

Weekly Briefing

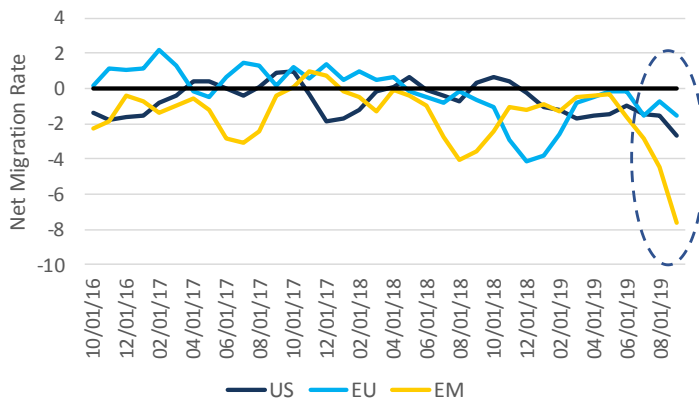
SKYView: Upgrades & Downgrades

Fed rate cuts aside, a turn for the worse in credit ratings migration rates has been our most discussed topic over the past week. As the cycle ages and earnings growth stagnates, the rating agencies appear to have become more prone to cut corporate credit ratings. In this *Weekly Briefing*, we take a deeper look at trends behind the increase in net downgrades and gauge the impact that such developments may have on high yield bond performance.

High yield ratings migration rates (presented below on a trailing-3-month basis for greater clarity) have been on the decline in 2019, with emerging markets high yield demonstrating a higher degree of downgrade acceleration relative to US and Euro high yield over the last several months. Even US high yield ratings, which had shown tremendous resiliency in 2017 and 2018, have trended downward this year. For investors, the impact of such downgrade actions have not been problematic in aggregate. As demonstrated in the chart below (right side), the relationship between trailing-3-month rating migration rates and changes in spread over the subsequent 3-month period are statistically insignificant.

High Yield Ratings Migration Rates Have Turned Negative

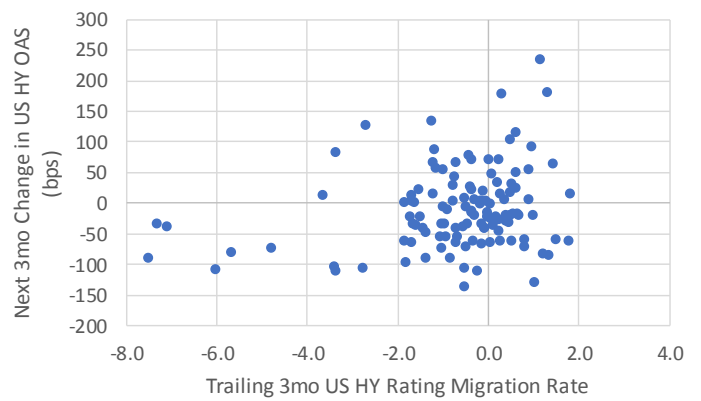
trailing 3 month data



Source: SKY Harbor, BofA Merrill Lynch, ICE BofAML Indices

Migration Rates Not Correlated to Next Period Spread Change

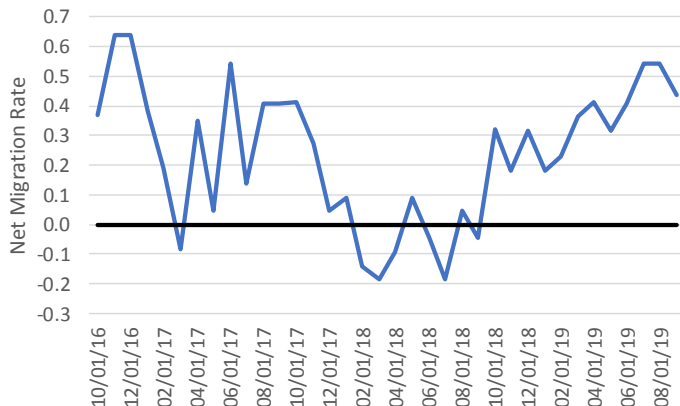
monthly data, trailing 3 years



While rating migration rates may not exhibit a strong correlation to ensuing market-wide spread changes for a multitude of reasons (rating actions tend to be reactive in nature, concentrated pockets of downgrades can be more problematic than a diversified set, etc.), we acknowledge the technical impact downgrades can have on various indices (the danger of fallen angels flooding the US high yield bond market being the risk that immediately comes to mind). Recall that rapid growth of the BBB segment of the US investment grade corporate index – now \$3.4tn in size, or nearly 3x the size of the ICE BofAML US High Yield Index – has fueled uneasiness that an earnings slowdown and subsequent wave of downgrades could pressure secondary market trading levels (particularly among BBs). Fortunately, investment grade rating migration rates have been on the rise, materially alleviating this concern. Year to date through September month-end, the notional value of rising stars (\$70.4bn) has exceeded the value of fallen angels (\$20.7bn) by a ratio of 3.4:1.

