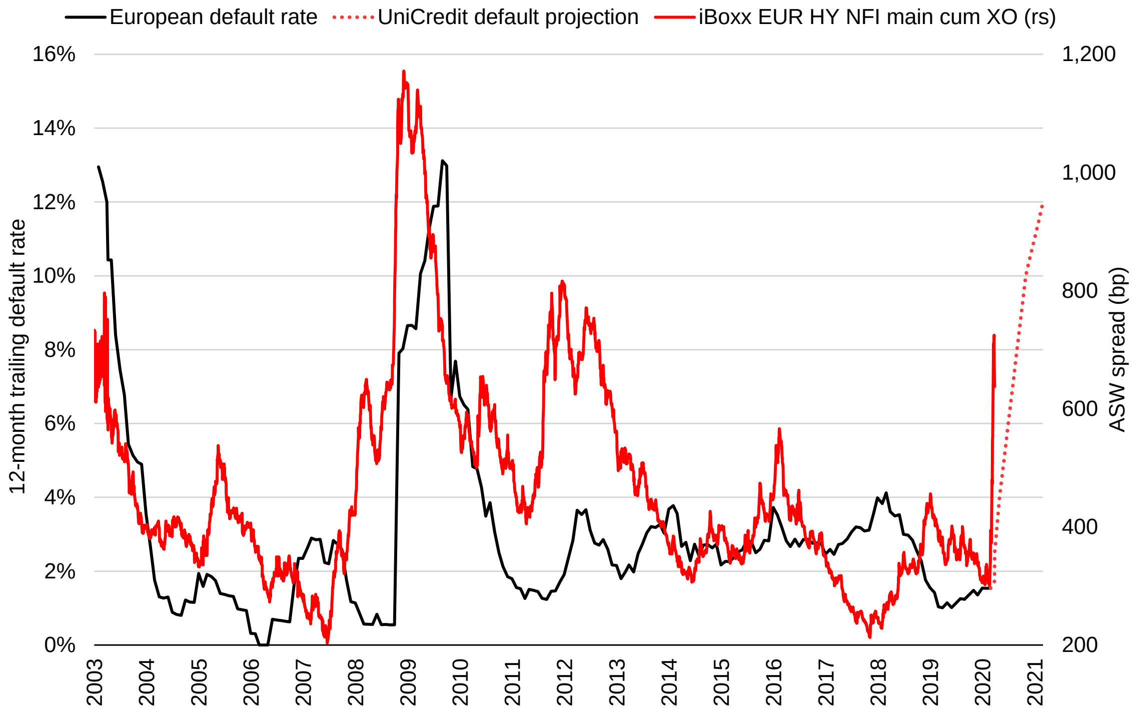
HY investors are likely underestimating default rates



Source: iBoxx, Moody's, UniCredit Research

- The increasing likelihood that widespread corporate defaults will occur in the coming months has resulted in significant repricing in European HY debt markets. Credit spreads in the iBoxx HY NFI have reached about 720bp, and credit risk premiums have increased at their fastest pace ever (see red line in chart). In the meantime, however, spreads have rebounded to about 640bp, which implies a HY default rate of about 8% (at a recovery rate of 20%). Looking at current spread development (dramatic as it is), we note that the market is far from experiencing a credit crunch, as spreads have not yet widened to levels reached during the financial crisis in 2008-09.

- The longer the coronavirus crisis lasts, however, the more severe its impact on supply and demand and on financial markets is likely to be. Furthermore, we think that the depth of the current crisis also matters given that its economic impact is likely to be much larger than that of the 2008-09 financial crisis in terms of their peak-to-trough effect on GDP. As UniCredit head economist Erik Nielsen wrote in his Chief Economist's Comment – Sunday Wrap, economic projections are likely to end up reflecting drops in 2020 GDP of between 10% and 15% for the eurozone. Such drops would be two to three times the size of those resulting from the 2008-09 financial crisis.

- The announcement of fiscal measures and monetary stimulus has helped stabilize credit markets, but volatility is likely to remain strongly elevated over the next three months. However, the ECB's significant corporate-bond-buying programs, including the new pandemic emergency purchasing program, benefit first and foremost senior IG credit. Much depends on the flattening of the pandemic curve, but the question remains when (and whether) there will be a second wave of widespread infection (as social distancing measures are eased and/or the virus evolves). We think that risks to growth are significantly skewed to the downside, since the coronavirus may take longer than expected to contain. As a result, credit fundamentals are deteriorating, and the probability of credit events occurring has significantly increased.

