Credit

Follow the Fed to fallen angels…

As markets continue to grapple with the economic fallout from the COVID-19 outbreak, the Federal Reserve has been quick to implement unprecedented levels of stimulus. In a (somewhat) surprising move, on April 9 the Fed announced its ability to intervene directly in sub-investment-grade credit markets.

KEY TAKEAWAYS

- Fallen angels, long cited as a key risk to high yield markets, have become particularly buzzworthy lately with record levels of bond downgrades expected this year.
- The Federal Reserve recently announced a policy allowing it to purchase some of the recently fallen angels.
- We view fallen angels as a source of opportunity to high yield investors rather than an outsized risk.

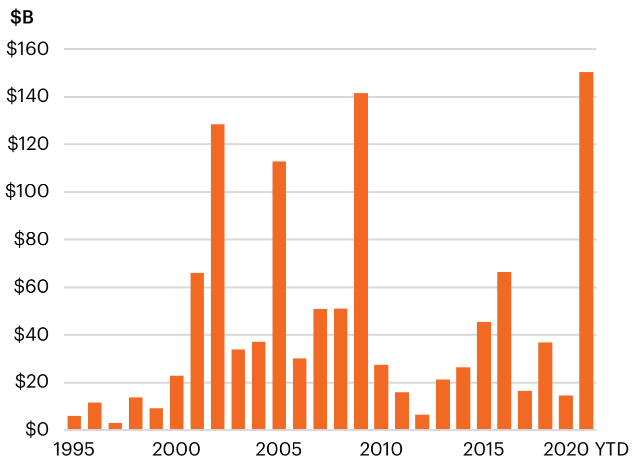
This new mandate allows the Fed to purchase fallen angels, companies downgraded from investment-grade rated to below investment-grade rated, which has been a source of broad concern. In this note we discuss the opportunity, even without Fed intervention, that we see in fallen angels and assert that they are not the demonic risk that many may believe.

The Federal Reserve has truly thrown the kitchen sink (and cabinets and countertops and pantries) at markets lately in efforts to stymie market volatility and provide much-needed liquidity. The Fed made waves when it announced for the first time in U.S. history that the new Secondary Market Corporate Credit Facility would purchase investment-grade corporate bonds and ETFs. Now, given its most recent announcement, the Fed has one-upped itself by allowing the purchase of high yield bonds—in the form of recent fallen angels—and high yield bond ETFs as well.

Fallen angels have garnered incessant media coverage lately, given the record level of bond downgrades widely expected this year. The virtual halt in economic activity we saw in March all but guaranteed declining revenue and cash flow figures. Though we'd argue that leverage levels were manageable entering 2020, they were on the high end of historical averages and will tick higher during the recent downturn. The combination of these deteriorating fundamentals portends heightened downgrade activity.

In just the first three months of this year there have already been $150 billion in U.S. fallen angels—a record level, with that dollar amount surpassing any other *full* year in history.

DOLLAR AMOUNT OF FALLEN ANGELS



Source: J.P. Morgan, as of April 14, 2020.

With nearly half of these fallen angels occurring in just 10 days, from March 23 to April 2, the Fed took action. It extended its Secondary Market Corporate Credit Facility to include the purchase of recent fallen angels and some high yield bond ETFs. As a limit, issues must have been investment-grade rated as of March 22 and companies must maintain a minimum rating of BB-/Ba3. At the time of print, this equates to roughly $77 billion in already-fallen angels and includes, notably, Ford Motor Company, which is the largest fallen angel in history. Other well-known names include Macy's, QVC and Royal Caribbean Cruises.

Fallen angels are certainly controversial, and pundits made quick work of voicing their opinions on the Fed's new policies. We stand firmly in the camp that fallen angels present a compelling investment opportunity—and not just for major central banks. As they say, "follow the Fed."

What's the BBBig deal?

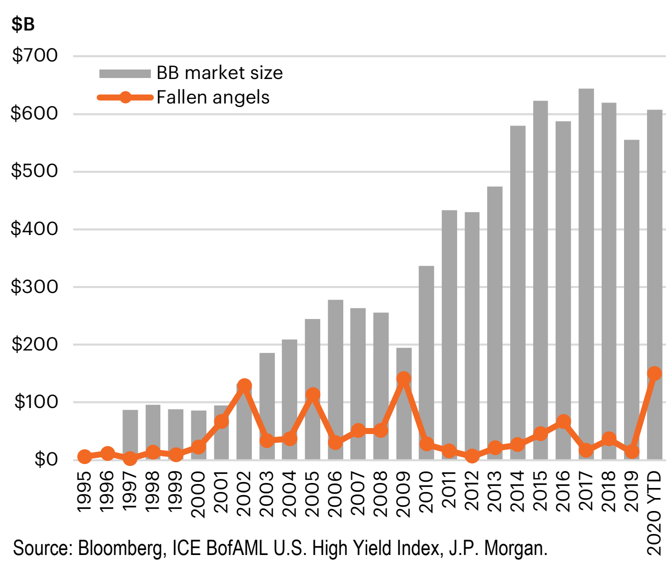
One of the commonly cited risks of fallen angels is the potential for downgrades to create excess supply and overwhelm the high yield market. In the wake of the most recent market pullback, with demand for risk assets already low, these arguments grew louder. Critics cite the proportion of the investment-grade bond market made up of BBB rated bonds, which technically represents the universe of potential downgrades. While there are a significant number of BBB bonds, that doesn't mean that they will all be downgraded. When put into context, the expected downgrade levels this year, while high, are not as overwhelming as they may seem.

