Second-Quarter 2017 Corporate Credit Market Insights

Morningstar Credit Ratings, LLC
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David Sekera
Managing Director
+1 312-696-6293
david.sekera@morningstar.com

Key Takeaways

- Rising federal-funds rate did not preclude fixed-income indexes from rising in the first quarter.
- Corporate credit spreads remain near the tightest quartile they have registered over the long term.
- Corporate credit rating upgrades continue to outpace downgrades.

Summary

Fixed-income indexes performed well during the first quarter of 2017, as interest rates held relatively steady and credit spreads tightened slightly. Corporate credit markets have been supported by a combination of generally improving credit metrics and the market's expectation that possible revisions to tax and regulatory policies enacted by the Trump administration will reinvigorate economic growth and earnings.

Morningstar's Core Bond Index, our broadest measure of the fixed-income universe, rose 0.90% in the first quarter through March 27. The return has been generated by a combination of the yield carry on the underlying securities, as interest rates have generally been flat thus far this year, and by a slight tightening in corporate credit spreads. Representative of the Treasury market, the Morningstar U.S. Government Bond index rose by 0.82% and the Morningstar Agency Bond Index rose 0.71%. Inflation expectations have also held relatively steady, and the Morningstar Treasury Inflation-Protected Securities Index has risen 1.40%.

In the corporate bond market, the Morningstar Corporate Bond Index (our proxy for the investment-grade bond market) rose by 1.41%, and in the high-yield market, the Bank of America Merrill Lynch High Yield Master Index rose 1.67%. However, while corporate bonds performed well in the U.S., the Morningstar Euro Corporate Bond Index declined 0.33%. Corporate credit spreads were relatively unchanged this past quarter, and U.S. long-term interest rates were generally steady, but in the eurozone, underlying sovereign interest rates rose as the European Central Bank began to intimate that it is nearing the time it will begin to wind down its easy monetary policy. For example, the yield on Germany's 10-year bond almost doubled, rising 18 basis points to 0.39%.

The emerging-markets fixed-income indexes posted the strongest returns in the first quarter among the fixed-income universe, as the Morningstar Emerging Market Composite Index rose 3.49%. Underlying the composite index, the Morningstar Emerging Market Sovereign Index rose 4.18%, and the Morningstar Emerging Market Corporate Index rose 3.09%.

Exhibit 1 Fixed-Income Index Returns

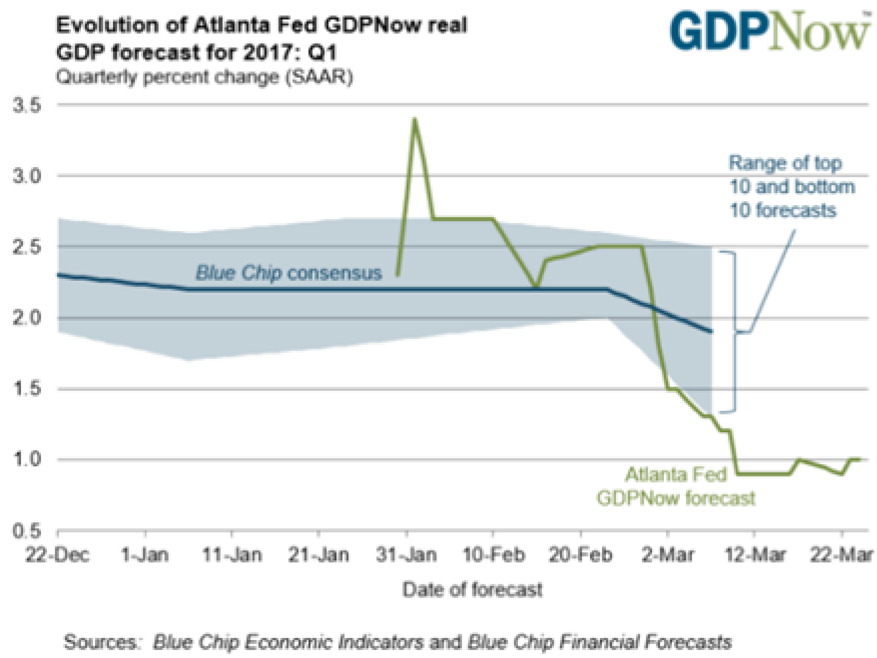
	YTD	2016	2015	2014	2013	2012	2011
Broad Market Index							
Core Bond	0.90	2.64	0.98	6.07	-1.89	4.41	7.97
Sector Indexes							
US Gov't Bond	0.82	0.97	0.91	5.08	-2.74	1.98	9.35
Agency	0.71	1.67	0.72	3.01	-1.03	1.96	5.24
Corporate Bond	1.41	5.81	-0.46	7.20	-1.50	10.54	7.21
BofAML High Yield Master II	1.67	17.49	-4.64	2.50	7.42	15.58	4.38
Eurobond Corp	-0.33	4.66	-0.59	8.35	1.94	12.67	2.94
TIPS	1.40	4.68	-1.60	3.95	-8.53	6.93	13.49
Emerging Markets Indexes							
Emerging Mkt Composite	3.49	9.94	0.62	5.06	-4.39	16.25	2.65
Emerging Mkt Sovereign	4.18	9.25	1.15	7.69	-3.40	13.75	3.98
Emerging Mkt Corporate	3.09	11.30	0.08	3.47	-2.81	15.32	0.18

Source: Morningstar, Inc., Bank of America Merrill Lynch Global Indexes. Data as of 03/27/2017.

While the corporate bond market has been pricing in the expectation that revisions to tax and regulatory policies that might be enacted by the Trump administration will reinvigorate economic growth, recent economic activity appears to have slowed in the first quarter. Robert Johnson, Morningstar, Inc.'s director of economic analysis, is expecting that GDP growth in the first quarter will only be about 1.0%. He expects economic growth will rebound in the second quarter to 2.1% and will range between 1.75% to 2.0% for full-year 2017. While his first-quarter estimate is below the average expectations of Wall Street economists, it is in line with the GDPNow estimate produced by the Federal Reserve Bank of Atlanta. Data over the past few weeks has led the Atlanta Federal Reserve to lower its GDPNow estimate for economic growth in the first quarter of 2017 to 1.0% from as high as 2.5% as recently as Feb. 27. Factors that have led to the lower estimate include weakening construction spending, light vehicle sales, and manufacturing reports. However, even at this slower pace, our corporate credit analysts expect economic growth should be enough to generally support the credit quality of corporate issuers and financial institutions.

Among Johnson's other forecasts, he expects that at the end of this year, the yield on the 10-year U.S. Treasury will be 3.00% to 3.50% and that the run rate of inflation will be 2.00% on a fourth-quarter over fourth-quarter basis.

Exhibit 2 GDPNow - Federal Reserve Bank of Atlanta



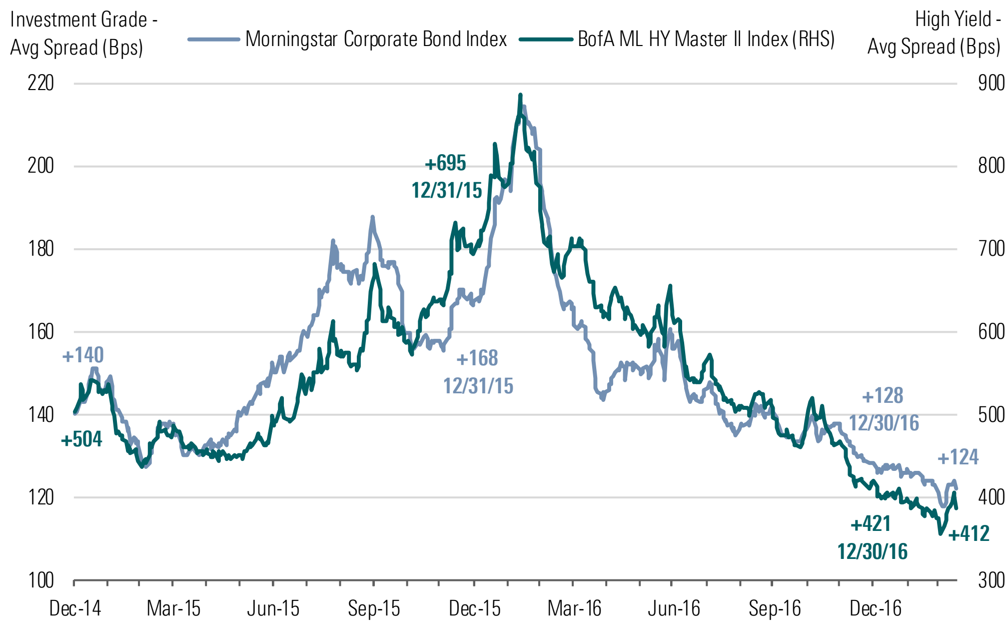
Source: Federal Reserve Bank of Atlanta.

Corporate Credit Spreads Have Tightened Modestly in the First Quarter

Since the end of last year, the Morningstar Corporate Bond Index, our proxy for the investment-grade bond market, tightened 4 basis points to +124, whereas the Bank of America Merrill Lynch High Yield Master Index tightened 9 basis points to +412.

Much of the tightening has occurred in sectors that are either highly correlated to improving economic conditions or to higher interest rates. For example, in the first quarter, the basic industries sector has tightened the most, as underlying commodity prices have risen off of the early 2016 lows and have held steady thus far this year. Manufacturing has also been one of the better-performing sectors this year. The rise in oil prices has improved the outlook for companies that manufacture equipment used in the oil sector, and the expectation of protectionist policies from the Trump administration has lifted companies that have significant U.S. manufacturing operations. The expectation of rising interest rates has led to outperformance by the finance sector because banks are expected to be able to raise their net interest income margins.

