# Quality Control

## Euro investment grade ratings migration

European Credit Strategy
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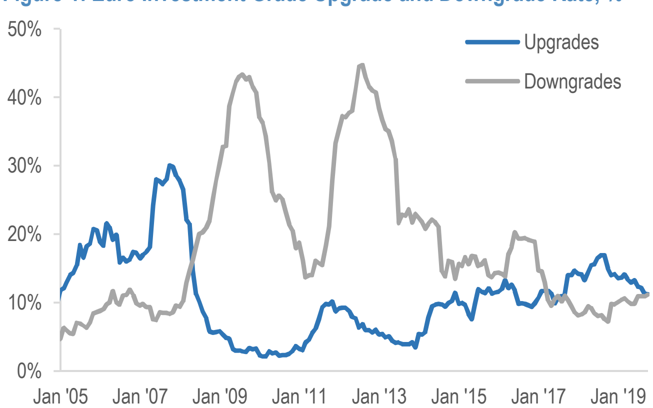
- **Euro investment grade net ratings drift has been negative for much of the past decade. In general, higher-quality names have seen more ratings erosion throughout this cycle.**
- **The year-to-date fallen angel rate remains extremely low at 0.3%, although this is a small rise from last year. We update our list of fallen angel candidates.**

With the Euro Area Composite PMI at the lowest level in six years, investors are paying more attention to downgrade and dispersion risk. At the moment, the main concern has been profit warnings in the manufacturing sector, but there are also signs that the weakness is spilling over into consumer spending.

In this note, we look at ratings drift for over 6000 investment grade bonds since 2005. We use ratings from S&P, Moody's and Fitch, and define an 'upgrade' or 'downgrade' as a change in the mean rating of the bond over the previous twelve months using the iBoxx methodology, adjusting for newly assigned ratings. We define net ratings drift as the proportion of bonds in the index which have been upgraded minus the percentage which have been downgraded.

**At present, we are seeing effectively the same number of upgrades as downgrades (Figure 1).** Over the past year, approximately one-tenth of the index has been upgraded by at least one notch, while a similar proportion has been downgraded. As a result, the net ratings drift rate is close to zero (Figure 2). However, it has been trending downward for the past year, having peaked at +9.4% in August 2018.

**Figure 1: Euro Investment Grade Upgrade and Downgrade Rate, %**




Source: J.P. Morgan, Bloomberg, S&P, Moody's, Fitch. Last twelve months rolling.

**Figure 2: Net Ratings Drift, % Upgrades - % Downgrades**


Source: J.P. Morgan, Bloomberg, S&P, Moody's, Fitch. Last twelve months rolling.

**See page 9 for analyst certification and important disclosures.**

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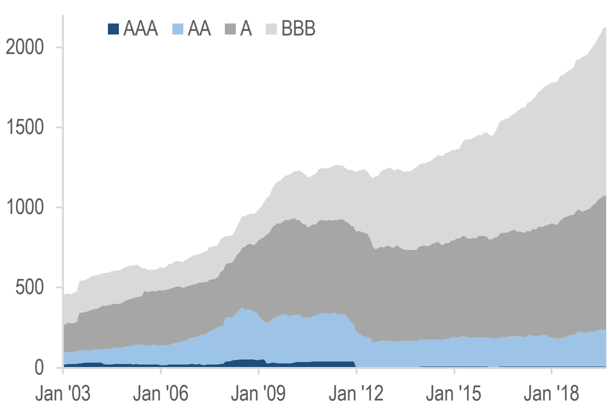
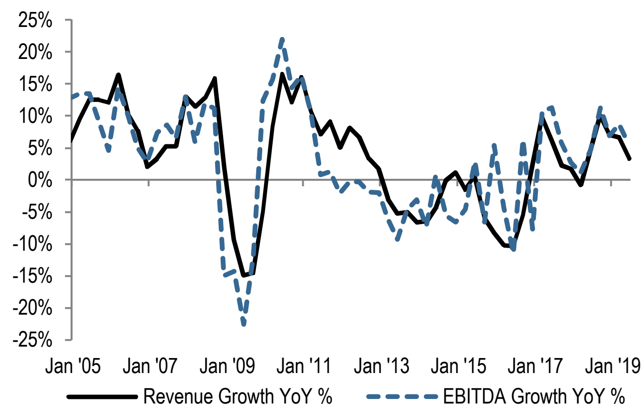
**Further, for most of this cycle, we have seen a steady deterioration in credit ratings.** This should not come as a surprise, as we have previously highlighted the rapid growth of the EUR BBB market from €190bn in 2009 to €1.05tn today (Figure 3). In our view, this has been driven by three trends: i) periphery downgrades during the Eurozone crisis, which affected names notched to the sovereign; ii) an earnings recession between 2012 and 2016, with EBITDA for our sample of 200 investment grade corporates still 2% below the 3Q11 peak (Figure 4); and iii) credit negative acquisitions by higher-rated names.

