CreditSights

US IG in 2020: A Wild Ride

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Market View

Investment Grade: Outperform

The Fed’s support is the backbone of our recommendation, as it has driven inflows to the asset class, strengthened the primary market, and now is adding technical support as well.

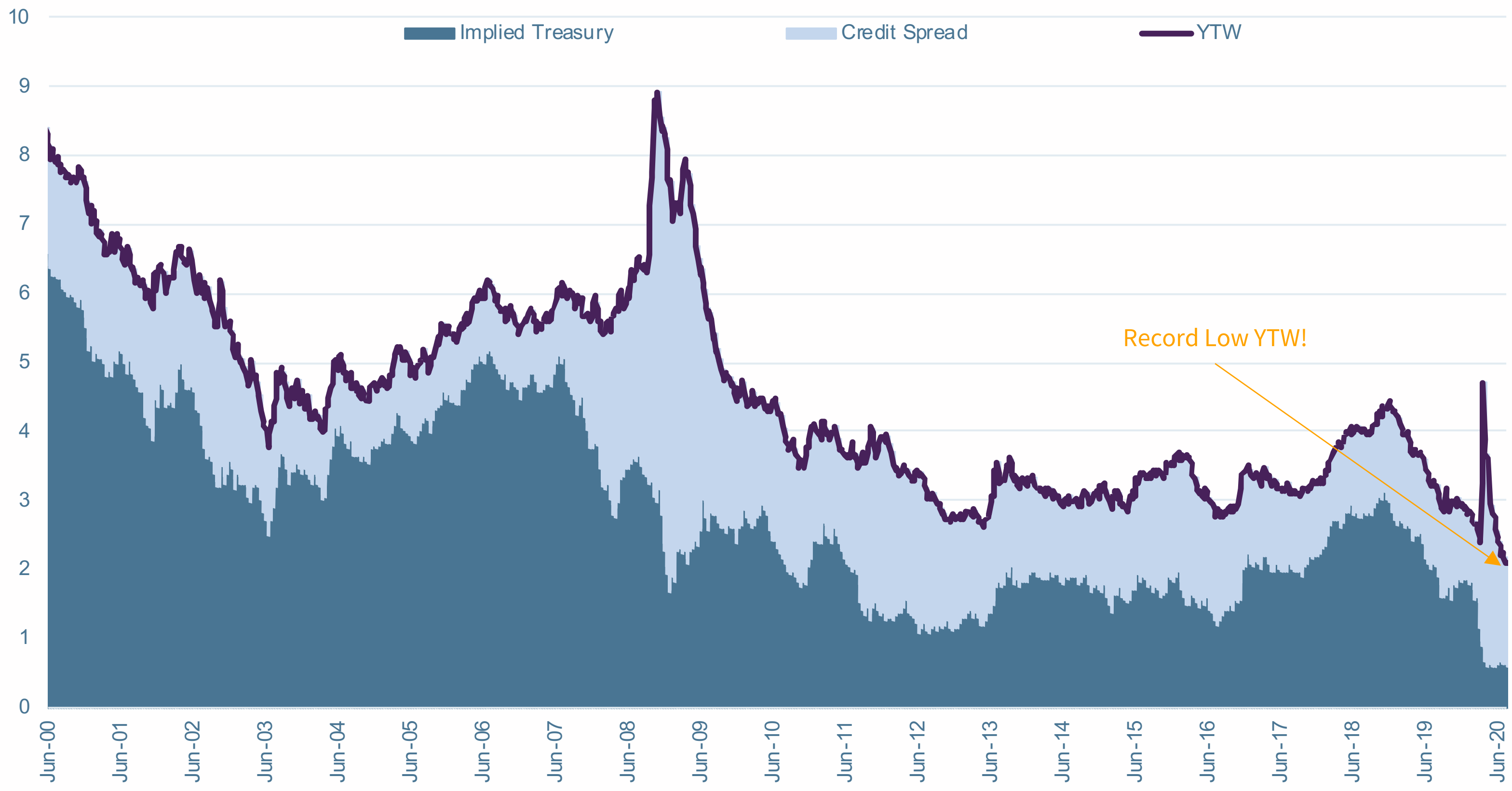
We see risks of a second wave of COVID (although we would not expect a government mandated shutdown), a very uncertain election outcome, and increasing anti-China rhetoric from Washington, which could result in additional tariffs. We also have increased turmoil across the US, an economy that isn’t yet back to normal, and government support that is set to run out at the end of July.

Year End Spread Target: 130-140bp (ICE BAML Index), currently 152bp

Wider Credit Spreads, But Still Low Yields

IG YTW = 2.10%; OAS = 150bp

IG YTW by the Components (%)



ICE BAML Index data, CreditSights. Data as of July 13, 2020

What Yield Is Available?

IG Index = 2.11%

Grid of YTW cut by rating and tenor

US IG Corporate Yield to Worst (%) by Rating, Tenor												
Yield to Worst	Index	AAA	AA	A1	A2	A3	BBB1	BBB2	BBB3	BB1	BB2	BB3
Index	2.11	1.52	1.48	1.53	1.65	1.88	2.25	2.39	3.28	4.73	4.69	5.16
3Y	1.12	0.38	0.53	0.69	0.77	0.92	1.11	1.33	2.49	4.50	4.21	4.98
5Y	1.61	0.65	0.87	0.95	1.16	1.28	1.59	1.67	2.97	4.60	4.90	5.39
7Y	1.95	0.95	1.14	1.31	1.56	1.66	1.87	2.12	3.21	4.48	4.58	5.16
10Y	2.24	1.58	1.53	1.56	1.84	1.95	2.16	2.44	3.34	4.71	4.43	4.70
30Y	3.07	2.14	2.52	2.50	2.65	2.80	3.25	3.55	4.50	5.37	6.14	7.41

ICE BAML Index data, CreditSights, Bloomberg, FactSet. Yields as of July 12, 2020

Who Owns Corporate Bonds?

