JOHCM Funds

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Global Value and Income Dispatch

Don't pay too much attention to the default rate. It's rating migration that matters.

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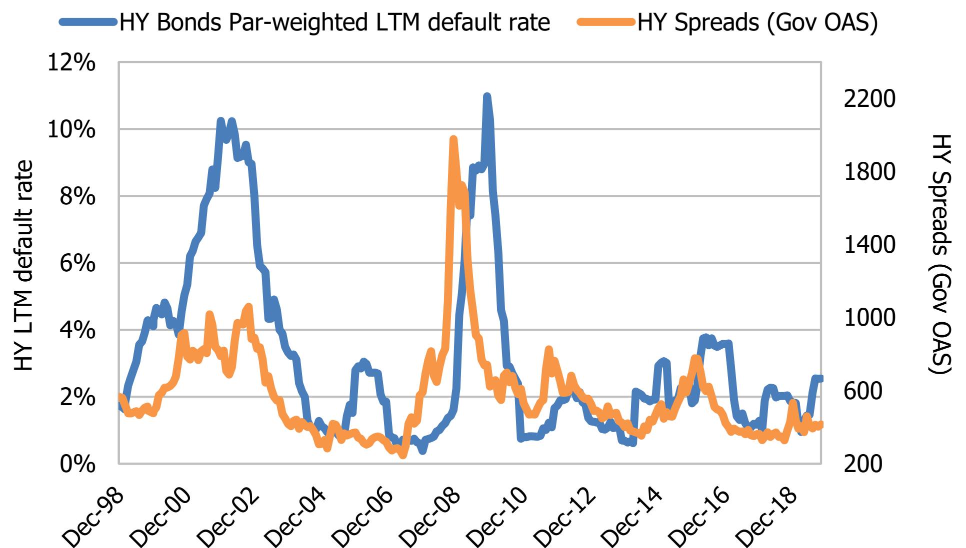
Highlights

Default rate could misrepresent HY market health. QE and looser covenants will prolong the inevitable bankruptcy filing while bond prices will move lower to reflect capital impairment risk.

"How did you go bankrupt?" Two ways. Gradually, then suddenly."
— Ernest Hemingway, The Sun Also Rises

The quote above from Ernest Hemingway, is a perfect summary of the next default cycle in high yield. It will be a prolonged process where a company's securities trade at distress levels with official default/restructuring being postponed to the last possible time. The reason is simple – in an era of abundant liquidity and QE, combined with looser covenants it is very hard to default. We have written extensively about looser covenants (high yield covenants & adjusted EBITDA) which in our view will prolong the default cycle. **In other words, don't pay attention to the default rate, what matters are the sectors that are under stress, rating migration (i.e. downgrade ratio) trend, CCC exposure, and assumed recovery rate to get to a fair value assumption on the HY default compensation risk.**

Default rate vs. high yield spreads – Spreads generally lead the increase in default rates

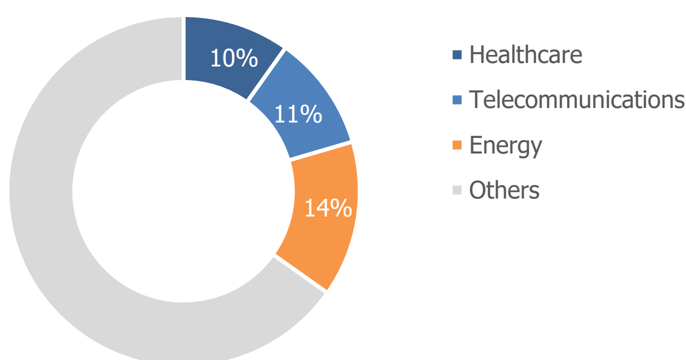


Source: J.P. Morgan; S&P LCD

If you were to look at the chart above, you will see that credit spreads will start to widen out preceding the increase in the overall default rate. The reason is simple – markets are forward looking, however, you may be disappointed to know that the correlation between spreads and the default rate is only 0.50 over the last 20 years. This begs the question then what an outsider should be watching out for?

In this note, our goal is to distill this process to three items that should be on your watch list.

