Morningstar Corporate Credit Research Highlights

Third-Quarter 2019 Fixed-Income Market Roundup

Morningstar Credit Ratings, LLC
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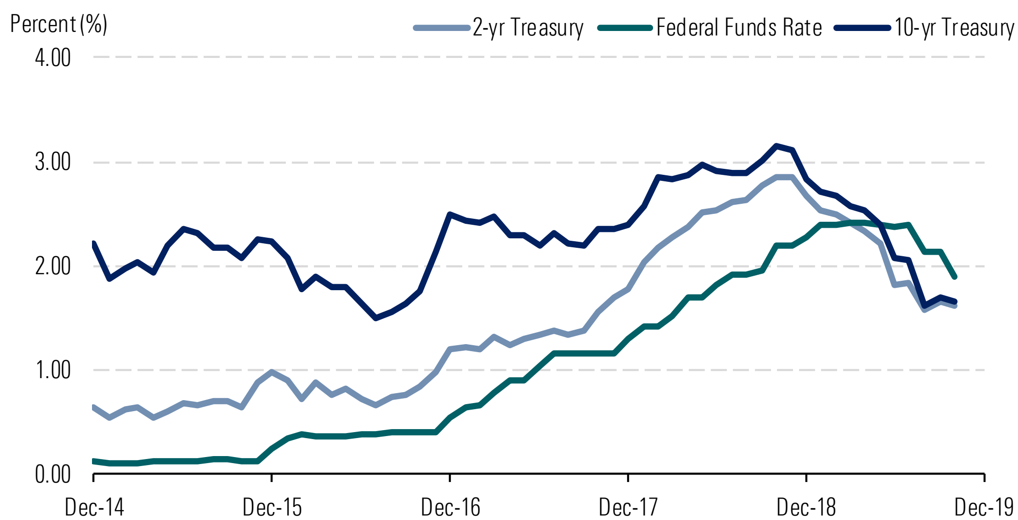
Credit Market Insights

Third-Quarter 2019 Fixed-Income Market Roundup

The fixed-income market generated relatively strong returns in the third quarter driven mainly by the continued decrease in interest rates, which pushed bond prices higher across the board. In the U.S. Treasury bond market, the overall yield curve declined, but the curve also flattened as interest rates on the longer end of the curve fell further than the shorter end. In the short end of the curve, the 2-year declined by only 13 basis points to 1.62%, whereas in the longer end, the 10-year declined 35 basis points to 1.66%, close to its multiyear lows.

US Interest Rates



Source: Federal Reserve Bank of St. Louis as of September 30, 2019.

As a result, the Morningstar Core Bond Index, our broadest measure of the fixed-income universe, rose by 2.28%, well in excess of the yield carry it generated over the quarter. Underlying the broader index, the short-term index rose a little under 1%, the intermediate index rose a little over1%, and with its long duration, the long-term index well outperformed with a 5.5% return.

Fixed Income Index Returns

Broad Market Index	*3Q2019*	*YTD2019*	*2018*	*2017*	*2016*	*2015*	*2014*
Core Bond	2.28	8.41	-0.01	3.64	2.64	0.98	6.07
Short-Term Core	0.82	4.01	1.46	1.12	1.46	0.79	1.04
Intermediate Core	1.34	6.08	0.93	2.63	2.22	1.96	5.56
Long-Term Core	5.49	17.92	-3.24	8.39	5.10	-1.55	15.10
Sector Indexes							
US Gov't Bond	2.51	7.79	0.86	2.41	0.97	0.91	5.08
Agency	1.98	6.71	1.35	2.10	1.67	0.72	3.01
Corporate Bond	3.05	12.91	-2.30	6.40	5.81	-0.46	7.20
ICE BofAML High Yield Master I	1.22	11.50	-2.26	7.48	17.49	-4.64	2.50
TIPS	1.56	7.85	-1.27	3.10	4.68	-1.60	3.95
Emerging Markets Indexes							
Emerging Mkt Composite	1.38	11.33	-2.82	8.24	9.94	0.62	5.06
Emerging Mkt Sovereign	-0.21	11.07	-4.72	9.31	9.25	1.15	7.69
Emerging Mkt Corporate	2.44	11.71	-1.71	7.85	11.30	0.08	3.47
Emerging Mkt High Yield	-1.30	8.77	-4.61	9.34	15.17	1.42	2.63

Sources: Morningstar, Inc. and ICE BofAML Index. Data as of 09/30/2019.

