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Beyond the Obvious Upheaval, 2020 Was a Year of Huge Contrasts

It's safe to say that most Americans were happy to close the book on 2020, with the possible exception of stock traders and investment bankers. The New Year will still present more than its share of unique challenges, particularly in the first half, until enough Americans are vaccinated for COVID-19 and begin to resume more normal lifestyles. Nonetheless, 2021 almost certainly will be an improvement over the horrific year we just experienced.

COVID-19 exacted a huge toll on American lives, livelihoods and the U.S. healthcare system. Nearly 350,000 lives were claimed by the virus in 2020, and the excess death rate in the eight months of April-November 2020 is estimated at 15%, according to the National Center for Health Statistics.[1] As the year ended, 14% of all U.S. hospital beds were occupied by COVID-19 patients, with many ICUs strained or overwhelmed by COVID patients. Worse yet, an estimated 150,000 more Americans may succumb to the virus by mid-February.[2] The economic toll of COVID-19 has been devastating in another sense. In September, a consumer survey released by Pew Research Center indicated that 25% of respondents said they or someone in their household had experienced a job loss or furlough during the pandemic.[3] While a majority of furloughed workers have been recalled, continuing unemployment claims remain sky-high and there is wide agreement among economists that several million jobs lost during the pandemic will not be coming back. We've all seen video footage of long lines of cars, including many large SUVs, in various cities waiting to receive relief packages at food banks, a strange sight to behold that upends our idea of what food insecurity looks like these days.

Beyond these hardships we are all familiar with, we were also struck by some huge contrasts that became evident as the year played out, some of which included:

The Selective Cruelty of the COVID-19 Virus

Aside from the elderly, who are always more vulnerable to the ravages of disease, the toll of COVID-19 has been particularly harsh for people and communities of color. African-Americans and Hispanics were nearly 50% more likely to contract the

1 *Excess Deaths Associated with COVID-19*, National Center for Health Statistics, CDC.gov

2 *U.S. COVID Death Toll Projected to Surpass 500,000 Within One Month*, Newsweek, January 4, 2021, cited projections from IHME at the University of Washington

3 *Economic Fallout From COVID-19 Continues to Hit Lower Income Americans the Hardest,* Pew Research Center, September 24, 2020

virus than White Non-Hispanics, and were nearly four times more likely to require hospitalization and nearly three times more likely to die from COVID, according to data from the CDC[4], which also pointed out that racial and ethnic disparities in COVID-19 data reflect various underlying conditions, including socioeconomic status, exposure to the virus through occupation, and access to healthcare. At the other extreme, the CDC estimates that 40% of those who contract the COVID-19 virus are asymptomatic carriers.

Short-Term Incremental Solutions to Long-Term Systemic Problems

Short-termism is the prevailing mindset at most levels and institutions of our public and private sectors. Our nation seems to have become incapable or unwilling to take on systemic problems in substantive ways. Congress flirts with government shutdowns regularly as it fights over budget impasses and is unfazed at projected trillion-dollar annual budget deficits for the rest of the decade. The chamber also took months to pass a second COVID relief bill that barely addresses the dire needs of hard-hit states and individuals, including an 11-week extension of federal unemployment benefits that surely will need to be revisited when it expires in mid-March. As things stand now, it's highly unlikely that unemployment will improve much amid the winter wave of COVID, while millions will remain jobless and exhaust all their unemployment benefits. State and local municipalities and agencies saddled with untenable budget deficits and unsustainable debt loads will not enact meaningful cuts to operating budgets and seem content to borrow more to bridge financing gaps for as long as markets will allow. In the corporate sector, hundreds of large "zombie companies" with little prospect of being competitive or profitable continue to plod along thanks to pliant credit markets that allow them to "kick the can" again and again until the money runs out. Owners and large creditors of distressed companies often engage in multiple rounds of debt exchanges and other desperate attempts to rejigger the capital structure rather than acknowledge the obvious. In many respects, lax attitudes seem to prevail when it comes to tackling large intractable issues, with many key actors content to nibble around the edges.

