# The Cost Of A Notch

## Fallen Angels Remain Costly Despite Tightening Spreads

S&P Global Ratings

**Aug. 19, 2024**

*This report does not constitute a rating action*

*(Editor's Note: See Appendix for details about how we calculate credit spreads for this report.)*

### Key Takeaways

- The absolute cost of falling to speculative grade (to 'BB+' from 'BBB-') has shrunk considerably to 34 basis points (bps) as of July 31, 2024, from 54 bps the year prior.
- However, the percentage cost of falling to, or close to, speculative-grade remains very high from a historical standpoint. Among all rating levels, the percentage differential in spreads peaks a step above the downgrade to speculative-grade.
- The absolute differential in credit spreads currently peaks between 'CCC+' and 'B-'. At this time last year, it occurred between 'B-'and 'B'. This may suggest a greater focus on likely defaults.
- Spreads on debt from issuers with negative rating outlooks are wider than those on debt from similarly rated issuers with stable or positive rating outlooks. This could reflect the value of our rating outlooks as reliable indicators of relative downgrade potential.


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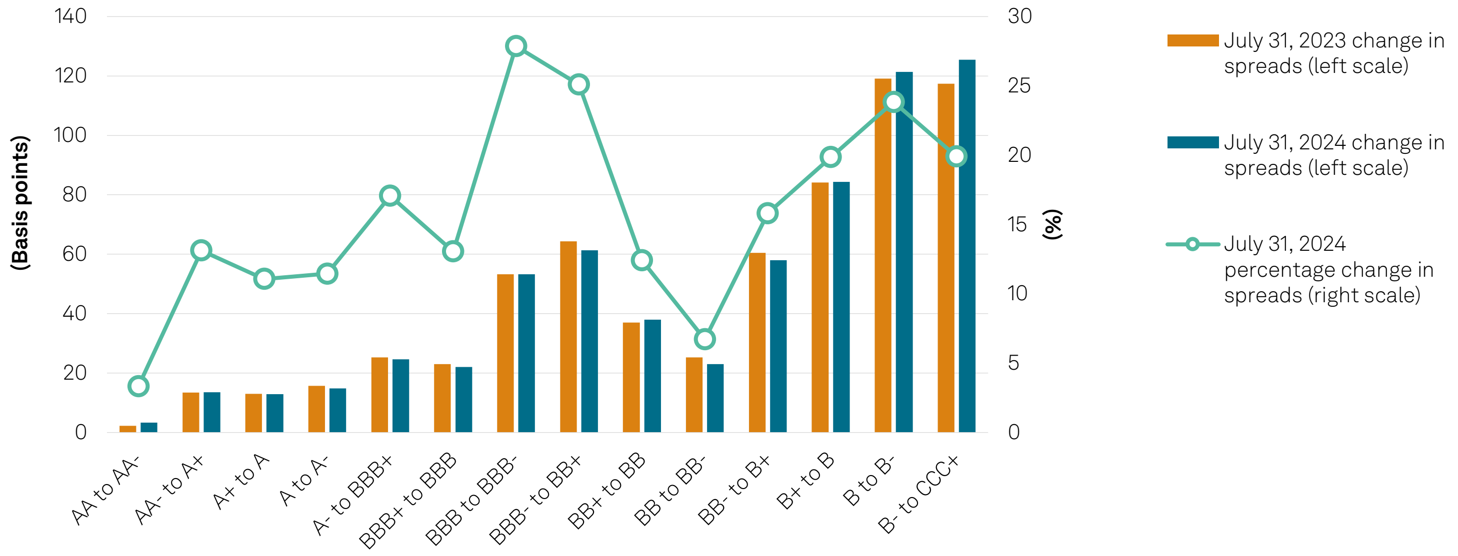
S&P Global Ratings' credit ratings correlate negatively with the cost of debt, meaning cost usually rises as ratings decline. Our credit ratings on corporate issuers are useful benchmarks in determining the margins over risk-free Treasuries that they pay to access the capital markets.

Chart 1

### The long-term cost of falling to speculative-grade remains high




Data as of July 31, 2024. Averages for each index were calculated daily between May 23, 2013, and July 31, 2024.
Source: S&P Global Ratings Credit Research & Insights.

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Despite the narrowing in absolute credit spreads in the first half of 2024, since 2013 the cost of falling to, or close to, speculative-grade ('BB+' or lower) has been very high. The percentage differential in spreads across all rating levels peaks between 'BBB-' and 'BBB', at 28%.

