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Distressed Debt Is Dormant — Does It Matter?

There's little end in sight to the rally in U.S. leveraged credit markets that is approaching its one-year anniversary. The pace of speculative-grade debt issuance to date is on track to top last year's huge totals, with U.S. high-yield bond issuance already topping $100 billion by early March while leveraged loan issuance in January and February posted its largest monthly totals since early 2020, before COVID-19 was declared a pandemic. Speculative-grade bond yields are near their lowest levels on record, even with the recent uptick in longer-dated U.S. Treasury notes. It is an unprecedented tidal wave of capital in search of a return.

Debates about excessive market valuations are common these days and are mostly centered around market values of equities relative to operating earnings expectations over the next several years and the appropriate discount rate (or multiple) to apply to these cash flows. What makes this a lively debate currently is the wide range of post-COVID recovery scenarios and earnings forecasts across companies and industries as the economy prepares to move into a post-pandemic environment. Some commentators and investors are wildly bullish on the growth prospects for our reopened economy. Others don't share that unbridled enthusiasm and question whether operating results can recover quickly enough and grow at rates that justify very high valuation multiples by any historical measure.

However, in the world of credit, debates over valuation are framed differently: Does the return on a bond or loan over a holding period adequately compensate the holder for the issue's default risk and likely recovery value in the event of default? An overvalued bond would undercompensate the holder in terms of the yield (YTM) it provides relative to the issuer's risk profile and likelihood of default. Currently, the average market yield on speculative-grade corporate bonds (Bloomberg Barclays U.S. Corporate High Yield YTW) is just 4.35%, 45 bps above its all-time low set in February.[1] The debate over excessive market valuations is intuitively less clear for corporate credit than it is for equities but be assured that leveraged credit markets are leading the charge these days when it comes to investors' exuberance.

How do we know this? For starters, the number and volume of distressed corporate debt — a market-determined designation — have all but disappeared since mid-2020. Market prices for corporate credit securities change daily in secondary markets to provide a buyer with a yield return (YTM) that is commensurate with an issuer's perceived default risk and recovery value. S&P's U.S. distressed debt ratio — traditionally defined as the percentage of all domestic speculative-grade issues with market yields (YTM) more than ten percentage points in excess of comparable Treasury securities — has plummeted to 4% currently from 35% last March, when credit markets were seizing up.[2] In other words, the amount of distressed corporate debt has decreased by nearly 90% over the last eleven months, from 736 issuers in March 2020 to just 89 in February, according to a recent S&P report.[3] More than 500 of these credits lost their distressed debt label due to the compression of spreads in secondary trading markets. Even more noteworthy, the huge contraction in distressed debt totals has occurred over the course of a recession and a crawl out of the COVID ditch.

More to the point, corporate credit markets are showing little concern for potential defaults, judging from current market yields and the declining trend in the distressed debt ratio. To give this some perspective, the current distressed debt ratio of 4% is the lowest reading in a decade[4], according to S&P, and far below its long-term average of 13% over the last 30 years. It is truly an Alfred E. Neuman ("What, Me Worry?") moment in leveraged credit markets — a boomer reference to be sure.

Historically, the distressed debt ratio has been a cyclical data series with a tendency to spike occasionally, and it has reached its current low levels several times in recent decades. However, what makes this moment so unique is that the ratio has never been this low against the backdrop of such weak corporate credit quality, with nearly 40% of U.S. speculative-grade issuers now rated B or worse — easily an all-time high (**Exhibit 1**).

In short, corporate credit markets determine market yields for debt securities which, in turn, determine the distressed debt ratio. Why does this matter? Because credit investors supposedly anticipate changes in default activity, and the distressed debt ratio has a respectable track record over the years of foretelling trends in default activity some nine to 10 months in advance.

