Credit Notes: Fallen angels: Lower, but not low

Lotfi Karoui
+1(917)343-1548 | lotfi.karoui@gs.com
Goldman Sachs & Co. LLC

Amanda Lynam, CPA
+1(212)902-9238 |
amanda.lynam@gs.com
Goldman Sachs & Co. LLC

Spencer Rogers, CFA
+1(801)884-1104 |
spencer.rogers@gs.com
Goldman Sachs & Co. LLC

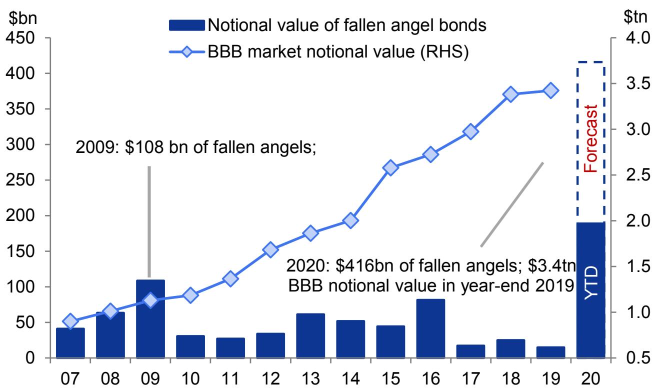
Michael Puempel, Ph.D.
+1(212)357-8483 |
michael.puempel@gs.com
Goldman Sachs & Co. LLC

James Weldon
+1(212)357-6538 |
james.weldon@gs.com
Goldman Sachs & Co. LLC

In late March, after nearly $151 billion worth of USD-denominated IG-rated bonds migrated into HY, we forecasted an additional $550 billion of fallen angel downgrades over the next few quarters. We also forecasted €180 billion of fallen angel downgrades in the EUR market, which we expected would add to the €37 billion that already materialized in 1Q. These forecasts reflected the severity of the economic downturn combined with pre-existing vulnerabilities among USD issuers after years of active balance sheet re-leveraging.

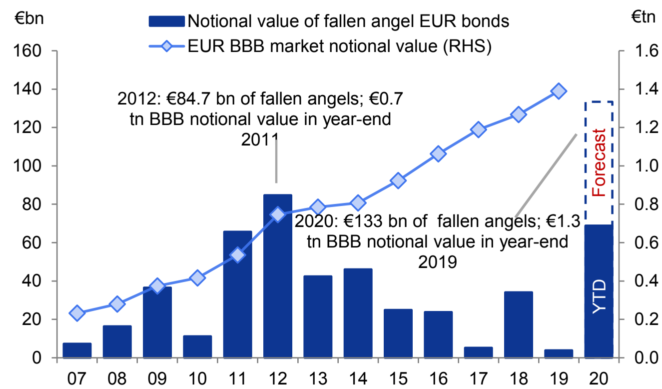
Three months later, fallen angel activity has surprised us in a positive sense, with the amount of additional bonds that have transitioned from IG to HY totaling just shy of $38 billion in the USD market and €32 billion in the EUR market. We are lowering our 2H fallen angel forecasts to $227 billion and €64 billion in the USD and EUR markets, respectively. For full-year 2020, these forecasts imply total amounts of fallen bonds of $416 billion and €133 billion in the USD and EUR market, respectively (Exhibits 1 and 2, and more below for our methodology).

