HIGH YIELD INVESTING

SHOULD HIGH YIELD INVESTORS WORRY ABOUT THE BBB OVERHANG?

SEPTEMBER 2018
EXECUTIVE SUMMARY

• For active high yield managers, some of the biggest opportunities can come when bonds are downgraded from BBB to high yield

• Analysis by Barclays shows that on average, bond prices recover in the months after being downgraded to high yield\(^1\)

• Careful credit analysis can pinpoint medium term turnaround stories, which can deleverage and return to investment grade

• Regionally we believe Europe is more vulnerable, with credit markets distorted by central bank purchases, and yields and coupons are at historically low levels

• Within high yield, we believe B-rated bonds are more attractive than BB-rated bonds as the technical picture is cleaner and global backdrop still supportive

\(^1\)Source: Bloomberg Barclays indices, Barclays Research as at July 2018.
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ALTHOUGH GLOBAL ECONOMIC GROWTH CONTINUES TO SHOW MOMENTUM, AT SOME STAGE THE CREDIT CYCLE WILL TURN, OR AN EVENT WILL IMPACT A PARTICULAR SECTOR, LEADING TO CREDIT DOWNGRADES. AN ISSUE WE ARE FOCUSED ON AT INSIGHT IS THE GROWTH OF BBB ISSUERS IN INVESTMENT GRADE CREDIT. FOR HIGH YIELD INVESTORS THIS OVERHANG OF BONDS WHICH COULD DROP INTO THE HIGH YIELD MARKET REPRESENTS BOTH A RISK AND AN OPPORTUNITY.

THE GROWTH OF BBB

Over the last 10-years, the amount of outstanding BBB issuance has grown significantly, climbing from around 25% of the Bank of America Merrill Lynch Global Corporate Index to just under 50% (see Chart 1). More recently, the growth of outstanding BBB debt has largely been a result of an increase in M&A-related activity and, in the US, stock buybacks. The largest share of outstanding BBB debt is in US dollars.

Chart 1: BBB bonds outstanding in major markets, 10-year history

BBBS NOW MORE THAN DOUBLE  
THE SIZE OF THE HIGH YIELD MARKET

This increase in issuance has been compounded by an upward trend in issuers being upgraded from high yield to investment grade (rising stars). As a result, the amount of outstanding BBB debt has grown relative to outstanding B and BB debt (see Chart 2).

Chart 2: Issuance by rating category

FALLEN ANGELS – RISK OR OPPORTUNITY?

Although the amount of outstanding BBB bonds has grown, there are many reasons for this over the medium term, not all of which are negative. Lower credit ratings for banks, as a result of changes in methodology post the global financial crisis and new forms of bank capital, are part of the BBB story. But many banks actually have higher capital ratios than before their downgrades and arguably are now less vulnerable. So although we have concerns about the BBB overhang, especially the M&A related growth of recent years, we also believe that the majority of these issues will continue to be investment grade even if global economic conditions deteriorate.

But, at some point in time, a credit event could lead to another spike in downgrades and a shift of issuers from BBB into high yield. As outstanding BBB issuance has grown it is reasonable to expect that such an event will be proportionately higher than historical episodes. Two notable credit events in recent history would be the global financial crisis and more recently in 2015/2016 when the decline in global commodity prices led to a downgrade of energy and mining companies. During the financial crisis, the cumulative 12-month gross volume of debt dropping down into the high yield category peaked at just over $100bn, while the peak during the commodity shock was just over $80bn (see Chart 3). These are significant volumes relative to the overall size of the high yield market.

Critically for high yield investors, the majority of any negative price impact on average occurs before an issue is downgraded to high yield. There will generally be a negative flow of news stories in the lead up to downgrade, and some investors will be forced to sell as they are unable to hold credit below investment grade. Analysis by Barclays suggests that historically, issuers on average have experienced a roughly 6% price decline in the five months before...
they lose investment grade status, but then recover by over 2% in the five months following downgrade (see Chart 4).

Chart 4: Price performance of fallen angels^5

But wouldn’t there be a negative impact on high yield overall?

If we examine the price performance of high yield and investment grade indices in the year leading up to the peak in downgrades and the year following, there is a notable difference between the global financial crisis and commodity shock. In 2009 there were broad-based declines in asset markets which led to a drawdown for both high yield and investment grade investors. But one year after the peak in downgrades high yield investors had experienced significant gains. In 2016, however, high yield investors experienced greater returns than investment grade investors in both the run-up to the peak in downgrades and in the year following (see Chart 5). These differences suggest that while a wave of downgrades might apply downward pressure on high yield markets, high yield could well provide higher returns than investment grade over a medium term time horizon.

Chart 5: Bloomberg Barclays high yield and investment grade index total returns (USD)^6

The duration of BBB debt is typically significantly longer than the duration of high yield debt (see Chart 6). One potentially negative consequence of a shift of previously BBB-rated issuers into high yield would, therefore, be that the duration of high yield indices could increase at a time when interest rates are expected to gradually rise.

A credit event could lead to another spike in downgrades and a shift of issuers from BBB into high yield.

So is it an opportunity?

