The economy to come

# How We'll Surf (and Trade) the Looming Bankruptcy "Tidal Wave"

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Thousands of American companies – many of them publicly traded – are sliding toward bankruptcy.

The U.S. Federal Reserve is buying the bonds of some failing companies in an effort to keep them alive.

But this is one gambit that's not going to work.

The coming tidal wave of bankruptcies will overwhelm the Fed's rescue efforts and could sink the stock market.

Here's what's coming our way. And here's how you can take the bit of "market intelligence" we're going to give you today and turn it to your personal advantage.

Got Junk?

Let's face it: Hundreds of companies that were in trouble before the pandemic sealed their fate. Most of them, known as "zombie companies," stayed alive by issuing and rolling over their junk-rated debt.

Yield-hungry investors queued up to buy the high-yielding debt of these wheezing enterprises (mostly in "packaged" form) – understanding there could defaults, but reasoning that a diversified portfolio with a high-enough yield would still net good returns.

Now, in the wake of the COVID-19 pandemic, investors are afraid more companies will default, meaning the risk of holding junk bonds has become untenable for a lot of portfolio managers.

At the same time, companies with investment-grade ratings are facing downgrades as their prospects sink in lockstep with the economy.

An astounding two-thirds of all non-financial corporate bonds in the United States are rated junk or "BBB," which is just one level above junk.

Adding insult to injury: **Goldman Sachs Group Corp.** (NYSE: [GS](https://moneymorning.websol.barchart.com/?module=symbolSearch&override=1&symbol=GS)) in April predicted that more than $550 billion worth of investment-grade bonds will fall to "junk" status by October.

If that happens, the aggregate value of junk bonds would reach a stunning $1.375 trillion.

The fallout will be clear.

Edward Altman, an emeritus professor of finance for the New York University Stern School of Business, estimates about 8% of all firms whose debt is rated speculative grade will default in the next 12 months.

Over the next two years, 20% will go belly-up. Altman also expects at least 165 large firms with more than $100 million in liabilities will go bankrupt by the end of 2020.

Altman isn't alone in sounding the alarm.

Back on May 12, James Bullard, president of the Federal Reserve Bank of St. Louis, announced that "YOU WILL get business failures on a grand scale."

There were 32 worldwide junk-bond defaults in April – 21 of them in America. That's the most in any one-month period since the financial crisis a decade ago.

At the peak of the financial crisis, the global default rate for junk bonds was 10%.

The credit-rating agency Moody's predicts that if the current crisis is more severe than the financial crisis, the default rate could rise to 21%.

It's Not Just a Wave – It's a Tsunami

The coming bankruptcy wave could be worse than during the financial crisis because it will be more widespread, says Debra Dandeneau, a bankruptcy specialist at Baker McKenzie law firm.

All the companies at risk have added debt to their balance sheets within the past three years, and some have rolled over maturing debt regularly – often at higher rates.

As investment-grade debt gets downgraded and sub-investment grade debt prices fall, as investors back away from owning debt products whose underlying issues slide closer to default, the negative effects show up in several ways.

Not only does the equity of faltering companies get priced lower, but hedge funds and other aggressive investors and traders buy credit-default insurance on teetering companies.

Downward pressure on share prices and debt prices alerts other traders to the plight of these distressed companies. And they make additional bets against those struggling companies, sometimes sealing their fate.

The Federal Reserve last month announced its intention to support the secondary market for junk bonds through the central bank's new "Secondary Market Corporate Credit Facility." The program's goal is to buy bonds, including credit ETFs – something the Fed has never done before – to shore up prices of investment-grade bonds, as well as "fallen angels," or junk bonds.

With this move, the central bankers' message to the high-yield market is that they're there and willing to support prices so issuers can continue rolling over their debt and staving off insolvency and bankruptcy.

But even the Fed program may come up short.

The Central Bank would have to buy hundreds of billions of dollars' worth of junk bonds to save the secondary market from drowning in the coming wave of expected bankruptcies.

Some of the hardest-hit businesses are restaurants, retailers, and mall owners and operators.

According to the retail-analytics firm Coresight Research, U.S. retailers have announced 2,210 permanent closures already this year – and most were made public before the pandemic began.

That follows a year in which more than 9,700 stores closed, Coresight said.

Papyrus, Modell's Sporting Goods, and Art Van Furniture had already revealed plans to liquidate all 635 of their locations this year.

Besides retailers who've already declared bankruptcy, there are several others likely to declare once the economy opens and they can liquidate inventories.

Creditors have taken a step back during the shutdown and are essentially waiting for the stores to reopen to get a better sense of the liquidation value of their collateral.

The timing of store reopenings will be a driver of liquidation value, just as inventory values will be critical to determining bankruptcy timing and options.

After the lockdown measures are lifted and stores and other industries reopen, lenders may start aggressively pushing companies into bankruptcy.

On the subject of malls, S&P credit analyst Sarah Wyeth wrote in a recent research note, "In particular, if there were any doubts about the eventual demise of many American malls, the impact of the pandemic will likely dispel them."

Restaurants are equally at risk, according to credit ratings agencies.

Of the 125 restaurant or retail companies tracked by S&P Global Ratings, about 30% now have a credit rating that indicates they have at least a one in two chance of defaulting on their debts. A default is often a precursor of bankruptcy or liquidation.

Chapter 11 bankruptcies allow companies to reorganize and reduce their debt levels, while smaller companies may be forced into Chapter 7, which liquidates a company's assets to pay off creditors.

