

**PART TWO****BENIGN DEFAULTS TO BUOY  
EUROPEAN HIGH YIELD**

By PGIM Fixed Income's European Leveraged Finance Team

- **As the European economy slides into a likely recession, investor concerns naturally turn to the consequent increase in corporate debt defaults. Indeed, some forecasts anticipate an uptick from their historically low levels—but corporate fundamentals start from a position of strength.**
- **Our second post in a series on the European high yield sector demonstrates that these concerns and forecasts require context regarding the macro backdrop and how these projections are constructed.**
- **Unlike many other forecasts, our scenario-based corporate default analysis combines a top-down macro/sector assessment with a bottom-up issuer analysis of the index that results in only a moderate increase in defaults.**
- **Furthermore, this year's significant increase in yields provides more than adequate compensation for expected default losses.**

## Weathering the economic slowdown

At PGIM Fixed Income, we expect a Eurozone recession in the coming quarters, and we anticipate real GDP growth of 3.2% in 2022 will contract to -1.4% in 2023. Despite this projection, as we show in the subsequent sections, we expect high-yield default rates to only rise moderately. Importantly, at current spread levels, European high yield more than compensates investors for the anticipated default losses.

Given the weakening economic backdrop, many credit analysts expect that corporate high-yield default rates will slightly rise from their historically low levels (Figure 1). For example, European default rates averaged 2.9% between 2010 through 2021 (inclusive), compared to 3.6% in U.S. high-yield bonds over the same period, according to Moody's Investors Service.

Moving to the more volatile period in 2022, European default rates remain contained, with the latest 12-month trailing default rate at 2.1% (Figure 2). Yet, nearly all of this year's defaults are Russian or Ukrainian issuers as

the Western European-only universe has recorded default rates of only 0.4%.

Some of the more pessimistic scenarios with stickier inflation and a deeper recession estimate a default rate of up to 4.0% in 2023, which is still well below the 8.3% average during the Global Financial Crisis of 2008-09. We provide context to our scenario-based forecasts in a subsequent section.

## Drivers behind a decade of low defaults

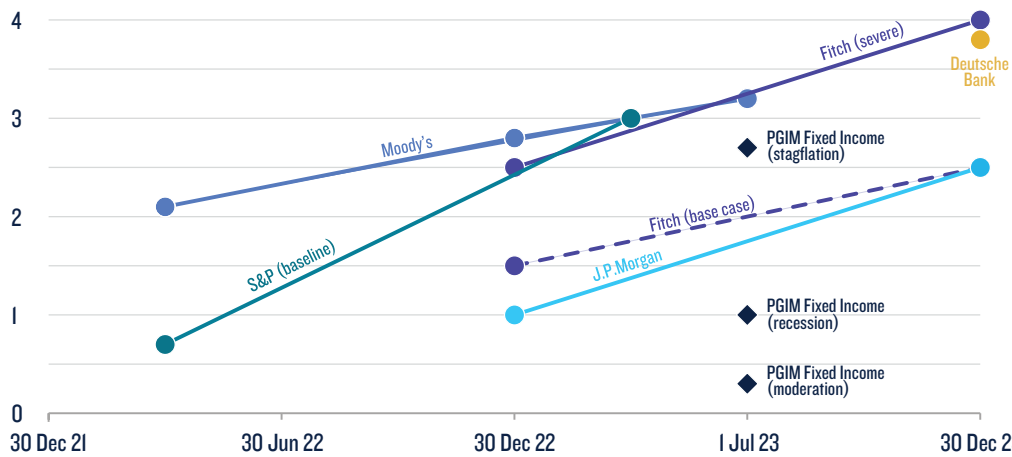
The preceding forecasts also warrant perspective as they are constructed on a top-down basis, which applies default rates from previous cycles to individual credit rating categories (i.e., BB, B, and CCC). Hence, we look at some historical drivers of credit performance in prior cycles and how they have evolved through this year.

