T.RowePrice®
INVEST WITH CONFIDENCE

PRICE POINT®

November 2018

In-depth analysis and insights to inform your decision-making.

Steven Boothe
Portfolio Manager

Fixed Income

GROWTH OF BBB BONDS—KEEPING RISKS IN PERSPECTIVE

KEY POINTS

- BBB rated issuance has grown substantially in recent years, largely due to a surge in merger and acquisition (M&A) activity. This could constitute an increased headwind should the U.S. economy moderate as it approaches late cycle.
- However, we view the risk as primarily an idiosyncratic sector- and issuer-level concern as the growth of BBB supply is concentrated in a few industry sectors.
- The downside should remain contained as M&A activity has largely been in noncyclical industries and corporate fundamentals remain positive.

ARE BBB BONDS A CAUSE FOR CONCERN?

It's no secret that investment-grade credit markets have witnessed a deterioration in overall credit quality in recent years due to an explosion of BBB rated paper. In the U.S., BBB rated bonds compose roughly half the entire investment-grade market compared with just over one-third 10 years ago.[1] The surge has been even more pronounced in euro-denominated credit markets.[2] While these trends have yet to have a significant impact on pricing, we think this could change. The question then becomes: What part of the BBB market is most at risk?

To pinpoint this, the key trend to note is that much of the credit deterioration stems from a prolific level of merger and acquisition (M&A) finance over the past three years. This has spurred both an uptick in new issuance by BBB names to fund M&A as well as A rated credits falling into the BBB bracket by levering up to fund acquisitions. We believe such "credit negative" M&A deals could be the first to come under the microscope should corporate profits start to fall as the U.S. economy enters late cycle. Interest rates are projected to continue moving northward into 2020, which would only exacerbate the problem as companies' debt-servicing costs climb.

An additional risk is that companies may soon face a maturity wall. While maturing BBB bonds make up only around 2% of the U.S.- and euro-denominated investment-grade markets in 2019, this jumps to 10% or higher for both currencies in 2020 and remains elevated in the years following.

In our view, rating agencies have been slow to recognize the unhealthy levels of M&A leveraging, partly due to the above-potential pace of the U.S. economy. There is growing concern about a potential increase in the number

[1]Bloomberg Barclays U.S. Aggregate Corporate Bond Index.
[2]Bloomberg Barclays Euro Aggregate Corporate Bond Index.

of "fallen angels" (investment-grade credits being downgraded to high yield) as economic downturns typically feature an uptick in rating downgrades. With more of the market concentrated within the BBB rating bracket, an increasing portion of potential downgrades would cross the threshold into high yield. We believe the M&A-driven BBB universe should therefore be assessed cautiously.

UNEVEN SPREAD OF RISK FAVORS EUROPEAN ISSUES

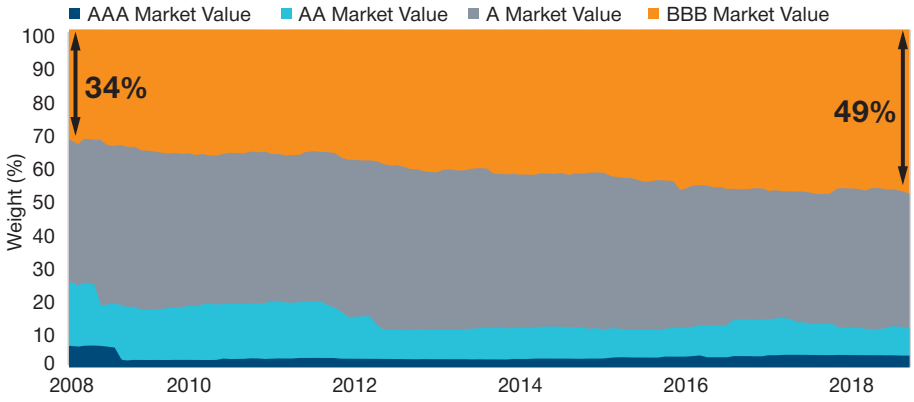
A deeper look at a regional and sector level reveals that the deterioration in credit quality has been disproportionate. The risk is largely contained in certain market sectors rather than constituting a systemic threat to the wider asset class.

We see BBB growth posing greater concern in the U.S.-denominated market rather than its euro counterpart. While BBB paper composes a similar portion in both markets, reverse-Yankee bonds (U.S. companies issuing in euros) have accounted for more than a quarter of the growth of the euro-denominated BBB market over the past five years and now compose around 20% of the total. These reverse-Yankee issues could be among the first affected should the U.S. credit cycle roll over.

