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SFA Research Corner

Subprime Borrowers Caught Between Economic Tides

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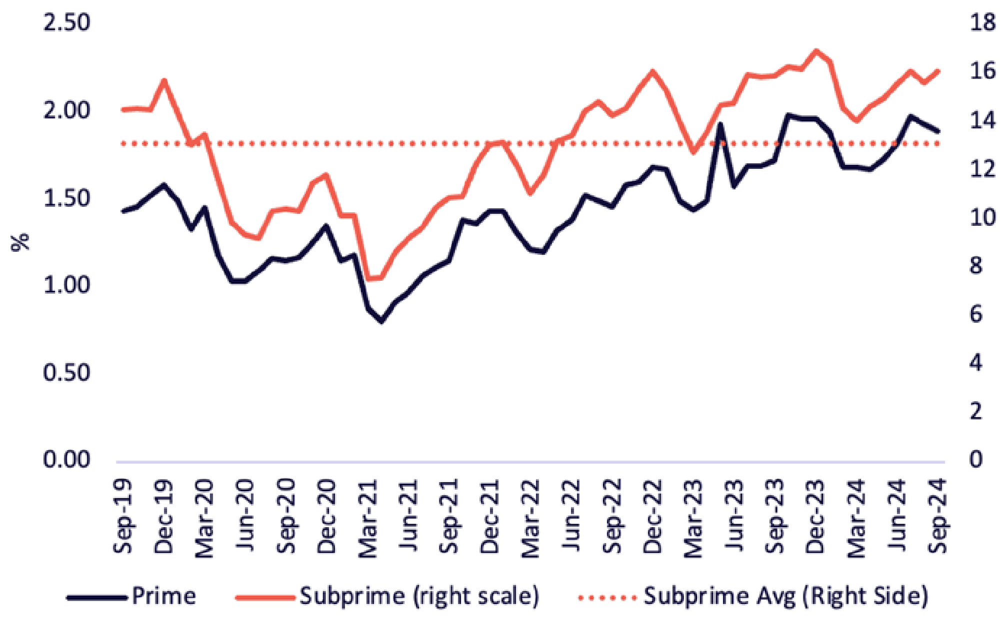
Subprime Borrowers Caught Between Economic Tides

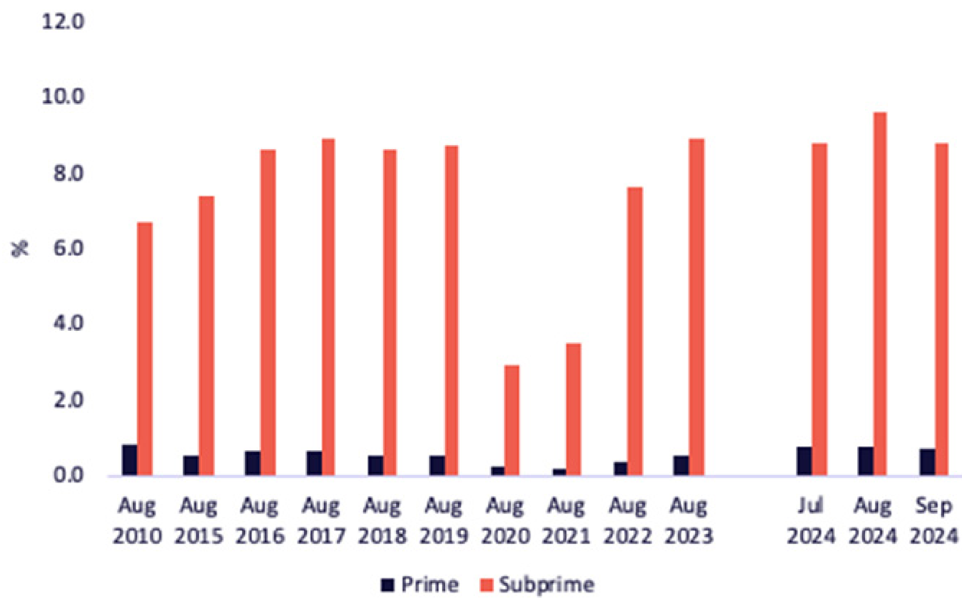
The October Survey of Consumer Expectations from the New York Fed signals improving consumer sentiment, with near-term inflation expectations falling to a four-year low of 2.9% as inflation steadied in October, leaving headline and core year-over-year rates at 2.6% and 3.3%, respectively. However, this optimism has not alleviated pressures for these borrowers as higher living costs and interest rates continue to strain their financial stability. S&P Global Ratings' latest **U.S. Auto Loan ABS Tracker** underscores the financial strain facing subprime borrowers, particularly in the auto loan sector. In September 2024, the 30-plus-day delinquency rate for subprime loans in auto ABS pools rose to 16.05%, up from 15.59% in August and 13.39% a year earlier. While net loss rates for both prime and subprime collateral showed slight month-over-month improvements, these figures follow a period of elevated losses, with August marking the highest loss rates for the month since 2010 for prime and 2009 for subprime collateral. The persistent financial pressures stem not only from higher interest rates but also from larger loan amounts and increased monthly payments, reflecting broader economic challenges for subprime borrowers.

