

# Spotlight on credit



## Credit migration: fallen angels and rising stars

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David Fancourt, senior credit portfolio manager

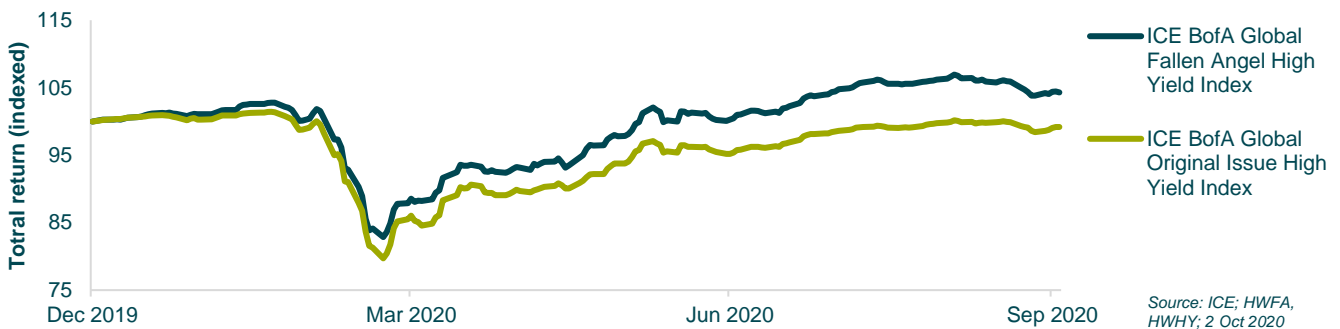
Earlier this year, 'fallen angels' became a hot topic among credit investors, as a number of large issuers were downgraded from investment grade (IG) to high yield (HY). In April, we wrote about how fallen angels have historically outperformed original-issue HY over the long term. We suggested the two main reasons for this outperformance were that fallen angels were oversold when they entered the HY index, and that they had a higher chance of returning to IG than bonds originally issued as HY. In this note, we look at the more recent performance of fallen angels and provide our thoughts on their future prospects.

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### Fallen angels performance

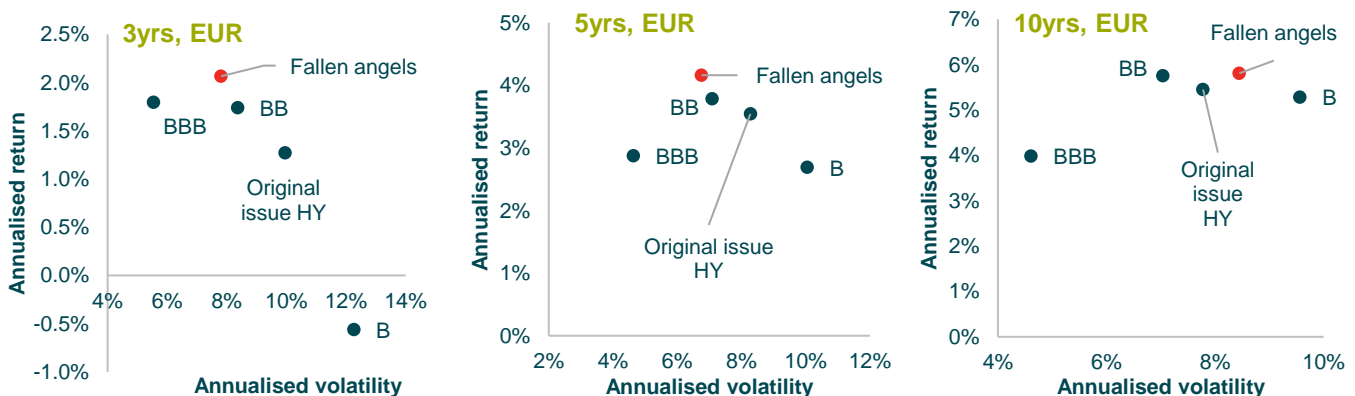
Globally, fallen angels have outperformed bonds originally issued as HY, both in the year to date (YTD) and since the peak of crisis at the end of March (see Figure 1). Within the European market, there has also been YTD outperformance – however, European fallen angels have lagged original-issue HY since March, as they did not fall as far during the market rout.