Among corporate bonds, the investment-grade market outperformed high yield this past quarter as investment-grade bonds generally have a longer duration than high yield. As a result, the Morningstar Corporate Bond Index, which is our proxy for the investment-grade market, rose 3%, whereas the ICE BofA Merrill Lynch High-Yield Index only rose1.25%. After tightening earlier this year, corporate credit spreads ended the third quarter close to where they began. The average credit spread in the investment-grade market was unchanged at a spread of 119 basis points over treasuries and high yield only tightened 5 basis points to a spread of 402 basis points over treasuries.

Although emerging markets have generated robust returns year to date, economic weakness in Asia and the strong dollar combined to form a strong headwind throughout the third quarter. -Morningstar's Emerging Market Composite Index rose almost 1.4%, however there was a wide distribution of performance across the underlying components. The Emerging Market Corporate Bond Index rose by almost 2.5%, which was partially offset by a loss of 0.2% in the Emerging Market Sovereign Index. With its high correlation to economic activity in Asia, the Emerging Market High-Yield Index was the worst performer among our indexes this past quarter, posting a 1.30% loss.

Corporate Credit Spreads Widen on Weaker Economic News

Weak economic metrics and the impeachment drama caught up with the fixed-income market last week, where investors scrambled out of corporate bonds and sought out the safety of U.S. Treasury bonds. Early in the week, the Chicago Purchasing Managers Index dropped to 47.1 and the ISM Manufacturing Index fell to 47.8. Both of these readings are well below 50.0, which is the demarcation between economic growth (above 50.0) and economic contraction (below 50.0). As investors became increasingly worried that contagion from global economic weakness was spreading to the U.S., the equity market sold off and economically sensitive commodities such as oil and copper fell. On Thursday, the ISM Non-Manufacturing Index revealed the services sector, which had been heretofore resilient to economic weakness, dropped to 52.6. While this reading continues to indicate economic growth, the level was well below consensus expectations. As the economic reports came in, the market began to price in a higher probability the Federal Reserve will cut the federal funds rate in October. By Thursday, the probability of a rate cut in October became high enough that the stock market began to rebound as the "bad-news-is-good-news" trading mentality took over.

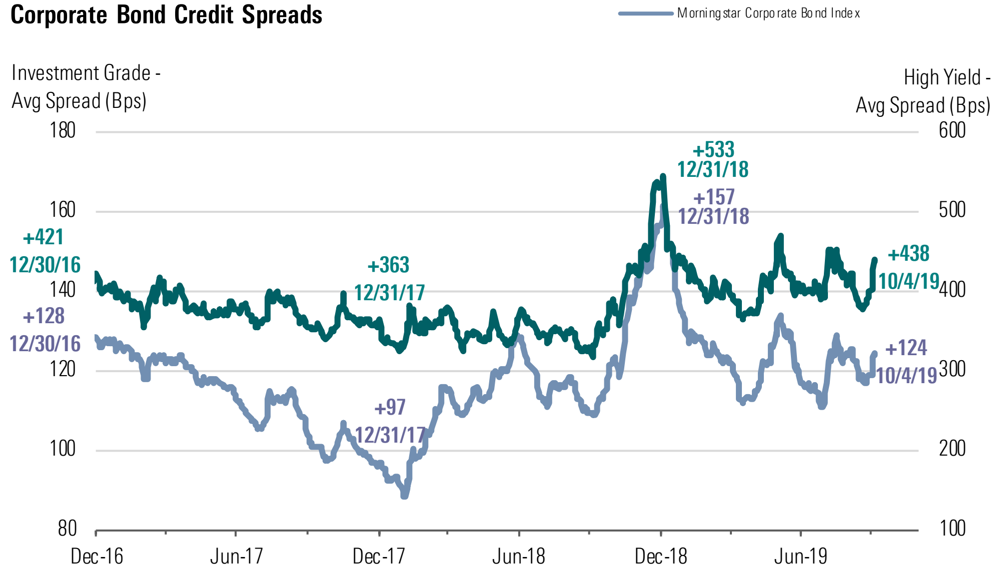
Over the week, U.S. Treasury bond prices marched higher, with the short end pricing in an impending rate cut and the long end pricing in economic weakness. According to the CME FedWatch Tool, the probability the Fed will cut the federal funds rate by 25 basis points to a range of 1.50% to 1.75% in October rose to 78% from less than 50% last week. The probability the Fed will cut rates in December even further to a range of 1.25% to 1.50% rose to 42%, more than double the probability just one week ago.

