Second-Quarter 2018 Corporate Credit Market Insights

Most Fixed-Income Indexes Decline in Second Quarter as Rising Interest Rates Takes Their Toll

Morningstar Credit Ratings, LLC
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Contents

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Key Takeaways

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- Yield Curve Continues to Flatten
- Outflows Among High-Yield Open-End Funds Overwhelm ETF Inflows
- Downgrades Edge Out Upgrades During the Second Quarter

Summary

Most fixed indexes continued their declines over the course of the second quarter as interest rates rose and investment-grade corporate credit spreads widened out. However, with its shorter duration and higher correlation to economic growth, the high-yield sector was one of the few standouts this quarter that registered gains.

Morningstar's Core Bond Index, our broadest measure of the fixed-income universe, declined 0.42% in the second quarter through June 25 and has fallen a total of 1.94% year to date. The decline was mainly driven by the increase in interest rates across the entire yield curve but was also under pressure from widening investment-grade corporate credit spreads. Underlying the Core Bond Index, Morningstar's Short-Term Core Bond Index was able to post a small gain of 0.15% even as short-term rates rose to their highest levels in over a decade. This gain in the second quarter helped to offset earlier losses and this index is now only down 0.24% for the year. The Intermediate Core Bond Index declined 0.11% during the quarter and has dropped 1.39% year to date. With its longer duration and greater price sensitivity to interest rates, the Long-Term Core Bond Index fell by 1.63% this quarter and had registered a 4.75% loss this year as falling bond prices from rising rates more than offset the yield carry from the underlying bonds in this index.

In the Treasury market, the Morningstar U.S. Government Bond index fell by 0.14% and has declined 1.34% thus far this year. Similarly, the Morningstar Agency Bond Index declined 0.16% in the quarter and 0.70% year to date. One of the bright spots this quarter was in the Treasury Inflation Protected Securities market. As inflation measures edge up, investors looked to TIPS, which led the Morningstar TIPS Index to a gain of 0.42%; however, that gain was not enough to offset the losses incurred in the first quarter and the index remains in the red to the tune of 0.35% for the year.

During the second quarter, through June 25, the yield on the 2-year Treasury bond rose another 26 basis points on top of the 38 basis points it rose in the first quarter. At its current yield of 2.53%, the 2-year is trading at its highest yield since August 2008. The yield on the 5-year Treasury bond rose 19 basis points to 2.75%, which rivals its highest yield since 2010. Along the long end of the curve, the yield in the 10-year Treasury rose 14 basis points to 2.88%. The yield on the 10-year briefly broke through the psychological ceiling at 3% but was quickly driven back down as concerns that a global trade war would emerge drove a flight to safety. At the longest end of the curve, the 30-year rose only 5 basis points to 3.02%. As short-term rates have continued to rise faster than long-term rates, the spread between the 2-year Treasury and the 10-year Treasury has since compressed to 35 basis points, representing the flattest the yield curve has registered since fall 2007.

In the corporate bond market, the Morningstar Corporate Bond Index (our proxy for the investment-grade bond market) declined 1.25% this quarter as the combination of higher interest rates and wider credit spreads pushed bond prices down. Year to date, our corporate bond index has lost 3.46%. In contrast, in the high-yield market, the Bank of America Merrill Lynch High Yield Master Index rose 0.48% in the second quarter as credit spreads tightened and the higher yield carry of the index more than offset the impact of higher interest rates. Year to date, the high-yield market has risen 1.43%. Among European fixed-income markets, the Morningstar Euro Corporate Bond Index rose 0.11% as the benefit from the decline in underlying interest rates on benchmark German bonds offset the amount that corporate credit spreads widened. Year to date, the European Corporate Bond Index has registered a loss of 0.19%.

Once again, the emerging-markets fixed-income indexes were among the worst-performing fixed-income asset classes following significant losses in the first quarter. Quarter to date, the Morningstar Emerging Market Composite Index fell 2.60%, as the underlying Morningstar Emerging Market Sovereign Index declined 4.03% and the Morningstar Emerging Market Corporate Index fell 1.79%. Morningstar's Emerging Market High Yield Index dropped by 4.68%. Year to date, the composite index has fallen 4.23%, the sovereign index has dropped 5.96%, the corporate index has declined 3.24%, and the high-yield index has plunged by 5.88%.

