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Default, Dear Brutus, Is Not in Our Stars

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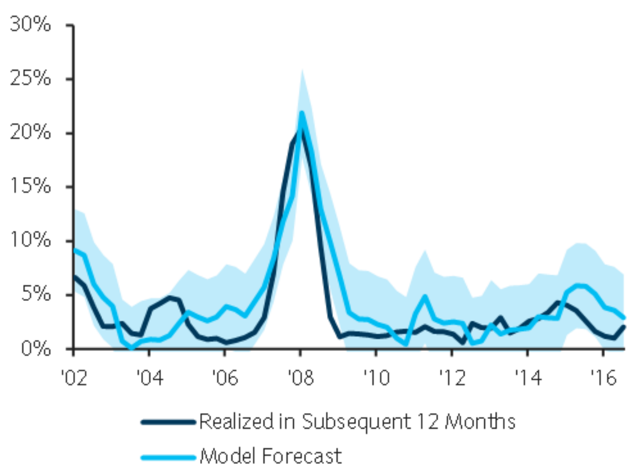
Given the recent update of our high yield total return forecast for the year to 3.5-4.5% (see *Rates Drag Returns*), we evaluate default trends for the first half of 2018 and review possible drivers of defaults for the rest of the year. Of course, recovery rates are important for portfolio performance as well, as discussed in *Downside to Recoveries after a Long Recovery*. As a refresher on our default views, late last year, we forecast a 2-3% default rate for bonds in 2018 (Figure 1), on both a par- and an issuer-weighted basis (see *2018 High Yield and Loans Default Outlook*). The current par-weighted LTM measure sits at 2.2% per Moody's, after bottoming earlier this year at 1.0%, and thus remains within the bounds of our earlier full-year forecast. As outlined below, an update of our analysis suggests that this subdued level of defaults should persist for the near term.

With spreads essentially unchanged on the year, the paltry year-to-date total return of just 0.47% is largely due to the stiff headwinds as rising Treasury yields counter bond coupons. Given the low default rate, the effect on returns of defaulted bonds that were in the US High Yield Index to start the year has been minimal (Figure 2). In addition, year-to-date recoveries for unsecured bonds have been in the mid-$40s, largely in line market expectations over the long run.

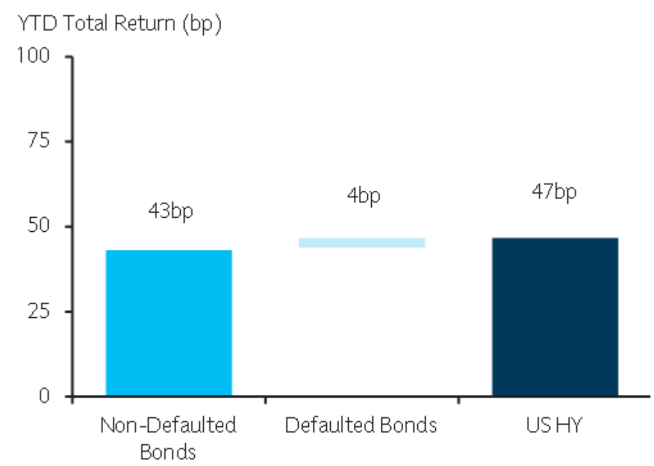
In our 2018 default outlook, we highlighted two factors that we find to be the most reliable drivers of the corporate default rate: the net percentage of loan officers tightening C&I lending standards to large- and mid-cap companies and the bond distress rate (as measured by the percentage of bonds trading wide of 1000bp). Focusing only on the former, we note that the net percentage of loan officers reporting tighter lending standards has continued to fall in 2018, with five consecutive quarters of net loosening since the 2015/16 commodity downturn, and is now back to levels last seen in early 2014 (Figure 3).

