Previously published in the U.S. Credit Alpha
10 November 2017

2018 High Yield and Loans Default Outlook

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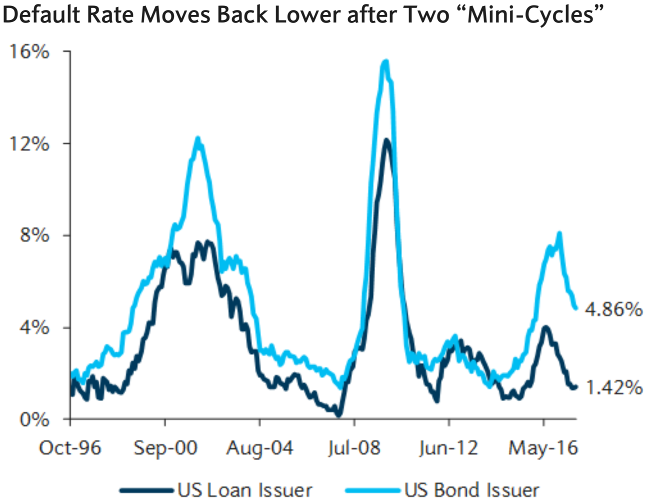
We forecast a continuing drop in issuer high yield bond defaults for 2018, with loan defaults holding largely steady at already-low levels. In keeping with our annual exercise, we combine both bottom-up and top-down econometric approaches to arrive at our forecast. Specifically, we see bond defaults falling again, from 4.9% to 2.0-3.0% in 2018 on an issuer-weighted basis. Given stresses in larger capital structures, we believe that the par-default rate will end 2018 slightly higher than the current paltry 1.3% and can thus converge with the issuer-default rate. In the loan market, we see defaults holding steady or moving marginally higher at around 1.5-2.5% on both an issuer- and a par-weighted basis. These largely benign outcomes are supported by balance sheet repair across many of the commodity-exposed names over the past year, a stable macro backdrop, and still-accommodative lending conditions.

While many debates between market participants these days focus on how long the "business cycle" can last, it is important to acknowledge that US corporate credit markets have gone through two atypical "mini-" default cycles since the end of the last recession in June 2009. While small in magnitude when viewed through a historical lens, corporate defaults did bump higher starting in early 2012 as the euro sovereign default crisis (ultimately short lived) started to tighten financial conditions globally. More recently, the broad commodity corporate credit complex went through its own cleansing with a even larger pickup in defaults starting in early 2015, followed by a steady decline from the peak early this year (Figure 1). We recall the historical experience simply to highlight that despite these two mini-cycles, the default waves have not resulted in a material and broader rationing of capital overall that would typically lead to a recession.

The Look Back First to Set up the View Forward

To contextualize 2017, note that defaulted bond volume has fallen by nearly 70%, from $64.3bn through the first three quarters of 2016 to $20.6bn over the comparable period this year, along with a similar 50% drop in the loan market, from $31.5bn to $15.4bn. That has left issuer-weighted default rates at 4.9% and 1.4%, respectively. We list the more prominent defaults in Figure 2.

FIGURE 1
Default Rate Moves Back Lower after Two "Mini-Cycles"



Source:Barclays

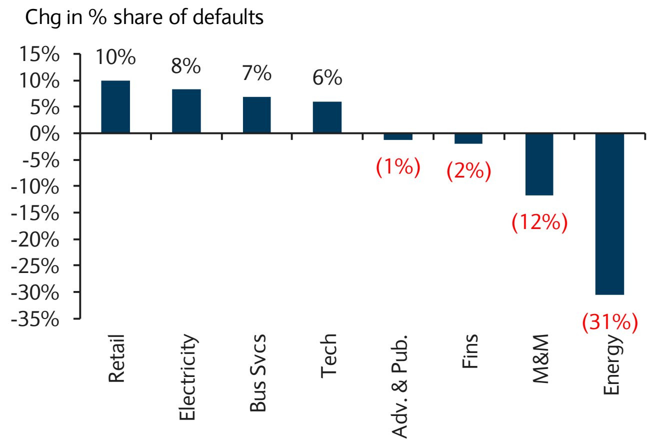
FIGURE 2
Top Bond and Loan Defaults in 2017

