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J O Hambro Capital Management Group

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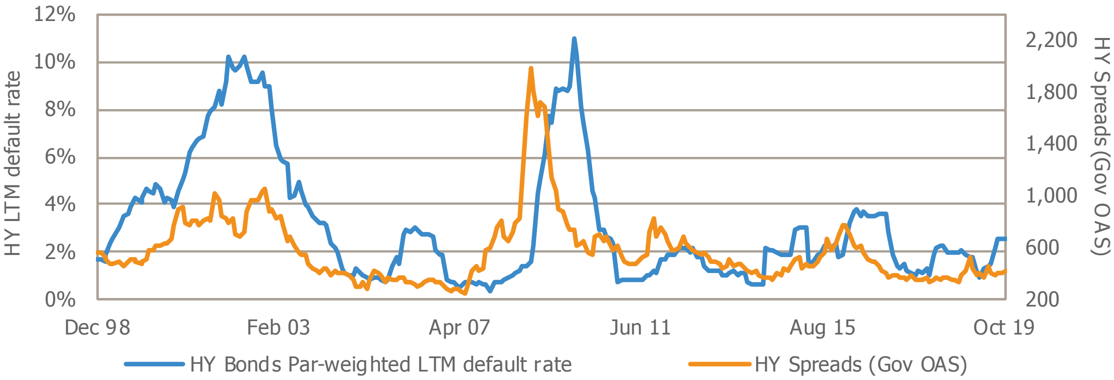
Default rates could misrepresent HY market health. QE and looser covenants will prolong the inevitable bankruptcy filing while bond prices will move lower to reflect capital impairment risk

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

Hemingway’s quote 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 minute. 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, 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



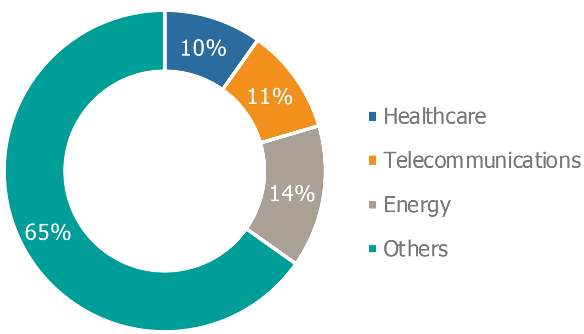
Source: JP Morgan; S&P LCD.

Looking 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: what should an outsider 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 overleaf, at various points in the cycle each sector gets its fair share of defaults. Capital intensive sectors, such as telecommunications, 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 commodity price moves.

US high yield by sector

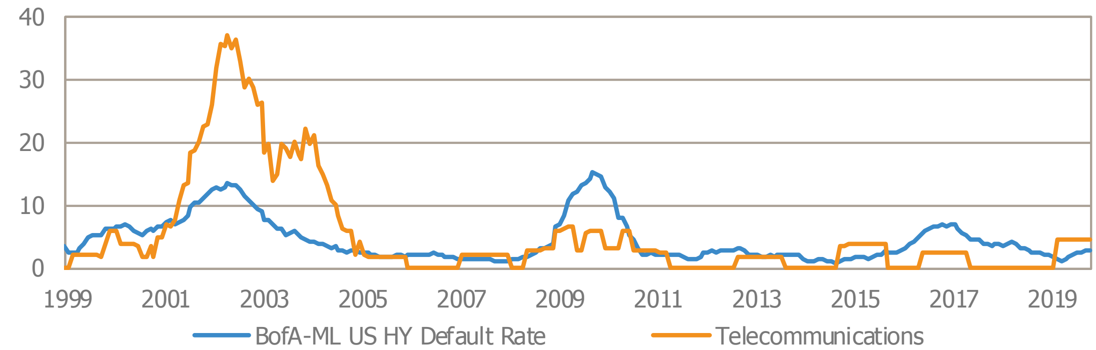


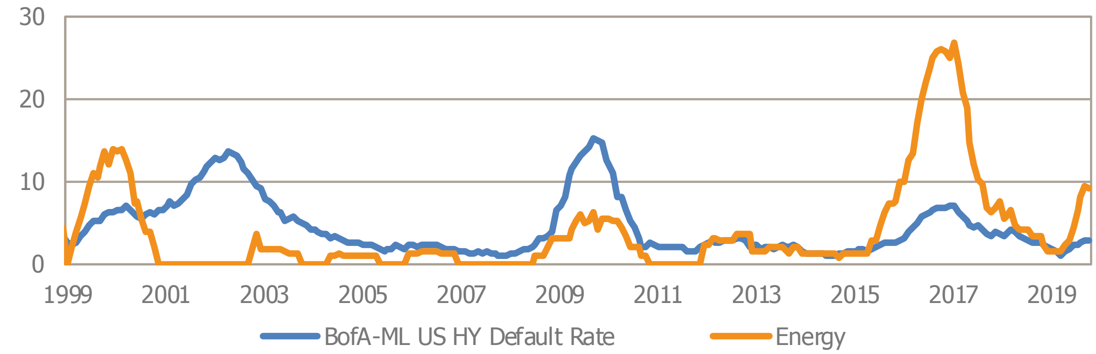
Source: ICE BofAML US HY Index as of 31 October 2019.