FIGURE 1
Defaults Tracking Close to Our Model Forecast



Note: Data are on a par-weighted basis
Source: Moody's, Federal Reserve, Bloomberg Barclays Indices

FIGURE 2
Defaulted Bonds Have Had Little Effect on High Yield Total Returns Year-to-Date

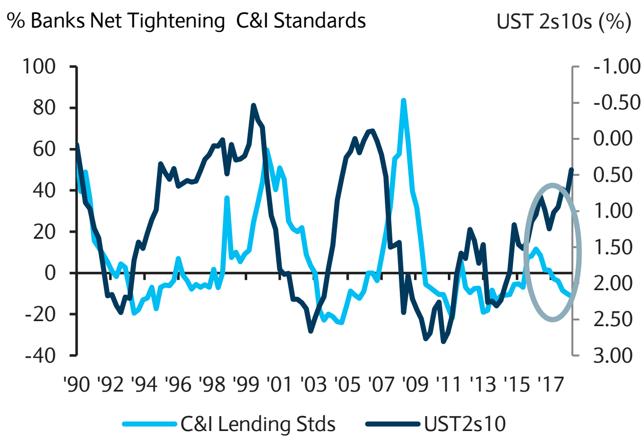


Source: Bloomberg Barclays Indices, Moody's

Completed: 12-Jul-18, 23:16 GMT Released: 13-Jul-18, 10:30 GMT

FIGURE 3

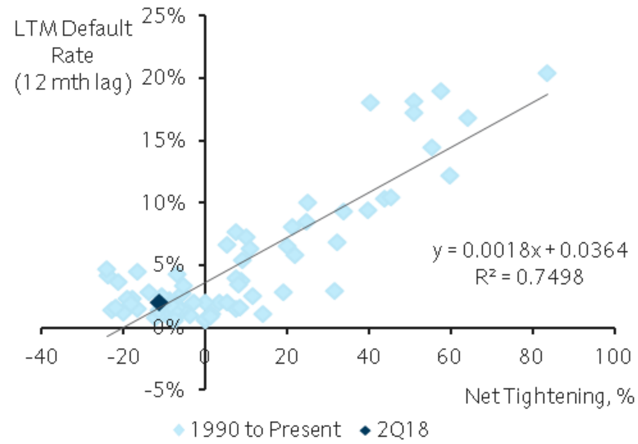
Percentage of Banks Tightening Lending Continues to Fall



Source: Barclays Research, Federal Reserve

FIGURE 4

A Strong Relationship with Loan Officers Tightening C&I



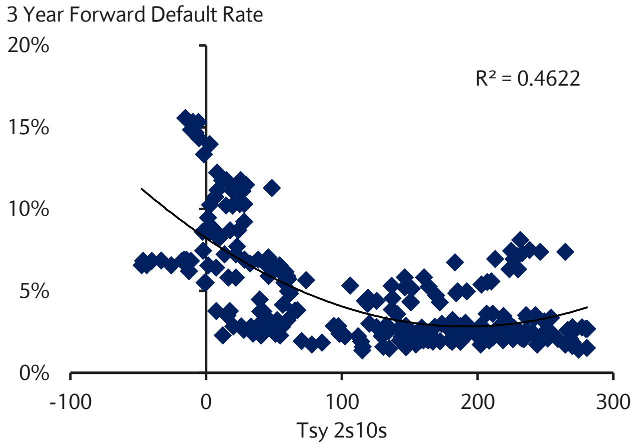
Source: Barclays Research, Federal Reserve, Moody's

Furthermore, this measure became marginally more accommodative in 2Q than in 1Q, despite bouts of increased market volatility during 1H18. As seen in Figure 3, the current divergence between loosening lending standards and a flattening yield curve is notable, if not unprecedented: intuition suggests that banks would consider tightening lending standards as net interest margins decrease because of curve flattening amid escalating concerns of a downturn. But it is worth noting that a similar gap prevailed for several years in the mid-1990s and mid-2000s and that banks' lending standards have remained accommodative for most of the post-crisis period, as loan demand has been tepid. For context, the regression in Figure 4 suggests that the net percentage of loan officers tightening C&I lending standards would need to swing by nearly 20pp from the most recent reading of -11.3% to result in a 5% par-weighted default rate, the average since 2000.

