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Buy or sell: the downgrade dilemma

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High yield investors are worried about the scale of downgrades in the BBB area of the investment grade credit market; and the possibility that fallen angels could swamp the relatively smaller high yield market. In this report, we consider the scale of the potential downgrades and their likely impact on the high yield space. Perhaps surprisingly, we see such downgrades as positive for the high yield market as they will diversify and improve the quality of the issuer base.

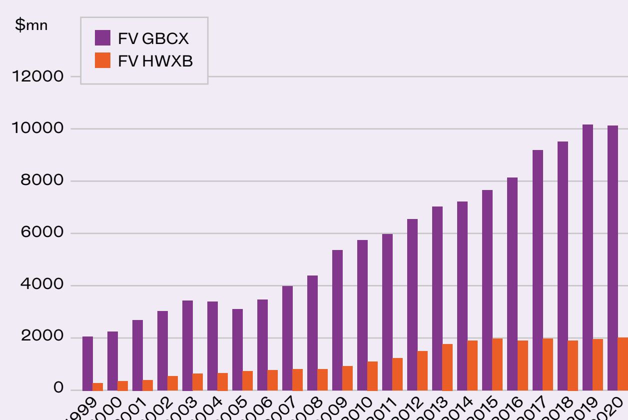
The year started off with enthusiasm as markets extended the longest bull run in recent memory. There were concerns about the rally running out of steam, but the extent of the subsequent reversal was beyond most investors' expectations.

As coronavirus fears picked up, governments took drastic measures to slow the spread of this contagion. This led to confinement and social distancing measures not experienced in living memory. With consumers in lockdown, businesses experiencing significant volume reductions and global supply chains under pressure, the high yield market took a turn for the worse from 21 February with high yield and investment grade spreads gapping to c. 1,200 basis points (bps) and c. 350bps, respectively.

To make matters worse, the already challenged energy sector was hit with a supply dispute between Russia and Saudi Arabia, leading to further pressure across credit markets. Nearly all asset classes generated negative returns during this period. But just as quickly as the market had collapsed, so did it rally at an unprecedented rate as major fiscal stimulus packages were unveiled. Government support comprised previously unheard of financial support to businesses and consumers.

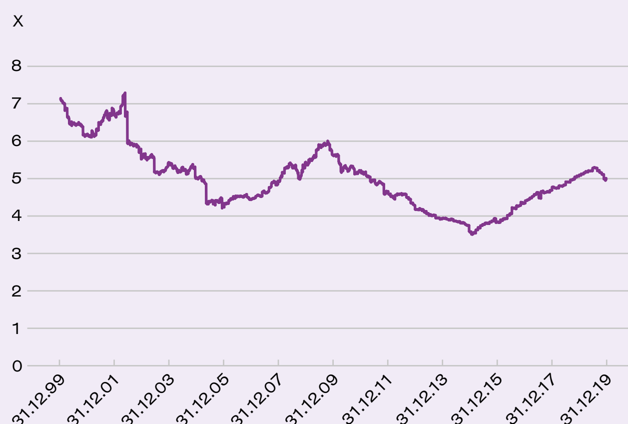
With credit now well off the lows, attention is turning back to credit quality and fundamentals and the potential impact to investment grade and high yield. Downgrade risk is of material concern, particularly given the exponential growth in the asset class over the past two decades combined with the relative market sizes. Investment grade BBBs in the US now represent around $2.5tn in corporate bonds outstanding, while the global BBB

Figure 1: Growth in face value of the global investment grade and global high yield markets



Source: ICE BAML Global investment grade corporate index GBCX and ICE BAML Global high yield index HWXB

Figure 2: Ratio of face value of Global IG/Global HY



Source: ICE BAML Global investment grade corporate index GBCX and ICE BAML Global high yield index HWXB

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corporate debt outstanding is over $4.5tn in bonds compared with a $2tn global high yield market. The BBB segment has grown through a combination of rising leverage, more aggressive financial policies, M&A and positive ratings migration. Both high yield and investment grade have grown markedly, but the growth of the BBB market has been particularly notable.

When you compare the growth of the BBB market relative to high yield over a longer period, the rate of growth has been largely similar, with the BBB segment being approximately 1.2 times the high yield market. However, with BBB debt increasing at a rapid pace over the past five years, and now the greater risk of a downgrade cycle, investor concerns have increased with questions asked about the quantum of downgrades that the high yield market could absorb. (See Figure 3 and Figure 4.)

