SKY HARBOR
CAPITAL MANAGEMENT

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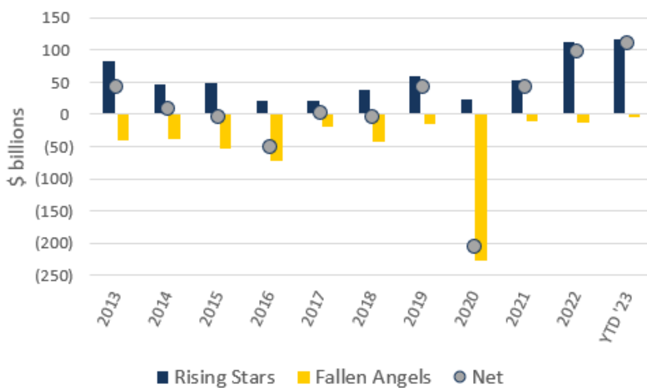
SKY Harbor Weekly Briefing

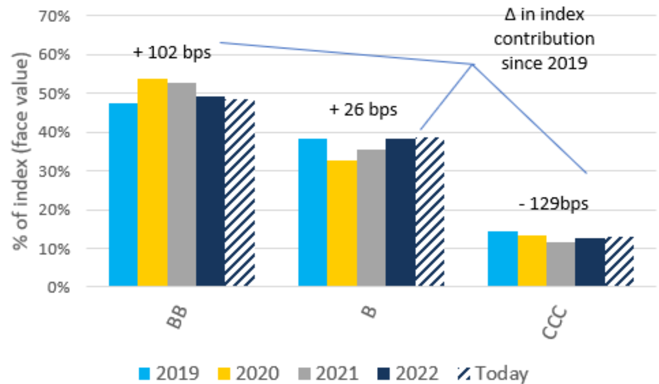
A Downgrade Wave, not a Tsunami

The market continues to digest a mixed set of economic datapoints – September Retail Sales +0.7% (+0.3% expected), Q3 US GDP growth +4.9% (+4.5% expected), ISM Manufacturing 46.7 (49.0 expected) – prolonging the stalemate between recession and expansion camps. We remain convinced, however, that fundamental credit ratios will weaken toward long-run average levels in the coming months, particularly as looming maturities force issuers to reset coupons higher. Though we anticipate such headwinds will be manageable for high yield issuers and therefore not cause defaults to spike, an uptick in rating agency activity is expected. With that in mind, we update our credit rating migration model in this *Weekly Briefing*, gauging the impact downgrades may have on the pricing of market risk.

A Round Trip

Pandemic-era lockdowns thoroughly disrupted both investment grade and high yield markets, leading to a rapid uptick in rating agency downgrades in 2020. The severity of the move, coupled with an outsized BBB cohort within the US Investment Grade Index at the onset, led to an extraordinary wave of fallen angels. More specifically, **the high yield market was forced to absorb ~ $225bn of formerly IG-rated debt in 2020, and it took until last month for cumulative rising stars ($54bn in '21, $113bn in '22, and $69bn YTD through Sep '23) to fully offset the initial influx**. Despite this recent exodus of BB-rated bonds from the high yield universe via upgrade, average high yield index quality remains better than pre-COVID levels, on the margin a function of weaker issuers leaving the asset class (often seeking funding needs from either leveraged loan or private debt markets) and fundamental improvements over the last decade.

