

# Debt Defaults: A Growth Market

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How Much Speculative Grade  
Debt Will Default in This Cycle?

# Assumptions:

Default surge begins in 2018.  
(2016 reprises 1986 false start.)

Recent trend in number of issuers continues until start of default surge.

Cumulative default rate in line with normal default rate surges of past.

Private debt default numbers reflect ratio of private to public speculative grade debt outstanding.

# Projected Market Size

Number of issues in BofA Merrill Lynch Global High Yield Index  
August 31, 2016 = 1,630

Recent growth rate (3 months) = -7 issues/month

Projected number of issues Jan 1, 2018 = 1,518

Face Amount/Issuer = \$1.324 B

Total Debt/Bonds Multiplier

- Moody's issuers/BAML Global High Yield Index issuers = 1.8X (Jan 1, 2015)
- Altman-Kuehne 2015 face amount (Loans + Bonds)/Loans = 2.0X
- Median = 1.9X

Projected January 1, 2018 market size = 1,518 X \$1.324 B X 1.9 = \$3.819T  
Issuers Face Amount Multiplier  
per Issuer

## Default Rates in Previous Default Surges

Surge	Years Above-Average Default Rate	Years	Beginning Issuer Count	Defaults	
				Number	Percent
1	1989-1992	4	866	241	27.8
2	1999-2003	5	1,860	644	34.6
3	2008-2009	2	2,106	358	17.0

Our projection assumes a normal-length (4 to 5 years) default surge. The projected default rate is the median of the percentages for Surges 1 and 2, or 31.2%.

## Projected Default Amount in Default Surge Beginning in 2018

$$\begin{array}{rclcl} \$3.8 \text{ Trillion} & \times & 31.2\% & = & \$1.2 \text{ Trillion} \\ \text{Market Size} & & \text{Default Rate} & & \text{Default Amount} \end{array}$$

Sources: BofA Merrill Lynch Global Research, used with permission; Altman-Kuehne/NYU; Moody's Investors Service; FridsonVision calculations.

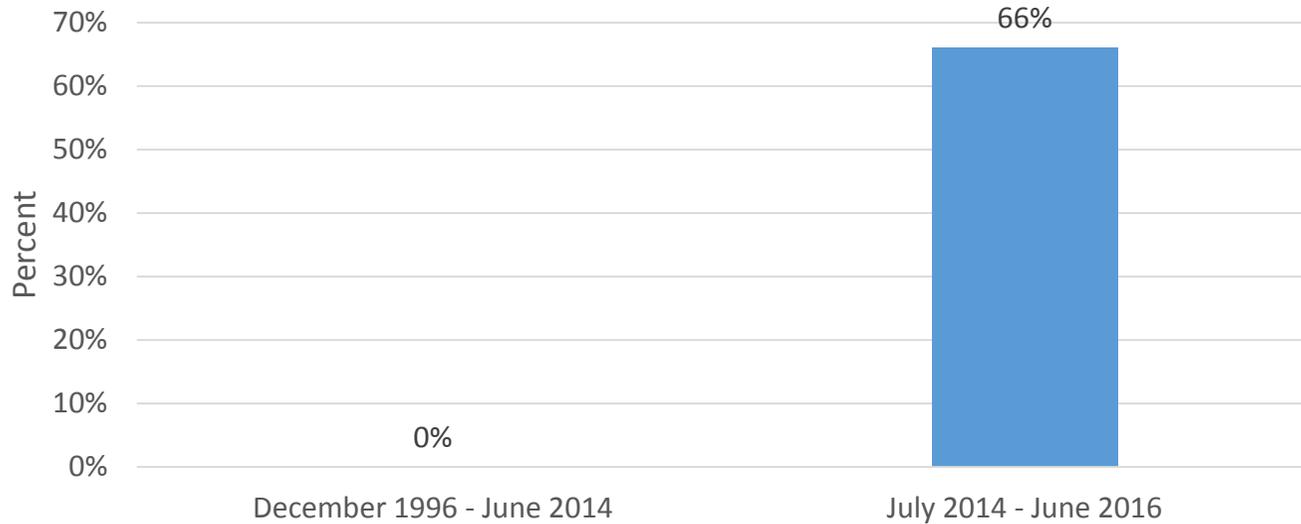
The large total reflects long-run growth of the speculative grade universe, rather than an expectation of exceptionally severe economic distress in this cycle.

