BLUE OWL

US Consumer vs. Corporate Risk: A Case in Misperception

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Overview

Introduction

The 2008-2009 financial crisis fundamentally altered the lens through which investors perceive the world. While there were many valid lessons learned from the crisis (e.g., residential real estate prices do not always rise), certain misperceptions took root in investors' minds as well. Among these misperceptions is the false notion that consumer credit assets are inherently riskier than corporates, particularly during periods of macroeconomic distress. We believe this opinion stems from the 2008 financial crisis that began with consumers, who were enabled by structured products and derivatives created by a frenzied Wall Street, buying houses with little equity and incurring an unsustainable amount of mortgage debt along the way. Overly indebted consumers indeed played a central role in the 2008 financial crisis; however, the picture that emerged from the crisis and permeated investor minds – one of the US consumer as a reckless, debt-binging individual – does not align with historical data. In fact, Blue Owl's research suggests the opposite: consumers have demonstrated more stability and less downside volatility, on average, than corporates during each of the past three recessions. Finally, while this paper focuses on relative risk, not relative return, we find that US consumer loans have also enjoyed a ~300bps greater historical interest rate on average since 1979.

Background

Blue Owl's Alternative Credit strategy has extensive experience investing in various consumer credit assets over the past decade, and this asset class has grown to be one of our largest exposures today. Our investment activity is primarily comprised of lending against or buying consumer credit assets and has been propelled by a similar opportunity set that created the private credit opportunity set: bank retrenchment from lending to small- and medium-sized businesses. This affected consumer credit availability to an even greater degree, creating a capital void filled by specialty finance lenders including Blue Owl. In our own experience, we have found that consumer investments exhibit less risk than corporate equivalents because of elements unique to the consumer sector, such as the rapid amortization profile of the underlying assets and structured nature of the investments (e.g., cash control mechanisms). While we previously spent many hours focusing on the micro level by evaluating the historical performance of discrete portfolios during recessions, we spent less time considering the macro question: On average, which asset type has historically been riskier and exhibited more downside volatility – consumer or corporate? We began research to answer that question, the results of which are discussed herein.

Analysis

Our analysis centers on evaluating the relative volatility and resiliency profiles of consumers and corporates during the prior three recessions (i.e., 2008 financial crisis, 2001 dot-com recession, and early 1990s recession), using a combination of fundamental indicators and asset performance data.

Specifically, we first analyze the underlying fundamental drivers of credit performance in the 2008 downturn (i.e., revenue, net income, and net worth) to determine how each performed during the financial crisis, measuring (a) peak-to-trough drawdown percentages and (b) recovery periods (i.e., the time it takes to recover the prior peak level). We then expand our analysis to include the two prior recessions to survey the consistency of the relationships identified from the 2008 data. Next, we transition to annualized loss volatility across all three recessionary periods to gauge an indicator of asset performance. Finally, we look at one of the divergent patterns that preceded and contributed to the severity of consumer distress in 2008.

US Consumer vs. Corporate Risk

Top Line Performance

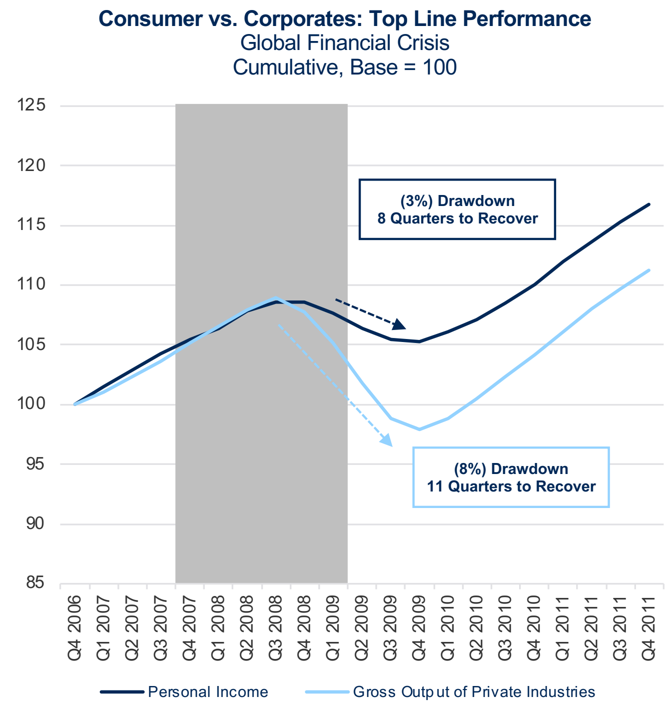
Revenue (i.e., "top line") volatility is the first metric we examine, as it is the most direct measurement of economic sensitivity. We assessed Total Personal Income and Gross Output of Private Industries for consumers and corporates, respectively. Both datasets are published by the Bureau of Economic Analysis (BEA).[1]

