Corporate Credit Spread Chartbook
Industrials Sector

Morningstar Credit Ratings, LLC
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Contents

Basili Alukos, CFA, CPA
Assistant Vice President
+1 312 384-4984
basili.alukos@morningstar.com

Rick Tauber, CFA, CPA
Senior Vice President
+1 312 384-5431
rick.tauber@morningstar.com

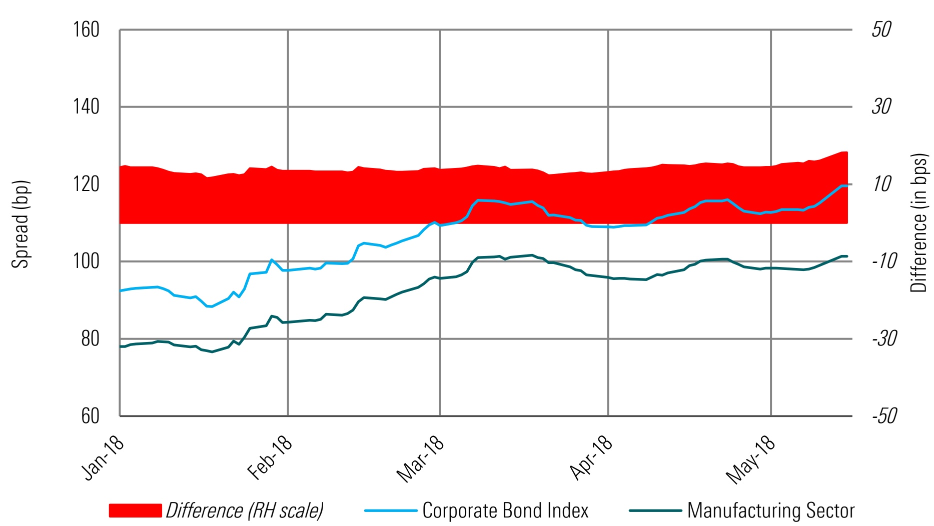
Executive Summary

We experienced a bevy of rating activity in the industrials landscape since our previous publication in January. In total, we upgraded three companies on positive improvements in credit profiles, while two companies saw their respective ratings decline one notch from a commitment for debt-funded repurchases and another from the ill effects of debt-financed acquisitions, of which we expect may continue in the sector. We shifted one automotive supplier's outlook to stable from negative on improving trends and moved one logistics company to negative outlook. Spreads across the board widened during the quarter, coming off recent post-recession tights in both the Manufacturing Sector and the index as a whole.

Historical Sector Spreads

The credit spreads of the Morningstar, Inc. Corporate Bond Index and the Manufacturing Sector Index both widened out since our January Industrials Chartbook. The CBI widened 27 basis points to +120, while the MSI widened 23 basis points to +101. The MSI ended the quarter +18 basis points inside of the CBI versus +14 basis points at the start of the period. The ending differential of +18 basis points was essentially the high differential during the period, wide of both the average of +14 basis points and low of +12 basis points.

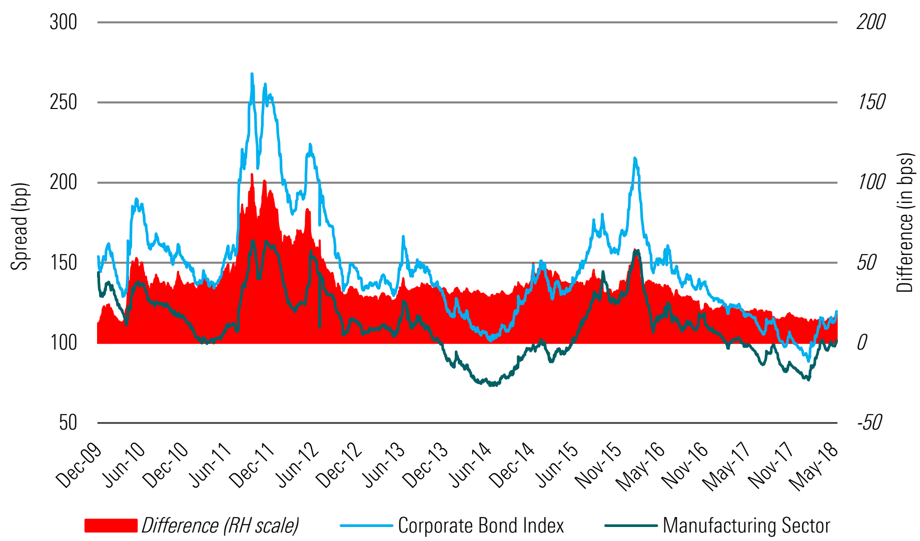
Exhibit 1 Morningstar, Inc. Corporate Bond Index Versus Manufacturing Sector (Since Jan. 16, 2018)



