THEMATIC

HY default cycle and rating changes: how it is "different" this time

Despite a severe macro contraction, policy reaction to the covid-crisis limited most of corporates' rating migration and HY defaults to low-rated debt. This piece outlines our expectations on both rating and default cycles to come.

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A) The default cycle

1. Global HY default rates doubled in just a few months to their highest levels in the last decade

Global defaults mainly driven by US companies

Reflecting the credit effects of the coronavirus-induced recession and the stress already prevailing in the energy sector before the crisis, the global default rate of speculative grade companies has now peaked in relation to the last decade. According to Moody's, since the outbreak of the pandemic crisis, in just six months, the US HY default rate almost doubled, rising from a pre-covid level of 4.5% to 8.7% by the end of August, before subsiding to 8.5% in September. The European default rate has doubled also but from much lower starting levels: at just 1.7% in February, it rose to 3.4% in July and 3.9% in September: the gap between US and European default rates moved therefore from 2.8% in February to close to 5% in September.

So far, the global speculative-grade default cycle among advanced economies looks mostly like a US story and not just on a simple default rate basis: North America accounted for 117 defaults in the first nine months of the year while Europe accounted for 27. The dominant contribution of US companies to the rise in global defaults is evident and despite there being several reasons for this, they seem to be mainly due to a different sectoral exposure and rating mix.

Mainly a low-rated debt and sectoral story

a. US defaults mostly driven by energy and retail...

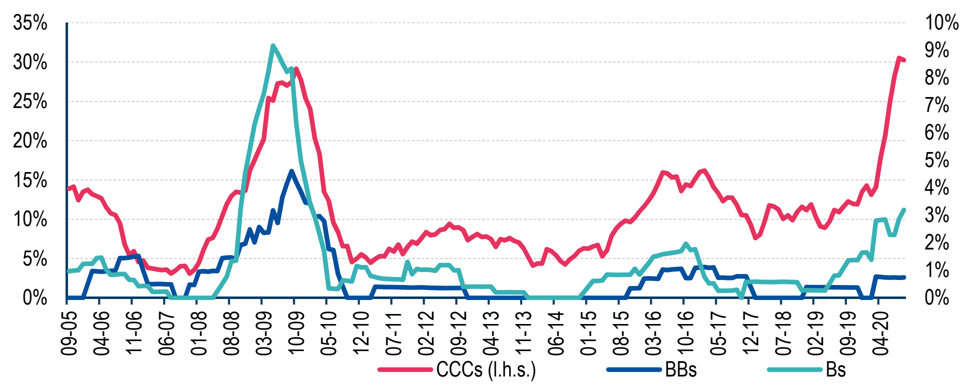
Depressed oil prices created a challenging operating environment for the Oil & Gas sector, and specifically for Exploration & Production and Oilfield Service companies, the most sensitive to the sharp fall recorded in energy prices. In September, four other companies belonging to these business-models defaulted, bringing the entire sector's year-to-date total to 41. The other two sectors accounting for a large proportion of defaults in the US, and struggling more than others with business disruption related to the pandemic, are Retail with 21 defaults year to date, followed by Business Services, with 19 defaults. Moody's recently pointed out that the newcomers in the default cycle tend to be those sectors mostly impacted by disruptions produced by the pandemic crisis: *"In the coming year, we expect Business Services to have the largest number of defaults, followed by Hotel, Gaming & Leisure and Oil & Gas. As measured by default rates, however, Hotel, Gaming & Leisure will likely be the most troubled sector globally."*

b.…and by a higher weighting of lower-rated debt

Broadening the analysis to the rating breakdown, the current crisis looks quite different from previous ones. At the time of writing, with default rates doubling seven full months into the crisis, the trend was almost entirely a CCC-rated story, as high and mid-rated companies still show very few bankruptcies, close to historical low levels. Interestingly, as chart 2) shows, current BB-rated and single B-rated default rates are at just 0.7% and 3.2% respectively, while CCC-rated default rates have already jumped to the highest levels of the GFC, close to 30%. Moody's assessment of this aspect shows that this dichotomy is likely to remain over

For the first time, no credit crunch in high yield markets took place, while a strong increase in refinancing activity left default rates a lowest rating/sector story

