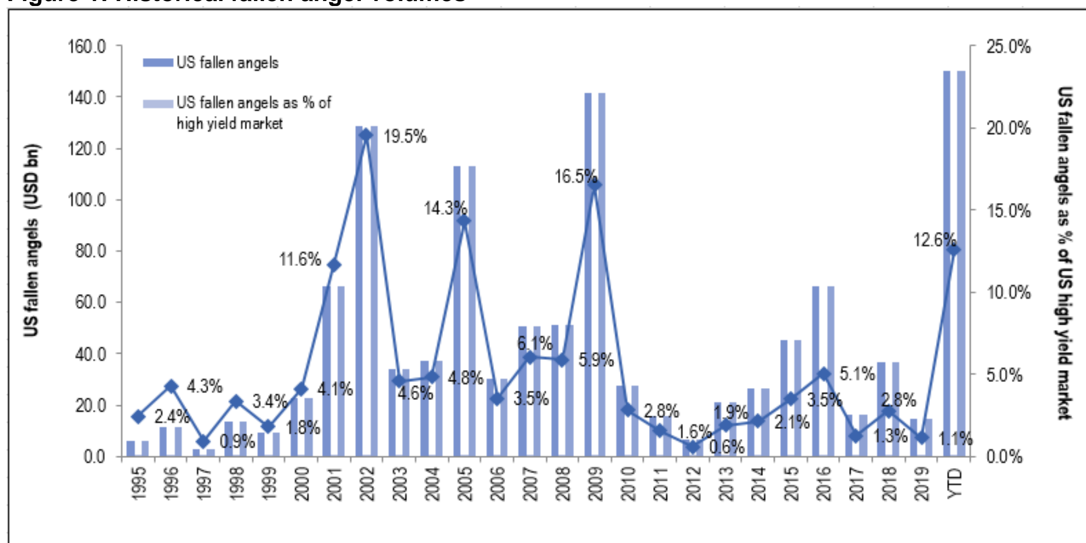
Weekly Update
April 17, 2020

Invesco Fixed Income

Fallen angels: This time is different
Around USD150 billion of US investment grade debt has been downgraded from investment grade to high yield so far this year, with most downgrades taking place in March (Figure 1). These so-called “fallen angels” owe their drop in credit status to the twin pressures of the country-wide pandemic related lockdowns and the collapse in oil prices caused by a simultaneous supply/demand shock. Invesco Fixed Income (IFI) expects the total volume of fallen angels to reach around USD216 billion in 2020, well above the prior record of USD141 billion set in 2009 (Figure 1).

Figure 1: Historical fallen angel volumes



Source: JP Morgan, Invesco, data from Jan. 1, 1995 to April 10, 2020.

Below, we look at the recent rise in fallen angels from the dual perspectives of the investment grade and high yield markets and highlight why this cycle might differ from the past.

Sector focus: Investment grade
We believe this fallen angel cycle will differ from that of past cycles, not only due to the sheer volume of debt likely to be downgraded, but because of the velocity of downgrades. Rating agencies appear to have concluded that they provided too much leeway to overly-levered companies in the past, and this time are being more proactive.

Another, and arguably more important, reason this fallen angel cycle differs from prior cycles is that US investment grade bonds - and fallen angels that remain at least low BB – now have the direct support of the US Federal Reserve (Fed). On March 23, the Fed announced its intention to purchase investment grade corporate bonds via the Primary and Secondary Market Corporate Credit Facilities. On April 9, the Fed expanded the definition of bonds eligible for purchase to include those with investment grade ratings as of March 23, even if they had since been downgraded to high yield, as long as they remain in the BB category.

The current level of Fed support to investment grade markets is unprecedented. During the global financial crisis, the Fed unveiled measures such as TARP and TALF, which bought troubled or illiquid securities, but its assistance has never included the direct buying of corporate bonds. Although the Fed’s buying programs are not yet up and running, the mere announcement of its intention to buy bonds has underpinned investment grade spreads.

