



## Fallen Angels and Recent General Electric Headlines

November 2018

***The large amount of BBB issuance over the past several years combined with the recent downgrade of General Electric (GE) debt to Baa1/BBB+ has led to a number of news articles focused on the potential for a wave of “Fallen Angels” slipping from investment grade and adversely impacting the trading levels of below investment grade debt. Using some of the major indices\*, BBB-rated bonds outstanding in U.S. dollars have grown from about \$1.3 trillion in 2010 to about \$3.1 trillion in late 2018. This report takes a brief look at GE relative to the size of the high yield market as well as other major historical downgrades into the high yield bond market. Each period in which there have been numerous downgrades has had its own unique characteristics; however, each period has created intriguing investment opportunities.***

### The Current Focus on General Electric

GE debt is now a major focus of the market. Both Moody's and Standard & Poors, the two major rating agencies, currently have the outlook for the credit as stable. The company's core businesses are aerospace, power and healthcare. Management has announced plans to pursue asset sales, which they have stated will be deleveraging with a goal of achieving leverage below 2.5x. Since October 8th, the stock is down 43% and on average, the GE U.S. dollar non-floating rate debt held in the major indices\* has widened 145bps to 278bps as of November 28th on an OAS basis. These levels, even without a downgrade, may attract some buyers and take demand away from high yield bonds, as did TEVA and Wyndham earlier this year.

The total amount of GE bonds outstanding is about \$100 billion. There is also about \$6 billion of short term financing as well as other obligations, such as pension and insurance liabilities, that could exceed \$45 billion. The company has reported that they have \$18 billion of cash on hand (excluding Baker Hughes).

- While the \$100 billion could all theoretically be bought by investors currently in the high yield bond market, the reality is more nuanced.
- The major U.S. dollar indices\* include about \$48 billion face value (\$42 billion market value) of GE's

debt, equal to about 1.3% market value of the BBB index and if downgraded, about 3.5% of the U.S. dollar high yield bond index.

- These indices typically exclude debt with a maturity of less than one year, non-U.S. dollar denominated debt, and variable rate debt, all of which account for the bulk of the difference between the estimated \$100 billion and \$48 billion of GE bonds outstanding. Of the estimated \$14.6 billion in variable rate debt, about \$3 billion is non-U.S. dollar. This debt could attract high yield investors, and while it is not secured, the floating rate issues could attract money currently invested in leveraged loans.
- To place the \$48 billion of U.S. dollar index-included paper in the context of new supply, this amount is equal to about 16% of 2017 high yield new issuance\*\* and about 25% of YTD 2018 issuance.
- The other point to note is that the US\$ HY market has declined in size by about \$103 billion in market value; a GE downgrade to high yield would replace approximately half of that amount.

The larger concern of a downgrade for a company as large as GE, or any wave of downgrades, is the crowding-out effect of such an event on existing high yield paper. This size of a downgrade would likely initially lead to a temporary re-pricing of debt in the high yield market and quite possibly be felt most in BB issues. On a spread basis, BBs have widened by about 62bps YTD.

There are factors that could limit the impact of a downgrade. Many investment grade investors have buckets in which they can hold below investment grade debt, and therefore may not be forced sellers. It appears likely that there will be a long lead time before any actual downgrade may happen (the debt is still three notches from high yield), allowing for some repricing and repositioning within investment grade portfolios over time. GE's future credit performance is unknown; however, more tactical and “tourist” investors have generated substantial returns buying some relatively recent Fallen Angels, most notably in the 2016 downgrades of commodity companies. An event, such as a downgrade of a company as large as GE, may bring this tactical money back into the high yield bond market to absorb some of the supply rapidly.

