Morningstar Corporate Credit Research Highlights
Volatility Returns With a Vengeance

Morningstar Credit Ratings, LLC
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Contents

Credit Market Insights

Volatility Returns With a Vengeance

After trading within a relatively narrow band for much of the year, market volatility has returned with a vengeance. Following the Federal Open Market Committee meeting at the end of July, as measured by the CBOE Volatility Index, the volatility of the S&P 500 surged from near 52-week lows to its highest level year to date last Monday, before settling down somewhat by the end of the week.

As expected, the Federal Reserve cut the federal-funds rate by 25 basis points to 2.00%-2.25%; however, in a rare display of contention on the Federal Open Market Committee, two voting members (presidents of the Boston and Kansas City Federal Reserve Banks) dissented from this action. These dissents called into doubt the assumption of additional near-term easing, and many traders feared that the Fed might be one-and-done for the foreseeable future. Without the prospect of additional near-term monetary easing, many traders decided to sell and lock in some of the gains they have made thus far this year. Compounding investors' concerns that the Fed might not be in any hurry to lower interest rates further, President Donald Trump announced his intention to impose 10% tariffs on $300 billion worth of imports from China. After a brief cease-fire, the resumption and expansion of the trade war renewed fears that the United States will not be able to stave off contagion from the global economic malaise that has been spreading in Europe and Asia.

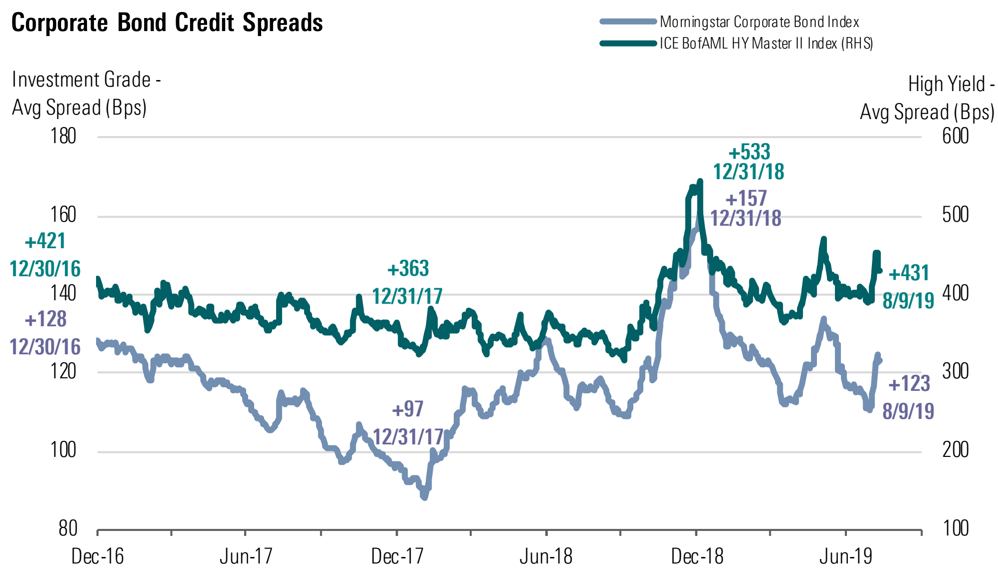
Following this initial wave of selling the prior week, when the markets opened last Monday, the stock market was further pummeled and the S&P 500 fell approximately 3%. The spark that instigated this conflagration was the precipitous overnight decline in the value of the yuan versus the U.S. dollar. The value of the yuan gapped from 6.94 per dollar to 7.05 per dollar as the Chinese government reportedly allowed the currency to devalue before stepping in to halt the decline. At this exchange rate, the yuan is trading at its weakest level versus the dollar since 2008. While this rate change may not appear to be very meaningful on the surface, it was a significant one-day move for the trading pair. Global macroeconomic traders have been closely watching the trading level of the yuan versus the dollar and using it as a proxy for the Chinese response to the trade dispute with the U.S.

As investors fled the equity market, safe havens such as U.S. Treasury bonds soared and pushed interest rates down across the yield curve. The yield on the 2-year Treasury bond fell to its lowest level in two years, and the yields on 5- and 10-year Treasury bonds fell to their lowest levels of the past three years.

