Asset Management

IS THE BBB CREDIT BUBBLE READY TO BURST?

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Summary

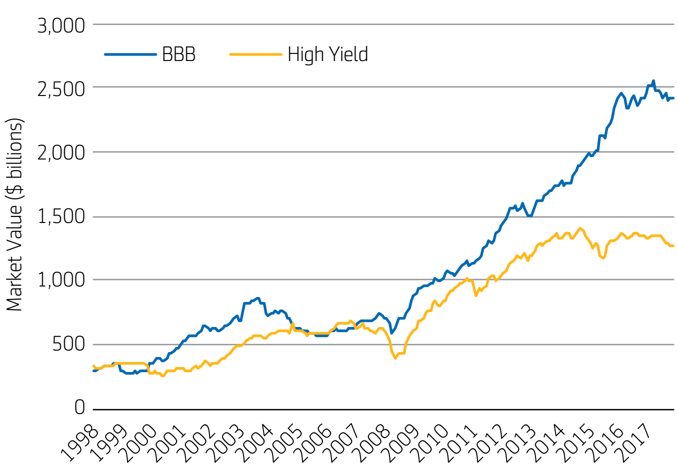
- BBB-rated credit issuance has grown exponentially over the last 10 years as a result of increased investor demand for yield and low borrowing rates for companies.
- We believe the BBB market growth raises two questions – Can companies retain their investment grade ratings? If not, what will be the impact to the credit markets as BBBs transition to high yield?
- A weakening economy or a change in the outlook for improving credit fundamentals could lead to increased downgrade risk. Potential catalysts could include a Fed policy mistake, contagion from emerging market volatility creating a risk-off environment, or increasing shareholder friendly behavior by management teams.
- While a bubble may be developing in BBB credit, we don't think it is ready to burst anytime soon. We continue to closely monitor the credit markets for signs. We remain generally constructive on credit and not view the potential increase in fallen angels to be a near-term risk to credit investors

Growth in BBB credit market

The size of the outstanding BBB-rated corporate debt has exploded in recent years, nearly quadrupling since the 2000s (Exhibit 1). The dramatic increase in BBB debt results from a few primary market drivers: low borrowing rates; cost of capital models guided companies to take advantage of relatively immaterial incremental punitive costs of BBB versus A-rated debt; growth in the overall size and scale of companies through M&A activity; and increased investor demand for yield.

Exhibit 1: BBB-rated corporate bonds have grown at a much higher rate than high yield bonds in recent years