# Current Fallacies

# Fallacy #1

“High yield bonds have decoupled from oil prices due to improvement in credit quality of Energy Universe”

## Oil Prices and High Yield Valuations

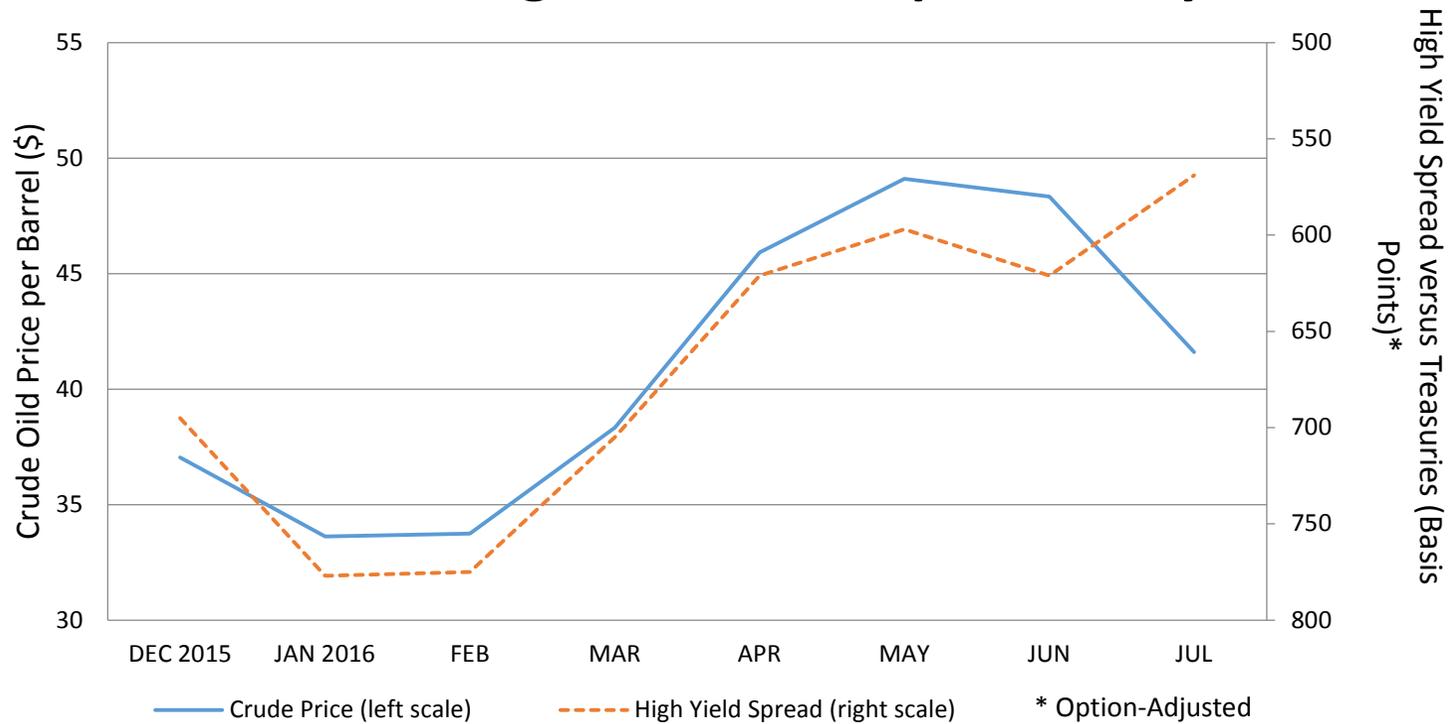


Percentage of monthly variance in BofA Merrill Lynch US High Yield Index's option-adjusted spread versus Treasuries explained by NYMEX 1st Crude Future, West Texas Intermediate.

