PERSPECTIVES

COVID-19 AND CORPORATE DEFAULT RATES IN RECESSIONS AND DEPRESSIONS PAST

May 20, 2020
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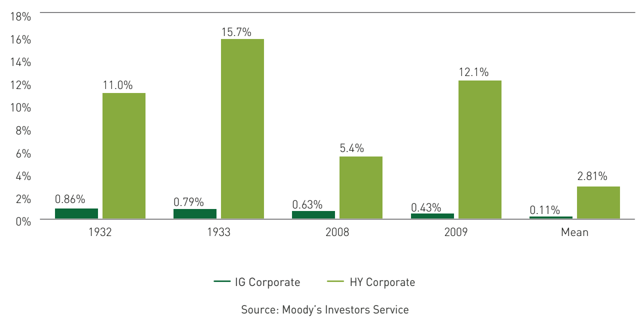
As COVID-19 ripples through the global economy, inevitably some will look to compare the economic impact and corporate bond default cycle to prior periods. They will find that investment grade (IG) corporate bond issuers maintained a low level of defaults relative to issuers rated high yield (HY).

Based on Moody's Annual Default Study, which covers corporate bond defaults and recoveries from 1920-2017, peak default rates occurred during the Great Depression in 1932-1933 and were marginally above what was seen during the Great Recession in 2008-2009.[1] During the two prior most difficult economic periods, the corporate default rate increased over time after the initial dual shocks of stock market collapses and banking crises.

In each era, speculative or HY issuer-weighted default rates exceeded the experience in the IG corporate bond market, as can be seen in Figure 1. During these two periods of economic contraction, while still very low, IG corporate default rates averaged 0.64 percent, or about four times above the mean (0.15 percent), since 1920. The HY corporate default rates during these two cycles averaged 10.4 percent, which was also about four times above the 2.8 percent long-term mean.

FIGURE 1: MOODY'S ANNUAL ISSUER-WEIGHTED CORPORATE BOND DEFAULT RATES



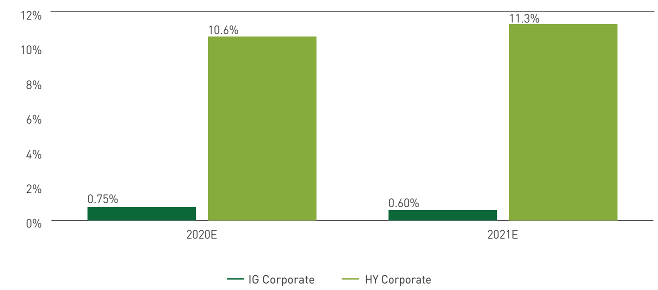
Source: Moody's Investors Service

As a result of the pandemic, the global economy may contract by 3 percent in 2020, worse than the less than 1 percent decline during 2008-2009.[2] By comparison, between 1929 and 1932, global GDP fell by an estimated 15 percent.[3] The economic effects of the COVID-19 lockdown drove the steepest job losses in the shortest period in U.S. history. American employers cut payrolls by 20.5 million in April 2020 and the unemployment rate more than tripled to 14.7 percent.[4] While many job losses may be temporary, the current level of unemployment already has eclipsed its peak rate of 10 percent in 2009, while remaining lower than during 1933 when it hit 24.9 percent. Nevertheless, with the spike in unemployment and drops in oil prices and consumer spending, it is reasonable to expect corporate credit stress to increase in coming quarters.

As the U.S. moves into economic recession, net earnings for S&P 500 Index companies could decline by one-third in 2020, according to some estimates.[5] Under such a scenario, it is reasonable to expect corporate bond default rates to rise in 2020 and 2021. Double-digit default rates should be expected in the HY market, while the experience of 1932-1933 and 2008-2009 would suggest that IG defaults may be unlikely to rise materially above 1 percent.

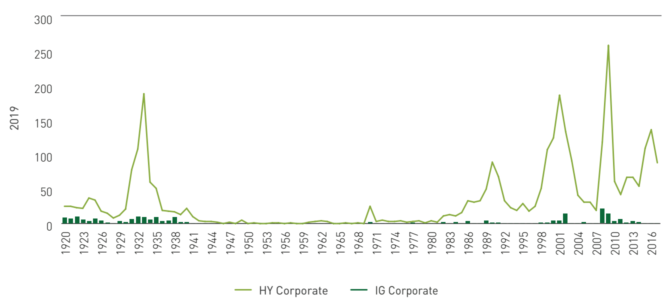
In its baseline forecast, Moody's projects a global corporate default rate of 10.6 percent by the end of 2020, moving to 11.3 percent is the first quarter of 2021, as shown in Figure 2.[6] Applying the IG corporate experience of 1932-1933 and 2008-2009 implies default rates of 0.75 percent and 0.60 percent in 2020 and 2021, respectively. A caveat is that the IG default rate and counts could be lower in U.S. markets with the Fed's unique program to buy corporate bonds.[7]

FIGURE 2: ESTIMATED ANNUAL RATED GLOBAL CORPORATE ISSUER DEFAULT RATES



Source: Moody's Investors Service, Breckinridge

FIGURE 3: MOODY'S ANNUAL RATED GLOBAL CORPORATE ISSUER DEFAULT COUNTS, 1920-2017



Source: Moody's Investors Service

CONCLUSION

IG corporate bond defaults are very rare, historically. An average of two IG corporate bond issuers default in any given year, and in fifty-seven of the 99 years since 1920 there were zero defaults, per Figure 3.

IG corporate defaults are historically clustered in periods of deep and lengthy economic recessions. As cash flow declines in economic recession, overleveraged borrowers can run into problems rolling over debt obligations and default on a covenant and/or interest payment. There is evidence that corporate governance lapses are more prevalent during these periods.[8] IG issuers that migrate to HY—commonly called fallen angels—due to a decline in creditworthiness are a risk to IG investors, given a higher default probability once an issuer is rated HY. However, the Fed's program to buy IG and fallen angel primary and secondary corporate bonds has helped to make debt capital more available to non-Financial corporate issuers in this recession.

As with most financial measures, past experience is no guarantee of future results. The historical record suggests IG bonds offer investors a margin of protection against default relative to HY bonds. Our research analysts are stress-testing and evaluating liquidity, rollover risk and cash flow generation of corporate holdings to scrutinize the margin of protection and longer-term resiliency of each borrower. In addition, access to Fed liquidity during the post COVID-19 period, depending on its duration, it is possible that the IG default rate could be lower prospectively than in the prior two most difficult periods in U.S. corporate bond market history.

FOOTNOTES:

1. Moody's Investors Service, Annual Default Study: Corporate Default and Recovery Rates, 1920-2017, February 15, 2018.
2. International Monetary Fund, World Economic Outlook: The Great Lockdown, April 2020.
3. Ibid.
4. Bureau of Labor Statistics, April Jobs Report, May 8, 2020.
5. Kostin, David J., Goldman Sachs & Co, Profit Growth Set to Slip by 33%, April 3, 2020.
6. Moody's Investors Service, Default Trends – Global: March 2020 Default Report, April 9, 2020.
7. Federal Reserve System, Primary and Secondary Market Corporate Credit Facilities, March 23, 2020.
8. Valukas, Anton R. White-Collar Crime and Economic Recession. University of Chicago Legal Forum, Vol. 2010. See also *https://www.breckinridge.com/insights/details/covid-19-crisis-corporate-bonds-and-esg-implications/*