Exhibit 1: We are lowering our USD fallen angel forecast and now expect $227 billion of downgrades in 2H2020



Source: Bloomberg, Goldman Sachs Global Investment Research

Exhibit 2: In the EUR market, we make a similar revision (lower) and now expect €64 billion of downgrades in 2H2020

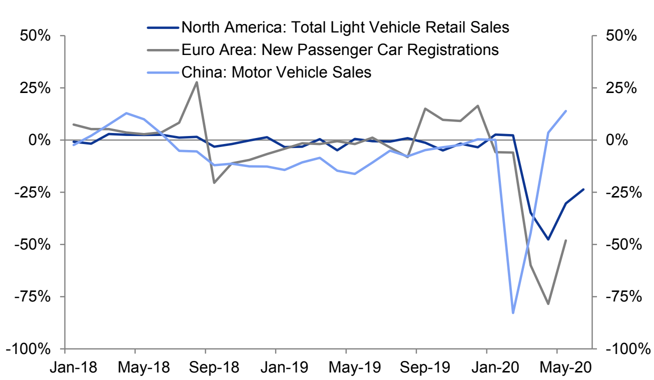


Source: Bloomberg, Goldman Sachs Global Investment Research

Beyond a post-1Q earnings season "mark to market," these revisions reflect two key ingredients.

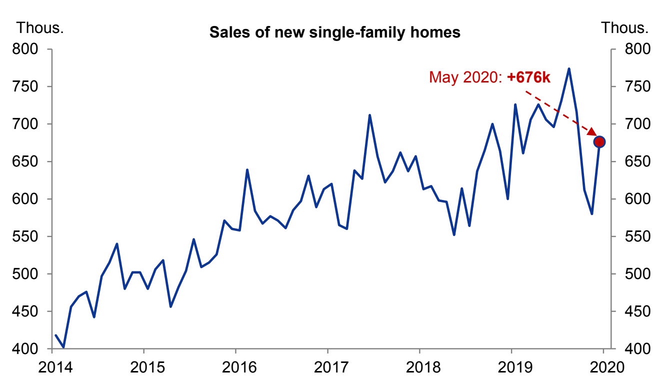
- First, the economic recovery has been more front-loaded than initially expected, as the deepest recession since World War 2 remains on track to be the shortest. As discussed by our economists, global GDP has now recouped roughly half of the 17% drop seen from mid-January to mid-April, with solid gains all across the board. And while the recent surge in new infections in the US has prompted our economists to downgrade their third quarter GDP forecast to 25% from 33%, they continue to expect the US economy to keep growing on a sequential basis.
- Second, the recovery has been stronger in many sectors that appeared quite vulnerable only a few months ago. This has been particularly visible in Autos, Housing, and Energy (Exhibits 3-5). The Auto recovery in particular has been evident across some of the largest geographical markets such as China, the US, and the Euro Area (again, Exhibit 3). And the oil market rebalancing that began in late April has pushed both WTI and Brent higher, as shown in Exhibit 5.

Exhibit 3: Auto demand has bounced off the lows across regions
Year-over-year change in monthly sales from Jan 2018 for North America, the Euro Area, and China



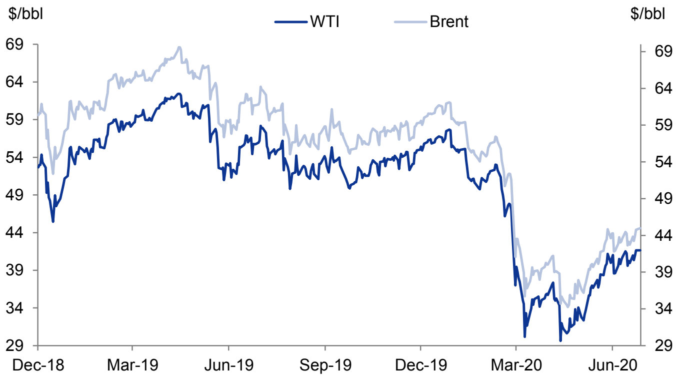
Source: Autodata, ECB, China Association of Automobile Manufacturers, Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 4: Housing demand has also shown signs of recovering



Source: US Census Bureau, Goldman Sachs Global Investment Research

Exhibit 5: The oil market rebalancing has also supported the prices of WTI and Brent
12-month contracts



