First-Quarter 2017 Corporate Credit Market Insights

Morningstar Credit Research
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Interest Rates Rising On Global Reflationary Expectations

- While long-term global interest rates have generally been rising, the rate of increase picked up substantially in the U.S. following the U.S. presidential election.
- Strong demand for corporate bonds has helped push credit spreads tighter across all sectors and the average spread of the indexes is now much tighter than their long-term averages.
- Though most fixed-income sectors have given back many of the gains they generated earlier this year, the high-yield sector had been able to buck the downward trend.
- After years of downgrades outpacing upgrades, we upgraded the same number of companies as we downgraded in the fourth quarter.

In the fourth quarter, global interest rates continued to climb as investors priced in expectations that the global economy is entering a reflationary environment based on renewed economic activity. Rising rates pushed bond prices down, leading to losses in most fixed income classes. Investment-grade bonds registered losses as the amount credit spreads tightened was overwhelmed by rising rates. The high-yield sector was able to generate a small gain as junk bond credit spreads tightened enough to mitigate the impact of rising rates.

Summary

Long-term global interest rates bottomed out in July 2016 and have continued on an upward trend throughout the fourth quarter. Within the U.S., the rate of increase in interest rates picked up substantially subsequent to the U.S. presidential election on Nov. 8. In fact, the yield curve in the U.S. has risen to levels higher than where the markets began the year. The impetus for rising rates has been the market's expectation that the economy is entering a reflationary environment based on renewed economic activity that will be spurred by fiscal stimulus and tax reductions. In addition, oil prices and industrial commodities have not only stabilized, but are also trending upward.

Since the election, investors have flocked to economically sensitive assets, with those assets that have the greatest sensitivity to economic growth performing the best. For example, since Nov. 8, the average spread of the Morningstar Corporate Bond Index has tightened 8 basis points, the Bank of America Merrill Lynch High Yield Index has tightened 79 basis points, and the S&P 500 has risen 5.87% through

Dec. 21. Economically sensitive commodity prices have also generally risen. For example, oil has increased more than 16% over the same time period.

As investors have bid up prices of risk assets and ratcheted up their expectations for inflation to rebound, the desire for safe-haven assets such as U.S. Treasury bonds has dwindled. Since the election, Treasury yields have increased across the yield curve anywhere from 34 to 68 basis points, depending upon the maturity date. Further pressuring interest rates, the Federal Reserve increased the federal funds rate by 25 basis points early in December. The rate hike was not a surprise as it had already been priced into the federal funds futures market; however, what did surprise the markets was the Fed's summary of economic projections that showed that the Fed is forecasting three more rate hikes by the end of 2017.

While interest rates have not risen as quickly in the other developed markets, after reaching unprecedented negative yields in other countries, long-term interest rates in Europe and Asia have at least risen back into positive albeit still abysmally low territory. For example, the yield on the 10-year German bond bottomed out at a negative (0.19)% in July and has since risen to positive 0.27% and the yield on Japan's 10-year bond bottomed out at negative (0.29)% and has risen to positive 0.06%.

With interest rates surging higher, those fixed-income sectors that are highly correlated to U.S. Treasury prices gave back much of their year-to-date gains during the fourth quarter. For example, the Morningstar U.S. Government Bond Index pared 4.42% thus far this quarter, and is now only up 0.42% year to date.

Within the corporate bond sector, credit spreads tightened, helping to offset some of the impact of rising rates. However, it wasn't enough to overcome the downward pressure on bond prices from rising interest rates. The average spread of the Morningstar Corporate Bond Index tightened 10 basis points thus far this quarter to +129, but the yield on the 10-year Treasury has risen 94 basis points, overwhelming the amount that investment-grade corporate credit spreads tightened. As such, the Morningstar Corporate Bond Index lost 3.62% quarter to date and is now only up 5.06% for the year. Conversely, in the high-yield market, credit spreads have tightened enough this quarter to mitigate the negative impact of rising interest rates. The average credit spread of the Bank of America Merrill Lynch High Yield Master Index tightened 78 basis points to +419, leading the index to a 1.41% gain quarter to date and healthy return of 16.95% year to date.

Although emerging markets typically perform well in an environment where investors are looking to increase risk to their portfolios, emerging markets were not able to escape the negative impacts from rising rates and were further pressured by the rapidly escalating value of the U.S. dollar. Quarter to date, the Morningstar Emerging Market Composite Index has declined 3.52%. While this offsets some of the gains registered earlier in the year, the index still remains up 9.46% year to date.

