THEMATIC

HY default rates: recent and expected trends

Persistent supportive funding conditions and the improved macro picture are consistent with a current and expected benign picture for US and European default cycles, which are likely to remain on a downward trend in the coming months. Emerging markets' high yield corporate default rate remains quite low and we expect a further decrease in the next month. Higher risk in China, in particular in the property sector. Beijing will continue with financial de-risking and reducing housing sector leverage but systemic financial risk will be prevented.

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Our views on US and Europe

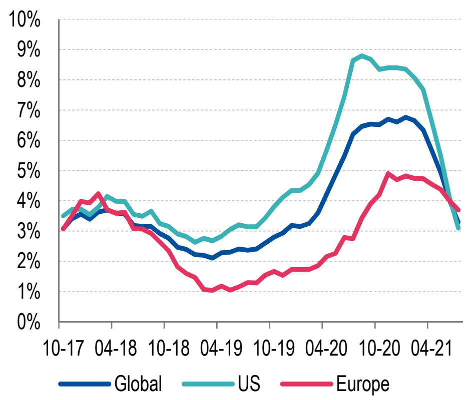
Global default rates keep falling significantly, thanks to a strong economic recovery, abundant liquidity in the capital markets and persistently low cost of debt servicing. According to the latest figures from Moody's, the trailing 12-month global speculative-grade default rate was 3.3% at the end of July, the same as the pre-pandemic level, at the end of February 2020. July also marked the seventh consecutive month in which the global rate had declined since hitting a cyclical peak of 6.8% in December 2020. A look at trends by geographical area over the past few months shows that the speculative grade default rate has fallen more rapidly in the US than Europe, down from higher peaks, and finally matched the remaining gap with Europe in June. In July the US default rate finally fell to 3.1% from 4.0% in June, while the European default rate fell to 3.7% from previous month's 4.0%. In first half of this year the default number totalled 28 companies, roughly just a quarter of the 114 defaults that occurred in the same period last year (H1-'20).

As we have often underlined in previous publications, this cycle was mostly concentrated in the lowest-rated and most vulnerable names. Thanks mainly to prompt and effective policy intervention, BB and B-rated default rates have remained very low by historical standards, as no credit crunch took place and financial conditions remained supportive. Just as CCC default rates drove this cycle upward, the recent downward move has been led by the lowest-rated segments. Over the past few months their default rate has roughly halved from cyclical peaks above 30%, while other rating categories are already close to being quite low.

Moody's expects the downward trend to continue in the next few months and then to stabilise below 2% by the end of the year and in H1 2022. In short, the global default rate should keep falling, albeit at a slower pace than in H1, and the latest 12-month projections by the rating agency for US and European HY default rates point to 2% for both areas, while forecasting even lower levels by the end of this year, respectively at 1.5% and 1.8%. Moody's baseline scenarios for the two areas assume ongoing supportive funding conditions and an improved macro picture. In our view, this benign picture is consistent with distress ratios and other indicators of financing conditions remaining at quite favourable levels by historical standards and is consistent as well with macro and micro prospects. In this respect, a look at European market sees supportive readings from the latest bank lending standards survey published by the ECB and encouraging trends in HY primary market. On one side, loans standards applied by banks to non-financial companies have improved in the last two quarters, while, on the other, a remarkable volume of refunding activity through bonds issuance has made it possible for many companies to increase the average duration of their debt at very low costs. Fundamental trends keep showing supportive earning growth, ultimately being consistent with on-going improvement in credit metrics and lower default rates.

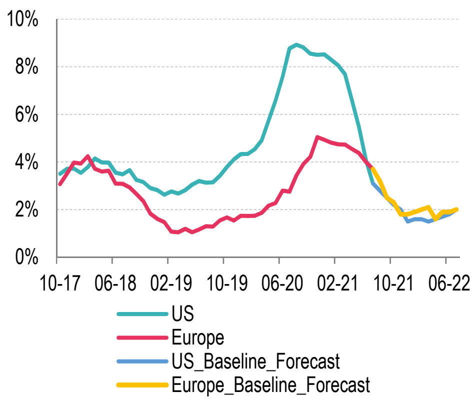
A look at the European market sees supportive readings from the latest bank lending standards and encouraging trends in the HY primary market

1/ **Global HY Default rates (Moody's)**



Source: Moody's, Amundi Research - Data as of 13/08/2021

2/ **US and Europe HY Default rates: actual and projected by Moody's**



Source: Moody's, Amundi Research - Data as of 13/08/2021

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The emerging high yield corporate default rate is stabilising, at slightly above 3%

Internal calculations see GEM HY corporate default rates decreasing further on a six-month horizon in the range of 1.8%-2.3%

