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Not Your Father's Credit Crunch

Right now, with every stress in the banking sector, there is a developing orthodoxy that a credit crunch will occur and that recession-driven credit problems will inevitably follow, with those twin threats happening in either order and with either phenomenon being the proximate cause for the other.

We disagree. We believe the above shorthand is conflating the experiences of past recessions with today's facts and fails to capture important key differences, which are important and will serve to lessen any such impact.

Back Then: Supply Imbalances

To start, let's remember that the recessions of 1975, 1980 and 1982 were accompanied by crippling energy shocks and significant embedded inflation. The degree of pressure is not the same today. And the recessions of 1990 and 2008 were accompanied by commercial and residential real estate booms that burst. Importantly in the latter cases, there were very real imbalances in the economy that do not exist today. This is no small matter. The point is that in 2008, housing starts declined in part because interest rates went up, but they principally declined because those extra homes were not needed because of a housing bubble going into the period. There is no such imbalance today. In fact, there is still an accumulated housing shortage compared to household formation. What this means is: true, housing prices need to readjust lower to match buying power with higher interest rates, but once that threshold is met, then housing demand will resume because families need those homes.

We recognize that new commercial real estate is "not needed" right now. However, in addressing the usual concerns about that topic today, we note that commercial real estate is characterized by long rental streams and bigger shock absorbers for the banks in the form of lower loan-to-value ratios.

Losses: Not All Are The Same

But what about a credit crunch per se impacting the economy? We point out that in prior recessions, the banks were facing severe and immediate credit losses -- often on loans to developers or on mortgages, which is why it is easy to conflate the impact of those periods with today's different starting point. Those losses threatened the banks' capital positions, and thereby put a crimp on lending. Today, it is true that the banks are facing pressure on their bond portfolios, but this is manageable. The bonds are not marked to market, and the aggregate amount of losses on the banks' bond and mortgage portfolios totaled about $600B at year end 2022, when interest rates were higher and not accounting for offsetting gains in their fixed rate liabilities. We estimate that the banking system earns the better part of $500B annually in pre-tax, pre-provision earnings that can be used to offset the problems in their bond portfolios – annually. We therefore don't anticipate a systemic hit to capital accounts. And if there is no systemic hit to capital accounts, then banks will continue to lend out the deposits on their balance sheets.

And it makes little difference when we hear about surveys that banks are "tightening credit standards". While there is something of a correlation between tightening lending standards and GDP, we really don't know which causes which, and the analysis includes periods when banks faced realized hits to their equity accounts, which we do not see today. Whether JP Morgan stops lending to a subprime credit card borrower and lends instead to Dow Chemical to build an ethylene plant, it doesn't matter: the borrower will spend the same amount of money.

In sum, we believe that the "shorthand" investors are using on analyzing the financial system relies too heavily on the different circumstances of past recessions and we believe that the system is more resilient than many investors believe to be.

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Mutual Fund investing involves risk. The Trust invests in lower rated debt securities which may be subject to increased market volatility based on factors such as: the ability of an issuer to make current interest payments, the potential for principal loss if an issuer declares bankruptcy, and the potential difficulty in disposing of certain securities in a timely manner at a desired price and therefore can present an increased risk of investment loss. Diversification does not eliminate the risk of experiencing investment losses.

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Investors should carefully consider investment objectives, risks, charges and expenses. This and other important information about the Trust is contained in the prospectus or summary prospectus, either of which may be obtained by calling 1-800-225-6704 or by visiting www.northeastinvestors.com. Please read either one carefully before investing.

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