July 1998 – June 2018

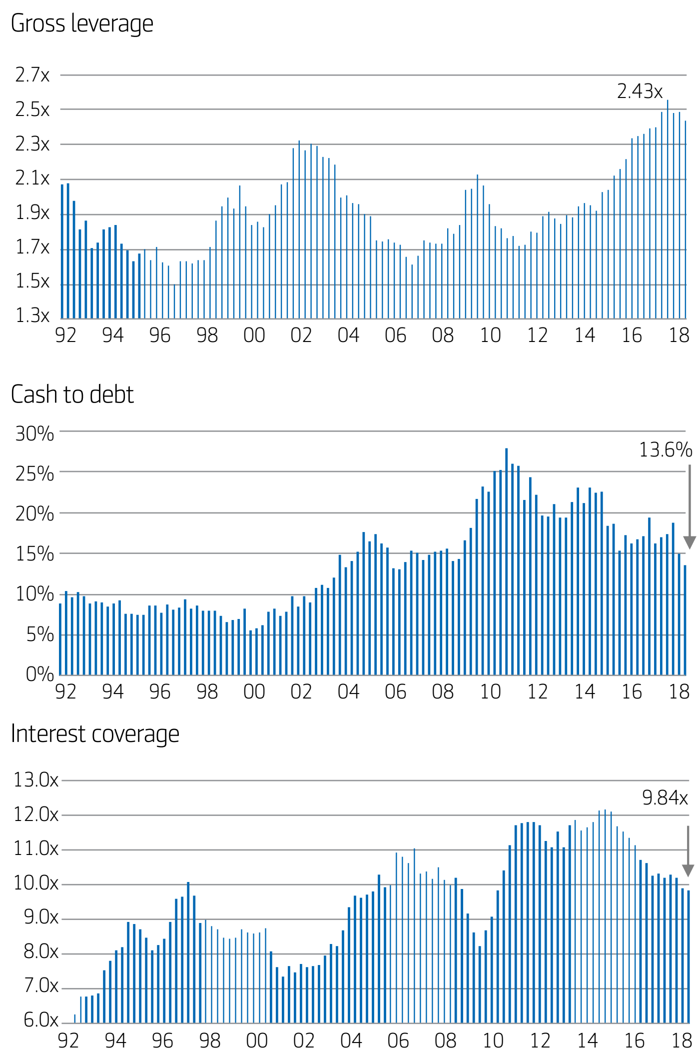


Source: Bloomberg Barclays. Includes monthly market value allocation of the Bloomberg Barclays Corporate Index.

Weakening credit fundamentals

While the investment grade credit market has been growing, aggregate credit fundamentals have been weakening (Exhibit 2). According to Morgan Stanley, debt-to-EBITDA, a measure of corporate leverage, has been trending upwards since 2012 while the interest coverage ratio for investment grade companies has declined since 2014. A noticeable increase in the leverage ratio and decrease in interest coverage implies that companies have not only regained comfort taking on debt, but are becoming increasingly aggressive. Meanwhile, the cash-to-debt ratio has been deteriorating since 2012 as US tax law changes have enabled companies with cash overseas to repatriate it in a more cost efficient manner. This cash, which had previously been buoying net debt ratios, is in part being used for shareholder friendly activity as opposed to debt reduction.

Exhibit 2: Debt-to EBITDA for investment grade issuers continues to increase, while interest coverage and cash-to-debt ratios deteriorate



Source: Morgan Stanley. Used with permission granted on 9/28/18.

The BBB growth leads to two key questions

A booming BBB market has investors asking two key questions: Will these companies be able to maintain their investment grade status as the cycle continues to mature and company results begin to soften? If not, what will be the impact on credit markets as they transition to high yield?

#1 - Will these companies be able to maintain investment grade status?

Our baseline view is credit will continue to benefit from a steadily growing economy in the US over the near-to-intermediate term. The current favorable economic backdrop continues to be supportive of growing revenue, cash flow and earnings for corporate issuers. Meanwhile, companies have added leverage to fund organic and M&A growth while rating agencies are giving companies latitude to operate with weaker-than-normal credit profiles for their given ratings.

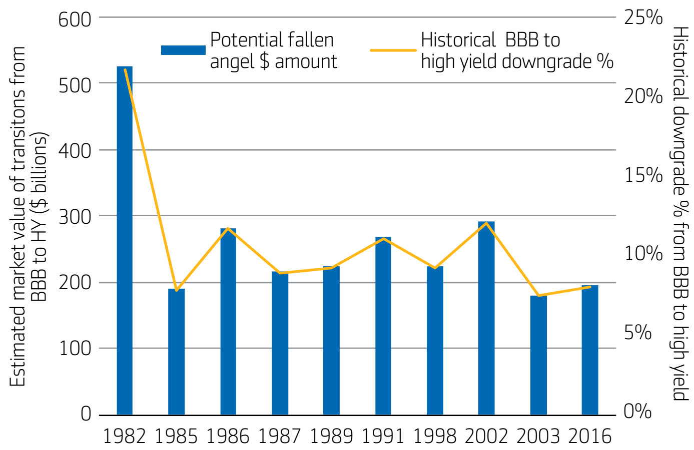
Longer term, we believe we will see downgrades consistent with past economic cycles. We are watching a number of catalysts that could spur the next downgrade wave. In our view, the most likely triggers include; a traditional business cycle slowdown materializing sooner than anticipated, a Fed policy mistake such as raising rates too far too fast, unintended consequences of tariff negotiations, or idiosyncratic credit stress in emerging markets spreading to developed markets.

