June 20, 2024

Global Credit Weekly:

Defaults: early signs of a plateau

BlackRock

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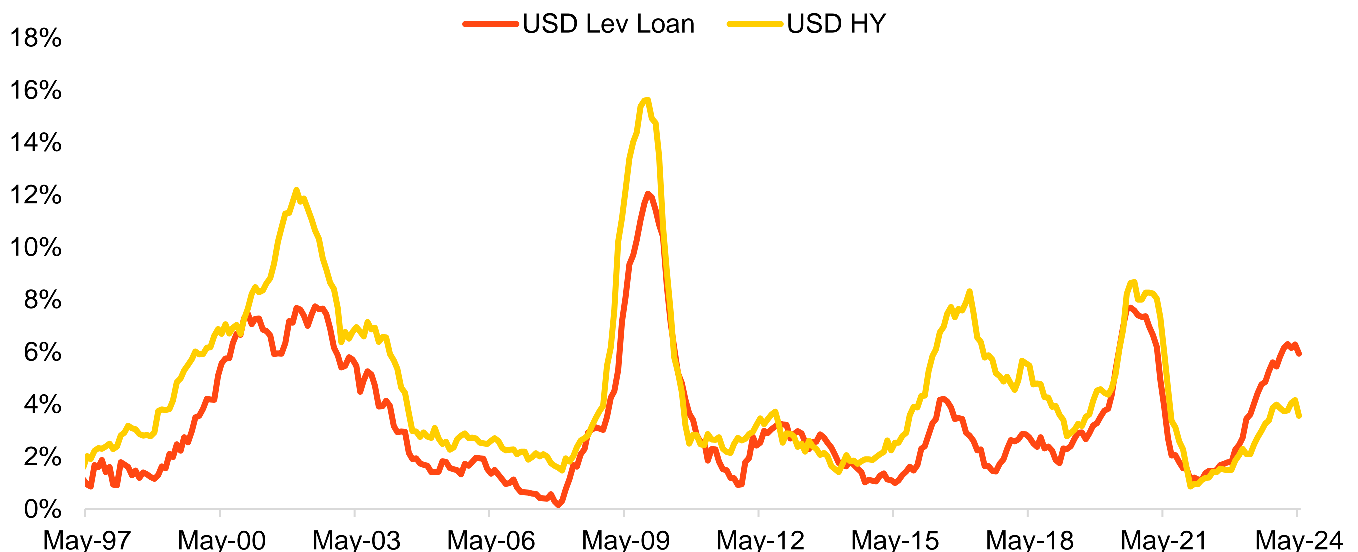
Key takeaways

- One prevailing theme over the past several months has been the relative resilience of the USD corporate credit market (liquid and private) – both in terms of spread valuations and fundamentals – despite the persistently elevated interest rate environment. With the Federal Reserve on hold with its current monetary policy stance, many market participants have been bracing for a wave of financial stress among speculative grade corporates.
- As we noted recently, covenant defaults in the USD private credit market have declined for *four consecutive quarters* (through 1Q2024) and realized losses have been modest. The most recent data in the USD liquid market shows a similarly encouraging trend: defaults are showing early signs of a potential plateau (Exhibit 1), and recovery rates have been moving higher in recent months (Exhibit 5).
- As we highlighted last week, we believe the groundwork is being laid for the start of a U.S. monetary policy *normalization* cycle (but not necessarily a large *easing* cycle) in late 2024. Absent a sharp deterioration in the U.S. labor market, we expect only a shallow rate cutting cycle. As a result, corporate borrowers will need to continue to navigate an elevated cost of capital environment – at least by the standards of the post-financial crisis era.
- We continue to expect an investing landscape characterized by dispersion, but not widespread market disruption. That said, two factors underpin this view and will be important for corporate credit investors to monitor: (1) the U.S. growth backdrop, which will need to remain slightly above or at trend, to allow corporates to absorb elevated debt servicing costs, and (2) the USD HY and loan debt markets, which will need to remain amenable to refinancing from lower-rated issuers.