This is a notch above the actual tipping point into speculative-grade, where the percentage differential also remains elevated at 25% (see chart 1). While absolute spreads have narrowed, the data suggests investors remain highly cautious about fallen angel risk and seek to adjust credit risk pricing accordingly. (Fallen angels are issuers downgraded to speculative-grade from investment-grade.)

The absolute differential in credit spreads peaks at another natural pressure point: the downgrade into the 'CCC' rating category (to 'CCC+' from 'B-'). In contrast, this time last year the fall to 'B-'from 'B' had the largest gap.

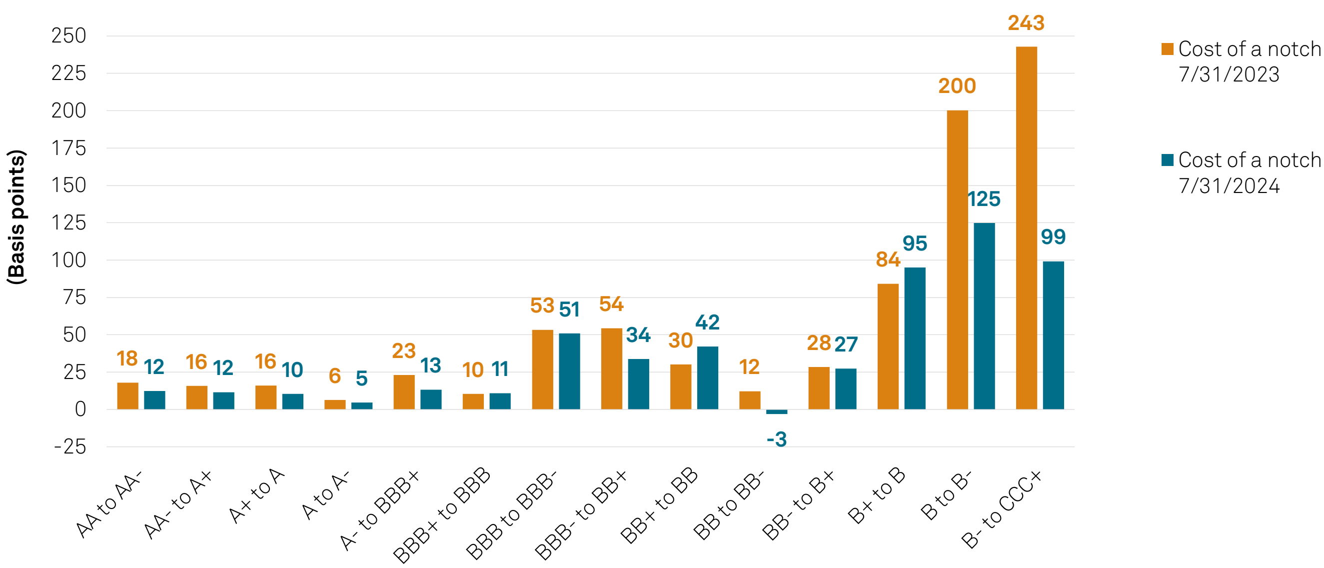
Investors have always paid great attention to  likely defaults at the 'B-' category, because weakest links--issuers rated 'B-' or below with negative outlooks--are typically 8x more likely to default than the overall speculative-grade population. However, this perceived risk may be elevated as the population of issuers rated 'B-' has increased in recent years.

While supply and demand could be affecting the low end of the credit spectrum, the change in the peak absolute differential may also reflect--given this year's more supportive macroeconomic conditions--investors' confidence that some issuers rated in the lower 'B' category may recover, while issuers downgraded to the 'CCC' category face a greater possibility of default.

## The Absolute Cost Of Becoming A Fallen Angel Has Dropped Year-Over-Year

Chart 2

The cost of falling to speculative-grade fell markedly in the last 12 months




Data as of July 31, 2024. Source: S&P Global Ratings Credit Research & Insights.

