The Low Hanging Fruit Is Falling, So Bring a Basket

This might be the most confounding economy in memory, one that refuses to conform to any predictable script or playbook — just ask Fed Chair Powell, who continues the central bank's yearlong efforts to slow an economy that won't easily be tamed. But if you mention to someone outside of the restructuring profession that you're a corporate bankruptcy advisor, the response you are likely to hear is something to the effect of, "Oh, business must be good these days."

Why is that a common response from those outside our circle? A long-anticipated recession remains elusive, pre-pandemic lifestyles have resumed in full, corporate earnings are still healthy, financial markets are hanging tough, inflation is easing, jobs are plentiful, and the labor market remains uncannily strong. More than a year after the Fed began to hike interest rates aggressively and drain liquidity from the banking system, the domestic economy has not slowed enough to give the Federal Open Market Committee cover to end this tightening cycle even as political and business pressure mounts to do so. These are hardly idyllic times for most Americans but, all things considered, domestic economic performance has been impressively resilient despite the Fed's best efforts to tamp it down. Nonetheless, there is a widely shared perception that this economy is "meh" at best and nearing a downturn[1] — and that sentiment is shared not only by regular folks but many corporate leaders[2] and pundits as well, who for many months have been warning of an economic contraction that has yet to materialize and still doesn't seem imminent.

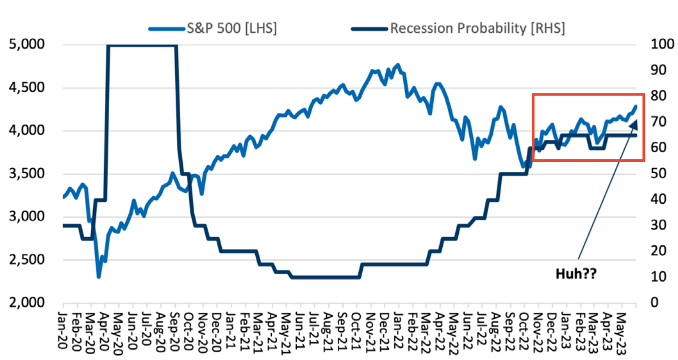
Economic pessimism prevails but is it justified?

Another surprisingly strong jobs report for May would seem to have diminished the likelihood of a recession beginning in 2023, yet an economic downturn remains the consensus expectation among economists. Nearly two-thirds of economists polled by Bloomberg still expect a U.S. recession to start within 12 months, a percentage that has barely budged this year even as the economy has outperformed and financial markets have rallied (**Figure 1**). Why the persistent negativity in the face of better-than-expected results? Some experts in the recession camp believe the full impact of Fed tightening measures to date have yet to take hold, while others expect the Fed to keep turning the screws until inflation capitulates. However, much of the lingering pessimism is not explained by facts on the ground, which are still pretty solid.

Moreover, there is a lot of incongruous economic data that is hard to fit into a coherent narrative, as evidenced by **Figure 1**. Corporate layoff announcements to date in

2023 have quadrupled compared to the same period a year ago,[3] yet jobs are plentiful, with consistently more than 10 million openings. Consumer sentiment is in the dumps, yet spending remains robust. Mortgage rates are the highest since the early 2000s, yet home prices have barely retreated from all-time highs in many regions of the country. Interest rates are high, but consumers are racking up credit card and auto debt. Inflation remains onerous but meaningful spending cutbacks are not apparent, as most recently evidenced by ambitious summer vacation plans for millions of Americans. Such apparent contradictions seem more prevalent in 2023, and this makes it harder to characterize the state of the economy in any distinct way.

Figure 1: Recession Probability vs S&P 500 Index



Source: Bloomberg and S&P Capital IQ

The 24/7 media's tendency to amplify negative economic news also contributes to the general state of pessimism among the masses, reinforcing perceptions of a sputtering economy in the minds of news junkies. Bad economic news gets disproportionately more coverage than good news. For instance, when egg prices soared earlier this year due to an outbreak of avian flu, media coverage of the story was ubiquitous (arguably, egg-cessive). Egg prices have since plummeted as depleted chicken flocks were restocked, but you wouldn't know that from recent media coverage. Similarly, when gasoline prices were spiking a year ago, media coverage was unrelenting, with reporters routinely converging on gas stations to get firsthand accounts of drivers' woes. However, as gasoline prices retreated in late 2022, so did the media coverage. Many commodity price spikes that drove inflation higher in 2022 have eased considerably, as have global supply-chain bottlenecks, but those unwinds aren't as newsworthy as the windups. That's just how it goes. The economic equivalent of the old newsroom adage, "If it bleeds, it leads," prevails at many media companies.

Lastly, popular economic perceptions have become highly influenced by political affiliation. This is a recent phenomenon. The University of Michigan's Survey of Consumers issued a report in 2021 (*The Partisan Economy*[4]) that began bluntly with, "Partisan views now dominate consumers' economic expectations." This tendency was evident during the Bush and Obama presidencies, but it has exploded since the Trump and Biden terms, according to the report. People's views of both current and expected economic conditions are mostly informed by whether "their guy" is in the White House. What this means is that given this bias and the nearly even political divide in the country, at least half of all Americans will reflexively say (and likely believe) that the economy is lousy no matter how it is performing. Sadly, not even views on the economy can avoid political division nowadays, no matter who is sitting in the Oval Office. Soon enough, neighbors will be arguing over the weather.