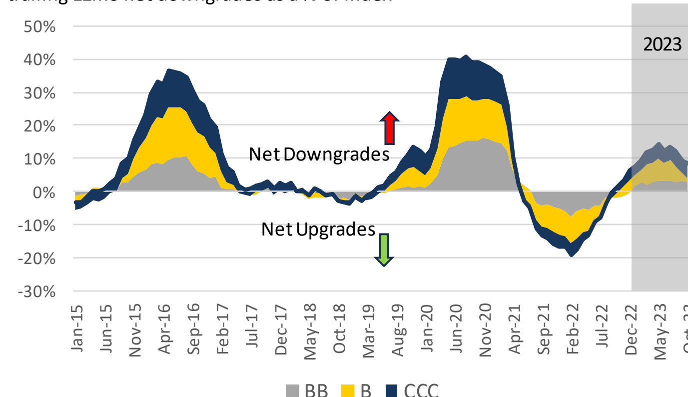


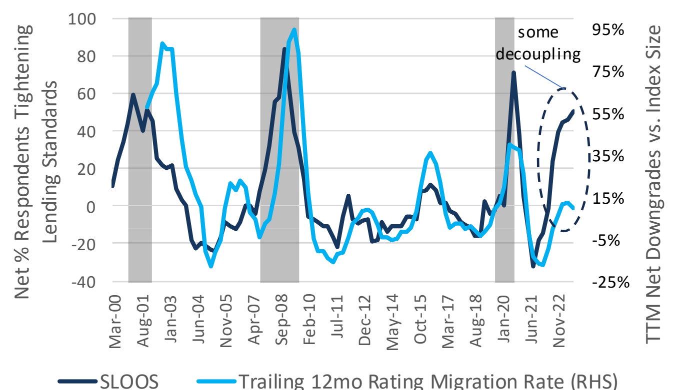


Source: SKY Harbor, ICE Data Indices, JP Morgan

At an Inflection Point?

Though rising stars have been more prevalent than fallen angels in recent years, downgrades have outpaced upgrades since early 2022, more recently led by pressure among single-B and CCC-rated issuers. **Trailing 12-month net downgrades hit a recent high of approximately 14% of index value, a sharp turn from a period of peak earnings in the post-pandemic era, but well below COVID and commodity-crisis net downgrades in the 40% context**. Is there more downside rating activity to come? A rolling time series provided below (right side), demonstrates the tendency for migration rates to favor downgrades in times of stress (recessions are shaded grey), with a high degree of overall correlation to bank lending standards (which continue to become more restrictive). Note, however, recent decoupling of rating migration rates and the senior loan officer opinion survey on lending standards (SLOOS). In our view, cash injections from private equity sponsors, private market solutions amidst healthy fund flows, and voluntary extensions among current bondholders have served to de-emphasize the impact of banks in leveraged credit markets (as highlighted in a recent *Weekly Briefing* found here), partially explaining the falloff in correlation.





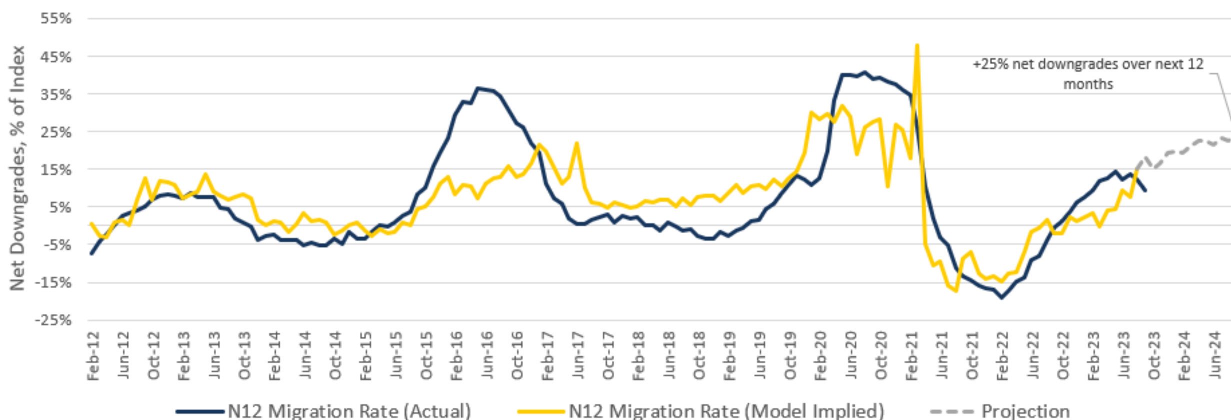
Source: SKY Harbor, ICE Data Indices, BofA Merrill Lynch, Federal Reserve

