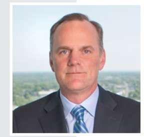
BARINGS

Fear of Fallen Angels May Be Overblown



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FIXED INCOME

Many headlines over the last year have called attention to the growth of the lower-rated BBB portion of the investment grade market—and predicted a wave of fallen angels to high yield. But in that time frame, we have seen more HY companies upgraded to IG than the other way around.

Biggest Risk

One of the biggest potential risks facing fixed income markets is that current valuations are not reflecting the potential for an economic slowdown. As we wrote in a recent blog post, a near-term recession is not our base case scenario. Nonetheless, there are a number of macro risks on the horizon—from trade wars to Brexit to political rhetoric that could impact global growth. It is plausible that these risks could affect the real economy in a more substantial way than what we are forecasting based on what we're currently seeing from individual issuers. With spreads at fairly tight levels today, particularly in the higher-quality part of the high yield market, any change in growth expectations could lead to spread widening.

While this is certainly a potential risk, it is not what we view as the most likely scenario, for a few reasons. From a fundamental perspective, we believe corporate earnings and balance sheets look relatively healthy, and we generally see a strong consumer in the U.S. driving steady economic growth. Defaults remain low by historical standards, and while we might see an uptick in more challenged sectors such as energy, retail and health care, we don't expect to see a widespread increase. We are also fairly optimistic that some of today's more pressing macro issues will reach a reasonable conclusion.

Biggest Opportunity

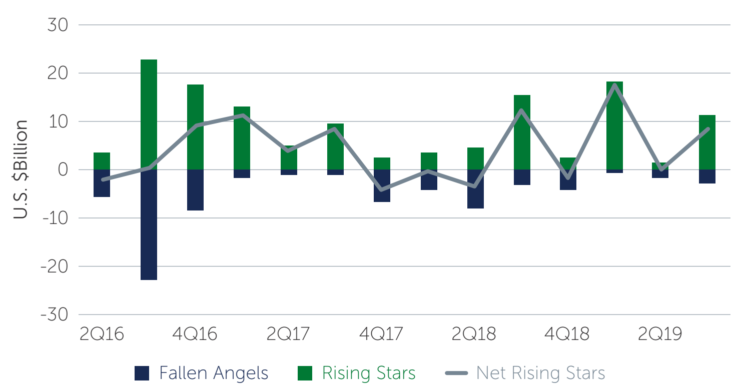
In the high yield market, one of the most interesting opportunities we see is being driven by the bifurcation in the market—which we discuss in our recent podcast, High Yield: Rates, Recession and Relative Value. Over the last year, the higher-rated BB part of the market has outperformed lower-rated B and CCC credits. As a result, spreads on BB credits today are somewhat compressed, whereas spreads in the lower part of the market have stayed relatively wide. Looking at the market today, we think there are select opportunities in B and CCC credits—but it's not a case of just buying the market. In order to find the hidden gems in the lower-rated part of the market, it's critical to do the due diligence and gain a thorough understanding of a company, and how it's going to perform going forward. With the right amount of research, this is where the opportunities will continue to materialize over the next year, in our view.

In fixed income more broadly, we are increasingly seeing opportunities outside of traditional corporate and government bonds—in areas like collateralized loan obligations (CLOs), distressed debt and certain parts of the asset-backed securities (ABS) market. In addition to diversifying risk exposure and lowering the correlation of the asset classes in the portfolio, allocations to these areas can offer an opportunity to earn incremental yield relative to traditional corporate credit.

Bold Prediction

There have been numerous headlines over the last year calling attention to the growth of the lower-rated BBB portion of the investment grade market—and predicting a wave of fallen angels, or credits that fall from the lowest IG rating to a high high-yield rating. It's important to remember that credit ratings are not always painting a complete picture of a corporate issuer's financial health, but can be more indicative of what corporate treasurers have been incentivized to do. In recent years, continued low rates and very little penalty associated with falling from A to BBB have incentivized companies to add more leverage. But in many cases, these are high-quality companies that have the ability to make adjustments to their balance sheets and deleverage as needed. In this context, one bold prediction is that despite the headlines, we will not see a wave of fallen angel credits disrupting the high yield markets in 2020. In fact, in the last year, we have seen many more high yield companies upgraded to investment grade than the other way around.

Despite Headwinds, Upgrades Have Outpaced Downgrades in the U.S.
U.S. Rising Star/Falling Angel Volume



SOURCE: Credit Suisse. As of September 30, 2019.