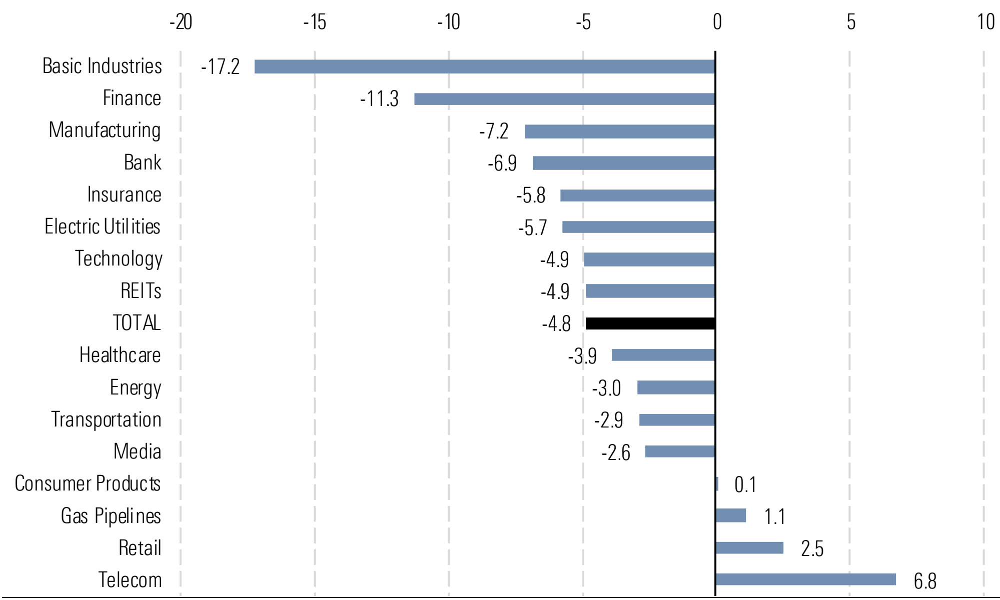
Exhibit 3 Corporate Bond Credit Spreads



Source: Morningstar, Inc., Bank of America Merrill Lynch Global Indexes. Data as of 03/27/2017.

The retail and telecommunications sectors have performed poorly. In the retail sector, lower same store sales and a shift away from traditional retailers to e-commerce have led to declining credit quality. In the telecommunications sector, the decline in credit quality has mainly been self-inflicted, as management teams look to increase growth through strategic acquisitions, which have been funded by greater amounts of debt, leading to worsening credit quality.

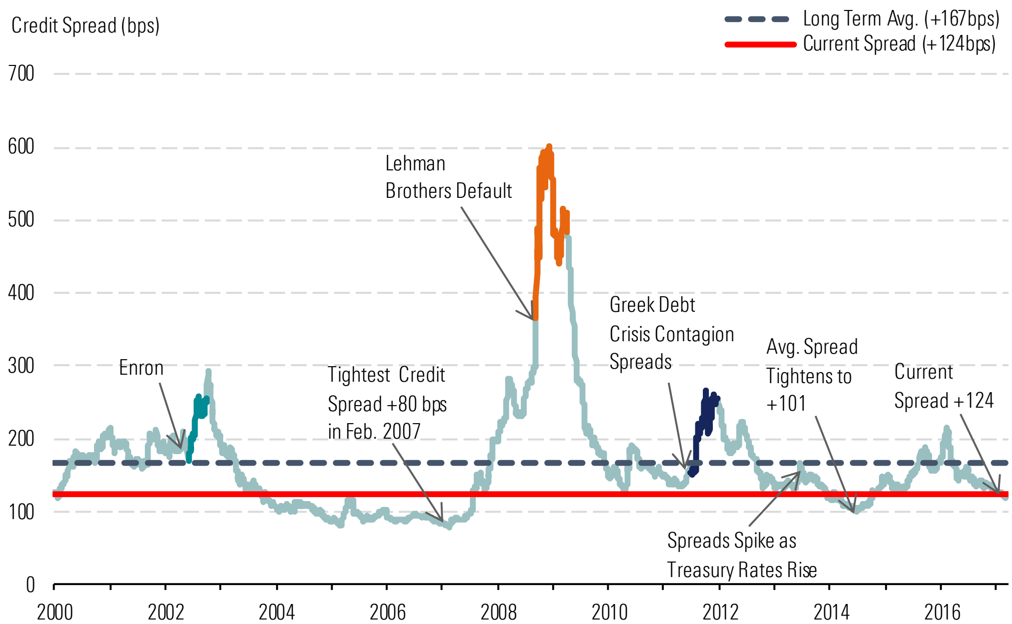
Exhibit 4 Morningstar Corporate Credit Index YTD Spread Change



Source: Morningstar, Inc. Data as of 03/27/2017.

At current levels, both the investment-grade and high-yield indexes are trading much tighter than their long-term historical averages. Since the end of 1998, the average spread of our investment-grade index is +168, and since the end of 1996, the average spread of the high-yield index has averaged +580. As an indication of how tight corporate credit spreads have become compared with their historical averages, since the beginning of 2000, the average spread of the Morningstar Corporate Bond Index has registered below the current level only 26% of the time. In addition, not only are credit spreads tighter now than in much of the recent past, the average credit quality of the Morningstar Corporate Bond Index is lower than it has been much of the time. Currently, the average credit quality of the Morningstar Corporate Bond Index is A-, whereas since 2000, the average credit quality has been either closer to, or a single A for much of the time.

Exhibit 5 Morningstar Corporate Bond Index Average Credit Spread



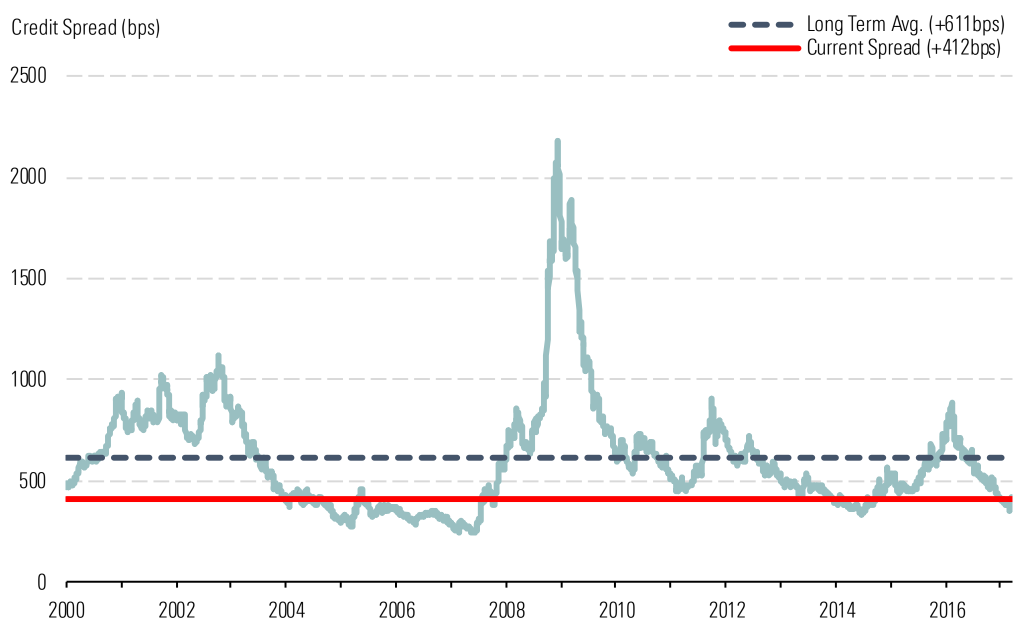
Source: Morningstar, Inc. Data as of 03/27/2017.

Exhibit 6 Morningstar Corporate Credit Index Average Rating

Source: Morningstar, Inc. Data as of 03/27/2017.

In the high-yield market, the average spread of the Bank of America Merrill Lynch High Yield Master Index has registered below its current level less than 25% of the time over the past 17 years. Most of the time that these corporate bond market indexes were tighter than the current credit spread was during the buildup to the 2008-09 credit crisis. In 2004 through 2007, corporate credit spreads were pushed to new historically tight levels as new structured investment vehicles were engineered to arbitrage the differentials in expected default risk; however, once the credit crisis emerged, investors found that many of these vehicles did not perform as advertised.

Exhibit 7 Bank of America Merrill Lynch U.S. High Yield Option-Adjusted Spread



Source: Bank of America Merrill Lynch Global Indexes. Data as of 03/27/2017.

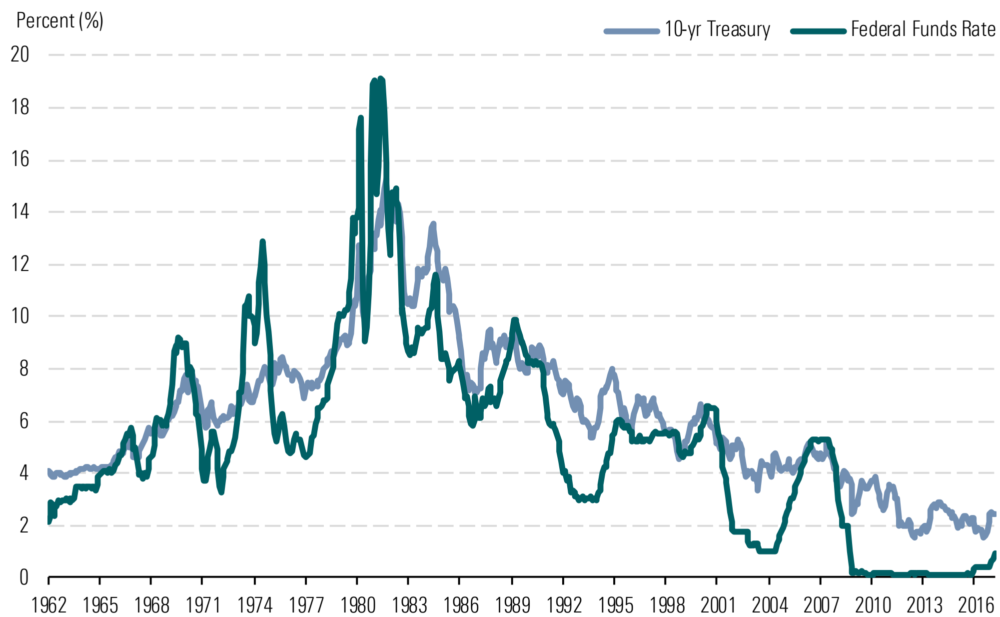
Futures Market Pricing in Additional Fed Rate Hikes

The Federal Reserve raised the federal-funds rate in March by 25 basis points to a range of 0.75% to 1.00%. At the beginning of the year, the market-implied probability of a rate hike so early in the year was very low, but that rose quickly a few weeks before the March meeting of the Federal Open Market Committee, as Federal Reserve officials intimated within several public speeches that a rate hike was in the offing. However, even after this rate hike, the market continues to expect a couple more this year. The Fed's median forecast for the federal-funds rate at the end of 2017 is 1.4%.