Exhibit 1 Fixed-Income Index Returns

Broad Market Index	QTD	YTD	2017	2016	2015	2014	2013	2012
Core Bond	-0.42	-1.94	3.64	2.64	0.98	6.07	-1.89	4.41
Short-Term Core	0.15	-0.24	1.12	1.46	0.79	1.04	0.57	1.75
Intermediate Core	-0.11	-1.39	2.63	2.22	1.96	5.56	-1.07	4.25
Long-Term Core	-1.63	-4.75	8.39	5.10	-1.55	15.10	-6.88	8.32
Sector Indexes								
US Gov't Bond	-0.14	-1.34	2.41	0.97	0.91	5.08	-2.74	1.98
Agency	-0.16	-0.70	2.10	1.67	0.72	3.01	-1.03	1.96
Corporate Bond	-1.25	-3.46	6.40	5.81	-0.46	7.20	-1.50	10.54
BofAML High Yield Master II	0.48	1.43	7.48	17.49	-4.64	2.50	7.42	15.58
Eurobond Corp	0.11	-0.19	1.81	4.66	-0.59	8.35	1.94	12.67
TIPS	0.42	-0.35	3.10	4.68	-1.60	3.95	-8.53	6.93
Emerging Markets Indexes								
Emerging Mkt Composite	-2.60	-4.23	8.24	9.94	0.62	5.06	-4.39	16.25
Emerging Mkt Sovereign	-4.03	-5.96	9.31	9.25	1.15	7.69	-3.40	13.75
Emerging Mkt Corporate	-1.79	-3.24	7.85	11.30	0.08	3.47	-2.81	15.32
Emerging Mkt High Yield	-4.68	-5.88	9.34	15.17	1.42	2.63	-4.99	24.07

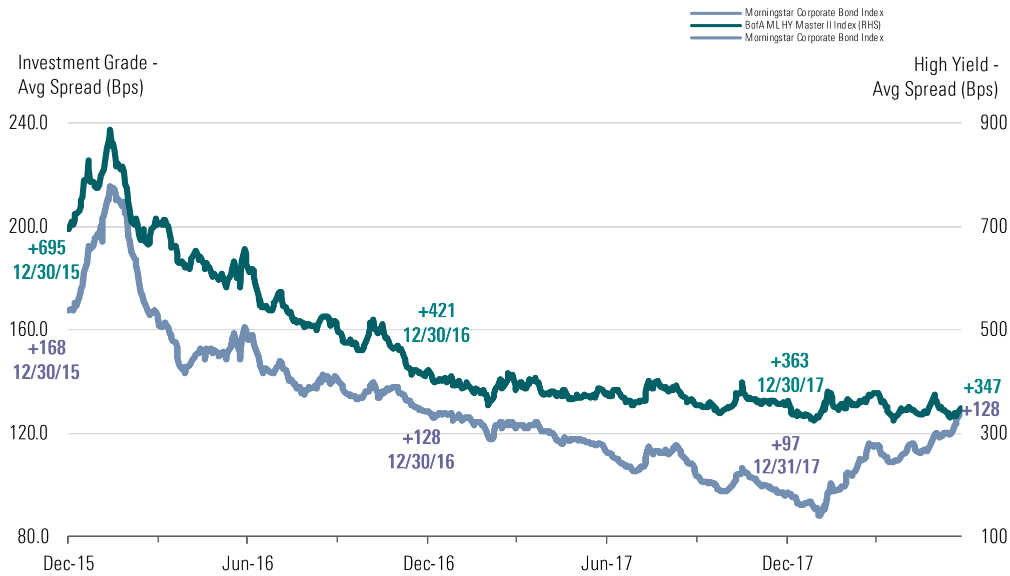
Source: Morningstar, Inc., Bank of America Merrill Lynch Global Indexes. Data as of June 25, 2018.

A Tale of Two Bond Markets: Investment Grade Struggles While High Yield Strengthens

It's been a tale of two cities across the corporate bond markets thus far this year. Since the end of last quarter, through June 25, the average credit spread of the Morningstar Corporate Bond Index, our proxy for the investment-grade bond market, widened 13 basis points to +128; however, in the high-yield market, over the same time period, the Bank of America Merrill Lynch High Yield Master Index has tightened 32 basis points to +347. Year to date, the investment-grade index has widened 32 basis points, whereas the high-yield index has tightened 16 basis points.

