

High Yield

Tracking a Thousand Stars

We find that rising stars tend to outperform by 60bp in OAS terms in the weeks before their upgrade and just 10bp in the weeks after. Bonds that are shorter dated and those that are not call-constrained lead performance, with larger issuers benefiting as well.

High yield spreads rebounded this week, as coronavirus concerns have eased somewhat and corporate earnings have exceeded expectations, with the market 30bp tighter since last Friday. Much like 2019, higher quality has led performance in 2020, with BB returns outpacing lower-rated cohorts (although last year's outperformance was driven by spread tightening and this year's returns have been the result of the rates move). A tailwind for BB performance in recent years has been rising star volumes, which have outpaced fallen angels in eight of the past nine years, with 2019 posting the largest net rising star volume in history.

We believe that 2020 will be more balanced than recent years in terms of fallen angel and rising star volumes based on the combination of our top-down analysis of fundamental trends and growth expectations and bottom-up views from our fundamental analysts (for more details, see [2020 Rising Star and Fallen Angel Forecast](#)). That said, rising star performance should continue to have a meaningful effect on portfolio returns, especially in regard to the timing of performance around the upgrade.

To quantify this effect, we evaluate the performance of more than 1,000 rising star bonds dating back to 2006 relative to their respective indices (the US High Yield Index before the upgrade and the US Credit Corporate or US 144A Index following the upgrade). On average, rising star bonds outperform by a total of 70bp over the 24 weeks around the upgrade. While we find no material difference in performance for 144A bonds relative to registered bonds, longer-dated bonds and call-constrained bonds tend to outperform less. Bonds from larger issuers outperform bonds from smaller issuers by nearly double, all of which tends to occur before the downgrade. Rising stars that were issued in the investment grade market saw no material performance difference from those issued with high yield ratings.

With this context of analysis, we provide a list of rising star candidates for 2020 based on research provided by our fundamental analysts.

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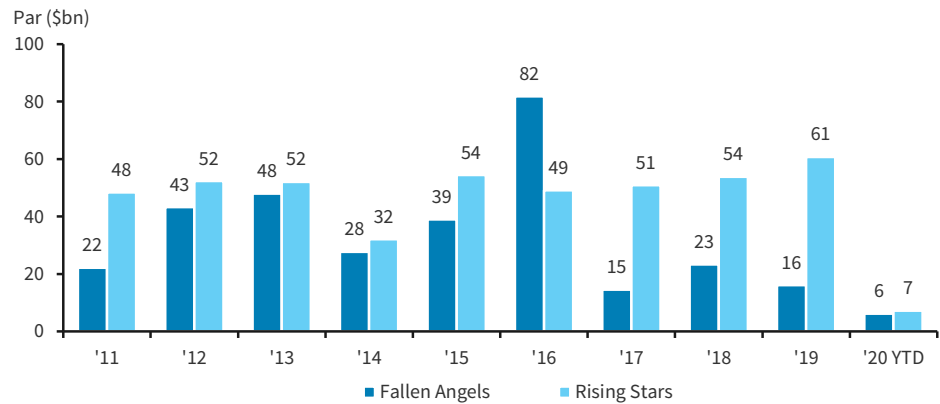
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FIGURE 1. Rising Star Volumes Have Outpaced Fallen Angels in Eight of the Past Nine Years

Source: Bloomberg, Barclays Research

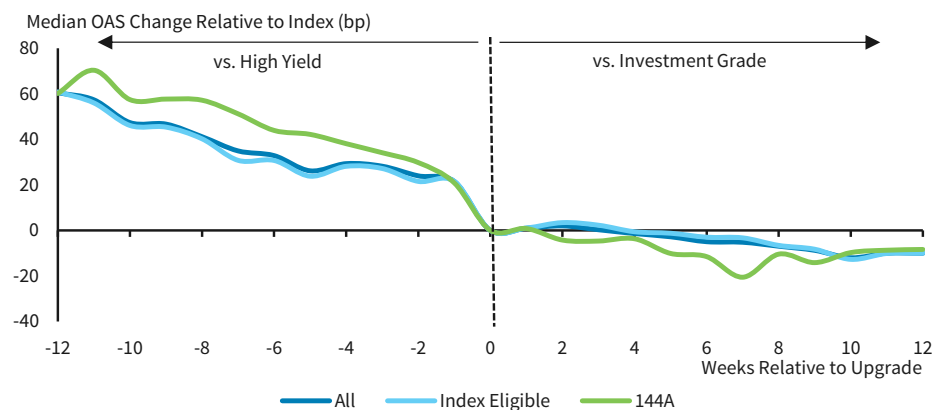
All Rising Star Performance

Across all rising stars, we find that bonds tend to tighten by 60bp relative to the high yield index in the twelve weeks leading into the upgrade. In the twelve weeks following the upgrade there is modest outperformance relative to the investment grade index of 10bp (Figure 2). Of these bonds, roughly 58% were still in the IG or 144A indices twelve weeks after the upgrade, meaning that 42% fell out of their index as a result of being called, reaching less than one year to maturity, or not meeting the increased amount outstanding threshold for the investment grade-rated indices.

