FIRST PRINCIPLES CAPITAL MANAGEMENT

"Fallen Angels or Red Herrings?"

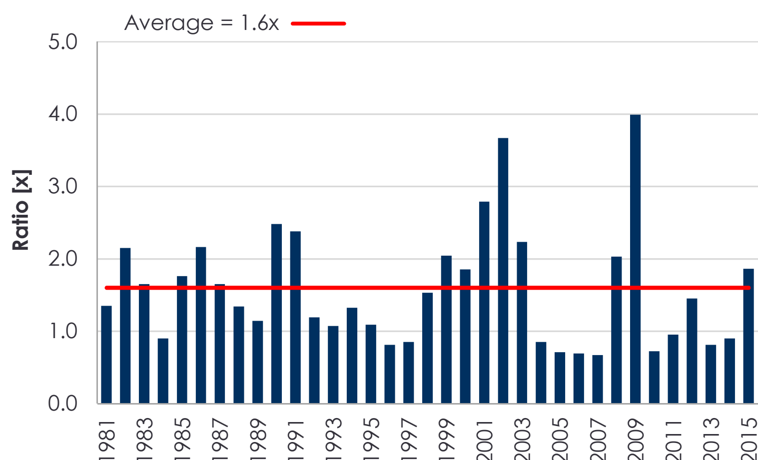
October 2019

The confluence of continued market volatility with an aging credit cycle have accentuated credit investors' focus on downward rating migration in the investment grade corporate credit market. While most of the attention in the investment grade market has been concentrated on fallen angels, downward rating migration within higher-rated categories of the investment grade corporate index garners much less attention. Nonetheless, the proportion of single-A and higher rated debt in the Bloomberg Barclays U.S. Investment Grade Corporate Index has persistently declined over the past few decades, thereby significantly reducing the universe of higher-quality investment opportunities. Downward rating migration can have important implications for institutional investors as it pertains to portfolio construction and bond benchmarks. Key questions investors should ask include: what is currently driving credit migration, what are the segments most at risk, and are investors adequately compensated for the increased credit risk from downgrades?

Cyclical and structural drivers of ratings migration

It has been well documented that economic and credit cycles often coincide. Like defaults, ratings migrations exhibit a strong correlation with respect to macroeconomic conditions and are inextricably linked to the state of the credit cycle. Chart 1 portrays the ratio of downgrades to upgrades in the Barclays Global Credit universe over a 34-year period. One can observe credit cycles coinciding with economic cycles, e.g., the early 1990's, the early 2000's (technology bubble), and the Global Financial Crisis of 2008. The average ratio of downgrades to upgrades was 1.6x, pointing to credit quality being negatively asymmetric. In addition to organic rating migration through credit cycles, there has been a noticeable structural deterioration in credit quality in the corporate debt market.

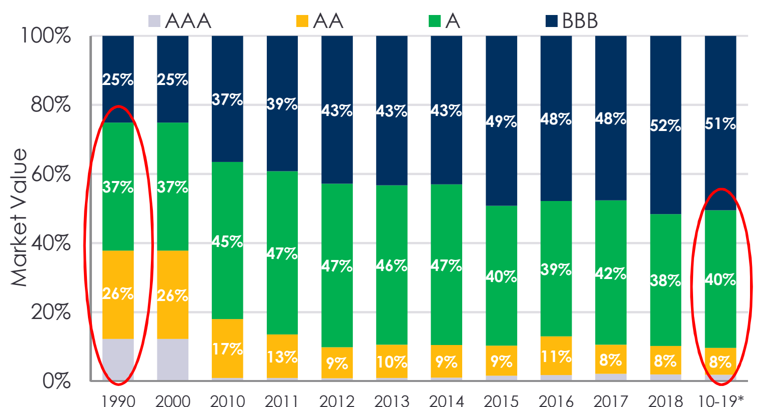
Chart 1: Downgrade/upgrade ratio of global IG credit index



Source: Barclays

Chart 2 portrays the gradual deterioration of the investment grade corporate index' credit quality over the past three decades. During that timeframe, the combined proportion of single-A and higher-rated debt receded from 75% of the index to 49%. The change is even more dramatic when looking at the issuers' count and composition: in 1990, 114 US issuers were rated AAA (including a variety of corporates such as Exxon, Johnson & Johnson, IBM, GE, and Pfizer) compared with only nine today. Of these nine issuers, only two are corporates (MSFT and JNJ), while the rest are universities! It is worth mentioning that this downward shift in quality is not only symptomatic of deteriorating fundamentals but also a product of innocuous or even positive drivers, namely a greater number of BBB rated corporates issuing debt alongside an increasing number of rising stars.

