BEWARE OF THE KILLER B'S

Preponderance of Deep Junk Issuers Will Keep Default Activity Lively in 2020

By Michael Eisenband

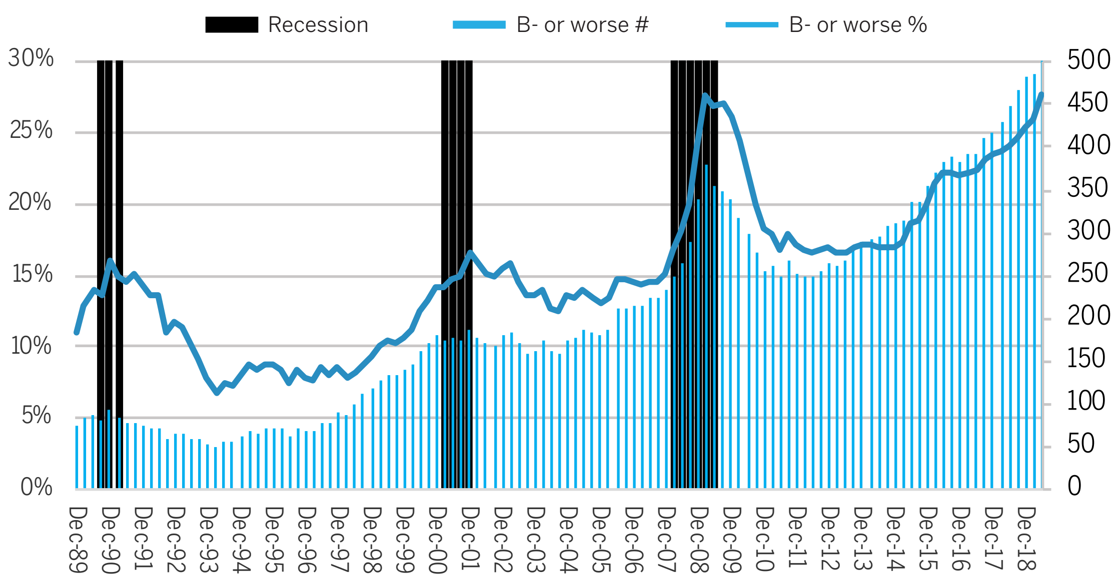
It may not have felt like it, but 2019 was the second-best year of the decade with respect to the number of rated debt defaults and large Chapter 11 filings, trailing only 2016. Large bankruptcy filings increased by 20% last year while S&P rated debt defaults increased by 43% over a quiet 2018. Nobody would call 2019 a gangbuster year for restructuring activity, but in a year when financial markets rallied so fiercely, we'll gladly take it.

Last year we devoted several columns to the disconnect between the performance of financial markets, corporate operating results and U.S. macroeconomic conditions. This widening disparity is largely attributable to the Fed's abrupt reversal on monetary policy in early 2019, three subsequent reductions to the Fed Funds target rate, and the Fed's renewed balance sheet expansion (don't call it "quantitative easing," insists Fed Chair Powell) later in the year to stabilize the repo market — all of which stoked late-cycle risk-taking activities by investors and lenders but had more muted effects on the corporate sector and the real economy. Most business folks recognize that the U.S. economy is not nearly as strong or invulnerable as major market indexes would imply, and robust levels of restructuring activity in 2019 support that assertion. So, what's in store for 2020? We believe that restructuring activity will continue to pick up pace even without a recession.

Perhaps the most persuasive indication that default activity will remain lively in 2020 and beyond is the distribution of speculative-grade corporate credit ratings, which have become decidedly "junkier" in recent years. Within the corporate speculative-grade universe (BB+ or lower), of which there are nearly 2,000 rated U.S. issuers, there has been a pronounced drift towards the lower end of the junk scale since 2015. Consider that approximately 28% of speculative-grade issuers are currently rated B– or worse, often referred to as "deep junk," compared to 13%-14% in 2005-2007 and less than 10% in the late 1990s **(Exhibit 1)**, which are two comparable periods of late-cycle economic expansion and low default rates. The number of deep junk U.S. issuers (again, B– or worse) now tops 500 and has doubled since 2013. We are very far into uncharted territory with respect to the proportion of deep junk issuers in a non-recession period. To amplify that point, the proportion of deep junk issuers is higher today than it was in mid-2009 at the height of the Great Recession when credit downgrades were rampant. At a minimum, the current ratings skew towards deep junk is indicative of the vulnerability of these issuers to a business slowdown, economic downturn, or shock event.

