

CFA Trending Topics

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Ratings relativity & the great migration to BBB

Key takeaways:

- In 2017, 52% of rated issuers in the S&P 500 were BBB, compared to 43% in 2008 and 29% in 1998.
- Of the ~400 companies in the S&P 500 that are currently rated by both S&P and Moody's, 50% have the same rating while 40% have lower Moody's ratings.
 - Of the 40% that are more conservatively rated at Moody's, many are in the healthcare and industrial sectors.
- With more firms than ever rated BBB, a "ratings correction" could have broad market consequences

Firms have been willing to migrate to the BBB ratings category, with the deep and attractive BBB debt market continuing to provide a low cost of capital since the financial crisis of the late aughts. However, the inherent nature of a rating is to capture the long-term credit risk of an issuer, and this ultimately leads to a "stickiness" in the assigned ratings. Further, ratings analysis should reflect relative risk, and hence, in this sense, not all firms can have the same ratings. If all BBBs are not created equal, which direction might a potential "ratings correction" swing, especially given the differing ratings between Moody's and S&P?

Further questions worth evaluating in the context of capital structure decision-making: what happens to the BBB segment of issuers if we encounter a recession? Can the HY market absorb "all" BBB debt if "angels" start "falling" into this category (recall the turmoil of energy sector downgrades after the 2014 collapse of oil prices)? How should different sectors approach the optimal capital structure decision in light of these market and ratings related implications? These factors need to be taken into greater consideration as firms contemplate shifts down the credit ratings spectrum.

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