Exhibit 1: The USD default rate is showing early signs of plateauing

Issuer-weighted trailing 12-month default rates for the universe of USD leveraged loan and USD HY bond issuers captured in the Moody's universe



Source: Moody's, BlackRock. Captures data through May 31, 2024 (most recent available). The Moody's default rate includes distressed exchange activity.

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Default activity: Early signs of a plateau

One prevailing theme over the past several months has been the relative resilience of the USD corporate credit market (liquid and private) – both in terms of spread valuations and fundamentals – despite the persistently elevated interest rate environment. With the Federal Reserve on hold with its current monetary policy stance, many market participants have been bracing for a wave of financial stress among speculative grade corporates.

As we noted recently, covenant defaults in the USD private credit market have declined for *four consecutive quarters* (through 1Q2024) and realized losses have been modest. The most recent data in the USD liquid market shows a similarly encouraging trend. The issuer-weighted default rates for USD HY and leveraged loan issuers captured by the Moody's universe have demonstrated early signs of a potential plateau (Exhibit 1).

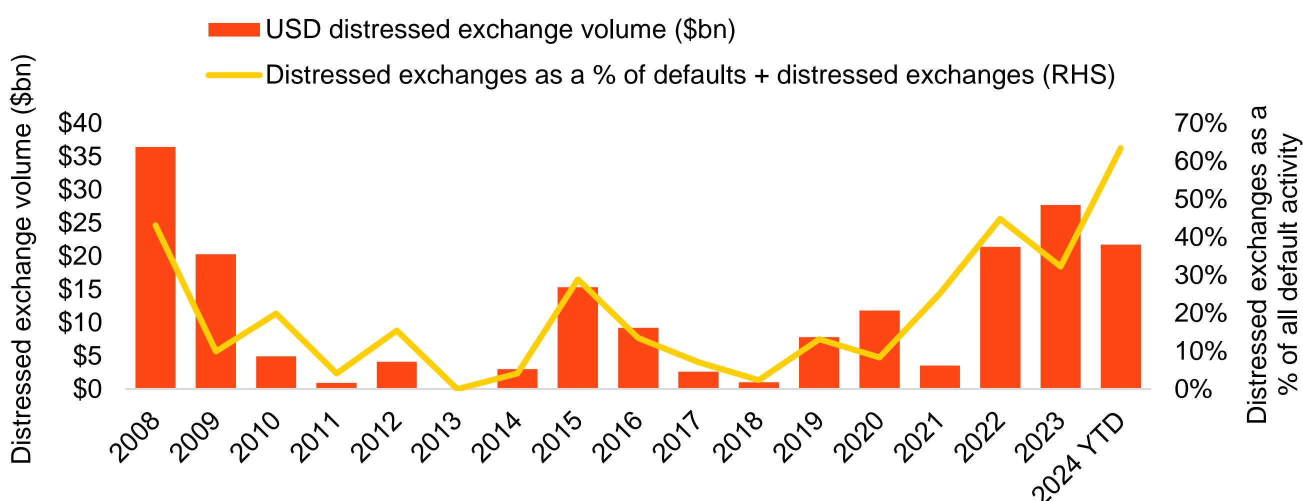
As we highlighted last week, we believe the groundwork is being laid for the start of U.S. monetary policy *normalization* (but not necessarily *easing*) in late 2024. But absent a sharp deterioration in the U.S. labor market, we expect only a shallow rate cutting cycle. As a result, corporate borrowers will need to continue to navigate a cost of capital environment that is elevated in the context of the post-financial crisis era. Two factors will be paramount for corporate borrowers' success, in our view: (1) the U.S. growth backdrop, which will need to remain slightly above or at a trend pace, and (2) the receptivity of HY and leveraged loan capital markets, which will need to remain open to lower-rated issuers for refinancing.