Source: BofA Merrill Lynch Global Research, used with permission.

Crude oil prices historically had no impact on high yield risk premiums. When oil prices plunged in 2014, the connection became very strong.

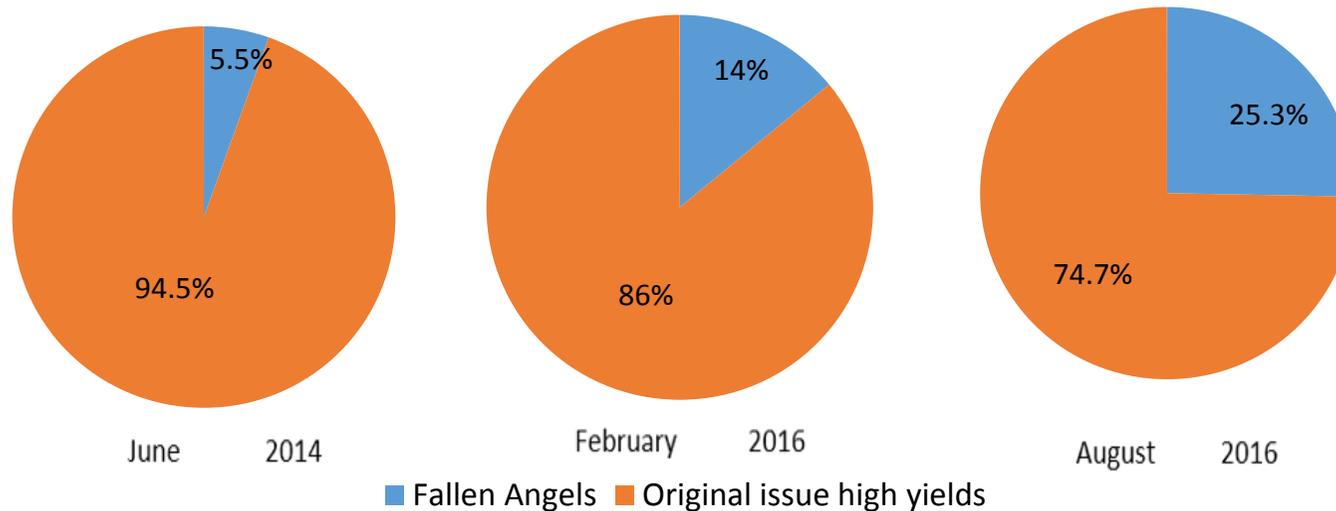
# Oil and High Yield Decoupled in July



Based on NYMEX 1<sup>st</sup> Crude Future, West Texas Intermediate and BofA Merrill Lynch US High Yield Index

