Fallen Angels Holding in Well, So Far

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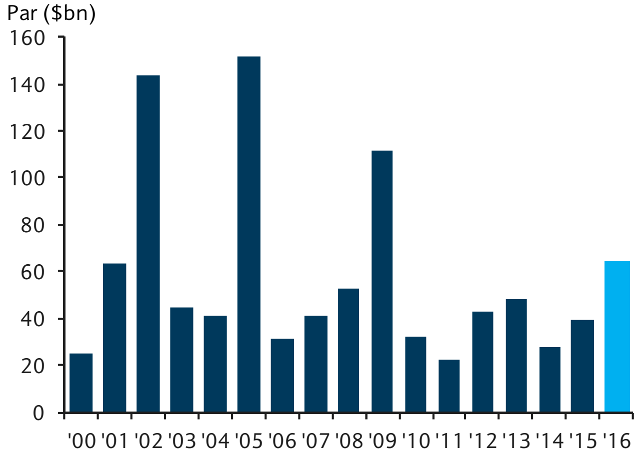
As rating agencies have adjusted their commodity price outlooks lower, fallen angel volumes have risen sharply. About $62bn of debt (by amount outstanding) has been downgraded from investment grade to high yield in the first two and a half months of the year, which is already higher than any other full-year total since the crisis (Figure 1). Almost all of the downgrades this year have been in the commodities sectors, continuing the trend from last year. In fact, metals and energy together now account for over 75% of fallen angel debt (debt that has been downgraded to high yield within the past 18 months; Figure 2).

Although $62bn of bonds have already fallen to high yield, we continue to expect roughly $155bn of downgrades in 2016 and the first half 2017 (*Will Angels Drop Like Flies?*, January 22, 2016), with significant risks to the upside if oil prices resume their declines and stabilize closer to $30/bbl over the longer term. The total would exceed previous historical highs on an absolute basis (eg, 2002 and 2005), although it would be substantially lower as a percent of the US High Yield Index. The $62bn of downgraded debt year-to-date is about 5% of the index, and $155bn would be roughly 12% of the index; in comparison, the $140bn of downgrades in 2002 represented about 30% of the index at that time. That said, 12% (and 5% so far this year) is a nontrivial number and could be large enough to cause technical dislocations in the index.

Year-to-date, fallen angel issuers have generally mirrored historical performance patterns around downgrade events, underperforming investment grade leading up to the downgrade, but outperforming upon entering the High Yield Index (Figure 3). The outperformance after entering high yield, however, has been especially notable: fallen angels have generated 10% better returns than the broader high yield market in the six weeks following a downgrade. This is likely in large part due to the better risk sentiment that has characterized markets over the past month (most of the fallen angel issuers have been downgraded within the past month).

FIGURE 1

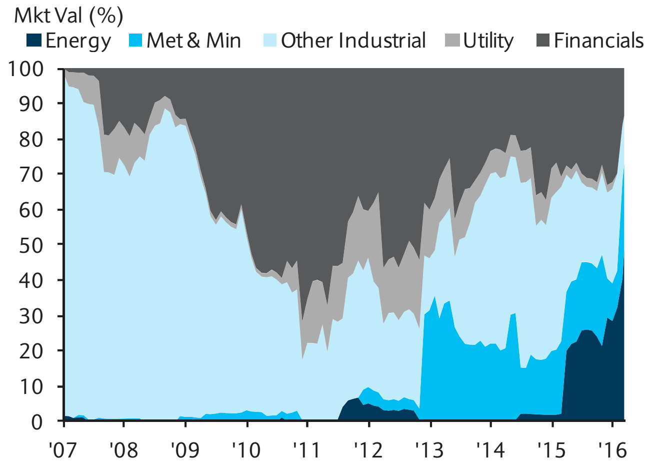
Fallen Angel Volumes Have Accelerated in 1Q16