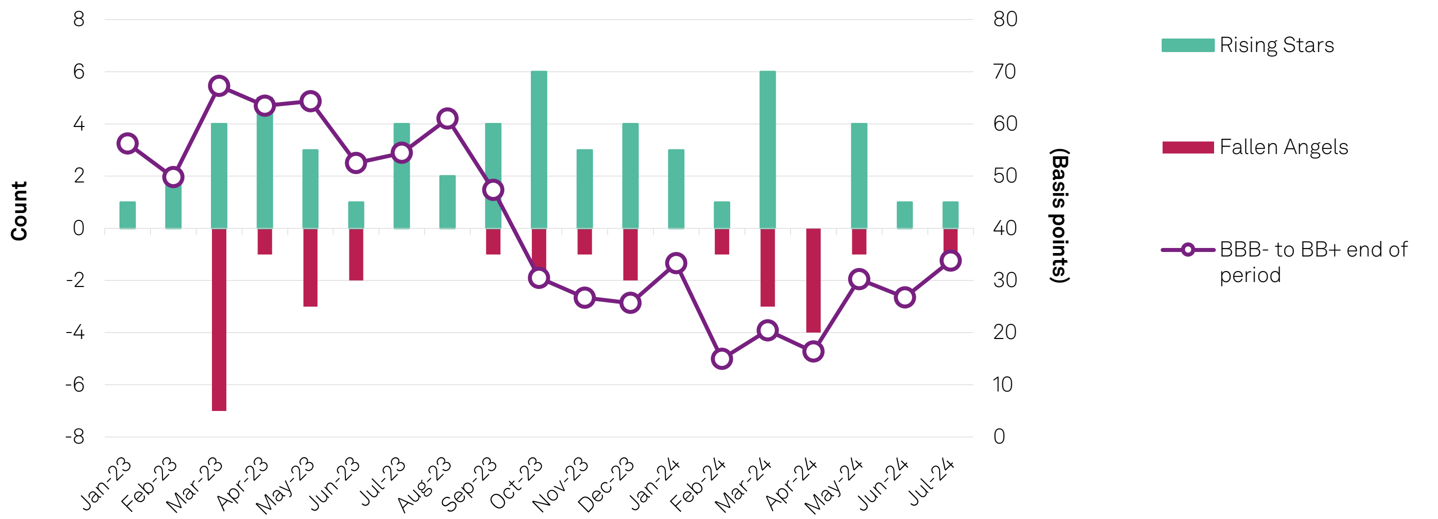
The cost of a notch has narrowed markedly over the last year across nearly all rating transitions (see chart 2). Despite higher interest rates and simmering geopolitical risk, the cost of falling to speculative-grade declined by about 20 bps, or 38% year over year. Over the last 12 months, 'BB+' rather than 'BBB-' spread tightening has been the key driver narrowing the gap in this rating transition.

In addition, the relative dearth of fallen angels compared to rising stars--issuers upgraded to investment-grade from speculative-grade--since the beginning of 2023 may play a role (see chart 3). At a high level, a lack of fallen angels would likely lower the cost of falling to 'BB+' from 'BBB-', whereas an increase in fallen angels would probably increase this cost.

Another explanation could be the lack of speculative-grade bond supply through late 2023, which has only recently picked up in the first half of 2024.

Chart 3

### Rising stars have far exceeded fallen angels since the beginning of 2023




Data as of July 31, 2024. Source: S&P Global Ratings Credit Research & Insights.

Chart 4

### The cost of becoming a fallen angel during different periods of stress

| | Global financial crisis | COVID-19 | Current |
|---|---|---|---|
| Gap between ‘BBB-’ and ‘BB+’ spreads | 246 bps | 284 bps | 34 bps |
| | Dec. 4, 2008 | March 27, 2020 | July 31, 2024 |

Source: S&P Global Ratings.

The cost of becoming a fallen angel peaked on March 27, 2020, at the height of the COVID-19 pandemic (see chart 4). The cost (as in the spread differential between 'BBB-'and 'BB+') as of July 31, 2024, is 34 bps, which is 88% below its March 2020 peak and 86% below the prior peak in December 2008, during the global financial crisis.

The narrower current spread differential likely reflects the more constructive macroeconomic outlook and strong continued demand for credit, which have resulted in strong absolute spread tightening over the last 12 months.

