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Weekly Credit Brief Jan 19 - Jan 25 2021

US Fallen Angels to be sustained in 2021

by [Lee Wei Qi]

- **In 2020, US domiciled corporates accounted for a majority of the fallen angels worldwide**
- **Amongst the top 3 sectors with the highest amount of rated BBB range debt, CriAT's iRAP points to increasing proportions of NIG issuers from Jan 2021 to Jul 2021**

Defined as former investment grade (IG) bonds that were downgraded to non-investment grade (NIG) status, fallen angels ran up to over USD 367bn in 2020. The issuance downgrades were most prominent amongst corporates domiciled in the United States (US). In Mar 2020, about USD 83bn of US IG corporate bonds were downgraded to junk status. By the end of Q3 2020, the 1-year rolling tally of fallen angels within the ICE BofA US IG index came in at USD 241bn. This brief provides a review of US fallen angels in 2020 and explores the top 3 sectors with the highest amount of debt within the rated BBB range[1]. CriAT's iRAP[2] and NUS-CRI's Aggregate Forward 1-year Probability of Default (Forward PD[3]) signal possible credit deterioration of corporates within the 3 selected industries – Financials, Communications and Energy.

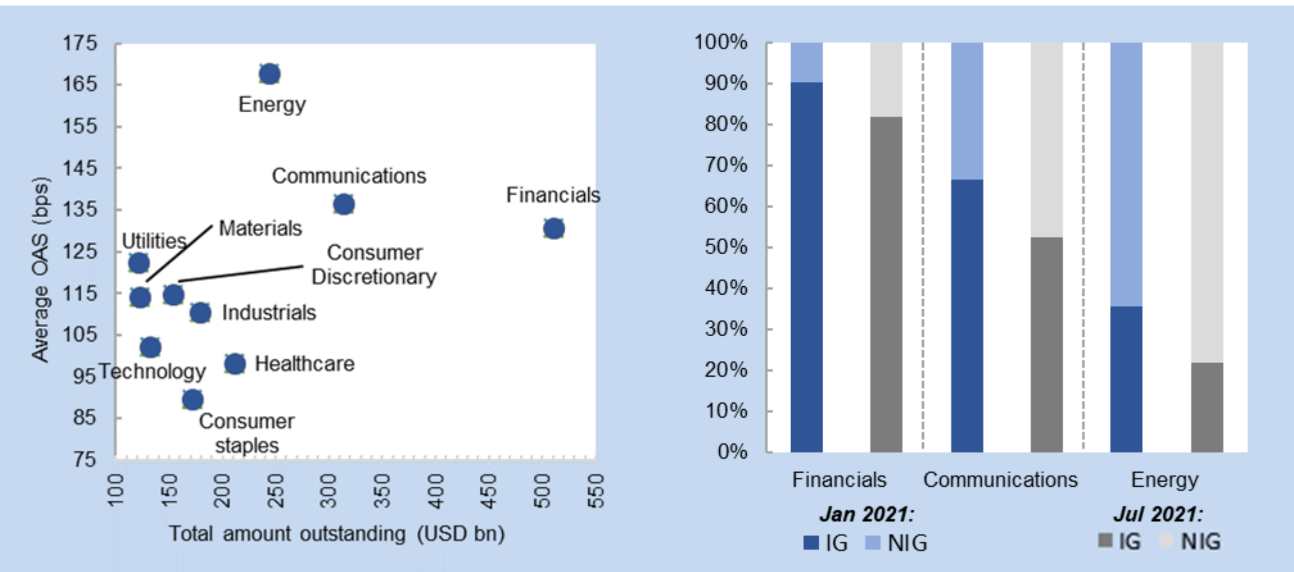

Figure 1a (LHS): Outstanding BBB- to BBB+ rated issuance and their corresponding average OAS of US domiciled corporates by sectors as of Jan 2021. *Source: Bloomberg* Figure 1b (RHS): Current and forecasted PDiR2.0[4] rating distributions of US domiciled corporates (selected industries) based on date feed as of Jan 2021. *Source: NUS-CRI and CriAT*

[1] The brief adopts a more targeted approach where only bonds that are closer to NIG bound (BBB+ to BBB-) are explored. The bond specific ratings are gathered from Bloomberg. This provides a more convenient analysis that stakeholders are familiar with. Moreover, it is more apt to utilise the ratings from which the issuance is priced with. Any reference to the credit profile and outlook of the corporates are based on NUS-CRI Probability of Default.