Figure 3: Euro Investment Grade Notional Outstanding, €bn




Source: J.P. Morgan, Markit Group.

Figure 4: European Investment Grade Revenue and EBITDA Growth

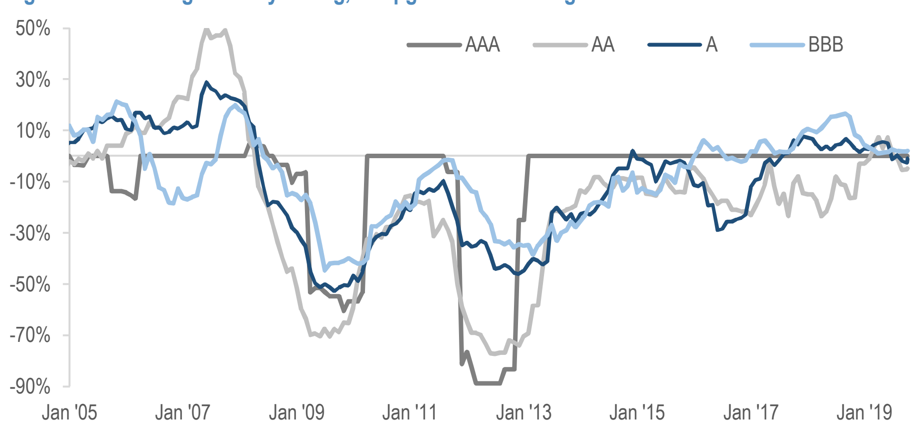



Source: J.P. Morgan, S&P Capital IQ.

**Ratings migration by rating**

Notably, most of the credit deterioration over the past decade has been in higher quality names. If we look at net rating drift over the last twelve months by rating at the beginning of the period, the ratings trend for bonds rated single-A or better has consistently been worse than for BBBs (Figure 5).

Figure 5: Net Ratings Drift by Rating, % Upgrades - % Downgrades




Source: J.P. Morgan, Bloomberg, S&P, Moody's, Fitch. Last twelve months rolling.

In our view, this has primarily been driven by the cheap funding environment, which has encouraged firms to lever up their balance sheets. Most of the 'transformative' acquisitions we have seen, such as AB Inbev / SABMiller, Bayer / Monsanto and BAT / Reynolds has been from single-A rated names. Additionally, it should be noted that close to four-fifths of AA-rated bonds were downgraded during the Eurozone crisis, mostly due to sovereign notching.

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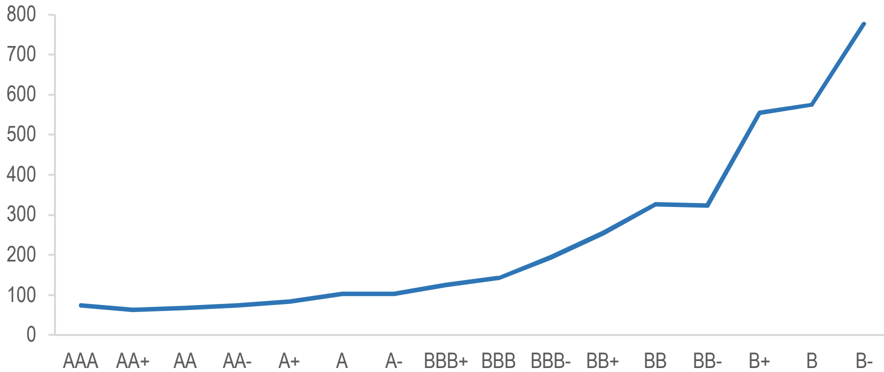
By contrast, in our view, lower-rated issuers have generally acted conservatively during this cycle. The most striking example of this has been the growth of the corporate hybrid market from €20bn in 2009 to €140bn today, as lower-rated firms engaging in 'incremental' acquisitions have often issued hybrids to protect their senior ratings. Additionally, sectors which have gotten into distress, such as Oil & Gas in 2015/6, have generally acted quickly to engage in 'self-help' measures including cost cutting, asset disposals and equity raises.