Exhibit 1

Fixed Income Index Returns

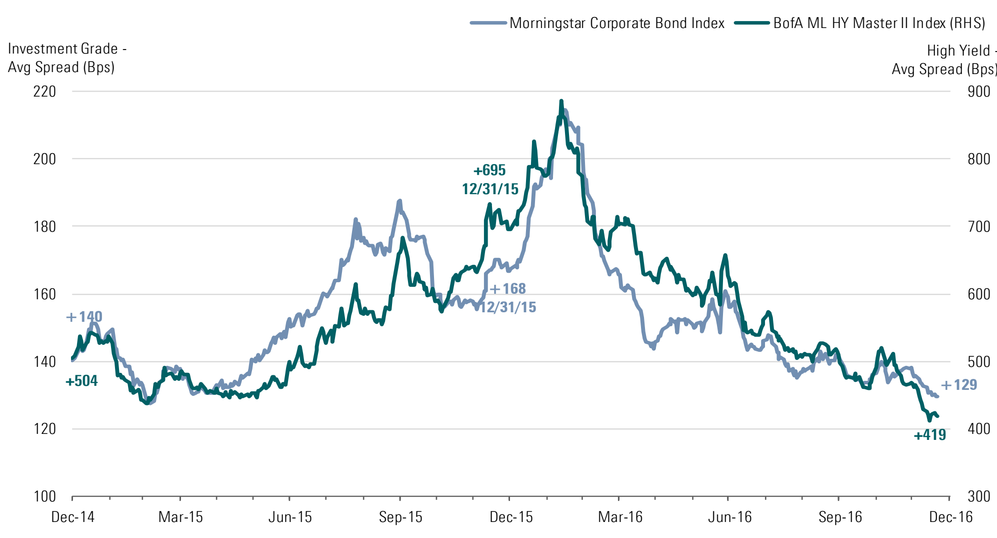
	QTD	YTD	2015	2014	2013	2012	2011
Broad Market Index							
Core Bond	-3.70	1.96	0.98	6.07	-1.89	4.41	7.97
Sector Indexes							
US Gov't Bond	-4.42	0.42	0.91	5.08	-2.74	1.98	9.35
Agency	-2.66	1.27	0.72	3.01	-1.03	1.96	5.24
Corporate Bond	-3.62	5.06	-0.46	7.20	-1.50	10.54	7.21
BofAML High Yield Master II	1.41	16.95	-4.64	2.50	7.42	15.58	4.38
Eurobond Corp	-1.67	4.45	-0.59	8.35	1.94	12.67	2.94
TIPS	-3.57	3.56	-1.60	3.95	-8.53	6.93	13.49
Emerging Markets Indexes							
Emerging Mkt Composite	-3.52	9.46	0.62	5.06	-4.39	16.25	2.65
Emerging Mkt Sovereign	-5.37	8.70	1.15	7.69	-3.40	13.75	3.98
Emerging Mkt Corporate	-2.02	10.89	0.08	3.47	-2.81	15.32	0.18

Sources: Morningstar, Inc. and Bank of America Merrill Lynch. Data as of 12/21/16.

With interest rates rising and investors expecting better economic growth ahead, many U.S. fixed-income investors revised their investment strategies to increase their allocation to corporate bonds and reduce their allocation to Treasury bonds. In addition, attracted by the higher all-in yields offered in the U.S., foreign investors remain significant buyers of U.S. dollar-denominated corporate bonds. Although new-issue supply remains robust, the combined demand from both U.S. and foreign investors has outstripped supply and led to tightening corporate credit spreads.

Exhibit 2

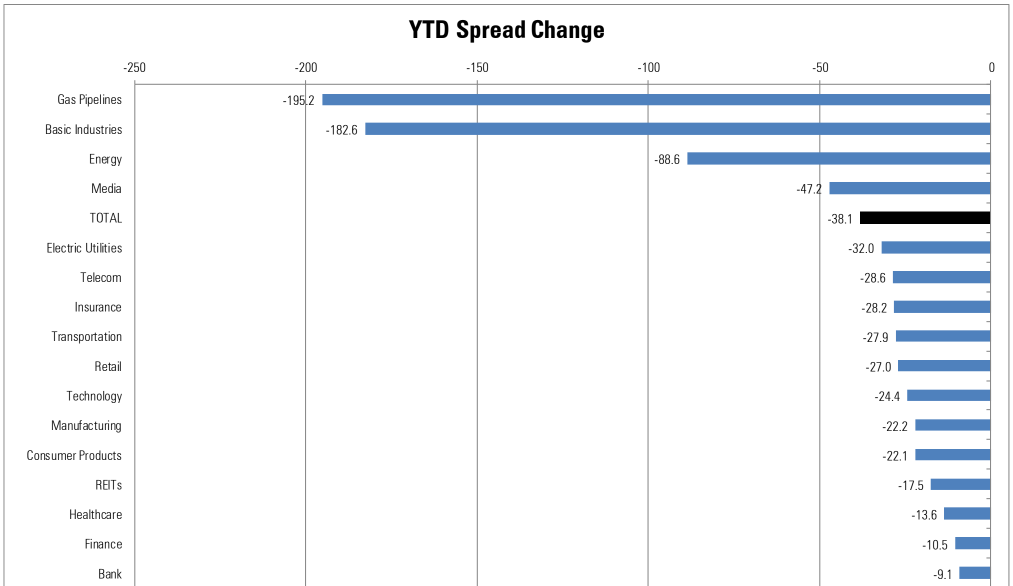
Corporate Bond Credit Spreads



Source: Morningstar,Inc., BofA Merrill Lynch Global Indexes. Data as of 12/21/2016.

Much of corporate credit spreads' tightening of this year was incurred in those economically sensitive sectors that experienced the brunt of losses in 2015 and early 2016. There are four sectors that have tightened more than the overall index: gas pipelines, basic industries, energy, and media. Gas pipelines have outperformed as the price of natural gas has soared 22% this quarter in response to the early onset of unusually cold weather this winter. Basic materials has benefited from a rapid recovery in prices this year. For example, coking coal prices have tripled, iron ore and thermal coal have more than doubled, and copper has increased approximately 25% this year. After having fallen to below $30 per barrel in Feb. 2016, oil has rebounded to over $52 per barrel, which has significantly reduced near-term bankruptcy risk within the energy sector.

