COMMUNITY CAPITAL MANAGEMENT

The Implications of Fallen Angels in a Weakened Liquidity Environment

A Fallen Angel, generally speaking, is a bond that was initially given an investment-grade rating but has since been reduced to high yield – or junk bond – status by at least two of the three major ratings firms. The downgrade is caused by a deterioration in the financial condition of the issuer.[1] While much has been written about the pending cascade of Fallen Angels, we have yet to see any research addressing the impact on all corporate credit markets in a post-Dodd-Frank liquidity environment.

With the Federal Reserve (the Fed) backstopping Investment Grade (IG) debt, we believe higher rated IG corporate debt (those rated A or better) are offering excellent risk/reward profiles. However, with many BBB or BBB-rated corporate debt at risk, market liquidity for these assets is extremely concerning. Together, the BBB and BBB-ratings categories account for approximately 30 percent of the investment grade subsector of the Bloomberg Barclays Aggregate Index (the most commonly used benchmark to evaluate the performance of the U.S. bond market). If downgrades happen broadly and rapidly within these sectors, there could be massive dislocations across the entire corporate bond market and markets in general.

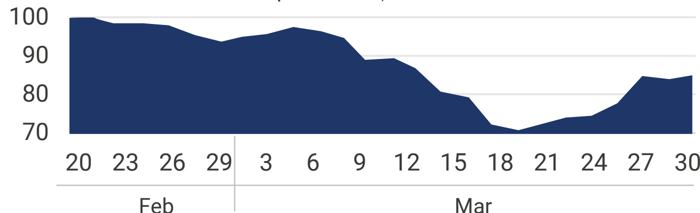
There is currently $868 billion of investment-grade debt that has at least one BBB- or equivalent rating, just one level above junk.[2]

Current Market Liquidity Issues

The violent moves in March in agency real estate investment trust (REIT) and IG preferred markets were one of the first major liquidity tests in a post Dodd-Frank regulatory environment and the markets failed miserably. The liquidity constraints imposed on dealers by the regulation – combined with outflows in Exchange Traded Funds (ETF's) and unwinds of leveraged structures like exchange traded notes and closed end funds – led to forced selling. For example, below are price charts for preferred shares of AGNC, an agency REIT, and a JP Morgan Preferred.

Preferred Shares of AGNC | Last Price, As of 3/30/2020

Preferred Shares of JPM | Last Price, As of 3/30/2020



Source: Bloomberg

Both of these securities had little underlying credit risk and turned around sharply when the Fed entered the market. However, this may not be the case for Fallen Angels, as the Fed is currently avoiding buying junk-rated paper.

Goldman Sachs and Guggenheim Partners predict $850 billion and $1 trillion, respectively, worth of bonds that may attain Fallen Angel status[3] – which would double the size of the high yield market. While not necessarily comparable in size or scope, the most recent Fallen Angel event occurred in 2005 with Ford Motor Company and General Motors. The biggest differences between 2005 and now are the growth of ETF's and foreign buyers in the IG corporate space, both of whom might have to sell without regard to price, and the loss of dealer-provided liquidity. Assuming buyers even emerge, what will be their bids? How much will IG spreads widen in sympathy? And what will be the impact on equity markets?

Conclusion

We do believe the Fed learned a lot from the financial crisis in 2008 and has acted quickly to lower rates, add liquidity to the system, and put a floor under IG credit with a massive bond buying program. It is possible they may have to add high yield purchases, but we suspect that will only be after significant damage has been done across all credit and equity markets.

[1] https://www.investopedia.com/terms/f/fallenangel.asp
[2] https://www.bloomberg.com/news/articles/2020-03-13/why-billions-in-bonds-now-trade-like-fallen-angels-quicktake
[3] https://www.bloomberg.com/news/articles/2020-03-13/why-billions-in-bonds-now-trade-like-fallen-angels-quicktake; Goldman Sachs Global Investment Research

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