The penalty for falling into high yield is relatively modest at the moment, with a 61bp differential between BBB- and BB+ bonds on average (Figure 6). Nonetheless, in our view, the 'stigma' of being a fallen angel will mean that lower-rated issuers remain defensive going forward. Additionally, non-financial corporates risk losing their CSPP-eligibility if all of their ratings are sub-investment grade.

Figure 6: Euro Benchmark Spread by Narrow Rating, bp

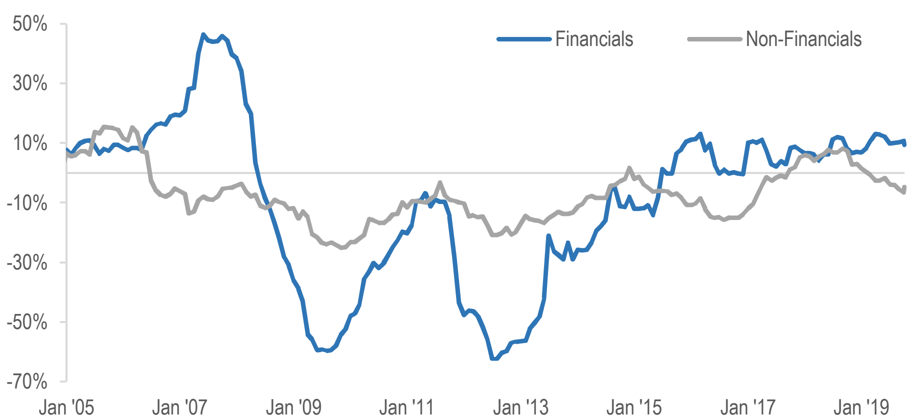



Source: J.P. Morgan, Markit Group.

### Ratings migration by sector

We have also seen a divergence in trends between sectors, with Financials ratings unsurprisingly more volatile during the twin crisis periods (Figure 7). In general, banks saw their ratings fall between 2008 - 2014, due to a combination of sovereign notching, rising non-performing loans, and declining net interest margins. However, the sector has seen consistent upgrades for the past four years, as banks have shed risk weighted assets and issued new capital to meet regulatory requirements, increasing the subordination cushion on their senior debt.

Figure 7: Net Ratings Drift by Sector, % Upgrades - % Downgrades




Source: J.P. Morgan, Bloomberg, S&P, Moody's, Fitch. Last twelve months rolling.

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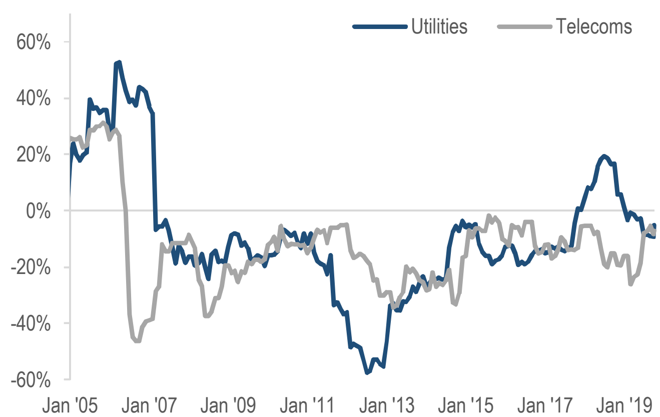
By contrast, Non-Financials ratings have been persistently downward trending. In Figures 7 to 10 below, we show the ratings drift by narrow sector. Telecoms have been an outsized contributor to the erosion, which we think was driven by a combination of weak service revenue growth, adverse regulation, elevated fiber investment, and some re-levering deals. (Figure 8).

Utilities were also on a deteriorating trajectory for most of the last decade, although primarily due to corporate actions. The sector added leverage through acquisitions in the first half of the cycle, before being impacted by falling power prices during the commodity crisis. Since then, however, some names have disposed of assets or cut costs to improve their credit profiles.