In the short end of the curve, the interest rate on the 2-year bond dropped 23 basis points to 1.40%, its lowest yield since September 2017. In the belly of the curve, the yield on the 5-year fell 22 basis points to 1.34%, its lowest yield since October 2016. In the longer end of the curve, the yield on the 10-year declined 16 basis points to 1.52%, close to the lowest yields it has ever traded. At the longest end of the curve, the 30-year bond declined by 11 basis points to 2.01%, also trading near its all-time lowest level.

Among economic forecasts, the GDPNow model estimate provided by the Federal Reserve Bank of Atlanta for real GDP growth in third-quarter 2019 dropped to 1.8% from 2.1% the prior week; whereas, the Nowcast as calculated by the Federal Reserve Bank of New York for third-quarter GDP remained essentially unchanged at 2.03%.

In the corporate bond market, on a week-over-week basis, the Morningstar Corporate Bond Index widened 5 basis points to +124 and in the high yield market, the ICE BofAML High-Yield Master II Index gapped 39 basis points wider to +438.

Corporate Bond Credit Spreads



Source: Morningstar, Inc., ICE BofAML Global Indexes. Data as of 10/04/2019.

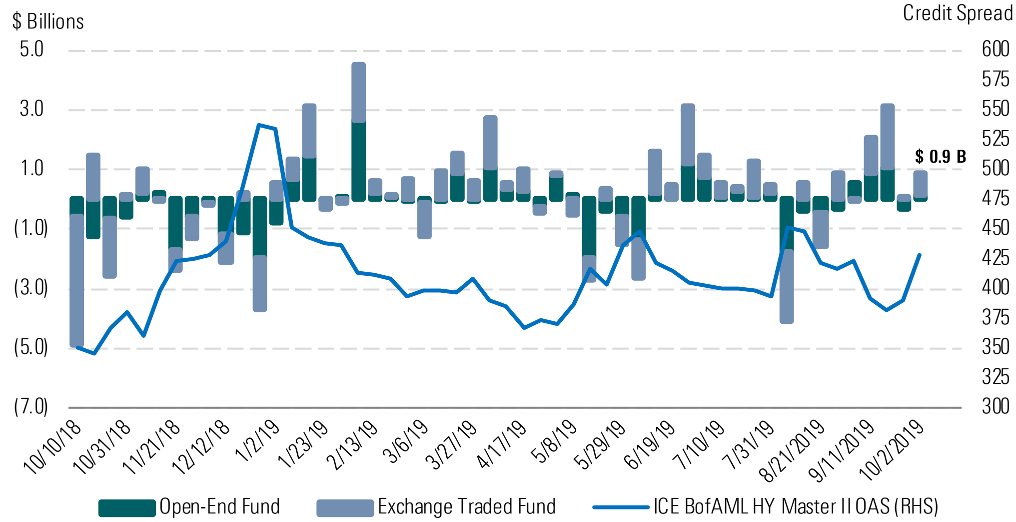
While liquidity in the overnight funding markets has improved over the past few weeks, it has still required the Federal Reserve to provide additional liquidity for the market to clear at normalized interest rates. Market participants had hoped the issue would have been resolved after the quarter ended last Monday. Many banks will often reduce the amount of repurchase agreements they are willing to fund at quarter-end to increase the amount of cash they hold on their own balance sheet to bolster their liquidity ratios. This is known as "window dressing". However, this is not the case and on Friday, the Federal Reserve announced it would extend its program of offering daily overnight repurchase agreements up to $75 billion through November 4 and will also offer eight term repurchase agreements between $35 billion to $45 billion for six- to 15-day terms through the end of October.

Weekly High-Yield Fund Flows Edge Higher

Retail investors shied away from investing much new money in the high-yield asset class last week, but institutional investors dipped their toes back into the water. In total, there were $0.9 billion of net inflows into the high-yield asset class, consisting of only $0.1 billion of inflows in the open-end mutual funds, but there was $0.8 billion of net new unit creation across the high-yield exchange-traded funds,or ETFs. Historically, open-end funds have been considered a proxy for retail investor demand; whereas ETFs have been considered more of an indicator of institutional fund flows.

Year to date inflows into the high-yield asset class total a solid $20.0 billion, consisting of $14.4 billion worth of net unit creation among the high-yield ETFs and $5.6 billion of inflows across the high-yield open-end mutual funds.

