INSTITUTIONAL PERSPECTIVES

What High Yield Valuations Are Implying About the Forward Corporate Default Rate

March 19, 2020

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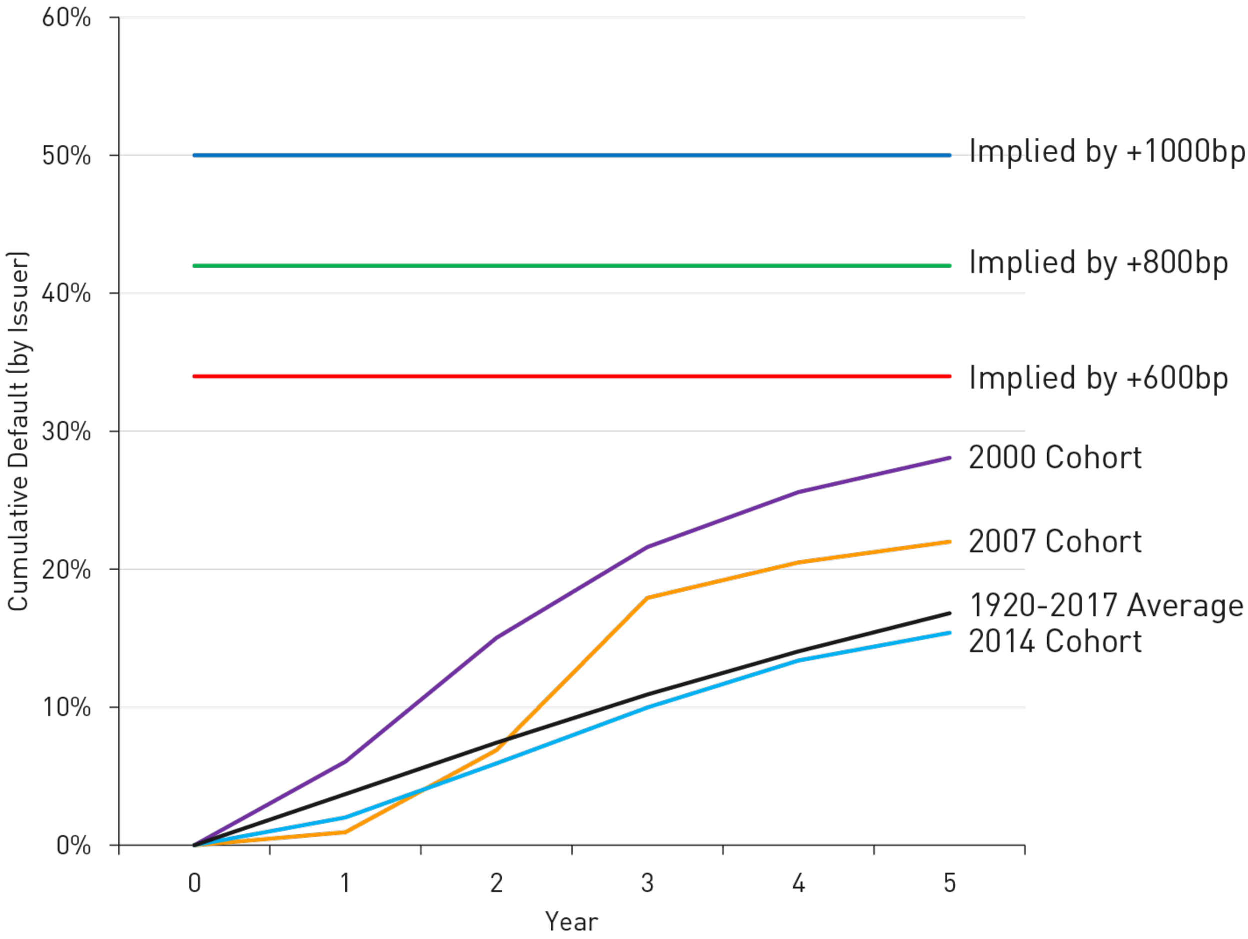
The current market environment is leading many credit investors to more closely examine default and recovery expectations.

