Morningstar Corporate Credit Research Highlights

Corporate Credit Spreads Tighten After New Issuance Slows From Record-Breaking Pace

Morningstar Credit Ratings, LLC
16 September 2019

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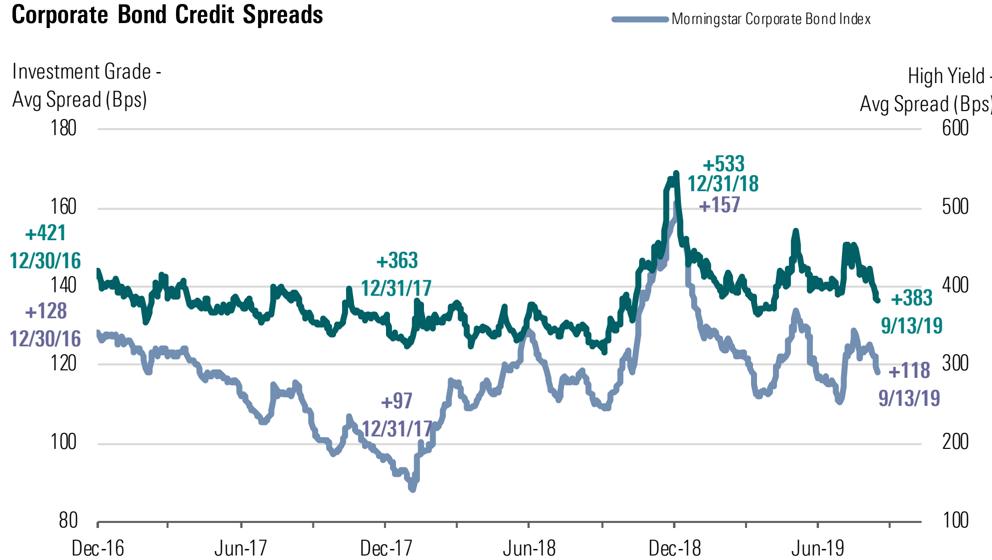
Credit Market Insights

Corporate Credit Spreads Tighten After New Issuance Slows from Record-Breaking Pace

The two most market-moving items in the headlines last week were goodwill gestures from the Chinese and U.S. administrations, and the European Central Bank's, or ECB's, announcement it was ramping-up its already extraordinarily loose monetary policy. In order to stimulate moribund economic activity in the European Union, the ECB announced it would lower its key short-term lending rate to a negative 0.50% from negative 0.40% and would restart its bond-buying program at a rate of EUR20 billion per month. The bond-buying program is scheduled to begin in November, just under one year from when it was discontinued last December. In regard to the ongoing trade tensions between the U.S. and China, the markets received a jolt of optimism as each side announced concessions. Among the goodwill gestures each side made, the U.S. announced it would delay the imposition of new tariffs on $250 billion worth of Chinese imports for two weeks and the Chinese government announced it would waive tariffs on some U.S. farm products including soybeans and pork. U.S. and Chinese officials are scheduled to resume trade negotiations at the beginning of October.

In the U.S. corporate bond market, the amount of new-issue volume decreased last week compared with the frantic, record-breaking pace of the prior week. The amount of new issuance continued to run at a brisk pace but based on the high demand among global institutional investors for US corporate bonds the new supply was easily digested by the market. Between the lower supply of new issues and positive news headlines, corporate credit spreads tightened across both the investment grade and high-yield markets. In the investment-grade market, on a week-over-week basis, the Morningstar Corporate Bond Index tightened 5 basis points to +118 and in the high-yield market, the ICE BofAML High Yield Master II Index tightened 22 basis points to +383.

Corporate Bond Credit Spreads



Source: Morningstar, Inc., ICE BofAML Global Indexes. Data as of 9/13/2019.

This week, the outlook for the amount of new issuance is more uncertain than usual as syndicate desks are expecting anywhere from $10 billion to $30 billion of new issuance. After two weeks of "getting deals done left and right" as one Wall Street trader described it, he expects new-issue volumes will be at the lower end of the range as the issuers that were looking to tap the capital markets after the U.S. Labor Day holiday have already done so. He expects secondary trading to pick up significantly as portfolio managers look to rightsize their positions to capture, where they see, relative value as the focus shifts away from the primary market. He also expects market volatility will subside for the next two weeks based on his expectation that the Chinese and U.S. administrations will keep a low profile in the news and social media in advance of the trade negotiations at the beginning of October.