We observe that while both consumers and corporates suffered top line declines, consumer incomes declined much less from peak levels (suggesting less exposure to economic volatility) and also recovered more quickly (pointing to greater resiliency).

Consumer revenue fell only 3% and took eight quarters to reclaim peak levels, whereas corporate revenue fell by more than three times that amount – an 8% decline in total – and required an additional three quarters to recover

Figure 1

Top Line Performance



Source: BEA, Bloomberg

Bottom Line Performance

For both consumers and corporates, declines in the bottom line reflect the decline in revenue offset by any coincident changes in expenses (e.g., spending, taxes, etc.). For consumers, we analyzed personal savings, which is defined as total personal income less total personal expenditures, including taxes. Effectively, personal savings represents remaining household income after all expenses are paid, which is conceptually comparable to after-tax corporate net income. Corporate expenses are a function of the composition of the underlying cost structure (i.e., fixed vs. variable) and how quickly management can practically reduce costs to offset declining revenue. To assess bottom line performance volatility (see Figure 2), we have compared the trailing 12-month US Personal Savings[2] from the BEA for consumers and trailing 12-month Corporate Net Income from the BEA for corporates.

Here, the disparity in the results is even more pronounced than in the prior top line analysis. While personal savings declined only 3% and quickly recovered thereafter, corporate net income declined 41% and took four years to recover. What might explain this striking difference? We believe the answer lies in the fact that consumers can adjust their spending to reflect declines in revenue much more quickly than corporates can identify and effectuate material cost reductions, which ultimately increases relative consumer resiliency. Grocery shopping instead of dining out; purchasing generic and lower priced brands; and skipping a vacation are all simple ways consumers can quickly cut substantial expenses. Laying off workers, realigning annual budgets, closing stores, and shutting down production are all far more complex and slow-moving endeavors and highlight that the operating leverage inherent in corporates works both ways (not just to the upside) during periods of stress.

The financial media often associates consumer "health" with increasing consumer spending. This characterization exists due to the positive impact that rising consumer spending has on GDP growth and the idea that growing personal consumption is reflective of improving consumer fundamentals (i.e., consumers are inclined to spend more when they are optimistic about their financial condition). However, consumers often outspend their means during these periods and engage in "unhealthy" financial behavior by foregoing or depleting their savings in exchange for immediate consumption. While a baseline level of consumer spending growth is essential to a well-functioning economy, a reasonable balance between spending and saving is necessary to ensure the sustainability of that growth. As a lender to the consumer space where saving or dissaving (i.e., spending more than earnings) can be a strong predictor of longer-term credit risk, Blue Owl associates consumer "health" with balanced spending and savings patterns and does not subscribe to the financial media's preferred definition of simply increasing spending.

> The consumer peak-to-trough decline was only a fraction of the corporate decline, and consumers recovered prior peak levels more quickly than corporates.

