

The BBB overhang: opportunity or threat?

The Investment team at Insight Investment, a BNY Mellon company

Investors looking to plot a course through fixed income in 2019 could do well to keep a sharp eye on the question of the triple-B overhang. It's called an overhang for a reason.

Over the last 10 years, the amount of debt rated at this level has grown significantly, climbing from around 25% of the Bank of America Merrill Lynch Global Corporate Index¹ in 2008 to just under 50% today. More recently, the growth of outstanding BBB debt has largely been a result of increased M&A-related activity and, in the U.S., stock buybacks.

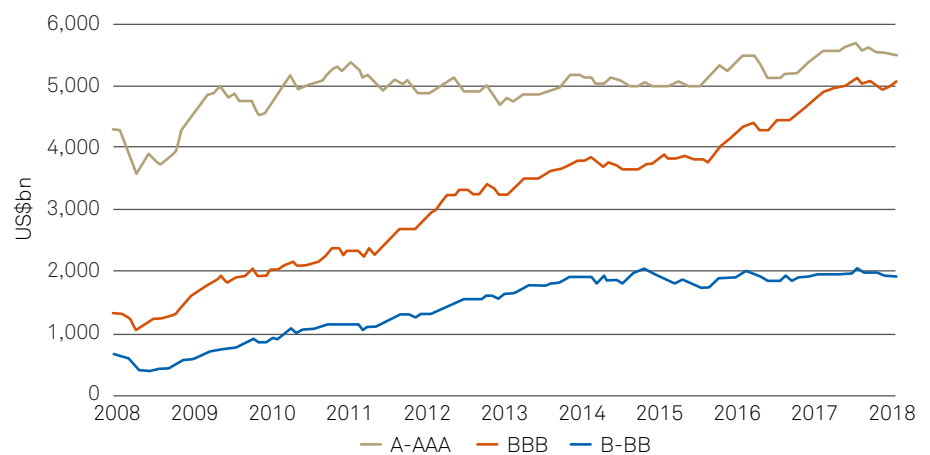
The growth in BBB issuance has been compounded by what we refer to as the 'rising star' phenomenon, that is, high yield issuers being upgraded to investment grade. As a result, the amount of outstanding BBB debt has grown significantly relative to outstanding B and BB debt.

The larger the pool of BBB issues on the threshold of investment grade, the larger the potential volume of downgrades during future credit events.

Our view is that when bonds are downgraded to high yield it can represent an opportunity, as bond prices tend to fall

before a downgrade, then recover some of those losses after the downgrade has occurred. But careful analysis is needed. The dangers of a passive approach to high yield is that issues that are downgraded are bought regardless of their long-term outlook.

GLOBAL ISSUANCE BY RATING CATEGORY

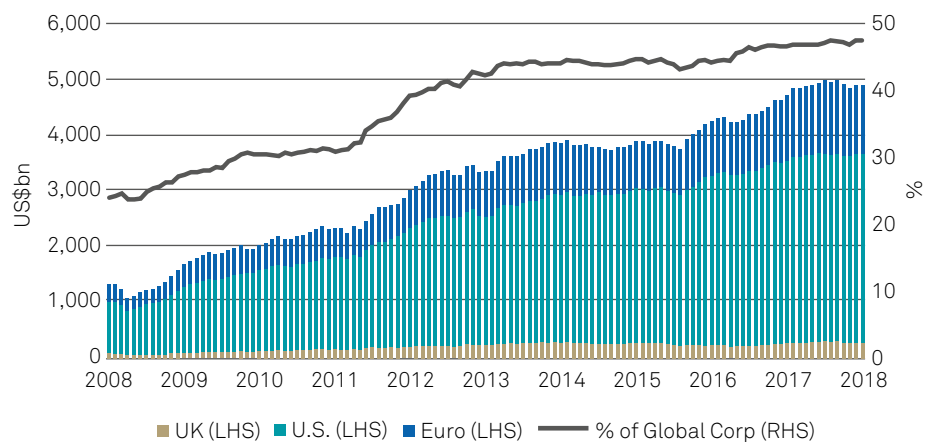


Source: Bank of America Merrill Lynch. Data as at July 31, 2018.

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While this recent trend is fine in theory, in practice it means that the potential overhang of debt which could be downgraded to high yield is significant.

BBB BONDS OUTSTANDING IN MAJOR MARKETS, 10-YEAR HISTORY



Source: Bank of America Merrill Lynch. Data as at July 31, 2018.

¹ The ICE BofAML Global Corporate Index tracks the performance of investment grade corporate debt publicly issued in the major domestic and eurobond markets.

All investments involve risk including loss of principal.

Charts are provided for illustrative purposes and are not indicative of the past or future performance of any Dreyfus product.

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