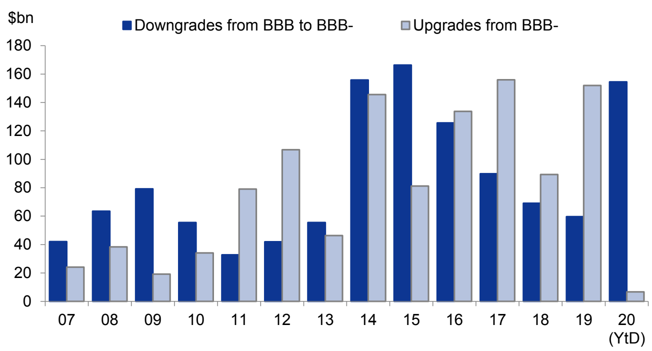
Source: New York Mercantile Exchange, ICE Futures Europe Commodities, Goldman Sachs Global Investment Research

So why not push our forecasts even lower? After all, our estimates still imply a 2020 par value-weighted transition rate from the BBB bucket into HY of 12% and 9% in the USD and EUR markets, respectively. These figures are comparable to the previous peak of 11% for the USD market in 2009 and 16% at the height of the European debt crisis in 2011 for the EUR market (again, Exhibits 1 and 2). We see two main reasons for a still cautious stance on fallen angel activity.

- First, we continue to expect additional ratings pressure in sectors heavily exposed to social distancing restrictions and discretionary spending such as Retail (department stores and apparel), Restaurants, Lodging, Travel/Leisure, and Media/Entertainment. And while the commodity market rebalancing mentioned above will likely be good enough to allow higher-quality Energy and Metals & Mining firms to maintain their investment grade ratings (at least in the near term), issuers that are already at the cusp of HY may still transition as additional fallen angels. Additionally, many of the firms in the most vulnerable sectors proactively issued debt in the past few months – helping to drive the record-shattering year-to-date volumes in the USD IG primary market – to build liquidity reserves and reduce near-term refinancing risk. In some cases, the debt was issued to supplement lost business or mitigate a cash burn. To the extent the recovery of demand in these sectors underwhelms, this may translate into a reduced ability to repay the incremental debt added to these IG balance sheets – potentially resulting in ratings pressure. In other words, the magnitude of debt issued over the last three months increases the likelihood of idiosyncratic downgrades related to execution risk and capital management actions, in our view.

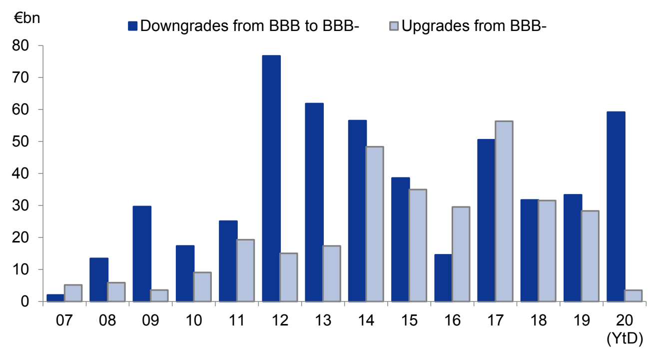
- Second, the signaling from the rating agencies also remains sufficiently cautious to support an expectation for continued downward ratings pressure. Exhibit 6 illustrates this by showing the notional amount of debt downgraded from mid-BBB (BBB/Baa2) to low-BBB (BBB-/Baa3) by at least one rating agency year-to-date; this far outweighs the amount of debt that experienced positive ratings momentum. Notably, of the $154 billion downgraded so far this year, $111 billion (72%) of it occurred in 2Q2020. A similar pattern can be seen in the EUR market, as shown in Exhibit 7. Nearly €60 billion of debt has been affected by a downgrade from BBB to BBB-, while just over €3 billion has been upgraded. Similarly, the total amount of BBB/BBB- debt with a Negative Outlook by at least one rating agency also remains elevated in both markets. At $939 billion in the USD market, this is by far the highest on record (Exhibit 8). And while not quite as outsized in the EUR market relative to previous years, it is elevated enough to mark a new post-crisis record (Exhibit 9).

