

Credit migration: fallen angels and rising stars

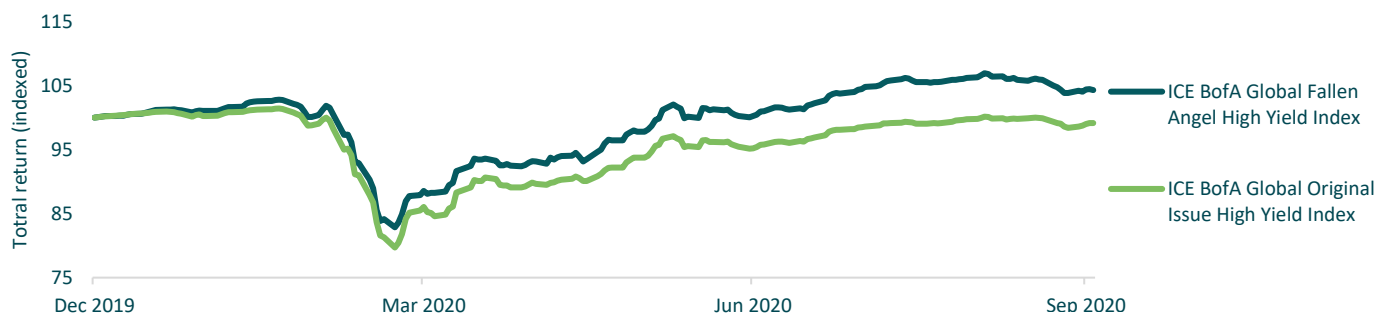
January 2021

- In 2020, ‘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.
- The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Where past performance is shown, this is not a guide to future performance.

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.

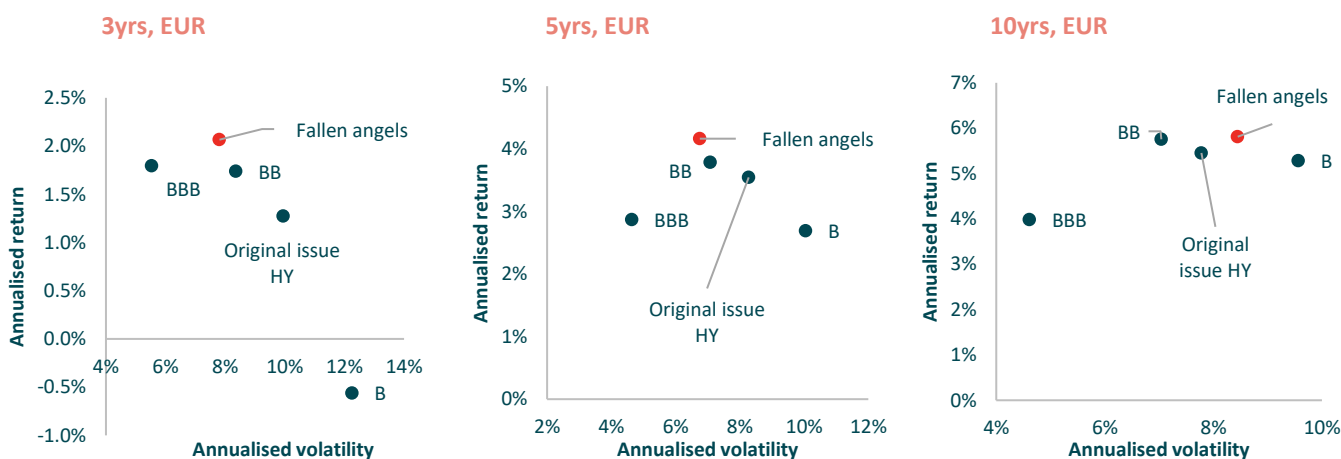
Figure 1. Fallen angels have outperformed original-issue HY in 2020



Past performance is not a guide to future performance. Source: ICE; HWFA, HWHY; 2 Oct 2020. For a full description of indices, please see end of document.

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.