Digging into the details

The default rate among leveraged loan issuers continues to outpace its HY bond peer – a direct result, in our view, of floating rate issuers' sensitivity to the Federal Reserve's rate hiking cycle which began in March 2022 (again, Exhibit 1). Simply put, leveraged loan issuers saw their borrowing costs rise in tandem with the Federal Funds rate, while fixed rate borrowers encountered higher debt costs if and when they chose to refinance. Indeed, data from J.P. Morgan Research shows that "loan-only" capital structures have represented 56% of default activity from January 2021 through May 2024, and 68% of default activity year-to-date. These figures are well above the long-term "loan only" share (since 2008) of 37%, according to J.P. Morgan Research.

As has been the case for the past several quarters (and as illustrated in Exhibit 2), distressed exchanges have represented a growing share of the overall default activity (alongside "traditional" restructurings such as a Chapter 11 filings).

Exhibit 2: Distressed exchanges have increased as a percentage of overall default activity
USD HY bond and leveraged loan distressed exchange volume by year ($bn), and the share of overall default activity represented by distressed exchanges (RHS)



Source: J.P. Morgan Research, PitchBook Data Inc., Bloomberg Finance L.P., S&P/IHS Markit, BlackRock. Captures data through May 31, 2024.

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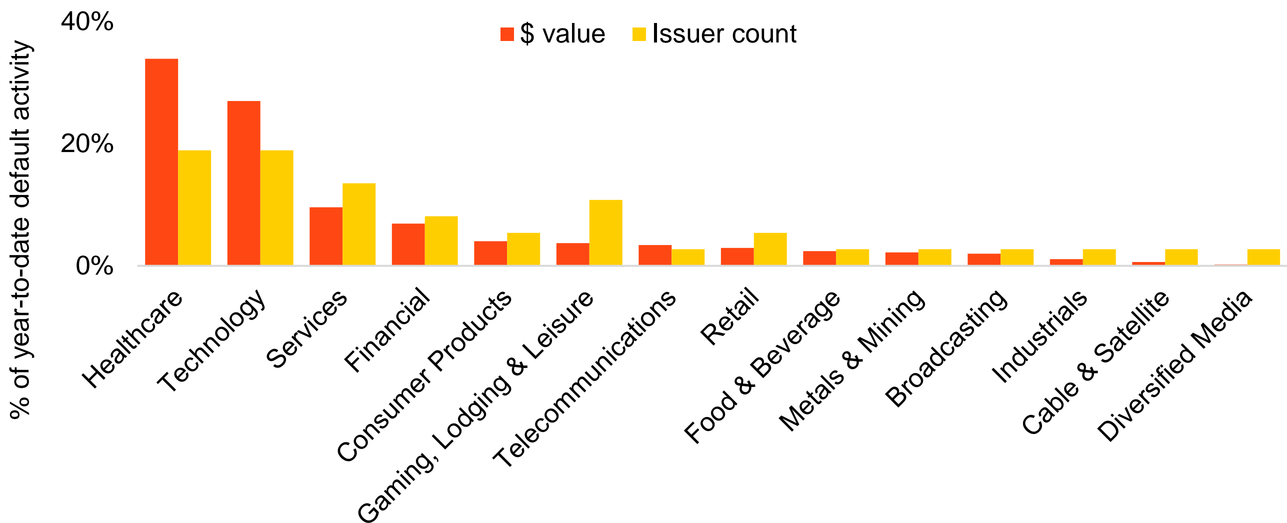
Sector drivers of defaults

At the sector level, Healthcare and Technology have represented large shares of the year-to-date default activity across USD HY bonds and leveraged loans (Exhibit 3). That said, a wide range of other sectors have contributed. In our view, this reflects the broad, macro nature of the stress from higher rates.