Exhibit 6: The signaling from the rating agencies remains negative in the USD market, as highlighted by the strong skew towards downgrades (vs. upgrades) within the BBB bucket year-to-date
Outstanding notional amount of USD-denominated bonds downgraded from BBB to the BBB- notch vs. amount of bonds upgraded from BBB-



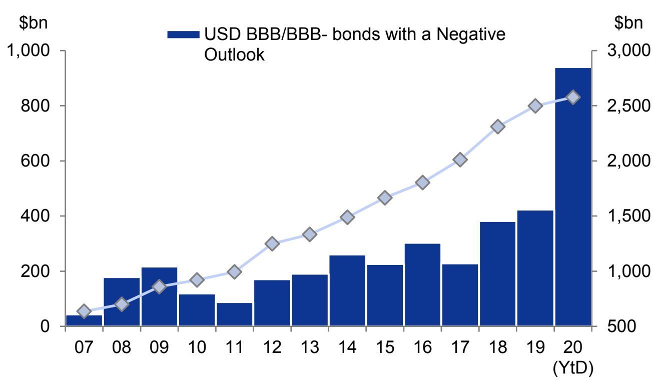
Source: Bloomberg, Goldman Sachs Global Investment Research

Exhibit 7: A similar pattern is evident in the EUR market
Outstanding notional amount of EUR-denominated bonds downgraded from BBB to the BBB- notch vs. amount of bonds upgraded from BBB-



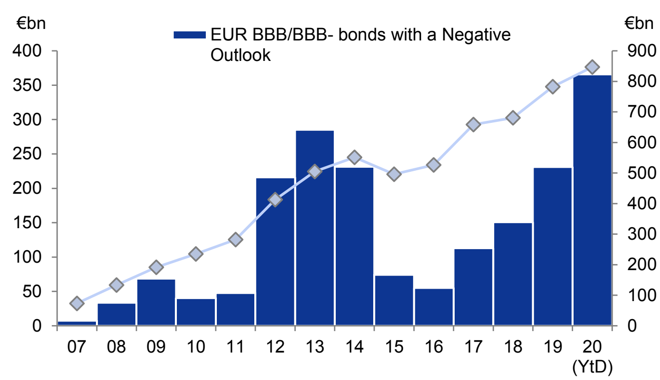
Source: Bloomberg, Goldman Sachs Global Investment Research

Exhibit 8: Rating agency signaling also appears negative when focusing on the amount of mid- and low-BBB debt with a Negative Outlook
Notional amount of BBB/BBB- USD-denominated bonds with a Negative Outlook by at least one rating agency



Source: Bloomberg, Goldman Sachs Global Investment Research

Exhibit 9: Again, a similar pattern is present in the EUR market
Notional amount of BBB/BBB- EUR-denominated bonds with a Negative Outlook by at least one rating agency



Source: Bloomberg, Goldman Sachs Global Investment Research

How we crunched the numbers

We continue to view fallen angel downgrade risk on a scale, influenced predominately by (1) current ratings and Outlooks/Watches (i.e., the "rating cushion") and (2) sector vulnerabilities to the twin oil-virus shock (the fundamental risks, which in many cases are independent of recent financial performance). We follow the same logic we used to produce our previous forecasts. We bucket the universe of bonds rated BBB and BBB- into four subcategories based on the industry type (distressed vs. non-distressed) and Downgrade Watch/Negative Outlook (Yes or No). Using the above decomposition, we assign a subjective probability of downgrade into HY, for each subcategory. These probabilities range from 95%, for bonds in distressed sectors, on Downgrade Watch/Negative Outlook and rated BBB-, to 5% for those in non-distressed sectors, on negative Outlook but not on Downgrade Watch and rated BBB.

