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Mitch on the Markets

Portfolio Manager Investing Insights

What Do Rising Corporate Debt Defaults Mean for the Economy?

For the past couple of years, investors and analysts have been debating how higher interest rates and the possibility of a recession would ripple through corporate debt markets. A major concern was the so-called "maturity wall" of debt coming due. Many corporations—especially those in the high-yield category—were likely facing the painful reality of having to refinance 'cheap' (post-pandemic, pre-inflation) debt at much higher rates.

In a sense, some of these fears and concerns have come to fruition. In 2023, corporate debt defaults rose to 153 (from 85 in 2022), and through mid-March, the tally was already at 29—the highest Q1 total since the Global Financial Crisis. The numbers alone suggest that corporations are having trouble accessing debt markets, and are struggling to generate the cash flow needed to pay interest due on debt, or both.[1]

ABOUT MITCH ZACKS

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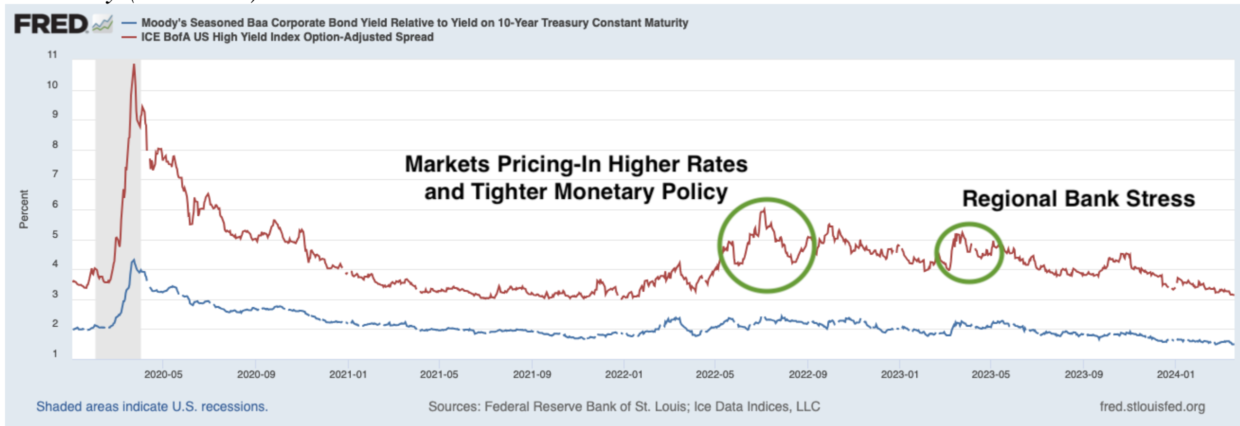
But there's more to the story beyond these numbers.

When investors want to check in on corporate financial health, they should generally start with credit markets. The question to pose is: *what is the implied cost of refinancing bonds, both for investment-grade corporations and the high-yield/junk category?* One might expect that with rising defaults and higher interest rates, refinancing debt is not only more expensive but also quite prohibitive for many.

Credit spreads tell us otherwise.

For junk-rated bonds, the implied cost of refinancing bonds is at its lowest level since May of 2022, and investment-grade bonds are at their cheapest since the summer of 2022. As seen in the chart below, credit spreads appear to be locked in a downward trend, having weathered the Fed's aggressive rate hike campaign and the regional bank stress one year ago.

High Yield Option-Adjusted Spread (red line) & Baa Corporate Bond Yield Relative to 10-Year U.S. Treasury (blue line)