Rest of World = a major holder base

Distribution of Corporate and Foreign Bond Holdings ($bn)

Holders of Corporate Bonds - Current Amounts and Recent Changes ($bn) as of 1Q 20	Current		Change vs		
	1Q 20		4Q 19	1-Yr Ago	4Q18
Total Market Value	**$ 13,849.1**	**% of Total**	**$ (426.1)**	**$ 638.0**	**$ 1,199.5**
Households & Misc.	$ 1,020.0	7%	$ 16.6	$ 124.6	$ 77.0
Households, Hedge Funds, PE	$ 801.8	6%	$ 17.2	$ 114.8	$ 62.5
Nonprofits	$ 218.1	2%	$ (0.6)	$ 9.8	$ 14.5
Mutual Funds	$ 2,236.8	16%	$ (50.7)	$ 105.9	$ 220.3
Closed-End Funds	$ 59.4	0%	$ (15.7)	$ (13.8)	$ (9.7)
ETFs	$ 517.8	4%	$ (26.3)	$ 57.1	$ 97.3
Money Market Funds	$ 13.8	0%	$ (4.7)	$ 5.1	$ 6.3
US Banks	$ 454.1	3%	$ (45.5)	$ (44.3)	$ 2.5
Life Ins Cos	$ 3,088.8	22%	$ (82.6)	$ 214.4	$ 378.0
Property & Casualty Cos	$ 581.4	4%	$ (13.4)	$ 21.7	$ 47.4
Private Pension Funds	$ 960.6	7%	$ (12.3)	$ 74.8	$ 125.2
Fed Govt Ret Funds	$ 14.2	0%	$ (1.9)	$ (0.1)	$ 0.7
State & Local Gvt Ret Funds	$ 469.1	3%	$ 0.7	$ 38.8	$ 53.8
Other	$ 650.8	5%	$ 28.9	$ 35.9	$ 28.7
Rest of the World	$ 3,781.9	27%	$ (219.2)	$ 18.0	$ 172.1

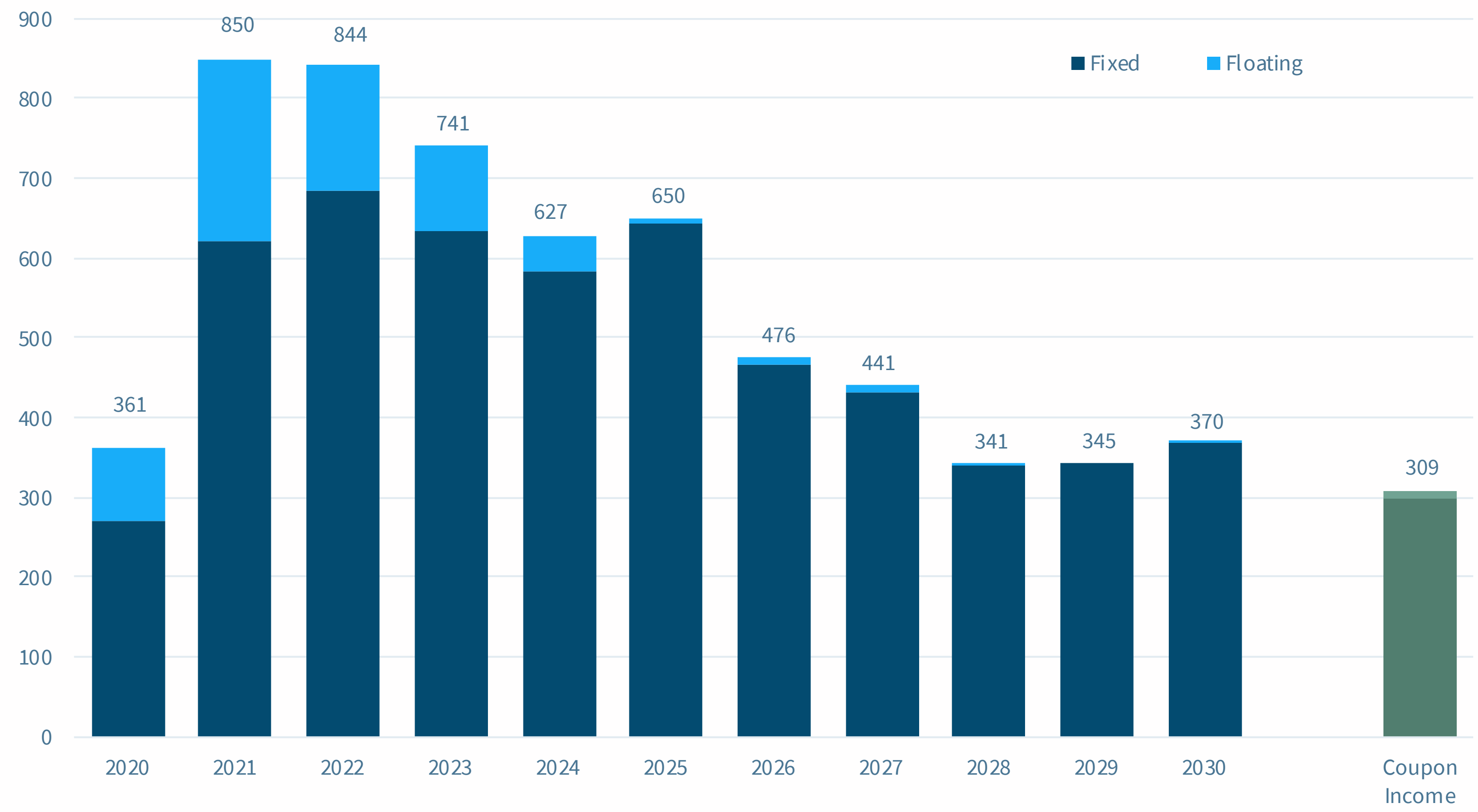
Updated 6/11/20. Source: CreditSights, Federal Reserve System.

Source: Federal Reserve Z tables, CreditSights

Maturity Wall or Demand Driver?

Lots of money will need to be reinvested – or a liquidity squeeze

IG Index Maturity Schedule, by Year and Type ($bn)