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



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

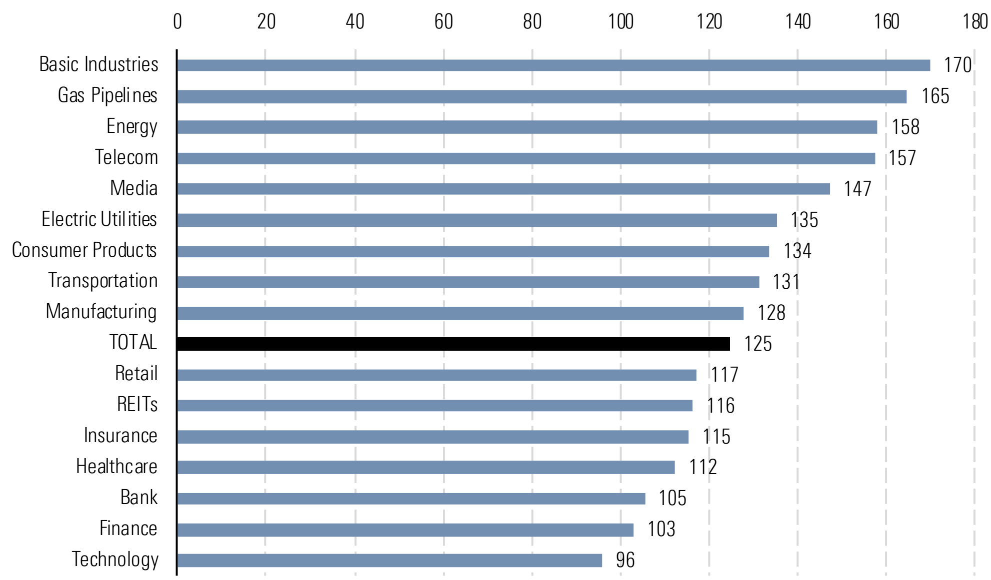
Exhibit 1 Morningstar Corporate Bond Index Sector Summary

Sector	Average Rating	Number of Issues	Modified Duration	Spread (bps)	MTD Spread Chg (bps)	YTD Spread Chg (bps)	MTD Total Return (%)	YTD Total Return (%)
TOTAL	**A-**	**5,375**	**7.4**	**124**	**5**	**(33)**	**0.82**	**13.83**
FINANCIAL	**A-**	**1,459**	**5.7**	**103**	**4**	**(38)**	**0.79**	**11.44**
Bank	A-	849	4.9	101	4	(41)	0.73	10.75
Finance	A-	259	5.4	97	3	(39)	0.77	11.11
Insurance	A	236	9.2	114	4	(24)	1.00	15.18
REITs	BBB+	106	6.7	114	1	(35)	1.04	12.61
INDUSTRIAL	**A-**	**3,177**	**8.1**	**131**	**6**	**(31)**	**0.82**	**14.87**
Basic Industries	BBB	274	7.8	174	9	(24)	0.72	14.69
Consumer Products	BBB+	351	8.4	129	6	(31)	0.83	16.11
Energy	A-	399	7.7	170	12	(26)	0.66	14.36
Healthcare	A-	444	8.4	111	4	(25)	0.94	14.22
Manufacturing	A-	509	6.5	120	4	(41)	0.72	12.82
Media	BBB+	174	9.4	145	4	(33)	0.86	17.31
Retail	A-	212	8.5	114	4	(30)	0.97	14.44
Technology	A	376	7.6	99	3	(28)	0.91	13.76
Telecom	BBB+	159	10.0	150	6	(41)	0.78	19.55
Transportation	BBB+	201	9.3	131	4	(25)	0.88	15.34
UTILITY	**BBB+**	**682**	**9.1**	**150**	**5**	**(36)**	**0.91**	**15.86**
Electric Utilities	A-	379	9.9	131	3	(39)	1.12	16.61
Gas Pipelines	BBB	283	8.0	174	8	(34)	0.63	14.98
Rating Bucket								
AAA Bucket		121	7.9	50	2	(9)	0.97	11.62
AA Bucket		492	6.6	64	2	(22)	0.86	10.69
A Bucket		1,957	7.5	94	3	(29)	0.90	12.85
BBB Bucket		2,805	7.6	161	7	(43)	0.74	15.32
Term Bucket								
1-4	A-	1,718	2.3	67	2	(34)	0.47	5.79
4-7	A-	1,233	4.8	108	4	(47)	0.83	11.26
7-10	BBB+	859	7.0	138	7	(42)	0.89	15.15
10PLUS	A-	1,565	14.3	181	6	(28)	1.10	24.11