Note: 2016 numbers are as of March 16. Source: Barclays Research

FIGURE 2

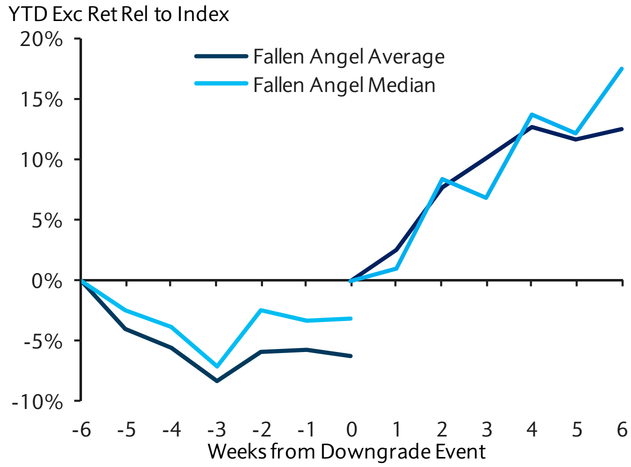
Commodity Composition of Fallen Angels Is Now about 75%



Note: Includes issuers that have downgraded with the past 18 months at any given point in time. Source: Barclays Research

FIGURE 3

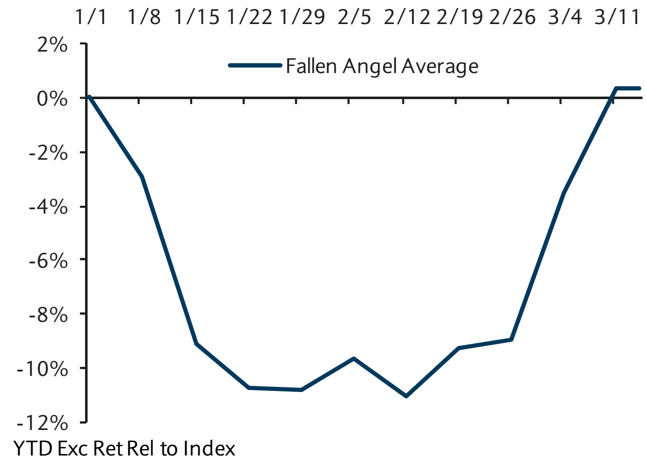
Fallen Angel Performance around Downgrade Date for Issuers that Have Been Downgraded This Year



Source: Barclays Research

FIGURE 4

Year-to-Date Performance of Recent Fallen Angels Relative to the Index



Note: For fallen angels that have been downgraded to high yield in 2016. Source: Barclays Research

Indeed, fallen angel outperformance only began when the index as a whole was rallying. Figure 4 tracks the year-to-date performance of the current list of downgraded issuers (not around the downgrade date, but for the entire year). While downgraded credits underperformed the index by almost 12% initially, on average, excess returns are now roughly in line with the rest of the index following the recent market rally (which began in mid-February). In our view, this suggests that market factors have been dwarfing technical headwinds, as recent increases in oil and commodity prices have disproportionately benefited commodity credits.

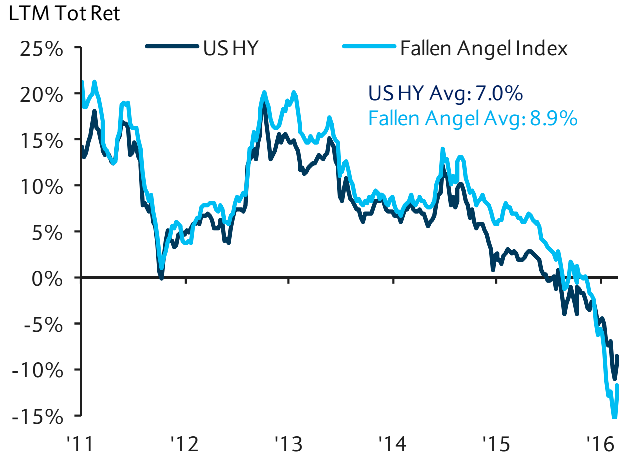
Furthermore, we believe a few other technical factors are offsetting the fallen angel effect. First, USD high yield supply has been very low. Only $22.3bn has been issued so far this year in the primary market, which equates to only about $100bn on an annualized basis. This would be a 60% drop-off from last year. With so little primary issuance coming in to compete for demand, fallen angel issuers are likely to be taken up well by the high yield market. Second, demand technicals have improved markedly in the past month. More than $10bn has flowed into high yield mutual funds and ETFs over the past four weeks, and now flows are net positive for the year. Under these circumstances, there has been plenty of appetite to add risk, especially in BBB and BB commodity names. As long as these market conditions remain, we expect fallen angels to perform well.