In fast-moving and choppy market environments like today, it can be worthwhile to consider the question: "What's in the price?" Credit investors are compensated for a number of risks and factors through a credit spread above and beyond the yield on risk-free benchmarks. They can include compensation for relative liquidity, credit quality changes brought about by both management actions, or the operating environment itself, and of course default risk. Further, investor sentiment and flows can play a role in driving credit spreads in the short term. For strategic investors with a long term mindset, we believe default and recovery estimates are *the* key considerations in determining appropriate spread levels.

Chart 1. Looking at Pricing from a Default Perspective
Severe default outcome already priced in to high yield spreads



Source: Moody's and Lord Abbett. Data as of 12/31/2019. Implied default analysis assumes 5-year term and 30% recovery. **Past performance is not a reliable indicator of future results.** For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

In the chart above, we address these key variables by approximating the implied cumulative default of a hypothetical credit portfolio of five-year maturity, assuming 30% recovery. Specifically, we run sensitivities around the implied default expectations in a portfolio at credit spreads of +600 basis points (bps), +800 bps and, +1000 bps. For example, at a spread of 800 bps, our analysis suggests that this level of credit spreads could be considered "fair value" should 42% of the issuers in a hypothetical credit portfolio default over five years. Keep in mind that the current spread on the ICE BofA US High Yield Constrained Index is right around there as of March 18 (+841 bps).

Next, we then chart out the cumulative default experience for a number of starting cohorts that were the source of periods of rising defaults in the high yield market: January 2000, January 2007 and January 2014. A few points worth noting on each period (utilizing default data from Bloomberg):

- 2000: This cohort's default experience resulted from the leverage built up in credit markets leading to Y2K, the tech boom, outsized capital spending in the telecommunications sector and the ultimate failure bourn of accounting scandals at WorldCom and Enron. Notably, this is the most severe of the three cycles we considered – actually worse than the cumulative corporate default experience around the Global Financial Crisis.

- 2007: This cohort's defaults were again driven by corporate leverage built up pre-crisis from the climb in leveraged buyout (LBO) activity, outsized corporate spending, debt financed share buybacks and the financial crisis that resulted from the troubles in the global banking system, U.S. housing market, and with consumer balance sheets.

- 2014: This cohort's defaults were driven by leverage that largely built up in a few specific sectors, namely: energy, mining and to a lesser extent, retail. Note that the cumulative default experience in the five years that followed was not all that far off from the average default experience seen over five year periods using data from 1920. No recession ensued as the credit damage was largely contained to a small segment of the economy.

A Final Word on Market Pricing Considerations

At prevailing credit spreads, investors are bracing for almost twice the cumulative corporate default experience that eventually occurred around the Global Financial Crisis. Of course every cycle can be different, and much of the market's reactions around 2008 were about systemic counterparty and banking system issues, not corporate credit. There is much still to be determined about the amount of economic output and growth ”lost” versus ”delayed” given the current macro environment. But we believe it's always important to calibrate what the market is already priced for and consider if that outcome should be a base case assumption about the picture going forward.

Glossary of Terms

A **basis point** is one one-hundredth of a percentage point.

The **fair value** of a bond is the present value of the bond's coupon interest payments plus the present value of the face value payment at maturity, discounted at the market's required rate of return for the bond in question.

“LBO” refers to leaveraged buyout.

Spread is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure. A bond spread is often expressed as a difference in percentage points or basis points (which equal one-one hundredth of a percentage point). The **option-adjusted spread (*OAS*)** is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst uses the Treasury securities yield for the risk-free rate.

Treasuries are debt securities issued by the U.S. government and secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes.

ICE BAML US High Yield Index tracks the performance of US dollar denominated below investment-grade corporate debt publicly issued in the US domestic market.

ICE BofAML Index Information:

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