According to data from the CME, the market-implied probability priced into the federal-funds futures market that the Fed will hike the federal-funds rate after the June meeting is 53%. The probability that it will be over 100 basis points after the December meeting is 89%. Additionally, the market-implied probability that there will be two more rate hikes this year is 55%. If the Fed were to hike interest rates two more times this year, the federal-funds rate would range between 1.25% and 1.50% at the end of this year. That would be the first time since 2008 that the federal-funds rate has risen above 1% and will finally bring it back above its previous historical low, which was reached in 2003, when the U.S. was recovering from the tech bubble.

While the Fed is tightening monetary policy in the U.S., the ECB has held its course and remains in an easy monetary policy stance. Earlier in March, the ECB decided to keep its short-term interest rates at negative yields and will maintain its EUR 60 billion monthly purchase program through year-end. However, ECB President Mario Draghi recently alluded to signs of strengthening in the eurozone and the re-emergence of inflation. Many investors took this to mean that the ECB is edging closer to dialing back its dovish monetary policy.

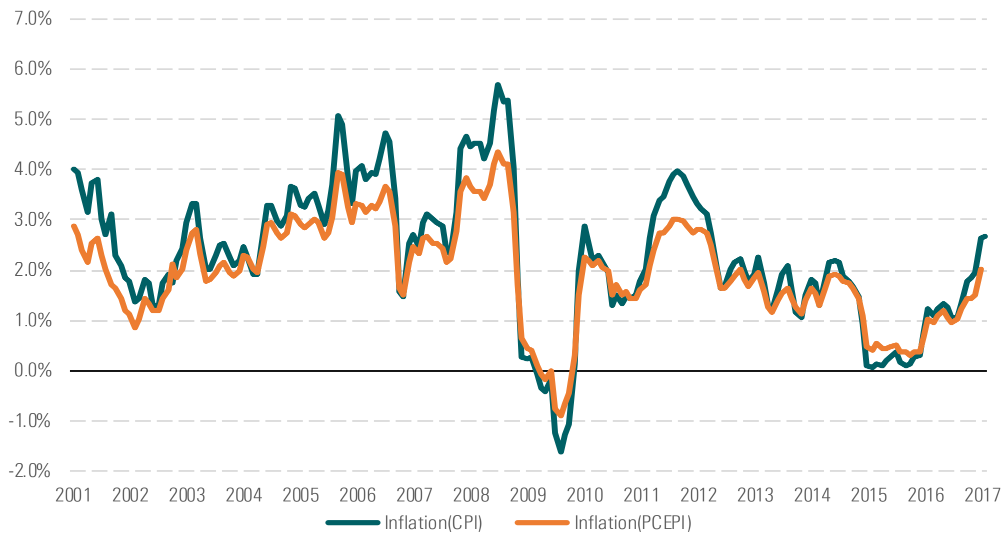
Exhibit 8 Federal-Funds Rate vs. 10-Year Treasury Yield



Source: Federal Reserve Bank of St. Louis. Data as of 03/27/2017.

The reason the Fed is raising the federal-funds rate is that many of the measures it watches have normalized and are either at or near their targeted levels. Unemployment is at its lowest level since 2007, and both inflation and inflation expectations have rebounded and stabilized near the Fed's 2% inflation target. For example, since oil bottomed out in February 2016, both the Consumer Price Index and the personal consumption expenditure price index (the Fed's preferred measure of inflation) have steadily risen toward, or above, the Federal Reserve's 2% inflation target.

Exhibit 9 U.S. Consumer Price Index vs. Personal Consumption Expenditure Price Index



Source: Federal Reserve Bank of St. Louis. Data as of 03/27/2017.

In addition, the 5-year, 5-year forward inflation expectation rate rose above 2% in November and has held relatively steady since then.

Exhibit 10 5-year, 5-year Forward Inflation Expectation Rate

Source: Federal Reserve Bank of St. Louis. Data as of 03/27/2017.

Positive Credit Trends Continue in the First Quarter

After upgrades slightly outpaced downgrades in the fourth quarter, our rating changes firmly pushed into positive territory during the first quarter, as we upgraded 15 firms and downgraded 10 through March 23. The basic materials and consumer cyclical sectors saw the most upgrades, while the energy and healthcare sectors were dominated by downgrades. Rating changes in other sectors were more balanced.

Deleveraging through both debt redemption and profit growth remained key themes for several sectors in the first quarter, and we would highlight the improving profit trends in the consumer cyclical sector that led to nearly half of our upgrades. In basic materials, deleveraging produced upgrades at CRH (on debt redeemed after previous acquisitions and solid profits), Freeport-McMoRan (through asset sales), and Vulcan Materials (on EBITDA growth.) In consumer cyclical, we upgraded seven firms (Advance Auto Parts, AutoZone, O'Reilly Automotive, Amazon, Best Buy, Carnival, and Royal Caribbean Cruises), all with signs of improving profitability. In consumer defensive, we upgraded Conagra Brands on recent portfolio restructuring activities. In energy, we upgraded Total on its improved operations and outlook since our previous downgrade in 2015. In industrials, we upgraded Masco on deleveraging through debt redemption and profit growth, and we upgraded Terex on deleveraging after a recent asset sale. In the insurance sector, we upgraded Allstate on a lower risk assessment of its insurance operations since our last rating action.

Exhibit 11 Ratio of Rating Upgrades to Downgrades, by Quarter by Sector

Sector	Q4 2014 Ratio	Q1 2015 Ratio	Q2 2015 Ratio	Q3 2015 Ratio	Q4 2015 Ratio	Q1 2016 Ratio	Q2 2016 Ratio	Q3 2016 Ratio	Q4 2016 Ratio	Q1 2017 Ratio
Basic Materials	0 / 3	0 / 0	0 / 1	0 / 0	0 / 6	1 / 1	0 / 1	1 / 2	0 / 1	3 / 0
Communication Serv	0 / 0	0 / 2	0 / 0	0 / 2	0 / 0	0 / 1	0 / 4	0 / 0	1 / 0	0 / 0
Consumer Cyclical	0 / 2	0 / 4	0 / 2	0 / 5	0 / 1	3 / 2	1 / 2	0 / 0	1 / 0	7 / 0
Consumer Defensive	0 / 0	0 / 0	0 / 0	0 / 0	0 / 1	0 / 3	1 / 1	1 / 2	3 / 1	1 / 1
Energy	0 / 0	0 / 0	0 / 7	0 / 0	0 / 4	0 / 3	0 / 2	0 / 2	0 / 5	1 / 4
Financial Services	2 / 0	0 / 4	0 / 1	0 / 2	0 / 0	2 / 1	0 / 0	2 / 1	1 / 0	0 / 0
Healthcare	2 / 9	2 / 2	0 / 1	2 / 4	0 / 3	0 / 2	2 / 3	2 / 1	2 / 1	0 / 2
Industrials	0 / 0	2 / 1	1 / 0	2 / 2	0 / 0	1 / 4	1 / 1	6 / 4	2 / 1	2 / 1
Insurance	0 / 0	0 / 0	0 / 0	0 / 0	0 / 0	0 / 0	0 / 0	0 / 0	0 / 0	1 / 2
Real Estate	0 / 0	0 / 0	0 / 0	0 / 0	0 / 0	0 / 0	0 / 0	0 / 0	0 / 0	0 / 0
Techology	0 / 2	0 / 0	0 / 0	0 / 0	0 / 3	0 / 0	1 / 3	0 / 3	2 / 2	0 / 0
Total	**4/16**	**4/13**	**1/12**	**4/15**	**0/18**	**7/17**	**6/17**	**12/15**	**12/11**	**15/10**
Ratio Upgrades to Downgrades	**0.25**	**0.31**	**0.08**	**0.27**	**0.00**	**0.41**	**0.35**	**0.80**	**1.09**	**1.50**

Source: Morningstar, Inc. Data as of 03/23/2017.

Profit pressure and acquisitions were key themes in our downgrades. In consumer defensive, we downgraded Wal-Mart on its multiyear erosion of profitability. The energy sector was dominated by downgrades, as Exxon Mobil, Occidental Petroleum, EOG Resources, and Marathon Oil finally succumbed to a lower base-line forecast of oil/gas prices after sharp declines in commodity prices since late 2014. In healthcare, we downgraded Abbott Laboratories after incorporating its recent leverage-increasing acquisition activity, and we downgraded AstraZeneca on its ongoing commitment to shareholder returns, despite deteriorated cash flows. In industrials, we downgraded Parker Hannifin on a recent leverage-increasing acquisition. In insurance, we downgraded AIG on significant returns to shareholders and ongoing operational problems as evidenced by recent large reserve charges, and we downgraded Humana after its merger agreement with higher-rated Aetna was blocked.

Exhibit 12 First-Quarter 2017 Upgrades and Downgrades

Company Name	Ticker	Old Rating	Current Rating	Date
Upgrades:				
Best Buy Co., Inc	BBY	BB	BBB-	03/20/17
Carnival Corp	CCL	BBB	BBB+	03/15/17
Allstate Corp	ALL	BBB	BBB+	03/14/17
CRH PLC	CRH	BBB-	BBB	03/14/17
Royal Caribbean Cruises Ltd	RCL	BB+	BBB-	03/14/17
Total SA	FP	BBB+	A-	03/14/17
Vulcan Materials Co	VMC	BB+	BBB-	03/14/17
Amazon.com Inc	AMZN	BBB+	A	02/21/17
Conagra Brands Inc	CAG	BBB-	BBB	02/13/17
O'Reilly Automotive Inc	ORLY	BBB	BBB+	02/13/17
Terex Corp	TEX	BB-	BB	02/13/17
Freeport-McMoRan Inc	FCX	B-	B+	02/07/17
Advance Auto Parts Inc	AAP	BBB-	BBB	02/03/17
AutoZone Inc	AZO	BBB	BBB+	02/03/17
Masco Corp	MAS	BBB-	BBB	01/20/17
Downgrades:				
Humana Inc	HUM	BBB+	BBB	03/15/17
American International Group Inc	AIG	BBB+	BBB	03/14/17
Abbott Laboratories	ABT	A	BBB+	03/03/17
Parker Hannifin Corp	PH	A	A-	02/23/17
Marathon Oil Corp	MRO	BBB	BBB-	02/21/17
Exxon Mobil Corp	XOM	AAA	AA+	02/17/17
AstraZeneca PLC	AZN	A	A-	02/16/17
Occidental Petroleum Corp	OXY	AA-	A	01/26/17
EOG Resources Inc	EOG	A	BBB+	01/19/17
Wal-Mart Stores Inc	WMT	AA	AA-	01/18/17

Source: Morningstar, Inc. Data as of 03/23/2017.

