Tortoise QuickTake Credit Podcast

Tortoise

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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, Tortoise provide a timely update on trending topics in the market.

Welcome to the Tortoise Credit weekly podcast. I am Jeff Brothers, Senior Portfolio Manager for Tortoise. With uncertainty rising for U.S. economic growth, consumer spending, which accounts for roughly two-thirds of overall economic activity, stands out as the last pillar of strength and critical to preventing a potential recession. On the surface, the fundamentals for the U.S. consumer look very solid, with robust labor markets, improved balance sheets, and a high savings rate. In today's podcast, we wanted to do a quick check-up on the health of the consumer and consider any potential warning signs.

Let's start with the good news. While manufacturing and business investment have faltered, the U.S. consumer continues to fire on all cylinders. Personal consumption expenditures were up a very strong 4.6% in the second quarter and are now up 2.6% over the past year. The consumer has benefited from the very strong labor markets, with the unemployment rate at a 50-year low and solid wage and job growth. Measures of consumer balance sheets have also improved significantly since the financial crisis. From the New York Federal Reserve's quarterly report on household debt, consumer debt increased 1.4% in the second quarter to almost $14 trillion. This was the twentieth consecutive quarterly increase in debt and is now $1.2 trillion higher than the previous peak in the third quarter of 2008. The increase in overall household debt is primarily attributable to the rise in auto debt and student loans. Mortgage debt, which accounts for sixty- eight percent of aggregated household debt, has actually been flat since the financial crisis. Debt levels have gradually increased, but have been more than offset by the rise in consumer assets and income and the decline in the cost of debt. Aggregate debt to disposable income is near a twenty year low and the financial obligations ratio, which measures total household financial obligations as a percent of disposable income, is down 17% from the peak.

While debt has gradually increased, the underwriting standards and delinquency rates, in aggregate, have been stable. Delinquencies on overall household debt fell in the second quarter to 4.4%, compared to the peak in the 2009 of 12%. The underwriting for new auto and mortgage loans was solid with a median credit score of 703 and 759 respectively. Consumers have also been helped by gains in household net worth from stock and home price appreciation. Household net worth hit new highs in the second quarter and topped $113 trillion. The savings rate is a healthy 7.9%, as the recent tax cut appears to have gone towards rainy day funds rather than consumption. Lastly, the University of Michigan and Conference Board measures of consumer sentiment have dipped recently, but are still near the peak for the business cycle.

U.S. consumers in aggregate have made an impressive rebound from the financial crisis, but some warning signs below the surface point to potential vulnerabilities. First, the labor markets remain strong, but the trend is definitely slowing for job creation, wage growth, and hours worked. For example, the economy averaged only 167,000 new jobs created in 2019 versus 223,000 in 2018 and the growth rate in index of hours worked is at a nine year low. There is also a risk that weakness in business investment and confidences spills over into demand for labor. Looking in more detail at consumer credit performance also highlights potential red flags. In aggregate delinquencies for consumer debt are at a cycle low, driven by the continued improvement in mortgage loans. Despite the solid consumer fundamentals, trends for non-mortgage debt, however, have deteriorated with both auto and student loan delinquencies near the peak for the cycle and problem credit card debt rising since 2016. In addition, subprime auto loans, whose borrowers may not have experienced the same income or net worth gains, are showing weakness with charge-offs and delinquencies at record highs.

To conclude, it has been a great comeback for the U.S. consumer since the financial crisis and we think the good times can continue despite some early warning signs. Incomes are still solid and consumers can tap ample savings in the event of a modest slowdown in growth. This leads us to three big takeaways. First, we believe the strength in the consumer should be enough to keep the economic expansion on track and avoid near term recession risks. Secondly, we continue to favor

consumer credit over investment grade credit, where corporate leverage has been steadily increasing. Lastly, we believe it is time to be more cautious on unsecured consumer credit like credit cards and lower quality borrowers like subprime auto.

Thanks for listening and we will talk to you again next week.

Thank you for joining us. And stay tuned for our next cast. Have topics you want covered or other feedback to share? Write us at info@tortoiseadvisors.com.

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