

Views From the SHIP

Fallen Angels – How Credit Downgrades Improve Overall Credit Quality in Global High Yield

September 2016

Fallen Angels Are Transforming the Market

The growth of “fallen angels” – the outstanding bonds of former investment-grade-rated companies that have been downgraded to speculative ratings – is transforming the global high yield bond market. While U.S. corporate debt still accounts for the largest percentage of this market, the European and emerging markets high yield debt universes have experienced sizeable growth, driven in large part by a rise in fallen angels. This transformation provides another milestone in the evolution of the global high yield market and increases the attractiveness of the asset class as a core institutional investment in our view.

Developments in the Global High Yield Market

High yield bonds were first issued in the U.S.; the market grew in the mid-1980s as they were issued to finance emerging sectors (Cable Television, Cellular, Telecom/Media, and Gaming), mergers and acquisitions and leveraged buyouts. Additionally, the bonds were used to provide financing for companies that were previously unable to access the capital markets due to factors such as small size and/or lack of sufficient operating history. Part of the growth of the market can also be attributed to management teams of investment-grade-rated companies becoming more comfortable operating with higher leverage. In its development, the market went through various stages, including the rise of Drexel Burnham (the primary underwriter of high yield bonds) during the 1980s and its subsequent collapse in 1990, the boom and bust of the Telecom sector in the late 1990s/early 2000s, the financial crisis of 2008 and the collapse of commodity prices in late 2014/2015.

The growth of the European high yield market began in the late 1990s, more than a decade after the U.S. market. Like the U.S. market in its early days, the European high yield market was focused on financing the growing Telecom/Media sector. In 1998, the Bank of America Merrill Lynch European Currency High Yield Index (“European high yield index”) was only €4.9 billion in size with 35 issues, and was dominated by the Communications sector, which accounted for 49% of the index. This phase of growth ended poorly in the early 2000s, as the Telecom sector became over-invested and over-leveraged, causing many companies to default on their debt. The next milestone for the European high yield market, the boom years prior to 2007, was a frenetic period of leverage buyouts driven, as in the U.S., by private equity firms using leverage to finance acquisitions. This period was characterized by significant market growth (the European high yield index grew from €53 billion in March 2003 to €84 billion in March 2007), until the financial crisis brought a sudden end to leveraged buyout activity. After a brief slowdown in 2008, the market began its most recent stage of development – refinancing bank loans – with the index growing by €276 billion since 2008 to €358 billion in June 2016. This enormous growth, we believe, was a result of the more robust banking regulatory framework, coupled with greatly increased bank capital requirements. In turn, the banking sector reduced risk and constrained corporate lending, leading a number of companies to access capital markets for new financing and refinancing needs.

In emerging markets, the rise of hard currency corporate debt is more recent, but the Bank of America Merrill Lynch High Yield Emerging Markets Corporates Plus Index (“emerging markets corporate index”) has grown at a faster rate than all other high yield markets, increasing 120% over the past five years and currently totaling \$384 billion. This growing sector of the high yield market allows investors to gain access to companies in emerging markets, a segment of the world economy that accounts for approximately 50% of total global GDP. Many high yield companies in these countries are active participants in two broad areas of their economies: infrastructure and the emergence of a middle class with an expanded consumption profile. These economic sectors are expected to be long term drivers of growth. Emerging markets debt has evolved from being an extremely volatile asset class in the early 1990s to a larger, more mature segment of the global financial markets as a result of increased political stability and more conservative fiscal policies in many emerging countries. Additionally, the credit quality of the issuing companies has improved.