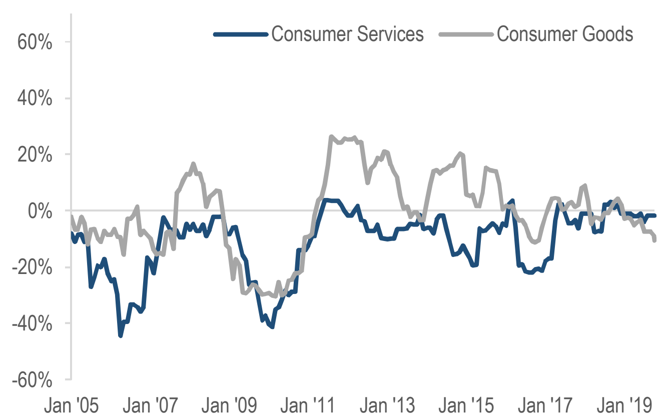
In terms of recent trends, the biggest improvements have been in Basic Materials and Oil & Gas (Figure 10). This is also a result of self-help measures following the commodity crisis, although we think that they could be at risk looking forward if the slowdown in global manufacturing continues to get worse. By contrast, Healthcare is seeing the most downgrades at the moment with a net ratings drift of -16% over the past year, primarily driven by acquisitions such as Bristol-Myers Squibb / Celgene, Danaher / GE Biopharma, and Amgen / Otezla.

**Figure 8: Net Ratings Drift by Sector, % Upgrades - % Downgrades**



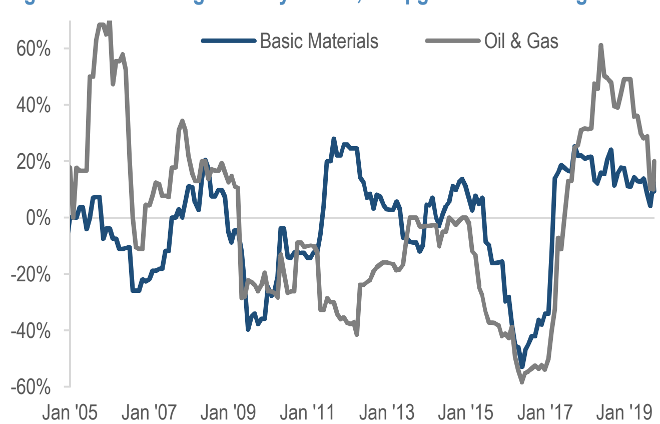

Source: J.P. Morgan, Bloomberg, S&P, Moody's, Fitch. Last twelve months rolling.

**Figure 9: Net Ratings Drift by Sector, % Upgrades - % Downgrades**



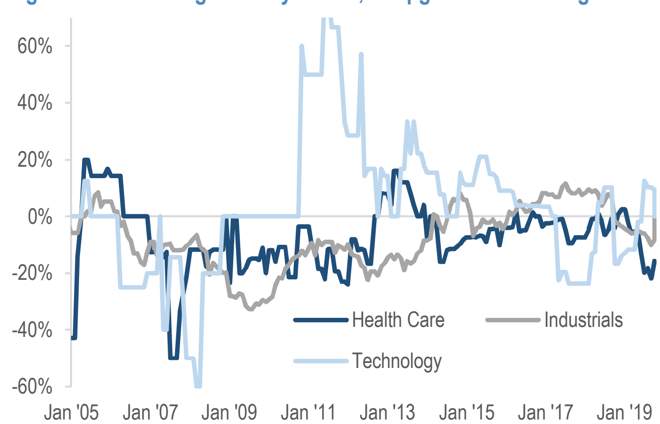

Source: J.P. Morgan, Bloomberg, S&P, Moody's, Fitch. Last twelve months rolling.

**Figure 10: Net Ratings Drift by Sector, % Upgrades - % Downgrades**




Source: J.P. Morgan, Bloomberg, S&P, Moody's, Fitch. Last twelve months rolling.

**Figure 11: Net Ratings Drift by Sector, % Upgrades - % Downgrades**




Source: J.P. Morgan, Bloomberg, S&P, Moody's, Fitch. Last twelve months rolling.

