MOODY'S

Credit Strategy

EUROPE CREDIT STRATEGY

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ABOUT

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UK Credit Review & Outlook

Cycle Bottom May Be Taking Shape for UK Corporate Credit Risk

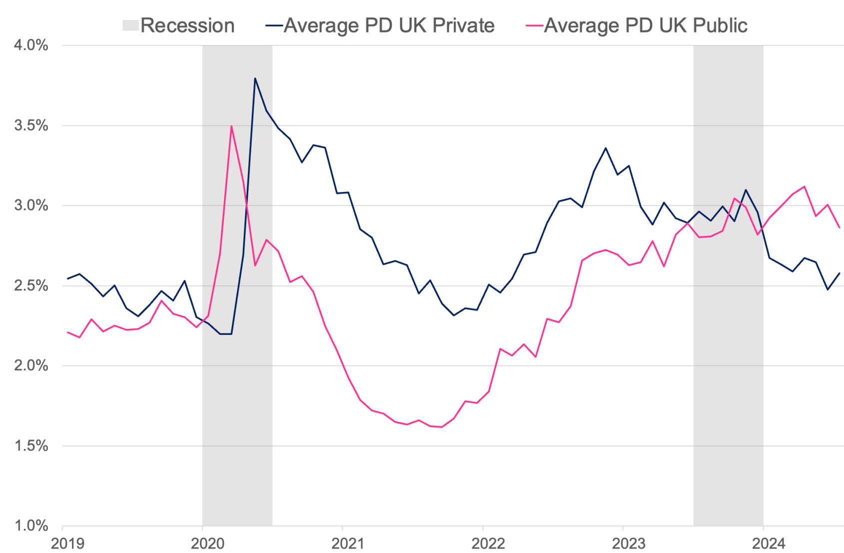
But the path to sustained lower credit risk may not be direct or smooth

Key Take-Aways:

- The outlook for UK corporate credit risk is cautiously optimistic, but the year-ahead outlook does not indicate a peak or sustained easing of credit risk until the latter part of 2025, as headwinds to improvement remain.
- Credit risk for UK private companies edged down in the first half of 2024, with the average probability of default easing to 2.7% as of July from 3% in December 2023. For public companies, the average PD was 2.8% as of July, within its range since mid-2023.
- The realized default rate for Moody's-rated UK companies may trend down towards 1% over the next year from its current 1.3%.
- Seven industry sectors saw their credit risk fall over the past 12 months compared to 13 that deteriorated, indicating a broad-based improvement in credit risk for public companies in the UK has yet to take hold. In a positive sign for UK credit risk, the share of firms with high or severe early warning signals has fallen since the fourth quarter 2023.

FIGURE 1 After a technical recession in the last half of 2023, UK corporate credit risk may be showing signs of topping out

Average 1-year probability of default (PD), monthly



Data source: Moody's EDF-X platform.