Estimates for levels of fallen angels in 2020 run the gamut, as uncertainties related to the ultimate spread and impact of the virus abound. Initial forecasts lie in the $200–$225 billion range, with outsized forecasts as high as $500–$600 billion. At the lower end, this estimate is roughly 1.5 times the record $150 billion of fallen angels in 2009. But at the beginning of 2020, the high yield market was nearly twice as large as it was in the beginning of 2009.

Plus, the BB market, which would be tasked with absorbing this influx of supply, has withstood worse on a relative basis. In both 2001 and 2009, the dollar amount of fallen angels was equal to roughly 70% of the BB market size at the beginning of the year.

In 2002, that number was 97%. The BB market today is roughly $569 billion in size as of March 31. Even at the high end of the range, an additional $500 billion in fallen angels is large, but not unprecedented when compared to heightened fallen angel environments of the past. While it is possible that fallen angels on a percentage basis may eclipse the largest instances on record, these numbers look a little more manageable.

FALLEN ANGEL VOLUME VS. HIGH YIELD MARKET SIZE

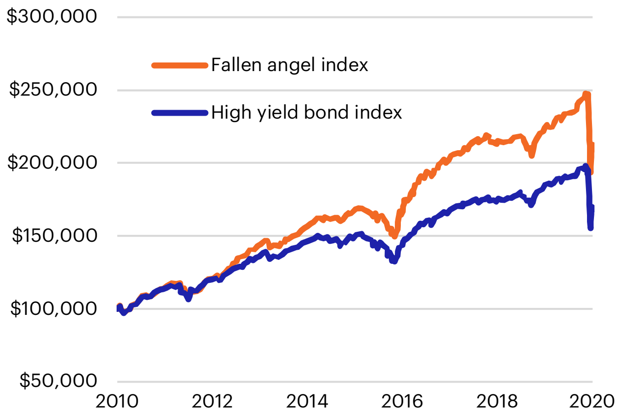


Source: Bloomberg, ICE BofAML U.S. High Yield Index, J.P. Morgan.

Heavenly returns for high yield

We can debate the merits and risks of fallen angels, but what do the numbers say? History shows that the returns since inception for an index composed solely of fallen angels has consistently outperformed the broader high yield index.

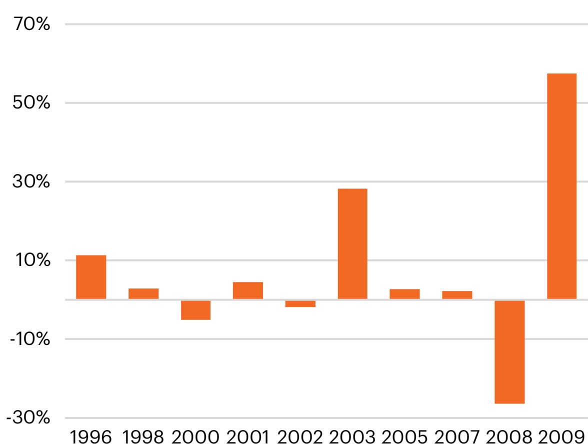
FALLEN ANGEL VS. HY BOND PERFORMANCE



Source: Bloomberg, ICE BofAML U.S. Fallen Angel High Yield Index, ICE BofAML U.S. High Yield Index.

Even during years of heightened volume of fallen angels, high yield returns have historically been strong. In 7 of the 10 years with the largest fallen angel volume by percentage of high yield market size, high yield bonds have posted positive returns, suggesting that this excess supply does not necessarily cause negative returns for the broader high yield market. We see a few key reasons for this strong performance.

HY BOND RETURNS: YEARS OF HIGHEST FALLEN ANGEL VOLUME BY PERCENTAGE OF HY MARKET



Source: Bloomberg, ICE BofAML U.S. High Yield Index.