At its current level, the average credit spread in the investment-grade market is at its widest level this year and is at its highest level since the beginning of 2017. At that time, the corporate bond markets were still recovering from an earlier plunge in oil prices which bottomed out in 2016. In contrast, the average credit spread of the high-yield index is not that far off of its tightest levels since prior to the 2008–09 credit crisis. Since the beginning of 2000, the high-yield index has only ever traded below the current level approximately 12% of the time.

Exhibit 2 Corporate Bond Credit Spreads



Source: Morningstar, Inc., Bank of America Merrill Lynch Global Indexes. Data as of June 25, 2018.

There are several factors in play that have led to this divergence. Investment-grade credit spreads are more susceptible to sell-offs in relation to debt-leveraged mergers and acquisitions than are high-yield spreads. Following a recent court ruling in which the Justice Department lost its attempt to block the proposed merger between **AT&T** T and Time Warner, investment-grade portfolio managers have become increasingly concerned that the potential for mega-mergers and acquisitions that may not have passed antitrust regulators in the past, may now be possible. For example, as soon as the Department of Justice announcement was made, **Comcast** CMCSA commenced a bidding war by making a counter offer to acquire certain assets from **Twenty-First Century Fox** FOX, for which **Disney** DIS had made a prior offer. Typically, mergers and acquisitions are funded with significant amounts of newly issued debt, which heighten default risk and often lead to rating downgrades. However, more often than not, high-yield companies are purchased by larger, investment-grade companies and the outstanding debt of those acquired high-yield companies are upgraded to the same rating as the acquirer.

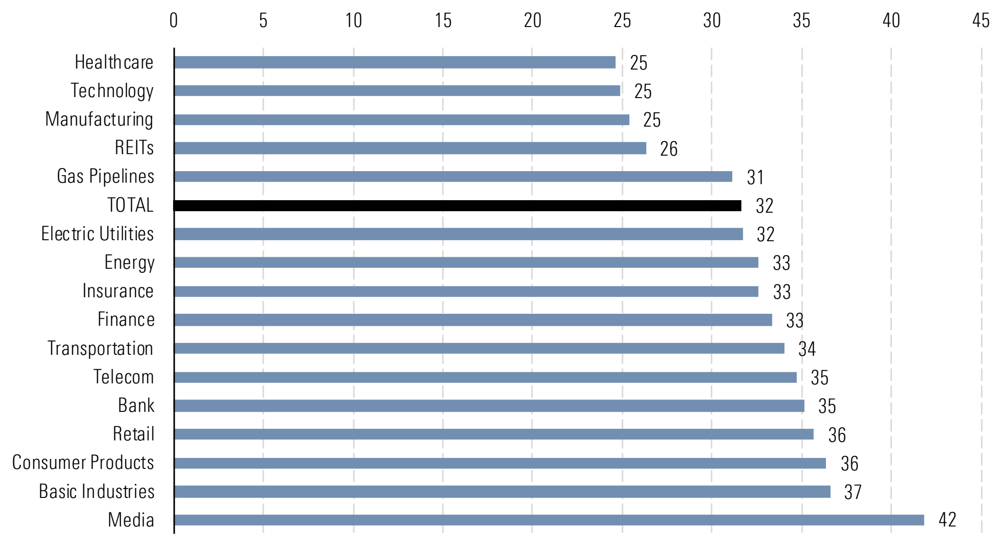
While investment-grade has struggled, the high-yield market has outperformed thus far this year as the performance of the underlying companies in the high-yield universe are more affected by changes in economic activity, which has been robust this quarter. Whether it has been driven by the implementation of the tax cuts earlier this year, or some other reason, economic activity has been on a tear recently and is much stronger than was expected at the beginning of the quarter. In its most recent GDPNow estimate based on current economic metrics, the Federal Reserve Bank of Atlanta is projecting that second-quarter GDP growth will be 4.7%. This rate of growth would represent the second strongest quarterly growth rate over the past four years, surpassed only in third-quarter 2014.

Rising interest rates have also played a significant part in the divergence between the performance of the investment-grade and high-yield markets. With their lower credit spread and longer average duration, investment-grade bond performance is more closely correlated to movements in interest rates than high-yield bonds. High-yield bonds typically have shorter durations and wider credit spreads, which are more closely tied to the performance of the underlying companies. Similar to the credit spread widening that occurred during the "taper tantrum" in mid-2013, investors are requiring additional credit spread to compensate for the risk that interest rates rise further.