Cautious Optimism – Emphasis on the Caution

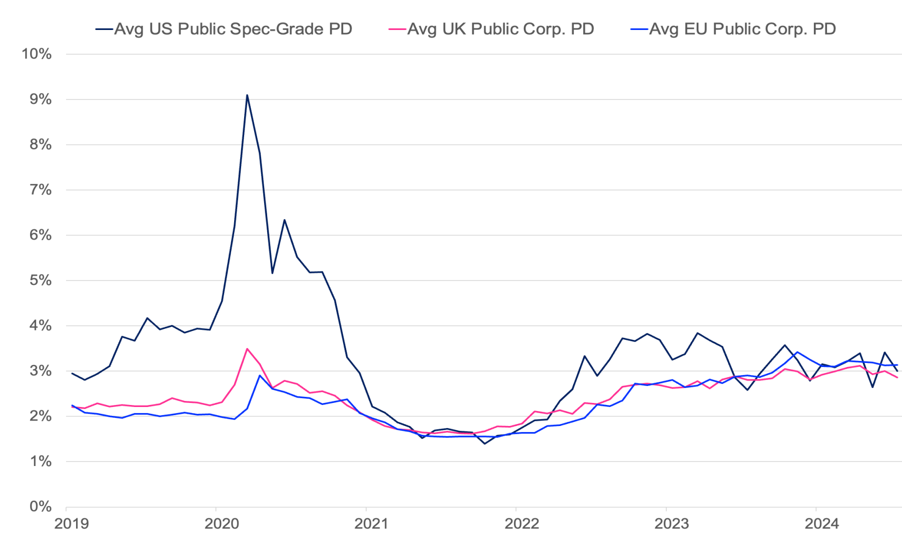
The credit risk of UK companies appears to be showing signs of plateauing, but Moody's year-ahead forecast does not yet indicate a sustained easing of credit risk until the latter part of 2025. Credit risk measures came in mixed in the first seven months of 2024, with the average probability of default for UK public and private companies moving in opposite directions. Figure 1 shows the average one-year ahead probability of default (PD) for UK private and public companies from 2019 to July 2024.[1] These time series plot *expectations* for the average level of corporate credit risk over the next twelve months, not realized default rates. Credit risk for private companies edged down to 2.6% as of July from 3% in December 2023. For public companies, credit risk has been range-bound between 2.8% and 3.1% since May of 2023. The average PD for public companies was 2.9% as of July 2024.

The data in Figure 1 shows that UK-based companies weathered the technical recession in the latter half of 2023 reasonably well. The average risk of default for both public and private firms was virtually unchanged in the last two quarters of 2023, despite GDP growth registering -0.1% in Q3 and -0.3% in Q4. Yet, the first quarter 2024's stronger than expected +0.6% GDP print – the strongest growth since Q4 2021 – has also failed so far to materially bend the trajectory of credit risk across all companies. Private companies seem to have benefited most from the recent show of economic resilience, and although credit risk for public companies did not rally in sympathy, it has nonetheless been stable. To put these figures into context, the one-year probability of default for UK corporates has averaged about 2.8% since 2004. So while credit risk for public companies remains somewhat elevated relative to the levels just prior to and immediately after the pandemic shock, it has been hovering in the range of its historical average since early 2023.

Changes in the average PD of public companies historically tends to lead changes in private company credit risk. This leading relationship is visually apparent in Figure 1. Moody's PD measures for both private and public companies incorporate forward-looking market information, but the metric for public companies, which tend to be larger and have traded equity and debt, responds to changes in expected credit risk faster. If that leading relationship holds up, we may see the average PD for private firms tick back up again in the coming months, or move sideways until the average PD of public companies begins to show a downward trend.

FIGURE 2 Credit risk for public companies across the UK, the US, and Europe has converged

Average 1-year probability of default (PD) for public companies, monthly



The UK's strong 1Q GDP growth has so far not materially bent the trajectory of corporate credit risk.

Data source: Moody's EDF-X platform.

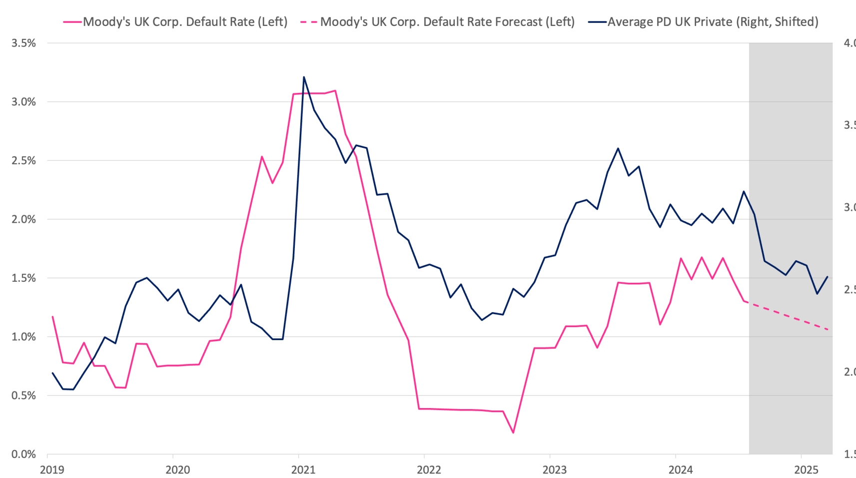
[1] The average one-year ahead PDs are calculated from Moody's EDF-X platform, which includes data on over 75K public and 44M private entities with detailed financials, 4M with payment data, and 98M inactive entities including those in default, merger/take-over status for more than 200 countries/territories globally. Learn more about [EDF-X.](EDF-X.)

