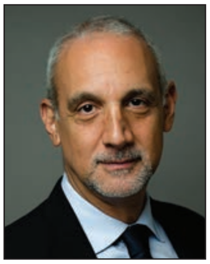
AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
The Essential Resource for Today's Busy Insolvency Professional

Turnaround Topics

By Michael Eisenband and John Yozzo[1]

Can a Default Cycle Coincide with Sky-High Financial Markets?

Michael Eisenband
FTI Consulting, Inc.
New York



Coordinating Editor
John Yozzo
FTI Consulting, Inc.
New York

Michael Eisenband is a senior managing director with FTI Consulting, Inc. in New York and co-head of the firm's Corporate Finance and Restructuring Practice. John Yozzo is a managing director in the same office.

The socioeconomic, political and market-related fallout from the global pandemic is so unprecedented that it is hard to find relevant context or a historical parallel. Regardless of the specific topic, be it the human toll of COVID-19, a near shutdown of the domestic economy, sudden unemployment spikes or dramatic financial market movements, the word "unprecedented" has become justifiably overused. There is no template or playbook for this moment, and that lack of precedent is one reason why expectations among business leaders, financial markets and policymakers are so wide-ranging and erratic.

The U.S. economy has experienced 11 recessions in the 75 years since the end of World War II, only three of which have occurred since 1983.[2] Economic expansion cycles have become longer in recent decades, and contractions have occurred less frequently. Two of the last three expansions endured for a decade each, which is unprecedented in this nation's history.[3] On average, recessions have lasted 11 months in the post-War era, with a range of six to 18 months.[4] It seems as if the business cycle (or boom-and-bust cycle), a feature of Western economies dating back hundreds of years, has been tamed to some degree. Few appreciate the infrequency of recessions compared to decades past. We can now add another one to the list.

In June 2020, the National Bureau of Economic Research (NBER), the official arbiter of U.S. business cycles, declared that a recession began in February 2020 and was pandemic-related.[5] This was an unusually fast call by the NBER, which typically declares the start of a downturn many months after the fact. The NBER acknowledged that the severity of the contraction affected its quick call, stating that "the unprecedented magnitude of the decline in employment and production, and its broad reach across the entire economy, warrants the designation of this episode as a recession, even if it turns out to be briefer than earlier contractions."[6] Analysts who were predicting a 2020 recession had no idea that it would be coming to us in this particular way.

On the corporate side of the economy, the default cycle is our profession's proxy of business recession. Its underlying metric is the speculative-grade default rate, which is the proportion of all rated spec-grade corporate issuers that default on rated debt over the trailing 12-month (TTM) period. Hence, the spec-grade default rate is a lagging indicator of corporate failure because it is measured on a TTM basis. As such, the spec-grade default rate continues to climb after economic conditions have stabilized, and typically peaks six to nine months after a recession has ended, as shown in Exhibit 1.

A default cycle can be loosely defined as a prolonged period in which the default rate is at least two to three times its long-term average of approximately 4 percent. Historically, the default rate in a default cycle typically peaks at a low double-digit rate, in the range of 10-14 percent, and is roughly symmetrical on both sides of its peak. As expected, a default cycle has accompanied each of the last three U.S. recessions (as shown in Exhibit 1). So, where does that leave us today?

Events of corporate failure, as measured by large chapter 11 filings or corporate debt defaults (which also include distressed-debt exchanges and missed interest or principal payments) had been

1 The views expressed herein are those of the authors and not necessarily the views of FTI Consulting, Inc., its management, its subsidiaries, its affiliates or its other professionals.
2 "U.S. Business Cycle Expansions and Contractions," Nat'l Bureau of Econ. Research, *available at* nber.org/cycles/cyclesmain.html (unless otherwise specified, all links in this article were last visited on July 10, 2020).
3 *Id.*
4 *Id.*
5 "Determination of the February 2020 Peak in US Economic Activity," Nat'l Bureau of Econ. Research (June 8, 2020), *available at* nber.org/cycles/june2020.html.
6 *Id.*

trending gradually higher since late 2018, but have soared since the pandemic and shutdown began in March (as shown in Exhibit 2).

