Triggers, Credit and High Yield:
Understanding the Debt Markets Today

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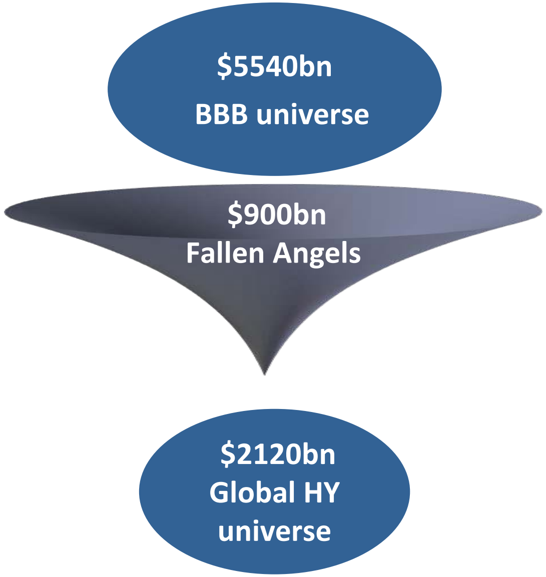
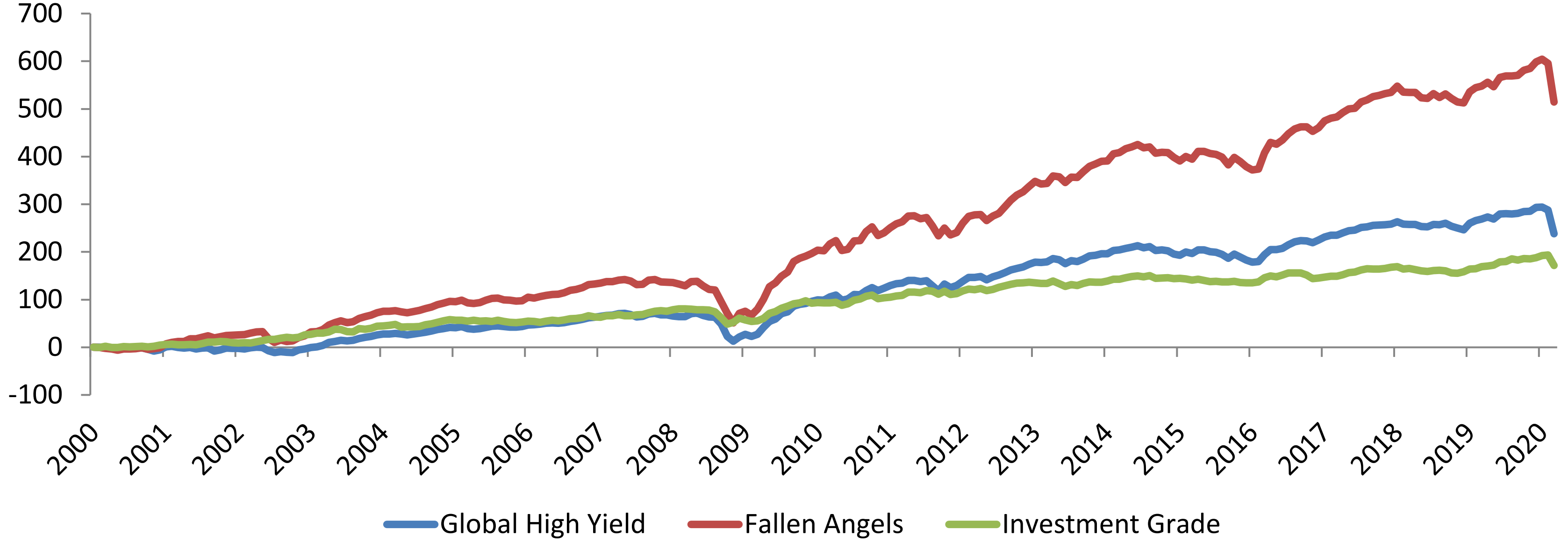
Fallen Angels are bonds downgraded from Investment Grade to High Yield