The concerns

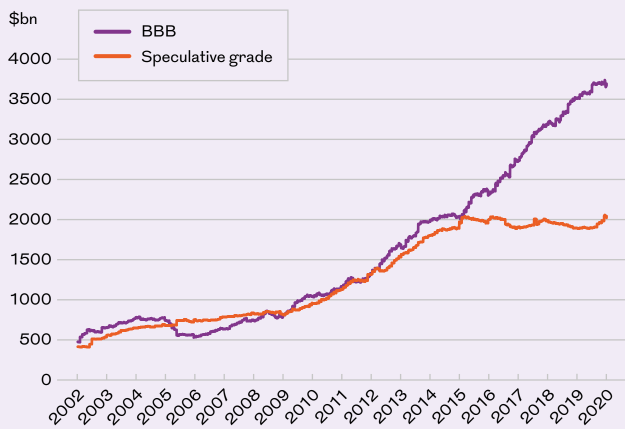
What is the size of the BBB segment that could be downgraded?

This is a key question. To calculate the extent of likely downgrades, we need to look at the composition of the BBB category as well as historical precedents. Using a lens on both historical downgrades and sectoral composition, we estimate c. $700-800bn.

Composition

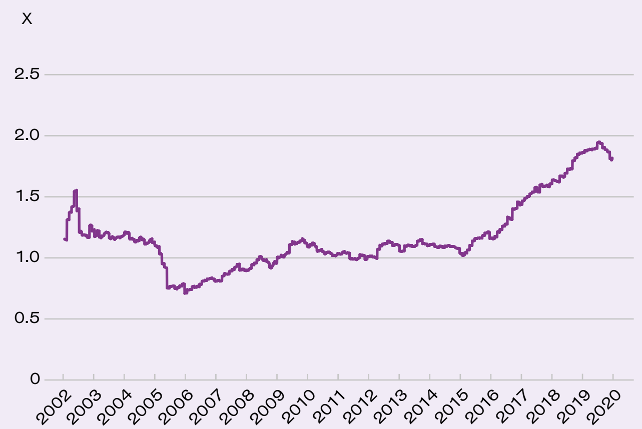
The ratings category most at risk of downgrade is the BBB category (S&P BBB Pulse – 9 April 2020). When we look at the composition of investment grade debt across ratings and sectors, the outlook doesn't appear materially different to previous shocks.

Figure 3: Growth in face value of global BBB and global high yield markets



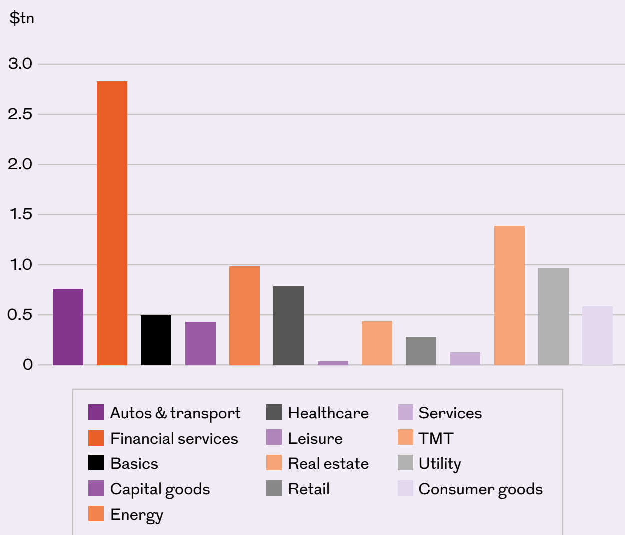
Source: ICE BAML BBB Index GFIQ and Global High Yield index HWXB

Figure 4: Ratio of BBB to global high yield over time



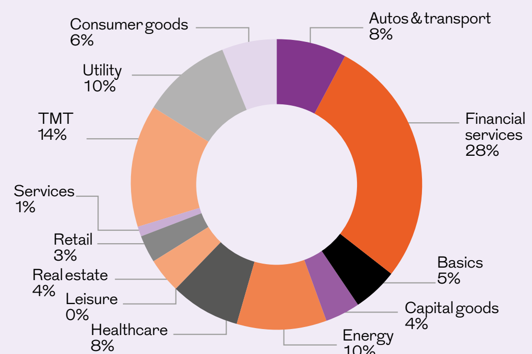
Source: ICE BAML BBB Index GFIQ and Global High Yield index HWXB

Figure 5: Investment grade market by sector ($)