144A versus Registered Bonds

Somewhat surprisingly, we find no meaningful difference in performance between US Credit Corporate Index-eligible bonds and 144As, which are excluded from the investment grade index, pointing to a similar technical for 144A and registered bonds. Although they represent more than half of the high yield market now, 144As were a small portion of high yield bonds up until a few years ago and, therefore, represent roughly 20% of the rising stars in our study.

The outperformance relative to the high yield index prior to the upgrade tends to be fairly smooth, with a more drastic move only in the week of the upgrade. In fact, aside from a median outperformance of 22bp in the week of the upgrade, no other week saw a move of more than 10bp, implying a fairly stable grind tighter in the months leading into the upgrade.

FIGURE 2. Rising Stars Outperform the High Yield Index by 60bp before Upgrade and Modestly Outperform the Investment Grade Index After

Source: Bloomberg, Barclays Research

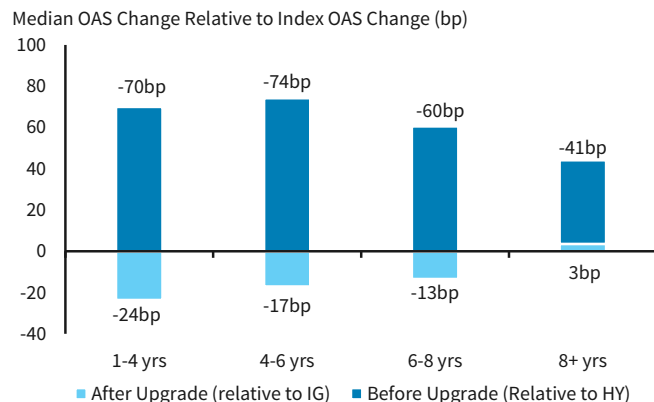
Maturity Buckets

The outperformance of rising stars tends to decline for bonds with longer time to maturity. In Figure 3, we bucket rising star bonds based on years to maturity from the time of their upgrade. Bonds in the 1-4 year and 4-6 year buckets posted similar performance, outperforming by 94bp and 91bp, respectively, across the 24-week period. Conversely, long-dated bonds outperformed the index by only 37bp, with modest underperformance (3bp widening) occurring following the upgrade. The same relationship exists when we run the analysis across duration buckets as well.

Price and Call-Constrained

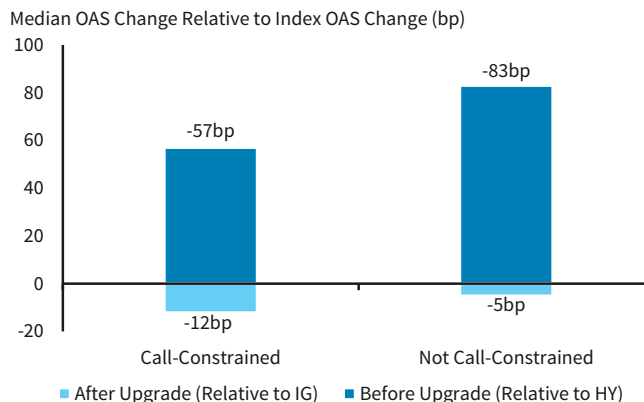
Unlike maturity, the absolute price of a bond at the time of upgrade does not seem to have a strong relationship with performance. That said, the price of the bond relative to its next call price is material. As seen in Figure 4, bonds that were trading above their next call price at the time of the upgrade outperformed by a total of 69bp (57bp before the upgrade and 12bp after the upgrade). Conversely, bonds that were below their next call price or bullet bonds outperformed by 88bp given the lack of cap on upside found in call-constrained bonds.

FIGURE 3. Rising Stars with More Time to Maturity Experienced the Least Outperformance