1/ US HY default rates, by rating



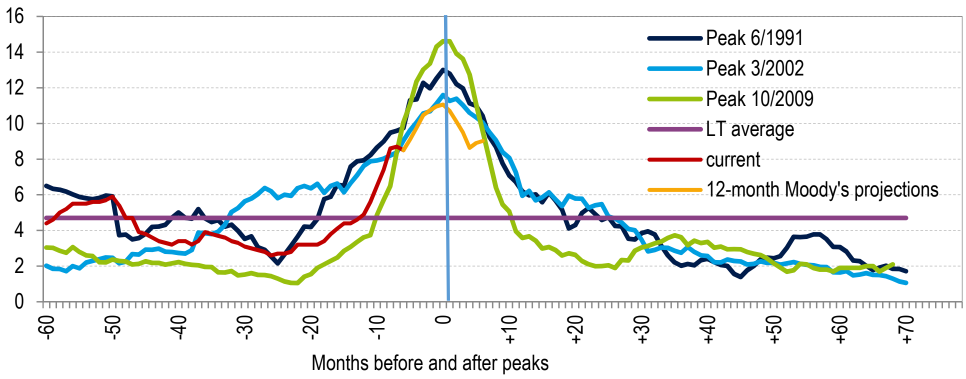
Source: BofA ML, Amundi Research - Data as of September 2020

It would be reasonable to assume that the default rates trend will be more uneven than in previous cycles

the next two years, when a macroeconomic rebound is expected, as *"the uneven economic recovery will likely be insufficient to save many of the weakest companies from default, especially those in the hardest hit sectors or those that were already struggling before the coronavirus."*

Extraordinary fiscal and monetary reaction to the crisis, both in the US and in Europe, limited its worst impacts to the most vulnerable companies rated speculative grade, mostly lower-rated and, for example, not benefiting like BBs from Fed intervention in favour of fallen angels. For the first time, no credit crunch in high yield markets took place, while a strong increase in refinancing activity left default rates a lowest rating/sector story. The Fed was quite effective in keeping defaults from rising through its unprecedented active approach, entering corporate purchases for the first time, and even giving support to fallen angels. In Europe, the combination of unprecedented fiscal measures especially through state guarantees, and all of the liquidity measures put in place by the ECB on the monetary policy side (through TLTROs initially) also proved to be quite effective in avoiding the credit crunch risk on bank loans, the key funding channel for European companies. The latter relied quite heavily on bank loan facilities and did not need to tap the bond market for substantial refinancing and to build cash buffers. Finally, the low yield environment is likely to temper defaults, too, especially among high and mid-rated companies.

2/ **Previous three cycles of US HY default rates vs the current cycle with peak projected on last Moody's forecasts**



Source: Moody's, Amundi Research - Data as of September 2020

2. Short-term prospects see a peak expected by Q1 2021, followed by lower defaults in Q2

Despite a pause in defaults over the last two months, driven by a lower number of defaulted issuers, rating agencies projections still point to a further, albeit limited, rise, especially in the US where Moody's foresees a peak close to 11% by Q1 next year. Projections for the European rate is for a lower peak at 5.6%, therefore with a wide gap remaining between the two areas. Moody's also mentions the indirect effect of ratings on its estimates: *"Our forecast of rising default rates through March 2021 is underpinned by the increased share of lower-rated companies in recent years and the downward rating momentum earlier this year following the pandemic-induced economic turmoil."* We address this important aspect of the current credit cycle in a later section. We share the view that a significant gap is likely to persist between the two areas over the next few months, as European speculative grade debt has much lower exposure to most of the troubled sectors (energy and sectors heavily hit by the pandemic crisis, such as retail and transportation) and a limited component of lowest rated debt vs the US. We also see Q1 2021 as the timing for the peak, as financial conditions and market-based leading indicators point to this outcome. Distress ratios in particular have rapidly fallen to low levels and they tend to lead defaults by between 9 to 12 months. In the reported chart, we compare the first phase of the current cycle, combining both the very first leg of actual defaults recorded with the next 12-months forecast by Moody's, with the previous three complete default cycles. The peak should be lower than in the past, mainly thanks to central bank intervention and fiscal stimulus, while the rise to the peak looks like it will be rapid and similar to the one recorded in the GFC. At the cost of potentially oversimplifying, we could say that monetary and fiscal interventions both seem behind the more rapid dynamic of GFC and (projected) current cycle, and that the lower peak expected next year has probably also to do with much higher volumes of stimulus vs the GFC.

