Flash commentary

UBS Asset Management I Fallen angels – the impact on Fixed Income markets

The economic backdrop

The unprecedented measures taken by governments across the world aimed at slowing the spread of COVID-19 has significantly impacted economic activity. Prior to the emergence of this pandemic, much had been publicized about the re-leveraging and general deterioration in quality that was occurring in high grade corporates. For example net leverage, as represented by Net Debt to EBITDA ratio had increased from 1.1 in 2011 to 1.9 in 2019 in US corporates according to data from Morgan Stanley. Additionally, the lowest quality tier of the high grade debt universe for example bonds rated BBB, had steadily increased from 30% of the overall market at the end of the 2008/09 financial crisis to roughly 50% today as the chart shows.

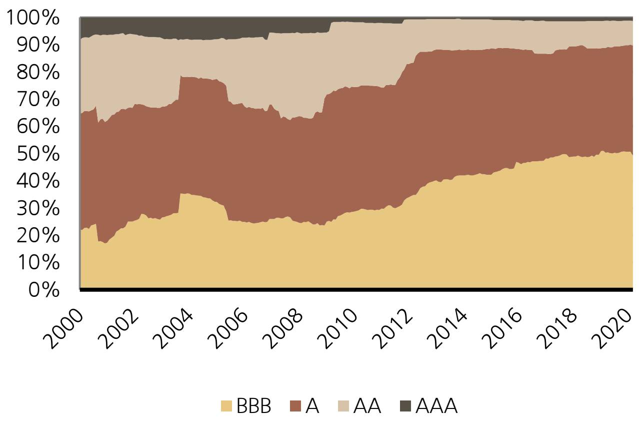
Although credit rating agencies have selectively downgraded a number of issuers from investment grade (IG) to high yield (HY) over the past few years, the focus was often on borrowers in a handful of sectors such as energy and metals and mining. What seemed to be missing was a catalyst that would trigger a broad based wave of so-called "'fallen angels', a term used to described bonds that have been downgraded from investment grade to non-investment grade – enter COVID-19 and the collapse of oil prices.

The disruption to economic activity has been staggering with almost all sectors and industries feeling the impact of a global economy at a near standstill. Expectedly, the number of bonds that have actually been downgraded to HY and the number that currently have a rating of BBB-, the last notch within IG, have both risen dramatically as ratings agencies assess the impact of the crisis on corporate balance sheets. For instance, S&P has already stripped 21 companies of their investment grade rating since February of this year, the highest such tally since 2015. Simultaneously, the universe of borrowers it has rated BBB- with a negative outlook (potential fallen angels) currently stands at 96, the highest since March 2009.

While European and US corporate issuers have garnered most of the attention in regards to fallen angels, developments in other areas especially in the Emerging Markets – and to a smaller extent – developed Asia, all point to rising downgrade risks. South Africa's loss of its only remaining investment grade rating last month and Mexico's recent downgrade to BBB- by one of the three major agencies both have significant ramifications for the corporates and quasi-sovereigns in those economies.

In this commentary we share a number of key findings from a recent study conducted by our credit research team on the par amount of likely fallen angels across Europe and the US in the next three to six months. We then examine the impact of these potential downgrades on credit markets and conclude with our outlook and positioning.

Global corporate bonds historical rating distribution



Source: Bloomberg Barclays Global Aggregate Corporates Index, as at 31 March 2020.

Fallen angels – What is the UBS-AM view?

To better understand the impact and the risks associated with fallen angels, UBS-AM credit analysts recently conducted an independent assessment of the US and European corporate bond markets. We summarize their expectations for ratings downgrades in the next three to six months as follows:

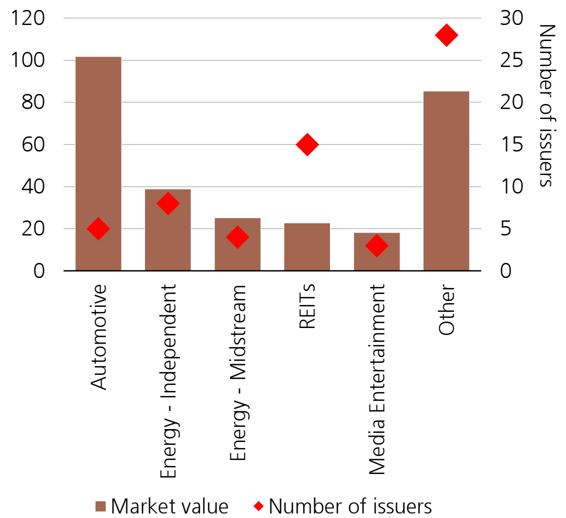
- US IG market value: 292 billion across 63 issuers
- EUR IG market value: 141 billion across 27 issuers