There were more S&P-rated debt defaults in April than in any month since April 2009, and the monthly total of 34 defaults exceeded the 31 defaults in the entire first quarter of 2020, while the 91 global defaults in the second quarter were the most in any quarter since the second quarter of 2009.[7] Similarly, May produced 26 large chapter 11 filings (>$50 million), more than any month since March 2009, while filings to date through June were up 54 percent over the prior year period.[8] Chapter 11 filings and rated debt defaults (there is considerable overlap between the two) should not be expected to maintain such lofty levels in the second half of the year, but they remain very elevated relative to long-term historical monthly averages. There were 122 S&P-rated global debt defaults year-to-date through June compared to 118 in all of 2019,[9] and 114 large chapter 11 filings through June compared to 144 in all of 2019.[10]

Debt defaults have been running ahead of chapter 11 filings in 2020 because missed debt payments, which are often preludes to filings, have been surging in 2020 and are being counted as default events even without a filing. The number of S&P-rated global debt defaults likely will approach or top

7 "The Number of Corporate Defaults Tripled in Second Quarter 2020," S&P Ratings Direct (July 2, 2020).
8 As reported by *The Deal Pipeline*.
9 S&P Ratings Direct, *supra* n.7.
10 *The Deal Pipeline*, *supra* n.8.

Exhibit 1: U.S. Speculative-Grade Default Rate (in %)