[2] iRAP (intelligent Risk Analysis Platform) is a software developed by CriAT (https://www.criat.sg/) for conducting both firm-level and portfolio-level credit analysis. iRAP utilizes the NUS-CRI Probability of Default (PD) model and links it to the live NUS-CRI database offering PDs on almost 80,000 exchange-listed corporates globally.

[3] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months – this is conditional on the firm's survival in the next 6 months.

[4] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

The COVID-19 induced lockdown and safe distancing practices have resulted in business disruption across the board. The corresponding fall in revenue, cash strapped conditions and increasing leverage contributed to a multi-year high amount of fallen angels. While the amount of fallen angels in 2020 was substantial, it was not as extreme as predicted. This can be attributed to the Federal Reserve's (Fed) prompt and extensive corporate bond purchase programme. This initiative has extended credit guarantees and liquidity to these fallen issuers.

Diving into the US's existing rated BBB range debt universe, the industries were sorted via the total amount outstanding and the representative average OAS (Proxy for the risk premium demanded on debt). Resultantly, the financials, communications and energy industries stood out (Figure 1a). CriAT's iRAP forecasts increasing proportions of NIG issuers by Jul 2021 - Financials (+8 percentage point (pp)), Communications (+14 pp) and Energy (+14 pp) (Figure 1b).