For active investors, who can carefully sift through the companies that are falling into the high yield space, fallen angels can represent an opportunity, although downgrades in sizeable volumes tend to be disruptive for markets. By definition these companies are under some form of stress, which has ultimately led to their credit rating being downgraded. Some will stabilise their business and over time, recover, potentially being upgraded once again – and these represent significant opportunities to generate returns. But some businesses will continue to decline and eventually could default. Some of these companies may have reasonably large absolute levels of outstanding debt relative to an average high yield company and can thus quickly become sizeable weightings of high yield indices. Passive investors that track these indices have to purchase this debt regardless of the outlook, and for these investors, fallen angels can be a clear danger.

Chart 6: Duration by credit rating^7

CHECKING FOR REGIONAL VULNERABILITIES

Rather than simply reacting to downgrades it is important to have a depth of credit expertise, analysing the whole spectrum of issuers across all credit ratings on a bottom-up basis. This allows investors to highlight vulnerable parts of the investment grade bond market in advance of any deterioration in credit rating and to take action before a credit event occurs. An analyst that recommends a credit be sold from an investment grade portfolio on the expectation of a deteriorating credit outlook may have a more positive view once the issuer is downgraded, the business stabilises and spreads widen. This issuer may then become a perfect target for a high yield investor. Credit events can also be focused on specific sectors or countries, independent of company-specific news. In this scenario judging when to buy or sell can be a top-down or thematic call.

For example, in Europe, downward pressure on Italian sovereign ratings has a knock-on effect on all Italian corporate bonds. When we examine the outstanding issuance of BBB bonds as a percentage of high yield, Europe clearly stands out as having a significant BBB overhang, almost double the size of the US, with weaker eurozone countries key to this.

Chart 7: Outstanding BBB debt (excluding emerging markets) relative to the size of the high yield markets*

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European Central Bank (ECB) purchases critical for euro credit demand

At the end of the second quarter of 2016, the ECB launched its corporate sector purchase programme, which enabled it to directly purchase investment grade euro-denominated bonds issued by non-bank corporates. To the end of July 2018, the ECB had purchased €165bn in investment grade issuance (in both primary and secondary markets), versus a total of €347bn in net new issuance (see Chart 8). The ECB has thus been a significant support for eurozone corporate bond markets in recent years. With this huge buyer crowding out investors, anecdotal evidence suggests that those investment grade funds which have been able to allocate money into high yield have been purchasing BB-rated issuers in a search for higher yields. As the ECB moves to become less accommodative over time, so these investors may move away from these issues, which could create selling pressure in the BB area.

We believe that understanding these issues is key for asset allocation decisions and highlights the importance of being able to allocate regionally. The low yields in Europe, created as a result of these policies, have led to securities issued with coupons in the

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*aSource: Bank of America Merrill Lynch. Data as at 30 June 2018.*
2%-3% range. We would be extremely cautious on these issues given the expectation of a gradual normalisation in ECB policy and would generally favour US high yield over European high yield at this stage.

Chart 8: Euro-denominated credit issuance versus ECB purchases

TO B OR BB? THAT IS THE QUESTION

With investment grade investors allocating to BB-rated debt, we believe that the technical outlook is weak. In 2018, B-rated securities in both euro and US dollar-denominated debt have outperformed their BB rated counterparts (see Chart 9). On a risk/return basis, B performance has also been impressive, having a higher Sharpe ratio than BB-rated bonds (see Table 1).

Chart 9: BB versus B – total returns year-to-date

Table 1: Sharpe ratio

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<th>Euro BB</th>
<th>Euro B</th>
<th>US BB</th>
<th>US B</th>
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<tbody>
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<td>12 month Sharpe ratio</td>
<td>0.15</td>
<td>0.30</td>
<td>0.12</td>
<td>0.39</td>
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This is partially a result of the higher duration of BB bonds in an environment of gradually rising interest rates, and partially a result of very low default rates, which has left investors in lower-rated credits able to fully capture the yield premium available. For now, we expect this backdrop to continue and would thus favour B-rated securities over BB.

*Source: Bloomberg, Barclays. Data as at 31 July 2018.*
CONCLUSION

The growing role of BBB-rated issuance in investment grade indices has been the subject of market discussion for some time and is an issue which high yield investors need to be aware of. In future credit events, there will almost certainly be issuers that are downgraded from investment grade to high yield and the larger the pool of BBB issues, the larger the potential volume of downgrades. But the process of downgrade takes time and, as investment grade investors sell in anticipation of a downgrade, so prices decline before the bonds reach the high yield market. For active managers this can represent an opportunity, but careful analysis is needed to ensure that management have a workable plan to stabilise the business or, where the downgrade cycle is more systematic, that the business is positioned to benefit during any economic recovery.

When we look at the growth in BBB issuance globally, Europe stands out as having the largest overhang. This is partially the result of declining credit ratings in countries such as Italy and has been supported by the ECB who have been buying investment grade bonds. With monetary policy starting to normalise, European high yield could be more vulnerable than US high yield in this cycle. ‘Tourists’ who have been pushed into high yield by low interest rates, especially in Europe, could retreat as interest rates rise; creating a weaker technical picture for BB rated bonds. With the economic outlook still positive and defaults low, we favour B-rated issues at this time and expect them to continue their outperformance.

IMPORTANT INFORMATION

RISK DISCLOSURES

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

ASSOCIATED INVESTMENT RISKS

Where high yield instruments are held, their low credit rating indicates a greater risk of default, which would affect the value of the portfolio.

The issuer of a debt security may not pay income or repay capital to the bondholder when due.

Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.

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