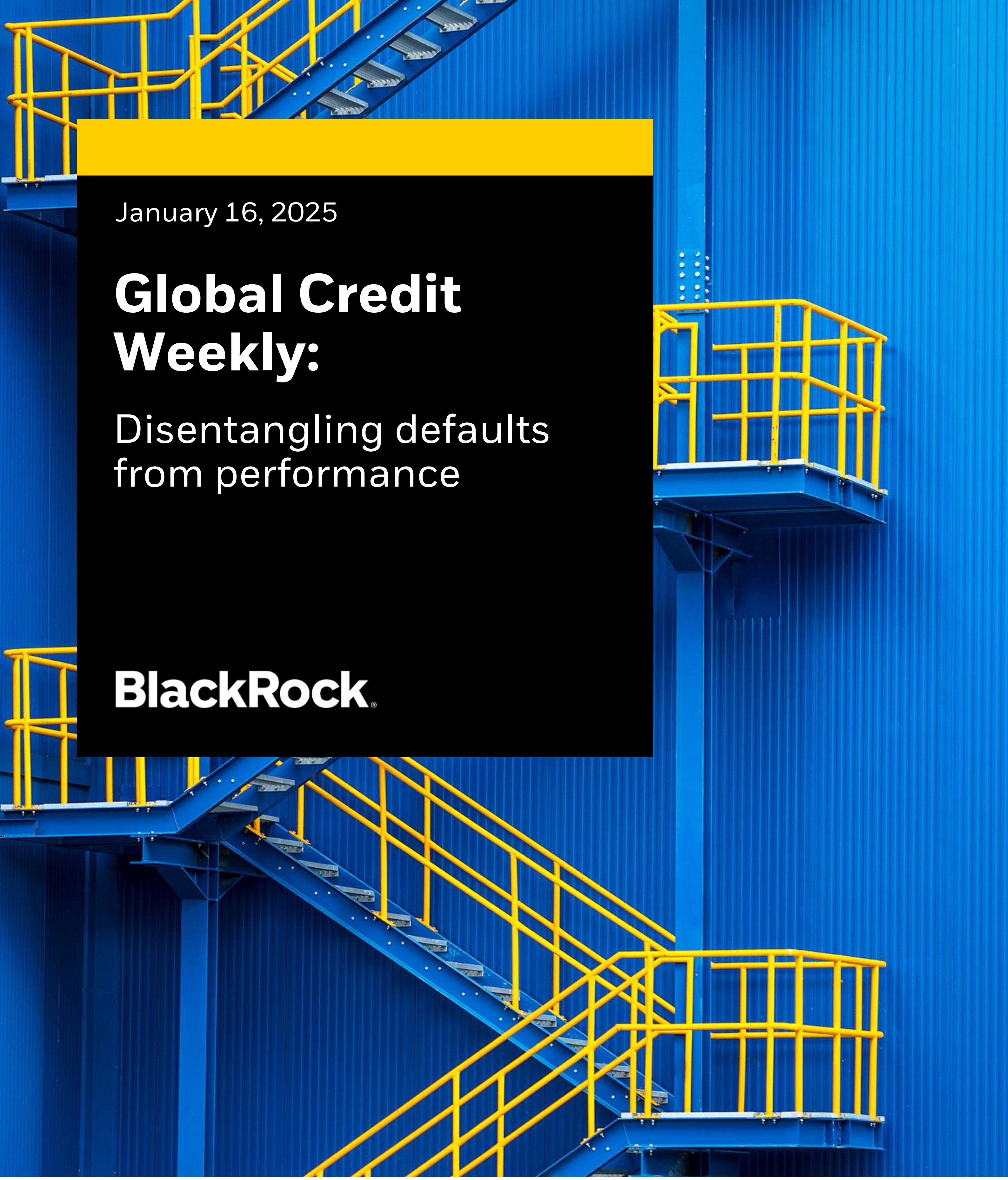

January 16, 2025

Global Credit Weekly:

Disentangling defaults from performance

BlackRock

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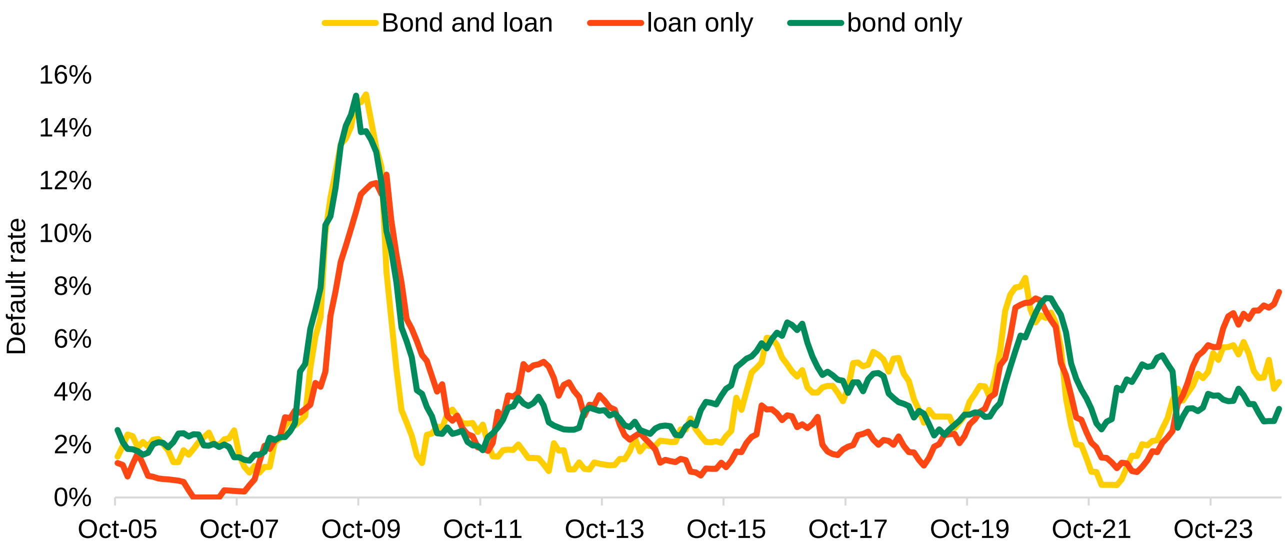
Key takeaways

