INVESTMENTS®

Research note September 2020

Credit

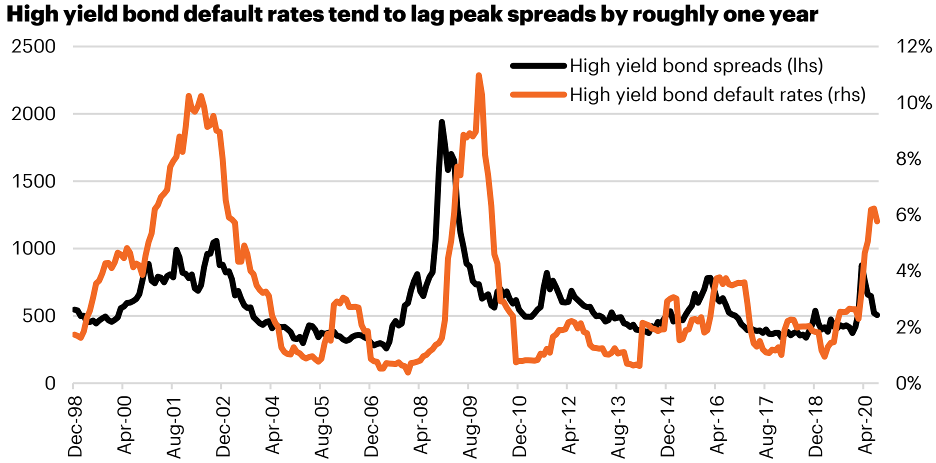
The implications of a rising default rate

Markets have recovered in spectacular fashion following the sell-off during the first quarter. Equities eclipsed their previous record high and credit markets are flirting with positive year-to-date returns. The ride back up was relatively smooth, especially in comparison with the thrashing that markets took throughout February and March. However, as the pandemic lingers and the world still faces a great deal of uncertainty, many investors seem to be wondering when (or if) the proverbial other shoe is going to drop. In credit, many cite the coming wave of defaults as cause for concern. We feel differently.

Key takeaways
- Default rates tend to lag peak spreads by roughly one year, meaning we could see rising default rates in credit for the next six months.
- As a lagging indicator, an increase in defaults does not necessarily mean lower returns.
- The complexities of investing in defaults or distressed investments, and the range of potential outcomes, require experienced managers.

The virtual halt in economic activity this year has all but guaranteed rising default rates in credit markets. The Federal Reserve's swift, omnipresent actions have undoubtedly been instrumental in staving off a financial crisis, and the combination of direct lending to companies and the purchase of corporate bonds in the secondary market has helped many bond and loan issuers ensure liquidity during this unprecedented time. But virtually no industry or company has been unaffected by the COVID-19 crisis. Defaults have already begun to rise, and we expect to see that trend continue. The default rates for both high yield bonds and senior secured loans have reached 10-year highs, hitting 5.77% and 4.38%, respectively.

High yield bond default rates tend to lag peak spreads by roughly one year



Source: ICE BofAML High Yield Index, Bloomberg, J.P. Morgan, as of August 31, 2020.

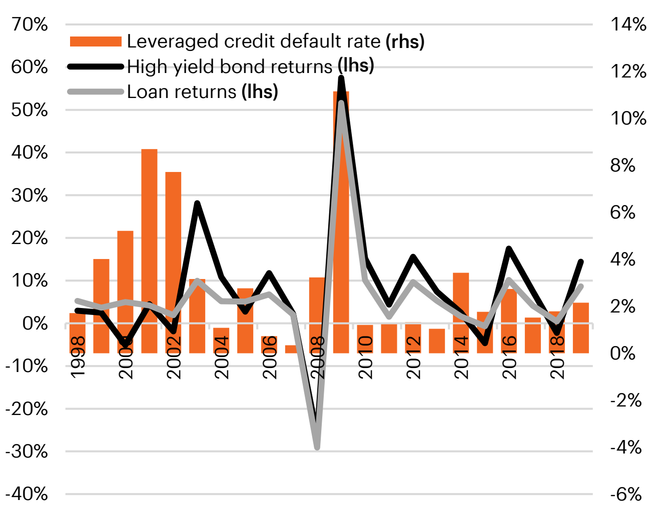
Historically, default rates have tended to lag peak credit spreads by roughly one year. Spreads peaked on March 23, meaning if the typical pattern holds, we may see increasing levels of defaults for another 6–8 months. At that time the default rate may begin to fall, but current forecasts for 2021 are still in excess of historical averages.