Exhibit 3

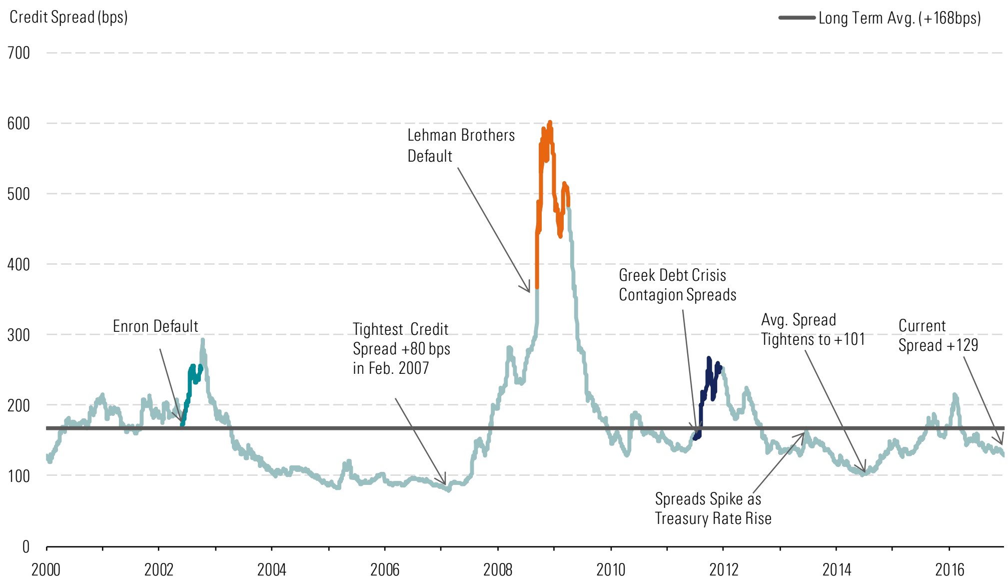


Source: Morningstar, Inc. Data as of 12/21/2016.

In February 2016, corporate credit spreads reached their widest levels since 2012, when the market was recuperating from the European sovereign debt and banking crisis. However, these lofty spreads didn't last long and have been tightening ever since. In fact, demand for corporate bonds has been so great, that both the investment-grade and high- yield indexes are now trading at levels that are 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 high-yield index has averaged +580. As of Dec. 21, the average spread of the Morningstar Corporate Bond Index is +129 and the average spread of the Bank of America Merrill Lynch High Yield Master Index is +419. As a point of reference, the tightest that the Morningstar Corporate Bond Index has ever traded was at +80 in February 2007 and the tightest the high-yield index registered was +241 in June 2007.

Exhibit 4

Morningstar Corporate Bond Index Average Credit Spread

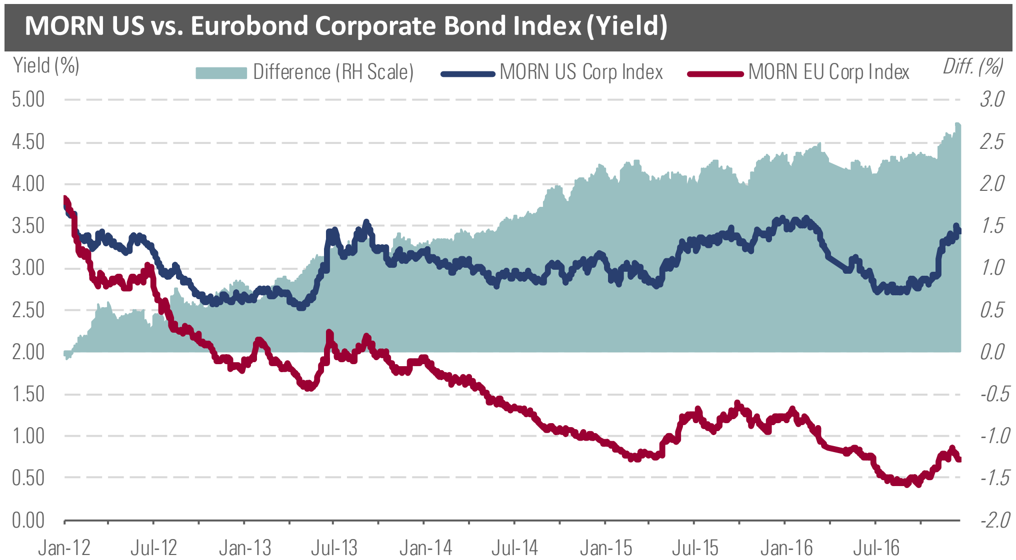


Source: Morningstar, Inc. Data as of 12/21/2016.

Foreign Investors to Continue Purchasing U.S. Agency and Corporate Debt

Through September, net foreign investment for U.S. agency and corporate debt totaled over $350 billion. Over the same time period, foreign investors (led by China) have divested $242 billion of U.S. Treasuries. Over the course of the year, we have highlighted those factors that have driven foreign investors to U.S. dollar denominated fixed-income securities, especially corporate bonds. Those factors include developed market sovereign debt trading at negative yields earlier this year, corporate credit spreads in Europe being artificially manipulated lower through the European Central Bank's corporate sector purchase program, and the strengthening of the U.S. dollar. The results of these factors have led to much higher all-in yields provided by U.S. fixed-income securities. In addition, foreign investors were attracted by being invested in the safety of the U.S. dollar. In early 2012, the yield of investment grade bonds in the U.S. and Europe were substantially similar. Over the past four years though, the disparity between the yield Morningstar Corporate Bond Index and the Morningstar Eurobond Index has continued to grow and is currently at its greatest differential.