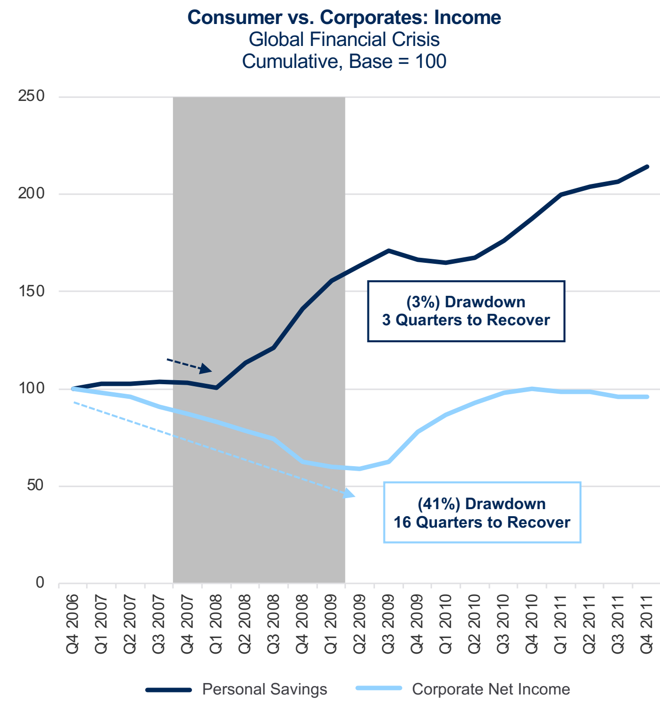
Net Worth Performance

Net worth is the balance sheet component of our analysis, representing the difference between assets and liabilities. For consumers, the metric represents the difference between all assets of households and nonprofits (including the market value of securities and real estate) and all liabilities, whereas for corporates it is Nonfinancial Corporate Equity Value per the BEA.

The findings from our net worth analysis resemble those from the revenue and income analyses. The consumer peak-to-trough decline was only a fraction of the corporate decline, and consumers recovered prior peak levels more quickly than corporates. Consumers meaningfully outperformed corporates from a peak-to-trough standpoint, as household net worth fell 18% compared to the 44% drawdown experienced by corporates. Consumer net worth recovered to pre-recession peak levels in 20 quarters, whereas it took corporates an additional two quarters.