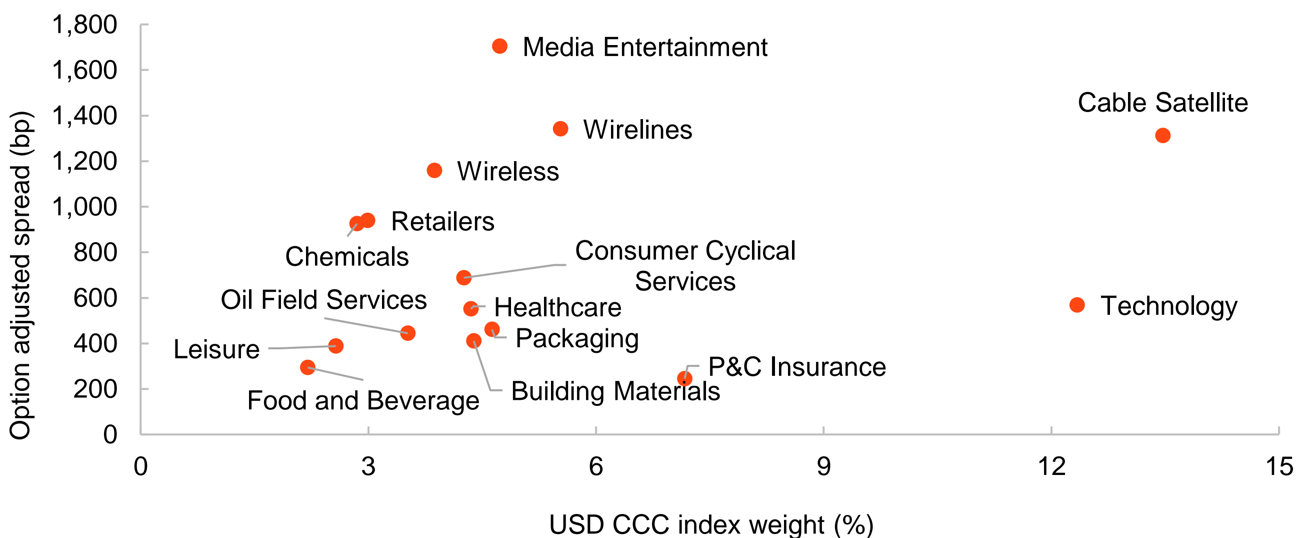
In the context of discussing defaults and potential pockets of financial distress, many market participants often point to the CCC-rated subset of the USD HY market (as well as the lower-rated portions of the leveraged loan market) for insights. While CCC-rated firms are indeed among those with the thinnest financial cushions, Exhibit 4 illustrates how dispersed – and idiosyncratic – this cohort is, as shown by the wide range of sectors and average spread levels.

Exhibit 3: Healthcare and Technology have been driving the year-to-date default activity
Year-to-date USD HY and leveraged loan default activity (including distressed exchanges) by sector, as a percentage of dollar value and issuer count



Source: J.P. Morgan Research, PitchBook Data Inc., Bloomberg Finance L.P., S&P/IHS Markit, BlackRock. Excludes sectors with no defaults year-to-date. Captures data through May 31, 2024. Distressed exchanges are included in default measures.

Exhibit 4: The USD CCC-rated cohort is highly idiosyncratic and spans a range of sectors
Market value weights (%) and option adjusted spreads (bp) for the 15 largest sectors in the Bloomberg USD HY CCC Corporate Index



Source: Bloomberg, BlackRock. As of June 17, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