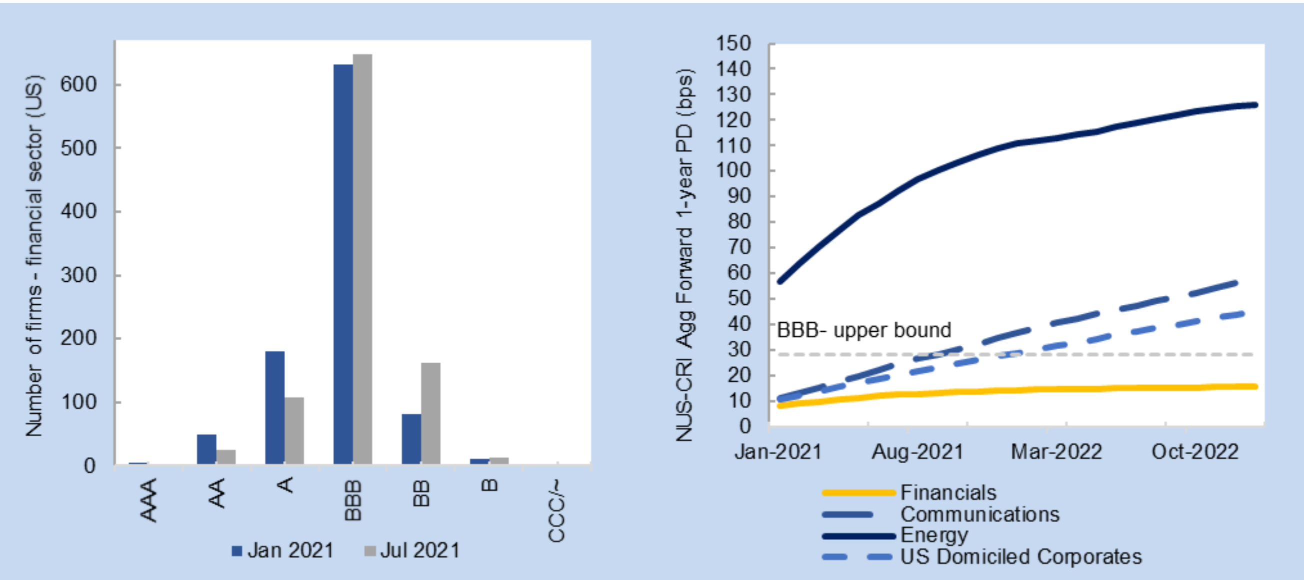

Figure 2a: Present and forecasted credit distributions of the US financial industry. *Source: NUS-CRI and CriAT* Figure 2b: Agg Forward 1-Year of US domiciled corporates - both country and sector aggregates based on data feed as of Jan 2020 with reference to the PDiR2.0. *Source: NUS-CRI*

Within the US financial sector, majority of the issuers are concentrated around the BBB rating as per CriAT (Figure 2a). While there are some laggards in the sector, the financial industry as a whole exhibits a relatively flat aggregate NUS-CRI Forward PD term structure (Figure 2b). Less credit worthy financial corporates are more susceptible to credit stress arising from an uptick in delinquent loans resulting from the sluggish economic outlook. While loan loss provisions have been on a rise, the US financial industry are well endowed to withstand the potential headwinds due to their strong capital buffers. Moreover, banking leaders have benefited from 2020's strong profit performance from their capital market and trading arms.

The forward term structures also show that the communications and energy sectors may face credit deterioration over time (Figure 2b). While the communications sector has been supported by their recurring subscription-based business model, firms with exposure to small and medium enterprises may see relatively subdued outlooks. The industry saw a fall in return on assets to 4.36% in 2020 (2019: 5.74%). Doubts are casted upon the possible material impact of the prevailing 5G growth on the sector's top line. Increasing near-term wireless competition, such as DISH, Comcast, and Altice, may also result in margin compression.

The elevated forward term structure of the energy industry signals substantial credit deterioration to come. This can be attributed to the dampened demand and commodity prices. In light of the prevailing conditions, there is a need for the industry to consolidate and enhance upon their cost saving capabilities. After undergoing structural shifts in demand, energy faces greater exposure to potential fallen angels. The resulting loss in competitiveness decreases the odds of recovery that the issuers' debts regain IG status. In contrast, issuers that are downgraded as a result of a bust or micro-financial causes have a greater chance for a positive debt revision.

The aggregate leverage of US corporates is at an all-time high and the 2020's dash for cash has to be mitigated with greater balance sheet management and fiscal discipline in 2021. In Mar 2020, the cost of downgrade from BBB- to BB+ shot up by 141bps. Though the spread has tapered down by the end-2020, the gap between the IG lower bound and the speculative grade upper bound remained substantial. The heightened risk premium demanded by investors signals possible repricing of rated debt. More specifically, the yield from the representative BBB- paper has increased. Despite the caution exercised by investors, a substantial increase in fallen angels is not expected should there be a steady vaccine rollout. Beyond the effectiveness of the public health policies, the US domiciled corporates can find relief from the Fed's accommodative monetary stance and the coming USD 1.9tn Covid Relief Plan.

Credit News

Corporate bond sales in India set to slow after a record year

Jan 25. Debt sales in India's corporate bond market are likely to significantly slow down this year with issuance set to fall by 17% to INR 7.55tn as companies are in less need to build up cash buffers. The economy is set to rebound strongly after the worst contraction since 1952, which should ease funding pressures. This comes after the RBI aims to normalize liquidity operations. So far, corporate bond issuances have declined 20% YoY, with similar trends seen across other South-East Asian countries across all currencies. (Bloomberg)

