The Bond Market Subsidy of Prospective Fallen Angels

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HARVARD | BUSINESS | SCHOOL

Paper’s Insight is Two-Fold

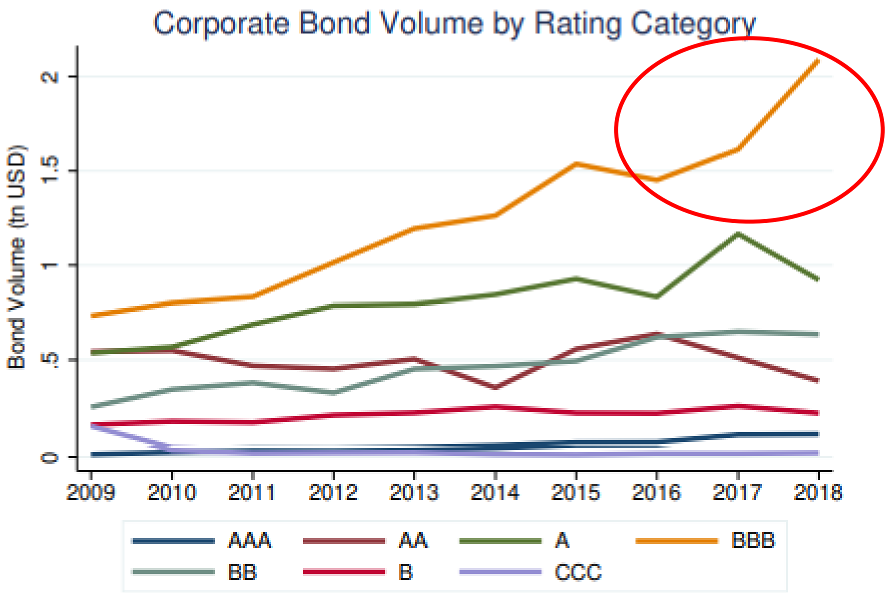
1. QE (Large-Scale Asset Purchases/”LSAP”) pushed the IG capital to riskier end, thus, pushing its cost down
2. As a result, firms took advantage of this shift in such way that created fragility in the economy

Identification Factory

1. QE (Large-Scale Asset Purchases/"LSAP") pushed the IG capital to riskier end, thus, pushing its cost down
2. As a result, firms took advantage of this shift in such way that created fragility in the economy

- Both are new, big & empirically difficult claims
    - Complete narrative, but triple causal statement (see underlined)
- Good news: (2) can still be at play without (1) being the cause

1. Did ”LSAP” push the IG capital to riskier end (BBB)?



- Although it is very plausible, it is hard to conclude that; it could also be a product of low interest rate environment, or a shift in risk preferences during the expansionary phase

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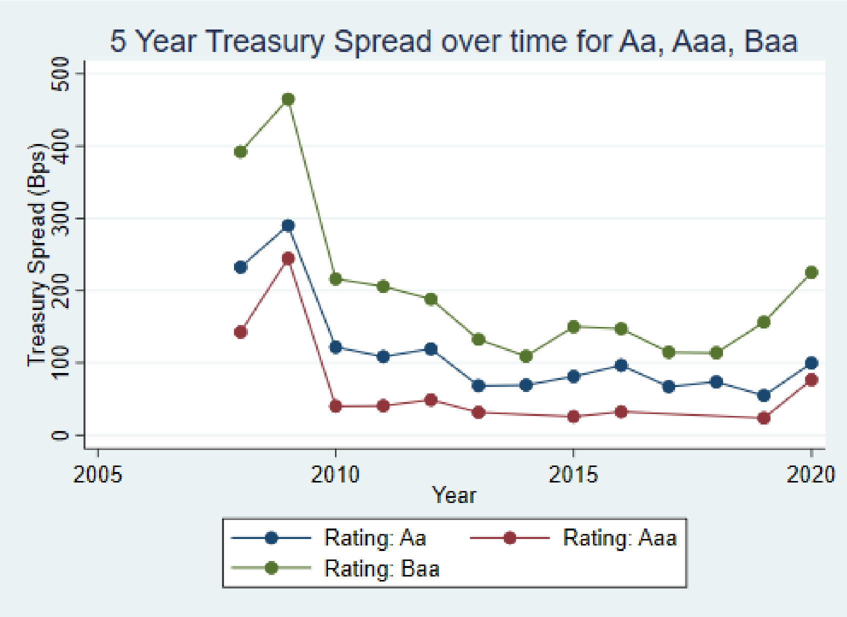
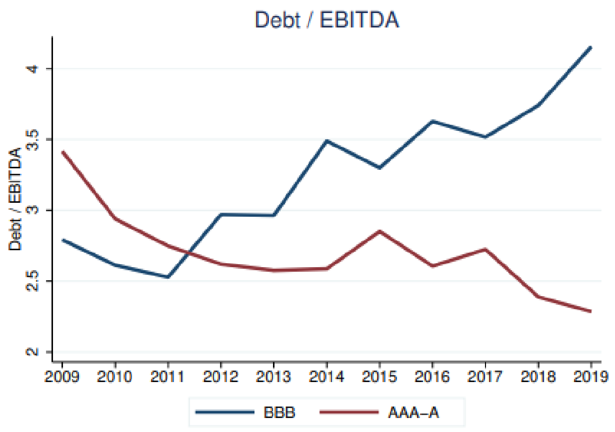