## Fallen Angel Cycles

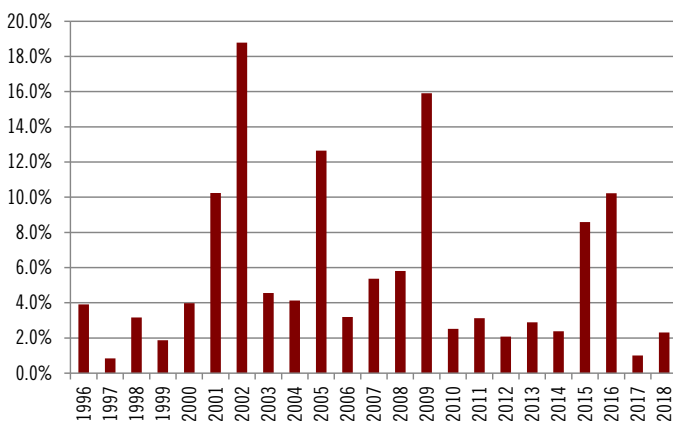
There have been several cycles of Fallen Angels. Usually these periods are dominated by one or two related industries. Each period has been unique and occurred in a different environment. Additionally, the constituents and participants in the high yield bond market varied each time this happened.

- In 2002, the downgrades were dominated by telecommunications. One of the most notable never really stopped in the below investment grade bond market, as WorldCom went straight from BBB to default.
- The 2005 cycle was dominated by the big three automobile companies, General Motors and Ford in particular but also Chrysler. Eventually General Motors and Chrysler filed for bankruptcy in 2009. Additionally many high yield automotive suppliers also filed during this period.
- Financials accounted for the major downgrades that occurred during the Great Recession. Many of these companies that entered the market as Fallen Angels have since departed as Rising Stars as they have been upgraded back to investment grade, such as Lloyds and Royal Bank of Scotland.
- The most recent cycle was the late 2015/early 2016 period in which a massive amount of commodity companies, especially in oil and gas, were downgraded to high yield from investment grade. Energy prices quickly rose during 2016 and led to significant outperformance by these Fallen Angels soon after they were downgraded.

Exhibit 1 shows each of these Fallen Angel cycles as a percentage of the market prior to the downgrade.

### Exhibit 1

#### Fallen Angels as a % of the Previous Year-End High Yield Market Size



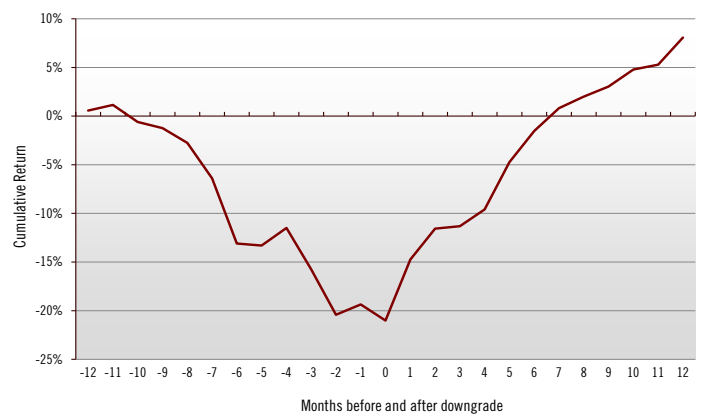
Source: J.P. Morgan

It is always hard to separate the overall events going on in the economy from the impact of the downgrades on the high yield market, but there does seem to be some similarity in the pattern of performance around these major downgrades.

First, we looked at the largest downgrades in each of the last three cycles\*\*\*, using the 12 months before the downgrade and the 12 months after the downgrade to show the performance of these outsized Fallen Angels. All of these issues have been consolidated and averaged in Exhibit 2 and with the month of downgrade as the "zero" date.

### Exhibit 2

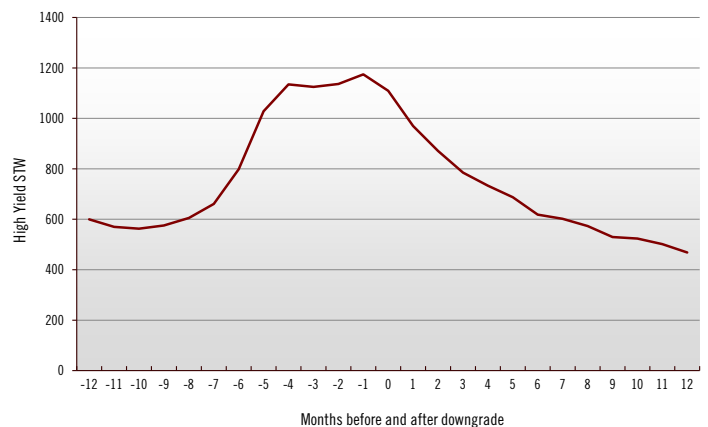
#### Average Cumulative Return for Selected Major Fallen Angels 12 Months Before to 12 Months After Downgrade\*\*\*



