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New default risks emerging

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New default risks emerging

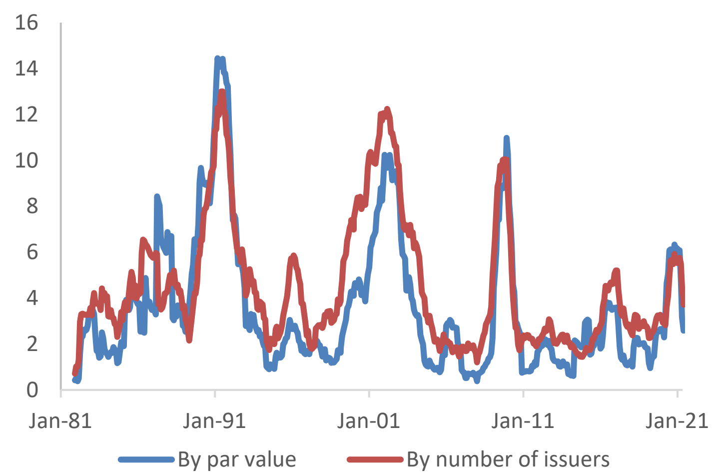
- Massive fiscal and monetary support have limited high-yield defaults
- But margin pressures and leverage are new concerns
- The risk is that default rates rise even as the recovery broadens

The default fallout from the Corona Pandemic in the US has been modest by past standards (see Chart 1). After a spike between April and July of last year, defaults declined quickly and so far this year have been running at a low clip.[1]

We believe overall default rates will drop further as the recovery broadens this year. However, we see new default risks from rising margin pressures and higher debt loads, especially for companies that are emerging from the Pandemic with challenged business structures. In our view, the risk is that default rates move higher next year even as the recovery leads to a new expansion.

Chart 1: US high-yield default rates

% 12-months rolling



Source: JPMorgan [2]

Not as bad as feared

The default fallout since the start of the Corona Pandemic has not been as bad as we had initially feared. In our view, the favorable default outcome is driven by the rapid economic recovery, which rests on four factors:

1. The enormous fiscal support for households and businesses;
2. The massive monetary stimulus and the quick restoration of easy financial conditions that maintained funding access for most firms;
3. The rapid progress in developing and deploying vaccines;
4. The quick rebound in oil prices.

The oil price recovery is particularly important for the high-yield market. The oil & gas sector is the largest high-yield issuer group and suffered a surge in defaults as oil prices plummeted last year. Of the 48 high-yield defaults last year, 25 were from the oil & gas sector, while only three oil & gas companies defaulted so far this year.[3]

In addition, we have observed that companies were extremely fast and resourceful in cutting costs from the beginning of the Pandemic. This was facilitated by the quick support from the government but nevertheless shows that firms were not asleep at the wheel.

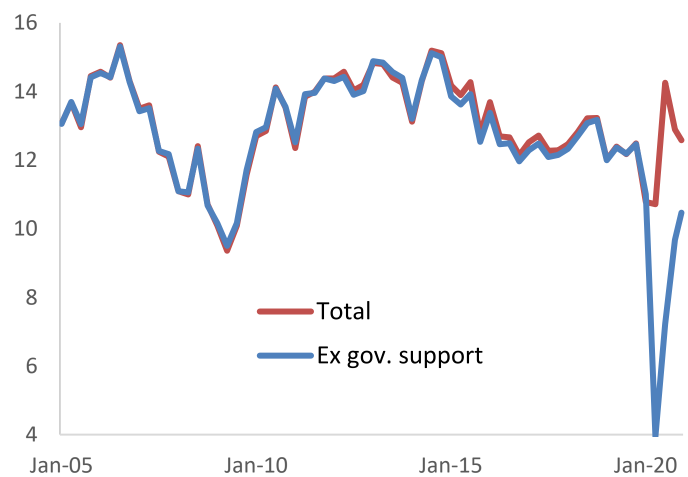
By July, when most defaults from last year will drop out of the 12-months calculation, we expect that default rates will decline to their pre-Pandemic levels and potentially even lower. We are also optimistic that the economic recovery will lead to an expansion, creating a favorable backdrop for the restoration of corporate health. The main risks to this favorable outlook will likely come from two directions, in our view.