Source: Morningstar, Inc. Data as of May 30, 2018.

At the beginning of the current economic expansion, the Manufacturing Sector Index experienced the same fluctuations as the overall Morningstar, Inc. Corporate Bond Index, but maintained its characteristic of trading inside of the CBI. The latter widened during summer 2011, which coincided with the downgrading of the United States' credit rating as well as the sovereign debt crises and contagion of Iceland, Ireland, and Greece. The index widened, related to global growth worries leading into the end of 2015 and into 2016, which coincided with falling energy prices and the impending default risk. We think President Trump's stance on global trade policies may have contributed to market spread widening. Still, the MSI ended the period at +18 basis points inside of the CBI, roughly +8 basis points from the low of +10 basis points and tight to the +36 basis points inside the CBI it averaged during this span.

Exhibit 2 Morningstar, Inc. Corporate Bond Index Versus Manufacturing Sector (2010–present)



Source: Morningstar, Inc. Data as of May 30, 2018.

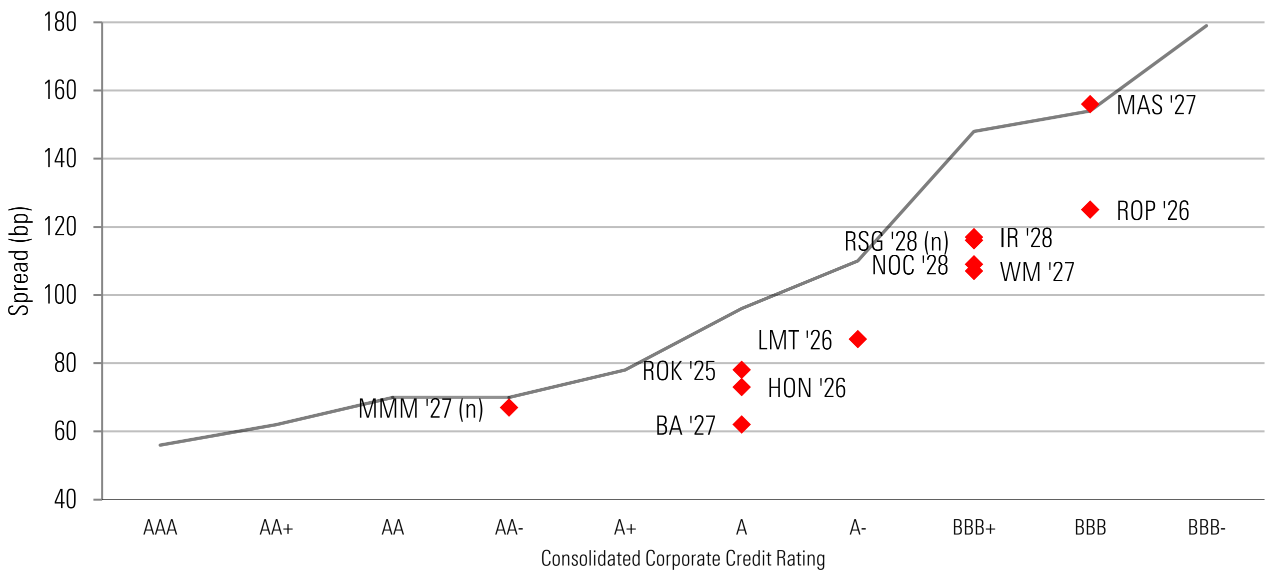
Our optimistic view for the industrials sector remains untarnished despite the recent economic furor over the president's enacted tariffs on steel and aluminum. Our most influential leading indicator, the Institute for Supply Management Purchasing Managers' Index, a diffusion index, remains in strong positive territory. May's ISM reading of 58.7 increased 1.4% from April's figure, with none of the 18 manufacturing industries surveyed indicating a decrease in the month-over-month readings. At this early juncture, we are likely to conclude that the weak April reading of 57.3 was in part the visceral response to the trade war. In fact, some of the internals such as new orders and production levels are nearly as high as those reported in the February release, which, at 60.8, was the highest we've seen this year. All told, we believe these strong PMI levels are a result of tax reform, as many of the diversified industrials noted upbeat sentiment during their quarterly earnings calls. We still think that the biggest beneficiaries will be mostly domestic-focused companies because the large diversified companies already have effective tax rates below statutory levels. Moreover, we think given the large exposure to energy, so long as the price of oil remains robust, we would expect the diversified industrial economy to motor along.