After hitting their lowest yields over the past few years, the demand for U.S. Treasury bonds plunged last week and the decline in Treasury bond prices pushed up yields up significantly. In the short end of the curve, the interest rate on the two-year bond rose 26 basis points to 1.80% and the five-year rose 32 basis points to 1.75%. In the longer end of the curve, the yield on both the 10- and 30-year bonds rose by 34 basis points to 1.90% and 2.37%, respectively. After having inverted at the end of August, the yield curve between the two-year and 10-year steepened to 10 basis points. The spread between the 2s10s has been watched closely by the markets as an inversion between these two points on the curve has historically been an indicator of impending economic recessions.

In the equity markets, the S&P500 rose 0.96% and is currently trading less than 1% from its all-time closing high. The risk-on sentiment was not limited to the U.S. and the positive contagion spread across global markets. In Europe, the German DAX rose 2.27%, the French CAC rose 0.92%, and even with the U.K. mired in its Brexit drama, the FTSE rose 1.17%. China's Shanghai Index rose 1.05%.
Similar to the U.S. bond market, as the risk on sentiment took hold and European stock markets surged higher, prices fell across the board for European sovereign bonds, sending interest rates higher,

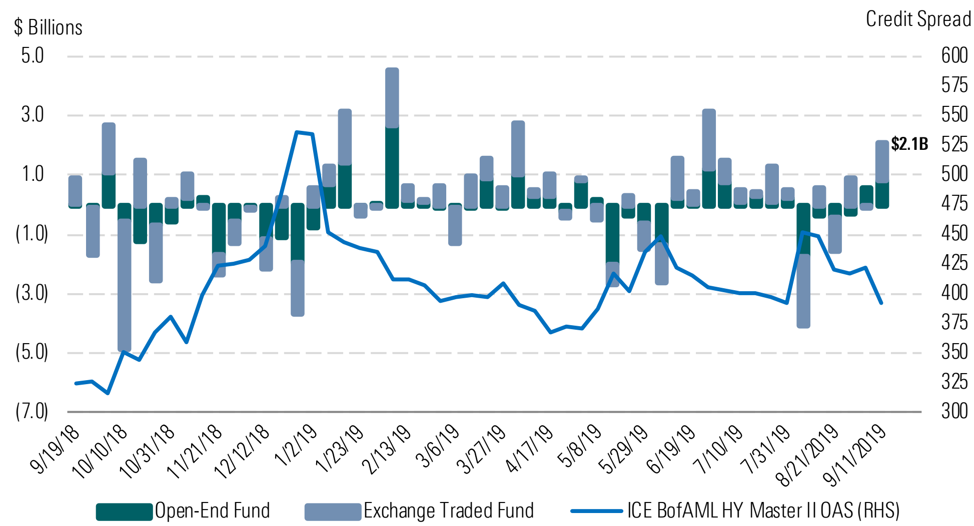
although the benchmark bonds are still trading at negative yields. For example, the yield on the 10-year German bond rose 19 basis points to a negative 0.45% and the Swiss 10-year rose 26 basis points to a negative 0.66%. Among other benchmark sovereign bonds, the Japanese 10-year bond rose 9 basis points to a negative 0.15%.

Institutional Investors Follow Retail Investors Back Into the High-Yield Market

Net inflows into the high-yield sector increased to $2.1 billion last week. The increase was driven by the return of institutional investors. Net unit creation among the high-yield exchange traded funds (ETFs) rose to $1.2 billion last week compared with a slight net unit redemption of $0.1 billion the prior week. Asset flows among the ETFs is typically considered a proxy for institutional and "hot-money" investors. Among the open-end high yield mutual funds, inflows rose to $0.9 billion, an increase from the $0.6 billion of inflows the week before. Historically, flows among the open-end funds has been attributed to individual investor demand.

Year to date, there has been a total of $16.3 billion of net inflows into the high-yield asset class. Most of the inflows have been driven by $11.6 billion of net unit creation across the high yield ETFs as the open-end funds have only received $4.7 billion of new investments.

Estimated Weekly High-Yield Bond Fund Flows and High Yield Credit Spreads



Source: Morningstar, Inc. and ICE BofAML Global Indexes.