US Investment Grade Migration Rates Remain Positive...

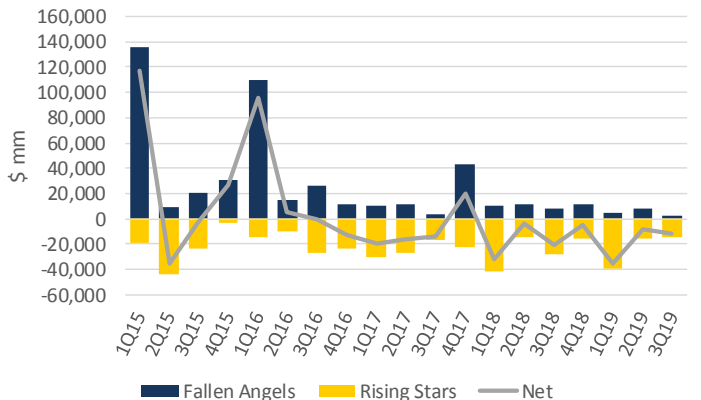
trailing-3-month data



Source: SKY Harbor, BofA Merrill Lynch, ICE BofAML Indices

...And Rising Stars Continue to Outnumber Fallen Angels

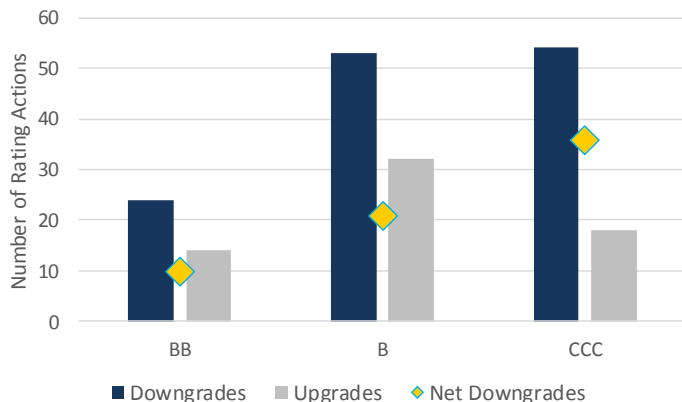
YTD upgrades vs. downgrades



Trends that underpin US high yield negative ratings migration rates are worthy of deeper analysis, and on a micro basis have shown to be statistically correlated with performance of various baskets within the US high yield index. Thus far in 2019, the absolute number of downgrade “events” (131) have outnumbered upgrade “events” (64), with net downgrades being most prevalent within the CCC ratings bucket. Commoditized sectors such as Energy as well as sectors more closely tied to generally weakening industrial end-markets (Capital Goods) have had the largest number of net downgrades.

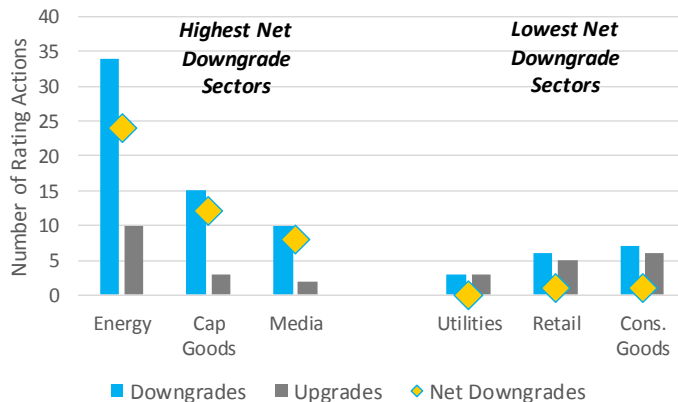
US HY Downgrades Have Been Most Prevalent in the CCCs...

