Corporate Debt:

Sizing Up Risk—and Opportunity—in BBB Bonds

The amount of U.S. corporate debt one rung above junk has never been higher. Here we take a closer look at the risks and rewards this space presents investors today.

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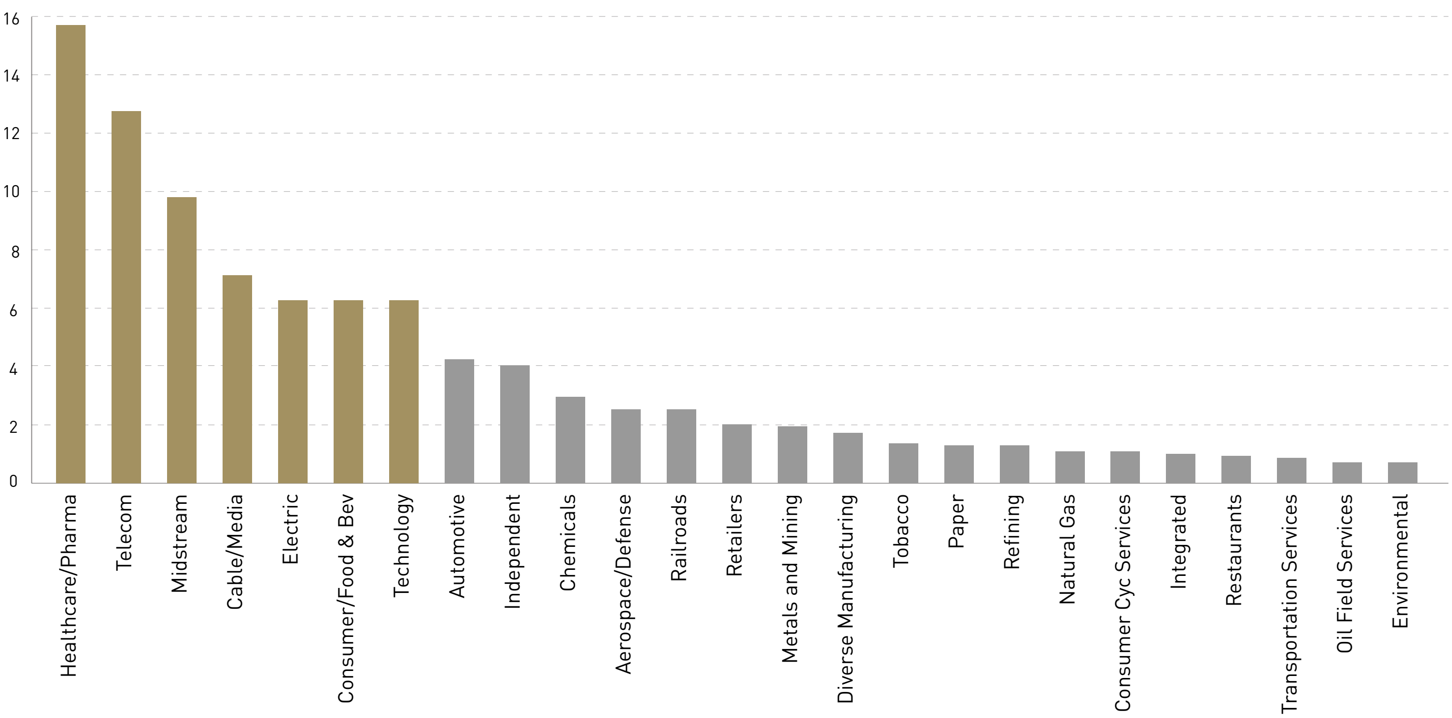
Chart 1. The Many Sectors Represented in the BBB Space Help to Diversify Idiosyncratic Risk
*Top sectors in the BBB category, % of market value, as of June 30, 2018**



Source: Bloomberg Index Services. *Most recent data available.
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In Brief

- The 'BBB'-rated sector accounts for more than half of the investment-grade corporate bond market as of January 18, 2019, and the biggest share of that is held by large-cap companies.
- Large-cap 'BBB'-rated companies are strongly motivated to not fall below that rating and have substantial cash-flow levers that could be used to avoid downgrades.
- We consider the current U.S. economic environment to be reasonably positive, and thus we are not concerned about a wave of "fallen angels" (companies downgraded below BBB) at this time.

