How a K-Shaped Economy Affects Opportunities in Asset Based Finance

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Key Takeaways:

The “K-shaped” divide endures even as it evolves. Higher-income households keep benefiting from equity gains, home price appreciation, and solid earnings, while lower-income households face mounting pressure from elevated costs and tighter credit. But recent data suggest the story is becoming more nuanced.

For investors, today's consumer credit stress looks idiosyncratic, not systemic. Subprime weakness traces largely to underwriting within specific 2022–2024 vintages rather than a broad decline in borrower quality, and – unlike 2008 – does not appear to pose systemic risks.

Investors should favor discipline within consumer credit and other household-linked asset based finance investments. We believe investors looking to ABF today should favor high quality, seniority, vintage quality, and flexibility across collateral types rather than uncritical enthusiasm for the asset class or blanket caution.

Not all U.S. consumers are experiencing today’s economy the same way. Wealthier households continue to benefit from rising asset prices and solid earnings growth, while lower-income families are still absorbing the effects of years of elevated costs and tighter lending standards.

For investors navigating consumer-related credit and other household-linked investments, particularly within asset-based finance (ABF), this uneven economic backdrop – and how it’s evolving – matters. Today’s economic landscape has led us to favor select higher quality investments backed by consumers with strong balance sheets over subprime exposures and other areas of potential weakness.

ABF – a subset of private lending where investments are backed by specific collateral – also extends beyond consumer-related sectors, with other areas that can help investors diversify and mitigate consumer-specific risks.

Meanwhile, the lower half of the income distribution remains pressured, although it is no longer deteriorating uniformly. Recent private-sector payroll and deposit-account data suggest wage growth among lower income earners has accelerated somewhat over the past year, narrowing a gap that had developed with higher earners. At the same time, employment gains have picked up in select lower-wage industries, including segments benefiting from the surge in AI-related infrastructure investment.

The result is an economy that remains bifurcated, but perhaps less cleanly than before. Rather than a simple divide between strong and weak consumers, the labor market increasingly appears characterized by pockets of strength alongside pockets of softness. Overall hiring remains subdued by historical standards, yet workers in certain industries continue to enjoy solid wage gains and employment opportunities.

That creates an unusual dynamic. Lower-income households are benefiting from some improvement in labor income, but many continue to face the cumulative effects of several years of elevated prices, depleted excess savings, and tighter credit conditions. Higher-income households, meanwhile, remain financially secure but may be more exposed to emerging risks associated with AI-driven disruption in white-collar employment.

An open question is whether AI ultimately narrows or widens these divides. Thus far, labor-market disruption has been concentrated in entry-level professional and technology-oriented occupations, while job growth in specialty trade construction has accelerated.

As seen in subprime auto loan asset backed securities (ABS), a meaningful share of the increase in subprime consumer delinquencies over the past several years traces back to underwriting quality within specific 2022–2024 vintages – loans originated when competition for volume was intense – rather than a broader decline in borrower credit quality. Underwriting has since tightened, and outside of subprime, performance has been comparatively stable.

It’s worth considering whether today’s subprime weakness is a leading indicator of broader stress to come, or whether any broader stress would require an exogenous catalyst – a genuine labor-market shock, or an abrupt end to the AI capital-expenditure cycle – to materialize.

We do not think weakness in subprime lending today poses a similar risk to the broader economy as the subprime mortgage crisis did in 2008. We do not expect this cycle to replay that period, when balance-sheet weakness itself caused the crisis. Today’s pockets of stress look more contained and idiosyncratic.

But that view is worth testing, and we would grow more concerned if labor-market softening broadened beyond entry-level and AI-exposed roles into more durable job losses across income cohorts, or if higher-income households’ balance sheets – the segment currently offsetting weakness at the bottom of the K – came under pressure.

Source: https://www.pimco.com/us/en/insights/how-a-k-shaped-economy-affects-opportunities-in-asset-based-finance