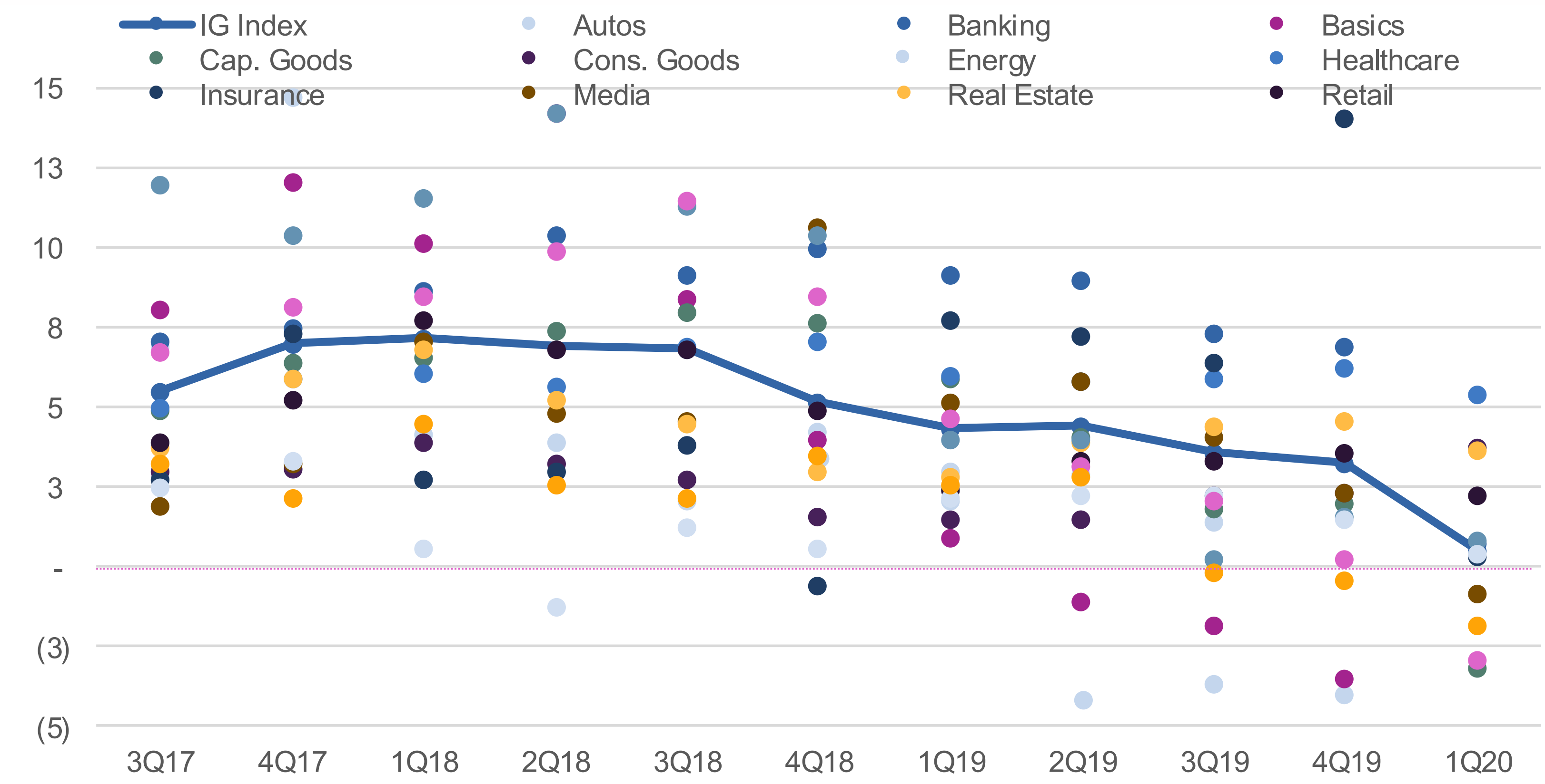


ICE BAML Index data, CreditSights, Bloomberg. Data as of May 30, 2020.

How Healthy Are Credit Fundamentals?

Median revenue growth slowing; 4Q19 = 3.2% → 1Q20 = 0.3%

YoY Revenue Growth by Sector and Index (%)

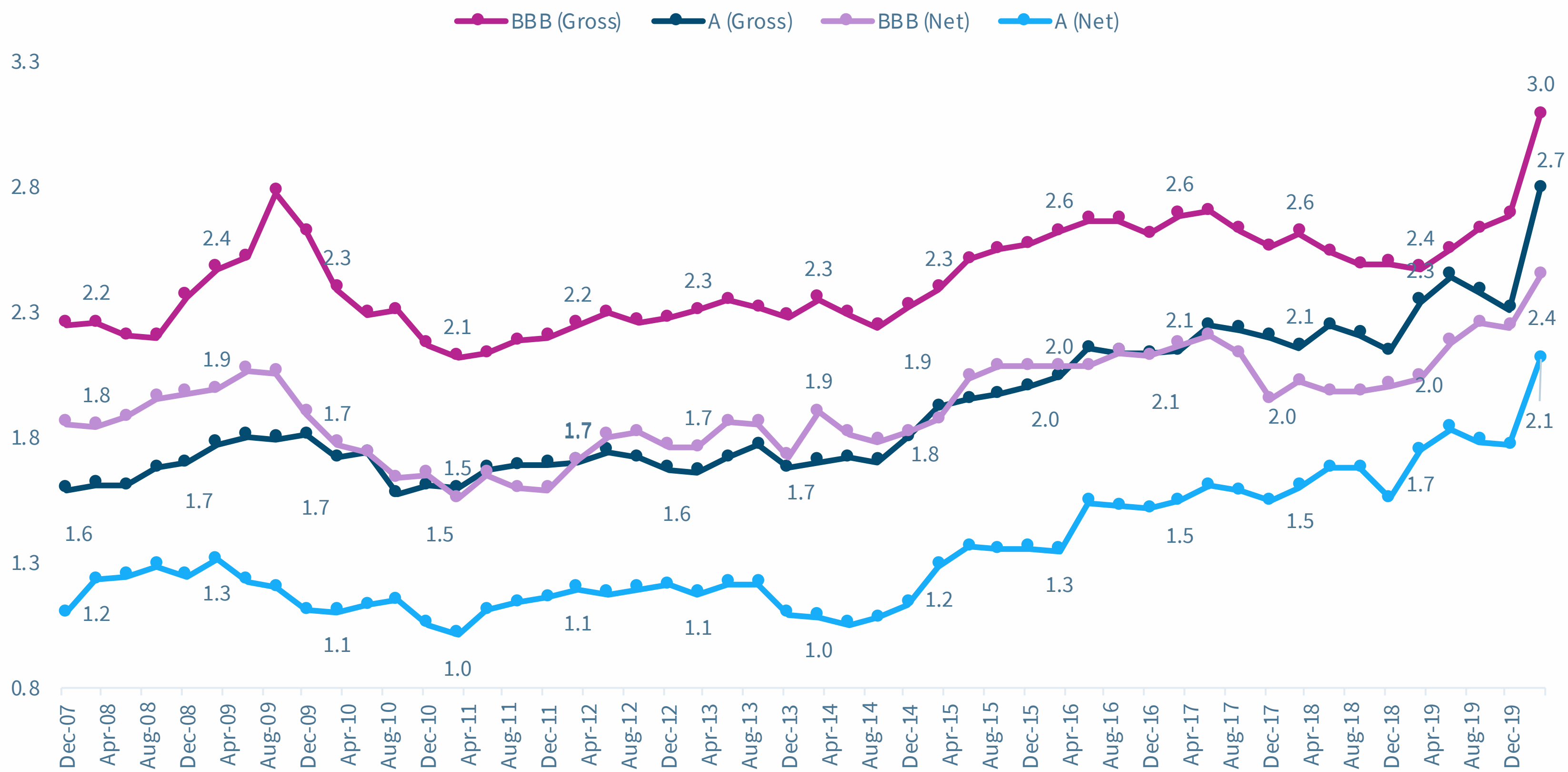


Bloomberg, Company Reports, CreditSights

Leverage: Deteriorating, Fast

Also focus on the proximity of BBB- and A-rated leverage

Gross and Net Leverage, by Rating Band (x)



ICE BAML Index data, CreditSights, Bloomberg, FactSet. Data as of 1Q20.