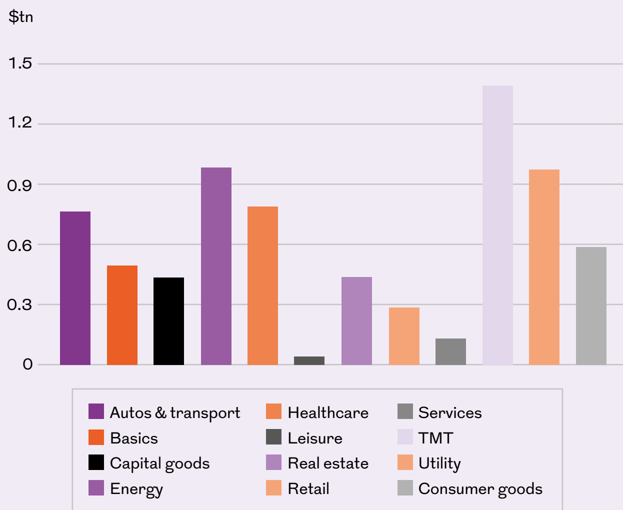
Source: ICE BAML global broad market corporate excluding sub financials index GBCX and RLAM estimates

Figure 6: Investment grade market % of total



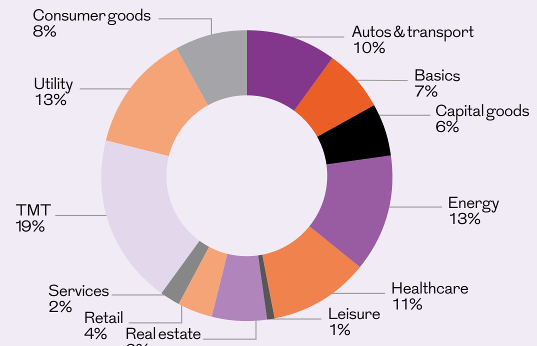
Source: ICE BAML Global investment grade corporate index GBCX

Figure 7: Investment grade market by sector ($) (ex financials)



Source: ICE BAML Global investment grade corporate index GBCX

Figure 8: Investment grade market % of total (ex financials)



Source: ICE BAML Global investment grade corporate index GBCX

Looking at the Global Investment Grade Index, this comprises c. $10.5tn of debt (face value). However, 28% of this is issued by financial services companies. Looking at the corporate bond market excluding financials the approximate value of this index would be c. $7.5tn. This a more relevant universe for our high yield and MAC funds as we focus on corporate (non-financial) debt.

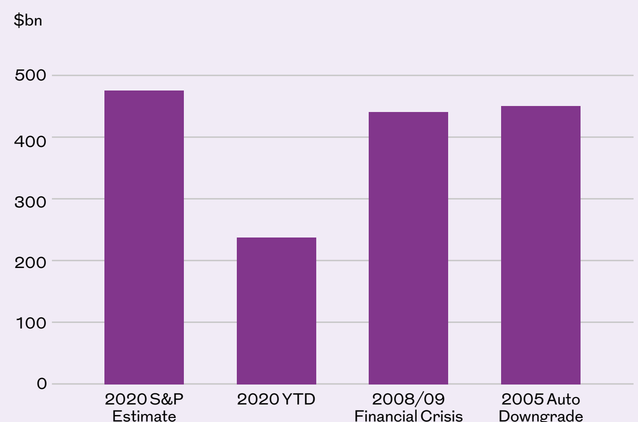
As figures 5 through 8 highlight, once the financials debt is excluded, corporate debt distribution is primarily across five core sectors. Also, three of these sectors (TMT, utilities and healthcare) are more defensive and are therefore less likely to be impacted by downgrade risk. This leaves us with energy and autos/transports as the two higher risk sectors in the top five (c. $1.7tn). The other cyclical sectors, including basics, leisure, retail and services, represent c. $950bn in debt. However, leisure and retail investment grade debt is much smaller in comparison at c. $320bn.

As we can see, the highest risk components of the investment grade index are much smaller. That said, there will be some volatility as fallen angels enter the high yield market, particularly if we experience a large inflow from cyclical sectors such as autos/transports and energy.

Historical investment grade to high yield transition

Ratings agencies and analysts estimate large-scale downgrades range from $500bn to $900bn. The sheer size of these estimates sounds concerning, but to put this into context, Figure 9 illustrates some of the major downgrade events that the high yield market has experienced over the last 20 years. It shows that in the US corporate bond market alone over $400bn of bonds were downgraded to high yield during both the 2008/9 financial crisis and when Ford and GM were downgraded back in 2005. These figures are similar to S&P's estimate of the amount of US investment grade bonds expected to be downgraded during 2020, which is $475bn (S&P BBB Pulse – 9 April 2020). Moreover, the high yield market is much larger now than it was in 2005 and 2008/9, and possibly better placed to absorb the large inflows.

