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2020 High Yield and Loan Default Outlook: Stress to Lead to an Uptick

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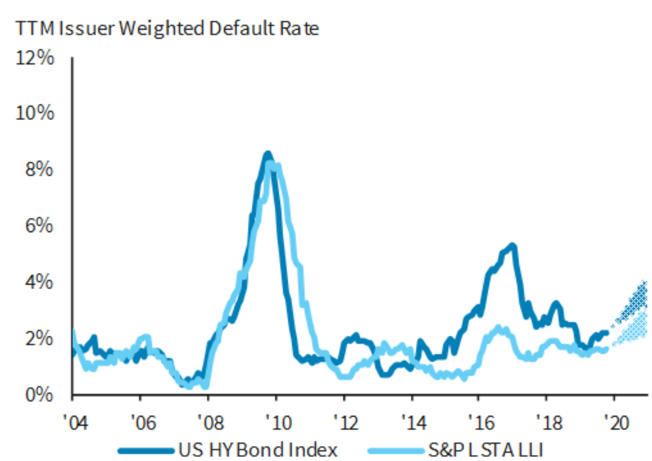
Despite a continued supportive macroeconomic backdrop and low rates environment, worries of a material increase in defaults persist, especially given the increase in rating agency downgrades for lower-quality bonds and loans. Although default rates have been well below long-term averages this year, there has been a slight uptick from recent lows.

We expect 2020 full-year issuer-weighted default rates for bonds to be 3.0-4.0% and for loans to be 2.0-3.0%. On a par-weighted basis, we expect default rates of 2.5-3.5% for bonds and 1.5-2.5% for loans. The midpoints of these rates represent a roughly 1.0% increase from current levels. As always, we arrive at our forecasts through a combination of top-down analysis based on macro factors, current index dynamics, and a bottom-up evaluation in conjunction with our fundamental credit analysts.

We expect bond default rates to remain above loan default rates given the bond market's outsized exposure to energy, the sector that has led in defaults this year and represents the greatest portion of distressed bonds. For both markets, we expect issuer-weight default rates to exceed par-weighted rates, in line with the historical trend, given the higher default rate among smaller capital structures that have less debt outstanding than the average issuer in each market.

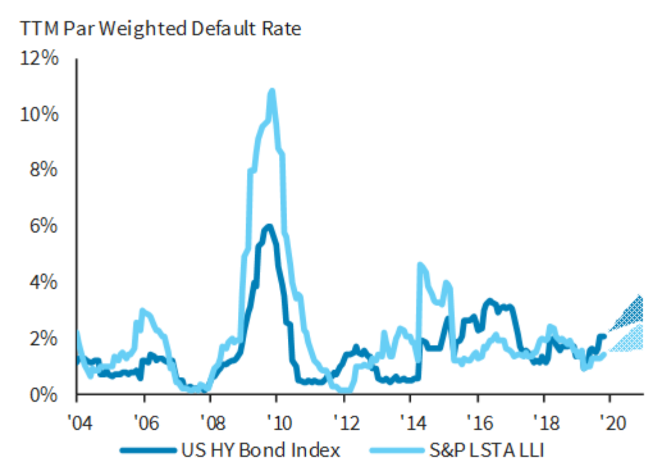
It is important to note that much of our previous default rate analysis was based on data from rating agencies on the entire universe of rated corporates. In order to predict default rates specifically for the high yield bond and leveraged loan markets, we constructed historical default rates for the US High Yield Index for bonds and used data provided by S&P LSTA for its Leveraged Loan Index (LLI). Below, we provide the basis for our 2020 default forecasts, combining top-down analysis of various factors with bottom-up commentary from our fundamental analysts.

FIGURE 1
Issuer-Weighted Default Rates and 2020 Forecast



Note: PCG not included in default data because the company went from investment grade-rated to default in the same month.
Source: S&P LCD, Bloomberg Barclays Indices