What Happens When...?

Top 200 Issuers Leverage Scenarios

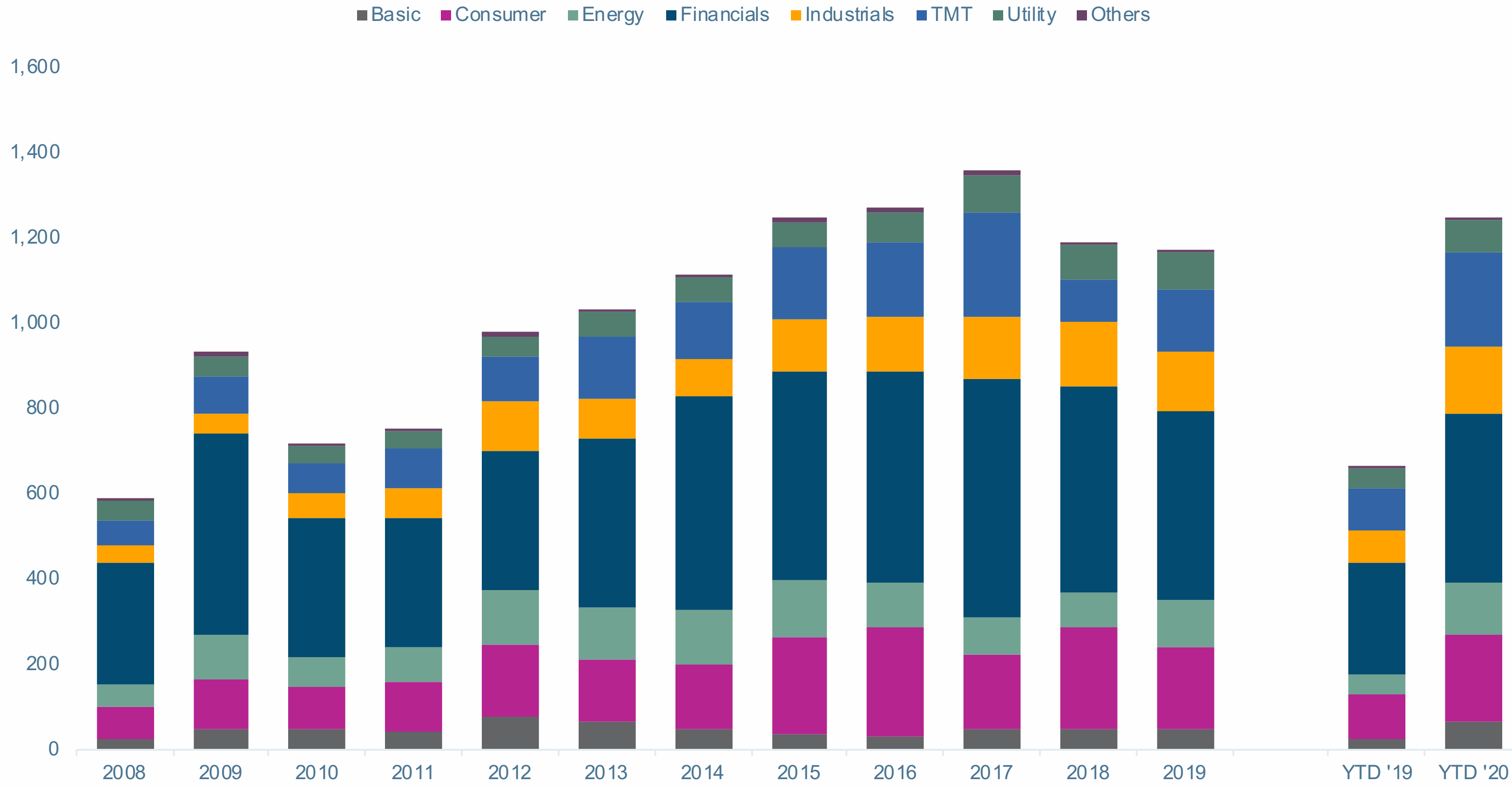
Median Gross Leverage Scenarios (x)								
	EBITDA Margin							
Revenue Growth	-15.0%	-12.5%	-10.0%	-7.5%	-5.0%	-2.5%	0.0%	2.5%
-25%	12.6	12.2	11.9	11.6	11.3	11.0	10.7	10.4
-20%	10.7	10.4	10.1	9.8	9.6	9.3	9.1	8.9
-15%	8.0	7.8	7.6	7.4	7.2	7.0	6.8	6.6
-10%	6.7	6.5	6.3	6.1	6.0	5.8	5.7	5.5
-5%	5.3	5.1	5.0	4.9	4.7	**4.6**	4.5	4.4
0%	4.0	3.9	3.8	3.7	3.6	3.5	**3.4**	3.3
5%	3.2	3.1	3.1	3.0	2.9	2.8	2.7	2.7
10%	2.8	2.7	2.6	2.5	2.5	2.4	2.4	2.3

ICE BAML Index Data, CreditSights, Bloomberg. Current leverage of 3.4x based on Q1 2020 numbers.

2020 Supply Skyrockets

2020 supply at $1.23 tn, vs $1.17 tn in FY 2019

Gross USD IG Supply, by year and sector ($bn)