- Many of the fallen angel candidates have c$50bn debt
- The largest High Yield ticker = c$15bn
- A 2% position could be $40bn
- So loose bonds need to be cheap to encourage an overweight position
- Over time the price will normalise if the credit profile warrants it

Source: Allianz Global Investors, April 2020. Market and economic conditions are subject to rapid change. All opinions and views expressed constitute judgments as of the date of the writing and may change at anytime without notice and with no obligation to update.

Fallen angels can offer opportunities for returns above high yield & investment grade



Source: Bloomberg/ICE indices, to March 2020. Returns in USD unhedged terms. Global High Yield = ICE BofAML Global High Yield Index (HW00); Fallen Angels = ICE BofAML Global Fallen Angel High Yield Index (HWFA); Investment Grade = ICE BofAML Global Broad Market Corporate (G0BC).Past performance is not a reliable indicator of future results.

Fallen Angel performance in recessions

For longer-term investors (12 month forward returns):

Our research shows that the post-recession bounce typically dominates the overall return experience

In the Global Financial Crisis, fallen angels outperformed credit and equities

		12M Forward TRs (annualised)							
[4Q 2018; 2Q 2013; 3Q 2011]	**GDP**	**Date**	**A**	**BBB**	**BB**	**B**	**CCC**	**Fallen Angels**	**S&P**
Going into recession	2.9%	as at Sept-2018	13%	13%	10%	6%	-5%	7%	2%
Emerging from recession	1.1%	as at Dec-2018	13%	16%	16%	14%	9%	17%	29%
	3.1%	as at Mar-2019	-4%	-8%	-14%	-18%	-29%	9%	-21%
Going into recession	3.6%	as at Mar-2013	1%	2%	6%	7%	10%	9%	19%
Emerging from recession	0.5%	as at June-2013	7%	10%	11%	11%	14%	15%	22%
	3.2%	as at Sept-2013	6%	9%	8%	7%	7%	11%	17%
Going into recession	2.9%	as at June-2011	9%	9%	8%	6%	3%	6%	3%
Emerging from recession	-0.1%	as at Sept-2011	11%	12%	18%	18%	25%	20%	27%
	4.7%	as at Dec-2011	10%	12%	14%	15%	20%	22%	13%

Q4 2018

2013 "taper tantrum"

2011 Euro crisis

		12M Forward TRs (annualised)							
[2008 GFC]	**GDP**	**Date**	**A**	**BBB**	**BB**	**B**	**CCC**	**Fallen Angels**	**S&P**
Going into recession	2.0%	as at June-2008	0%	5%	1%	-7%	-10%	3%	-28%
During recession	-1.9%	as at Sept-2008	19%	22%	21%	15%	30%	39%	-9%
	-8.2%	as at Dec-2008	16%	31%	45%	48%	97%	65%	23%
Emerging from recession	-5.4%	as at Mar-2009	22%	33%	41%	47%	110%	68%	47%
	-0.5%	as at June-2009	15%	20%	23%	21%	46%	32%	12%

2008 Global Financial Crisis

Source: Allianz Global Investors. BAML, Bloomberg, 26 March 2020. Past performance, or any prediction, projection or forecast, is not indicative of future performance.