But relative to our previous framework, we excluded some sectors, such as Autos, where we think the likelihood of downgrade has substantially declined. We also narrowed the overall universe of fallen angel candidates to firms rated BBB/Baa2 or BBB-/Baa3, and already on Negative Outlook/Watch (Exhibits 10 and 11).

Exhibit 10: How we derived our $230 billion fallen angel forecast in the USD market

Current rating	Distressed Sector?	Downgrade Watch or Negative Outlook?	Notional Outstanding ($bn)	Fallen Angel Likelihood	2H estimate of Fallen Angel amount ($bn)
BBB-	☑	Downgrade Watch	28.3*	95%	26.9
BBB-	☐	Downgrade Watch	48.9	80%	39.1
BBB-	☑	Negative Outlook	144.3	50%	72.2
BBB-	☐	Negative Outlook	167.3	20%	33.5
BBB	☑	Downgrade Watch	5.0	60%	3.0
BBB	☐	Downgrade Watch	29.2	50%	14.6
BBB	☑	Negative Outlook	163.7	10%	16.4
BBB	☐	Negative Outlook	429.8	5%	21.5
Total			**1,016.6**		**227.1**

Note: *Excludes Autos manufacturers.

Source: Bloomberg, Goldman Sachs Global Investment Research

Exhibit 11: How we derived our €64 billion fallen angel forecast in the EUR market

Current rating	Distressed Sector?	Downgrade Watch or Negative Outlook?	Notional Outstanding ($bn)	Fallen Angel Likelihood	2H estimate of Fallen Angel amount (€bn)
BBB-	☑	Downgrade Watch	11.9*	95%	11.3
BBB-	☐	Downgrade Watch	6.8	80%	5.5
BBB-	☑	Negative Outlook	21.7	50%	10.9
BBB-	☐	Negative Outlook	71.7	20%	14.3
BBB	☑	Downgrade Watch	5.8	60%	3.5
BBB	☐	Downgrade Watch	12.8	50%	6.4
BBB	☑	Negative Outlook	49.2	10%	4.9
BBB	☐	Negative Outlook	154.2	5%	7.7
Total			**334.2**		**64.5**

Note: *Excludes Autos manufacturers.

Source: Bloomberg, Goldman Sachs Global Investment Research

Disclosure Appendix

Reg AC

We, Lotfi Karoui, Amanda Lynam, CPA, Spencer Rogers, CFA, Michael Puempel, Ph.D. and James Weldon, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

Unless otherwise stated, the individuals listed on the cover page of this report are analysts in Goldman Sachs' Global Investment Research division.

Disclosures

Regulatory disclosures

Disclosures required by United States laws and regulations

See company-specific regulatory disclosures above for any of the following disclosures required as to companies referred to in this report: manager or co-manager in a pending transaction; 1% or other ownership; compensation for certain services; types of client relationships; managed/co-managed public offerings in prior periods; directorships; for equity securities, market making and/or specialist role. Goldman Sachs trades or may trade as a principal in debt securities (or in related derivatives) of issuers discussed in this report.

The following are additional required disclosures: **Ownership and material conflicts of interest:** Goldman Sachs policy prohibits its analysts, professionals reporting to analysts and members of their households from owning securities of any company in the analyst's area of coverage. **Analyst compensation:** Analysts are paid in part based on the profitability of Goldman Sachs, which includes investment banking revenues. **Analyst as officer or director:** Goldman Sachs policy generally prohibits its analysts, persons reporting to analysts or members of their households from serving as an officer, director or advisor of any company in the analyst's area of coverage. **Non-U.S. Analysts:** Non-U.S. analysts may not be associated persons of Goldman Sachs & Co. LLC and therefore may not be subject to FINRA Rule 2241 or FINRA Rule 2242 restrictions on communications with subject company, public appearances and trading securities held by the analysts.