The impact to corporate credit spreads on the investment-grade market from issuers that engage in large, debt-funded M&A can be seen in the performance of Disney and Comcast notes. As the bidding war for the Fox assets between the two rages on, the credit spreads for those company's bonds have widened out as investors price in a higher probability that debt leverage will increase significantly for whichever firm emerges as the winner. With its higher credit rating, Disney's notes had been outperforming the market earlier this year, but this month Disney's 2027 notes widened 18 basis points and are 33 basis points wider than at the end of 2017. While the credit spread on Comcast's 2028 notes was unchanged in June, the notes have widened 48 basis points since the end of last year. This compares to the index which widened 8 basis points in June and 32 basis points year to date.

Among the winners and losers this quarter, those companies with a significant amount of cash that had previously been held overseas to avoid tax payments upon repatriation, performed well as the new tax laws took effect. Both the healthcare and technology sectors outperformed the overall investment-grade index thus far this year as both sectors have a high percentage of issuers that fit this description. To the downside, the media sector has far underperformed the overall market as debt-financed M&A ravages the credit quality for many of the issuers within that sector.

Exhibit 3 Morningstar Corporate Credit Index YTD Spread Change



Source: Morningstar, Inc. Data as of June 25, 2018.

Yield Curve Continues to Flatten as Rates Rise

In conjunction with the hikes in the federal funds rate, short term rates have continued their march higher. However, the rise in long term rates has lagged the rise in short-term rates, which has led to further flattening of the yield curve. On the shorter end of the curve, the yield on the 2-year Treasury bond rose 26 basis points this quarter to 2.53%, rivaling the highest yield it has traded at this year and the highest yield the 2-year has registered since mid-2008. Along the longer end of the curve, after breaking above the 3% psychological barrier a few weeks ago, the 10-year has rallied once again and sunk below that threshold to 2.88%. The bid for longer-term U.S. Treasuries coincided with the increasing rhetoric surrounding global trade re-negotiations and the rising risk that new tariffs will be imposed and the responding retaliatory tariffs will impede global economic growth. This drove the spread between the 2-year and 10-year Treasury to 35 basis points, representing the flattest the yield curve has been since fall 2007.

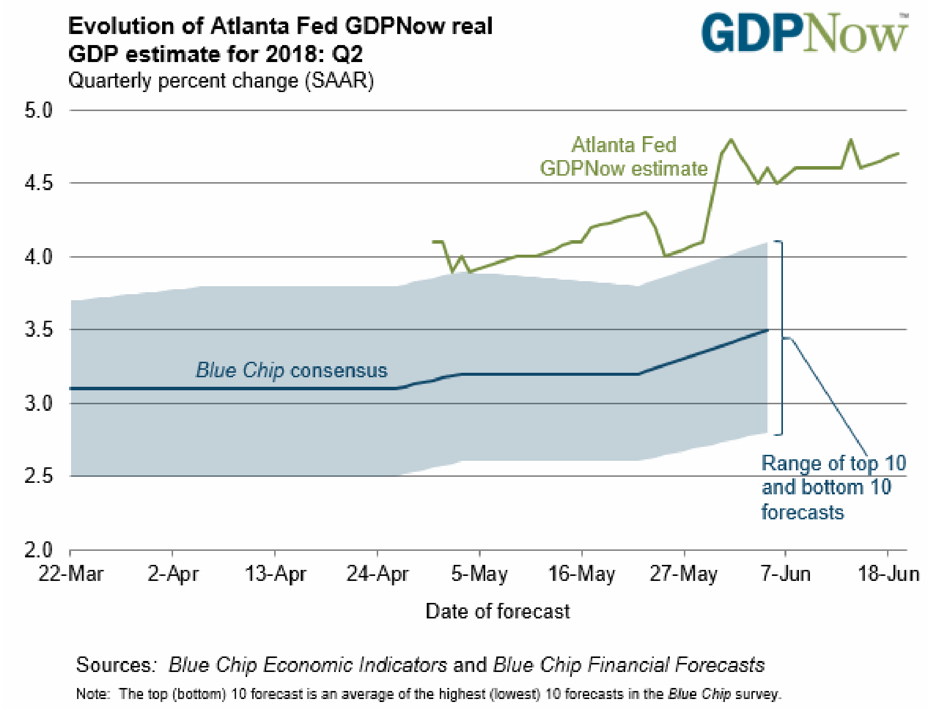
Exhibit 4 10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity

Source: Morningstar, Inc. Data as of June 25, 2018

The yield curve has been on a multiyear flattening trend since the Fed began to raise short-term rates in its pursuit to normalize monetary policy and this trend may not yet have fully run its course. According to the CME FedWatch Tool, the market is pricing in additional hikes to the federal funds rate (currently 1.75%–2.00%) over the course of the year. The probability that the federal funds rate at the end of 2018 will be greater than 2.00% is 91% and the probability that the federal funds will be 2.25% or higher is 50%. At the beginning of the year those probabilities were 44% and 13%, respectively.

In the past, when the yield curve has been flattening and then invert, it has often been an indicator of a weakening economy and in many cases portended an impending recession. This time around, this signal may not be foreshadowing a near-term recession risk, as it is being heavily influenced by global central bank actions and current economic activity hasn't shown any indications of slowing down. In fact, as an indication of the current economic strength, the Atlanta Fed's GDPNow model forecast for second quarter 2018 real GDP growth has risen throughout the second quarter to 4.7%, which would be a strong acceleration from the 2.3% GDP growth rate in the first quarter and would be the strongest quarterly growth rate since the third quarter of 2014.

Exhibit 5 GDPNow—Federal Reserve Bank of Atlanta

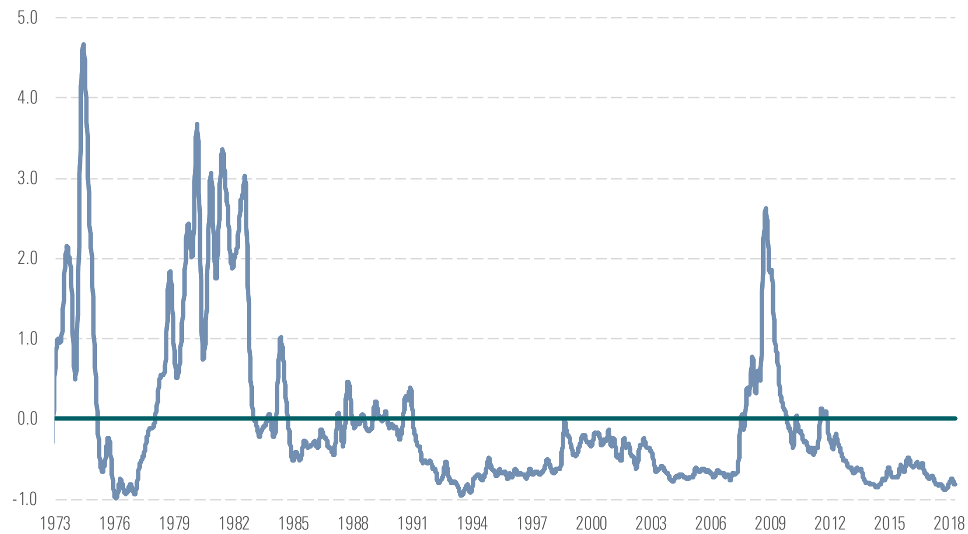


Source: Federal Reserve Bank of Atlanta as of June 19, 2018.

While the Fed's monetary policy actions have been directly impacting short term rates in the U.S., rates in other developed markets continue to be influenced by their central bank interventions. For example, at its most recent press conference, the ECB disclosed its plans to keep its deposit rate at a negative yield of (0.40)% through the summer of 2019. Furthermore, although the ECB announced that it will begin to taper its asset purchases this fall, it will continue to purchase EUR 30 billion of debt securities per month through September and then reduce the purchases to EUR15 per month until the end of the year. Even though the 10-year U.S. Treasury is yielding only 2.88%, that yield has been attractive to global bond investors as the yield on Germany's 10-year bond is only 0.33% and the yield on Japan's 10-year bond is only barely positive at 0.04%.