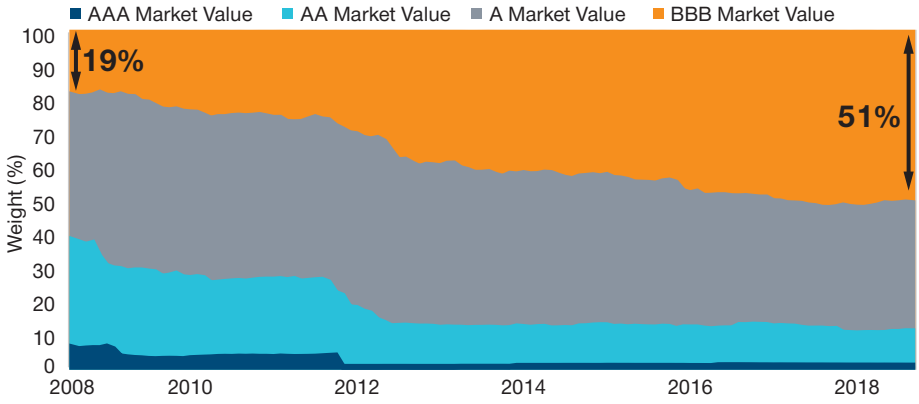
FIGURE 1: **Steady Growth of BBB Bonds in Both U.S. Dollar and Euro Credit Markets**

As of September 2018

U.S. Corporate Market Rating Breakdown



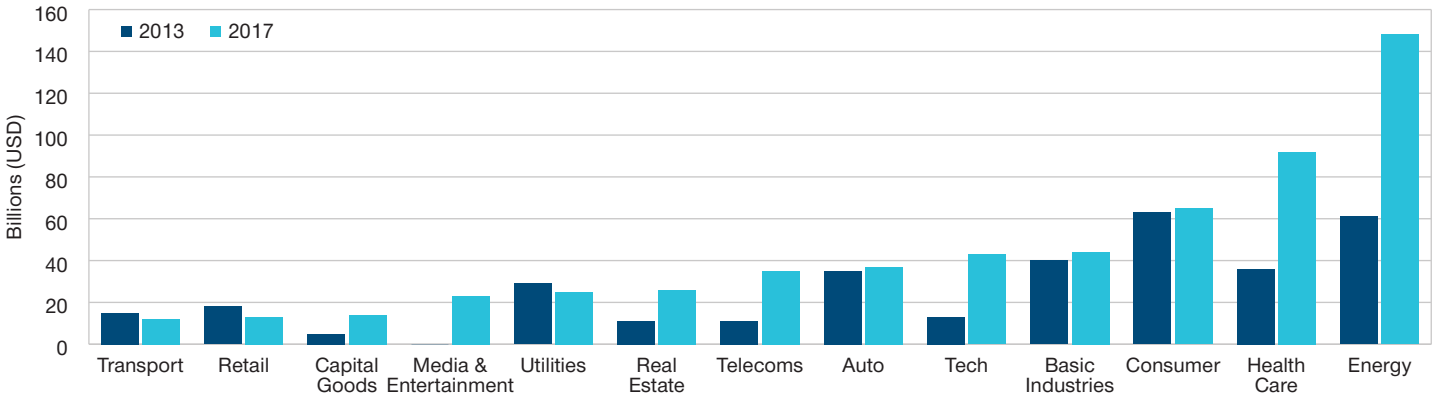
Euro Corporate Market Rating Breakdown



Source: Bloomberg Index Services Ltd. Copyright © 2018, Bloomberg Index Services Ltd. Used with permission.

FIGURE 2: **Energy and Health Care Primary Source of BBB Surge**

As of December 2017

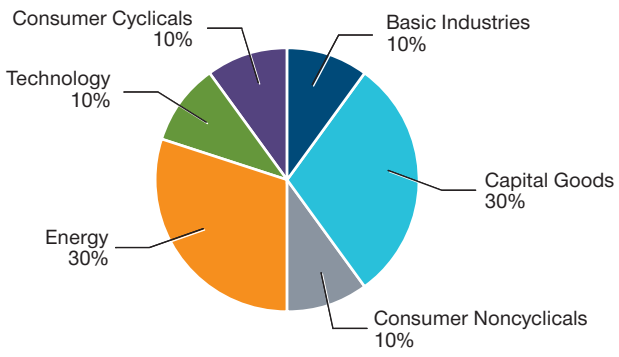


Source: Information has been obtained from sources believed to be reliable but J.P. Morgan does not warrant its completeness or accuracy. The index is used with permission. The Index may not be copied, used, or distributed without J.P. Morgan's prior written approval. Copyright © 2018, J.P. Morgan Chase & Co. All rights reserved.