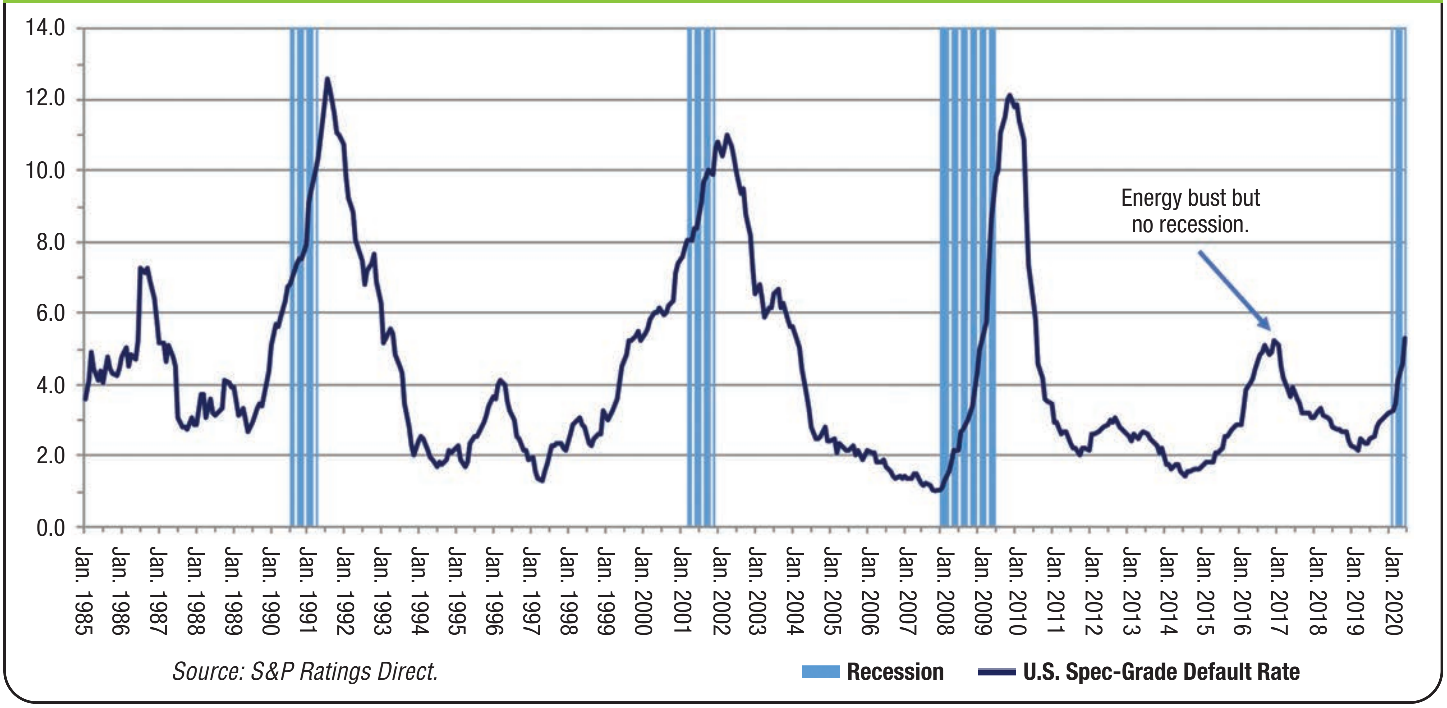
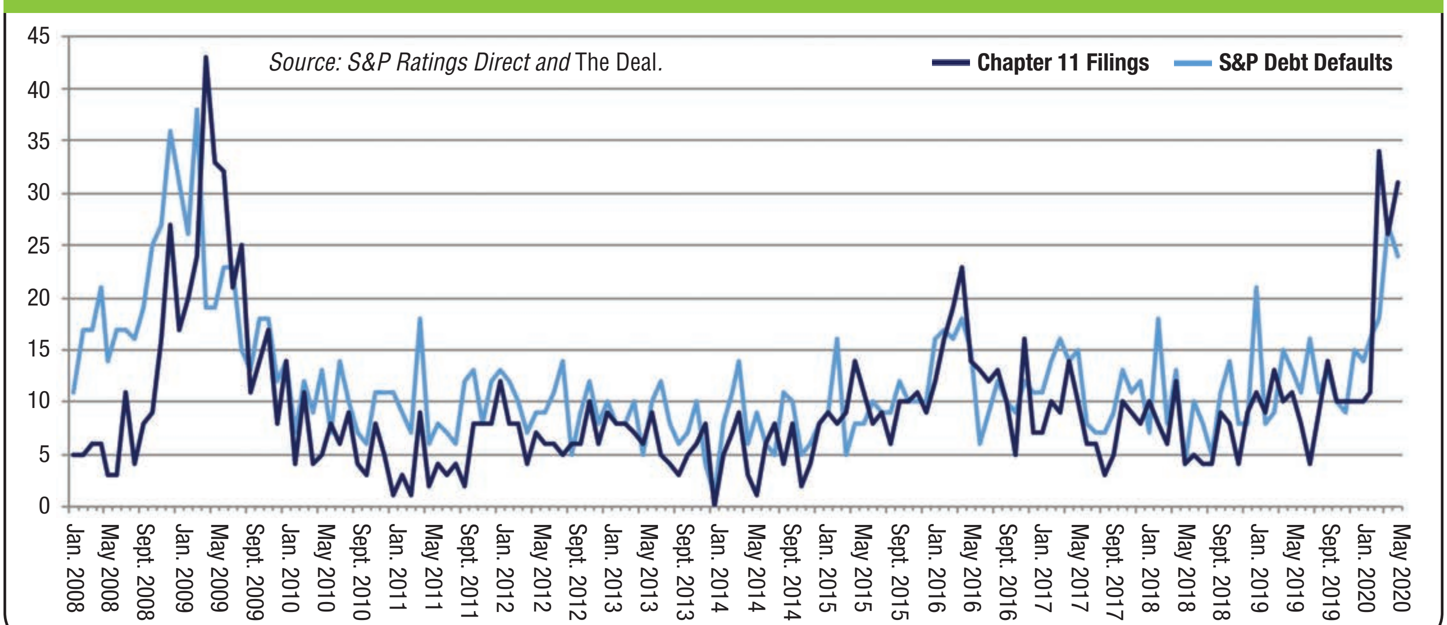


Exhibit 2: Monthly Chapter 11 Filings and Rated Debt Defaults



200 in 2020, the first time that has happened since 2009, with more than two-thirds being U.S.-based issuers. However, debt defaults this year will not top 2009's all-time highs.

