

## Global Credit Comment

### Corporate defaults: What is the outlook and is it priced in?

#### Credit Strategy

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In this article we attempt to address several commonly asked questions from investors: first, what is the current pace of corporate defaults and recoveries? What proportion is energy versus ex-energy? Second, what is the outlook for credit losses? Third, and most important, how much is already priced in?

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As per Moody's the US speculative grade default rate sits at 2.5% at end-September, up from 2.1% in Q2 and 1.6% one year prior; for comparison, the global and European default rates are 2.5% and 2.1%, respectively. And US senior unsecured bond recovery rates sit at \$32, down from \$48 in Q2 and \$65 one year ago. Across industries the energy and metals/mining sectors have accounted for one-quarter to one-third of defaults this year; for the energy/ natural resource sector overall the default rate is 10% versus 6% in Q2 and 3% 12 months ago. Away from natural resources, above average default rates are evident in the leisure/ gaming/ media (3.4%), forest and building products/ builders (2.5%) and consumer/ service sectors (2%).

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Looking ahead US speculative grade default rates appear poised to finish in the low 4% context by mid-2016. Default rates are clearly rising, but the trajectory is uncertain. Issuer default rates in Q3 did not show further deterioration versus Q2, although based on the prior six months annualized the US default rate will approach 3.3% by Q1 2016. However, commodity prices remain depressed and capital market conditions deteriorated further in Q3. In short, we still think 4% is the right handle for default rates by next summer, largely driven by commodity-focused sectors. Energy/ natural resource default rates seem likely to reach 15% over the next year, albeit there is significant variability depending on the evolution for commodity prices. Ex-energy, defaults rates should remain more muted in the mid 2% range, but there is increasingly upside risk, particularly toward the latter half of 2016. For example, our default rate forecasting model and our new metrics for non-bank lending conditions suggest default rates could rise as high as 4.8% by Q3 '16'. Among non-resource related sectors we see greater vulnerability in the aerospace/ defense, services, media, retail, leisure/gaming and telecom industries. And, while we do not have an official framework to forecast recovery rates, we believe some of the underlying factors driving below average recovery rates in 2015 are structural in nature; namely, excessive valuation multiples, peak earnings, elevated leverage, lack of covenant protection and market illiquidity.

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The 64k question, however, is how much of this outlook is already factored into high yield spreads? We believe a few observations are critical. First, spreads lead defaults, not vice versa; in turn, our forecasting models for high yield credit spreads suggest valuations are fairly priced, implying much of our outlook for defaults is largely priced into valuations. Second, what loss rates – a function of defaults and recoveries – are priced into the market is not a straightforward calculation. (Continued on Page 2)

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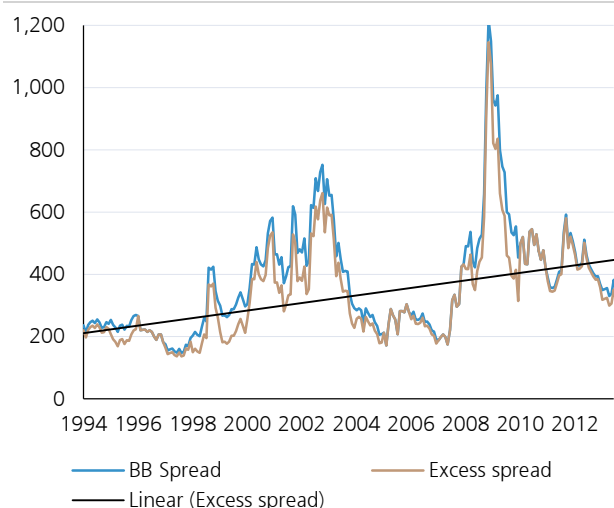
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<sup>1</sup> [Credit Cycle Turning? Non-Bank Liquidity Hits Multi-Year Lows](#), S. Caprio, M. Mish, 08-Oct-2015

Some market participants may posit this notion, but there is an array of academic literature attempting- with only modest success- to explain the corporate bond credit spread puzzle. The point is that a significant portion of high yield credit spreads are not explained by expected default losses alone<sup>2</sup>. And, in fact, some argue that much of the time series variation in high yield credit spreads is attributable not to changes in expected default losses, but rather changes in credit risk premium<sup>3</sup>. Earlier in the year we performed a similar analysis by decomposing high yield spreads by rating into loss and non-loss components, the latter of which we termed 'excess' spreads.