Updating Our Model

Given the recent relationship breakdown between lending standards and upgrade/downgrade volumes, we turn to an alternative methodology for insights into future trends. Leveraging a database of key economic indicators, fundamental credit ratios, and various high yield and ancillary asset class metrics, we updated our multi-variable regression model to project credit rating migration rates (i.e., the rolling 12-month measure of downgrades vs. upgrades relative to index size, with positive rates indicating a greater proliferation of downgrades). Due to an elevated probability of recession, modestly higher gross leverage ratios, and a recent uptick in the unemployment rate, and partially offset by resilient consumer sentiment and output growth readings, **the model projects the net downgrade rate reaching 25% over the next year**. In absolute terms, this translates into downgrades outpacing upgrades by another $225bn in the coming quarters – worsening, but stopping well short of recent peaks over the last decade.

Our Migration Model Remains in Net Downgrade Territory

monthly data, since 2011



Source: SKY Harbor, BofA Merrill Lynch, Univ. of Michigan, Bloomberg Economics, Bureau of Economic Analysis, Bureau of Labor Statistics, ICE Data Indices

Selection is Key

With our projection of net downgrade rates in hand, we next gauge the impact rating agency activity may have on total returns. First, we note a few assumptions to be aware of (and highlight that the following analysis employs a number of estimates and an over-simplification of dynamics that are likely to contribute to actual performance):

- Downgrades occur uniformly across all rating buckets
- Downgrades are not already fully reflected in current bond prices
- Default candidates in the coming year will likely be downgraded beforehand, so we net out the impact of defaults from our downgrade loss projection
- Spread widening of a downgrade candidate is commensurate with convergence to comps rated one to three notches lower
- Ending price of a downgrade candidate is a function of aforementioned spread widening in the context of average cohort starting price and duration

A 25% net downgrade migration rate (or, 20.3% after excluding our 4.7% projected default rate), concurrent with our price decline estimates stemming from a bond re-rating, equates to ~ 175 bps of return variability in the coming year. This, **coupled with our default loss estimate, implies nearly 400 bps of total return at stake when it comes to avoiding credit hits**. In the context of expected total returns over the next 12 months, approximately 400 bps in variation dependent upon selection is likely to be meaningful.

Default & Downgrade Losses Appear Material Relative to Total Return Outlook

SKY Harbor estimates; data rounded for simplicity

	BB	B	CCC	Index
% of Index (face value)	48%	39%	13%	100%
Est . Default Rate	0.7%	4.1%	21.5%	4.7%
Default Target Characteristics				
Est. Universe Price	77.0	65.1	44.4	
Est. Recovery	35.0	30.0	25.0	
Est. Default Loss (bps)	35	221	939	
Est. Contribution to Index Default Loss (bps)				**~ 225 bps**

	BB	B	CCC	Index
% of Index (face value)	48%	39%	13%	100%
Net Downgrade Rate	25.0%	25.0%	25.0%	25.0%
Rating Bucket Default Rate	0.7%	4.1%	21.5%	4.7%
Non-Default Downgrade Rate	24.4%	20.9%	3.5%	20.3%
Downgrade Target Characteristics				
Est. Starting Price	83.9	80.9	65.6	
Est. Ending Price*	78.0	73.0	45.0	
Est. Downgrade Loss (bps)	171	204	110	
Est. Contribution to Index Downgrade Loss (bps)				**~ 175 bps**

* Assumed average price correction to widen toward OAS commensurate with downwardly revised rating
Source: SKY Harbor, ICE Data Indices

Attractive Non-Distressed Yields

We believe high yield carry remains quite attractive, with investors being well compensated to remain invested through this period of uncertainty. Even more compelling, in our view, is the ability to capture top quartile yields even absent exposure to distressed credits at further risk of default or downgrade should market uncertainty lead to increasingly negative sentiment. Given this backdrop, we continue to view an upward bias in quality as providing protection against potential downgrades, particularly as an expected uptick in primary market issuance prompts agencies to re-examine existing credit ratings.

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