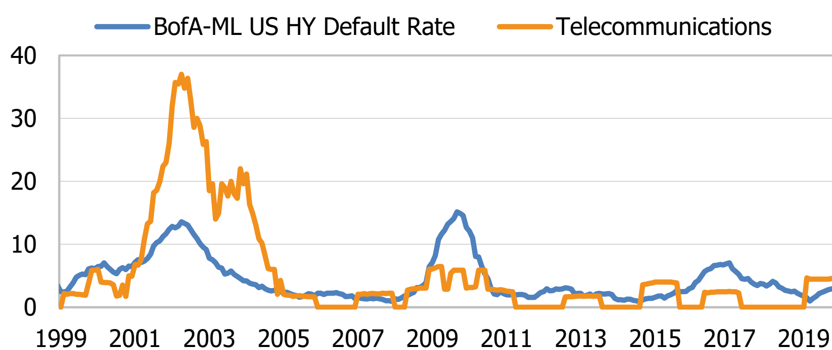
1) Sector composition matters - As you can see from the table below, at various points in the cycle, each sector gets its fair share of defaults. Capital intensive sectors, such as telecom, energy, metals & mining are easy to pick out as their massive capex programs are generally funded with debt with debt service coverage (for the commodity linked sectors) influenced by the commodity price moves.
Today, the widely used BofAML US High Yield Index has three sectors that are ~10% or larger – Energy (14%), Telecommunications (11%) and Healthcare (10%), representing ~35% of the HY index. The trends in these sectors will matter to the overall HY spreads and subsequently the future default rate.

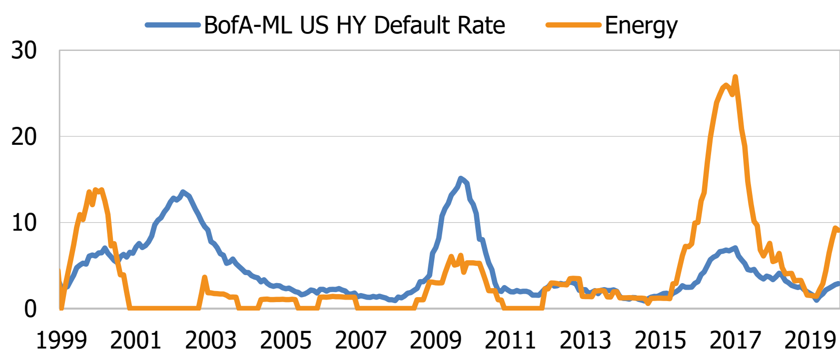


Source: ICE BofAML US HY Index as of October 31, 2019

The sector composition then should be mapped with an assumption around what percentage of the companies within that specific sector will go bankrupt. Past experiences suggest that the number can be large as you can see from the charts below showing the Telecom bust in 2002 and the Energy default cycle in 2016.

LTM Issuer Default Rate (%)





Source: Bank of America, High Yield Strategy Charts, as of November 1, 2019

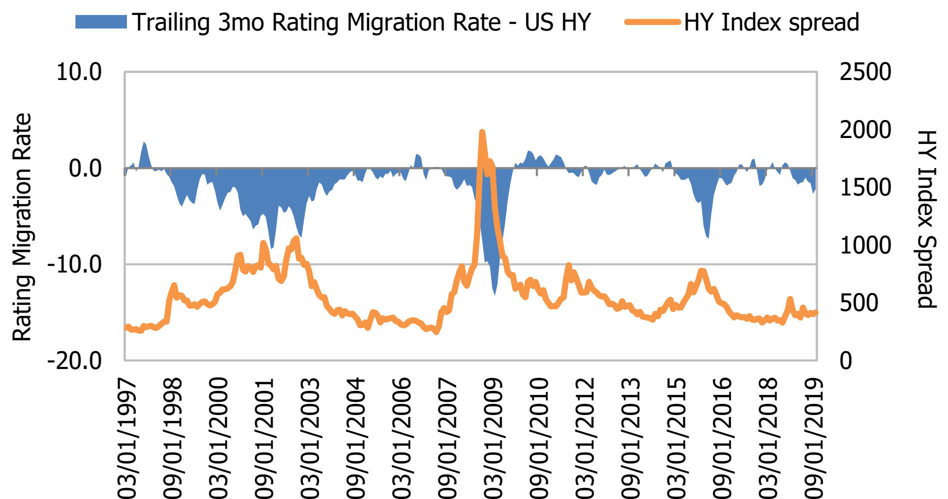
2) Ratings also matter - If you don't want to get too much into the weeds of sector composition, an easy back of the envelope way of assessing future credit risk is to look at the market composition by ratings. As the table below will indicate that generally CCC composition is a good indicator of future default rate. Today, 14% of the BofAML US HY index is rated CCC.