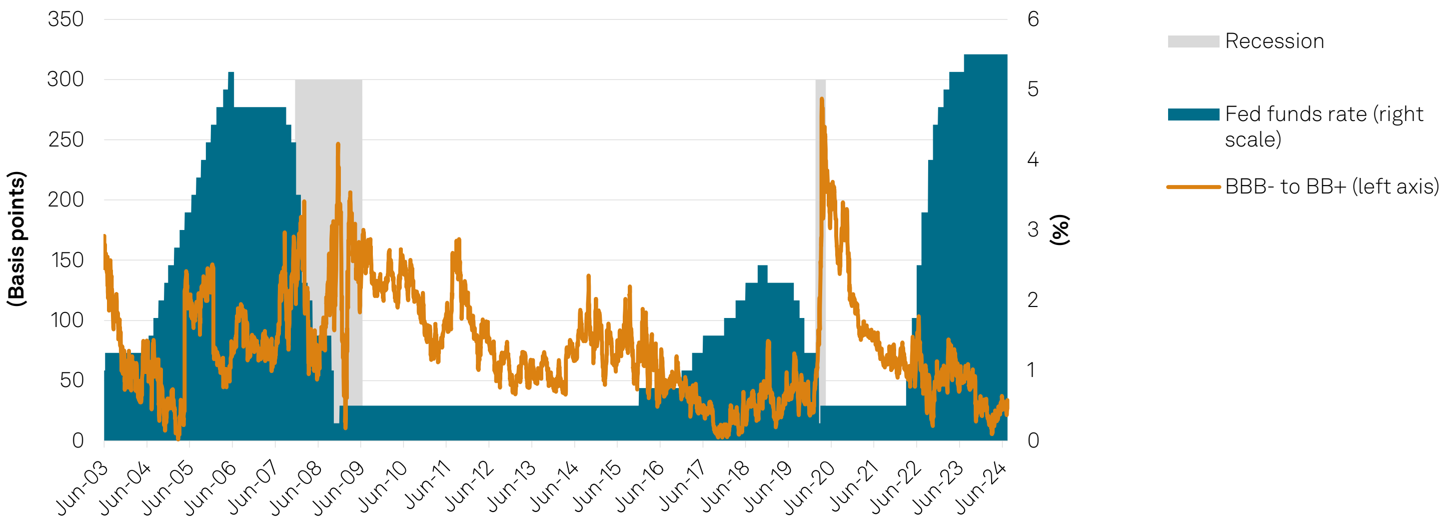
However, a narrower differential also suggests that markets are pricing in less of a fallen angel risk premium than they were previously. This may be overly optimistic, despite the drop in fallen angels, given historical data suggests a clear delineation and premium between the bottom of investment-grade ('BBB-' or higher) and the top of speculative-grade.

## Economic Stress Steers Credit Spread Volatility

There's no clear correlation between a higher federal funds rate and the cost of becoming a fallen angel (see chart 5). However, the cost of becoming a fallen angel can be exceptionally volatile during recessions. With the possibility of a U.S. recession rising (25%-30% in S&P Global Ratings economists' most recent estimate), admittedly from a very low base, this cost may become more volatile.