Figure 2

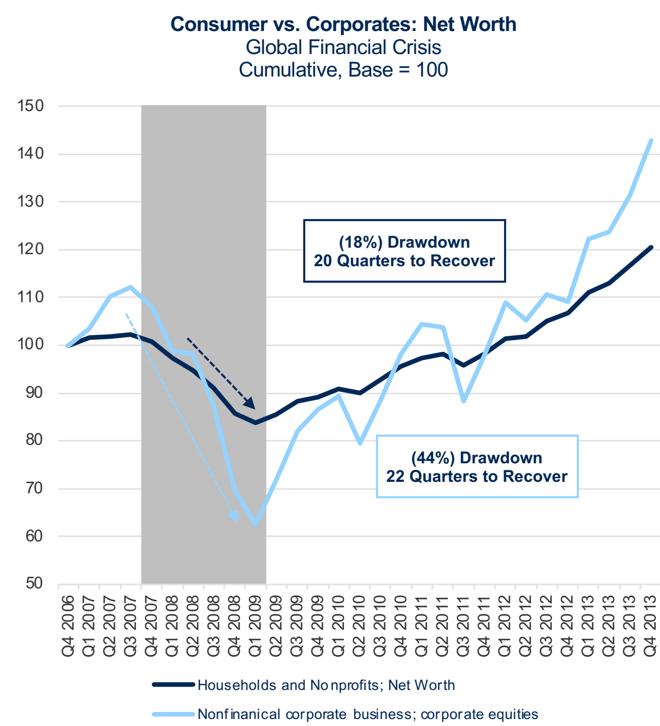
Bottom Line Performance



Source: BEA, Bloomberg

Figure 3

Net Worth



Source: Federal Reserve Bank of St. Louis, Bloomberg

Historical Recessions Summary

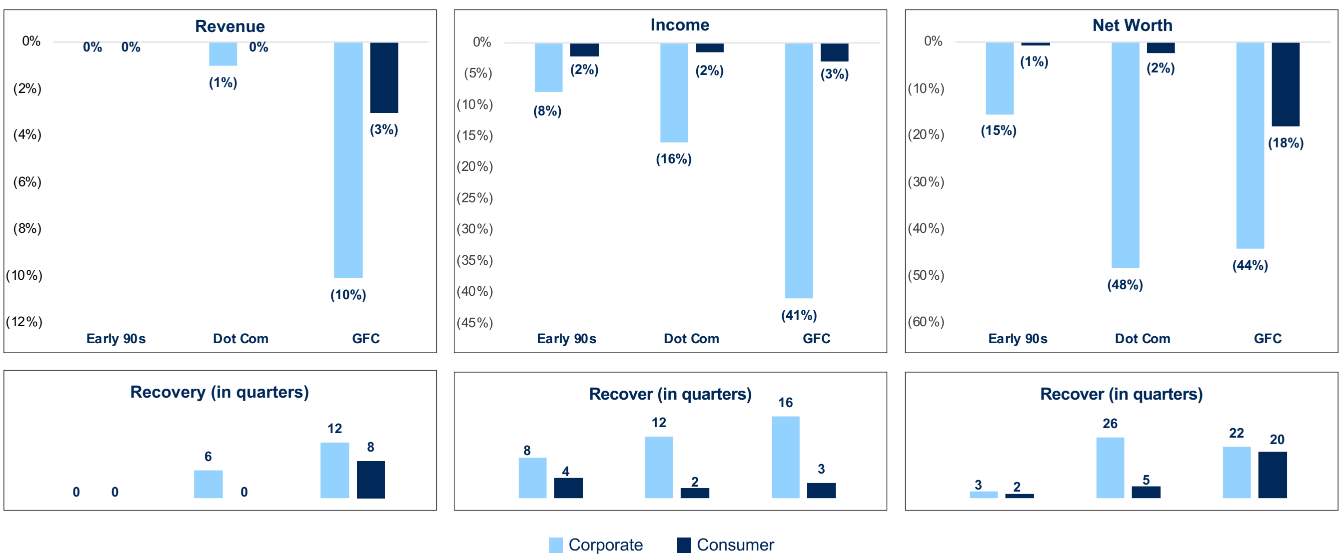
After examining the 2008 data, we expanded our analysis to include the dot-com recession in 2001 and the early 1990s recession to gauge the consistency of our findings across prior recessions. The top panel of Figure 4 illustrates relative peak-to-trough drawdowns across revenue, net income, and net worth, while the bottom panel shows the time to recover to the local peak prior to the drawdown.

Across every single data point analyzed in Figure 4, consumers universally exhibited smaller drawdowns and faster recovery periods than corporates. Accordingly, on an aggregate basis, it is apparent that the fundamental drivers of consumer credit performance have displayed less downside volatility and more resiliency than their corporate counterparts during the three recessions seen over the last three decades.

The other striking observation from Figure 4 is the severity of the 2008 financial crisis relative to the other recessions. Across all metrics, drawdowns were more pronounced and the recovery periods longer than in the prior two recessions. If history is any guide, the next recession should not resemble the gravity of the 2008 financial crisis, which appears to be a historical outlier.

