

Key Questions

How Should Investors Navigate Rising Downgrade Risks?

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As risks and opportunities in the corporate bond market increase, we prefer an active, defensively oriented, high-quality approach to investing in the credit market.

Meeting the demands of yield-hungry investors, the volume of corporate bond issuance rose steadily in the years following the Global Financial Crisis (GFC) of 2008. Today, corporate bonds brought to market over that time period account for nearly 60% of all issued debt. However, as pointed out in a prior Key Questions article, the overall credit quality of the corporate bond market has declined as issuers have taken on more debt and relaxed their own underwriting standards in turn.

BBB-rated debt (the lowest-ranked investment-grade debt) represents over 50% of the \$9.5 trillion investment-grade corporate bond index. In a trend that is worrying, many issuers have used low funding rates to refinance existing debt at more attractive rates and extend their debt maturity distribution profiles. However, in an economic downturn, lower-rated investment-grade companies have an increased likelihood of being downgraded to below investment-grade or “junk” status. With continued volatility in the markets, we could see a rise in the number of “fallen angels” — the moniker given to companies that lose their investment-grade title.

Rating agency downgrades have recently stripped companies, including Kraft Heinz Co. and Ford Motor Co., of their investment-grade ratings. Year to date, approximately \$120 billion of investment-grade debt has been downgraded to junk, and roughly \$110 billion in additional debt remains vulnerable to being downgraded. Some strategists forecast more than \$300 billion of investment-grade debt will be downgraded this year. Further, the pace at which rating agencies are applying negative rating actions has increased in anticipation of deteriorating credit fundamentals.

All indications point toward a deep economic recession as a result of the impact of the coronavirus outbreak. Under these conditions, highly levered bond issuers face the imminent risk of downgrades and defaults. Market segments such as retail, travel, lodging, and gaming that are currently stressed — perhaps even distressed — are the most exposed for obvious reasons.

As fear of the coronavirus contagion gripped the capital markets last month, investment-grade corporate bond yields traded significantly higher than US Treasuries, so much so that the spread (the differential in yields) widened to levels not seen since the GFC. The US Federal Reserve (Fed) quickly responded to avoid a liquidity crisis.

Over the past three weeks, investment-grade and high-yield corporate bond markets have stabilized and spreads have compressed at record speed. With the Fed purchasing corporate bonds and ETFs through its recently launched Primary Market Corporate Credit Facility (PMCCF) and

Secondary Market Corporate Facility (SMCCF), the bullish tone in corporate credit continues to gain strength. However, this does not alleviate the risk of bond downgrades given the rise in the probability of an economic recession. Furthermore, default rates are expected to increase over the next 12 months as the uncertainties associated with the coronavirus are far from behind us.

Our primary focus at Key Private Bank has always been preservation of capital. We remain committed to our underlying investment process: As we continue to manage the downgrade risk of both investment-grade and high-yield corporate bonds, we search for value in issuers and segments of the market that can withstand current unpredictable market conditions and those that we believe will directly benefit from Fed and/or congressional actions.

Within the investment-grade universe, we prefer the banking, healthcare, insurance, and telecommunications segments. Under current market conditions, we are avoiding basic industry, leisure, and real estate, where the risk of further downgrades and default remains elevated. We also continue to favor external investment managers who are adept at navigating volatile markets and employ a strong security selection discipline.

While the number of downgrades will likely increase, there will be both risks and opportunities. Now is the time to prepare accordingly.

For more information, [please contact your Key Private Bank Advisor.](#)

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