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Default, Transition, and Recovery:

The U.S. Corporate Default Rate Is Forecasted To Rise To 3.4% In 2013

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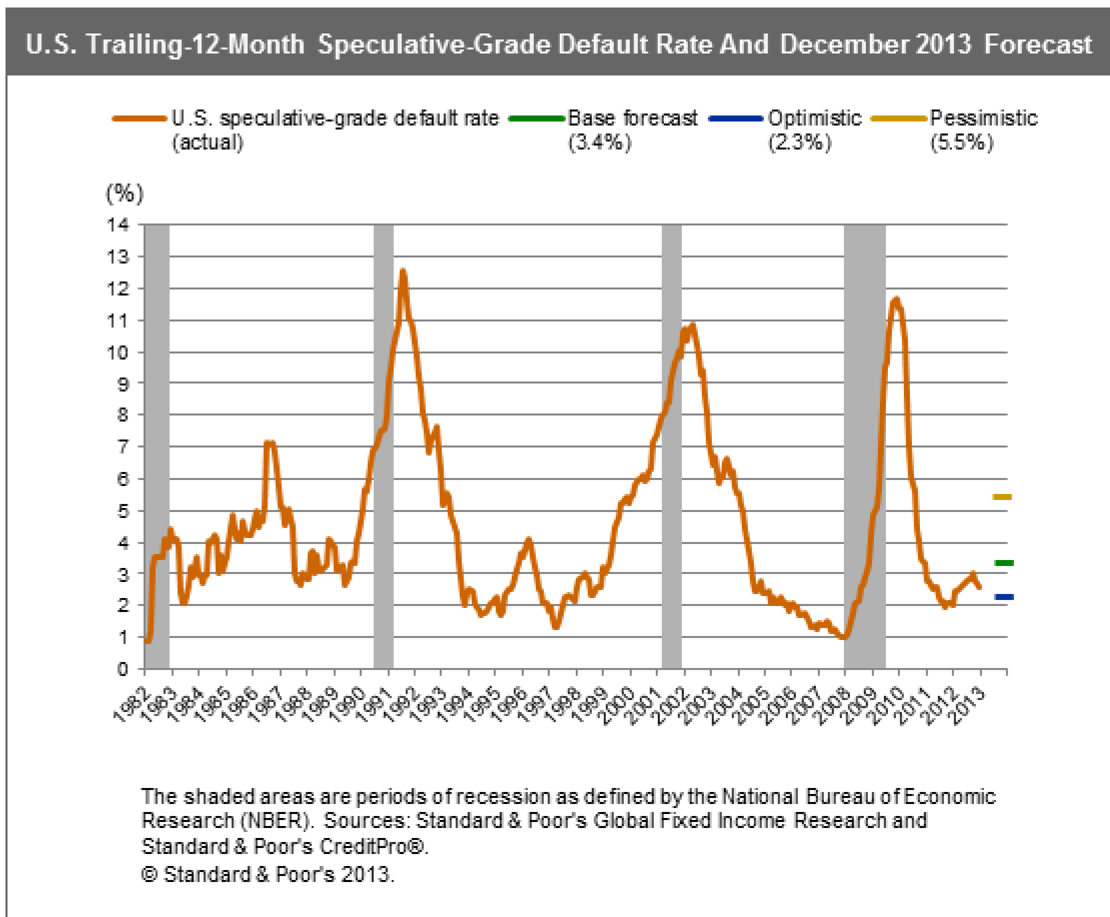
The U.S. Corporate Default Rate Is Forecasted To Rise To 3.4% In 2013

We expect the U.S. corporate trailing-12-month speculative-grade default rate to increase to 3.4% by year-end 2013 from 2.6% as of December 2012 (see chart 1). Our baseline projection is lower than the long-term (1981-2012) average of 4.5%. A total of 54 speculative-grade issuers (those rated 'BB+' and lower) would need to default in 2013 to reach this projection. By comparison, 39 speculative-grade entities defaulted in 2012.

Our baseline forecast is partly based on the assumptions that U.S. economy will grow by 3% in 2013, and the unemployment rate will decline to 7.3%. The Bureau of Economic Analysis' advanced estimate for real GDP growth in 2012 was 2.2%. And according to the Bureau of Labor Statistics, more than 1.5 million jobs were created in 2012, indicative of the continuing improvement in the labor market. More importantly, businesses continued to hire despite the uncertainty regarding the U.S. fiscal cliff towards the end of 2012 (and the presidential elections before that). The unemployment rate declined to 7.8% as of December 2012 from 8.5% as of December 2011. We believe that the potentially stronger economic recovery in 2013 is encouraging and should help companies expand their business and improve their bottom lines.