During the first quarter, we resolved 10 reviews and did not place any additional companies under review, causing the companies under review to fall to 21 as of March from 31 at the end of December. After those rating reviews were resolved, we continue to expect more downgrades than upgrades from our current rating reviews. As of March 17, 48% of these under-review firms were downgrade candidates (UR-), 33% were upgrade candidates (UR+), and 19% could go in either direction (UR).

Exhibit 13 Companies Under Review by Sector

Sector	UR+	UR	UR-	Total
Basic Materials	0	2	1	3
Communication Services	2	0	2	4
Consumer Cyclical	0	0	0	0
Consumer Defensive	0	0	3	3
Energy	2	1	0	3
Financial Services	1	0	0	1
Healthcare	0	0	1	1
Industrials	0	1	1	2
Insurance	2	0	0	2
Real Estate	0	0	0	0
Technology	0	0	2	2
Total	7	4	10	21
% of Total Under Review	33%	19%	48%	100%

Source: Morningstar, Inc. Data as of 03/23/2017.

While weak commodity prices remain a concern in basic materials, our current rating reviews in this industry are related to leverage-changing M&A and separations. Monsanto's (rating: A/UR-) credit rating remains under review with negative implications on its plan to merge with lower-rated Bayer AG (rating: A-/UR-) in a leverage-increasing transaction. Also, our credit ratings for Dow Chemical (rating: BBB/UR) and E. I. DuPont de Nemours & Co (rating: A-/UR) remain under review on their merger plans; the direction and outcome of these reviews remain uncertain.

In communication services, our ratings for AT&T, CenturyLink, Sky, and Windstream remain under review on planned mergers and acquisitions. AT&T (rating: BBB/UR-) plans to acquire Time Warner (rating: BBB+/UR-), in a leverage-increasing deal that could cut into their credit ratings. CenturyLink's (rating: BB/UR-) review is based on its plan to acquire Level 3, which may boost leverage enough to cut into its credit rating. Sky's (rating: BBB/UR+) review relates Twenty-First Century Fox's (not rated) plan to fully acquire it, which could have positive rating implications for the target. Windstream Holdings' (rating: B-/UR+) recent merger with EarthLink appears to have positive implications for its credit profile based on lower expected financial leverage and higher profitability relative to its stand-alone status.

In consumer defensive, leverage-increasing acquisitions also dominate our reviews. British American Tobacco (rating: BBB+/UR-) remains under review with negative implications on its plan to buy the rest of Reynolds American (rating: BBB/UR-), which is also under review with negative implications on this planned transaction. British American's management team has stated a commitment to an investment-grade rating, but given the proposed debt financing, that could take several years to achieve. Danone's (rating: BBB+/UR-) rating remains under review on plans to acquire WhiteWave (not rated) in a leverage-increasing deal, which could lead to a downgrade of the acquirer.

In energy, Baker Hughes, Tesoro, and Western Refining remain under review. Our review of Baker Hughes (rating: BBB+/UR+) relates to its planned merger with the GE Oil & Gas segment. We understand that GE Oil & Gas will not bring any debt to the new combined entity, so the new entity should benefit from the combined cash flow of GE Oil & Gas and Baker Hughes and have lower leverage at inception. We are also reviewing the ratings on Tesoro (rating: BBB-/UR) and Western Refining (rating: BB/UR+) on their pending merger. Assuming consummation of the deal, we estimate Tesoro's pro forma gross and net leverage probably will not change substantially, including merger synergies. Therefore, our rating of the combined entity may be in line with Tesoro's current rating, especially if refining industry conditions do not deteriorate further.

In financial services, Janus Capital Group (rating: BBB/UR+) remains under review with positive implications on its pending merger with Henderson Group (not rated) in an all-stock deal that may lead to a better credit profile relative to the stand-alone entity.

In healthcare, Bayer's (rating: A-/UR-) credit rating remains under review after it agreed to acquire Monsanto (rating: A/UR-) in a leverage-increasing transaction. If completed as planned, we suspect the combined entity's rating will be lower than Bayer's current rating.

In industrials, Joy Global and Rockwell Collins remain under review on recent merger and acquisition activities. Joy Global's (rating: BB-/UR) rating remains under review on its plans to be acquired by Japanese firm Komatsu (not rated). We expect to withdraw our rating on Joy after the merger, which is expected to close in mid-2017. Our review of Rockwell Collins (rating: A-/UR-) revolves around its agreement to buy B/E Aerospace (not rated), which will push up leverage initially, and its plan to shoot for a higher long-term leverage target than it operates with as a stand-alone entity.

In insurance, the U.S. Department of Justice's attempt to block the merger of Anthem (rating: BBB-/UR+) and Cigna (rating: BBB-/UR+) was successful in the first legal battle. However, Anthem is appealing that decision, and another court date is scheduled for April. Before the legal battle, our ratings assumed that the merger would close as planned. However, if it is not completed, we see the potential for positive credit rating implications for Anthem and Cigna, given the lower leverage that both firms could carry in stand-alone scenarios. However, the companies have not fully revealed their stand-alone capital-allocation plans, and we will continue to review their ratings until we have a better sense of how they intend to manage their balance sheets in the long run.

In technology, acquisitions and business reorganizations are the primary reasons for our rating reviews, and Time Warner and Analog Devices remain under review with negative implications. Our review of Time Warner (rating: BBB+/UR-) relates to its planned combination with AT&T (rating: BBB/UR-). Relative to a stand-alone Time Warner, we project that the combined entity will operate with more leverage and a potentially weaker Business Risk profile, which could cut into its rating. Analog Devices (rating: A+/UR-) remains under review with negative implications on its recent leverage-increasing merger with Linear Technology (not rated).

Exhibit 14 Companies Under Review

Company	Ticker	Sector	Rating	Rating Status
Dow Chemical Co	DOW	Basic Materials	BBB	UR
E.I. du Pont de Nemours & Co	DD	Basic Materials	A-	UR
Monsanto Co	MON	Basic Materials	A	UR-
AT&T Inc	T	Communication Services	BBB	UR-
Sky PLC	SKY	Communication Services	BBB	UR+
CenturyLink Inc	CTL	Communication Services	BB	UR-
Windstream Holdings Inc	WIN	Communication Services	B-	UR+
British American Tobacco PLC	BATS	Consumer Defensive	BBB+	UR-
Danone SA	BN	Consumer Defensive	BBB+	UR-
Reynolds American Inc	RAI	Consumer Defensive	BBB	UR-
Tesoro Corp	TSO	Energy	BBB-	UR
Baker Hughes Inc	BHI	Energy	BBB+	UR+
Western Refining Inc	WNR	Energy	BB	UR+
Janus Capital Group Inc	JNS	Financial Services	BBB	UR+
Bayer AG	BAYN	Healthcare	A-	UR-
Joy Global Inc	JOY	Industrials	BB-	UR
Rockwell Collins Inc	COL	Industrials	A-	UR-
Anthem Inc	ANTM	Insurance	BBB-	UR+
Cigna Corp	CI	Insurance	BBB-	UR+
Analog Devices Inc	ADI	Technology	A+	UR-
Time Warner Inc	TWX	Technology	BBB+	UR-

Source: Morningstar, Inc. Data as of 03/23/2017.

Contributed by Julie Utterback, CFA

Individual Sector Outlook

Banking

Higher interest rates, lower corporate tax rates, and changing financial regulation are the key factors that could affect banks in 2017. In March, the Federal Open Market Committee raised its benchmark federal-funds target rate by 25 basis points to 0.75%-1.00%, representing its third increase of this tightening campaign. FOMC press releases and financial market indicators, including futures and implied forward interest rates, point to two to four more 25-basis-point increases during the next year. In general, higher interest rates benefit banks by allowing them to raise interest rates on their loans faster than they increase their deposit and other funding costs, which contributes to higher net interest margins and higher interest income. In addition, many bank loan portfolios are structured as floating-rate loans that are pegged to short-term indexes like Libor, which quickly reflect Fed policy. We continue to expect the regional banks we cover to benefit more than global banks because of their greater reliance on interest income sources. However, an offset to higher interest income is lower fee income from originating and selling mortgages, a result of higher interest rates, which brings lower refinancing activity.

Although details of possible policy changes discussed by the new presidential administration are unclear at this point, we will be considering the effect of a lower corporate tax rate on bank lending and bond underwriting. In a Feb. 27 Select Research publication, Financial Sector Tax Reform Impact: So Much Winning, It's Yuge, Morningstar's Equity Research Group reasons that a lower corporate tax rate and an inability to deduct interest expense would reduce the need for debt or bank loans for corporate America. Morningstar estimates that a 5%-15% decrease in the corporate tax rate could lead to a 3.1%-16.3% contraction in the corporate debt market. The adverse effects of this change would be felt by regional banks with a focus on commercial lending, including Comerica (rating: A-, stable), Zions Bancorp (rating: BBB-, positive), and KeyCorp (rating: BBB+, stable). More directly, banks that derive revenue from bond underwriting, like Goldman Sachs (rating: BBB+, stable) and Morgan Stanley (rating: BBB, stable), could be adversely affected by fewer bond underwritings. More broadly, we will be watching for details to emerge on the administration's call for lower banking regulation. In general, we would expect such changes to benefit the global banks like Citigroup (rating: A-, stable), JPMorgan Chase (rating: A-, stable), and Bank of America (rating: BBB, stable) over more narrowly focused regional banks. Understanding the costs of financial regulation on small and midsize banks, the Federal Reserve recently announced that banks with assets between $50 billion and $250 billion would not be subject to the qualitative aspects of the Fed's annual Comprehensive Capital Analysis and Review starting in June. They will, however, continue to be subject to the quantitative aspects of the test. As a result, this modification should reduce costs and management distractions of companies we cover in the credit card sector, including Discover Financial Services (rating: BBB+, stable), Synchrony Financial (rating: BBB, stable), and American Express (rating: A-, stable), as well as many of the regional banks.

