Euro high yield: where are default rates heading?

Alexia Latorre, Fund Manager–Analyst and high yield specialist, explains how corporate default rates fared during last year's unprecedented health crisis.

Summary

1. Default risk: integral to high yield debt but often overestimated
2. 2020: lower-than-expected default rates
3. 2021: defaults likely to fall below historical averages

Outlook

1. Technical factors (supply and demand) will influence spread changes as interest rates rise in 2021
2. Demand for high yield should be underpinned by low duration and attractive yields

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Default risk: integral to high yield debt but often overestimated

Default risk is a integral part of the high yield investment universe. Between 2012 and 2019, we saw three or four defaults per year on average among euro-denominated high yield bonds and the average recovery rate was 35–55%, depending on bond seniority.

High yield spreads exceed those of investment grade debt for precisely this reason: the additional credit spread serves to compensate investors for the risk of potential losses due to corporate defaults.

In the past, **the market has required an average premium of around 250 bps above the level needed to cover default-related losses.** This means that when defaults have occurred, the **losses** (weighted according to the recovery rates) **have been more than offset by the risk premia offered by issuers.**

2020: lower-than-expected default rates

The 2020 health crisis caused an unprecedented recession and, **unsurprisingly, default rates rose.**

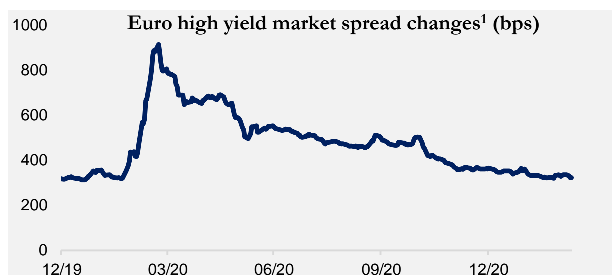
However, the **increase was lower than expected** thanks to an array of **government support measures** (short-time compensation, tax deferrals, guaranteed loans) that enabled companies to curb the impact on their cash consumption. Furthermore, **bond markets continued to operate throughout, providing companies with access to liquidity.**

At the end of February 2021, one full year after the start of the crisis, the default rate for the preceding 12 months as measured by Moody's, stood at **4.7%. This level is significantly lower than that of 2009** following the subprime crisis (11.3%, see Appendix 1). While some sectors have suffered more than others (Services, Retail, Leisure), zooming in on the companies that defaulted provides the most insight.

In 2020, Moodys recorded a total of **38 defaults in Europe of which 12 were euro-denominated bonds.** Just two of these had not been triple-C rated in 2019. In other words, **the companies that failed to survive the crisis were already fragile**.

Another point worth highlighting is that in addition to the default rate being relatively low given the scale of the crisis, **recovery rates were particularly high**. This is illustrated by the fact that Europcar bonds have been valued at 65% following a financial restructuring in addition to being swapped for shares, and confirmed by JP Morgan's calculation that the **average recovery rate** over the last 12 months stands at **60%**. **Overall, losses stemming from defaults will be lower than those observed during the European sovereign crisis in 2012** when the default rate was 3.6% but the recovery rate was lower.

In March 2020, **when spreads reached 913 bps, they were pricing in a default scenario based on 2009** that has ultimately failed to materialize. The premia were compensating potential losses that greatly exceeded those observed.



2021: defaults likely to fall below historical averages

In 2021, **economic recovery should contribute to a gradual decline in the default rate**. Moody's expects the rate to fall to 2.5% by the end of the year (2% under the optimistic scenario), compared to 1.5% in February 2020 and an average of 2.8% over the past 15 years. **The macroeconomic improvement should translate into better credit ratios**, especially from the second quarter of 2021 onwards. While the number of fallen angels[2] was very high in 2020, the trend should stabilize or possibly reverse in 2021. **We have already seen two rising stars[2]** since the start of the year (Stellantis and Smufit Kappa). In addition, a busy equity market lends itself to IPOs[3] with attractive multiples for shareholders, **accelerating corporate balance sheet deleveraging**.

In 2020, the main concern was how high the default rate would go. In 2021, the main factor driving credit spreads **will be supply and demand amid rising interest rates.** Against the prevailing economic backdrop, high yield bonds **provide an attractive investment alternative with their low duration and generous credit spreads**.