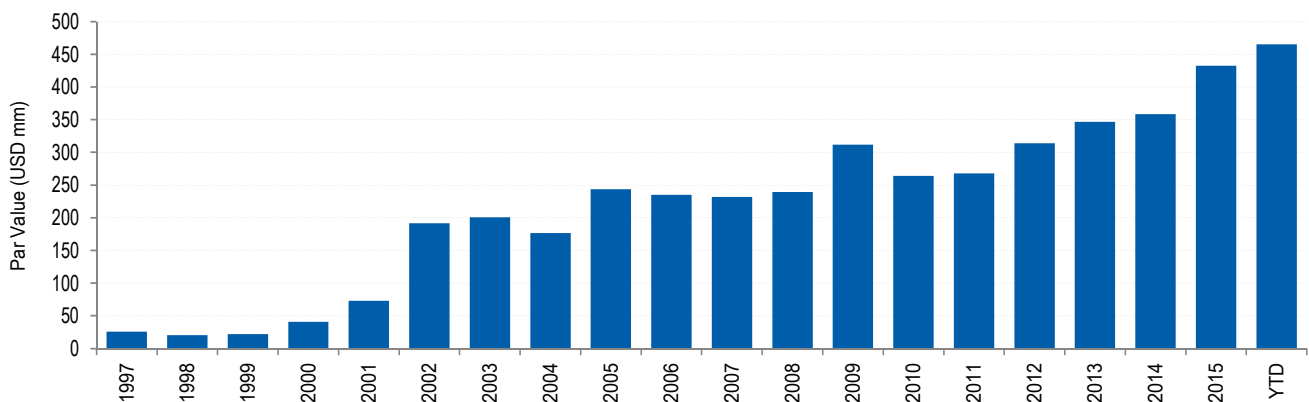
The Global Impact of Fallen Angels

The impact of fallen angels on the various segments of the global high yield market has varied over the past three years. The emerging markets sector of the global high yield market has been, by far, the most affected by a growing share of fallen angels, accounting for 45% of the total since 2013. In 2015, emerging markets accounted for 70% of all fallen angels. The large increase in emerging markets fallen angels was due to downgrades in the Energy and Financial sectors. In addition, the sovereign downgrade of Brazil triggered a number of corporate downgrades in the country. Furthermore, the oil price collapse led to the downgrades of the Russian and Brazilian energy giants, Gazprom and Petrobras, respectively. Following the inclusion of these two companies, the Energy sector now accounts for 27% of the emerging markets corporate index, up from 12% in 2014.

The European high yield market has also been significantly affected by fallen angels. In 2014, European fallen angels accounted for 54% of the total, driven primarily by downgrades of financial institutions in both Italy and the U.K. Because the Energy sector represents a much smaller component of the European debt universe, the European high yield market was not as affected by the commodity price collapse in late 2014/2015.

During the first six months of 2016, the U.S. high yield market, as represented by the Bank of America Merrill Lynch High Yield Master II Index, was most impacted by fallen angels, accounting for 49% of the total. A significant part of this increase stemmed from declines in commodity prices that caused ratings downgrades (35% and 37% of the fallen angels were in the Energy and Metals/Mining sectors, respectively).

Par Value of Fallen Angels Has Increased in Recent Years



As of 30 June 2016. Source: Bank of America Merrill Lynch Global High Yield Index.

Portfolio Implications

The rise of fallen angels within the global high yield market is important because of the potential impact on returns and risk diversification within global portfolios. The inclusion of large fallen angels within the European and emerging market high yield sectors in particular has greatly increased geographic diversification opportunities within the global high yield market. Fallen angels have also had a distinct impact on the quality ratings of the indexes. For example, on a market value basis, weighting of the BB-rated sector of the emerging markets corporate index increased nearly eight percentage points in 2015, primarily due to the high volume of fallen angels entering the index. These higher quality bonds have the potential to positively impact overall returns as well as the spreads of the geographic sectors.

Fallen angels have generated significantly better returns than original issue bonds over the past two-plus years, as illustrated below. Spreads have also tightened as higher quality fallen angels entered the Bank of America Merrill Lynch Global High Yield Index (“global high yield index”). As of 30 June 2016, the global high yield index spread was 616 basis points (“bps”), with the spread of fallen angels at 491bps and 650bps for original issue securities, respectively.

