A Volatile Recovery: The Capital Markets for 2012

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The U.S. emerged from the longest recession since the 1930s fraught with an uncertainty that continues to plague the capital markets. Concerns over the faltering U.S. recovery; European bank and sovereign debt issues; and U.S. federal spending, policy changes, and presidential election results, buffeted by a series of self-inflicted, confidence-bashing episodes, have contributed to anxiety throughout the system.

The barrage of negative headlines might seem to imply that the capital markets are frozen. However, certain positive trends based on recent market statistics could indicate a thaw, as investors pursue safe, quality assets.

Historically, recessions have had a definitive beginning and substantive decline in economic activity and have ended in a trough that marks the beginning of the next expansion. An expansion does not necessarily mean that favorable economic conditions or normal operating capacity has returned. Economic activity can remain below expectations well into an expansion cycle.

The National Bureau of Economic Research, the official arbiter of U.S. recessions, determined that the last recession ended in June 2009. Accordingly, the U.S. economy has been in an expansion period for three years. At this point in the cycle, historical analysis would suggest that markets will expand, employment data will improve, housing prices will stabilize, and consumer confidence will increase. However, the latest recovery appears more volatile and difficult to measure than any previous post-recession period.

Taken independently, some metrics do appear to reflect improvement. U.S. housing prices have recently begun to stabilize throughout most of the country. The National Board of Realtors and the latest Fiserv Case-Shiller Indexes reported modest rebounds as housing inventory levels shrank across the U.S. With record low mortgage interest rate environment, total existing home sales in the second quarter of 2012 were 8.6 percent above the second quarter of 2011.

Conversely, there is little evidence of the sustained growth expected at this point in the recovery cycle. The unemployment rate edged up to 8.3 percent in July, while gross domestic product (GDP) for the second quarter grew at a meager 1.5 percent, well below the norm of 3.3 percent. Economic activity appears to be stagnant, and the explanation can be found in the headlines, where volatility has become the norm.

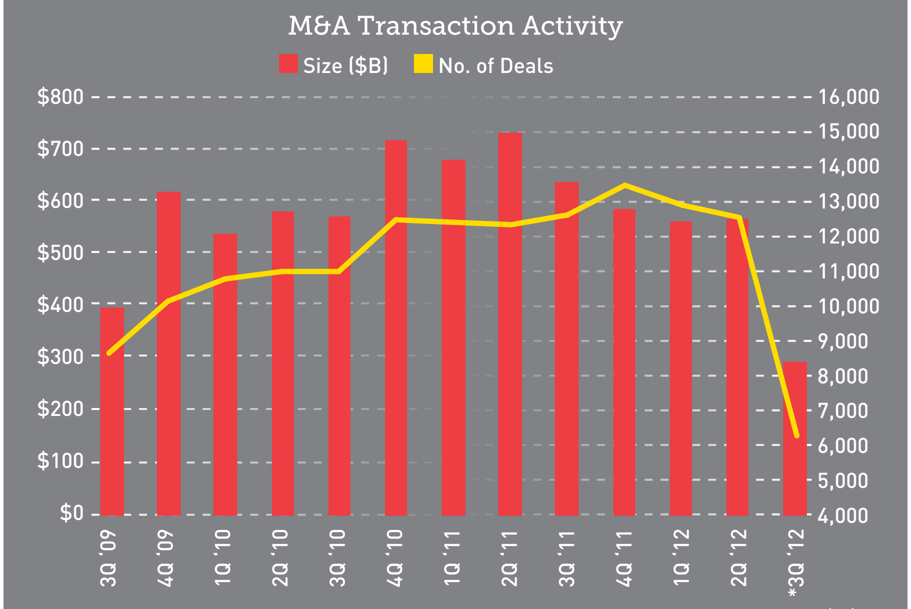
Crisis of Confidence

In the past 12 months, the capital markets have dealt with one crisis after another, punctuated by systemic institutional lapses and global governmental and regulatory uncertainty. The crisis of confidence that spread from the collateralized loan obligation (CLO) market to the commercial paper market and led to declines in corporate lending during the recession has been replaced by a crisis of confidence in the capital market system.

The institutional lapses at JP Morgan Chase & Co., weak money laundering controls at HSBC, the LIBOR scandal at Barclays, allegations of regulatory and legal violations at Standard Chartered Bank, and trading disruption at market-maker Knight Capital Group have done little to minimize the volatility of the economic recovery. Taken in isolation, each of these events would cause only ripples of concern, but the cumulative effect casts doubt on the sustainability of the "too big to fail" banking model and further erodes confidence.

