LOMBARD ODIER
INVESTMENT MANAGERS

Alphorum

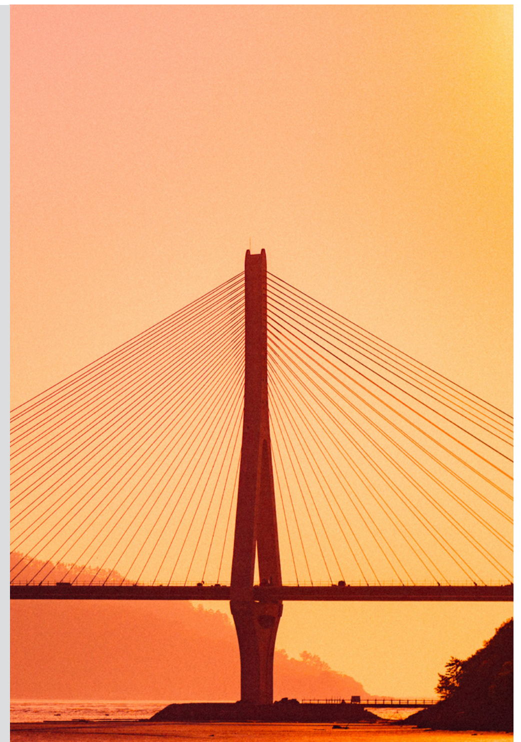
Alpha-seeking perspectives on global fixed income

For professional investor use only • Fixed Income

Q2 2023

Key points

- **As US tightening approaches peak levels, two advantages are becoming clear.** First, Treasuries are likely to outperform cash after the final interest-rate hike, a trend evident in cycles dating back to 1995 **(see p.06)**.[1] Second, the lack of correlation between duration and credit risk – absent during 2022's aggressive hiking – is normalising, enabling portfolios to benefit from carry's shock-absorbing capacity and the ability of duration to support returns amid a slowdown. **See p.02**
- **Fallen Angels fall for a reason – it pays to know why.** Sometimes it's the business cycle, sometimes it's the result of a one-off shock. Or a bond's downgrade from investment grade can be driven by an intentional change in the issuer's financial policy. Whatever the reason, understanding why is essential to determining whether a new entrant to the high-yield universe is mispriced and likely to recover to par. **See p.08**
- **Green stimulus heightens transition risk on both sides of the Atlantic.** Seen as Europe's response to the US Inflation Reduction Act, the Green Deal Industrial Plan aims to simplify the regulatory framework for decarbonising energy and industry, diversify sources of critical materials and technology, and ultimately accelerate progress towards climate neutrality. Combined with the central bank's 'green tilt' and the bloc's carbon border tax, it stands to heighten transitional risks for corporate-bond issuers. **See p.11**
- **A new hedge against investment-grade losses?** Fallen Angels can be used as a diversifying, more convex or generally up-in-quality high-yield exposure. But we believe they can also complement investment-grade portfolios: a relatively small allocation can potentially recover the enforced losses incurred when bonds downgraded to high yield are forced to the exit. **See p.14**



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In our monthly Forum, LOIM's fixed-income specialists debate market dynamics to clarify their convictions. *Alphorum* reflects this pursuit of diverse alpha sources, which drives our global strategy.

LEAD COMMENTARY
Who said bonds are boring?

Yannik Zufferey, PhD
CIO, Fixed Income

Philipp Burckhardt, CFA
Fixed Income Strategist
and Portfolio Manager

Need to know

- The first quarter of 2023 was an eventful one, with markets offering investors every emotion from euphoria through anxiety to panic and paranoia, as initial optimism was rocked by sticky inflation and struggling banks
- Despite inevitable comparisons, the banking sector is in a much better place than it was in 2008. However, tightening financial conditions are likely to have repercussions for indebted companies in cyclical sectors
- Peak rates should see the textbook negative correlation between rates/duration and risky assets return; a real opportunity is coming in fixed income, but volatility means diversifying entry points as well as holdings

If, as Harold Wilson supposedly said, a week is a long time in politics, three months certainly seems like a long time in fixed-income investing. The first quarter of 2023 disproved the idea that 'bonds are boring', with markets producing enough drama to script a Netflix series.

The year began with markets euphoric, buoyed by strong economic data and indications that inflation was starting to peak. However, by February, central banks were becoming anxious amid signs that inflation had in fact become entrenched, and markets repriced in anticipation of further hikes. By March, the collapse of Silicon Valley Bank (SVB) threw markets again. Then, before this news could properly be digested, the sudden takeover of Credit Suisse by UBS[2] – midwifed by the controversial intervention of the Swiss National Bank, the Financial Markets Supervisory Authority and its Finance Minister – further rocked bond markets.

Investors have reacted by becoming far more cautious, even pessimistic, with the consensus view pricing in rate cuts by the end of the year. We think market expectations are overstated in this respect, and that sticky inflation could prevent central banks from reducing rates in the near term. But irrespective of the precise path of rates over the coming months, opportunity knocks for active fixed-income investors able to exploit changing market dynamics.

Banking: bruised but not broken

Comparisons between recent events and the beginnings of the 2008 financial crisis are perhaps inevitable, and the potential for further issues in the banking sector should not be ignored. However, our overall view is that both the SVB and Credit Suisse events were essentially idiosyncratic. For most banks, capital and liquidity is strong, especially in Europe. There were definitely problems at SVB and Credit Suisse, but market confidence was the deciding issue.

Governments and regulators have moved swiftly to contain any fallout. In the aftermath of SVB's collapse, Federal Reserve (Fed) and Federal Deposit Insurance Company (FDIC) officials are already signalling significant regulatory changes to address capital, liquidity and interest-rate risk. Measures including enhanced stress tests and more stringent rules on liquidity levels and capital requirements will restore some of the protection lost by the Trump administration's watering down of the 2010 Dodd-Frank Act. Having said that, in the short term, there is good reason to be cautious towards small-to-medium sized US banks that could be facing similar pressures to those that proved unmanageable for SVB.

In Europe, the write-down of CHF 16 billion of Credit Suisse AT1 capital in the UBS deal caused consternation in fixed-income markets. Investor concern is understandable – the Swiss authorities' solution was unorthodox to say the least. However, we believe it is an approach few officials would wish to replicate, given the importance of maintaining a structured and predictable environment for investors. Indeed, European Union, UK, Canada and Singapore regulators all promptly released statements reiterating the importance of respect the hierarchy of investors exposed to a troubled bank: namely, that Common Equity Tier 1 should bear losses before AT1 debt holders. While it is too early to say whether there will be long-term repercussions for the AT1 market, investors are currently distinguishing Swiss AT1s from those in other jurisdictions, and prices have recovered accordingly.

[1] Past performance is not a guarantee of future results.
[2] Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities discussed in this document.

The financial system tightens its belt

While recent events have been a shock, our view is that they have ultimately helped temper a somewhat irrational level of market exuberance that saw investors effectively defy the actions and intentions of the Fed. After more than a decade of near-zero rates and easy credit, the financial system needs to ‘normalise’, and that process will almost inevitably involve some collateral damage.

Viewed in this light, the actions taken by Swiss and US authorities are probably best regarded as efforts to tread the line between reinforcing and supporting the market while seeking to remove the ‘moral hazard’ from banking by letting investors pay the price to some extent. The Swiss solution was clear in this respect, and while US Treasury Secretary Janet Yellen was blunt in guaranteeing all deposits in some regional banks, she refrained from offering a system-wide guarantee.

One new issue clearly in evidence in the case of SVB is that digitalisation means bank runs can now happen at astonishing speed, making market confidence a far more powerful factor than before. However, overall, measures such as system-wide stress testing and higher capital and liquidity requirements in most jurisdictions mean the banking sector is far more robust than in 2008.

Yet while idiosyncratic issues may have precipitated both the SVB and Credit Suisse events, the likely consequence will be an overall tightening of conditions in the broader financial system – an outcome central banks were already seeking through hawkish monetary policies. As a result, growth will likely be weaker, credit less abundant and more costly, and these conditions should slow inflation. In the US, that would take some of the heavy lifting away from the Fed, which is now positioning for one more rate hike rather than further successive increases.

On the other hand, tighter conditions give central banks less room to fight inflation while limiting the risk of second-round effects – in the case of the Fed, the bank had previously shown itself ready to risk recession, but a fragile banking sector reduces its ability to take such risks. If inflation proves sticky, this puts central banks between a rock and a hard place: with a continuing firm stance needed to maintain credibility, there is a real risk of rate hikes being overdone. A hard landing would then be more likely.

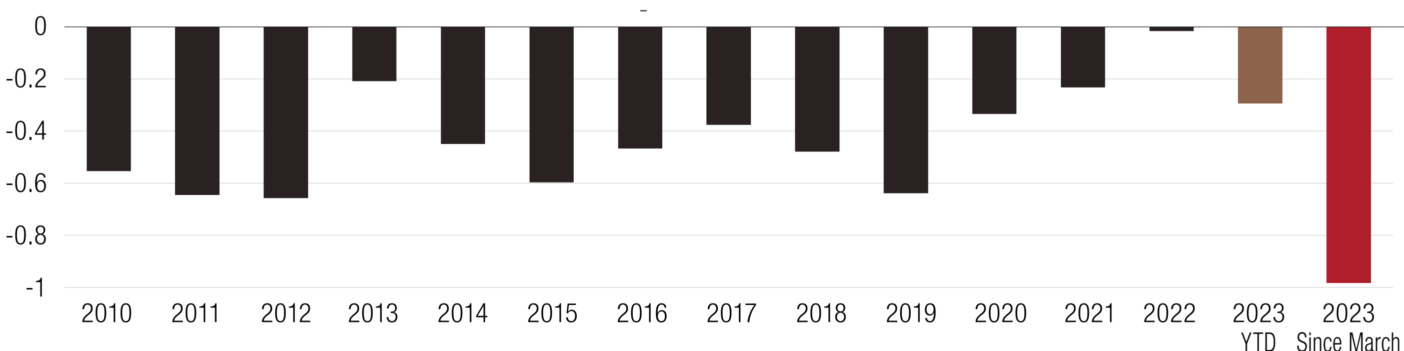
The return of ‘textbook’ fixed-income dynamics?

Traditionally, the negative correlation between rates/duration and risk assets like high yield and equities means sovereign and investment-grade bonds represent safe havens during downturns. This is because carry acts like a shock absorber and duration can provide a boost to portfolios if growth decelerates to the point of recession. However, over the past few years, with interest rates approaching zero, markets have increasingly failed to reflect these textbook dynamics. The most recent example was 2022, when credit and rates risk sold off at the same time as central banks began fighting inflation hard after a decade of loose monetary policy.

Fortunately, with the end of the hiking cycle now in sight, this correlation should start to normalise. In contrast to the last decade, rates will be able to fall as well as rise, marking the return of the diversification effect that fixed income has traditionally been known for. Indeed, this already happened in March this year, when credit sold-off but rates rallied (see figure 1).

FIG 1. THE NEGATIVE CORRELATION BETWEEN RATES AND DURATION IS RETURNING

WEEKLY CORRELATION: CHANGE IN US 10-YEAR TREASURY YIELD AND US HIGH-YIELD SPREAD



Source: Bloomberg, LOIM at March 2023. For illustrative purposes only. Past performance is not a guarantee of future results.

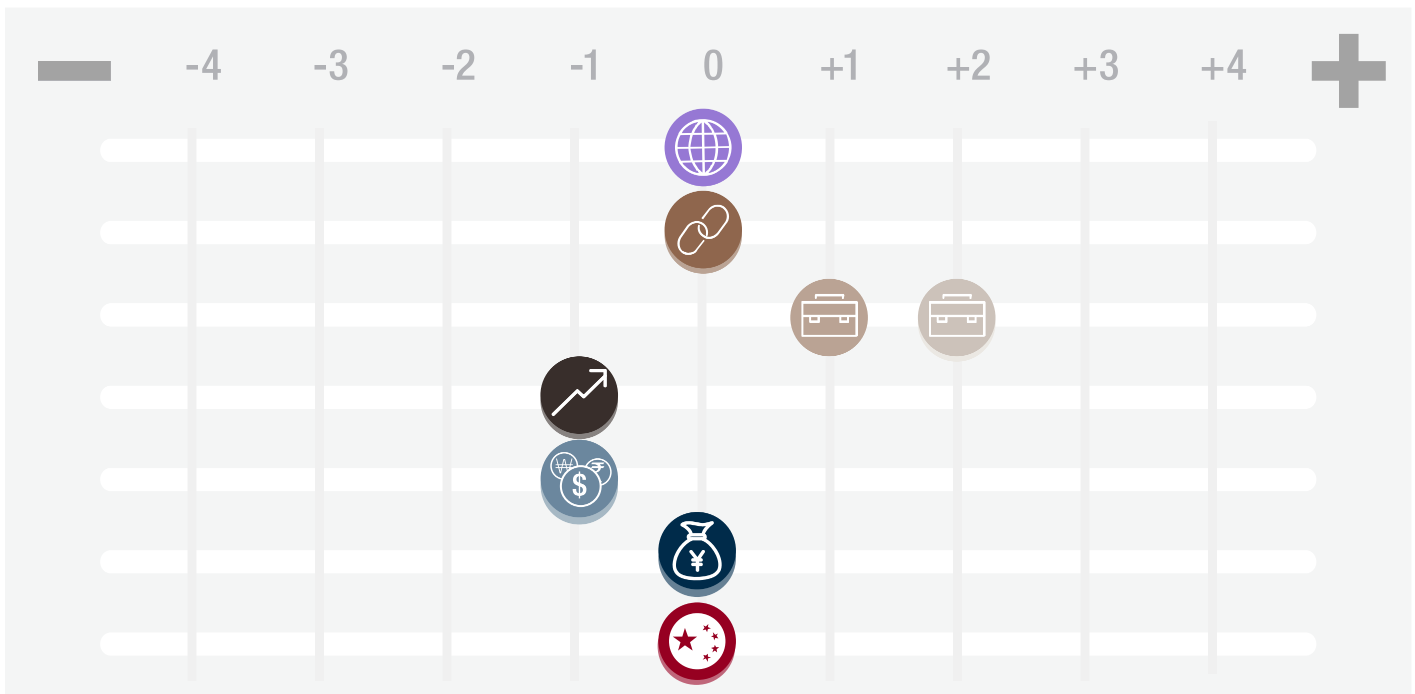
The benefits of carry mean there is a real opportunity for actively managed fixed-income strategies, in our view. Sitting on the side-lines could prove costly as key opportunities could be missed. As central-bank hiking cycles approach their peaks, we are becoming the most constructive we have been on developed-market sovereign bonds for some time – you can read more about this in the Government Bonds section of *Alphorum*.

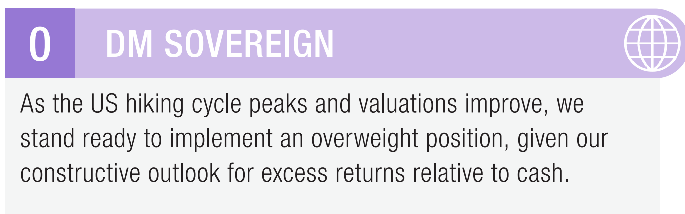
However, while there is plenty to be positive about, there is no doubt that ongoing volatility makes timing difficult. To counter this, our approach is to remain alert and ready to seize opportunities as they arise, diversifying not only holdings but also entry points into the market in an effort to capture the best possible returns while limiting risk.

As financial conditions tighten, there will undoubtedly be repercussions in the fixed-income universe. While the initial impact has been on financials, weaker links in the broader corporate space could be the next to be affected – particularly in more indebted and cyclical sectors. Tighter lending conditions will have an impact on credit fundamentals, which will in turn lead to further deterioration in ratings drift and ultimately result in a rise in fallen angels. That represents an opportunity for investors in the crossover and upper high-yield space. Here, we also favour an active approach: fallen angels fall for a reason, and only by understanding the drivers of a downgrade can fallen angels be caught and falling knives avoided.

At the same time, investors need to be both exposed to the upside and protected from the downside. One way to potentially achieve this is by incorporating an exposure to fallen angels, which can help investment-grade investors hedge losses incurred from bonds being downgraded to high yield. Read our Corporate Credit and Systematic Research sections for further analysis of the triggers for fallen angels and the opportunity this creates for prepared fixed-income investors.

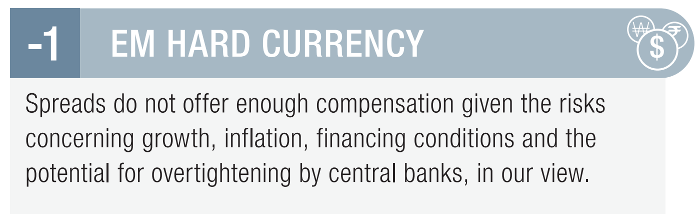
Convictions scorecard





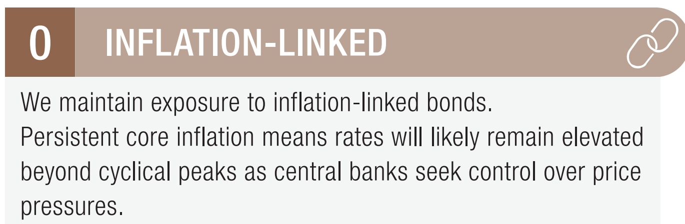
0 DM SOVEREIGN

As the US hiking cycle peaks and valuations improve, we stand ready to implement an overweight position, given our constructive outlook for excess returns relative to cash.



-1 EM HARD CURRENCY

Spreads do not offer enough compensation given the risks concerning growth, inflation, financing conditions and the potential for overtightening by central banks, in our view.

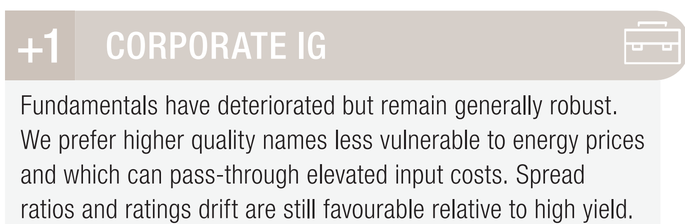


0 INFLATION-LINKED

We maintain exposure to inflation-linked bonds.
Persistent core inflation means rates will likely remain elevated beyond cyclical peaks as central banks seek control over price pressures.

0 EM LOCAL CURRENCY

Given recession and inflation risks, valuations are expensive relative to US Treasuries. But we are constructive on emerging-market currencies.

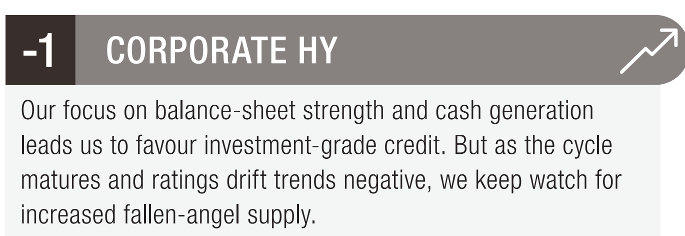


+1 CORPORATE IG

Fundamentals have deteriorated but remain generally robust. We prefer higher quality names less vulnerable to energy prices and which can pass-through elevated input costs. Spread ratios and ratings drift are still favourable relative to high yield.

0 CHINA LOCAL CURRENCY

An attractive diversifier given China's unsynchronised economic cycle. Post-covid re-opening is likely to be supported by further fiscal easing, but geopolitical risk over Taiwan creates uncertainty.



-1 CORPORATE HY

Our focus on balance-sheet strength and cash generation leads us to favour investment-grade credit. But as the cycle matures and ratings drift trends negative, we keep watch for increased fallen-angel supply.

Source: LOIM as at March 2023. For illustrative purposes only.

GLOBAL GOVERNMENT AND INFLATION-LINKED BONDS
Peaking rates signal opportunities in sovereigns

Nic Hoogewijs, CFA
Senior Portfolio Manager

Need to know

- While inflation is proving difficult to tame, recent issues in the banking sector show that hawkish monetary policy is beginning to bite. The resultant financial tightening should reduce the need for central banks to raise rates further
- We believe stubborn core inflation and tightness in the labour market make it unlikely central banks will be able to cut rates quickly. However, there can be little doubt the peak of the US hiking cycle is approaching
- Data from past cycles shows sovereign bond markets have historically performed well once central-bank tightening ends. We stand ready to move back to an overweight stance as soon as valuations improve

Fundamentals and macro

In the first quarter of 2023, more than a year into the global rate-hiking cycle, the effect of global monetary-policy tightening still appeared to be relatively muted. Despite tentative improvements in price pressures in the US in the final months of 2022, February 2023 saw economic data once again surprise to the upside, with core inflation rising 0.5% month on month. Other major developed markets saw similar dynamics. Central banks reacted by raising their respective policy rates further into restrictive territory, although the magnitude of hikes has moderated, with the Fed moving in 0.25% increments over its past two meetings.

While inflation is proving difficult to tame, the issues in the banking sector in March made it abruptly clear that tighter monetary policy is biting in other ways. Following on from the collapse of Silicon Valley Bank in the US, the wiping out of junior Credit Suisse bonds triggered a dramatic repricing of bank funding costs. As a result, the bank-lending channel is set to tighten significantly. For central banks, this has the useful side effect of reducing the need to raise rates further.

However, in our view, given the tightness of the labour market and broad-based nature of underlying inflation pressures, central banks are unlikely to be able to deliver aggressive rate cuts this year to support particular sectors, such as banking. Instead, targeted tools such as the Fed's recently announced Bank Term Funding Program will be used to address specific situations of stress.

In emerging markets, resilient economic data from the US, Europe and China has improved asset fundamentals, although financial conditions remain challenging.

Sentiment

Over the month of February, the market-implied peak in the policy rate repriced to a fresh high of 5.5% for the Fed and 4% for the European Central Bank (ECB), on the back of strong economic data. Having been patient and waiting for yields to become sufficiently attractive, we finally moved our recommendation from neutral to tactically overweight in early March. However, shortly afterwards, fallout from the issues in the banking sector triggered a spectacular rally in sovereign fixed-income markets, with the 2-year US Treasury yield dropping more than 100 basis points in just three sessions.

In the second half of March, sovereign interest rates remained extremely volatile, as the market tried to gauge to what extent tighter financial conditions would reduce the need to maintain elevated policy rates. We therefore moved back to a neutral position for the time being. However, our view is that while there will likely be some further localised issues, the tightening of financial conditions is a necessary adjustment for the global economy. We expect central banks are likely to keep policy rates in restrictive territory in their effort to regain control over inflation.

For emerging markets, sentiment strongly correlated with the continuing risk-on risk-off behaviour of the US dollar and wider risk sentiment.

Technicals

Going into 2023, the technical picture looked challenging for government bonds – particularly in the UK and Europe, where fiscal deficit spending and quantitative tightening have boosted net supply to multi-year highs. February saw a sell-off largely driven by the repricing of expectations for central-bank policy rates. However, the sharp drop in yields in January and March appears to have been supported by solid demand – including renewed interest from retail investors, whom JP Morgan estimates made net purchases of over USD 100 billion in bond funds (equivalent to an annualised pace of about USD 600 billion).[3]

The picture is not entirely positive – we mentioned in last quarter's *Alphorum* that as the Bank of Japan's yield-curve control measures become less stringent, Japanese investors are returning to domestic bonds at the expense of international sovereigns. However, in general, healthy demand at these high yield levels is highly supportive from a technical perspective.

Valuations

Fallout from the issues in the banking sector has seen the market move back to pricing in multiple cuts to the Fed rate before year end. However, current pricing is strongly impacted by the significant risk premium for potentially severe nonlinear shocks to financial conditions that would require the US central bank to aggressively cut rates.

Our view is that market pricing of early rate cuts seems too keen. While we foresee rates peaking in the summer, absent a major financial shock, we think they are unlikely to start to fall before the end of year. Central banks need to keep monetary policy focused on bringing inflation under control and are therefore using other tools at their disposal to maintain financial stability.

Emerging-market yields are relatively high compared to historical levels, although the yield differential versus the USD is less attractive. However, USD weakness is supportive for emerging-market local currency bonds, and with the US hiking cycle approaching its peak this could be sustained over the next few months.

Outlook

The current monetary-policy cycle is unusual, not least because early rate cuts are already anticipated in pricing. Given ongoing strong core inflation data, we believe any rapid decline in policy rates is unlikely. However, central banks will be wary of overshooting on rate hikes. We expect that by mid-2023 most will pause their tightening campaigns, albeit with policy rates staying elevated at least through to the end of the year.

Data from past cycles shows that bond markets have historically performed well from the point when central-bank tightening peaks. Figure 2 shows the excess return of US Treasuries versus cash in the months after the Fed's final rate hike over the last four hiking cycles. As you can see, Treasuries have outperformed cash consistently in the 18-month periods following final hikes.

With policy rates probably approaching their peak, investors should be wary of maintaining an underweight position on duration. We are maintaining a neutral stance as the tightening cycle matures, while looking to exploit tactical opportunities and standing ready to return to an overweight position once valuations improve.

FIG 2. US TREASURIES: EXCESS RETURNS AFTER TIGHTENING-CYCLE PEAKS

Final hike	3 months	6 months	12 months	18 months
December 2018	0.64%	4.25%	5.00%	13.47%
June 2006	2.66%	2.04%	0.36%	5.59%
May 2000	2.71%	3.73%	5.21%	10.30%
February 1995	2.72%	5.58%	10.78%	6.19%
Average return	2.18%	3.90%	5.33%	8.89%

Source: LOIM, Bloomberg at March 2023. For illustrative purposes only. Past performance is not a guarantee of future results.

[3] JP Morgan Global Markets Strategy. “Flows & liquidity”. Published 9 March 2023.

Please read important information at the end of this document

CORPORATE CREDIT
In bond markets, why do angels fall?

Ashton Parker
Senior Portfolio Manager and
Head of Credit Research

Need to know

- Fallen angels fall for a reason. The causes at the issuer level can be either accidental or intentional, and include: financial-policy changes, acquisition, competition and reduced demand, as well as one-off shocks such as reputational incidents
- At the most basic level, bonds leave the investment-grade index because their credit metrics – changed by one of the types of events described above – are no longer commensurate with an investment-grade rating
- Our challenge is to understand whether these metrics will stabilise – or even improve – to make the bond a suitable investment, or continue to deteriorate and be identified as a fallen angel that should be avoided

As noted elsewhere in this issue of *Alphorum*, tighter lending conditions stemming from the March banking crisis will inevitably have an impact on already weakening credit fundamentals. The resulting increase in ratings drift for corporate bonds will ultimately lead to a rise in fallen angels. That creates an opportunity for credit investors – albeit one that is best exploited using an in-depth knowledge of the market and a bottom-up approach, in our view.

Here we offer insights into the many triggers that can cause a bond's rating to fall and how we distinguish fallen angels that are fit for investment from falling knives which will continue to deteriorate both in rating and performance.

Three golden rules of fallen angel behaviour

Before looking at some of the triggers that lead to bonds being downgraded and leaving the investment-grade index, it's helpful to keep in mind three key points.

1. Fallen angels fall for a reason	Fundamentally, the credit has deteriorated, so it is vital to understand the reasons why. Is the company still sound and able to operate effectively as a BB-rated business, in which case the bond's performance should stabilise and recover in time? Or is the downgrade a sign of more profound issues from which the firm may never recover?
2. Financial metrics are only part of the story	Fallen angels descend because their credit metrics are no longer commensurate with an investment-grade rating. However, financial metrics are backward-looking, and are always a function of the company's business profile: the environment in which it is operating, its management, strategy, financial policy and other factors
3. Downgrades can be accidental or intentional	While a company's credit rating usually falls 'accidentally', in certain circumstances it can also be allowed to fall on purpose. It is therefore important to understand whether the downgrade is the consequence of external pressures – or the result of a choice made by the business for a reason

Source: LOIM at March 2023.

It is important to remember that a fallen-angel strategy is not about identifying future rising stars that will return to investment grade. Instead, it aims to exploit the market's short-term, negative overreaction in the pricing of downgraded bonds. To do so, thorough quantitative and qualitative analysis is needed to separate fallen angels – essentially sound businesses whose bonds will recover from the excess underperformance that is characteristic of a downgrade to high yield – from falling knives, whose ratings and prices are likely to deteriorate further.

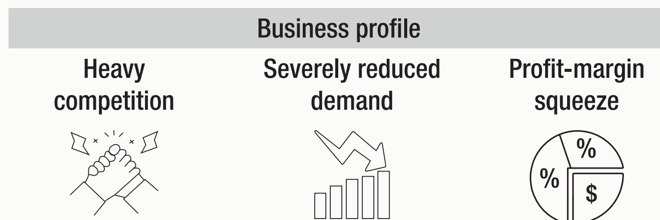
Understanding deliberate downgrades

It may seem counterintuitive for a company to deliberately allow its credit rating to fall. However, this can happen for two key reasons:

- **A change in financial policy.** In certain circumstances, a company may choose not to adhere to the investment-grade criteria set by a ratings agency. For example, to maintain a BBB- rating, the agency may require a company to have net EBITDA of above 3x; the company may find this too demanding and consider an EBITDA of 4x perfectly feasible for its business. In that case, it may accept a downgrade to BB. Nothing has changed from an operational perspective, so if the company is able to fund itself effectively despite paying more for its debt, there may not be a significant issue
- **Increasing leverage for a major acquisition:** A firm may accept a downgrade to high yield when its financial metrics are impacted by taking over another business. Often the company's stated aim will be to return to their previous rating within two to three years, either via asset sales or by deleveraging through cashflow. In this scenario it is necessary to consider the execution risk involved in making the acquisition and integrating the acquired business.

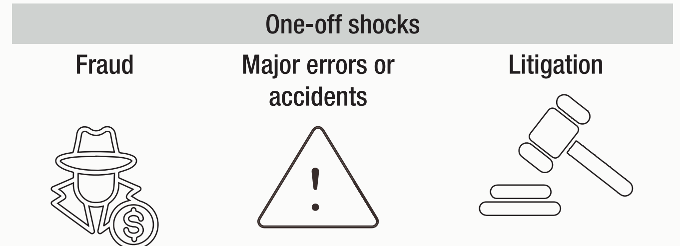
The reasons for 'accidental' downgrades

Accidental downgrades fall into one of two main categories: either they relate to the company's business profile, or they result from a significant one-off shock to the company.



For example, turbine maker Bilfinger[4] failed to adapt quickly enough to lower demand for its products as big utilities companies progressively reduced capex. Having issued multiple profit warnings, its rating eventually fell several notches. However, post-downgrade, the firm reduced its cost base and rightsized its operations to operate effectively at BB grade, as a market still existed for its products.

In contrast, video rental company Blockbuster failed to adapt as videos and DVDs were replaced by streaming – most significantly perhaps by not buying Netflix[2] as a start-up. As a result, the downgraded business went into terminal decline.



The consequences of these shocks can be financial, operational and/or political. For example, Brazilian metals and mining company Vale[4] was responsible for two fatal dam collapses in the space of four years, with the Brumadinho disaster in 2019 causing a public outcry which led to the firm paying USD 7 billion in compensation. The company's bonds were downgraded to high yield in the wake of the ruling, but its strong profile as one of the world's biggest iron ore and nickel producers means its ratings have since recovered. But our analysis of ESG business practices led us to believe that Vale had not learned from these tragic events and we did not invest – and still consider the firm to be highly controversial. This shows another benefit of an active approach to investing in fallen angels: the ability to integrate qualitative ESG and sustainability insights.

The infamous Enron serves as an example of a one-off shock that turns a firm into a falling knife. The energy company's downgrade in November 2001, following the discovery of one of the biggest accounting scandals in history, was effectively a one-way ticket to bankruptcy.

Finally, a less common issue to be aware of is when a large, investment-grade business is acquired by a smaller, high-yield company. However, most investment-grade businesses now have a 'change of control' clause that means bonds can be repriced at par in this eventuality.

[4] Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities discussed in this document.

Understanding the impact

Whatever the cause of a downgrade, the key to identifying a fallen angel is understanding the longer-term impact of the change in rating. To do this, investors can ask three key questions:

1. Is the situation as significant as the market judges it to be?	For example, while the reputational impact of an incident may be severe, this is usually of less importance to a non-consumer-facing business, particularly one which is dominant in its sector
2. Are the problems endemic or do they amount to a one-off issue?	Covid is a good example that created severe one-off issues for businesses such as cruise liners. However, because the setback was ultimately temporary and the underlying business models of ship operators like Carnival[5] were extremely strong, these companies withstood a shutdown of operations. With bookings now even higher than before the pandemic, we expect their ratings to recover.
3. Can the issues be fixed?	The threat of litigation or even the shutting down of operations may look fatal for a business, however, this risk is usually resolved by paying a fine or compensation. If the company takes corrective action, the outcome may ultimately be positive. Volkswagen[5] after Dieselgate and BP[5] after Deepwater Horizon are examples where improving procedures and/or changing a business model have actually made a company stronger than before.

Knowing the space as an active manager

An effective fallen-angels strategy should always be based on an active approach, in our view. Quantitative analysis of fundamentals is necessary to understand the financial robustness of a company, while qualitative analysis is vital to understand the circumstances of a downgrade, and thus its likely longer term consequences.

Our investment model means analysts work across the investment-grade and high-yield universe (in other investment businesses a bond will be sold as it leaves the investment-grade universe and will be considered anew by a high-yield analyst). We know the companies in the BBB-BB space well, and while we may not agree with a downgrade, we will rarely be surprised by it. Indeed, in many cases we can anticipate downgrades – The US department store Kohl's is a recent example where the company's investment-grade rating made no sense in relation to its competitors Nordstrom and Macy's, which sat at BB.[5]

Our understanding of a company's sector, competition, differentiators, management, financial profile and reputation mean we can usually understand whether a downgraded bond is a potential fallen angel or falling knife within 24 hours. We can then stand ready to purchase at the end of the month, when forced selling by investment-grade desks means supply is highest and pricing is lowest.

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SUSTAINABILITY
The EU Green Deal Industrial Plan: what does it mean for credit markets?

Erika Wranegard
Portfolio Manager

Need to know

- Since the announcement of the US Inflation Reduction Act, several high-profile European companies have expressed interest in relocating operations to the United States
- In response, the European Commission recently announced its Green Deal Industrial Plan, which aims to build on existing efforts under the European Green Deal and REPowerEU
- Implementation of the plan will further favour decarbonising companies over environmental laggards. Corporate-bond investors should be ready to adjust their portfolios accordingly, in our view

In the Q4 2022 issue of *Alphorum*, we highlighted how the USD 260 billion earmarked to be spent under the US Inflation Reduction Act (IRA) is encouraging US companies to focus on targeting net zero. However, the impact of the IRA is far from limited to US companies. In fact, the generous subsidies it offers, coupled with the clarity of the rules surrounding them and the resulting ease with which they promise to be implemented, are proving highly attractive to international businesses with roots elsewhere. Italian energy company Enel,[6] German car manufacturer Volkswagen and Swedish battery manufacturer Northvolt are just some of the European companies that have expressed interest in relocating future production to the US to benefit from the IRA.

The EU reacts to the IRA: a simpler and faster framework

While not positioned as a direct response to the IRA, the stated aims of the European Commission's Green Deal Industrial Plan (GDIP) announced on 1 February, 2023 are to "enhance the competitiveness of Europe's net-zero industry and support the fast transition to climate neutrality". In tacit recognition of the appeal of the IRA, European Commission President Ursula von der Leyen stated that the GDIP would be based around a simpler and faster framework.

The GDIP is built upon four pillars:

1. **Simplifying the regulatory framework**
   - Reducing red tape – which firms complain makes getting access to existing funding cumbersome – through a predictable and simplified regulatory environment
2. **Providing faster access to funding**
   - Making it easier for member states to grant the necessary incentives to stimulate green industry
   - Proposing a European Sovereignty Fund to increase the scope of the European Capital Markets Union
   - Supporting the net-zero transition among economically weaker countries
3. **Enhancing skills**
   - Establishing Net-Zero Industry Academies to up-skill and re-skill workers in strategic industries – the Commission estimates 35-40% of all jobs could be affected by the green transition
   - Facilitating the access of third-country nationals to European Union (EU) labour markets in priority sectors
   - Fostering and aligning public and private funding for skills alignment
4. **Enabling open trade for resilient supply chains**
   - Developing the EU's network of free trade agreements and cooperation
   - Ensuring access to critical raw materials
   - Protecting the EU single market from unfair trade

[6] Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities discussed in this document

Following the unveiling of the GDIP, on 16 March the European Commission released further details of how the EU aims to support the net zero transition, by announcing two new Acts:

- **The Net Zero Industry Act**. With the headline aim of "making the EU the home of clean technologies manufacturing and green jobs", it targets strategic net-zero technologies manufacturing capacity of at least 40% of the EU's deployment needs by 2030.
- **Critical Raw Materials Act**. Focused on "ensuring secure and sustainable supply chains for the EU's green and digital future", it identifies a list of raw materials – including platinum, nickel, rare earths and lithium – and sets the following targets for diversifying the EU supply chain by 2030:
  - At least 10% of annual consumption for extraction to come from the EU
  - At least 40% of annual consumption for processing to come from the EU
  - At least 15% of annual consumption for recycling to come from the EU
  - Not more than 65% of annual consumption of each strategic raw material at any relevant stage of processing to come from a single third country

The two acts, together with a reform of the electricity market, set out a clear framework to reduce the EU's reliance on highly concentrated sources of imports.

Why does it matter?

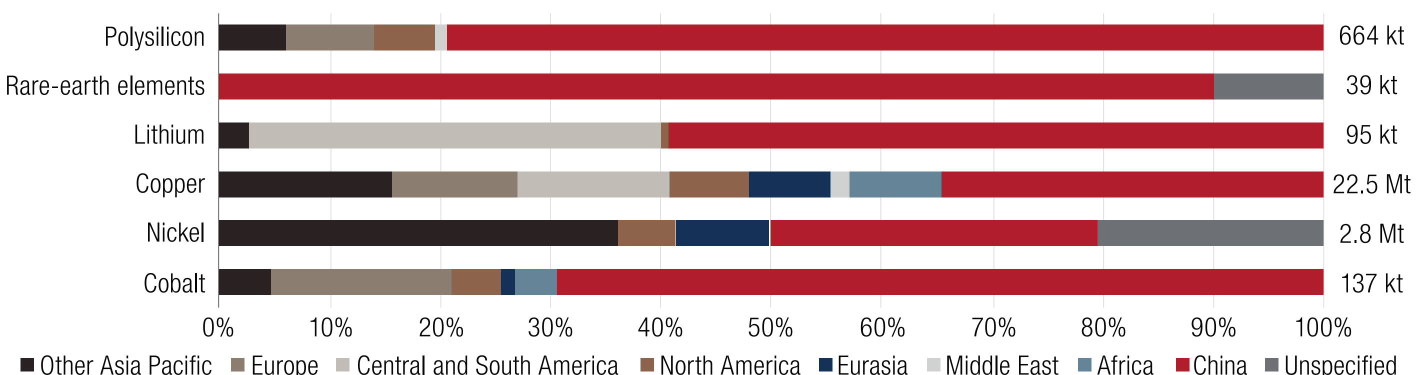
Maintaining an advantage in the net-zero transition is central to the European Union's plans for economic growth and energy security, as well as for meeting its climate targets. In light of this, the GDIP is important for three key reasons:

1. **It reinforces the EU's commitment to decarbonisation**, sending a strong signal to all market participants that climate action is a strategic focus for one of the world's largest economies
2. **It increases the speed of the net-zero transition** through incentives that simplify the regulatory framework and cut handling time for renewable energy instalments
3. **It positions the EU to benefit from innovation and growth opportunities** offered by the transition to net zero

While the move has been described in some quarters as the start of a climate trade war with the US, the EU's focus on 'open trade and resilient supply chains' points more towards reducing dependencies on highly concentrated supply chains originating in countries outside the bloc – most obviously China (see figures 3 and 4).

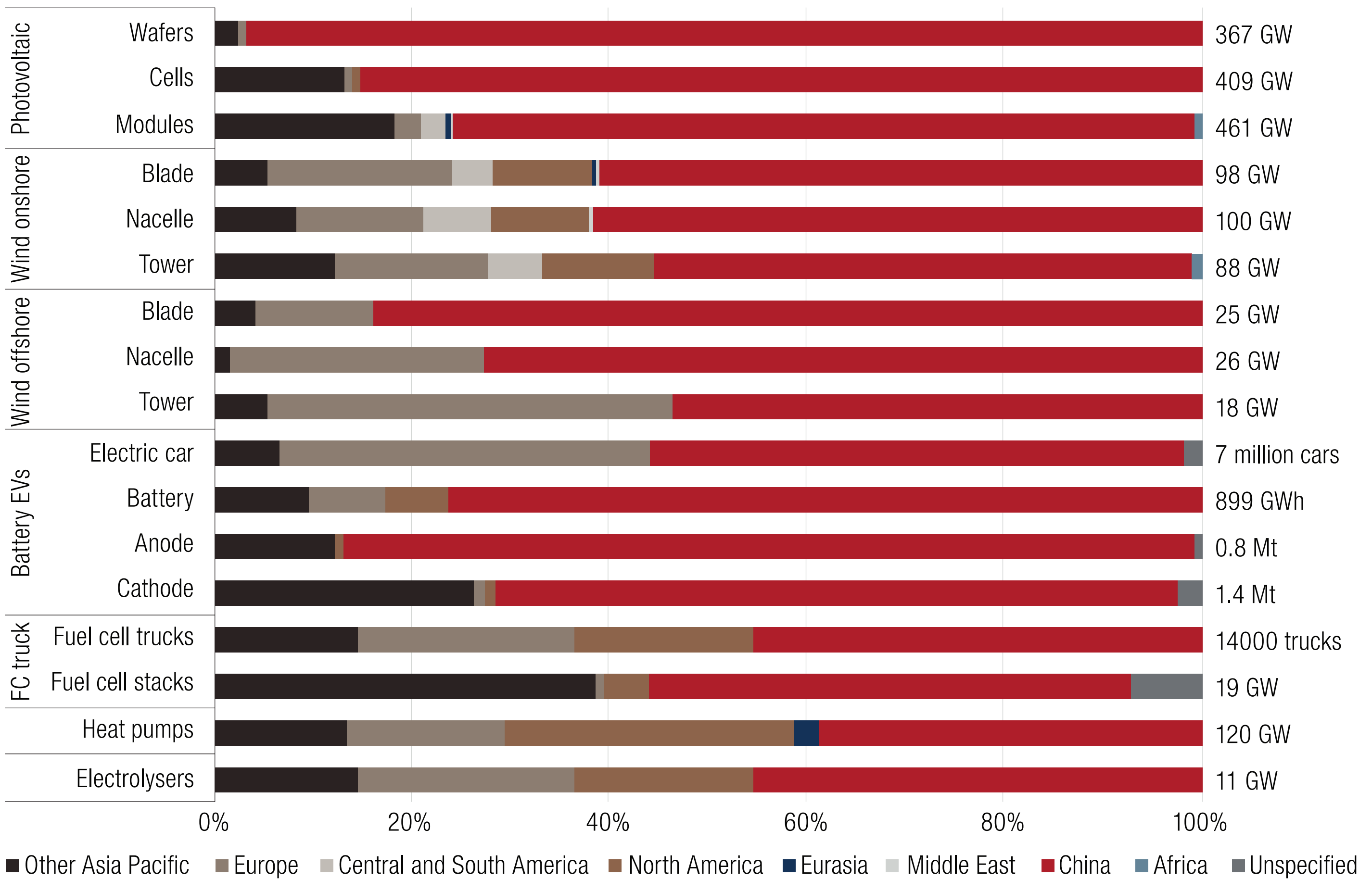
The war in Ukraine exposed Europe's energy dependence, particularly on Russian gas, thus placing the net-zero transition at the heart of the EU's strategic priorities. Rather than marking the start of a potentially damaging trade war, an increased focus on net zero in both the US and the EU can be seen as a win-win scenario,

FIG 3. GLOBAL PRODUCTION OF SELECTED MATERIALS CRITICAL TO THE ENERGY TRANSITION, 2021



Source: IEA 2023. Energy Technology Perspectives 2023. Licence: IEA. CC BY 4.0.

FIG 4. MASS-MANUFACTURING OF CLEAN TECHNOLOGIES AND COMPONENTS BY REGION, 2021



Source: IEA 2023. Energy Technology Perspectives 2023. Licence: IEA. CC BY 4.0.

which should drive increased global spending and innovation towards a low-carbon economy. This further supports our thesis that the transition will unfold more quickly than the market currently anticipates.

What are the implications for the corporate bond market?

The GDIP intensifies transition risks in investors' corporate bond portfolios. Additional fiscal support for the net-zero transition will reduce production costs for green or transitioning companies. At the same time, the EU has increased penalties for climate laggards by increasing the scope of its Emissions Trading System and Carbon Border Adjustment Mechanism, which we explored in the Q1 issue of *Alphorum*.

This adds to other drivers already impacting the European corporate bond market. For example, in terms of monetary policy, the ECB has introduced a climate tilt favouring companies with good climate scores and penalising those with weaker ones, by capping maturities for reinvestment and reducing the amount reinvested in climate laggards.

All these initiatives aim to support transitioning companies by ensuring capital is available to companies seeking to decarbonise, while limiting access to finance for insistent polluters. The result is likely to be increasing dispersion in credit spreads between decarbonising companies and environmental laggards.

As an investor, keeping up to date with the latest policy developments – and adjusting your portfolio accordingly – is becoming increasingly important. Transition risk is particularly material in high-emitting sectors such as energy and building materials. By aligning portfolios to net zero, investors can take advantage of the opportunities presented by the net-zero transition, while managing the risks effectively.

SYSTEMATIC RESEARCH
Can fallen angels help investment-grade allocations stop the losses?

Anando Maitra
PhD, Head of Systematic Research and Portfolio Manager

Jamie Salt
Systematic Fixed Income Analyst and Portfolio Manager

Need to know

- Having previously documented the negative price overreaction experienced by fallen angels as they lose investment-grade ratings, we now consider the underperformance caused by forced selling of fallen angels
- To quantify the cost incurred, we compare average credit excess returns for investors who sell at the point of downgrade with those who do not. We compare this with the risk mitigated by a fallen angels exposure
- Our analysis indicates that making an allocation of just 5% to fallen angels is sufficient to compensate for the losses experienced by downgrade-intolerant investment-grade investors from ratings-based stop-losses[7]

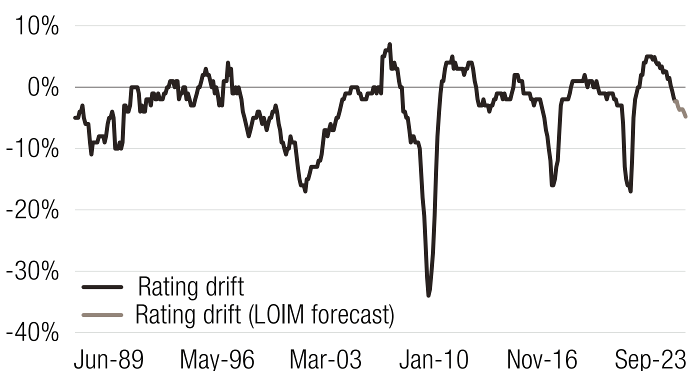
In past editions of *Alphorum* we have thoroughly documented the negative price overreaction fallen angels experience both leading up to and at the point of downgrade to high yield – something which is a key factor in their outperformance as a standalone asset class. However, we have yet to explore the flipside of the equation – namely, the underperformance of investment-grade-only portfolios that are forced to sell bonds at the point of downgrade to high yield, when price levels are depressed. In this issue, we quantify the impact forced sales have on investment-grade-only portfolios and consider how a fallen angels allocation within a diversified fixed-income portfolio can counteract this underperformance.

Ratings drift: where do we stand and what is the outlook?

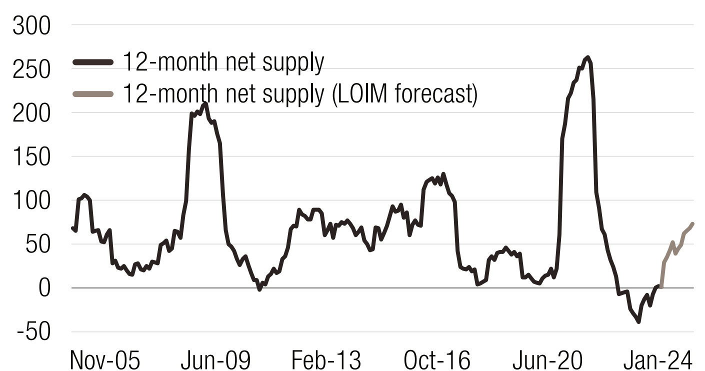
In the Q3 2022 edition of *Alphorum* we presented our model-based forecast for ratings drift and fallen angel supply. Revisiting the situation some nine months later, ratings drift has turned negative and net supply has increased as expected, albeit at a slightly slower pace than predicted. Going forward, we predict a continuation in increased drift towards lower ratings (see figure 5A), accompanied by a further pickup in fallen angels net supply (see figure 5B).

FIG 5. TRAILING RATINGS DRIFT AND SUPPLY FORECASTS, 2005-2023 (EUR AND USD COMBINED)

A: TRAILING SIX-MONTH RATING DRIFT AND FORECAST



B: TRAILING 12-MONTH FALLEN ANGEL NET SUPPLY AND FORECAST



Source: Bloomberg, LOIM calculations as at March 2023.

[7] Simulated performance results do not reflect actual trading and have inherent limitations.

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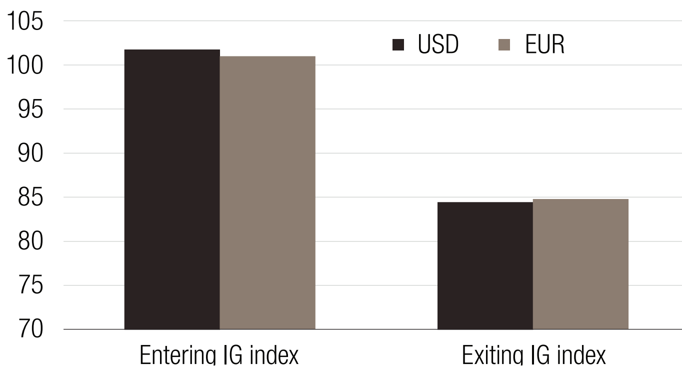
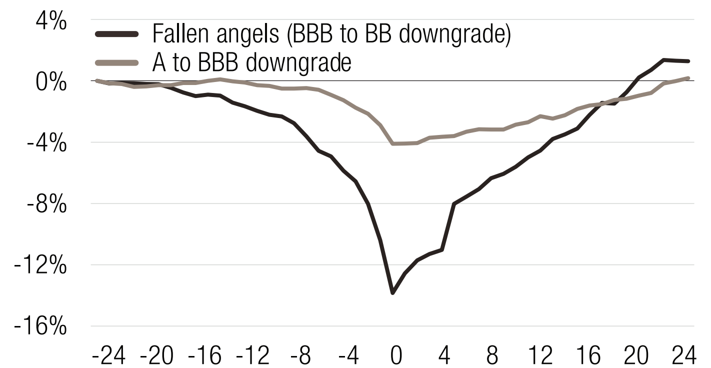
FIG 6. THE AVERAGE PRICE OF BONDS ENTERING AND EXITING THE INVESTMENT-GRADE INDEX, 2004–2023



Source: Bloomberg, LOIM at March 2023.

FIG 7. CUMULATIVE PRE- AND POST-DOWNGRADE PERFORMANCE OF DOWNGRADED US BONDS VERSUS PEERS, 1989-2023



Source: LOIM calculations, Bloomberg at March 2023. Downgrade occurs in month zero.

We note that data inputs into the model are yet to reflect the fallout from March's banking turmoil. Our expectation is that tighter lending conditions will result in forecasts for greater drift and higher fallen angel supply. With that in mind, forced selling by downgrade-intolerant investment-grade investors looks likely to increase in the coming months.

The cost of forced selling in diversified investment-grade mandates

The forced selling of fallen angels from investment-grade portfolios is generally costly, as it enforces 'buy-high, sell-low' behaviour that can ultimately be detrimental to returns. For diversified investment-grade mandates following index-based rules, investment-grade bonds are often purchased at an issuance price of close to 100. In contrast, when a forced sale occurs due to a bond being downgraded to BB or lower, the sale price is often substantially lower. In fact, our research finds that the new-issue premium means the average price at which bonds enter the investment-grade index at the end of the issuance month is slightly above 100. In contrast, when bonds exiting the investment-grade index as fallen angels are sold, the average price is slightly above 80 (see figure 6).

This 'sell-low' behaviour is generally used to mitigate risk, although it can also be additive to performance if a downgraded bond continues to exhibit negative price momentum and eventually runs into distress, becoming a falling knife. However, our research shows that the negative, overreactive pricing of fallen angels is often followed by a post-downgrade reversal.

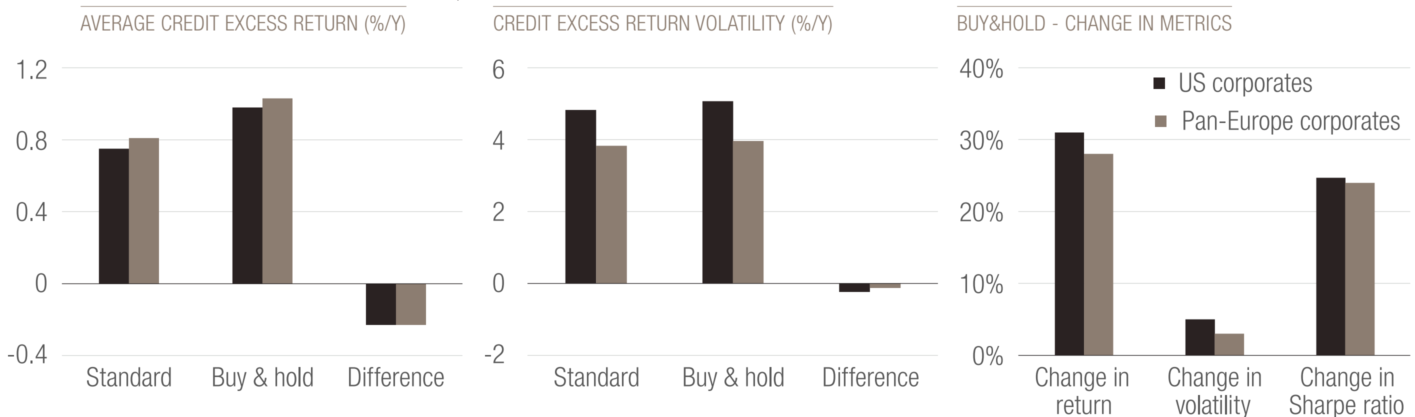
This price overreaction in the lead up to and upon the ratings change means downgrade-intolerant investment-grade investors are forced to sell fallen angels at depressed prices as they leave the index. Historically, the month of downgrade often represents peak underperformance for a fallen angel versus its peers, making this the worst time to sell (see figure 7). To emphasise the magnitude of the underperformance generated as a bond crosses the investment-grade to high-yield threshold, we have made a comparison with the average underperformance of downgrades from A to BBB. Whilst A-to-BBB downgrades also exhibit peak underperformance in the month they are downgraded, the severity of their underperformance is less than a third of that experienced by fallen angels. Therefore, the natural outcome of a credit-ratings-based selling rule is 'buying-high' and 'selling-low', and this dynamic is exacerbated in the case of bonds that are sold due to being downgraded from investment grade to high yield.

To quantify the cost incurred by downgrade-intolerant investors through the forced selling of fallen angels, we can compare their average credit excess returns with those of buy-and-hold investors who do not sell upon downgrade to high yield. As shown in figure 6, bonds generally enter the investment-grade universe at an issuance price of a little above 100, while forced sales are typically at prices of around 80. This mark-to-market loss substantially outweighs any gains from avoiding defaults, which are exceptionally rare for bonds issued at investment-grade ratings.

Ultimately, the losses from these forced sales result in downgrade-intolerant investment-grade investors underperforming their buy-and-hold peers by around 25bps per year (see panel A of figure 8) – a figure which is broadly consistent across geographies. Given that the average annual credit excess returns of investment-grade corporate bonds are around 75 bps, losses therefore account for 30% of average excess returns.

We have established that forced selling is clearly detrimental to returns, but does it compensate for lower returns by mitigating risk, as intended? Our analysis finds that there is indeed a reduction in volatility, however it is much lower than the reduction in return. In fact, the percentage increase in return for buy-and-hold investors is around 30%, while the consequent rise in volatility is below 5% (see panel C of figure 8).

FIG 8. CREDIT RETURN AND VOLATILITY, 2004-2023



Source: Bloomberg, LOIM Calculations at March 2023.

Is there salvation in an allocation to fallen angels?

Regulation and investor guidelines can make downgrade tolerance in investment-grade allocations difficult. This is especially true if the investment-grade bucket is used to match liability cash flows, since a meaningful rise in default risk makes it less eligible to be considered in such an allocation.

A separate, strategic allocation to fallen angels would help recover these losses, in our view. The size of the allocation required can be calculated quite simply by taking the ratio of the average loss from forced sales to the average credit outperformance of fallen angels over investment grade. Since fallen angels outperform investment grade by around 5% (see figure 9), a 5% exposure (0.25%/5%) would be suitable.[5] This would likely increase returns substantially with only a minor increase in volatility (see the right-hand panel of figure 9).

Alternatively, if the allocation is to be added to replace an existing high-yield allocation, we would apply a similar calculation but use the outperformance of fallen angels over high yield, instead of investment grade. Since fallen angels typically outperform high yield by about 2%, this would point towards an allocation of around 10% (0.25% / 2%).[8]

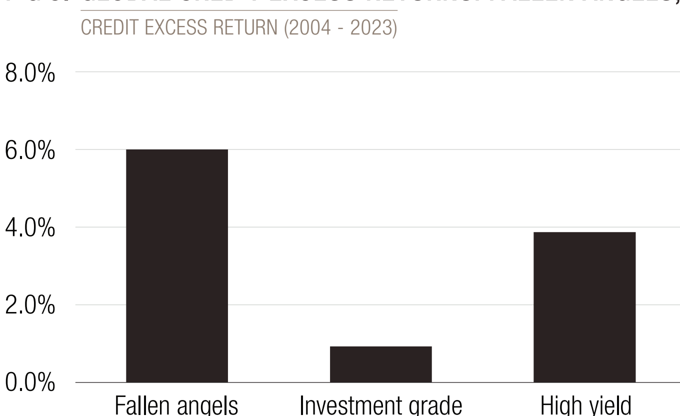
Recouping the cost of forced selling

Credit ratings are an important driver of credit risk, and fallen angels are subject to higher distress risk than their peers. As we showed, sector distress is a strong driver of risk for fallen angels, making ratings-based stop-loss rules appear to be a prudent risk-reduction approach.

However, as we have seen, this risk mitigation comes with an outsized cost. Bonds are naturally very sensitive to downside risk, so prices also tend to overreact on the downside. Ratings downgrades are therefore a significant source of price overreaction. The split of the investment universe into investment grade and high yield, combined with the rise in rules-based passive investing, further exacerbates this overreaction. This is because periods of stress often result in a dearth of buyers to match the increase in supply of downgraded bonds from forced sellers.

Almost 30% of credit performance is lost from these stop-loss rules, while the reduction in risk is less than 5%. We therefore recommend a simple rule of thumb to mitigate this effect: an allocation of just 5% to fallen angels should sufficiently compensate for the losses from ratings-based selling rules.[8]

FIG 9. GLOBAL CREDIT EXCESS RETURNS: FALLEN ANGELS, INVESTMENT GRADE AND HIGH YIELD, 2004–2023



	IG	IG + 5% FA
Average excess return	0.93%	1.19%
Excess return volatility	4.55%	4.78%
Sharpe ratio (ex. Ret)	0.20%	0.25%

Source: Bloomberg, LOIM at March 2023.

[8] Past performance is not a reliable guarantee of future results.

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