July Ratings and 2Q02 Defaults: Two Thumbs Down

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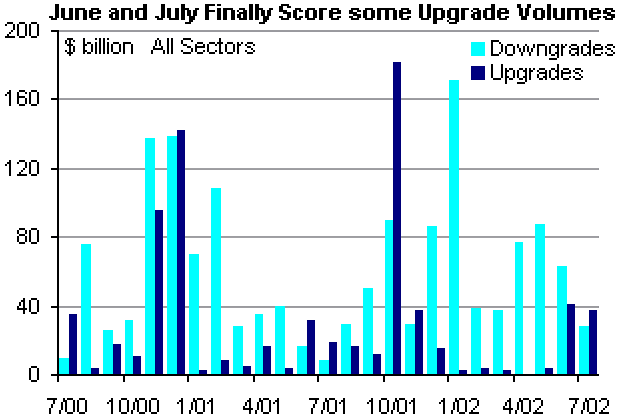
?July downgrades show no let up in the trend of credit deterioration.
?38 downgrades of $57 billion exceeded 13 upgrades of $38 billion
?$36 billion of the upgrades can be attributed to a single action.
?2Q02 set a new record for default volumes.

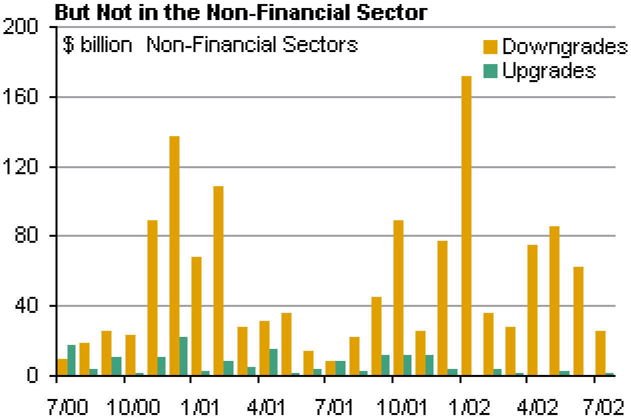
The market retraced much of yesterday's rout on a lack of new bad news to drive prices out further. After spreads widened in a vacuum on Ford on Monday, Tuesday saw retracement of about 20 – 25 bp across the curve as headline spreads of +400 bp on Ford 10-years didn't seem to make sense on a relative value basis to GM and DCX. It remains to be seen what happens going forward on an absolute basis. The calm in the autos drove spreads 5-7 bp tighter on bank/finance/brokerage paper as well. High yield spreads also benefited about 15 bp from the positive tone in equities and from a series of reports in the last few days questioning whether the selloff in the market had gone too far. The market will keep a wary eye on the prospect for a double dip, which may cap any big move up. Finally, beleaguered emerging markets investors had a flat return day, although spreads were 9 bp tighter on the backup in Treasury yields.

Ratings trends showed little improvement during July according to the latest Moody's data, which reveals that the 38 downgrades to US corporates once again far outweighed the minimal number of upgrades during the month (13). The dollar value of downgrades at $57 billion also exceeded upgrades ($38 billion) and the divergence is even greater if the effect of a $35.9 billion upgrade to US Bancorp is taken into account. This continues the trend of recent years where the minimal number of upgrades that have occurred have been very much concentrated in the financial arena. **For the month of July outside of the finance arena just $1.7 billion of debt was upgraded.** The downgrades were fairly evenly weighted between investment grade credits ($29.5 billion) and speculative grade credits ($27.8 billion) but remained concentrated in the utility, power and telecommunications sectors, which accounted for over half of the negative actions. Credit pressure in these sectors does not seem to be lessening either as they accounted for 17 of the 35 reviews for downgrade that occurred during July.

June and July Finally Score some Upgrade Volumes



But Not in the Non-Financial Sector



Source: Moody's

The continuing evidence of credit deterioration in July is unwelcome, but unfortunately unsurprising, news coming on the heels of a harrowing period for corporate bond defaults. **In 1H02 according to**

Moody's, 89 corporate bond issuers defaulted on $76.7 billion of debt with 21 issuers defaulting on over $1 billion each. The pace in 2Q02 actually quickened over the first quarter of the year and the $42.6 billion of bond defaults set a new record for volume, if not for the actual issuer count—42 issuers defaulted in 2Q02 but the record is 58 issuers in 1Q01. The second quarter's defaulted bond volume is roughly double the $21.4 billion of the first quarter of 2002. And as further indication of just how severe credit attrition has become 4 issuers defaulted on $4 billion of debt in 1H02 within one year of holding an investment grade rating. While that may not be considered good, it will soon pale into insignificance once the WorldCom statistics hit the tally in 2Q02 as WCOM defaulted on some $28 billion of debt and managed to do so within three months of holding an investment grade rating.

2002 Rated Defaulted Bond Statistics

Industry	Volumes ($bn)	Issuer Count
Telecom	$ 42.225	33
Retail	$ 12.320	10
Banking	$ 3.259	8
Media	$ 9.112	10
Consumer	$ 2.087	3
Technology	$ 0.773	3
Utilities	$ 1.032	2
Financial	$ 0.970	15
Transportation	$ 0.240	2
Industrial	$ 4.641	3
Total	**$ 76.658**	**89**

Source: Moody's

When all the above is taken into account the speculative grade dollar-volume-weighted default rate is up sharply, finishing June at 17.6% from 14.0% for 1Q02. One way of capturing just how severe the impact of the telecom sector meltdown has been is to calculate the default rate ex-telecom. Doing so sees the rate drop a full 740 bp from 17.6% to 10.2%. The degree to which the default story in 2002 has been penned by the telecom sector can also be seen in the industry analysis. With an economy that has been struggling since March 2001 and with the developing crises in emerging markets, there have been many sources of negative pressure on credit quality but for sheer magnitude, nothing comes close to the telecom washout, which alone has accounted for more than 50% of defaulted volume in the last six months.

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