Figure 9: US investment grade corporate credit largest downgrade transition to high yield ($bn)



Source: Standard & Poor's and RLAM estimates

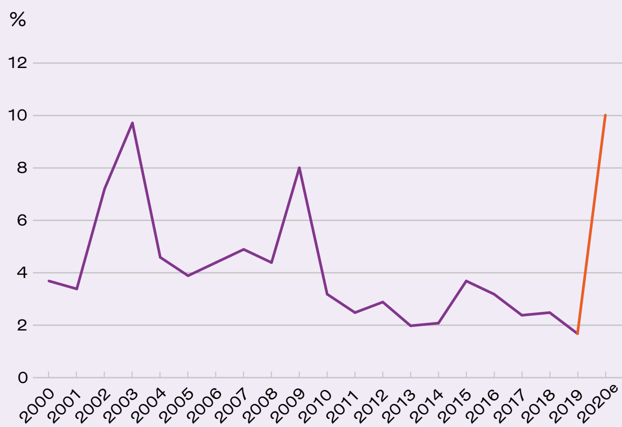
Our assessment

Historical basis

Historically, the average rate of global investment grade bonds downgraded to high yield has been approximately 4% by value (transition or fallen angel rate). However, during major events such as the autos downgrade and the global financial crisis this figure has approached 10%. If we take S&P's BBB corporate bond debt, which it estimates as 'at risk' debt of $640bn, and include a further $250bn in emerging markets-related corporate bonds, that would mean up to 8.5% of investment grade debt at risk of downgrade (fallen angel rate), which would be in line with past peaks. Figure 10 illustrates the historical fallen angel rate with the red part highlighting a potential of up to 10% for 2020, which would be in line with historical downgrade cycles.

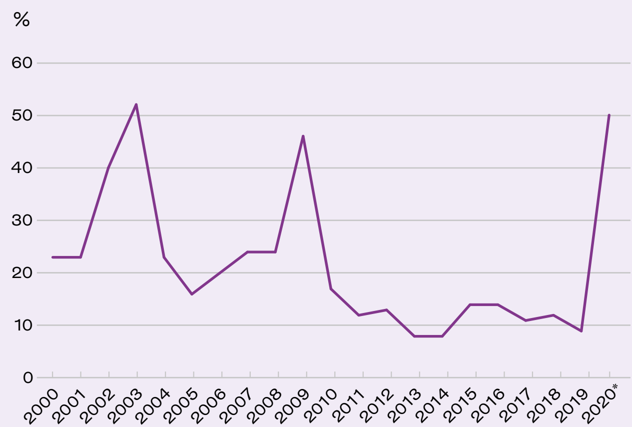
From a high yield perspective, the fallen angel debt would represent a fairly substantial portion of the high yield market (see Figure 11). If we use the average annual fallen angel rate to derive the percentage of debt that has historically entered the high yield market, it appears to be about 22%. However, during peak downgrade cycles as noted above, the percentage of high yield debt that is coming from such downgrades can be as high as 50%. This was experienced in 2003, following the TMT downgrade cycle and 9/11. Similarly, a downgrade rate of 10% of the current investment grade market into high yield would amount to 50% of the global high yield index, again in line with the recent peaks.

Figure 10: Weighted average annual fallen angel rate



Source: RLAM estimates and Standard & Poor's

Figure 11: Percentage of global high yield face value that is fallen angel



Source: ICE BAML Global High Yield Index HWXB, RLAM estimates and Standard & Poor's data.

* 2020 Estimate

Figure 12: Investment grade credit downgrade to high yield transition risk ($)