Sources: BofA Merrill Lynch Global Research, used with permission; Bloomberg

# Distribution of High Yield Energy Universe By Bond Type

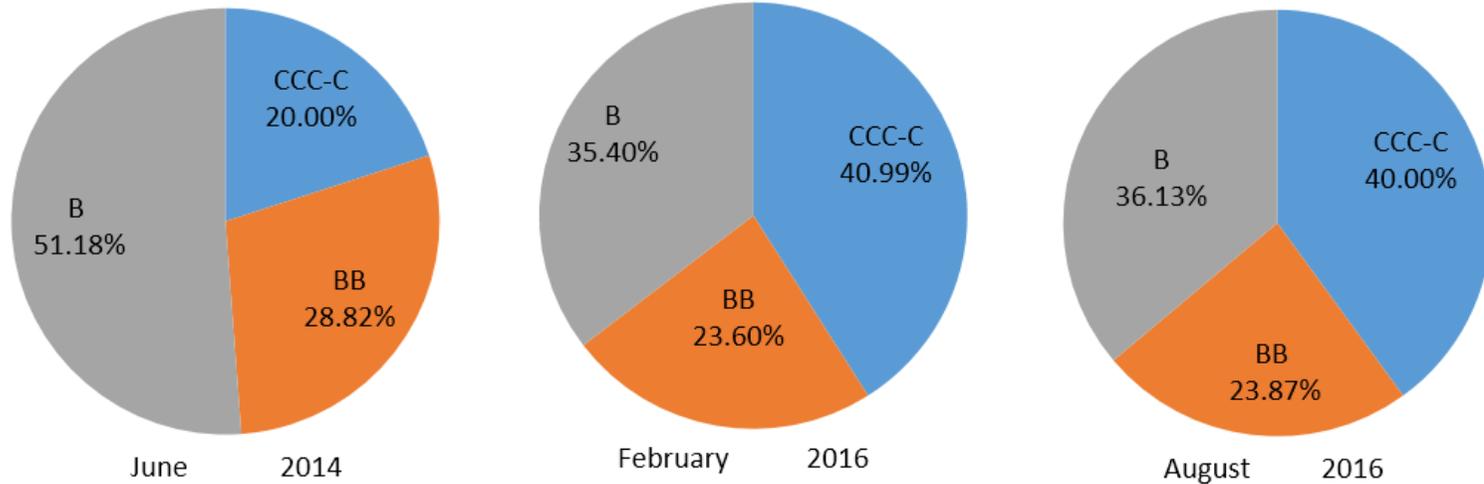


Based on BofA Merrill Lynch US High Yield Energy Index

Source: BofA Merrill Lynch Global Research, used with permission.

It is true that downgrades from the investment grade category increased as a percentage of high yield energy issues after oil prices began their plunge.