After further reviewing the results we made two major observations regarding the types of risks faced by high-grade borrowers:

- Direct risks – These are issuers in industries affected by quarantine measures, such as airlines and transportation services
- Second order risks – These are borrowers in sectors

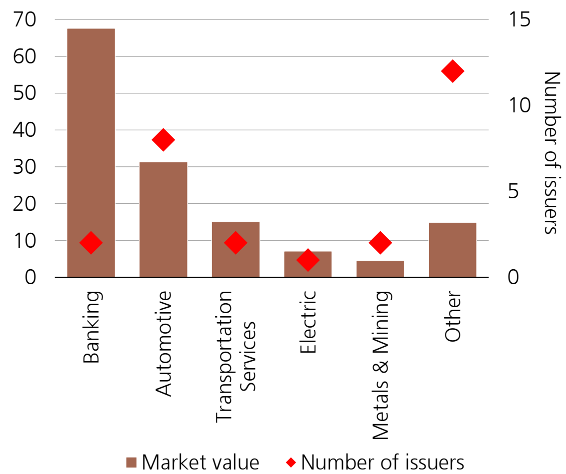
which could suffer in a scenario of rising unemployment, lower consumer confidence and falling business investment spending such as automotive.

US IG fallen angels forecast (USD billions)



Note: This does not constitute a guarantee by UBS AG, Asset Management. Data as at 31 March 2020. Analysis conducted on BBB and BBB- rated bonds.

EUR IG fallen angels forecast (EUR billions)



Note: This does not constitute a guarantee by UBS AG, Asset Management. Data as at 31 March 2020. Analysis conducted on BBB and BBB- rated bonds.

The above estimates are not dissimilar to what the broader market expects. However, the situation remains fluid and dependent on several exogenous factors such as the length of lockdowns imposed in various countries and the nature of any potential exit paths. We will therefore continue to reassess market conditions and update our forecasts as the current environment evolves.

What is the impact on credit markets?

Investment Grade

Many fallen angel candidates are already trading at HY levels. For example, at the end of March our expected fallen angels for Europe were trading at 460bps, broadly in line with HY bonds rated BB+/BB. This is in stark contrast with bonds rated BBB and BBB- which traded 360 bps tighter back in January this year. One notable exception to this trend of spread widening in IG can be observed in the US where trading levels have rebounded meaningfully following the announcement by the US Federal Reserve (Fed) that it would begin buying fallen angels as part of its broad-based measures to support markets. Going forward we expect this intervention to provide a floor to pricing levels for US fallen angels with some nuances across sectors.

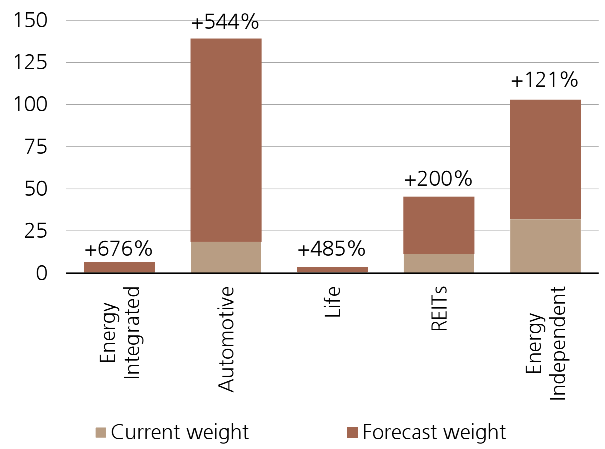
Compared to the global financial crisis (GFC), the fiscal and monetary support programs being enacted by central banks in response to the current challenges are helping restore order to credit markets. It is also worth noting that banks are healthier today than they were back in the GFC. They have stronger capital and liquidity buffers and we therefore expect a significantly lower incidence of downgrades of subordinated bank debt to high yield. Additionally because banks are in better health, compared to 2008/09, they are in a much stronger position to support businesses during these difficult times.

