November Downgrades: The Tally Continues

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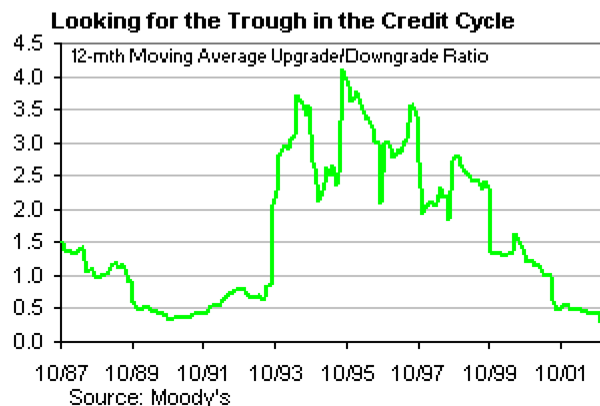
? November agency downgrade data reveals that the erosion of credit quality continues unabated.
? On several measures year-to-date totals are already worse than full-year 2001.
? Financial sector downgrades are on the rise.
? The recent improvement in the aggregate CRE of the largest debt issuers may be an early sign of a turn in the credit cycle.

The summary of the most recent monthly data confirms that from a ratings perspective the deterioration in credit quality continues unabated. **According to Moody's, November saw a further 60 downgrades affecting $98 billion worth of debt, which shows no weakening from 2002's average monthly pace. Year-to-date 584 companies and over $1 trillion of debt have now been downgraded.** While this is still less than the number of downgrades that took place in full-year 2001 (645) it already exceeds the dollar total of debt affected as 2001's total was $949 billion. The dismal trend in upgrades also continues with just 9 upgrades being awarded in the latest month. There have been only 123 upgrades on $248 billion of debt so far in 2002, well short of 2001's full year total of 220 upgrades affecting $420 billion of debt.

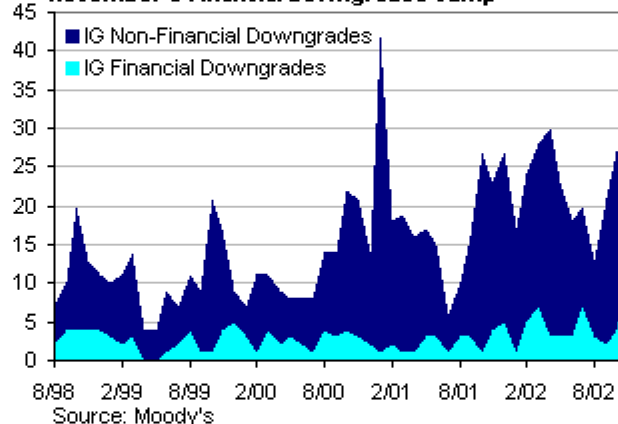


The 27 downgrades of investment grade companies accounted for the bulk of the debt affected ($62.4 billion) and indeed it is the high grade arena where credit quality erosion has been most egregious in 2002. Here we already exceed 2001 totals. So far this year there have been 248 investment grade downgrades affecting $713 billion of debt versus 2001's 236 and $588 billion totals. Unfortunately the high yield arena is faring little better. There were just five speculative grade upgrades during November affecting a mere $0.5 billion of debt, while over $35 billion of high yield debt was downgraded. This saw the fallen angel tally rise as a further six companies lost their investment grade status, bringing the year-to-date tally to 67 versus just eight rising stars in the

same period. The 12-month moving average of the upgrade to downgrade ratio is mired below one, a level that it maintained for close to four years during the early 1990's recession, demonstrating the extensive time lag required for an improvement in economic conditions to actually translate into an improvement in credit quality (in as much as it is expressed in rating actions). And given that we are on track to record the fewest investment grade upgrades since Q487, by this measure at least it seems highly pre-emptive to be looking for a turning point in the credit cycle.

Of note is the recent uptick in investment grade financial sector downgrades. The clean slate that the financial sector has maintained on this score through the last two years has been one of the few bright spots in an otherwise widespread erosion of credit quality. It is a trend that appears to be coming to an end however, with **the sector experiencing 11 downgrades in November compared to an average of just three a month since the beginning of 2001.** While we are not surprised by this rotation of risk from the industrial to the financial sector (and in fact have been quite circumspect on our financial sector allocations given the very tight level of spreads reached in advance of this phenomenon) we are not yet seeing wholesale ratings risk in the banking sector. In fact, according to Moody's eight of the 11 downgrades were actually insurance companies, which have been battling credit quality issues on several fronts for many months now. The last fall in the overall upgrade to downgrade ratios to levels worse than seen in many years however, is highlighting that the financial sector is no longer providing a pipeline of upgrades as the factors which are causing such stress in the industrial and utility sectors are having a second order effect on the full spectrum of financial companies.

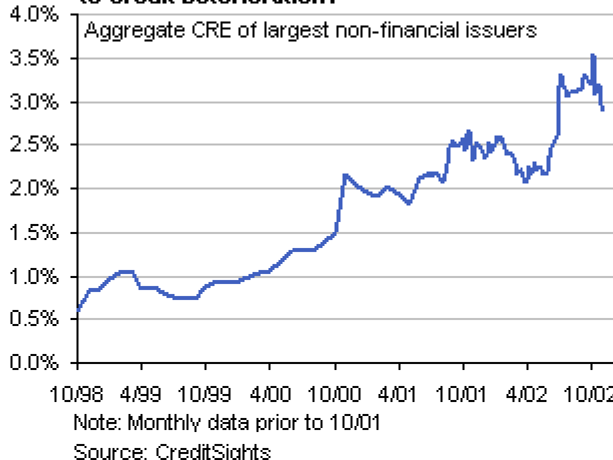
End of a Trend?
November's Financial Downgrades Jump



Source: Moody's

The ratings statistics tell a story of credit deterioration that brooks no argument and the pessimism gains further traction when we look at the prevailing negative signs in early indicators such as ratio of negative to positive outlook changes or rating reviews. That being said, ratings tend to be reactive to, rather than predictive of, weakening company fundamentals. Investors however, can be much more pre-emptive when they smell a change in the economic wind as has been clearly demonstrated in the last two months**. By the time the ratings statistics themselves confirm that the credit quality cycle has in fact bottomed we will likely be many months into a sustained spread rally. The recent rebound in the equity market and significant contraction in credit spreads have begun the process of alleviating the pressure on over-stretched balance sheets and by using our BondScore model and tracking the aggregate Credit Risk Estimate (CRE) for the largest investment grade and high yield debt issuers we can already see the improvement that this has brought about in this measure of the risk being incurred by corporate bond investors.** (The CRE is the probability of default within the next 12 months and we note that BondScore rates only industrial companies and so financial companies are excluded from this estimate, despite their heavy weighting in the debt indices.) The fall in aggregate CRE has only occurred since the beginning of November and so we are some way short of a sustained trend and as yet it is hardly a retracement of the four-year trend that preceded it. However, given the more responsive nature of such a measure of credit strength, we would expect

Do Recent Aggregate CRE Moves Indicate an End to Credit Deterioration?



Note: Monthly data prior to 10/01
Source: CreditSights

readings such as these will indicate an end to the rampant credit deterioration of the last two years well before the same is evidenced in the agency rating statistics. For further information on the BondScore model and interpreting CRE data please **click here**.

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