US ban on China firms could affect USD 60bn of bonds: JP Morgan

Jan 23. The crackdown on US investors holding Chinese-issued securities has the potential to disrupt over USD 60bn worth of debt securities and cause a massive selloff. The executive order stipulated that US residents would be barred from investing in companies deemed to have a connection to the Chinese military. The debt market has been facing frictions in complying with the rule, however, as the bonds were issued by subsidiaries rather than the actual companies themselves. ChemChina and CNOOC are two companies that have been significantly affected by the moves imposed by the US government. However, these actions are likely to affect US investors more than Chinese debt issuers, given the relatively smaller exposure these companies have in the US market. (Reuters)

CLO, asset-backed buyers fear rally doesn't match fundamentals

Jan 22. Recent pricing rallies seen on US securitized products, such as leveraged loans and commercial mortgages, may not be indicative of the headwinds faced by the sectors. There is a disconnect between tightening spreads and the real economy. Risk premiums are even lower than they were prior to the pandemic. As such, investors are trying to find lower-rated bonds in search of yield. From a relative value standpoint, CLO BB tranches and equity are more attractive than corporate bonds. Areas of concern may be the leverage loan market, which is seeing a significant rally and lowest yields since 2018. As such, the vaccine should help in reducing this mirage and put forth a 'truth serum' which helps in accurately reflecting the reality in certain sectors. (Bloomberg)

Investors seek out riskiest junk-rated bonds

Jan 22. Yields on the lower-rated junk debt are at their lowest on record, highlighting the need for investors to find return in a low-rate environment. Triple-C rated bonds' yield has recently reached 6.42%, significantly lower than 7.4% at the start of the year. This is a marked shift in investor interest in bonds, as capital outflow jumped as a result of the pandemic. Strong monetary and fiscal policies helped to ensure this rise in bond prices, as corporate credit was pulled out of troubled waters. Higher yields of junk-rated securities continue to be of interest, with over USD 33bn being raised so far this year. (WSJ)

Investment grade bonds stumble on rising yields

Jan 21. Investment Grade (IG) corporate bonds have been the worst performers in the debt market this year and rising yields are compounding worry that the worse is yet to come. IG rated investors lost about 0.90% on average this year, compared to the 0.63% gain in high-yield bonds and 0.10% gain from municipal debt. This was bought on by the increase in US-treasury yields, which rose sharply recently due to expectations of an economic recovery and rising inflation, thus reducing investor's real returns. IG debt is affected because of its low protection to interest rate rises. Investors are being urged by companies to reduce their exposure to IG debt due to the resultant fall in spreads. (WSJ)

Global green bond issuance hit new record high last year (Reuters)

Verisure taps frothy bond markets for EUR 1.6bn private equity payout (FT)

Evergrande shares soar as early bond repayment eases debt worries (FT)

Regulatory Updates

France's central bank has pledged to green its balance sheet

Jan 22. France's central bank vowed to shift over EUR 22bn worth of assets, such as pension funds and other portfolios, into green investments. The body aims to do this by divesting from all companies that were involved with coal by 2024. At the same time, it plans to forgo all companies that generate more than half of its revenues from gas and push back against fossil fuel projects. This is a similar move made by the Swiss National Bank, which plans to remove coal mining companies from its holdings. While eyes have been on the ECB to do the same, over 40% of their holdings purchased from March to May last year were companies linked to the production of fossil fuels. It is unlikely, however, that major changes will be made for fear of significantly affecting the market. (FT)

ECB details bond-buying shift as it holds rates and stimulus ready

Jan 22. After leaving its main stimulus policies and interest rates unchanged, the ECB is judging how much to spend on its emergency bond-buying programme by checking if lending rates and credit conditions are favorable to boost demand and inflation. The ECB also decided to reconfirm its very accommodative monetary policy stance after judging the worsening downside risk. This policy stance is going to be used to preserve favorable financing conditions, for which specifics remain ambiguous while ensuring that their arsenal of resources can be expanded further if needed. As such, fewer policy decisions are expected from the ECB during the first half of this year. (FT)

UAE cabinet approves debt strategy to build local currency bond market (Reuters)

Tightening loan regulations drive market into further confusion (Korea Times)

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