Chart 2: Downward rating migration — IG corp index



Source: Barclays, Bloomberg, *Through 10/1/19

Market pricing of downgrade risk

The potential effects of credit migration are an essential component of a credit portfolio strategy. While the literature on credit migration is plentiful, relatively little work addresses the impact of credit migration on portfolio risk. A 2010 study by Moody's analytics finds that credit migration can explain as much as 51% of a typical credit portfolio's volatility. The natural undulation of credit ratings over time is usually well absorbed by the market. In general, the market reprices either in advance of, or coincident to, changes in credit quality. We should note, however, that in important instances, rating agencies have lagged

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rather than led the market in identifying mass downgrade events, most recently in display with a plethora of downgrades in the energy sector in 2016.

A recent study by Barclays examined the average A and BBB rated issuer-level spread performance versus the index in the weeks around a one-notch downgrade, as depicted in Chart 3. The results are fairly linear: the lower the rating, the worse the underperformance, e.g., a move from BBB to BBB- will induce more spread widening than a move from A to A-. There is one distinct exception: a downgrade from A- to BBB+ results in 9 basis points (bp) of spread widening, nearly twice the underperformance seen for any other one-notch downgrade. This is mostly driven by selling from investors with single-A or better mandates, including a more ratings-sensitive overseas investor base (mostly from Asia). Unlike fallen angels, which tend to rally post downgrade as a new high-yield buyer base develops, most credits that suffer intra-investment grade downgrades continue to widen even after the rating move.

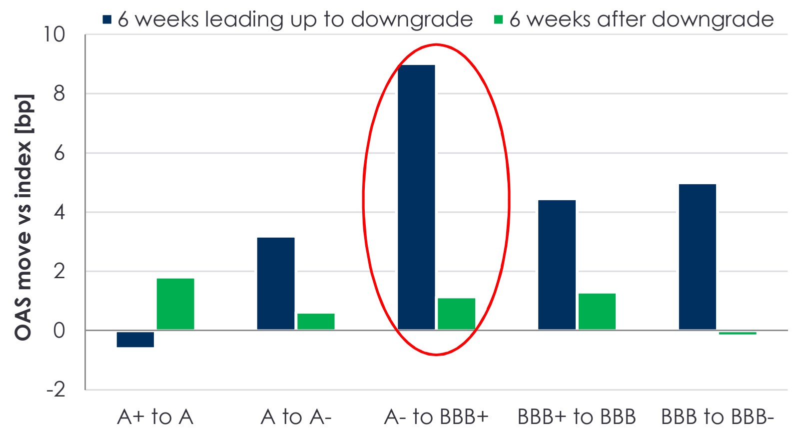
Apparent rating stability

On the surface, current investment grade rating migration trends suggest a stable, if improving credit environment, as portrayed in Chart 4. Rating upgrades have surpassed downgrades in 2019 in the investment grade market, both on issuer count and bond notional basis. Moreover, the upgrade activity was largely concentrated within the BBB space ($134 billion), while higher-quality, single-A bonds were the source of most downgrade activity ($59 billion). Chart 5 portrays the quantum of debt migrating between the BBB and A/AA parts of the investment grade complex from 2015 to 3Q19. AA/A rated debt has noticeably led the decline in credit quality for most of the period through 2018. However, the trend seems to have reversed in 2019 with a higher proportion of debt being upgraded from BBB to A/AA. One could argue that rating migration is somewhat backward looking, however the amount of BBB/BBB+ rated debt on upgrade watch is larger by a third compared to the amount of A/A- debt on downgrade watch, suggesting that the current positive trend is likely to continue.

Are single A credits the new fallen angels?

