

The credit default cycle lives and breathes, but the current one is not the death of corporate credits, despite depression-like error run rates.

With the aftermath of the global financial crisis, the market has entered a new era of historically high default rates. This paper discusses the reasons for these high default rates, why the rated universe is different from history and the consequences for the performance of credit.

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For Institutional Investors Only

insights

ING INVESTMENT MANAGEMENT

Credit Default Rates – Putting them into perspective

Introduction

The cause and effect of the global financial crisis (GFC) have been extensively analysed and commented upon by many academics, market observers, market practitioners and regulators.

As a consequence of one of the worst credit crises in history, we have seen corporate default rates accelerate aggressively over the past 18 months. To put this in perspective, global default rates have risen from their historical lows of 0.87% in 2007 to the current 12 month rolling rate of 10.8%¹, which is more than the level of defaults experienced during the last default cycle that peaked in 2001. These default rates are also more than twice the long-run average of about 4.2% (based on S&P default ratings).

While tentative signs are emerging of a bottoming in deteriorating global economic conditions, and in some instance there is evidence of improvement, the pace of such is insufficient to halt the rising default rate. This is because overall, global economies have been supported by substantial remedial measures, using fiscal, monetary and regulatory solutions which are largely temporary boosts. The bigger issue of self-sustained growth and recovery in spending from over-leveraged consumers will weigh heavily on industry in the coming year. Until we see a return to revenue growth and margin expansion, and for some, a considerable reduction in corporate debt, the concerns for industry will continue to exist. Accordingly, defaults are expected to grow in a global context by a further three to four per cent

over the next six to nine months and then drop away materially.

What are the consequences of this continued rise in default rates for Australian credit investors? Can we compare this default cycle to that experienced around the Great Depression (of the 1930s) when default rates peaked at their historical highs of 15.4%²? Are global default rates relevant to Australia? Can we compare this default cycle to others, and if the prevailing cycle is second only to, perhaps even equal to the Great Depression, what are the consequences for valuations going forward?

This default cycle is unique

Historically, default cycles have commenced with industrial sectors the first to evidence deterioration in credit worthiness which then filters through the banking system. However, the order of events was different during the GFC, with the banks the first sector to experience instability. The four³ phases of the credit crisis which unfolded were:

- Phase One - commenced with hedge fund failure resulting in the US company, Bear Stearns, bailing out these funds only to later suffer a crisis of its own. Subsequently Bear Sterns was bailed out by JPMorgan.
- Phase Two - involved massive asset write downs and losses across banks' balance sheets globally (to date US\$1.6 trillion in bank / insurer capital has been destroyed⁴),

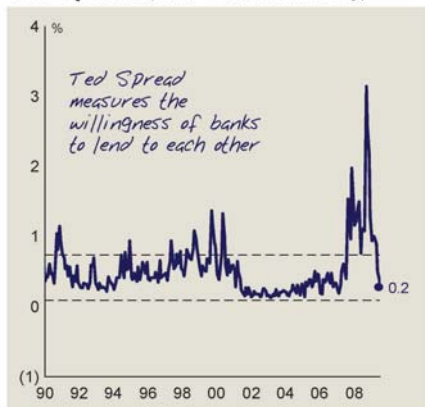
¹ S&P 12 month rolling default rate as reported on 9th October 2009 for September 2009

² Moody's Annual Speculative Grade Default Rates, 1920-2008

³ Source: "The Credit Crisis Explained", Nomura, January 2009

⁴ Source: Bloomberg

Chart 1: TED Spread has normalised

Ted Spread (Libor – 3 month Treasury)

Inter-bank lending has moved back into its historic range signaling that the financial system is behaving more normally.

Source: Moody's, Reuters, US Federal Reserve, Bloomberg, FactSet

- Phase Three - saw a market liquidity crisis evolve as a consequence of the aforementioned capital deterioration and fear of bank insolvency. With banks not lending to each other we ended up with a stagnant credit market.
- Phase Four - a full blown GFC culminated with Lehman Brothers' default and subsequent government intervention to avert complete financial system failure.

As a consequence of the GFC, banks became more selective in their lending practices, as they sought to preserve capital and liquidity during a period of extreme financial pressure and instability. In turn, many marginal firms faced challenges in rolling or refinancing maturing debt, at which point the default cycle commenced.

In the space of 18 months the global default rate rose from a historical low of 0.87% to the prevailing 10.8% which continues to grow. This in turn created a second round effect, as banks' corporate exposures came under pressure. This led to many banks selling loans before they defaulted, but at distressed prices, thus feeding the negative market momentum.

The rated universe evolution

This leads us to the rated universe evolution - from a period of low interest rates and easy credit to a period of credit rationing and de-leveraging.

