

## Focal Point

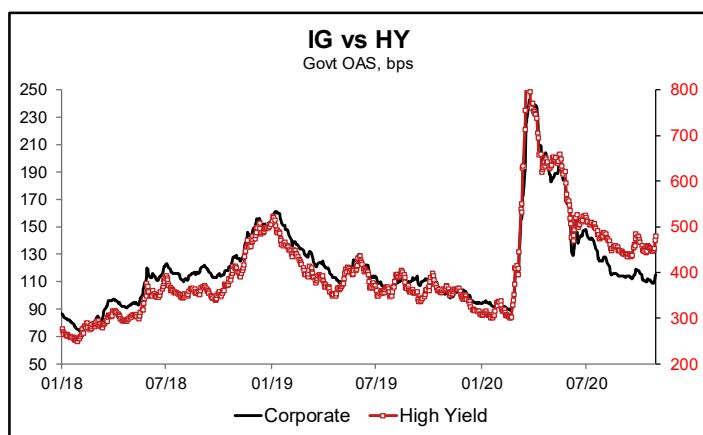
# European defaults likely to stay low

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**Author: Elisa Belgacem**

- Correlations between defaults and macroeconomic variables suggest European defaults may rise above 8% in the months to come. However, both monetary and fiscal support are set to contain the impact to a much more moderate 5-6% peak in H1 2021 in our view.
- Rating agencies have also factored in this policy support but they will, of course, continue to closely monitor the credit quality of European issuers. We deem the rating migration risk now more serious for IG and BBB in particular, while HY has already suffered from the bulk of the downgrades since the global spreading of Covid-19.
- Hence within the crossover space, we think investment opportunities can be found in fallen Angels that are already pricing in a downgrade to high yield and in solid BBs and Bs. HY appears hard to avoid over the medium term but credit selection is key as idiosyncratic risk will remain elevated. We also continue to favour subordination risk to credit risk.

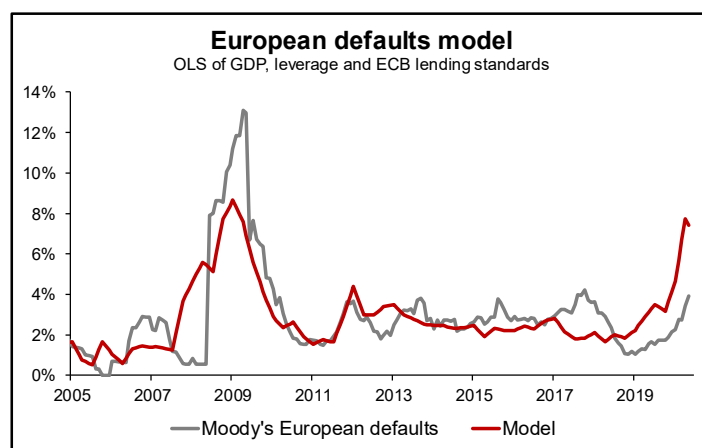
Since March, credit markets have retraced a large part of the Covid-related spread widening, alongside rebounding risk sentiment. Although the rally has been substantial, it has remained defensive with IG outperforming HY on a beta-adjusted basis. The main reason in our view have been concerns about rising defaults. In this note, we show why European defaults will likely remain substantially below 2008-2009 numbers. Appetite for HY has been dented also by unfavourable rating migration, but we think this trend could reverse in the coming months.



### Substantial policy support to corporates...

Historically there was a strong correlation between diffusion indices like IFO, PMIs and default rates, which would point to default in the region of 10% currently. A model based on GDP, leverage and ECB lending standards suggest upcoming 12m default rates for European Corporates of 8%. Traditional default projection models are based on

such variables but given the specificities of the Covid crisis we deem them less suitable this time.

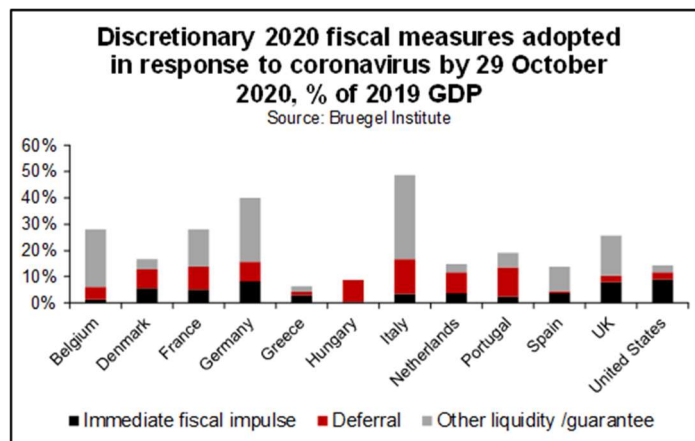


Indeed extraordinary policy measures have been taken governments and central banks to mitigate the destructive nature of stringency measures on the corporate world. As a result, we think default rates in Europe will remain much below the 2009 level and only rise from 3.9% currently to 5-6%. Market participants are considering the positive impact of policy measures including monetary and fiscal ones:

1. **Corporate bonds have become a policy tool:** Credit had already been bought by central banks over the past decade but it becomes clear that corporate bonds are now part of the central bank toolkit across the globe for good. We expect the ECB to expand its PEPP

program in December, both in size and in time. Although credit has remained a small part of the PEPP so far, the share of corporate bonds could easily be increased to ensure European large corporations access to markets. We suspect that in a worst-case scenario the ECB could even make fallen angels eligible to QE after they already rendered them eligible to collateral. Such a decision would likely be accompanied by a fiscal guarantee scheme at the EU level. Indeed by tightening the spreads of IG credit spreads, the ECB is forcing investors to go down the rating spectrum. Doing so they also improve the liquidity of HY markets. As most HY defaults happen when a big loan or bond fails to be refinanced, it is fair to say that the ECB is also helping to keep defaults low although it is not active on the market where most defaults happen, namely the HY universe.

- II. **Furlough schemes are supporting corporate solvency:** Billions have been spent across Europe to keep people in employment. According to the Bruegel Institute (see report [The fiscal response to the economic fallout from the coronavirus](#)), the “chomage partiel in France is costing EUR31bn, “kurzarbeit” in Germany represents EUR23.5bn for example. This provides a clear economic relief for corporates while their earnings remain under pressure due to stringency measures.
- III. **Guaranteed loans and moratoria are keeping liquidity risk of corporates low:** Governments have done everything in their power to avoid tightening conditions, ensuring smooth access to banking loans. The question is of course what happens when this support starts to diminish. We expect the government to start to withdraw their support gradually over the second half of 2021 because of its very elevated cost. But profits are recovering much faster than GDP, and most bond issuers will have by then recovered a more normal credit profile. Moreover, the primary market was barely closed for corporates in 2020, and issuers have taken the opportunity to build significant liquidity buffers that will help them survive when the support diminishes. If the horizon doesn't seem that cloudy for bond issuers in Europe, SMEs will have more issues going forward, leading to significantly higher NPLs compared to 2009 according to Andrea Enria Chair of the Supervision at the ECB they could even jump to 1.4Tn (see [link](#) to FT article).

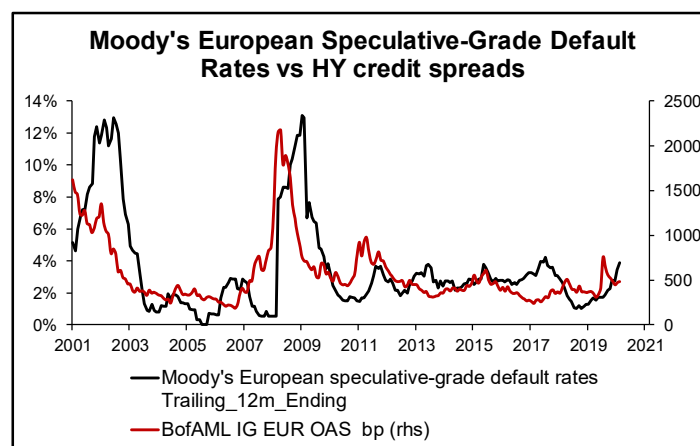


...will help to keep default rates contained

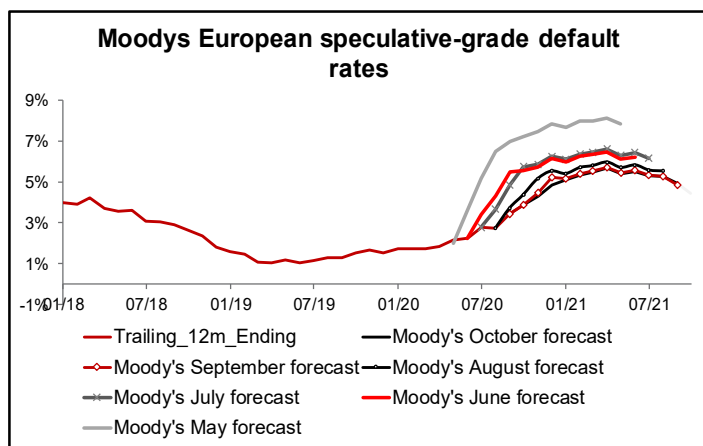
Hence, since the first half of 2020, we have been of the view that defaults will remain much lower than 2009 defaults than traditional macroeconomic variables such as either diffusion indices or unemployment.