Figure 4

Recession Survey



Source: BEA, Federal Reserve Bank of St. Louis, Bloomberg

Credit Losses

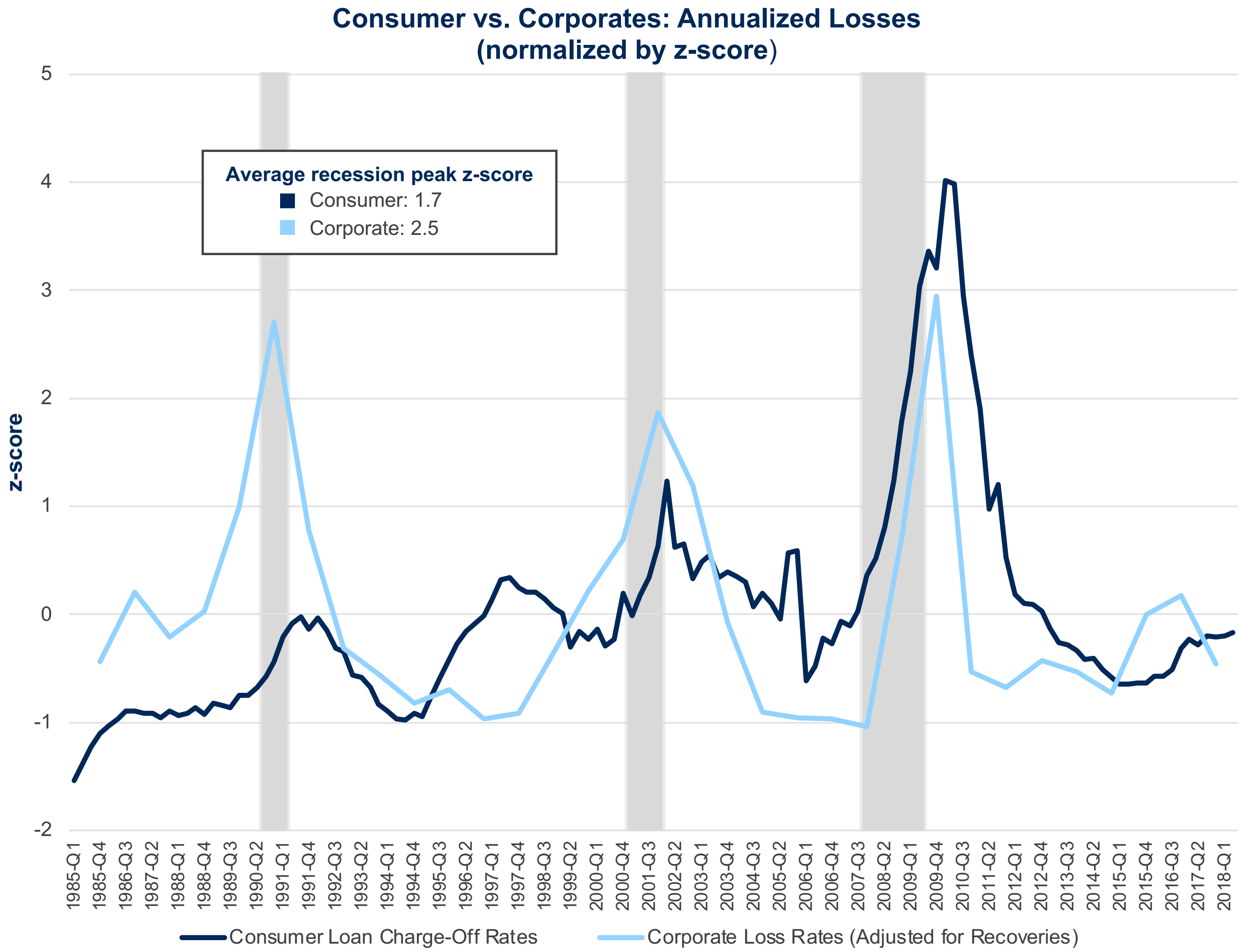
Having analyzed the underlying fundamental drivers of credit, we turned our attention to asset performance, specifically annualized losses. We compared net charge-off data (inclusive of recoveries) from all consumer loans other than real estate loans[3] to loss-given-default for the US corporate debt universe (i.e., annualized default rates adjusted for recovery rates).

For both asset classes, Figure 5 shows the z-score for each metric over time, which is a way to standardize a measure of volatility that calculates the number of standard deviations away from the mean for each data point. We've shown the analysis going back to the mid-1980s to capture the three recessionary periods mentioned above.

This analysis illustrates that annualized corporate credit loss rates have historically spiked by 2.5 standard deviations, on average, during periods of financial distress. In comparison, on that same normalized basis, consumer loan charge-offs have spiked by only 1.7 standard deviations, equating to roughly 50% less downside volatility.