The trend in credit risk for UK public companies has converged with those of other western economies. The times series of average PDs for the US non-investment grade public company, UK public company, and Western Europe company portfolios have converged to a level of around 3% as of July, as shown in Figure 2. The convergence and the level of risk implied by these forward-looking forecasts of credit risk suggests a careful balancing of two tidal forces: interest rates that may be seeing their tightening cycle peaks and economic growth, which has proved resilient but is increasingly seen as at-risk. The Bank of England's August 1 rate cut puts it in the club of five central banks that have recently lowered policy rates (that group includes Canada, the Euro Zone, Switzerland, and Sweden). At its most recent meeting, the Fed signaled the potential of a rate cut in September.

The trailing 12-month default rate for Moody's-rated UK debt issuers ticked down to 1.3% in July from 1.7% in January. Moody's Ratings' default rate is one of the market's key barometers of corporate credit risk. Although a lagging indicator of financial health, the realized default rate is helpful for gauging trend. Figure 3 shows the average PD for UK private companies (the same as in Figure 1) and Moody's Ratings' trailing 12-month default rate for rated UK debt issuers. [2] The average PD for private firms shows a strong leading relationship to the realized Moody's default rate, leading changes by nine to twelve months. In the graph we have shifted the average private company PD forward by nine months to emphasize that relationship and highlight the potential projected path of the Moody's default rate. Based on the correlation in changes of the two time series, we project that the UK default rate may drift down to 1.1% by the first quarter of 2025.[3]

FIGURE 3 Moody's Ratings' default rate for UK debt issuers may see further improvement

Average 1-year probability of default (PD) for private companies (shifted) and Moody's trailing 12-month default rate, monthly



Private firm credit risk shows a strong leading relationship to Moody's default rate, pointing toward a level of 1% over the next 12 months.

Data source: Moody's EDF-X platform, Moody's Ratings.

While the data we have discussed so far give reasons for cautious optimism, our longer-run, scenario-based projections for corporate credit quality indicate that the path to sustained lower credit risk may not be direct or smooth. We derive our longer-run forecasts of the average probability of default by conditioning the measures on two economic scenarios.[4] The baseline scenario is the most likely expected set of economic conditions, some of whose key assumptions as of the time of this report include GDP growth below potential, a moderate

[2] Moody's Rating's trailing 12-month default rate is based on counts of issuers, not volume of debt. The average PD for private companies is derived from Moody's EDF-X platform and includes more than 270,000 UK companies.

[3] The projected trend of the Moody's default rate in Figure 3 is not a forecast made by the ratings agency. It is based only on the correlation between the average private company probability of default and the realized historical default rate.

[4] The full description of Moody's economic scenarios, as well as other alternative scenarios can be found in Moody's monthly economic release "U.S. Macroeconomic Outlook Baseline and Alternative Scenarios." The conditional average PDs shown in Figure 4 are based on the economic scenarios in the July 2024 release.