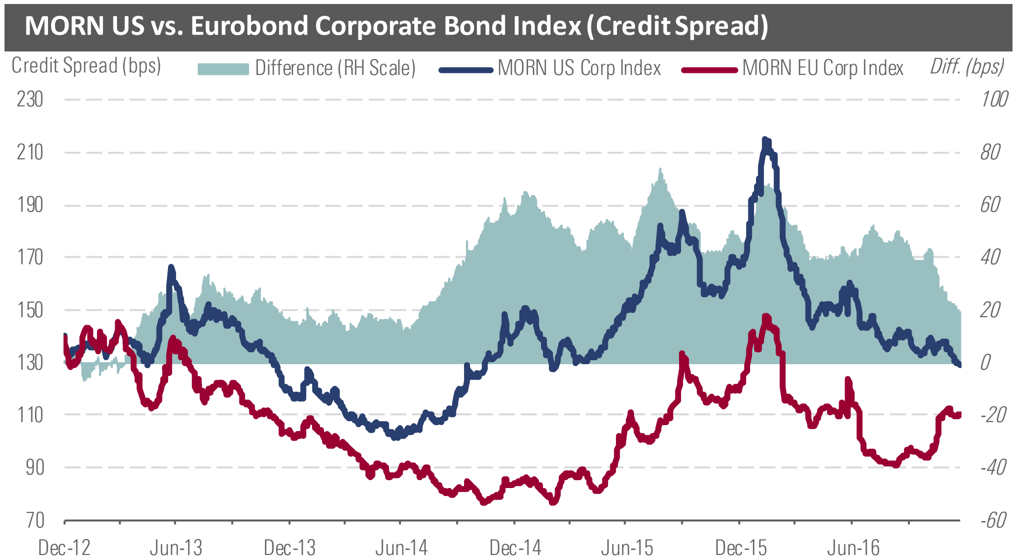
Exhibit 5



Source: Morningstar. Data as of 12/21/2016.

While part of the differential in the all-in yield is provided by the higher underlying U.S. Treasury yields, the other differential is that until recently, corporate credit spreads were much wider on U.S. denominated corporate bonds. For example, since the beginning of 2016, the average spread of the Morningstar Corporate Bond Index has been 44 basis points wider than the Morningstar Eurobond Index; whereas, in late 2012 the credit spreads of the two indexes were nearly identical. While the spread has tightened as U.S. corporate bond spreads have tightened, the current differential is still 19 basis points. In addition to the spread differential, institutional investors had an increasingly difficult time finding enough supply of corporate bonds in the secondary market to invest in. In June 2016, the ECB began is corporate sector purchase program and through Dec. 16, has purchased a total of EUR 50.6 billion worth of investment-grade euro-denominated corporate bonds. Based on our calculations, the ECB has purchased roughly 12% of the average daily trading volume of euro-denominated investment-grade bonds.

Exhibit 6



Source: Morningstar. Data as of 12/21/2016.

In addition to ramping up purchases of U.S. dollar-denominated debt, foreign investors have shifted their purchases to U.S. agency debt as a substitute for Treasury bonds. U.S. agency securities typically offer higher yields than Treasuries as they are not guaranteed by the U.S. government; however, many investors assume that agency debt is implicitly guaranteed by the U.S. government and would be bailed out if needed.

The factors that have led to these disparities remain in place. Both short-term and long-term interest rates in the U.S. are significantly higher than in Europe. While the ECB's overnight deposit rate remains at negative (0.40)%, the U.S. Federal Reserve has raised the federal funds rate to a range of 0.50%–0.75%. Economic growth in the U.S. continues to expand at a faster rate than the Eurozone which should continue to lift the value of the U.S. dollar relative to other currencies. Even after the recent tightening in corporate credit spreads in the U.S. corporate credit spreads are wider than in Europe. The ECB has begun to pare its asset purchase program (decreasing to EUR 60 billion per month from EUR 80 billion per month) but even at this lower pace, the purchase program will still remove a significant amount of supply for the secondary trading markets. Based on these factors, we expect foreign investors will continue to shift investment allocations towards U.S. dollar denominated fixed income
For greater detail, please see our report Foreign Investors to Continue Purchasing U.S. Agency and Corporate Debt published by Stephanie Mah in December 2016.

Central Bank Monetary Policy Review

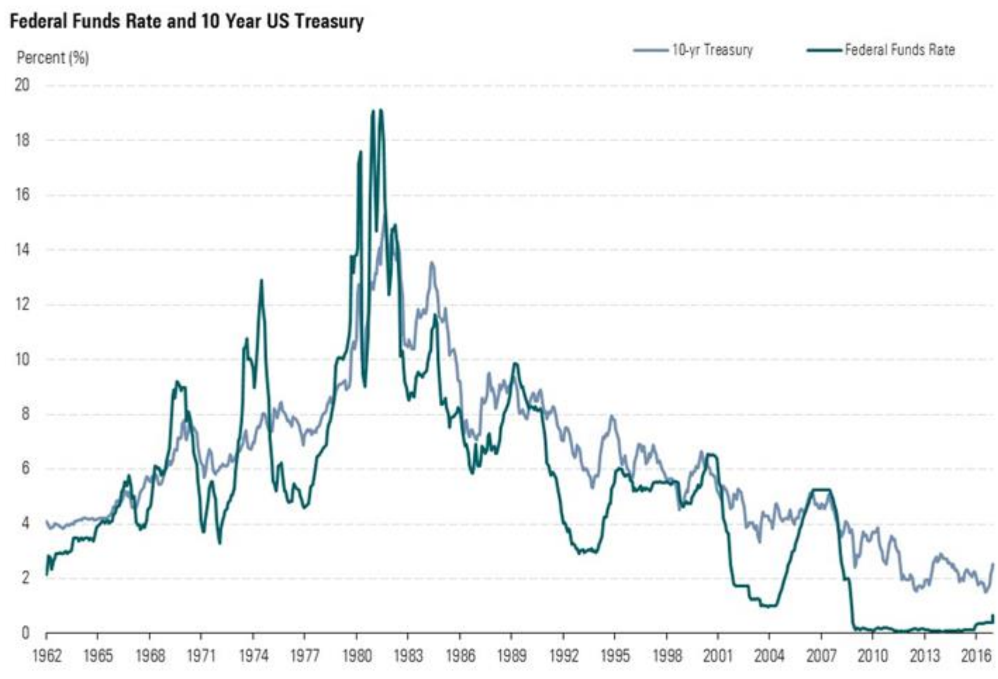
As expected, the Fed raised the federal funds rate by 25 basis points to a range of 0.50%–0.75% at the December meeting. The rate hike was a surprise to no one as it was fully priced in by the federal funds futures market well in advance of the actual rate increase. However, the market was surprised that the