By midweek, the markets found their footing and began to recoup earlier losses as other global central banks announced cuts to their short-term interest rates. India, New Zealand, and Thailand announced interest-rate reductions and were quickly followed by the Philippines with its own interest-rate cut. Market prognosticators expect Australia to quickly follow suit. Asset markets took solace in these moves as proof that central bankers will take action to help reinvigorate weakening global economic growth. Investors were also relieved to see that while the value of the yuan continued to weaken versus the dollar, the rate of devaluation slowed from its initial drop.

Markets tried their best to recover by the end of the week but were unable to get back to even. For the week, the S&P 500 fell 0.46% and corporate bond credit spreads remained wider. In the investment-grade market, the average spread of the Morningstar Corporate Bond Index widened 6 basis points to +123. In the high-yield market, as measured by the ICE BofAML High Yield Master II Index, credit spreads widened 12 basis points to an average of +431.

Corporate Bond Credit Spreads



Source: Morningstar, Inc., ICE BofAML Global Indexes. Data as of 8/9/2019

As risk assets recouped some losses in the second half of the week, the demand for safe-haven assets dwindled and U.S. Treasury bonds gave up some of their gains. At the end of the week, the interest rates on 2-, 5- 10-, and 30-year bonds closed at 1.65%, 1.586%, 1.74%, and 2.26%, some of their lowest rates over the past two to three years.

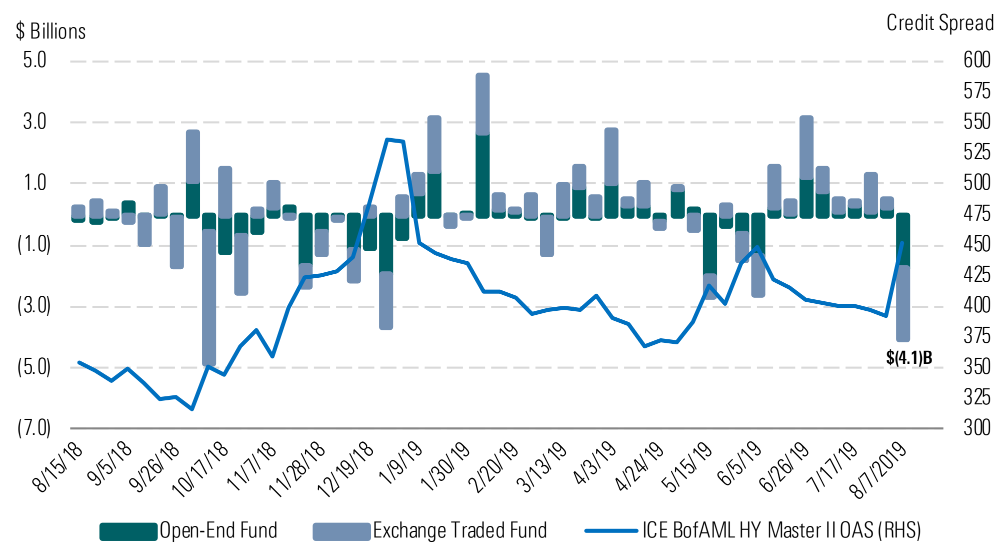
Not only are interest rates at multiyear lows in the U.S., but interest rates in Europe are continuing to hit new lows, or in many cases, trading at even greater negative yields. Between weakening economic growth in the European Union and the heightened potential for a no-deal Brexit, investors are expecting the European Central Bank to pursue even more extreme monetary policies later this year in an attempt to bolster EU economies. Prices on German bonds continued to surge higher last week and pushed yields even deeper into negative territory. The 5- and 10-year German bonds ended the week at their historically lowest yields of negative 0.82% and negative 0.58%, respectively.

High-Yield Investors Head for the Exit

After eight consecutive weeks of inflows into the high-yield asset class (the first time since October 2013), approximately half of those inflows were withdrawn last week. For the week ended Aug. 1, a total of $4.1 billion of outflows were registered across open-end mutual funds and exchange-traded funds. To place this amount in context, this was the second-largest weekly outflow over the past year (trailing the $4.9 billion of outflows in October 2018) and the sixth-largest weekly outflow we have registered since we began calculating weekly outflows in mid-2009. Across high-yield open-end mutual funds, investors redeemed $1.8 billion of funds; among high-yield ETFs, net unit redemptions totaled $2.3 billion.