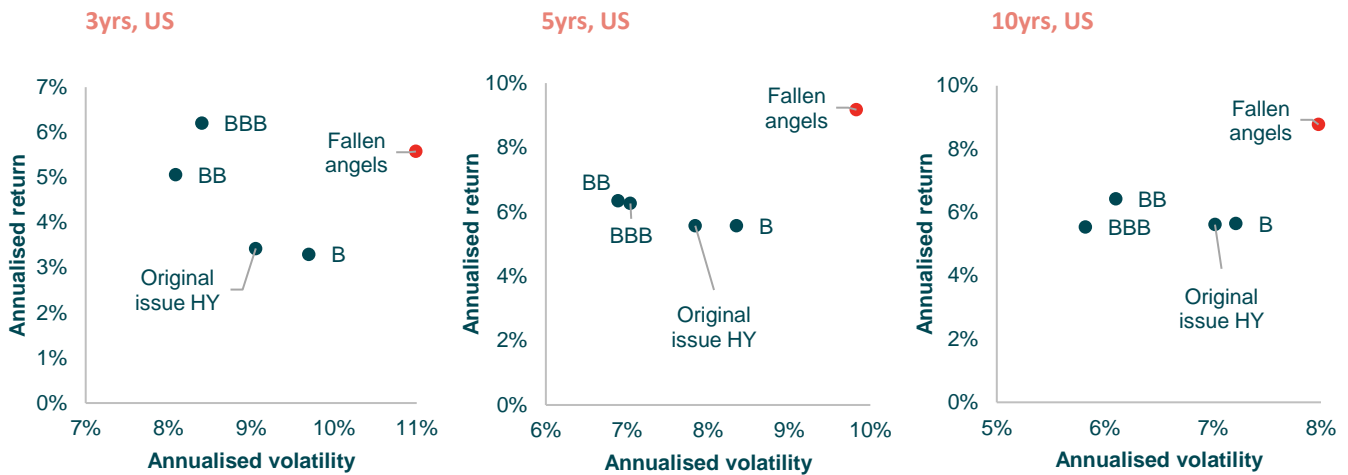
Figure 2. Fallen angels performance over 3, 5 and 10 years – euro debt



Past performance is not a guide to future performance. Source: ICE; HEFA, HEHY, HE10, HE20, ER40; 30 Sep 2020. For a full description of indices, please see end of document.

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



Past performance is not a guide to future performance. Source: ICE; HOFA, HOHY, HOA1, HOA2, COA4; 30 Sep 2020. For a full description of indices, please see end of document.

Market size

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

Figure 4. Fallen angels volume has doubled since March

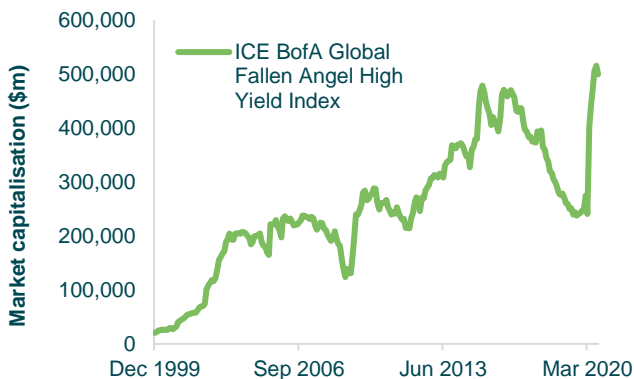
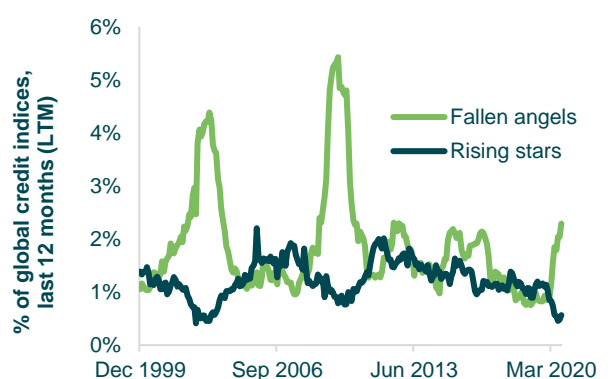


Figure 5. Fallen angels & rising stars, LTM



Information is subject to change and is not a guarantee of future results. Fig 4 source: ICE, HWFA, 30 Sep 20. Fig 5 source: ICE; GOBC, HW00; 30 Sep 20. For a full description of indices, please see end of document.

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

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

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

Past performance is not a guide to future performance. 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

Information is subject to change and is not a guarantee of future results. *Please note that totals can be affected by rounding. Source: ICE, 20 Oct 2020. For a full description of indices, please see end of document.

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



Information is subject to change and is not a guarantee of future results. Source: ICE; COA0; 30 Sep 2020. For a full description of indices, please see end of document.

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

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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, in our view, that 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...

