Morningstar Corporate Credit Research Highlights

Weaker Economic Expectations in Europe Pressure Corporate Bond Market

Morningstar Credit Ratings, LLC
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Credit Market Insights

Weaker Economic Expectations in Europe Pressure Corporate Bond Market

Following the brief sell-off at the end of last year, investors have had a steady appetite for risk assets thus far this year. As an indication of investors' comfort in taking on greater risk in order to reach for yield, long-beleaguered Greece returned to the public bond markets in the middle of last week and was able to issue EUR 2.5 billion of 10-year bonds at a yield of 3.90%. The demand for the new issue was almost 5 times oversubscribed, with reportedly EUR 11.8 billion worth of orders for the new notes. This was the first 10-year bond offering priced by Greece since before the 2011-12 Greek debt crisis. After years of working to improve its creditworthiness, Greece has been making a comeback in the public capital markets; earlier this year, it successfully priced EUR 2.5 billion of 5-year notes at 3.60%.

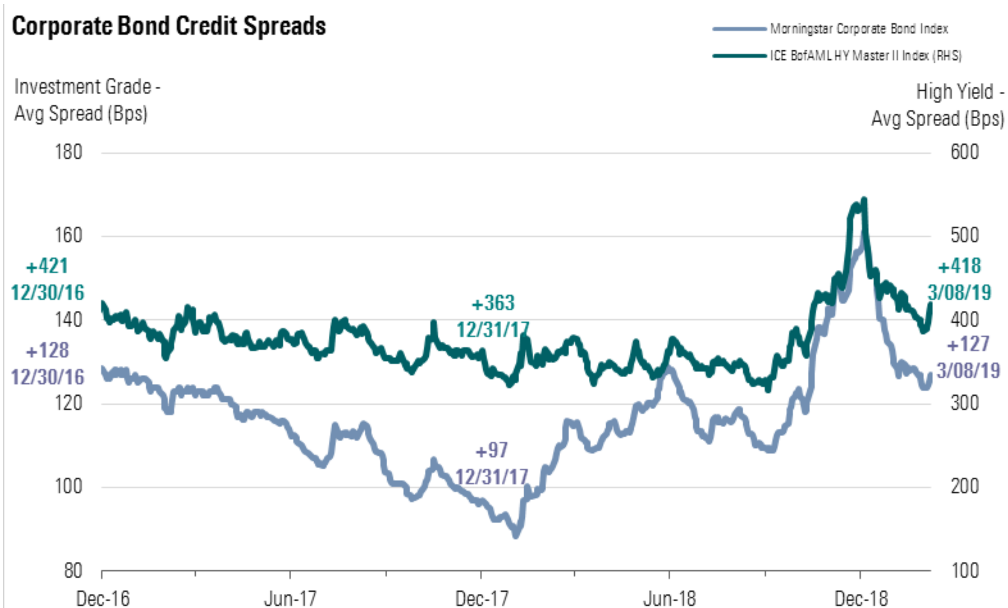
However, after steadily rallying for much of the year to date, many risk asset markets pulled back last week. Part of the reason for the pullback was dour news out of Europe. Following the European Central Bank's meeting Thursday, the governing council announced that it kept its key interest rates unchanged and expects that those rates will remain at current levels through at least end of this year. The reason for the continued easy monetary policy of negative interest rates for the foreseeable future was that the ECB lowered its forecast for 2019 GDP to 1.1% from 1.7%. In addition, the ECB lowered its GDP forecast for 2020 to 1.5% from 1.6% and held its forecast steady for 2021 at 1.5%. To bolster the economy during this softening patch, the ECB also announced that it will restart its targeted longer-term refinancing operations in order to increase liquidity in the European Union. On the basis of the lower growth estimates, the ECB reduced its inflation forecasts. It now forecasts inflation of only 1.2% in 2019 compared with its prior forecast of 1.6%. The ECB lowered its 2020 and 2021 inflation forecasts to 1.5% and 1.6% from its prior expectations of 1.7% and 1.8%, respectively.

Between the lower economic growth and reduced inflation expectations, European investors rotated out of stocks and into sovereign bonds. Most of the main European stock indexes fell about 1%, whereas sovereign government bonds rallied. As bond prices rose, the yield on the German 5-year note fell 8 basis points to negative 0.35%, and the yield on the German 10-year bond declined 11 basis points to 0.07%. While still in positive territory, this is the lowest yield that the German 10-year has traded at since September 2016. The Swiss 10-year bond, another safe-haven investment, rallied, which pushed the yield down 12 basis points to negative 0.34%. Even though the Swiss 10-year has rarely traded with a positive yield since 2014, this is the most negative yield since September 2016.