Spread Charts by Subsector

In the pages that follow, we discuss credit trends and the major headlines since our last publication.

Capital Goods

Exhibit 3 Capital Goods Versus Morningstar, Inc. Industrials Index



Source: Morningstar Credit Ratings, LLC, Morningstar, Inc., and Interactive Data as of June 7, 2018.
(UR) = rating under review/(p) = positive outlook/(n) = negative outlook

Credit Trends

On average, bond spreads in this subsector widened +24 basis points since our last publication versus the CBI, which widened 27 basis points. Many companies produced solid calendar third-quarter earnings. Industrial companies reported solid low- to mid-single-digit quarterly organic growth rates, with the continued resurgence in the energy patch further fueling top-line growth in housing, consumer, and aerospace end markets. M&A activity was again front and center, although no large deal was consummated. Still, many management teams of large industrials have commented that tax reform could create a catalyst using their overseas cash balances for acquisitions.

Issuer Highlights

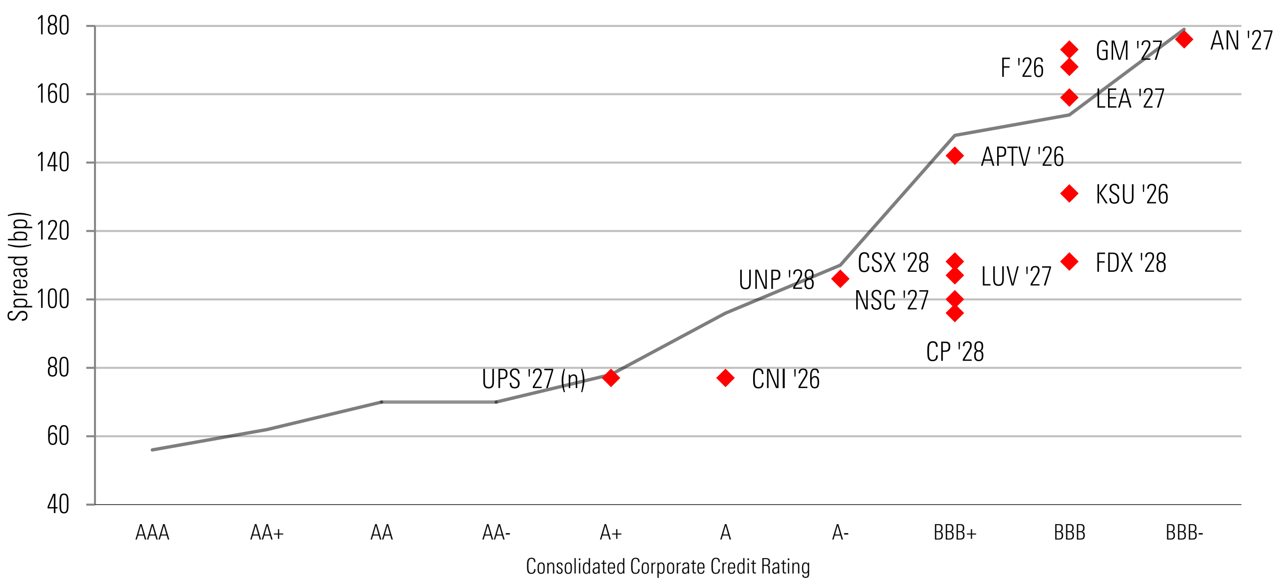
- Northrop Grumman (BBB+, stable) completed its acquisition of Orbital ATK in early June. We had downgraded Northrop's rating one notch to BBB+ and established a stable outlook in advance of the deal closing in March. The acquisition and corresponding higher leverage, along with a more shareholder-friendly capital allocation policy, drove the downgrade. Still, Morningstar's Equity Research Group upgraded Northrop's moat to wide from narrow in June, supporting a solid Business Risk pillar.