"Traditional Chapter 11 proceedings have often been too expensive for many small businesses, leaving Chapter 7 as the only viable option," said Michael Weiner, a partner at Slate Law Group in San Diego.

Law Prof. Jared Ellias, of the University of California at Hastings, argues that "lenders don't know whether to restructure out of court, grant forbearance or insist on Chapter 11 bankruptcy when you have no idea when a firm will make money again."

Courts could be flooded, experts say.

"It will be very difficult for courts to keep up with the onslaught," says Judith Fitzgerald, a former bankruptcy judge now at Tucker Arensberg, a law firm in Pittsburgh.

Vincent Buccola, a legal studies professor at Wharton business school, believes "prepackaged" bankruptcy deals and "debt exchanges" (lenders agreeing to swap less-onerous new debt for old unserviceable debt) that are done out of court will be a more viable option because they can be settled quickly.

Ride It Out Like a Pro

Given this outlook, what can you do?

What should you do?

In most bankruptcy scenarios, shareholders face being wiped out.

That's why you need to be aware of ratings downgrades and how companies' debt is being priced in the secondary market.

Astute investors are aware of companies' capital structures and how their bonds are trading, and often are the first ones to short the equity companies at risk.

In my newsletter subscription services and sometimes in [***Total Wealth***](https://totalwealthresearch.com/), my free weekly e-letter, I identify companies at risk of defaulting on their debt and potentially facing bankruptcy, and I recommend ways to profit on these companies' failures.

For investors looking for stocks to buy, the move to make is to focus on the "haves" – the companies with strong businesses, a compelling post-pandemic story, and balance sheets with the muscle to weather any post-pandemic storm.

Right now, the companies I like in this category include tech giant **Microsoft Corp.**(NASDAQ: [MSFT](https://moneymorning.websol.barchart.com/?module=symbolSearch&override=1&symbol=MSFT)), mutual-fund heavyweight**T. Rowe Price Group Inc.**(NASDAQ: [TROW](https://moneymorning.websol.barchart.com/?module=symbolSearch&override=1&symbol=TROW)), and logistics player**Expeditors International of Washington Inc.**(NASDAQ: [EXPD](https://moneymorning.websol.barchart.com/?module=symbolSearch&override=1&symbol=EXPD)), each of which have just token debt amounts on their balance sheets.

And then there are companies whose stocks soared because of lockdowns, specifically **Dominos Pizza Inc.**(NYSE: [DPZ](https://moneymorning.websol.barchart.com/?module=symbolSearch&override=1&symbol=DPZ)), whose equity valuation masks the huge debt load that the company is actually carrying.

Dominos' share price won't stay so high for too long once the U.S. economy begins to reopen – consumers start returning to their favorite restaurants – and investors will focus on the pizza-maker's knee-buckling debt yoke.

For traders, there's a big opportunity in shorting the shares of the "zombie firms"- as well as overleveraged companies experiencing revenue evaporation.

There are plenty of zombie companies, but nowhere are they more concentrated than in the energy sector – where firms like **Equitrans Midstream Corp.**(NYSE: [ETRN](https://moneymorning.websol.barchart.com/?module=symbolSearch&override=1&symbol=ETRN)), **Tetra Technologies Inc.**(NYSE: [TTI](https://moneymorning.websol.barchart.com/?module=symbolSearch&override=1&symbol=TTI)), and **Denbury Resources**(NYSE: [DNR](https://moneymorning.websol.barchart.com/?module=symbolSearch&override=1&symbol=DNR)) are possibly headed onto the DNR (as in *"Do Not Resuscitate"*) list.

Overleveraged companies worth shorting include **General Electric Co.**(NYSE: [GE](https://moneymorning.websol.barchart.com/?module=symbolSearch&override=1&symbol=GE)) (anybody really surprised?), **AMC Entertainment Holdings Inc.**(NYSE: [AMC](https://moneymorning.websol.barchart.com/?module=symbolSearch&override=1&symbol=AMC)), and **Community Health Systems Inc.**(NYSE: [CYH](https://moneymorning.websol.barchart.com/?module=symbolSearch&override=1&symbol=CYH)).

Besides the losers, one strategy we're employing in my advisory service, [***The Money Map Report***](https://moneymappress.com/subscription/money-map-report/), is buying one big company capable of handling the tsunami of bankruptcies coming our way.

We're also buying the workout and turnaround companies that will reap huge rewards from rolling up bankrupt companies, restructuring others, and taking over others to fix and sell during the recovery.

There's a lesson here – an important one – that I learned during my time as a trader, hedge-fund manager, and professional investor.

You see, I ultimately discovered that in any market, in any environment, and in any economy, there's always a place to make money.

*Always*.

So it's not the "news" – good, bad, or neutral – that matters.

It's what you *do* with the insights you develop from that news that matters.

The analysis shows you where to go to find those moneymaking opportunities and profits, whether it be successful, smart companies or misguided ones.

And we'll have fun along the way tracking them together.

In the meantime, don't forget to check out my colleague Michael Robinson's latest presentation for an opportunity you don't want to miss…

You see, there are over 70 companies racing to develop the vaccine for coronavirus as you read this. Any one of them could pull it off, but it's not just about developing the vaccine. It's about developing the vaccine FIRST.

Most people would put their confidence in large biotech institutes, but Michael has overwhelming evidence that *this* tiny biotech company 1/200th the size of Pfizer could finish in first place.

The evidence: "They're already planning to ship their first million doses by year's end." [**Click here to get the full details**](https://pro.moneymappressinfo.com/m/1559891)…

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