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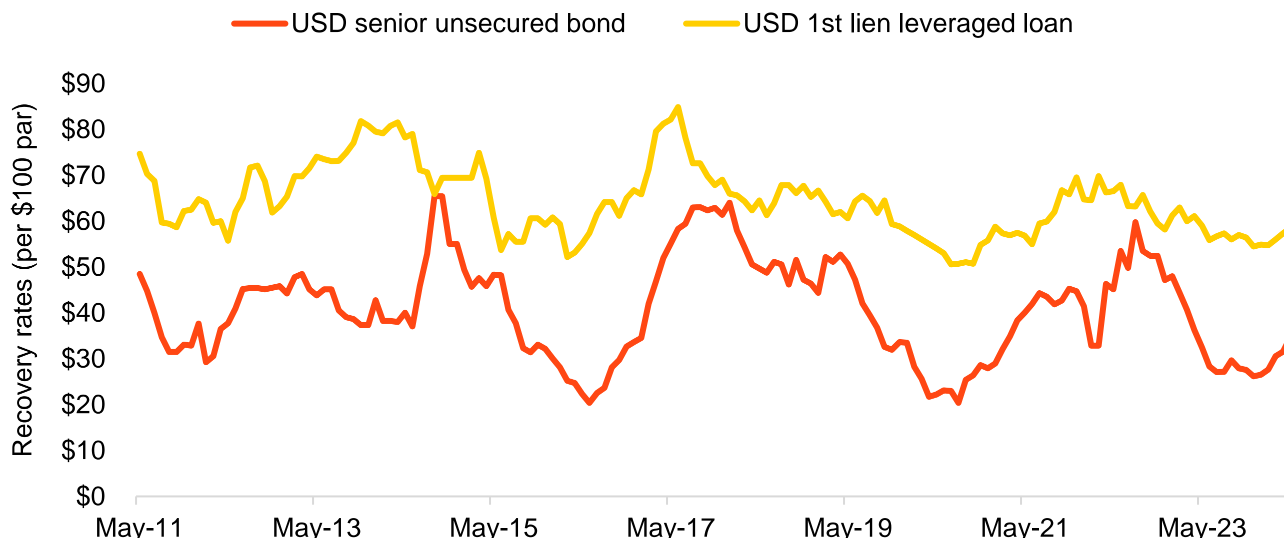
Recovery rates: Trending higher in recent months

Perhaps more important than the *frequency* of default activity is the *severity* of the loss. Exhibit 5 shows that, in recent months, there has been a slight improvement in recovery values in the USD market. This is notable considering the declines in place from late 2022 through 2023. That said, there is a high degree of dispersion across sectors, as shown in Exhibit 6.

Exhibit 5: Recovery rates have trended higher in recent months

Trailing 12-month recovery rates (per $100 par) for the universe of USD HY bond and USD leveraged loan issuers captured in the Moody's universe



Source: Moody's, BlackRock. Captures data through May 31, 2024 (most recent). Recovery rates are measured by debt prices which are taken immediately prior to distressed exchanges or 30 days after non-distressed exchange defaults.

Exhibit 6: There is a wide degree of variation in recovery rates across sectors

Cumulative recovery rates by industry (2008 through present), for USD HY bond and USD leveraged loan issuers

	USD HY bonds	USD leveraged loans
Autos	$59.4	$43.1
Broadcasting	$31.7	$52.0
Cable & Satellite	$66.2	$79.3
Chemicals	$46.6	$49.6
Consumer Products	$34.4	$40.6
Diversified Media	$29.1	$45.0
Energy	$29.5	$52.9
Financial	$31.1	$51.2
Food & Beverage	$23.7	$49.4
Gaming, Lodging & Leisure	$32.1	$54.6
Healthcare	$36.1	$53.0
Housing	$36.5	$48.5
Industrials	$32.6	$59.4
Metals & Mining	$28.7	$44.3
Paper & Packaging	$34.8	$57.8
Retail	$39.1	$39.8
Services	$41.8	$54.9
Technology	$34.3	$42.7
Telecommunications	$31.0	$62.9
Transportation	$31.2	$48.8
Utility	$67.8	$55.7

Source: J.P. Morgan Research, PitchBook Data Inc., Bloomberg Finance L.P., S&P/IHS Markit, BlackRock. Captures data through May 31, 2024.