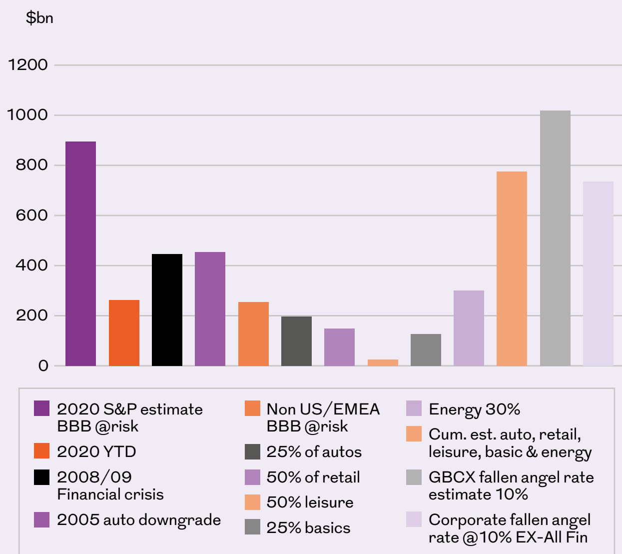
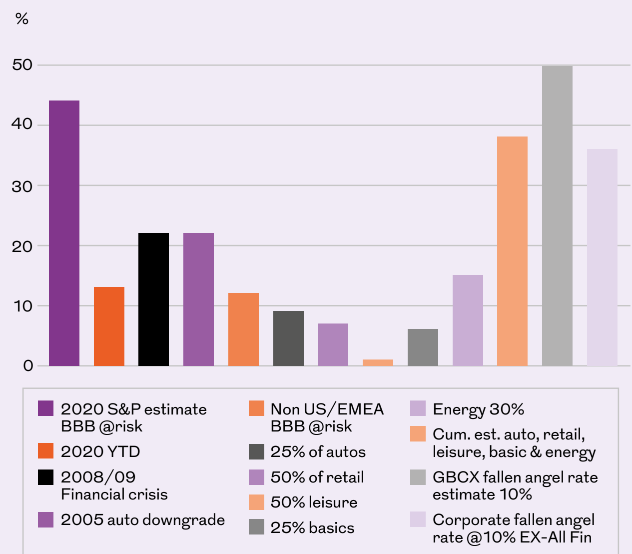


Figure 13: Downgrade impact as a percentage of current face value of high yield



Source: ICE BAML global broad market corporate excluding sub financials index GBCX, ICE BAML Global High Yield Index HWXB RLAM estimates and Standard & Poor's

Figure 14: Near-term debt maturity profile: current vs. estimated incremental $750bn of downgrades ($)

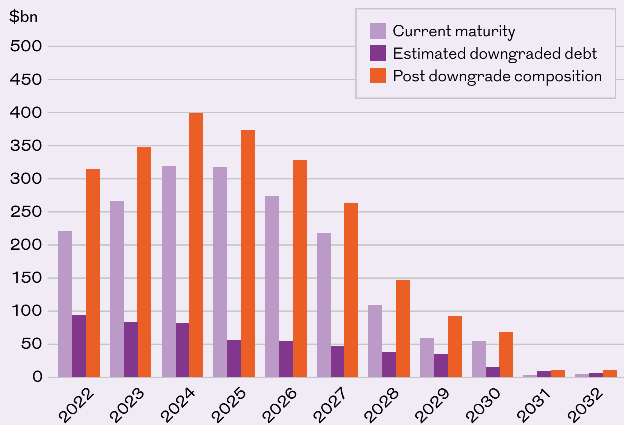
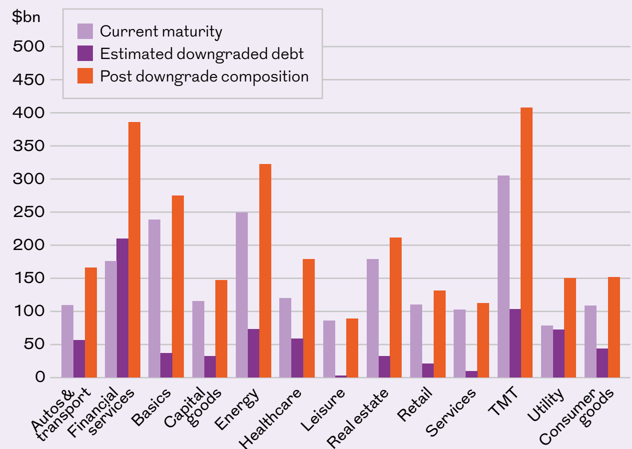


Figure 15: Estimated debt distribution by sector: current vs. following $750bn downgrade



Source: ICE BAML global broad market corporate excluding sub financials index GBCX, ICE BAML Global High Yield Index HWXB, RLAM estimates

Sectoral basis

To assess the potential range of the downgrade risk, we can expand the scenarios to outcomes based on historical events and sectoral distribution in the investment grade index.

Figures 12 and 13 illustrate this in two parts, the first being historical downgrade events along with S&P's current estimate of 'at risk' debt. The second part (the right hand side of the chart) illustrates the amount of debt at risk of downgrade based on some of our assumptions. As noted earlier, of the top five sectors in the investment grade index, three are more defensive and would likely face less pressure of downgrade – even if they did, they would have good cross-over investor support.