Chart 1



The shaded areas are periods of recession as defined by the National Bureau of Economic Research (NBER). Sources: Standard & Poor's Global Fixed Income Research and Standard & Poor's CreditPro®.

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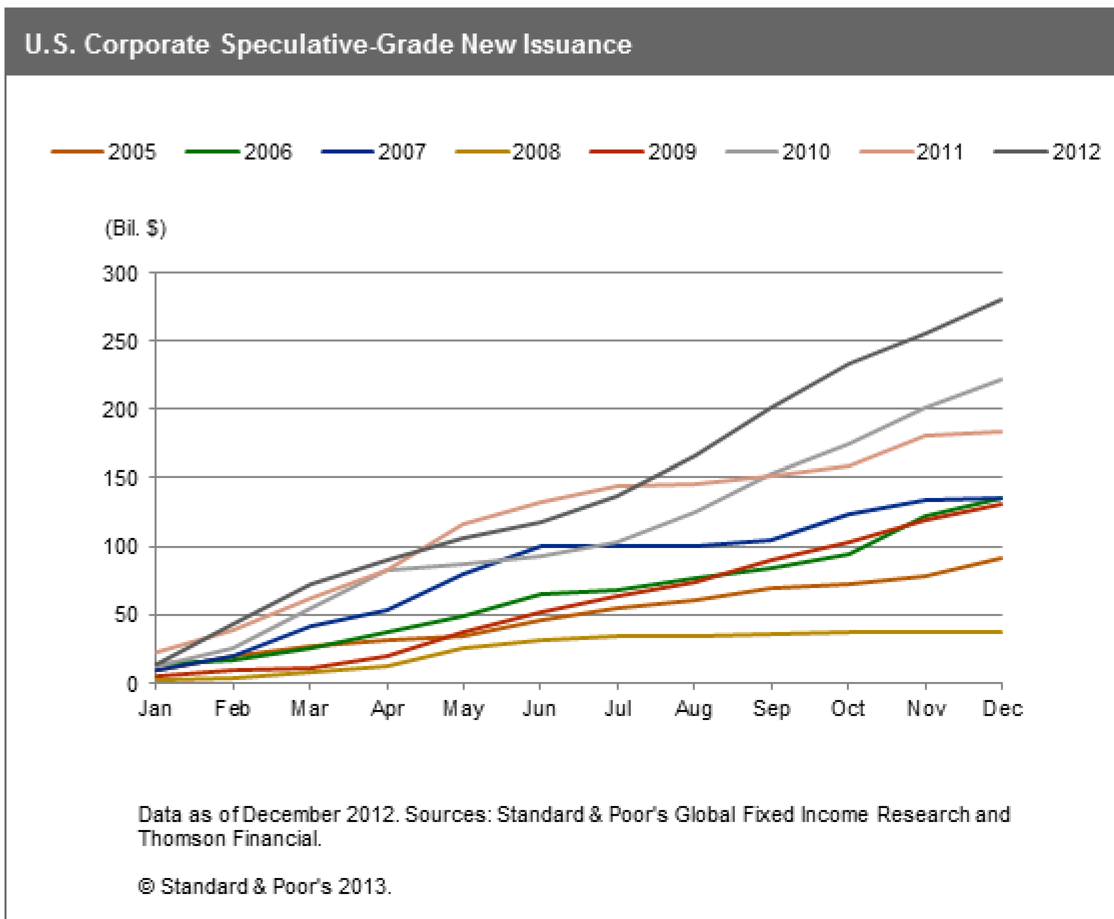
The relatively easy access to the credit markets was one of the reasons defaults were infrequent in 2012, in our view. Robust demand for corporate debt pushed U.S. speculative-grade new issuance to a record $281 billion in 2012 (see chart 2). Despite investor concerns regarding Europe's sovereign crisis and the uncertainty brought about by the U.S. presidential elections and the succeeding political wrangling regarding the fiscal cliff, investors allocated significant capital to the credit markets. As a result, many companies were able to raise capital to refinance maturing debt at relatively attractive terms or explore other opportunities that would diversify or expand their interests.

Chart 2



In 2013 (through Jan. 28), $22 billion new bonds came to market, continuing the strong issuance trend from 2012. However, investors appear to be more selective, allocating only 20% (or $8.9 billion) of the total issued to bonds rated 'B' and lower. This represented a sharp decline from the average of 37% (or $17.7 billion) per month in the second half of 2012 (see chart 3).