When the cycle turns, we expect downgrade activity from investment grade to high yield, commonly referred to as fallen angels, will likely be consistent with past downturns in percentage terms. However, given the size of the current BBB market, the dollar volume is likely to outpace prior cycles.

To assess the potential size of the next fallen angel wave, we applied Moody's historical rating migration percentages to the current BBB market value of $2.4 trillion as of Q2 2018. Focusing on the years with the largest percentage of downgrades from BBB to high yield status, we can estimate transitions from BBB to high yield based on some of the worst downgrade years since 1970. Assuming an average rate of 11% for the ten worst downgrade years, the next downgrade wave could exceed $250 billion if the severity mirrors prior years (Exhibit 3).

Exhibit 3: Potential magnitude of future fallen angel activity

Top 10 largest historical BBB to high yield downgrade rates applied to current BBB market size



Source: Aegon AM US, Bloomberg Barclays and Moody's. Reflects top 10 largest ratings transition years from BBB to high yield ratings based on data from Moody's from 1970 – 2017. Applies historical downgrade percentages to BBB market size as of June 30, 2018.

#2 - What will be the impact on credit markets as BBB-rated companies transition to high yield?

First, a weakening credit environment is likely to increase the risk premium required by investors to hold investment grade bonds as they begin to price in the risk of downgrades. Second, the transition from investment grade to high yield may cause dislocation in the high yield market. Given the current size and scale of BBB bonds, the high yield market may have increased difficulty absorbing the rising number of fallen angels.

Continuing with our earlier example, $250 billion of migration in a year is roughly equivalent to 20% of the aggregate high yield market and approximately equal to the average annual gross high yield issuance over the past ten years through August 2018. Contrary to most new high yield issuance, downgrades typically aren't price sensitive. They happen regardless of market conditions or investor demand and prices adjust to facilitate the needed transitions. Furthermore, fallen angels tend to rise when the high yield market is also facing fundamental pressures from weakening credit conditions. When considering this, and overlaying the scale of downgrades in our high yield market example, one can see why it is likely that the rise in fallen angel activity could have a meaningful impact on high yield spreads.

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Market liquidity and other concerns

Another potential concern relates to how changes in market liquidity could impact the transition from investment grade to high yield. Financial industry regulation following the 2008 crisis has decreased the capacity of dealers to hold proprietary positions resulting in smaller dealer inventories. Much of the trading now involves a pass-through from buyer to seller without dealers taking positions into inventory. Such large dislocations could create greater price movement than observed in prior periods of stress as traders work to clear the market without dealer inventory serving as a buffer.

Additional challenges for high yield managers that can arise during periods of increased rating migration may include; managing issuer concentrations limits caused by the size of some investment grade issuers, increased interest rate risk given the longer duration of many BBB bonds, and reduced covenant packages relative to traditional high yield issuance. From an investment grade manager perspective, the urgency with which they want, or need, to address the downgrade is also a major contributor. The more discretion a manager has in addressing the downgrades can provide them an opportunity to avoid a forced fire-sale of assets.

Despite concerns, we remain constructive on credit fundamentals

In the near-to-intermediate term, we believe the potential downgrade risks are manageable and unlikely to manifest into a broader credit issue without a risk-off market event. We continue to closely monitor credit markets for signs of stress. While we have become mildly more cautious on credit, this is primarily a result of valuation and concern over whether we are getting paid for increasing risks as the cycle matures. We continue to favor a modest overweight to corporate credit with an increasingly balanced view between investment grade and high yield overweights. Barring a market shock, the BBB market growth and potential for an increase in fallen angels is a concern that bears watching, but in our view, it is not an imminent risk to credit investors.

We acknowledge that there will eventually be a downturn in the credit markets as the business cycle turns. The extreme growth in BBB corporate credit market, coupled with aggressive borrowing practices, is likely to give way to the next wave of fallen angels. While the timing of such an event is hard to predict and there will be consequences for credit markets, a rise in fallen angel activity also provides opportunities to active investment managers that are able to effectively manage client portfolios and navigate the crossover credit market from an investment grade and high yield perspective.