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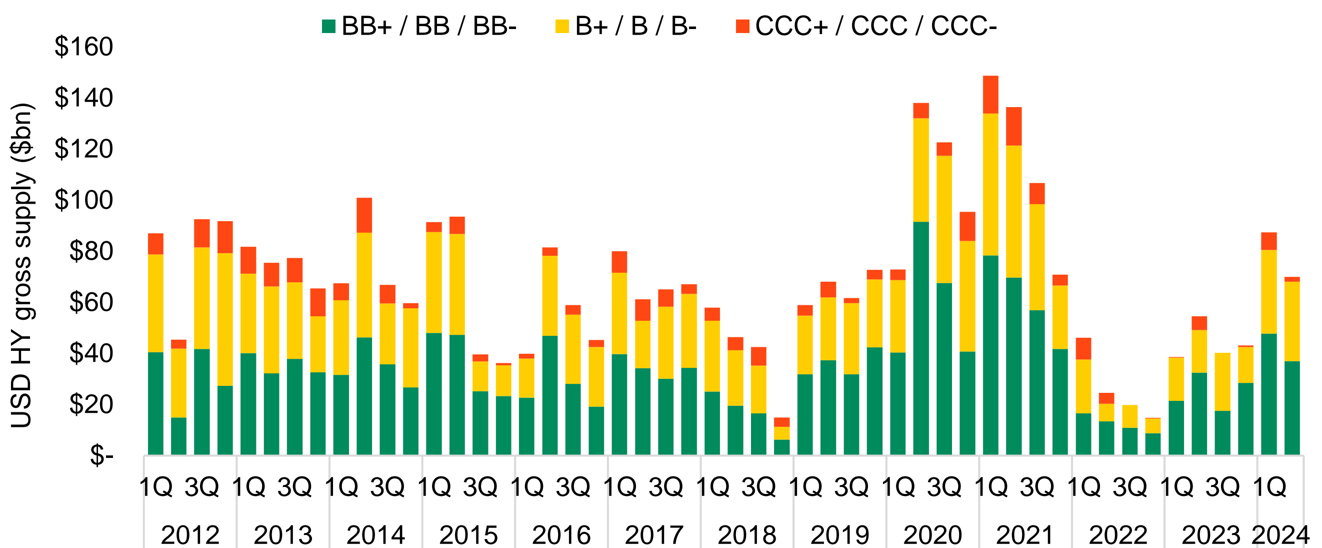
Primary markets have been receptive to refinancing from lower-rated issuers

Another factor which has helped to keep default activity relatively contained has been the receptivity of the syndicated debt markets (both HY bond and leveraged loans) to lower-rated issuers, for their refinancing needs. More than $160 billion of debt has been issued in the USD HY bond market so far this year (through June 19th), which is roughly double the pace of 2022/2023, using data complied by Dealogic.

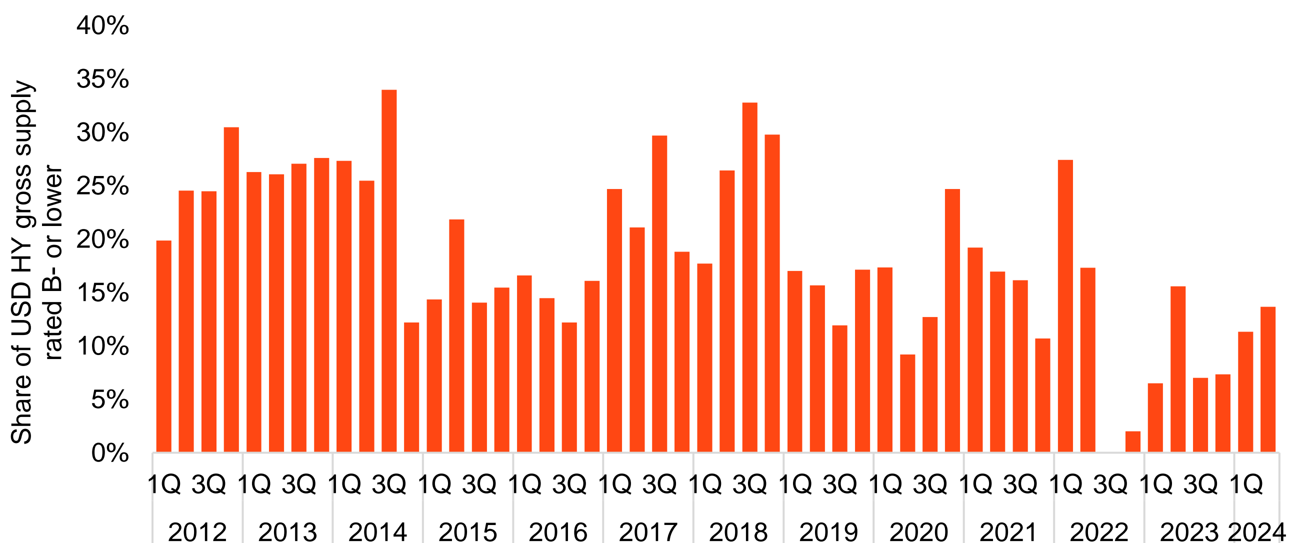
Moreover, 77% of the year-to-date 2024 issuance has been earmarked for debt repayment or refinancing according to Dealogic – the highest share of the post-financial crisis era (the next-highest amount is 2017's 67%). Our review of deal level information compiled by Dealogic shows some issuers are refinancing late 2025 and 2026 maturities – a proactive approach to addressing upcoming maturity walls, in our view. Importantly for the most financially vulnerable corporates, the syndicated markets have been receptive to lower-rated issuers (Exhibits 7 and 8). This will be key to monitor, going forward.