Chart 5

### Despite higher-for-longer rates, the absolute cost of becoming a fallen angel remains relatively low

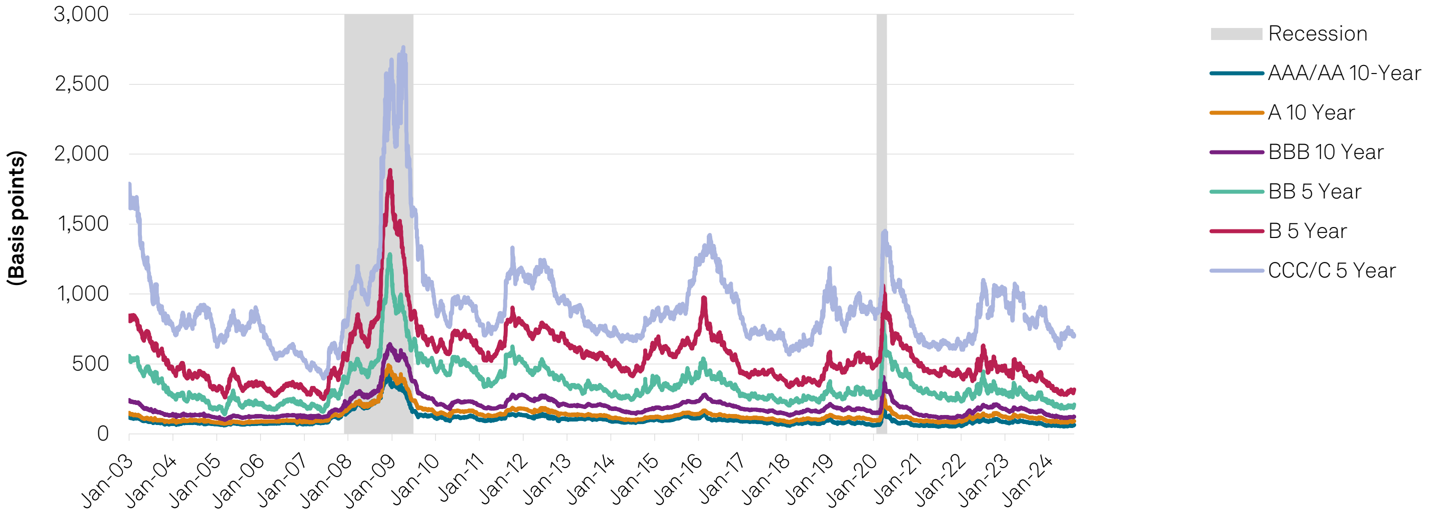



Data as of July 31, 2024. Sources: Federal Open Market Committee (FOMC) and S&P Global Ratings Credit Research & Insights.

With S&P Global Ratings economists forecasting 150 bps of rate cuts over the next 12 months, the question is whether this will lead to fewer fallen angels. However, we have found that downgrade ratios still tend to rise when benchmark yields are falling, likely because of sector-specific factors (see "Credit Trends: 'BBB' Pulse: 'BBB's Tough Out Interest Rate Cycles," March 14, 2024). Moreover, downcycles typically (but not always) coincide with slowing economic growth. Yet, for issuers rated 'BBB', the negative correlations are still far lower than those for speculative-grade.

Chart 6

Corporate bond spreads at all rating categories display similar trends




Data as of July 31, 2024. Source: S&P Global Ratings Credit Research & Insights.

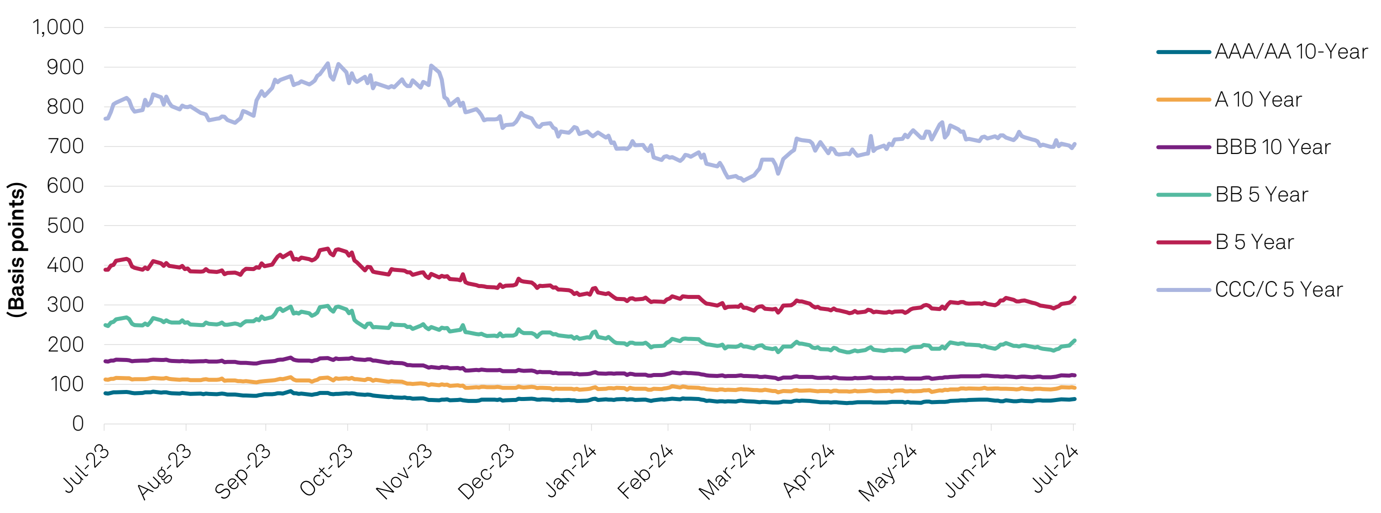
Unsurprisingly, 'AAA'/'AA', 'A', and 'BBB' spreads have historically traded at materially lower levels than speculative-grade spreads.

