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Marketing Material

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CORPORATE AMERICA: FLOAT BABY FLOAT

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IN A NUTSHELL

- Corporate America could float about $1 trillion of additional debt in 2020
- Corporates, sole proprietorships and not-for-profits will be the first loss absorbers of sharp revenue declines
- The Treasury is providing relief through corporate-credit and liquidity programs via the SBA and Fed
- We expect higher S&P non-financial debt/EBITDA, lower EBITDA/interest expense ratios
- Despite higher credit costs and the associated risks, banks are likely to boost loans

CORPORATE AMERICA COULD FLOAT ABOUT $1 TRILLION OF ADDITIONAL DEBT IN 2020

The shutdown of many U.S. businesses will likely continue into May, but most banks and credit markets are generally open and functioning. Because the financial system can largely operate in the electronic world and because the balance sheets of banks and much of corporate America were healthy before the pandemic, we expect the extension and drawdown of credit to be the economy's lifeline until the recovery begins. We expect 2020 to break prior records for net issuance of corporate-debt securities and origination of bank and other loans to companies. This borrowing will cause long-lasting shifts in capital structure and claims on operating profits and enterprise value, from in small parts to in full, but it should safeguard the survival of businesses in the shutdown. Equity will sacrifice recovery upside as creditors bear unusually high short-term risk.

"Credit is mans-confidence-in-man." – Senator Daniel Webster.

ABSORPTION OF EXTRAORDINARY LOSSES: COMPANIES, GOVERNMENT, HOUSEHOLDS

Nominal U.S. gross domestic product (GDP) was $21 trillion in 2019. The costs incurred by corporates, sole proprietorships, and not for profits are 85% of U.S. GDP. Because these entities direct most of the economy and bear most costs, they will be the first loss absorbers of sharp revenue declines while trying to meet fixed and (more socially) sticky expenses such as rent, interest, property taxes and employee pay and benefits. We expect these entities to suffer $1 trillion in losses in 2020 that will require borrowing to fund. We think that about half the losses are suffered by publicly listed companies and large private firms with access to fixed-income capital markets. We think the other half of these losses are suffered by small, medium and some large firms that will need to turn to banks for credit and emergency Small Business Administration (SBA) loans. Including loss funding, raising cash and working capital and some rescue or opportunistic actions by those with access to credit, we expect net issuance of corporate-credit securities to jump by about $750 billion in 2020 to over $10 trillion. We also expect corporate loans to increase by roughly $250 billion net of forgiven Paycheck Protection loans.

GOVERNMENT CORPORATE CREDIT AND LIQUIDITY PROGRAMS VIA THE SBA AND FED

Per the $2 trillion+ CARES Act, the U.S. Treasury provided $349 billion to the Small Business Administration for loans to firms with under 500 employees. We expect 80% or more of these loans to be forgiven under Paycheck Protection. The Treasury also provided $454 billion to the U.S. Federal Reserve (Fed) to use for new credit facilities that will purchase existing and new-issuance Investment Grade (IG) corporate and municipal debt. The Fed might initiate partner programs with banks to provide credit to mid- and larger-sized firms not IG rated or without collateral to secure loans or securitize. The new Fed facilities can leverage the capital provided by the Treasury, perhaps by a factor of 10 to 1; thus these facilities could provide $4 trillion of credit to

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companies and municipalities. Because the Fed will buy Treasuries to support a ~$2.5 trillion federal deficit in 2020 and mortgage-backed securities, while also deploying these new credit facilities, the Fed's balance sheet could expand from about $4 trillion to $7-10 trillion.

HIGHER S&P NON-FINANCIAL DEBT/EBITDA, LOWER EBITDA/INTEREST EXPENSE

Corporate America's debt-to-GDP ratio increased in recent years, but so did its assets compared to GDP. We considered leverage ratios healthy at corporate America, especially at large-cap companies, but with some concerns for small caps and especially at energy, retailers and the more cyclically exposed parts of real estate. S&P 500 non-financial earnings before interest, tax, depreciation and amortization (EBITDA) / net interest expense was very strong at over 12x in 2019, but it likely falls to about 8x in 2020. But this masks what's likely to be inadequate coverage, covenant breaches and reorganizations at many of the vulnerable industries and smaller companies. Russell 2000 non-financial leverage ratios were 150% of S&P non-financials in 2019.

BANKS LIKELY TO BOOST LOANS DESPITE HIGHER CREDIT COSTS; COUNTERCYCLICAL, BUT RISKY

Banks went into this crisis with strong balance sheets and liquidity. We expect banks to suffer high credit costs this year and next, but not to shrink their balance sheets like they did in the last recession. Despite rising credit costs, we expect banks to initiate new loans and provide favorable terms of forbearance with missed payments being rolled into outstanding principle balances without penalty. While this is a risky strategy, and loan-loss provisions must climb as a result of this, we think with Fed support and public confidence that this approach is in the best interest of the economy and also the banks. However, banks should raise additional loss-participating capital and curtail dividends to fortify.

GLOSSARY

In some transactions, collateral is used to protect the lender against the borrower's default. In case the borrower defaults on the interest or principal payment, the collateral can be used to offset the loan.

A corporate bond is a bond issued by a corporation in order finance their business.

Covenants designate contractual obligations or restrictions intended to protect the financial interests of creditors.

Coverage broadly defines the degree to which an issuers earnings, cash flow and assets allow it to cover interest payments and other liabilities.

Cyclical is something that moves with the cycle.

A dividend is a distribution of a portion of a company's earnings to its shareholders.

EBITDA (earnings, before interest expenses, taxes, depreciation and amortization) is an accounting measure calculated using a company's net earnings, before interest expenses, taxes, depreciation and amortization are subtracted.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Investment grade (IG) refers to a credit rating from a rating agency that indicates that a bond has a relatively low risk of default.

Leverage attempts to boost gains when investing through the use of borrowing to purchase assets.

A mortgage-backed security (MBS) is a special type of asset-backed security where the holder receives interest and redemption payments from pooled mortgage debtors, secured by the underlying mortgages.

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The Russell 2000 Index is an index that captures the 2,000 smallest stocks of the Russell-3000 index, which again comprises 3,000 small- and mid-cap U.S. listed stocks.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

The U.S. Federal Reserve, often referred to as "the Fed", is the central bank of the United States.

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