The downgrade dilemma

Khuram Sharih considers the impact of corporate downgrades on the high-yield bond market

As fears around the coronavirus pandemic hit financial markets in March, investment grade (IG) and high yield (HY) credit spreads gapped to around 350 basis points (bps) and 1,200bps, respectively. Nearly all asset classes generated negative returns during this period. But just as quickly as markets collapsed, so did they rally as major fiscal stimulus packages were unveiled.

With credit now well off the lows, attention is turning back to credit quality, fundamentals and the potential impact on IG and HY credit. Downgrade risk is of material concern, particularly given the relative market sizes: global BBB corporate debt is over $4.5 trillion, compared with the $2 trillion global HY market.

The BBB segment has grown through a combination of rising leverage, more aggressive financial policies, M&A and positive ratings migration. Both HY and IG have grown markedly, but the growth of the BBB market has been particularly notable, bringing into question the quantum of downgrades that the HY market could absorb.

Estimates suggested c. $700-800 billion in potential downgrades. However, when looking at the composition of IG debt, these aren't materially different from previous shocks. Notably, in the corporate bond market ex-financials, the highest risk components of the IG index are small i.e. retail /leisure. That said, there will be some volatility as fallen angels enter the HY market, particularly if we experience a large inflow from cyclical sectors such as autos, transport and energy.

Such downgrade estimates sound alarming, but some of the major downgrade events that the HY market experienced over the past 20 years saw similar migrations. In the US corporate bond market alone, c. $400 billion of bonds were downgraded to HY during both the autos downgrade cycle in 2005 and the global financial crisis. Moreover, the HY market is much larger now than it was in 2005 and 2008/9, and possibly better placed to absorb the large inflows.

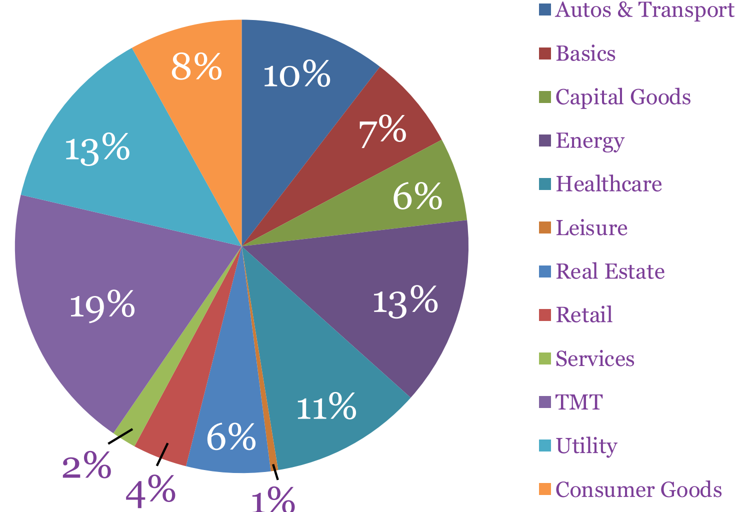
Historically, the average rate of bonds downgraded to HY has been 4 per cent by value. However, during major events, this has approached 10 per cent. If we take current estimates of $640 billion in 'at risk' debt, and include a further $250 billion in emerging markets bonds, that would mean up to 8.5 per cent of IG debt is at risk of downgrade, which would be in line with past peaks.

From an HY perspective, the 'fallen angel' debt would represent a fairly substantial portion of the market. Historically, about 22 per cent of the HY market has entered the asset class, but during peak downgrade cycles, the percentage of HY debt that comes from such downgrades can be as high as 50 per cent. This was experienced in 2003, following the TMT downgrade cycle and 9/11.

Downgrade risk can be assessed sectorally as well taking into consideration historical downgrade cycle trends and the sector distribution within corporate IG bonds. As illustrated (figure 1), of the top five sectors in the IG index, three are more defensive and would likely face fewer downgrades – even if they were to be hit, they would have good cross-over investor support.

The more cyclical sectors have a higher probability of downgrade. Based on sectoral analysis, we estimate c. $750 billion in corporate bonds (ex-financials)

Figure 1: Investment grade market by sector % ($, ex-financials)



could potentially enter the market. This would represent around 35 per cent of the current global HY market, in line with the peaks of previous cycles.

The impact of this potential downgrade cycle can also be viewed from a debt maturities perspective. We would see a considerable increase in maturities 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 IG debt.

Despite the potential increase in near-term HY debt maturities following a downgrade event, the recently-announced Federal Reserve (Fed) programme to repurchase short-dated US bonds of fallen angels should be supportive and help to manage the absorption of this large quantum of debt.

A potential post-downgrade sector composition would also show some notable changes to the debt distribution. In particular, we would likely see an increase in some sectors that are much smaller in HY than the IG market, such as TMT, autos, energy, utilities and healthcare.

The incremental debt from first order pandemic-affected sectors, such as retail and leisure, represent a small fraction of IG debt and therefore larger downgrades from such sectors should be absorbable. There could be potential considerable new HY opportunities in historically less-cyclical, higher-valuation sectors, such as TMT and healthcare. This in turn could be supportive for spreads by attracting interest from IG investors.

Technicals could also be supportive due to benchmarking and ETF demand. Additionally, some companies may implement more conservative financial policies to help reinstate their IG rating – particularly those that would benefit from shorter-term financing and commercial paper-type programmes.

Additionally, estimating that the HY market will lose 15-20 per cent of bonds through defaults over the next few years, a further c. $300 billion to $400 billion in non-performing debt will exit the HY market and therefore improve the quality of the overall HY index. Moreover, these defaults are likely to be skewed towards the more structurally challenged or cyclical sectors, improving the overall composition of the HY index.

Although $750 billion in downgrades would represent a sizeable element of the HY index, the composition would be strengthened over the medium term, while the inflow net of defaults into the index would likely be $350-$450 billion. Fallen angels will have overall better balance sheets, higher ratings and a longer maturity profile compared to existing HY constituents. This, coupled with a more favourable sector representation, should support HY spreads.

The risks from downgrades are further mitigated by:

- Demand for HY has been strong as evidenced through year-to-date inflows.
- More liquid downgrade constituents re-weight the market as fallen angel credit qualities are often better than existing constituents, which can attract a wider range of investors.
- Fallen angels have historically been good investments: data demonstrate that following a major downgrade cycle, HY credit spreads have normally rallied.
- Downgrades have been flagged for some time and the pace of downgrade still appears to be manageable.
- Monetary and fiscal policy measures have also been supportive of the credit markets, including the purchases of HY bonds announced by the Fed and European Central Bank.

In conclusion, despite the potential for large downgrades from IG to HY, we don't believe there will be a material impact on spreads. While uncertainty is likely to persist, the combination of quick fiscal and monetary policy intervention coupled with the changing dynamics of the HY and IG markets, means that the HY market is better positioned to absorb the pressure from ratings migration.

We believe opportunities will persist in the HY asset class and, rather than being seen as a negative, the downgrades should be seen positively in diversifying and improving the quality of the market.

For the complete analysis, please read our report: 'Buy or sell: the downgrade dilemma'.

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