U.S. Treasury bonds also traded higher across the curve, sending their respective yields down to interest rates that rival their lowest levels since early last year. The 2-, 5-, 10-, and 30-year bonds fell by 9, 13, 12, and 11 basis points respectively to 2.46%, 2.43%, 2.63%, and 3.01%. Although investors flocked to the safety of the U.S. Treasury bond market, that same sentiment did not carry through to the corporate bond market, and credit spreads widened out. The average spread of the Morningstar Corporate Bond Index (our proxy for the investment-grade corporate bond market) widened 3 basis points to end the week at +127. In the high-yield market, the average spread of the ICE BofAML High Yield Master II Index widened 32 basis points to +418.

The week ended on a sour note after Chinese stocks plunged overnight before the U.S. trading session opened Friday. The Shanghai Index fell 4.40% on Friday following a report from a Chinese investment bank opining that the Chinese stock market had become overheated after having risen over 20% since the beginning of the year. But even after this pullback, the Shanghai Index remains up 19% year to date.

Corporate Bond Credit Spreads



Source: Morningstar, Inc., ICE BofAML Global Indexes. Data as of 03/08/2019

Recent Morningstar Credit Ratings Research Reports

Morningstar published a rating report on Abbott Laboratories (A, positive) highlighting our view of the improvement of the company's credit risk and the rationale behind our differentiated rating on the company. Through two rating actions, Morningstar Credit Ratings, LLC has upgraded Abbott's credit rating by two notches since early 2018, reflecting the rapid deleveraging undertaken since the firm completed the St. Jude Medical and Alere acquisitions in 2017. That deleveraging has positively influenced Abbott's leverage-sensitive pillars—Cash Flow Cushion, Solvency Score, and Distance to Default. Going forward, management has indicated a preference for internal investments and increasing balance sheet flexibility, which points to the potential for further deleveraging. Also, the Business Risk pillar could improve, as the company focuses on increasing profitability and managing its balance sheet conservatively. As such, our outlook on Abbott's rating remains positive, and we see the potential for another upgrade in the next couple of years.

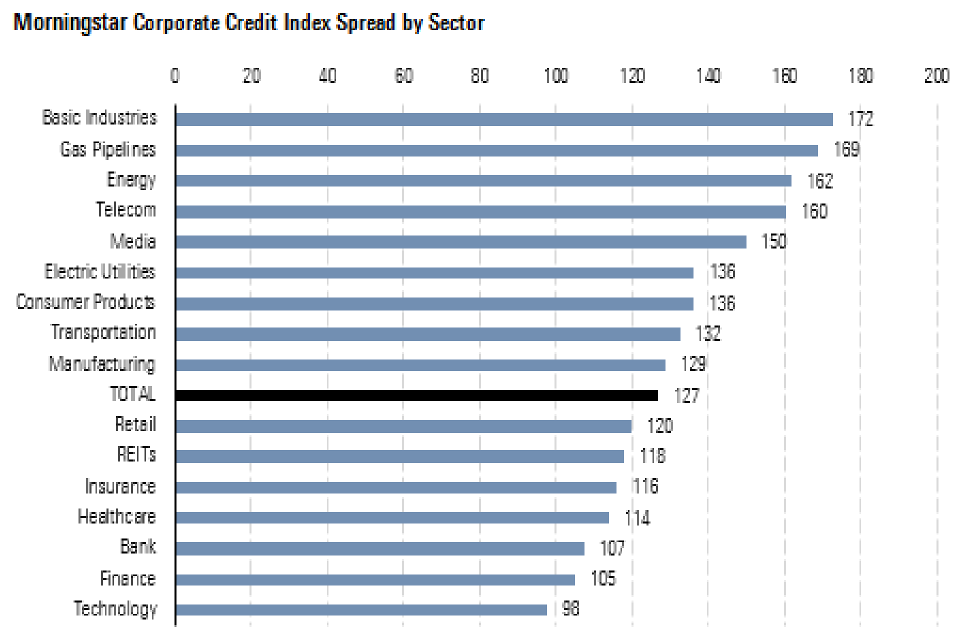
Exhibit 1 Morningstar Corporate Bond Index Sector Summary