Default rate: by rating 12 months prior to default

	2016	2017	2018	LTM	20-yr Avg.
BB	0.00%	0.00%	0.00%	0.00%	0.89%
BB	5.51%	0.24%	0.15%	0.66%	2.76%
CCC/Split CCC	5.05%	4.64%	7.80%	11.36%	6.07%
HY Default rate	**3.57%**	**1.27%**	**1.83%**	**2.54%**	**3.16%**

Source: J.P Morgan. Twenty-year average is as of December 31, 2018.

3) Rating migration rate may be the most forward looking factor - There is a strong correlation (0.8) between rating migration and HY spreads. In fact, if you can watch one factor, this may be it as fundamental deterioration in credit quality will be first reflected in spreads and eventually be reflected in ratings.

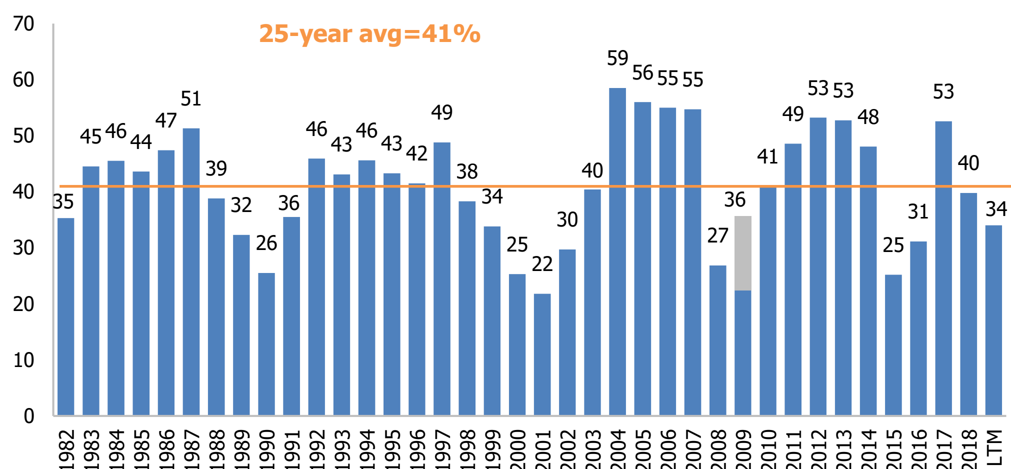


Source: Bank of America, High Yield Strategy Charts, as of November 1, 2019

It's hard to go bankrupt nowadays. An era of looser covenants and abundant liquidity (compliments of ZIRP/QE) will definitely prolong the inevitable restructuring of companies, as companies will exhaust every loophole in the covenant documentation to come up with 1.5 liens, second liens, third liens, stripping assets to issue debt at various subsidiaries etc. The result of this is that default rates will most likely remain in a muted range, but credit spreads will move out to reflect capital impairment risk in the future. **Don't be fooled into thinking that HY asset class may be attractive by the low default rates. Instead, monitor the distress ratio (i.e. percentage of bonds trading below $80 cents and above 1,000 in spread) or rating downgrade trend to asses the underlying credit fundamental health.**

Finally, expect lower recovery rates. The average recovery rate over the last 25 years have been ~41 cents. However the experience of lower recoveries at a time of more aggressive covenant structures indicates a lower recovery rate in the future for the bond holders. We are using 35 cent in recovery in our models.

Bond issuer-weighted recovery rates



Source: Moody's Investors Services; J.P. Morgan. Recoveries in 2009 were 22.4 based on process 30-days post default and were 35.7 based on year-end prices.

Short answer to the question of "Why haven't the default rates gone up?"

Loose covenants and abundant liquidity is making the default rate a notable lagging indicator.

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