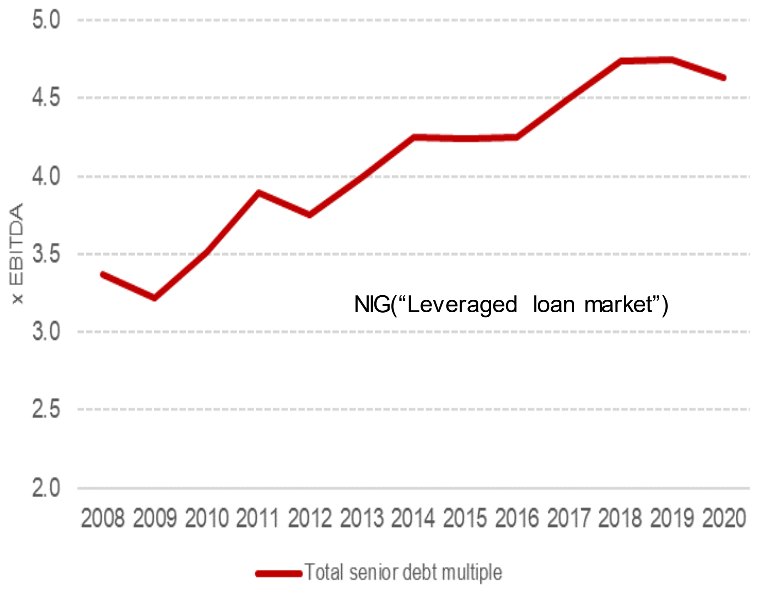
Source: Mergent

- It appears that the effect is primary in quantities

2. Is BBB riskier in 2019 than it was in 2009?

- Yes, and it appears to be a broader post GFC phenomenon for BBB <u>and</u> for NIG
  - I.e., this reinforces that this is more likely to be connected to the low yield environment than to LSAP





Delta: ~ 1.5-2x

Delta: 2x

3. Did it Create Fragility/Risk? And Is It Mispriced?

- Super important, and very difficult questions
    - I have a first hand experience with these questions on the NIG spectrum (e.g., Ivashina and Vallee, 2020)
        - To emphasize: I think these are great questions within a broader debate about potential fragility emanating from reaching for yield environment
    - It is certainly interesting to think about BBB behavior, especially because--in this case--it does not come from weakening in credit standards (bond vs. loans)

3. Did it Create Fragility/Risk? And Is It Mispriced? (2)

- How to catch risk?
  - Here: Z-score, within BBB rating
    - Technically, this assumes that the model is correct and (for purposes of time-series inferences) time-consistent. Is it? Some discussion would be important
    - COVID spreads do help (should go upfront)
      - It wasn’t clear whether Z-score (unconditionally) predicted downgrades in COVID (although, I suspect, that is likely)

3. Did it Create Fragility/Risk? Is It Mispriced? (3)

- How to catch mispricing?
  - Potential hypothesis: No connection between Z-score and spreads
  - Here: <u>Opposite</u> connection between Z-score and spreads
  - And only for A and BBB

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The economic mechanism is not fully clear:

Why would an investor pursue these bonds? Why chase “worst” bonds *in a given rating* that pay lower spread?

- Typical RfY narrative would say that investors chase yield without fully understanding risk
- Here, the suggestion is that the risk comes from M&A
  - Much more information is needed about the differential M&A activity to understand whether this is indeed the primary driver
  - How does the Z-score model do in the context of M&A?

3. Did it Create Fragility/Risk? Is It Mispriced? (4)

- How to catch mispricing?

  (cont.)

  - Once M&A are identified as a primary form of investments (TBD), looking at value creating vs. value destroying M&As (based on the initial market reaction) is an interesting take on getting at mispricing – Clever!

  - Although, we are talking about debt (not equity), how do we think about spreads vs. equity value loss of 1.4pp?

  - Nice evidence from COVID shock! (Figure 8 – should be front and center)

    - A baby elephant in the room: Unobserved heterogeneity in types of M&A? (I.e., there are business that are less well understood by cookie-cutter approaches like Z-score, or industry analyst coverage, hence, the imperfect fit of these models for explaining the spreads, and, hence, market short-term misunderstanding of their M&A acquisitions.)

In Sum

- I don't think that this is LSAP, and I am not sure if this is important, the result are perfectly consistent with reaching for yield (above and beyond policy intended part of it) and its consequences
- This (M&A activity and <u>its tie</u> to downgrades) is a fascinating result, and, for my taste, I would dig deeper into it