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Speculative grade default cycle: an earlier peak and an expected benign trend

Sergio BERTONCINI,
Senior Fixed Income Research Strategist

Extraordinary policy intervention has made this HY default cycle unusually short-lived, helping to limit quite significantly the rise in defaults among mid- and high-rated speculative grade companies. A turn into a more benign falling trend over the next quarters looks likely, in light of improved macro perspectives, expected progress in vaccinations and encouraging signals from financial drivers.

A short-lived, quite unique cycle

The current cycle has recorded a very rapid rise in default rates, driven by the credit effects of the coronavirus-induced recession and the stress already prevailing in some sectors like energy and retail, especially in the US before the crisis. After being quite low by historical standards for a long period, the global default rate of speculative grade companies rose rapidly to its highest levels in the past decade, **doubling in just a few months to 6.6% from its 3.3% level of February 2020**. The initial shock to economic activity and to financial market conditions, though the latter was only short-lived, led credit events to move rapidly between March and the summer. Accordingly, **US default rates** immediately **moved higher from the 4% area, rapidly reaching 9% in the summer**. **European default rates were more resilient in the first months of the crisis**, also thanks to much lower exposure to the energy sector and higher average credit quality, **but then to some extent they closed the gap partially with the US, moving from a 2% starting level to 5% in autumn**.

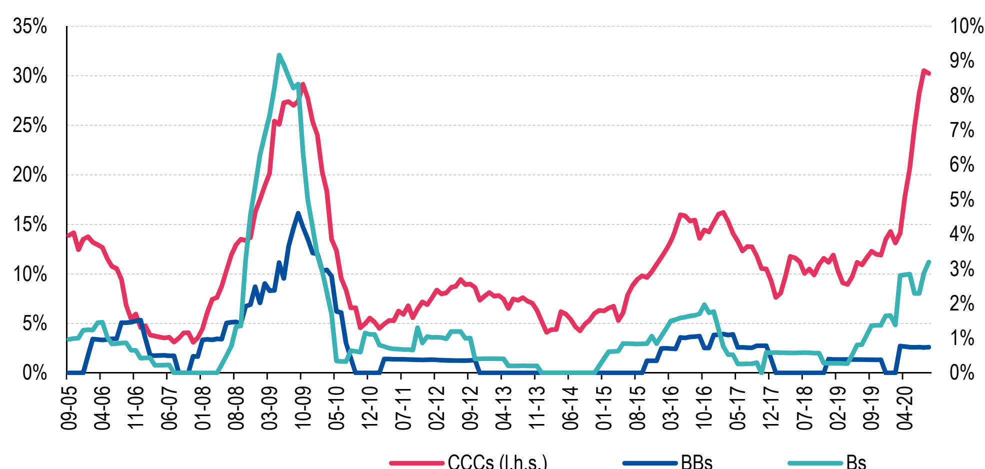
As we highlighted in previous focuses, the main drivers of the upward trend were **US companies** in the **energy sector**, challenged by depressed oil prices, which created a tough operating environment within the Oil & Gas sector, especially in the Exploration & Production and Oilfield Service subsectors. The other two sectors accounting for a large proportion of defaults in the US, and struggling more than others with pandemic-related business disruption, were Retail and Business Services.

In terms of **credit quality affected**, an analysis of the defaults rating breakdown probably shows the most striking divergence with previous experiences. Even at the time of writing, which is already seeing the start of a downward trend in bankruptcies, the cycle still looks **almost entirely a CCC-rated story**, as high and mid-rated companies still show very few defaults, close to historically low levels. Interestingly, as chart 1) shows, current BB-rated and single B-rated default rates are still quite low by historical standards for a recession, even more if we account for the severity of the 2020 contraction. In a nutshell, the chart shows that both rating categories peaked in terms of defaults at less than one third of the usual recession-high levels. On the contrary, most vulnerable and less "policy-supported" CCC-rated default rates have rapidly jumped to the highest levels of the GFC, namely in the 30% area.