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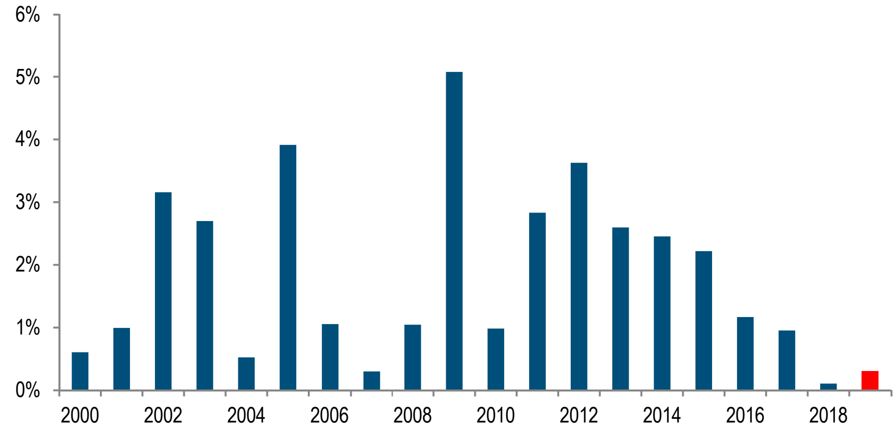
## Fallen angels: The only way is up

In Fall from Grace, 11th October 2018, we analysed fallen angel rates from 2000 – 2018, defined as bonds migrating between the iBoxx EUR Corporates and iBoxx EUR High Yield benchmarks. **Since then, the fallen angel rate has remained extremely low, at just 0.3% of notional year-to-date**, up to the end of September (Figure 12). Based on our data, just seven bonds have been downgraded to high yield this year, as shown in Table 1 below.

**Figure 12: European Investment Grade Fallen Angels Rate, %**




Source: J.P. Morgan, Markit Group.

**Table 1: Fallen Angels in 2019**

| Issuer | Coupon | Maturity Date | Notional | Exit Date |
|---|---|---|---|---|
| CNALN (sub) | 3 | 10/04/2021* | 750 | 30/04/2019 |
| NOVO | 1.625 | 20/09/2023 | 500 | 30/06/2019 |
| BPSOIM | 2.375 | 03/04/2024 | 500 | 30/06/2019 |
| SABSM | 1.75 | 10/05/2024 | 1000 | 30/06/2019 |
| BKIASM | 1 | 25/06/2024 | 500 | 31/07/2019 |
| VOD (sub) | 3.1 | 03/10/2023* | 2000 | 31/08/2019 |
| VOD (sub) | 4.2 | 03/07/2028* | 500 | 31/08/2019 |

Source: J.P. Morgan, Markit Group. *first call dates.

While the primary story here is that the fallen angel rate is close to zero, it is notable that over half of the notional was corporate hybrids, at €3.25bn from Centrica and Vodafone (Figure 13). In percentage terms, 4.9% of the sub-asset class was downgraded, which is the highest since 2013 (Figure 14). In our view, this is because there is less of a stigma of downgrade for hybrids, because they are notched to the senior rating. Additionally, it was only three bonds, so this may have just been reflective of idiosyncratic issues. As a note, there are currently €44.5bn of BBB-rated corporate hybrids.

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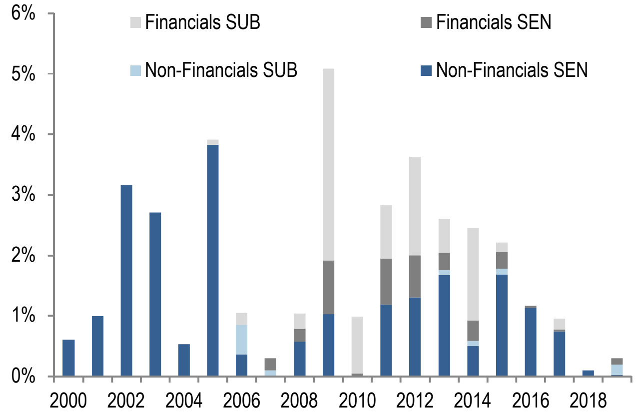
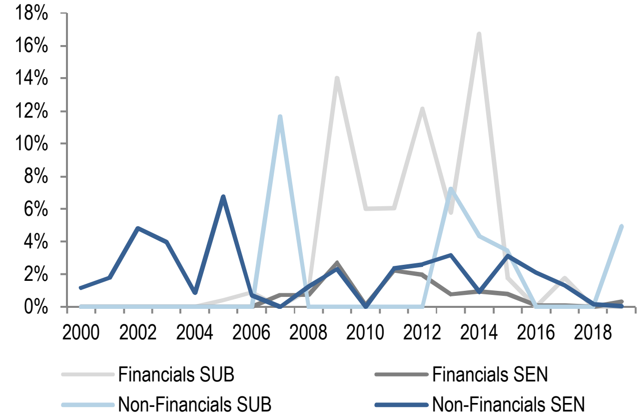
Figure 13: Fallen Angel Rate Contribution by Asset Class, %




Source: J.P. Morgan, Markit Group.

