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Q&A: Despite Signs Of A U.S. Economic Trough, Borrowers Will Face Difficulties Into 2010

Global Fixed Income Research:

Diane Vazza, Managing Director, New York (1) 212-438-2760; diane_vazza@standardandpoors.com

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In the following series of questions and answers, Diane Vazza, managing director of Standard & Poor's Global Fixed Income Research, discusses the near-term outlook for U.S. corporate borrowers and bond issuance, and the refinancing risk that many of these borrowers face. Standard & Poor's Ratings Services plans to continue its Q&A sessions with Ms. Vazza on a monthly basis, in which she will comment on recent trends in, and near-term outlooks for, the global fixed income space.

Questions & Answers

With Federal Reserve Chairman Ben Bernanke and other economists suggesting that we may have seen the worst of the U.S. economic recession and that there are signs of a rebound on the horizon, what can we expect for speculative-grade corporate borrowers in the months ahead?

Our expectation is that while the economy will likely bottom out in the third quarter of this year, the recovery will be long, slow, and painful--with no pickup in employment. In this light, things are going to continue to be difficult for speculative-grade borrowers.

It's true we've seen signs that the bottom has been reached, as our downgrade ratio reflects. The ratio (the number of downgrades among all rating actions) slipped slightly, to 89.3% in the second quarter of this year, from 93.3% in the first quarter. But we need to look at those numbers in the context of our overall outlook. In short, we have a global negative bias--based on the total number of borrowers with ratings that either carry negative outlooks or are on CreditWatch with negative implications--of 36.6%, which is significant. Moreover, we expect this negative bias to continue to be high, albeit wane slightly--meaning there's still high potential for additional corporate downgrades.

As it stands, our current 12-month trailing forecast for U.S. corporate speculative-grade defaults is 13.9% by mid 2010, with a pessimistic scenario of 18% and an optimistic scenario of 11.4%.

Are there any other bright signs out there?

The number of our weakest links--those issuers rated 'B-' or lower, with either a negative outlook or on CreditWatch with negative implications--has waned slightly. And while our potential downgrades have started to decline, potential upgrades have ticked up. On top of this, our distressed-debt ratio (the number of issuers with options-adjusted spreads of more than 1,000 basis points) has clearly pulled in a bit, to 36%. But while the 12-month moving average for this is around 52%, the current ratio is more than double the historical average of 16%. This is not a rosy scenario. Basically, these signs of improvement merely mean that we're simply not adding to the pile of companies in trouble.

You mentioned distressed debt and spreads--where are spreads for speculative-grade borrowers and, more importantly, where are they heading?

Granted, spreads offered to speculative-grade borrowers have come in from their high of around 1,700 basis points (bps). But even while hovering at around 900 bps in July, this is still way above the 15-year long-term average of

about 520 bps.

We think that at this point, spreads may have come in to a level at which risk-return ratios are getting out of balance. A look back at recessions and recoveries shows that defaults, which we expect to reach a plateau in the first quarter of 2010, typically peak six to nine months after a trough in GDP. We don't expect that to change this time around, except to possibly skew toward the longer end of that range.

How has bond issuance been affected by the swings in spreads?

Global corporate issuance has approached record highs this year--with much of this in the U.S. financial services area, facilitated by programs such as those implemented by the Federal Deposit Insurance Corp. (FDIC), under which it guarantees the new senior unsecured debt of banks and thrifts, among others. But in the first half of the year, investment-grade issues made up more than 80% of the record \$1.79 trillion--much higher than the 72% in 2008--while the proportion of speculative-grade issuance has tumbled to levels not seen since 1991. And after speculative-grade issuance popped up in the second quarter, commensurate with the narrowing of spreads, it dropped precipitously in July.

Basically, while we've seen--and continue to see--investment-grade corporate borrowers have unfettered access to credit markets, the nonfinancial speculative-grade corporates most in need of capital still have limited access. And unless things change very dramatically and very rapidly, they will continue to have trouble for the foreseeable future.

There's been a lot of talk about refinancing risk for borrowers at the lower end of the rating spectrum. How serious is this risk?

The bulk of upcoming maturities will happen in the 2011 to 2014 period, and a lot needs to happen in the markets for these refinancings to occur. Spreads will have to come down rather significantly, and macroeconomic conditions need to improve substantially. We do see some inklings of improvement, but things are not going to suddenly turn around in 2010, which is right around the corner.

After periods of great debt accumulation, there are inevitably painful phases of deleveraging, the readjustment of balance sheets, and the repricing of risk. A look at the buildup of credit in recent years suggests that this time around won't be any different.

What areas might see the most turbulence in coming months?

This is always difficult to predict, but there are some historical precedents that offer clues about areas on which to focus.

Financial crises naturally take an especially heavy toll on the financial sector. And while financial institutions historically experience rating changes less often than nonfinancial companies, the risk of sudden default (defined as default following downgrades of nine rating notches or more in one year) is higher in the former. In this light, jump-to-default risk could be higher for financial institutions that suffer sudden downgrades to below an acceptable level (e.g., to speculative grade), thus threatening the viability of their business models. All told, we could see a larger number of casualties in the financial sector than in recent recessions.

And while defaults tend to be dispersed more widely across sectors during credit downturns, peak default rates vary significantly across sectors. In the past 28 years, maximum default rates range from 4.72% for health care and chemicals, to 20% for telecom. But the variations don't necessarily mean that certain sectors are more or less prone to default than others. In fact, in the context of economic and credit movements, a mix of factors, including debt leverage, management vision, and government support, can affect some sectors differently than others.

In short, it's no secret to say that investors will have it as good or as bad as the asset mix in which they've invested.

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