Supporting the Atlanta Fed's GDP forecast, the level of the National Financial Conditions Index remains near the strongest readings it has ever registered and is currently indicating that financial conditions remain near their loosest since October 1994. This index is published by the Federal Reserve Bank of Chicago and measures more than 105 variables to gauge how "loose" or "tight" financial conditions are among U.S. capital markets, as well as the traditional and shadow banking systems. These variables include credit availability and cost, leverage, risk, interest rates, and credit spreads. Index levels above zero indicate tighter than average conditions, whereas levels below zero represent looser than average conditions.

Exhibit 6 Chicago Fed National Financial Conditions Index



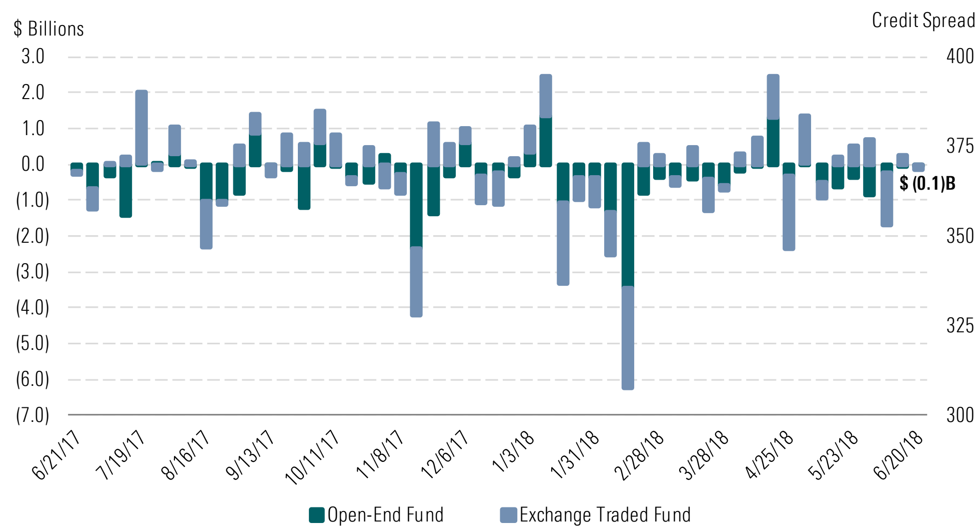
Source: Federal Reserve Bank of Chicago. Data as of June 25, 2018.

Outflows Among High-Yield Open-End Funds Overwhelm ETF Inflows

During the second quarter, high-yield open-end mutual funds have registered $1.9 billion of outflows, whereas the high-yield exchange traded funds have experienced net unit creation of $1.2 billion, resulting in a net outflow of $0.7 billion across the asset class. This marks a significant decrease in the pace of outflows recorded in the first quarter in which $13.6 billion of funds were pulled out of the high-yield sector. The amount of weekly flows in the second quarter was more closely balanced between inflows and outflows as compared to the first quarter which had set a record for the greatest number of consecutive weekly outflows since we first began tracking the data. During the first quarter, there had been eight consecutive weeks of outflows.

Year to date, there has been a total of $14.2 billion of outflows in the high-yield sector, consisting of $9.7 billion of outflows among the open-end high-yield mutual funds and $5.7 billion of net unit redemptions among the high-yield ETFs. Typically, open-end funds are considered a proxy for individual investors and ETFs are considered a proxy for institutional investor demand.

Exhibit 7 Estimated Weekly High-Yield Bond Fund Flows



Source: Morningstar, Inc. and BofA Merrill Lynch Global Indexes. Data as of June 20, 2018.

Downgrades Edge Out Upgrades During the Second Quarter

In the second quarter of 2018, we downgraded seven and upgraded six credit ratings. Of the downgrades, only one was driven by a deterioration in the firm's underlying business prospects. The other downgrades were driven by management decisions to purposefully weaken their balance sheet in order to finance acquisitions or to reward shareholders by significantly increasing the size of their share buyback programs. While the upgrades were generated by idiosyncratic factors at each company, generally, the upgrades were driven by a combination of improving business prospects and the resulting improvements to the firm's credit metrics in our forecasts.

