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The August Rally Won't Stop Defaults

By George Schultze
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August was a great month for the stock markets—the major indexes made up losses suffered in the collapse this Spring due to Covid-19, and then some. The big rally, continued monetary accommodation plunging interest rates to record lows, and indications from the Fed that it has no plans to raise rates, (easing fears of inflation), has a lot of people thinking a financial crisis has been averted and there's nothing to worry about. While it's true that quarantines are subsiding and many are hopeful that an effective vaccine will be available soon, there are still a large number of companies in distress. Many of these companies are currently, or will soon be, defaulting on their debt obligations and ultimately going through bankruptcy proceedings.

Although things typically slow down in the summer, nothing has been typical about 2020. In the last month alone, the pandemic helped force 20 companies with more than $50 million in liabilities into bankruptcy, making this the worst August for bankruptcies yet, although it signals a drop from the roughly 30 filings in each of the three previous months. There have been 180 bankruptcy filings so far this year, putting 2020 on track to surpass the worst year ever—2009, when there were 271 bankruptcy filings.

Equally troubling is the increase in the default rate for loans and bonds. According to JPMorgan's Default Monitor, since the beginning of the year through August 31, 75 companies have defaulted on bonds and loans valued at $114 billion. Additionally, there have been 13 distress transactions totaling $8.9 billion, bringing the default total so far this year to $122.9 billion. Only 33 companies, with a total $42.9 billion in debt, defaulted or completed a distressed exchange during the first eight months last year. That figure is second only to 2009's $205 billion in defaults—there are still four more months left in the year. Year-end forecasts see default rates of 8% for high yield bonds, and 5% for loans.

Certain sectors were already undergoing stress due to secular changes within their spheres, like energy, telecom, and retail, but now the distress seems to be everywhere. But when doing careful analysis, it's important to investigate beyond broad sector reports. For example, both

the telecom and cable/satellite sectors appear to be seriously affected, but if you strip out one big bankruptcy from each (Frontier Communications with almost $17 billion in bond and loan defaults, and Intelsat with $14 billion), those two sectors don't appear to have any more significant defaults. Yet that doesn't guarantee that other pockets of distress won't pop up in those sectors as the year continues.

To the retail sector, which had already been weathering through massive secular change, the pandemic dealt an immense blow. Keep in mind, every kind of retailer that relies on foot traffic and in person sales has been affected. You might think that with dining options mostly off the table, and millions more meals being consumed at home every month, that this would be a profitable time for supermarkets. Yet one of the companies filing for Chapter 11 protection in August was KB US Holdings—operator of 10 Balducci's and 25 Kings supermarkets. Though supermarkets differ from clothing or electronics stores, they face many of the same challenges that have brought down many brick and mortar retailers—expensive, long-term leases and increasingly thin operating margins, particularly when you consider how much of a supermarket's inventory is perishable. On top of those other pressures, supermarkets now face stiff competition from Amazon Fresh, an Amazon service that provides free two-hour grocery delivery to Prime members.

As for energy companies, the picture remains as grim as it has been for the last few years—excess supply from fracking, low prices, and too much debt. Clearly that's not an ideal situation in the best of times, but when you combine that with reduced energy consumption from air travel, fewer cars on the road and businesses with their lights off, energy companies face an ongoing disaster.

The COVID-19 pandemic is not the sole factor behind all that's going on in the distressed space, but it did make it much harder for those companies already struggling to survive. Many companies have seen a drop in revenue of well over 25% due to shutdowns. This is bound to trigger more distress, increasing both the level of defaults and the number of bankruptcies. But it's also an unprecedented opportunity for investors who understand how to balance value, fundamentals, and risk.