Exhibit 7: USD HY issuance was robust in 1H2024, driven by refinancing activity
USD HY gross issuance ($bn) by quarter, using Dealogic Effective Rating at Launch



Source: Dealogic (ION Analytics), BlackRock. As of June 19, 2024. Excludes "Not Rated" debt.

Exhibit 8: The USD HY primary market is open to lower rated issuers
Share of total USD HY gross issuance rated B- or lower, using Dealogic Effective Rating at Launch



Source: Dealogic (ION Analytics), BlackRock. As of June 19, 2024. Excludes "Not Rated" debt.

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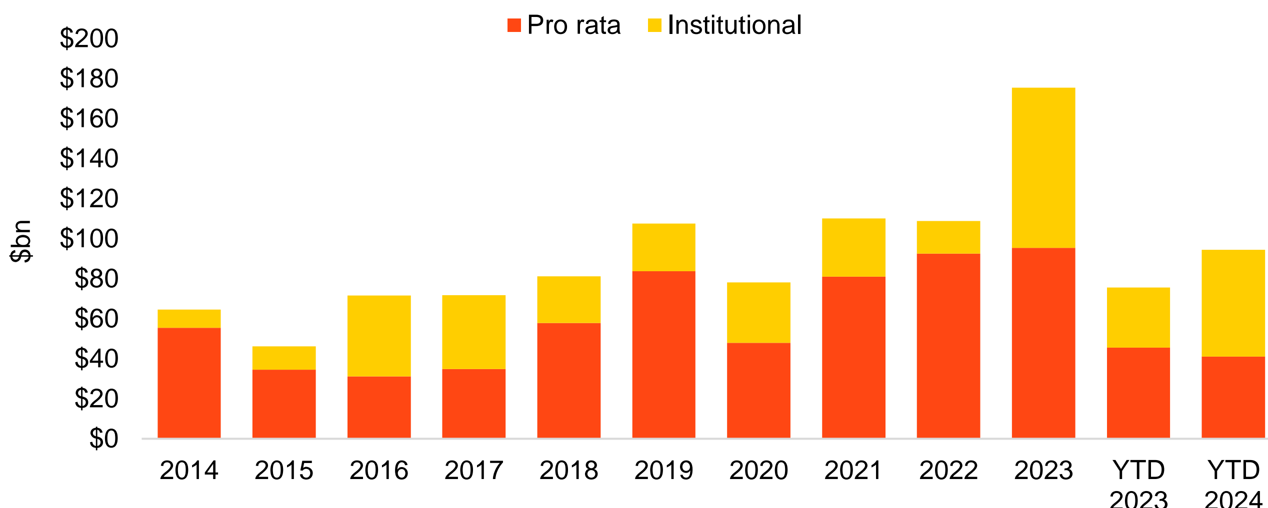
The syndicated leveraged loan markets have also been active so far in 2024. Institutional leveraged loan issuance of $270 billion is up 169% vs. the 2023 pace, per data from Pitchbook LCD. This record setting pace has been driven by refinancing activity (and to a lesser extent, M&A). Collateralized loan obligation (CLO) creation of $97 billion year-to-date – which has increased 86% vs. 2023 and is on track to surpass the prior record set in 2021 – has provided ample demand for this leveraged loan issuance. Indeed, as of early June, Pitchbook LCD estimated a "supply shortfall" of approximately $100 billion, to meet the year-to-date (measurable) investor demand for leveraged loans.