# Ratings Mix of High Yield Energy Universe

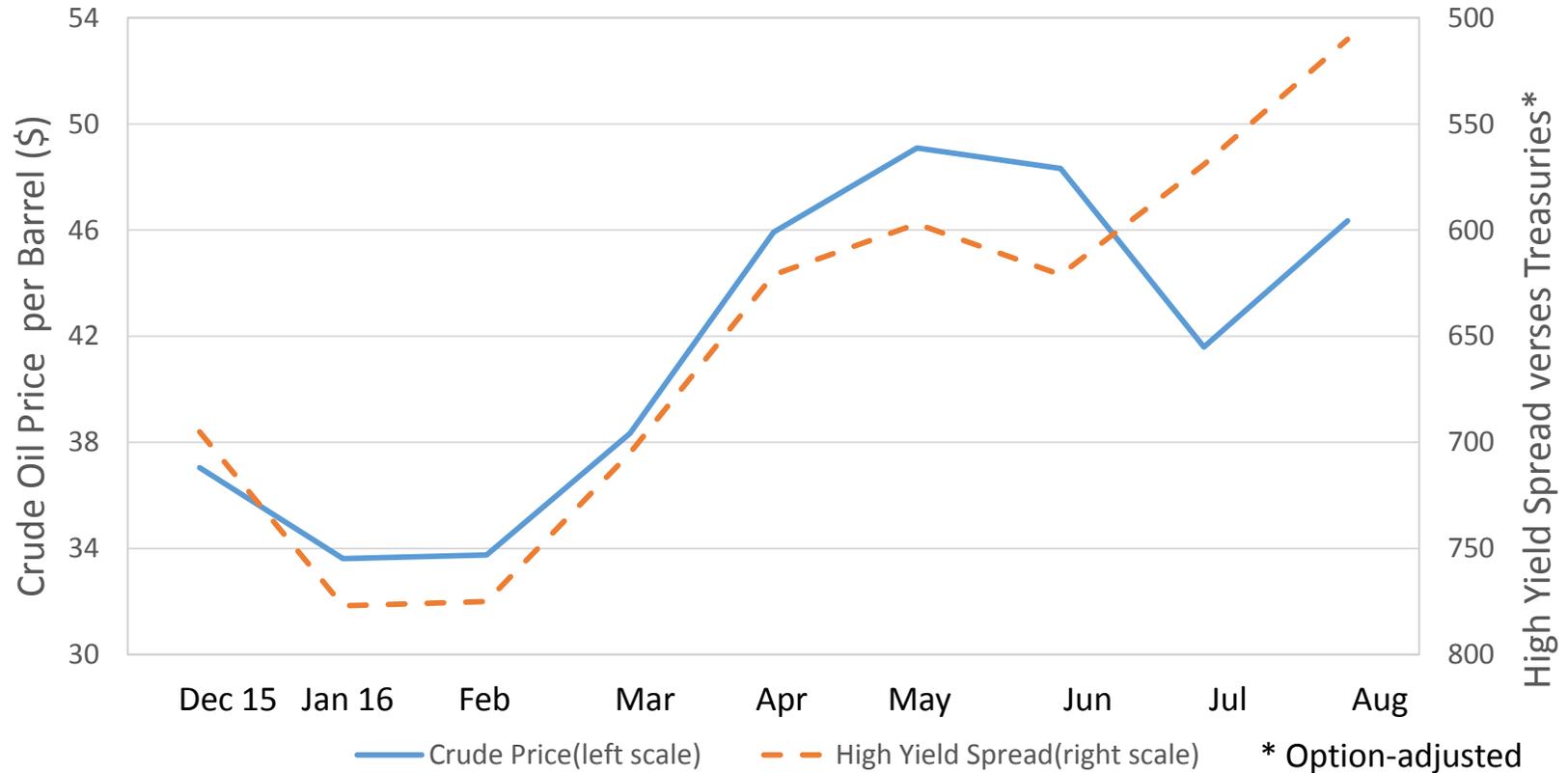


Ratings distribution of issuers in BofA Merrill Lynch US High Yield Energy Index

Source: BofA Merrill Lynch Global Research, used with permission.

Contrary to claims of some market participants, the July decoupling of the crude price and the high yield spread cannot be explained by improvement in the quality of energy bonds.

# Oil and High Yield Recoupled in August



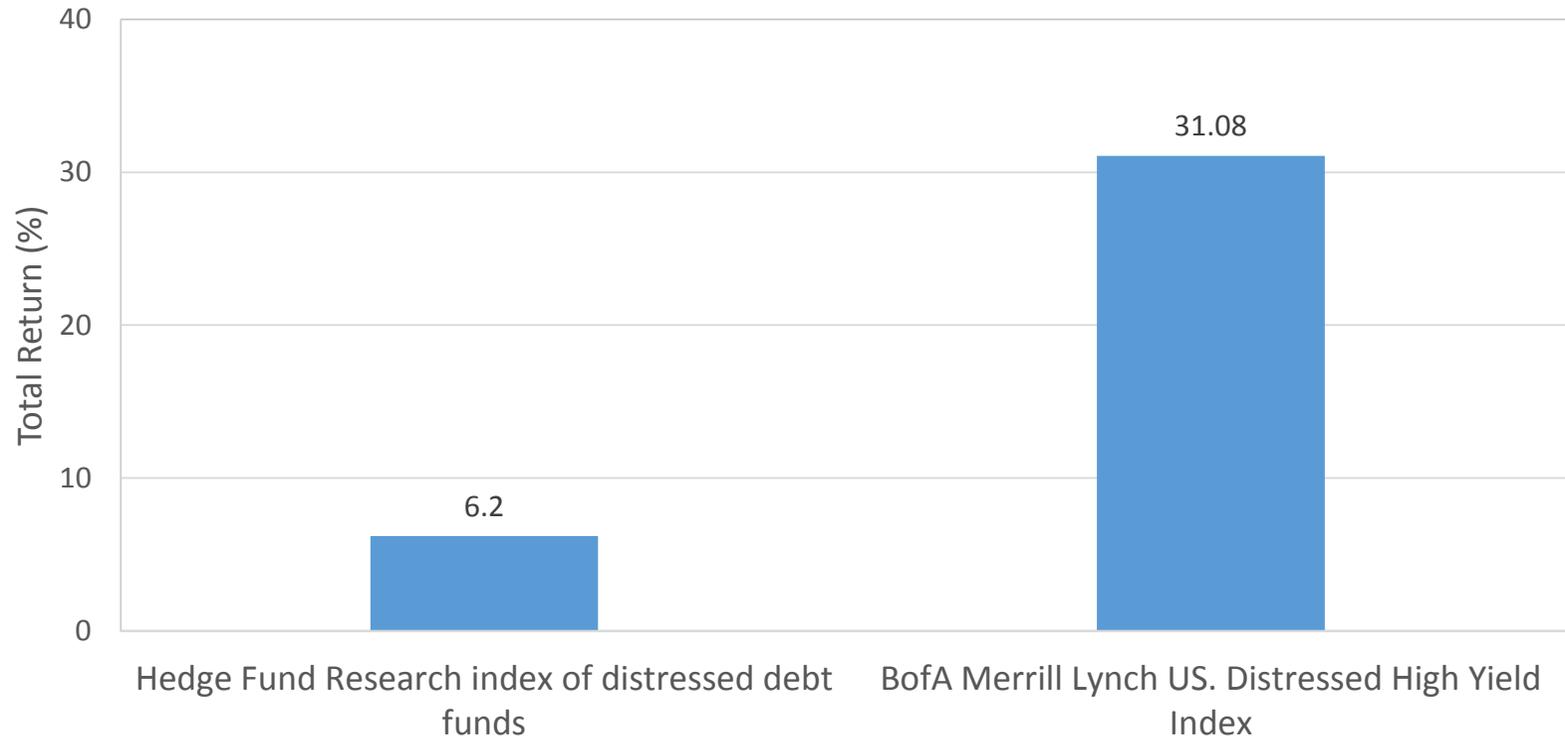
Based on NYMEX 1st Crude Future, West Texas Intermediate and BofA Merrill Lynch US High Yield Index