Company	Default Event	Default Amt ($mn)	Rat at Default
Bonds			
Avaya, Inc.	Chapter 11	$2,683	Caa2
CGG SA	Bankruptcy	$1,921	Ca
GenOn Energy, Inc.	Chapter 11	$1,827	Caa3
Global A&T Electronics Ltd.	Missed Interest	$1,127	C
Intelsat S.A.	Distr. Exchange	$1,027	Caa2
Loans			
Avaya, Inc.	Chapter 11	$3,309	B2
Toys 'R' Us	Chapter 11	$2,453	Ba3
Drillships Financing	Bankruptcy	$1,834	Caa2
Drillships Ocean Ventures	Bankruptcy	$1,268	Caa2
Vanguard Nat Resources	Chapter 11	$1,250	NR

Source: Barclays

FIGURE 3

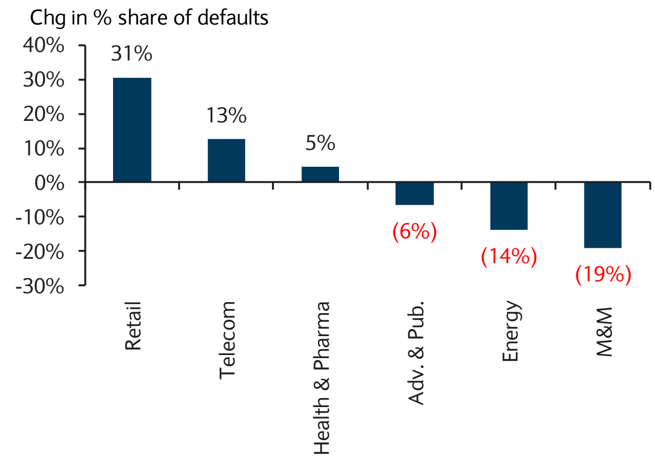
Y/y Change in Select Sectors' Representation as a Percent of Overall Bond Defaults



Source: Moody's, Barclays Research

FIGURE 4

Y/y Change in Select Sectors' Representation as a Percent of Overall Loan Defaults



Source: Moody's, Barclays Research

Reflecting on the mix of sectors represented in defaults over the year, no particular narrative strikes us as unifying and overarching, unlike in 2015 and 2016. But in Figures 3 and 4, we highlight the sectors with the biggest percentage changes as a proportion of defaults from 2016 to 2017 to show where defaults have picked up the most and where they have fallen off. Most recently, high yield credit investors have been navigating choppy waters in wirelines, retail, supermarkets, and pharma/healthcare. As we recently noted in *Sector Opportunities Widespread*, we believe the greater-than-market dispersion of constituents within each of these sectors is actually modestly indicative of a healthy credit market, all else equal, as investors appear to have differentiated among single names in these sectors even as the broader US High Yield Index hovered near post-crisis tights. But there is reason for caution nonetheless, as increased dispersion means more names have come under stress.

Focusing on retail/supermarkets, the drivers reshaping the sector are well documented, but it is worth noting that these sectors represent just 3.5% of the US High Yield Corporate Index. While the sector represents closer to 6% of the loan market, defaults in this sector alone are unlikely to affect broader sentiment among creditors, in our view, given its small representation in most credit investors' portfolios. More likely, the linkage of retailers' woes to the broader economy will come through employment. In particular, in *Technology-based change leaves retail looking overextended*, we suggested that the restructuring of retail and the potential associated job losses, instead of triggering an economy-wide recession (and protracted turn in credit spreads), could increase the severity of or prolong a downturn in activity as retailers shed capacity during a recession.

Unlike the distress that developed in the broader commodity sectors starting in 2015, most of the sectors mentioned earlier as vexing high yield investors represents a meaningful proportion of the overall high yield market. Similar to retail, wirelines represents only 3.8% of the High Yield Index and an even smaller portion of the loan market. While pharma/healthcare is larger in both markets and constitutes 9% of high yield, most of the sector remains far from distress. In addition, this pales in comparison with the 19% of the high yield market represented by the energy and metals & mining sectors at the beginning of 2015.