FIGURE 2
Par-Weighted Default Rates and 2020 Forecast



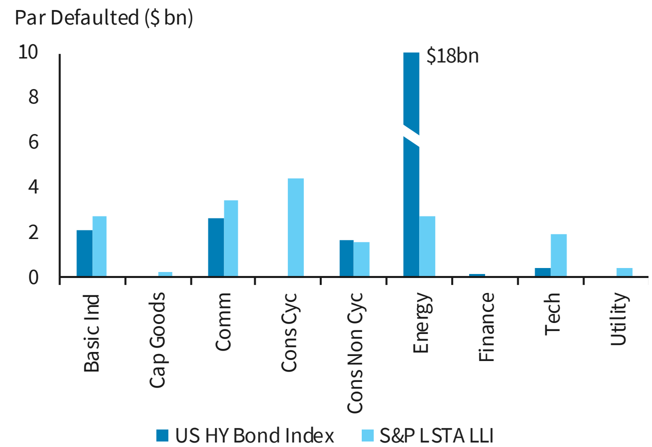
Note: PCG not included in default data because the company went from investment grade-rated to default in the same month.
Source: S&P LCD, Bloomberg Barclays Indices

FIGURE 3
Largest Bond and Loan Defaults in 2019

Company	Trigger Event	Month of Event	Default Amount ($ bn)
Bonds			
Weatherford	Ch. 11	May	6.2
Chesapeake Energy	Exchange	September	3.4
EP Energy	Missed Interest	September	3.1
Windstream	Ch. 11	February	2.6
Loans			
Neiman Marcus	Exchange	June	3.0
Windstream	Ch. 11	February	1.9
Murray Energy	Ch. 11	October	1.7
Ditech	Ch. 11	February	1.5

Note: Data are through October 2019. PCG not included in default data because the company went from investment grade-rated to default in the same month.
Source: S&P LCD, Moody's, Barclays Research

FIGURE 4
2019 Bond and Loan Defaults by Sector



Note: Data are through October 2019. PCG not included in default data because the company went from investment grade-rated to default in the same month.
Source: S&P LCD, Moody's, Barclays Research

2019 in Review: A Slight Uptick in Defaults, Driven by Energy

Through the first ten months of 2019, 21 issuers with a combined $25bn in par defaulted from the US High Yield Index. On a pro rata basis, this represents roughly $30bn of defaults for the full year, an increase from $18bn in both 2017 and 2018 but down from the levels seen during the energy crisis of 2015-16 ($34bn in 2015 and $42bn in 2016). As a result of this increase, the current bond market trailing twelve-month issuer-weighted default rate of 2.2% is up from 1.8% at the end of 2018, with the par-weighted default rate of 2.1% up from 1.4%. We base our default data on bonds in the US High Yield Index. As a result, Pacific Gas & Electric (PCG) was excluded because the company was downgraded from investment grade to default in January and therefore did not fall into the US High Yield Index.

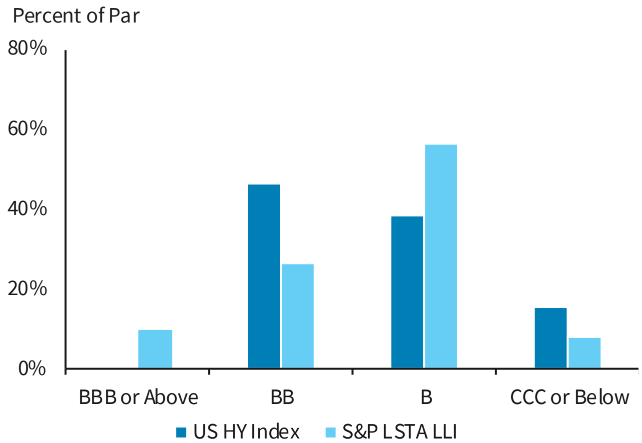
Over the same period, the loan market had 20 issuers default with a combined par outstanding of just over $17bn. The annualized level of defaults this year is trending in line with the $24bn and $21bn of defaulted loans in 2017 and 2018, respectively. Default rates have also remained fairly in line, with the loan issuer-weighted default rate of 1.6% unchanged from the end of 2018 and the par-weighted rate of 1.4% down slightly from 1.6%.

Figure 3 highlights the largest defaults in each market this year. Weatherford accounted for the largest default, with $6.2bn in bonds, and Windstream had $4.5bn of debt default across the bond and loan markets. Energy was the largest driver of defaults this year, representing $18bn of the $25bn (72%) of bond defaults (Figure 4).

Energy represents a much smaller share of the loan market than of the bond market (3.5% by amount outstanding versus 13.5%), helping to keep loan defaults broadly unchanged from last year. Quality has also played a factor in the different default rates of the two markets. While the loan market is over 50% single-B rated, CCCs and below represent a larger portion of the bond market (Figure 5), with 80% of bonds that have defaulted in 2019 starting the year rated CCC or below.