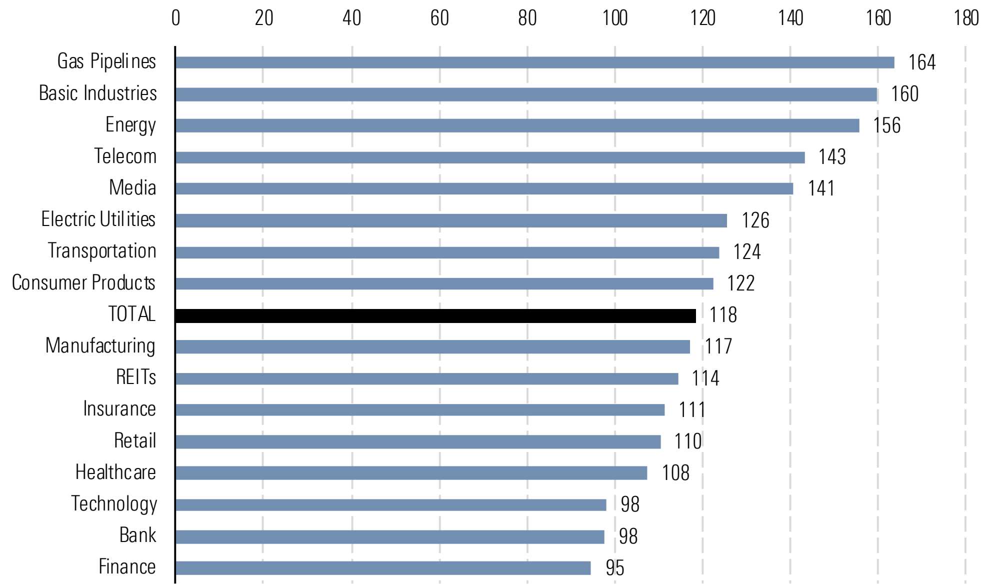
Exhibit 1 Morningstar Corporate Bond Index Sector Summary

Sector	Average Rating	Number of Issues	Modified Duration	Spread (bps)	MTD Spread Chg (bps)	YTD Spread Chg (bps)	MTD Total Return (%)	YTD Total Return (%)
TOTAL	**A-**	**5,338**	**7.2**	**118**	**(5)**	**(38)**	**(2.30)**	**10.97**
FINANCIAL	**A-**	**1,457**	**5.4**	**99**	**(2)**	**(42)**	**(1.81)**	**9.13**
Bank	A-	859	4.8	98	(3)	(45)	(1.49)	8.76
Finance	A-	258	5.2	95	(1)	(41)	(1.70)	8.82
Insurance	A	230	8.8	111	(1)	(27)	(3.43)	11.38
REITs	BBB+	101	6.2	114	3	(34)	(2.35)	9.65
INDUSTRIAL	**A-**	**3,148**	**7.9**	**125**	**(7)**	**(37)**	**(2.47)**	**11.77**
Basic Industries	BBB	270	7.6	160	(12)	(38)	(2.01)	12.22
Consumer Products	BBB+	342	8.1	122	(6)	(37)	(2.64)	12.87
Energy	A-	400	7.6	156	(17)	(41)	(1.90)	11.71
Healthcare	A-	443	8.2	108	(3)	(28)	(2.80)	10.88
Manufacturing	A-	499	6.4	117	(6)	(44)	(1.84)	10.23
Media	BBB+	176	9.1	141	(6)	(37)	(3.02)	13.64
Retail	A-	212	8.3	110	(4)	(33)	(2.75)	11.10
Technology	A	373	7.3	98	(4)	(29)	(2.50)	10.50
Telecom	BBB+	157	9.8	143	(6)	(48)	(3.20)	15.77
Transportation	BBB+	199	9.0	124	(4)	(33)	(3.00)	12.21
UTILITY	**BBB+**	**676**	**8.9**	**143**	**(6)**	**(43)**	**(2.80)**	**12.51**
Electric Utilities	A-	373	9.6	126	(6)	(44)	(3.29)	12.67
Gas Pipelines	BBB	283	7.8	164	(7)	(44)	(2.13)	12.41
Rating Bucket								
AAA Bucket		123	7.5	49	1	(10)	(2.89)	8.37
AA Bucket		492	6.3	62	(2)	(23)	(2.15)	8.03
A Bucket		1,957	7.2	92	(3)	(32)	(2.50)	9.88
BBB Bucket		2,766	7.4	153	(9)	(51)	(2.14)	12.52
Term Bucket								
1-4	A-	1,726	2.2	68	(2)	(33)	(0.51)	4.71
4-7	A-	1,232	4.7	104	(5)	(51)	(1.36)	9.12
7-10	BBB+	853	6.9	129	(6)	(50)	(2.19)	12.39
10PLUS	A-	1,527	14.0	173	(6)	(36)	(4.68)	18.64

