A gathering storm?

US default rates for high-yield bonds have remained surprisingly low over the past three years. Some argue this indicates that the world has changed, but we have heard this story before, argues ***David Rowe***

Ed Altman, of New York University's Stern School of Business, is the grand old man of corporate debt analysis. He has been analysing and predicting corporate default behaviour for more than 40 years. In a recent paper, he discussed the persistently low default rates in the US high-yield bond market from 2004 to 2006.[1] From annual levels of 9.8% and 12.8% in 2001 and 2002, default rates dropped dramatically over the ensuing four years. It appears that the rate for 2006 will come in below 1%.[2] The last year in which this occurred in his data was 1984.

Altman's model for predicting the high-yield default rate is primarily driven by the historical credit rating composition of new issues in that market. In effect, the default rate at a given time is a function of the quality of newly issued bonds over preceding years and the historical incidence of default over time for each rating category. In both the 1990–91 and 2000–01 recessions, default rates began to rise well in advance of the official economic downturn, and Altman's approach was able to pick up this increase quite well.

Recently, however, his model has been overestimating the realised default rate. I have long argued that econometric models serve their most valuable purpose when they start to go wrong. Forecasting errors can be an early warning that one or more structural changes are exerting an effect not reflected in the current formulation of the model. In the case of the high-yield debt market, Altman outlines a number of such potentially relevant structural changes.

One possible factor is the aggressive entry of hedge funds and private equity funds as a source of demand for high-yield bonds. As competition in this field has intensified in recent years, there has been growing pressure to achieve higher yields. At the same time, massive inflows of investment funds into these vehicles have tended to eliminate many of the less risky arbitrage opportunities.[3] In this context, high-yield corporate debt has presented an attractive alternative for many hedge funds. In addition, such funds are often more aggressive than traditional institutional lenders and have viewed newly distressed debt situations as opportunities to achieve attractive yields at acceptable risk.

At the same time, there has been a resurgence of leveraged buy-out activity reminiscent of the late 1980s. The visibility and reputation of large private equity investors has made traditional institutions more willing to hold the substantial amount of new high-yield debt that usually accompanies these transactions.

The new lender-friendly US bankruptcy code of 2005[4] is another possibly relevant structural change. This revision to the bankruptcy code limited the debtor-in-possession's exclusivity period to 18 months with respect to filing a reorganisation plan and other prerogatives. Altman argues that this revision has resulted in an expectation of increased post-default recovery (reduced loss given default) for creditors. Such an expectation might discourage companies from opportunistic bankruptcy filings. On the other hand, it could make creditors more aggressive in forcing such filings if they believed that doing so would improve their leverage over the distressed company.

Regardless of these structural changes, Altman's data exhibits one notably disturbing pattern. He tracks the proportion of new high-yield bond issues that were rated B– or below from 1997–2006. From an average of around 20% in 1993–1996, this figure rose to more than 27% in 1997, almost 41% in 1998 and remained above 30% in 1999 and 2000. What followed was the meltdown of 2001–02, with the default rates noted above. The years 2003–2006 have followed an eerily similar pattern to that of 1997–2000. The proportion of new high-yield issues rated B– or below was almost 30% in 2003, 39% in 2004 and remained in the mid-30% range in 2005 and 2006. This pattern points to a likely rise in high-yield default rates as these cohorts age.

While structural changes may have a mitigating influence on the rise in default rates, some reversion to the traditional pattern seems far more likely than a continuation of the remarkably favourable experience of 2006. It seems increasingly likely that we are observing a gathering storm in the US high-yield credit markets. The big question is likely to be not whether such a storm will occur, but how severe it will be. ■

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[1] *Altman, E, 'Are Historically Based Default and Recovery Models in the High-Yield and Distressed Debt Markets Still Relevant in Today's Credit Environment?', New York University Salomon Center, Stern School of Business, October 2006*

[2] *Altman calculates this rate as the par value of defaulted bonds divided by the mid-year par value of outstandings excluding defaulted issues*

[3] *See Rowe D, 'With a bang or a whimper?',* Risk *October 2004, page 62*

[4] *The Bankruptcy Abuse Prevention and Consumer Protection Act went into effect on October 17, 2005*