Figure 14: Fallen Angel Rate by Asset Class, %




Source: J.P. Morgan, Markit Group.

Scenario analysis

| | Notional | Fallen Angel (%) | Fallen Angels |
|---|---|---|---|
| AAA | €8bn | 0.0% | €0bn |
| AA | €228bn | 0.0% | €0bn |
| A | €837bn | 0.1% | €1bn |
| BBB | €1050n | 12.6% | €132bn |
| Total | €2124bn | 6.3% | €133bn |

**Updating our fallen angel candidates**

Unfortunately, however, we think that the fallen angel rate has likely bottomed, and that slowing growth is likely to bring more idiosyncratic downgrade risk. In our base case, this is likely to only be a modest increase, which is confined to cyclical sectors. However, at worst, as discussed in 'Fall from Grace', if this proves to be the start of a global recession, we estimate that we could see ~€130bn of fallen angels over a twelve month period based on historical figures (see side box).

Below, in **Error! Reference source not found.**, we update our bottom-up list of fallen angel candidates in a recession scenario. Like previously, we have screened the iBoxx EUR Corporates benchmark for names which currently have an average rating of BBB- across S&P, Moody's and Fitch, and which additionally satisfy at least one of the following conditions: i) on negative watch by at least one rating agency; ii) rated Underweight by our single-name analysts; iii) in a cyclical industry; or iv) primarily exposed to the periphery (Italy/Spain/Portugal).

Altogether, this amounts to €156bn of bonds, of which €42bn are already just one downgrade by any rating agency away from falling into high yield. With that said, we have less conviction on our fourth criteria – periphery exposure – than the first time we published this list, when the Italian 2019 budget deficit conflict was at the top of the headlines. We have decided to keep it in as a criteria, as sovereign debt sustainability could return as an investor concern in a recessionary environment, but if we were to exclude it the volume of potential candidates falls to €137bn, closer to our top-down estimate.

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### Table 2: Fallen angel candidates

