A Leading Global Investment Management Firm

Viewpoint

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Credit Opportunities Amid Downgrades and Fallen Angels

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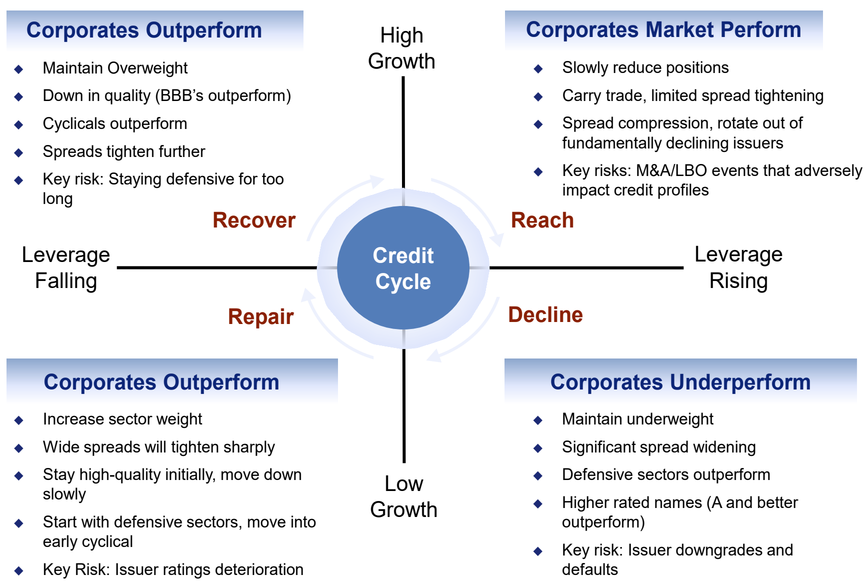
Conning believes that the U.S. corporate market has been in the later stages of the credit cycle – i.e., the “Reach” phase (see Figure 1) – for the last several years. Since March, economic damage caused by social-distancing measures and business closures to slow the spread of COVID-19 has abruptly pushed the cycle into the “Decline” phase.

In this Decline phase, we expect corporate earnings will be dramatically impacted by higher unemployment, reduced consumer spending and weak business investment. Companies are also aggressively drawing on credit facilities and issuing bonds to augment liquidity profiles, ensuring adequate financial flexibility to survive a potentially deep recession. This increased leverage, combined with expected lower earnings, should contribute to weaker credit metrics and a general deterioration of corporate credit profiles.

Despite expansive monetary and fiscal policy support, there remains a high degree of uncertainty surrounding the resumption of normal economic activity, potential consumer behavioral changes that could influence future spending and the resulting impact on corporate credit vitality.

Nonetheless, Conning believes valuations remain compelling for certain investment-grade (IG) corporate issuers with durable balance sheets that can withstand a potentially prolonged economic downturn. Careful fundamental analysis can identify the credits best prepared to successfully manage through this environment.

Figure 1 The Credit Cycle

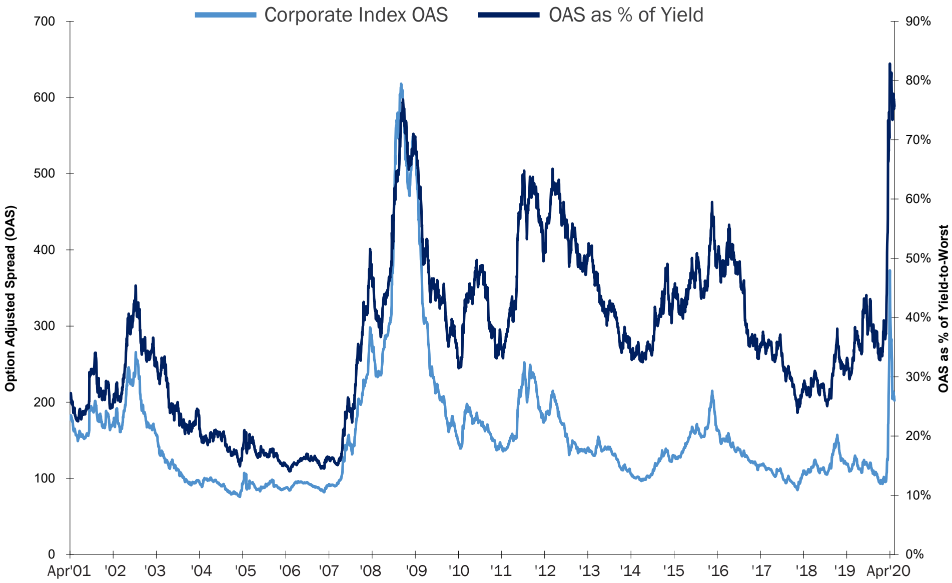


Prepared by Conning, Inc. as of May 13, 2020.

