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Large Angels Fall Harder but Bounce Higher

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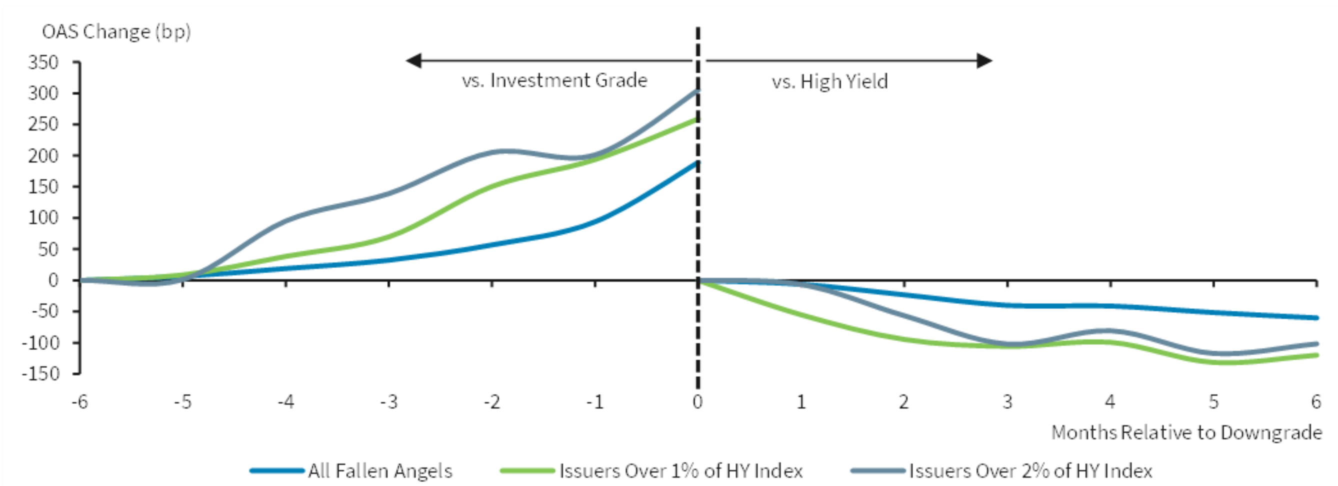
We continue to expect fallen angel volumes for 2019 to remain muted, projecting roughly $35bn of downgrades to high yield. In fact, we believe that rising stars will outpace fallen angels this year – continuing of the trend seen in eight of the past nine years (*Angels Flirt but Won't Fall*). That said, many investors remain cautious about the potential implications of large fallen angel volumes – for both the credits downgraded to high yield and legacy high yield issuers. In addition, specific focus has been placed on the largest BBB capital structures, especially given the shrinking size of the high yield market in recent years.

As outlined in *Big BBBs Won't Break Bad*, our investment grade analysts think that the largest BBB issuers have a low risk of downgrade to high yield given their significant cash flow levers and general defensive business industry positioning. That said, these names remain topical and continue to be a concern for investors. As a result, we think it is worth evaluating the historical performance of large fallen angels for investors who may have a more bearish view and view fallen angel risk as more problematic in 2019.

We find that the largest fallen angels fall the hardest but bounce the most. As seen in Figure 1, the OAS of fallen angel bonds since 2000 has, on average, widened 200bp more than the Investment Grade Index in the six months leading up to the downgrade to high yield. The bonds tightened versus the High Yield Index by roughly 60bp in the six months following the downgrade. When we look specifically at capital structures that are large enough to represent either 1% or 2% of the High Yield Index by amount outstanding after falling, we find that the moves are even larger, to both the upside and the downside. For example, debt structures that become more than 2% of the High Yield Index widen roughly 300bp relative to the Investment Grade Index in the six months before the downgrade and then tighten by more than 100bp relative to the High Yield Index in the six months following.

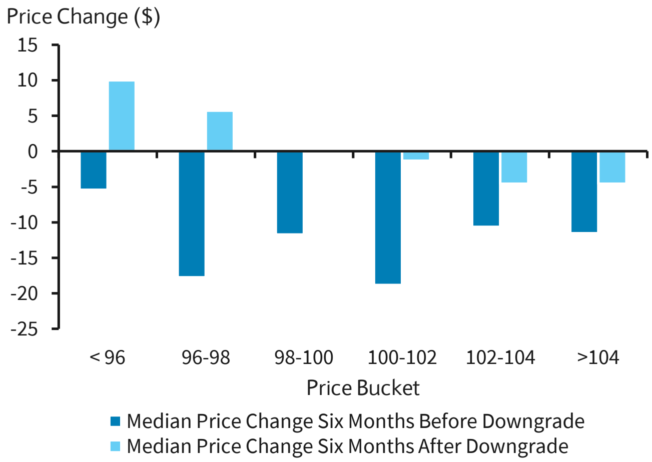
FIGURE 1
Larger Debt Structures Underperform More before Downgrade but Outperform More after Downgrade