Sources: BofA Merrill Lynch Global Research, used with permission; Bloomberg

# Fallacy #2

“The main reason that distressed debt hedge funds have underperformed the distressed index is that they avoided making one big bet on oil prices.”

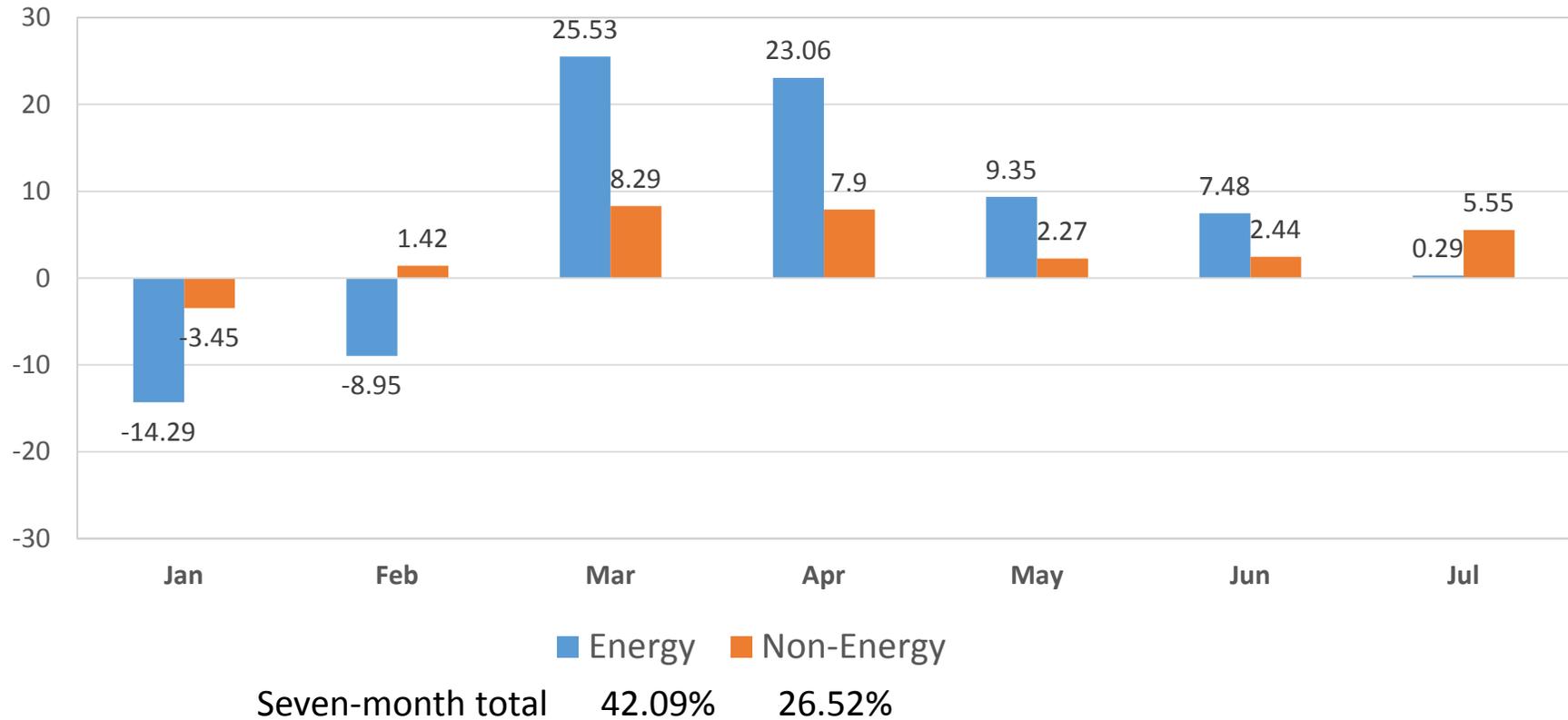
# Distressed Hedge Fund Performance 2016, Through July 31