Fed’s summary of economic projections showed that the Fed is forecasting three rate hikes by the end of 2017. The Fed's median forecast for the federal funds rate at the end of 2017 is 1.4%.

While the probability of additional rate hikes has been increasing in the federal funds futures markets, it appears that the market is taking the Fed's projections with a grain of salt. Over the past few years, the Fed has had a poor forecasting track record. For example, when the Fed first increased short-term rates in December 2015, the median forecast for the federal funds rate at the end of 2016 was also 1.4%. Even back at the end of 2014, the Fed's median 1-year forecast for the federal funds rate was 1.125%.

Currently, the probability is low for another rate hike over the next few months. The probability of another rate hike doesn't increase materially until May 2017 when the market-implied probability rises to 46%. Further, the probability of a second rate hike does not approach even 50% until September 2017. By December 2017, the probability that the Fed will have conducted three rate hikes is only 43%.

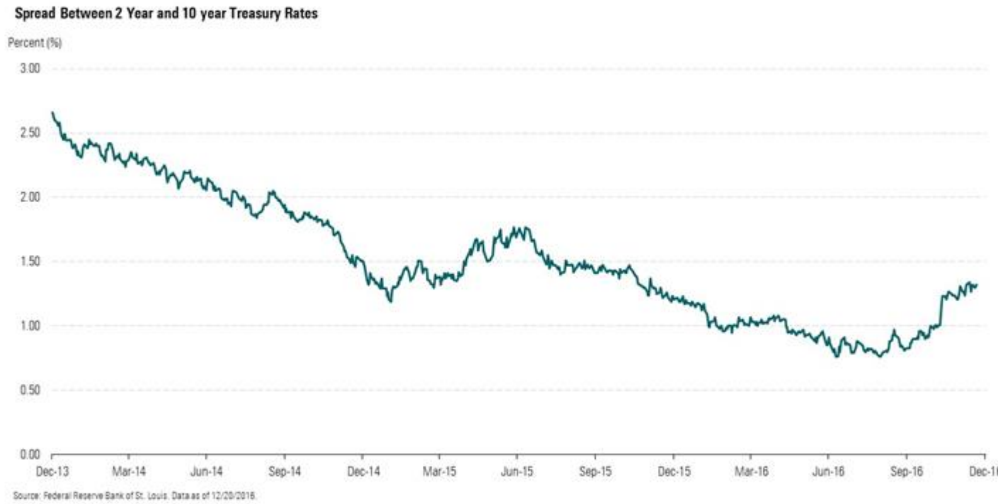
Exhibit 7



Source: Federal Reserve Bank of St. Louis. Data as of 12/21/2016.

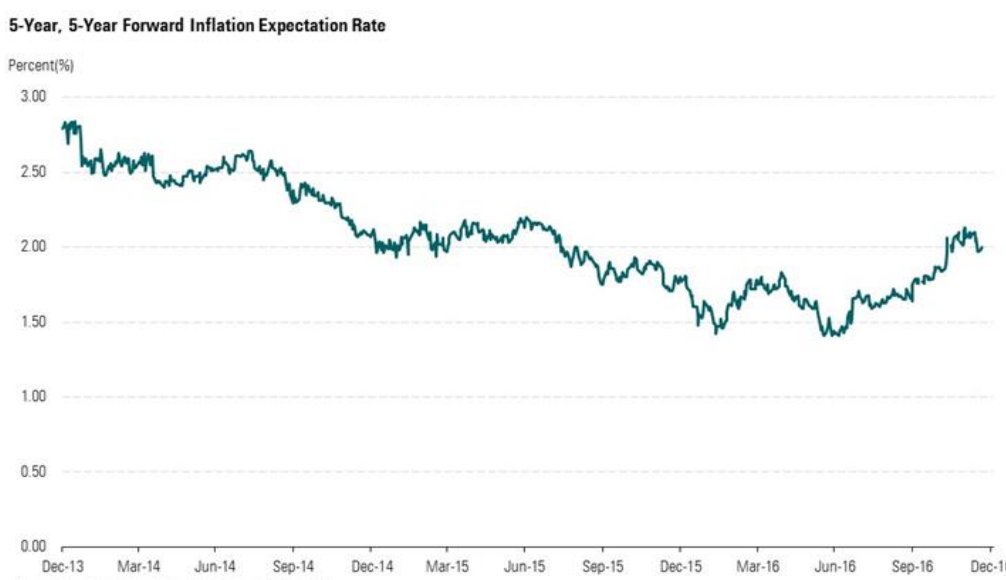
After tightening for several years in a row, the yield curve has begun to steepen as long-term rates have been rising faster and further than short-term rates. A steepening yield curve should bode well for the credit quality in the banking sector. Rising interest rates will have a positive impact on bank earnings as rising rates tend to allow banks the opportunity to increase 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.