Source: Bloomberg Barclays Indices

FIGURE 2

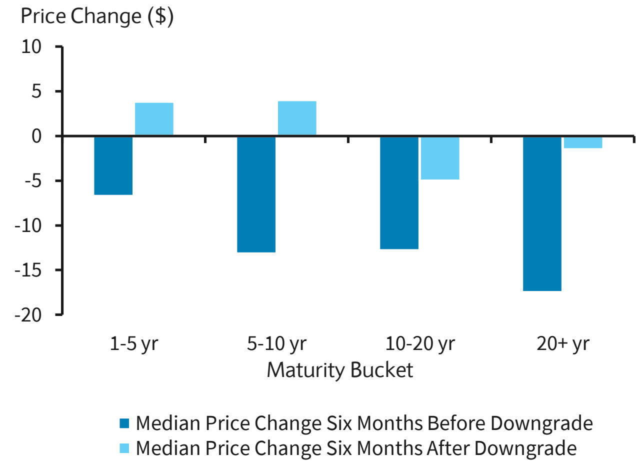
High Dollar Price Bonds of Large Fallen Angels Continue to Decline Following the Downgrade…



Note: Tracks bonds from fallen angel issuers that represent at least 1% of the US High Yield Index. Source: Bloomberg Barclays Indices

FIGURE 3

…As Do the Bonds with Longer Maturity at Time of Downgrade



Note: Tracks bonds from fallen angel issuers that represent at least 1% of the US High Yield Index. Source: Bloomberg Barclays Indices

We note, however, that data are limited for fallen angel cap structures that become more than 2% of the High Yield Index after downgrade, with only six instances since 2000 (the most recent in 2008) – Worldcom (2002), Qwest (2002), El Paso (2002), General Motors (2005), Ford (2005), and Sprint (2008). This group of credits outperformed the high yield market despite the dramatic underperformance of Worldcom, which filed for bankruptcy protection shortly after falling to high yield.

To get a more robust dataset of historical fallen angels that stayed in the High Yield Index for an extended period (ie, to avoid companies that quickly went from investment grade to high yield to default), we evaluate downgraded credits that represented at least 1% of the High Yield Index and remained in the index for at least one year after downgrade. This includes more than 300 bonds from 22 different large-cap structure fallen angels since 2000.

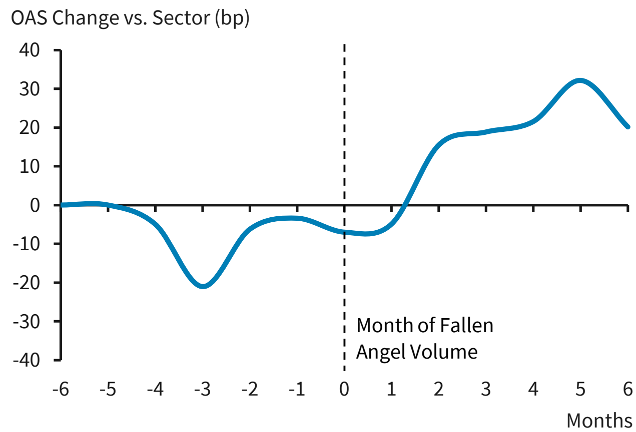
- **Performance by starting price:** Figure 2 illustrates the price change of these bonds in the six-month periods before and after the downgrade to high yield based on their price six months prior to the downgrade. High dollar price bonds tend to continue to decline after the downgrade, while lower dollar price bonds rebound. This supports our research indicating that lower dollar price bonds have better convexity than higher dollar price bonds (see *Capture the Convexity* for more details).

- **Performance by maturity:** Figure 3 breaks down these fallen angel bonds by years from the downgrade until maturity and shows that bonds with 10 or more years until maturity continue to decline in price by roughly $3 in the six months after downgrade. Conversely, bonds with less than 10 years to maturity experienced a median price rebound of $4 following the downgrade to high yield. This outperformance of the front end is consistent with high yield investors' preference for shorter-dated paper.

While the results above are for large capital structures, similar conclusions hold generally for all fall angels. In addition, while some of the higher-priced bonds are longer maturity, there seems to be no significant relationship between starting price and maturity buckets in our analysis.