- In recent weeks, market pricing has reflected some reduced scope for Federal Reserve (Fed) interest rate cuts - beyond the 100bp already delivered. This is consistent with our expectation for a monetary policy *normalization* cycle (vs. *easing*) and a backdrop of structurally higher interest rates – at least relative to much of the post-financial crisis era.
- In response to these developments, some market participants have questioned whether such a backdrop could drive an increase in financial distress (and defaults) among USD corporate credit borrowers. We believe the bar is high, owing in large part to a supportive (above-trend) U.S. growth backdrop which should enable corporates to continue to navigate higher rates with resilience (at least in aggregate). Moreover, the proactive refinancing and pre-funding activity completed over the past few quarters has bolstered financial flexibility among speculative grade borrowers and reduced the likelihood of a payment shock, in our view.
- While our general expectation remains "dispersion and not widespread disruption," in this *Global Credit Weekly*, we take a closer look at the signaling from recent default data. We identify four key patterns: (1) a record divergence between leveraged loans and HY bonds; (2) smaller firms defaulting at a higher rate vs. larger peers; (3) an increase in distressed exchanges; and (4) a record level of "repeat defaulters". We also outline why the impact of default activity on aggregate corporate credit performance was rather limited in 2024 – a trend we expect to persist.
- While "default" terminology is not directly comparable across liquid and private credit markets (we prefer instead to compare loss rates), one consistent theme is evident: the smallest firms (by EBITDA) have also been generating a disproportionate share of covenant default activity in the U.S. private credit market.

Exhibit 1: Default dispersion across capital structure types

Issuer-weighted, trailing 12-month default rates for the global universe of issuers tracked by Moody's. Default rates include payment defaults and distressed exchanges.



Source: Moody's, BlackRock. As of November 2024 (most recent available as of January 14, 2025).

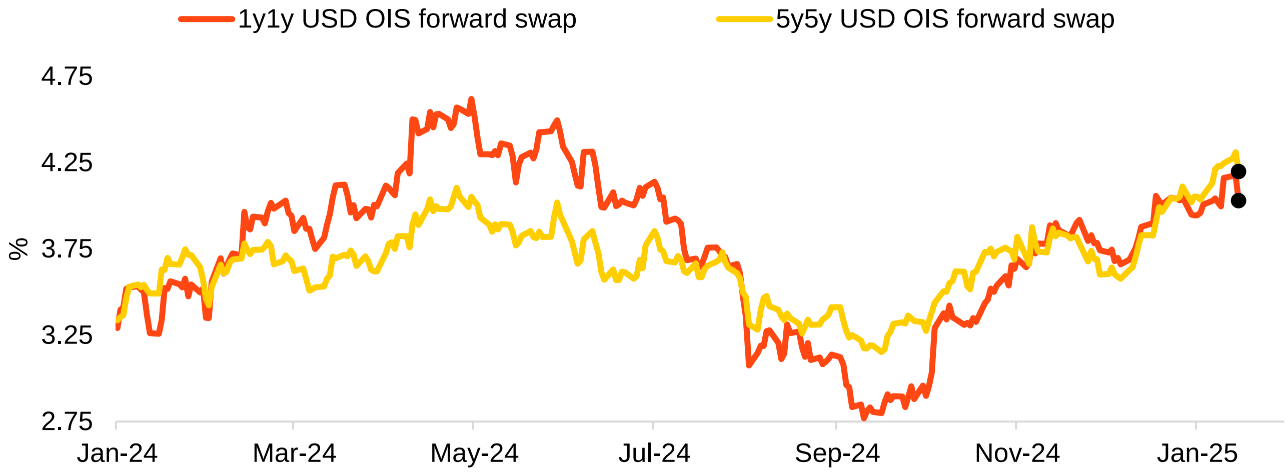
Structurally higher rates, and the read-through for credit

Expectations for additional rate cuts from the Federal Reserve – beyond the 100bp already delivered since September 2024 – have moderated since early December (Exhibit 2). The market's repricing of a higher terminal rate for this cycle, as well as a higher longer-term neutral rate, is consistent with our expectation for monetary policy *normalization*, as opposed to *easing*. After all, U.S. growth is still tracking at an above-trend pace (+2.7% per the Atlanta Fed GDPNow, as of January 9th) and the labor market has shown early signs of stabilization, following the cooling that occurred over the past several months (Exhibit 3).

These developments – and the prospect of a prolonged period of structurally higher interest rates, at least relative to much of the post-financial crisis era – have caused some market participants to question whether this could drive an uptick in financial distress among corporate debt issuers.