High Yield

Whilst the absolute amount of fallen angels in Europe is forecasted to be lower than in the US, when compared to the size of the respective HY markets, Europe is expected to feel a heavier impact from downgrades. Based on our analysis the EUR HY market is expected to incur an increase in size of close to 50%. This compares to an increase of just over 25% in the US HY universe.

Top sectors most impacted by rating downgrades to HY

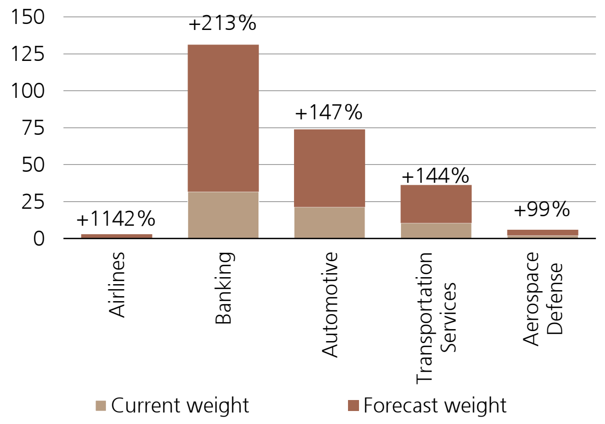
US HY (USD billions)



Note: This does not constitute a guarantee by UBS AG, Asset Management. Data as at 31 March 2020. Analysis conducted on BBB and BBB- rated bonds. Forecast weight includes the forecasted fallen angels.

Top sectors most impacted by rating downgrades to HY

EUR HY (EUR billions)



Note: This does not constitute a guarantee by UBS AG, Asset Management. Data as at 31 March 2020. Analysis conducted on BBB and BBB- rated bonds. Forecast weight includes the forecasted fallen angels.

While the incidence of fallen angels is likely to be elevated in the current environment, the phenomenon of wide-spread downgrades from IG to HY is not without precedence. Similar occurrences took place during the global financial crisis, the Eurozone sovereign crisis and in the oil price collapse of 2014/15. On each of those occasions the market absorbed the supply of those companies that were deemed as being of a higher quality relative to the other downgraded with support bids coming from both dedicated HY investors and cross-over IG investors. Additionally, more recent episodes of downgrades were supported by favorable technical factors such as central bank intervention and yield hungry investors.

Despite the sheer magnitude of expected fallen angels, we believe they will likely be absorbed by the market over the medium to long-term. Key to this will be a balance between supply and demand for high yield credit. Factors supporting a balance are:

- we forecast supply to be lower versus previous years as many issuers have already extended their maturity profiles and current uncertainty will discourage opportunistic refinancings
- investors have substantial coupon income to be reinvested
- an expected improvement in the quality of the HY universe generally due to BB rated fallen angels entering the universe and deeply distressed default candidates leaving

As previously mentioned, a key support to the US HY market is the commitment of the Fed to buy fallen angels. With regards to other markets, further intervention from central banks cannot be ruled out due to the unprecedented nature of the crisis. However, it is important to note that there will be some nuances with regards to sectors. We expect those with signficant downgrades to take more time to digest and consequently exhibit higher spread volatility.

What are we doing in light of these findings?

Based on the analysis undertaken by our credit research team we conclude that while the road ahead will be a bumpy one it could also offer attractive opportunities for us to deploy capital on a select basis. Specifically, we see value in:

- US IG and EUR IG as these are segments of the market which are supported by direct central bank bond purchase programs and valuations appear attractive
- Prefer short-duration US HY based on Fed HY ETF purchases with a bias towards the higher-quality segment of the market that benefits directly from Fed bond purchases. Additionally, Asia HY based on China property companies receiving government support

Through these challenging periods, what remains unwavering is our commitment to active management of bond portfolios and the reliance on strong bottom-up fundamental credit research coupled with forward-looking macro insights to generate the best possible risk-adjusted return outcomes for clients.

For information purposes by UBS. For professional / qualified / institutional clients and investors only.
Published April 2020

This document does not replace portfolio and fund-specific materials. Commentary is at a macro or strategy level and is not with reference to any registered or other mutual fund.