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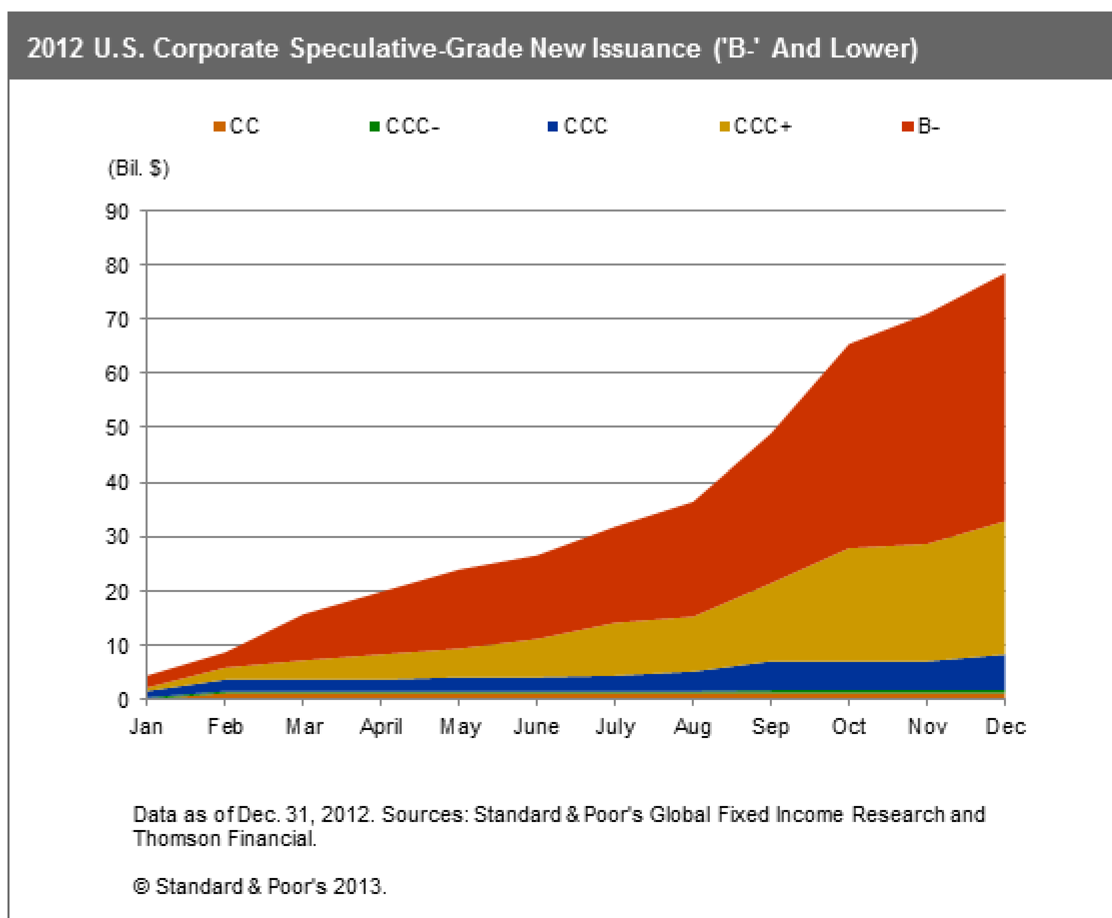
Chart 3



Investors can be temperamental and usually at the detriment of entities with lower credit quality. In recent weeks, investors have been selling treasuries on the heels of stronger employment and economic data and robust equity markets. Offsetting the Fed's treasury purchases, the broad sell-off pushed the 10-year treasury yield to as high as 2% on Jan. 29, from just 1.6% a few weeks earlier. The yield continued to hover at 2% despite the lower fourth-quarter GDP figures reported on Jan. 30. While it is too early to confirm if the treasury sell-off will continue or can be sustained, the dramatic rise in yields in a short period serves as a reminder that the recent period of easy access to the credit markets could fade in 2013. A significant movement of assets from cash and bonds to the equity markets could hurt companies at the lower end of the rating spectrum that have less financial flexibility and rely on the credit markets for capital to fund operations or refinance maturing debt. We believe these companies are most vulnerable to default.

In Europe, we expect the region to emerge from recession by year-end 2013, followed by a weak recovery that is strained by austerity measures. We also expect continued economic contractions in Italy and Spain, and sluggish growth in France and Germany. The deleveraging in Europe will continue to hurt domestic demand even as exports increase, particularly exports to the emerging markets. We also expect continued progress on the policy front, which would help ease pressures in the periphery economies.

Default Forecasts: Base (3.4%), Optimistic (2.3%), And Pessimistic (5.5%)

Our U.S. default forecast is based on current observations and future expectations of the likely path of the U.S. economy and financial markets. In addition to our baseline projection, we forecast the default rate in our optimistic and pessimistic scenarios. Our optimistic default rate forecast assumes faster U.S. economic growth, fueled by a stronger recovery in the housing sector and robust growth in consumer and business spending. Under this scenario, we also expect a faster-than-expected improvement in the labor market. And as a result, we would expect the default rate to decline to 2.3% in 2013 (or 37 defaults during the next 12 months).