3. What about a longer horizon?

In light of the unusual and to some extent artificial recovery in financial drivers of default rates, over a longer horizon, the risks of higher default rates mostly relate to challenging macro and micro trends on the one hand and the foreseeable reduction of current public support (for example, subsidies or loan guarantees) at some point in the future, on the other. On the macro side, the degree of the slump and the time needed to regain pre-covid levels represent the main challenges. On the micro side, we would highlight the high level of leverage many companies entered the crisis with, the legacy of a few sectors that were already in some distress, the high proportion reached by BBB debt and the likelihood of persisting effects of the crisis in some sectors over the long run. In recent months, financial leverage has generally increased, because of the sharp fall in earnings and cash flows and the increased recourse to debt in order to build liquidity buffers and to match the sudden drop in revenues. Further down the road, for example, companies in the travel and leisure industry that have accessed funding in this phase will still face a challenging outlook to their business models via their capacity to regain pre-covid levels of activity. If the near-term outlook for defaults remains quite benign vis à vis the severity of the macro backdrop, the recovery phase is also unlikely to be normal. Although a second cycle of defaults looks unlikely, unless a new shock materialises and in light of vaccine developments, in the context of very elevated leverage levels, it would be reasonable to assume that the default rates trend will be more uneven. In other words, it could stay longer than previously in the mid-range levels during the recovery phase, rather than simply dropping to historical lows and stabilising as in previous cycles.

The actions of central bankers and politicians largely contributed to the slowdown in rating downgrades from May 2020

B) Rating changes driven by the crisis

1) Recent post-Covid trends

The rating agencies downgraded a record number of issuers and drastically revised down their economic growth forecasts following the lockdown measures taken worldwide in March 2020 to limit the spread of the Covid-19 virus.

Coordinated and unprecedented intervention by governments and central banks played a key role in this crisis. Central banks have created a safety net for bond markets, in particular for corporate debt, supporting the refunding of many companies and significantly limiting the number of defaults. Indeed, many companies have used the liquidity raised to increase their cash flow and extend the average maturity of their debt. This made a big difference during the 2008 crisis.

The actions of central bankers and politicians largely contributed to the slowdown in rating downgrades from May 2020. Indeed, the rate of downgrades fell from 10-20 per week versus more than 100 per week at the end of March, early April 2020.

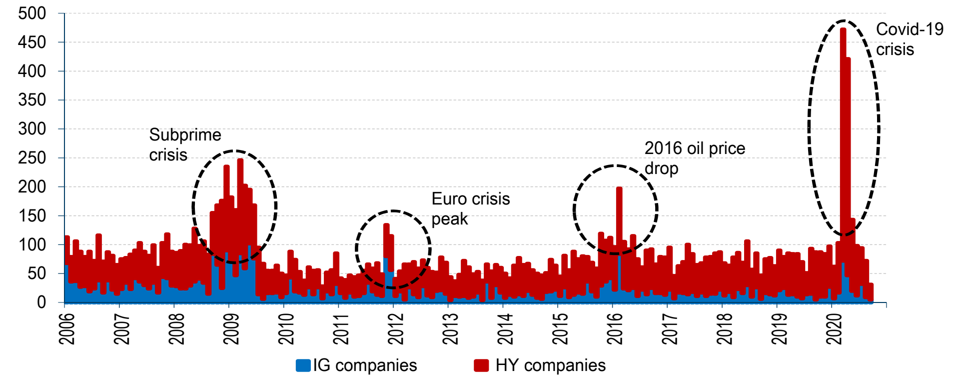
2) Details on ratings / sectors, most affected area

The number of rating downgrades for IG issuers remained limited, as these companies obtained more support from the central bank measures. **Fallen angels (companies moving from IG to HY) represented 28 issuers in total** in Europe and the US since the start of 2020. The existing cases correspond to the sectors most affected by the crisis: Energy (32% fallen angels), retail (14%) and travel (14%). **On the other hand, there have been numerous rating downgrades for High Yield companies.** These companies have a more fragile financial structure and are much more sensitive to a downturn in economic activity. As you can see in the graphs n°5 of the number of downgrades per year, there are many more downgrades for HY companies than for IG companies in 2020. Furthermore, we note that in terms of proportion in 2008 during the financial crisis, IG companies were downgraded more heavily than in 2020.

- In the US, HY issuers represent 85% of the total number of downgrades since the start of 2020.
- In Europe, on the other hand, there have been fewer downgrades of these issuers, which represent 68% of the total number of downgrades since the start of 2020.