Exhibit 8



Inflation expectations had already been rising off their recent lows in conjunction with the rebound in oil prices, but the 5-Year, 5-Year Forward Inflation Expectation Rate took a large one-day jump after the U.S. presidential election. This metric measures the expected inflation rate for a five-year period that begins five years in the future that is derived from current trading levels in Treasury bonds and strips. Last year and early this year, falling energy and commodity prices exerted significant deflationary pressures on inflation expectations; however, as the prices of these commodities have stabilized and are trending upward, the rising prices should provide a continued tailwind to inflation expectations moving forward.

Exhibit 9



Continuation of Positive Credit Trends Create More Balance in Fourth Quarter: Rating Changes and Reviews

After years of downgrades outpacing upgrades, we upgraded the same number of companies (11) as we downgraded (11) in the fourth quarter. The energy sector produced the most downgrades while rating actions were more positive or balanced in other sectors.

Exhibit 10

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
Basic Materials	0 / 3	0 / 0	0 / 1	0 / 0	0 / 6	1 / 1	0 / 1	0 / 2	0 / 1
Communication Services	0 / 0	0 / 2	0 / 0	0 / 2	0 / 0	0 / 1	0 / 4	0 / 0	1 / 0
Consumer Cyclical	0 / 2	0 / 4	0 / 2	0 / 5	0 / 1	3 / 2	1 / 2	0 / 0	1 / 0
Consumer Defensive	0 / 0	0 / 0	0 / 0	0 / 0	0 / 1	0 / 3	1 / 1	1 / 2	2 / 1
Energy	0 / 0	0 / 0	0 / 7	0 / 0	0 / 4	0 / 3	0 / 2	0 / 2	0 / 5
Financial Services	2 / 0	0 / 4	0 / 1	0 / 2	0 / 0	2 / 1	0 / 0	2 / 1	1 / 0
Healthcare	2 / 9	2 / 2	0 / 1	2 / 4	0 / 3	0 / 2	2 / 3	2 / 1	2 / 1
Industrials	0 / 0	2 / 1	1 / 0	2 / 2	0 / 0	1 / 4	1 / 1	6 / 2	2 / 1
Real Estate	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
Utilities	0 / 0	0 / 0	0 / 0	0 / 0	0 / 0	0 / 0	0 / 0	0 / 0	0 / 0
Total	**4/16**	**4/13**	**1/12**	**4/15**	**0/18**	**7/17**	**6/17**	**11/16**	**11/11**
Ratio Upgrades to Downgrades	**0.25**	**0.31**	**0.08**	**0.27**	**0.00**	**0.41**	**0.35**	**0.69**	**1.00**

Data as of 12/21/2016

Improving credit fundamentals in the form of higher profitability and/or lower debt leverage led to most of our upgrades during the fourth quarter. In Communication Services, T-Mobile US' (rating: BB, stable) ongoing customer growth helped push profits higher and leverage lower, which instigated our upgrade. In Consumer Cyclical, we upgraded Home Depot (rating: A+, stable) on multiyear improvement in free cash flow generation. In Consumer Defensive, Constellation Brands (rating: BBB-, stable) and Altria Group (rating: A-, stable) were upgraded on improving profitability. In Financial Services, our upgrade of Affiliated Managers Group (rating: BBB+, stable) reflects multiyear improvement in operating performance, product diversification, and distribution capabilities. In Healthcare, we upgraded AmerisourceBergen (rating: A, stable) and McKesson (rating: A-, stable) on recent deleveraging after previous acquisition activities. In Industrials, General Dynamics (rating: A+, stable) and Raytheon (rating: A, stable) were upgraded primarily on improved profitability in recent years. In Technology, we upgraded Advanced Micro Devices (rating: B-, stable) on recent steps to improve liquidity relative to debt. We also upgraded advertising giant The Interpublic Group of Companies (rating: BBB, stable) on improved profitability and debt reduction in recent years.

Our downgrades primarily reflected elevated leverage on weak end-market demand or aggressive capital allocation policies. For example, in Basic Materials, we downgraded CF Industries Holdings (rating: BB, stable) on elevated leverage and the firm's unwillingness to enact credit-friendly measures during a period of weak nitrogen market conditions. In Consumer Defensive, we downgraded Anheuser-Busch Inbev SA (rating: BBB+, stable) after the leverage-increasing acquisition of SABMiller. In the face of weak oil and natural gas prices, we downgraded Hess Corp (rating: BBB-, stable), Marathon Petroleum Corp. (rating: BBB, stable), Murphy Oil Corp. (rating: BB+, stable), Phillips 66 (rating: BBB+, stable), and Weatherford International PLC (rating: B+, negative) in the Energy sector. In Healthcare, we downgraded Owens & Minor (rating: BBB, stable) on its debt maturity schedule drawing closer and higher expected returns to shareholders in the wake of a key client loss. In Industrials, we downgraded AGCO Corp. (rating: BBB-, stable) primarily as weak agricultural equipment demand has contributed to an increase in debt leverage. In Technology, we downgraded Microsoft (rating: AA+, stable) and Symantec (rating: BBB-, negative) primarily on leverage-increasing acquisitions and shareholder returns.