From the above, we can surmise that a material pickup in defaults sourced through the transmission mechanism of the banking system does not appear to be a particular near-term risk. To gauge how Fed policy has served as a catalyst for defaults in the past by influencing the shape of the yield curve, in Figure 5, we find that the relationship between the Treasury 2s10s curve and the LTM default rate is best fit on a three-year lagged basis. Again, using history as a guide, today's relatively flat yield curve does not necessarily portend a material pickup in the default rate over the next couple of years, even as our work suggests that credit spreads will peak approximately one year prior to the actual peak in defaults. We think that the current slow but steady hiking cycle should be considered more of a normalization than a default-inducing, restrictive path of monetary policy.

FIGURE 5

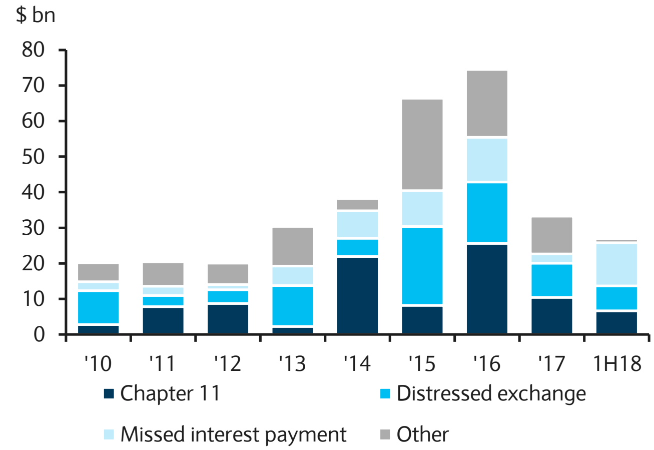
Default Rate Best Fit to Yield Curve Shape on a Three-Year-Forward Basis



Source: Bloomberg, Moody's, Barclays Research

FIGURE 6

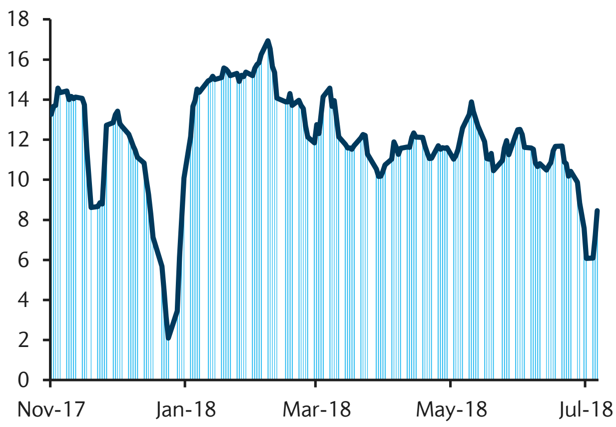
Tracking the Share of Reasons for Defaults



Source: Moody's, Barclays Research

Finally, despite the low default level thus far in 2018, it is useful to consider whether any particular sectors, or specific default-triggering events, have emerged more frequently among defaults year-to-date. The default of large issuers, especially iHeartCommunications (IHRT), has skewed the results. IHRT's roughly $9.0bn of defaulted debt represents one-third of the year-to-date volume according to Moody's. As a result of IHRT's missed interest payment, the media & entertainment sector has an outsized representation in defaults and the share of missed interest payments among default events has increased (Figure 6). As expected from the bottom-up forecast in our 2018 outlook, retailers also rank prominently among defaulted issuers this year, led by Claire's Stores, Tops, and Bi-Lo (all Chapter 11). On the flip side, energy represents just 3.8% of defaulted volume year-to-date, compared with 40.4% in 2017 and 53.5% in 2016.

