RBC Global Asset Management

Special situations in today's default market

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> **"Notably, there is a higher proportion of BB-rated companies than in previous cycles, indicating a higher level of creditworthiness."**

Special situations and distressed debt expert, Adam Phillips considers why the challenging economic backdrop is presenting a multitude of challenges for corporates and investors alike.

The macro environment is providing a rich opportunity set for investors in special situations and distressed debt. And fortunately, our special situations team has seen at least six major default cycles going back to the 1990s. This gives us a huge amount of experience and is useful to look at the current market in the context of previous cycles, including those in the 1990s in Asia, the dot.com bubble, the global financial crisis and the Covid period.

Corporates are facing a range of challenges

Many companies went into Covid very highly leveraged due to the availability of money at unprecedentedly low-interest rates and have subsequently had to borrow more to survive. Macro factors are also causing turmoil, including supply disruptions, surging inflation and energy prices, and interest rates rising to rates unseen since before the global financial crisis and the war in Ukraine.

Rising defaults

Looking at these highly challenging market conditions, it is unsurprising that defaults are rising, albeit from a low base. Interestingly, they are rising at a slower pace than might be expected when focusing only on these macro factors. The pace of defaults will likely increase, but, for the time being, the market remains relatively tight, with spreads narrower than they have been at this point in previous cycles. This can partly be attributed to the high-yield market quality this time. Notably, there is a higher proportion of BB-rated companies than in previous cycles, indicating a higher level of creditworthiness.

A $3.5 trillion market

That said, there is also a good proportion of CCC-rated companies, and we need to consider default rates in the context of the current size of the combined high-yield and leveraged bond market, which has increased significantly since the global financial crisis: today, the US and European high-yield and leveraged loan markets total around $3.5 trillion.

So, while we are not predicting default rates to reach the 10-12% per year that we saw towards the end of the global financial crisis, given the market's current size, we may end up with a similar volume of defaults.

Private debt now plays a much larger role

In addition to the market's increased size and number of participants, we also need to look at the potential role of private debt in the current environment. Private debt funds play a significantly larger role, and refinancing by these funds is much more prevalent than in previous cycles.

The strategies and portfolio underwriting of these funds are a further consideration and add to the complexity of the current landscape. Defaults are rising in a huge and dynamic market, with significant stresses coming down the pipeline. Our expertise, experience and agility with deals of varying sizes and across multiple sectors and geographies enable us to approach this default cycle with maximum returns in mind.

Portfolio Manager Perspectives

Our experts offer their perspectives on the latest developments in global credit and the state of the markets.

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