Additional disclosures required under the laws and regulations of jurisdictions other than the United States

The following disclosures are those required by the jurisdiction indicated, except to the extent already made above pursuant to United States laws and regulations. **Australia:** Goldman Sachs Australia Pty Ltd and its affiliates are not authorised deposit-taking institutions (as that term is defined in the Banking Act 1959 (Cth)) in Australia and do not provide banking services, nor carry on a banking business, in Australia. This research, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act, unless otherwise agreed by Goldman Sachs. In producing research reports, members of the Global Investment Research Division of Goldman Sachs Australia may attend site visits and other meetings hosted by the companies and other entities which are the subject of its research reports. In some instances the costs of such site visits or meetings may be met in part or in whole by the issuers concerned if Goldman Sachs Australia considers it is appropriate and reasonable in the specific circumstances relating to the site visit or meeting. To the extent that the contents of this document contains any financial product advice, it is general advice only and has been prepared by Goldman Sachs without taking into account a client's objectives, financial situation or needs. A client should, before acting on any such advice, consider the appropriateness of the advice having regard to the client's own objectives, financial situation and needs. A copy of certain Goldman Sachs Australia and New Zealand disclosure of interests and a copy of Goldman Sachs' Australian Sell-Side Research Independence Policy Statement are available at: https://www.goldmansachs.com/disclosures/australia-new-zealand/index.html. **Brazil:** Disclosure information in relation to CVM Instruction 598 is available at https://www.gs.com/worldwide/brazil/area/gir/index.html. Where applicable, the Brazil-registered analyst primarily responsible for the content of this research report, as defined in Article 20 of CVM Instruction 598, is the first author named at the beginning of this report, unless indicated otherwise at the end of the text. **Canada:** Goldman Sachs Canada Inc. is an affiliate of The Goldman Sachs Group Inc. and therefore is included in the company specific disclosures relating to Goldman Sachs (as defined above). Goldman Sachs Canada Inc. has approved of, and agreed to take responsibility for, this research report in Canada if and to the extent that Goldman Sachs Canada Inc. disseminates this research report to its clients. **Hong Kong:** Further information on the securities of covered companies referred to in this research may be obtained on request from Goldman Sachs (Asia) L.L.C. **India:** Further information on the subject company or companies referred to in this research may be obtained from Goldman Sachs (India) Securities Private Limited, Research Analyst - SEBI Registration Number INH000001493, 951-A, Rational House, Appasaheb Marathe Marg, Prabhadevi, Mumbai 400 025, India, Corporate Identity Number U74140MH2006FTC160634, Phone +91 22 6616 9000, Fax +91 22 6616 9001. Goldman Sachs may beneficially own 1% or more of the securities (as such term is defined in clause 2 (h) the Indian Securities Contracts (Regulation) Act, 1956) of the subject company or companies referred to in this research report. **Japan:** See below. **Korea:** This research, and any access to it, is intended only for "professional investors" within the meaning of the Financial Services and Capital Markets Act, unless otherwise agreed by Goldman Sachs. Further information on the subject company or companies referred to in this research may be obtained from Goldman Sachs (Asia) L.L.C., Seoul Branch. **New Zealand:** Goldman Sachs New Zealand Limited and its affiliates are neither "registered banks" nor "deposit takers" (as defined in the Reserve Bank of New Zealand Act 1989) in New Zealand. This research, and any access to it, is intended for "wholesale clients" (as defined in the Financial Advisers Act 2008) unless otherwise agreed by Goldman Sachs. A copy of certain Goldman Sachs Australia and New Zealand disclosure of interests is available at: https://www.goldmansachs.com/disclosures/australia-new-zealand/index.html. **Russia:** Research reports distributed in the Russian Federation are not advertising as defined in the Russian legislation, but are information and analysis not having product promotion as their main purpose and do not provide appraisal within the meaning of the Russian legislation on appraisal activity. Research reports do not constitute a personalized investment recommendation as defined in Russian laws and regulations, are not addressed to a specific client, and are prepared without analyzing the financial circumstances, investment profiles or risk profiles of clients. Goldman Sachs assumes no responsibility for any investment decisions that may be taken by a client or any other person based on this research report. **Singapore:** Further information on the covered companies referred to in this research may be obtained from Goldman Sachs (Singapore) Pte. (Company Number: 198602165W). **Taiwan:** This material is for reference only and must not be reprinted without permission. Investors should carefully consider their own investment risk. Investment results are the responsibility of the individual investor. **United Kingdom:** Persons who would be categorized as retail clients in the United Kingdom, as such term is defined in the rules of the Financial Conduct Authority, should read this research in conjunction with prior Goldman Sachs research on the covered companies referred to herein and should refer to the risk warnings that have been sent to them by Goldman Sachs International. A copy of these risks warnings, and a glossary of certain financial terms used in this report, are available from Goldman Sachs International on request.

