# Is the price of risk too low today?

AlbaCore's David Allen crunches the numbers to see if investors are getting sufficiently paid in the riskier end of the credit market

In April, two CCC bonds priced in the European market in the same week for the first time since 2015. This led us to assess whether investors were getting sufficiently compensated for the risk at the bottom end of the credit rating spectrum. We started by looking up the three ratings agency definitions of CCC:

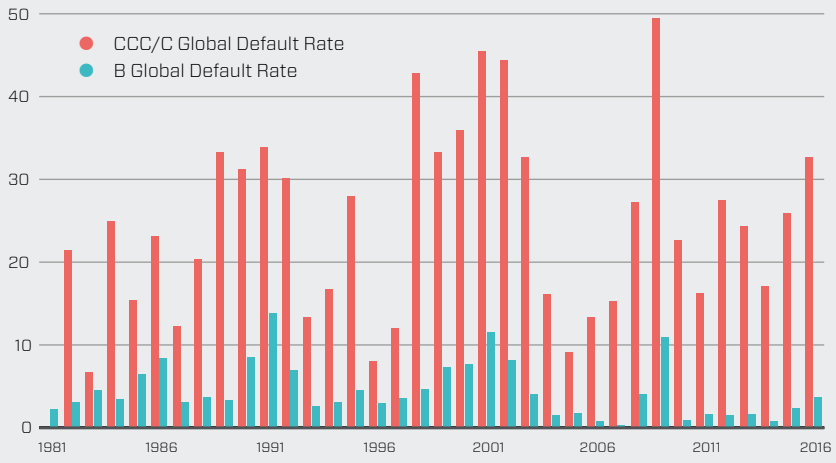
- Moody's: "Obligations rated Caa are judged to be speculative of poor standing and are subject to very high credit risk."
- S&P: "An obligation rated 'CCC' is currently vulnerable to non-payment, and is dependent upon favourable business, financial, and economic conditions for the obligor to meet its financial commitment on the obligation. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet its financial commitment on the obligation."
- Finally, and very much to the point, Fitch: CCC – "Substantial credit risk. Default is a real possibility."

So it sounds like CCC-rated securities are very risky, but what is the actual percentage of these securities that default every year? We ran the data back to 1981 in order to get a longer-term view (*see Figure 1*). It is striking how infrequently the CCC default rate was less than 10%. In fact, just three times since 1981: 6.7% in 1983, 8.0% in 1996 and 9.1% in 2005. In those last two years of low defaults (1996 and 2005) in which we have data for the market return, HY returned 11.3% and 2.7%

Surprisingly, since 1981, in a given year it is more likely that CCC default rates are over 40% (four times. 1998, 2001, 2002 and 2009) than below 10% (three times: 1983, 1996, 2005). And in general investors did perhaps better than they would expect in those big default years, with US high yield returning 3%, 4.5%, negative 2% and positive 58%.

The range of annual defaults for CCC is quite broad: from 6.7% (1983) to as often as 49.5% (2009). The median rate of default for CCCs is 23.7%.

## Fig 1: Global default rates




*Source: S&P Global Default Report (2016)*

## Fig 2: Spread vs default ratio

| Current spreads (bps) | CCC | B | Ratio |
|---|---|---|---|
| US | 738 | 393 | 1.9x |
| Europe | 693 | 405 | 1.7x |
| **Global default rates (1981-2016)** | | | |
| High | 49.50% | 10.90% | 4.5x |
| Median | 23.71% | 3.46% | 6.9x |
| Mean | 23.96% | 4.44% | 5.4x |

So, what was happening in 1983 when defaults were so low? On the back of stronger growth, the US Fed kicked off a new rate-hike cycle on 2 May 1983. There were 15 months of rate hikes, from 9.5% to 11.75% between May 1983 and September 1984. The economy was very strong too, with GDP growth of 4.6% and 7.3% in 1983 and 1984, respectively. Strong earnings growth protected companies from defaults.

Meanwhile, we all know what happened in 2009 when defaults topped 49% – in 2008, the Fed lowered rates from 4.25% to 0.25% by the end of the year, reacting to the global financial crisis. Despite this reduction in rates, GDP still fell 2.8% in 2009 with stocks plummeting 49.2% from January 2008 to February 2009. Interestingly, this was a great time to buy high-yield bonds. In 2009, European and US high-yield bonds returned 75% and 58% while European and US equities returned 21% and 23%. Many of the defaults were caused more by liquidity than by earnings shrinking.