Conclusion

Although defaults are an integral part of the high yield universe, they are not a major concern given that **the additional yield offered by the asset class more than compensates for the risk**.

Default rates will fall in 2021: the primary focus and main factor driving spread changes will shift away from default rates and towards the **technical factors (supply and demand) at play amid rising interest rates**.

Of all the bond asset classes, **high yield debt is the least sensitive to interest rate changes with its low effective duration of 3.4 years**. This **lower sensitivity** combined with a **yield** of 3.2%[4] represents an attractive option for investors.

Default risk management is at the heart of Lazard Frères Gestion's investment approach. It is based on **in-depth and rigorous issuer analysis** that aims to identify and avoid future defaults, and on **portfolio weightings determined by risk levels**. **This approach** enables us to capture opportunities while managing exposure to risk.

Source: Lazard Frères Gestion, Bloomberg, March 2021
1. Source: Bloomberg, 31 December 2019 to 28 February 2021 (HEAE index – OAS Spread)
2. Fallen angel: a corporate bond previously rated investment grade that has subsequently been downgraded to high yield | Rising star: a corporate bond previously rated high yield that has subsequently been upgraded to investment grade
3. IPO: Initial Public Offering
4. Bloomberg: HEAE index data as of 28 February 2021

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Appendix 1: Default rates

Source: Moody's Investor Services, March 2021

Main risks

Risk of capital loss: The strategy does not provide any guarantees or capital protection. It is therefore possible that you may not recover the full amount of your initial investment.
Interest rate risk: Risk of a fall in the value of equities, and hence in the portfolio, resulting from a change in interest rates. Because of its sensitivity range, the value of this component of the portfolio may decrease, either in the case of a rise in interest rates if the portfolio's sensitivity is positive, or in the case of a fall in interest rates if the portfolio's sensitivity is negative.
Credit risk: Credit risk is the risk that the borrower does not repay his debt or cannot pay the coupons during the lifetime of the security. Risk of a fall in the value of equities, and hence in the portfolio, due to a change in the credit quality of the issuers or to the change in credit spreads. Because of its credit sensitivity range, the value of this component of the portfolio may decrease, either in the case of a rise in spreads, if the portfolio's credit sensitivity is positive, or in the case of a fall in spreads if the portfolio's credit sensitivity is negative.
Risks linked to contingent or subordinated securities: The strategy may be exposed to contingent or subordinated securities. Subordinated debt and contingent convertible bonds are subject to specific risks of non-payment of coupons and capital loss in certain circumstances. At a certain solvency threshold, referred to as the "trigger" threshold, the issuer may or must suspend the payment of coupons and/or reduce the nominal value of the security or convert such bonds into shares. Notwithstanding the thresholds specified in the issuing prospectuses, the supervisory authorities may apply these rules preventively if the circumstances require, based on a subjective threshold known as the "point of non-viability". These securities expose holders to either a total or partial loss of their investment following their conversion into shares at a predetermined price or because of the application of a discount provided for contractually in the issuing prospectus or applied arbitrarily by a supervisory authority. Holders of these securities are also exposed to potentially large price fluctuations in the event that the issuer has insufficient equity or experiences difficulties.
Currency risk: The strategy may invest in securities and UCIs that are themselves permitted to purchase stocks denominated in currencies other than the euro. The value of these assets may decline in line with changes in the exchange rates.
Liquidity risk: This is the risk that a financial market can absorb the volumes of sell (or buy) transactions only by significantly decreasing (or increasing) the price of assets when trade volumes are low or when there are market tensions, resulting in a possible decrease in the fund's net asset value.
Equity risk: Investors are exposed to equity risk. Fluctuations in share prices may have a negative impact on the fund's net asset value. The fund's NAV may decrease during periods in which equity markets are falling.
Counterparty risk: Counterparty risk is related to the use of over-the-counter products. The strategy is exposed to the risk of non-payment or delivery by the counterparty with which the transaction is negotiated. This risk may result in a decline in the fund's NAV.
Risk associated with investment in the futures markets: The use of derivatives may cause exposure to an upward or downward change of the fund's net asset value.

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