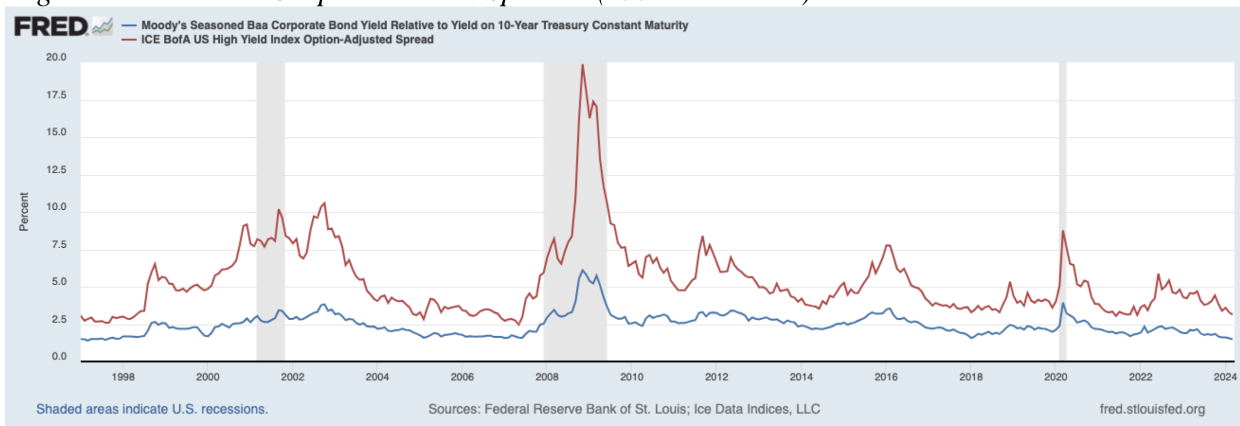


Source: *Federal Reserve Bank of St. Louis*[2]

It follows that on average, a company issuing junk bonds today to replace maturing bonds would only be adding about 175 basis points to its annual interest bill, compared to nearly 500 basis points if the company refinanced in October 2022. The picture for investment-grade bonds looks similar.

If we take the above chart and zoom out to look back at the past 25+ years, it becomes apparent that spreads are not only at historically low levels, they are also at levels that corresponded to strong economic growth previously.

High-Yield and Baa Corporate Bond Spreads (1998 – Present)



Source: *Federal Reserve Bank of St. Louis*[3]

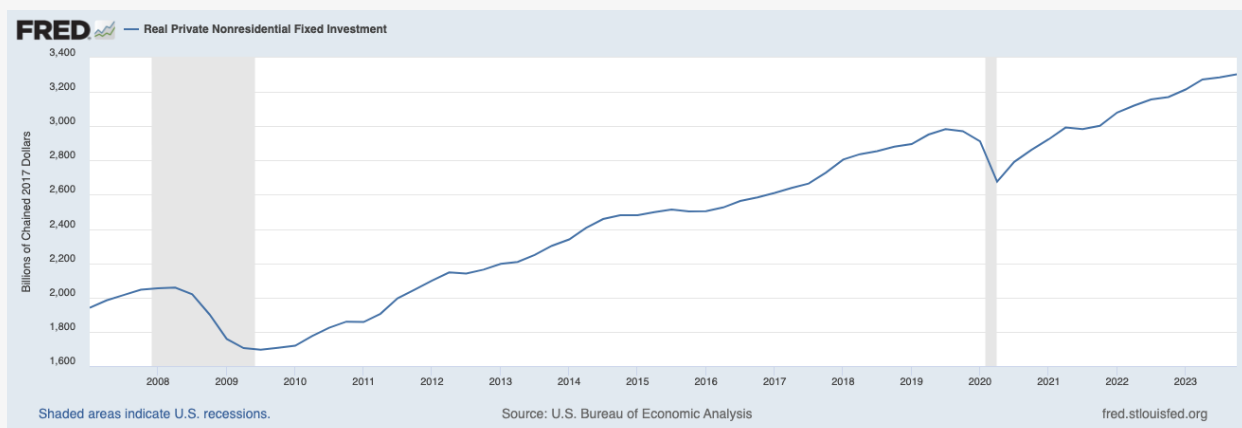
Readers may wonder: *if credit spreads are so low and corporate debt markets are seeing a flurry of activity, then how do you explain the rise of defaults in 2023 and year-to-date 2024?*

The answer is that credit markets give us insight into present and future conditions for corporations, while defaults tell us more about the past—i.e., how a recession or tighter financial conditions ultimately affected businesses. In other words, recent defaults are telling us how industry struggles and Fed rate hikes in 2022 and 2023 ultimately caused a handful of companies to buckle, while credit spreads (the market) help us understand what corporations are experiencing today and what lies ahead.

Bottom Line for Investors

Aiding in the positive environment for corporate borrowing has been the anticipation of rate cuts later this year. The hope for lower borrowing costs in the future has nudged many investors to take a risk-on mindset in corporate bond markets, and companies have been responding in kind by issuing more debt—the supply of corporate bonds globally is 30% higher in 2024 year-to-date as compared to the same period last year.

Overall, U.S. corporations remain in a strong financial position, as evidenced by record levels of investment (chart below), strong balance sheets, and projected earnings growth in 2024.



Source: Federal Reserve Bank of St. Louis [4]

Corporate debt defaults could continue to rise as the year progresses, perhaps setting off some alarms in financial media. But as long as credit spreads remain relatively low, I think investors can reasonably interpret defaults as telling us what the economy endured in the past—not where it's heading in the future.