The Disconnection Between Financial Markets and the Real Economy

This almost seems too obvious to mention. While millions of small business owners and employees are still contending with the rippling effects of COVID-19 nearly one year after it reached our shores, financial markets moved past the pandemic months ago and have been rewarding investors hugely ever since. High-yield bonds are trading at their lowest yields ever while spec-grade credit quality and ratings distribution are near their worst levels on record. Extreme policy initiatives by the Federal Reserve since late March, intended to prevent the collapse of financial markets, arguably have created rampant moral hazard in markets and have encouraged excessive risk-taking and wild speculation. Few voices are warning about it while many rationalize the excess. As Wall Street ended the year with big rounds of

4 *COVID-19 Hospitalization and Death by Race/Ethnicity,* Centers for Disease Control and Prevention (CDC), Updated on November 30, 2020.

virtual high-fives, Main Street limped into the New Year. Yes, it has been pointed out many times that Wall Street isn't the economy, but the disparity between the two now borders on obscene.

Bankruptcy Filings Fell Sharply During a Recession

For all the financial hardship experienced by millions of individuals and small businesses, bankruptcy filings fell sharply in 2020 apart from large corporate filings. We pointed this out a couple of months ago, but this trend has continued intact, and we have yet to see any meaningful discussion of the paradox. Non-commercial bankruptcy filings fell by nearly 30% since March (YOY) while total commercial filings, including businesses of all sizes, fell by 23% compared to the same period in 2019.[5] Large corporate bankruptcy filings increased by nearly 50% in 2020 but faded in the second half of the year. Is this really a good thing? The answer isn't so obvious. Federal financial relief combined with roaring credit markets, rent deferrals and temporary freezes on evictions and foreclosures undoubtedly contributed to these better outcomes. However, most of these measures have just put off a reckoning that will have to be confronted. Few of the chronic problems facing struggling individuals and businesses were resolved in 2020; they were merely deferred thanks to the generosity of Uncle Sam, the sheer optimism of credit markets, and the accommodation of lenders and other creditors.

Huge Discrepancies in Unemployment Figures

The official unemployment rate dropped to 6.7% in November from 14.7% in April, according to the Bureau of Labor Statistics (BLS), with 10.7 million Americans still out of work compared to 5.8 million in February and 23 million in April. That sounds like quite a comeback considering where the economy was around mid-year. However, claims data for unemployment insurance from the U.S. Department of Labor (DOL) reveal a much worse picture, with nearly 21 million Americans still filing for continuing unemployment benefits in late November (including 14 million who were filing for Federal pandemic unemployment payments) compared to 1.8 million a year earlier.

There is no precedent for the number of Americans filing for continuing unemployment benefits to exceed the number of jobless workers as estimated by BLS, as the former is a subset of the latter. BLS unemployment estimates include not only job losers (the only ones eligible to claim unemployment insurance) but also voluntary job leavers, people reentering the job market and new entrants. Moreover, the number of jobless workers receiving continuing unemployment insurance benefits tends to shrink over time in a recession, as the long-term unemployed exhaust their benefits but are still considered unemployed by BLS.

One explanation that bridges much of the gap between these two measurements of unemployment is the cohort of self-employed workers. Some nine million self-employed Americans continue to receive unemployment compensation via federal Pandemic Unemployment Assistance (PUA), a provision of The CARES Act meant to provide unemployment compensation to jobless workers who otherwise would not be eligible for state programs. Bottom line: Either BLS is vastly underestimating the number of unemployed workers by consistently undercounting self-employed people who are essentially jobless, or perhaps huge numbers of "self-employed" Americans are scamming PUA and receiving benefits to which they are not entitled, or a combination of the two. This huge discrepancy in unemployment figures between BLS (10.7 million) and DOL (20.7 million) is a big deal, as it obscures an accurate reading of the jobless situation. The BLS unemployment estimate is based on its monthly survey of households while continuing unemployment claims mostly represent filers receiving cash payments, so the latter is more likely to be an accurate estimation of joblessness. If so, the unemployment situation is considerably worse than official statistics from BLS indicate. Finally, initial weekly unemployment claims consistently exceeding 750,000 since September (vs. 225,000 pre-pandemic) are highly inconsistent with an official unemployment rate of just 6.7%.