European Union: Disclosure information in relation to Article 6 (2) of the European Commission Delegated Regulation (EU) (2016/958) supplementing Regulation (EU) No 596/2014 of the European Parliament and of the Council with regard to regulatory technical standards for the technical arrangements for objective presentation of investment recommendations or other information recommending or suggesting an investment strategy and for disclosure of particular interests or indications of conflicts of interest is available at https://www.gs.com/disclosures/europeanpolicy.html which states the European Policy for Managing Conflicts of Interest in Connection with Investment Research.

Japan: Goldman Sachs Japan Co., Ltd. is a Financial Instrument Dealer registered with the Kanto Financial Bureau under registration number Kinsho 69, and a member of Japan Securities Dealers Association, Financial Futures Association of Japan and Type II Financial Instruments Firms Association.

Sales and purchase of equities are subject to commission pre-determined with clients plus consumption tax. See company-specific disclosures as to any applicable disclosures required by Japanese stock exchanges, the Japanese Securities Dealers Association or the Japanese Securities Finance Company.

Global product; distributing entities

The Global Investment Research Division of Goldman Sachs produces and distributes research products for clients of Goldman Sachs on a global basis. Analysts based in Goldman Sachs offices around the world produce research on industries and companies, and research on macroeconomics, currencies, commodities and portfolio strategy. This research is disseminated in Australia by Goldman Sachs Australia Pty Ltd (ABN 21 006 797 897); in Brazil by Goldman Sachs do Brasil Corretora de Títulos e Valores Mobiliários S.A.; Ombudsman Goldman Sachs Brazil: 0800 727 5764 and / or ouvidoriagoldmansachs@gs.com. Available Weekdays (except holidays), from 9am to 6pm. Ouvidoria Goldman Sachs Brasil: 0800 727 5764 e/ou ouvidoriagoldmansachs@gs.com. Horário de funcionamento: segunda-feira à sexta-feira (exceto feriados), das 9h às 18h; in Canada by either Goldman Sachs Canada Inc. or Goldman Sachs & Co. LLC; in Hong Kong by Goldman Sachs (Asia) L.L.C.; in India by Goldman Sachs (India) Securities Private Ltd.; in Japan by Goldman Sachs Japan Co., Ltd.; in the Republic of Korea by Goldman Sachs (Asia) L.L.C., Seoul Branch; in New Zealand by Goldman Sachs New Zealand Limited; in Russia by OOO Goldman Sachs; in Singapore by Goldman Sachs (Singapore) Pte. (Company Number: 198602165W); and in the United States of America by Goldman Sachs & Co. LLC. Goldman Sachs International has approved this research in connection with its distribution in the United Kingdom and European Union.

European Union: Goldman Sachs International authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority, has approved this research in connection with its distribution in the European Union and United Kingdom.

General disclosures

This research is for our clients only. Other than disclosures relating to Goldman Sachs, this research is based on current public information that we consider reliable, but we do not represent it is accurate or complete, and it should not be relied on as such. The information, opinions, estimates and forecasts contained herein are as of the date hereof and are subject to change without prior notification. We seek to update our research as appropriate, but various regulations may prevent us from doing so. Other than certain industry reports published on a periodic basis, the large majority of reports are published at irregular intervals as appropriate in the analyst's judgment.