Recent Headlines

- Morningstar's Equity Research Group raised the economic moats of Waste Management Inc (BBB+, stable) and Republic Services Inc (BBB+, negative) to wide from stable. We did not change our rating or outlooks on these credits as our Business Risk pillar already reflected the strength of their competitive advantages.

Transports & Automotive

Exhibit 4 Transports & Automotive Versus Morningstar, Inc. Industrials Index



Source: Morningstar Credit Ratings, LLC, Morningstar, Inc., and Interactive Data as of June 7, 2018.
(UR) = rating under review/(p) = positive outlook/(n) = negative outlook

Credit Trends

On average, bond spreads in this subsector widened +16 basis points since our last publication versus the CBI, which widened 27 basis points. Looking to the transportation sector, the class-I rails reported solid quarterly earnings. Carload volume grew, although the effects from the devastating hurricanes created some headwinds. Still, profitability and free cash flow generation generally improved, as core pricing power and operating efficiencies mitigated the impact of overall rail inflation. Management teams provided a tempered, albeit encouraging, outlook for the remainder of the year and early hints for 2018. They expect strength in intermodal and chemical commodities likely to be offset by a weakening automotive environment. So long as the manufacturing economy continues to run on high gear, we expect the rails to keep chugging along.

Issuer Highlights

- We lowered our corporate credit rating on Union Pacific Corp one notch to A- to account for the unveiling of management's new capital allocation strategy. This new policy includes increasing the rent-adjusted leverage target to 2.7 times from up to 2.0 times today. In total, management is looking to reward shareholders by repurchasing $20 billion worth of shares by 2020; a move that will necessitate a total of at least $8 billion of incremental debt by our calculation.
- Our rating on Aptiv (BBB+, stable) was affirmed but the outlook changed to stable from negative as the firm exhibited a clearer picture of its capital allocation priorities. Along with this, Aptiv remains very well

positioned as the industry transitions to autonomous cars with continually increasing electronic content and technology. As such, we believe Aptiv can also gradually deleverage.

Recent Headlines

- Labor relations issues reared their heads this quarter, as Canadian Pacific Railway Ltd (BBB+, stable) experienced walkout when more than 3,000 conductors and engineers and 360 signal maintainers were unable to reach a new contract. Less than 24 hours later, the walkout was over, and the parties agreed a new, four-year agreement. Separately, United Parcel Service Inc (A+, negative) was notified by the union representing 260,000 of UPS' 454,000 workers that its members had given the go-ahead to call a strike should the two sides fail to renew the contract that expires July 31, 2018.

Morningstar® Credit Research

For More Information
Todd Serpico
+1 312 384-5488
todd.serpico@morningstar.com

22 West Washington Street
Chicago, IL 60602 USA