Exhibit 8 Ratio of Rating Upgrades to Downgrades, by Quarter by Sector

Sector	Q2 2016 Ratio	Q3 2016 Ratio	Q4 2016 Ratio	Q1 2017 Ratio	Q2 2017 Ratio	Q3 2017 Ratio	Q4 2017 Ratio	Q1 2018 Ratio	Q2 2018 Ratio
Basic Materials	0 / 1	1 / 2	0 / 1	3 / 0	0 / 0	2 / 0	2 / 0	1 / 0	1 / 0
Consumer Cyclical	1 / 2	0 / 0	1 / 0	7 / 0	0 / 1	1 / 0	0 / 2	0 / 1	0 / 2
Consumer Defensive	1 / 1	1 / 2	3 / 1	1 / 1	0 / 0	0 / 2	1 / 0	0 / 0	0 / 1
Energy	0 / 2	0 / 2	0 / 5	1 / 4	0 / 0	0 / 0	0 / 1	2 / 0	2 / 0
Financial Institutions	0 / 0	2 / 1	1 / 0	1 / 0	1 / 0	5 / 0	1 / 3	5 / 1	0 / 0
Healthcare	2 / 3	2 / 1	2 / 1	0 / 3	1 / 1	0 / 3	1 / 2	3 / 4	2 / 1
Industrials	1 / 1	6 / 4	2 / 1	4 / 1	1 / 1	2 / 0	0 / 1	3 / 2	0 / 1
Insurance	0 / 0	0 / 0	0 / 0	1 / 2	4 / 0	0 / 0	0 / 0	0 / 0	0 / 0
Real Estate	0 / 0	0 / 0	0 / 0	0 / 0	0 / 0	0 / 0	0 / 0	0 / 0	0 / 0
Technology, Media, and Telecom	1 / 7	0 / 3	2 / 2	0 / 0	0 / 3	0 / 0	0 / 2	0 / 0	1 / 2
Technology	1 / 3	0 / 3	1 / 2	0 / 0	0 / 1	0 / 0	0 / 0	0 / 0	1 / 0
Media	0 / 0	0 / 0	1 / 0	0 / 0	0 / 0	0 / 0	0 / 0	0 / 0	0 / 1
Telecom	0 / 4	0 / 0	1 / 0	0 / 0	0 / 2	0 / 0	0 / 2	0 / 0	0 / 1
Total	**6/17**	**12/15**	**12/11**	**17/11**	**7 / 6**	**10 / 5**	**5 / 11**	**14 / 8**	**6 / 7**
Ratio Upgrades to Downgrades	**0.35**	**0.80**	**1.09**	**1.55**	**1.17**	**2.00**	**0.45**	**1.75**	**0.86**

Source: Morningstar Credit Ratings, LLC. Data as of June 25, 2018.

In the second quarter, we upgraded six companies with concentrations in energy (two) and healthcare (two) and one upgrade in each of the technology and basic materials sectors.

In the energy sector, we upgraded **ConocoPhillips** COP and **Anadarko Petroleum** APC based on our expectations for gradually improving credit metrics in light of our current oil and gas price forecasts. In the healthcare sector, we upgraded **Boston Scientific** BSX based on the firm's improving financial flexibility and our projection for a stronger Cash Flow Cushion score over the forecast period. The upgrade for **HCA Healthcare** HCA was driven by improvements in our Business Risk pillar. In the technology sector, we upgraded **Adobe Systems** ADBE as the firm's credit metrics will be supported by robust revenue growth from its product lineup. Finally, we upgraded **Anglo American** NGLOY as the firm has made substantial progress towards reducing debt and enhancing free cash flow.

Among the downgrades in the second quarter, we downgraded seven companies across myriad sectors. In the consumer cyclical sector, we downgraded **Bed Bath & Beyond** BBBY, reflecting our expectation that pricing pressure will lower profitability at a greater pace that we originally expected. While the underlying business continues to operate within our expectations, we downgraded **Starbucks** SBUX as the firm ramps up its share buyback program which we expect will weaken its credit metrics. Similarly, we downgraded **Union Pacific** UNP as the firm ramps up its debt leverage to repurchase equity.
We downgraded **Cisco** CSCO, reflecting our expectation for increasing pressure on both the firm's Cash Flow Cushion and Solvency Score over the next two years as a result of management's intention to depart from its historically conservative capital policy through a reduction in cash and investment balances to support a higher volume of share repurchases. In the consumer defensive sector, we downgraded **Campbell Soup** CPB following a large, debt-financed acquisition which significantly increased the firm's debt leverage. Among the other downgrades driven by debt leveraged acquisitions,

we downgraded **Discovery** DISCA upon the closing of its acquisition of Scripps Network. Finally, we downgraded **Mallinckrodt** MNK as the company is experiencing significant operational pressure from the company's transformation into an innovative specialty medicine firm, heavy reliance on its best-seller Acthar Gel, and high financial leverage.