On the other hand, our pessimistic scenario assumes that the U.S. reverts back into a recession, with the economy contracting 0.5% in 2013. The U.S. recession would result from financial contagion from the eurozone (European Economic and Monetary Union), where the recession is longer and deeper than expected in 2013, stemming from a slowdown in foreign trade, particularly with the emerging markets; consumer retrenchment; and deterioration in the capital markets. A material economic slowdown in the emerging markets as well as the uncertainty related to the U.S. debt ceiling and budget negotiations would also have a direct impact on U.S. growth. With the U.S. in another recession, available credit would be constrained significantly, particularly credit to entities with lower credit quality. These entities tend to have less financial flexibility in their funding sources and are more vulnerable to capital flight when investor confidence goes awry. Under this pessimistic scenario, we expect the default rate to rise to 5.5% (or 88 defaults during the next 12 months).

We determine our forecast based on a variety of factors, including Standard & Poor's proprietary default model for the U.S. corporate speculative-grade bond market. The main components of the model include economic variables such as the unemployment rate; financial variables such as corporate profits, the Fed's Senior Loan Officer Opinion Survey on Bank Lending Practices, the interest burden, and the slope of the yield curve; and credit-related variables such as negative bias. The interaction between the dependent variable--the U.S. speculative-grade default rate--and the input variables is in line with our expectations. For instance, increases in the unemployment rate and the negative bias are positively correlated with the speculative-grade default rate, which means that as the unemployment rate increases or as the proportion of entities with negative outlooks or ratings on CreditWatch negative rises, default rates usually increase. We update our outlook for the U.S. issuer-based corporate speculative-grade default rate each quarter after analyzing the latest economic data and expectations.

Long-term risks

A sustained and significant flight of capital from bonds to other asset classes, such as the equity markets, could result in a more considerable increase in defaults. Moreover, a reversal in investor sentiment could lead to a sustained slowdown in bond issuance activity, which, together with an increase in borrowing costs, could be detrimental to the credit markets. Low-rated companies, particularly among companies that have yet to refinance maturing debt, would be disproportionately more at risk, especially if the economy or the financial markets deteriorate. Based on the maturity schedules of all speculative-grade U.S. fixed- and floating-rate corporate bonds and bank debt, maturing debt will escalate significantly in 2013 and 2014 (see table 1). Borrowers vying for capital would likely face increased competition, especially in light of the nearly $800 billion of debt that we expect to mature from investment-grade entities during the same period. (For more details, see "U.S. Refinancing Study: Challenges Loom For Financial

Institutions And The Lowest Rated Corporate Issuers In 2012 And Beyond," published June 14, 2012, on RatingsDirect on the Global Credit Portal.)

Table 1

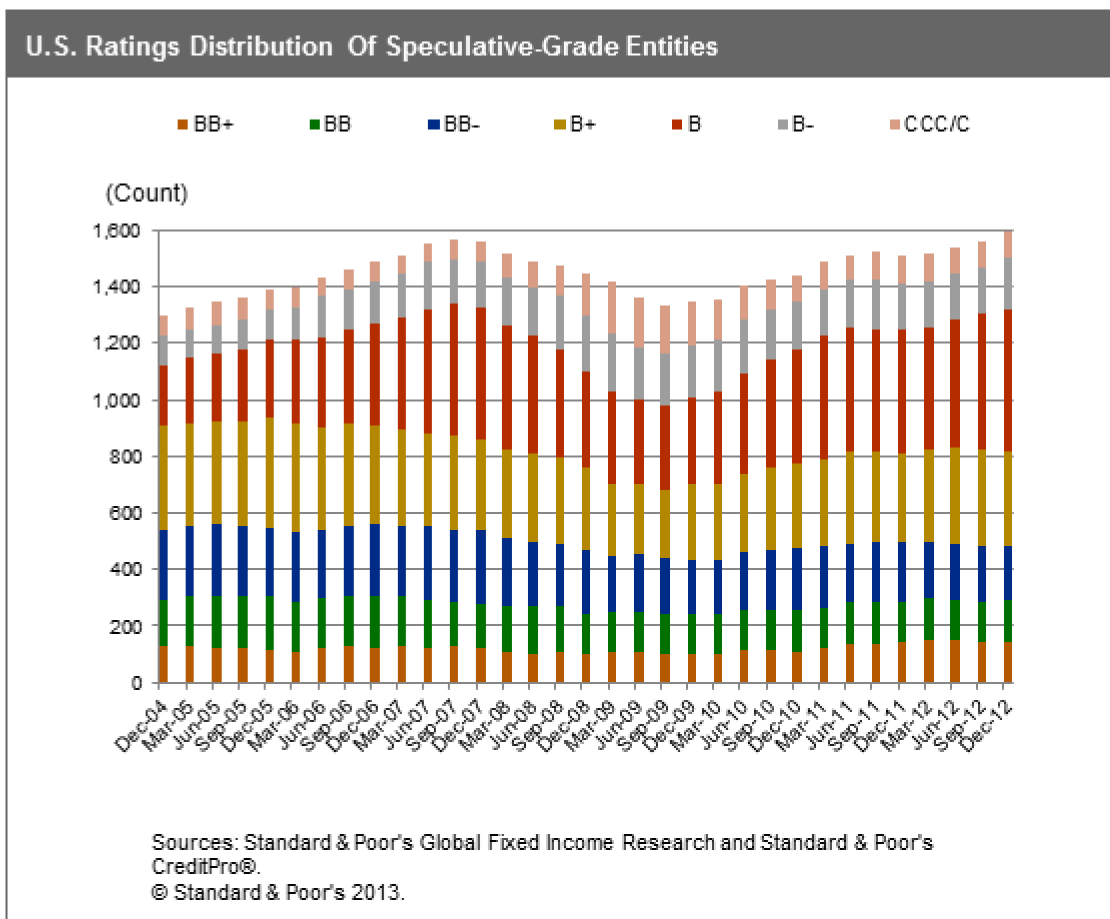
Maturing U.S. Speculative-Grade Corporate Debt*

