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“Kick the Can” Is Running Out of Road Unless the Fed Paves Some More

In April, as the U.S. economy contended with the early stages of an unprecedented pandemic-induced recession whose severity and duration is unknowable, dozens of stricken speculative-grade companies, many underperforming and over-levered before COVID-19 arrived, addressed their busted business projections, limited earnings visibility and pressing liquidity needs in the usual way—they borrowed more money. Why? Because they could.

Let's not try to normalize what happened last month. As the Fed began cranking up its money-printing moral hazard machine to 11 (that's a “Spinal Tap” movie reference for anyone under 40), investors rejoiced as if the cavalry had come to the rescue just in the nick of time. Credit markets soon reopened for business and deal flow resumed, including speculative-grade issuers, who reported nearly \$90 billion of total debt issuance just one month after new issuance nearly came to a standstill. Moreover, these spec-grade issuances were dominated by companies in the media and entertainment, travel and leisure, and hospitality sectors, where business prospects and recovery timing are the murkiest. Nonetheless, many of these debt issuances were oversubscribed as fixed-income investors snapped up bonds and loans with juicy coupons. Some of these issuers still had senior or secured borrowing capacity that they utilized to issue new debt, while many others were able to issue subordinated debt. Still others opted to max out on their revolvers to the extent that loan documentation permitted. In short, many high-risk companies facing the certainty of

sharply deteriorating operating performance in 2020 (and likely beyond) have further leveraged themselves with pricey new debt as they enter the teeth of a recession. This money was borrowed not for purposes of capital investment, expansion or strategic initiatives but to fund operating shortfalls or losses and build a financial buffer to endure the downturn.

Paving the way for this credit market rally were new lending facilities, announced by the Fed on March 23 and then detailed in early April, that were without precedent, as they permitted the Fed's intervention in corporate high-yield debt markets. Specifically, the Primary Market Corporate Credit Facility (PMCCF) and Secondary Market Corporate Credit Facility (SMCCF) combined could ultimately account for \$750 billion of eligible corporate debt purchased by the Fed, either directly via loans or indirectly via secondary market purchases. These facilities are primarily intended for investment-grade (IG) companies but were expanded to include “Fallen Angels” within the definition of eligible

issuers, that is, companies that are rated within the BB/Ba cohort (the highest spec-grade letter rating) at the time the Fed facility is executed but which were rated at least BBB-/Baa3 (the lowest IG rating) as of March 22, 2020. Hence, the Fed made a specific provision that enabled it to provide direct financing or to purchase the securities of issuers that crossed over from investment-grade to spec-grade as a result of the COVID-19 pandemic. Companies rated single-B or lower are not eligible issuers for these facilities, as they pose greater credit risk to the Fed.

The Fallen Angel problem has lurked in the background of high-yield markets for several years, and credit rating agencies have been warning of its disruptive potential for a while. There is such a huge amount of outstanding U.S. corporate debt rated BBB-/Baa3 (\$575 billion) that a recession or shock event would cause much of this debt to be downgraded one notch or more into speculative-grade territory, triggering a wave of forced selling by institutions and funds committed to IG holdings and potentially overwhelming the high-yield market, which is considerably smaller than IG and has a different investing clientele. Many credit market pundits have warned of exactly this scenario as corporate debt issuance exploded in recent years while the economic expansion began to tire.

Lo and behold, a rash of credit downgrades attendant with the COVID-19 impact has begun, and markets and investors finally have become concerned with the Fallen Angel problem. S&P recently reported that \$235 billion of U.S. IG debt was downgraded to spec-grade in 1Q20, with another \$240 billion vulnerable to a downgrade to spec-grade later in 2020. This total is equivalent to 36% of the size of the entire U.S. spec-grade market at the end of 2019.

The quickly improvised solution devised by the Fed and Treasury Department should trouble all those who believe in free and unfettered capital markets. The Federal Reserve, the lender of last resort to the U.S. banking system, decided it would become the buyer of last resort for newly designated corporate spec-grade debt, stepping in to mitigate potential dislocations that capital markets could not handle. While some commentators praised these particular Fed actions as bold, the actions in effect condition investors to expect that they will be saved from loss exposure when markets seize up or break down, and thereby encourage more aggressive risk-taking — which is the very definition of a moral hazard.

The mere announcement of these lending facilities by the Fed set off a rally in corporate credit markets that caused credit spreads to contract sharply from their worst levels of March. The Fed has yet to make a loan or purchase a security under either PMCCF or SMCCF, as these facilities won't be up and running until mid-May. But markets expect them to step up to the plate; after all, that's why they started buying again. Many market watchers anxiously await to see how aggressively the Fed will scoop up Fallen Angel debt now that markets have settled down. Hard as it may be to believe, the Fed is poised to add corporate junk bonds and high-yield ETFs to its already bloated balance sheet.

