Lloyds TSB | Corporate Markets

Credit Market Analysis

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What do macroeconomic prospects say about the UK corporate default rate?

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UK growth remains relatively strong, but will slow this year

Despite the onset of the credit crisis, the UK economy still expanded at the trend rate of 0.6% a quarter in the second half of last year. All latest indicators, including retail sales and manufacturing output figures, suggest that growth in Q1 2008 remained at or near trend. Business and consumer confidence surveys have painted a somewhat less optimistic picture and, on balance, we expect UK growth to slow to just above 2% for 2008 as a whole. This is down from the strong 3% growth rate last year, but is only slightly below the long-term average of 2.5%. Hence, the UK economy is not heading for a recession, but unemployment is forecast to rise slightly from current 30-year lows.

How will slower economic growth impact on corporate default rates?

The default rate fell to only 0.6% last year, well down from the peak of near 3% in the last recession back in the early 1990s. We expect the corporate default rate to start to rise this year, but to remain low by historical standards, rising to 0.8% by 2009 - see chart a.

The relationship between economic growth and corporate default rates in the last 20 years is shown in chart b. In particular, the early 1990s recession led to a sharp rise in the default rate, but a sustained period of growth since then has pushed the default rate lower. A similar picture emerges in chart c, which shows the relationship between industrial production and corporate default rates. Notably, we expect the weaker pound will support the manufacturing sector, so the forecast rise in corporate defaults could be more concentrated in other sectors more affected by the current economic slowdown, including retail, finance and property. Chart d shows the close relationship between the unemployment rate, which is of course another indicator of economic activity, and the corporate default rate. (Individual insolvency rates and mortgage arrears will also be affected by changes in unemployment).

Tighter corporate lending standards will also lead to higher defaults, but to what degree?

Bank lending standards also have an impact on economic activity. Both the Bank of England's latest credit conditions survey and the ECB's bank lending survey (which has a longer history) show that corporate lending standards remained tight, though there

Chart a: Corporate default rate is forecast to rise, but to remain low by historical standards

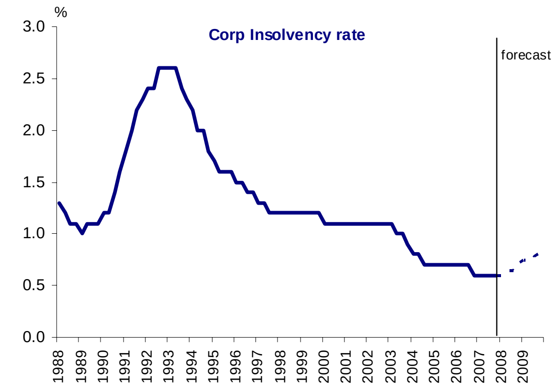


Chart b: Weaker economic growth leads to higher corporate defaults

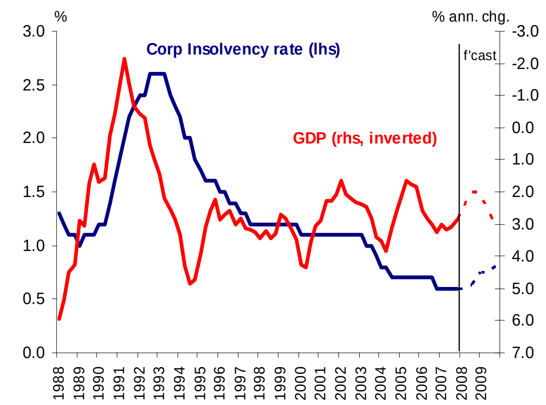
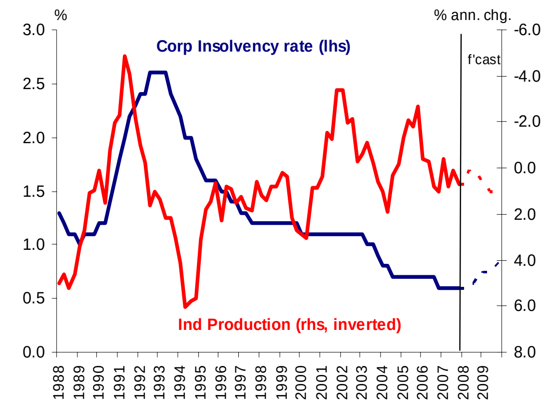


Chart c: The industrial sector will be supported by the weaker pound, hence most defaults may occur in other sectors



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are indications that conditions may become slightly less restrictive in the next three months. Chart d shows that looser corporate lending standards before the credit crisis began last summer contributed to lower corporate default rates. Therefore it seems sensible to assume that the tightening of credit availability will weaken economic growth and result in higher corporate default rates.

However, corporate balance sheet indicators such as profits remain relatively strong, and this will help to cushion many companies from the impact of tightening corporate lending standards and, indeed, of wider credit spreads. So, overall, the credit crisis will weaken UK growth and raise default rates this year, but the situation is nowhere near as bad as during the early 1990s.