Source: Bloomberg, Barclays Research

FIGURE 4. Outperformance Is Limited for Call-Constrained Rising Stars

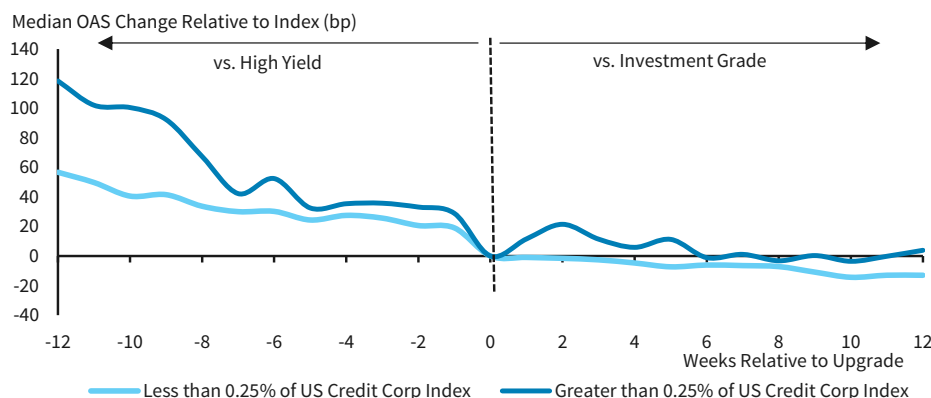


Source: Bloomberg, Barclays Research

Size of Issuer

In addition, the size of the capital structure being upgraded matters in regard to performance. Figure 5 divides the universe of rising stars into two buckets: issuers whose total upgraded bonds represent at least 0.25% of the investment grade index at the time of the upgrade and issuers below that threshold (that divide is roughly \$13bn currently). Roughly one-fourth of the upgraded bonds in our study were above this bar and had a median relative spread tightening of almost 120bp – nearly double the level of smaller capital structures. Following the upgrade, though, there is modest outperformance by smaller issuers (13bp), while the large issuers underperform their respective index by a few basis points, on average.

The increased magnitude of performance for large capital structures echoes our fallen angel findings. As discussed in [Large Angels Fall Harder but Bounce Higher](#), bigger fallen angels tend to underperform the investment grade index before the downgrade more than the average fallen angel, with greater outperformance relative to high yield after the downgrade.

FIGURE 5. Larger Rising Star Structures Outperform Smaller Structures

Source: Bloomberg, Barclays Research

Originally Issued with Investment Grade or High Yield Ratings

Understandably, many of the rising stars in our analysis were originally issued as investment grade bonds. In fact, 30% of the bonds in the study were fallen angels prior to being rising stars, indicating that they were returning to the investment grade market. Despite the lack of call provisions for the bonds issued as investment grade, which could cap upside, there was no meaningful performance difference between bonds that were originally investment grade and those that were issued in the high yield market.

Issuers took advantage of the chance to refinance debt at investment grade levels in the weeks following the upgrade at roughly the same rate for bonds that were issued in the investment grade and high yield markets. Roughly 55% of the bonds initially issued with investment grade ratings were still in the index after twelve weeks, a rate similar to bonds that were initially high yield rated.

2020 Rising Star Candidates

Using this analysis as a backdrop, we work with our fundamental high yield analysts to highlight an updated list of issuers that they believe could be rising stars in 2020. This list can be seen in Figure 6 and includes commentary focused on the leverage targets provided by the issuers and rating agencies.

FIGURE 6. Rising Star Candidates for 2020

Ticker	Company	Sector	US HY Amount Outstanding (\$ bn)	Analyst	Commentary
AES	AES Corp	Electric Utility	3.9	Not Covered	AES was upgraded to investment grade at Fitch in November, having achieved its deleveraging target (parent leverage of 4x or below), and is on BB+ positive outlook at S&P. We think S&P could upgrade this year if AES retains recourse leverage below 4x and manages challenges at non-recourse opcos (eg, DPL and Argentina) such that there is no change in the recourse leverage profile.
CF	CF Industries	Chemicals	3.0	Brian Lalli	As of early December, both S&P and Fitch now rate CF BB+/Positive – an upgrade will ultimately require sustainable free cash flow generation and an outright commitment from management (which it recently made on the 3Q19 conference call).
CIT	CIT Group	Banking	3.8	Peter Troisi	CIT already has one investment grade rating (Fitch), and its Ba1 rating at Moody's has a positive outlook. CIT has met most of Moody's upgrade criteria, and we believe the agency is waiting for a quarter or two of integration progress with regard to a recently closed acquisition. We see little risk to a smooth integration and expect otherwise stable fundamentals to support an upgrade from Moody's later this year.

Ticker	Company	Sector	US HY Amount Outstanding (\$ bn)	Analyst	Commentary
CNC	Centene	Health Insurance	13.9	Not Covered	CNC's pro forma leverage is roughly 3.0x, and debt to cap is roughly 39% (pro forma). Fitch is targeting 2.8x leverage and 36% debt to cap for an upgrade. Moody's targets include leverage below 2.2x, a reduction in Medicaid concentration, and lower reliance on full risk membership. Considering that the company is near Fitch's targets, we believe the agency's focus is on consolidated results and evidence that the integration is going well, implying that it may be 1-2 quarters before an upgrade. Given the strong earnings power of the two entities (CNC and WCG), we believe there is a high probability of upgrade.
RBS	Royal Bank of Scotland	Banking	1.2	Christy Hajiloizou	In-scope securities are legacy T1 hybrids and are subject to idiosyncratic outcomes. Moody's has a positive outlook on the Ba1 rating, which has been in place since July 2018. An upgrade seems likely in the event that the company substantially completes its multi-year restructuring exercise and maintains organic capital generation and sustainable profitability.

Source: Bloomberg, Barclays Research

Analyst(s) Certification(s):

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