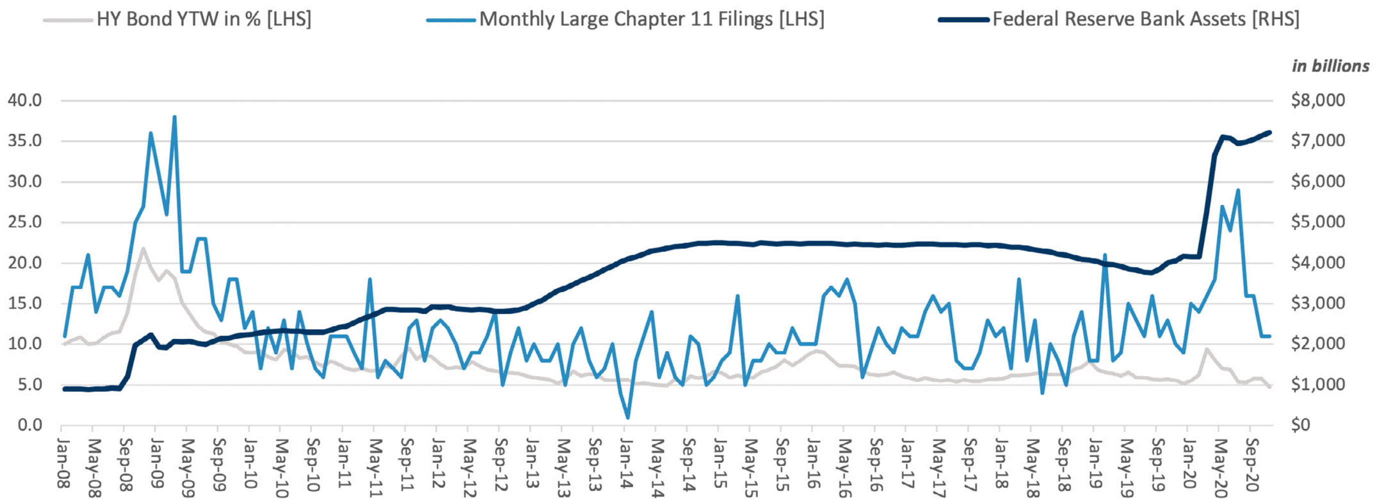
Restructuring Activity Soars and Swoons

For the restructuring community, 2020 was also a year of sharp contrasts. Large corporate Chapter 11 filings were tracking near an annual total of 260 in July but finished the year at 210—still a very solid showing for filings, but clearly a

5 Source: aacer/ Epiq Systems

year of two distinct halves **(Exhibit 1)**. By now it's apparent that we are not getting the monster wave of defaults that many expected at mid-year. The credit rating agencies have all reduced their default rate forecasts for 2021 from previous peak estimates of approximately 12%, which was consistent with previous cyclical peaks, to high single digits by mid-to-late 2021. Market-based indicators of future defaults, such as HY spreads and the distressed debt ratio, portend an even lower default rate than that. It's hard to fathom why financial markets are so optimistic about the business prospects for 2021 given the unknown timeline to a post-COVID revival, the lasting economic damage of the pandemic and the many economic uncertainties that still linger. In particular, the travel, leisure, entertainment and real estate sectors will remain highly challenged in 2021, with operating performance likely to trail pre-pandemic levels for at least another year and likely longer. Don't write off this default cycle yet. Given this backdrop, 2021 is likely to be a solid but unspectacular year for corporate distress compared to the rollercoaster ride that was 2020.

Exhibit 1



Source: Bloomberg and The Deal

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