Dealogic, CreditSights, Bloomberg. Data as of July 13, 2020

So Much Cheaper To Refi

Yields are well below the par-weighted coupon

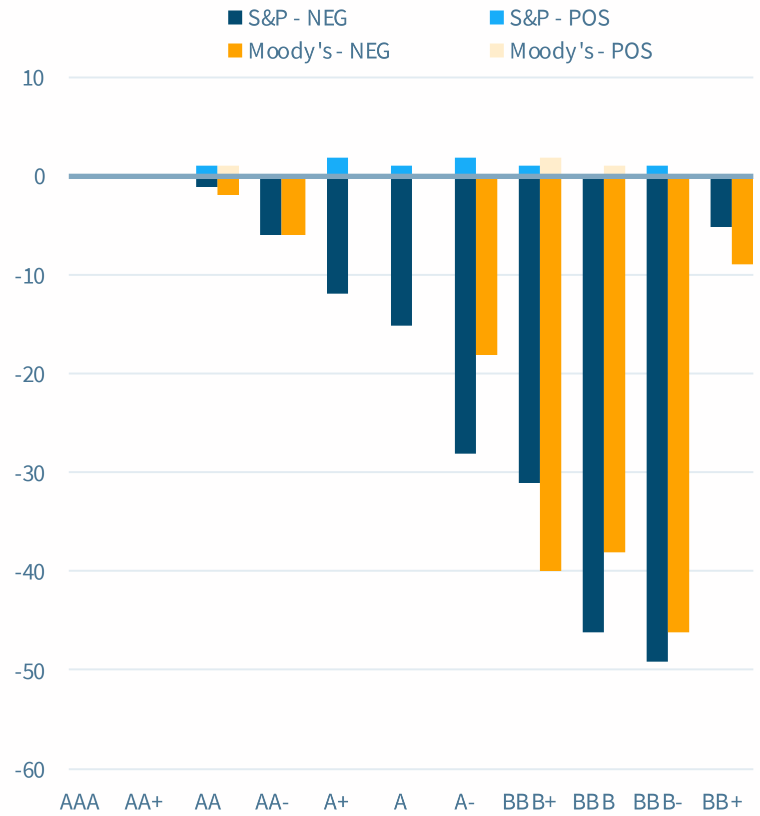
YTW vs Par-Weighted Coupon (%)

Source: ICE BAML Index Data, CreditSights. Data as of July 13, 2020

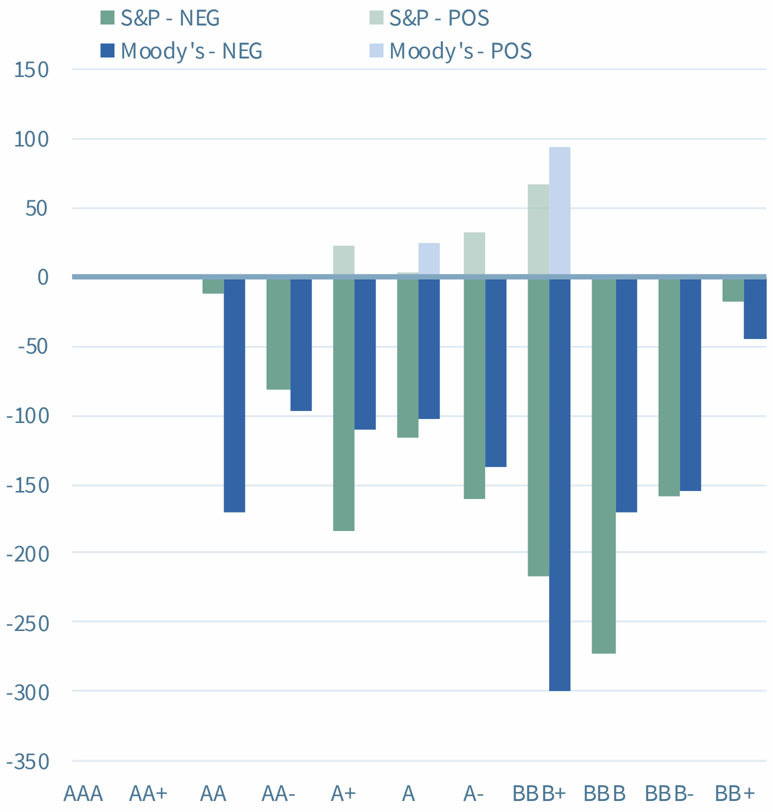
How Worried Are The Agencies?

Potential Fallen Angels

Number of Credits with POS and NEG Outlooks



Face Value of Credits with POS and NEG Outlooks



ICE BAML Index data, Bloomberg, CreditSights. Data as of June 15, 2020

Do We Need to Worry About BBB Downgrades?

Potential Fallen Angels

Fallen Angel Scorecard

Debt in IG Index ($ nm)		Ratings(Moody's, Fitch, S&P)	Ratings Outlooks	Fallen Angel Score	Downgrade Risk - Analyst View	Timing?
Basic Industry						
Vale Overseas Limited	5,652	Ba1/BBB-/BBB-	Stable/Stable/Neg	High	Low	-
Teck Resources Limited	2,671	Baa3/BBB-/BBB-	Stable/Stable/Stable	High	Low	-
Capital Goods						
The Boeing Company	18,948	Baa2/BBB/BBB-	Neg/Neg/Stable	High	Medium	6-12 Months
Consumer						
Conagra Brands Inc	8,532	Baa3/BBB-/BBB-	Stable/Stable/Neg	High	Low	1 year
Molson Coors Beverage Com	5,400	Baa3/BBB-u/BBB	Stable/Neg/Neg	High	Medium	12-18 months
Mylan NV	6,497	Baa3/BBB- *+/BB	Stable/-/-	High	Low	<12 months
Marriott International Inc.	5,686	Baa3/BBB-u/BBB	Neg/Neg/-	High	High	3-12 months
GLP Capital L.P. and GLP Fina	4,675	Ba1/BBB-/BBB-	-/-/-	High	Medium	3-12 months
Host Hotels & Resorts L.P.	2,800	Baa2/BBB-/BBB-	Neg/Stable/-	High	High	3-12 months
Hyatt Hotels Corporation	1,150	Baa3/-/BBB- *-	Neg/-/-	High	High	3-12 months
Nordstrom Inc.	2,616	Baa3/BBB-u/BBB	Neg/Neg/Neg	Very High	High	3-12 months
Kohls Corporation	1,100	Baa2/BBB-/BBB-	Neg/Neg/Neg	Very High	High	3-12 months
Energy						
EnergyTransfer Operating L P	31,271	Baa3/BBB-/BBB-	Stable/Stable/Neg	Very High	Medium	<12 months
Oneok Inc.	11,222	Baa3/-/BBB	Stable/-/Stable	High	Medium	<12 months
Plains All American Pipeline I	8,150	Ba1/BBB-/BBB-	-/-/-	Very High	Medium	<12 months
Cheniere Corpus Christi Holdi	5,749	Ba1/BBB-/BBB-	Pos/Stable/-	High	Medium	<12 months
Noble Energy Inc.	5,700	Baa3/BBB/BBB-	Neg/Neg/Neg	Very High	High	<12 months
Hess Corporation	5,528	Ba1/BBB-/BBB-	Stable/Stable/Neg	High	Medium	<12 months
Marathon Oil Corporation	4,700	Baa3/BBB/BBB-	Neg/Neg/Neg	Very High	High	<12 months
Devon Energy Corporation	4,275	Ba1/BBB/BBB-	Stable/Stable/Neg	Very High	Medium	<12 months
Cimarex Energy Corporation	2,000	Baa3/-/BBB-	Stable/-/Neg	Very High	Medium	<12 months
Financials						
Aercap Ireland Capital DAC	11,300	Baa3 *-/BBB-/BB	-/Neg/-	Very High	Medium	3-12 months
Air Lease Corporation	9,000	BBB /- / BBB	Neg / - / Neg	High	Medium	3-12 months
TMT						
Viacom Inc	15,367	Baa2/BBB/BBB	Stable/Stable/Neg	High	Medium	6-12 months
Discovery Communications LL	11,120	Baa3/BBB-/BBB-	Stable/Stable/Stable	High	Medium	6-12 months
The Interpublic Group of Com	2,750	Baa2/BBB+/BBB	Neg/Stable/Neg	High	Low	6-12 months
Dell International L.L.C. and E	16,250	Ba2/BB/BB-	Stable/Neg/-	High	Medium	3-12 months
Seagate HDD Cayman	3,649	Baa3/BBB-/BB+	Stable/Stable/-	High	Low	3-12 months
EXPEDIA GROUP INC	2,250	Baa3/BBB-/BBB-	Neg/Neg/Neg	Very High	High	3-12 months
Arrow Electronics Inc.	2,000	Baa3/BBB-/BBB-	Stable/Stable/Stable	High	Low	<12 months
Flex Limited	1,750	Baa3/BBB-/BBB-	Stable/Stable/Stable	High	Low	3-12 months
Avnet Inc.	1,200	Baa3/BBB-/BBB-	Stable/Stable/Stable	High	Low	<12 months
Jabil Inc	1,000	Baa3/BBB-/BBB-	Stable/Stable/Stable	High	Low	3-12 months
Microchip Technology Incorp	1,000	Baa3/BBB-/BB+u	Stable/Neg/Stable	High	Medium	<12 months