FIGURE 4

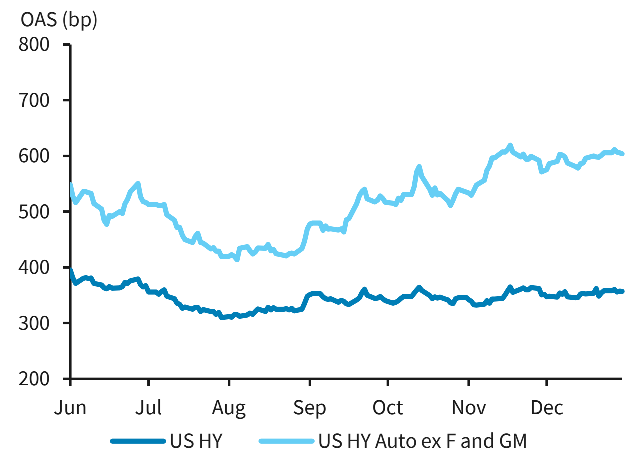
Performance of Largest Legacy High Yield Issuer Relative to the Sector When a Large Fallen Angel Enters the Sector



Source: Bloomberg Barclays Indices

FIGURE 5

Legacy US High Yield Automotive Spreads Widened Following the Downgrade of GM and Ford to High Yield



Source: Bloomberg Barclays Indices

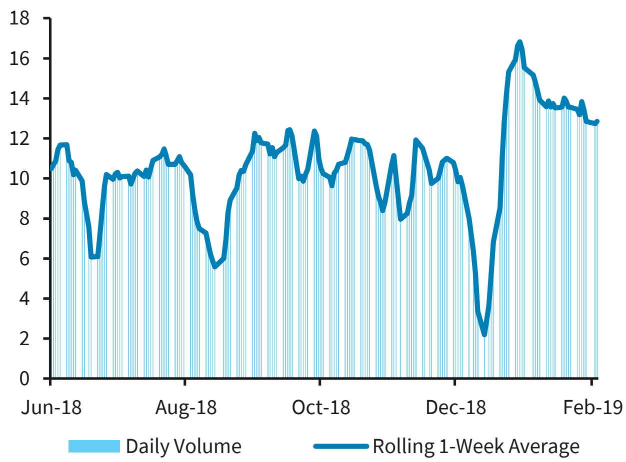
While this analysis explains the performance of fallen angels themselves, there are also trends for high yield issuers following large levels of downgrades, specifically for BB issuers as whole, as well as companies in the industries where the downgrades occur. In *Gauging the Effect of Falling BBBs,* we found that legacy BB names (BB issuers excluding fallen angels) tended to perform in line with their beta-implied levels in periods of significant fallen angel volumes. Specifically, they outperformed BBBs but underperformed single-Bs. This indicates the ability of legacy BBs to digest large amounts of new bonds that fall into the High Yield Index.

On an issuer-level basis, the story is different. Figure 4 shows the spread move of the largest issuer in a specific high yield sector relative to the index when there is at least $10bn of fallen angel volumes in a given month in that sector (see *Angels Flirt but Won't Fall* for more details). On average, the largest legacy high yield issuer tends to widen by more than 20bp relative to the index in the six months following a large volume of fallen angels in the same sector.

Following Fitch's downgrade of Newell Brands (NWL) to BB+ earlier this week, the company would fall to the High Yield Index with a one-notch downgrade by either Moody's or S&P (Moody's has the company on negative outlook). While Newell's roughly $6bn of US High Yield Index-eligible debt would represent only 0.5% of the High Yield Index, it would constitute approximately one-fourth of the high yield consumer products sector – a magnitude that could cause ripples in the valuations of existing issuers in the sector. Mattel (MAT), Spectrum Brands (SPB), and Energizer Holdings (ENR) are currently the largest issuers in the high yield consumer products sector (see *4Q18 Review: A Longer Road to Staying IG* for more details).

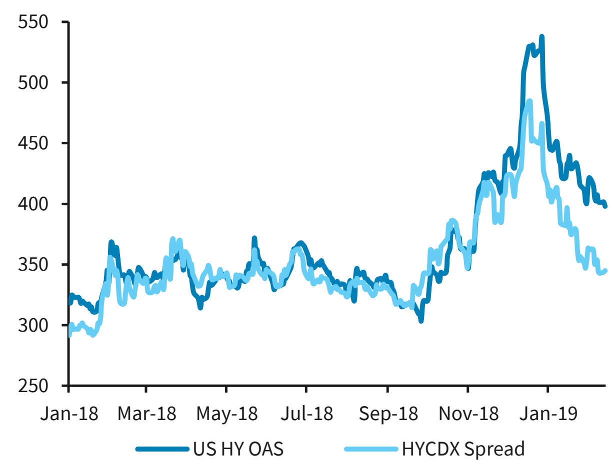
A noteworthy example of a large volume of fallen angel debt within the same sector occurred in May 2005, when both General Motors and Ford were downgraded to high yield. As seen in Figure 5, US High Yield Index spreads tightened nearly 40bp in the six months following the downgrade of GM and Ford, while the legacy high yield automotive index saw spreads widen nearly 60bp. Although some of this performance can be explained by secular pressures on the industry, we think that the addition of GM and Ford to the high yield automotive subsector resulted in selling pressure on legacy high yield names. Ultimately, the underperformance of high yield issuers during periods of large fallen angel volumes will be exacerbated if multiple large capital structures are downgraded within a compressed period, especially if those issuers are in the same industry.