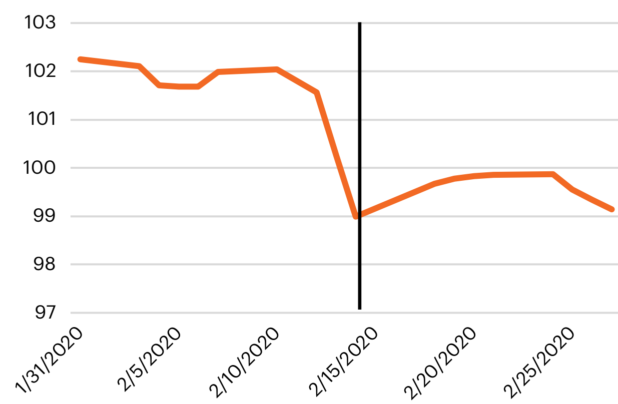
Fallen angel flight pattern

What exactly happens after an issue is downgraded? We think the more appropriate question may be: What happens to an issue before it is downgraded?

Data shows that most of the price move in fallen angels happens before they are actually downgraded. Markets react more quickly than rating agencies. Institutions or mutual funds with investment-grade mandates, unable to hold high yield issues, often preemptively sell before an impending downgrade. The forced selling drives down the price of these issues before any adverse rating action is taken. This generally causes the issues to fall to the high yield universe at already oversold prices.

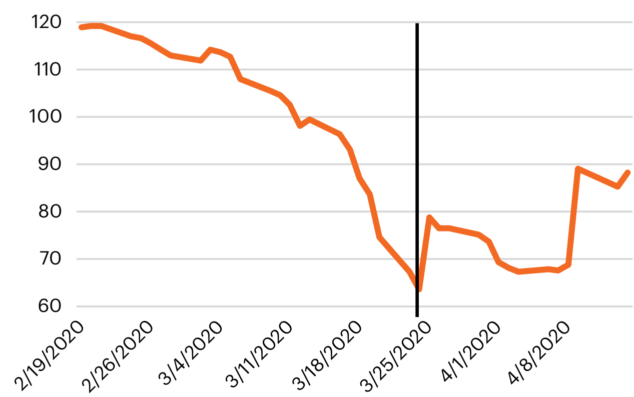
Let's look at two recent highly publicized fallen angels, Kraft Heinz and Ford. Each of the charts below shows the price history of the issuer's debt before and after the downgrade date (marked by a black vertical line).

KRAFT HEINZ TRADING PRICE



Source: Bloomberg.

FORD MOTOR CO. TRADING PRICE



Source: Bloomberg.

As formerly investment-grade rated companies, these issuers are generally higher quality than many high yield issuers with bonds that benefit from higher asset coverage and greater margins of safety. Plus, fallen angel companies may be more incentivized to return to investment-grade status and regain the lower-cost financing that accompanies it. This could mean cost cutting and debt reduction or other measures to improve credit fundamentals.

One person's trash is a high yield investor's treasure...

Select fallen angels may represent compelling investment opportunities amid the various dislocations caused by COVID-19. The bonds may be of higher quality than directly issued high yield debt and may yield more due to depressed prices upon entry into the market. Every bond that falls from a BBB to BB rating improves the overall rating mix of the sub-investment-grade market, which benefits all high yield investors, not just those who purchase fallen angels.

While we view fallen angels as a potential source of opportunity for investors, we do not necessarily advocate a broad-based exposure to every issue that hits the high yield market, especially in the current climate. We acknowledge there are risks associated with fallen angels. These companies were downgraded for a reason, whether it is faltering revenue, increased leverage or other deteriorating fundamentals. The economic shutdown we have seen is wholly unprecedented. Managers with the ability to perform the necessary fundamental analysis as well as underwriting to ever-changing economic outlooks will be in the best position to unlock the value in fallen angels. We think we'll see unprecedented opportunities emerge from this crisis if accessed correctly.

We also acknowledge that the new Federal Reserve policy, while removing a major source of risk going forward for high yield, is not a cure for the virus's impact on markets. The Fed cannot prevent an issue from being downgraded. The Fed cannot directly save a company from default. But the Fed can provide price-insensitive demand, a backstop and a sense of assurance to high yield investors and markets broadly.

And for now, we're keen to follow their lead.

Robert Hoffman
Managing Director, Investment Research

As Managing Director of Investment Research, Robert leads the team that analyzes the fundamentals behind market movements, macroeconomic trends and the performance of specific industries — as well as their potential impact on investors. His nearly two-decade tenure in the financial services industry includes experience as a loan portfolio manager and senior credit analyst focused on corporate loan issues. Robert serves as the firm's primary subject matter expert on the corporate credit markets and select alternative investment solutions, developing targeted communications and educational resources

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