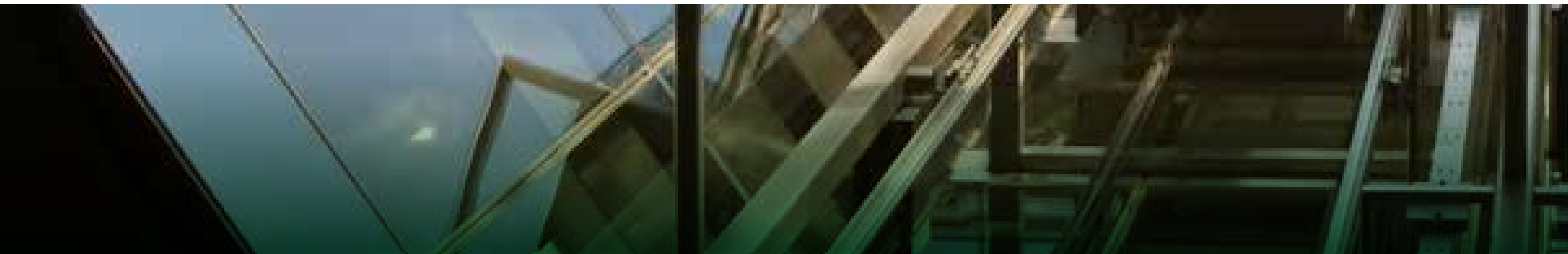
These movements have often variously championed a backlash against globalization, a shift from monetary to fiscal policy stimulus and wealth redistribution.

As such, the question of whether politics will be more supportive of capital or labor over the coming decades is becoming less certain.

Figure 3: Global support for anti-establishment political parties has surged[5]



[4] Source: Federal Reserve: Distributional Financial Accounts for the United States. https://www.federalreserve.gov/releases/efa/efa-distributional-financial-accounts.htm. Adjusted for inflation using quarterly US CPI series sourced from Bloomberg. Data as of December 31, 2018. [5] Source: Deutsche Bank, 2019 Countries included are US, UK, France, Italy, Germany, Japan and Spain.



THE US CONSUMER IS SHOWING SIGNS OF RESURGENCE

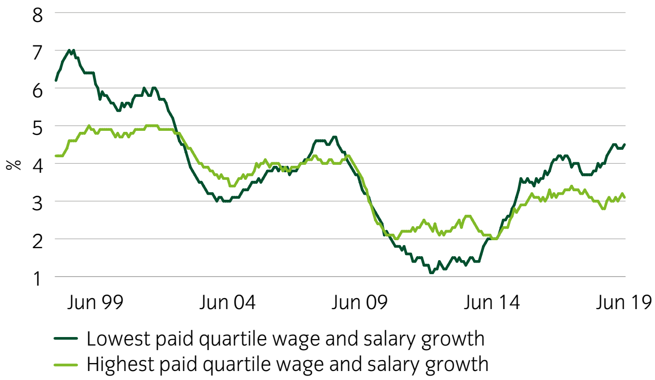
With the US locked in trade tensions with China (and other regions), volatility in corporates has increasingly become a concern. In October 2019, the ISM manufacturing index hit a 10-year low of 47.8, with survey respondents citing global trade as their most significant concern[6].

Meanwhile, the US consumer is emerging as the primary economic growth driver. In Q2 2019, US GDP outperformed at 3% on stronger-than-expected consumer spending growth (exceeding 4%). The personal savings rate remained above 8%, providing a healthy buffer for households.

A number of banks, despite reporting disappointing trading volumes, beat overall earnings expectations thanks to strong consumer credit quality and consumer credit growth. JP Morgan chief Jamie Dimon notably stated “We continue to see positive momentum with the U.S. consumer – healthy confidence levels, solid job creation and rising wages”[7]

US households are enjoying 50-year lows in unemployment following the longest economic expansion on record. Wages are also showing signs of improvement. The lowest-paid workers are seeing faster proportional wage growth than the highest-paid workers (Figure 4).

Figure 4: The lowest earners are seeing the fastest wage growth[8]



This is potentially encouraging for US consumption – because the lowest earners often have the highest propensity to spend their incremental income (whereas the highest earners can save most of theirs).

However, it is less obviously positive for corporate margins. On one hand, corporates will face higher labor costs. On the other, they will benefit from higher consumer demand. The net impact may differ by firm.

For us, this highlights the rising importance of rigorous security selection in credit, and the potential for diversifying into consumer risk exposure.