Credit spreads are pricing close to the worst data seen over the past 30 years

SLIDO: Is pricing in the GFC for credit spreads
1. Complacent
2. About right
3. Too conservative

The cost of a rating downgrade is temporary based on the spread differentials between rating categories

In BBB this cost is 4.5x more than default risk – it is this COST that we are capitalising on

Lower down the spectrum default risk becomes more of a worry but in BBs there is a healthy premium to harvest if you avoid defaults

S&P data charts the worst downgrades and defaults by rating category (mostly in Global Financial Crisis but also 2001/2)

- **In this data “fallen angels” total 16.76% - this is in line with the highest estimate forecast by investment banks**

BUT there is NO CERTAINTY that the worst case experienced in the past will be what we see this time around

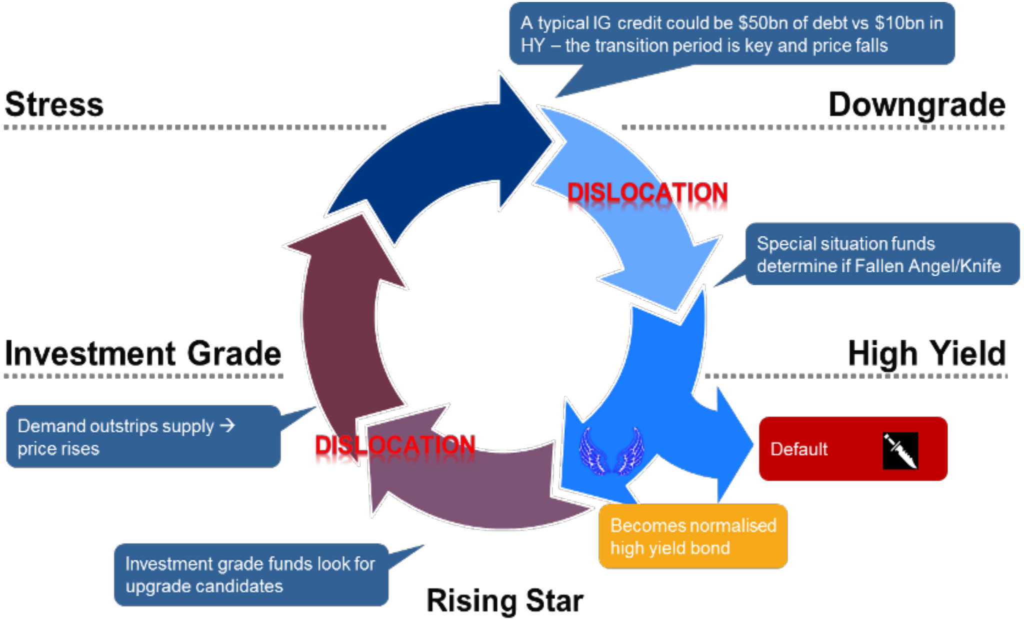
The LENGTH of CoVid lockdown and EFFECTIVENESS of government policies are determining factors

Worst 1y transition rates	% downgraded to BB	% downgraded to B	% downgraded to CCC	% default	Cost of rating downgrade	Cost of default	Spread needed to pay for downside	Yield Apr 2020	Spread Apr 2020
BBB	10.67%	1.88%	0.54%	1.01%	278	61	339	3.4	299
BB	n/a	21.98%	1.88%	4.22%	467	295	762	5.7	538

Source: S&P Default & Transition Study 2019, using annual rates from 1981-2019 and calculations by Allianz Global Investors. Spread/Yield data Bank of America/ICE indices 14 April 2020.