Goldman Sachs conducts a global full-service, integrated investment banking, investment management, and brokerage business. We have investment banking and other business relationships with a substantial percentage of the companies covered by our Global Investment Research Division. Goldman Sachs & Co. LLC, the United States broker dealer, is a member of SIPC (https://www.sipc.org).

Our salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to our clients and principal trading desks that reflect opinions that are contrary to the opinions expressed in this research. Our asset management area, principal trading desks and investing businesses may make investment decisions that are inconsistent with the recommendations or views expressed in this research.

We and our affiliates, officers, directors, and employees, will from time to time have long or short positions in, act as principal in, and buy or sell, the securities or derivatives, if any, referred to in this research, unless otherwise prohibited by regulation or Goldman Sachs policy.

The views attributed to third party presenters at Goldman Sachs arranged conferences, including individuals from other parts of Goldman Sachs, do not necessarily reflect those of Global Investment Research and are not an official view of Goldman Sachs.

Any third party referenced herein, including any salespeople, traders and other professionals or members of their household, may have positions in the products mentioned that are inconsistent with the views expressed by analysts named in this report.

This research is focused on investment themes across markets, industries and sectors. It does not attempt to distinguish between the prospects or performance of, or provide analysis of, individual companies within any industry or sector we describe.

Any trading recommendation in this research relating to an equity or credit security or securities within an industry or sector is reflective of the investment theme being discussed and is not a recommendation of any such security in isolation.

This research is not an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Clients should consider whether any advice or recommendation in this research is suitable for their particular circumstances and, if appropriate, seek professional advice, including tax advice. The price and value of investments referred to in this research and the income from them may fluctuate. Past performance is not a guide to future performance, future returns are not guaranteed, and a loss of original capital may occur. Fluctuations in exchange rates could have adverse effects on the value or price of, or income derived from, certain investments.

Certain transactions, including those involving futures, options, and other derivatives, give rise to substantial risk and are not suitable for all investors. Investors should review current options and futures disclosure documents which are available from Goldman Sachs sales representatives or at https://www.theocc.com/about/publications/character-risks.jsp and https://www.fiadocumentation.org/fia/regulatory-disclosures_1/fia-uniform-futures-and-options-on-futures-risk-disclosures-booklet-pdf-version-2018. Transaction costs may be significant in option strategies calling for multiple purchase and sales of options such as spreads. Supporting documentation will be supplied upon request.

Differing Levels of Service provided by Global Investment Research: The level and types of services provided to you by the Global Investment Research division of GS may vary as compared to that provided to internal and other external clients of GS, depending on various factors including your individual preferences as to the frequency and manner of receiving communication, your risk profile and investment focus and perspective (e.g., marketwide, sector specific, long term, short term), the size and scope of your overall client relationship with GS, and legal and regulatory constraints. As an example, certain clients may request to receive notifications when research on specific securities is published, and certain clients may request that specific data underlying analysts' fundamental analysis available on our internal client websites be delivered to them electronically through data feeds or otherwise. No change to an analyst's fundamental research views (e.g., ratings, price targets, or material changes to earnings estimates for equity securities), will be communicated to any client prior to inclusion of such information in a research report broadly disseminated through electronic publication to our internal client websites or through other means, as necessary, to all clients who are entitled to receive such reports.

All research reports are disseminated and available to all clients simultaneously through electronic publication to our internal client websites. Not all research content is redistributed to our clients or available to third-party aggregators, nor is Goldman Sachs responsible for the redistribution of our research by third party aggregators. For research, models or other data related to one or more securities, markets or asset classes (including related services) that may be available to you, please contact your GS representative or go to https://research.gs.com.

Disclosure information is also available at https://www.gs.com/research/hedge.html or from Research Compliance, 200 West Street, New York, NY 10282.