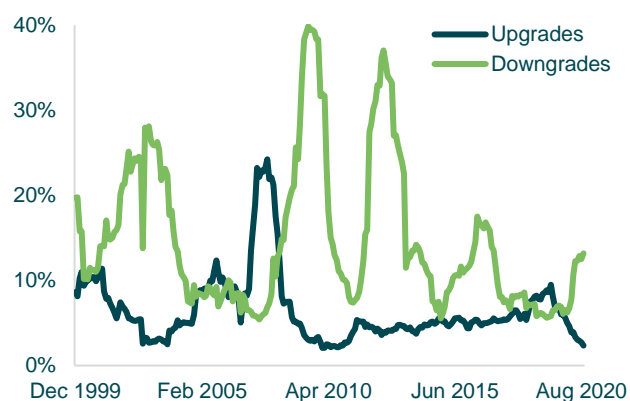
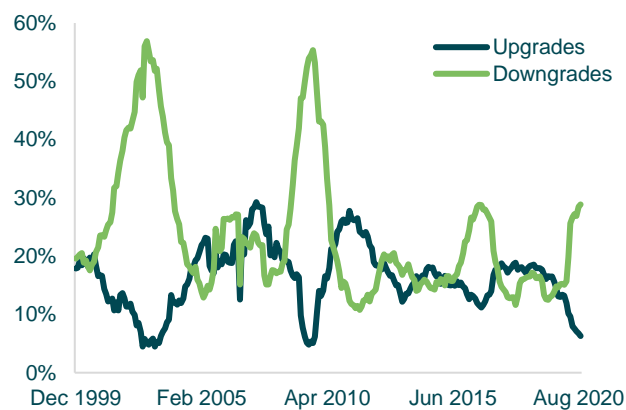
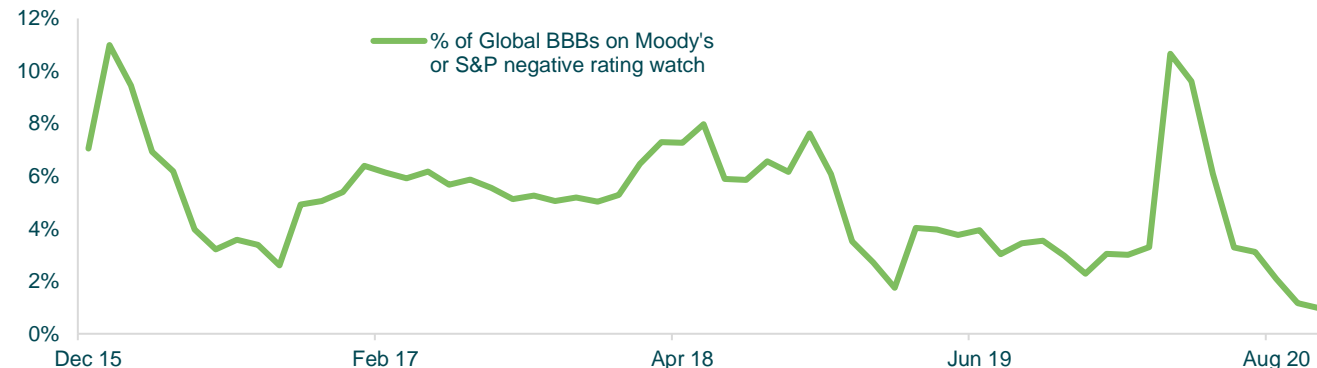


Figure 11... and in HY



Information is subject to change and is not a guarantee of future results. Fig 10 source: ICE; G0BC; 30 Sep 2020. Fig 11 source: ICE; HW00; 30 Sep 2020. For a full description of indices, please see end of document.

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



Information is subject to change and is not a guarantee of future results. Source: Bloomberg; G0BC; 22 Oct 2020. For a full description of indices, please see end of document.

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

References

Credit indices referenced:

COA4 – ICE BofA BBB US Corporate Index

ER40 – ICE BofA BBB Euro Corporate Index

G0BC – ICE BofA Global Corporate Index

H0A1 – ICE BofA BB US High Yield Index

H0A2 – ICE BofA Single-B US High Yield Index

H0FA – ICE BofA US Fallen Angel High Yield Index

H0HY -- ICE BofA US Original Issue High Yield Index

HE10 – ICE BofA BB Euro High Yield Index

HE20 – ICE BofA Single-B Euro High Yield Index

HEFA – ICE BofA Euro Fallen Angel High Yield Index

HEHY -- ICE BofA Euro Original Issue High Yield Index

HW00 – ICE BofA Global High Yield Index

HWFA – ICE BofA Global Fallen Angel High Yield Index

HWHY -- ICE BofA Global Original Issue High Yield Index

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