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-**	**5,161**	**6.9**	**127**	**2**	**(30)**	**0.48**	**3.06**
FINANCIAL	**A-**	**1,441**	**5.2**	**108**	**1**	**(33)**	**0.45**	**2.87**
Bank	A-	883	4.7	107	1	(35)	0.41	2.95
Finance	A	237	5.1	105	(2)	(30)	0.49	2.52
Insurance	A	221	8.3	116	3	(22)	0.59	2.80
REITs	BBB+	91	5.8	118	(1)	(31)	0.60	2.84
INDUSTRIAL	**A-**	**3,048**	**7.5**	**134**	**3**	**(28)**	**0.50**	**3.16**
Basic Industries	BBB	254	7.3	172	5	(26)	0.34	3.23
Consumer Products	BBB+	372	7.6	136	6	(23)	0.63	3.08
Energy	A-	398	7.2	162	3	(34)	0.49	3.94
Healthcare	A-	434	7.7	114	2	(22)	0.49	2.49
Manufacturing	A-	485	6.0	129	4	(32)	0.29	2.92
Media	BBB+	180	8.6	150	2	(28)	0.67	3.79
Retail	A-	169	7.6	120	4	(24)	0.32	2.47
Technology	A+	347	7.2	98	1	(29)	0.57	3.01
Telecom	BBB+	160	9.2	160	1	(31)	0.63	4.10
Transportation	BBB+	182	8.9	132	2	(24)	0.53	3.08
UTILITY	**BBB+**	**615**	**8.7**	**150**	**2**	**(35)**	**0.56**	**3.36**
Electric Utilities	A-	352	9.2	136	0	(33)	0.79	2.79
Gas Pipelines	BBB	246	7.9	169	5	(39)	0.23	4.20
Rating Bucket								
AAA Bucket		123	7.5	50	1	(9)	0.51	1.66
AA Bucket		495	5.8	65	2	(21)	0.42	2.04
A Bucket		1,879	6.8	94	2	(30)	0.51	2.75
BBB Bucket		2,664	7.1	167	4	(36)	0.47	3.58
Term Bucket								
1-4	A-	1,701	2.3	72	1	(29)	0.22	1.53
4-7	A-	1,154	4.7	115	0	(40)	0.49	3.12
7-10	A-	860	6.9	147	3	(33)	0.62	3.65
10PLUS	A-	1,446	13.5	184	3	(24)	0.69	4.41

Data as of 03/08/2019

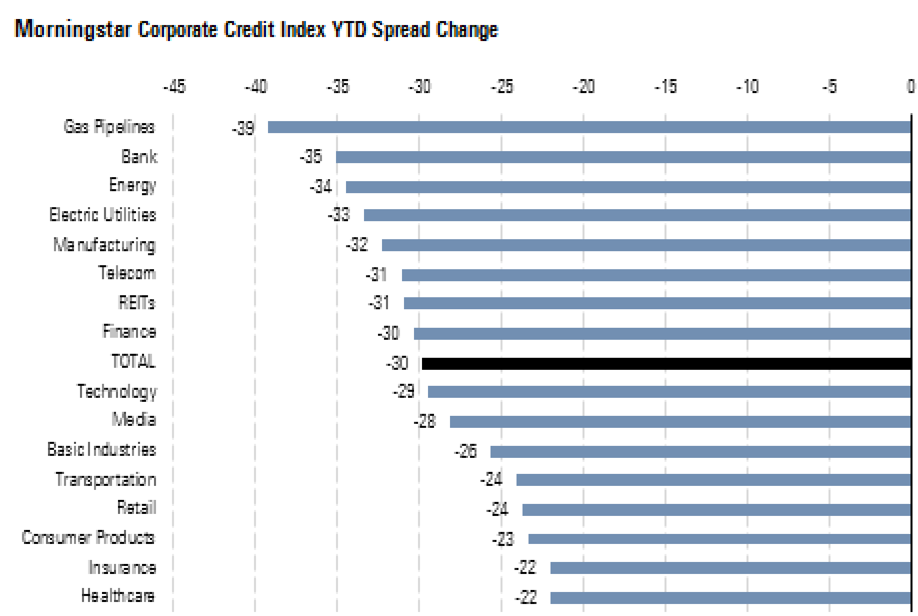
Source: Morningstar, Inc.