Figure 5

Annualized Credit Losses



Source: Board of Governors of the Federal Reserve System; Moody's Investors Services

In absolute, non-normalized terms over all non-recessionary periods, annual corporate credit loss rates have averaged 0.7%. However, loss rates spike in downturns, averaging 1.8% over recessionary periods. Corporate credits have experienced a 103% to 190% increase in loss rates during recessionary periods relative to pre-recession levels. In comparison, consumer loan charge-off rates have averaged 2.2% over non-recessionary periods, increasing to 3.5% on average during recessionary periods. Increases in consumer loss rates have been lower than corporates, ranging from 50% to 120%.

While annualized consumer losses exhibit less downside volatility than corporate losses on both a normalized (i.e., z-score) and non-normalized (i.e., percentage change) basis per the above, the average level of annualized consumer losses has been ~150bps greater than corporate losses during non-recessionary periods (0.7% for corporate vs. 2.2% for consumer). However, the difference in losses is more than offset by consumer loan interest rates, which have averaged ~300bps higher than corporate loans since 1979. The net result is that consumer loans show consistently higher returns net of losses over the observed time period in addition to exhibiting less downside volatility during recessionary periods.

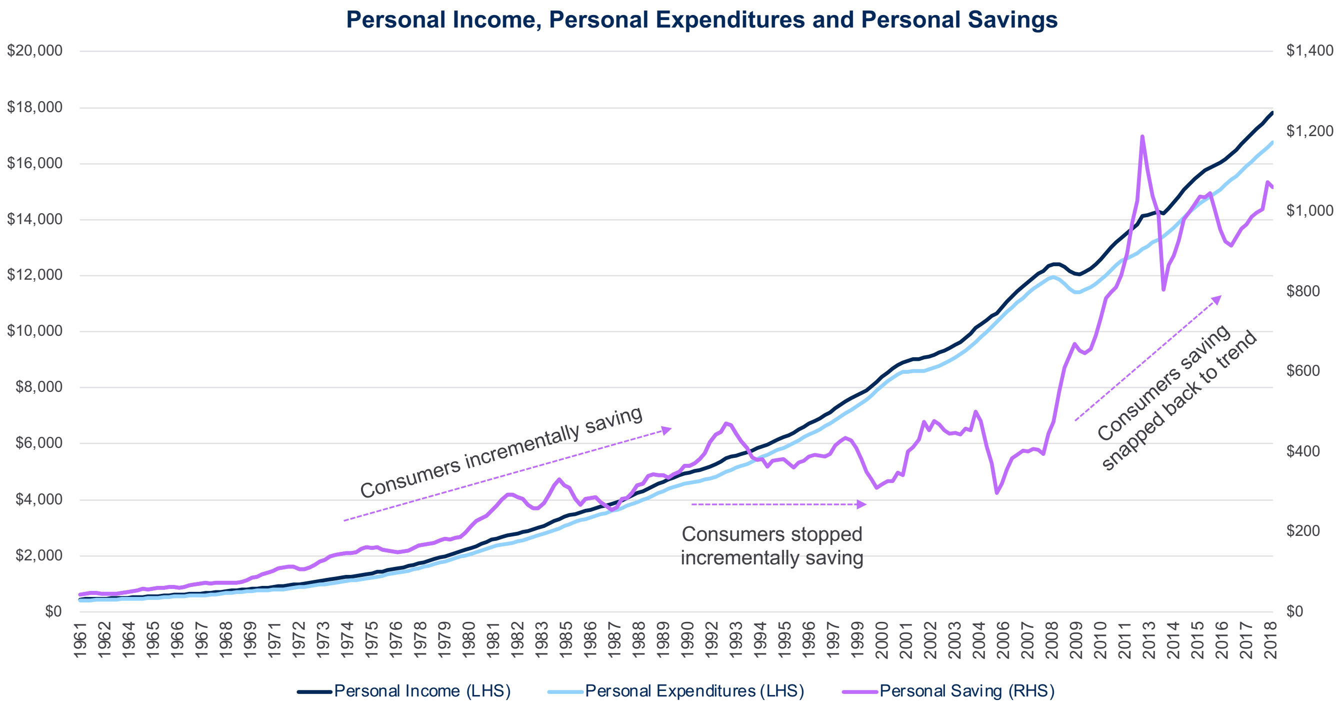
One notable observation is that during the 2008 recession consumer loan charge-offs increased slightly more than corporates on a normalized basis (four vs. three standard deviations). So naturally, we found ourselves asking: what happened and was it foreseeable?