Profit margins under pressure

First, profit margins are not as strong as it seems and are coming under renewed pressure. Aggregated headline profit margins did not fall as much during the Pandemic as during the Financial Crisis, thanks to the large government support payments. Excluding government payments, however, profit margins fell much more deeply and are still at depressed levels despite the recent recovery (see Chart 2).

Chart 2: US corporate profit margins

Profits / gross value added (%)



Source: US Bureau of Economic Analysis and ZAIS calculation [4]

The profit figures in GDP are aggregated; the profit situation differs between sectors and companies. In our view, most firms are doing well and we think further economic recovery will be sufficient to compensate for the fading out of government support payments for a large majority of companies, but not for all.

Furthermore, we expect rising costs to create new margin pressures.

- Commodity prices have shot up after the initial collapse in 2020 and stand now about 20% above the level before the Pandemic.[5]
- Unemployment is still elevated, yet companies struggle to find employees and wages are accelerating. Hourly wages have increased 5.1% at an annual rate since the start of the Pandemic versus average wage growth of 3% before the Pandemic.[6]

In our view, not all companies will be able to pass on these cost increases in full. As a result, we believe the positive effect on profit margins from the economic recovery will be at least partially offset by rising costs.

More debt to carry

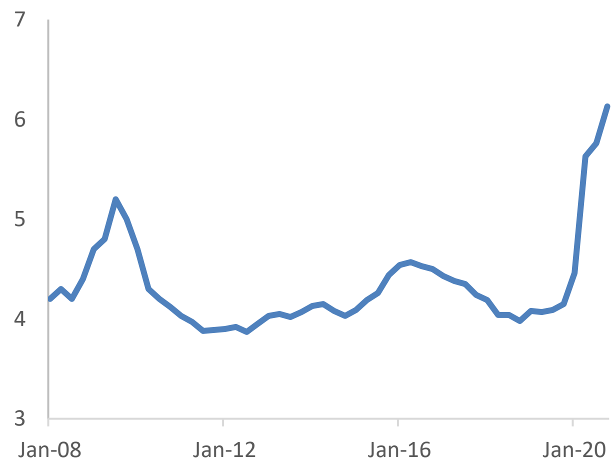
Second, companies have shouldered more debt. Besides the government support, critical for many companies to make it through the Pandemic was the ability to borrow funds and preserve liquidity.

Much of the bank borrowing has been paid back, but the overall debt burden remains significantly higher than before the Pandemic. In the high-yield sector, total leverage has jumped from around 4xEBITDA to around 6xEBITDA, much more than the increase during the Financial Crisis (see Chart 3).

After the Financial Crisis, most companies were able to reduce their leverage ratios as low cost pressures reduced the need to increase capital spending and profits recovered strongly. We think this time will be different. We expect costs will continue to rise more rapidly and companies will be challenged to invest more to raise productivity and keep up with technological and structural changes as well as rising environmental requirements.

Chart 3: US high-yield leverage ratio

Debt/EBITDA

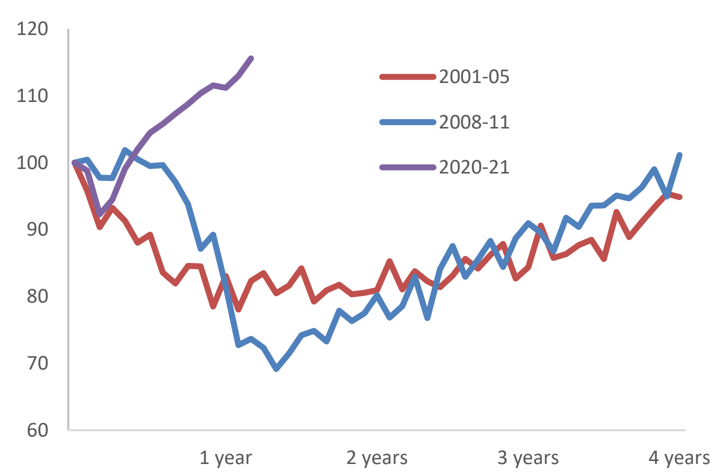


Source: JPMorgan [7]

While capital expenditures went through long slumps after the previous two recessions, firms are in aggregate already spending about 15% more on machinery and equipment than before the Pandemic (see Chart 4). This investment push means that firms with weaker credit may either take up more debt than they can handle or find it difficult to keep up with stronger competitors.