Exhibit 2 Morningstar Corporate Bond Index Spread by Sector



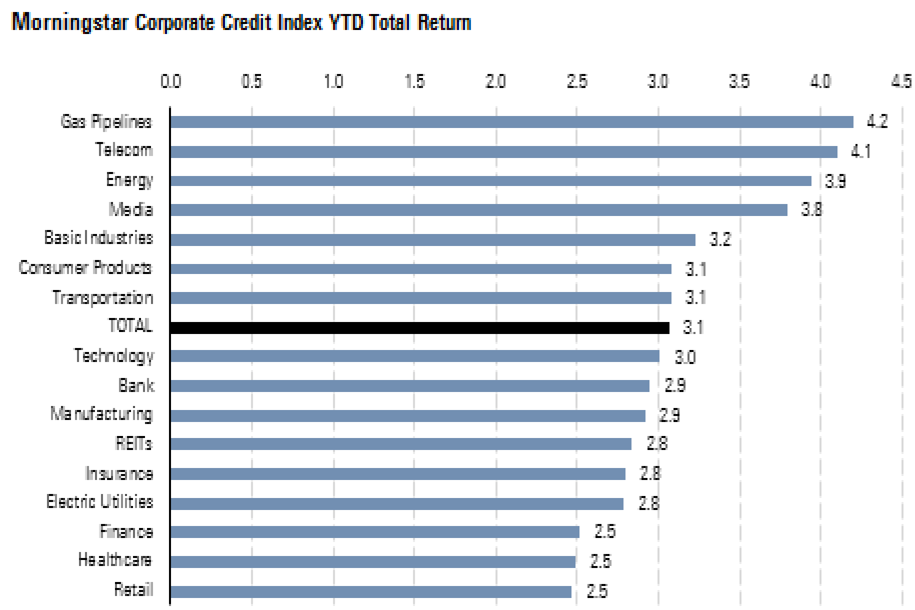
Source: Morningstar, Inc.

Exhibit 3 Morningstar Corporate Bond Index YTD Spread Change



Source: Morningstar, Inc.

Exhibit 4 Morningstar Corporate Bond Index YTD Return



Source: Morningstar, Inc.

Recent Notes Published by Credit Analysts

Pfizer (AA-, Stable) Issuing Debt to Refinance Outstanding Commercial Paper

Market News and Data

Pfizer (AA-, stable) is in the market with a proposed offering that includes 3-, 5-, 10-, 20-, and 30-year fixed-coupon maturities. The firm stated that use of proceeds will be directed to general corporate purposes, including repayment of outstanding commercial paper that totaled approximately $4.8 billion as of Feb. 26.

For closest comparisons to Pfizer's notes, we look to similar-rated Roche Holding AG (AA-, stable). All the following bond data was sourced from Interactive Data.

In the approximate 5-year maturity bucket, bonds from these issuers recently traded over the nearest Treasury as follows:

- Pfizer's 3.00% notes due 2023 at +34 basis points.
- Roche's 1.75% notes due 2022 at +44 basis points.

In the approximate 10-year maturity bucket, bonds from these issuers recently traded over the nearest Treasury as follows:

- Pfizer's 2.75% notes due 2026 at +66 basis points.
- Roche's 2.38% notes due 2027 at +64 basis points.

For comparison to the approximate 10-year maturities, the Morningstar Corporate Bond Index is at +63 basis points in the general AA category.

In the approximate 30-year maturity bucket, bonds from these issuers recently traded over the nearest Treasury as follows:

- Pfizer's 4.40% notes due 2044 at +108 basis points.
- Roche's 4.00% notes due 2044 at +88 basis points.

MCR Credit Risk Assessment

Pfizer's AA- rating and stable outlook reflect the firm's successful efforts to overcome key drug patent expirations thanks to aggressive business development in 2015-16 and productivity from its internal research engine. We think the firm can navigate its dwindling patent cliff, especially following the loss of U.S. market exclusivity for pain treatment Lyrica (9% of global revenue) in 2019, to generate sales growth in the low single digits on a compound annual basis over the next five years. Our assumption considers sustained uptake of novel medicines, notably prostate cancer treatment Xtandi, blood thinner Eliquis, immuno-oncology agent Bavencio, and breast cancer therapy Ibrance. In addition, our forecast is supported by the firm's productive research program that saw recent regulatory approval of three cancer medicines: Vizimpro (first-line non-small-cell lung cancer), Lorbrena (ALK+ NSCLC), and Talzenna (advanced breast cancer). Pfizer's solid ability to trim operating expenses as sales of best-selling medicines have eroded due to generic competition may boost EBITDA in the midsingle digits through 2023, in our estimation. We see this steady operating performance backstopping a strong Cash Flow

Cushion, which has also benefited from a pause in major business development activities over the past two years. One of our top concerns is Pfizer's penchant for transformational deals that would stress its Cash Flow Cushion and Solvency Score pillars in light of its shareholder-friendly stance. While we expect less product diversification from a pending divestment of its consumer health business into a joint venture with GlaxoSmithKline plc (A, stable) in the second half of 2019, Pfizer's minimal Business Risk pillar would stay intact.