[6] Source: Institute for Supply Management, October 2019, https://www.instituteforsupplymanagement.org/ismreport/mfgrob.cfm?SSO=1.
[7] Source: JP Morgan Q2 2019 earnings statement, July 2019 https://www.jpmorganchase.com/corporate/investor-relations/document/11eb716c-277c-948a-8673-d0e96b5c6789.pdf. [8,9] Source: Bureau of Labor Statistics, ‘Current Population Survey’, August 2019.

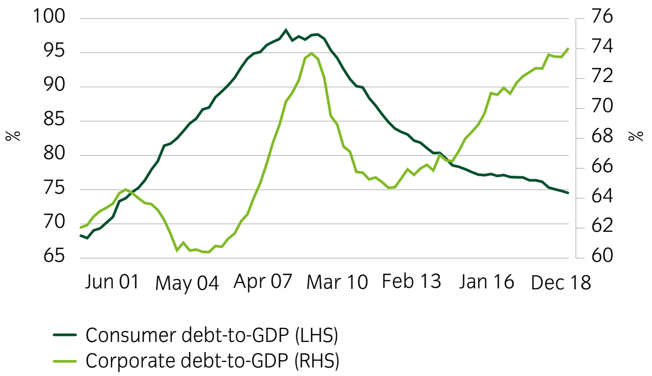
WHY IS THE US CONSUMER LOOKING STRONGER?

Household debt metrics have been improving materially since the 2008 financial crisis.

Although absolute levels of household non-mortgage debt are at record highs, actual leverage ratios are well-contained and falling (Figure 5). In our view, areas such as subprime auto loan markets have been unjustified sources of concern. Auto loan volumes have correlated with auto sales and have not been indicative of excess credit creation[9].

Corporate metrics, conversely, have been trending in the opposite direction (Figure 5). The corporate credit cycle shows many signs of maturing, exemplified by trends towards equity buy-backs and M&A activity. Corporate-debt-to-GDP is $4trn above its historical average[10].

Figure 5: Consumer and corporate leverage are currently on opposing trajectories[11]



To us, the consumer looks better-prepared to weather trade wars or an economic downturn.

[10, 11] Source: Bloomberg, August 2019.

COULD LABOR BE VULNERABLE TO MASS AUTOMATION?

Since the first industrial revolution, there have been concerns about machines displacing workers en-masse. So far, this has never materialized but the debate has re-ignited among economists, technologists and futurists given developments in artificial intelligence and machine learning.

A McKinsey study[12] projects at least 60% of occupations have 30% of activities that could be automated by 2030 (but notes demand for new labor could also arise – as it has in the past).

So far, employment and productivity statistics offer a firm rebuttal. Rapid automation would need to coincide with a corresponding acceleration in labor productivity growth. However, productivity growth has been poor for well over a decade (Figure 6).

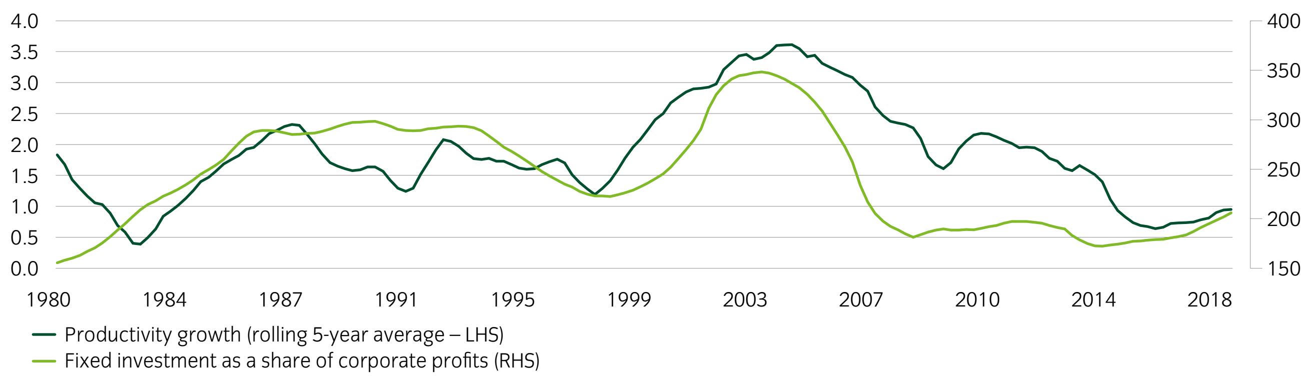
Figure 6 also shows productivity growth tends to correlate with business investment, which has also been disappointing. A pick-up in investment is likely needed to spur productivity growth, but would potentially eat into corporate profit margins – indicating that it might still be worth diversifying corporate risk exposure.

The outlook for productivity growth additionally continues to look weak. The OCED[13] cites the prevalence of zombie companies (structurally propped up by low interest rates) as a key reason.