The fallen angel strategy exploits price dislocation caused by the credit cycle

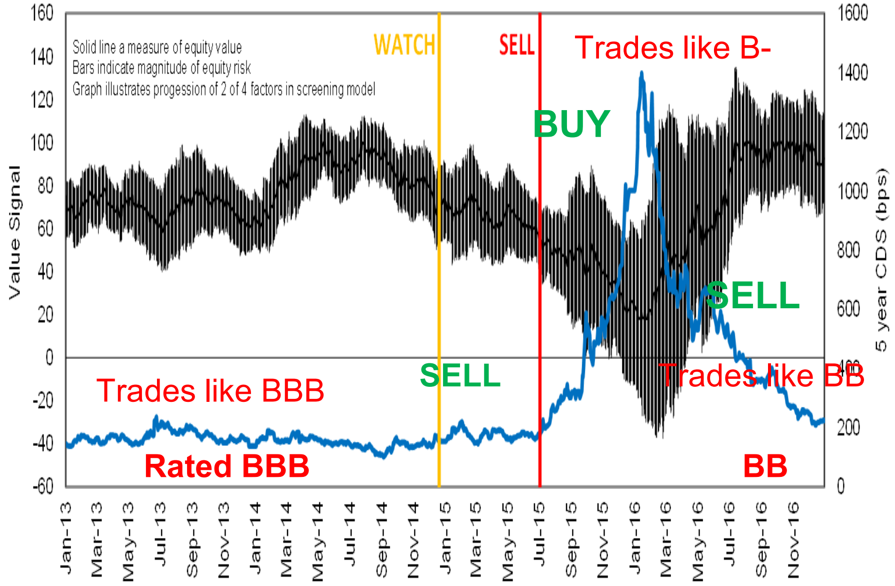
- There could be up to $900bn of fallen angels in the coming downgrade cycle
- This is c 45% of the whole high yield market
- During the transition from investment grade to high yield there is likely to be significant price dislocation
- The strategy will take short term positions in bonds that trade significantly cheaper than credit fundamentals suggest, and sell when these approach fair value
- Typical investment horizon 3 months



Source: Allianz Global Investors, 30 April 2020. For illustrative purposes only.

"Outsized" dislocation can be short term

Illustrative buy & sell based on mismatch between fundamental & valuation



Timing is crucial to capture the opportunities – most of the performance can come in the first three months, if at all

This is why for example FTSE offers a time weighted fallen angel index; more recent entrants are given up to 5x outstanding weight

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Attractive historic ratings migration trends allow longer term opportunities

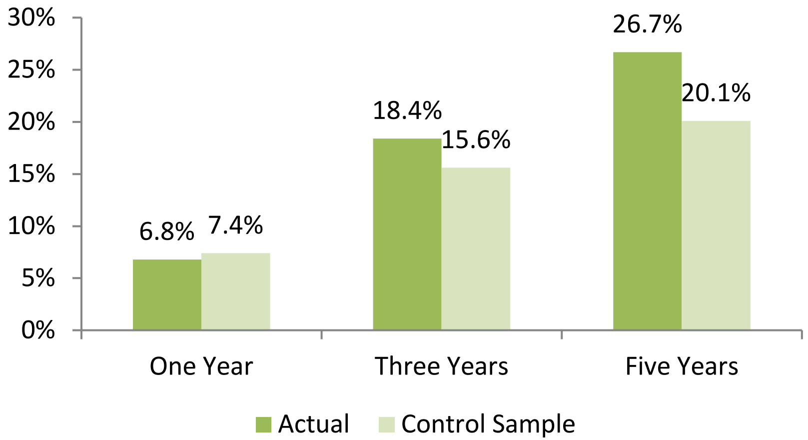
Fallen angels were more likely to become investment grade than a sample of similarly rated non-fallen angels:

- Our analysis of BofAML data on fallen angels vs. rising stars, which runs from 1998 to Q1 2019 shows
- Of the 772 fallen angels, 26% appeared subsequently on the rising star list with a median lag of just over 2 ½ years
- The figure is similar to Moody's analysis of 28% subsequently recovered investment grade status
- 15% subsequently defaulted

Fallen angels were not significantly more likely to default than similarly rated non-fallen angels

Active analysis needed to avoid falling knives

Cumulative Rising Star Rates for Fallen Angels and a Control Sample of Similarly-Rated Non-Fallen Angels at Firm Level



Source: Allianz Global Investors, using data from 1998 to March 2019; Moody's (2014).
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Active security selection is key