What Our Top Down Default Model Says for 2018

As a reminder, our econometric model is built on a regression of the 12-month-forward default rates against the two factors mentioned below. We find that these two factors – among many surveyed – are the most reliable predictors of defaults.[1]

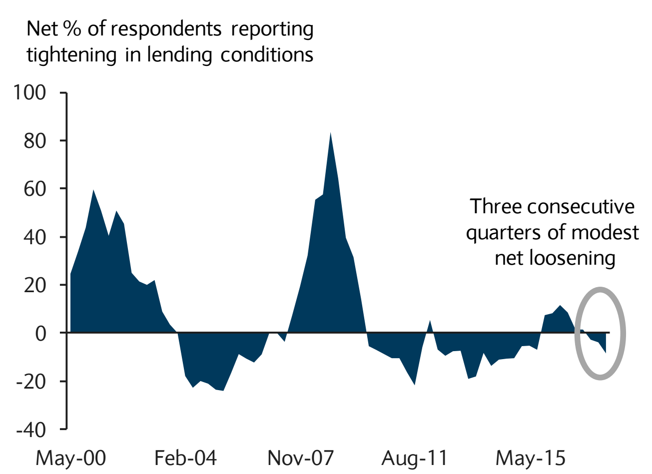
- C&I lending standards: The net percentage of senior loan officers reporting plans to tighten lending standards for commercial and industrial (C&I) loans. This quarterly series comes from the Federal Reserve and is highly correlated with defaults 12 months forward. Figure 5 shows that we have experienced three consecutive quarters of net loosening in credit conditions, suggesting that default rates should remain anchored below current levels.
- Distress rate: The percentage of bonds in the Barclays US High Yield Index trading with a spread of 1,000bp or higher and the percentage of loans in the S&P/LSTA Leveraged Loans Index trading below a price of $80. Besides capturing the market's expectations of impending defaults, this factor also relates well to the likelihood of distressed exchanges, which Moody's accounts for in its default rate. Figure 6 shows that the amount of bonds trading at distressed levels as a percent of the overall leveraged finance market has trended lower over the year for both markets (140bp lower for high yield and 120bp lower for loans). While off the lows, the current reading still points to low default rates in the year ahead.

As such, our model suggests a continuation of the benign default environment, with most of the commodity-related stresses largely behind us, and forecasts 3.0% and 2.1% issuer-weighted default rates for high yield and loans, respectively. Both models are highly predictive of future defaults, with correlations of 0.90-0.95 between realized and estimated default rates.

The results of our model are in keeping with a backdrop characterized by stable corporate fundamentals, favorable macro conditions, still-easy lending conditions, and steady free cash flow generation – all of which we believe should continue throughout 2018 in the absence of a broader risk-off episode. These trends help support our position that default rates should remain benign throughout 2018, for both high yield and loans.

FIGURE 5

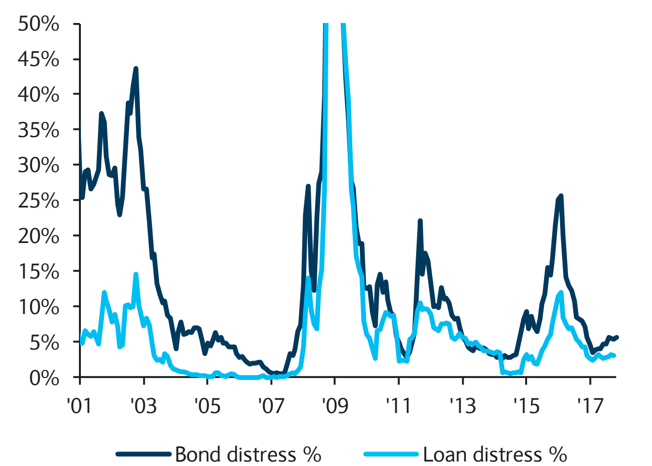
Lending Conditions Continue to Loosen, Helping to Limit Defaults



Source: Federal Reserve, Barclays Research

FIGURE 6

Percent of Bonds and Loans Trading at Distressed Levels Just off the Lows



Source: Bloomberg Barclays Indices, Barclays Research

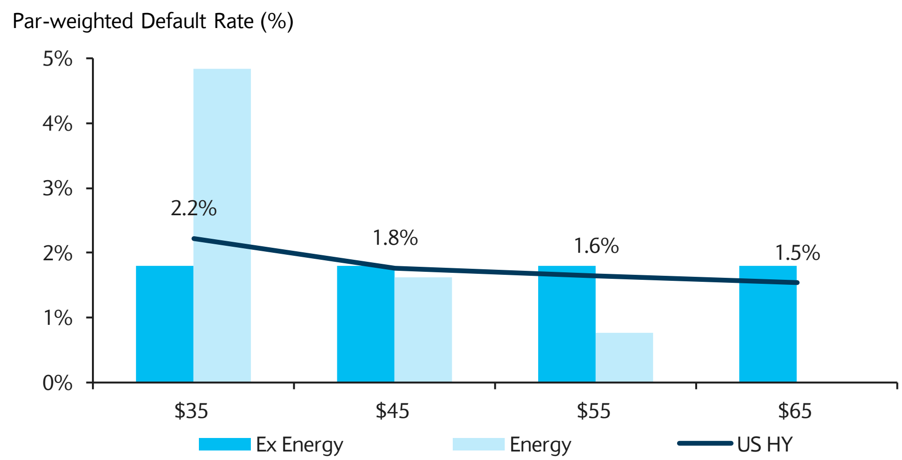
[1] We have additionally explored i) the slope of the credit curve ii), capital expenditures as a percent of sales, and iii) LBO loan issuance volumes as three other factors in this year's iteration. Please refer to the Appendix for further details.