Default rates quoted by the main rating agencies of Moody's and Standard & Poor's (S&P) relate to their respective rated universe only – although there is considerable overlap and as such the stated default rates are similar throughout history. At the peak of the last default cycle (in 2001), Moody's recorded a default rate of 9.98%, while S&P reported a figure marginally less at 9.62%.

In comparing the current default cycle with previous ones, consideration should be given to the composition of the rated universe. In this regard, during the years following the last cycle, especially between 2004 and 2007, there was an explosion of first time issuers rated single B and lower (i.e. below investment grade). Over this period, on average, 68% of sub-investment grade issuers were rated single B or lower compared to a longer run average in the 35%–45% range.

The huge increase in lower rated issuers was not surprising given that the global economy was enjoying strong growth and a low interest rate environment. The combination of these two factors created an attractive environment for borrowers. For lenders, the risk appetite was also strong, as the growth cycle encouraged confidence in higher yielding credits.

However, if we take history into consideration, over any given five year period, we expect, on average, one in three single B rated credits to default. Another way of looking at this is that corporate issuers rated single B or lower are 25 times more likely to default than issuers rated BBB- (investment grade) or higher.

Here is the scenario we are in:

- Firstly, twice as many of these lower rated bonds have been issued relative to the historical average.
- Secondly, with these bonds 25 times more likely to default than higher grade issues, we have a recipe for higher default rates.

In summary, the overall credit quality of the rated universe during this cycle has been diluted by the growing inclusion of riskier credits.

Paying the price for the boom years

Of the S&P rated corporate universe, approximately 25% of issuers are currently rated lower than single B. In addition, history shows that approximately 70% of issuers that are initially rated single B tend to default within five years. With the rapid issuance of such credits between 2004 and 2007, combined with the effects of the GFC, we can expect to see default rates continue to climb as this five year 'default risk phase' plays out over 2009 to 2012.

In addition to this, the credit market is dominated by US companies in default occurrences. Using the S&P default rate for 2008, US domiciled companies accounted for 76% of defaults. Year-to-date numbers in 2009 reflect a similar theme with the outlook for defaults also dominated by US domiciled firms. In this regard, of the 278⁵ companies considered at real risk of default, 71% of them are US domiciled.

In a local context, during 2008 only one Australian rated company defaulted and so far in 2009, only one company has defaulted as well. This by no means suggests that Australian companies are a better quality credit, but rather that many of the corporate defaults experienced were non-rated companies. Also, Australia's rated corporate universe is predominantly investment grade rated, i.e. BBB- and higher, which implies an ability to withstand economic cycles much better than lower grade credits.

Market reaction to rising default rates

From an investors' perspective, how has the rising default rates impacted the credit market and have investor expectations changed?

Credit markets tend to react before defaults actually start to materialise, which is not surprising. Defaults by and large are 'slow moving train wrecks' and can be seen coming, unless of course event risk is the catalyst for default - although these are in the minority.

Over the cycle, default rates only really began to accelerate as we entered the third quarter of 2008. The rolling 12 month default rate increased from 1.5% to 2.07% at the end of September 2008. Credit spreads (CDX⁶ is used as a proxy) on the other hand began to move approximately 12 months earlier. What happened was that CDS pricing reaction for investment grade credits by and large was much more muted than for cash bonds. In the domestic market, the forced unwinding of credit funds, structured investment vehicles (SIVs) and conduits pushed bonds into a market where demand was all but non-existent. Basically, everyone was selling and hardly anyone was buying as credit quality became largely irrelevant. Sentiment, or more specifically fear, was driving spreads.

In some instances we saw iconic Australian companies with their CDS priced at levels reflecting deep sub-investment grade characteristics. To get an appreciation of how little regard the market had for credit quality let's look at pricing action for BHP. BHP CDS (A+/Stable) spreads approached 550 bps in the fourth quarter of 2008. This implied a probability of default over a 5 year term of around 38%. This pricing is equivalent to default risk of a CCC / B- rated corporate not an A+ rated corporate. BHP's credit profile did not deteriorate, but unfortunately the GFC created an environment where technical forces were driving prices rather than actual fundamentals. Today BHP is trading around 64 bps, which equates to default probability of about 5.4% (or BB+), still suggesting worse credit quality than the company actually rates.

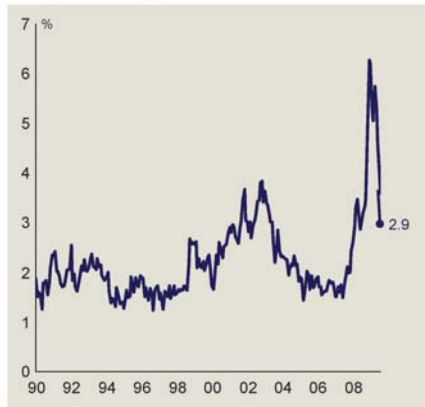
⁵ S&P Weakest Link list as at 9th October 2009

⁶ The Dow Jones CDX is a family of indices comprising of a basket of credit derivatives that are representative of certain segments of North American investment grade credit derivatives, high volatility, high yield, high-yield non-investment grade, as well as emerging markets.