Fallen Angel Index

In order to gauge the historical performance of fallen angels upon entering the High Yield Index and to put the current market dynamics into a broader context, we have created a fallen angel index that includes companies that have been downgraded to high yield within the past 18 months. As Figures 5 and 6 show, recently downgraded issuers tend to outperform the broader index on a total return basis (especially in risk-adjusted terms). Over the past five years, our fallen angel index has generated a 1.9% higher return per year, on average, with a significantly higher Sharpe ratio. In other words, a strategy of buying downgraded credits at the end of the month of downgrade and selling them after holding for eighteen months has tended to perform well against the broader index.

FIGURE 5

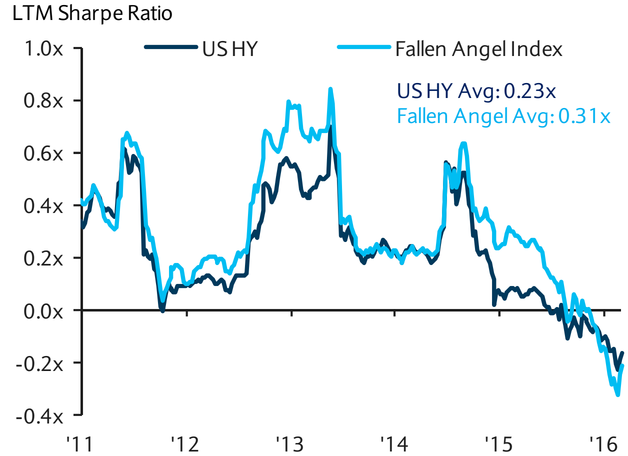
A Basket of Recent Fallen Angels Has Historically Posted Significantly Higher Returns than the US High Yield Index…



Basket includes bonds downgraded in past 18 months. Source: Barclays Research

FIGURE 6

…Especially on a Risk-Adjusted Basis



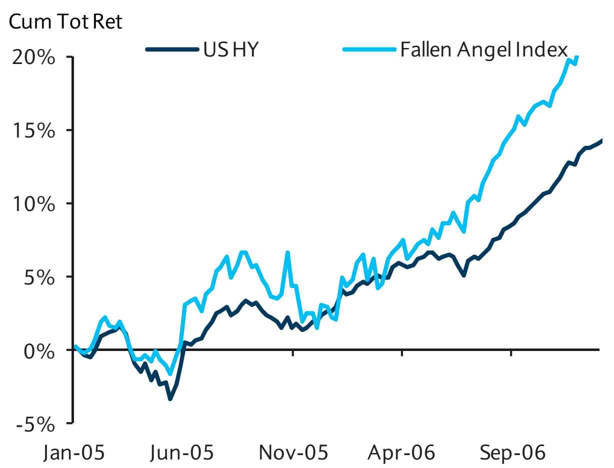
Note: Sharpe ratio. = average LTM weekly return/52-week volatility. Source: Barclays Research

In fairness, the past five years have had relatively low fallen angel volumes by historical standards. Our custom index, however, does go back to 2004 and captures two other "high fallen angel" periods: 2005 and 2009. In both cases, fallen angel issuers tended to hold up well, eventually outperforming the broader index. In our view, the 2005 downgrades are the better comparison, given that downgrades were focused on a specific sub-sector (autos) and occurred even as the broader economy was relatively healthy. Despite brief underperformance in late 2005, the fallen angel index rallied quickly and was outperforming high yield by early 2006 (Figure 7). In 2008-09, angels held up even better, performing in line with the index through the crisis and outperforming afterward (Figure 8).

