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Stimulus Money May Jumpstart The Economy, But Who Is Picking Up The Tab?

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The situation is changing day to day, sometimes hour by hour, throwing investors of all stripes into a panic. In hindsight, the equity market sell off during March was the biggest drop since 1931. By month's end, some of those losses had been recouped but the outlook by April Fools' Day was uncertain at best. Similar turbulence was witnessed around the globe in most markets. At this point, we can't predict whether we've hit bottom but we can take some comfort in the fact that worldwide governments are using every tool available to stem the economic free-fall. In any event, the IRS will start mailing stimulus checks next week.

In addition to the massive new CARES Act, we've also seen unprecedented action by the Federal Reserve. While Congress and Trump were still negotiating, the Fed acted unilaterally by setting up a new $300 billion facility to buy Treasuries, investment grade corporate and municipal bonds, and even went so far as to bail out ETFs that own investment grade debt. It also committed to provide new funding for the SBA to extend emergency loans to distressed

companies of all sizes. More recently, it even agreed to buy certain junk-rated bonds.

These actions have caused the markets to rally, but the economy will still contract significantly, as unemployment spikes – possibly to 15% or more. Clearly, these are unprecedented times calling for extraordinary responses. However, the question remains: Who's going to pay for all this?

There's no doubt that it's socially desirable to rescue our economy; but are we attempting to solve a debt problem by piling on more debt? That's a scenario that may not end so well. Also, why were we so focused on stopping a market correction? Doesn't the mere drop in prices caused by a dramatic market sell off automatically help form the basis of the next market recovery? Socializing losses while privatizing profits sounds great politically, but with each successive crisis, the likelihood of future victories grows more remote. That's because efficient markets, which automatically reallocate capital from failed businesses to successful ones, get unsettled when politically-powerful zombie firms (with far too much debt) successfully lobby for handouts when times get tough.

According to the IMF, U.S. GDP measured $21.4 trillion in 2019. That's impressive, but less so when we consider our $21 trillion in debt outstanding, even before adding entitlement obligations such as pensions, Social Security, and Medicare. Adding those in increases the figure to over $100 trillion. Can we really afford a $6 trillion investment to lessen the social impact of a virus-driven temporary drop in demand? Should taxpayers backstop American Airlines AAL and Boeing BA – both of which rewarded private stockholders when times were good with huge stock buybacks?

Investors who've been paying attention to equity markets are rightly concerned about what comes next. If Asian markets are indeed a good precursor for how markets will react once the virus situation gets a little more under control, we may see a continuing market rebound. Another important question: who'll be the winners and losers after all these extraordinary new relief measures?

We're undoubtedly in a time where distressed investing should get more attention—as of this writing, distressed debt outstanding has multiplied to over $1.0 trillion. Energy firms were the biggest junk-rated borrowers so the double whammy of a demand-and supply-shock in that sector makes it the "ground zero" of distressed debt. However, forecasting future cash flows for energy firms while oil prices plunge makes fundamental analysis challenging, if not impossible.

Separately, so-called "fallen angels" (investment grade companies that get down-graded) also represent a growing slice of the distressed debt market. For example, when Ford's $41 BN in bonds were recently downgraded, it became the 2nd largest fallen angel of all time. Other major bellwethers, such as Kraft Heinz and Macy's M, saw similar downgrades, and we're likely to see many more going forward. Clearly, there's a lot going on in distressed debt right now so long-term investors would be wise to consider this asset class while dislocation persists.

However long this crisis lasts, the companies which are best positioned to survive are those with strong balance sheets that allow them to weather a sharp, hopefully temporary, demand shock. We don't know if it's going to be three months, six months, or longer, but we do know there's going to be a major drop-off in demand. Companies that aren't overloaded with debt should do better and, at a high level, that's where investors should focus.

As noted at the start, March was the worst monthly market sell off since 1931. But consider those investors who had cash in 1931, or after the market rout in 1987, who started buying fundamentally sound companies after those crashes. Those investors probably did fine over the long term, and the same fate is likely for similarly-positioned investors today.

Our current situation is analogous to the market turmoil 90 years ago, except that this time around, there's far more debt outstanding. Luckily, we now have better technology which gives us more transparency into what's going on. We also benefit from dramatic central bank responses that we didn't have before. Finally, governmental fiscal policy responses, including the IRS stimulus checks that will go out next week, may help us recover even more quickly.

Concerns remain about the effect of this continual debasing of our currency. However, policy makers appear to be doing all that they can to urgently fight the problem at hand. In the meantime, long-term investors would be wise to renew their focus on distressed securities while we wait to see how all these new relief measures will play out.