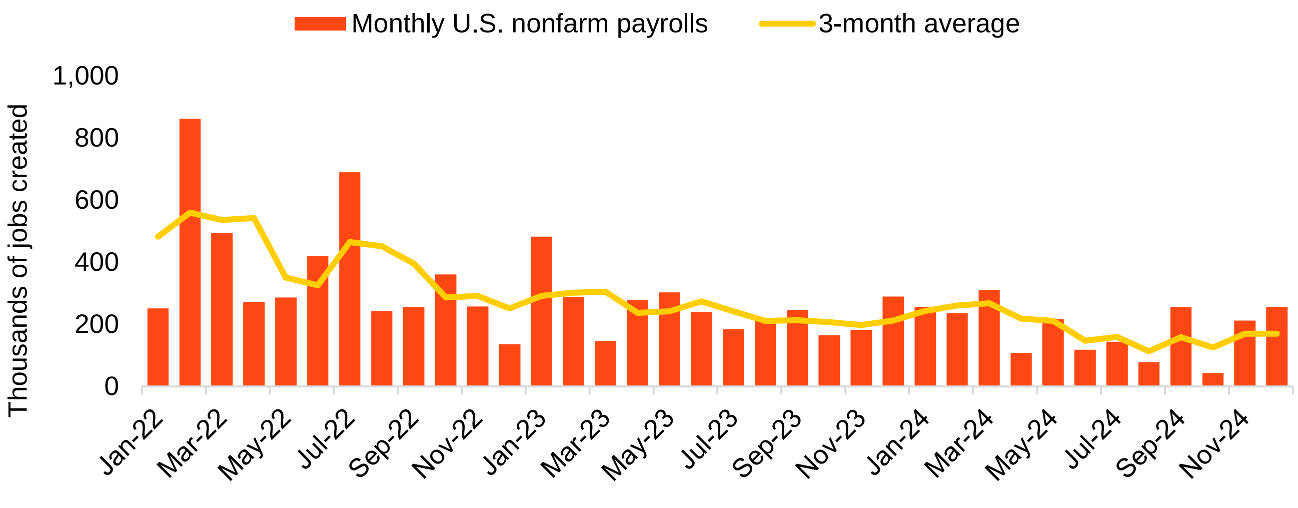
In this *Global Credit Weekly*, we highlight the nuanced patterns visible in the default data in recent quarters and address why the impact on performance has, so far, been quite limited. Looking ahead, the growth backdrop remains paramount for corporate credit fundamentals. So long as the pace of growth is at a trend pace (or ideally, above), we believe corporate borrowers can continue to show resilience in aggregate and navigate a higher interest rate environment. That said, dispersion will likely persist.

Exhibit 2: The market's pricing of the Fed's terminal and neutral rates has fluctuated
1y1y Overnight Indexed Swap (OIS) forwards, as a proxy for the terminal rate of this cycle, and 5y5y OIS as a proxy for the long-term neutral rate



Source: Bloomberg, BlackRock. As of January 15, 2025. **There can be no guarantee any forecasts may come to pass.**

Exhibit 3: Payrolls have shown early signs of stabilization, after a few months of weaker prints
Monthly change in U.S. nonfarm payrolls and the three-month moving average pace of job creation



Source: BlackRock, Bloomberg, Bureau of Labor Statistics. Captures data through December 31, 2024 (most recent available).

The nuances of the default backdrop

Four visible patterns have emerged from the recent default data in the liquid credit market:

1. **Leveraged loan defaults** have continued to meaningfully outpace their HY bond peers – a highly unusual development in the context of the past two decades.
2. **Smaller companies** are driving the bulk of the default activity. Notably, a similar trend is also visible in the private credit market, when isolating covenant defaults.
3. **Distressed exchanges** are representing a greater share of overall default activity.
4. **The share of "repeat defaulters"** is elevated relative to history. This suggests that, in some instances, distressed exchanges may not provide the degree of balance sheet relief ultimately required (compared to a traditional Chapter 11, for example).

We expand upon each factor below, and outline how some are interconnected. We also outline why the impact of defaults on corporate credit performance has remained somewhat muted, in aggregate.

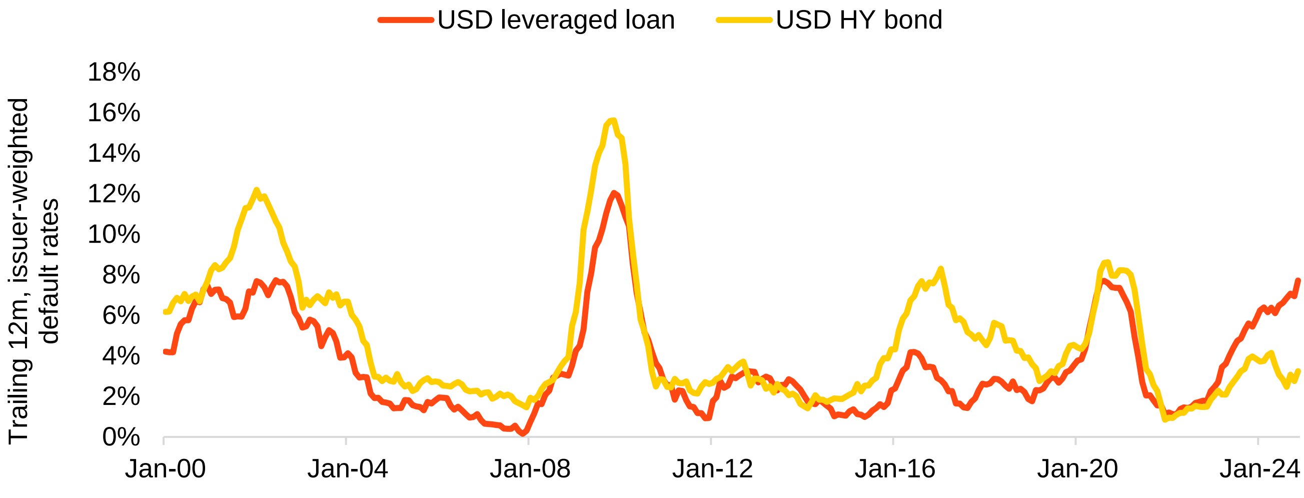
#1: Leveraged loan defaults continue to outpace HY bonds

One of the most notable default-related trends in the USD liquid credit market has been the persistent divergence between leveraged loans and HY bonds. This is illustrated in Exhibit 4, using issuer-weighted default data from the universe of USD leveraged loans and HY bonds tracked by Moody's. Exhibits 1 and 5 provide more granular cuts of the data, by capital structure mix. Here too, so-called "loan only" capital structures have led in terms of defaults in the liquid credit market, by issuer count and by volume.