High Yield Average Institutional Trade Volume ($bn)

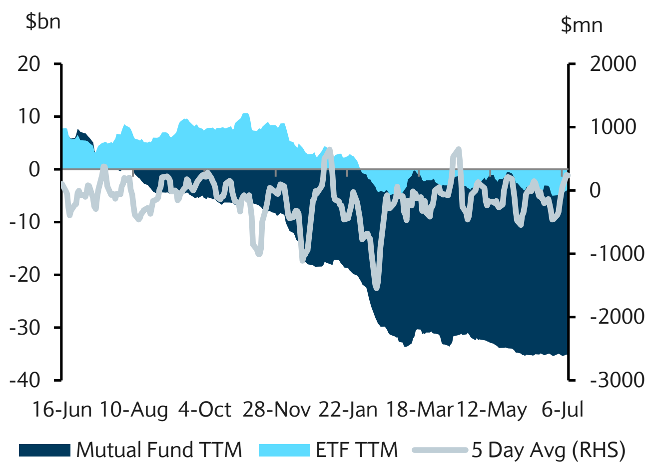


Note: Includes both registered and 144A volumes. Source: FINRA TRACE

On-the-Run HYCDX versus US High Yield Index (bp)

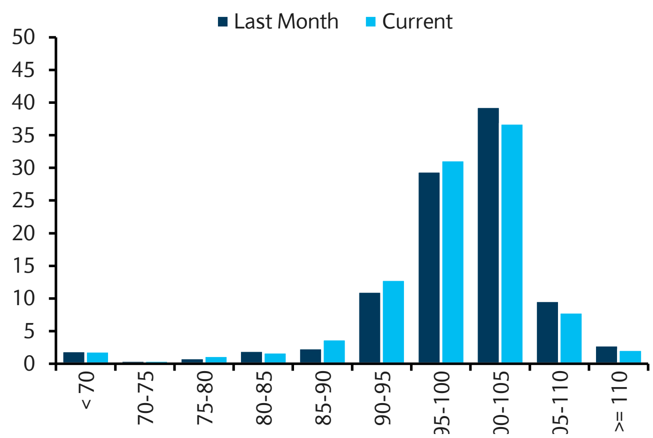
Source: Barclays Research

Flows to High Yield Mutual Funds and ETFs



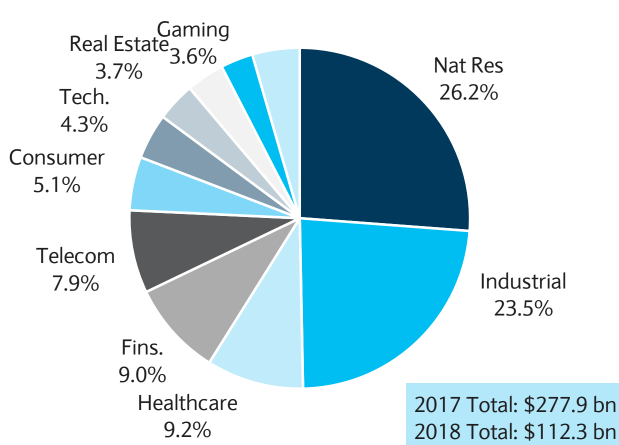
Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



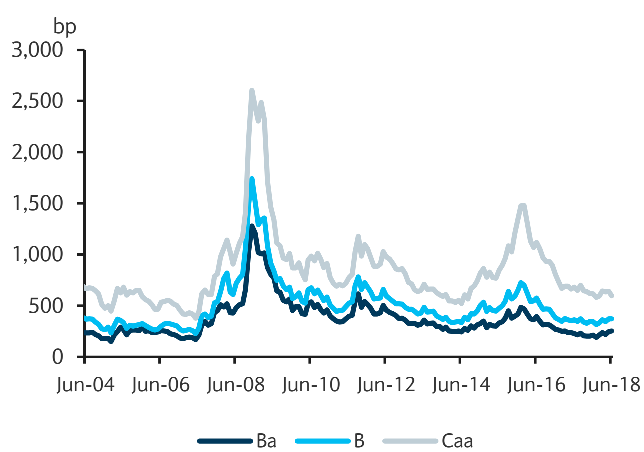
Source: Barclays Research

High Yield Supply by Sector



Source: Barclays Research

High Yield Spreads by Credit Quality



Source: Bloomberg Barclays Indices

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