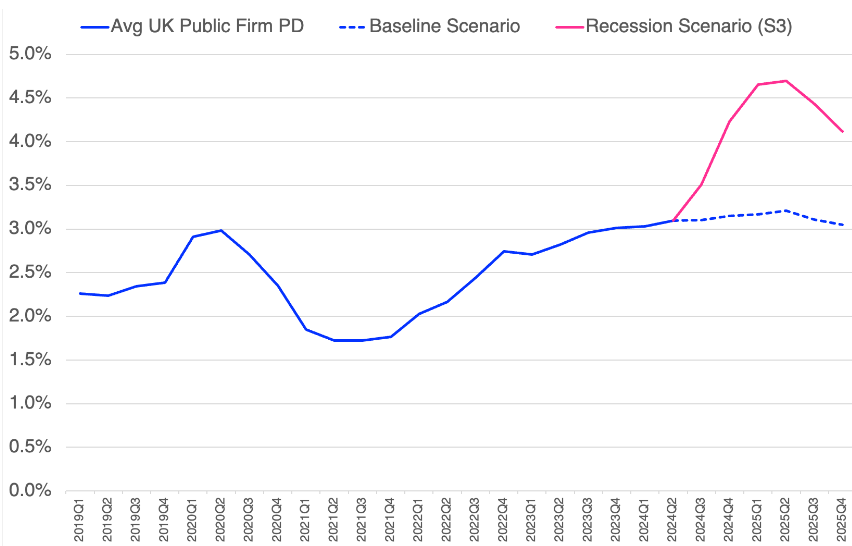
uptick in the unemployment rate, and a gradual easing of the BOE policy rate. The recession scenario (S3), a much less likely but plausible scenario, envisions a situation where real GDP declines by 0.1% in 2024 and by 3.9% in 2025.

Figure 4 shows the scenario-conditioned average PDs for UK public companies through the end of the fourth quarter 2025. Moody's forecasts a 1.3% chance of a recession in the UK over the next twelve months, and under that scenario the projected average one-year PD for public companies would increase to 4.7% in the second quarter 2025. That represents a level of expected credit risk exceeding that reached at the peak of the pandemic and not seen since the GFC. However, it is also a level of risk consistent with a garden variety recession, such as 2001, rather than a catastrophic GFC-level event. The first quarter's impressive GDP growth has significantly reduced the likelihood of such a scenario.

Under the baseline economic scenario, the projected average PD peaks at 3.3% in the second quarter of 2025, then subsides to 3.1% by the end of the fourth quarter 2025. This projection of credit risk is only slightly outside the range the average PD has trended since the middle of 2023 (as we pointed out above). It also implies that the recent easing of credit conditions we see in the recent data (Figures 1, 2, and 3) may not yet signify a bona fide peak, and that the health of the economy and resolution of uncertainty about the future path of interest rates will be critical for assessing whether credit risk has indeed crested. A higher-for-longer rate path is one of the strongest headwinds for the improvement of public company credit risk.

FIGURE 4 Economic forecasts imply that credit risk may not top out until Q2 2025

Average 1-year probability of default (PD) for public companies, quarterly



Below potential economic growth and a higher-for-longer rate path are the strongest headwinds for the improvement of UK public company credit risk.

Data sources: Moody's EDF-X platform, Moody's Economic Scenarios.

Mixed Sector Performance, But Early Warning Signals Show Improvement

The mixed picture for the UK corporate credit risk outlook is also evident at the industry sector level. More industry sectors experienced an increase in forward-looking average credit risk over the past twelve months than experienced an improvement. Figure 5 charts the average PD levels for the UK public company portfolio for the most recent quarter, the previous quarter, and the year-ago quarter for 20 industry sectors. The graph also shows the year-over-year change in PD for each sector on the bar graph on the right. These data points represent expectations about the one-year ahead risk of default for each of these industry sectors.