EXHIBIT 1

U.S. Speculative-Grade Ratings Distribution



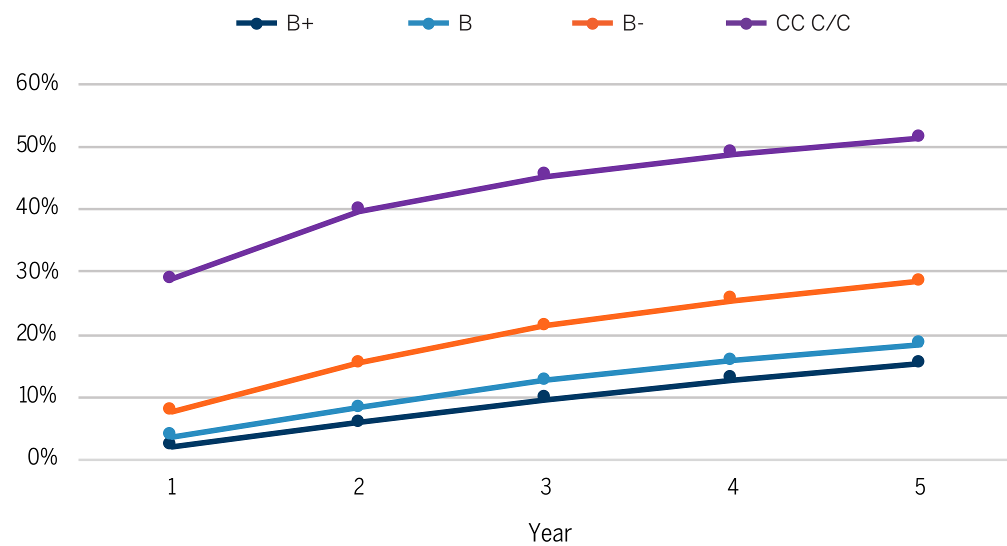
Source: S&P Ratings Direct

Why are distinctions within the single-B rating category so critical? Because historical default tendencies among issuers rated B+, B and B– differ significantly — more than in any other letter-rating category. According to historical data from S&P, an issuer with a B– rating is more than twice as likely as an issuer rated B to default within one year (7.7% vs. 3.6%), and much more likely to default within three years (21.3% vs. 12.6%) — a huge difference for just a one-notch rating separation. Default histories, as measured by cumulative default rates over time, are mostly similar for issuers rated B+ and B but are starkly higher for B– issuers **(see Exhibit 2)**. While the five-year cumulative default rate is in the mid-to-high teens for issuers with B+ and B ratings, it jumps to nearly 30% for B– issuers and 50% for the CCC/C ratings bucket, according to nearly 40 years of S&P corporate default history.

Also noteworthy are distinct differences in ratings migration tendencies among junk-rated issuers, where the B– rating is uniquely a "point of no return" for many issuers. Within the BB ratings cohort (BB+/BB/BB–) it is almost equally likely that an issuer will be upgraded or downgraded one or two notches within a year. For issuers rated B+ and B, the likelihood of a downgrade of one or two notches slightly exceeds that of a corresponding upgrade. However, for B– issuers, the chance of a one- or two-notch downgrade is nearly twice as likely as a corresponding upgrade. Hence, far more B– issuers don't make it back up from this slippery slope. More often than not, the B– rating category turns out to be a one-way ticket to Default City. It is why the B– rating is considered the threshold of deep junk.

EXHIBIT 2

U.S. Corporate Cumulative Default Rates by Rating



Source: S&P Ratings Direct

If we simply map out historical one-year default rates by ratings categories and apply those default rates to the current distribution of all U.S. speculative-grade ratings, we get a default projection that tops last year's total and exceeds most other default forecasts for 2020. We estimate nearly 95 U.S. issuer defaults versus 78 in 2019, or a U.S. speculative-grade default rate approaching 5.0% by late 2020 compared to 3.2% at the end of 2019. (This uptick in activity likely would extend to bankruptcy filings by large companies without rated debt.) Again, this is not a rip-roaring expectation, but it would be a healthy base-case scenario if historical default tendencies stay true to form (which, of course, may not happen in any given year), with upside potential should the economy weaken or leveraged credit markets tighten up.

As for the prospect of recession, financial markets have blithely moved past this scenario, but most economists still peg the likelihood of one at 20%-30% in the next 12-18 months, lower than their expectations in mid-2019 but still elevated. We don't know exactly when that meal is coming, but the table is set. For now, it's just hors d'oeuvres.

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