The investment-grade corporate debt market, in general, has been on a growth trajectory for years. But what has caught the attention of many in the financial media of late is the overall size of the debt in the 'BBB'-rated credit sector—the lowest credit rating still considered investment grade. According to Bank of America, the 'BBB'-rated corporate bond market is worth around $3 trillion (as of December 31, 2018)—more than double the size of the U.S. high-yield market ($1.2 trillion), which has been shrinking for the last several years.

The BBB sector accounts for more than half of the investment-grade corporate bond market as of January 18, 2019, according to Barclays. And the biggest share of that debt is issued by large-cap companies, including AT&T (T), Verizon (VZ), Anheuser-Busch InBev (AIBB), CVS Health Corp. (CVS), Charter (CHTR), General Electric (GE), General Motors (GM), Ford (F), Cigna (CI), United Technologies (UTX), and Kinder Morgan (KMI).

The focus on BBBs is not without merit. Analysts are quick to recall the "wave of fallen angels" in the first half of 2016, when Moody's downgraded 55 companies in the energy sector to junk status as oil prices plunged, according to the Financial Times. The alarm expressed in the financial press is that another such "wave" is about to befall us. Further, there is concern this wave could overwhelm the ability of markets to respond.

Why? Some common high-yield indexes limit issuer size to a maximum of 2%. i.e., no more than $25 billion of debt outstanding. If any one of these large 'BBB'-rated companies was downgraded to junk status, it would constitute more than 2%, according to Barclays, creating a possible shortage of natural buyers.

While it is true that high levels of concentration in any one area can become problematic for investors, particularly in a declining economic environment, there are a number of potentially mitigating factors that can give rise to investing opportunities in the corporate debt space.

Incentives to Maintain and Repair Balance Sheets

A quick glance at a Moody's credit-ratings migration table (see Table 1) shows that, historically, BBBs have been nearly as likely to be upgraded as downgraded. That's because incentives and behaviors change when a company is on the cusp of a downgrade to speculative grade. Companies that have cheap access to financing are incented to use that access to debt and buy or invest in such things as their own stock, competitors, or capital investments. Once a company becomes 'BBB'-rated, however, it is less inclined to do such things because speculative grade markets aren't as liquid or cheap. Instead these companies "on the cusp" focus on ways to maintain or improve their balance sheet positioning.

Table 1. Historically, 'Baa'-Rated* Companies have been Nearly as Likely to be Upgraded as Downgraded

*Average one-year letter rating migration rates, 1970-2017***

FROM/TO	Aaa	Aa	A	Baa	Ba	B	Caa	Ca-C	WR	DEFAULT
Aaa	87.71%	7.94%	0.58%	0.07%	0.02%	0.00%	0.00%	0.00%	3.67%	0.00%
Aa	0.82%	85.15%	8.51%	0.42%	0.06%	0.04%	0.02%	0.00%	4.95%	0.02%
A	0.05%	2.46%	86.78%	5.37%	0.048%	0.11%	0.04%	0.01%	4.64%	0.05%
Baa	0.03%	0.14%	4.12%	85.72%	3.79%	0.69%	0.15%	0.02%	5.17%	0.17%

Source: Moody's and Lord Abbett.

*The Baa rating by Moody's credit rating agency is equivalent to a BBB rating used by Fitch and Standard and Poor's. ** Last cohort formed on January 1, 2013; most recent data available. WR is withdrawn rating (became unrated or was called). For Illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.