ICE BAML Index data, Bloomberg, CreditSights. Data as of June 30, 2020

Appendix:
Sector Views

CreditSights | Know More. Risk Better.

Sector Focus: Financials

US Large Banks (M/P)

We upgrade to a Market perform recommendation on US Large Banks, characterized by a strong fundamental bias but tempered by middling valuations and what we expect will remain a high beta sector. We still think US banks are a good defensive play in the age of COVID-19, with the sector entering the crisis on strong footing, but clearly so does the market and we see current spreads as roughly fair value. We are also wary of technical risk if the surge in IG corporate issuance proves to be a pull forward of 2H20 volumes, setting up the potential for US banks to underperform as steady, consistent issuers amid a technical bid for corporates amid dwindling supply. To be clear, we are bullish on bank fundamentals, particularly for the large banks that enjoy greater balance sheet and earnings diversification that should be a benefit in the coming default wave and for the post-default capital rebuild (greater fee income to help offset margin pressures and boost profitability, i.e. organic capital generation). But we also limited opportunity for any real outperformance, underscoring our neutral market view.

Regional Banks (U/P)

While still on sound footing from a capital and liquidity standpoint, the sector is facing a number of headwinds given the sensitivity of much of the sector to interest rates and credit impacts, as lending accounts for most of the revenue base within the sector particularly among medium-sized and smaller regional banks. For this reason, within the sector we like names that have solid revenue diversification through fee income sources, in addition to names with more limited exposure to heavily-impacted sectors or consumers. Also, we see geographic positioning as a key differentiator, with regions that went with more moderate shutdowns and earlier reopenings having an advantage over areas with more lengthy shutdowns.

Sector Focus: Financials

Insurance (M/P)

We have a Market perform recommendation on the Life and P&C insurance sectors. The highest quality names in each sector are sound and will be able to manage through the pandemic, but given the long duration of the Life and P&C insurance sector we struggle to craft a scenario whereby Insurance outperforms Banks if projections regarding economic recovery are reasonably accurate. At this point, duration-adjusted spreads aren't conducive to Outperformance versus the wider Financials sector. Key risk factors for the P&C sector include unfavorable legal developments associated with policies like business interruption and workers' compensation. For the life insurance sector, continued equity market turbulence and flattening of the 10s-30s curve could be problematic, particularly for lower rated insurers.

REITs (M/P)

The pre-virus sector fundamental story was near-universally strong credit and liquidity profiles, a far cry from where REITs were in 2007. That fundamental credit story still holds, but the effects of COVID-19 and related shutdown policies are having wildly disparate impacts, from retail as the most impacted to industrial which could actually stand to benefit. For the first time in recent memory, we view REITs as a credit (or property-type) selection sector with more alpha opportunities (and pitfalls) than is typical. The pre-virus fundamental strength should allow most to muddle through, even the hard-hit retail names, but there's a long hard road ahead; even though we see limited fallen angel risk at this point for the high-BBB sector, we do think multi-notch downgrades are a distinct possibility. As such, we would generally prefer the more defensive names in the space despite tight trading spreads, and would be very selective around taking risk.

Sector Focus: Consumer

Consumer Goods (O/P)

While COVID-19 impacts will continue to hit credits more exposed to discretionary spending and foodservice, we anticipate the overall impact to be a net positive for consumer staples as consumers shift to a more cost conscious mindset, and spend on groceries rather than dining out. This should help accelerate deleveraging for credits that are still repairing the balance sheet from M&A in the last couple years. We continue to recommend a Market perform recommendation on the Tobacco sector. The sector's lack of operational volatility and its ability to generate robust free cash flow through the economic cycle makes it attractive in an environment plagued by economic uncertainty. Although we anticipate some operational volatility from COVID-19, we expect the industry's resilient pricing power to continue to drive revenue growth over the course of the year.

Retail (M/P)