Contributed by Chris Baker, CFA

Basic Materials

For the basic materials sector, we expect the outlook to be stable for the second quarter. Given the rebound in prices for mined commodities and metals, which accelerated in the final quarter of 2016 and the first quarter of this year, the outlook for the metals and mining subsector has improved dramatically from a year ago. The other subsectors in basic materials are expected to continue to exhibit decent credit fundamentals into the second quarter, albeit each subsector is at different stages in its business cycle.

Over the last couple of quarters, the headliner has been the metals and mining subsector, with prices for mined commodities and metals increasing, in some cases substantially. Formerly investment-grade issuers such ArcelorMittal (rating: BB-, positive), Anglo American (rating: BB, positive), Freeport-McMoran (rating: B+, positive), Teck Resources (rating B+, positive), and Vale (rating: BB, positive) have all benefited from the price increases, as EBITDA and cash flow are expected to be much more robust in 2017 compared with 2016. Additionally, some of these companies have actually reduced gross debt balances by selling assets or issuing equity to strengthen their capital structures to deal with an uncertain price environment in the intermediate to longer term. The positive outlooks on the issuers above indicate the strong possibility of credit rating upgrades over the next several months.

The agricultural subsector is in a consolidation phase largely due to weakening fundamentals in the farm sector over the last couple of years. Lower crop prices received by farmers have negatively affected issuers that participate in the fertilizer, crop protection, and seeds segments of the industry. The combinations of Dow Chemical (rating: BBB, UR) and DuPont (rating: A-, UR) as well as Agrium (rating: BBB, stable) and Potash Corporation of Saskatchewan (rating: BBB, stable) are both stock-for-stock mergers and are not leveraging. However, Bayer's (rating: A-, UR-) acquisition of Monsanto (rating: A, UR-) is leveraging and would raise Bayer’s debt/EBITDA to over 4 times. For the most part, we view credit trends in this sector as stable despite the subdued outlook for prices for fertilizer, crop protection, and seeds. Most issuers are solidly capitalized and have conservative financial policies that can withstand trough economic conditions in this subsector.

The chemicals subsector’s outlook remains stable as a result of consistent demand and product pricing in the industry. Generally speaking, we expect the stable outlook to remain unless a recession occurs. As we have said in previous quarters, we see the potential for mergers and acquisitions in this subsector because of the consistent free cash flow profiles of many issuers and the still low interest rates available to many corporate borrowers with investment-grade ratings.

The building materials subsector is the strongest of the subsectors in terms of demand fundamentals. Issuers are experiencing revenue and cash flow gains that we expect to continue into the near and intermediate term. We anticipate that increased spending on infrastructure in the U.S. will further support growth for issuers in the industry. In the first quarter, we upgraded Vulcan Materials to BBB- (stable outlook) from BB+ and CRH to BBB (stable outlook) from BBB- due to expectations of continued robust volume and product pricing gains.

Contributed by Sean Sexton, CFA

Consumer Cyclical

Morningstar Credit Ratings expects credit quality in the consumer cyclical sector will be mixed for the rest of 2017, with lower unemployment and higher wage growth supporting consumer spending. So far in the first quarter, MCR upgraded seven issuers and downgraded one in the consumer cyclical sector, while revising the outlook to negative for four issuers and to positive for two. In addition, MCR affirmed nine issuers. Going forward, MCR believes that ratings in the consumer cyclical industry will continue to be driven by shifting consumer spending patterns, the strong growth of online shopping, a strong housing market, solid automobile sales, mergers and acquisitions, and international risks and opportunities.

Consumer preferences have shifted toward leisure spending, increasing travel demand. The gaming, lodging, and leisure sector has benefited as increasing bookings have bolstered revenue growth and margin expansion at online travel agencies, cruise lines, and hotel operators. Online travel agents continue to benefit from this trend and are expected to grow faster than the travel market because online penetration rates of worldwide bookings remains low at about 35%. While the total travel market is currently growing at roughly 5%, online is growing at approximately double that rate. MCR revised the outlook to positive for Priceline (rating: A-, positive) and Expedia (rating: BBB-, positive), reflecting the potential for an upgrade if solid growth rates in its accommodation reservation services and EBITDA growth continue, further building out their competitive advantages, while maintaining excellent balance strength. Cruise line issuers have benefited from increasing demand, relatively low penetration levels, and the ability to move assets to the highest-yielding geographies. The industry remains dominated by the top three cruise lines, with an estimated 80% share of the industry, and competition has remained rational under a favorable economic backdrop along with limited new supply with shipyards operating at full capacity. In the first quarter, MCR upgraded Carnival (rating: BBB+, stable) and Royal Caribbean Cruises (rating: BBB-, stable) based on these industry dynamics, as well as substantial operating improvements and improving balance sheet strength.

Most issuers in the specialty retail sector should benefit from positive industry demand, with low double-digit growth rates from e-commerce leading the way. MCR's first-quarter two-notch upgrade of Amazon (rating: A, stable) reflects the company's improving competitive position as evidenced by a multiyear expansion in EBITDA margins and return on investment. Still, traditional store-based retailers remain challenged to adapt their business models under this fast-changing competitive landscape. Best Buy's (rating: BBB-, stable) first-quarter upgrade to investment grade reflects its success at increasing share in certain electronics categories as it continues to expand store-within-store partnerships, by building out its online platform, and through enhanced store-based shipment capabilities. On the other hand, MCR revised its outlook to negative on Bed Bath & Beyond (rating: BBB+) because of declining comparable sales and eroding margins, as the company has increased investments to develop its e-commerce platform and integrate it with its store base. MCR believes that certain store-based retail segments remain insulated from the growth of online retailing, often due to in-store service expertise, breadth of inventory, or low-cost and fast distribution capabilities. This includes the auto-parts retail sector, which has also been supported by lower gasoline prices, a stronger economy, and healthy industry dynamics determined by increases in the average life of vehicles and growth in the average number of miles driven. In the first quarter of 2017, MCR upgraded O'Reilly Automotive (rating: BBB+, stable), AutoZone (rating: BBB+, stable), and Advance Auto Parts (rating: BBB, stable). Positive trends exist in the U.S. housing market, where favorable supply/demand dynamics are expected to continue through the end of the decade, supporting continued market share gains by home improvement retailers.

MCR foresees negative credit trends continuing in the department store sector for the next several years as traditional department store retailers continue to lose market share to online retailers that offer better convenience and lower prices. Participants have been forced to adapt by changing their business models, including substantially higher investment spending on e-commerce initiatives and efforts to reduce or reconfigure stores and selling square footage, which negatively affect margins and cash flow. Nordstrom's (rating: BBB+) outlook was revised to negative in the first quarter, reflecting the possibility that the rating could be lowered if recent investments fail to stabilize profitability. In addition, 2016 rating downgrades of both Macy's (rating: BBB-, stable) and Kohl's (rating: BBB-, stable) reflected a weakened competitive position underscored by deteriorating credit metrics and ongoing same-store sales declines.

Brand-name apparel retailers and manufacturers do command certain positive competitive attributes. First, they generally have pricing power that comes with a brand intangible asset, and second, apparel issuers have reduced exposure to declining foot traffic at traditional store-based retailers by ramping up their own websites or stores to sell directly to consumers. Still, the sector remains burdened by higher operational investments that are required to move merchandise to customers from design more quickly. In addition, pricing power has been under pressure at certain issuers whose brands may be threatened by shifting preferences, such as the growth of off-price retailers by customers who increasingly favor lower price over brand labels. The negative outlook on the rating of Ralph Lauren (rating: A-) and Gap (rating: BB+) in part reflect these issues.

The historically defensive discount and grocery segment also faces heightened competitive threats from the rapid growth of e-commerce. Discounters are responding to these challenges by accelerating investments to build out online market share; to increase the service and experience of existing stores, including shipping, to develop new store formats and designs; and to maintain everyday low pricing. While these initiatives are necessary and warranted, MCR believes that margins and profitability will be negatively affected for the next several years. Wal-Mart's (rating: AA-) downgrade and outlook revision to negative in the first quarter reflected a multiyear erosion in profitability and returns due to increased competition. A rating downgrade could occur if competitive pressures erode Wal-Mart's long term sustainable competitive advantages or if management allocates substantially more of its free cash flow toward shareholder distributions, resulting in heightened debt levels. Target (rating: A) faces a similar threat, which prompted a revision in the rating outlook to negative, reflecting the potential for a lower rating if proposed investments do not stabilize Target's competitive position and lead to a recovery in revenue, profitability, and returns.

Contributed by Wayne Stefurak, CFA

Consumer Defensive

During the first quarter of 2017, we took several rating actions in the consumer defensive sector; we upgraded one issuer, and affirmed 11 others, of which two were assigned positive outlooks, one a negative outlook, and the remainder stable outlooks.

The one rating upgrade during the quarter was Conagra Brands (rating: BBB, stable), which was due to the successful operational and financial restructuring and its emergence as a pure-play packaged foods company. The divestiture of its lower-margin Private Brands operations and its Lamb Weston business has allowed the company to focus on its branded packaged foods portfolio. The company has assembled a strong lineup of new products that contain organic ingredients and do not include artificial colors, flavors, or preservatives. Financial restructuring resulting in substantial debt reduction improved Conagra's Solvency Score and Cash Flow Cushion.

There are three firms that are under review with negative implications resulting from pending mergers or acquisitions: Danone (rating: BBB+/UR-), British American Tobacco (rating: BBB+/UR-), and Reynolds

American (rating: BBB/UR-). Danone has a definitive agreement with WhiteWave Foods to acquire the company for an enterprise value of approximately $12.5 billion and an adjusted EBITDA multiple of 25 times, excluding estimated annual synergies. Pro forma debt/EBITDA is about 5.0 times, and we anticipate a possible weakening of Danone's Cash Flow Cushion and its Distance to Default scores. We believe that the acquisition will invigorate Danone's top line by doubling the company's U.S. business. WhiteWave's brands complement Danone's dairy portfolio and will significantly expand it to the organic dairy, non-GMO, plant-based alternatives to milk and yogurt, and coffee creamers categories. Danone completed the financing for the acquisition during the fourth quarter of 2016, with a $5.5 billion bond issue and a EUR 6.2 billion multitranche bond issue and is awaiting regulatory approval. British American's acquisition of the remaining 57.8% of Reynolds American is expected to close in the third quarter of 2017. The transaction represents an enterprise value of $93 billion and an EBITDA multiple of 16.3 times. The total consideration for the remaining 57.8% of Reynolds American is estimated at $47 billion, of which approximately $20 billion would be in cash and $27 billion in British American shares. We estimate that the company's total debt/EBITDA will be about 5.0 times and its EBITDA/interest approximately 6.0 times. Heightened leverage is likely to weaken British American's Business Risk, Solvency, and Cash Flow Cushion scores. This combination will make British American the world's largest tobacco company. We believe that Danone and British American will be able to maintain their investment-grade ratings.