Pfizer's debt load remains historically elevated as the firm is still working down funding for $34 billion worth of acquisitions in 2015-16 and resulting higher leverage limits any improvement to the firm's strong Solvency Score and very strong Distance to Default pillars. At the end of 2018, Pfizer's debt load was $41.7 billion, or 2.0 times EBITDA. Considering cash and short-term investments of $18.8 billion on Dec. 31, 2018, net leverage was 1.1 times for the year. The firm routinely utilizes commercial paper borrowings, backstopped by $7.5 billion in unused lines of credit (as of Dec. 31), to supplement its liquidity needs. These sources are more than enough to satisfy $14.7 billion in debt maturing in 2019 to 2023. However, we think the firm may devote most cash flows to shareholder rewards and business development as it seeks to deepen therapeutic strengths in its innovative health unit and build scale and reach of its essential health division. During 2018, Pfizer distributed $8.0 billion in dividends and repurchased $12.2 billion of shares, meeting its goal of $12 billion of shares for the year. Over our five-year forecast horizon, we expect slight improvement in debt leverage to primarily stem from EBITDA growth along with a relatively modest reduction in the debt load. The firm had about $14.2 billion of share-repurchase authorization on Dec. 31, 2018, including a new $10 billion program authorized in December 2018.

Merck (AA, Stable) Issuing Debt to Refinance Commercial Paper and Near-Term Maturities

Market News and Data

Merck & Co Inc (AA, stable) is in the market with a proposed offering that includes 5-, 10-, 20-, and 30-year fixed-coupon maturities. The firm said use of proceeds will be directed to general corporate purposes, including repayment of outstanding commercial paper that totaled approximately $5.1 billion as of Dec. 31, 2018.

For closest comparisons with Merck's notes, we look to similar-rated Eli Lilly & Co. (AA, stable) and Novartis AG (AA, stable). We also look for comparison with lower-rated peer Pfizer Inc (AA-, stable). The following bond data is sourced from Interactive Data.

In the approximate 5-year maturity bucket, bonds from these issuers recently traded over the nearest Treasury as follows:

- Merck's 2.35% notes due 2022 at +33 basis points.
- Eli Lilly's 2.35% notes due 2022 at +34 basis points.
- Novartis' 2.40% notes due 2022 at +26 basis points.
- Pfizer's 3.00% notes due 2023 at +31 basis points.

In the approximate 10-year maturity bucket, bonds from these issuers recently traded over the nearest Treasury as follows:

- Merck's 2.75% notes due 2025 at +52 basis points.
- Eli Lilly's 3.10% notes due 2027 at +69 basis points.
- Novartis' 3.10% notes due 2027 at +62 basis points.
- Pfizer's 1.00% notes due 2027 at +78 basis points.

For comparison to the approximate 10-year maturities, the Morningstar Corporate Bond Index is at +63 basis points in the AA category.

In the approximate 30-year maturity bucket, bonds from these issuers recently traded over the nearest Treasury as follows:

- Merck's 3.70% notes due 2045 at +96 basis points.
- Eli Lilly's 3.95% notes due 2047 at +94 basis points.
- Novartis' 4.00% notes due 2045 at +91 basis points.
- Pfizer's 4.40% notes due 2044 at +109 basis points.