Data as of 09/13/2019

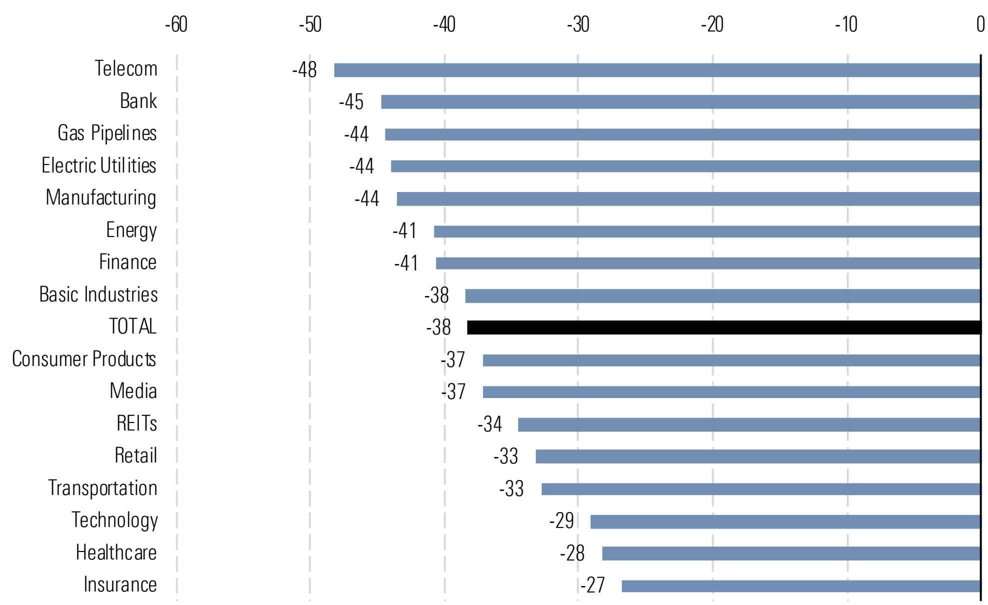
Source: Morningstar, Inc.

Exhibit 2 Morningstar Corporate Bond Index Spread by Sector



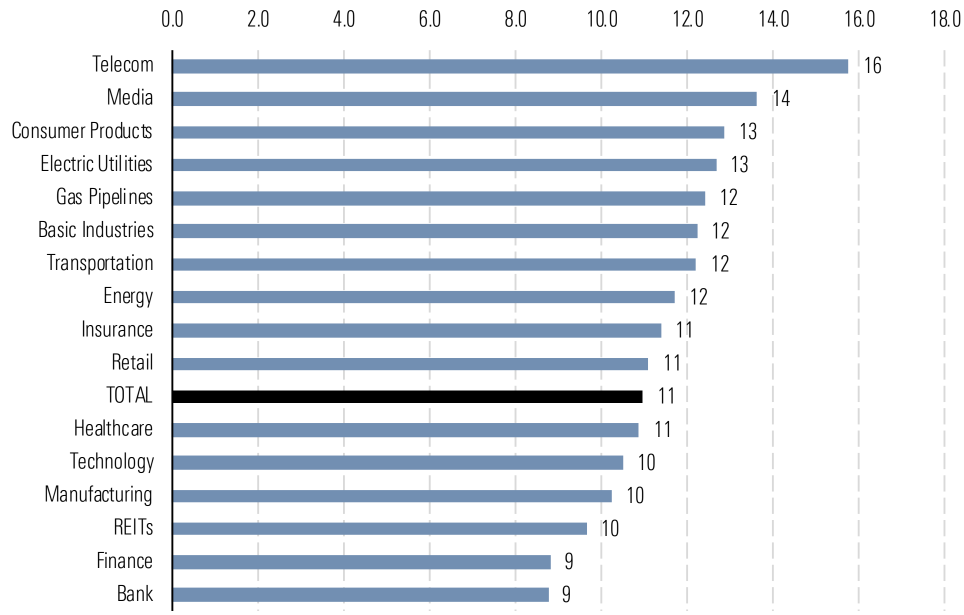
Source: Morningstar, Inc.

Exhibit 3 Morningstar Corporate Bond Index YTD Spread Change



Source: Morningstar, Inc.

Exhibit 4 Morningstar Corporate Bond Index YTD Return



Source: Morningstar, Inc.

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