Another peculiar feature of this default cycle is its limited length, made quite short-lived by unprecedented interventions of both fiscal and monetary policies through a very prompt deployment of huge stimulus, ultimately preventing a credit

Rating agencies have progressively cut their forecasts on projected defaults

1/ **US HY default rates, by rating**



Source: BofA ML, Amundi Research - Data as of March 2021

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crunch to materialize and lowering even more financing cost. For the first time in a crisis, furthermore, a strong increase in refinancing activity made default rates a lowest rating/sector story. In fact, the Fed was quite effective in keeping defaults from rising through its unprecedented active approach, entering corporate purchases for the first time, and even moving in support of 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 markets for substantial refinancing and to build cash buffers. Finally, the low-yield environment tempered defaults, too, especially among high- and mid-rated companies. With respect to the severity of GDP contraction, then, the level of the default peak looks quite low, too.

From this respect, we stress that in the past two quarters **rating agencies have progressively cut their forecasts on of projected defaults**, especially in the US, where they were higher between March and the summer. Furthermore, the duration of the cycle has been shortened, as the peak until a few months ago was still projected for the end of Q1 2021, one year since the start of the crisis. Recently, on the back of better than expected year-to-date trends and improved macro perspective, Moody's revised down its 12-month estimates, indicating as well an earlier peak in the cycle, which likely is already behind us. According to its latest projections published in the March default report, the rating agency now expects US HY and European default rates to fall, respectively, to 4.9% and to 2.8% by February 2022. The gap between the two areas should therefore remain in favour of Europe, albeit to a lesser extent than in past months. Moreover, in terms of sectoral drivers, the impact is going to turn from previous trends, as Hotel, Gaming & Leisure is expected to be among the most impacted sectors on a one-year timeframe in both advanced areas.

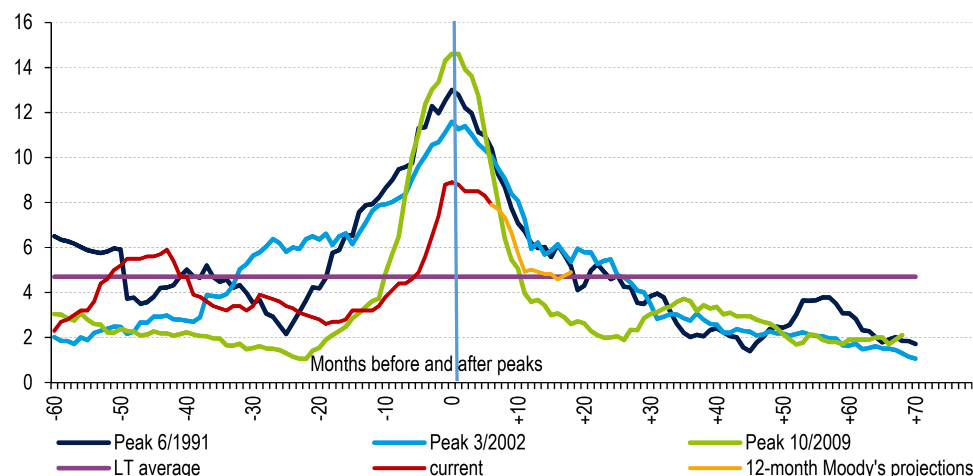
Although recent volatility has led long-term yields higher, the overall cost of financing remains close to historical lows for speculative grade companies

2021 starting trends and forward-looking indications from financial drivers of defaults

Global defaults fell in February, with the global 12-month speculative grade default rate standing at 6.6%. US HY defaults moved down to 7.9%, from 8.4% in December, while European defaults decreased slightly to 4.7%. The most active period in terms of defaults was from April to July 2020, with a monthly average of 28 global corporate debt issuer defaults. Since then, the pace has lost momentum, with the number of defaults dropping to 13 in August and September and remaining relatively stable by the end of the year. In January and February, the trend moved further down. The decline in the number of defaults that took place mainly in the US was supported by the macro recovery, persistent easy financial conditions and the very low cost of funding. According to Moody's, in fact, Europe recorded just one default in the first two months of 2021, while four US companies defaulted over the same period. Recent months showing improving trends in global trends did not change either the composition of defaults by rating or the high concentration in low-rated names we reported earlier. Assuming a downward trend in defaults over the next year, that would mean that one of the most peculiar features of this cycle on different impacts by rating category would be confirmed.

Among financial drivers of defaults that we monitor closely, distress ratios (or the percentage of bonds trading at or above 1,000 bp spreads) had already fallen rapidly

2/ **US HY current default cycle vs previous**



Source: Moody's, Amundi Research - Data as of March 2021

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and remarkably from their March peaks (above 30), sharply declining in December last year at 5.4% and 5.1%, respectively, in the US and Europe. By the end of February, these ratios had fallen further into the 3% area, reinforcing the likelihood of a low default rate environment one year from now.