Adding to the turmoil is anxiety over public finance, questions about the safety and quality of government debt, and shifting opinions of debt service obligations, as reflected by ratings agencies' warnings and the uptick in municipal bankruptcy filings. Municipal

Figure 1



Source: S&P Capital IQ

* As of 8/20/12

bankruptcies are particularly prevalent in California, where three cities have declared bankruptcy since June, including Stockton, the largest city to file for bankruptcy in U.S. history.

The sovereign debt crisis in Europe that began in 2009 amid revelations of massive deficits in Greece has been a game of economic Whac-a-Mole for euro zone leaders and the European Central Bank. Stopgap efforts, including bailouts and austerity measures, coupled with concerns about the long-term viability of the euro, continue to dampen any positive economic news. The German economy is expected to grow, but faces exposure to the debt crisis, and the country's leaders face voter hostility toward further concessions.

The European debt crisis has had a global impact and will likely require seismic shifts in the role of government in each of the member states and that of the European Union as overseer. Whether voluntarily or via market coercion, the shift will materialize over several years. Widespread market fluctuations should be expected as the European Central Bank develops and implements measures such as the European Stability Mechanism to promote the economic and monetary union.

The current political and regulatory environment in the U.S. also fosters volatility on many fronts. The recent U.S. Supreme Court affirmation of the constitutionality of the Affordable Care Act created a wave of uncertainty, not only for participants in the health care industry, but also for businesses of all shapes and sizes, which must determine the long-term impact and cost of the legislation. The capital markets must also assess the impact of a fiercely contested presidential election that presents diametrically opposite platforms for growth.

Also looming ahead is the so-called fiscal cliff, which threatens to cause a repeat of the debt ceiling brinkmanship in Washington that hobbled an already struggling economy in 2011. For now, any debate over the impact of automatic spending cuts accompanied by the expiration of tax cuts will be framed by election year politics.

The ultimate solution presents a conundrum: cutting the budget and raising taxes to address the burgeoning debt ceiling risk sending the economy into a downward spiral. But failing to act and allowing the current imbalances to remain in place risk even more dramatic consequences. The inherent uncertainty in either approach is temporary, but the long-term effect is meaningful and potentially devastating.

Market Reaction

M&A transactions perhaps best reflect the combined impact of the uncertainty. Corporations are laden with cash, and buyout firms remain hungry for deals. Nonetheless, M&A activity is down significantly from 2011 (**Figure 1**). The decline in M&A volume is in part a function of the volatile macroeconomic picture, because firms remain reticent to commit to large-scale, costly initiatives. It may also be due to credit market volatility over the past 12 months.

The fixed income markets experienced some stability during the first half of 2012 as investors pursued a flight to quality. Corporate bond issuances were strong in total and saw declining spreads throughout the period, while high yield issuances were generally even with 2011. CLO issuance, after an anemic 2011, started strong in 2012, with total new issuances in excess of $17 billion during the first half of the year. New issuances averaged in excess of $4 billion per month during the second quarter of 2012.

The middle market has seen an uptick in activity, with a void in money center bank lending being filled by regional banks, newly minted asset-based groups, and the U.S. Small Business Association's Small Business Investment Company (SBIC) program. Second lien and unitranche lenders are active and are aggressively competing for deals. Accordingly, middle market competitive dynamics have been intense, characterized by excess supply and limited demand, due in part to compressed strategic spending and M&A volume.

Significant pricing pressure was reported by market participants during the first half of 2012. This asset class has been attractive to investors seeking quality in volatile markets.

High yield default rates remain low, increasing slightly to 2.2 percent in July from 2 percent in June. Fitch Ratings predicted that the default rate would increase and noted a negative trend at the end of July, as the entire pool of bonds rated CCC or lower, at $221.7 billion, represented 21 percent of market volume, up from $196.8 billion, or 19 percent, at the beginning of the year. The CCC share had risen for three consecutive months and was at its highest level since May 2010.

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Leveraged loan defaults indicate a similar trend, with a current default rate of 1.04 percent, up from 0.21 percent at year-end 2011. Commercial bankruptcy filings were down during the first six months of 2012. Taken as a whole, the default rates and related trends present something of a mixed message. Default rates are low while select trends are negative. Much of the excess from the go-go days has washed through the system. This, combined with relatively anemic new issuance from 2008-2010, helps explain the low default rates. Conversely, economic volatility appears to be pushing such rates back up.