The remaining activity across the sectors includes affirmations. In the packaged food sector, MCR affirmed: Mondelez International (rating: BBB, positive), Campbell Soup (rating: A-, stable), Hormel Foods (rating: AA-, stable), Kraft Heinz (rating: BBB-, stable), General Mills (rating: BBB+, stable), and Kellogg (rating: BBB, stable). Kraft Heinz's rating was affirmed after it withdrew its $143 billion proposal to acquire Unilever (rating: A+, stable). Although Unilever resistance and cultural incompatibly may have been the reasons for the withdrawal, the opening bid of an 18% premium on the company's stock price at the time seemed low. In the food-service sector, MCR affirmed McDonald's (rating: A-, stable) and Sysco (rating: A-, stable). McDonald's ratings were affirmed ahead of its announced $22 billion-$24 billion new three-year return-to-shareholder plan, which we believe can be accommodated without an increase in leverage given the company's successful operational turnaround. Increased cash flow generated by strengthened same-store sales growth, operating margin improvement and refranchising proceeds is expected to be sufficient to fund the company's return-to-shareholders plan. In the household products and personal-care sector, MCR affirmed Kimberly-Clark (rating: A, stable).

Continued lackluster global economic growth has resulted in limited organic growth opportunities, driving management teams to seek strategic acquisitions, which increases M&A risk and is one of the most disruptive forces to credit ratings stability for the consumer defensive sector—Kraft Heinz's bid for Unilever, for example. It is well-known that Kraft Heinz is seeking to expand its international footprint to faster-growing regions and that Unilever has one of the most diversified portfolios in the consumer sector, with almost 60% of its sales generated from emerging markets. Another example is Mondelez's unsolicited and unsuccessful $26 billion bid for Hershey (rating: A+), which clearly indicates that these companies, and others in the industry, are in the hunt for strategic acquisitions. Nonetheless, we believe that Hershey remains an attractive target, with a leading position in the U.S. chocolate market (45%

share), healthy operating margins of about 20%, high returns on invested capital, and low leverage. However, for any potential acquirer, the Hershey Trust, with its 80% voting control, represents a formidable hurdle.

Other strategies for growth are bolt-on acquisitions, which are incorporated into the ratings and an ongoing tactic that management has used to spur the top line. While it has become a mainstay for many of the sector participants' growth strategies, it often takes several years for them to make a meaningful contribution to revenue and earnings. In the absence of acquisition candidates, other management teams have looked to boost earnings per share by conducting large share buyback programs and have been willing to take the headroom out of their ratings or sacrifice their credit ratings in the effort to bolster shareholder value. However, debt-financed acquisitions concurrent with share repurchases tend to increase leverage, weaken Solvency Scores, and Cash Flow Cushions, and will likely lead to negative rating actions.

In the near term, cost cutting and increased efficiency remain a directive for the consumer defensive sector. Industry participants will be closely watching the newly merged Kraft Heinz (rating: BBB-, stable) and management's success in reducing its cost structure. Its target is $1.5 billion worth of cost savings and synergies from the combined company. Noting the success that 3G’s management team attained extracting cost savings and generating efficiencies from Heinz, many firms in the consumer defensive sector are examining and scrutinizing their own cost structures. Most of them are undergoing widespread, multiyear restructuring programs to reduce their manufacturing base, improve supply chain management, and squeeze savings out of working capital. Several firms are examining their cost from the bottom up and have either implemented zero-based budgeting or some form thereof. We believe the heat remains on management teams, particularly those in the food and beverage sector, as they may be cognizant of 3G and Warren Buffett's broader strategy to become industry consolidators.

We expect that consumer confidence may vacillate, but will stay strong as low gasoline prices, low unemployment rates, and increasing wages lead to higher disposable income, which will spur an increase in consumption and sales. This in turn will help drive top-line organic growth in the consumer products sector with heightened spending on nondiscretionary items first and then on discretionary goods and services. We will look for leisure spending to increase, particularly food consumed away from home, benefiting the restaurant industry and food-services firms, at least in the near term. We anticipate that the increase in revenue along with operating leverage and cost-savings initiatives will result in operating margin expansion. In addition, with greater disposable income and steady consumer confidence, branded products producers that invested in new product development may recover some of the market share they have lost to private-label brands over the past few years. These improving fundamentals should support branded food manufacturers, which have struggled over the past few years.

Contributed by Wesley E. Moultrie II, CPA, CGMA

Energy

Early in 2017, we still believe that oil supply/demand fundamentals will gradually improve through the year, supporting price. Oil production cuts, which were to begin on Jan. 1 by OPEC and several large, non-OPEC producers, including Russia, Oman, Sudan, and Kazakhstan, have been partially implemented. Of the planned OPEC cut of 1.2 million barrels per day, market reports indicate about 80% has now been achieved. However, the planned non-OPEC cut of 558,000 barrels per day is estimated to be only 50% implemented. The duration of OPEC's agreement is six months (ends June 30), extendable for another six months.

Thus far, the impact on global oil oversupply from the cuts has not been very effective. The OECD crude-oil inventory has increased slightly to 1,510 million barrels (through January) from 1,504 million since the beginning of the year, but U.S. crude-oil inventory has increased by 11% to 533 million barrels currently from 479 million. Rapid reacceleration of U.S. shale oil production and the U.S. inventory build has pressured the oil price back to about $48 per barrel (West Texas Intermediate basis) from $54 earlier in 2017, following a surge in anticipation from $45 per barrel just before the OPEC-Russia cut agreement was signed on Nov. 30. Unless the impact from initial production cuts soon becomes more evident (that is, declining crude-oil inventories), it appears that a six-month extension of cuts will be necessary to push near-term oil pricing higher. We now forecast a $55 per barrel WTI oil price by mid-2017, a reduction from $55-$60 previously, and initiate a forecast of $55-$60 per barrel by year-end.

Longer term, we maintain our view that oil prices will continue to gradually increase, subject to bouts of volatility. With support from especially sharp cuts to global exploration and production expenditures during the past two years and the likelihood of only a moderate rebound in upstream spending in 2017, we look for oil pricing over the next 12-18 months to seesaw—two steps ahead, one step back—in anticipation of gradually more balanced global supply/demand fundamentals. The near-term crude-oil concerns continue to be:

- Heightened global inventories of oil, with U.S. commercial crude inventories at an all-time high.
- The significant rebound in U.S. shale oil production year to date. From a longer-term pricing perspective, the recent oil price pullback is healthy since it signals to shale oil speculators that their investments are not a sure bet, which should help to brake the run-up in output.
- Despite reasonably good cooperation on the current cut agreement, there is a history of cheating by OPEC members and other participants on previous agreements to cut production. Given Saudi Arabia's desire to eventually IPO state-owned Saudi Arabian Oil Co. (Aramco), the kingdom seems incentivized to extend the current cut agreement, if necessary, to help support a higher oil price. An extension would require that other OPEC members are cooperating since the Saudis do not want to bear the cost of production cuts alone.
- Subdued growth in Chinese oil consumption, the world's largest oil importer.

These concerns are partly mitigated by fears of a more significant Venezuelan oil production outage caused by economic crisis there.

The spot natural gas price spiked to $3.93 per million British thermal units in late December, caused by a surge in heating demand as cold early-winter temperatures set in. Since then, the gas price retraced lower on much-warmer-than-typical February temperatures to $2.56/mmBtu, before bouncing back to $3.05/mmBtu currently, as it was premature to think that winter was over. The U.S. underground gas storage inventory is now about 2.1 trillion cubic feet, which is 15% above the five-year average.

Domestic gas demand typically peaks during winter. Although the brunt of heating demand is now behind and with the U.S. gas-storage inventory above average as we exit winter, ongoing growth in pipeline and liquefied natural gas exports should help support spot pricing at about $3.00/mmBtu during the spring shoulder period. The gas injection season typically runs from early April through late October. As we move in to summer, the combination of steadily growing power plant demand and hot temperatures could spark another price surge.

Despite the recent volatility and drop in WTI oil prices below $50 per barrel, we think the pricing will gradually grind higher, which bodes well for all energy credit ratings. In particular, E&P and oilfield-service companies, which leaned out their cost structures during the challenging price environment over the past two years, are poised to benefit from any sustained increase in pricing. For Schlumberger (rating: A+, stable), a strong service backlog coming in to the sharp cyclical slowdown and the ability to continue winning new orders have cushioned revenue and margin degradation much better relative to the 2009 downturn. Further, conservative use of financial leverage, broad geographic coverage, and product diversification have all given Schlumberger staying power. Synergies from the purchase of Cameron, which closed in April 2016, are coming about a bit faster than originally planned.

On Nov. 2, we placed our BBB+ credit rating on Baker Hughes under review with positive implications on the announcement that it agreed to merge with the GE Oil & Gas segment (not rated) to form the "new" Baker Hughes. GE Oil & Gas will not bring any debt to the new combined entity. So, the new Baker Hughes should benefit from the combined cash flow of GE Oil & Gas and Baker Hughes and have lower leverage at inception. GE and Baker Hughes expect the transaction to close in mid-2017.

On Nov. 17, Tesoro (rating: BBB-/UR) announced that it was acquiring Western Refining (rating: BB/UR+), both U.S.-based, independent petroleum refiners, in a stock transaction. We affirmed our credit ratings on both companies and placed Tesoro under review and Western Refining under review positive. By combining U.S. refining assets that complement one another geographically and offer many cost-saving opportunities, we believe the merger makes strategic sense. From the perspective of Western Refining, we estimate that gross and net leverage will decline sharply. Tesoro expects the transaction to close in the first half of 2017.

On March 14, we upgraded the credit rating of Total by one notch to A-, based on ongoing improvements to the company’s portfolio of operations and on our renewed oil and gas and refined product price forecasts. Total's scale, diversified cash flow, and financial strength allowed the company to continue to invest through the bottom of the price cycle, cherry-picking only the best developments from its large inventory of projects, in particular, expanding along the natural gas value chain.