The 446bp differential between the USD leveraged loan and HY bond default rate is now the widest since the Moody's data began in 1996. As we have outlined previously, a key reason for this is the transmission of monetary policy. Floating rate borrowers were impacted by higher borrowing costs shortly after the Fed began raising rates (in March 2022). Borrowers with fixed rate bonds, by contrast, encountered higher borrowing costs if/when they refinanced lower cost debt into a higher interest rate environment.

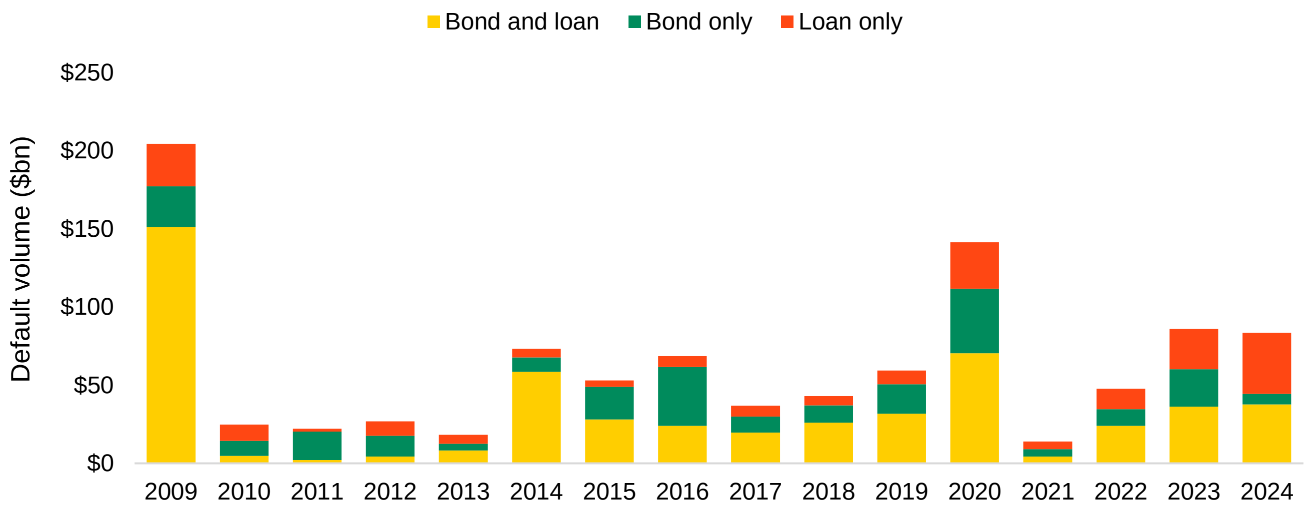
Other fundamental differences between the USD leveraged loan and HY bond markets – such as the loan universe's lower rating distribution and different sector exposures – have also likely contributed, as we outlined in late 2024. But in our view, the transmission of monetary policy is the key driver. While some incremental rate relief has flowed to floating rate borrowers following the rate cuts already delivered, the impact from structurally higher rates has nonetheless impacted fundamentals. We look for the leveraged loan default rate to stabilize by mid-2025, barring a sharp downturn in growth (not our base case).

Exhibit 4: The leveraged loan vs. HY default rate divergence has persisted
Trailing 12-month, issuer-weighted default rates for the universe of USD HY bonds and leveraged loans tracked by Moody's



Source: BlackRock, Moody's. As of November 30, 2024 (most recent available as of January 14, 2025). Moody's default definition includes both a payment default and distressed exchange activity.

Exhibit 5: “Bond-only” capital structures were less likely to default in 2024
Default volume, by capital structure type. Default includes payment defaults as well as distressed exchanges.



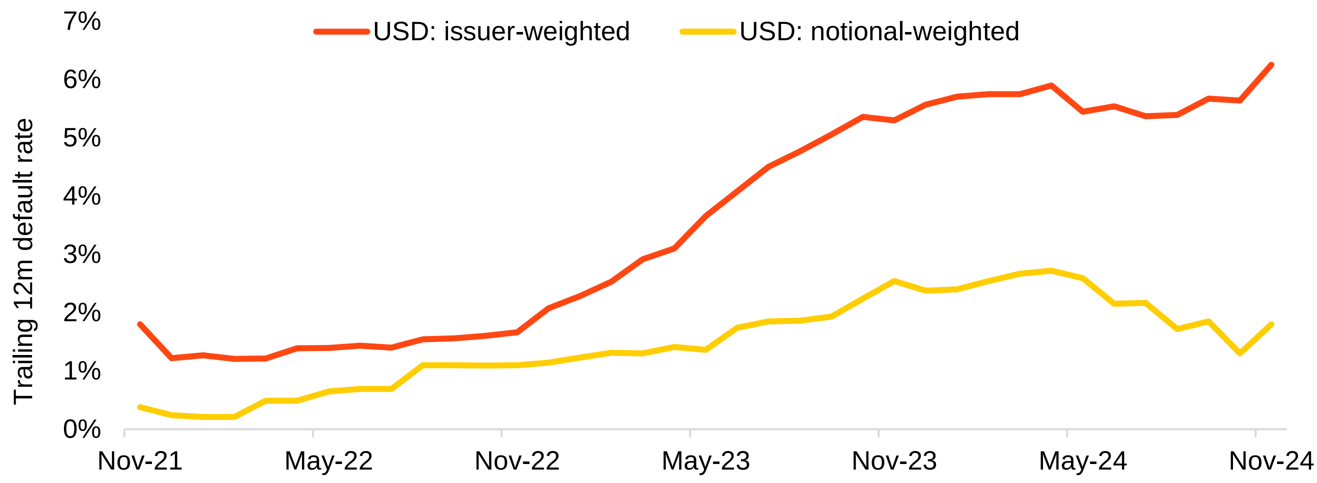
Source: J.P. Morgan Research, PitchBook LCD, Bloomberg, S&P/IHSMarkit, BlackRock. Captures data through December 31, 2024.