Overall, the data in Figure 5 is further evidence that a broad-based improvement in credit risk for public companies in the UK has yet to take hold. Seven industry sectors saw their average credit risk improve over the past twelve months compared to 13 that deteriorated. The sectors exhibiting the most deterioration in the second quarter were also the ones where the level of credit risk is also relatively high, and includes Aerospace and Defense, Natural Resources, and Consumer Non-Durables and Services. Banks and REITS also saw their average PDs move higher on a YoY basis, but given their low PDs small nominal moves translate into potentially large percentage changes. Seven industry sectors experienced a 20% or higher increase in the average PD, the continuation of a downward trend in that number that we have observed since the fourth quarter of 2023. On a quarter to quarter change, the balance was more even, with ten sectors improving and 10 deteriorating.

FIGURE 5 More sectors experienced increases in credit risk among UK public companies

Average 1-year-ahead PD levels and annual change by industry sector for UK public companies, quarterly

Data source: Moody's EDF-X platform.

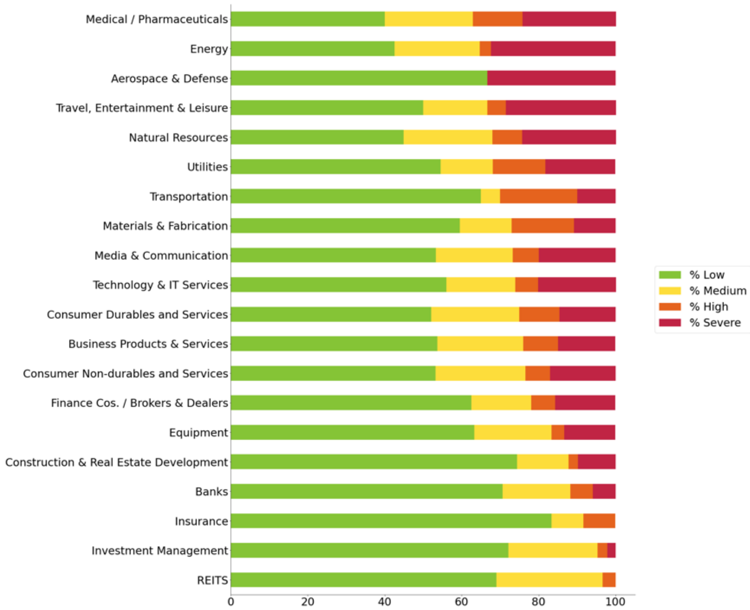
Changes in average PD are essential measures for monitoring and comparing credit risk across industry sectors. But when it comes to proactively identifying which exposures represent material risk requiring immediate attention, credit measures alone are insufficient because they do not tell you when to get worried. Moody's Early Warning System (EWS) was designed to identify when a change in a company's PD becomes a significant risk. The EWS uses two key measures to identify companies as low, medium, high, or severe risk over the next 12 months. The two measures are (1) whether a company's forward-looking PD measure is above an appropriate sector early warning trigger level; and (2) the change in the company's PD-implied rating. Moody's research has shown that public companies with high or severe early warning signals are 25 times more likely to default over the next year than firms with low early warning signals.

In a positive sign for UK credit risk, the share of firms with high or severe early warning signals has fallen since 2Q 2023.