Available Cash Levers

For the most part, the large-cap 'BBB'-rated sector consists of companies with meaningful cash-flow levers (such as the ability to raise equity, cut dividends, and sell assets) that could be used to avoid downgrades. One example is General Electric. It has taken multiple steps in recent months in order to free up cash to pay down debt, including raising $4 billion through the sale of its stake in oilfield services unit Baker Hughes, reducing its quarterly dividend from 12 cents per share to one cent, and cutting share buybacks.

More Diverse BBB Sector

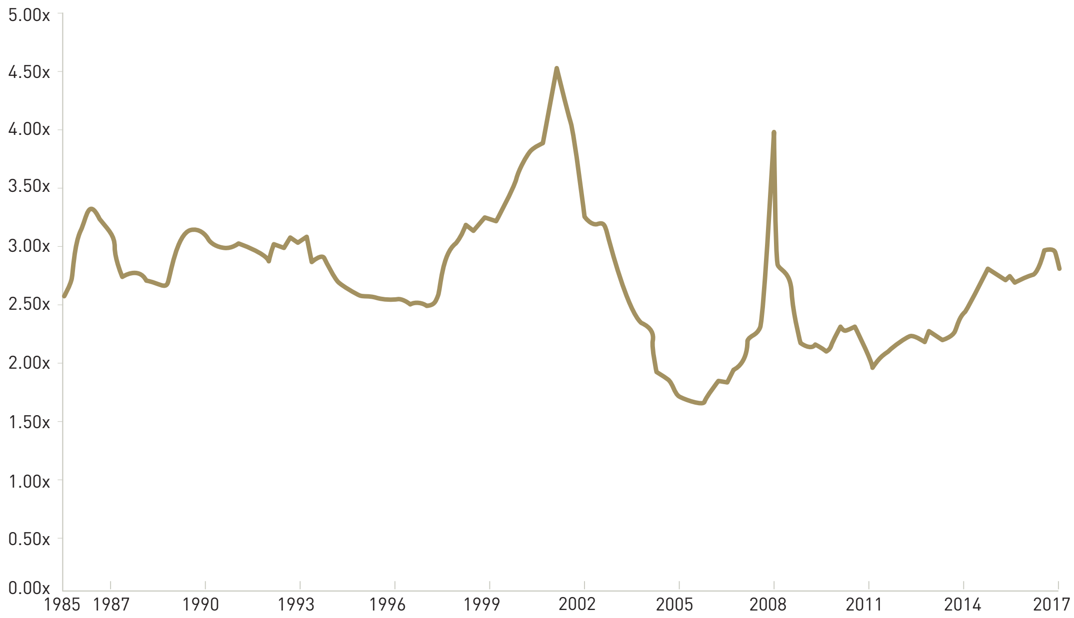
One benefit of such a broad-based increase in leverage among corporate issuers is that there are many sectors represented in the BBB space. A BBB market consisting of diverse sectors can help diversify idiosyncratic and more narrow factors, such as the fall in oil prices that hurt 'BBB'-rated energy companies in 2015 and 2016. As shown in Chart 1, sector representation in the BBB space is varied and, where there is concentration, it is in less cyclical sectors like pharmaceuticals, telecommunications, and media.

Healthy Cash Flows

It's true that corporate leverage continues to increase as a percent of U.S. gross domestic product (GDP) and as a percent of book value, as many in the media have reported. However, operating margins have been robust as well, leading to debt servicing ratios that are well within historical norms as shown in Chart 2. With debt at 3x EBITDA (earnings before interest, taxes, depreciation, and amortization) and interest rates so low, the debt levels we see today are very manageable, in our opinion. This highlights the scope of the concern around BBBs today. The real risk is that these companies may not have enough cushion to safely navigate through a recession, not they are nearing insolvency.

Chart 2. Debt Servicing Ratios are Well Within Historical Norms

*Non-financial corporate leverage over time, debt as a % of EBITDA, 1985-2017**



Source: St. Louis Federal Reserve Bank. *Most recent data available.