Chart 4: US core capital goods orders

Index 100=start of recession and following years



Source: US Census Bureau [8]

We are not worried that inflation will get out of control and that the Fed will have to hit the panic button. Yet, we believe the monetary policy cycle will gradually have to turn, probably starting with a tapering of bond purchases by the Fed towards the end of the year.

To us, that means interest rates will be gradually trending higher in a context of rising capital spending by firms and persistent large fiscal deficits. That will create challenges for firms with weak profits and high leverage. And given the heavy use of floating rate debt, the pressure will increase further once the Fed starts raising the funds rate.

Rising defaults is a clear risk

To be sure, we are not expecting a surge in default rates unless the recovery itself falters, which is a low probability scenario in our view. We think the most likely scenario is that the recovery will offset the negative effects of margin pressures, higher debt and rising interest rates for the majority of companies. Yet we see that as leaving a smaller group of firms that will struggle, especially companies that suffer lasting dislocations in their business from the Pandemic.

Compared to the days before the Pandemic, we expect more people to work from home, less demand for business travel and entertainment as well as further advances of the digital economy in retail and consumer services. As a result, we think sectors like traditional retail, office commercial real estate and cinemas are unlikely to return to business as usual.

The market recognizes these changing trends and many assets in these sectors still trade well below pre-pandemic levels. However, properties in specific regions and industries may have greater downside than what is currently priced into the market.

In our view, the number of firms that will buckle under these pressures and new business conditions is likely to rise next year. That may not be enough to push overall defaults significantly higher, but we think markets in their recovery euphoria currently underestimate this risk.

More information

As always, we are available to discuss our views with you. Please contact your Client Relations representative at +1 732 978 9722 or zais.clientrelations@zaisgroup.com

[1] Total US high-yield defaults in the first 5 months of this year were 5 versus 48 for the whole of last year. JPMorgan Default Monitor; June 1, 2021; page 7. https://markets.jpmorgan.com/#research.na.high_yield

[2] JPMorgan Default Monitor; June 1, 2021; page 7 and prior issues. https://markets.jpmorgan.com/#research.na.high_yield

[3] JPMorgan Default Monitor; June 1, 2021; Appendix A & B pages 20-22. https://markets.jpmorgan.com/#research.na.high_yield

[4] U.S. Bureau of Economic Analysis, Corporate profits with inventory valuation and capital consumption adjustments: Domestic industries: Nonfinancial [A463RC1Q027SBEA], retrieved from FRED, Federal Reserve Bank of St. Louis; May 31, 2021.

https://fred.stlouisfed.org/series/A463RC1Q027SBEA

U.S. Bureau of Economic Analysis, Gross value added of nonfinancial corporate business [A455RC1Q027SBEA], retrieved from FRED, Federal Reserve Bank of St. Louis; May 19, 2021.

https://fred.stlouisfed.org/series/A455RC1Q027SBEA

U.S. Bureau of Economic Analysis, Net value added of nonfinancial corporate business: Taxes on production and imports less subsidies [W325RC1Q027SBEA], retrieved from FRED, Federal Reserve Bank of St. Louis; May 31, 2021.

https://fred.stlouisfed.org/series/W325RC1Q027SBEA

[5] International Monetary Fund, Global Price Index of All Commodities [PALLFNFINDEXM], retrieved from FRED, Federal Reserve Bank of St. Louis; May 30, 2021.

https://fred.stlouisfed.org/series/PALLFNFINDEXM

[6] U.S. Bureau of Labor Statistics, Average Hourly Earnings of All Employees, Total Private [CES0500000003], retrieved from FRED, Federal Reserve Bank of St. Louis; June 4, 2021.

https://fred.stlouisfed.org/series/CES0500000003

[7] JPMorgan Credit Strategy Weekly Update, March 19, 2021, Figure 12, page 12.

https://markets.jpmorgan.com/#research.na.high_yield

[8] U.S. Census Bureau, Manufacturers' New Orders: Nondefense Capital Goods Excluding Aircraft [NEWORDER], retrieved from FRED, Federal Reserve Bank of St. Louis; May 20, 2021.

https://fred.stlouisfed.org/series/NEWORDER

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