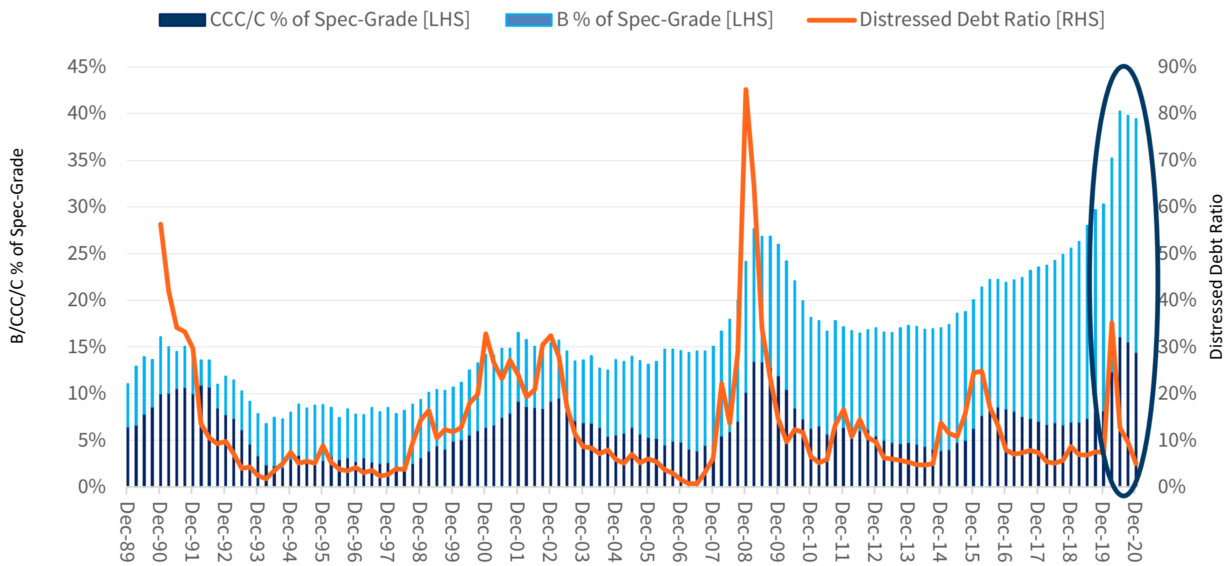
The distressed debt ratio is hardly an infallible predictor of upcoming default activity, but its track record is impressive enough not to be ignored. If the distressed debt ratio is indeed prophetic, we should expect very low default rates by year-end — around 2.5%-3.0%, which is less than one-half the current U.S. default rate of 6.6% and even lower than the optimistic scenarios of credit rating agencies. However, this outcome seems highly unlikely given such weak corporate credit quality, as evidenced by the ratings distribution of speculative-grade issuers. Historical annual default rate averages by each speculative-grade rating category tell us that default totals in 2021 very likely will exceed those implied by the distressed debt ratio, given the large numbers and proportions of very low-rated debt. Moreover, default activity and Chapter 11 filings to date, though hardly on track to rival 2020, are also on pace to exceed the paltry default totals implied by the distressed debt ratio. We're also seeing that Chapter 11 filings to date have been dominated by middle-market companies, those with liabilities of $50 million to $100 million and having no rated debt. That trend could persist in 2021 as credit markets show favor to the largest issuers.

At the moment, there is a sharp divide between the corporate debt default expectations of leveraged credit markets and those of the rating agencies. The default forecast models of S&P and Moody's are not expecting such a precipitous decline in default activity this year, and it seems more likely that leveraged credit markets are underestimating default risk currently. If not, it's going to be a painfully quiet year for the restructuring profession. But we're not distressed over the dismally low distressed debt ratio. Instead, we're betting that leveraged credit markets are overly complacent, which they tend to be when capital is plentiful.

We're three months into 2021 and there still is no clear consensus about the restructuring outlook for the year ahead, other than the near certainty it will fall short of

2020's huge totals. However, restructuring activity to date has been robust enough to convince us that 2021 won't be a dud either. While the reopening play has financial markets in full risk-on mode, the lofty expectations attached to a post-pandemic economy are way ahead of today's reality, and too many industries are too far from normal to give them all the benefit of the doubt, as markets have done.

Exhibit 1 - U.S. SPEC-GRADE RATINGS DISTRIBUTION VS. DISTRESSED DEBT RATIO



Source: S&P Global Ratings Research

Endnotes
1. Bloomberg, March 15, 2021
2. The U.S. Distress Ratio Is Down Nearly 90% Since March, S&P Ratings Direct, March 10, 2021
3. Ibid
4. Ibid

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