MCR Credit Risk Assessment

Merck's AA credit rating and stable outlook reflect the firm's success in overcoming the patent lapses of leading medicines over the past two years through new product innovation, notably the immuno-oncology cornerstone Keytruda. Growth of this cancer treatment alone has already mitigated the withering effect of patent expirations in 2016-17 of once-bestselling cholesterol medicines Zetia and Vytorin, multiblockbuster autoimmune treatment Remicade, and hospital-based antibiotic Cubicin. Over the past two years, the firm has expanded its oncology drug offering through partnerships with AstraZeneca PLC (BBB+, stable) pertaining to Lynparza and Eisai regarding Lenvima, in addition to acquiring Viralytics (for promising drug candidate Cavatak). Greater breadth of cancer medicines, a cutting-edge vaccine portfolio, and a leading animal health business provide overall diversification of the corporate portfolio, which helps maintain minimal Business Risk. While Merck could face generic versions of blockbuster diabetes medicine Januvia in 2019, we expect significant growth of its broadened cancer drug portfolio to support revenue growth in the midsingle digits through 2023, compounded annually. We anticipate increased research expenses above the historical norm of approximately 17% of revenue through the long term to investigate increased clinical utility of Keytruda, Lenvima, and Lynparza and support late-stage study of Cavatak. Ongoing cost trimming should moderate the firm's marketing spending to counter the rise in research costs over the next few years to yield EBITDA growth in the high single digits compounded annually in 2018-23, in our estimation.

Merck has maintained a strong balance sheet as it contended with a longstanding patent cliff dating back to Zocor in 2006, which positively influences our moderate Cash Flow Cushion, strong Solvency Score, and very strong Distance to Default pillar. Generally, the firm held gross leverage around 2 times or less over this period to the present. As of Dec. 31, 2018, Merck owed unsecured debt totaling $25.1 billion, or 1.7 times EBITDA. Considering $15.1 billion of cash and investments at the end of 2018, net leverage stood at 0.7 times. We expect the firm to readily manage well-laddered debt maturities of $1.9

billion in 2020, $2.3 billion due in 2021, $2.2 billion due in 2022, and $1.7 billion due in 2023, given our expectation that Merck may generate annual free cash flow averaging more than $11 billion through 2023. Strong liquidity also arises from full availability under a $6 billion revolving credit facility expiring in June 2023. Despite this solid financial flexibility, we see debt reduction as a lower priority for capital deployment than the firm's generous dividend, tuck-in business development, and aggressive share repurchasing. Accordingly, Merck distributed $5.2 billion in dividends and repurchased $9.1 billion in shares during 2018 as gross debt increased about $700 million from the end of 2017. As such, we expect any leverage improvement to stem from operational strength as Merck likely refinances its maturing debt obligations.

ArcelorMittal (BBB-, stable) Issuing 7-Year Notes

Market News and Data

ArcelorMittal SA (BBB-, stable) is reportedly issuing $750 million of 7-year notes and intends to use the proceeds toward repayment of existing debt.

According to Interactive Data, ArcelorMittal's 6.125% notes due June 2025 recently traded at spread over the nearest U.S. Treasury of +182 basis points. In terms of comparisons, we look to similar-rated Anglo American PLC (BBB-, stable), whose 4.75% notes due April 2027 traded at a spread of +210 basis points. For an index comparison, we look to the BBB- Morningstar Corporate Bond Index, which is at a spread of +202 basis points.

MCR Credit Risk Assessment

ArcelorMittal's BBB- rating reflects high Business Risk and moderate risk profiles for its Cash Flow Cushion, Solvency Score, and Distance to Default. The high Business Risk results from the industry in which the company operates, which is characterized by overcapacity, cyclicality, and a lack of product diversification. The Cash Flow Cushion reflects good operating cash flows offset by capital spending requirements and a heavy nearer-term maturity schedule, while the Solvency Score is supported by a moderately leveraged capital structure along with robust interest coverage. Notwithstanding industry factors, ArcelorMittal's management has done a solid job of deleveraging since the end of 2015, when gross debt totaled approximately $20 billion, compared with $12.6 billion as of Dec. 31. Net debt/EBITDA as of this date was $10.2 billion after accounting for $2.4 billion of cash and equivalents. Strong industry conditions have enabled EBITDA to increase for the latest 12 months to approximately $10.2 billion, which is the highest level since 2011, resulting in gross leverage of approximately 1.2 times EBITDA (1.0 net). Nevertheless, the company is further burdened by approximately $7 billion of underfunded pension and other postretirement obligations, which raises its adjusted leverage nearly another turn of EBITDA.

Liquidity is provided by cash and equivalents of $2.4 billion and $5.5 billion in undrawn credit facilities as of Dec. 31. As of the end of 2018, we estimate maturities were $3.2 billion in 2019, $3.2 billion in 2020, $1.8 billion in 2021, $1.7 billion in 2022, and $800 million in 2023. In terms of capital allocation, the company maintains deleveraging as its priority with a net debt target of $6 billion. After that, priorities are to invest in its assets, growth, and shareholder returns. ArcelorMittal aims to increase shareholder returns only once its net debt target is achieved.

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