**HIGH YIELD BRACES FOR FALLEN ANGELS**

**FIDELITY INTERNATIONAL WHITE PAPER**

* Roughly $215 billion of US debt and €100 billion of European debt is expected to be downgraded to high yield this year.
* BBB spreads indicate some complacency
* Oil sector most exposed with $90 billion at immediate risk

**London, 23 April 2020:** With a recession now upon us, many zombie companies are at risk of being downgraded into high yield and becoming fallen angels.

A new white paper released today by Fidelity International - [***Downgrade risks when zombies become fallen angels***](https://eumultisiteprod-live-b03cec4375574452b61bdc4e94e331e7-16cd684.s3-eu-west-1.amazonaws.com/filer_public/fc/39/fc39f745-1721-468a-b1f6-f5f4521e1cc5/fallen_angel_whitepaper_v5.pdf)*-* explores the impact of zombie companies - firms that show little signs of life but manage to survive thanks to cheap borrowing costs - being downgraded to high yield and highlights the sectors most at risk.

Roughly $215 billion of US debt and €100 billion of European debt is expected to be downgraded to high yield this year.1 The face value of bonds rated BBB has grown steadily since the financial crisis and faster than the high yield market. In the US, the amount of BBB3-rated bonds outstanding now equals around 70 per cent of the entire US high yield market.

**Chart 1: The sheer size of potential fallen angels could overwhelm the US high yield market**



***Source: IIndices: H0A1, C0A4. Source: Bloomberg, Fidelity International, April 2020.***

**Martin Dropkin, Global Head of Research, Fixed Income, Fidelity International, comments:** “The twin shocks to the global economy of the Covid-19 outbreak and the sharp oil price decline have resonated through all asset classes. The high yield bond market must now contend with a third potential shock - an influx of downgraded investment grade bonds.

“This has significant implications for a global high yield market already reeling from the abrupt economic downturn.”

In the last month, the difference between the spreads of BBB and BB-rated bonds in the US corporate indices has risen to 273 basis points. This partially reflects the overall performance of respective benchmarks, but Fidelity believes the BB spreads are also anticipating an influx of fallen angels into the high yield index.

Fallen angels, which will largely move from BBB to BB, will swell the size of the BB category in the index, forcing managers of both passive and active strategies to reallocate from riskier categories to maintain benchmark constraints.

While spreads from potential fallen angels’ bonds already have downgrades priced in, analysis by Fidelity reveals that only around 5 per cent of the US investment grade index is currently trading at spreads equal to or wider than comparable BB-rated bonds. Considering around 27 per cent of the index is rated as BBB2 or BBB3 - the categories most at risk of a downgrade to high yield - this looks a little complacent considering the near-instantaneous stop to economic activity in some sectors.

**Commenting on how to navigate the fallen angel risk Dropkin said:** “As we move through this crisis, more zombies will be flushed out and market stresses will begin to dissipate. In the meantime, a good way to navigate the heightened downgrade risk is to run detailed liquidity and covenant analysis on weaker companies to determine how long they can survive without additional funding while access to liquidity remains limited.

“Despite these risks, we believe investment grade bonds are currently trading at very attractive levels, with US bonds especially well positioned. Within the BBB category, however, thorough research is needed to understand those issuers most at risk from being moved into high yield. High degree of caution is also necessary at the riskier end of the high yield spectrum (CCC/B). Credit selection here is paramount.”

**Sectors most at risk of downgrades**

The ***energy sector*** is most at risk of downgrades, being at the epicentre of both the oil glut and the demand shock from Covid-19. Around $60 billion of investment grade debt at the upstream end of the energy market has already been downgraded to high yield, out of around $90 billion at immediate risk. Despite the already sizeable numbers involved, there is scope for more downgrades if the oil price stays low.

The **autos sector** headed into the coronavirus outbreak in a weak position. Ford recently became the largest ever fallen angel as a direct result of the current crisis. Several more issuers in the sector are at risk of crossing into high yield, and the aggregate face value of downgrades could be large if S&P becomes more aggressive with its rating actions.

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