Global Special Situations Outlook

Higher rates to weigh on speculative grade credit

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In Brief

- In assessing the impact of central bank policy on the markets, the economy and borrowers, it can take a year for the full impact of rate hikes to be felt.
- If that is the case, then the “current rate” has just reached 4.33%, as this was the effective fed funds rate in January 2023.
- The effect of tightening monetary policy is being felt across the credit markets but has perhaps had its greatest impact in speculative grade credit; this is expected to worsen in 2024.
- As the weight of high interest costs hamper speculative grade companies in 2024, they will be faced with difficult financing options, especially those with debt maturating over the next 12-18 months, which could lead to an increase in default rates.
- According to Moody’s and S&P, default rates for speculative grade credit could range from 5.0% to 5.4% or reach as high as 7.0% in a pessimistic scenario.
- We believe the impact of higher rates will weigh on speculative grade capital structures, creating investment opportunities for managers with flexible pools of capital and high-quality underwriting and structuring expertise.

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Impact of higher rates

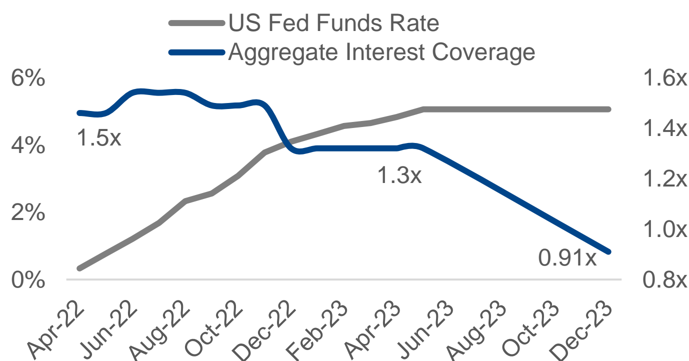
In assessing the impact of central bank policy on the markets, the economy and borrowers, it is our opinion that it takes time for the full impact of rate hikes to be felt. There is a commonly held view that it takes a year for interest rate increases to be fully felt by the economy. If that is the case, even though base rates have reached 5.5%, the "current rate" has just reached 4.33%, as this was the effective fed funds rate in January 2023. Economic data over the back half of 2023 suggests that interest rate increases have started to have the desired effect of lowering inflation and slowing the economy. For example, the Core Consumer Price Index (excluding food and energy) was 4.0% for November 2023, down from 6.0% 12 months prior. Meanwhile, some leading indicators, such as capital spending projections and small business survey expectations, seem to indicate weaker growth ahead.[1] In Europe, the Purchasing Manufacturers' Index (PMI) readings for October and November were both below 50,[2] historically a leading indicator of economic contraction. We are seeing signs of this on a micro level as well, as a retail company we follow recently reported consumer spending was down over 27% year over year.

Weaker credits may be challenged

The effect of tightening monetary policy is being felt across the credit markets but has perhaps had its greatest impact in speculative grade credit. From year-end 2021 through 2023, borrowing costs have nearly doubled for speculative grade companies. This increased interest expense for below investment-grade credit has put strain on the balance sheets of these businesses. In 2024, this burden is expected to worsen. For example, Moody's estimated in July 2023 that the aggregate interest coverage ratio of B3 companies would be below 0.91x by the end of 2023, as more than 60% of B3 companies will have an interest coverage ratio below 1.0x.[3] This compares to 1.5x in early 2022. As the weight of this high interest cost continues to hamper speculative grade companies in 2024, they will be faced with difficult financing options, especially those with debt maturating over the next 12-18 months. Our expectation is that default rates, which increased in 2023, are likely to increase further over the year ahead. According to Moody's and S&P, default rates for speculative grade credit could range from 5.0% to 5.4% or reach as high as 7.0% in a pessimistic scenario.

Weaker credits are feeling the impact of higher rates

Figure 1: Aggregate Interest Coverage of B3 Companies



Source: Moody's Investor Services, J.P. Morgan Asset Management; as of July 2023.

[1] Bloomberg, Non-residential capex & NFIB Optimism Survey results, November 2023.
[2] Standard & Poor's, J.P. Morgan Economic Research, J.P. Morgan Asset Management, November 2023.
[3] Study conducted by Moody's on 305 corporate issuers in the U.S. and Canada that were rated B3 as of April 2023.

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Defaults expected to rise

The spike in default rates may be less dramatic than what occurred during the GFC, but the notional volume of defaulted assets could exceed it due to the growth in the size of the speculative grade market. From 2007 to 2022, the size of the high yield and leveraged loan markets has grown from $1.8 trillion to over $4 trillion. Thus, using a default range of 5%-7%, the total volume of defaulted speculative grade supply could be $200-280 billion.[4] This calculation doesn't account for growth in the private credit market, which has grown nearly eight-fold from 2007 to 2022, reaching over $1.4 trillion in AUM according to Preqin. Since the widespread adoption of private credit solutions there has not been a sustained rate hike cycle, so it remains to be seen how well these floating rate loans fair in this new environment.

Asset allocation implications

We believe that as a Special Situations manager, it is best to remain dynamic and adjust to the market environment as it evolves. Being able to invest in stressed and distressed companies in the private and public markets opens up a broad investment opportunity set in 2024. The persistence of higher interest rates could force otherwise performing companies to accept new capital at higher costs and potentially cause good companies to have financial performance issues. Additionally, stressed and distressed companies that were hoping to delay dealing with unsustainable capital structures could be forced to start restructuring processes. Whether this process unfolds slowly in a soft-landing scenario or abruptly in a hard landing scenario remains to be seen. Either way, the impact of higher rates will weigh on speculative grade capital structures, creating opportunities for mangers with flexible pools of capital and high-quality underwriting and structuring expertise.

Next steps

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[4] Based on $4.1 trillion of high yield and leveraged loans outstanding and a 5%-7% default rate.

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