May 2014 Investment Publications Highlights

"Why Fallen Angels Fall: An Examination of Nonfinancial Corporate Fallen Angels 1999-2013 and 2014 Outlook"

Kenneth Emery and Daniel Gates, Moody's, February 3, 2014

Limits on junk bond holdings in investment-grade portfolios can lead to indiscriminate selling when debt gets downgraded from investment grade to speculative grade. Moody's examines the long-run characteristics of such "fallen angels" and concludes that the outlook for such downgrades is benign but worsening slightly.

Institutional investors are often required to limit their holdings of non-investment-grade credits. Once bonds are downgraded to speculative grade, portfolio managers often sell these so-called fallen angels indiscriminately as a result. This phenomenon may contribute to the superior long-run excess returns seen in the highest-rated speculative credits (i.e., credits rated BB) as compared to corporate bonds with either higher or lower ratings. In examining 477 non-financial fallen angels over the 1999–2013 period, Kenneth Emery and Daniel Gates look for the characteristics that explain why fallen angels get downgraded in the first place. The authors conclude that company- and industry-specific factors are the primary culprits, and that the outlook for the fallen angel rate in 2014 is benign but worsening slightly.

Over the full 1999–2013 period, the average cumulative probability of an investment-grade firm becoming a fallen angel was 12%. In other words, slightly more than one in ten companies was eventually slapped with a "junk" rating. This average, however, masks differences in the downgrade rate seen during the two major default cycles of the last 15 years. The peak fallen angel rate of almost 4% during the 2008–09 financial crisis was noticeably below the 8% rate seen at the 2003 peak. The scarcity of fallen angels during the recent crisis was due to the relatively healthy nature of balance sheets in the non-financial corporate sector (and in stark contrast to the dangerous levels of leverage employed by the finance sector). The Federal Reserve's extraordinary monetary stimulus has also helped keep downgrades low by stimulating investors' appetites for yield, and thus corporate debt.

As the current period of low default rates gets long in the tooth, Emery and Gates's work serves as a reminder of what made investment-grade companies' positions deteriorate in the past. They find that either company-specific factors (42% of fallen angels) or industry-wide stress (30%) accounted for the most downgrades out of the six primary causes they identify. They categorize SprintNextel's 2008 downgrade, for example, as company specific: its weakening market position as compared to other US wireless carriers hurt its financial strength. In contrast, they classify *The New York Times'* 2009 downgrade to junk status as a result of the ongoing deterioration in the newspaper industry. Other factors, including changes in company financial policy (such as increasing dividends), leveraged acquisitions, regulatory actions, and macroeconomic/sovereign issues, played more minor roles.

Although not all fallen angels remain fallen forever, the final outcomes for fallen angels can hardly be described as inspiring. Only 28% of the fallen angels studied eventually returned to investment-grade status, while 15% defaulted and 18% had their ratings withdrawn. In general, the higher the rating of an issuer at the time of its downgrade to fallen angel status, the less likely was an eventual default.

Using Moody's issuer-specific data on today's investment-grade universe, the authors estimate a rising fallen angel rate for the second and third quarters of 2014. More specifically, they project a rise from today's rate of 2.2% to a peak near 3.0% later in the year. By year end, they expect the rate to dip back down to 2.0%. Their forecasts are conditioned on a 6.2% unemployment rate and 400 bp high-yield spread at the end of the year.

"The New Neutral"

Richard Clarida and Bill Gross, PIMCO, May 2014

The amount of total global debt outstanding combined with subpar economic growth rates will constrain central bankers and pin future policy rates close to zero over a multi-year time horizon, notes PIMCO. In this "new neutral" environment, investors will likely find limited risk but achieve subpar returns.

In the aftermath of the credit crisis, the global economy underwent a massive transformation as central bankers inflated their balance sheets and pushed policy rates to zero. This was a significant departure from the global economic model of years past, in which excess supply in high-saving, commodity-producing EM countries and excess demand in some low-saving rich countries generated enormous international capital flows that were sufficient to offset each other. Five years later, the global economy has yet to find a sustainable growth model and investors find themselves stuck in "the new neutral": an environment with limited upside but reduced risk thanks to the zero-bound interest rate policies of central bankers.

Despite all the talk of deleveraging in recent years, the total stock of public and private debt outstanding in the global economy is at an all-time high in both dollar terms and as a share of global GDP. The private sector deleveraging that's occurred has, at least on a global basis, been replaced by public sector leverage. Thus, despite the Fed's own intentions to raise rates after QE3 winds down, the outlook for sustained *global* zero interest rate policies remains in place.

In the case of China, the amount of leverage in the shadow banking system has quadrupled in the past four years and now exceeds $1.6 trillion. Policymakers will likely attempt to limit shadow banking over the next three to five years, but recognize that this will drag on GDP growth over the secular horizon. Chinese officials will also have to be careful about how they choose to go about liberalizing their internal interest rate market, and monetary policy is likely to remain highly accommodative as a result.

In the case of Europe, sovereign bond yields have plunged since the summer of 2012. Yet the sovereign debt of many countries is too large relative to GDP to be sustained unless interest rates remain low or growth rebounds to well above the current rate. The leverage overhang in Europe is likely to remain an important consideration for ECB policymakers in the years to come, keeping rates lower for longer and adding to the odds of a major quantitative easing program.

Meanwhile, in the United States, the private sector has deleveraged and growth prospects appear much better than in most other developed markets. However, there is risk that the *global economy* will be unable to grow and generate inflation at pre-crisis levels for many years to come—even if monetary policy rates remain at zero in nominal terms and negative in real terms.

Zero interest rate policies have already been reflected in asset prices: credit spreads are narrow, yields on many fixed income assets hover near record lows, and stock prices are approaching peaks based on stable profit margin expectations. However, if real policy rates are centered at zero over the secular horizon, the

investment implications are significant because markets are currently pricing in rising interest rates in the near future. At first glance there appears to be more risk than reward on the horizon for investors. But if the "new neutral" environment plays out, risk may be lower than expected, though asset returns are likely to remain subdued. ■

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