Different signals came from **surveys on bank lending standards** in US and Europe: thanks to combined ECB huge liquidity injection and the ample usage of government guarantees, EZ bank lending standards remained substantially stable and close to pre-Covid levels in the first months of the crisis, until the past two quarterly readings. On the contrary, bank lending standards tightened considerably in the US in the aftermath of the crisis, with a subsequent more limited activity in leverage loan market, compared with bond market issuance. However, the very last quarterly readings have shown quite a decisive reversal, with the gap between the two areas compressing and recently turning, as European banks moved to tighter standards, while US banks retraced from tighter peaks. The very last survey recently published by the ECB pointed to a further tightening in the Eurozone, confirming a first move higher in Q3 survey, albeit with quite some differences among countries.

Interestingly, **the tightening in EZ standards affected more SMEs** in Q4, with the net percentage of banks tightening rising from 19% to 25%, while the same percentage remained stable and lower for large companies, at 16% in Q4, too. The opposite was the case for **US banks**, which saw quite a fall in the net percentage of banks tightening lending standards in the latest Fed survey, namely from 37% to 5%. The improved picture for US economy is likely behind this recent change in banks' stance towards loan standards in the US.

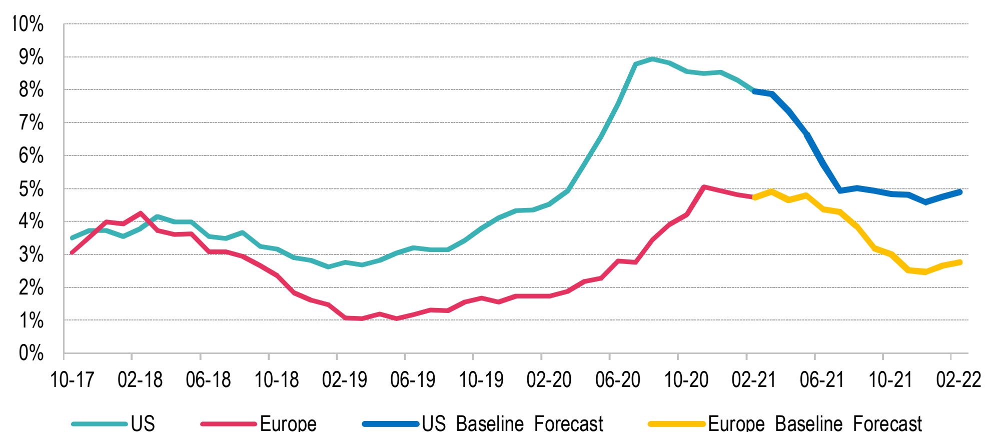
The March TLTRO auction was quite successful, with a high overall take-up above consensus, indirectly sending an encouraging signal for credit trends and future readings of lending standards. An improving macro picture expected in H2 this year and in 2022 should limit the potential for further tightening in lending standards, even though government guarantees will later fade, and contribute to stabilising the trend in the last two quarters.

Conclusions

Extraordinary fiscal and monetary intervention has made this cycle unusually short-lived, contributing to compressing the extent of rise in defaults and limiting quite significantly its negative impact on mid- and high-rated speculative grade. A turn into a more benign falling trend over the next quarters looks sustained by both improved macro perspectives on the back of further fiscal stimulus recently approved and ongoing expected progress in vaccinations, and by encouraging signals coming from financial drivers. Although recent volatility in bond markets has led long-term yields higher, the overall cost of financing remains close to historical lows for speculative grade companies, as monetary policy stances continues to anchor short-term rates at low levels in advanced economies, indirectly making spreads relatively resilient to the steepening of yield curves. We expect, as well, central banks to keep preserving easy financial conditions for the time needed to for the recovery to gain ground and move back to pre-Covid levels, ultimately indirectly supporting an improved picture for credit metrics on the fundamental side. At the same time, the specific and global challenges for company leverage caused by the crisis and the time needed to recover in some sectors maintains the preference for high quality and a focus on selection that will make all the difference during the recovery phase, too.

Finalised on 19 March 2021

3/ **HY Default rates**



Source: Moody's, Amundi Research, Data as of March 2021

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