- We think that HY markets have so far underestimated the potential severity of the disruption to economic activity the outbreak is likely to cause. We think that default rates could soar to about 12%, close to levels seen during the 2008-09 financial crisis. Such elevated default levels mainly reflect the current size of the crisis but also take into account that comprehensive policy responses (in the form of guarantee schemes for the corporate sector) have been implemented in various countries. These measures should mitigate risk, in that they are intended to prevent companies from having to face a liquidity shortage in the short term. Policy responses so far are subject to downside risks, however. While these policy responses are impressive compared to past crisis responses, they may ultimately fall short of their goal of preventing mass defaults given the magnitude of the potential shock that could be wrought by the current crisis.

- As our chart suggests, an increasing default rate does not seem to have been fully priced into European HY credit markets yet. This leads us to expect that credit risk premiums for HY debt will widen further as default rates rise, and we think this would be consistent with a fair value for HY credit spreads of around 960bp in the short term. As a result, investors should remain defensive. Opportunities are likely to arise for companies with robust business models and sound credit fundamentals once containment measures are eased and the economy rebounds, which is projected to happen in 2H20.

Holger Kapitza
Credit & High Yield Strategist
(UniCredit Bank, Munich)
+49 89 378 28745
holger.kapitza@unicredit.de

Legal Notices

Glossary

A comprehensive glossary for many of the terms used in the report is available on our website: https://www.unicreditresearch.eu/index.php?id=glossary

Disclaimer

Our recommendations are based on information obtained from or are based upon public information sources that we consider to be reliable, but for the completeness and accuracy of which we assume no liability. All information, estimates, opinions, projections and forecasts included in this report represent the independent judgment of the analysts as of the date of the issue unless stated otherwise. We reserve the right to modify the views expressed herein at any time without notice. Moreover, we reserve the right not to update this information or to discontinue it altogether without notice. This report may contain links to websites of third parties, the content of which is not controlled by UniCredit Bank. No liability is assumed for the content of these third-party websites.

This report is for information purposes only and (i) does not constitute or form part of any offer for sale or subscription of or solicitation of any offer to buy or subscribe for any financial, money market or investment instrument or any security, (ii) is neither intended as such an offer for sale or subscription of or solicitation of an offer to buy or subscribe for any financial, money market or investment instrument or any security nor (iii) as marketing material within the meaning of applicable prospectus law . The investment possibilities discussed in this report may not be suitable for certain investors depending on their specific investment objectives and time horizon or in the context of their overall financial situation. The investments discussed may fluctuate in price or value. Investors may get back less than they invested. Fluctuations in exchange rates may have an adverse effect on the value of investments. Furthermore, past performance is not necessarily indicative of future results. In particular, the risks associated with an investment in the financial, money market or investment instrument or security under discussion are not explained in their entirety.

This information is given without any warranty on an "as is" basis and should not be regarded as a substitute for obtaining individual advice. Investors must make their own determination of the appropriateness of an investment in any instruments referred to herein based on the merits and risks involved, their own investment strategy and their legal, fiscal and financial position. As this document does not qualify as an investment recommendation or as a direct investment recommendation, neither this document nor any part of it shall form the basis of, or be relied on in connection with or act as an inducement to enter into, any contract or commitment whatsoever. Investors are urged to contact their bank's investment advisor for individual explanations and advice.

Neither UniCredit Bank AG, UniCredit Bank AG London Branch, UniCredit Bank AG Milan Branch, UniCredit Bank AG Vienna Branch, UniCredit Bank Austria AG, UniCredit Bulbank, Zagrebačka banka d.d., UniCredit Bank Czech Republic and Slovakia, ZAO UniCredit Bank Russia, UniCredit Bank Czech Republic and Slovakia Slovakia Branch, UniCredit Bank Romania, UniCredit Bank AG New York Branch nor any of their respective directors, officers or employees nor any other person accepts any liability whatsoever (in negligence or otherwise) for any loss howsoever arising from any use of this document or its contents or otherwise arising in connection therewith.

This report is being distributed by electronic and ordinary mail to professional investors, who are expected to make their own investment decisions without undue reliance on this publication, and may not be redistributed, reproduced or published in whole or in part for any purpose.

This report was completed and first published on 31 March 2020 at 14:00.

