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How bad is the credit crunch and what does it mean for the stock market?

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- Central Banks worldwide have taken decisive action against inflation and thus put the handbrakes on the economy.
- While the U.S. economy has proven to be remarkably resilient, we believe that it is improbable that it will avoid a recession in the near term.
- However, as we have highlighted previously, the economic cycle and the stock market are seldom completely aligned.
- The current market environment bears many similarities to the Savings and Loan Crisis of the late 80s and early 90s - an episode that demonstrated that equity markets can do exceptionally well even when banks are failing.

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Financial conditions in the U.S. have deteriorated following the sharp tightening of monetary policy in 2022. According to survey data, smaller businesses especially suffer from the increased cost of debt, resulting in considerable divergence between small-cap indices and the S&P 500. Nevertheless, broader measures of credit conditions have stayed at healthy levels, and on aggregate, equity markets have held up well. For investors, this raises the question of whether the fallouts of the Fed's tightening have been priced correctly or whether more trouble is brewing.

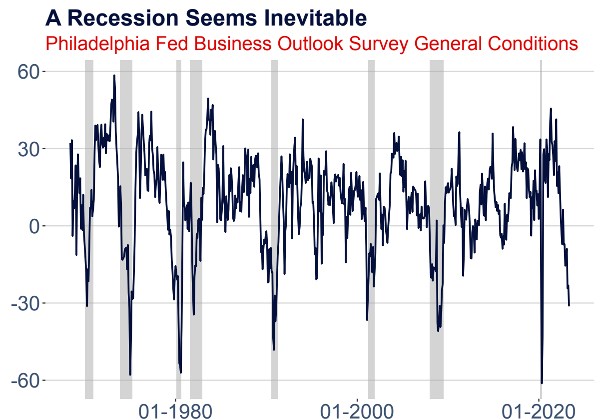

Figure 1: *Since the 70s, businesses have been in a similarly somber mood only 8 times, and the economy has avoided a recession in none of these cases.*

1 Economic, fundamental, momentum, and sentiment indicators are giving contradictory signals

In July last year, we published an article discussing whether U.S. corporations were poised to head into an earnings recession [5]. Back then, we looked at the trajectory of corporate sales and profits during the last inflationary period in the 70s and 80s and found that while valuation multiples contracted in line with rising inflation, triggering a major correction, companies managed to grow the bottom line, and successfully protected real profits. So far, the contemporary inflationary period seems to follow the same playbook. Companies have boosted revenues and even expanded margins as price pressures rose, catapulting profits to record levels. At the same time, valuation multiples contracted, though less severe than during the 70s and 80s, grace to substantially lower peak inflation. Consequently, as price pressures have abated on the back of a recovery in trade and the normalization of oil prices, markets have stabilized. Recent turmoil in the banking sector caused by the decisive action of the Fed has shifted investors' attention from uncontrolled inflation toward financial stability and liquidity.

In this context, we now observe a sharp divergence between buoyed stock markets, remarkably resilient GDP growth, strong labor markets, and robust earnings on the one hand, and pronouncedly bearish speculative investor positioning, elevated credit spreads, rising de-