Figure 1. Fallen angels have outperformed original-issue HY in 2020



European fallen angels have also performed well over longer periods from a risk-reward perspective, This can be seen in Figure 2, which shows euro-denominated debt over 3-, 5- and 10-year periods.

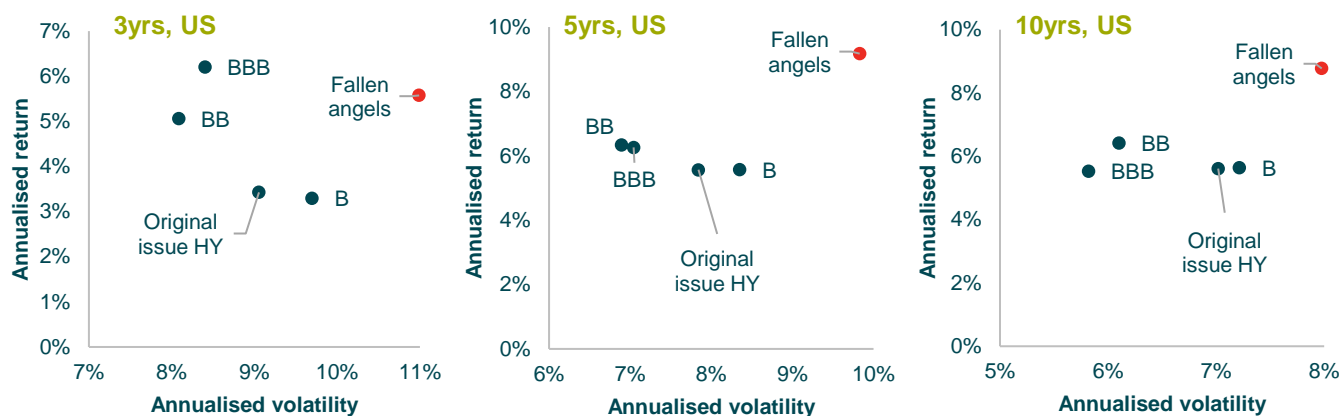
Figure 2. Fallen angels performance over 3, 5 and 10 years – euro debt



Source: ICE; HEFA, HEHY, HE10, HE20, ER40; 30 Sep 2020

Meanwhile, US dollar (USD) fallen angels have performed even more strongly over the long term.

**Figure 3. Fallen angels performance over 3, 5 and 10 years – USD debt**



Source: ICE; H0FA, H0HY, H0A1, H0A2, C0A4; 30 Sep 2020

### Market size

The volume of fallen angels globally has doubled since the end of March, with their combined market capitalisation surpassing \$500bn (see Figure 4). This is due to both the significant number of fallen angels and diminished number of rising stars (see Figure 5).

**Figure 4. Fallen angels volume has doubled since March**

**Figure 5. Fallen angels & rising stars, LTM**



Source: ICE; HWFA; 30 Sep 2020



Source: ICE; G0BC, HW00; 30 Sep 2020

The largest new entrants to the fallen angel universe since March can be seen in Figure 6 below. Most of this additional debt is USD-denominated.