Responsibility for the content of this publication lies with:

UniCredit Group and its subsidiaries are subject to regulation by the European Central Bank

a) UniCredit Bank AG (UniCredit Bank, Munich or Frankfurt), Arabellastraße 12, 81925 Munich, Germany, (also responsible for the distribution pursuant to §34b WpHG). Regulatory authority: “BaFin“ – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany.

b) UniCredit Bank AG London Branch (UniCredit Bank, London), Moor House, 120 London Wall, London EC2Y 5ET, United Kingdom. Regulatory authority: “BaFin“ – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany and subject to limited regulation by the Financial Conduct Authority, 12 Endeavour Square, London E20 1JN, United Kingdom and Prudential Regulation Authority 20 Moorgate, London, EC2R 6DA, United Kingdom. Further details regarding our regulatory status are available on request.

c) UniCredit Bank AG Milan Branch (UniCredit Bank, Milan), Piazza Gae Aulenti, 4 - Torre C, 20154 Milan, Italy, duly authorized by the Bank of Italy to provide investment services.

Regulatory authority: “Bank of Italy”, Via Nazionale 91, 00184 Roma, Italy and Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany.

d) UniCredit Bank AG Vienna Branch (UniCredit Bank, Vienna), Rothschildplatz 1, 1020 Vienna, Austria. Regulatory authority: Finanzmarktaufsichtsbehörde (FMA), Otto-Wagner-Platz 5, 1090 Vienna, Austria and subject to limited regulation by the “BaFin“ – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany. Details about the extent of our regulation by the Bundesanstalt für Finanzdienstleistungsaufsicht are available from us on request.

e) UniCredit Bank Austria AG (Bank Austria), Rothschildplatz 1, 1020 Vienna, Austria. Regulatory authority: Finanzmarktaufsichtsbehörde (FMA), Otto-Wagner-Platz 5, 1090 Vienna, Austria

f) UniCredit Bulbank, Sveta Nedelya Sq. 7, BG-1000 Sofia, Bulgaria. Regulatory authority: Financial Supervision Commission (FSC), 16 Budapeshta str., 1000 Sofia, Bulgaria

g) Zagrebačka banka d.d., Trg bana Josipa Jelačića 10, HR-10000 Zagreb, Croatia. Regulatory authority: Croatian Agency for Supervision of Financial Services, Franje Račkoga 6, 10000 Zagreb, Croatia

h) UniCredit Bank Czech Republic and Slovakia, Želetavská 1525/1, 140 92 Praga 4, Czech Republic. Regulatory authority: CNB Czech National Bank, Na Příkopě 28, 115 03 Praga 1, Czech Republic

i) ZAO UniCredit Bank Russia (UniCredit Russia), Prechistenskaya nab. 9, RF-119034 Moscow, Russia. Regulatory authority: Federal Service on Financial Markets, 9 Leninsky prospekt, Moscow 119991, Russia

j) UniCredit Bank Czech Republic and Slovakia, Slovakia Branch, Šancova 1/A, SK-813 33 Bratislava, Slovakia. Regulatory authority: CNB Czech National Bank, Na Příkopě 28, 115 03 Praha 1, Czech Republic and subject to limited regulation by the National Bank of Slovakia, Imricha Karvaša 1, 813 25 Bratislava, Slovakia. Regulatory authority: National Bank of Slovakia, Imricha Karvaša 1, 813 25 Bratislava, Slovakia

k) UniCredit Bank Romania, Bucharest 1F Expozitiei Boulevard, 012101 Bucharest 1, Romania. Regulatory authority: National Bank of Romania, 25 Lipscani Street, 030031, 3rd District, Bucharest, Romania

l) UniCredit Bank AG New York Branch (UniCredit Bank, New York), 150 East 42nd Street, New York, NY 10017. Regulatory authority: “BaFin“ – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany and New York State Department of Financial Services, One State Street, New York, NY 10004-1511

Further details regarding our regulatory status are available on request.

ANALYST DECLARATION

The analyst’s remuneration has not been, and will not be, geared to the recommendations or views expressed in this report, neither directly nor indirectly.

All of the views expressed accurately reflect the analyst’s views, which have not been influenced by considerations of UniCredit Bank’s business or client relationships.

POTENTIAL CONFLICTS OF INTERESTS

You will find a list of keys for company specific regulatory disclosures on our website https://www.unicreditresearch.eu/index.php?id=disclaimer.

RECOMMENDATIONS, RATINGS AND EVALUATION METHODOLOGY

You will find the history of rating regarding recommendation changes as well as an overview of the breakdown in absolute and relative terms of our investment ratings, and a note on the evaluation basis for interest-bearing securities on our website https://www.unicreditresearch.eu/index.php?id=disclaimer and https://www.unicreditresearch.eu/index.php?id=legalnotices.

