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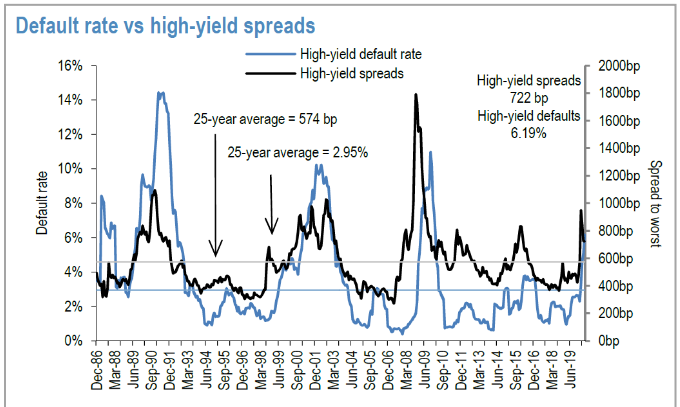
Distress in the COVID-19 Era

July 2020

During the second quarter of 2020, there were $82.2 billion in high yield defaults and distressed exchanges, marking the largest quarterly default volume on record. Through June, the defaults already place 2020 in second place for annual default volume behind 2009, although attaining first place may be challenging given the global economic recovery has begun. In addition, rating agencies have been extremely busy downgrading borrowers. There were $68.5 billion in high yield downgrades during June helping depress the upgrade/downgrade ratio to a near historic low of 0.36:1. The high yield market was further buffeted by a record number of "fallen angels," investment grade securities downgraded to junk. Global fallen angel debt totaled $191.4 billion through June which comfortably exceeds the $150.2 billion downgraded in 2009. Despite the bad news, high yield spreads narrowed 206 basis points during the quarter and were nearly 400 b.p. through the wide print of 1,082 b.p. on March 23, 2020. While high yield spreads remain wide by historical standards, do the tighter levels make sense in light of the turmoil we are experiencing?



Note: Default rate is par-weighted

Source: J.P. Morgan; Moody's Investors Service

The world's current recession is unusual in many ways including the speed with which it happened, its brevity and its genesis. Unlike most periods of economic transition, the global economy was growing at a reasonable clip without the stresses often associated with turning points. While not globally uniform, corporate debt was manageable, even if larger, and consumer debt was low compared to levels reached in 2008. Government debt had been rising, however away from perennial defaulters like Argentina and Ecuador, few countries experienced distress. Furthermore, pre-COVID, few economists forecast a recession in 2020. Nevertheless, the recession was forced upon the world causing people, companies and countries significant hardship. Ironically, the unique features of this tumultuous downturn may actually mitigate the pain generally imparted on the economy and financial markets by elevated insolvencies.

COVID-related Defaults Overstated

Unquestionably, many companies were thrust into default because of the financial hardship inflicted on them by forced lockdowns. However, we believe the newsworthy headline is the volume record. During 2020, default levels have been meaningfully influenced by five previously troubled companies that were expected to reorganize regardless of the pandemic. The lockdowns may have accelerated filings that likely would have occurred in 2020 anyway. These companies account for $41.1 billion of 2020's default volume and $24.4 billion of second quarter defaults. These companies are Frontier Communications, Intelsat, Neiman Marcus, JC Penny and Diamond Offshore. Frontier was known to be preparing a restructuring proposal, Intelsat suffered an adverse ruling on spectrum it intended to release and the others had known solvency challenges. These companies' bonds were all trading at distressed levels at the end of 2019 suggesting they were not exclusively victims of the COVID recession.

Government Support

As financial markets collapsed in March, the Federal Reserve took swift and decisive action. Shortly thereafter, the federal government enacted the CARES Act, a massive fiscal stimulus package intended to cushion the blow to the economy from the pandemic. A key Fed objective was to assure the ongoing availability of credit given the potential damage a wave of bankruptcies could inflict on the banking system and the broader economy. Recognizing its mandate prohibits direct lending to companies or industries, the central bank created various facilities aimed at increasing liquidity and encouraging financial market participants to lend.