Now that European economies experience a second Covid-19 wave, there is little doubt that the monetary and fiscal policymakers of advanced economies will forcefully act against a tightening of financial conditions. Hence many of the above mentioned supporting measures will have to be extended well into 2021.

**Historically credit spreads had also a strong predictive potential of likely defaults as they led the default cycle by 8 to 9 months.** Assuming this correlation would remain valid this time it would imply index defaults in Europe slightly above 4% (see chart below). Since, in their numbers, rating agencies also include companies that are off benchmarks, their default statistics are mechanically higher, meaning that market-implied default rates would be consistent with a 5-6% 12-month trailing defaults number, peaking in early 2021 in Europe.



Interestingly rating agencies have diverging views on defaults over the coming months. S&P was expecting defaults to peak in H1 2021 at slightly below 9% while Moody's kept revising down its projection throughout 2020, foreseeing a peak now at 5.7%.



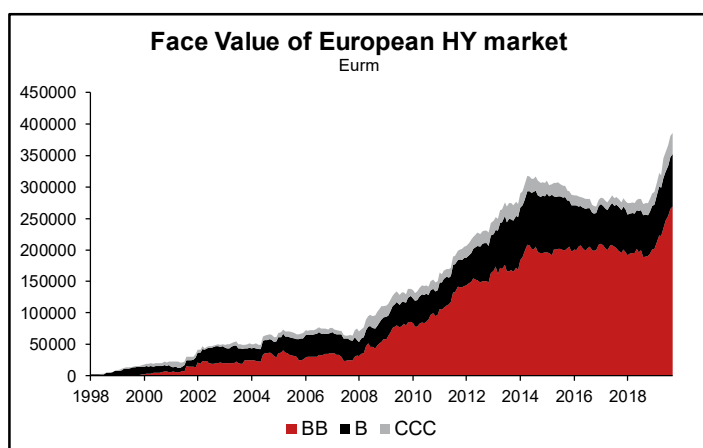
Although our scenario might sound quite optimistic, we acknowledge that there is, like for rating agencies, more downside to our central default scenario than upside.

### What makes European HY companies so resilient for now?

In Europe so far, defaults are not properly picking up, therefore they barely hit traditional HY investors. Indeed, most defaults since March were considered in rating agencies' universe but not included in HY benchmarks, while defaults among HY benchmarks were mostly due to EUR debt issued by US firms, where default rates are higher (see Intelsat for example).

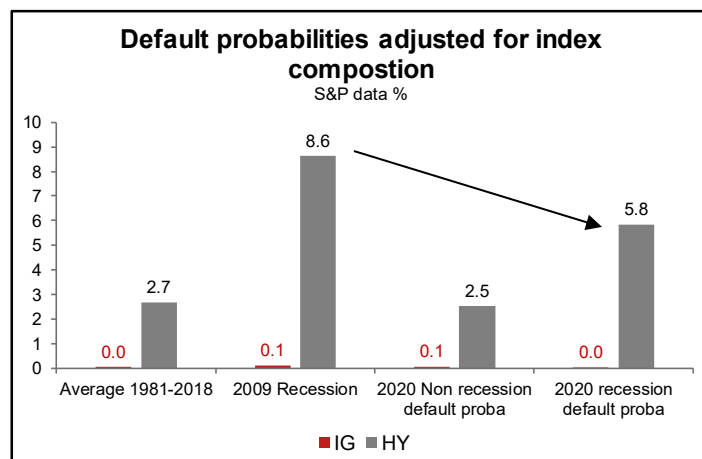
There are several explanations for the resilience of European defaults at this point. The first is a composition bias, where the largest sectors are Telcos, automotive, and banks – sectors with no defaults over the recent years. On the opposite, the industries most affected by the Covid outbreak – retail, restaurants, travel, and leisure – represent only a smaller part of the EUR HY universe.

Also, we note that compared to the 2008 crisis, the European credit market is much larger but it mostly grew via the BB segment and in proportion, the single-B and below segment is now much lower.