Nonetheless, if disruptive technologies were to threaten mass unemployment, displaced workers will still comprise the majority of voters. Through periods of uncertainty – backing the voter may be a sensible strategy.

> ...productivity growth
> has been poor
> for well over a decade

Figure 6: Productivity growth and potentially automation would require business investment[14]



[12] Source: McKinsey Global Institute, "Jobs Lost, Jobs Gained: Workforce Transitions in a Time of Automation," December 2017.
[13] Source: OECD, 'Confronting the Zombies: Policies for Productivity Revival, December 2017. [14] Source: Bloomberg, July 2019.

Consumer credit risk can be directly accessed through the secured finance market

CONSUMER CREDIT EXPOSURE CAN OFFER VALUE AND STRUCTURAL SAFEGUARDS

Consumer credit risk can be directly accessed through the secured finance market, a $16trn[15] global marketplace encompassing investments backed by collateral.

Consumer risk is one of the market's three major pillars (Figure 7) encompassing debt backed by assets such as residential mortgages, credit card debt and auto loans.

Figure 7: Consumer risk is one of the three pillars of the secured finance market[16]

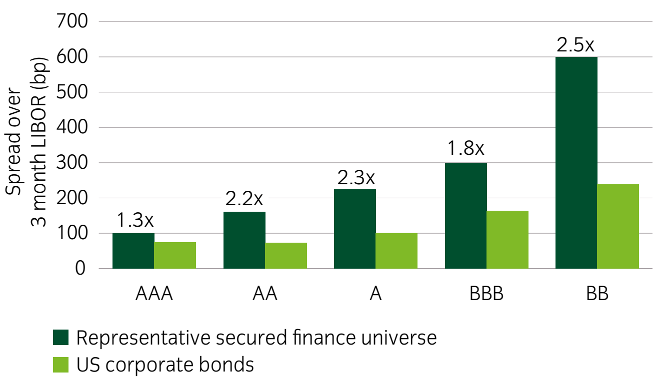
SECURED FINANCE:

	Residential and consumer	Commercial	Secured corporates
Public securities	Prime residential mortgages MI/MSR RMBS Consumer ABS	Commercial mortgage securities CRE CLOs NPL portfolios	Collateralised loan obligations (CLOs) Whole business securitisations EETC
Private debt	Mortgage pools Bridging finance Auto/credit card pools	CRE loans Multifamily Aircraft	Corporate loan warehouse Small medium enterprise pools Trade Finance

[15] Source: Bloomberg, Insight, World Trade Organization, JP Morgan, SIFMA, AFME, CFA Society, Mortgage Bankers Association, CBRE, UK Finance and S&P Global Market Intelligence. The definition of secured finance excludes agency securitisation, infrastructure debt, direct mid-cap corporate cashflow lending. [16] For illustrative purposes only.

Secured finance can be accessed from AAA to B credit quality risks. The market offers a 'complexity premium' over comparably-rated corporate bonds given the skills required to analyze, model and invest (Figure 8).

Figure 8: Secured finance (including consumer debt) can offer a complexity premium over the more crowded corporate bond market[17]



Despite this, secured finance also typically offers structural safeguards that are rare in mainstream bonds – such as credit enhancement, debt covenants and security against underlying assets (like real estate).

Secured finance can be accessed through standalone strategies, multi-sector strategies or as allocations within more traditional bond strategies.

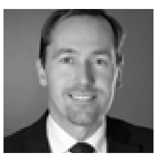
Dedicated portfolios can range from AAA ultra-short and highly liquid portfolios to less-liquid private loan structures that can be particularly attractive to investors such as insurers.

More mainstream strategies such as Core and Core Plus portfolios can also add allocations to structured credit given appropriate manager capability and guideline flexibility.

IS IT TIME TO BACK THE CONSUMER?

As we move into unchartered economic and political territory, the secular trends of the last 40-years are becoming increasingly challenged. It may be unwise to expect the future to continue mirroring the past. Investors across the board may benefit from diversifying some of their corporate exposure into consumer risks to better capture the full range of economic growth drivers.

CONTRIBUTORS



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[17] The secured finance spreads shown are for illustrative purposes only and are not indicative of the strategy spreads. US corporate bonds used to reflect corporate bonds: BofA Merrill Lynch AAA US Corporate Index, AA US Corporate Index, A US Corporate Index, BBB US Corporate Index & BB US High Yield Index. Representative secured finance universe reflects the global universe of structured credit opportunities plus lending margins in private debt markets where appropriate. Information shown does not reflect any strategy account or fund managed by insight. There could be material differences between the information shown and the strategy. Investors cannot invest directly in any index.

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