That said, credit spreads at all rating categories generally exhibit similar volatility trends during periods of stress or market events, with the absolute levels reflecting relative credit risk rankings (see chart 6).

Despite ongoing geopolitical and economic risks, mixed corporate results, and U.S. and European speculative-grade trailing 12-month default rates of 4.4% and 4.8%, respectively, as of July 31, 2024, spreads at the lower end of the rating spectrum remain well below recent peaks.

Chart 7

'BB' and below corporate bond spreads exhibited higher volatility than other rating categories in the last 12 months




Data as of July 31, 2024. Source: S&P Global Ratings Credit Research & Insights.

## Rating Outlooks Reliably Indicate Downgrade Potential

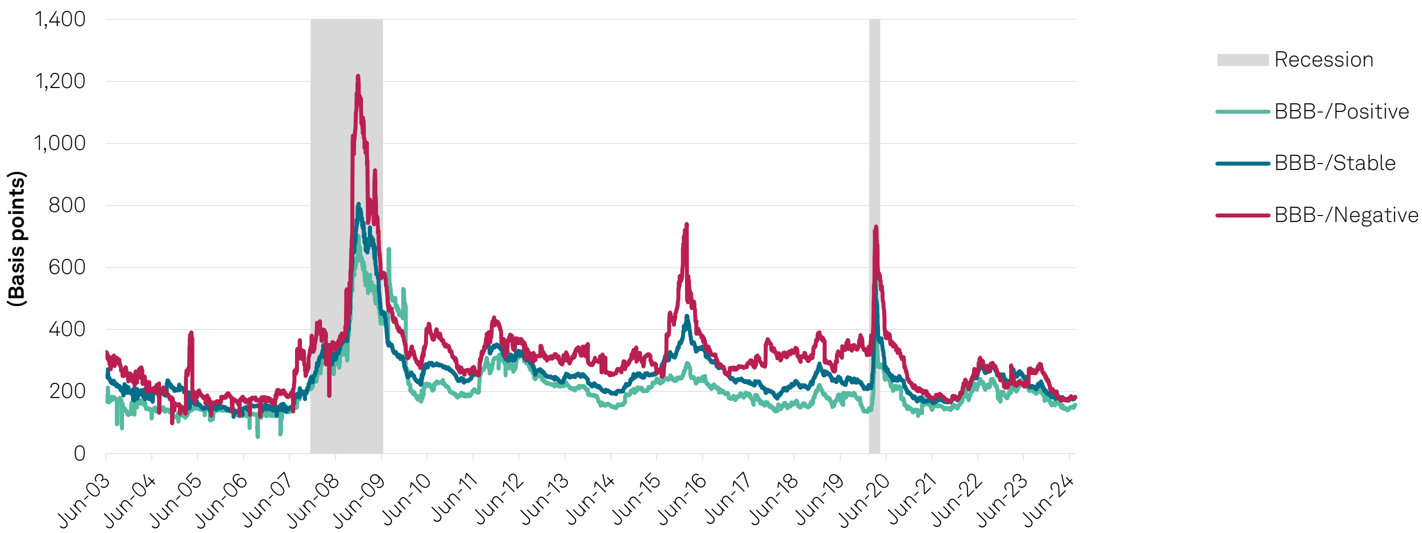
We have found that our corporate rating outlooks are reliable indicators of downgrade potential at the lower bound of investment-grade. For example, bonds from issuers rated 'BBB-' with a negative outlook historically have a spread around 41 bps over bonds from similarly rated issuers with a stable outlook and around 101 bps over bonds from similarly rated issuers with a positive outlook (see chart 9).

While idiosyncratic sector or regional factors also drive pricing, a 'BBB-' bond spread could differ by nearly 150 bps across different rating outlooks. Furthermore, historical data indicates these gaps between spreads are more pronounced during recessions.

Over the last 12 months, the historical spread differential between bonds rated 'BBB-' with stable and negative outlooks has narrowed as spreads have tightened. In fact, as of July 31, 2024, the spread for bonds rated 'BBB-'with a stable outlook is 2 bps higher than for a negative outlook.

