Q&A

Credit Market Update:
Fallen Angels, Fed Liquidity Programs and Conning's Market Outlook

April 20, 2020

The following is an interview with Conning's Head of Corporate and Municipal Teams, Matt Daly, that took place on April 20, 2020.

1. **The percentage of BBBs in the Bloomberg Barclays IG Credit Index has been increasing over the past few years and was as high as 50% pre-crisis. What's the market value of BBB-rated securities that have been downgraded to high yield over the recent weeks?**

We have been in the later stages of the credit cycle since 2013. Globally low interest rates, accommodative credit markets to support debt-fueled acquisitions, and investor need for yield all contributed to huge growth in BBB-rated corporate debt. As large swaths of the economy closed due to COVID-19, the rating firms wasted no time downgrading bonds. Downgrades from investment grade to high yield (fallen angels) have exceeded $120 billion this year. Although some of this occurred prior to the crisis, downgrades certainly accelerated during the past number of weeks, a trend likely to continue given the expectations for further earnings and credit metric deterioration.

2. **Are there any specific sectors in which we can expect a series of downgrades over the next few months?**

Fallen angels related to the crisis have mostly been concentrated in the energy industry so far, with a notably large exception being Ford Motor. Within the energy industry, we believe a handful of marginally investment-grade-rated exploration and production companies with heavy exposure to oil are most at risk of becoming fallen angels. Our internal close-watch list at Conning, which essentially consists of issuers viewed with higher risk of potentially crossing the rating threshold from investment grade to high yield, has exploded over the past month. Highly leveraged investment-grade issuers in more economically sensitive industries, or those areas more directly affected by social distancing measures, carry the most fallen angel risk.

Our recommendation on investment grade credit is now overweight, focused on issuers we believe have the balance sheet and credit profile durability to weather a prolonged downturn.

3. **Have the Fed's recent liquidity programs helped stabilize the credit market?**

Yes, the recently announced programs by the Federal Reserve have successfully stabilized the market. The primary and secondary corporate credit facilities have proven beneficial in a few ways. The primary facility ensures liquidity will be available for investment-grade issuers as well as recent fallen angels, provided they still have BB ratings and meet other eligibility criteria. This greatly mitigates refinancing risk should the market seize up. The secondary facility helps ensure appropriate market functioning and even includes high yield ETFs. Since these facilities were announced on March 23, spreads have rallied tighter in a meaningful way. The facilities are not actually purchasing bonds yet, but the signaling effect has been tremendously beneficial from a valuation perspective.

4. **What are Conning's current market views within investment grade and high yield corporates?**

We became more constructive on credit in mid-March. Specifically, we changed our recommendation on investment-grade credit to overweight, with a focus on issuers that our team believes have the balance sheet and credit profile durability to weather a prolonged economic downturn. There has been great opportunity to add exposure to these types of names in the new-issue market. We have a market-weight recommendation to high yield, but this is strongly biased to the BB segment. Again, we believe thorough bottom-up fundamental analysis is crucial at this time of economic uncertainty.

5. **What are Conning's views on the impact of COVID-19 on the U.S. economy in 2020? Do we anticipate an improvement in the economy in the latter half of 2020?**

Conning expects the U.S. economy to be dramatically impacted in the first half of 2020. Economic data has already been shockingly bad, and this is likely to continue in the near term. The depth and duration of the downturn remains uncertain and we do not expect companies to be able to shed much light on guidance in the upcoming earnings calls. We believe that the country will reopen regionally, in a deliberate and phased approach. However, there remains the risk of reinfection going forward, which could impact the rate of economic recovery.

6. **What is your favorite pastime right now?**

I enjoy hiking the trails around my house.

Matthew Daly, CFA is a Managing Director and Head of Corporate and Municipal Teams and a member of Conning's Investment Policy Committee. Prior to joining Conning in 2003, he previously held credit analyst roles with Webster Bank, Brown Brothers Harriman & Co. and FleetBoston. Mr. Daly earned a degree in economics and business administration from Gordon College.

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Investment Risk - The potentially complex structure of the security may produce unexpected investment results not based on default or recovery statistic
Valuation Risk - Valuation of structured credit products are provided by third parties, based on models, indicative quotes, and estimates of value, in addition to historical trades. There is inherent difficulty in valuing these assets, and there can be no assurances the assets can be disposed of or liquidated at the valuations established, or that published returns will be achieved
Underlying Asset Credit Risk - During periods of economic uncertainty and recession, the incidence of modifications and restructurings of investments may increase, resulting in impairments to the underlying asset value
Economic Risk - Changing economic, political, regulatory or market conditions, interest rates, general levels of economic activity, the price of securities and debt instruments and participation by other investors in financial markets may affect the value of the structured security and all other asset classes
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