#2: Smaller companies are driving the default activity

Second, default activity has been driven by smaller issuers over the past several quarters. This is visible when comparing issuer-weighted metrics (which treat each default equally, regardless of the size of companies' debt capital structures) and notional-weighted metrics (which would be influenced by the *amount* of debt that defaults). In Exhibit 6, we show the divergence between issuer- and notional-weighted metrics for the universe of USD leveraged loans and HY bonds (combined) tracked by Moody's. The data indicate smaller companies have been driving much of the increased default activity in recent quarters. For example, the trailing 12-month, *issuer-weighted* default rate was 6.3% as of November 2024, but the n*otional-weighted* default rate was only 1.8%.

In many instances, smaller firms may lack the financial flexibility, operational efficiencies, and diversification that many of their larger peers may enjoy. They may also skew more heavily towards “loan only” capital structures, where the minimum size requirements for index eligibility for a loan tranche tend to be smaller than those determining index eligibility for a HY bond tranche.

Exhibit 6: Smaller issuers have been driving the recent default activity in the USD market
Issuer-weighted and notional-weighted trailing 12-month default rates, for the universe of USD leveraged loans and HY bonds tracked by Moody's. Data includes payment defaults as well as distressed exchanges.



Source: Moody's, BlackRock. As of November 30, 2024 (most recent as of January 14, 2025).

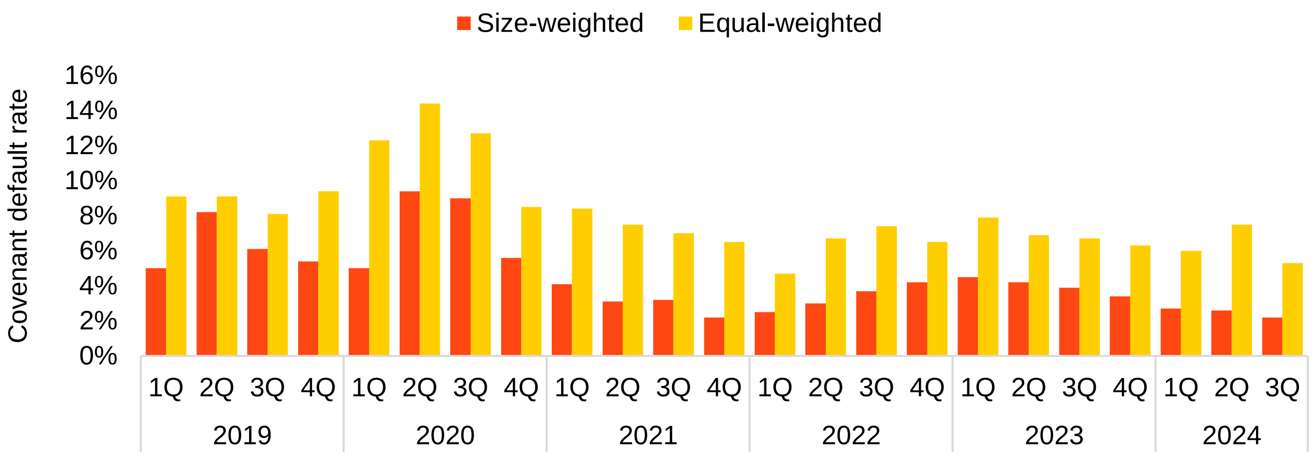
Private credit *covenant* default trends echo the same size distribution

Notably, we see the same pattern in the private credit market related to company sizing and covenant default activity. Exhibits 7 and 8 illustrate this using the universe of U.S. portfolio companies (approximately 5,200) captured in the Lincoln International Proprietary Private Market Index. As shown below, the size-weighted covenant default rate has been declining for six consecutive quarters. But the equal-weighted covenant default rate is more elevated. Moreover, the companies on the smallest end of the size spectrum – those with less than $10 million in annual EBITDA – have the highest rate of covenant defaults. This again underscores the point on dispersion within asset classes.

Note: For more information on the important differences between “default” terminology across private credit and liquid credit markets – as well as the most recent data on private credit *loss* rates (which we view as most informative) – please see our *1Q2025 Global Credit Outlook*.