Americas
The views expressed are a general guide to the views of UBS Asset Management as of April 2020. The information contained herein should not be considered a recommendation to purchase or sell securities or any particular strategy or fund. Commentary is at a macro level and is not with reference to any investment strategy, product or fund offered by UBS Asset Management. The information contained herein does not constitute investment research, has not been prepared in line with the requirements of any jurisdiction designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research. The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith. All such information and opinions are subject to change without notice. Care has been taken to ensure its accuracy but no responsibility is accepted for any errors or omissions herein. A number of the comments in this document are based on current expectations and are considered "forward-looking statements". Actual future results, however, may prove to be different from expectations. The opinions expressed are a reflection of UBS Asset Management's best judgment at the time this document was compiled, and any obligation to update or alter forward-looking statements as a result of new information, future events or otherwise is disclaimed. Furthermore, these views are not intended to predict or guarantee the future performance of any individual security, asset class or market generally, nor are they intended to predict the future performance of any UBS Asset Management account, portfolio or fund.

EMEA
The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith, but is not guaranteed as being accurate, nor is it a complete statement or summary of the securities, markets or developments referred to in the document. UBS AG and / or other members of the UBS Group may have a position in and may make a purchase and / or sale of any of the securities or other financial instruments mentioned in this document.

Before investing in a product please read the latest prospectus carefully and thoroughly. Units of UBS funds mentioned herein may not be eligible for sale in all jurisdictions or to certain categories of investors and may not be offered, sold or delivered in the United States. The information mentioned herein is not intended to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. Past performance is not a reliable indicator of future results. The performance shown does not take account of any commissions and costs charged when subscribing to and redeeming units. Commissions and costs have a negative impact on performance. If the currency of a financial product or financial service is different from your reference currency, the return can increase or decrease as a result of currency fluctuations. This information pays no regard to the specific or future investment objectives, financial or tax situation or particular needs of any specific recipient.

The details and opinions contained in this document are provided by UBS without any guarantee or warranty and are for the recipient's personal use and information purposes only. This document may not be reproduced, redistributed or republished for any purpose without the written permission of UBS AG.

This document contains statements that constitute "forward-looking statements", including, but not limited to, statements relating to our future business development. While these forward-looking statements represent our judgments and future expectations concerning the development of our business, a number of risks, uncertainties and other important factors could cause actual developments and results to differ materially from our expectations.

UK
Issued in the UK by UBS Asset Management (UK) Ltd. Authorised and regulated by the Financial Conduct Authority.

APAC
This document and its contents have not been reviewed by, delivered to or registered with any regulatory or other relevant authority in APAC. This document is for informational purposes and should not be construed as an offer or invitation to the public, direct or indirect, to buy or sell securities. This document is intended for limited distribution and only to the extent permitted under applicable laws in your jurisdiction. No representations are made with respect to the eligibility of any recipients of this document to acquire interests in securities under the laws of your jurisdiction.

Using, copying, redistributing or republishing any part of this document without prior written permission from UBS Asset Management is prohibited. Any statements made regarding investment performance objectives, risk and/or return targets shall not constitute a representation or warranty that such objectives or expectations will be achieved or risks are fully disclosed. The information and opinions contained in this document is based upon information obtained from sources believed to be reliable and in good faith but no responsibility is accepted for any misrepresentation, errors or omissions. All such information and opinions are subject to change without notice. A number of comments in this document are based on current expectations and are considered "forward-looking statements". Actual future results may prove to be different from expectations and any unforeseen risk or event may arise in the future. The opinions expressed are a reflection of UBS Asset Management's judgment at the time this document is compiled and any obligation to update or alter forward-looking statements as a result of new information, future events, or otherwise is disclaimed.

You are advised to exercise caution in relation to this document. The information in this document does not constitute advice and does not take into consideration your investment objectives, legal, financial or tax situation or particular needs in any other respect. Investors should be aware that past performance of investment is not necessarily indicative of future performance. Potential for profit is accompanied by possibility of loss. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice.

Australia
This document is provided by UBS Asset Management (Australia) Ltd, ABN 31 003 146 290 and AFS License No. 222605.

Source for all data and charts (if not indicated otherwise): UBS Asset Management

Follow us on LinkedIn

UBS