Source: BofA Merrill Lynch Global Research, used with permission; *Financial Times*

# Breakdown of distressed debt returns

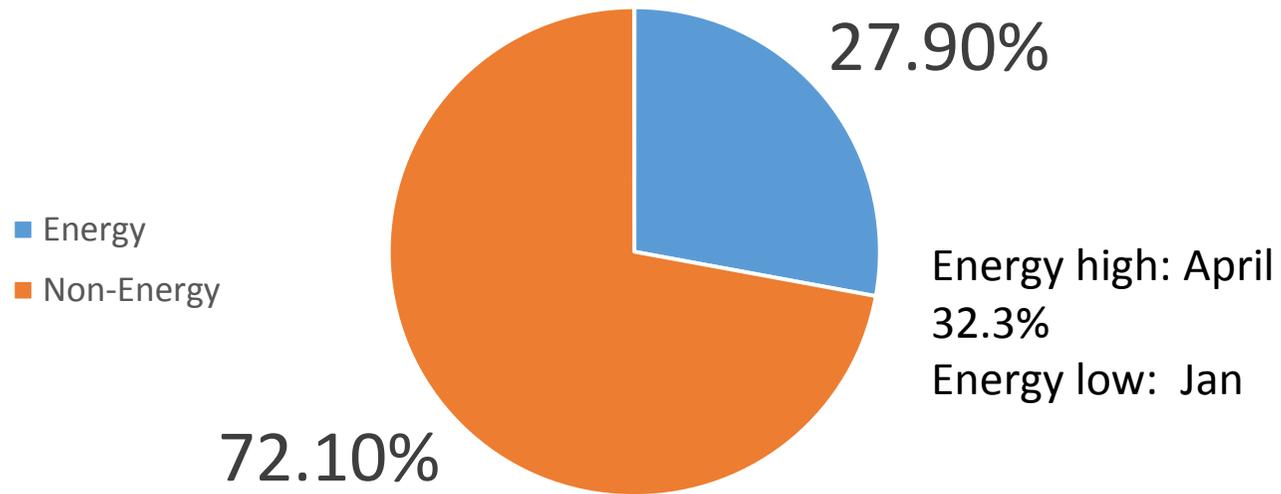
## Monthly 2016



Based on BofA Merrill Lynch US Distressed High Yield Index  
Source: BofA Merrill Lynch Global Research, used with permission