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1 Advisor Perspectives. March 13, 2024. https://www.advisorperspectives.com/articles/2024/03/13/corporate-bond-rush-breaking-down-maturity-wall-that-everyone-feared

2 Fred Economic Data. March 18, 2024. https://fred.stlouisfed.org/series/BAA10Y#

3 Fred Economic Data. March 18, 2024. https://fred.stlouisfed.org/series/BAA10Y#

4 Fred Economic Data. February 28, 2024. https://fred.stlouisfed.org/series/PNFIC1#

STEADY INVESTOR WEEK

- **The Fed holds rates steady**
- **U.S. industrial output flat in February**
- **The new rules for buying and selling homes**

The Fed Holds Rates Steady, But Reaffirms Outlook for Cuts

The March Fed meeting wrapped up this week, and as expected, officials held the benchmark fed funds rate steady at 5.25% to 5.50%. Investors were watching closely for insights on the future path of rates in 2024, most notably if the Fed intended to follow through on 75 basis points of cuts sometime this year. Fed officials delivered. A narrow majority – but a majority nevertheless – of Fed officials reaffirmed projections of three rate cuts in 2024, with longer-term projections showing the benchmark fed funds rate settling just under 4% by the end of 2025 and slightly north of 3% in 2026. Investors should not read too much into these longer-term projections, as history tells us they are rarely adhered to. But the spirit of the Fed's nearer-term plans with rates shows that most officials believe inflation is still on the right path, despite slightly hotter than expected readings in January and February. The policy statements also offer implicit acknowledgement from the Fed that rates are currently at restrictive levels and should come down. The jobs market and wage growth continue to be strong, but both have shown deceleration in recent months – a trend that Chairman Jerome Powell indicated "could also be a reason for us to begin the process of reducing rates." For its part, the market continues to price-in rate cuts starting this summer, with futures markets anticipating a 75% chance the Fed will cut rates at the June meeting.[1]

U.S. Industrial Output Flat in February

The manufacturing slump in the U.S. continues. According to Federal Reserve data, manufacturing output rose by 0.8% in February, but that followed a downwardly revised -1.1% drop in January activity. The Fed indicated that January's downward revision was a result of harsh winter weather. February's month-over-month increase, then, can be seen as a recovery from a previously weak month, and zooming out exposes the overall weakness. Year-over-year, factory output was down -0.7% in February. Still, there was some good news in the data. The business equipment component of manufacturing saw a sharp month-over-month increase in February, which indicates solid investment activity. Consumer demand also remains strong, which has helped factories reduce inventories and set up better supply/demand-aligned production looking ahead in 2024. Overall, manufacturing is a small slice of U.S. economic output, so weakness in the sector does not portend weakness in the broad economy.[2]

A Landmark Decision That Could Reshape the Real Estate Market

The National Association of Realtors (NAR) has been the target of several lawsuits claiming the industry group conspired to keep real estate agent commissions in the U.S. high. Last week, the NAR essentially conceded defeat by agreeing to a settlement that stands to change residential

real estate transactions as we know it. At the core of the settlement was the NAR’s agreement to scrap a rule that required home sellers to disclose how much they would pay a home buyer’s agent, which plaintiffs and consumer groups have for years said hamstrung buyers from negotiating with agents. In effect, this rule had kept commissions for home sales at 5% to 6% of the total sales price, which is significantly higher than most of the developed world. The new rules of the road take effect this summer. For most buyers, you will need to sign an agreement detailing how much your agent will be paid for their services, which can either be covered by the home seller or be paid out of pocket by the buyer directly. This arrangement in theory will provoke buyers to negotiate fees with agents, whether that’s a flat fee, an hourly rate, or some other structure. Assuming this fee is less than the 2.5% to 3% of the home’s purchase price, buyers stand to save money. For sellers, the new rule structure may mean only paying your own agent, instead of both agents as is currently the case (the 5% to 6% commission rate is generally split between the seller’s agent and the buyer’s agent). It could also mean paying significantly less to buyer’s agents, which in both cases could mean saving thousands of dollars.[3]

[1] Wall Street Journal. March 20, 2024. https://www.wsj.com/economy/central-banking/fed-officials-still-see-three-cuts-this-year-0b039532?mod=hp_lead_pos7

[2] Windsor Star. March 15, 2024. https://windsorstar.com/pmn/business-pmn/us-industrial-output-barely-rises-after-weather-related-slump/wcm/49e70d16-1550-4ab8-bb10-16fa4edfb5af/amp/

[3] Wall Street Journal. March 15, 2024. https://www.wsj.com/economy/housing/realtor-commision-settlement-new-rules-explained-bc634645?mod=economy_feat5_housing_pos2

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