Overall, a basket of downgraded credits appears to have consistently generated better returns than the High Yield Index. In the medium term, we expect the performance of fallen angels to be highly dependent on oil and commodity prices, given the high concentration of commodity credits. In any case, for investors looking to increase exposure to energy, recently downgraded credits may be a good place to invest, relative to others in the High Yield Index.

FIGURE 7

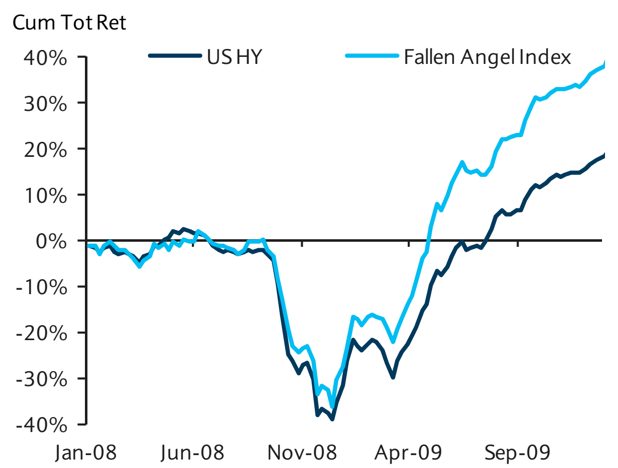
Fallen Angels Outperformed around the August 2005 Auto Downgrades



Source: Barclays Research

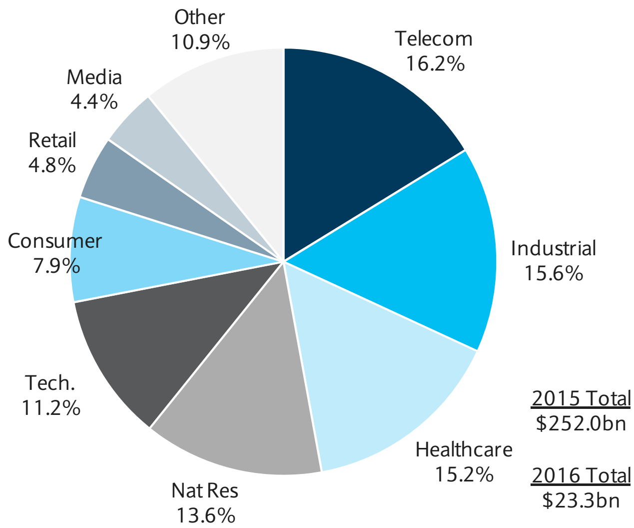
FIGURE 8

Fallen Angels Outperformed in 2008-09 as Well, Following Crisis-Related Downgrades