Bottom-Up Approach Yields a Similar Result

Finally, in parallel with our econometric model approach, we collaborate with our fundamental analysts, who have reviewed the issuers in the Bloomberg Barclays US High Yield Index and flagged the companies in their coverage universes that they believe have at least a 25% chance of default in 2018. For companies not covered by our analysts, we use market signals on distress to estimate the number of issuers and par amount that could potentially default in 2018.

FIGURE 7

Bottom-Up Approach Similarly Suggests a Relatively Benign Default Forecast across 2018 Oil Price Scenarios



Source: Barclays Research

Finally, while oil prices have rebounded strongly over the past 18 months, many of our conversations with investors still revolve around scenarios in which energy prices move back down. To account for that scenario, we also incorporate our energy analyst's view of the sensitivity of individual companies in the energy sector to a range of oil price assumptions for 2018. Combining all of the above considerations and methods, our bottom-up estimate for the speculative grade bond default rate at an issuer level is slightly below our top-down forecast of 2.0-3.0%, while the par-weighted result is within that range as a result of stress among some larger issuers. Because of the constraints on coverage mentioned above, we often find the bottom-up analysis to be slightly lower, but do not believe the difference is appreciable enough to change our overall range. As shown in Figure 7, there is no appreciable bump up in our estimated par-weighted default rate until oil price assumptions fall closer to $35/bbl. That is indicative of the successful balance sheet repair and cost containment efforts across the sector over the past two years. In addition, these bottom-up default estimates fall comfortably within the results implied by our econometric model, as discussed above.

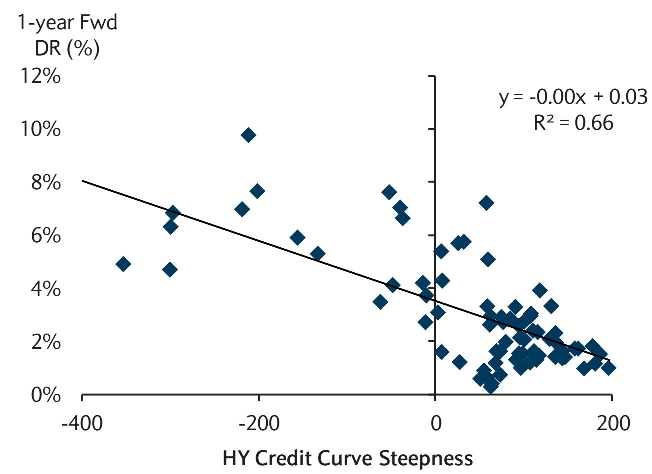
Appendix

While we have tested many variables in the past, we vetted several additional factors in an effort to enhance the explanatory power of our bond and loan macro models. First, in the bond model, we considered the slope of the high yield credit curve. Intuition suggests that defaults should pick up during curve-flattening regimes, especially when issuers have difficulty terming out front-end maturities. Figure 8 confirms a decent relationship between the current slope of the credit curve and the one-year-forward default rate. While curve steepness may be a leading indicator of tightening in financial conditions, it is apparently already captured by our SLOOS factor, since it does not offer additional explanatory power in a multi-factor context. The second factor we explored is capital expenditures as a percent of sales, to capture changes in corporate fundamentals. An increase in capital spending has been a precursor to a spike in defaults in prior cycles, as an increase in cash outlays can challenge companies' ability to service their debt. While capital spending is a decent signal of default, once again, it is not additive to our multi-factor model (Figure 9).