Default rates and returns

What do rising default rates mean for credit investors today? The short answer could be not a whole lot. While some may believe that elevated defaults are a reason to reduce exposure or delay an allocation to credit, history tells us otherwise. Defaults are typically a lagging indicator, meaning it is not uncommon to see default rates rise coincidentally with markets.

During the Great Financial Crisis (GFC), default rates peaked in November 2009. After that, the one-year forward return for high yield bonds was 18.8%. Examining annual default rates versus annual returns for both high yield bonds and loans shows that rising default rates do not necessarily mean lower returns.

Rising default rates do not necessarily mean lower returns



Source: ICE BofAML U.S. High Yield Bond Index, S&P/LSTA Leveraged Loan Index, J.P. Morgan, January 1, 1999–December 31, 2019.

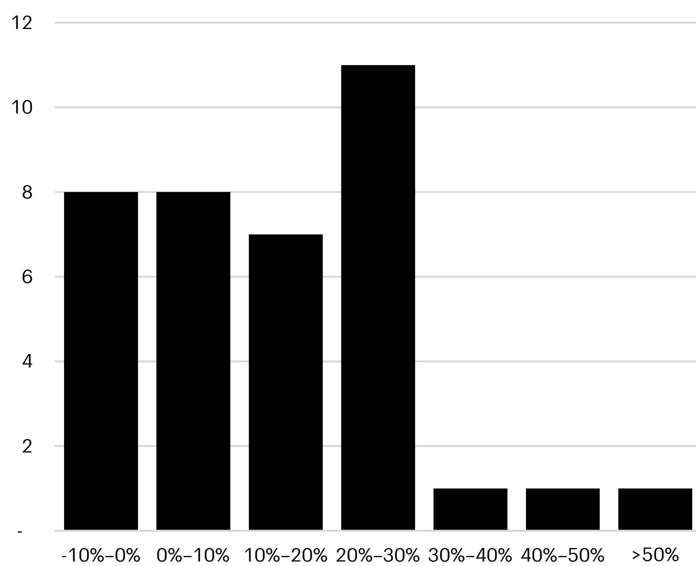
This relationship, or lack thereof, becomes especially apparent when plotting monthly returns versus default rates. History shows very little (if any) correlation between the two measures.

Monthly high yield returns vs. default rates

Source: ICE BofAML U.S. High Yield Index, December 31, 2000–August 31, 2020.

While historically there is little correlation between defaults and returns over the long term, data shows returns for high yield following periods of elevated defaults have historically been strong. Forward 12-month returns have been positive approximately 80% of the time when TTM default rates are greater than 6%, as they are today. Furthermore, the median return is nearly 7%, roughly 50 bps better than average annual returns during all periods.

Frequency of forward 12-month returns following default rates >6%



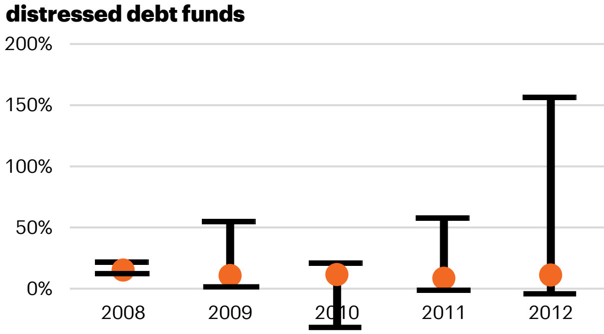
Source: ICE BofAML U.S. High Yield Index, J.P. Morgan, January 1, 1999–August 31, 2020.

