UBS

Fixed Income Default Study

2023 – UBS Asset Management

Fixed Income Default Study – 2023

Contents

Introduction

This paper examines our bottom-up default outlook and total return forecasts for 2023. The fixed income default study is based on a proprietary, bond by bond analysis conducted by our dedicated team of credit analysts. The team utilises reference indices to form a comprehensive, bottom-up estimate of defaults and distressed exchanges by industry.

Key takeaways

Expected default rate	UBS-AM 2023
EUR HY	3.4%
US High Yield	3.3%
EMD Corporates	1.9%
EMD High Yield Corporates	4.3%
Asia ex-Japan	0.7%
Asia ex-Japan High Yield	3.9%

Source: UBS Asset Management, 31 December 2022

- We forecast defaults in developed markets to increase from last year's all-time lows, but remain below long-term trends:
  - Euro high yield at 3.4% driven by expected weaker fundamentals and higher rates, but mitigated by the fact that there are relatively limited refinancing needs. These forecasts range in the middle compared to those of a selection of sell-side strategists.
  - US high yield at 3.3%, towards the lower end of forecasts from the same selection of sell-side strategists.

- In Asia ex-Japan, we expect a modest 0.7% default rate. Focussing only on high yield issuers, our projected default rate is 3.9%.

- For emerging market (EM) corporates, we expect a 1.9% default rate, or 4.3% when considering only high yield.

- Our projections for EM corporates and Asia ex-Japan are lower, largely due to improved sentiment in the Chinese property market.

These projections translate into the following total return forecasts (also taking into account our rates and spreads forecast):

- US high yield looks to have a high return potential with relatively limited downside risk.

- Asia high yield appears to be the highest potential return sector, albeit with the potential for a wide dispersion.

- In Euro high yield, the absolute yield level in local currency is lower due to lower EUR rates. However, it still looks attractive given the market is higher in quality compared to US high yield. At the current yield level, we see a nice cushion to mitigate any potential adverse movements in rates and spreads, thus expecting an outperformance over EUR IG by 1.5-2%.

Total return forecast for 2023

US High Yield	9–12%
Euro High Yield	2–8%
Asia High Yield	3–22%
EM Corporates	8–10%

Source: UBS Asset Management, 31 December 2022

UBS-AM Default study

EUR High Yield defaults expected to be 3.4% (EUR mm)

Our forecast for Euro high yield default rates to increase from 2022 historical lows reflects our expectations that weakening demand and compressed margins will impact fundamentals. However, many corporate issuers took advantage of suppressed rates in recent years to extend maturity schedules and so defaults should remain below long-term averages. Looking beyond next year, if primary markets remain unaccommodating and interest rates elevated, default rates could step up in light of significant refinancing requirements in 2024-2025.

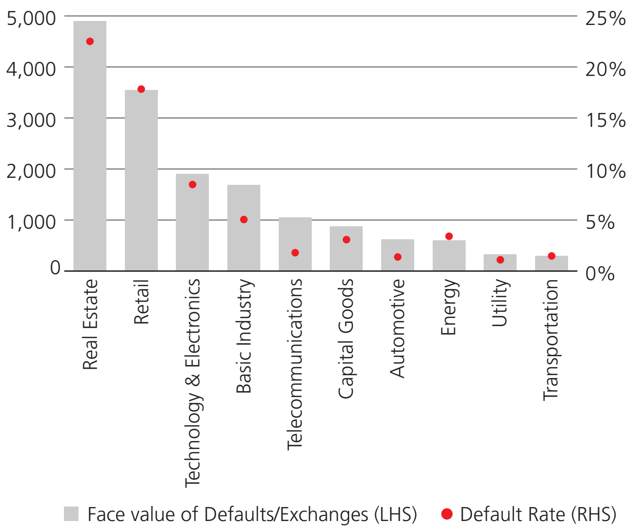
The key negative sector outliers in 2023 are likely to be real estate and retail, both of which are heavily influenced by single issuers with large and complex debt structures.

US high yield defaults expected to be 3.3% (USD mm)

As with the European forecast, US default rates should increase this year. However, our analysts are somewhat more optimistic than the market consensus as we expect several stressed names with 2023 and 2024 maturities to work towards refinancing. Credit fundamentals appear to be skewed to the downside, and we expect slowing demand as the Federal Reserve's actions take hold.