**Figure 6. Largest new HY market entrants (face value, bn)**

	CAD	EUR	GBP	USD
<b>Petroleos Mexicanos</b>		10.2	0.8	58.6
<b>Ford Motor Company</b>	3.4	6.4	1.0	32.1
<b>Occidental Petroleum Corporation</b>				27.0
<b>Electricite de France SA</b>		4.3	2.0	3.6
<b>Western Midstream Operating LP</b>				7.2
<b>ArcelorMittal SA</b>		3.8		3.1
<b>Apache Corporation</b>				6.0
<b>Braskem Netherlands Finance BV</b>				5.3
<b>Carnival Corporation</b>		1.2		4.0

Source: ICE; 20 Oct 2020

## Index composition

Perhaps counter-intuitively, IG indices do not appear to be riskier as a result of recent credit migration. Across the dollar, euro and sterling markets, changes to the ratings composition of IG indices has been very minor (see Figure 7). The weakest credits have left as fallen angels, and there has been a large amount of issuance to take their place.

Figure 7. IG credit universe composition is relatively unchanged\*

% mkt value	US IG			Euro IG			GBP IG		
	31/12/19	20/10/20	Change	31/12/19	20/10/20	Change	31/12/19	20/10/20	Change
AAA	1.5	1.4	-0.1	0.4	0.4	+0.0	20.0	19.4	-0.6
AA	8.2	7.7	-0.5	10.6	11.2	+0.6	13.1	12.6	-0.5
A	40.3	40.6	+0.3	39.7	38.2	-1.5	28.4	28.7	+0.3
BBB	50.0	50.1	+0.1	49.4	50.1	+0.7	38.5	39.1	+0.6

\*Please note that totals can be affected by rounding. Source: ICE, 20 Oct 2020

Although IG credit risk is relatively unchanged at an index level, it is worth noting that issuance at the long end has significantly increased interest rate risk in USD markets. Figure 8 below shows how the average life of the USD market has lengthened by over a year on average since the beginning of 2019. US IG investors are now taking 19% more interest rate risk than they were at the start of last year. The average life of other markets has remained stable.

Figure 8. USD IG interest rate risk has increased by one-fifth since the start of 2019



Source: ICE; C0A0; 30 Sep 2020

Meanwhile, HY indices have improved in credit quality over the course of the year, due to the influx of fallen angels, particularly in the USD market. However, the euro HY universe remains of significantly higher quality than the US overall (see Figure 9).

Figure 9. HY index quality has improved due to fallen angels\*

% mkt value	US HY			Euro HY		
	31/12/19	20/10/20	Change	31/12/19	20/10/20	Change
BB	48.9	55.5	+6.6	67.1	70.0	+2.9
B	39.0	32.9	-6.1	26.2	22.5	-3.7
CCC & lower	12.2	11.3	-0.9	6.8	7.4	+0.6

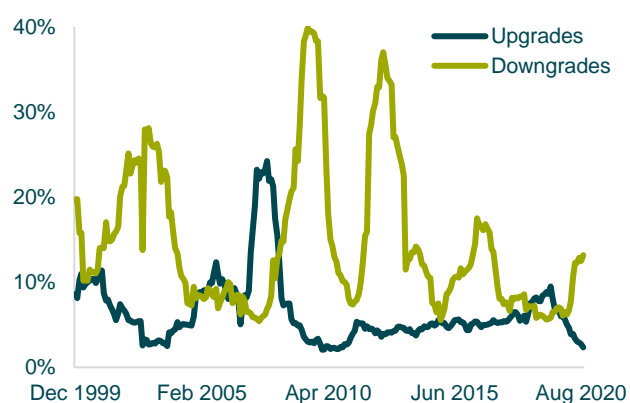
\*Please note that totals can be affected by rounding. Source: ICE, 20 Oct 2020

## Future credit migration

The prospect of another spike in fallen angels appears unlikely, absent a further shock. 'Rating drift', which can be measured as credit rating upgrades less downgrades, is in firmly negative territory for both IG and HY corporates (see Figures 10-11). However, rating agencies have already implemented the downgrades for most of the IG issuers that were on their negative rating watch (see Figure 12). HY downgrades also appear to have stabilised. It is therefore likely we are past the worst in HY, absent another market shock.

