Do we have a solvency problem?

What started as a liquidity crisis may be turning into something more sinister.
We look at the fundamentals.

Speaking at last week’s Federal Open Market Committee (FOMC) press conference, Fed chairman Jay Powell delivered a bitter reality check to financial markets with a dismal assessment of the country’s economic outlook for the coming years. This follows similar comments in recent weeks where Powell highlighted the unprecedented downside risks that could do lasting damage to households and businesses. While the markets have priced in a fast economic recovery, the Fed has stressed that the recovery may take some time to gather momentum, and the passage of time can turn liquidity problems into solvency problems.

This view was reflected in the Fed’s latest economic forecasts, which estimate an unemployment rate of 9.3% in 2020, remaining elevated through to 2022, and economic output contracting by 6.5% in 2020 before recovering by 5% in 2021. Having skipped the March assessment, these are the first projections by the Fed since the COVID-19 crisis and upend December’s outlook which estimated 2020 unemployment of 3.5% and economic growth of 2%. These forecasts indicate a slower path to recovery than the markets, and indeed the Trump administration, were hoping for. But, without the extraordinary fiscal and monetary support stimulus that has shielded the economy during the pandemic, the outlook may have been considerably worse.

In their May 2020 Default Report, Moody’s forecasted that the global high yield default rate will increase from the current 4.7% to 9.2% by the end of 2020 and peak at 9.5% by February 2021. Unsurprisingly, business services, oil & gas and hotel, gaming & leisure are expected to be the industries that see the most defaults as a result of lockdown and crash in oil prices.

Looking at credit fundamentals, we have observed a rise in leverage, with companies issuing debt at record levels in 2020, and a drop in interest coverage as earnings continue to deteriorate. Despite this, credit spreads have tightened considerably from their March highs, indicating a sharp economic recovery. The Bloomberg Barclays Global High Yield Index spread is 658bps (as at 12/06/2020), having fallen from almost 1,200bps on 23rd March. The below chart compares this to the Moody’s default forecast:

High Yield Default Rates vs. Credit Spreads

Source: Bloomberg, Moody’s Investors Service
While defaults are a lagging indicator, the expectation of them occurring in a recession acts as a drag on asset prices. With the recent market recovery, a disconnect has appeared between financial markets and fundamentals. For example, we continue to view the fiscal spending seen to date as more akin to disaster relief than economic stimulus whereas the market seems to see it as the latter. Similarly, we fear that the current levels of liquidity being provided by central banks can delay a solvency crisis but cannot postpone it indefinitely. It is unlikely that we will see mass state bailouts in the event of a wave of defaults. In the coming months, the true level of strain caused by lockdown policies and social distancing will become more apparent in markets as defaults likely become more commonplace.

Investors can very easily be influenced by the momentum in financial markets, but our investment process brings us back to the fundamental assessment of the economy and the prospects for profitability and solvency. At the very least there appears to be significant question marks about the timing and velocity of the recovery and it is our judgement that financial markets have become unanchored from fundamental realities. We therefore continue to adopt a more cautious approach in our credit selection.

James Carter
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Risk Warnings

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