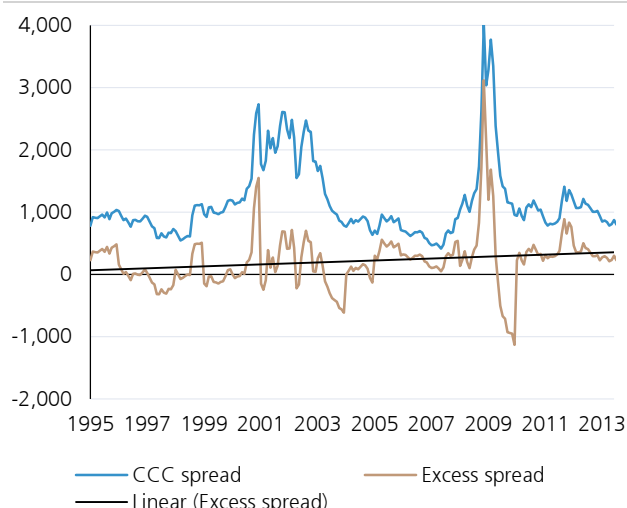
The takeaway is that double B bonds provide significant excess spread relative to the total spread, and that excess spread has been structurally rising over the last two decades; conversely, for triple C bonds the excess spread is minor relative to the total and there has not been the same degree of structural increase (Figures 1, 2). Triple C annual default rates range from 6 – 35% through prior cycles, and triple C spreads hover in a similar band (400 – 3800bp or 4 – 38%, respectively, Figure 3). In comparison, energy triple C spreads are currently trading at 2800bp (dollar price in the low 40s) versus ex-energy triple Cs at 800bp (dollar price in the low 90s). Bottom line, energy triple Cs are increasingly priced like triple C spreads in recessionary periods. But recovery rates must also be considered in more detail. However, ex-energy triple Cs look largely priced for perfection. So while our default outlook is largely baked into current high yield spreads, it is not appropriately calibrated in triple C valuations.

**Figure 1: US high yield BB spreads and loss-adjusted or 'excess' spreads (bp)**



Source: UBS, Yieldbook, Moody's. Note data is through Q2

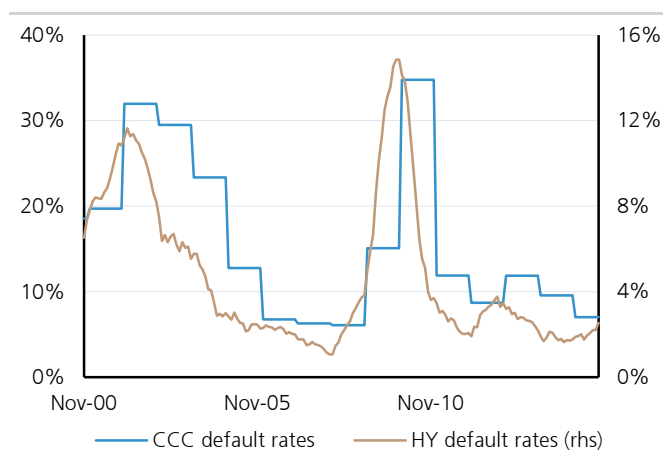
**Figure 2: US high yield CCC spreads and loss-adjusted or 'excess' spreads (bp)**



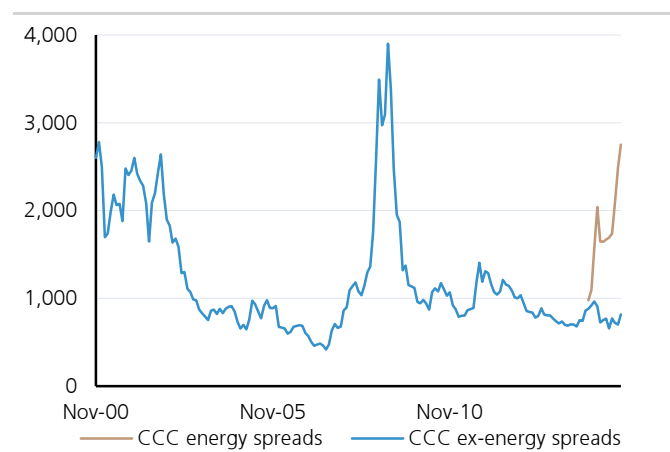
Source: UBS, Yieldbook, Moody's. Note data is through Q2