	--(Bil. $)--		
	2013	**2014**	**2015**
BB+	28.71	24.78	28.70
BB	25.09	22.04	31.04
BB-	30.02	44.38	44.69
B+	43.87	85.00	42.69
B	42.28	69.30	54.11
B-	18.16	23.22	37.79
CCC+ and lower	13.07	39.90	38.67
Total	201.20	308.61	277.70

*Includes bonds, loans, and revolving credit facilities. The estimates are likely biased on the high side because our tallies do not always take into account amortization schedules and loan paydowns. In addition, the revolving credit facilities are usually tallied at full value whether or not they are fully drawn. The data includes all debt issued by U.S. companies and their foreign subsidiaries, both in U.S. dollars and foreign currencies. The foreign currencies are converted to U.S. dollars at the exchange rate on close of business on May 28, 2012. The data do not include foreign companies issuing dollar denominated debt under the name of their U.S. subsidiary. Data as of May 28, 2012. Sources: Standard & Poor's Global Fixed Income Research and S&P Capital IQ.

From a rating perspective, the combination of downgrades from investment-grade to speculative-grade and new speculative-grade entities has pushed the number of speculative-grade entities to a record level that exceeds the pre-2008 recession level (see chart 4). As of year-end 2012, there were 1,594 U.S. speculative-grade entities in our database, which is significantly higher than the 1,332 entities as of third-quarter 2009 and slightly higher than the previous high of 1,569 as of third-quarter 2007. Speculative-grade companies comprised nearly 53% of all rated entities as of December 2012--the highest level ever reached. Based on our study of historical data, we've found that default occurrence is not only more frequent among low-rated companies, but the time it took those companies to default is also shorter (see "2011 Annual U.S. Corporate Default Study And Rating Transitions," published March 23, 2012).

Chart 4



Sources: Standard & Poor's Global Fixed Income Research and Standard & Poor's CreditPro®.