Exhibit 7: In the private credit market, a divergence between size-weighted and issuer-weighted covenant default metrics exists

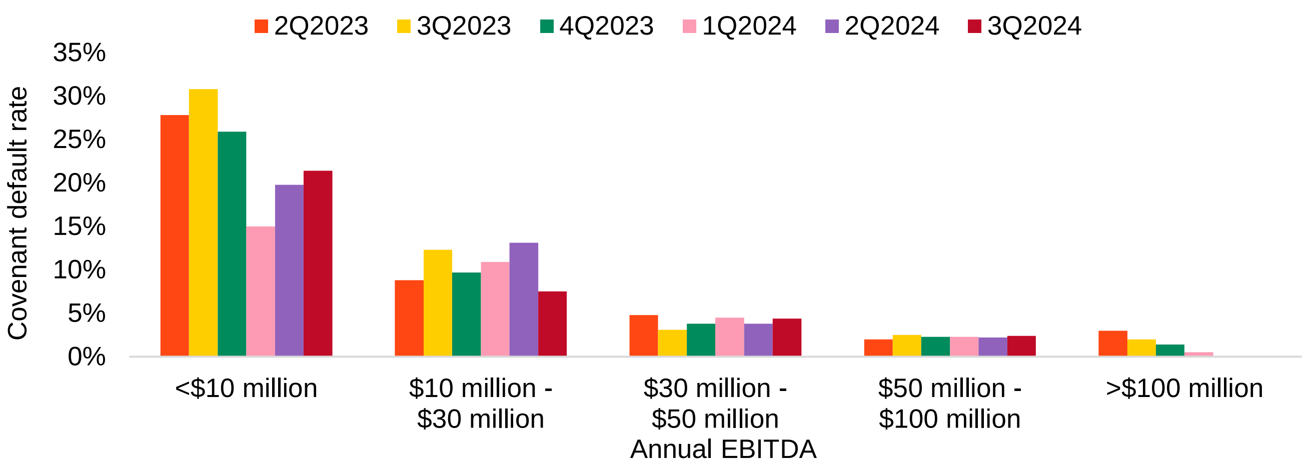
Aggregate covenant default rate, including size-weighted and instance-weighted, for the U.S. portfolio companies included in the Lincoln International Proprietary Private Market Database



Source: Lincoln International Valuations & Opinions Group Proprietary Private Market Database, BlackRock. As of 3Q2024 (most recent as of January 14, 2025). A default is defined by Lincoln as a covenant default (not necessarily a monetary default). The size-weighted calculation considered the total net debt balance for each of the portfolio companies that had a defaulting security in the respective quarter.

Exhibit 8: The smallest firms continue to generate the highest covenant default rates

Covenant default rates (size-weighted, by annual EBITDA) for U.S. portfolio companies in the Lincoln International Proprietary Private Market Database



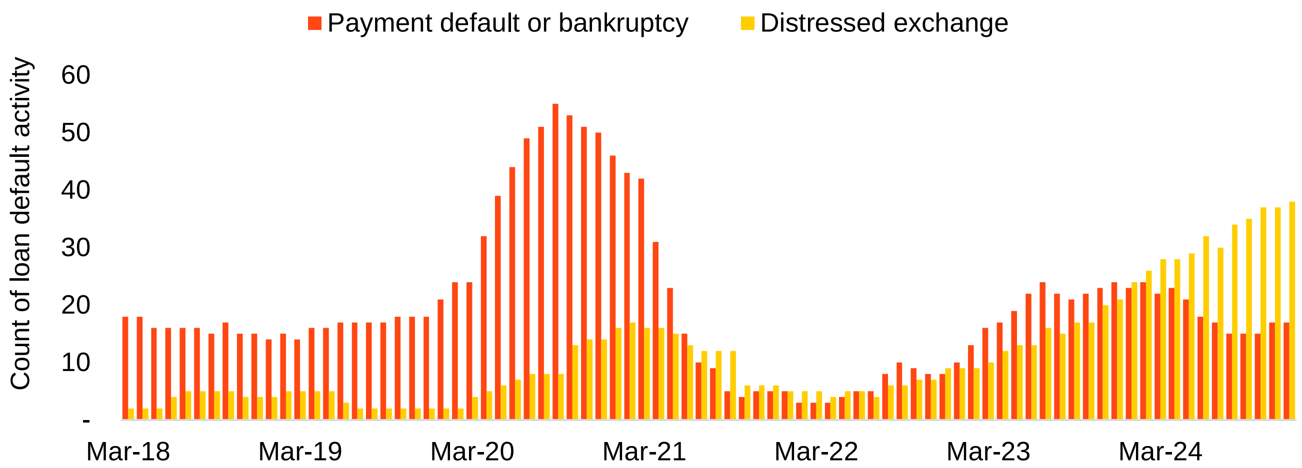
Source: Lincoln International Valuations & Opinions Group Proprietary Private Market Database, BlackRock. As of 3Q2024 (most recent as of January 14, 2025). Note: A default is defined as a covenant default (not necessarily a monetary default). The analysis is based on a size-weighted approach, which considers the total net debt balance for each of the portfolio companies that had a defaulting security in the respective quarter.

#3: Distressed exchanges are becoming more common

The third visible pattern relates to the increased frequency of distressed exchanges, which are sometimes referred to as out-of-court "liability management exercises (LMEs)". Distressed exchange volume in USD syndicated markets (including both leveraged loans and HY bonds) doubled from $28 billion in 2023 to $57 billion in 2024, according to J.P. Morgan Research. Loans represented 75% of distressed exchange volume. Exhibit 9 uses data from Pitchbook LCD to demonstrate how USD leveraged loan default activity (by count of transactions) has shifted to favor distressed exchanges. 77% of such transactions (also by count) in 2024 were driven by sponsor-backed companies, per data compiled by Pitchbook LCD.