There is little reason to expect that these trends will abate any time soon, with S&P currently forecasting a U.S. spec-grade default rate of 12.5 percent[11] by the first quarter of 2021. Default expectations have been revised considerably higher since March and therefore assume a large corporate casualty toll resulting from the pandemic and shutdown effects. Although the U.S. default rate is currently just 5.3 percent (remember that it is measured on a TTM basis), it is reasonable to assume that we have embarked on a new default cycle that is likely to stick around for a while. Meanwhile, corporate credit and equity markets are whistling past the graveyard, either rejecting this dour scenario or believing that the larger corporate landscape is immune to its fallout.

So here we are, amid a downturn whose expected duration and rebound is the topic of intense debate and consequence. Ironically, the severity of the initial contraction in March through May will likely contribute to it being labeled a short recession, technically speaking, as economic activity for this purpose is measured on a consecutive monthly or quarterly basis (rather than year-over-year), and it is highly unlikely that further contraction will occur beyond these first few months. Rather, it will be a long climb out of a deep ditch. We would not be surprised if this recession is declared over well before year's end. However, the lingering effects of the shutdown and residual impact of COVID-19 on the U.S. economy will endure for many months after the recession is technically over. Several million furloughed workers who will not be getting their jobs back, and significant numbers of new corporate layoffs and reductions in states' budgets and payrolls in the months ahead will be an impediment to the recovery.

Nonetheless, financial markets are behaving as if the entirety of this painful episode will soon be in the rear-view mirror, with a multi-trillion-dollar tab that federal and state governments mostly will be picking up. Thanks to huge emergency lending programs and potentially massive credit market interventions by the Federal Reserve, credit is flowing, corporate credit spreads are slightly wider than pre-pandemic levels, "better quality" spec-grade companies have been able to access credit markets for needed liquidity, and equity markets are within 10 percent of all-time highs despite a plunge in corporate earnings for 2020 and perhaps a return to 2019 earnings levels in 2021 for many industries.