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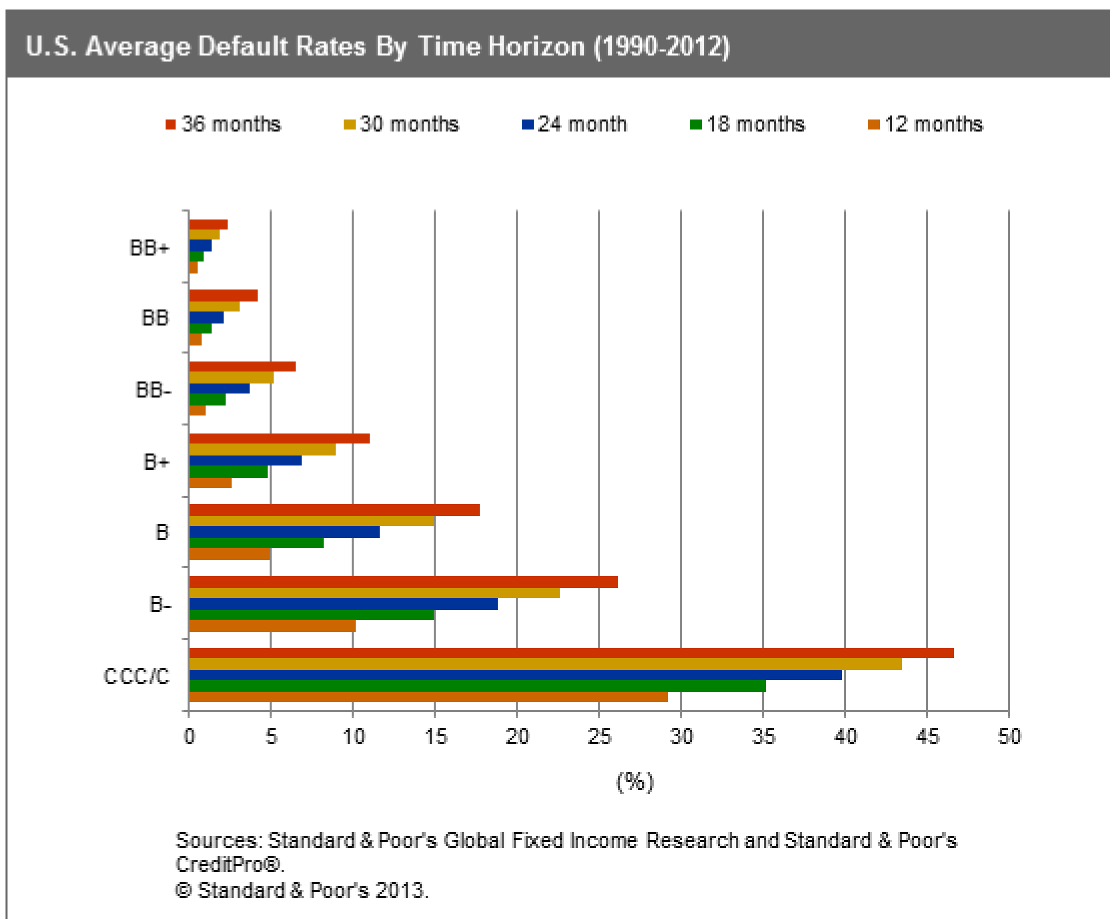
Of the 1,594 entities in the U.S. speculative-grade pool, 180 entities were rated 'B-' and 92 entities were rated 'CCC' and lower, accounting for a combined 17% of the total. Since 1990, an average of 10.1% and 29.2% of entities rated 'B-' and 'CCC' and lower, respectively, defaulted within a 12-month period. Hypothetically, applying these averages to the current mix of entities rated 'B-' and lower would yield a total of 45 defaults during the next 12 months, excluding any defaults from entities with higher ratings. To put this in perspective of our baseline forecast, 54 entities must default during the next 12 months from a total pool of 1,594 U.S. speculative-grade entities for the default rate to rise to 3.4%. The historical default rates for longer time horizons (such as 24 months or 36 months) are even higher (see chart 5).

Chart 5



Default Signposts

According to the Fed's fourth-quarter 2012 Senior Loan Officer Opinion Survey, banks, on net, were slightly more willing to lend to corporations, compared with the previous quarter (see table 2). Corporate profits and industrial production continued to improve but at a slower pace from a larger base. The yield curve, as measured by the 10-year U.S. treasury rate minus the three-month T-bill, was 173 basis points (bps) as of year-end 2012, compared with 155 bps in the third quarter, 158 bps in the second quarter, and 216 bps in the first-quarter. The number of distressed companies (speculative-grade entities trading at 1,000 bps or higher) declined to 9.7% in December from 10.6% in September and 14.5% in June, reflecting the decline in the speculative-grade spread in recent months. Volatility (as measured by the Chicago Board Options Exchange Market Volatility Index [VIX]) rose in the fourth quarter due to uncertainties regarding concerns in Europe, the U.S. presidential elections, and the U.S. fiscal cliff negotiations that followed. These kept the global financial markets on edge, pushing the VIX higher to 18 points at the end of 2012, from 15.7 points in September and 17.1 points in June. The default rate rose for much of 2012, reaching 3% in September before declining to 2.6% by year end. The number of weakest links (issuers rated 'B-' and lower with either negative rating outlooks or ratings on CreditWatch negative) increased slightly to 89 in December but essentially held steady at

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less than 100 entities throughout the year.