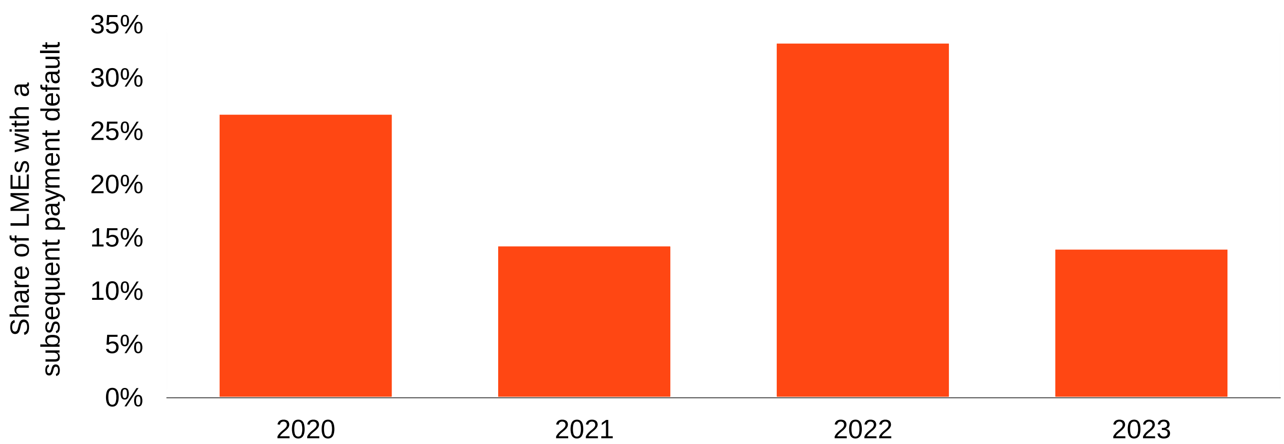
Distressed exchanges can be favored by financial sponsors as they may often avoid some of the costs associated with more traditional bankruptcy proceedings, such as a Chapter 11, and may also help preserve equity value. That said, in certain instances these transactions can also fail to deliver the magnitude of balance sheet relief that may ultimately be required. As Exhibit 10 shows, a portion of LMEs will experience a payment default (either a bankruptcy or payment failure) within the subsequent three years. Indeed, 14% of 2023 LMEs have *already* experienced such a default. A longer-term analysis by J.P. Morgan Research (published in January 2025) found that 45% of distressed transactions from 2008-2022 resulted in a repeat default action. This occurred, on average, roughly two years after the original distressed exchange.

Exhibit 9: Distressed exchanges represented a larger share of 2024 loan default activity
Count of trailing twelve-month defaults for USD leveraged loans, by default activity type (inclusive of payment defaults and distressed exchanges)



Source: PitchBook LCD, Morningstar LSTA US Leveraged Loan Index, BlackRock. Captures data through December 31, 2024.

Exhibit 10: A notable share of distressed exchanges have subsequently defaulted
The share of USD leveraged loan liability management exercises (LMEs) in each year that have experienced a payment default in the subsequent three years.



Source: Pitchbook LCD, BlackRock. Captures data through December 31, 2024.

#4: The share of "repeat defaulters" has also increased

The pattern related to distressed exchanges providing "incomplete" balance sheet relief is likely directly relevant to theme #4: "repeat defaulters." Indeed, the share of repeat defaulters reached a post-financial crisis high in 2024, at 35% of default transactions in the USD market (Exhibit 11).

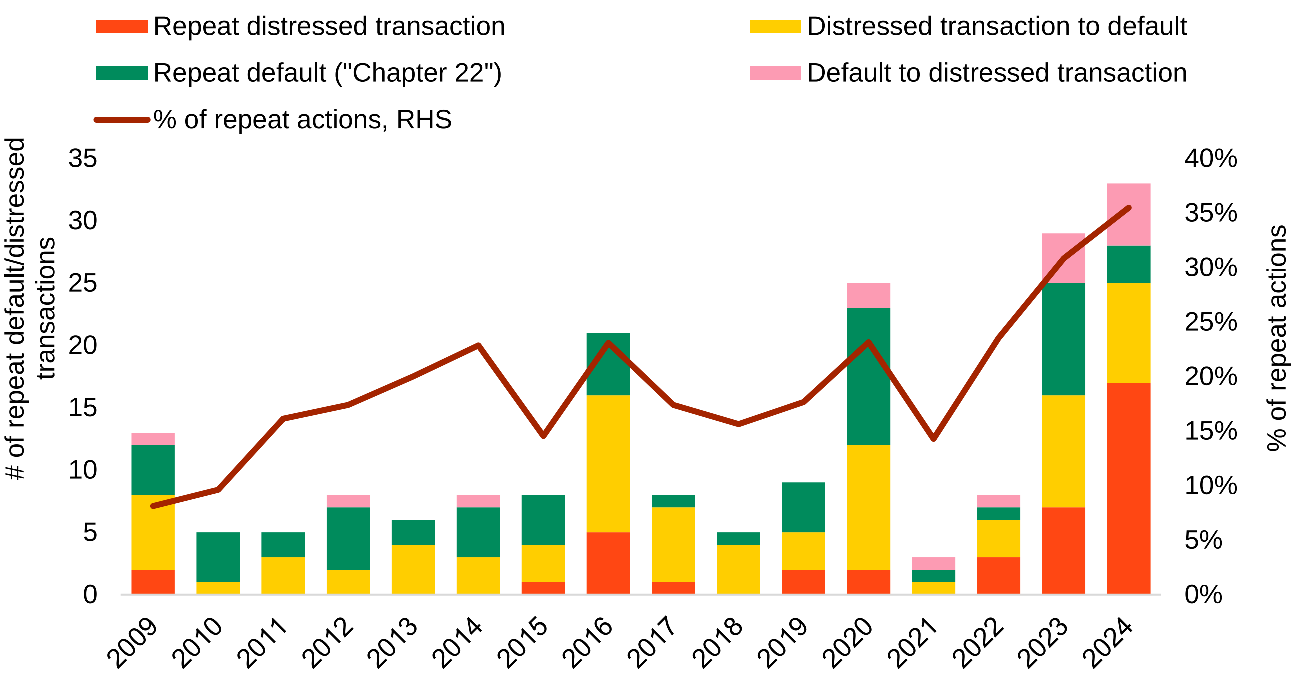
The longer-term experience shows that these "repeat" transactions can manifest in a variety of sequences and different forms. For example, some firms defaulted first and subsequently completed a distressed exchange, while others completed two distressed transactions. Yet another cohort defaulted twice via Chapter 22, as shown in Exhibit 11.

