



19 February 2016

### Moody's downgrades \$39.6bn of Energy paper to HY

One of our calls for this year was that the rating agencies would begin to downgrade significantly more companies than in recent memory. In our view, the ghosts of the financial crisis and the scrutiny the agencies experienced during the GFC over their delayed reaction to changing fundamentals could leave them much more inclined to downgrade shaky companies. Sure enough, earlier this week Moody's concluded rating reviews on 15 North American investment-grade rated companies and downgraded 9 of those to high yield status in what we believe marks the beginning of the next downgrade cycle. As a result of the rating agency's actions, 6 companies for a combined \$22.5bn will fall into our US HY index at the next rebalancing on February 29<sup>th</sup> (Table 1). When also factoring in \$1.4bn of defaulted Energy bonds month-to-date, the Energy portion of our HY index is expected to grow by more than \$21bn to \$222.5bn notional, or a 10.5% increase from today's level. All else equal, this means that Energy will increase from representing 15.1% of our US HY index today (9.8% of market value) to representing 16.5% of the index on February 29<sup>th</sup> (11.0% of market value). What's more, 7 of the reviewed companies are now only one notch away from falling into our HY index. If either S&P or Fitch follows suit, the Energy portion of our index would increase by another \$31.2bn to represent a significant 18.35% of US HY face value and 14.1% of market value, all else equal.

**Table 1: Moody's concluded its review of 15 North American IG Energy companies**

Name	Amt out (\$mn)	New rating	Old rating	Spread (bps) as of 02/18
Cenovus	4,750	BB1	BBB2	698
Encana	4,700	BB1	BBB2	1,095
Candian Oil Sands Ltd	1,450	BB2	BBB3	469
Continental Resources Inc	5,600	BB2	BBB3	958
Murphy Oil	2,250	BB2	BBB3	1,228
Southwestern Energy	3,800	BB2	BBB3	1,458
Anadarko Petroleum Corporation	9,025	BBB3	BBB2	604
Cimarex Energy Co.	1,500	BBB3	BBB3	482
EQT Corporation	1,950	BBB3	BBB3	632
Hess Corporation	5,650	BBB3	BBB2	611
Noble Energy	7,389	BBB3	BBB2	569

Source: BofA Merrill Lynch Global Research, Moody's

BofA Merrill Lynch Index composite ratings are the simple averages of ratings from Moody's, S&P and Fitch.

3 of the 6 companies that will enter our HY index next month are already trading above the current double-B Energy spread of 1,005bps. While we [recently wrote](#) that on average an issuer realizes most of its selloff before entering the HY index and subsequently tightens relative to existing BBs over the next 12 months, we caution investors to avoid commodities-related names to avoid catching a falling knife. Sure enough, performance varies greatly amongst fallen angels and credit picking becomes crucial.

To this end, we believe better opportunities to invest in fallen angels will present themselves later this year as we think we are in the beginning stages of what will be a

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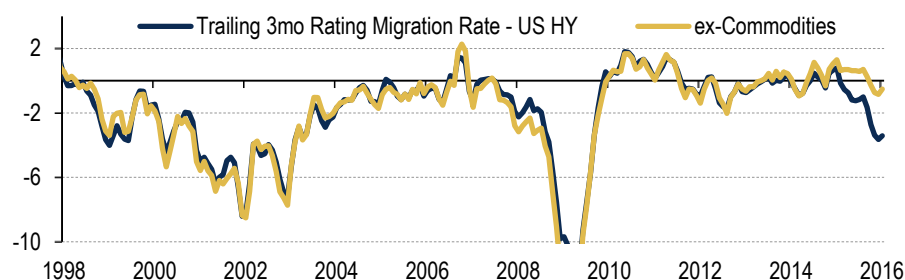
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prolonged downgrade cycle even outside of Energy paper. Even though ex-Commodities leverage is at all-time highs and ebitda growth remains anemic, ex-Commodities downgrades are only slightly outpacing upgrades (Chart 1). With \$38.3bn of ex-Commodity BBB- paper on negative watch or outlook by the rating agencies, we expect broad-based downgrades across all sectors later this year and into 2017.

**Chart 1: ex-Commodities rating migrations remain low**



Source: BofA Merrill Lynch Global Research

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