FIGURE 5

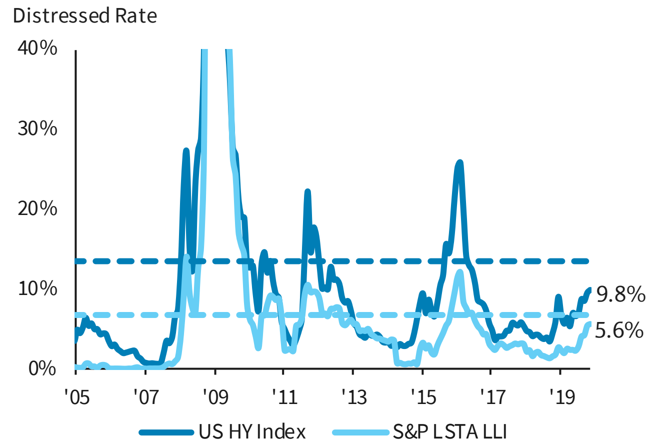
CCC and Below Credits Represent a Greater Portion of the Bond Market



Source: Bloomberg Barclays Indices, S&P LCD

FIGURE 6

Distressed Rates Have Increased in 2019 but Are Still below Long-Term Averages



Note: Distressed defined as bonds with greater than 100bp in OAS and loans trading below $80. Dashed line indicates 2000-present average level for each respective market. Source: Bloomberg Barclays Indices

While default rates have declined for the loan market, the level of distressed credits has increased meaningfully in 2019. Figure 6 highlights that although the rate has increased this year, the level of distressed credits in each market remains below the long-term average. The current bond distressed rate of nearly 10% is more than double the rate one year ago and increases from 4% to almost 7% when energy names are excluded.

Distressed loans have grown at an even greater rate, more than tripling over the past year. Several of the companies that contributed to this increase experienced massive price declines due to idiosyncratic risks, such as McDermott and 4L. In *To Stress or Not to Stress: Distressed in CLOs,* we found that there has been an uptick in the number of loans with large price moves this year relative to recent years, with this rate skewed materially toward large price declines, pointing to increased downside risk for many stressed companies even if they do not immediately default.

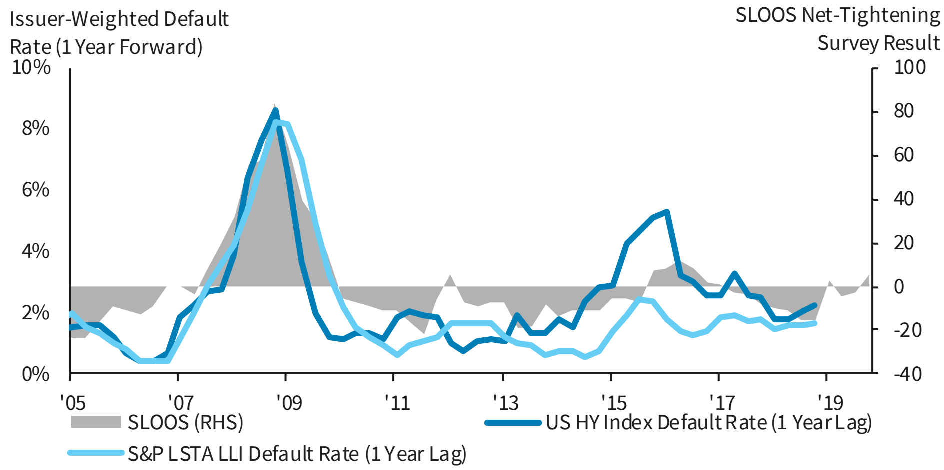
Top-Down Analysis: Defaults Continue to Trend Higher

To assist with our default forecasts, we use a model consisting of two variables that help predict future defaults. In the past, we have evaluated other factors for inclusion in the model, such as the shapes of the yield curve and the credit spread curve, capital expenditures as a percentage of sales, the CCC maturity wall, and LBO issuance volumes. However, we have found that the best R-squared results from a model containing only two factors: The Senior Loan Officer Opinion Survey on Bank Lending (SLOOS) and the distressed rate.