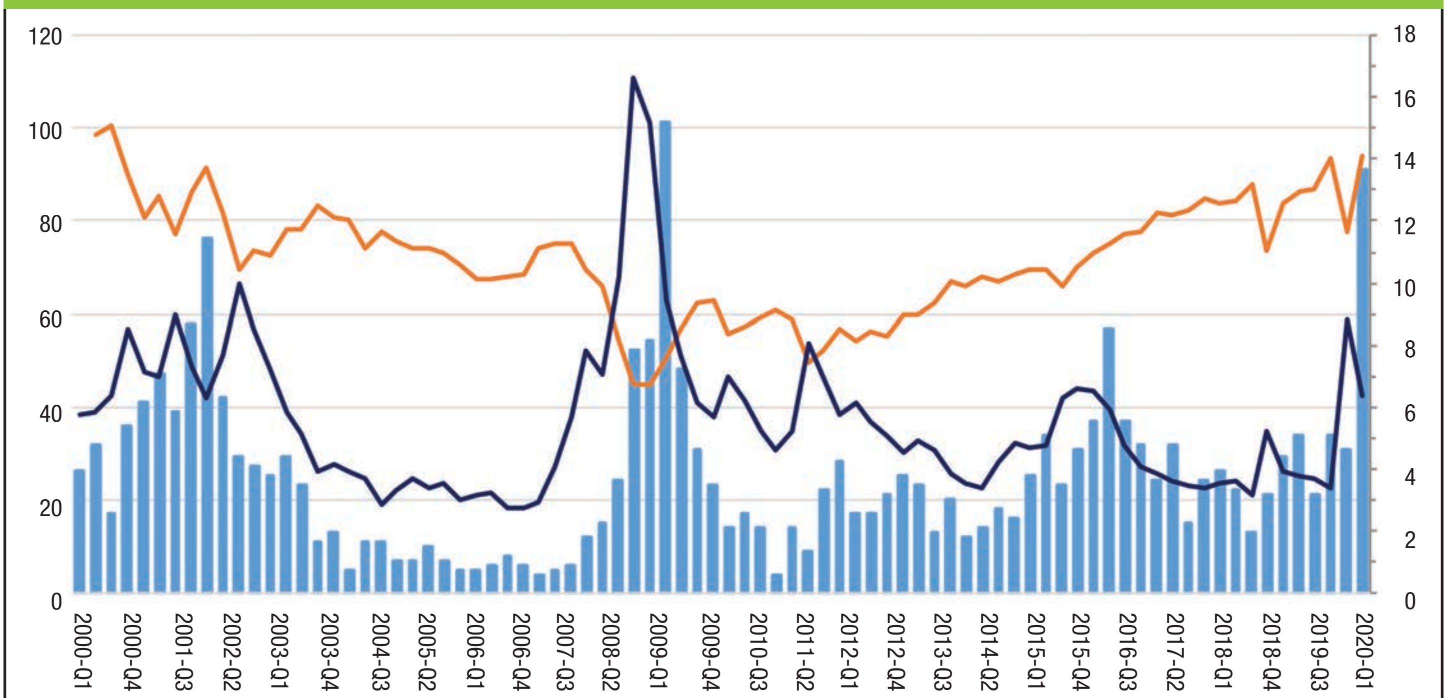
Whose vision of the economic recovery will prevail? The pessimistic argument is persuasive, primarily because corporate credit quality has never been so poor entering a recession. Nearly 35 percent of all U.S. spec-grade issuers were rated B- or worse in March, compared to 17 percent in the months that preceded the 2008-09 recession, representing 650 "deep junk"-rated companies compared to 250 in early 2008.[12] This implies that many hundreds of large corporations have limited financial flexibility to withstand the effects of an economic downturn that endures longer than expected.

Many low-rated issuers, especially middle-market companies, still cannot access credit markets on reasonable terms. The leveraging of corporate America over the last decade is a familiar story and has left many more companies vulnerable to shock events, such as the COVID-19 pandemic, imperiling their ability to endure persistent shortfalls in operating performance. Moody's reported that approximately two-thirds

11 "The U.S. Speculative-Grade Corporate Default Rate Is Likely to Reach 12.5% by March 2021," S&P Ratings Direct (May 28, 2020).

12 *Id.*

Exhibit 3: Speculative-Grade Defaults vs. S&P Valuation



Source: S&P Ratings Direct and Capital IQ.

of the issuers rated single-B or worse are companies owned by private-equity sponsors.[13]

Fundamentally, the road back to normal will likely be longer and bumpier than the markets expect. At the broadest level, the average GDP forecast from more than 50 economists tracked by Bloomberg indicates that real quarterly GDP going forward will not exceed a corresponding 2019 quarter until late 2021 — meaning that it will be more than a year until the U.S. economy climbs out of the ditch. For industries particularly sensitive to COVID-19's lingering effects, it likely will take longer.

Consensus economic forecasts from Bloomberg also indicate that the projected unemployment rate will remain near 10 percent at year's end and at 7 percent by the end of 2021, which is nearly double the pre-COVID-19 unemployment rate. While most furloughed workers will be rehired once the economy fully reopens, this unemployment rate estimate translates into 5 million more unemployed Americans at the end of 2021 than there were in February 2020. If that sounds implausible, consider that 32 million Americans are employed in the retail/restaurant and leisure and hospitality sectors, where most furloughs have occurred. What percentage of those jobs will not be coming back?