Source: Barclays Research

High Yield Supply by Sector



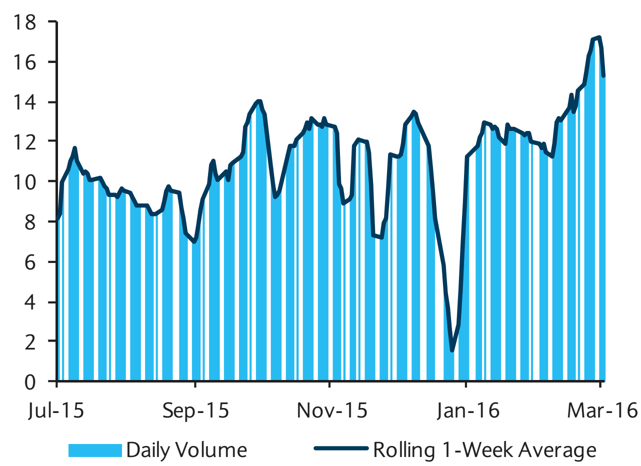
Source: Barclays Research

Top On-the-Run CDX Index Names by Weekly CDS Volume

	Notional Outstanding ($bn)		Volume – Week Ending 2/26/16 ($mn)
	Gross	Net	Gross
MBIA Insurance	23.2	1.0	198.4
Chesapeake	9.2	0.9	173.9
US Steel	7.2	0.8	172.2
JC Penney	13.5	0.7	131.8
K. Hovnanian	7.9	0.6	130.9
CIT Group	2.6	0.5	111.3
Hertz	4.8	0.6	108.2
Centurylink	10.1	0.7	99.1
Ally Financial	10.3	0.8	92.5
KB Home	6.5	0.5	85.5

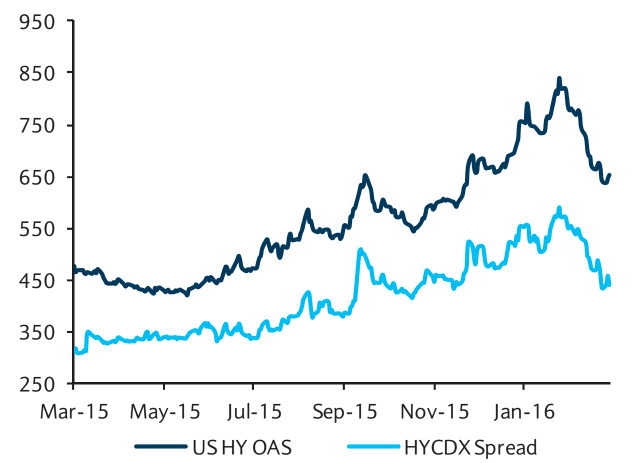
Source: DTCC

High Yield Average Institutional Trade Volume ($bn)



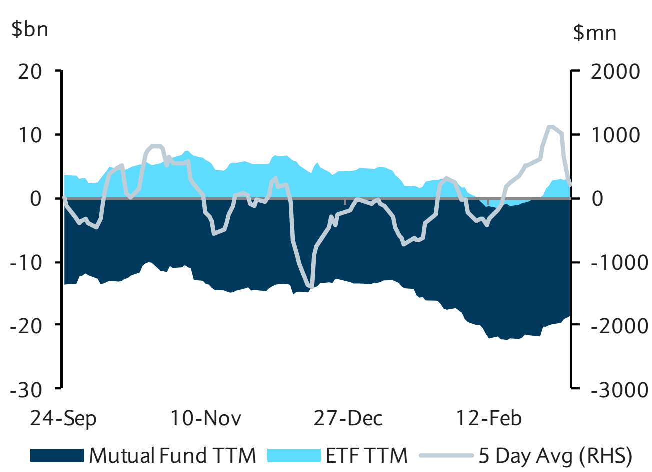
Note: Includes both registered and 144A volumes. Source: FINRA TRACE

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



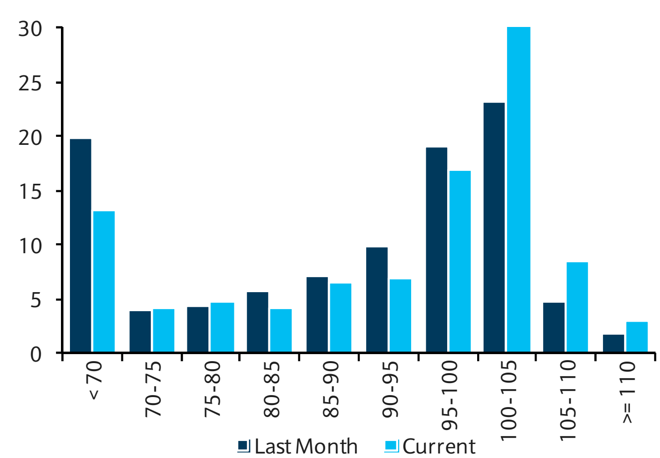
Note: CDX increase partly reflects roll to CDX.HY.25. Source: Barclays Research

Flows to High Yield Mutual Funds and ETFs



Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



Source: Barclays Research

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