

# US High Grade Strategy Flash

## A new definition of quality

- Index-driven orthodoxy calls for US high-grade bonds to be assigned to one of four rating categories (AAA to BBB) based on the middle rating of three agencies. We critique this method, propose an alternative for purposes of analysis, and apply it to today's compressed market environment, with some surprising results.
- After looking for signs of value across credit qualities by segmenting US IG paper into five novel and similarly sized rating tiers, we find that investors should favor the wings of the quality distribution over the belly.

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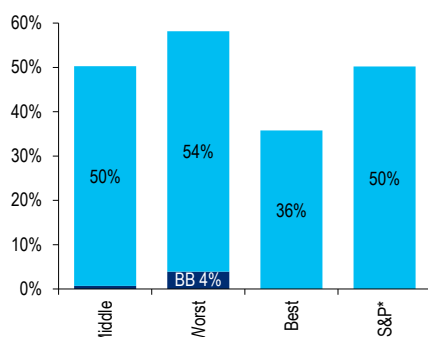
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**Figure 1. BBB share of IG corporate market under different rating classification systems**



Source: Citi Research; Refinitiv; Bloomberg Financial  
\* S&P if available, or else Moody's.

## A five-tier ranking system for IG quality

The familiar, four-tiered ratings classification system for high-grade corporate bonds has lost much of its utility in recent years. For one, rating categories have become extremely uneven in size. The US IG market has thinned out on top (in AAA/AA) and grown bottom heavy (in BBBs) as issuer quality has eroded (**Figure 1**). Beyond the bucket sizes, there are also deep ambiguities under the conventional approach classifying bonds by the middle-of-three rating. Twenty percent of bonds classified as single-A under this approach actually hold a BBB rating at one of the major agencies, and 29% of BBBs have at least one single-A rating. As credit cycles turn, the highest ratings of split-rated issuers [become vulnerable](#), making the conventional approach perilous for a late-cycle environment.

In this note, we propose a modification to the conventional classification system for alpha-level credit ratings of corporate bonds. Our classification system, which we apply here to non-bank bonds,<sup>1</sup> is intuitive in its definitions and has several other desirable properties for both portfolio analysis and credit strategy. First, it results in roughly evenly sized segments across five tiers. Second, it emphasizes disagreement between agencies across letter ratings, information that is typically

**Figure 2. The “wings” of IG non-bank market quality curve offer better value than the belly**

Tier	To tights (bps)	Percentile rank
Any AAA/AA	18	47%
Pure A	17	30%
Split A/BBB	23	25%
Pure BBB1-2	31	49%
Any BBB3/BB	37	55%

Source: Citi Research; Refinitiv; Bloomberg Financial  
Note: Nov 2017-July2019

discarded in the traditional index-based approach. Third, trends in spreads across these five segments suggest that they are more in line with how the market actually trades, a point we illustrate below. The basic contour of the model is simple. At the top and bottom tiers, even one very high or very low rating dominates.

■ Top tier – Any AAA/AA (18%): Bonds with a AAA to AA3 at any agency

■ Bottom tier – Any BBB3/BB (18%): Bonds with any BBB3/BB ratings

The middle three ratings are determined by the distribution across agencies.

■ Pure A (24%): Bonds with ratings exclusively in the A1-A3 range

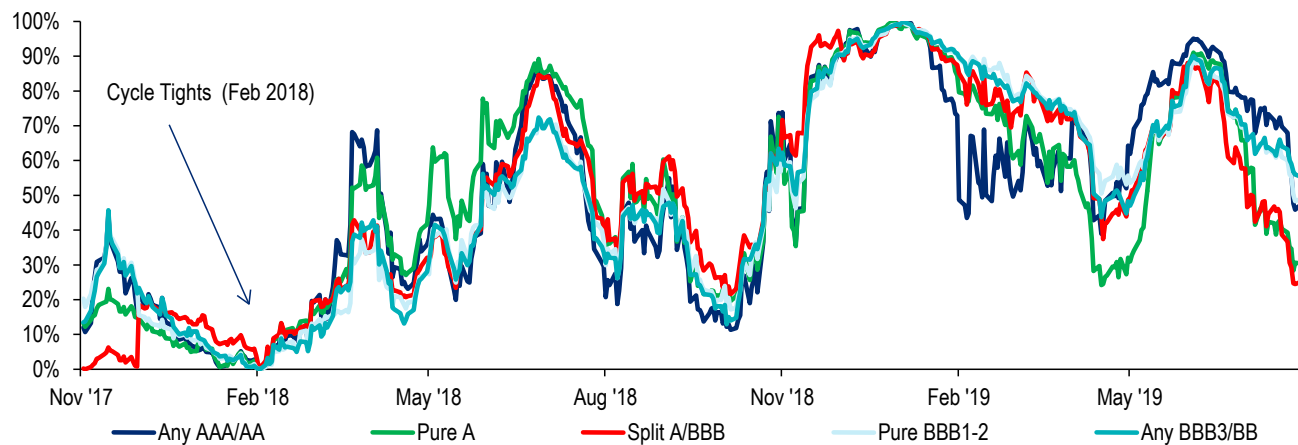
■ Split A/BBB (20%): Bonds with legs in both A and BBB

■ Pure BBB1-2 (20%): Bonds with ratings only in the mid- to high BBB range

At February 2018 tights, and the wides of early 2019, the spread across all five segments hit troughs and peaks simultaneously. We favor the highest- and lowest-quality segments over the belly of the quality curve (**Figure 2**), to capture a temporary divergence in spreads that has favored pure A and split A/BBB issuers (**Figure 3**).

<sup>1</sup> Bank credit rating trends have been led as much by agencies' model revisions as issuer quality.

Figure 3. Percentile rank of IG non-bank spreads across five-tier rating categories, November 2017 to July 29, 2019



Source: Citi Research; Refinitiv; Bloomberg Financial

## Appendix A-1

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