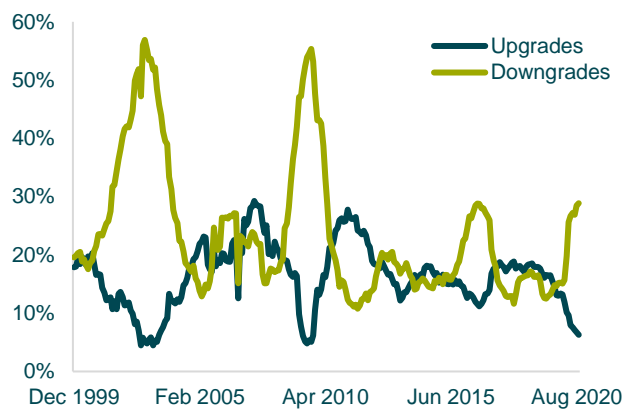
However, we do not expect to see many 'rising stars' moving from HY to IG soon either. The percentage of fallen angels on a positive rating watch with either S&P or Moody's is just 3.4%.

Figure 10. Rating drift is firmly negative in IG...



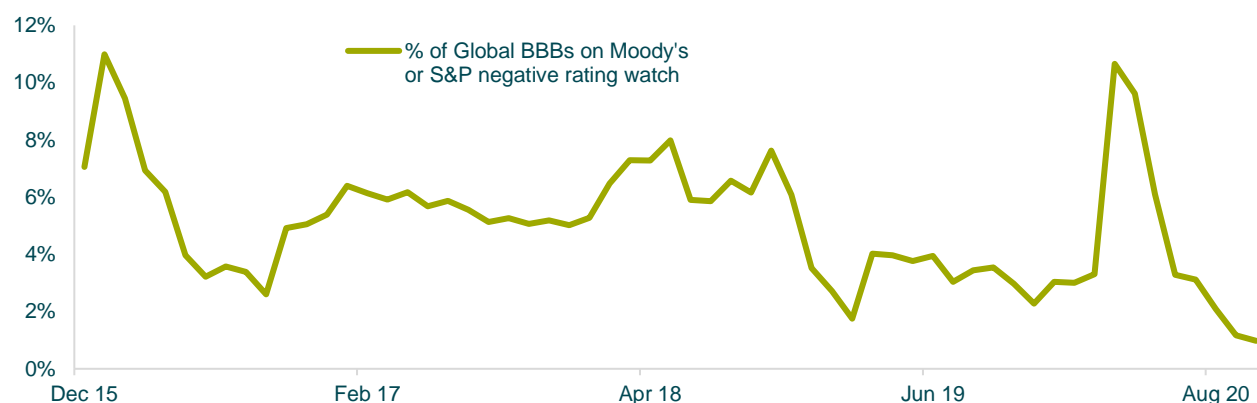
Source: ICE; G0BC; 30 Sep 2020

Figure 11... and in HY



Source: ICE; HW00; 30 Sep 2020

Figure 12. Rating agencies have already downgraded the majority of BBB credit on their negative watch lists



Source: Bloomberg; G0BC; 22 Oct 2020

## Outlook

As active managers, our key observation is that investors should be careful when comparing spreads across different markets and time periods, due to the credit quality differences we have highlighted. As we have shown, higher US HY spreads largely reflect their lower aggregate quality compared to Europe. Similarly, the quality of the global HY universe has changed meaningfully since the start of year, whereas IG indices are still of comparable quality overall – albeit with clear winners and losers within this universe. We believe these discrepancies create opportunities to outperform indices via active credit selection, with fallen angels being of particular interest, given the fundamental characteristics that have helped them to historically outperform original-issue HY credit.

However, this requires extensive resources to research individual credits, including those that other market participants may consider too difficult to analyse. We believe that, by identifying mispriced risk, it is possible to construct credit portfolios with more effective diversification and higher long-term return potential than can be found through passive investing, particularly in an environment where the fortunes of different areas of the economy are likely to continue to diverge.

**David Fancourt, senior credit portfolio manager, M&G**

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