The Rise of BBB Rated Debt

As highlighted in Figure 2, spreads on corporate bonds widened dramatically as the crises unfolded, starting in late February 2020, and further accelerating into March. Unprecedented monetary intervention from the U.S. Federal Reserve (the Fed) successfully addressed liquidity stress in the market, serving as a catalyst for meaningful tightening of corporate spreads from the peak reached on March 23. Specifically aiding the corporate market was the announcement of the Primary and Secondary Corporate Credit Facilities. The former will act as a funding backstop for eligible issuers that are unable to access adequate credit accommodations and the latter is intended to support market liquidity, allowing the Fed to purchase corporate bonds and bond ETFs that meet eligibility criteria.

Figure 2 Corporate Index Spread as Percentage to Yield-to-Worst (April 2001-April 2020)



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A key consequence of any Decline phase is the deterioration of credit profiles and a related increase in credit-rating downgrades of corporate bonds. The rapid pace of downgrades as this credit cycle turned is due to the sheer velocity of the economic downturn, which has reduced financial expectations surrounding more disaffected industries and companies within those industries. In fact, the magnitude of downgrades during the initial few weeks exceeded the pace of downgrades of any previous crisis period over the recent past.

A complicating factor for this cycle has been the tremendous growth in BBB-rated corporate bonds, a by-product of low borrowing costs, accommodative capital markets, a general shift by companies to more aggressive policies and this cycle's extended Reach phase. This contributed to a general decapitalization of corporate balance sheets as approximately $3 trillion of corporate bonds, or nearly 50% of the Bloomberg Barclays U.S. Corporate Index, were rated BBB at the end of February before the economy began to deteriorate (see Figure 3). The negative economic shock from COVID-19 will erode corporate earnings for the duration of the year and further pressure credit metrics that were already stretched heading into this downturn.

A Rise in "Fallen Angels"

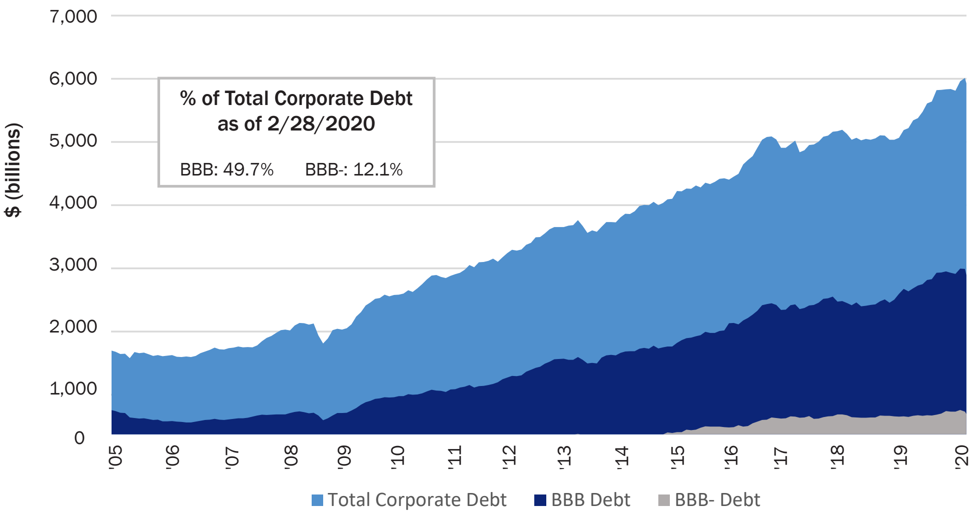
A consequence of the dramatic rise in BBB-rated debt and the rotation into the Decline phase are ratings downgrades known as "fallen angels," IG credits that are downgraded to high yield. Fallen angels have a meaningful impact on insurance companies: they face an exponential increase in capital charges on investments which are downgraded from NAIC 2 (IG) to NAIC 3 (below IG).