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The Bloomberg Barclays Investment Grade Credit Index spread reached a wide of 341 basis points on March 23.[1] Since the Fed announced its first installment of supportive measures, the spread has narrowed to under 200 basis points (as of April 15).[1]

Historically, fallen angels experience price declines when they exit investment grade indices amid forced selling by investors only eligible to hold investment grade debt, then quickly rebound when absorbed by high yield investors. Due to Fed intervention, we believe this dynamic will be different this time – it will likely entail less price volatility due to forced selling because of the Fed "backstop." In addition, we believe fallen angels eligible for Fed buying will react differently than ones not eligible. We believe ineligible bonds will improve commensurate with the overall market, but not to the same degree as bonds eligible to be purchased by the Fed.

We anticipate this price pattern to stay in place for the roughly USD100 billion of debt still at risk of becoming fallen angels, which IFI is proactively monitoring via our watchlist. Our watchlist alerts portfolio managers to issuers we believe are at risk of multi-notch downgrades or falling to high yield. IFI analysts add names when rating agency actions are anticipated. Not surprisingly, the number of names on the list has swelled to 150 from 60 at the end of February. We have already seen some watchlist names outperform the market since the Fed fallen angel interventions were announced. We caution that we do not expect all potential fallen angels to experience similar levels of spread tightening due to Fed support. For example, we would not expect the same degree of outperformance by energy names, as we think spreads will be more influenced by the dynamics of the energy market. We also do not expect the traditional level of price volatility in this cycle, thanks to the Fed.

Sector focus: High yield

As rating agencies have moved quickly during the coronavirus disruption, the impact of fallen angels on the US high yield market has been significant. If this year's volume of fallen angels reaches our expected total of USD216 billion, it would represent 18.0% of the high yield market, second only to the 2002 period (Figure 1).

This has multiple implications for the high yield market. First, the large volume of double-B bonds entering the high yield market could weigh on double-B spreads across the market. As the large amount of high-quality paper enters the market, investor focus on these new issues tends to reduce demand, resulting in higher spreads for existing double-Bs. Second, the impact on individual sectors of the market can be significant. Because the volume of fallen angels is uneven across sectors, the ability to absorb these volumes will likely be uneven as well. The energy sector, for example, is already under pressure, not only from reduced demand due to the pandemic, but also extremely low oil prices. Given the high number of energy-related fallen angels, the market will likely struggle to absorb them, causing potential price pressure.

The third impact of the large volume of fallen angels is refinancing risk. Many of the recent fallen angels have large capital structures and represent some of the largest issuers in the high yield market. If the credit quality of these large issuers continues to deteriorate, or the high yield market closes to new issuance, these large capital structures could struggle to refinance existing debt in a high yield market that is much smaller than the investment grade market.

Potential opportunities in high yield

While the volume of fallen angels creates challenges, it also presents potential opportunities. As noted above, the Fed has announced several policy tools to alleviate the market impact of the pandemic across different asset classes. Among them, the Fed took the unprecedented action to include fallen angels in any bond buying program. This should provide substantial market support, not only for bonds that currently qualify but also for future fallen angels that will be heading into the high yield market. Bonds that qualify will likely trade at a premium to similar quality credits. Besides Fed support, fallen angels have typically performed well once they drop into high yield and may offer an attractive return opportunity outright. Of course, identifying credits that will not continue to deteriorate is paramount in providing the best outcomes over time.

Impact of fallen angels on European high yield

Because the European high yield market is smaller than its US counterpart, concerns have grown about the potential impact of fallen angels on European high yield spreads. However, the European high yield market has historically integrated large amounts of fallen angels without undue difficulty, while also seeing a rise in credit quality of the overall market.

Although we estimate the volume of fallen angels year-to-date to be somewhat high (around EUR35 billion representing 10% of the European high yield market), it appears to have been easily absorbed. On our watch list, we estimate another EUR77 billion of debt from 50 domestic issuers to be on the cusp of becoming high yield, if rating agencies act on negative outlooks and downgrade.

These names represent 22% of the Bloomberg Barclays Pan European High Yield Index and already trade in line with the average BB index name.[1] Many of these names may retain one investment grade rating, which could allow them to maintain their eligibility within the European Central Bank corporate bond buying program (CSPP). However, if the current crisis worsens, we estimate that another EUR185 billion of bonds could move a step closer to high yield. In the current environment, we would not expect that to have too much impact, but the inclusion on larger issuers could generate volatility.

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[1] Source: Bloomberg L.P., data as of April 15, 2020.

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