For our loan model, we wanted to consider patterns of excessive issuance which could be a cause for concern considering our findings in *Counter-Cyclical Sector Allocation*. To account for the potential variation in default experience between loan-only issuers and loan and bond (crossover) issuers, we independently calibrated default forecasts for each cohort. We considered a new factor as a replacement for the SLOOS factor – one-year lagged LTM LBO issuance – which also captures changing credit conditions. As discussed in *Feeling Less Insecure*, the deterioration in credit quality over the past decade can be attributed to an increase in leverage through secured debt for loan-only issuers. Meanwhile, crossover issuers have shrunk leverage through the secured layer of the capital structure, which has actually declined as a percent of their balance sheets. The consequences of these competing trends are two-fold. First, the theoretical probability of default should increase for loan-only issuers that are now closer to the "default boundary" and result in lower-than-average loan recoveries for loan-only capital structures. But loan recoveries would be supported for crossover issuers given the larger unsecured cushion.

FIGURE 8

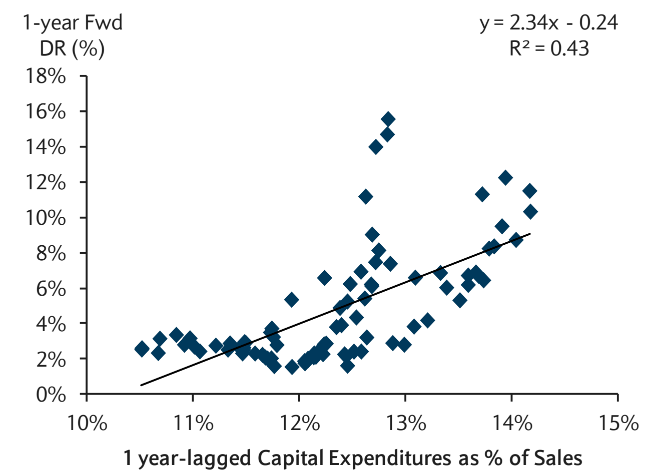
Flatter Credit Curve Correlated to the One-Year Forward Default Rate



Note: Default Rate reflects the issuer-weighted default rate. We measure the steepness of the high yield credit curve by considering the spread between the 5-8y and 1-3y duration buckets of the US High Yield Corporate Index.
Source: Moody's, Bloomberg Barclays Indices

FIGURE 9

One-Year Lagged Capital Expenditures as a Percent of Sales versus One-Year-Forward Default Rates

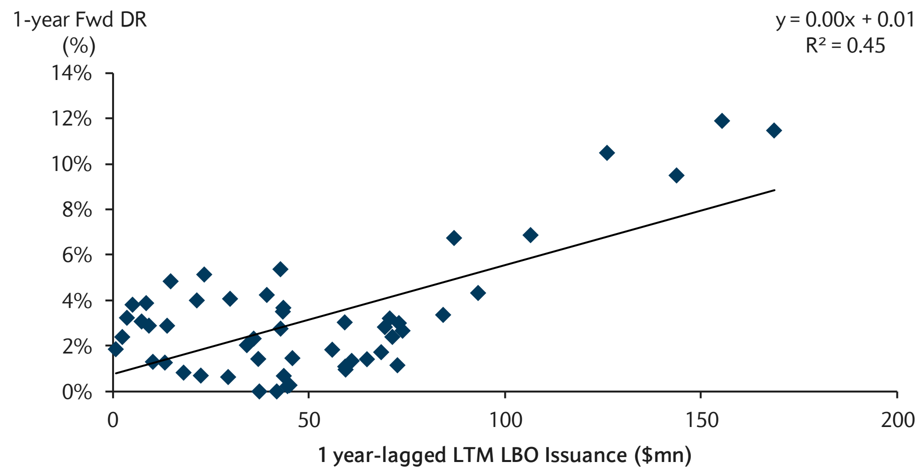


Source: Moody's, Federal Reserve, Barclays Research

Figure 10 shows a strong relationship between one-year lagged LTM issuance and the one-year-forward default rate. The increase in LBO issuance in 2016[2] would help offset the more benign default conditions implied by our SLOOS factor and appropriately characterize the default environment for loan-only issuers, in our view. Substitution of this factor suggests that loan-only defaults could range between 2% and 3%, an increase of as much as 50-100bp. That said, given the benign default backdrop for the rest of the market and the slightly better fit of the model with the SLOOS factor, we forecast loan default rates of 1.5-2.5% on both an issuer- and a par-weighted basis.

FIGURE 10

Loan Only Defaults versus One-Year-Lagged LTM LBO Issuance



Source: Barclays Research

[2] We would expect a pickup in LBO issuance in 2017 to be a leading indicator of the default experience for loan-only issuers next year.

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