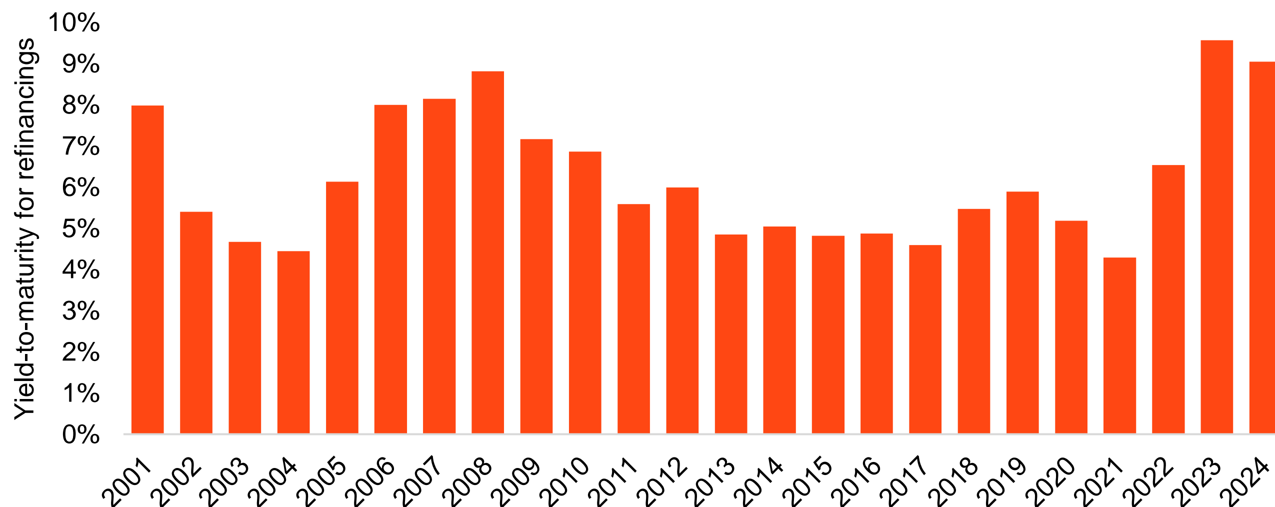
Amend-and-extend activity – which allows borrowers to extend the maturity of an existing loan without repricing the entire facility – in the USD leveraged loan market reached $94.5 billion through the end of May 2024. As Exhibit 9 shows, this has already surpassed the full-year totals of 2014-2018 and 2020. And to the extent this pace continues, 2024 is on track to exceed the full-year 2023 tally of $175.5 billion. Institutional amendments have been largely focused on 2026 and 2027 maturities, per data tracked by Pitchbook LCD, while pro rata amendments have mainly targeted 2025 and 2026 maturities.

Exhibit 9: The syndicated leveraged loan market is on pace to eclipse 2023's amend-and-extend volumes
USD syndicated leveraged loan market amend-and-extend volume



Source: Pitchbook LCD, BlackRock. Captures data through May 31, 2024. Note: Pro rata debt typically entails amortizing TLAs and/or revolving credit facilities and is traditionally syndicated to finance companies and banks. Institutional debt consists of term loans structured specifically for institutional investors, including CLOs.

Exhibit 10: Loan refinancings have captured some modest improvement in borrowing costs
Average yield-to-maturity for USD leveraged loan refinancings in the primary market



Source: Pitchbook LCD, BlackRock. 2024 captures data through May 31, 2024.

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