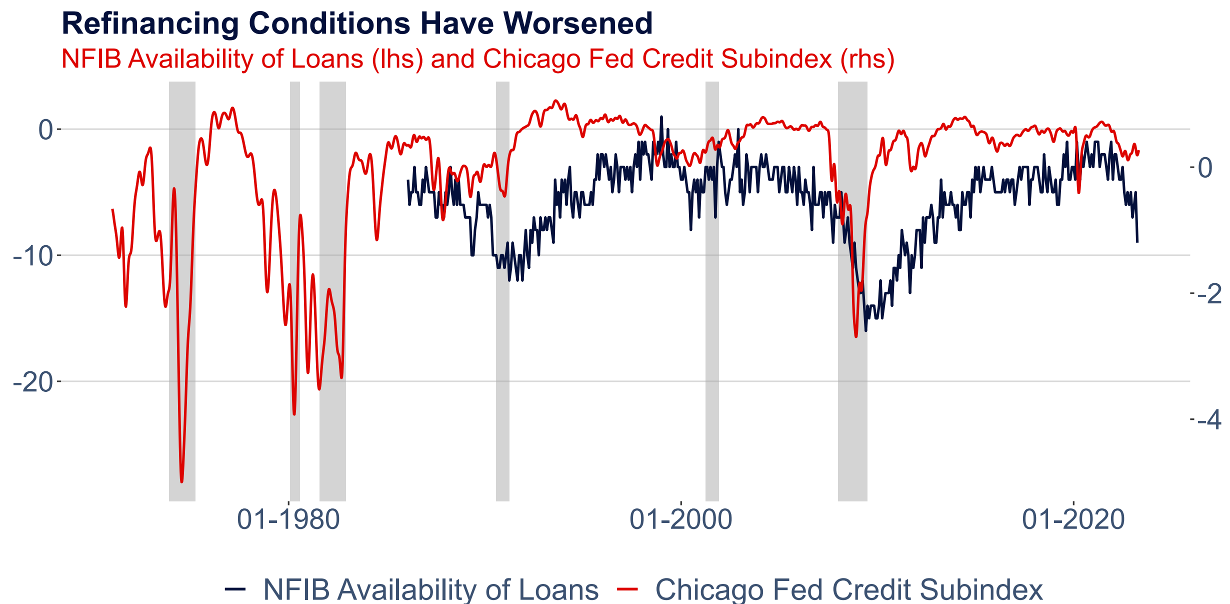

Figure 2: *We analyzed the Chicago Fed Financial Conditions Credit Subindex and the survey-based Availability of Loans Index by the National Federation of Independent Business to estimate how badly tighter monetary policy has affected business refinancing so far. The indices have historically been correlated, but as of today, the latter index looks significantly worse - just like in 1987 during the early years of the Savings and Loan Crisis.*

fault rates [4], declining market breadth, and sharply deteriorating business conditions on the other hand. Looking at General Business Conditions as measured by the Philadelphia Fed's Business Outlook Survey, a recession seems now inevitable. Since its launch in the 70s, this index has hit levels as negative as today's eight times, each time either during or immediately before recessions. In other words, the fantastic profits generated by the likes of Microsoft and a few other stocks holding up the S&P 500 conceal that under the hood, the Fed's restrictive monetary policy is already working and may, in fact, be working a bit too well.

We have, therefore, taken a closer look at credit conditions and, just like in July, asked what the current challenging business environment implies for equity investors. Undoubtedly, significantly higher benchmark rates, on top of elevated credit spreads, have made debt refinancing for corporations substantially more expensive even though, the immediate impact of higher rates varies, depending on the company's balance sheet structure and profitability.

We see a lot of listed blue chips with well-stretched-out debt maturity schedules that have refinanced themselves through the issuance of fixed-rate bonds in time. These companies may, in fact, benefit from the present environment as they upped cash flows on the back of inflation and are, thus, able to buy back their debt cheaper likely turning them into attractive opportunities. On the other hand, many Private Equity sponsors relied on floating rate debt and are certainly feeling the pain already.

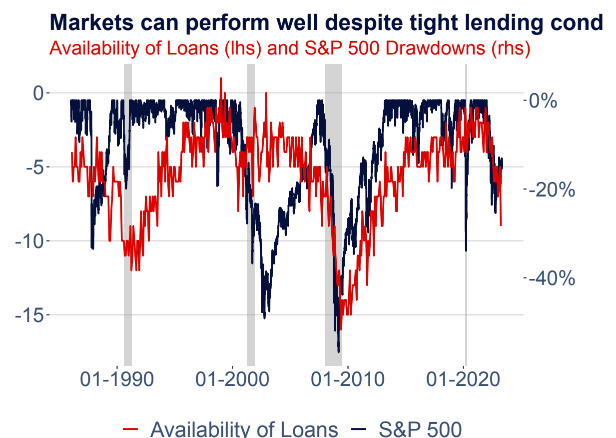

Figure 3: *Lending conditions were challenging during the early 90s when more than one-third of Savings and Loan Associations in the U.S. went bust, resulting in $132bn in losses for taxpayers [3]. Equity investors had reason to cheer, though. The Black Monday in 1987 [6] and the Early 90s recession [7] were short-lived corrections in an otherwise bullish setting, resulting in gains of over 300% between 1986 and 1995.*

2 2008 or 1990? For the equity market outlook, the difference is crucial.

Looking at the macro data beyond anecdotal evidence, bears will likely point to default predictions by the leading rating agencies and survey data such as the Small Business Credit Conditions Availability of Loans Index published by the National Federation of Inde-

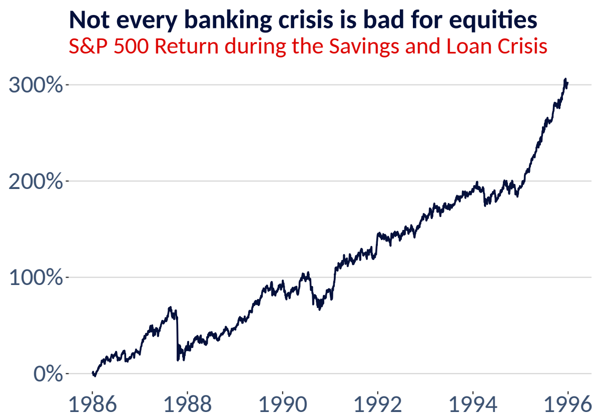

Figure 4: *The late 80s and early 90s brought the failure of more than 1000 Savings and Loan Associations in the U.S., but equity markets shrugged off the crisis as inflation retraced and profits expanded.*