Even after incorporating these outflows last week, year-to-date inflows into the high-yield asset class total a solid $14.5 billion: $10.2 billion of net unit creation among high-yield ETFs and $4.3 billion of inflows across high-yield open-end mutual funds.

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



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

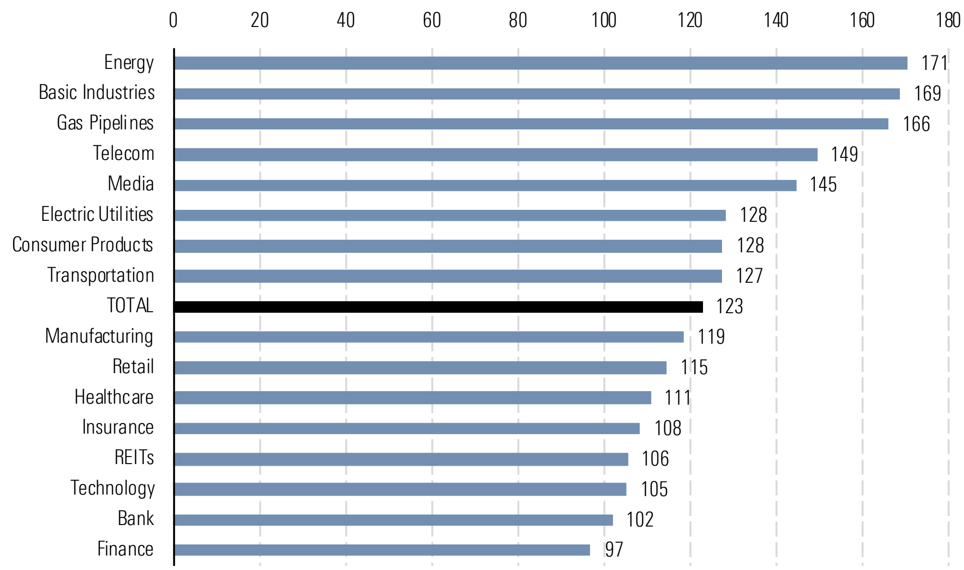
Exhibit 1 Morningstar Corporate Bond Index Sector Summary

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-**	**5,303**	**7.3**	**123**	**11**	**(34)**	**1.25**	**11.63**
FINANCIAL	**A-**	**1,463**	**5.5**	**102**	**9**	**(39)**	**1.09**	**9.76**
Bank	A-	869	4.9	102	9	(40)	0.92	9.18
Finance	A-	252	5.2	97	8	(38)	1.06	9.39
Insurance	A	233	8.8	108	8	(30)	1.86	13.08
REITs	BBB+	100	6.1	106	7	(43)	1.35	10.72
INDUSTRIAL	**A-**	**3,116**	**7.9**	**131**	**12**	**(31)**	**1.31**	**12.39**
Basic Industries	BBB	271	7.7	169	14	(29)	1.13	12.54
Consumer Products	BBB+	340	8.2	128	12	(32)	1.28	13.62
Energy	A-	389	7.6	171	13	(26)	1.12	11.92
Healthcare	A-	446	8.2	111	11	(25)	1.47	11.66
Manufacturing	A-	488	6.4	119	11	(42)	1.05	10.96
Media	BBB+	177	9.2	145	12	(33)	1.67	14.62
Retail	A-	209	8.3	115	10	(29)	1.52	11.81
Technology	A	371	7.5	105	12	(22)	1.17	11.02
Telecom	BBB+	157	9.9	149	13	(42)	1.69	16.50
Transportation	BBB+	195	9.1	127	13	(29)	1.40	12.99
UTILITY	**BBB+**	**665**	**9.0**	**145**	**14**	**(40)**	**1.48**	**13.55**
Electric Utilities	A-	370	9.8	128	11	(41)	1.86	14.01
Gas Pipelines	BBB	275	7.9	166	16	(42)	0.97	13.08
Rating Bucket								
AAA Bucket		127	7.6	50	6	(9)	1.54	9.31
AA Bucket		493	6.3	66	7	(20)	1.27	8.73
A Bucket		1,954	7.3	94	10	(30)	1.37	10.77
BBB Bucket		2,729	7.4	159	14	(44)	1.15	12.97
Term Bucket								
1-4	A-	1,737	2.2	73	8	(28)	0.46	4.76
4-7	A-	1,212	4.8	109	11	(45)	0.87	9.50
7-10	BBB+	852	7.0	136	12	(43)	1.24	13.00
10PLUS	A-	1,502	14.1	175	13	(34)	2.33	20.21

