Forbes

Decline in Defaults Doesn't Mean We're Back to Normal

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July 13, 2021

Over the last few months, the default rate on bonds and loans has dropped precipitously. This should come as no surprise, considering all the extreme monetary and fiscal policy measures the government has implemented to cope with Covid. That is a positive development for sure, but we can't forget that the economy is still heavily dependent on government spending, with the Fed continuing to buy about $120 BN worth of Treasuries and mortgage-backed securities ("MBS") every month.

Still cheap money is allowing more companies that would otherwise be facing Chapter 11 to meet their debt obligations. In the first six months of last year, there were some $104.2 BN of debt defaults compared to only $8.5 BN in the first half of 2021. That's the lowest level of defaults in the first two quarters since 2011, according to J.P. Morgan. Going forward, J.P. Morgan expects a slight increase in defaults, but volume will likely remain considerably lower than normal for some time.

In the past, low default rates usually signal that it's a good time to invest in post-distress companies, and while that's still probably true, it's more important than ever for investors to carefully consider the risks before making such a move.

Nevertheless, the banking sector is doing much better recently. With low interest rates, accommodative monetary policy, and the government literally giving away cash, distress has dropped and bank balance sheets are looking better. Those improved balance sheets helped all the major banks pass their June stress tests, after which they were able to begin making large stock repurchases raising dividends.

The corollary to all this "good news" is the risk of inflation and at this point it's unclear how it will play out. We seem to be moving from major crisis to major crisis, starting from the dot.com bubble, the Great Financial Crisis, the oil crisis, and now the pandemic, with each one requiring a bigger money-printing bailout.

Bailouts like these make inflation inevitable, because they are essentially just a way of monetizing the mounting pile of debt that the government cannot otherwise repay. If you're not going to pay it down, you have to either default or otherwise monetize it through inflation by printing more cash. This is the primary reason why the buying power of the US dollar is just a fraction of what it was a century ago.

The big question now is, "how do we get back to normal?" Unfortunately, there's no easy answer. The last time the Fed tried to get out of this game by raising rates slightly and tapering its monthly asset purchases, investors drove a dramatic market selloff, forcing the Fed back to the market to resume buying.

As we've noted in the past, eventually the bill for all this monetary and fiscal maneuvering will come due. Few politicians in Washington, certainly no one who want to be re-elected, is going to have the moral courage to turn off the spigot. If the free money stops flowing, it would almost certainly be followed by a market crash for which no politician wants to shoulder the blame. In contrast, the increasing creep of lost buying power from inflation is far easier to stomach from a day-to-day political perspective.

One possible indicator of higher inflation is the state of in the housing market. Home prices have jumped as people flee cities and mortgage rates remain near record lows. This has prompted speculation about a new housing bubble. Yet sales of both new homes (-5.9% m/m, which can be partially attributed to the increase in cost for building supplies) and existing homes (for the fourth consecutive month) were down in May. As the vaccination rate increases and panic subsides, it could be that people are re-thinking their need to escape, meaning that we've hit a peak, or it could just be a temporary pause.

Yet, any talk about housing inevitably brings us back to the role of the government. The two primary buyers of mortgages in the U.S. are Federal National Mortgage Association ("Fannie Mae") and Federal Home Loan Mortgage Corporation ("Freddie Mac"), both of which remain wards of the state since they have both been in conservatorship since 2008. With the purchase of $40 BN in MBS every month, it's almost like the Fed is supporting the entire housing market. That may be helping banks, but you have to wonder how much demand there would be for mortgages among private investors if the Fed were to stop buying.

How Do We Get Back to Normal?

Since the 1970s, government spending as a percentage of GDP has averaged around 33%. In 2020 it was over 46%. To return to some semblance of what we considered "normal" will require a dollar-for-dollar shift from massive governmental spending and monetary accommodation to an economy fueled by the private sector. That means we'll need to see more consumption, more savings, and more exports.

The pandemic has certainly led to an increase in savings, which nearly tripled in the first half of 2020, from $1.59 trillion annualized in the first quarter to $4.69 trillion in the second, according to the Bureau of Economic Analysis ("BEA"). This was by far the biggest increase in savings during modern history. Whether this trend will persist remains to be seen.

In terms of consumption, we still have a ways to go. Personal consumption expenditures ("PCE") increased slightly in May according to BEA. However, the $2.9 BN increase represented a gain of under 0.1%. That small win is offset by the fact that it actually represents a decrease of 0.4% in Real PCE. Excluding food and energy, the PCE price index increased 0.5% during the month.

The economy does appear to be growing very rapidly, attempting to make up for last year's lockdowns. People are returning to travelling, as we all saw from the massive lines at airports over the 4th of July weekend. Related to that, United Airlines just announced that it was purchasing 272 large aircraft from Boeing and Airbus, which will allow them to sell more First Class and Economy Plus seats and increase capacity by 30% per flight in the US by 2026.

While that purchase indicates a renewed optimism regarding travel and leisure, it is also another indicator of rising inflation. We have to look at all the indicators, not just prices of Bitcoin or gold. We need to monitor overall economic activity. Airports are full, restaurants are full, highways are jammed, and it seems like everything costs more for most consumers.

In an overheating economy, everything's busy and operating at full capacity, as we're seeing now. There's really not enough infrastructure to handle the demand, and so the price of everything rises. There's plenty of liquidity and plenty of cash available, but there just isn't enough productive economic capacity to take it all on.

These inflationary trends will likely continue. We'll also probably see more meme stocks and other types of disruptors, thanks to all the newly printed cash looking for a home in the market. These are interesting times and investors have to be both more cautious and more open to new ideas to make the most of them. Stay tuned because the return to normal will be filled with opportunities and pitfalls for investors.