Contributed by Andrew J. O'Conor

Healthcare

With Affordable Care Act repeal/replacement efforts hitting a roadblock without enough support in the House of Representatives in late March, the healthcare industry has been spared an imminent change to the status quo. The initial bill the Republicans proposed would have led to 14 million fewer insured Americans in 2018 and 24 million fewer by 2026 relative to ACA estimates, according to the nonpartisan Congressional Budget Office. However, without a viable bill, the Republicans have been forced to punt the healthcare issue to a later date, and it remains to be seen whether they will ever pick up this issue again.

Because of this delay in any significant changes to the U.S. healthcare system, several sectors in the industry look set to be spared immediate disruption. Without significantly lower insured patient volumes, we believe healthcare service providers, particularly acute-care hospitals, will get a reprieve from the proposed changes. Under the ACA, hospitals have benefited from higher insured patient volumes flowing through their largely fixed-cost infrastructure. This dynamic will likely continue, which will continue to benefit hospitals and the sectors that serve them, such as capital equipment providers in the medical technology field.

More negatively, the managed-care sector looks set to remain pressured by ongoing regulations. For example, under the previously proposed bill, health insurers would have been able to charge older people not yet eligible for Medicare up to 5 times more for the same coverage than people in their 20s were charged, versus the current ACA standard of up to 3 times. These and other regulatory changes would have helped boost the bottom lines of insurance companies. Without these changes, managed-care providers will have to operate under current rules. For example, covering people on the ACA exchanges has been an unprofitable business for many insurers, causing many to leave or consider leaving unprofitable geographic regions. With more healthy people likely able to opt out of the exchanges going forward, as we do not expect the Trump administration to actively enforce the individual mandate of the ACA, this exodus of insurers from the individual exchanges looks likely to continue. This dynamic could create a more powerful vacuum, leaving even fewer affordable insurance options over time.

Also, although we thought the changes to the ACA would have been more muted for pharmaceutical and biotechnology companies than in other sectors of the healthcare industry, pricing concerns have not disappeared. Given recent rhetoric from President Trump vowing to bring down drug prices, we think lowering drug prices will remain a key priority in the U.S. for the foreseeable future. Future healthcare bills may tackle drug costs, including allowing the government to negotiate pricing through the Medicare Part D program, which is restricted under current law but espoused by President Trump as a way to control drug spending. If successful, price control efforts could have negative effects on other sectors, too, such as the pharmacy benefit managers and drug distributors.

Beyond healthcare-specific regulatory changes, many companies we cover are looking forward to one of the next items on the president's legislative agenda—tax reform. If successful, high corporate tax payers would have more cash at their disposal for investments, debt reduction, and returns to shareholders. Also, interest deductibility on debt obligations have the potential to be removed during the tax reform process. If that happens, companies with high gross leverage may have incentive to reduce debt on their balance sheets, which could be a positive credit catalyst after several years of negative trends in the healthcare industry. However, as the ACA repeal/replacement efforts have recently shown us, uncertainty surrounds any of these legislative agenda items and are not guaranteed enactment.

Contributed by Julie Utterback, CFA and Michael Zbinovec

Industrials

As we've written previously, economic hardship among diversified industrial firms appeared to be concurrent with the decline in oil prices given the sector's meaningful exposure to oil and gas. (See Diversified Industrials: A Tale of Two Tax Reforms published Feb. 14, 2017.) This hardship trickled down to all sectors of the manufacturing economy, as growth in new orders, according to the U.S. Census Bureau, peaked in October 2014 and then fell unabated thereafter. However, oil prices stabilized in early 2016 and have rallied, while U.S. rig counts have nearly doubled to 768 in March 2017 from the May 2016 low of 404. Additionally, signs from manufacturing indicators suggest a promising outlook for 2017. We've seen a meaningful and sustained increase in the Institute for Supply Management Purchasing Managers' Index, a diffusion index that has properties of a leading indicator. The index has remained above the all-important 50 demarcation line for the last six months, with February registering a 1.7% increase from January's levels. Moreover, we believe there has been a strong positive relationship between oil prices (WTI) and new orders for nondefense capital goods excluding aircraft—another barometer of future industrial activity. Although oil prices have showed recent signs of weakness, we think both indicators suggest further improvement in the manufacturing economy.

Another dynamic for renewed economic vigor within the manufacturing sector is the new administration's bias toward domestic manufacturing, including calls for tax reform. Domestic companies should benefit from tax reform, and we highlight FedEx (rating: BBB, stable), United Parcel Service (rating: A+, stable), and Deere (rating: A, negative) as the likeliest largest beneficiaries given effective tax rates of 36%, 35%, and 31%, respectively. Although we expect to see potential benefits from such reforms, we expect potential savings are bound to be less than advertised given the tax strategies many diversified industrials already employ to reduce their effective tax rates. Notably, Caterpillar (rating: A-, negative) made headlines because law enforcement authorities entered its facilities regarding a tax issue from a Swiss-based subsidiary—CSARL—that Caterpillar set up in 1999. Caterpillar stated in its annual report that the IRS is claiming $2 billion in taxes and fines as a result of its 2010 to 2012 exam. (See our March 8 credit note New Potential Tax Claims Unearthed and Leveled at Caterpillar for further details.)

Nevertheless, an improving economic climate should bolster results for our coverage universe in the coming quarters, although we think it raises the prospect for the ever-present mergers and acquisitions risk. We highlight Emerson Electric (rating: A+, negative), United Technologies (rating: A, stable), and Pentair (rating: BBB, stable) as firms that have indicated a keen interest in acquisition spending.

Automotive

The auto sector continues to reshape itself as GM (rating: BBB-, positive) agreed to sell its struggling Opel unit to PSA SA (not rated) to largely get out of the European market. We view the deal as a modest credit positive given the reduction in capital spending required to meet regulatory hurdles as well as ridding itself of a no- or low-margin business. The emerging mobility segment of the auto business took a shift when Intel (rating: AA-, stable) agreed to buy Mobileye (not rated) for $15 billion to bolster its efforts in autonomous driving. The traditional auto manufacturers and suppliers are colliding with tech companies as these markets overlap, and we expect more deals to come. Previously, Delphi Automotive (rating: BBB+, stable) had developed partnerships with both Mobileye and Intel as part of its autonomous driving effort. The winners and losers will sort themselves out over the next several years, but we believe that taking technological leadership will generally benefit a company. This is often the driver behind the economic moats assigned to the auto suppliers by Morningstar's Equity Research Group. Still, for the original-equipment manufacturers, we will monitor the impact of elevated spending on new initiatives on credit quality as this must be balanced with required capital spending to keep product fresh and free cash generation.

Meanwhile, domestic auto sales remain strong, if slightly weaker than the near-record results produced a year ago. We expect modestly lower sales in 2017 versus 2016 and continue to monitor inventory levels to see if OEMs maintain production discipline. If not, sales incentives will rise, hurting margins. Globally, we continue to expect low-single-digit growth in sales, which should provide a modest tailwind to certain manufacturers and suppliers.

A third area that continues to evolve is the so-called border adjustment tax, which could have a meaningful impact on auto manufacturers. With the substantial number of imported products going into a car, an import tax would be a net negative for many OEMs producing in the U.S., and could more than offset any benefits from overall corporate tax reduction. Layering in the potential exit from NAFTA and substantial tariffs on Mexican-produced vehicles but possibly offset by reduced or extended Corporate Average Fuel Economy, or CAFE standards, leaves the auto sector with many puts and takes to come that will affect credit quality in the quarters ahead.

Aerospace/Defense

We expect ongoing robust underlying drivers for both aerospace and defense credits. With President Trump pushing to eliminate spending caps in the defense budget, while also pushing budgets higher, we expect many programs to be funded and benefit the large defense contractors. The sector also benefits from a dearth of mergers and acquisitions, as most portfolio pruning has already been accomplished. We believe there could be more activity among the small or midtier players, such as the purchase of B/E Aerospace (not rated) by Rockwell Collins (rating: A-/UR-). There could be some big diversified industrial companies hunting through the space, including United Technologies, but mostly in names we don't cover. With strong fundamentals and low event risk, credit quality risks are primarily associated with aggressive capital allocation policies. For the most part, the credits we cover have maintained healthy discipline over the past few quarters, and with stocks pricing in quite a bit of good news, we do not look for this posture to change.

Contributed by Rick Tauber, CFA, CPA and Basili Alukos, CFA, CPA

Insurance and Nonbank Financials

While there is no overarching theme in our outlook across the broad scope of nonbank financial sector companies, each market niche is currently navigating through issues we believe will be relevant heading into the second quarter of 2017. In a move largely expected throughout the financial-services and investing community, the Fed raised its target federal-funds rate 25 basis points to 0.75%-1.0%. While still well below the historical average, the move comes with a sigh of relief from those struggling with abnormally low rates, chiefly life insurers and fixed-income portfolio managers. There is also more confidence that rates will continue to gradually rise, with two further rate increases projected in 2017 and four more in 2018.

The 60-day delay of the U.S. Department of Labor's fiduciary rule—and possible full repeal—is by and large not deterring wealth management firms from going forward with implementing the changes required under the ruling. We believe that the asset shift toward fee-based accounts will continue whether or not the rule stands and that investor appetites for exchange-traded funds are contributing to the shift, if indirectly related.

Insurance

The property/casualty sector posted its first aggregate underwriting loss in three years at year-end 2016 with a 100.7% reported combined ratio, driven by increases in loss frequency and severity, particularly in personal and commercial auto lines of business. Adverse reserve development in auto and other liability occurrence products was also a large factor in the loss, with American International Group's (rating: BBB, negative) outsized fourth-quarter 2016 reserve charge—one of the driving forces in our recent downgrade of the rating—pushing the sector into loss territory. Deteriorating fundamentals in the form of pricing competition and increasing loss costs will likely lead to another modest industry underwriting loss in 2017, as there does not yet appear to be a catalyst for a shift toward a hard market.

Gradually rising rates should benefit the entire insurance industry but will have the largest positive impact on life insurers, whose earnings rely much more heavily on suitable levels of net investment income than P&C insurers. The spread between life insurer fixed-income investments and the rate on contractual obligations should widen given that two more rate increases are expected in 2017, though the boost to earnings may not materialize much in the short term. As an example, MetLife's (rating:BBB-) $3.2 billion reported aftertax loss on derivatives in the fourth quarter of 2016 resulted from the company hedging against a further drop in interest rates in order to protect Brighthouse's universal life liabilities, and the company's earnings should recover as interest rates rise.