# Sector distribution of distressed debt

Monthly average 2016, by market value



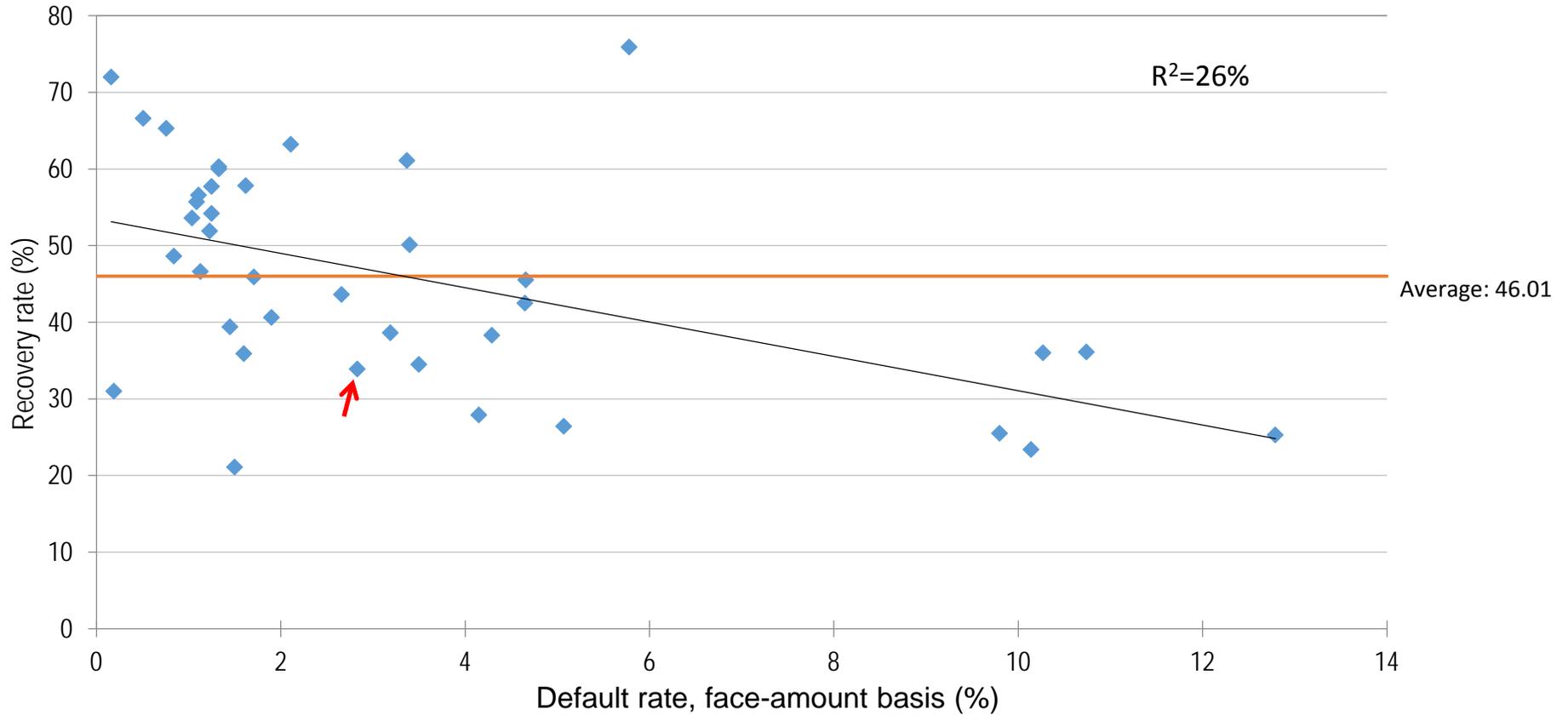
Based on BofA Merrill Lynch US Distressed High Yield Index

Source: BofA Merrill Lynch Global Research, used with permission

# Fallacy #3

“Recoveries on defaulted bonds are in a long-term decline.”

# Default Rate versus Recovery Rate Annually, 1978–2015



Source: Edward I. Altman and Brenda Kuehne, NYU Stern School

The 2015 default rate and recovery rate were “anomalously” both below average, but this phenomenon occurred in seven previous years. Low recoveries on oil companies and Caesars Entertainment skewed the 2015 data.

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