High Yield Average Institutional Trade Volume ($bn)



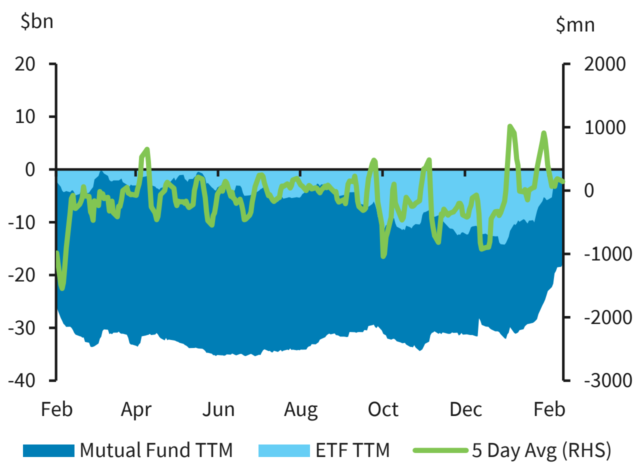
Note: Includes both registered and 144A volumes. Source: FINRA TRACE

On-the-Run HYCDX versus US High Yield Index (bp)



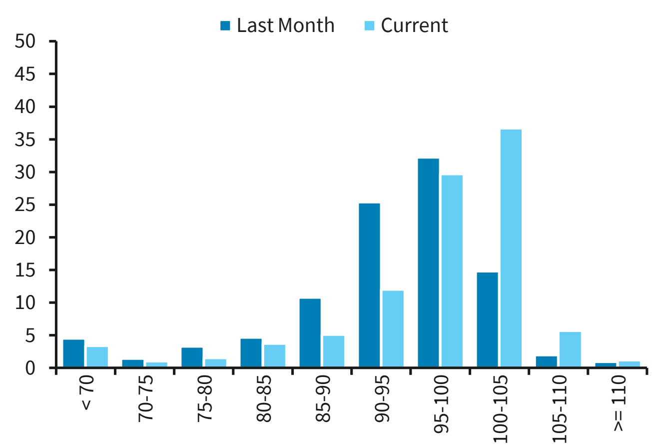
Source: Barclays Research

Flows to High Yield Mutual Funds and ETFs



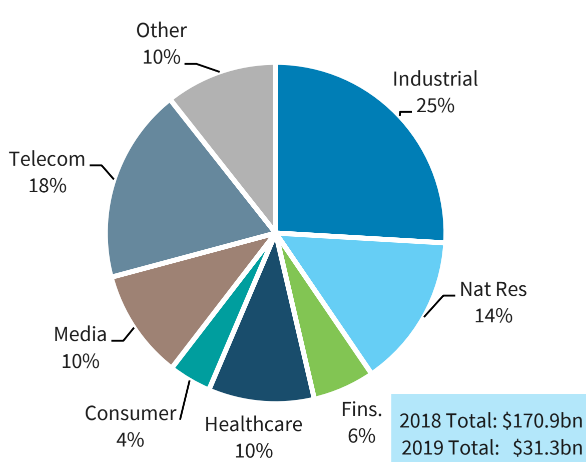
Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



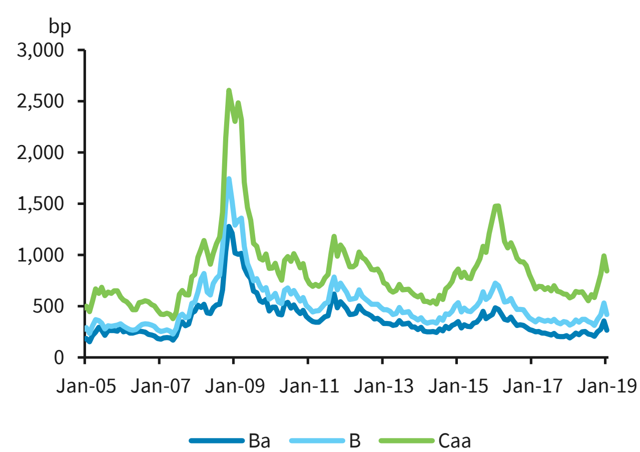
Source: Barclays Research

High Yield Supply by Sector



Source: Bloomberg Barclays Indices

High Yield Spreads by Credit Quality



Source: Bloomberg Barclays Indices

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