Table 2

U.S. Early Warning Signals Of Default Pressure

	Q4 2012	Q3 2012	Q2 2012	Q1 2012	2011	2010	2009	2008	2007
U.S. unemployment rate (%)	7.8	7.8	8.2	8.2	8.5	9.4	10.0	7.4	5.0
Fed survey on lending conditions	(7.6)	(9.5)	(6.9)	5.4	(5.9)	(10.5)	14.0	83.6	19.2
Industrial production (% change)	2.2	2.8	4.7	3.8	2.9	5.9	(1.6)	(9.4)	1.8
Slope of the yield curve (10-year U.S. treasury rate minus the three-month T-bill, bps)	173.0	155.0	158.0	216.0	197.0	315.0	354.0	239.0	110.0
Corporate profits (nonfinancial, % change)		5.1	6.8	17.2	13.7	16.4	59.0	(29.0)	(6.8)
Equity Market Volatility Index (VIX, points)	18.0	15.7	17.1	15.5	23.4	17.5	21.7	40.0	22.5
Speculative-grade spreads (bps)	565.1	617.0	685.0	623.0	723.0	521.0	604.0	1,647.0	561.0
Interest burden (%)		11.5	11.1	11.7	11.8	11.5	11.7	14.8	13.8
S&P distress ratio (%)	9.7	10.6	14.5	10.8	16.6	6.5	14.6	85.2	6.1
S&P speculative-grade outlook distribution (%)	63.5	62.0	66.0	66.0	64.0	60.0	77.0	83.0	70.0
Ratio of downgrades to total rating actions (%)	65.2	76.0	53.0	47.0	67.0	45.0	82.0	79.0	63.0
Proportion of speculative-grade issuance rated 'B-' and lower (%)	40.1	32.0	32.0	28.0	22.0	34.0	21.0	19.0	49.0
U.S. weakest links (no.)	89.0	81.0	79.0	81.0	92.0	80.0	152.0	190.0	78.0

Note: The Fed Survey refers to net tightening for large firms. Standard & Poor's outlook distribution is defined as ratio of companies with negative bias compared with companies with positive bias. Sources: Standard & Poor's Global Fixed Income Research and Global Insight.

U.S. corporate interest burden has been at about 10%-12% since 2009 (see chart 6). Despite the large borrowings in recent quarters, low interest rates and strong corporate profit growth has kept interest payments from rising higher. We define interest burden as net interest payments as a percentage of our EBITDA profits proxy (the sum of profits, consumption of fixed capital, and net interest payments).