The significant increase in BBB-rated debt was accompanied by a similar increase in low BBB-rated debt, which totaled $730 billion at the end of February 2020. Low BBB-rated debt is the bottom rung of IG and therefore the most susceptible to a downgrade to below IG.

As of May 1, 2020, the "fallen angel" label has been applied to 19 issuers with approximately $130 billion of index-eligible debt. Several notable large capital structures have "fallen" including Ford Motor ($36 billion), Occidental Petroleum ($27 billion) and Kraft Heinz ($21 billion). The pace of fallen angels increased notably as a result of the social-distancing measures and economic stoppage that began in March, with the majority of downgrades occurring in either the energy space, due to the dramatic decline in crude prices, or in other more consumer-affected industries.

Predictions for potential fallen angels in 2020 are generally in the $200-$300 billion range, which Conning views as reasonable. We also believe that rating agencies may take a more patient approach to downgrades given the significant amount of monetary and fiscal support deployed to combat the economic fallout from the pandemic. However, uncertainty remains regarding the future trajectory of earnings and cash flow, which will be influenced by the reopening of global economies, the strength of the potential economic rebound and the resilience of the consumer.

Figure 3 Growth of U.S. Corporate Debt and BBB, BBB- Exposures, 2005-2020



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Fed Aid for Some "Angels"

Many of the possible future fallen angels with larger capital structures are in the automotive industry, are heavily influenced by air travel and aircraft demand (Boeing, aircraft lessors), are exposed to potential lost advertising revenue or have highly leveraged balance sheets and cash flows may be negatively impacted by lack of consumer spending due to social distancing mandates. A key determinant for credit fundamentals, and ultimately the retention of IG ratings, will revolve around the duration and magnitude of the recession and the behavior of consumers after the economy reopens. Another wildcard involves the potential for further government aid, specifically for the airline and automotive industries.

There are also more issuers in the energy industry with ratings at risk for downgrade to high yield. Crude prices have been caught in the perfect storm of oversupply, evaporation of demand and limited storage capacity. The resumption of economic activity will be an important component to improving the demand side of the equation and influence the ultimate magnitude of ratings downgrades.

While more fallen angels during this credit cycle are a near certainty, a notable difference from past cycles will be the Fed's ability to purchase bonds of eligible fallen angels that are downgraded after March 22, 2020. This will not alter the fundamental challenges of these issuers, but it will mitigate liquidity and refinance risk and has already provided material support to bond valuations, essentially easing the transition to high yield.

Careful Analysis can Identify Opportunities

We believe high-quality IG corporate issuers with durable balance sheets to help withstand a prolonged economic downturn offer compelling value in the new issue market. Many IG-issuer management teams have already begun taking prudent actions to defend credit profiles, including eliminating share repurchases, curbing dividends and reducing expenses and capital spending, all steps management teams take as a credit cycle migrates from Decline to the "Repair" phase. Conning continues to anticipate an increasing number of issuers rotating into the Repair phase soon as they look to preserve and improve balance sheets and fortify liquidity profiles.

Conning's favored issuers are often found in industries that have more defensive attributes and should prove more resilient in an uncertain economic backdrop. This includes areas such as defense contractors, communications, consumer products, mass-merchandise retailers that have a strong home-delivery presence, tobacco, railroads and utilities. As corporate spreads have widened, there has been record-setting new issuance in the corporate bond market as issuers continue to shore up liquidity positions, which has created compelling valuations for securities that have historically been either difficult to source or were only available at unattractive spreads.

Strong fundamental analysis can help identify these sector opportunities and specific names within them as we navigate through the Decline phase of the credit cycle.

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Corporate Bond Risks:
Market Risk - Market, or systematic, risk is the risk that individual securities may be correlated with general market downturns regardless of the particular business conditions and outlook for the individual companies
Credit Risk – eroding fiscal health in issuing companies resulting in inability to meet debt obligations
Inflation Risk - Inflation erodes the purchasing power of future cash flows from investments. In times of high inflation the value of securities may be reduced
Liquidity Risk - Liquidity risk can occur when market conditions do not allow transactions to be made in a quick and orderly fashion in relation to indicative market prices.

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