The first input (SLOOS) is a quarterly survey conducted by the Federal Reserve that aims to capture lending standards – the number represents the net percentage of medium and large lenders' senior loan officers that reported tighter lending standards for commercial and industrial loans. A negative number represents easing standards while a positive number implies tightening. The most recent survey result was 5.4, suggesting that loan officials slightly skewed toward a tightening of standards. This input has been largely negative since the recession, with a slight positive stretch during the energy crisis in 2016.

FIGURE 7

Lending Standards Still Point to a Below-Average Default Rate for Bonds and Loans Next Year



Note: SLOOS defined as the Federal Reserve's Senior Loan Officer Opinion Survey on Banking and Lending Practices net percentage of domestic large and medium lenders tightening (+) or loosening (-).
Source: Federal Reserve, S&P LCD, Bloomberg Barclays Indices

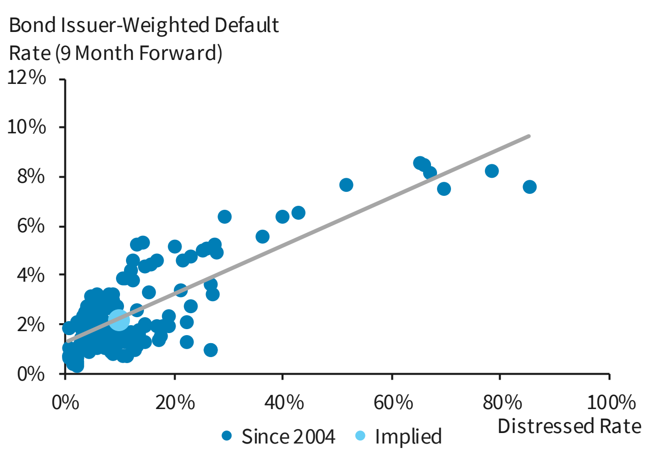
Overall, we have found that this indicator is a strong predictor of the 12-month forward default rate (Figure 7). Despite the recent positive reading, the value has been around zero for most of the year and still points to a relatively benign default environment in 2020, with issuer-weighted defaults of 2-3%.

The second variable is a measure of the bonds (or loans) trading at distressed levels. For this factor, we found that a nine-month lag for the default rate corresponds to the highest R-squared value (Figures 8 and 9). This factor alone again implies that forward default rates will increase slightly but be 2-3% on an issuer basis.

Based on these two factors and index default data, our model predicts an issuer-weighted default rate for bonds of 2.9% with an R-squared value of 64%. For loans, the model predicts an issuer-weighted default rate of 2.2% with an R-squared value of 91%.

FIGURE 8

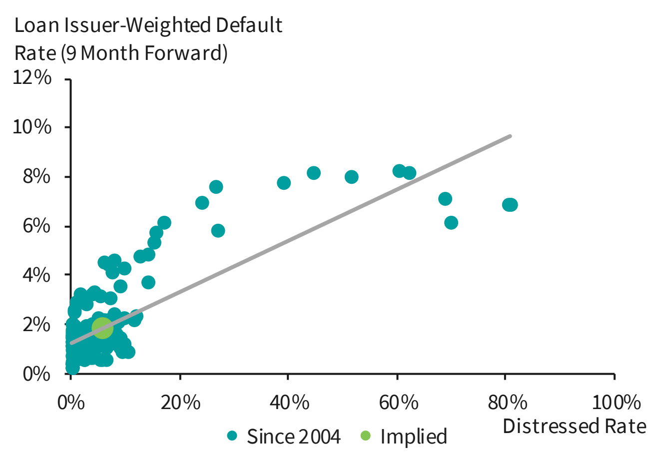
The Current Bond Distressed Rate Implies a Continued Low Default Rate for Bonds



Note: Distressed rate defined as bonds with OAS of 1000bp or more.
Source: Bloomberg Barclays Indices

FIGURE 9

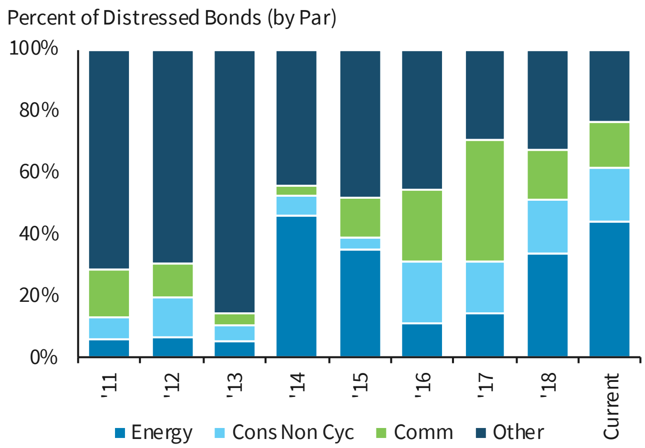
The Loan Distressed Rate Also Points to a Low Loan Default Rate