How to invest in defaults

Defaults are a normal part of the credit cycle and, in fact, investing in distressed or defaulted companies has the potential to be very rewarding—if done correctly. These are often extremely complex situations, with vast considerations—legal, financial and otherwise—that can lead to extremely different outcomes and return profiles. For instance, some investments in defaulted or bankrupt companies may look very similar to regular, performing investments. In these situations, debt at or near the top of the capital structure may be paid or accrue current income during the bankruptcy process and may be fully reinstated with no loss of principal at the end of the process. This typically occurs when the company is perceived to have sufficient enterprise value to fully cover the debt that remains current. In other situations, when there typically isn't enough enterprise value to cover more-junior debt obligations, those securities may end up converting into the new equity of the company. If invested in properly, these "loan to own" investments can reward investors with equity-like returns, but they also carry a heightened amount of risk. There are also a variety of situations that fall in between these opposing outcomes, making it imperative that investors appreciate the complexity of the bankruptcy process.

Choosing the manager then becomes crucial when considering investing in defaults or distressed investments. And it may not be an easy choice—as evidenced by the wide dispersion in returns among distressed credit managers following the GFC. We examined the internal rate of return for 2008, 2009, 2010, 2011 and 2012 distressed credit vintages (those we believe are best suited from a timing perspective to take advantage of the market distress following '08) and found a large disparity between the top, bottom and median performers.

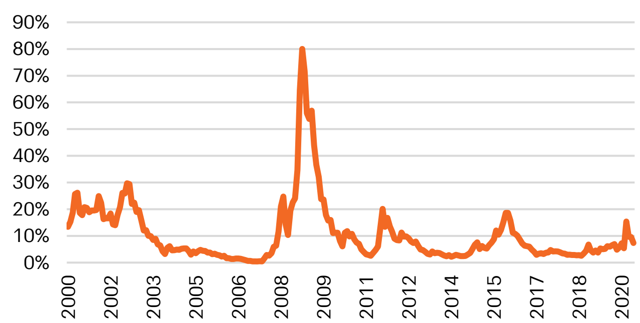
Performance dispersion among private distressed debt funds



Source: Preqin, as of June 30, 2020. High,low and median returns of private distressed debt funds

Plus, the opportunity set may be more limited this year than in other crises. Periods of higher defaults are typically preceded by a rising distressed ratio. In the high yield bond market, this measures the percentage of issuers trading with spreads wider than 1,000 bps. In the senior secured loan market, this is defined as the percentage of loans trading below 80 cents on the dollar. In the GFC, the distressed ratio in both the high yield bond and loan markets began rising in January 2008 and peaked at just over 80% in November 2008. The ratio remained in double digits for roughly two years before falling below 10%. In 2000, after reaching a peak of 25%, the distressed ratio remained elevated for 38 months before returning to single digits. In the current crisis, the distressed ratio peaked at 16.3% for just one month before falling to sub-10% levels again.

High yield distressed ratio



Source: ICE BofAML U.S. Distressed Index.

Today, the distressed ratio for high yield sits at 7.5%. Still more opportunity than in a "normal" market environment, but it has retreated significantly faster compared to what we've seen in previous default cycles.

We believe, however, that the dislocation story we're seeing in markets does not only extend to defaults or distressed investing. Record levels of fallen angels, technical dislocations in the loan market as result of forced selling by CLOs, and heightened dispersion among industries and credit ratings in broad markets have created unique, historic opportunities. We think managers with the ability to shift tactically across asset classes, industries and credit ratings, and those with the skills and expertise to invest in a variety of strategies or situations, including defaults and bankruptcies, may be best positioned to take advantage of today's market environment.

Robert Hoffman

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As Managing Director of Investment Research, Robert leads the team that analyzes the fundamentals behind market movements, macroeconomic trends and the performance of specific industries—as well as their potential impact on investors. His nearly two-decade tenure in the financial services industry includes experience as a loan portfolio manager and senior credit analyst focused on corporate loan issues. Robert serves as the firm's primary subject matter expert on the corporate credit markets and select alternative investment solutions, developing targeted communications and educational resources

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Kara is an associate on the Investment Research team at FS Investments, where she leads research efforts on the corporate credit sector and helps develop strategic education on liquid alternatives. She holds a BBA in Finance and a BBS in Accounting and has experience investing private credit funds and in public accounting. Kara sits on the advisory board of ECHOES Around the World and volunteers with FS Investments' financial literacy and education programs.

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