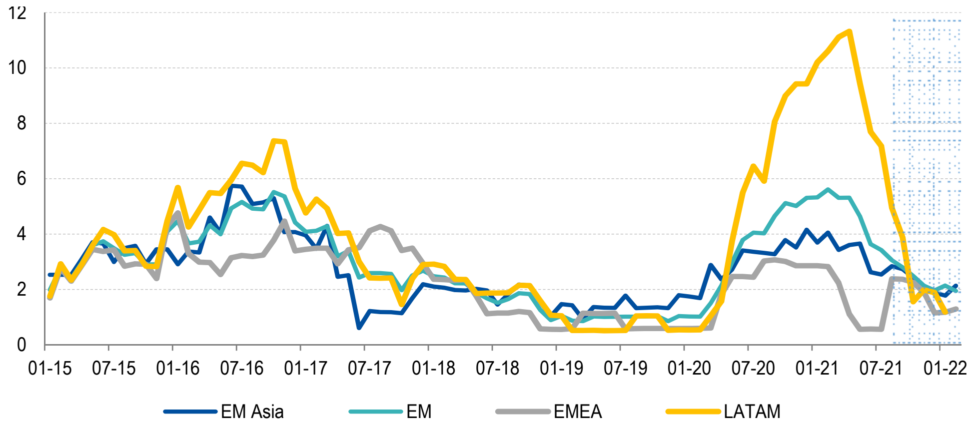
Risk perception remains higher in China, in particular in the property sector. We expect, however, Beijing will carefully prevent systemic financial risk

Our views on emerging markets

Emerging markets' high yield corporate default rate (source: Bank of America) is stabilising at slightly above 3% (3.4% in August from 3.6% in July). The region with the worst default rate is Latin America (7%), particularly Argentina and Mexico. The distress ratio in Latin America is close to 10.6%, but excluding Argentina is it only 2%. EMEA, on the other side, is the safest region (with a default rate of 0.56%).

In terms of forecasts, our internal calculations see GEM HY corporate default rates decreasing further on a six-month horizon in the range 1.8%-2.3%. Country risk perception (CDS) has stabilised, but spreads are not showing any further improvement, and this is visible in the distress ratio, which has moved up again to 17.6% in August from 15.5% in July. GEM earnings growth expectations are going to move down on a 12-month horizon from the current 18% to 16%, due to the slowing down recovery, which leaves less room for further pickup. On the positive side, leverage is improving for GEM, in both net (4.5) and gross (6.3) terms. Global financial conditions remains quite supportive and volatility is low.

3/ EM HY Default - forecast



Source: Bank of America, Amundi Research - Data as of 23/08/2021

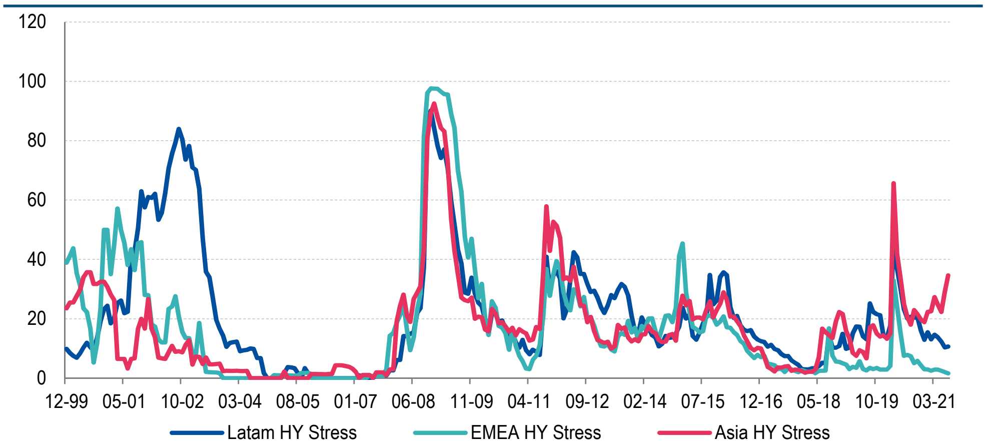
At the regional level, as we have seen, the Latin America default rate is still high, mainly in Argentina. We see some improvements in the next six months (default at 1.5%-2%) thanks to not excessive funding requests and a further recovery in earnings growth (Latin America is still a laggard).

In EMEA and EM Asia, default forecasts remain contained and not very far from current levels.

EMEA is the region where both current default rates (0.56%) and six-month forecast rates (1.2%) are lower, thanks to very contained leverage (net debt/EBITDA ratio at 2.7 and gross at 4) and distress ratios (1.6%).

On the other side, emerging Asia remains the region with the highest forecasted default rates on a six-month horizon, at slightly above 2%. In this region, the spread-to-worst increased further last month, and the distress ratio is mounting again (to 34.6% from 29%). Risk perception remains high mainly in China, in particular in the property sector, where spreads have widened. The case of Evergrande illustrates that Beijing will continue with financial de-risking and reducing housing sector leverage, but will carefully prevent systemic financial risk. In light of weakening growth momentum and with inflation risks at bay, we expect China's overall policy stance to turn more decisively to the dovish side.

4/ Distress ratio



Source: Bank of America, Amundi Research - Data as of 23/08/2021

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