Returns of Original Issues vs Fallen Angels

	Returns ¹ , %			Option Adjusted Spreads, basis points		
	Total	Original Issue	Fallen Angels	Total	Original Issue	Fallen Angels
Global High Yield (HW00)	3.55	2.63	7.43	616	650	491
U.S. High Yield (H0A0)	2.69	1.94	7.72	621	638	519
European ² High Yield (HP00)	4.58	3.92	5.80	500	539	418
Emerging Markets (EMUH)	4.89	NA	NA	726	NA	NA

Source: Bank of American Merrill Lynch. ¹Returns for the period 31 December 2013 through 30 June 2016, annualized. ²Returns are hedged into USD. Past performance is not a guarantee of future results.

Conclusion

Fallen angels have increased the depth and diversity of the global high yield market, particularly in Europe and emerging markets, which we believe is beneficial to investors. This market development has greatly strengthened the case for adopting a global approach to investment in high yield bonds in our view. Global strategies enable both rotation through regions and sectors and better risk control through wider diversification.

These developments indicate the inherent complexity of the global high yield markets and the opportunity potential for active managers to add alpha and reduce risk even when taking into account the differences in trading liquidity, bankruptcy laws, and accounting treatments. Fallen angels have transformed the opportunity set in high yield debt.

For more information, please contact your Client Relationship Manager or clientservice@shiplp.com

New York

31 W. 52nd Street
16th Floor
New York, NY 10019
+1 212 548 1200

London

48 Dover Street
5th Floor
London, W1S 4FF
+44 20 3205 4100

Melbourne

Suite 3143, Level 31
120 Collins Street
Melbourne
+61 3 9225 5064

Singapore

9 Temasek Boulevard
#09-03A Suntec Tower Two
Singapore 038989
+65 6671 9711

Important Disclosures

This material was produced by and the opinions expressed are those of Stone Harbor as of the date of writing and are subject to change. While information contained herein has been obtained from sources believed to be reliable, we do not represent that it is accurate or complete, and it should not be relied upon as such. The reader should not assume that any investments in securities, sectors and/or markets identified or described were or will be profitable. Investing entails risks, including possible loss of principal. The information in this material may contain projections or other forward-looking statements regarding future events, targets or expectations and is only as current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different than that is shown here. The information in this material, including statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons. Past performance is not a guarantee of future results. This material is intended only for institutional investors.

Index Definitions

Indices referred to herein are broad-based securities market indices. Broad-based securities indices are unmanaged and are not subject to fees and expenses typically associated with managed accounts or investment funds. Investments cannot be made directly in an index.

Bank of America Merrill Lynch Global High Yield Index (HW00): The Bank of America Merrill Lynch Global High Yield Index tracks the performance of USD, CAD, GBP and EUR denominated below investment grade corporate debt publicly issued in the major domestic or eurobond markets. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch).

Bank of America Merrill Lynch High Yield U.S. Emerging Markets Corporate Plus Index (EMUH): The Bank of America Merrill Lynch High Yield U.S. Emerging Markets Corporate Plus Index tracks the performance of US dollar denominated, below investment grade, emerging markets corporate debt that is publicly issued in the US domestic or eurobond market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch). Qualifying securities must have at least one year remaining term to final maturity, at least 18 months to final maturity at point of issuance, a fixed coupon schedule and a minimum amount outstanding of \$100 million.

Bank of America Merrill Lynch High Yield Master II Index (H0A0): The Bank of America Merrill Lynch U.S. High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of \$100 million.

Bank of America Merrill Lynch European Currency High Yield Index (HP00): The Bank of America Merrill Lynch European Currency High Yield Index tracks the performance of EUR and GBP denominated below investment grade corporate debt publicly issued in the eurobond, sterling domestic or euro domestic markets. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch).