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Fixed Income Group Research

Navigating the crossover bond market beyond the pandemic

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- Historically, crossover bonds—corporate bonds rated between low BBB and high BB that sit at the intersection of the investment-grade and high-yield markets—tend to offer attractive risk-adjusted returns. They can include high-yield bonds on the path to being upgraded to investment grade (known as rising stars) and their opposite, investment-grade bonds that are at risk of being downgraded to high yield (fallen angels).
- Every economic downturn is different, and while the Covid-19 pandemic initially triggered downgrades at an unprecedented pace, much of the impact was, not surprisingly, centred on sectors affected by travel restrictions and social distancing. The liquidity infusion from the swift action by governments and central banks globally and the ability of corporations to raise capital via the bond market limited the financial impact from business closures.
- Crossover spreads have recovered to historically tight levels on the back of improving corporate earnings and balance-sheet repair made possible by business reopenings in many developed nations and rising Covid-19 vaccination rates. Some relative-value opportunities still exist in the crossover universe, though, supporting an investment approach like ours that uses deep fundamental analysis and nimble active management.

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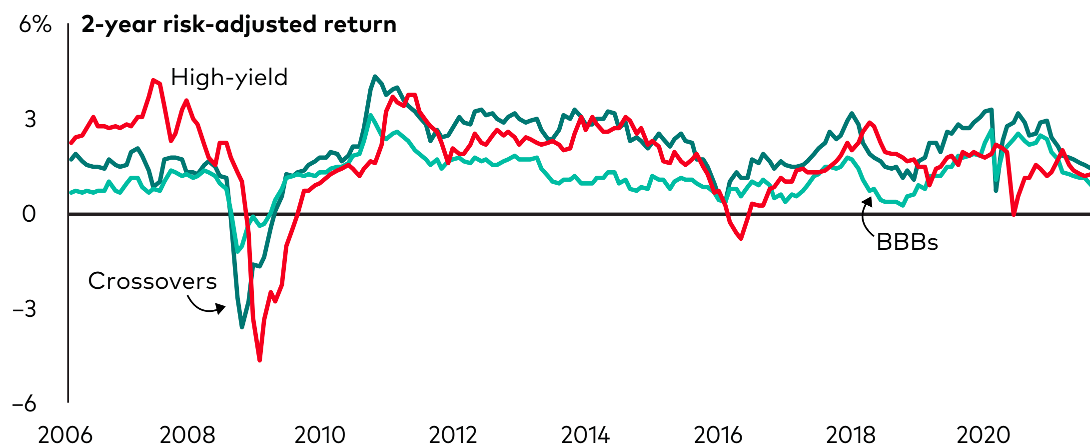
The investment case for crossovers

Crossover bonds are often seen as an attractive risk bucket on the credit-rating continuum. They tend to have lower credit risk than the broad high-yield market while providing more yield than higher-rated investment-grade bonds. As **Figure 1** shows, over the long term they have produced attractive risk-adjusted returns—a measure of the return earned for the amount of risk taken. From April 2006 to August 2021, the average annualised risk-adjusted return for crossovers was 2.2%, compared with 2.0% for high yield and 1.2% for BBBs, based on data from Bloomberg.

Figure 1. Over time, crossovers tend to generate higher risk-adjusted returns than BBBs or high yield



Notes: Data are 2-year averages from April 2006 to August 2021. Indexes used as proxies: High-yield: Bloomberg US Corporate High Yield Bond Index; Crossover: Bloomberg US Corporate Crossover Index; BBB: Bloomberg US Aggregate: Baa. Returns in USD. All three index returns are gross (price, coupon, currency, other) excluding costs.

Sources: Vanguard calculations, based on data from Bloomberg.

Past performance is not a reliable indicator of future results.

During times of economic stress, fallen angels are more prevalent. They typically underperform the debt of companies that get downgraded but remain within the investment-grade universe, in part because the buyer bases for investment-grade and high-yield bonds differ.

And when the economy is in a recovery phase, ratings upgrades tend to be more numerous, leading to a higher proportion of BB bonds migrating to investment grade. These rising stars typically see their spreads tighten and prices rise more than would be the case for an upgrade within the high-yield universe, in part because of their different buyer bases.

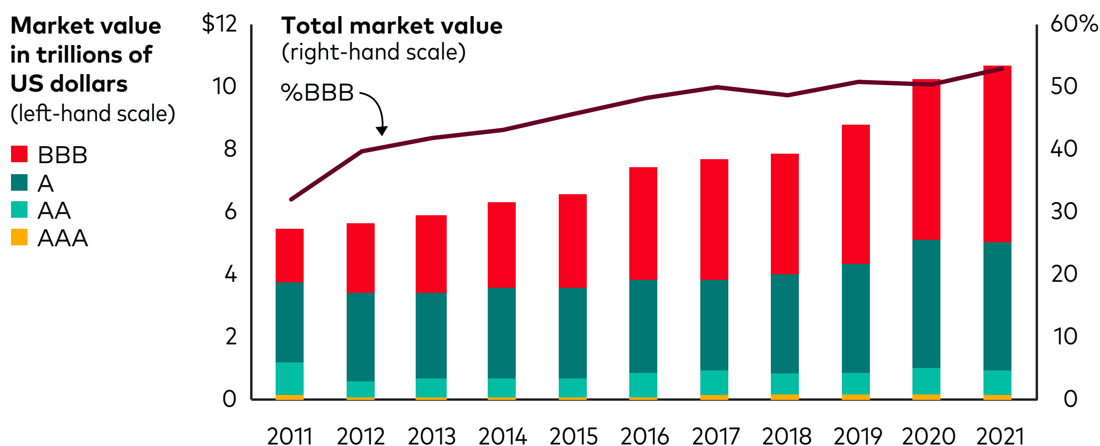
The price dislocations that occur with bonds crossing the dividing line between investment grade and high yield present opportunities for active bond managers. Vanguard has a large, seasoned team of corporate credit analysts who work collaboratively across geographic regions to assess issuers' credit profiles and, more importantly for our clients in this segment, where they may be headed.

Economic downturns: Each time is different

The recession we are just coming out of created a more challenging environment in some ways for crossovers than previous downturns did. It arrived after a decades-long run-up in the size of the corporate debt market. **Figure 2** shows that growth was particularly strong in BBB debt in the decade after the global financial crisis, in part because of low interest rates and companies taking on debt.

Investors were cautious regarding the growth in outstanding BBB debt pre-Covid-19. Given the stage of the credit cycle at the time, there were fears that an economic slowdown would trigger a wave of downgrades to high yield that the junk bond market might not be able to absorb easily amid forced selling by institutions and index funds with investment-grade-only mandates.

Figure 2. Outstanding BBB debt has grown even faster than investment-grade debt overall



Note: Data cover outstanding debt from 31 August 2011 to 8 September 2021 and show the total outstanding debt for investment-grade US corporate bonds and pan-European corporate bonds.

Sources: Vanguard calculations, based on data from Bloomberg. Bloomberg US Corporate Bond Index and Bloomberg Pan-European Aggregate Index used as proxies for market.

Those fears proved overblown. The onset of the pandemic initially produced fallen angels at an unprecedented pace. During the first seven months of 2020, the S&P Global Ratings credit-rating agency downgraded 40 issuers of a collective $340 billion in debt to junk status globally, including big companies such as oil company Occidental Petroleum, food group Kraft Heinz, cruise operator Carnival, Delta Air Lines and carmakers Renault and Ford. However, the major dislocation anticipated by the markets pre-pandemic didn't materialise.

This recession was also unusual in being largely caused by efforts to rein in a health crisis, not by more typical culprits such as an overheating economy, a bursting asset bubble or an unexpected external shock. Sectors that are more sensitive to travel restrictions and other social-distancing measures—such as transportation, leisure, hospitality and retail—were hit much harder than in other downturns and produced a larger proportion of fallen angels.

In other ways, however, the latest recession has played out better than might have been expected. Unlike during the global financial crisis, many governments and central banks provided swift and unprecedented support to help lessen the pandemic's blow by injecting liquidity into some of the most affected sectors. In the United States, for example, Congress

provided three rounds of grants and loans totalling nearly $80 billion to airlines; regulators showed flexibility in airport slot usage and lease payments on toll roads; and the US Federal Reserve made investment-grade bonds eligible for its asset-purchase programme and set up several corporate credit facilities to provide a financing backstop that helped stabilise the market and support a swift recovery in bond spreads.

Credit-rating agencies responded positively to these developments and to a surprisingly fast recovery in corporate earnings overall. We have seen multiple positive rating actions this year from rating agencies. The fallen angel steel company ArcelorMittal, for example, recently completed a round trip back to investment grade in a little over a year.

In this environment, Vanguard's team of corporate credit analysts was able to add significant value with crossovers. They held on to some fallen angels that were fundamentally solid, which limited the potential loss from fire sales and resulted in outsized returns when those companies began to recover. They also provided liquidity to some corporations that were expected to recover over time—including airlines, cruise lines and hotels—by purchasing new debt issued during the pandemic at very attractive levels.

Where crossover opportunities stand now

Historically, the ideal time to invest in fallen angels has been immediately after a downgrade to high-yield. That's because often most of the bad news has been priced in by the time of the downgrade. Since another wave of downgrades is unlikely at this point in the credit cycle, active managers still have the opportunity to try to add value by identifying potential rising stars well ahead of their being upgraded to investment-grade.

By sector, prospects too have shifted. For industries and companies that were facing long-term decline before the pandemic, business conditions could deteriorate further. For example, non-essential bricks-and-mortar retailers are likely to face more difficulties as online shopping has accelerated in popularity during the pandemic. As a result, some fallen angels in those industries may remain in high-yield territory.

On the other hand, although some hard-hit industries such as airlines, hospitality and leisure may see some structural damage to long-term demand for business travel, new demand spurred by global economic growth could offset this. Fallen angels in these industries should recover over time to pre-Covid-19 levels, enabling them to migrate back to investment grade.

And industries that are well-positioned to benefit from new trends emerging in the post-Covid-19 world—including digitisation, remote working and supply-chain reconfiguration—may also see benefits to profitability and thus potentially more rising stars.

The opportunity set within the crossover universe has narrowed as the global economy recovers from the recession, and the spreads of risk assets have meaningfully tightened over the past 12 months.

Our investment team still has a number of avenues at their disposal, though, to add value: by avoiding fallen angels, as they can experience severe price declines; by taking advantage of market inefficiencies, whereby investing in these fallen angels has proven to provide attractive risk-adjusted returns; and by identifying rising stars, to take advantage of their potential for price appreciation in the event of an upgrade to investment grade.

Written in collaboration with Min Fang, Vanguard credit analyst, and Bradley Marr, Vanguard senior high-yield credit analyst.

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Data as at 31 December 2020.

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