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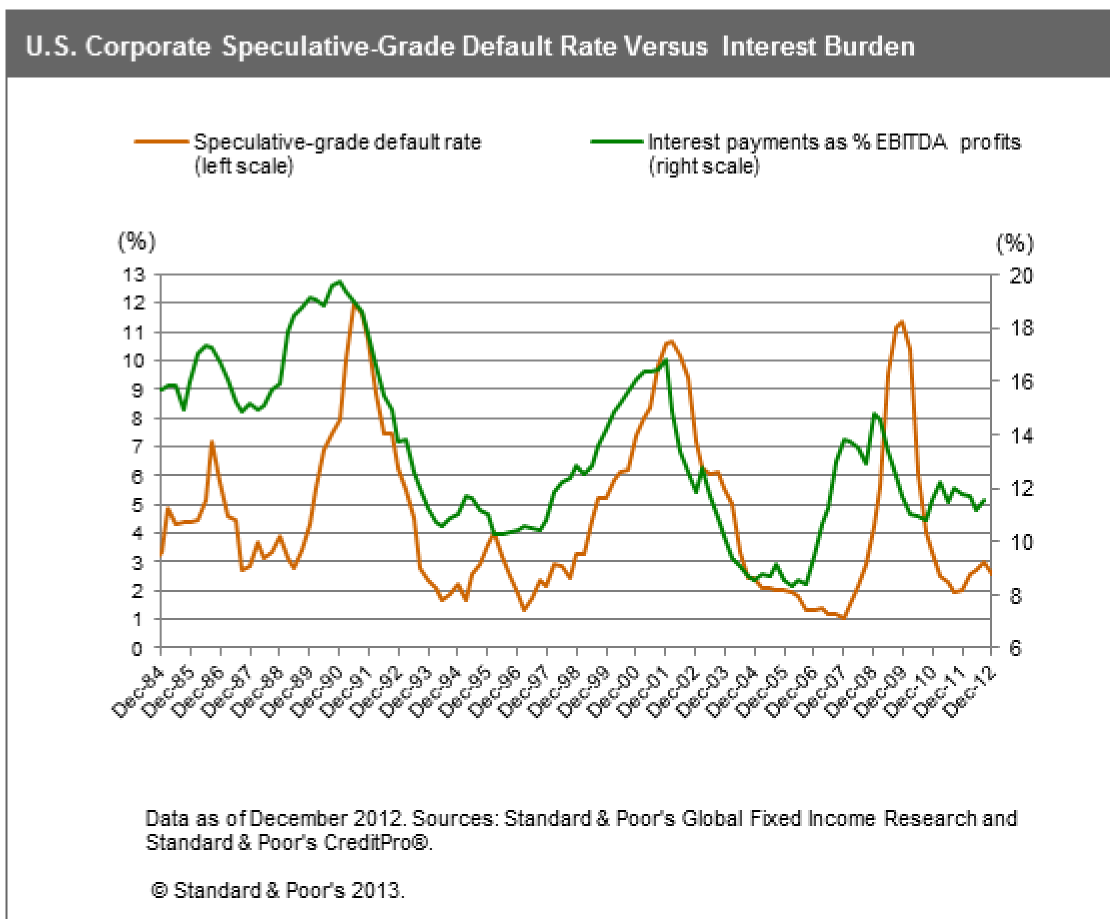
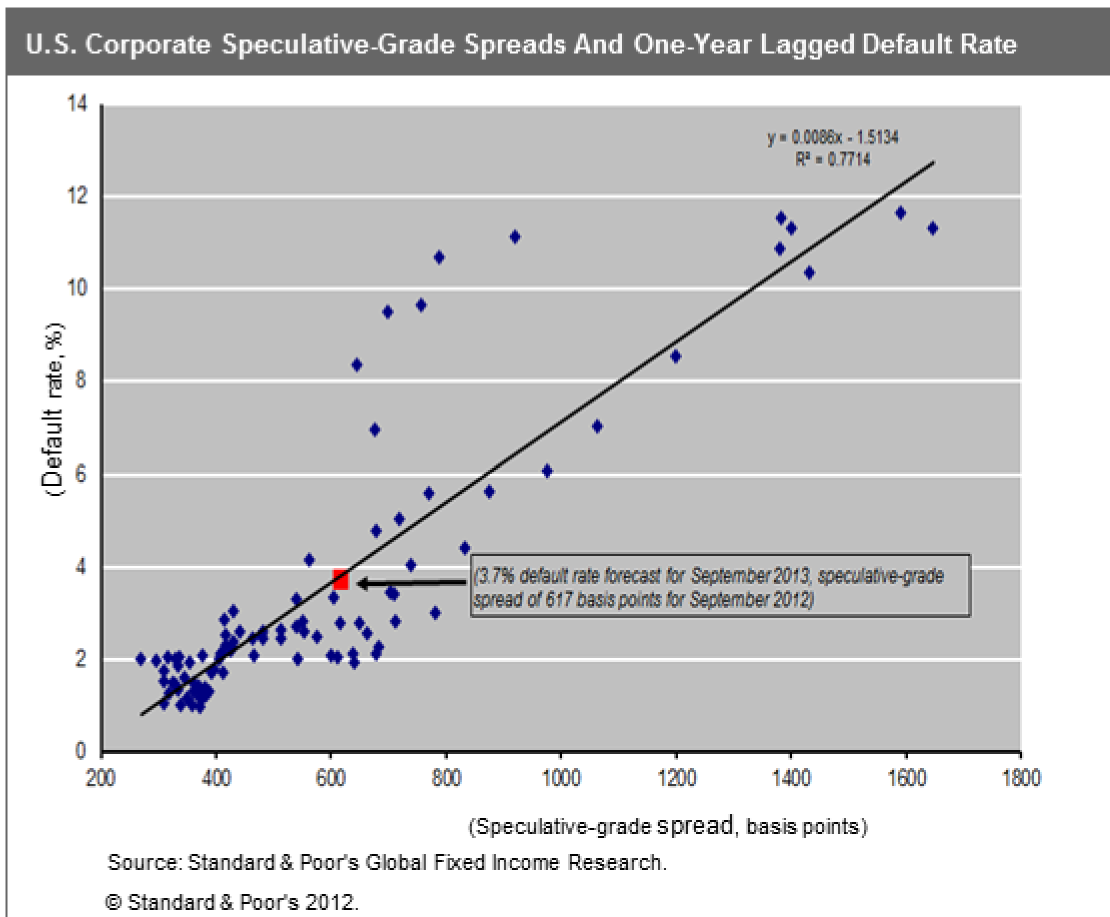
Chart 6



Companies' cost of borrowing is an important indicator of the health of the credit markets. A measure of this is the U.S. corporate speculative-grade spread, which inherently reflects default rate expectations. For example, the speculative-grade spread was at its five-year high in 2008, a wave of defaults followed, pushing the default rate to its peak in November 2009 (see chart 7). The speculative-grade spread has tightened considerably since then, and it is not surprising that the default rate has declined as well. In December 2012, the U.S. speculative-grade spread decreased to 565 bps from 617 bps in September and 685 bps in June. The spreads for December is actually on trend vis-à-vis our baseline forecast of 3.4% for December 2013.

Chart 7



Related Research

- U.S. Refinancing Study: Challenges Loom For Financial Institutions And The Lowest Rated Corporate Issuers In 2012 And Beyond, June 14, 2012,
- 2011 Annual U.S. Corporate Default Study And Rating Transitions, March 23, 2012
- 2011 Annual Global Corporate Default Study And Rating Transitions, March 21, 2012
- 2011 Default Synopses, March 21, 2012
- Most Of The Global Defaulters In 2011 Were Weakest Links, Jan. 20, 2012

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