	Fallen Angel	Falling Knife
Industry trends	Cyclical downturn	Structural downturn
Liquidity profile	Longer term; well-spaced	Short term dominance
Access to capital markets	Diversified funding base	Captive funding base
Cash flow profile	Levers to improve Free Cash Flow	Minimal Free Cash Flow levers
Cost base	Flexible	High fixed costs
Environmental	Good disclosure	Outstanding and unquantified litigation
Management	Flexible	Inflexible

- Falling knives may progress straight to distress: it is key to have active security selection
- All fallen angel index data we show includes “fallen knives” – so potential for better returns

Source: Allianz Global Investors, April 2020

Appendix

Central banks help with liquidity; not solvency

The Fed:

- Primary (PMCCF) and Secondary (SMCCF) Facilities ($750bn)
- Primary – new debt that the Fed can buy (if the market doesn't) to a max $500bn in IG and HY across loans and bonds
- Up to 130% of an issuer's debt outstanding between March 2019 & March 2020 with a maximum maturity of 4 years
- Secondary - the Fed can buy in the open market to a max $250bn in IG & HY across bonds only
- Up to 10% of the total debt outstanding with a maximum maturity of 5y.
- Up to $11bn per company across the two facilities.
- Businesses created or organized in the US or under the laws of the US with significant operations in and a majority of its employees based in the US. Depository Holding corporations (i.e. banks) are excluded
- That had 1 / 2 or 2 / 3 IG ratings before 23rd March 2020 and still has 1 / 2 or 2 / 3 BB ratings at the time of purchase

ETFs:

- Fed can buy ETF intended to provide broad exposure to the US corporate bond market. Limited to 20% of an ETFs outstanding shares.
- HY ETF are ~$50bil therefore the FED can buy ~$10bil (0.5% of total Global HY market)

Main Street:

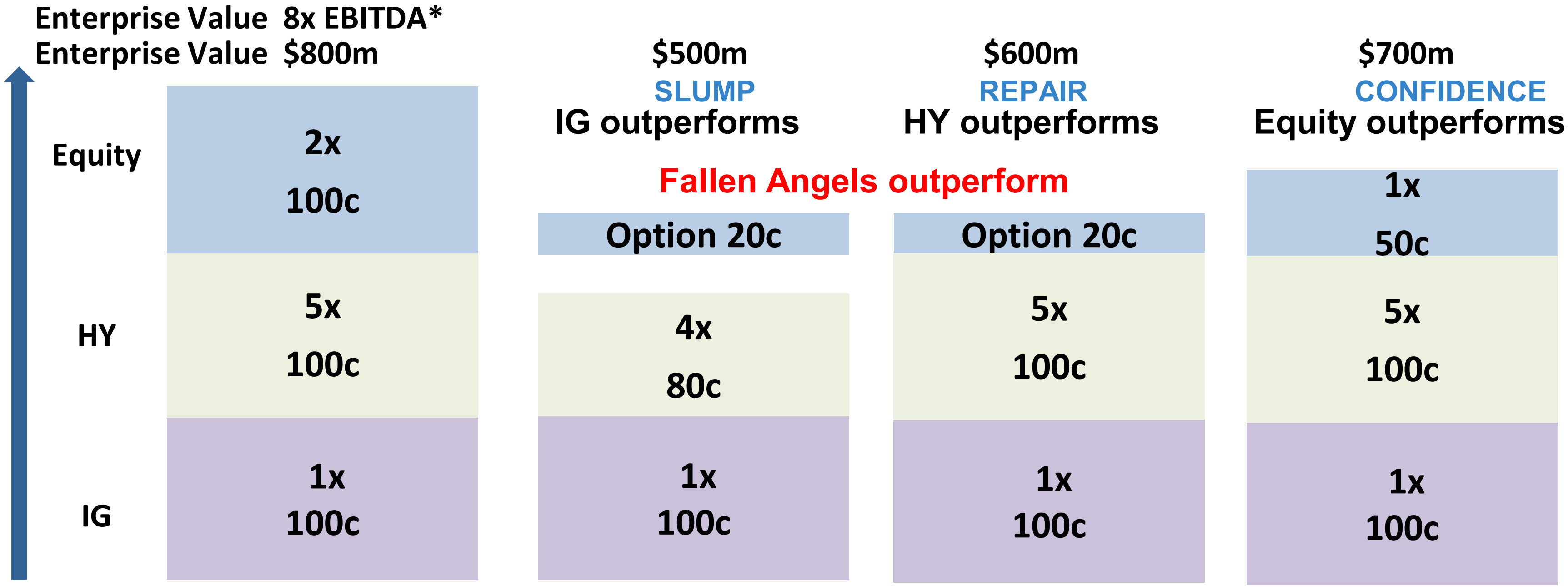
- 4 year maturity; Amortization of principal and interest deferred for one year then 15% in year 2 and 3 year. Fed will buy a maximum of 95% of each loan. Loans can be secured or unsecured
- Adjustable rate of SOFR + 250-400 basis points; Maximum loan size $200m or 35% of outstanding and undrawn debt, subject to a maximum leverage of 6x 2019 Adjusted EBITDA
- Unclear if a company can ask for multiple loans
- US eligibility. Maximum 15,000 employees and sales below $5 bn