| Ticker | Notional (€bn) | Country | Sector | Tier | Debt | Rating (S&P/ Moody's/Fitch) | # Notches from HY | Analyst | Rating | -ve Watch | Analyst UW | Cyclical | Periphery |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| AIB | 1.8 | IE | Banks | Bail-in | SEN | BBB-/Baa3/BBB- | 2 | Roberto Henriques | N | | | Y | |
| ARGSPA | 0.5 | BE | Banks | LT2 | SUB | BBB-/NR/NR | 1 | | | | | Y | |
| BKIR | 1.4 | IE | Banks | Bail-in | SEN | BBB-/Baa3/NR | 1 | Roberto Henriques | N | | | Y | |
| BKTSM | 1.3 | ES | Banks | LT2 | SUB | BBB-/Baa3/NR | 1 | | | | | Y | Y |
| BACR | 2.8 | GB | Banks | LT2 | SUB | BB+/Ba1/A- | 3 | Roberto Henriques | OW | | | Y | |
| CABKSM | 3.0 | ES | Banks | LT2 | SUB | BBB-/Ba1/BBB | 2 | Axel J Finsterbusch | N | | | Y | Y |
| CMZB | 2.9 | DE | Banks | LT2 | SUB | BBB-/Baa3/BBB | 3 | Roberto Henriques | N | | | Y | |
| DB | 14.2 | DE | Banks | Bail-in | SEN | BBB-/Baa3/BBB | 3 | Roberto Henriques | N | | | Y | |
| PBBGR | 1.0 | DE | Banks | Bail-in | SEN | BBB-/NR/NR | 1 | | | | | Y | |
| FRLBP | 2.9 | FR | Banks | LT2 | SUB | BBB-/NR/NR | 1 | | | | | Y | |
| MBKPW | 1.0 | PL | Banks | Pref | SEN | BBB/NR/BBB-+ | 2 | | | | | Y | |
| RBIAV | 1.5 | AT | Banks | LT2 | SUB | BBB-/Baa3/NR | 1 | Axel J Finsterbusch | OW | | | Y | |
| UCGIM | 6.1 | IT | Banks | LT2 | SUB | BB+/Baa3/BBB- | 1 | Roberto Henriques | OW | | | Y | Y |
| UBIIM | 1.8 | IT | Banks | Pref | SEN | BBB-/Baa3/BBB- | 2 | Roberto Henriques | OW | | | Y | Y |
| JEF | 0.5 | US | Fin Services | | SEN | BBB-/Baa3/BBB | 3 | | | | | Y | |
| ASSGEN | 6.1 | IT | Insurance | T2 | SUB | NR/Baa3/BBB | 2 | William W Wade | OW | | | | Y |
| MAPSM | 1.1 | ES | Insurance | T2 | SUB | BBB-/NR/BBB- | 1 | William W Wade | OW | | | | Y |
| SACEIM | 0.5 | IT | Insurance | T2 | SUB | NR/NR/BBB- | 1 | | | | | | Y |
| BALDER | 1.5 | SE | Real Estate | | SEN | BBB/Baa3/NR | 2 | Roberto Henriques | UW | | Y | | |
| MTNA | 2.8 | LU | Basic Resources | | SEN | BBB-/Baa3/BBB- | 2 | Benjamin Defay | UW | | Y | Y | |
| VALEBZ | 0.8 | BR | Basic Resources | | SEN | BBB-/Ba1/BBB- | 1 | Natalia Corfield | N | | | Y | |
| CE | 1.3 | US | Chemicals | | SEN | BBB/Baa3/NR | 2 | | | | | Y | |
| BNRGR | 0.6 | DE | Chemicals | | SEN | BBB/Baa3/NR | 2 | | | | | Y | |
| EVKGR | 0.5 | DE | Chemicals | | SUB | BBB-/Baa3/NR | 1 | Stephanie Vincent | UW | | Y | Y | |
| IFF | 1.3 | US | Chemicals | | SEN | BBB/Baa3/NR | 2 | | | | | Y | |
| SYNNVX | 1.0 | CH | Chemicals | | SEN | BBB-/Ba2/BBB | 1 | Stephanie Vincent | OW | | | Y | |
| SHAEFF | 2.2 | DE | Autos | | SEN | BBB-/Baa3/BBB- | 2 | Stephanie Vincent | N | | | Y | |
| FRFP | 3.0 | FR | Autos | | SEN | BBB/Baa3/NR | 2 | Stephanie Vincent | UW | | Y | Y | |
| ZFFNGR | 1.1 | DE | Autos | | SEN | BBB-/Baa3/NR | 1 | Stephanie Vincent | NR | | | Y | |
| F | 7.7 | GB | Autos | | SEN | BBB/Ba1/BBB | 3 | Stephanie Vincent | N | | | Y | |
| PEUGOT | 3.1 | FR | Autos | | SEN | BBB-/Baa3/BBB- | 2 | Stephanie Vincent | OW | | | Y | |
| RENAUL | 4.5 | FR | Autos | | SEN | BBB/Baa3/NR | 2 | Stephanie Vincent | N | | | Y | |
| VW | 12.5 | DE | Autos | | SUB | BBB-/Baa2/BBB- | 3 | Stephanie Vincent | OW | | | Y | |
| SZUGR | 0.5 | DE | Food & Beverage | | SEN | BBB-/NR/NR | 1 | Ela Kurtoglu | UW | | Y | | |
| ETLFP | 1.9 | FR | Media | | SEN | BBB-/Baa3/BBB | 3 | Christian Crosby | UW | | Y | | |
| ITVLN | 0.6 | GB | Media | | SEN | BBB-/Baa3/NR | 1 | Christian Crosby | UW | | Y | | |
| SESGFP | 1.2 | LU | Media | | SEN | BBB-/Baa2/WD | 2 | Christian Crosby | UW | | Y | | |
| AUCHAN | 4.7 | FR | Retail | | SEN | BBB-/NR/NR | 1 | Ela Kurtoglu | N | | | Y | |
| ESSLNG | 1.0 | IT | Retail | | SEN | BBB--/Baa2-/NR | 2 | | | Y | | Y | Y |
| TSCOLN | 2.0 | GB | Retail | | SEN | BB+/Baa3/BBB- | 1 | Ela Kurtoglu | OW | | | Y | |
| MEOGR | 0.5 | DE | Retail | | SEN | BBB--/NR/NR | 1 | Ela Kurtoglu | NR | Y | | Y | |
| LHAGR | 0.5 | DE | Travel & Leisure | | SEN | BBB/Baa3/NR | 2 | Danielle Ward | UW | | Y | | |
| ACFP | 2.3 | FR | Travel & Leisure | | SEN | BBB-/NR/BBB- | 1 | Brendan Breen | UW | | Y | | |
| BZUIM | 0.5 | IT | Construction | | SEN | BBB-/NR/NR | 1 | Benjamin Defay | UW | | Y | Y | Y |