Data as of 10/04/2019

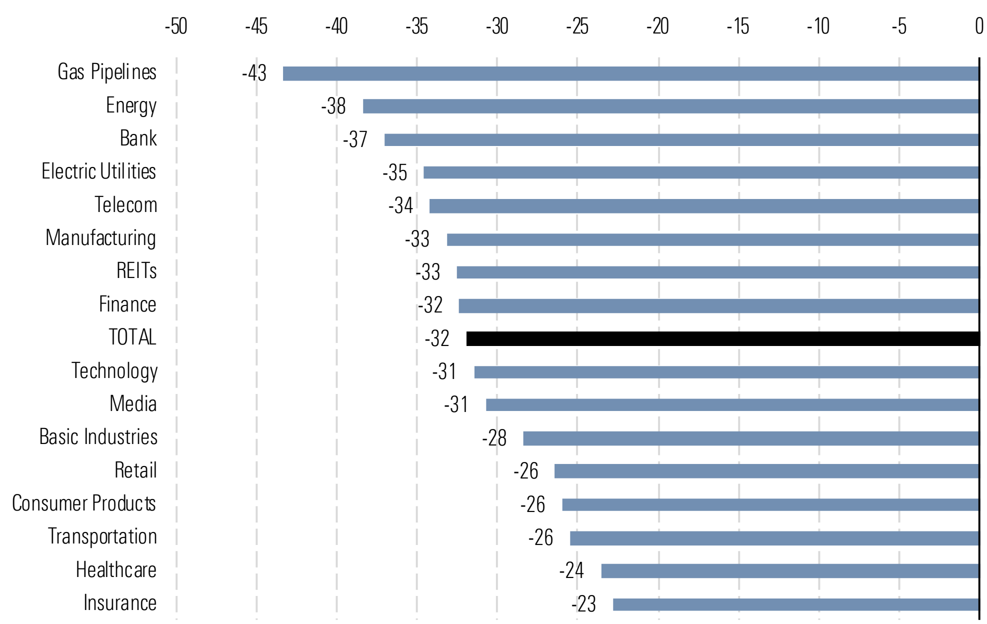
Source: Morningstar, Inc.

Exhibit 2 Morningstar Corporate Bond Index Spread by Sector



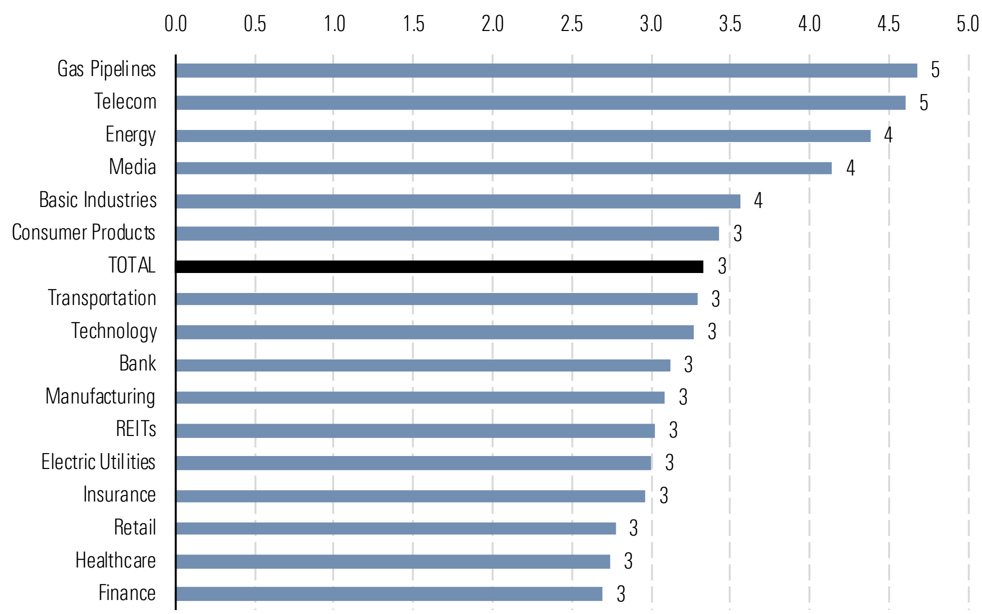
Source: Morningstar, Inc.

Exhibit 3 Morningstar Corporate Bond Index YTD Spread Change



Source: Morningstar, Inc.

Exhibit 4 Morningstar Corporate Bond Index YTD Return



Source: Morningstar, Inc.

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