The ECB:

- Companies rated BBB- or better on 7 April 2020 remain eligible for collateral (grandfathered) as long as rating is at least BB (2 notch easing). Includes covered bonds.
- ABS criteria A- and BB+ as of same date.
- New issuance from grandfathered companies allowed.
- Assets < BB/BB+ respectively will be haircut; haircut reduced by 20%
- Greek sovereign debt accepted as collateral
- New aid rules in place for COVID; EU countries can provide guarantees for < 70% of any corporate loan even if subordinate. If country wants to guarantee > 70%, EU Comp Commission has to approve

Source: Allianz Global Investors, April 2020. Market and economic conditions are subject to rapid change. All opinions and views expressed constitute judgments as of the date of the writing and may change at anytime without notice and with no obligation to update.

Illustrative capital structure behaviour in a sharp recession



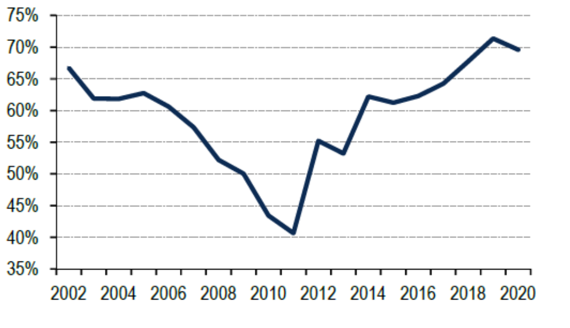
* Earnings Before Interest, Taxes, Depreciation and Amortisation

Source: Allianz Global Investors: Illustrative for a highly leveraged business. Different industries and capital structures will behave differently

CLOs may trigger some dislocation in the future

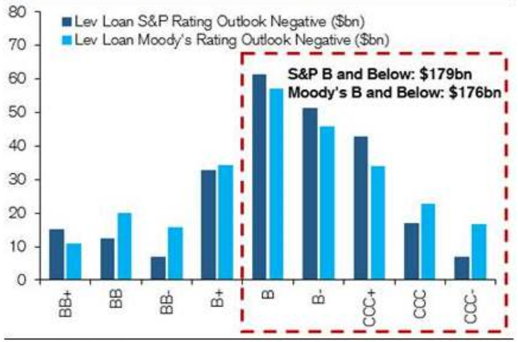
- CLO remain dominant player in Leverage Loans at 70%, Segregated Mandates 25% and Retail 5%
- CLO managers are not required to cure if CCC bucket > limit, only stipulates that excess to ~7.5% limit for CCC needs to be market value vs. par and therefore overcollateralization ratio deteriorates
- However, the overhang of single-B negative rating outlooks suggests that there will be continued downgrade pressure in the lower quality loan space. Such downgrade pressure will motivate CLO managers to lighten up on paper in this rating space to preserve WARF scores and preserve cash flows/fees lower down the capital structure.
- This could provide dislocation opportunities – especially vs the c30% bond overlap universe