Note: Distressed rate defined as loans with price below $80.
Source: S&P LCD

FIGURE 10

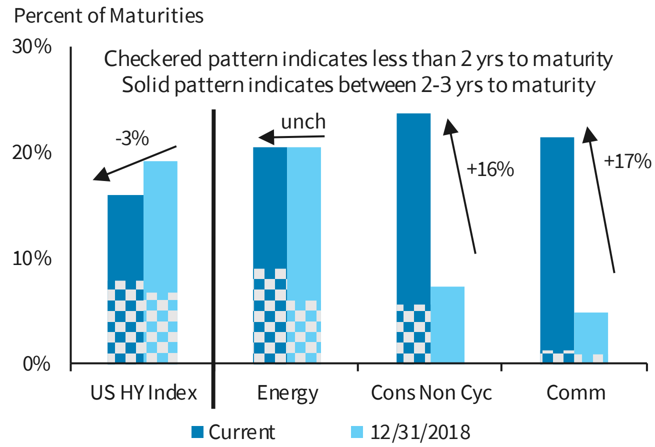
Three Sectors Make up the Majority of the Distressed Bond Universe



Note: Distressed bonds only.
Source: Bloomberg Barclays Indices

FIGURE 11

The Distressed Bonds for Those Sectors Have Increased Near-Term Maturity Walls



Note: Distressed bonds only.
Source: Bloomberg Barclays Indices

In addition to our macro model, we incorporate other factors into our top-down analysis of expected default rates. Figure 10 shows the breakdown of distressed bonds in the US High Yield Index by broad sector over time. Energy, consumer non-cyclical, and communications are the only three broad sectors that represent at least 10% of the current distressed universe. They currently make up 76% of all distressed bonds, with energy alone representing 44%.

More interesting, though, is the relatively high near-term maturity wall for these three sectors (Figure 11). Currently, 16% of distressed bonds across the entire US High Yield Index mature in the next three years, down from 19% at the end of last year. The consumer non-cyclical and communications sectors have seen significant increases in the rate of distressed bonds that are maturing in the next three years (up 16pts and 17pts, respectively). Although the majority of these maturities are at least two years out, the increased maturity wall presents an increased refinancing risk for the distressed companies in these sectors. While the level of distressed energy bonds that mature in the next three years has remained the same, there has been an increase in the rate of bonds maturing in the next two years. As a result of this increased maturity wall in the most meaningful distressed sectors, we think that our macro model may underestimate actual defaults in 2020.

Obviously, default losses for portfolios and the indices as a whole are predicated on recovery rates and not just default rates. With recovery rates trending lower, the drag on performance from defaults should be greater even if there is no change in default rates. As discussed in *Downside to Recoveries after a Long Recovery*, we expect recoveries to be lower through the next cycle, with a larger decline in loan recoveries than bond recoveries. This is due to the increase in total leverage for loan issuers, primarily as a result of greater first-lien debt and the lack of unsecured capital behind loans compared with the past. An increase in the amount of loan-only capital structures is likely to pressure recoveries as well.

Bottom-Up Analysis: Stressed Sector Spotlight

To supplement our overall default forecast, we also coordinate with Barclays' fundamental analysts to develop a bottom-up projection of defaults. The analysts reviewed a list of distressed bonds and loans and flagged securities that they feel have at least a 25% chance of defaulting next year. For companies that we do not formally cover, we applied the long-term average default rate based on index default data since 2000.

This approach results in a forecast that is below our overall estimates for both bonds and loans. However, this estimate has historically been lower than realized defaults, as many small issuers are not covered by our analysts. The potential default of these smaller issuers also supports our forecast that issuer-weighted default rates will be above par-weighted defaults. In addition, we focused mainly on bonds and loans currently trading at distressed levels, which does not take into account companies that are not currently distressed but could encounter unforeseen headwinds and be unable to react.

Despite the lower overall figure, this approach supports our forecast of lower loan defaults than bond defaults, on both an issuer and a par-weighted basis. Comparing loans with bonds, there are fewer loans trading at distressed levels as a percentage of par, the loan market has more limited energy exposure, and our fundamental analysts flagged fewer potential defaults for loans than for bonds, all of which support our conclusion.