The more cyclical sectors, however, have a higher probability of downgrade. As a result, we can assume estimates on the percentage of each sector that will downgrade: if we assume 25% of all autos/transports, 50% of all retail, 25% of all basic and 30% of all energy debt in the index is downgraded, that represents $770bn of potential debt entering the high yield market. Additionally, if we assume a flat 10% downgrade rate across all sectors that would translate into c. $1tn of downgraded debt; excluding financial services companies, the quantum would be $730bn.

As a result, a reasonable estimate for a range of higher-risk downgrades appears to be c. $730-770bn. This would represent around 35% of the current global high yield market (face value). Although this sounds high, this would be in line with the peaks of previous market downgrade cycles.

What would be the impact?

High yield market composition post downgrade:

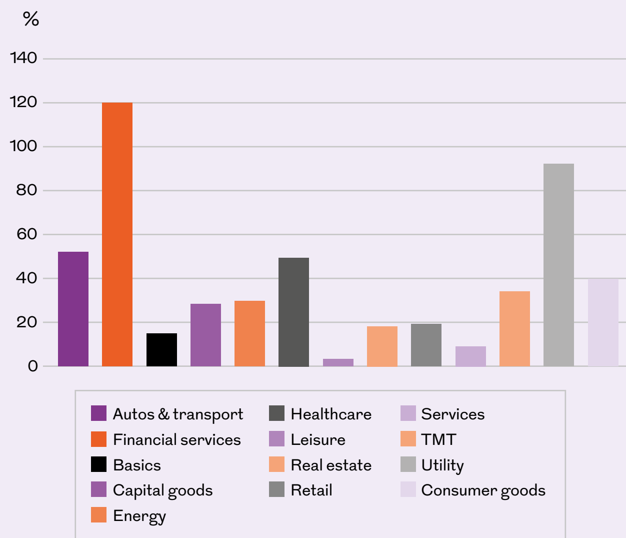
From a debt maturities perspective, we would see a considerable increase in the first couple of years, but this will gradually taper off as we get to the mid-part of the curve before increasing again due to the longer duration nature of current IG debt.

Despite the considerable increase in near-term high yield debt maturities following the downgrade event, the recently-announced Federal Reserve (Fed) programme to repurchase short-dated US bonds of fallen angels should be supportive to the high yield market and help to manage the absorption of this large quantum of debt. We will address the details of this later in this paper. Additionally, with estimated downgrade maturities skewed towards the front and tail ends, the maturing debt should be more manageable as fallen angel front-end maturities should benefit from the Fed programme. Figure 14 illustrates this skew towards front end and tail end maturities.

The post-downgrade sector composition also shows some notable changes to the debt distribution. In particular, we see a significant increase in some sectors which are much smaller in high yield than the investment grade market, such as TMT, autos, energy, utilities and healthcare. It is also worth noting that the incremental debt from sectors such as retail and leisure (first order pandemic affected) represent a smaller percentage of investment grade debt and therefore even larger downgrades from such sectors should be absorbable.

Excluding financials, the post-downgrade composition of sector debt would also look more similar to that of the investment grade market under this scenario. This also highlights that there will be considerable opportunities in historically less-cyclical, higher-valuation sectors, such as TMT and healthcare. This in turn could be supportive for high yield spreads by attracting investor interest from both high yield and investment grade investors.

Figure 16: Percentage increase in debt by sector based on RLAM estimates and $750bn in estimated downgraded debt



Source: ICE BAML global broad market corporate excluding sub financials index (GBCX), ICE BAML Global High Yield Index (HWXB), RLAM estimates

Technicals can also be supportive due to benchmarking and ETF needs. Furthermore, there may be several companies who may look to implement more conservative financial policies to help them reinstate their investment grade rating – particularly those who would benefit from shorter-term financing and commercial paper-type programmes.

Additionally, the high yield market will lose 20-25% of bonds through defaults over the next few years. This translates into a further $400bn to $500bn in non-performing debt that will exit the market and therefore improve the quality of the overall index. Moreover, the defaulted debt is likely to be skewed towards the more structurally challenged or cyclical sectors, paving the way for an improved overall composition of the index following the defaults.

Although $750bn in estimated downgrades would represent a sizeable element of the high yield index, the overall composition would be strengthened over the medium term. The net inflow into the index would be $250-$350bn, after the estimated $400-500bn exiting through defaults. Fallen angels will comprise credit with overall better balance sheets, higher ratings and a longer maturity profile compared to existing high yield composites. This coupled with a more favourable sector representation, including healthcare, TMT and utilities, should strengthen the composition of the index and support high yield spreads.