Investors' fear of fallen angels, while ultimately unfounded, emanated from a far more rational recognition of the vulnerability of "safe" credits to a potential global economic slowdown. A more granular look at rating migration trends suggests that single-A rated debt constitutes a risk to investment grade valuations. Rating agencies have been recalibrating ratings after years of increasing tolerance for higher leverage. This prompted S&P to accelerate the cadence of potential downgrades in May 2019 with seven of the ten largest single-A, non-bank issuers it rates placed on negative watch.

Chart 3: Performance around downgrades in single-A and BBB- debt



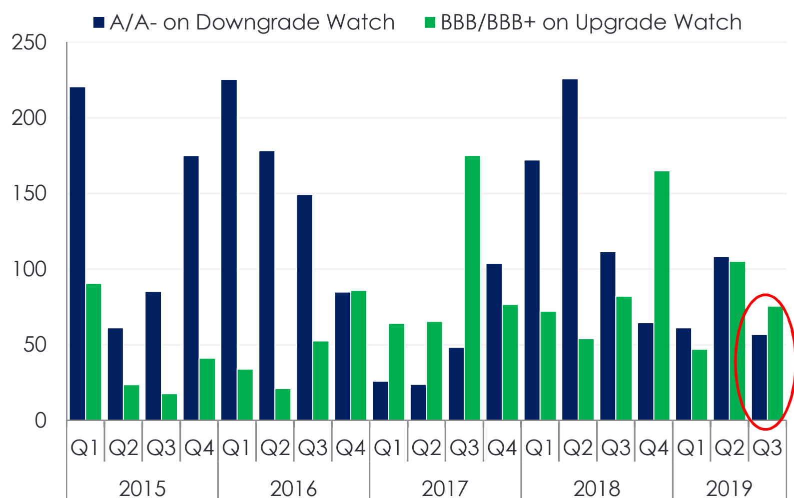
Source: Barclays

Chart 4: Year-to-date downgrades and upgrades [$bn]

Sector	ALL			AA		A		BBB	
	▼	▲	Up-Down	▼	▲	▼	▲	▼	▲
Basic Industries	0	1	1						1
Consumer Products	-1	2	1					-1	2
Energy	-10	16	6			-10			16
Healthcare	-5	37	32	-4		-1			37
Manufacturing	-8	17	9			-1		-7	17
Media	0	3	3						3
MLP	-17	42	25			-17			42
Retail	0	2	2						2
Technology	-11	6	-5					-11	6
Telecom	-7	1	-6					-7	1
Transportation	-12	1	-11			-12			1
Utilities	-22	13	-9			-18	7	-4	5
TOTAL	**-94**	**142**	**48**	**-4**	**0**	**-59**	**7**	**-31**	**134**

Source: Credit Suisse

Chart 5: Investment grade rating migration [$bn]



Source: Goldman Sachs, Data as of 10/6/19

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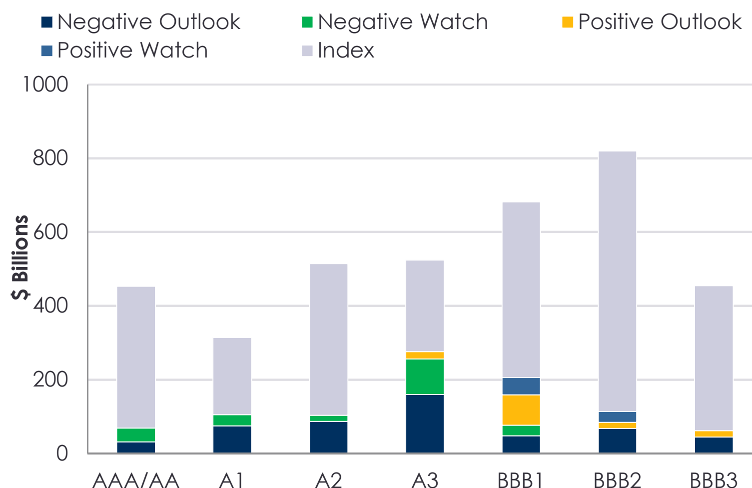
Combined, they account for $309 billion in debt, or two-thirds of total non-bank A rated debt on negative watch by S&P (Chart 6). Including another $159 billion of debt that carries a negative outlook by S&P, 38% of non-financial index bonds rated single-A by S&P could be downgraded in the next twelve to eighteen months! Of note, rating agencies recently initiated downgrades of highly-rated investment grade corporates on the basis of sizeable pension-funding shortfalls -- this was recently the case for UPS, the 15th largest single-A rated issuer in the corporate index.[1] As rates continue to pressure underfunded pensions for some large corporations, we expect this trend to accelerate.