Consumer Savings Trends

A look back reveals a paradigm shift in the amount of nominal consumer annual savings during the years leading up to the 2008 recession, which stripped consumers of their downside cushion. Figure 6 shows a 60-year history of personal revenue (i.e., income / top line) and personal expenditures – both on the left axis – as well as personal income (i.e., savings / bottom line), which is on the right axis. Personal savings is equal to the difference between the purple and navy lines, and it is charted on a different axis to better show trends. All of the data is in nominal terms.

Figure 6

Consumer Savings Trends



Source: Board of Governors of the Federal Reserve System; Moody's Investors Service

The break in the trend is obvious. While there were many contributing factors that led to consumer stress during the financial crisis, the meaningful change in savings patterns that emerged during the fifteen-year run-up to the financial crisis was certainly a key factor. From 1960 to the early 1990s, growth in personal savings generally tracked growth in income. However, starting in 1993, consumers stopped incrementally saving. From 1993 to 2008, personal income increased 125%, while nominal personal savings remained flat. In other words, consumers spent every single dollar of incremental income that they earned for a decade and a half. Since 2008, the amount of annual personal savings has snapped back to pre-1993 trend levels. This goes back to a concept discussed earlier – while consumer spending patterns during the 1990s and 2000s were "healthy" with respect to driving incremental GDP growth, they were quite "unhealthy" when viewed from a longer-term credit perspective.

> "
> Consumer loans show consistently higher returns net of losses over the observed time period in addition to exhibiting less downside volatility during recessionary periods.

Conclusion

The analysis presented above shows a clear trend and one that is different than investors might expect. In contrast to common perception, during recessionary periods consumer earnings and balance sheets have historically exhibited less volatility and more resiliency than corporates. There are also indicators today (e.g., elevated corporate leverage levels) that suggest an even greater degree of relative risk for corporates (vs. consumers) compared to historical periods. Our Alternative Credit team continues to see compelling investment opportunities across the consumer landscape that we believe have partially resulted from the gap between the perception and the reality of the risk profile inherent in these assets. Given Blue Owl's extensive investment experience and the observations we have presented here, we believe investments in US consumer-related assets represent an attractive investment today that will continue to perform relatively well throughout the macroeconomic cycle.

If you have any questions or would like to learn more, please contact Blue Owl's Alternative Credit business development and investor relations team at alternativecredit-ir@blueowl.com

Sources

1. For consumers, Personal Income includes all sources of income (e.g. wages, investment income, etc.) and represents the analogous concept to corporate revenue.
2. US Personal Savings is defined by BEA as: US Personal Income - Personal Taxes - Personal Consumption Expenditures - Personal Interest Payments - Personal Current Transfer Payments.
3. Real estate loans were excluded for a few reasons. First, given the size of the mortgage market (~$9.7 trillion) relative to the remainder of consumer debt market (~$4 trillion), mortgage debt meaningfully overwhelms the aggregate numbers. Second, while Atalaya does invest in residential real estate in a variety of ways, our exposure to the consumer sector is predominantly through non-housing debt verticals. Finally, performance of mortgage debt is principally a function of collateral values (i.e. home prices) as opposed to fundamental consumer credit risk. In our view, this last point is at the root of much of the misperception about consumers which was driven by media headlines from the last downturn, as many reports associated the bursting of the real estate bubble with volatile consumers.

Important information

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