But there are limits to the Fed's ability to save everyone's bacon, as deep-junk issuers are realizing. While spec-grade yield spreads have narrowed across the board since the announcement of the PMCCF and SMCCF facilities, the gains have been strongest within the BB/Ba rating family, where the Fed will be active in credit markets. However, debt rated B and CCC, the domain of distressed companies, has seen smaller gains, and consequently, the difference in spreads between debt rated BB and B or CCC remains quite wide (**Exhibit 1**). Even with the April rally, single-B bond spreads remain more than 400 bps higher than they were at year-end, while CCC spreads remain 600 bps higher. These borrowing rates are now unworkable for most highly levered companies that are barely scraping by. S&P reported as many corporate debt defaults in the month of April as it did in the first quarter of the year, many of which were triggered by missed payments.

The mindset of the moment in the credit community is that this storm will pass soon enough; lenders and creditors are being mostly accommodating, but that posture will surely change if operating performance continues to misfire in the quarters ahead. The divide between BB credits and deep junk with respect to access to capital and borrowing costs will widen further in leveraged credit markets should the post-COVID recovery fail to meet some high expectations.

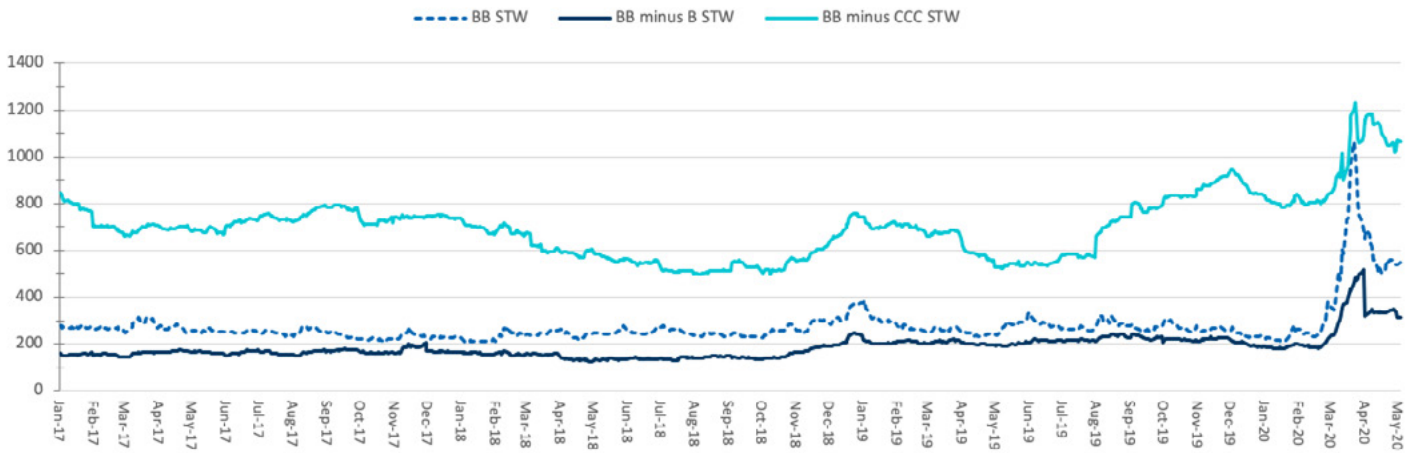
The Fed is becoming trapped in a box of its own making as it continues to intervene in various credit markets when these markets don't function properly or when buyers hit the exits en masse. Recent remedies prompted by the COVID-19 crisis ultimately may serve to make the underlying problem worse. As the Fed distorts natural interest rates and market returns with its interventions, investors become more emboldened

to take on more, and lower-quality, credit risk. Spec-grade issuers may be able to lever up their balance sheets further, even as earnings visibility diminishes. In turn, the Fed must continue to provide monetary stimulus and depress interest rates indefinitely to avoid a crush of defaults on a debt binge that it enabled.

Lenders and other capital providers seem willing to look past 2020 when making credit decisions — but they might want to take note that 2021 earnings estimates for most large companies tracked by equity analysts are coming down by the week.

Some market watchers openly speculate that the Fed might extend its eligible purchases to all BB-rated debt or deeper junk securities if the economy fails to respond to its massive stimulus. Unthinkable as that sounds, apparently nothing is off the table. Should that come to pass, let’s abandon all pretense that capital markets are free markets in any sense of the word.

Exhibit 1 – High Yield Spread to Worst



Source: Bloomberg

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