Hann-Ju Ho, Senior Economist

Chart d: Lower unemployment, reflecting strong economic activity, has led to lower corporate defaults

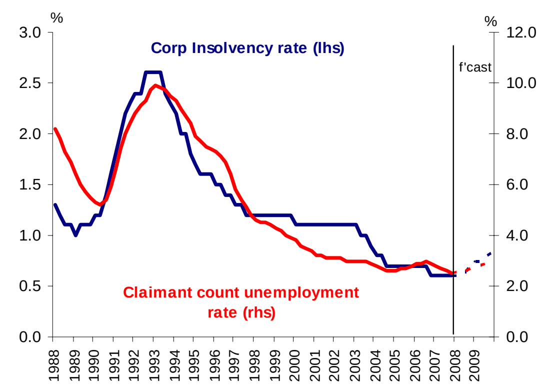
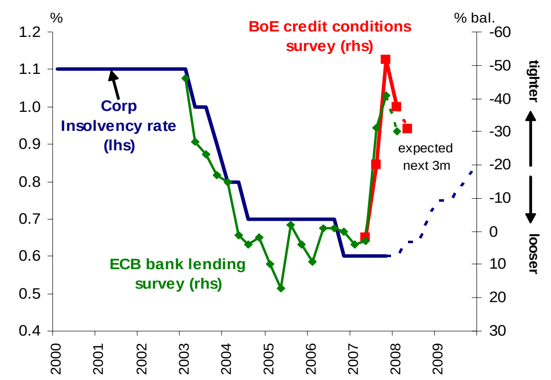


Chart e: Tighter corporate lending standards will leasd to weaker growth and higher defaults



**** Please turn over for key financial market interest rates and for interest rate and spread forecasts ****

Table 1: Key financial market interest rates

	latest 11 Apr 2008	1m ago	3m ago	12m ago
UK				
BoE repo rate	5.00	5.25	5.50	5.25
1m libor	5.52	5.65	5.70	5.42
3m libor	5.93	5.79	5.68	5.60
6m libor	5.90	5.76	5.61	5.72
2y swap	5.05	4.97	4.96	5.81
5y swap	4.97	4.97	4.91	5.69
2y govt	3.92	3.77	4.26	5.49
10y govt	4.41	4.36	4.42	5.08
High-grade spread (bps)	269	261	182	80
High-yield spread (bps)	815	840	665	225
Eurozone				
ECB refi rate	4.00	4.00	4.00	3.75
1m libor	4.36	4.31	4.20	3.86
3m libor	4.75	4.60	4.57	3.97
6m libor	4.75	4.58	4.62	4.10
2y swap	4.23	4.00	4.29	4.35
5y swap	4.14	4.00	4.27	4.38
2y govt	3.42	3.33	3.73	4.13
10y govt	3.92	3.79	4.09	4.21
High-grade spread (bps)	181	177	124	47
High-yield spread (bps)	706	768	576	210
US				
US fed funds	2.25	3.00	4.25	5.25
1m libor	2.72	2.89	4.24	5.32
3m libor	2.71	2.87	4.26	5.36
6m libor	2.71	2.74	4.08	5.37
2y swap	2.57	2.66	3.26	5.14
5y swap	3.38	3.55	3.72	5.12
2y govt	1.73	1.74	2.55	4.74
10y govt	3.46	3.59	3.78	4.74
High-grade spread (bps)	286	284	217	93
High-yield spread (bps)	770	795	668	275
Emerging market				
Corporate spread (bps)	663	636	568	285

source: Bloomberg, ML indices

Table 2: Interest rate and spread forecasts

	latest 11 Apr 2008	End Q2 2008	End Q3 2008	End Q4 2008	End Q1 2009	End Q2 2009	*5-year avg.*
US							
US fed funds target	2.25	2.00	2.00	2.00	2.50	3.00	3.25
3m libor	2.71	2.40	2.20	2.40	2.75	3.25	3.50
5yr swap	3.38	3.60	3.70	4.00	4.30	4.60	4.40
2y govt yield	1.73	1.80	2.20	2.80	3.20	3.60	3.45
10y govt yield	3.46	3.80	3.90	4.10	4.30	4.50	4.35
UK							
BoE repo rate	5.00	5.00	5.00	5.00	5.00	5.00	4.65
3m libor	5.93	5.55	5.25	5.25	5.25	5.45	4.90
5yr swap	4.97	5.10	5.25	5.30	5.50	5.55	5.10
2y govt yield	3.92	4.30	4.60	4.90	5.00	5.20	4.60
10y govt yield	4.41	4.60	4.65	4.75	5.00	5.10	4.65
High-grade spread (bps)	269	275	265	250	235	220	95
Eurozone							
ECB refi rate	4.00	4.00	4.00	4.00	4.00	4.25	2.60
3m libor	4.75	4.40	4.10	4.10	4.10	4.30	2.90
5yr swap	4.14	4.30	4.40	4.50	4.70	4.75	3.70
2y govt yield	3.42	3.60	3.90	4.00	4.20	4.25	3.00
10y govt yield	3.92	4.10	4.20	4.30	4.50	4.60	3.90

***All data and charts are sourced to Lloyds TSB Corporate Markets Economic Research, Datastream, Insolvency Service, Bank of England and ECB**