<sup>2</sup> The Corporate Bond Credit Spread Puzzle, FRBSB Economic Letter, March 2008

<sup>3</sup> For example, the Credit Risk Premium and Return Predictability in High Yield Bonds, J. Thomas, April 2012

**Figure 3: High yield and triple C default rates (annual, %)**

Source: UBS, Yieldbook, Moody's

**Figure 4: Triple C energy and ex-energy spreads (bp)**

Source: UBS, Yieldbook, Moody's

## US Daily Market Pulse

### Primary Market Recap

US IG issuance stood at \$0.7bn. LL issuance stood at \$0.3bn. HY pipeline on LCD is estimated by S&P at \$13.5bn of which \$0.9bn is expected to be priced this week. LL pipeline on LCD is forecasted by S&P at \$31.7bn.

### Secondary Market Recap

Credit indices closed mixed (US BIG -1bps, US HYCP 2bps, CDX IG 1bps, CDX HY - \$0.4, LL -0.01%). TRACE data showed \$814mn (0.86 Sell/Buy ratio) and \$77mn (0.96 S/B ratio) of client buying in IG and HY, respectively.

In IG, all sectors outperformed leading with Communications (-3.8bps). In HY, Sr. Financials (-10.2bps) outperformed while Health Care (+18.3bps) underperformed.

For IG, client buying was most prevalent in the Health Care sector (0.8 S/B ratio) and in the short end of the curve (0.8 S/B ratio).

For HY, client buying was most prevalent in the Health Care sector (0.8 S/B ratio), and in Caa1-Caa3 (0.9 S/B ratio) rated bonds. Client selling was most concentrated in the Materials sector (1.1 S/B ratio).

**Figure 5: Things to watch**

Time (EST)	Event	Survey	UBS Est.	Prior
8:30 AM	Initial Jobless Claims	265k	255k	255k
8:30 AM	Continuing Claims	2186k	--	2158k
9:00 AM	FHFA House Price Index MoM	0.50%	0.90%	0.60%
10:00 AM	Existing Home Sales	5.39M	5.36M	5.31M
10:00 AM	Leading Index	0.00%	-0.10%	0.10%
11:00 AM	Kansas City Fed Manf. Activity	-9	--	-8

Source: UBS, Bloomberg

**Figure 6: Market Update**

			Spreads (bp)				Yields (%)			
			Current	1d chg	1w chg	1m chg	Current	1d chg	1w chg	1m chg
US	Cash	US IG	162	-1	-5	-2	3.27	-0.04	0.01	-0.16
		US Fin	137	-1	-5	3	2.80	-0.03	0.02	-0.11
		US Non Fin	175	-1	-5	-5	3.46	-0.04	0.01	-0.19
		US HY	630	2	-25	29	7.38	-0.01	-0.22	0.10
	CDS	CDX IG	82	1	-3	1	-	-	-	-
		CDX HY (\$)	102.3	-0.4	0.7	-2.4	-	-	-	-
	Equities	S&P 500	2,019	-0.6%	1.2%	2.6%	-	-	-	-
		VIX	17	6.0%	-7.4%	-17.1%	-	-	-	-
	Treasury	10y UST	-	-	-	-	2.02	-0.04	0.05	-0.18
EU	Cash	iBoxx € Corp	160	0	-1	9	1.81	-0.04	0.01	0.00
		iBoxx € Fin	165	0	0	6	1.78	-0.04	0.01	-0.02
		iBoxx € Non Fin	156	0	-1	10	1.83	-0.04	0.01	0.01
		iBoxx € HY	501	2	-12	15	5.07	-0.01	-0.11	0.09
	CDS	iTraxx Main	78	0	-4	2	-	-	-	-
		iTraxx Crossover	325	0	-18	16	-	-	-	-
		iTraxx Fin Snr	74	-1	-7	-11	-	-	-	-
		iTraxx Fin Sub	153	-2	-15	-17	-	-	-	-
	Equities	€ Stoxx	3,272	0.5%	2.5%	2.7%	-	-	-	-
	Treasury	10y Bund	-	-	-	-	0.57	-0.06	0.03	-0.12
		10y UKT	-	-	-	-	1.80	-0.06	0.04	-0.09
	CDS									
		iTraxx Asia ex Japan IG	139	0	-5	-7	-	-	-	-

Source: UBS, Bloomberg, Markit, Yieldbook; Data as of COB Y'day.