Exhibit 9 First-Quarter 2018 Upgrades and Downgrades

Company Name	Ticker	Old Rating	Current Rating	Date
Upgrades:				
Boston Scientific Corp	BSX	BBB	BBB+	04/11/18
HCA Healthcare Inc	HCA	BB	BB+	04/16/18
ConocoPhillips	COP	BBB+	A-	04/24/18
Adobe Systems Inc	ADBE	A+	AA-	04/27/18
Anadarko Petroleum Corp	APC	BB+	BBB-	04/30/18
Anglo American PLC	NGLOY	BB+	BBB-	06/25/18
Downgrades:				
Discovery Inc	DISCA	BBB	BBB-	03/23/18
Campbell Soup Co	CPB	A-	BBB	04/06/18
Cisco Systems Inc	CSCO	AA	AA-	04/16/18
Bed Bath & Beyond Inc	BBBY	BBB-	BB+	04/19/18
Mallinckrodt PLC	MNK	BB-	B+	05/17/18
Union Pacific Corp	UNP	A	A-	06/08/18
Starbucks Corp	SBUX	A	A-	06/25/18

Source: Morningstar Credit Ratings, LLC. Data as of June 25, 2018.

We currently have 15 ratings under review in our coverage universe with five potential downgrades and three potential upgrades. By sector, our reviews are concentrated in the financial services sector (six) and healthcare sector (three) with energy, insurance, REITs, and technology rounding out the other credits under review.

Exhibit 10 Companies Under Review by Sector

Sector	UR+	UR	UR-	Total
Basic Materials	0	0	0	0
Consumer Cyclical	0	0	0	0
Consumer Defensive	0	0	0	0
Energy	1	0	0	1
Financial Institutions	0	6	0	6
Healthcare	0	1	3	4
Industrials	0	0	0	0
Insurance	0	0	1	1
Real Estate	1	0	0	1
Technology, Media, and Telecom	1	1	0	2
Technology	0	0	0	0
Media	0	0	0	0
Telecom	1	1	0	2
Total	3	8	4	15
% of Total Under Review	20%	53%	27%	100%

Source: Morningstar Credit Ratings, LLC. Data as of June 25, 2018.

The greatest change to the companies in which our rating is under review occurred in the Bank sector. We placed **BB&T** BBT, **Comerica** CMA, **Discover** DFS, **Fifth Third** FITB, **Regions Financial** RF, and **Zions Bancorp** ZION Under Review because of changes in the financial regulatory environment. Under the Economic Growth, Regulatory Relief, and Consumer Protection Act, which was signed into law this quarter, only banks with $250 billion or more in total assets will be designated as systemically important banks, or SIBs. Under Morningstar's Bank Credit Rating Methodology (September 2017), banks that are regulated as SIBs are compared with other SIBs, while non-SIBs are compared with other non-SIBs. We expect that, as a result of the Economic Growth, Regulatory Relief, and Consumer Protection Act, we will move many of these banks into our U.S. regional bank peer set from our global bank peer set.

Exhibit 11 Companies Under Review

Company	Ticker	Sector	Rating	Rating Status
Andeavor	ANDV	Energy	BBB-	UR+
BB&T Corp	BBT	Banks	A	UR
Cigna Corp	CI	Insurance	BBB	UR-
Comerica Inc	CMA	Banks	A	UR
CVS Health Corp	CVS	Healthcare	BBB+	UR-
DCT Industrial Trust Inc.	DCT	REITs	BBB	UR+
Discover Financial Services	DFS	Banks	BBB+	UR
Express Scripts Holding Co	ESRX	Healthcare	A-	UR-
Fifth Third Bancorp	FITB	Banks	BBB+	UR
Regions Financial Corp	RF	Banks	BBB+	UR
Sanofi SA	SAN	Healthcare	AA-	UR-
Shire PLC	SHP	Healthcare	BBB-	UR
Sprint Corp	S	Technology	B	UR+
Windstream Holdings Inc	WIN	Technology	B-	UR-
Zions Bancorp	ZION	Banks	BBB	UR

Source: Morningstar Credit Ratings, LLC. Data as of June 25, 2018.

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