Chart 6: S&P migration bias of US IG index (ex-banks), face value

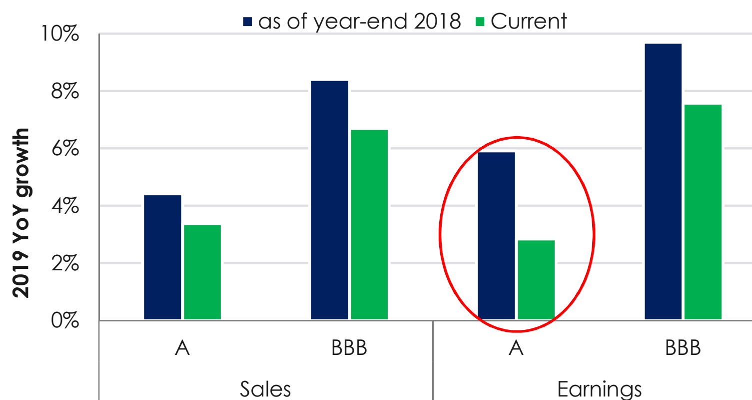


Source: Citigroup

Finding relative value

Somewhat disjointed with this trend, market pricing of BBB risk relative to single-A risk on a spread basis remains only 8bp wide of the last decade's average of 56bp. Perhaps investors are taking too much comfort in benign fundamentals. Earnings growth for investment grade corporates moderated to 2.8% year-to-date (Chart 7), less than half the growth experienced in 2018. Thirteen subsectors in the corporate index experienced earnings compression this year, mostly emanating from the technology and chemicals sectors -- directly exposed to trade tariffs and a global slowdown -- along with the aerospace and defense industries. Investors might also ponder that almost 50% of single-A rated debt in the corporate index are represented by financial institutions, which are more vulnerable to lower rates compared to other sectors in the investment grade index, and a number of which have been downgraded to single-A or lower since 4Q18 (including Visa and Invesco).

Chart 7: IG sales and earnings growth decline prevalent in A credits



Source: Barclays

What are the implications for the market?

As the global economic cycle matures, certain risks inherent in fixed income investing will become more apparent. Downward rating migration in an aging credit cycle should be expected and factored into one's investment outlook, strategy, and return forecast. Positioning portfolios in advance of downgrades is inordinately tricky. It is always tempting for investors to postpone a more defensive stance even with glaring evidence that some issuers are ill prepared for an economic downturn, leaving portfolios painfully exposed as the credit cycle ebbs. Active investors can alter their portfolios and avoid relying on benchmark quality for investment purposes. Although single-A rated debt has traditionally conjured "safety" for investors, this paradigm has begun to shift, as this segment of the corporate index is quickly receding. The outsized focus on BBB rated debt has obscured momentous shifts in the diversity and riskiness of the underlying higher quality segment of the index and serves as a reminder that even the most "defensive" credits are not immune to downgrade risk late in the cycle. The risk is by no means staggering in the context of an almost $6 trillion investment grade market, nonetheless as the credit cycle progresses, investors would be well served to be wary of passive index-like "buy and hold" strategies and favor more active investment approaches focusing on more concentrated portfolios.

[1] S&P downgraded UPS one notch to single-A on 8/9/19

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About the author:

Sandy H. Jephson Kroeber brings over 14 years of experience in corporate and leveraged finance.

Since joining FPCM in 2013, Mrs. Kroeber has sourced investment ideas and performed fundamental research across high yield, investment grade, loans and collateralized loan obligations (CLOs).

Immediately prior to joining FPCM, Mrs. Kroeber worked as a Vice President in the Leveraged Finance group at Deutsche Bank. Preceding her time at Deutsche Bank, Mrs. Kroeber was an Assistant Vice President at Merrill Lynch Capital and GE Capital. In this capacity, she was responsible for structuring LBO transactions for middle market and large corporates, with a focus on the Media and Consumer industries. She started her career at Citigroup as an Analyst in the Corporate Finance group, focusing on the Media and Telecom sectors.

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