COLUMBIA THREADNEEDLE INVESTMENTS

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HIGH YIELD: LOWER FORECASTED DEFAULT RATES, FOR NOW

High yield default forecasts: results and drivers

Our research team periodically provides a credit default forecast to be used internally across portfolio management teams to gauge both specific and relative asset class risk for high-yield (HY) bonds. The team of analysts evaluates the companies that they cover and assign a specific probability of default to those companies. This bottom-up method is intended less to identify individual companies that may be at risk—that analysis is ongoing—but more to evaluate overall sector and asset class risk through aggregated bottom-up company analysis.

Exhibit 1: Forecasted default rates

Par-weighted forecast	Forward 12-month	Forward 24-month
Total default rate	**2.9%**	**7.2%**
Default rate ex-energy	2.3%	5.6%

Source: Columbia Threadneedle Investments High Yield Research Team; as of September 2020. The 24-month forecast is cumulative and includes 12-month defaults. Forecast is for the High Yield Research Team coverage universe of approximately 590 issuers or 85% of the HY universe.

Lowered default rates

Comparing the forward 12-month outlook to our prior 2021 default forecast, we expect **lowered default expectations** to be driven by the following factors:

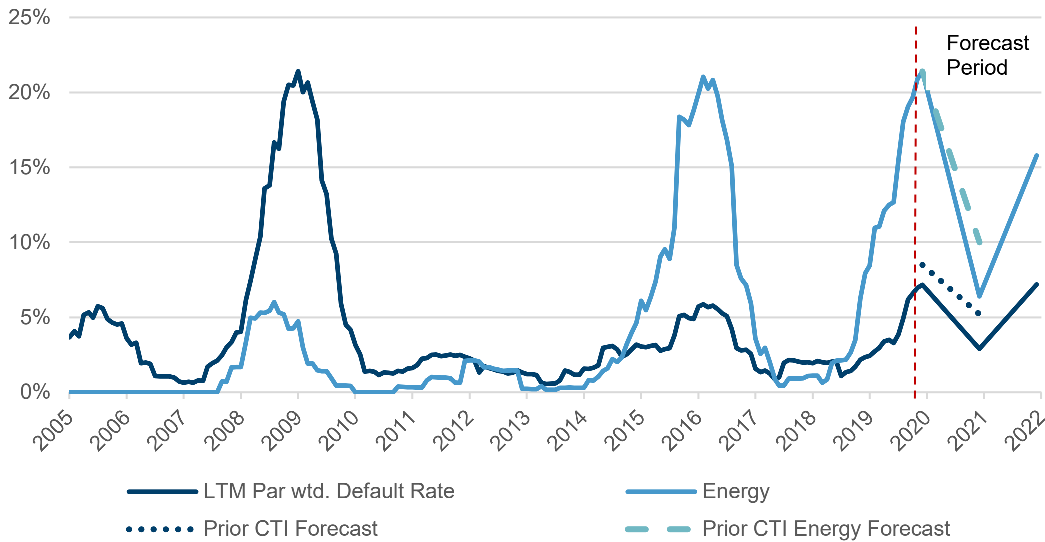
- Continued implied market **support from the Federal Reserve**, which has facilitated record HY issuance on a year-to-date basis, improving maturity profiles and enhancing liquidity.
- Faster-than-expected **fundamental recovery** or better-than-expected performance in certain sectors.

- Index composition changes, as **fallen angels have improved the credit quality** of certain sectors of the HY market.

By way of comparison, Bank of America Merrill Lynch (BAML) calculated the actual last-12-month (LTM) default rate in HY at 7.2% (as of 08/31/20), while JP Morgan calculated the LTM default rate at 6.4% (as of 09/01/20).

Historical comparison

Exhibit 2: High yield par-weighted default rate – historical and forecast



Source: Bank of America Merrill Lynch; Columbia Threadneedle Investments High Yield Research Team; as of September 2020

Taking a longer view, we can see the current default rate is much lower than during the financial crisis. The red line marks the current forecast period, and the blue dashed lines show our prior forecasts from May 2020. We can see that the default rates have been playing out as we had forecast 4 to 5 months ago. The increase in forecast defaults in 2022 is primarily a function of the uncertainty surrounding specific sectors and the trajectory of their recovery. Energy weighs heavily in this regard.

The energy sector, with a current higher default rate, is in the middle of its second default cycle of the past five years: many of the oil-field services companies that boosted fallen angel returns in 2016 have now defaulted or are distressed.

Still risk in the energy sector

Exhibit 3: Energy sector default forecast

Par-weighted forecast	Forward 12-month	Forward 24-month
Energy (Total)	**6.4%**	**15.8%**
Energy subindustries:		
Energy - exploration and production	6.5%	15.4%
Oil field equipment and services	24.0%	65.0%
Gas distribution	1.4%	2.9%
Energy ex-gas distribution	9.0%	22.5%

Source: Columbia Threadneedle Investments High Yield Research Team

The energy sector has led default activity—by par value and by the number of defaults—and is still one of the sectors in which we see a **higher degree of risk**.

Despite that, **forecast default rates in the energy sector have come down** because:

- **Defaults have been realized and occurred**. LTM sector defaults are 23% according to BAML
- The **outlook for oil and natural gas improved** from earlier this year
- The **composition of the energy sector has changed** as former investment-grade companies—fallen angels—have entered the HY market, improving the overall credit quality of the sector
- Some companies have been able to **access capital markets**, improving liquidity and maturity profiles.

Summary

Our base case par-weighted default rate is 2.9% for the 12-month forward period and 7.2% for the forward 24-month period.

Despite our lowered 12-month forecast, we continue to see risk of higher defaults due to the impact of COVID-19 on certain sectors. There remains a high level of uncertainty regarding the long-term recovery of some sectors, with this risk represented in a higher 24-month default forecast.

The sectors in which we see the most risk for defaults to increase are: energy, leisure, real estate and transportation.

Past performance does not guarantee future results.

There are risks associated with fixed-income investments, including credit risk, interest rate risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer term securities.

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