Mitigating factors

High yield flows have stabilised and the asset class is attractive on a relative value basis

General demand for high yield has been strong as evidenced by $1bn in year-to-date inflows, despite $17bn in outflows in March 2020; given where spreads are against expected default rates, we believe there is room for further compression.

Market expectations of defaults at the lower end accord with our estimate of c.20-25% of the asset class, so without downgrades the high yield market would shrink. Thus, the net impact of fallen angels and defaults in high yield will mean that the asset class is a net 10% larger than currently.

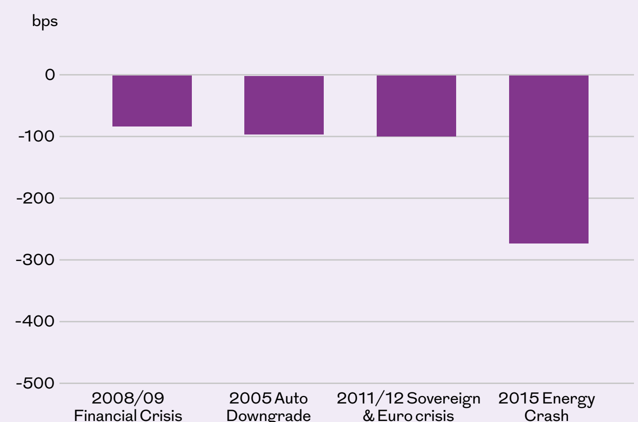
More liquid downgrade constituents reweight the market

Major downgrades can be supportive for the high yield market as the fallen angel credit qualities are often better than existing constituents. Additionally, investment grade bonds are often large capital structures that represent a larger portion of the index, therefore attracting a number of investors due to size and sometimes benchmarking requirements. The overall higher rating of fallen angels also tends to reweight the index towards the higher part of the ratings spectrum of BB against the lower single B and CCC categories.

Fallen angels have historically been good investments

Another interesting data point is illustrated in Figure 17. After a major downgrade event/cycle, credit spreads have normally rallied over the following calendar year. If we look at the past few events, we see that spreads have rallied from between c. 80bps to nearly 300bps in the calendar year following a material inflow of fallen angel debt into the high yield market. This can be attributed to the turning of the credit cycle, but also the composition of the revised index and index technicals. We are only one quarter through the current credit market retreat, so spreads have a long way to go to match historical compression trends.

Figure 17: Change in spread over calendar year following downgrade event



Source: RLAM estimates and ICE BAML High Yield Indices

Downgrades have been flagged for some time

Although the ratings agencies are taking a more proactive approach to downgrades during this credit cycle, the pace of downgrade still appears to be manageable. Concerns regarding rising leverage in BBBs, management financial policies and the end of the credit cycle have lingered for some time. As a result, some of the ratings migration risk was starting to reflect in weaker credits and sectors.

Policy support

Finally, and most importantly, monetary and fiscal policy measures have also been supportive of the credit markets. The Fed and US Treasury's announcement of the Primary and Secondary Corporate Credit Facilities (PMCCF/SMCCF) to purchase corporate securities, including short-dated investment grade bonds and certain ETFs, demonstrated the willingness of governments and central banks to step in and bolster the credit markets. The expansion of the $750bn programme also included recently downgraded US companies illustrating the magnitude of the steps that US policy makers are prepared to take to support the economy.

Moreover, the Cares Act, which was signed into law on 27 March, provided a $2.3tn economic relief package, equivalent to 10% of US GDP for 2019. The package had a wide mandate with the aim of aiding industry, consumers, small businesses and local governments. These policy measures helped to reopen the new issue corporate bond market, enabling issuers to raise liquidity. This package includes the PMCCF and SMCFF. These facilities will be funded by the US Treasury with an initial $75bn of equity into an SPV operated by the Fed, expandable up to a combined total of $750bn. The eligibility criteria for the PMCCF and SMCCF are detailed in the appendix.

Therefore, a flexible policy approach implemented by the Fed that gives it the ability to buy front-ended fallen angel debt means that our estimate of $750bn in gross downgrades should be manageable. Additionally, adjusting for a further $400-500bn of high yield debt that would exit the high yield index following default further limits the stress from inflows into the high yield index.

European Union (EU) credit expansion

The European Central Bank (ECB) has also taken measures to extend collateral eligibility to include high yield. This extended its plan from early April for temporary collateral easing measures in order to avail liquidity operations including TLTRO, LTRO and the Pandemic Emergency Purchase Programme. The aim of the programmes was to ease the condition at which credit claims are accepted as collateral (see appendix for further details).