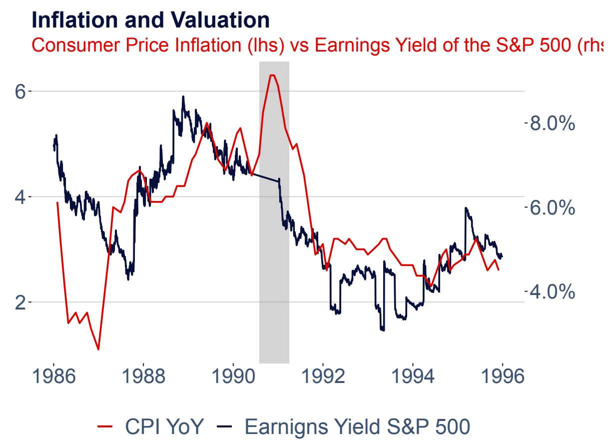

Figure 5: *Rapid earnings growth and an average dividend yield of 3% fueled the rally of the late 80s and early 90s. Valuation multiples continued to be highly correlated with inflation.*

pendent Business (NFIB). This index recently shocked market observers, falling to a level of -9, which evokes terrible memories, as with the benefit of hindsight a similar deterioration in refinancing conditions in June 2000 and September 2007 meant trouble was brewing. However, as outlined in Figure 3, U.S. corporations also reported difficult financing conditions for a prolonged period in the early 90s when markets corrected only briefly, driven by Iraq's invasion of Kuwait and the subsequent rise in oil prices [8]. Bulls won't miss the fact that following the 20% drop until October 1990 and well **before** the Availability of Loans Index jumped back above the current level of -9, markets returned almost 50%. Furthermore, there are other arguments supporting the view that the contemporary market environment may be much more comparable to the situation in the late 80s and early 90s than to the situation in 2008 [2].

3 A brief recap of history

In 1986, U.S. Consumer Price Inflation reached a low at just 1.1%, and stocks at an average Price/Earnings multiple of more than 20x were widely considered expensive, creating nervousness in the market. The latter likely contributed to the flash crash in 1987, remembered as the Black Monday, when markets fell more than 30% in October, however, followed by a rally that returned more than 80% until June 1990. Over the same time, inflation picked up, topping 4% towards the end of 1987 and climbing to over 6% in October 1990 when the Kuwait war fueled a 30% rally in crude. Does this sound familiar? The parallels don't end here since the late 80s and early 90s also saw the failure of nearly a third of the 3,234 U.S. Savings and Loan Associations resulting in massive bailouts by the government [3]. In hindsight, it is known that this meltdown known as the Savings and Loan Crisis was enabled by laxer regulation and lower capital requirements combined with a taxpayer-funded guarantee backstop that fueled massive asset growth among Savings and Loan Associations, a pattern all too familiar to modern-day investors after the collapse of SVB. Again, for equity bulls, this

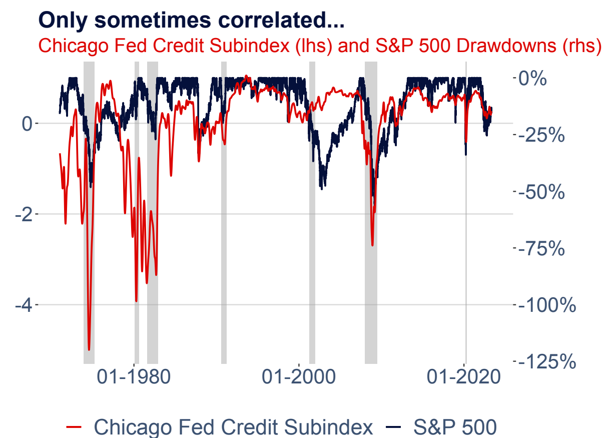

Figure 6: *Over the past decades, deteriorating financial conditions have accompanied and driven some but not all major bear markets. However, as measured by the Chicago Fed, the present environment does not look overly bleak. Moreover, the recent strong correlation between the Financial Conditions index and the stock market indicates that current levels are well priced-in.*

is all but bad news. The Savings and Loan Crisis is defined as having lasted from 1986 to 1995, a time during which the S&P 500 made more than 300% as earnings and dividends per share almost doubled while valuation multiples, well correlated with inflation, and expanded moderately from 15x in 1986 to 20x in 1995 as shown in Figure 5. Markets look slightly more expensive today with the P/E already at 19x. The present dividend yield of 1.7% may not be directly comparable given the increased role of buybacks.

