

Defaults | Can Corporate Defaults Stay Low?

We expect speculative-grade defaults to remain low through 2022, with the Europe and U.S. default rates at 2.5%, assuming there are no policy surprises or economic setbacks.

How this will shape 2022

Investors are increasingly embracing risk. Most economies are recovering from the pandemic's impact and support from central banks and governments will take a while to unwind, potentially extending current tailwinds for corporates into 2022. Ultra-low interest rates and quantitative easing have also led investors to accept more risk than before as defaults stay low. Despite the deepest economic recession in roughly 90 years, the default rate was 6.1% in Europe as of March 31, 2021, and 6.7% in the U.S. at year-end 2020. There were very few bankruptcies; none in Europe this year, or in the U.S. since March.

Markets remain supportive amid a lack of alternatives. Yields on benchmark government bonds and investment-grade debt have been low for over a year. 'CCC/C' bond spreads in the U.S. averaged 644 basis points in 2021, the lowest annual average since 2007, and have been more stable than in any previous year. This backdrop has allowed speculative-grade issuers to set new annual records for issuance in the U.S. and Europe, with new high-yield bonds and leveraged loans in the U.S. totaling more than \$1 trillion through October, with Europe hitting €288 billion. It should also push default rates down to near historical lows in the first half of 2022--possibly below 2%--before rising later but only slightly.

Bankruptcies among small and midsize businesses could spike. During 2020, defaults rose to multi-year highs, but bankruptcy filings among small and midsize firms and sole traders--which we don't rate--generally fell well below their typical trends as a result of extraordinary fiscal support in the U.S. and Europe. This likely allowed many businesses to stay afloat longer than they would have otherwise. With many support programs ending soon, a more typical pattern of bankruptcies could reappear. This could be offset in Europe by a possible extension through June of the European Commission's State Aid Temporary Framework. A rise in small business bankruptcies won't have a direct impact on our corporate default rate, but indirect pressure could arise through greater supply chain stress, or lower consumer spending because of job losses.

What we think and why

Virus waves and lockdowns have had little negative impact this year. Speculative-grade companies we rate have shown resilience to the pandemic, even through delta-variant surges and lockdowns. Despite outbreaks over the summer, defaults in the U.S. and Europe have been quite low. In fact, since the start of April, the U.S. speculative-grade default rate has been 1.45%, if annualized. And in Europe, it's even lower, at 1.37%. There is little that can disrupt this trend in the near term, in our view. The leisure, media, and transportation sectors still have higher proportions of 'CCC' to 'C' rated issuers and are expected to lag in terms of economic recovery, likely causing them to lead the default tally.

Most issuers have secured ample and exceptionally favorable financing. In both the U.S. and Europe, speculative-grade issuers have easily set new annual records for debt issuance, and about half of the bond and loan issuance in 2020 and 2021 was to refinance existing debt on better terms. In relation to upcoming maturities, this year's issuance totals surpass speculative-grade debt maturing through 2023. Still, this massive debt load will have to be paid back eventually, though only several years from now.

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Investors continue to embrace risk

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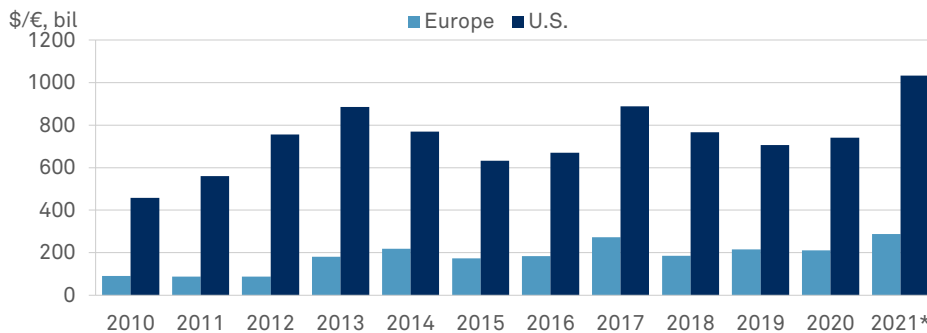
[The European Speculative-Grade Corporate Default Rate Could Reach 2.5% By September 2022](#), Nov. 18, 2021

[The U.S. Speculative-Grade Corporate Default Rate Could Reach 2.5% By September 2022](#), Nov. 16, 2021

Global Credit Outlook 2022: Aftershocks, Future Shocks, And Transitions

Chart 20

Speculative-Grade Debt Has Reached New Records In The U.S. And Europe In 2021



Source: Refinitiv; LCD. *Through Oct. 31, 2021. Combined leveraged loan and speculative-grade bond issuance.

Expect some upgrades, but not enough to repair the damage. Through September 2021, speculative-grade upgrades outpaced downgrades by roughly 2.9 to 1 in the U.S. and 1.7 to 1 in Europe. In the U.S., every sector saw more upgrades than downgrades. Our speculative-grade negative bias in both regions fell considerably in the 12 months to Oct. 31, in Europe to 18.1% from 45% a year earlier, and in the U.S. to only 14.4%, from 45.1%. Importantly, the positive bias has increased: to 9.3% in Europe, and to 11.4% in the U.S., resulting in many ‘CCC/C’ issuers being upgraded despite higher leverage. We expect a sustained economic recovery to translate into stronger revenue and earnings growth, with many sectors able to pass on higher input costs. But we don't expect this to lead to a return of the pre-2020 rating distributions in either region, since both will still have a high proportion of issuers rated ‘B-’ and lower (currently 36% in the U.S. and 30% in Europe).

What could go wrong

Economic growth could fall short of projections, or markets may pull back. Low default rates this year have been underpinned by strong economic performance and exceptionally supportive financial markets. But the delta variant led us to revise our U.S. economic projections more than once, and omicron and other variants could have a similar effect. Markets have kept borrowing costs low, even for ‘CCC/C’ rated firms whose leverage has risen this year. Our economists expect benchmark government yields to rise in developed economies, which should nudge corporate yields up as well. Underpinning it all, the weakest issuers are largely in sectors still vulnerable to lockdowns (travel, retail, media, and leisure).

Real or perceived policy missteps could blindside issuers and investors. As the Bank of England's recent surprise hold on interest rates shows, policy surprises can be disruptive. Governments and central banks have extended support measures put in place early in 2020, but at some point these will have to end. Timing may be everything. Although no “cliff-edge” effects from their removal have emerged yet, some sectors may need help for longer to fully recover, and central banks are already up against markets' concerns over current loose monetary policies.

“Late-cycle” behavior could lead to higher defaults. Spreads remain low, and rising inflation has pushed real speculative-grade bond yields negative in the U.S. and Europe. Bond and loan issuance has hit new highs; covenant-light instruments comprise roughly 90% of the leveraged loan market, and defaults have become exceptionally rare recently. Margin debt as reported by FINRA has increased dramatically since early 2020, breaking past \$900 billion, while high-yield returns have stagnated since the summer, leaving little room for further risk-taking by lenders and investors. In the worst case, default rates could rise to 5%-6% if issuers see a reversal of fortunes, which any or all of these risks could trigger, pushing defaults higher in the second half of 2022.

This report is an extract from "[Global Credit Outlook 2022: Aftershocks, Future Shocks, And Transitions](#)", Dec. 1, 2021.

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