The ECB also left the window open to further measures if needed. The aim was to ensure that banks have sufficient assets that they can post as collateral to access liquidity and pass along the benefits to the broader economy. Although there is less clarity regarding its extended programme compared to the Fed's, the ECB is demonstrating that it will take whatever steps are necessary to support the economy. This along with EU relief programmes will be supportive for European high yield and recently downgraded bonds.

Conclusion

We estimate that up to $750bn of investment grade bonds could be downgraded to high yield; however we don't think there will be a material impact on spreads as this would be within market expectations. Also, with defaults likely to comprise $500bn, the net impact is likely to be only around $250bn. While market uncertainty is likely to persist, the combination of quick fiscal and monetary policy responses coupled with the changing dynamics of the high yield and investment grade compositions and investor base, means that the high yield market is better positioned to absorb the pressure from ratings migration, even in this unprecedented downturn.

As a result we believe opportunities will persist in the high yield asset class and, rather than being seen as a negative, the downgrades should be seen positively in diversifying and improving the quality of the issuer base of the high yield market.

Appendix

Details of US and EU policy support

The Fed's announcement of the Primary and Secondary Corporate Credit Facilities (PMCCF/SMCCF) to purchase corporate securities, including short-dated investment grade bonds and certain ETFs, demonstrated the willingness of governments to step in and bolster the credit markets. These facilities will be funded by the US Treasury with an initial $75bn of equity into an SPV operated by the Fed, expandable up to a combined total of $750bn.

The PMCCF can:

- Purchase qualifying bonds as the sole investor in a bond issuance or portions of bonds and loans at issuance from eligible issuers with maturities of four years or less. PMCCF's participation is capped at 25%.
- Eligible issuers must be:
  - a US business, or have significant operations in or have the majority of its employees in the US; and,
  - rated at least BBB-/Baa3 by a major rating organisation or multiple major agencies, as of 22 March 2020; or if rated at least BBB-/Baa3 as of 22 March 2020, but subsequently downgraded, must be rated at least BB-/Ba3 (minimum of two agencies if rated by multiple agencies at time of purchase)
- Interest rates on the instruments will be determined by market conditions plus an additional 100bps facility fee for the PMCCF's share
- Issuers cannot borrow more the 130% of their outstanding bonds and loans during the period from 22 March 2019 to 22 March 2020. The issuer can raise debt to refinance maturities up to three months before the maturity date, and to issue additional debt at any time, provided the issuer's rating is reaffirmed at BB-/Ba3 or above

The SMCFF can:

- Purchase corporate debt issued by eligible issuers in the secondary market
  - eligibility includes corporate bonds as well as eligible corporate bond portfolios in the form of ETFs
  - instruments must have a remaining maturity of five years or less
  - For ETFs, the SMCCF may purchase US-listed ETFs "whose investment objective is to provide broad exposure to the market for US investment grade corporate bonds."
  - SMCCF eligibility requirements are similar to those of the PMCCF
  - purchase no more than 10% of an issuer's maximum bonds outstanding on any date between 22 March 2019 and 22 March 2020, and will not purchase shares of a particular ETF if after such purchase it would hold more than 20% of such ETF's outstanding shares.

These facilities are also limited to purchasing up to 1.5% of the combined potential of both facilities with respect to any one issuer and the facilities will continue to purchase loans and bonds until 30 September 2020, unless otherwise extended.

ECB credit expansion

The ECB has also taken measures to extend collateral eligibility to include high yield. This extended its plan from early April for temporary collateral easing measures in order to avail liquidity operations including TLTRO, LTRO and the Pandemic Emergency Purchase Programme. The aim of the programmes was to ease the condition at which credit claims are accepted as collateral.

The statement on extension of the early April collateral easing measures said that the ECB would grandfather until September 2021 eligibility of marketable assets used as collateral in Eurosystem credit operations falling below current minimum credit quality requirements. Specifically, it extended eligibility to marketable assets and issuers that met the minimum credit quality eligibility on 7 April 2020 (BBB- for all assets except asset-backed securities (ABS), so long as the rating stays at or above BB):

- The grandfathered assets would need to meet existing collateral requirements
- Future issuances from grandfathered issuers would be eligible
- Assets which fall below the minimum credit quality requirements will be subject to hair cuts
- Eligible covered bonds will also be grandfathered
- Currently eligible ABS which had maintained an A- ratings threshold would also be grandfathered up to a rating of BB+.

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