Quantitative easing since 2015 has kept default rates low by lowering borrowing costs (which boosted cash flows) and supporting valuations (which kept loan-to-value ratios under control). In addition, European high-yield

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**Figure 1: When looking to 2023, Moody's anticipates a default rate of 3.2%, while Fitch Ratings expects a 2.5% rate.**

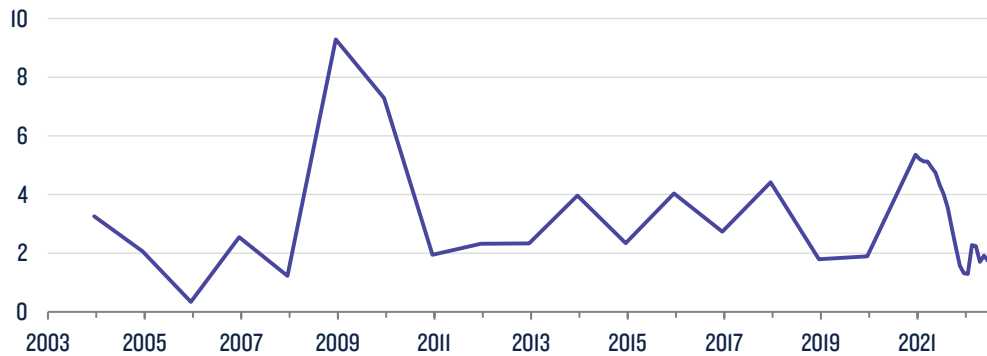
(% default rate last 12 months to date)



Source: PGIM Fixed Income, Fitch Ratings, Deutsche Bank, Credit Suisse, and J.P. Morgan as of June 2022. Moody's Investor Service as of July 2022.

**Figure 2: Historical European high yield rolling 12-month default rate**

(%)



Source: Moody's as of August 2022.

bonds have benefited from a robust profit backdrop. Furthermore, recent defaults don't typically mean that bond issuers run out of liquidity or fail to pay. Instead, defaults are mostly restructurings that involve investors accepting a partial "haircut" on the debt and/or swapping debt for equity.

In addition, the ratings quality of the European high-yield index has improved in recent years: 69% of the market is now rated BB, versus 59% in 2010, and 5.1% is rated CCC, versus 12.0% in 2010. That improved quality supports the expectation of lower default rates in the future. Even during the pandemic, defaults remained limited: governments cushioned the shock with widespread fiscal support and capital markets helped issuers with liquidity needs.

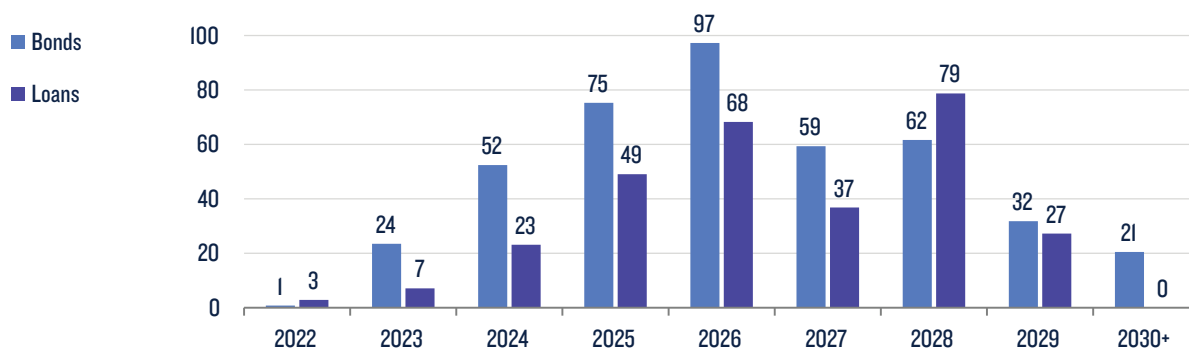
## PGIM Fixed Income's bottom-up default analysis

While the prior forecasts may indicate the direction of travel for default rates as the cycle evolves, they provide little information about the prospects of individual issuers or the health of their balance sheets. Our credit analysts use their company-specific knowledge of European high-yield issuers to supplement top-down default estimates with bottom-up analysis. We recently conducted this analysis under three macroeconomic scenarios: moderation, recession, and stagflation, and in doing so, we identified four key drivers of our outlook for defaults.