"It is fair to say that credit spreads became disconnected from fundamentals or realistic expectations of default risk."

Chart 2: US Corporate Spreads Relative to 10Yr US Treasury Yields

Corporate Spreads Baa



Spreads have declined over the past several months as market volatility has fallen.

NB: Corporate Baa spreads are benchmark average rates in excess of 10 Year US Treasury Yields

Source: Moody's, Reuters, US Federal Reserve, Bloomberg, FactSet

It is fair to say that credit spreads as a whole became disconnected from fundamentals or realistic expectations of default risk, with market premiums sky-rocketing as asset allocations out of credit and equities caused technical pressure on securities that remained fundamentally sound.

With the aid of government intervention globally, massive fiscal stimulus and accommodative monetary policy, the world has largely stepped back from the precipice of financial Armageddon, and confidence in the stability of the financial system and improving economic conditions continues to grow, albeit gradually. In this regard, credit spreads have reacted accordingly, tightening almost aggressively as they widened, at least in a CDS sense...but have they gone too far?

Are credit spreads pricing in too much optimism?

Credit spreads have undoubtedly contracted from their wiles. The question many people are asking is, as on the way up, have they overshot on the way down? This is a significant point of debate, with many market commentators arguing too much has been priced in too soon, i.e. the market is pricing in good news before it has really materialised. This may be the case in CDS markets where spreads are at levels not really reflective of the risks, while in the cash bond market there is still scope for tightening.

At time of writing, BBB rated cash bonds in the Australian market were yielding spreads equivalent to 320 bps for 5 year risk, which compares favourably to BBB band rated CDS with trades at an average of 109 bps. For BBB credits, compensation for default risk over a 5 year period is around 100 – 105 bps, so CDS is only just fair value from this perspective, while cash bonds offer sufficient default risk compensation and premium for market risk.

Recent 'big name' examples also highlight the upside benefit within cash bonds, including the Wesfarmers A\$500mn issue completed in September. This issue was priced at 260 bps for 5 years, while at the same time the CDS was pricing approximately 103 bps. An investor could theoretically pick up 157 bps of risk free (default) to Wesfarmers if they invested in the bond and hedged the default risk by buying CDS⁷.

From a pure credit perspective, spreads offered on credit continue to provide sufficient compensation for the risks, however the market premium earned is being gradually traded away as investors chase yield in a low rate environment. We're at the beginning of a recovery, or at least it appears we are, with slowing job losses in the US, sequential increases in retail sales, increases in new and existing homes sales, and increased consumer confidence⁸. All point to positive growth. However, the confusing issue is that the market seems to be pricing in more positive growth than that suggested by the evidence.

Growth of course is inevitable, the issue here is the strength of the growth and how long it will take to before fundamentals match valuations. Since March 2009, the peak in credit market hysteria, most of the low hanging fruit (ie. the easy trades) have been priced out and now represent anything from fair value to potentially being expensive – both in high yield and the high grade credit space.

The forced selling pressures that we saw at the height of the GFC have been played out, with current holders of risk assets in many instances sitting on material unrealised gains. How much of this is real money and how much is fast money (ie. non-traditional investors switching to the next big thing)? Despite the proportion across camps, even small flows of fast money out of credit assets is enough to put pressure on valuations.

⁷ Some currency risk would remain as CDS is priced in US\$

⁸ All US data, although all key given the importance of the US economy on the global economy

"High default rates are largely the domain of a particular segment of the credit universe. It would be wrong to lump all credits in the same 'default' basket."

Conclusion

As we look at the impact of the GFC and the current credit default landscape, it has become clear that credit markets have changed materially from the last comparable default cycle (ie. 2001).

We have seen enormous growth in the sub-investment grade sector, which has led to the number of issuers in the credit market universe balloon over the last economic cycle. Not surprisingly, the increasing composition of sub-investment grade issuers in the universe, coupled with the detrimental impact of the GFC on credit markets, has led to a dramatic increase in default rates. This in turn has created a high probability of default risk within the pricing of all credits, not just lower grade credits.

However, it is important to remember that the high default rates are largely the domain of a particular segment of the credit universe. It would be wrong to lump all credits in the same 'default' basket. As an institutional investor, ING Investment Management focuses on investment grade credits which have a considerably more stable credit history and lower default rates. Whilst these credits are not immune from default, the contamination caused by the GFC sell-off created unrealistic and unsustainable mispricing to the detriment of investors.

From a period of sentiment-driven pricing in the latter stages of 2008, we have now returned to a more normalised level of pricing in credit markets. We believe credit markets still form a valuable investment strategy in a diversified portfolio. The opportunities to generate positive alpha have reverted to traditional fundamental analysis and stock picking, while avoiding asymmetric risk.

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