We used the same methodology as in Exhibit 2 to track the spreads of the high yield market during each of these major downgrades in Exhibit 3. The markets appeared to react relatively in-line with the major downgrades, which may represent interesting timing patterns in the market.

### Exhibit 3

#### Average Spread on the High Yield Market 12 Months Before to 12 Months After Major Selected Downgrades\*\*\*

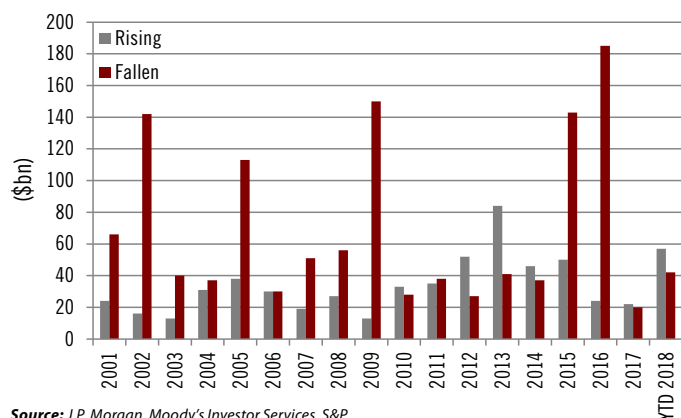


It should be noted that while the swings in quantity are not as extreme, the below investment grade bond

market also fairly consistently identifies a series of Rising Star upgrades to investment grade, often leading to significant spread tightening. Exhibits 4 and 5 track annual Fallen Angels and Rising Stars.

#### Exhibit 4

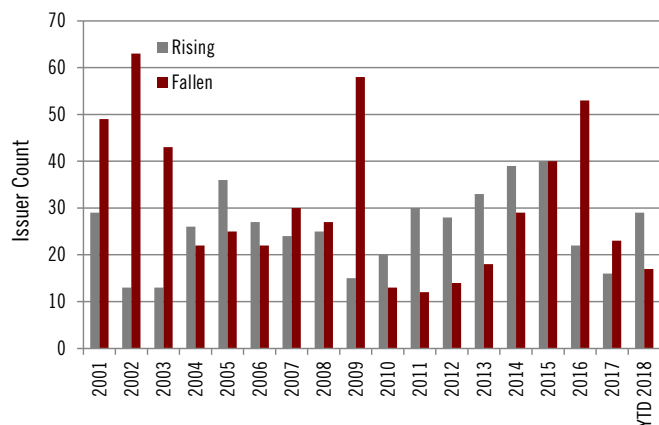
##### Rising Stars and Fallen Angels by Par Amount



Source: J.P. Morgan, Moody's Investor Services, S&P

#### Exhibit 5

##### Rising Stars and Fallen Angels by Issuer



Sources: J.P. Morgan, Moody's Investor Services, S&P

## Conclusion

Tracking the potential for Fallen Angels is critical to properly managing below investment grade portfolios, as is an understanding of all developments in the global credit markets. Historically, the high yield market has reacted to major downgrades but on average has snapped back fairly quickly and presented interesting periods to increase allocations. There will inevitably be future waves of Fallen Angels, particularly given the dramatic increase in BBB issuance in recent years. Credit transitions represent opportunities, if one has deep bottom-up credit analysis and is active in credit full-time. Shenkman Capital has developed specific strategies designed to capture these opportunities.

\*All references to market size utilize the ICE BAML family of indices

\*\*Supply data is based on JP Morgan information

\*\*\* Downgraded companies: General Motors, Ford Motors, Bank of America, Lloyds Banking Group, Royal Bank of Scotland, American International Group, CIT Group, Freeport-McMoRan, Anglo American and Continental Resources.

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