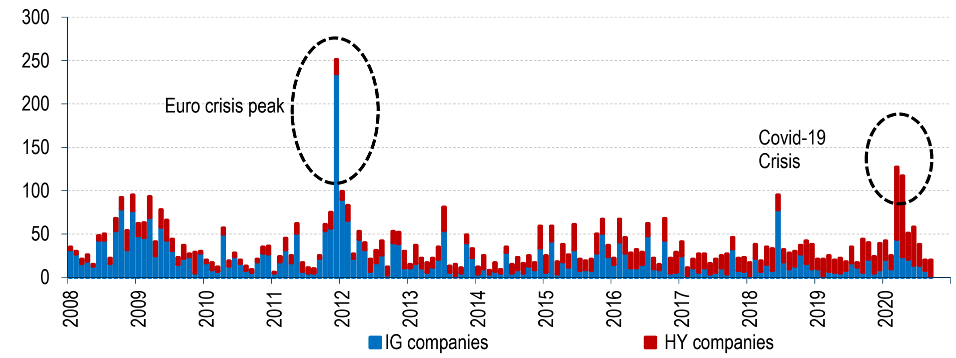
At the sector level, the deterioration is concentrated in the cyclical consumer sectors (30%) and more specifically media, entertainment, leisure and travel. These sectors are directly affected by the Covid-19 crisis. The energy and industrial sectors were also affected by this wave of deterioration.

3/ **US companies Nbr of negative rating actions S&P (Downgrade or CreditWatch negative placement)**



Source: S&P long term foreign rating, Bloomberg, Amundi Research, Data as of 14 September 2020

4/ Eurozone and UK companies Nbr of negative rating actions S&P (Downgrade or CreditWatch negative placement)



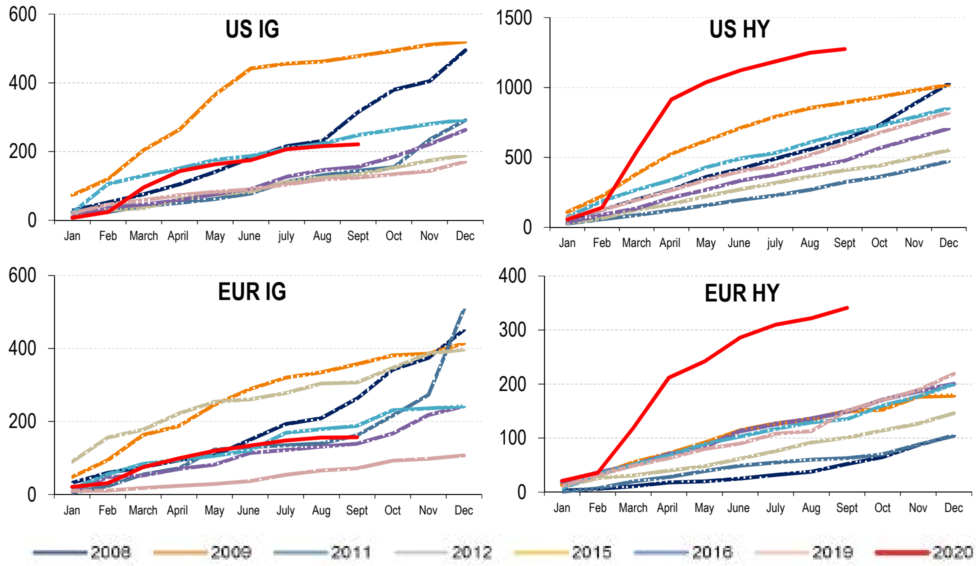
Source: Bloomberg, Amundi Research, Data as of 14 September 2020

The rating agencies are closely monitoring the evolution of (1) the health crisis and (2) the budgetary and monetary support measures put in place

3) What are the risks of a second wave of deterioration?

The rating agencies are closely monitoring the evolution of (1) the health crisis and (2) the budgetary and monetary support measures put in place. It is important to note that the rating agencies appear to be more accommodating towards companies with a high indebtedness level but which retain the capacity to generate cash flow. In fact, historically low interest rates allow companies to better sustain high levels of debt. Nevertheless, concerns remain around companies which have taken on debt to compensate for the decline in their activity and which have ultimately increased their debt.

5/ US and Eurozone+UK Companies cumulative number of negative rating actions by crisis period - S&P (Downgrade or CreditWatch negative placement)



Source: S&P long terme foreign rating,Bloomberg, Amundi Research, Data as of 14 September 2020

Conclusions

In a recession/crisis phase, default cycles are both a financial conditions story and a macro/micro story: unlike the past, these two stories have been showing diverging trends. Despite the fact that the expected economic slump (peak to trough) is far worse than during previous recessions and despite the long time needed to get back to starting GDP levels, the base case remains for a short-lived slump, thanks to extraordinary fiscal and monetary intervention. This short-term outlook seems to be confirmed by the trend in rating changes and by the fact that unprecedented stimulus reduced negative impacts on higher rated companies with respect to both the severity of the macro correction and past cycles. At the same time, the specific and global challenges for company leverage caused by the crisis and the time needed to recover may lead to more volatility than during past cycles in the phase when default rates fall from their peaks. In this respect, we believe that high quality and a focus on selection will make all the difference during the recovery phase also.

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