So how is the economy doing these days? It depends on who you ask. However, there remains a widespread sense of caution or foreboding with respect to what lies ahead, despite our economy's stubborn refusal to buckle no matter what is thrown its way.

There's nothing ambiguous about restructuring activity in 2023

Luckily for the restructuring profession, there is less ambiguity about the current state of our business; it has been a pretty darn good year so far, no matter what label you choose to put on the broader economy, and it seems safe to say that restructurings will remain elevated at least through the end of the year and likely longer. But a tidal wave it isn't.

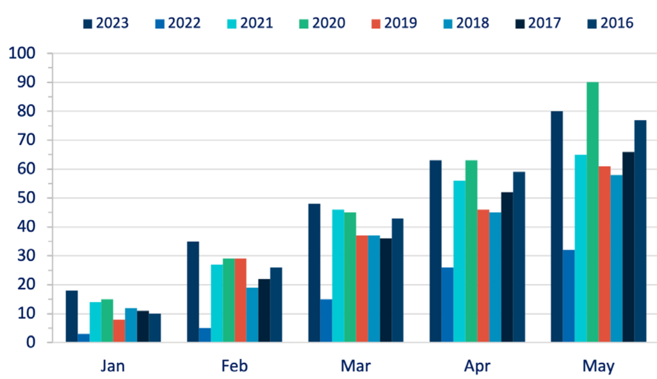
There were 80 large (>$50 million) Chapter 11 filings through May (not to mention four $1 billion-plus filings to begin the month of June) compared to 32 filings through May 2022 (**Figure 2**). Large filings this year have consistently stayed close to a monthly average of 15-16, nearly 50% above the long-term monthly average. We continue to downplay comparisons to 2022, especially 1H22, which was a stagnant period for filings. Nonetheless, that shouldn't detract from the standout performance to date for restructuring activity, which is running ahead of comparable average filings in 2016-2019 by nearly 25% (**Figure 2**); again, nothing gonzo but certainly gratifying. Including early June filings, seventeen $1 billion-plus filers in 2023 have already exceeded annual totals for 2022 and 2021. Cumulative YTD filings through May fell short of comparable 2020 totals (the early COVID period) by just 10 filings, but that comparison will worsen as this year progresses.

Among these filers are 23 PE-owned companies, eight “Chapter 22” filers that previously emerged from bankruptcy within the last five years, two suspect SPAC-owned companies, three long-struggling retailers, 12 healthcare service providers or facility-based operators hit by labor cost spikes and reimbursement pressure, and four companies that previously completed aggressive liability management exercises. In other words, these were companies already walking close to the precipice and highly vulnerable to failure with just a couple of missteps — early casualties of a high rate/high inflation environment. Plenty of others are poised to follow.

Like the broader economy, there is less clarity and more debate among restructuring professionals about where this is going. Despite elevated filings and default activity to date, the credit rating agencies are nudging their baseline default rate forecasts modestly higher into 2024, with Fitch’s 5.0% high-yield default rate forecast the highest of the three rating agencies but just one-half of a typical default cycle peak. These are unusually conservative expectations, especially considering how quickly defaults have accelerated since late 2022 with only some stressors on the corporate sector.

Consequently, some restructuring pros are speculating that this upturn won’t play out like previous cycles; its peak will be lower, but its duration will be considerably longer — perhaps two years or more — as interest rates remain higher for longer, suppressing business growth, draining corporate liquidity and forcing more over-leveraged underperformers to the courthouse. This is more of a sentiment than a developed theory, and it posits that defaults and filings can remain elevated for a long stretch even in the absence of recession should interest rates stay high and business growth remain sluggish. Unlike equity markets that are expecting rates to soon peak and begin falling towards year-end, this scenario assumes that huge upcoming Treasury borrowings, an elusive 2% inflation target, a hamstrung Fed, and a gradual pivot away from dollar exposure by some large geopolitical players will keep U.S. interest rates higher indefinitely. Sustained borrowing rates of 9%-10% or more for B-rated issuers will be an insidious killer over time. To sum it up, the low-hanging fruit will continue to fall but a bona fide recession, should it materialize, would really shake the tree.

Figure 2: YTD Cumulative Chapter 11 Filings
Liabilities at Filing > $50 million



Source: The Deal and FTI Consulting analysis

Endnotes

1. "The Conference Board Economic Forecast for the U.S. Economy," The Conference Board (June 15, 2023), https://www.conference-board.org/research/us-forecast.

2. "CEO Confidence Ticked Down Slightly in Q2," The Conference Board (May 4, 2023), https://www.conference-board.org/topics/CEO-Confidence/press/CEO-confidence-Q2-2023.

3. "Layoffs are up nearly fivefold so far this year with tech companies leading the way," CNBC.com (April 6, 2023), https://www.cnbc.com/2023/04/06/layoffs-are-up-nearly-fivefold-so-far-this-year-with-tech-companies-leading-the-way.html

4. "The Partisan Economy," Surveys of Consumers, The University of Michigan (January 12, 2021), http://www.sca.isr.umich.edu/files/partisaneconomy202201.pdf.

MICHAEL EISENBAND
Global Co-Leader of Corporate Finance & Restructuring
+1 212 247 1010
michael.eisenband@fticonsulting.com