- 1) As mentioned, top-down models apply historical default rates to individual credit rating categories, which overlooks issuers current, historically strong balance sheets.

**Figure 3: The moderate maturity profile of upcoming high-yield bond repayments**

(€ billion)



Source: J.P. Morgan as of July 2022.

- 2) Most top-down models don't incorporate the fact that many firms have no debt maturities due for several years (Figure 3).
- 3) Similarly, most top-down models don't incorporate current levels of inflation, which helps some companies—particularly those with pricing power—by reducing the real liability of their nominal debt stock.
- 4) Finally, top-down models don't count equity support. If shareholders perceive that there is equity value in a business, they may support it with an equity injection instead of negotiating with debt holders.

Details of our three macroeconomic scenarios and conclusions are shown in the box to the right.

## The capability of credit selection to lower defaults, raise returns

With the intent of keeping defaults below market levels and enhancing returns, our active management process starts with bottom-up credit views. In the economic downturn that is approaching, we see vulnerability in cyclical and consumer discretionary sectors, such as certain retailer and leisure names. We believe opportunities in cyclical sectors lie at a different, earlier stage of the credit cycle. By contrast, telecoms firms, packaging producers, and utilities appear more insulated due to their pricing power.

Avoiding vulnerable issuers and overweighting issuers with pricing power can substantially increase returns. In addition, we carry higher cash levels at times or use hedges to keep risk at appropriate levels. It is also

### SCENARIO 1: "MODERATION"

Inflation moderates towards pre-pandemic levels. Economic growth stabilises around 1%-2%. Issuers' profits continue to grow, and yields fall from current levels.

- In this scenario, defaults continue to remain benign in 2023-24.
- High yield returns would be significantly positive with minimal default losses, high coupon receipts, and capital gains.

### SCENARIO 2: "RECESSION"

Inflation falls back to trend or below, but the Eurozone economy shrinks in a mild recession. Issuers' revenues suffer, but central banks moderate their policy tightening.

- In this scenario, default rates rise in 2023 and peak around 2% in mid-2024. Defaults occur mainly among real estate, financial, travel/transport, and food businesses.
- Returns remain positive on a two-year basis given the support from limited default losses.

### SCENARIO 3: "STAGFLATION"

Inflation remains high and economic growth slows or turns negative, possibly due to a sudden stop of energy supplies. Issuers' revenues struggle, and central banks keep interest rates high to subdue inflation.

- In this scenario, default rates rise from 2023 and peak around 3% in 2025-26. In addition to the above sectors, defaults increase in the retail and industrial sectors.
- Returns remain positive on a medium-term basis, supported by moderate default losses. A more attractive entry point relative to current levels materialises over a longer timeframe.

Source: PGIM Fixed Income.

important to maintain liquidity as volatility presents attractive relative-value opportunities.

## **Conclusion: low defaults boost the outlook for high-yield bond returns**

Our conclusion remains similar in all three cases with two broad expectations. First, we expect defaults to remain below external analysts' top-down forecasts. Second, we expect default to stay in-line with historical averages. Even in our most severe downside scenario, we do not expect cumulative four-year defaults to exceed 12% (i.e., we expect them to remain below 3% per year, on average). These rates remain around historical averages, rather than the higher levels we saw during the Global Financial Crisis of 2008-09 or during the pandemic in 2020-21.

With these default expectations in mind, we think that current yield levels, especially in certain non-cyclical sectors, more than compensate investors for expected default losses on a medium-term basis.

Timing markets and entry points into specific asset classes, such as European high yield, is difficult. Yet, as a potential recession and further spread widening approaches, a peak level in credit spreads and all-in yields may lie in the near future.

This combination will present an attractive entry point for investors with longer time horizons.

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