Chart 4: CLO AUM, % of loan market



Source: BofA Global Research, S&P LCD

Negative rating outlook overhang remains



Source: Credit Suisse

CLO WARF scores pressured by rating downgrades

Source: Credit Suisse, KANERAI

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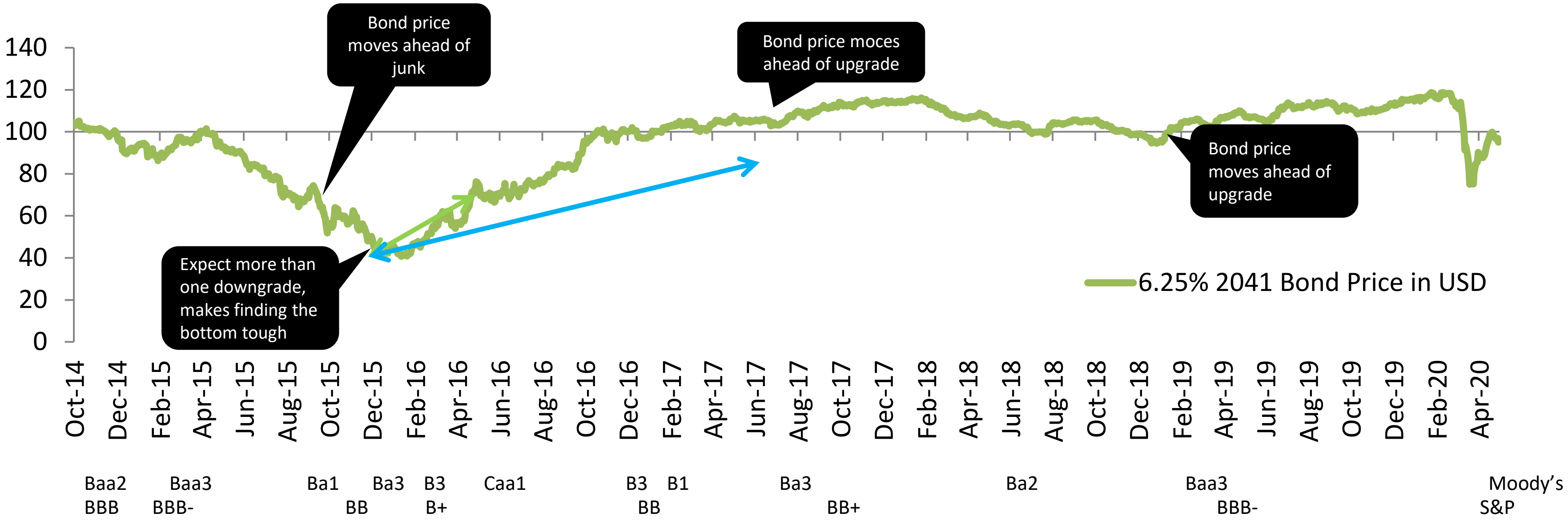
Historic case study: Mining Company



Dislocation trade: buy \$55 sell \$70 – 5 months - return (\$2.6+\$15)/\$55 = 32% Assume 0% for remainder of year in money mkt= c13% annualised

Fallen angel trade: buy \$55 sell \$110 – 28 months - return (\$14.6+\$55)/\$55 = 126% = c 52% annualised

Source: Allianz Global Investors, Bloomberg, 1st January 2013 to 29th April 2020. The information above is provided for the purpose to demonstrate the investment strategy only, it should not be considered a recommendation nor investment advice to buy or sell any shares of securities. Past performance, or any prediction, projection or forecast, is not indicative of future performance.

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