**Figure 7: Today's Earning Releases**

Time*	US	Estimate	Guidance	Time*	Europe	Estimate	Guidance
Bef-mkt	Dow Chemical Co/The	0.69	--	2:00 AM	Logitech International SA	--	--
Bef-mkt	Freeport-McMoRan Inc	-0.10	--	6:00 AM	Akzo Nobel NV	1.07	--
Bef-mkt	Eli Lilly & Co	0.76	--	6:30 AM	Daimler AG	2.07	--
Bef-mkt	Nucor Corp	0.47	--	6:30 AM	DNB ASA	3.83	--
Bef-mkt	Parker-Hannifin Corp	1.46	--	7:00 AM	Fortum OYJ	0.05	--
Bef-mkt	PulteGroup Inc	0.43	--	10:00 AM	Metso OYJ	0.36	--
Bef-mkt	Ryder System Inc	1.73	1.73	10:30 AM	Kone OYJ	0.49	--
Bef-mkt	Southwest Airlines Co	0.92	--	11:00 AM	Perrigo Co PLC	1.72	--
Bef-mkt	T Rowe Price Group Inc	1.14	--	11:00 AM	Amer Sports Oyj	0.59	--
Bef-mkt	Quest Diagnostics Inc	1.26	--	--	Bankinter SA	0.12	--
6:00 AM	Danaher Corp	1.03	1.02				
7:00 AM	Raytheon Co	1.43	--				
7:00 AM	Janus Capital Group Inc	0.23	--				
7:30 AM	Caterpillar Inc	0.77	--				
7:30 AM	3M Co	2.00	--				
7:30 AM	United Continental Holdings Inc	4.56	--				
7:58 AM	McDonald's Corp	1.28	--				
8:00 AM	Union Pacific Corp	1.43	--				
8:30 AM	Franklin Resources Inc	0.76	--				
4:05 PM	Capital One Financial Corp	1.94	--				
4:05 PM	E*TRADE Financial Corp	0.29	--				
4:15 PM	Altera Corp	0.30	--				
Aft-mkt	AT&T Inc	0.69	--				
Aft-mkt	Southwestern Energy Co	-0.03	--				
Aft-mkt	Microsoft Corp	0.58	--				
Aft-mkt	Stryker Corp	1.23	1.23				
Aft-mkt	Boyd Gaming Corp	0.12	--				
Aft-mkt	Amazon.com Inc	-0.13	--				

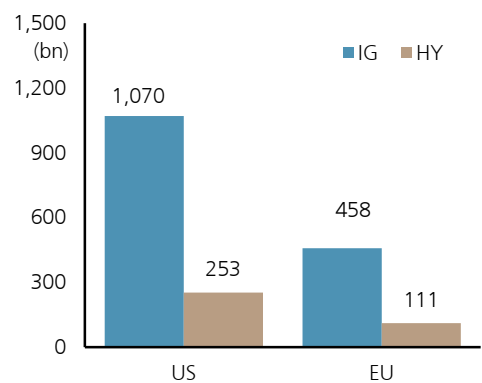
Source: UBS, Bloomberg \*US Time Zone – EST and Europe Time Zone – London Time; Amounts in local currency

**Figure 8: Yesterday's Global Corporate Bond Issuance**

Principal (mm)	Issuer	Cpn (%)	Maturity	Moody's	S&P	Spd (bp)
<b>684</b>	<b>USD Investment Grade</b>					
387	CVS Health Corp	4.750	12/1/2022	BBB+	Baa1	NA
296	CVS Health Corp	5.000	12/1/2024	BBB+	Baa1	NA
<b>0</b>	<b>USD High Yield</b>					
NA						
<b>300</b>	<b>EUR Investment Grade</b>					
300	Vesteda Finance BV	2.500	10/27/2022	NR	NR	237
<b>0</b>	<b>EUR High Yield</b>					
NA						
<b>0</b>	<b>GBP Investment Grade</b>					
NA						
<b>0</b>	<b>GBP High Yield</b>					
NA						