Exhibit 11

Fourth Quarter Upgrades and Downgrades

Company Name	Ticker	Old Rating	Current Rating	Date
Upgrades:				
AmerisourceBergen	ABC	A-	A	12/16/16
McKesson	MCK	BBB+	A-	12/16/16
Affiliated Managers Group	AMG	BBB-	BBB+	12/15/16
The Interpublic Group of Companies Inc	IPG	BBB-	BBB	12/07/16
Altria Group Inc	MO	BBB	A-	11/30/16
Advanced Micro Devices Inc	AMD	CCC	B-	11/28/16
Raytheon Co	RTN	A-	A	11/10/16
General Dynamics Corp	GD	A	A+	11/09/16
T-Mobile US Inc	TMUS	BB-	BB	11/03/16
Constellation Brands Inc	STZ	BB	BBB-	10/13/16
The Home Depot Inc	HD	A	A+	10/10/16
Downgrades:				
Microsoft	MSRT	AAA	AA+	12/19/16
Owens & Minor	OMI	BBB+	BBB	12/16/16
Marathon Petroleum Corp	MPC	BBB+	BBB	12/09/16
Symantec Corp	SYMC	A+	BBB-	12/06/16
AGCO Corp	AGCO	BBB	BBB-	12/01/16
Weatherford International PLC	WFT	BB+	B+	12/01/16
Phillips 66	PSX	A	BBB+	11/17/16
CF Industries Holdings Inc	CF	BBB-	BB	11/10/16
Anheuser-Busch InBev SA/NV	BUD	A-	BBB+	10/12/16
Hess Corp	HES	BBB	BBB-	10/05/16
Murphy Oil Corp	MUR	BBB-	BB+	10/05/16

Data As of 12/21/2016

Although we continue to expect more downgrades than upgrades based on the under review statistics on our existing coverage list, the percentage of firms that we are considering for upgrade has risen from the past quarter. As of Dec. 21, 29% (up from 19% as of September) of the 31 companies under review were candidates for upgrades (UR+), 52% (down from 63% as of September) were candidates for downgrades (UR-), and 19% (same as of September) could go in either direction (UR).

Exhibit 12

Companies Under Review Status by Sectors

Sector	UR+	UR	UR-	Total
Basic Materials	0	2	1	3
Communication Services	1	0	2	3
Consumer Cyclical	0	0	0	0
Consumer Defensive	0	1	4	5
Energy	3	1	0	4
Financial Services	1	0	1	2
Healthcare	2	0	4	6
Industrials	1	2	2	5
Technology	1	0	2	3
Total	9	6	16	31
% of Total Under Review	29%	19%	52%	100%

Data as of 12/21/2016

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 (rating: A-/UR-) in a leverage-increasing transaction. Also, our credit ratings for Dow Chemical (rating: BBB/UR) and E. I. DuPont de Nemours (rating: A-/UR) remain under review on their merger plans; the direction and outcome of these reviews remain uncertain.

In Communication Services, we placed our ratings for AT&T, CenturyLink, and Sky under review in the fourth quarter on planned M&A activity. 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. In particular, we believe a merger with the more profitable and competitively advantaged Fox could result in an improved Business Risk profile and a stronger Solvency Score for Sky.

In Consumer Defensive, leverage-increasing acquisitions dominate our reviews. In the fourth quarter, British American Tobacco (rating: BBB+/UR-) was placed under review with negative implications on its plan to buy the rest of Reynolds American (rating: BBB/UR-), which we also placed UR- on this pending transaction. British American's management team indicated that it is committed to maintaining a solid investment-grade rating, but given the proposed debt financing, it could take several years to achieve investment-grade credit measures. Danone's (rating: BBB+/UR-) rating remains under review on plans to acquire WhiteWave (not rated) in an leverage-increasing deal, which could lead to a downgrade of the acquirer. In food distribution, we are reviewing Sysco's (rating: A-/UR-) corporate credit rating for downgrade on its recent acquisition of the Brakes Group, a leading European food-service business. Beyond acquisition activity, our credit rating ConAgra Foods (rating: BBB-/UR) remains under review, reflecting the firm's recent separation into two independent, publicly traded companies -- ConAgra Brands (packaged foods) and Lamb Weston (frozen food).

In Energy, we placed Baker Hughes, Tesoro, and Western Refining under review during the fourth quarter. 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. Our rating on FMC Technologies (rating: BBB+/UR+) remains under review on its all-stock merger plan with Technip (not rated), which is scheduled to be completed in early 2017 and will likely improve FMC's credit profile.

In Financial Services, we placed Janus Capital Group (rating: BBB/UR+) under review with positive implications in the fourth quarter on its pending merger with Henderson Group (not rated) in an all-stock deal that may lead to better credit profile relative to the stand-alone entity. Our BBB+ credit rating for AIG remains under review with negative implications based on moves to return at least $25 billion in capital to shareholders. These actions aim to appease activist investors who were demanding a breakup of the firm, but AIG's leverage is increasing as a result, which could spark a downgrade.

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 managed care, the Department of Justice is attempting to block the Anthem (rating: BBB-/UR+)/Cigna (rating: BBB-/UR+) merger and the Aetna (rating: BBB+)/Humana (rating: BBB+/UR-) merger. Prior to the Justice Department's lawsuits, our ratings assumed that the mergers would close as planned. However, if they are not completed, we see positive credit rating implications for Anthem and Cigna, given the lower leverage that we would expect both firms to carry in a stand-alone scenario, and negative rating implications for Humana, given its smaller size and lack of sustainable excess economic profits in a stand-alone scenario. Our rating on Abbott Laboratories (rating: A/UR-) still remains under review with negative implications on its plans to acquire St. Jude Medical (A/UR-) and Alere (not rated). Since uncertainty surrounds Abbott's willingness to complete the Alere transaction and Abbott's ultimate capital structure, we have maintained our under review status so far.