30-plus-day Delinquency Rate Continues to Rise for Subprime Auto ABS



Source: S&P Global Ratings, U.S. Auto Loan ABS Tracker: September 2024 Performance

Net Loss Rates Improve Month-Over-Month



Source: S&P Global Ratings, U.S. Auto Loan ABS Tracker: September 2024 Performance

Lenders have responded to this weakening performance. The Senior Loan Officer Opinion Survey (SLOOS) found banks increasingly selective in lending to near-prime and subprime borrowers. While this cautious expansion improves delinquency risks for lenders, it restricts access to credit for high-risk consumers, which may amplify financial stress as living costs and interest rates are still elevated.

Near-prime and subprime borrowers, which make up about one-third of all borrowers, with lower credit scores and higher debt-to-income ratios, face a precarious financial environment. While job creation and wage growth under President-elect Trump's pro-growth policies could offer stability, the risk of rekindling inflation—especially if it outpaces wage increases—and rising interest rates may exacerbate these challenges.

The fixed income markets mirrored this dynamic. On November 7, 2024, 30-year Treasury yields surged by 17 basis points as markets anticipated increased demand and higher inflation. Conversely, the same expectation of heightened economic activity bolstered credit markets. Corporate bond spreads narrowed post-election as demand for higher-yielding assets drove prices higher, reflecting optimism around pro-growth policies. Similarly, asset-backed securities (ABS) prices, as indicated by credit spreads, have held steady or risen slightly.

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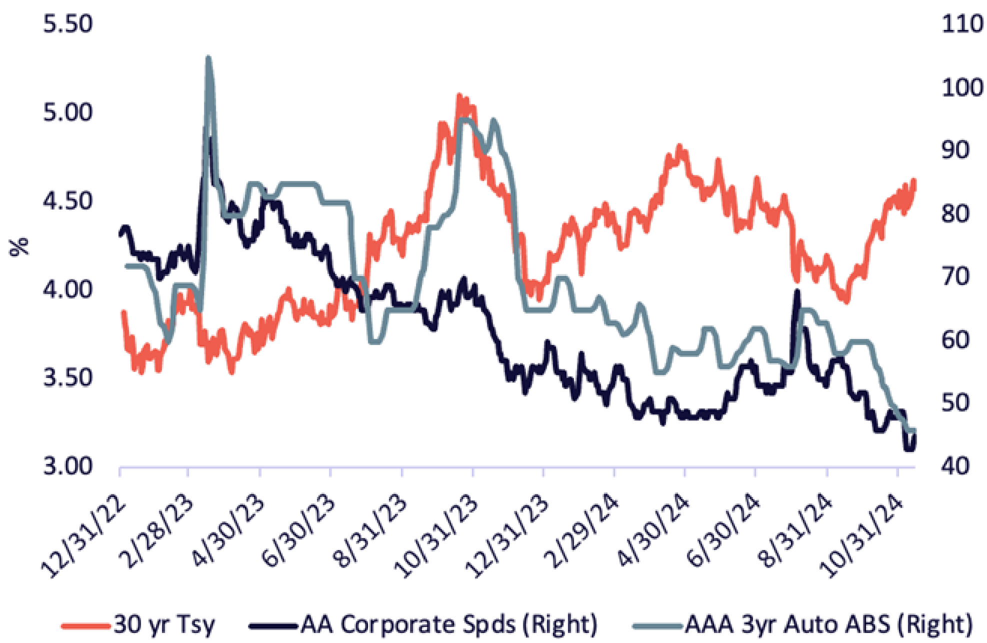
Markets React: Treasury Yields Climb as Credit Spreads Tighten



Source: SFA Market Compilation, Board of Governors Federal Reserve System Retrieved from FRED

Today's conditions highlight a dichotomy among borrowers. On one hand, rising disposable income and easing inflation point to overall financial resilience, with a reduced debt-to-income ratio signaling stability for many households, even as household debt balances grow. On the other hand, near-prime and subprime borrowers remain under significant financial strain, grappling with higher-interest credit products and limited flexibility to absorb economic shocks. Their heightened sensitivity to economic shifts underscores the need for balanced fiscal and monetary policies that support growth while addressing the unique vulnerabilities of these at-risk segments.