The bulk of the BB space is made of subordinated instruments issued by IG rated companies with large and supposedly solid balance sheets. For that reason, corporate hybrids, fallen angel corporates, and Tier 2 of national champion banks in the BB bucket have kept transition to default exceptionally low from better-rated high yield. In comparison, the US market has much more names rated single-Bs or below, making them more vulnerable to defaults.

Hence if we adjust S&P's numbers for instance for the new composition of the credit market, assuming 2009 default probabilities, we mechanically fall from 8.9% default in 2009 to 5.82% in 2020.



\*We adjust both recession and non-recession numbers for index composition and assume subordinated bond will suffer from their issuer rating default (IG in most cases).

But the question remains whether the support measure is allowing solvent companies to survive avoiding the bottom of a one-off crisis or whether governments are monetising the zombification of entire sectors of the economy that lost their *raison d'être* in a post-Covid world.

### Defaults could plateau with lower recoveries

Besides the severity of the crisis, its duration is also key. Despite the emergence of a second wave, we believe the extreme shock to world GDP is more a transitional one and peak defaults will be lower than during the 2008-09 GFC. However, default rates could remain high for longer, as some companies will be kept afloat by extraordinary policy support but could default afterwards. Loss severity could be higher due to:

1. the increase of leverage of the corporate world, which means that more debt will be repaid with the same assets, implying a lower recovery.
2. the broadening of covenant-lite structures with the lower-rated issuers (found in CLO structures), that implies that companies will default at a later stage, having the time to burn more capital, thus also implying a lower recovery rate.

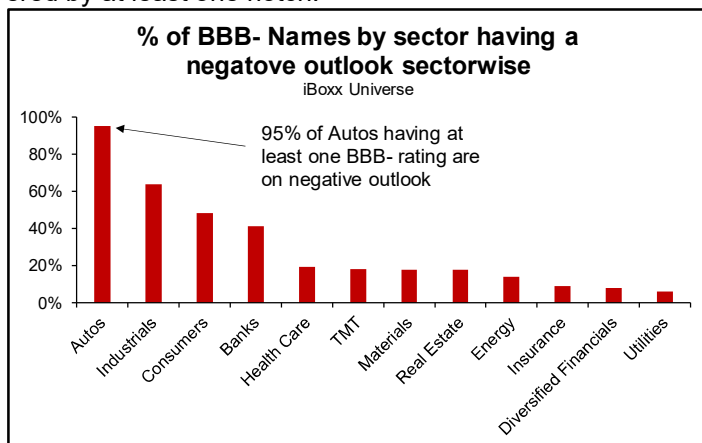
Moreover, if we expect low defaults for the credit market, SMEs will have more difficulties to survive, and this insolvency in the SME's space will translate into higher NPLs ratios for the banking sector. For the smallest banks of the periphery, this could add to an already elevated burden. Hence if from a default angle this crisis might be less severe than the GFC, the new cycle will not start on a clean sheet as it seems that the excesses of the currently finishing cycle will not be cleaned up. We will start the next economic cycle with an already elevated debt level that could dampen productivity and lower potential growth.

If default outlook for EU HY seem relatively benign, rating migration remain a tangible threat in 2021.

### Rating migration rather a threat to IG than HY

In proportion to the market size, rating agencies have mostly downgraded HY names and the most affected sectors. On IG they have been preparing the ground for potential downgrades by putting a large share of the BBB-universe under negative outlook, ready to act should the situation develop in a less positive way than initially hoped for.

Within the EUR iBoxx index, EUR59bn worth of names have been downgraded from IG to HY since January by at least one of the three rating agencies, and EUR46bn have effectively transitioned from the IG to the HY world, and that amount will keep rising in the months to come. By contrast, in the EUR HY index worth EUR143bn (almost half of the Index) have had their second-best ratings lowered by at least one notch.

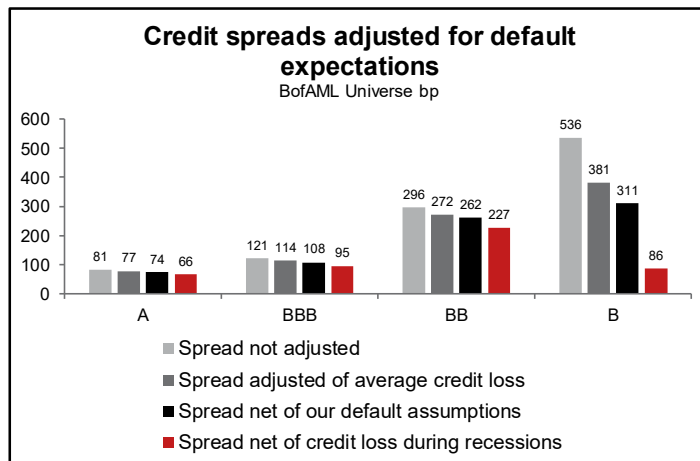


Consequently, we think that most of HY downgrades have already taken place while IG downgrades are still ahead of us. Rating migration is therefore rather a threat to IG, and particularly BBBs.