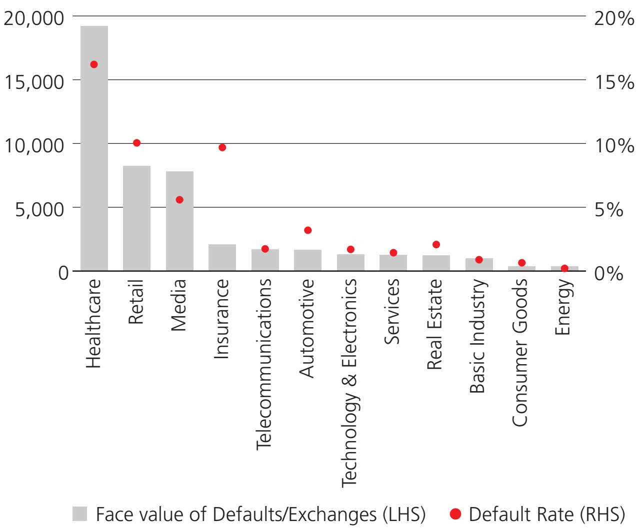
The key negative sector outliers are healthcare and retail: the healthcare forecast is influenced by a single sizeable constituent, while retail reflects broad-based weakness.

Euro high yield projected default rates, by sector
EUR MM



Source: UBS Asset Management, 31 December 2022
The bars represent the USD/EUR amount of total defaults per sector or geography based on the original face value. The dots represent the expected default rate by industry or geography.

US high yield projected default rates, by sector
USD MM

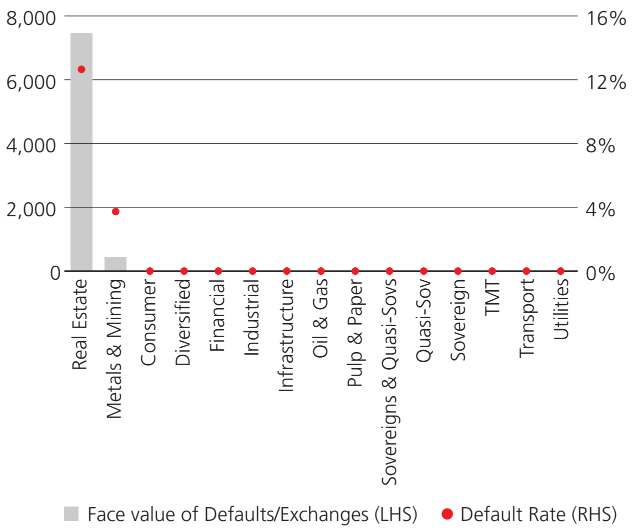


Source: UBS Asset Management, 31 December 2022
The bars represent the USD/EUR amount of total defaults per sector or geography based on the original face value. The dots represent the expected default rate by industry or geography.

Asia ex-Japan high yield defaults expected to be 3.9% (USD mm)

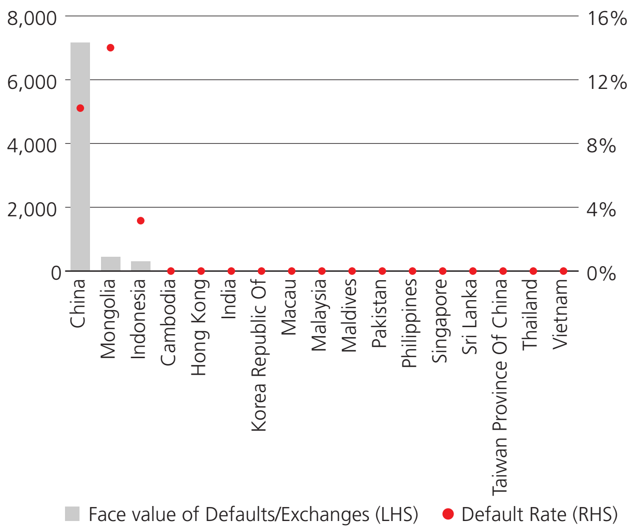
Within Asia ex-Japan, our forecast is considerably lower than last year. The key difference is the far more favourable outlook for Chinese Real Estate (given the shift in property policy), improved conditions onshore (given the reopening from Zero-COVID) and the fact that a significant number of property developers have already fallen out of the index in 2022 due to default or restructuring.