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.

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

Last 12 months issuer default rate (%)





Source: Bank of America, High Yield Strategy Charts, as at 1 November 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 indicates, generally CCC composition is a good indicator of future default rate. Today 14% of the BofAML US HY index is rated CCC.

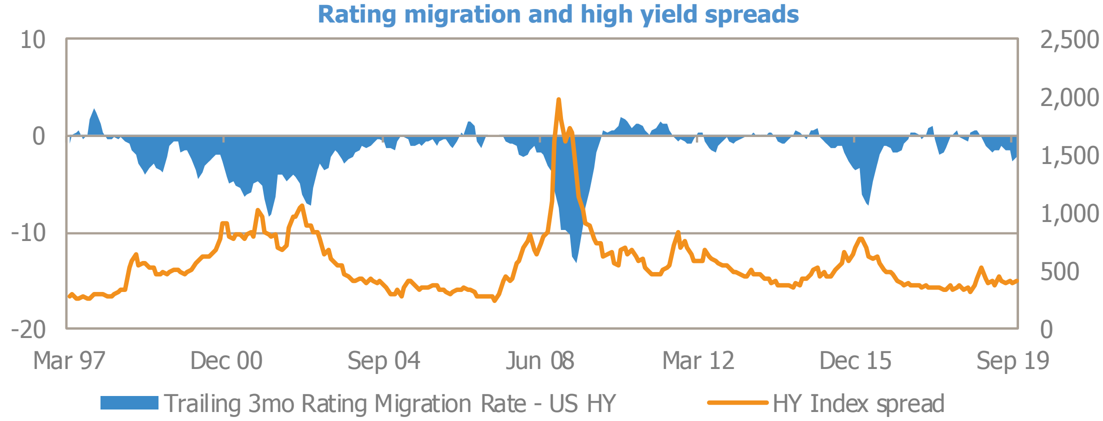
Default rate: by rating 12 months prior to default

	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: JP Morgan. Twenty-year average is as at 31 December 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 only watch one factor, this may be it as fundamental deterioration in credit quality will be first reflected in spreads and eventually in ratings.

Rating migration and high yield spreads

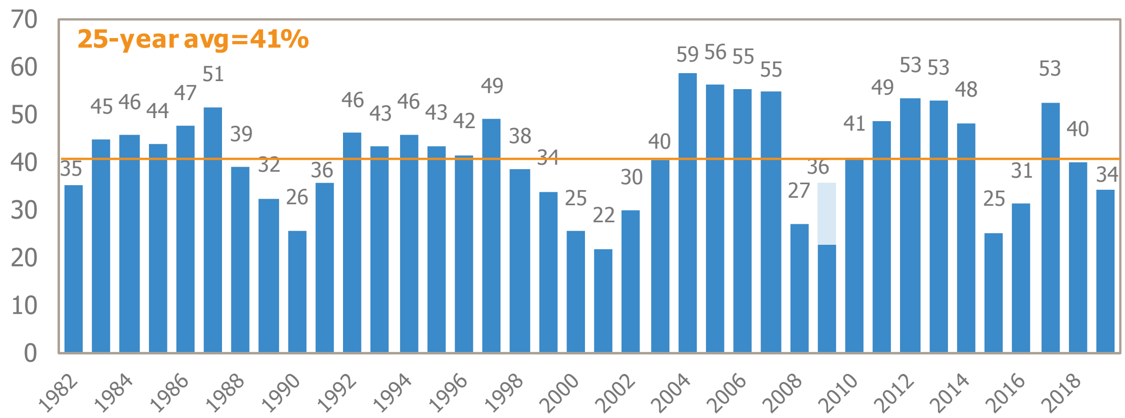


Source: Bank of America, High Yield Strategy Charts, as of 1 November 2019

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 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 the rating downgrade trend to assess the underlying credit's fundamental health.**

Finally, expect lower recovery rates. The average recovery rate over the last 25 years has 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 bond holders. We are using a 35 cents recovery in our models.

Bond issuer-weighted recovery rates



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

The 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.

JOHCM Global Income Builder Fund

5 year discrete performance (%)

Discrete 12 month performance (%):

	30.11.19	30.11.18	30.11.17	30.11.16	30.11.15
A GBP Class	12.19	-	-	-	-

Past performance is no guarantee of future performance.

Source: JOHCM/MSCI Barra/Bloomberg Index Services Limited, NAV of Share Class A in GBP, net income reinvested, net of fees. The A GBP Class was launched on 30 April 2018. Performance of other share classes may vary and is available on request. BLOOMBERG® is a trademark and service mark of Bloomberg Finance L.P. and its affiliates (collectively "Bloomberg"). BARCLAYS® is a trademark and service mark of Barclays Bank Plc (collectively with its affiliates, "Barclays"), used under license. Bloomberg or Bloomberg's licensors, including Barclays, own all proprietary rights in the Bloomberg Barclays Indices. Neither Bloomberg nor Barclays approves or endorses this material, or guarantees the accuracy or completeness of any information herein, or makes any warranty, express or implied, as to the results to be obtained therefrom and, to the maximum extent allowed by law, neither shall have any liability or responsibility for injury or damages arising in connection therewith.