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BBBs for the Long Run

Whether or not an investor earns an adequate return to compensate for the risk undertaken on a BBB investment depends on his or her sensitivity to mark-to-market risk. Forced selling when a company is downgraded to high yield costs 38 basis points (bps) annually for originally rated BBB bonds, cutting into much of the excess return advantage in holding 'BBB'-rated bonds, according to Bank of America research. A credit-focused active manager with deep research capabilities can maintain or add to a position after a downgrade, which is one reason historically active managers have tended to do very well in the corporate bond space.

Our Conviction Level

On balance, anyone seeking to make a reasoned observation as to the outlook for the 'BBB'-rated sector needs to have a level of conviction in two areas: the probability of a U.S. recession and the likely impact of a recession on corporate balance sheets.

Recession: We are not anticipating a recession in 2019. The consensus forecast is for gross domestic product of about 2.4%, which seems reasonable. Moreover, we don't see any evidence of the kind of speculative activity that historically precedes a recession, such as a stock market bubble or an overheated real estate market; in general, investor and corporate behavior is fairly restrained. And the U.S. Federal Reserve has made it clear that interest rates will not increase in 2019, which is broadly positive for corporate America.

Impact on balance sheets: Not all recessions look like 2008, which was swift and severe. Even during relatively deep recessions, the loss rate on 'BBB'-rated securities (technically securities that were rated BBB one-year prior) has peaked out at about 60 bps annually, according to Moody's, assuming a conservative 50% recovery on Moody's default figures. Investment grade companies, including 'BBB'-rated issuers, have navigated previous recessions well and, when a downturn in growth eventually occurs, we would expect today's large and diverse collection of BBB issuers to do the same.

Summing Up: The Case for BBBs

There are legitimate concerns around the large amount of 'BBB'-rated corporate debt in the marketplace. A wave of downgrades could leave the high yield market with a flood of supply that may require significantly higher spreads to entice investors. We do not think this wave of downgrades is likely, however, due to a number of potentially mitigating factors:

- Companies are motivated to not fall below a BBB rating, which has led to an upgrade bias for BBBs historically.
- Large and flexible balance sheets among BBB issuers give them the opportunity to deleverage.
- The diverse and defensive sector composition of BBB issuers means a wave of downgrades is less likely.

Finally, there are few signs of the end to this credit cycle, and BBBs have historically experienced only moderate defaults in previous downturns. We believe 'BBB'-rated corporatescontinue to present flexible active managers with opportunities to exhibit credit selection expertise.

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A Note about Risk: The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. High-yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, interest-rate, and general market risks. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price. Lower-rated bonds may be subject to greater risk than higher-rated bonds. No investing strategy can overcome all market volatility or guarantee future results.

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Glossary

One **basis point** is equivalent to 0.01% (1/100th of a percent) or 0.0001 in decimal form.

The **operating margin** measures how much profit a company makes on a dollar of sales, after paying for variable costs of production, such as wages and raw materials, but before paying interest or tax. It is calculated by dividing a company's operating profit by its net sales.

Debt service is the amount of money required over a period of time to repay debts. It includes repayment of principal and interest and lease payments. The debt servicing ratio is calculated by dividing the net operating income for a year by the amount of the total debt to be paid off (serviced) during that year.

The credit quality of the securities are assigned by a nationally recognized statistical rating organization (NRSRO), such as Standard & Poor's, Moody's, or Fitch, as an indication of an issuer's creditworthiness. Ratings range from 'AAA' (highest) to 'D' (lowest). Bonds rated 'BBB' or above are considered investment grade. Credit ratings 'BB' and below are lower-rated securities (junk bonds). High-yielding, non-investment-grade bonds (junk bonds) involve higher risks than investment-grade bonds. Adverse conditions may affect the issuer's ability to pay interest and principle on these securities.

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