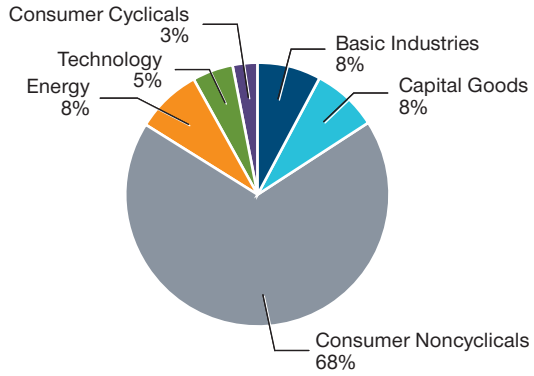
FIGURE 3: **Postcrisis M&A Activity Concentrated in Noncyclical Sectors**

As of June 2018

U.S. Corporate Market Rating Breakdown



Euro Corporate Market Rating Breakdown



Source: Barclays Capital. © 2018 Barclays. Analysis by T. Rowe Price.

We view the investment-grade credit market in Europe, including the BBB rated segment, as the more stable option in the medium term. Although a U.S. slowdown would not just impact U.S.-based companies, Europe may hold opportunities to selectively shift allocation as it also offers more attractive average valuations following underperformance so far in 2018.

Even within the U.S. market, risk is not spread evenly. The jump in BBB supply has been far more pronounced in some sectors, with health care and energy witnessing the largest spikes. Therefore, focusing on sectors that have seen little change, or even slight drops, in the percentage of BBB names can reveal more low-leveraged investment opportunities.

FAVORABLE TRENDS HELP MITIGATE THE DOWNSIDE

In addition to diversifying by region or sector, investors should not exaggerate the downsides. While the rise in risk associated with the increase in BBB securities is a concern, a thorough analysis reveals that a number of favorable trends will minimize the systemic risk.

First, the bulk of M&A activity after the financial crisis has come in the consumer noncyclical sector, whereas energy and capital goods dominated in the pre-crisis period. Lower-beta sectors, such as consumer noncyclicals, are likely to see relatively moderate weakness compared with higher-beta industries in the next downturn.

Furthermore, there are more former A rated credits than former BB rated names within the wider BBB universe. This suggests that further downgrades to high yield status, even in a downturn, may be limited as the negative rating action may have already occurred in many cases.

Another point that may help contain possible downgrades is that, on average, companies with BBB ratings typically tend to reduce their leverage levels more quickly than higher-rated names in the A rating bracket. We believe that strong management teams are more likely to recognize the jump in costs associated with losing an investment-grade rating and address leverage more proactively than an A rated issuer might when the impact of a move within investment grade is less. Many of the BBB rated names are former A rated companies with large capital structures that we see as still having room to maneuver to prevent further downgrades to high yield. This underscores the importance of active, bottom-up security selection in both the BBB and the A rated sectors.

We believe investors should not shun BBB rated credits altogether but adopt a disciplined and flexible approach. Focusing on shorter-dated credits while avoiding the long end, particularly in the more highly leveraged market sectors, should also help limit downside to this risk. Overall, corporate fundamentals are more favorable compared with recent history and the previous late-cycle period before the financial crisis. We continue to identify names in the BBB rating bracket that demonstrate positive and stable cash flows alongside sound long-term corporate strategies.

In our view, by prioritizing well-managed companies with long-term business models, investors can minimize their exposure to the corners of the BBB market that could experience the greatest stress in the next downturn.

INVEST WITH CONFIDENCE®

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

To learn more, please visit troweprice.com.

T.RowePrice®

Important Information

This material is being furnished for general informational purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, and prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request.

It is not intended for distribution to retail investors in any jurisdiction.

Australia—Issued in Australia by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. For Wholesale Clients only.

Canada—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

DIFC—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd. by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

EEA—Issued in the European Economic Area by T. Rowe Price International Ltd, 60 Queen Victoria Street, London EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

Hong Kong—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 21/F, Jardine House, 1 Connaught Place, Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

New Zealand—Issued in New Zealand by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

Singapore—Issued in Singapore by T. Rowe Price Singapore Private Ltd., No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

Switzerland—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

USA—Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

ID0001884 (11/2018)
201811-674067