Data as of 08/09/2019

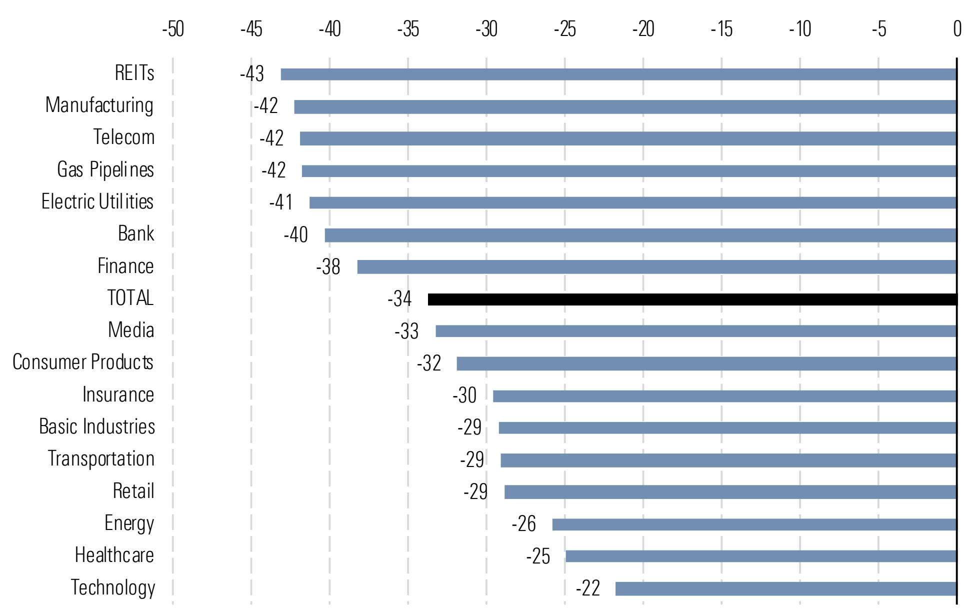
Source: Morningstar, Inc.

Exhibit 2 Morningstar Corporate Bond Index Spread by Sector



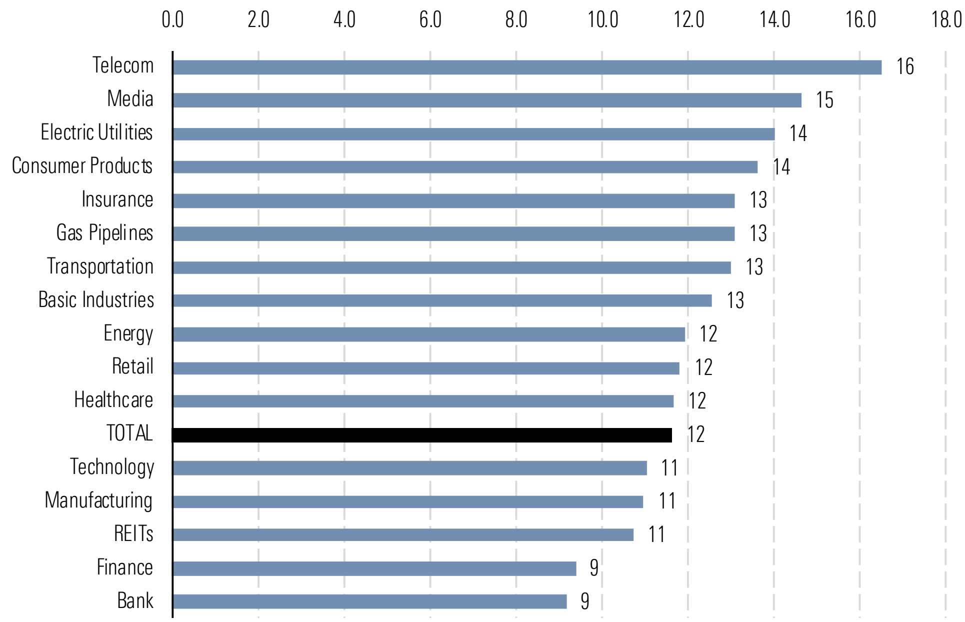
Source: Morningstar, Inc.

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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