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Defaults in First Half Concentrated in Emerging Markets

In the first half of 1997, sixteen companies have defaulted on a total of $3.25 billion of publicly held long-term debt, slightly lower than the $3.36 billion for the first half of 1996. Five of the sixteen defaulters were domiciled in emerging market countries. The fraction of defaulters coming from emerging markets, 31% year-to-date, is the highest on record, topping the 29% level reached in 1942. Still, default rates among Moody's rated issuers have remained at historically low levels throughout the first half of 1997. Economic expansion and a favorable interest rate environment have contributed to the continued financial health of corporate borrowers, and with the number of outstanding issuers and dollar volume up, default rates have continued to trend lower. In the second quarter, Moody's speculative grade trailing twelve-month issuer- and dollar-based default rates fell to 1.49% and 1.69% respectively. These rates have now fallen to post 1982 recession lows, although recent weeks' experience suggests that a rebound to more normal conditions is not unlikely.

The first quarter of 1997 was characterized by low interest rates and tight spreads and the second quarter has been much the same. The yields on long-term Treasuries finished off the quarter near their lows for the year at about 6.75% while corporate spreads have traded in a fairly tight range since April. The spread between the 7-year Treasury and Moody's 7-year speculative-grade index has hardly moved from 263 bps at the beginning of May to 267 bps at the end of June. At the cusp between investment and speculative grades, spreads have actually tightened further, with spreads over Treasuries for rated Baa3 and Ba1 issues finishing off the quarter at 93 and 133 bps, respectively.

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With low interest rates and strong investor demand creating ideal borrowing conditions, new issuance has continued to surge, both in the speculative- and investment- grade segments. Speculative-grade issuance soared to nearly $47 billion in the first half of 1997, an increase of over 30% from the same period a year ago. A major contributor to this growth has been the 144a market. Speculative grade 144a issuance climbed from $13 billion in the first half of 1996 to over $25 billion in the first half of 1997 and exceeded $18 billion in the second quarter alone. With institutional investors hungry for incremental yield, this market is likely to increase in volume and importance, at least until rates move higher and spreads reverse direction.

Asia and Latin America have been the sources of emerging market defaults in the first half of 1997. South Korea's Hanbo Steel Industry Co. defaulted on $45 million of long-term debt in January, after having amassed bank loans amounting to 20 times the company's net worth. Thailand has become a trouble spot, with the real estate firms Sahaviriya City PCL, and Somprasong Land PCL defaulting on over $100 million in January and April respectively. Weakness in Thailand's real estate market has now spilled over into the finance/securities industry, prompting a central bank move to add liquidity and reassure investors after a sharp increase in bank loan defaults. Regulators have recently suspended operations at some of the largest and oldest firms in the industry. The Argentine firm Buenos Aires Embotelladora (BAESA) which defaulted in June, is the largest franchised bottler of PepsiCo products outside the U.S. The company also sells and distributes other soft drinks and bottled water under its proprietary trademarks. Largely due to the company's costly expansion in Brazil, it posted a net loss of $452 million last year. Standstill agreements with its creditor banks did not help turn around the situation, leading to its failure to meet interest payments on its 8.5% negotiable obligations due 2000. In Mexico, Grupo Simec S.A. de C.V. (Simec), a manufacturer of steel and aluminum products for the construction industry, also defaulted in June. Simec's outstanding medium term notes are unconditionally guaranteed by its parent company Grupo Sidek S.A. de C.V.. The decision to defer interest payments and to offer to exchange its public notes for new non-guaranteed notes was prompted by persistent financial difficulties of Grupo Sidek, which is currently restructuring after failing on commercial paper payments in 1996.

In spite of the health of the U.S. economy, isolated domestic defaults have continued through the first half of 1997. Two noteworthy cases involve the repeat offenders Barry's Jewelers, Inc. and Harvard Industries, Inc. who have filed for Chapter 11 for the second and third times respectively. Barry's Jewelers' continued focus on risky credit sales in the bridal market segment again led to its inability to service its debt. Harvard's May 8th filing marked the second quarter's largest default, adding nearly $300 million to the default total. Poorly priced contracts and capacity constraints at the company's Doehler-Jarvis subsidiary acquired in the middle of 1996, produced a $198 million loss in the first quarter of 1997. For Harvard, a manufacturer of car and light truck components, rapid expansion in a highly competitive environment and management's inability to ease the company's debt burden in the regular course of business are responsible for its continued problems.

While current default rates still remain well below those experienced over the last decade, there are indeed signs that a return to more normal levels may be in the offing. For example, the overall credit quality of the corporate bond pool has continued to deteriorate in the second quarter. The ratio of Moody's rating upgrades to downgrades was above 1.6 in the first quarter of 1997 but has fallen in the second quarter to 0.7 for all corporate borrowers. In the more volatile speculative-grade segment, upgrades to downgrades fell from a strong 2.3 in the first quarter, to below 0.7 in the second, while on a 12-month moving average basis, the ratio has been drifting steadily lower since the middle of 1995. The result is that as of the end of June, almost 56% of speculative-grade issuers carried senior or implied senior unsecured ratings at or below the B1 rating, a new post WWII high and 3% higher than last quarter. While this upward trend largely reflects the beneficial effect of continued disintermediation and improved access to capital for midsize firms as loan and bond markets converge, it also indicates increased credit risk for public debt markets. Debtors rated B1 through C have defaulted at a rate of nearly 10% since 1995, compared to less than 0.6% for issuers with senior unsecured ratings in the Ba1-Ba3 range.

As the economy has continued to give off mixed signals, consensus forecasts for key economic variables have not changed much over the past quarter. The economy is expected to expand at a comfortable pace and the outlook for corporate profits remains positive. Inflationary pressure appears to be minimal, keeping a lid on rates. But with U.S. labor markets remaining tight and prospects for growth throughout the rest of the industrialized world having improved over the past quarter, inflation could quickly become a factor in the second half of the year. Indeed, while the Federal Reserve elected not to take any action in July, the possibility of the Fed lowering rates is not even being discussed. Clearly, soaring equity markets and high levels of liquidity are partly responsible for squeezing corporate spreads to these historic lows. Thus, while a wide array of conditions conducive to corporate financial health have helped keep default rates down in 1996 and the first half of 1997, these conditions have little room to improve from here and even marginally worse conditions could be expected to increase defaults in the second half.

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