Chart 8

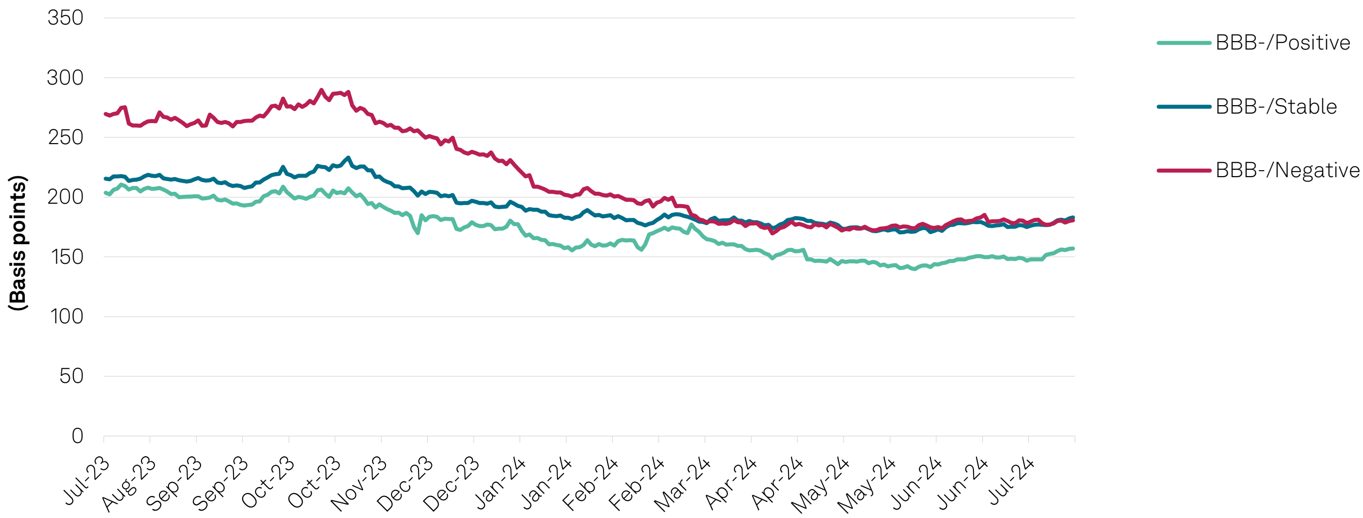
### Historical spreads for issuers rated 'BBB-' with positive, negative, and stable outlooks




Data as of July 31, 2024. Source: S&P Global Ratings Credit Research & Insights.

Chart 9

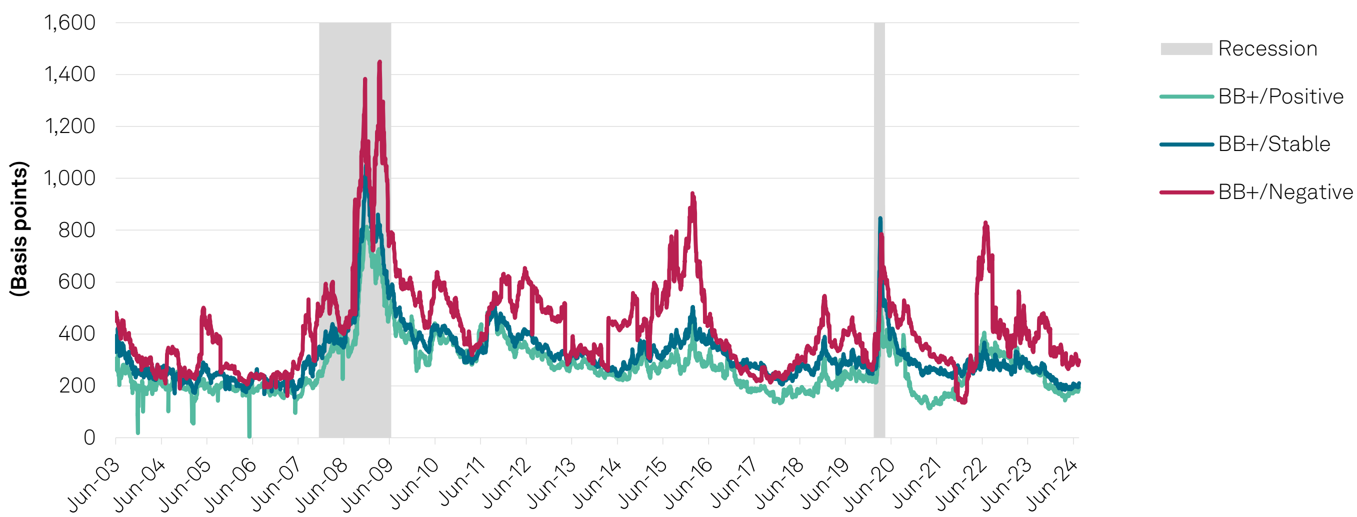
'BBB-' rated bonds: The gap between stable and negative outlooks has disappeared over the last year




Data as of July 31, 2024. Source: S&P Global Ratings Credit Research & Insights.