Several major industries are preparing for a slow recovery. Most healthy retailers have been accelerating their store-closing plans since COVID-19 struck, not to mention those being shuttered in bankruptcy. The active rig count in the oil and gas sector recently hit a 20-year low, easily surpassing the trough of the 2016 energy bust, while exploration and development budgets have been slashed. The airline sector is planning for material layoffs after Sept. 30 in anticipation of reduced air travel for several years to come.[14] Industry advocate IATA does not expect global passenger air travel to match 2019 levels until 2023. Car rental companies have cancelled a large percentage of planned new vehicle purchases over the next year, which will also impact automobile OEMs. Several major hotel chains also have announced plans for sizeable permanent layoffs, particularly corporate staff and support. These hardly sound like measures taken by industries expecting a strong economic rebound.

Economic growth will resume in the third quarter of 2020 and beyond, as businesses will be reopening quickly this summer, and pent-up consumer demand resulting from weeks of being housebound will need to be met. As we pivot away from a shutdown posture, the central issue confronting the U.S. economy will be the magnitude of the financial setback for millions of Americans, ongoing job-related anxieties, and their enduring effects on spending. Initial recovery readings will be encouraging because pent-up consumer demand will be strong, and many millions of furloughed workers will be recalled within a few months. Moreover, many laid-off and furloughed workers were kept whole financially thanks to various federal initiatives and programs that kept paychecks and financial assistance flowing during the shutdown.

However, many daunting challenges remain. Stimulus checks have been spent, federal unemployment benefits are scheduled to end in late July, and pay cuts have become more prevalent in stressed industries. Companies that have avoided layoffs to comply with the Paycheck Protection Program or other emergency federal loans will soon no longer be bound to maintain their payrolls. More ominous, several million furloughed workers will not be recalled to their jobs, and the financial safety net is wearing thin for this unfortunate cohort.

Lastly, there is mounting evidence that many corporations are planning for new layoffs in the months ahead. Some had postponed planned layoffs when the pandemic hit, while others are adjusting to new workforce realities. Such right-sizing actions might benefit these companies, but collectively would be detrimental to the broader economic recovery if these measures became commonplace.

Where Is This Going?

A culling of the most vulnerable competitors in the corporate landscape is underway, accelerated by the pandemic, and this will continue even as the economy begins to emerge from the abyss. Default rate expectations by S&P and Moody's would approach the heights of the Great Recession. There will be significant second-order effects as this default scenario plays out, such as the impact of failing retailers on landlords and real estate.

Financial markets are mostly unconcerned with facts on the ground and are looking past 2020 to a strong post-COVID-19 economy in 2021. Leveraged credit markets have resumed financing spec-grade companies, believing that "the Fed has their back," which is another way of saying that credit underwriting standards will remain loose and that the moral-hazard problem is pervasive.

Can a resurgent economy and rebounding financial markets persist alongside high unemployment and surging corporate defaults and bankruptcy filings? It is possible, but very unlikely. Broad-market indexes have become increasingly dominated by the technology sector, which is mostly recession-proof, as well as a resilient financial sector. However, it is much more likely that these opposing forces cannot coexist indefinitely. Either this default cycle will prove to be a momentary blip that fades as quickly as it started, or this is a market bubble that is poised to pop with highly unrealistic expectations for the economic recovery.

The closest historical parallel to the current moment is the end of the dot-com era in 2000. That was the last time that financial markets were so bullish and valuations so lofty as the economy was on the cusp of recession and a default cycle was underway (as shown in Exhibit 3). This ended badly, not just for dot-com stocks, but for broader markets and the corporate sector. It was a quick recession in 2001 but a prolonged default cycle that lasted more than two years (refer back to Exhibit 1). The dichotomy of soaring defaults and bankruptcies amid roaring financial markets cannot continue indefinitely. Something has got to give — and fairly soon. abi

Reprinted with permission from the ABI Journal, Vol. XXXIX, No. 8, August 2020.

13 "LBO Credit Quality Is Weak, Bodes Ill for Next Downturn," Moody's Investors Service (Oct. 18, 2018).

14 For a perspective of this industry amid the pandemic, *see* Dr. Israel Shaked and Brad Orelowitz, "The Airline Industry and COVID-19: Saving for a Rainy Day," XXXVIX *ABI Journal* 5, 36-37, 57-58, May 2020, *available at* abi.org/abi-journal.