Asia high yield projected default rates, by sector
USD MM (JACI – HY only)



Source: UBS Asset Management, 31 December 2022
The bars represent the USD/EUR amount of total defaults per sector or geography based on the original face value. The dots represent the expected default rate by industry or geography.

Asia high yield projected default rates, by country
USD MM (JACI – HY only)

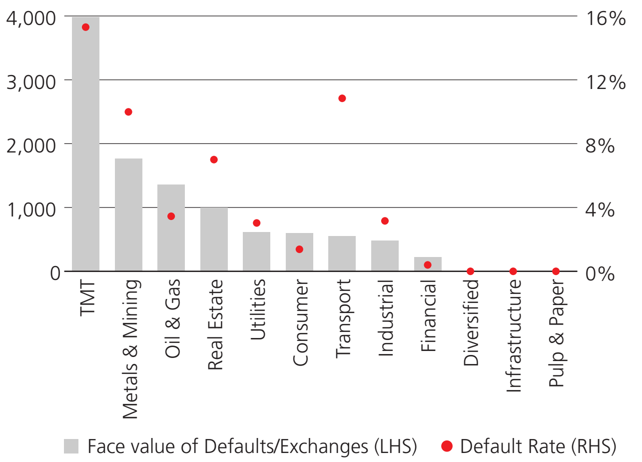


Source: UBS Asset Management, 31 December 2022
The bars represent the USD/EUR amount of total defaults per sector or geography based on the original face value. The dots represent the expected default rate by industry or geography.

Emerging market high yield corporate defaults expected to be 4.3% (USD mm)

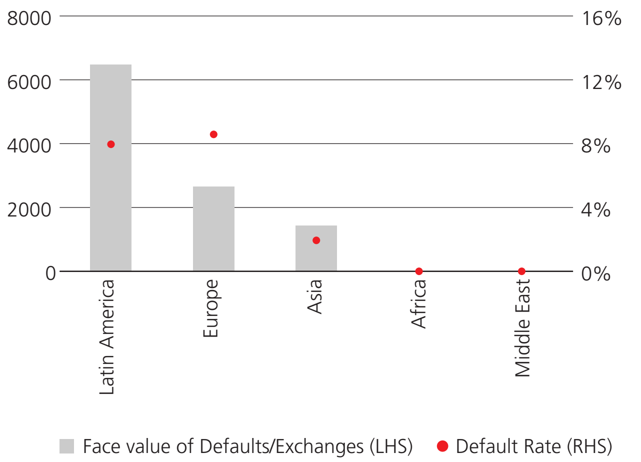
We expect an improvement in the default rate compared to 2022. Note that our forecast is below those of several sell-side strategists; this reflects our view that many of the stressed rated (CCC+ and below) names with no maturities in 2023 will muddle through the year. Geographically, the Asian high yield default rate of 1.9% is primarily driven by China property, the European default rate of 8.6% by the remaining Ukrainian names in the index, and the Latin American default rate of 8.0% by a group of TMT issuers across several countries (idiosyncratic issues).

EM corporates projected default rates, by sector
USD MM (CEMBI Broad Div - HY only)



Source: UBS Asset Management, 31 December 2022
The bars represent the USD/EUR amount of total defaults per sector or geography based on the original face value. The dots represent the expected default rate by industry or geography.

EM corporates projected default rates, by region
USD MM (CEMBI Broad Div - HY only)



Source: UBS Asset Management, 31 December 2022
The bars represent the USD/EUR amount of total defaults per sector or geography based on the original face value. The dots represent the expected default rate by industry or geography.

UBS-AM Default study

The Fixed Income Investment Forum is broadly constructive on high yield and emerging markets overall, and we forecast expected total returns to be positive for these sectors even in a negative scenario in 2023. Our base case is for Asia high yield to generate returns of up to 22%, albeit with high volatility and dispersion potential, followed by US high yield with an attractive range between 9-12% and Euro high yield between 2-8%. EM corporates is expected to return between 8-10%.

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