YTD upgrades vs. downgrades



...And Focused in Energy and Capital Goods / Manufacturing

YTD upgrades vs. downgrades

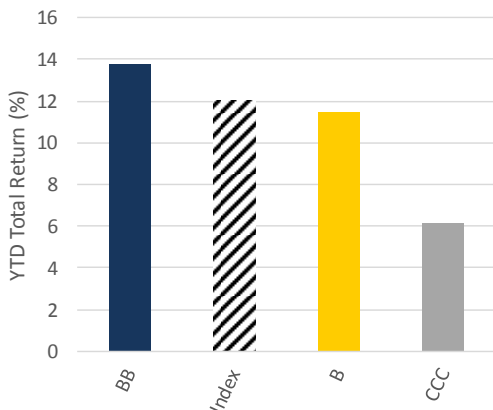


Source: SKY Harbor, Credit Suisse

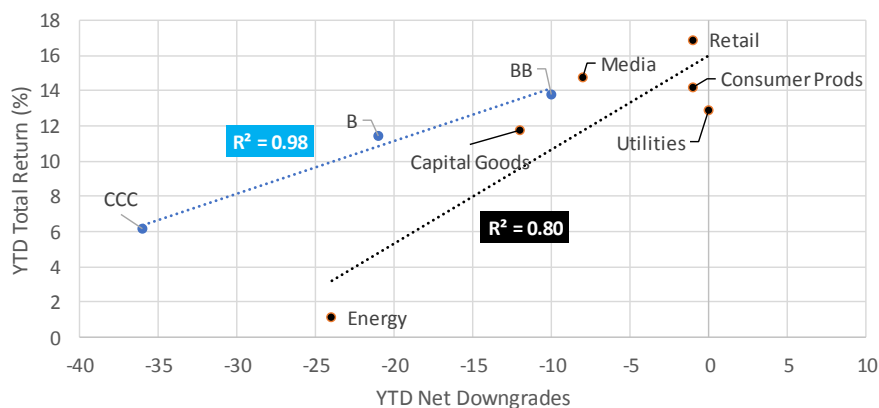
On this more granular basis, the relationship between YTD net downgrades and YTD total returns becomes much more visible, with the two most significant high yield laggard buckets (CCC rated and the Energy sector) suffering the most net downgrades. Although we do not believe a rating action in and of itself triggers a selloff (technical forces aside), the drivers of rating changes (fundamentals, most often) will certainly impact secondary market levels. As such, we remain mindful of issuers coming under the most pressure from a credit metric standpoint (those with exposure to non-US sales, trade uncertainty, and underlying commodity prices that are supported by accelerating global growth, etc.) in an attempt to preempt the repricing of portfolio risk over the intermediate term.

Rating Bucket and Sector Migration Rates Have Been Correlated to Total Returns on a Micro Basis

YTD data (through October 30, 2019)



YTD net downgrades vs. YTD total returns



Source: SKY Harbor, Credit Suisse, ICE BofAML Indices

In conclusion, ratings migration rates have turned negative in 2019, likely the result of limited rating agency patience amidst a backdrop of stagnant earnings growth. Although we find little evidence that aggregate ratings trends lead to subsequent index-level spread changes, we acknowledge the potential for technicals to impact the market. Furthermore, while positive investment grade ratings migration rates support our expectation that rising stars will continue to outnumber fallen angels, significant net downgrades appear to have weighed upon the lowest quality (CCC) and least-loved (Energy) parts of the high yield index. Going forward, we remain focused on avoiding credits prone to suffering the most severe fundamental credit headwinds in an effort to stay ahead of additional net downgrades.

On the Calendar

Occurred

Event	Release Date	Period	Survey	Actual	Prior
Wholesale Inventories MoM	28-Oct-19	Sep	0.2%	-0.3%	0.2%
Conf. Bd. Consumer Confid.	29-Oct-19	Oct	128.0	125.9	125.1
FOMC Rate Decision (Upper)	30-Oct-19	30-Oct	1.75%	1.75%	2.00%

Source: SKY Harbor, Bloomberg

Upcoming

Event	Release Date	Period	Survey	Actual	Prior
Factory Orders	4-Nov-19	Sep	-0.4%		-0.1%
Trade Balance	5-Nov-19	Sep	-\$53.0 bn		-\$54.9 bn
ISM Non-Manufacturing Index	5-Nov-19	Oct	53.5		52.6

Recommended Reading

Timiraos, Nick (2019, October 30). Fed Cuts Rates for Third Time This Year, Signals Pause. *The Wall Street Journal* (subs. req.), Retrieved from <https://www.wsj.com/articles/fed-cuts-rates-by-quarter-point-11572458556?ns=prod/accounts-wsj>

Donnan, Shawn et al. (2019, October 31). China Doubts Long-Term Trade Deal Possible With Trump. *Bloomberg*, Retrieved from <https://www.bloomberg.com/news/articles/2019-10-31/china-said-to-doubt-long-term-trade-deal-possible-with-trump>

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