ADDITIONAL REQUIRED DISCLOSURES UNDER THE LAWS AND REGULATIONS OF JURISDICTIONS INDICATED

You will find a list of further additional required disclosures under the laws and regulations of the jurisdictions indicated on our website https://www.unicreditresearch.eu/index.php?id=disclaimer.

E 19/3

UniCredit Research* — Macro & Strategy Research

Erik F. Nielsen
Group Chief Economist
Global Head of CIB Research
+44 207 826-1765
erik.nielsen@unicredit.eu

Dr. Ingo Heimig
Head of Research Operations
& Regulatory Controls
+49 89 378-13952
ingo.heimig@unicredit.de

Head of Macro Research

Marco Valli
Head of Macro Research
Chief European Economist
+39 02 8862-0537
marco.valli@unicredit.eu

Heads of Strategy Research

Dr. Luca Cazzulani
Co-Head of Strategy Research
FI Strategist
+39 02 8862-0640
luca.cazzulani@unicredit.eu

Elia Lattuga
Co-Head of Strategy Research
Cross Asset Strategist
+44 207 826-1642
elia.lattuga@unicredit.eu

European Economics Research

Dr. Andreas Rees
Chief German Economist
+49 69 2717-2074
andreas.rees@unicredit.de

Dr. Loredana Federico
Chief Italian Economist
+39 02 8862-0534
loredanamaria.federico@
unicredit.eu

Stefan Bruckbauer
Chief Austrian Economist
+43 50505-41951
stefan.bruckbauer@
unicreditgroup.at

Tullia Bucco
Economist
+39 02 8862-0532
tullia.bucco@unicredit.eu

Edoardo Campanella
Economist
+39 02 8862-0522
edoardo.campanella@unicredit.eu

Walter Pudschedl
Economist
+43 50505-41957
walter.pudschedl@unicreditgroup.at

Chiara Silvestre
Economist
chiara.silvestre@unicredit.eu

Dr. Thomas Strobel
Economist
+49 89 378-13013
thomas.strobel@unicredit.de

International Economics Research

Daniel Vernazza, Ph.D.
Chief International Economist
+44 207 826-7805
daniel.vernazza@unicredit.eu

FX Strategy Research

Roberto Mialich
FX Strategist
+39 02 8862-0658
roberto.mialich@unicredit.eu

FI Strategy Research

Michael Rottmann
Head
FI Strategist
+49 89 378-15121
michael.rottmann1@unicredit.de

Dr. Luca Cazzulani
Co-Head of Strategy Research
FI Strategist
+39 02 8862-0640
luca.cazzulani@unicredit.eu

Chiara Cremonesi
Deputy Head
FI Strategist
+44 207 826-1771
chiara.cremonesi@unicredit.eu

Francesco Maria Di Bella
FI Strategist
+39 02 8862-0850
francescomaria.dibella@unicredit.eu

Kornelius Purps
FI Strategist
+49 89 378-12753
kornelius.purps@unicredit.de

Credit & Equity Sector Strategy Research

Christian Stocker, CEFA
Lead Equity Sector Strategist
+49 89 378-18603
christian.stocker@unicredit.de

Holger Kapitza
Credit & High Yield Strategy
+49 89 378-28745
holger.kapitza@unicredit.de

Dr. Stefan Kolek
EEMEA Corporate Credits & Strategy
+49 89 378-12495
stefan.kolek@unicredit.de

Cross Asset Strategy Research

Elia Lattuga
Co-Head of Strategy Research
Cross Asset Strategist
+44 207 826-1642
elia.lattuga@unicredit.eu

UniCredit Research, Corporate & Investment Banking, UniCredit Bank AG, Am Eisbach 4, D-80538 Munich, globalresearch@unicredit.de
Bloomberg: UCCR, Internet: www.unicreditresearch.eu

M/S 20/2

*UniCredit Research is the joint research department of UniCredit Bank AG (UniCredit Bank, Munich or Frankfurt), UniCredit Bank AG London Branch (UniCredit Bank, London), UniCredit Bank AG Milan Branch (UniCredit Bank, Milan), UniCredit Bank AG Vienna Branch (UniCredit Bank, Vienna), UniCredit Bank Austria AG (Bank Austria), UniCredit Bulbank, Zagrebačka banka d.d., UniCredit Bank Czech Republic and Slovakia,ZAO UniCredit Bank Russia (UniCredit Russia), UniCredit Bank Romania.