Tight Timelines

Given the volatility and the magnitude of the 2007-2009 recession, some projected that the beginning of the recovery cycle would be an incredibly busy time for the restructuring, turnaround, and insolvency industries. While the industry certainly experienced a surge between 2008 and 2010, it would appear to have been short-lived (**Figure 2**).

According to the American Bankruptcy Institute, corporate bankruptcy filings reached a recession peak of 60,837 in 2009, declining to 47,806 in 2011. The number of cases filed has decreased quarter by quarter, with 10,374 filed in the second quarter of 2012 compared to 12,304 for the second quarter of 2011.

The drop-off in bankruptcy filings has contributed to contraction in the restructuring industry as professional service firms reevaluate practice group performance. The industry is also experiencing more lateral moves by professionals as advisory firms develop opportunistic strategies. Industry expertise and brand recognition take on greater significance to troubled companies and their stakeholders as market uncertainty compresses timelines for improvement.

The ongoing uncertainty in the economic, employment, and capital markets in the U.S. and around the world continues to impact decision making. Sustained credit growth depends on spending and capital investment to reverse the downward trend. Certain market trends may indicate stability in the credit markets, but may also reflect the short-term focus of an investor class seeking quality assets in a volatile, unpredictable world. True expansion and growth will only come about when the wild swings, piercing headlines, and destabilizing events have subsided. ■

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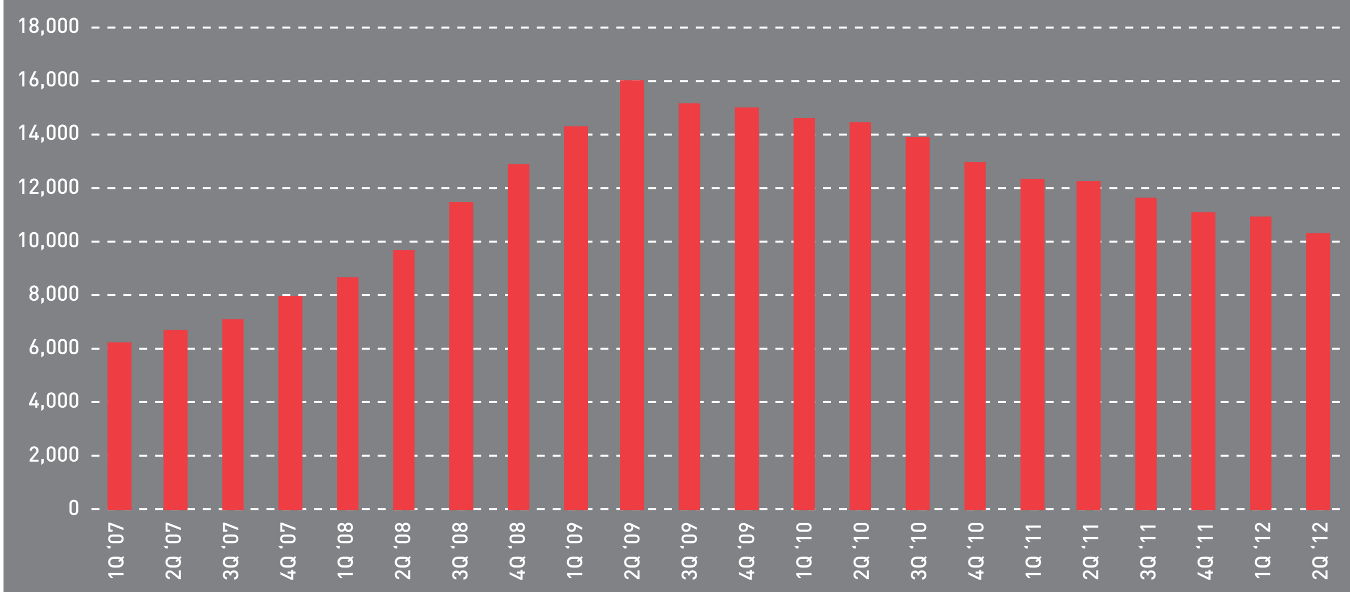
Figure 2

Quarterly Corporate Chapter 11 Bankruptcy Filings



Source: American Bankruptcy Institute