Chart 10

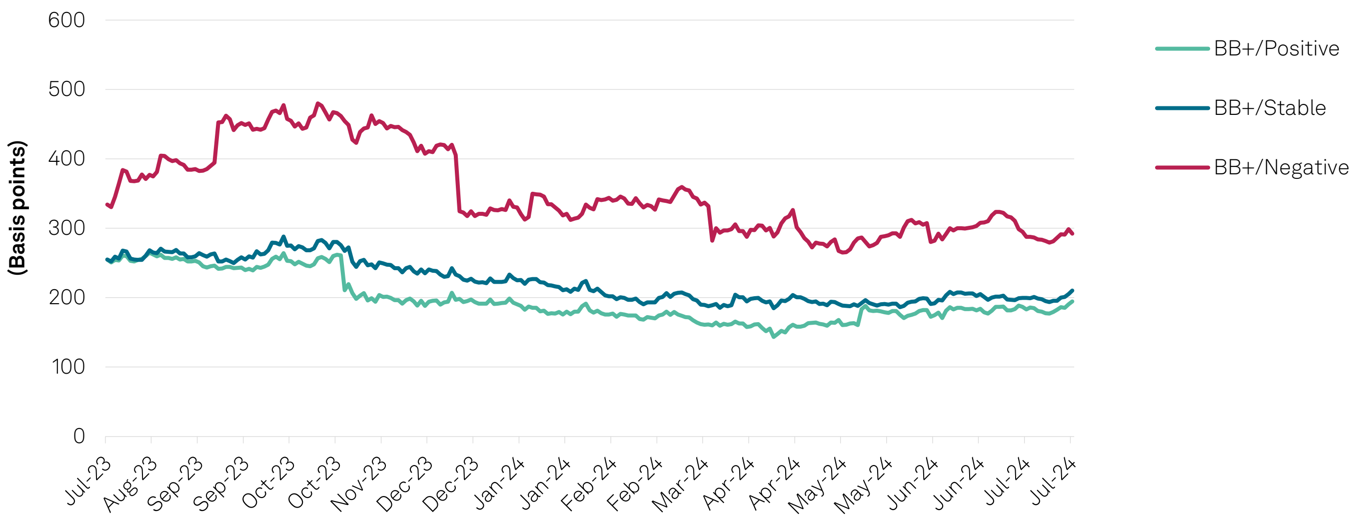
Downgrade potential carries a premium for speculative-grade




Data as of July 31, 2024. Source: S&P Global Ratings Credit Research & Insights.

Chart 11

Negative outlooks carry a higher risk premium than positive and stable outlooks for bonds rated 'BB+'




Data as of July 31, 2024. Source: S&P Global Ratings Credit Research & Insights.

Historically, bonds from issuers rated 'BB+' with a negative outlook carry, on average, an additional 104 bps over bonds from similarly rated issuers with a stable outlook and an additional 153 bps over bonds from similarly rated issuers with a positive outlook (see chart 11).

But, in the last 12 months, there has been little to no spread differential for bonds rated 'BB+' with a positive or stable outlook, potentially reflecting the strong demand for credit and an improving credit outlook. Negative outlooks continue to carry a risk premium.

# Appendix

This analysis is based on data as of July 31, 2024, so current conclusions may differ. In addition, this analysis focuses exclusively on pricing and rating data, and it does not account for regional or sectoral credit environments. The credit spreads in this report were calculated using the yields on U.S.-issued fixed-rate bonds with at least one year to maturity and a face value of at least $100 million.

# Related Research

- Credit Trends: 'BBB' Pulse: 'BBB's Tough Out Interest Rate Cycles, March 14, 2024
- The Cost Of A Notch: Markets Brace For Impact Ahead Of Time, June 27, 2023
- The Cost Of A Notch: During COVID-19, The Cost Of Falling To Speculative-Grade Reached A New High, April 14, 2021
- The Cost Of A Notch, March 26, 2019