In terms of timing between each action, granular data compiled by J.P. Morgan Research shows that it is not uncommon for multiple years (sometimes several years), on average, to separate the two events.

In practice, the valuation "overhang" for a company that has recently encountered financial stress takes time to resolve – even once the firm has emerged from a restructuring. Said another way, a "repeat defaulter" may be less likely to generate an outsized negative performance impact, if it *already* trades at a discount that is reflective of past financial pressures.

In our view, the risk of a repeat default underscores the importance of a company's ability to *sustainably* grow into its debt capital structure. It also reinforces the value of granular credit selection and stress-testing corporates' ability to navigate a structurally higher interest rate environment.

Exhibit 11: The share of "repeat defaulters" reached a post-financial crisis high in 2024
Count of default actions (inclusive of payment defaults and distressed exchanges) in the USD leveraged loan and HY bond markets from repeat defaulters (by transaction type), and share of total default actions that were repeat defaulters (RHS).



Source: J.P. Morgan Research, PitchBook, Bloomberg, S&P/IHSMarkit, BlackRock. Captures data through year-end 2024. "Chapter 22" refers to a company filing Chapter 11 bankruptcy a second time. *Default action includes defaults and distressed transactions.

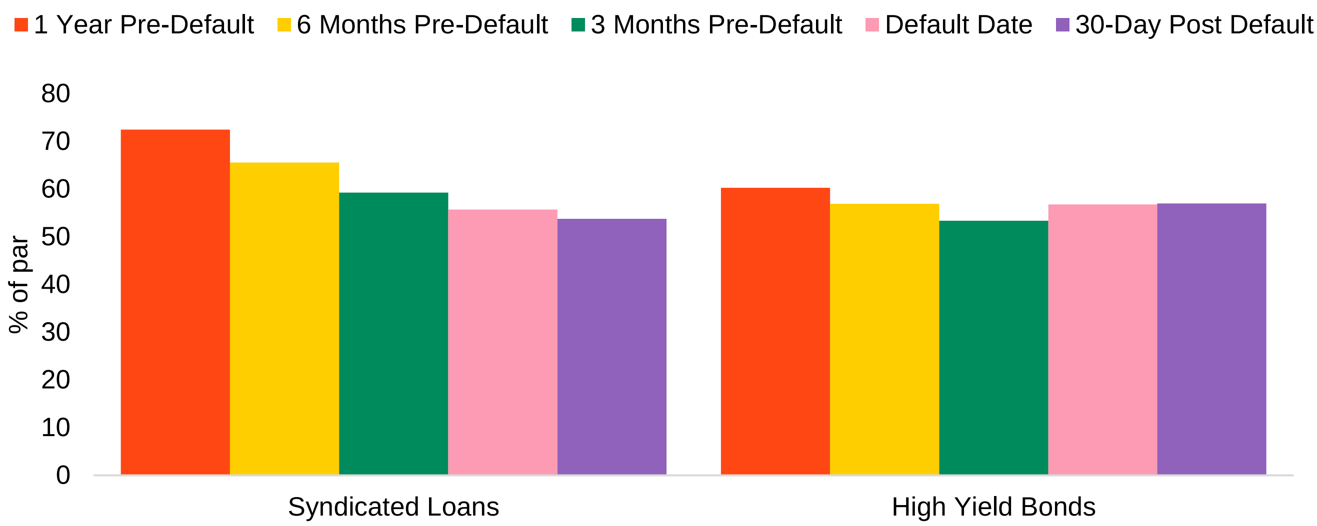
The (limited) impact to *aggregate* performance

Despite the uptick in default activity in some subsets of the corporate credit market, *aggregate* index-level performance has remained resilient. As we outlined in our *1Q2025 Global Credit Outlook*, lower-rated HY credit outperformed its higher rated IG peer group in 2024 on an excess and total return basis. And the 2024 total return of 8.95% for the USD Morningstar / LSTA Leveraged Loan Index did not reflect material performance concerns (of course, this was boosted in part by the interest rate backdrop). Additionally, USD HY credit spreads (268bp for the Bloomberg Corporate Index) continue to hover near the low end of the historical range and leveraged loan spreads remain similarly contained relative to a longer-term history (with an index-level spread-to-maturity of 393bp).

We see two primary reasons for the muted aggregate performance impact from defaults. First and foremost, borrower stress, or the possibility of a default, is often priced into liquid markets long before a borrower *actually defaults*. This reflects analysts and market participants responding to a combination of management commentary, earnings performance, and other industry data points / developments. Exhibit 12 illustrates this, with default observations in USD leveraged loan and HY bond markets trading well below par one year before the default. (Note: HY bonds and loans trading below 80 cents on the dollar are usually considered distressed.)

Second, the well-telegraphed trend of elevated all-in yields has provided a buffer for the market to absorb some portion of the defaults – especially since (as noted previously) much of the default activity has been skewed towards smaller issuers.

Exhibit 12: Borrower stress is often priced in before an *actual* default event
Trailing twelve-month average implied recoveries, unweighted, for the USD market



Source: KBRA DLD, Solve, BlackRock. As of December 19, 2024. Data includes 76 syndicated loans and 23 high yield bonds.

Unless otherwise stated, all reference to $ are in USD.

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