Nascent Economic Upturn Should Support Thinner Corporate Credit Risk Premia
By John Lonski in New York

The August beige book -- or the Fed’s qualitative summary of regional economic conditions -- was consistent with a nascent economic recovery. Respondents were described as being cautiously positive, which is in keeping with the ongoing narrowing of corporate credit risk premia, albeit it to still comparatively wide bands.

Similar to what was conveyed by August’s ISM surveys, the beige book suggested that manufacturing appears to be outperforming retailing and other services. The replenishment of depleted inventories and a more competitively priced dollar exchange rate ought to spur manufacturing into 2009.

The beige book’s description of consumer spending was uninspiring at best. To the contrary, the beige book was marginally more upbeat regarding prospects for housing, though decidedly downbeat about commercial real estate.

The outlook for the early years of the new economic recovery has production outperforming consumption. In conjunction with the rising profile of production, the beige book noted more in the way of temporary hiring and fewer layoffs.
Owing to considerable labor market slack and the consumers’ heightened anxiety, wage pressures are practically nonexistent. Commodity prices may occasionally spurt, but household purchasing power will not rise rapidly enough to sustain an otherwise troubling climb by price inflation. The Fed probably will remain very much concerned about real estate price deflation and give short-shrift to any fleeting rise by the CPI that is mostly the offshoot of steeper commodity prices.

Any substantive easing of the tight credit conditions described by the beige book probably will require at least a 150 basis points narrowing of the recent high yield bond spread of 820 basis points. Moody’s revised its projected November 2009 peak for the US’ high yield default rate from an early August projection of 12.7% to 13.2%. Still, the default rate is expected to sink rapidly thereafter, falling to 4.1% by August 2010,
which equates to a record breaking year-to-year drop of -8.1 percentage points from August 2009’s actual default rate of 12.2%.

The average expected default frequency (EDF) of US non-investment-grade companies recently sank by -6.7 percentage points from February 2009’s cycle high of 14.7%, which was of unprecedented depth for a seven month span. The old record deep drop over a seven month span was the -4.65 percentage points of October 2003. The US’ high yield default rate would then sink from the 5.8% of October 2003 to 2.9% by October 2004.

Mortgage applications rose sharply for the week-ended September 4 as applications for refinancing grew by 22.5% weekly to their highest reading since June 5, 2009, while applications from potential homebuyers advanced by 9.5% to their best score since January 2, 2009. During the 4-weeks-ended September 4, homebuyer mortgage applications grew by 8.0% from the contiguous 4 weeks, but fell by -15.6% from a year earlier. The latest climb by mortgage refis and home sales should benefit consumer spending materially by Q4-09 and continue to do so throughout 2010. Consistent with other broad indicators of housing activity, the monthly index of homebuyer mortgage applications bottomed in early 2009 (in February 2009) and subsequently rebounded by 13% as of August.