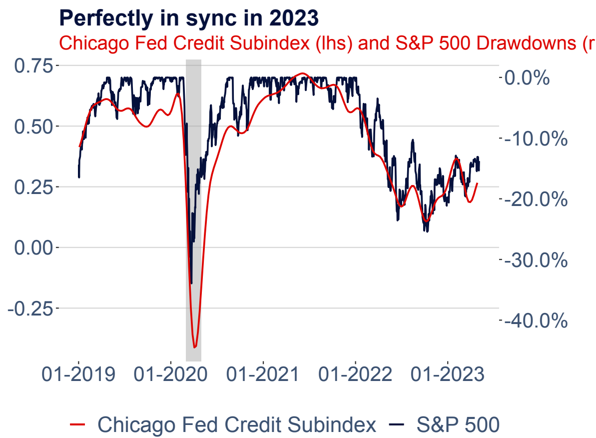

Figure 7: *Markets have almost perfectly tracked the Chicago Fed Financial Conditions Index in 2023.*

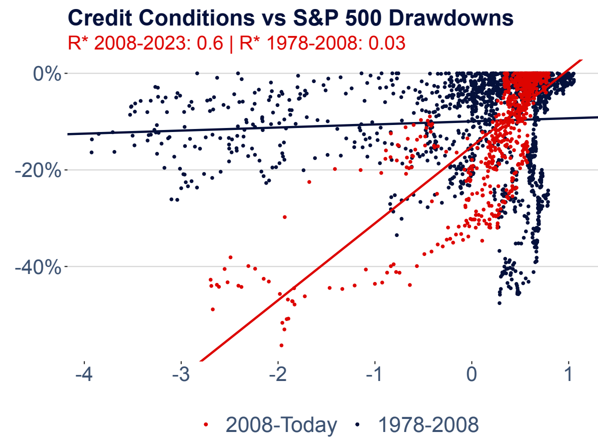

Figure 8: *Credit conditions and drawdowns in the S&P 500 have been well correlated since 2008.*

4 Another look at Financial Conditions

To develop a better understanding of contemporary conditions, we also took a closer look at the Chicago Fed National Financial Conditions Index and the respective Credit Subindex. The National Financial Conditions Index is a much broader measure of credit conditions, comprised of 109 indicators, including market-based measures such as the term premium, credit spreads, or option- based volatility [1]. As Figure 2 outlines, this index broadly follows the same trends as the survey-based Availability of Loans index by the NFIB, but the relationship broke down, for instance, in 1989 when surveys signaled diminished availability of loans for small businesses while general credit conditions stayed relatively healthy.

This year brought a similar divergence as the Chicago Fed Index continues to signal financial conditions, best described as not exactly easy but far from dire. Interestingly, the broad equity market has experienced a much closer correlation with this indicator than the Availability of Loans index. Avid readers will spot the collinearity problem introduced here as equity market conditions feed into the Chicago Fed index. We do not believe that this problem significantly impacts the statistics given that history clearly shows that the two time series can diverge substantially. Interestingly, the correlation was way less strong before the 2000s, especially during the highly inflationary 70s and 80s.

We regressed the maximum drawdown of the S&P 500 index and the Russel 2000 index on the inversed Chicago Fed Financial Conditions Credit Subindex. We obtained an R* of around 0.6 in both cases for the period between 2008 and today but only 0.03 and 0.019 for the time preceding this period (see Figure 8). Driven by rampant inflation, the 70s and 80s (and the early 2020s?) were characterized by wild swings in economic data, complicating seasonal adjustments and breaking otherwise strong correlations.

5 Conclusion

As Figure 7 indicates, the deterioration in Financial Conditions observed so far has likely been priced in by stocks. Survey data confirm what the strong underperformance of small-cap indices already told us: conditions are worse for small and medium-sized enterprises. While it seems unlikely that the U.S. economy will be able to avoid a recession, investors should never make the mistake of assuming that the economic cycle determines stock market performance. We showed last year that inflationary times can be excellent for corporate profits, and the Savings and Loan Crisis of the 80s and 90s (Figure 4) is a perfect reminder that equity markets can do very well even when lending conditions are tight, and banks are failing left and right.

Looking beyond public markets, it will be interesting to see how higher refinancing costs will impact frequently intermingled Private Equity and Private Debt investments. However, higher equity cushions and record-high levels of dry powder mean that sponsors are more likely to find a solution for companies troubled by mostly floating debt.

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