Asset Managers

The paradigm shift in preferred investment strategy to passively managed funds and away from active management is causing assets under management to decrease materially for some asset managers and is pressuring margins. ETFs are the current hot ticket item in the investing world because of their comparatively low fixed fees and ability to track a plethora of market indexes. We do not foresee the passive management craze dissipating anytime soon, which will inevitably cause asset managers to look toward expense reductions and new product initiatives to maintain margins.

Recent stock market gains after the U.S. presidential election will likely benefit first-quarter results, though our outlook on the continued rise of the stock market in the absence of concrete legislation on policy proposals is reserved. On March 21, 2017, the Dow Jones Industrial Average, S&P 500, and Nasdaq all reported their largest respective declines since the third and fourth quarter of 2016, as investor enthusiasm over corporate tax reform and the potential for increasing profits has somewhat waned.

Brokers

Charles Schwab (rating: A+, stable) recently sparked a retail trading fee war with competing brokers Fidelity Investments and TD Ameritrade Holding (rating: A, stable), whereby each broker has cut pricing on commissions by nearly, if not over, 50%. We believe the effects of the price war will begin to manifest in the second quarter of 2017 in the form of decreased revenue and modestly lower operating margins, as any hoped-for market share gains will most likely be muted and increased trading is not expected to cover the price cuts.

Contributed by Jeremy Graczyk, CFA

Technology, Media, and Telecommunications

We estimate that issuance of investment-grade, U.S.-dollar-denominated senior debt in tech, media, and telecom totaled $57.6 billion for the first quarter through March 28, up 28%, year over year, led mainly by an uptick in telecom issuance, which is up 161% from last year. Issuance has also been highly concentrated in large, multitranche deals, with two thirds of volume year to date from just three deals: Microsoft's (AA+, stable) $17 billion placement on Jan. 30, Verizon Communications' (BBB, stable) $11 billion issue on March 13, and AT&T's (BBB, UR-) and Apple's (AA-, negative) respective placements of $10 billion notes. The stated use of proceeds has been to fund pending acquisitions and to refinance short-term debt. Also, Viacom (BBB, negative) launched $1.1 billion of hybrid junior-subordinated notes on Feb. 24, targeted to refinance existing debt in 2018 through 2020 and to ease pressure on its balance sheet.

The telecom subsector of the Morningstar Corporate Bond Index widened 7 basis points for the first quarter through March 27. Meanwhile, the technology and media subsectors are 5 and 3 basis points tighter, respectively. Over the same period, Morningstar's Corporate Bond Index tightened by 5 basis points.

Technology

In the most recently reported quarter, revenue growth picked up sequentially across all segments of technology after a slowdown in early 2016. Semiconductor firms led this growth on the strength of higher PC volumes late in 2016 as well as ongoing growth in demand from automotive and industrial buyers of sensor and analog processing circuitry. We continue to expect growth from these end markets to buoy operating performance in early 2017.

Among most semiconductor firms, use of debt remains conservative when considered alongside ample cash and marketable investment reserves, while share repurchases have declined as a percentage of free cash flow over the past year. However, event risk remains elevated amid a general consolidation in the industry. On March 13, Intel (AA-, stable) announced a $15 billion acquisition of automated driver systems developer Mobileye (not rated). Meanwhile, Analog Devices' (rating: A+, UR-) pending acquisition of competitor Linear Technology (not rated) will likely close in the calendar second quarter.

For technology hardware firms, we have a greater number of negative outlooks than stable and positive outlooks. Revenue trends were negative for the trailing 12 months, but the rate of decline has eased during recent periods. Operating margins are running slightly weaker in this segment, but are comparatively stable given the weakness in revenue. Over time, we still expect ongoing revenue declines as systems applications formerly dependent on physical equipment will increasingly be replicated by server-based software, which will likely compress operating profitability of traditional hardware. Meanwhile, hardware firms' use of debt remains at the high end of the technology sector, though the trend has been reasonably stable over the past few quarters. Furthermore, during the past 12 months, firms have backed off on repurchasing shares, which has helped expand cash reserves across the segment.

In software, firms more heavily involved in cloud-based platforms continue to outperform traditional on-premises firms on revenue growth. Despite top-line weakness for legacy firms like CA (rating: A-, stable) and Oracle (rating: AA-, stable), operating margins have not deteriorated and cash flow remains ample, which supports our stable credit outlook across the segment. However, despite higher cash flows, average leverage of the segment moved a bit higher in the latest quarter while cash levels declined relative to EBITDA. We attribute much of this recent uptick in leverage to Microsoft's debt-funded acquisition of LinkedIn and Oracle's buyout of the remaining stake in NetSuite, both of which closed in the calendar fourth quarter of 2016. For 2017, we expect corporate actions and event risk to remain key themes in the sector, which may lead to further increases in debt.

Another source of uncertainty around tech firms is potential tax and regulatory policy changes in the United States, which could have a material impact on the sector, some positive and some negative. For example, the dramatic shift in immigration policy recently imposed by the Trump administration may bear heavily against firms that depend on a stable supply of employees holding H1-B visas. Conversely, a

Republican majority in the House of Representatives and Senate may bode well for the multinational tech firms harboring substantial overseas cash hoards that may directly benefit from a repatriation tax holiday as well as other corporate tax reforms. However, this would only benefit bondholders to the extent that repatriated cash was invested to generate business growth and profitability or used to reduce debt.

Media

Operating performance in the media sector has generally been solid in recent quarters despite market concerns that growth in Internet content streaming may reduce consumer demand for the traditional cable bundle. While advertising has recently been weak, growth in distribution and licensing fees has made up for it, with overall revenue growth for the sector remaining flat for the trailing 12-month period. However, the recent trend in margin compression continued in the latest quarter, driven in part by higher content spending.

Media sector debt levels remained stable, though payout of free cash flow remains elevated, averaging 97% over the most recent 12-month period. Event risk is also likely to remain an overhang as interest from companies outside of the media sector intensifies, most notably telecommunication companies. There is also pressure on media companies to invest in on-demand video streaming, along the lines of Walt Disney's (A+, positive) 2016 acquisition of a minority interest in Major League Baseball's streaming technology provider, BAMTech. With fees from traditional cable distributors declining as a result of fewer subscribers, the ability to distribute core content like ESPN or Disney Channel through new delivery networks is important to stabilizing subscriber levels and related ad revenue. Accordingly, we think content companies will likely strike more partnerships away from the traditional cable operators as new delivery modes are market-tested.

Meanwhile, with a new CEO at the helm and a merger with CBS (BBB, stable) off the table, Viacom has begun to address its turnaround strategy. In advance of the operational components of the plan, the company issued $1.3 billion of junior subordinated notes in February. In our view, the offering fully addresses two to three years of debt maturities, which will reduce senior leverage and free management's attention to stabilize revenue and profitability.

Telecommunications

We believe the credit profiles of telecommunications issuers will remain under pressure thanks to large dividend commitments, strategic acquisitions, and heavy capital spending plans. The market for telecommunications has become heavily saturated, particularly in U.S. wireless, which is likely to limit subscriber growth in future years. To confront this, carriers are increasingly looking for alternative ways to leverage their network investments to create new products and services to generate revenue. Verizon has invested heavily in mobile video delivery and advertising, with acquisitions of AOL and its pending acquisition of Yahoo (not rated). Meanwhile, Verizon competitor AT&T has made large-scale bets on video content and delivery, with its acquisition of DirecTV and its proposed merger with Time Warner, the latter following in the footsteps of Comcast's transformative 2013 acquisition of NBCUniversal studios.

Near term, wireless competition has intensified with Verizon’s recent launch of its unlimited data plan, which has spurred AT&T, T-Mobile (BB, stable), and Sprint (B, negative) to redesign their own unlimited offerings. The recent change in tone in Washington has removed the pressure on carriers to abide by strict net neutrality regulations, which allows carriers to exempt certain data consumption from data caps in exchange for a lower download speed on those streams. This benefits carriers like AT&T, which could exempt all DirecTV Now viewing from its high-speed data limits, giving it a competitive advantage over carriers that do not offer similar services.

Longer term, we also expect significant capital spending on network upgrades and, eventually, the roll-out of 5G technology, once a standard is agreed on. In the months ahead, we also expect to hear bidding results from the 600 megahertz wireless spectrum auction. Wireless industry blog FierceWireless recently reported that the main bidding phase of the auction has ended, with about $20 billion of commitments. We expect Verizon to be a significant bidder, along with T-Mobile, and possibly even Comcast (A-, stable). However, AT&T’s interest appears low based on a recent disclosure that its auction commitments are likely to more than satisfied by the $2.4 billion of deposits it has already paid. M

Contributed by Michael Dimler, CFA

Credit Contacts

Basic Materials
Sean Sexton, CFA
sean.sexton@morningstar.com
+1 312 348-3077

Consumer
Dave Sekera, CFA
david.sekera@morningstar.com
+1 312 696-6293

Consumer Defensive
Wesley Moultrie, CPA, CGMA
wesley.moultrie@morningstar.com
+1 312 384-5405

Consumer Cyclical
Wayne Stefurak, CFA
wayne.stefurak@morningstar.com
+1 312 696-6114

Energy
Andrew O'Conor
andrew.oconor@morningstar.com
+1 312 348-3021

Financials – Banks
Chris Baker, CFA
christopher.baker@morningstar.com
+1 312 244-7533

Financials – European Banks
Erin Davis
erin.davis@morningstar.com
+1 312 384-4810

Financials – Financial Services
Jeremy Graczyk, CFA
jeremy.graczyk@morningstar.com
+1 312 244-7491

Healthcare
Julie Utterback, CFA
julie.utterback@morningstar.com
+ 1 312 696-6278

Healthcare
Michael Zbinovec
michael.zbinovec@morningstar.com
+ 1 312 348-3136

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

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

REIT
Chris Wimmer, CFA
chris.wimmer@morningstar.com
+1 646 560 4585

REIT
Mike Magerman
mike.magerman@morningstar.com
+1 267 960 6022

Technology, Media, and Telecom
Michael Dimler, CFA
michael.dimler@morningstar.com
+1 312 696-6339

For More Information

Gregg Novek
+1 646 560-4529
gregg.novek@morningstar.com

MORNINGSTAR®

22 West Washington Street
Chicago, IL 60602 USA