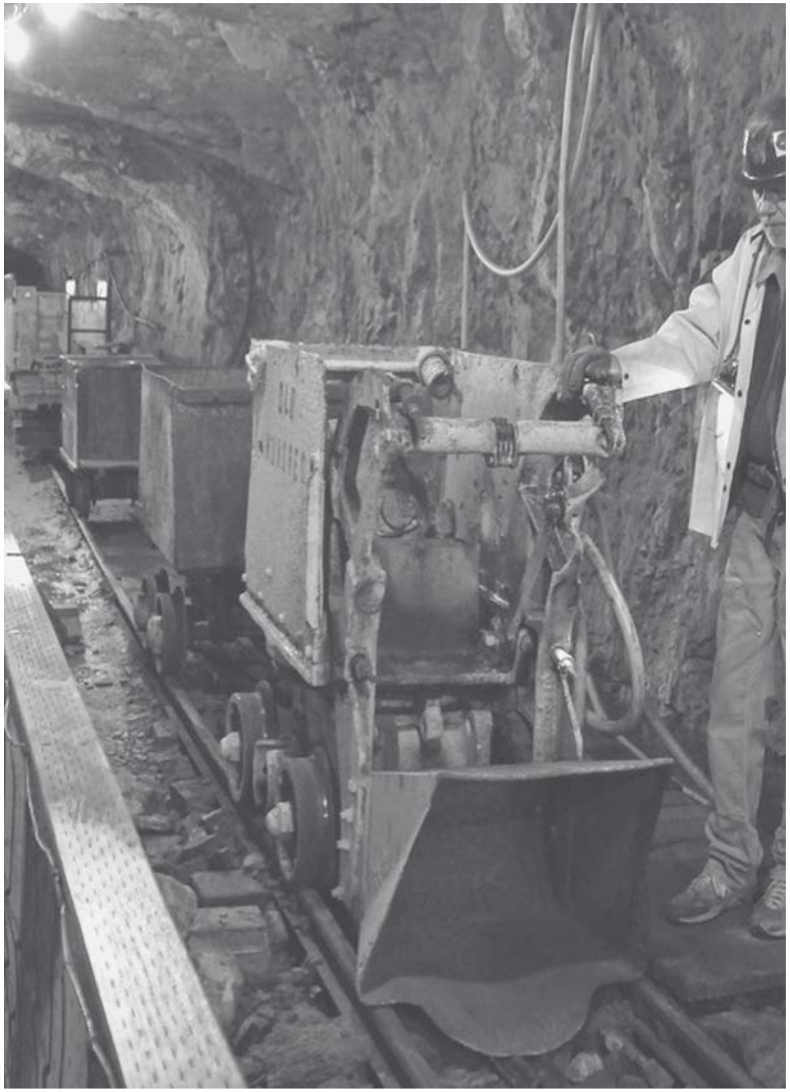
We are maintaining our Market perform recommendation on the Retail sector. Major index constituents including WMT, TGT, HD, and LOW have benefitted from largely uninterrupted business operations, and captured incremental demand from stock-up and stay-at-home trends, which were only partially offset by a temporary boost to operating costs. We'd note that consumer spending is still being supported by government transfer payments including temporary supplemental uninsurance and one-off Federal stimulus payments. While the IG retail space has shown resilience, the transition away from this environment, and into the realities of post-COVID recession impacts on consumer spending may limit further tightening. Most names in the IG retail space had little trouble raising cheap capital as an additional liquidity buffer, with on-the-ropes department stores like Kohl's and Nordstrom paying a high price for the privilege (and exhibiting a very tenuous grasp on IG ratings).

Sector Focus: Healthcare

Healthcare (M/P)

We have a Market perform recommendation on the managed care / health insurance sector. Though we continue to believe that the IG names have solid credit profiles and pandemic-related costs will be manageable, the sector is amongst the tightest across the IG space. The sector should be considered defensive and we believe that prevailing spreads incorporate this belief. Health insurers are benefiting from a reduction in non-emergency utilization of healthcare, offset by increased COVID-19 costs and potentially lower medical enrollment in the near future. We have a Market Perform recommendation on the Medical Products sector. The key risks in the sector are the potential for a protracted recovery in deferrable medical procedures and lower demand for capital equipment as COVID-19 has placed some healthcare providers under financial pressure. Our expectation is that the industry will not experience positive growth until 4Q20 at the earliest and even then, the rate of growth is likely to be below pre-COVID-19. That said, the sector remains defensive, particularly when compared to sectors that are more sensitive to the macroeconomic environment. We maintain a Market perform recommendation on the Pharma sector. While the sector will see 2Q20 disruption related to COVID-19 – largely tied to fewer doctor visits and lower prescription activity –headwinds should largely offset through 2H20. Furthermore, we see Pharma as a defensive sector when viewed through the lens of macroeconomic weakness, supporting the M/P rec despite spread levels well tight to the IG Index.

Sector Focus: Basic Industries



Basic Industries (M/P)

For Forestry and Paper, credits saw the benefit of strength in COVID-19 consumption patterns particularly in the panic buying of essential foods and goods primarily in the month of March. However, the path ahead remains unclear and players have pulled FY20 outlook on a lack of visibility, while also directing focus towards cash flow and enhancing liquidity. We are recommending moving into names with the dual benefit of a relatively lower leverage position and strong liquidity. In Chemicals, softer oil prices lower the raw material inputs for high cost petrochemical producers outside of the U.S., which in turn pressures the North American raw material advantage to the degree that oil prices fall faster than natural gas prices. For specialty chemical companies that use commodity feedstocks, the drop in oil prices and overall demand will result in lower raw material costs, which will be a tailwind for these companies. Given the plummeting oil prices and macro uncertainty brought on by the coronavirus, we recommend rotating out of names with significant oil exposure and into fertilizers, crop science and industrial gases. In Building Materials, we are remaining Market perform. Although the sector trades at the tight end of the wider Basics space, it has been, and is likely to continue to be, less impacted by COVID-19 than Metals or Chemicals.

Metals (M/P)

While COVID-19 has had an impact on the metals & mining sector, the IG metals & miners are well positioned given the balance sheet strength and exposure to gold & iron ore exposure. Gold prices have rallied, while iron ore prices have held up extremely well thus far in the year reflecting virus-driven supply concerns in Brazil and the solid recovery in steel production in China. In addition, the China-centric sector will benefit from the ongoing recovery in China, which is the main driver for commodities demand.

Sector Focus: Industrials

Autos (O/P)

This reaffirmation of our O/P is driven largely by the short duration nature of the sector as well as expectations for outperformance on the part of major index constituent GM, particularly given F has now fallen to HY, where wide spreads are currently reflecting crossover risk despite having been granted some leash in terms of remaining IG by Moody's likely into 2021. We would underscore again that in terms of taking exposure to automotive OEM's we would prefer to do so at the short end via captive paper when possible. Outside of GM we also like value-add supplier Aptiv at this point in the cycle thanks to its superior positioning relative to secular demand trends and expectations to outperform key markets going forward. It is important to highlight that crossover risk still permeates through the auto complex and we see potential for negative ratings action at Japanese OEM Nissan as well as more commoditized supplier Lear.

Capital Goods (U/P)

We maintain our rec on the back of weakening fundamentals and tight level of spreads levels. Heavyweights such as Boeing, RTX, GE all have outsized exposure to the commercial aerospace markets that remain among the hardest hit by the pandemic and will dominate the relative spread performance for the broader cap goods index. We see no signs for getting constructive on aerospace just yet and in fact, we still see some additional downside risk on further cuts to OEM production rates that could have more knock-on effects on the supplier chain. Expectations for higher aircraft retirements will also prolong aftermarket demand recovery that remains a key driver of profits and cash flows. A key swing factor for spread performance over the next few months will hinge on the 737 MAX regulatory approvals that could sway spreads for BA, GE and RTX, and in turn for the broader cap goods index. Outside of commercial aero, we continue to like the fundamental story and defensive characteristics of the defense contractors but note that this peer group will likely carry some more headline risk with the looming elections and debate on the budget environment. We continue to see value in RTX and NOC while we see GE and CARR as our top pans due to greater ratings risks.