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| Ticker | Notional (€bn) | Country | Sector | Tier | Debt | Rating (S&P/ Moody's/Fitch) | # Notches from HY | Analyst | Rating | -ve Watch | Analyst UW | Cyclical | Periphery |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| HEIGR | 7.8 | DE | Construction | | SEN | BBB-/Baa3/BBB- | 2 | Benjamin Defay | UW | | Y | Y | |
| SMDSLN | 1.9 | GB | Industrials | | SEN | BBB-/NR/NR | 1 | Benjamin Defay | OW | | | Y | |
| FLR | 0.5 | US | Industrials | | SEN | BBB/Baa3/WD | 2 | | | | | Y | |
| CNHI | 3.3 | GB | Industrials | | SEN | BBB/Baa3/BBB- | 3 | Brendan Breen | N | | | Y | |
| FLS | 0.5 | US | Industrials | | SEN | BBB-/Baa3/BBB- | 2 | | | | | Y | |
| MAERSK | 1.4 | DK | Industrials | | SEN | BBB/Baa3/NR | 2 | Danielle Ward | N | | | Y | |
| ATLIM | 1.8 | IT | Industrials | | SEN | BB+/Baa3-/BBB | 2 | William W Wade | UW | Y | Y | Y | Y |
| HITTFP | 3.0 | FR | Industrials | | SEN | BBB/Baa3/NR | 2 | William W Wade | N | | | Y | |
| GFSLN | 1.6 | GB | Industrials | | SEN | BBB-/NR/NR | 1 | Brendan Breen | NR | | | Y | |
| RCFFP | 1.4 | FR | Industrials | | SEN | BBB-/NR/NR | 1 | | | | | Y | |
| EEFT | 0.6 | US | Industrials | | SEN | BBB/Ba1/BBB | 3 | | | | | Y | |
| CEPSA | 0.5 | ES | Oil & Gas | | SEN | BBB-/Baa3/BBB- | 2 | | | | | Y | Y |
| MOLHB | 0.8 | HU | Oil & Gas | | SEN | BBB-/Baa3/BBB- | 2 | | | | | Y | |
| PKNPW | 1.3 | PL | Oil & Gas | | SEN | NR/Baa2/BBB- | 2 | | | | | Y | |
| EDPPL | 7.0 | PT | Utilities | | SEN | BBB-/Baa3/BBB- | 2 | | | | | | Y |
| ENBW | 1.0 | DE | Utilities | | SUB | BBB-/NR/BBB | 2 | Daniel Vaun | UW | | Y | | |
| ENELIM | 2.4 | IT | Utilities | | SUB | BBB-/Ba1/BBB | 2 | | | | | | Y |
| ERGIM | 0.5 | IT | Utilities | | SEN | NR/NR/BBB- | 1 | | | | | | Y |
| IBESM | 2.5 | ES | Utilities | | SUB | BBB-/Baa3/BBB | 3 | Daniel Vaun | OW | | | | Y |
| VIESGO | 1.1 | ES | Utilities | | SEN | BBB-/NR/NR | 1 | | | | | | Y |
| VATFAL | 1.0 | SE | Utilities | | SUB | BB+/Baa2/WD | 1 | Daniel Vaun | UW | | Y | | |
| GALPNA | 0.6 | PT | Utilities | | SEN | BBB-/NR/NR | 1 | | | | | | Y |
| NATUEN | 1.3 | ES | Utilities | | SEN | BBB-/NR/NR | 1 | | | | | | Y |
| REDEXS | 1.2 | ES | Utilities | | SEN | BBB-/Baa3/WD | 1 | | | | | | Y |
| CDPRTI | 0.8 | IT | Utilities | | SEN | NR/Baa3/BBB | 2 | | | | | | Y |
| AQUASM | 1.4 | ES | Utilities | | SEN | NR/NR/BBB- | 1 | Daniel Vaun | OW | | | | Y |

Source: J.P. Morgan. Negative watch is marked with - and positive watch with +

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