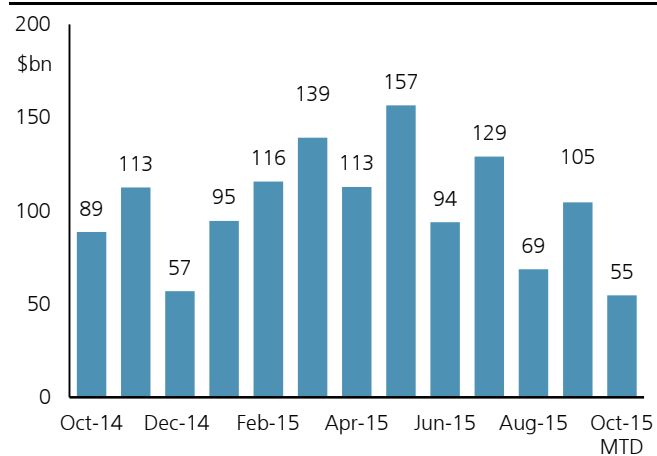
Source: UBS, Bloomberg; Amounts in local currency

**Figure 9: YTD Issuance Summary**



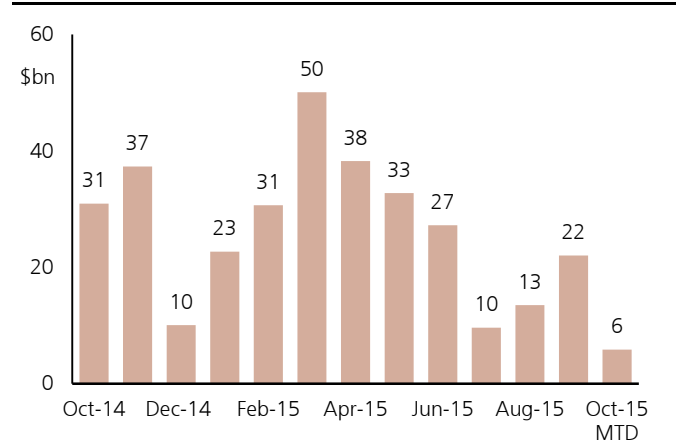
Source: UBS, Bloomberg; Amounts in local currency

**Figure 10: USD – IG Monthly Issuance**



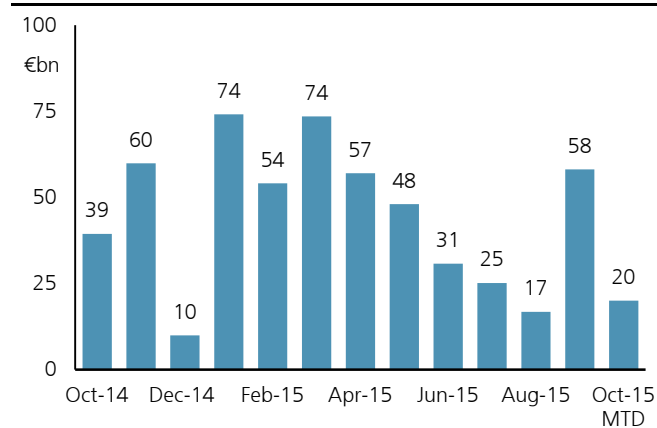
Source: UBS, Bloomberg

**Figure 11: USD – HY Monthly Issuance**



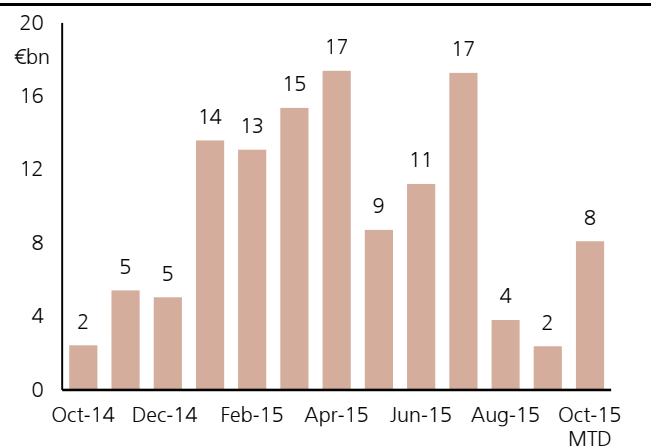
Source: UBS, Bloomberg

**Figure 12: EUR – IG Monthly Issuance**



Source: UBS, Bloomberg

**Figure 13: EUR – HY Monthly Issuance**



Source: UBS, Bloomberg

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CDS Recommendation	Buy Protection; Sell Protection	Up to 3 months	Recommendation to hedge a company's creditworthiness

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