Sector Focus: Energy & Utilities

Energy (O/P)

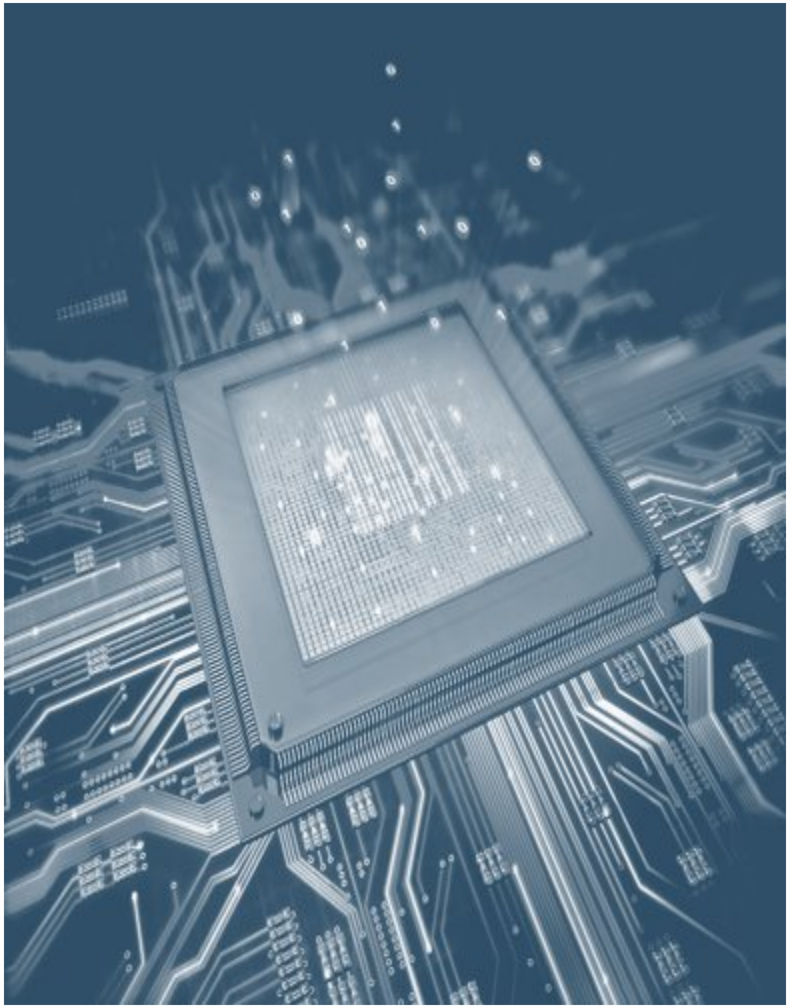
We are upgrading our sector level recommendations for the E&P and Integrated sectors to Outperform and Market perform, respectively, though security selection will remain key. E&P fallen angel risk has declined significantly with the weakest positioned names already out of the index and the remaining names being provided a runway to late 2021 by the agencies. Both sub-sectors offer significant spread pickup and will benefit from technical support in the secondary during the back half of the year as most names have bolstered liquidity and refinanced upcoming maturities. The oil price outlook remains weak, and is likely to be volatile, but strip prices are now in-line with agency 2021 outlooks with YE21 credit metrics being a key focus points for agencies, which reduces of a near-term price deck reduction.

We maintain our Outperform rating on Midstream with ~100bps of spread pickup as the sector once again showed its resilience to energy market volatility, as well as its willingness and ability to defend ratings when necessary. Management teams remain focused on improving the balance sheet and many core IG issuers have a significant portion of take-or-pay contracts that have no commodity price or volume exposure. Average 2020 consensus EBITDA estimates for IG Midstream only declined 6.7% YTD compared to a 44% downward adjustment for the 12 E&Ps under coverage.

Utilities (M/P)

We have a favorable view of U.S. utility credit quality but spreads 5-10 bps inside the corporate index keeps us at M/P. The two main issues to watch from Covid are falling commercial & industrial sales and bad debt expense. For falling C&I, being in earnings / deliveries de-coupled states is key (PPL, DUK, D) while there is risk in those without it (ETR, PEG). We expect bad debt expense to be recovered but recovery timing must be watched. Most utilities talked about the potential levers of cutting capex using O&M savings should Covid start impacting long-term earnings. CNP remains our Top Pick as agencies are late to removing the negative outlook despite the $1.4 bn equity raise.

Sector Focus: TMT



Tech (U/P)

Tech is a defensive sector, driven in part by massive A-rated issuers, and is currently trading slightly tighter than the overall A index. Given the limited carry, tech tends to outperform only during risk-off environments, although operating trends have also held up better than other sectors directly hit by COVID-19. With a shift to risk-on as businesses reopen, we are downgrading our tech sector rec from Market perform to Underperform. We expect demand for cloud computing and software to remain strong although the recent strength in notebooks given work-from-home and e-learning trends might be short-lived. We think hardware OEMs could see weakness in 2H of 2020 as businesses pull back on capex for on-premise infrastructure. In semis, strength in data center / compute and improving memory pricing are largely offsetting short-term weakness in automotive.

Media (M/P)

We are lowering our Media sector recommendation to Market perform from Outperform. While media companies have bolstered their liquidity positions via recent issuance and should be able to ride out the near-term COVID-19 storm, several operational and technical factors have deteriorated over the past quarter. First, we believe that macro-related advertising pressures and theatrical/theme park closures will result in severe EBITDA contraction in 2Q20 and weigh on profitability well into 2H20. Second, we think that COVID-19 will act as a catalyst for the acceleration in negative secular trends including cord-cutting and the shift to streaming video. Finally, we believe that rating downgrade risk has increased at Disney and Comcast, which have previously been viewed as safe havens and may see some forced selling if they drop from the A-rating category.

Telecom (O/P)

Visibility on operations and event risk is valuable at this stage. Telecom offers this and an attractive spread, which is why we are maintaining our Outperform view. The wireless heavy-weights are well positioned to weather COVID-19 headwinds and the sector is insulated if China trade tensions flare. The overhang from jumbo-sized issuance from TMUS (Sprint-merger) and AT&T (refinancing) was removed in April/May, which is reassuring. We also view ratings event-risk as low, most importantly for AT&T, while Verizon continues to strive for an upgrade. We see better value in Verizon relative to its media peers Disney and Comcast. We also believe there is tightening potential at AT&T, in particular at the 10-year section of the cash curve. We are more cautious on TMUS at the long-end, as we think the market got ahead of itself seeing only the positives when TMUS tapped the IG market.

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