However, interesting opportunities can be found in BBB names that are already pricing a downgrade to HY. For those investors who have the flexibility to navigate the crossover space, fallen angels tend to perform well on a downgrade as they enter HY benchmarks and meet consequently new buyers.

Within HY we tend to favour subordination to credit risk as we think the risks attached to corporate hybrids, Tier 2 and AT1 are rather low. In particular, corporate hybrids and Tier 2 have proved to be way more resilient than pure HY during the Covid crisis earlier this year.

Among senior HY, we prefer BBs, but opportunities can also be found in Bs while credit selection remains key. Investors are less reliant upon rating agencies in the HY space and they base their investments on their risk appreciation, while dispersion is high and likely to stay so while defaults keep rising.



Indeed, should the Covid-19 situation remain under control, we suspect HY will catch-up with IG. Over the medium term, with the low rate environment there for longer, the search for yield will remain and investors will regain appetite for riskier credit when the dust settles.

### Conclusion

In such a depressed yield environment, investing in HY appears over the medium term, one of the only asset classes set aside, that will post positive total returns over the medium term. Hence, we view the HY segment as unavoidable in a broader asset allocation exercise. The question of the timing will be crucial and we think that a defensive positioning in HY favouring subordinated bonds as well as solid BBs and single Bs is an opportunity in this context of receding risk aversion.

# Imprint

**Issued by:** Generali Insurance Asset Management S.p.A. SGR, Research Department

**Head of Research:** Vincent Chaigneau (vincent.chaigneau@generali-invest.com)

**Head of Macro & Market Research:** Dr. Thomas Hempell, CFA (thomas.hempell@generali-invest.com)

**Team:** Elisabeth Assmuth (elisabeth.assmuth@generali-invest.com)  
Elisa Belgacem (elisa.belgacem@generali-invest.com)  
Radomír Jáč (radomir.jac@generali.com)  
Jakub Krátký (jakub.kratky@generali.com)  
Michele Morganti (michele.morganti@generali-invest.com)  
Vladimir Oleinikov, CFA (vladimir.oleinikov@generali-invest.com)  
Dr. Martin Pohl (martin.pohl@generali.com)  
Dr. Thorsten Runde (thorsten.runde@generali-invest.com)  
Dr. Christoph Siepmann (christoph.siepmann@generali-invest.com)  
Dr. Florian Späte, CIIA (florian.spaete@generali-invest.com)  
Guillaume Tresca (guillaume.tresca@generali-invest.com)  
Dr. Martin Wolburg, CIIA (martin.wolburg@generali-invest.com)  
Paolo Zanghieri, PhD (paolo.zanghieri@generali.com)

**Head of Insurance and AM Research:** Michele Morganti (michele.morganti@generali-invest.com)

**Team:** Raffaella Bagata (raffaella.bagata@generali.com)  
Alberto Cybo-Ottone, PhD (alberto.cybo@generali.com)  
Mattia Mammarella (mattia.mammarella@generali-invest.com)  
Roberto Menegato (roberto.menegato@generali.com)  
Giovanni Millo, PhD (giovanni.millo@generali.com)  
Antonio Salera, PhD (antonio.salera@generali.com)  
Cristiana Settimo (cristiana.settimo@generali.com)  
Federica Tartara, CFA (federica.tartara@generali.com)

**Sources for charts and tables:** Refinitiv/Datastream, Bloomberg, own calculations  
Version completed: see front page

**In Italy:**  
Generali Insurance Asset Management  
S.p.A Società di gestione del risparmio

Piazza Tre Torri  
20145 Milano MI, Italy

Piazza Duchi degli Abruzzi, 1  
34132 Trieste TS, Italy

**In France:**  
Generali Insurance Asset Management  
S.p.A Società di gestione del risparmio

2, Rue Pillet-Will  
75009 Paris Cedex 09, France

**In Germany:**  
Generali Insurance Asset Management  
S.p.A. Società di gestione del risparmio

Tunisstraße 19-23  
50667 Cologne, Germany

[www.generali-investments.com](http://www.generali-investments.com)

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