Below, we include commentary from our fundamental analysts on select sectors that are facing either elevated default risk or significant idiosyncratic factors such as litigation or secular headwinds.

Energy – Covered by Paul Chambers

Looking forward to 2020, we see a continuation of 2019 trends, with pockets of distress concentrated in the E&P, offshore, and oil field services sectors. In high yield energy, we think several themes will contribute to additional credit deterioration. On the macro front, declines in natural gas and NGL futures curves will affect gas-biased E&P issuers. Unsurprisingly issuers with portfolios weighted toward tier 2 and 3 assets (applies across E&P, offshore, and oil field services) will likely face continued market headwinds. We expect the valuation shift in asset and lending markets toward cash flow and away from implied asset coverage to continue, affecting E&P, offshore, and oil field services companies. Many issuers generating modest or negative free cash flow may face declining access to capital markets. Compounding this, significant unsecured maturities are coming due through 2023. We have already seen depressed unsecured energy issuance year-to-date and these factors could worsen conditions in the new issue market and potentially further increase the high yield energy default rate.

Consumer and Retail – Covered by Hale Holden

In the consumer/retail sectors, the companies with the highest risk of default tend to be those that fell behind when faced with changes in consumer preferences. We find trends going against some companies in the makeup/cosmetics industry, but much of the default risk in the consumer/retail sectors remains concentrated among distressed retailers. Many retailers and department stores continue to face online pressure/shifting consumer preferences (away from the mall), and comps are persistently lower as a result. It is hard to find ways to crawl out of this hole for those that did not invest or adapt early, especially with large amounts of debt. And investors struggle with the question of whether a fragmented retailer/department store industry in its current form needs to exist when cheaper or more specialized options exist online. Some credit stories are relying on proceeds from asset sales or the IPOs of carved-out subsidiaries to buy time, but the industry's trends and debt load remain out of favor, creating elevated default risk over the next 12 months.

Healthcare and Pharmaceuticals – Covered by Rishi Parekh

Much of the default risk in these sectors will hinge on opioid litigation, with 2020 an important year for companies facing this risk. Considering the number of state lawsuits and multidistrict litigation (MDL) cases that will be heard next year, we expect the defendants to work aggressively toward a global settlement; otherwise, for some, restructuring or filing may be the only options. We think it is unlikely that the defendants will settle each case separately, and a global settlement must be signed by all state attorneys general and all

MDL plaintiffs to ensure no follow-on lawsuits. An unfavorable decision will have to be bonded to appeal, and this could be challenging for liquidity and credit quality.

We are not concerned about Teva's ability to pay but believe that it may have to increase the cash component of its proposed framework. The company generates ample free cash flow, and its debt is structurally below the opioid liabilities, which increases its ability to pay and may be targeted as plaintiffs structure their counter-proposal. The primary risks to TEVA bondholders are the possibility of eventual layering and a potential downgrade of the structure by the ratings agencies if liabilities exceed a certain threshold.

Endo International's (ENDP) ability to pay is not as great as Teva's, and we expect it to work aggressively toward a global settlement. While the company generates decent free cash flow (before litigation payments) and has a cash balance of more than $1.5bn, the risk of default or restructuring could increase substantially if it has to try each case individual and cannot reach a global resolution.

For Mallinckrodt (MNK), the risk of default in 2020 is tied entirely to the outcome of a global settlement. The company has already conducted a negligible exchange, but offered little to its existing guaranteed holders, especially in light of recent comments at a conference that opioid liabilities would be isolated to SpecGx (if the liabilities can be isolated, recovery on the guaranteed notes would likely be materially higher than current trading levels). While there are questions about how this would flow to the parent and whether the company can ring-fence non-named subsidiaries, the potential structural benefit is unlikely to influence any potential decision to file or restructure, although, depending on the timing, it could benefit current lenders and guaranteed holders.

Other than opioids, the sector's focus will be on the outcome of the presidential election. Although Medicare for All still seems unlikely to us, if the current proposed frameworks were implemented, companies would likely have to make significant financial adjustments. The risk from a default-standpoint lies beyond 2020; however, we expect pre-elect uncertainties to create pressure. Other legislative and federal actions that could create volatility include the balance billing legislation and the proposed price transparency rule.

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