So, what does all this mean for us now, considering when and where to invest? (*See Figure 2.)* Today, the average single B bond in the US trades at a spread of 393bps and in Europe at 405bps. The average CCC-rated bond in those markets currently trades at spreads of 738bps and 693bps, respectively. That means the ratio of spreads is approximately 1.8x greater for CCCs than single Bs. But the relative risk of default appears to be much higher for CCCs. During the crisis in 2009 for example, when 49.5% of CCC-rated bonds defaulted, only 10.9% of single B-rated bonds defaulted. On average, the default rate has been 5-7x higher for CCCs than single Bs.

So where does this take us? Credit spreads should compensate investors for risk of principal loss, which is why we see spread differentials increasing during periods of crisis (*see Figure 3*) and between types of assets: secured vs unsecured debt and CCC vs B or BB vs BBB. As debt is an asymmetric asset class, we care a lot about preserving capital. The first step in our investment process at AlbaCore is Capital Preservation. For spreads to compensate for loss, they should widen as investors add risk.

> “In markets like today’s where the difference between the pricing of CCC debt and single B debt is minuscule, we don’t think investors are compensated enough to take the extra risk of CCC-rated debt”

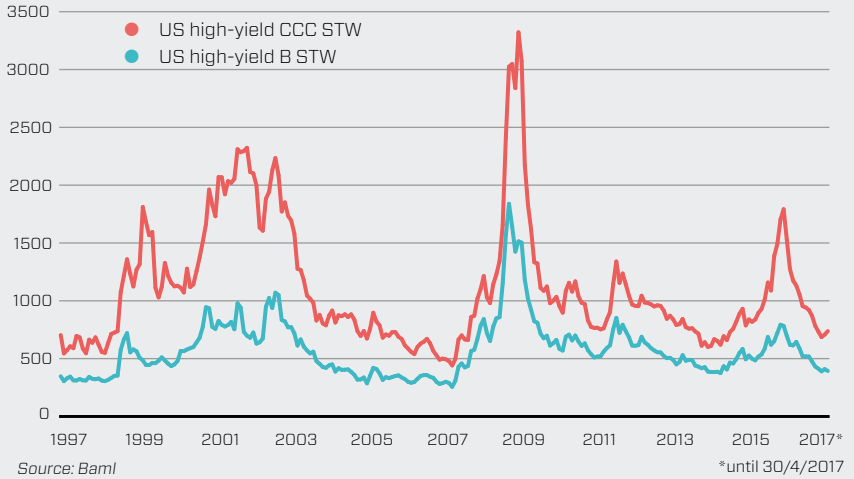
As CCC-rated securities have a much higher chance of defaulting over time, investors should get paid a sufficient premium for owning them. Sometimes that is the case: during the crisis when defaults were high, the average price for US CCC bonds was in the 35-40 cent range. If investors bought CCCs in 2009, they would have done well, returning 135% over the next twelve months.

However, when default rates and spreads are low, any reversion to the mean is likely to result in CCC investors substantially underperforming. In markets like today’s where we see low defaults, low spreads, and the difference between the pricing of CCC debt and single B debt is minuscule, we don’t think investors are compensated enough to take the extra risk of CCC-rated debt.

I don’t know when defaults will pick up, but some warning signs do exist. US consumer credit defaults are picking up; US car sales are expected to fall this year from 2016’s record levels. For example, Ford announced Q1 earnings sharply down this year already, with US sales down 5%. Overall US retail sales fell 0.2% in March. Data also shows an increase in the number of Americans filing for unemployment benefits recently. The VIX main volatility index reached 11% this week, its all-time low. The VIX is also known as the “fear index” which tells us people are feeling pretty bold today. Perhaps too bold.

When we go into a period of slowing growth, higher volatility and perhaps rising rates, we could see CCC-rated debt return to higher levels of default. Those investors with exceptional credit selection skills can potentially navigate a higher default environment and successfully pick the winners and losers, but CCC investors should be cognisant that the more of these securities they own, the more likely they might step on a land mine. We do not see the extra spread as worth the incremental risk and would rather invest in higher quality companies and in more senior parts of the capital structure at this point in the cycle. At good times like today, it’s even more important than ever to ensure risk is priced right. For sure, it was in 2009 at 35-40 cents, but at a pickup of 316bps, we see a narrow margin of safety.

## Fig 3: High-yield spread overtime




*Source: Baml*

*until 30/4/2017

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