In typical economic downturns, the central bank limits its actions to providing stimulus through monetary policy, generally by lowering short term interest rates. After the 2008 – 2009 recession, the Fed augmented its policy arsenal by initiating quantitative easing and establishing facilities to target market sectors that were experiencing extensive liquidity strains. Since the lockdown, the Fed vastly expanded this arsenal creating facilities to target the entire institutional economy. As a result, investors and banks are being encouraged to lend to all businesses, large and small. As examples:

- The Fed set up a Primary Market Corporate Credit Facility (PMCCF) and a Secondary Market Corporate Credit Facility (SMCCF) to support investment grade companies' funding needs. While these became active recently, their creation launched an explosion of issuance in investment grade credit that broke all historical borrowing records in just 4 months. To assist the high yield market and "fallen angels," the SMCCF included provisions for the purchase of securities formerly rated investment grade and high yield ETFs.
- A new Main Street Loan Facility was created to facilitate lending to small and medium sized businesses. The facility encourages small and medium sized companies to borrow because interest rates are low and repayment terms are generous. Banks are encouraged to lend because the Fed purchases 95% of the loans from them on attractive terms. Loans are available for companies with revenues up to $5 billion.
- The CARES Act included provisions for direct aid to companies like airlines, hotels and other hospitality businesses hit directly by the quarantines.

While these facilities cannot lend to bankrupt companies nor help prop up those in precarious condition, they ease the flow of credit to negatively affected companies that might otherwise be shut out by nervous lenders. Similarly, healthy companies that might be adversely tagged due to size, lower ratings or industry association can access necessary financing to meet their obligations.

Less than Distressed Exchanges

When creditors encounter bankruptcy filings, they generally expect to lose some of their principal and to accept new securities of lesser value in exchange for their claims. Often creditors become shareholders in a restructured company. Some companies do not go through a formal bankruptcy filing, preferring to offer creditors an exchange of their debt for securities of lesser principal and perhaps higher seniority. Common to both bankruptcies and forced distressed exchanges is loss of value. According to J.P. Morgan, the recovery rate for high yield bonds and loans hit a record low as of June 30, 2020 (17.1% for bonds and 47.3% for first lien loans measured over the last twelve months). Strategists believe the default rate will continue to rise potentially stressing the high yield market further.

We believe a different trend will emerge. Defaults will indeed continue to rise in the strict definition of the event. However, as we navigate the recovery, we expect many would-be defaulters will request forbearance instead of distressed exchanges or bankruptcy restructuring. A feature of the current recession for many borrowers is the sudden and complete loss of revenue for a period of time. Companies in the eye of the storm need a bridge to get past the forced closures. Already, large hotel chains, airlines and cruise operators have harnessed available collateral to raise the funds they need to get past the shutdown. Other entities that have suffered demand erosion or business deferrals may avail themselves of these requests, which we believe creditors will likely be happy to grant.

A common structure proposed by entities in this predicament, is the exchange of bonds maturing over the near term for new securities with a longer maturity. The new securities may include a "pay-in-kind" (PIK) feature which allows the borrower to defer interest while cash flow recovers. These forbearance requests do not include principal concessions and recognize the good will of creditors by adding features like higher coupons, premiums for PIK adoption and premium calls should the company's restoration be robust and quick. In a manner analogous to landlords helping tenants, we believe creditors are receptive to good faith efforts by borrowers to bridge an emergency they did not cause.

If these actions prove to be accurate, it is probable recovery rates get a meaningful boost. This also justifies a narrower spread for higher risk lending. One reason to expect companies to follow this path is that most stakeholders support it. A few companies in emerging markets have already proposed similar structures and received creditor support for their efforts. In a further irony, J.P. Morgan recently reduced its default forecast for emerging market borrowers, even though emerging market economies do not have the breadth of fiscal and monetary support the U.S. private sector enjoys. As is often the case, an alignment of interests can produce unexpected results.

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GIA Partners, LLC

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We have a thorough understanding of fixed income investments and their role in a globally diversified portfolio, which has rewarded our clients throughout market cycles.

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