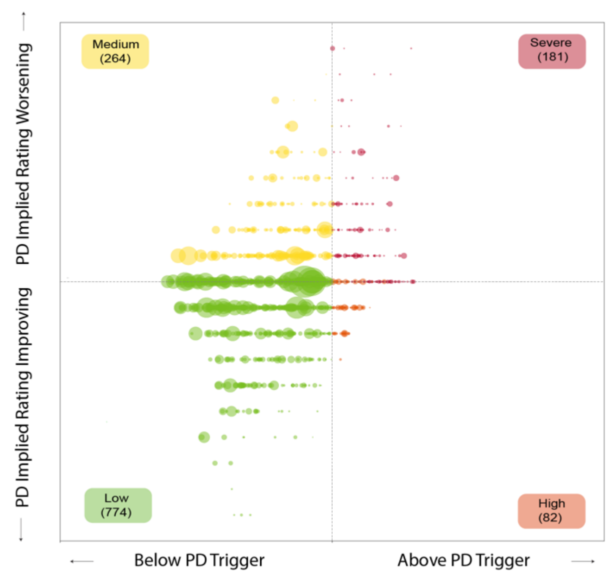
Not all of the increases in average PD across sectors we see in Figure 5 translate into risks triggering an early warning alert. In Figure 6A we graph the distribution of early warning signals for the same 20 industry sectors above. The list of sectors in Figure 6A is sorted by the industry sectors showing the highest percentage of high or severe early warning signals. In some cases, we do see sectors that exhibited a sharp increase in average credit risk also show a relatively high share of high/severe early warning signals, such as the Energy, Aerospace and Defense, and Travel, Entertainment and Leisure sectors. Other sectors, such as Medical/Pharmaceuticals, show up as high on the EWS list, but did not experience as large a change in PD.

FIGURE 6 The number of UK companies with high/severe early warning signals has fallen since Q4 2023

6A EDF-X Early Warning Signals by Industry Sector



6B EDF-X Early Warning Signals for all UK public companies



Data source: Moody's EDF-X platform.

Company size is strongly correlated with early warning status. Figure 6B shows the early warning signal distribution for all UK public companies as of July (as well as showing the two dimensions of early warning: PD vs. trigger on the horizontal axis and change in implied rating on the vertical axis). The size of each bubble in the graph is proportional to company asset value. Companies falling into the high (orange) and severe (red) EWS categories are generally smaller than those in the medium (yellow) and low (green) risk categories.

FIGURE 7 More UK public companies transitioned to less risky EWS categories over the past 12 months

EDF-X Early Warning Signals for all UK public companies, July 2023 vs. July 2024

	July 2024 EWS			
July 2023 EWS	Low	Medium	High	Severe
Low	70%	26%	0%	4%
Medium	65%	25%	2%	8%
High	45%	0%	23%	32%
Severe	20%	0%	30%	50%

Data source: Moody's EDF-X platform.

Across all UK public companies, the share of firms with high or severe early warning signals has fallen since the fourth quarter 2023. Moody's EWS categorized 263 companies as high or severe risk as of July 2024. That number is down from the fourth quarter 2023 when 320 companies were flagged with the highest early warning signals. Indeed, a healthy share of UK public companies have transitions to less risky EWS categories over the past twelve months. The transition matrix depicted in Figure 7 shows movement of UK public companies across the EWS categories over the past year. 65% of Medium, 45% of High, and 50% of Severe flagged UK public companies moved a lower-risk EWS category since the second quarter of 2023.

Summary

The outlook for UK corporate credit risk is cautiously optimistic, though a good amount of emphasis on the caution part is still warranted. Measures of credit risk for UK companies came in very mixed in the first seven months of the year, showing easing credit risk for private companies but sideways movement for public companies. Given that the forward-looking average probability of default for public companies historically leads that of private companies, we need to wait for a corroborating signal from the UK public company series to definitively call a peak. Nevertheless, based on the correlation between the average PD for private firms and Moody's realized trailing 12-month default rate for UK issuers, we may see a reduction on the number of rated defaults over the next year.

Credit risk projections conditioned on macroeconomic scenarios also indicate that we may not see a peak in UK corporate credit risk until the first half of 2025. Despite a cracking first quarter GDP reading, UK economic growth is expected to remain below potential, while the BOE is expected to lower its policy rate only gradually going forward. That relatively more UK public companies transitioned to less risky EWS categories than transitioned to higher EWS categories is another positive sign for the trend in credit risk. While there are positive signs that the cycle may be beginning to bottom, the overall credit outlook remains cautious, and close monitoring of both public and private company risk indicators will be essential in the coming months.

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