In Industrials, we placed Parker Hannifin and Rockwell Collins under review with negative implications in the fourth quarter on their respective leverage-increasing acquisition plans. Our review of Parker Hannifin (rating: A/UR-) relates to its planned acquisition of Clarcor that promises to boost leverage enough to consider a downgrade. 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 maintain a higher long-term leverage target than it currently operates with as a stand-alone entity. 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 upon consummation of the merger, which is expected in mid-2017. Positively in the sector, Terex's (rating: BB-/UR+) rating remains under review for a potential upgrade on its leverage-reducing plan to divest its material handling and port solutions business to Konecranes (not rated). In September, Johnson Controls (rating: BBB+/UR) and Tyco International combined in a cash and stock-financed inversion deal that increased leverage along with business size and diversity. Considering those potentially offsetting factors, Johnson Controls' rating remains under review with no directional implications.

In Technology, acquisition activities and business reorganizations are the primary reasons for our rating reviews. In the fourth quarter, we placed Time Warner and Windstream under review with negative implications on those activities. Our review of Time Warner (rating: BBB+/UR-) relates to its planned combination with AT&T (rating: BBB/UR-). Relative to Time Warner on a stand-alone basis, we project that the combined entity will operate with more leverage and a potentially weaker Business Risk profile, which could cut into its rating. Windstream's (rating: B-/UR+) planned merger with EarthLink appears to have positive implications for its credit profile based on lower expected financial leverage and higher profitability relative to the stand-alone entity. Analog Devices (rating: A+/UR-) remains under review with negative implications following its plan to merge with Linear Technologies (not rated) in a leverage-increasing transaction that is scheduled to close in mid-2017.

Contributed by Julie Utterback, CFA

Exhibit 13

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-
CenturyLink Inc	CTL	Communication Services	BB	UR-
AT&T Inc	T	Communication Services	BBB	UR-
Sky PLC	SKY	Communication Services	BBB	UR+
British American Tobacco PLC	BATS	Consumer Defensive	BBB+	UR-
Conagra Brands Inc	CAG	Consumer Defensive	BBB-	UR
Danone SA	BN	Consumer Defensive	BBB+	UR-
Reynolds American Inc	RAI	Consumer Defensive	BBB	UR-
Sysco Corp	SYY	Consumer Defensive	A-	UR-
Baker Hughes Inc	BHI	Energy	BBB+	UR+
FMC Technologies Inc	FTI	Energy	BBB+	UR+
Tesoro Corp	TSO	Energy	BBB-	UR
Western Refining Inc	WNR	Energy	BB	UR+
Janus Capital Group Inc	JNS	Financial Services	BBB	UR+
American International Group Inc	AIG	Financial Services	BBB+	UR-
Abbott Laboratories	ABT	Healthcare	A	UR-
Anthem Inc	ANTM	Healthcare	BBB-	UR+
Bayer AG	BAYN	Healthcare	A-	UR-
Cigna Corp	CI	Healthcare	BBB-	UR+
Humana Inc	HUM	Healthcare	BBB+	UR-
St Jude Medical Inc	STJ	Healthcare	A	UR-
Johnson Controls International PLC	JCI	Industrials	BBB+	UR
Joy Global Inc	JOY	Industrials	BB-	UR
Parker Hannifin Corp	PH	Industrials	A	UR-
Rockwell Collins Inc	COL	Industrials	A-	UR-
Terex Corp	TEX	Industrials	BB-	UR+
Analog Devices Inc	ADI	Technology	A+	UR-
Time Warner Inc	TWX	Technology	BBB+	UR-
Windstream Holdings Inc	WIN	Technology	B-	UR+

Data as of 12/21/2016

Banking

In December, the Federal Open Market Committee raised its benchmark federal funds target rate by 25 basis points to a range of 0.50%–0.75%. We expect additional rate hikes in 2017 to advance at a relatively gradual pace as inflation remains low and economic growth continues to advance at a modest pace. Rising interest rates will have a positive impact on bank earnings as rising rates tend to allow banks the opportunity to increase 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, which are pegged to short-term indexes like Libor that reflect Fed policy. A tighter interest environment can also lead to a steeper yield curve which can benefit loan spreads on longer-term loans. Regional banks like Zions Bancorp (rating: BBB-, stable), SunTrust (rating: BBB+, stable), and Regions Financial (rating: BBB, negative) should derive a greater benefit from higher interest rates, while global banks like JPMorgan (rating: A-, stable), and Citigroup (rating: A-, stable) will not benefit as much. We also expect banks focused on trust and custody, namely Bank of New York Mellon (rating: A, stable), State Street (rating: A, stable), and Northern Trust (rating: A+, stable) to benefit from higher short-term rates since these banks tend to invest a large portion of their securities portfolio in short duration and floating rate assets. Further, higher short-term rates should also contribute to lower money market fee waivers that these banks have been extending to their clients, which should contribute to higher investment management fees.

A partial offset to the benefits of higher interest rates for banks could come in the form of higher credit costs. Higher rates could exert pressure on the marginal borrower and cause higher delinquency and default rates to occur. Although we expect this effect to be modest, we could see higher credit costs first appear in companies that focus on consumer credit card lending like Capital One Financial (rating: A-, stable), Discover Financial Services (rating: BBB+, stable), and Synchrony Financial (rating: BBB, stable). On balance, we expect these companies to benefit more from higher interest income than to be harmed by higher credit costs.

We expect higher interest rates to dampen residential mortgage refinancing during 2017. Since the U.S. presidential election in early November, the 10-year Treasury rate often used as a proxy for mortgage refinancing has increased by around 70 basis points which has translated into average rates on 30-year mortgages of 4.16% according to FRED data, roughly 60 basis points above pre-election levels. Although mortgage refinancing hasn't been a large contributor to bank results so far this year, we expect higher mortgage rates to reduce refinancing income for those banks with an emphasis on mortgage lending which include: Wells Fargo (rating: A, negative), JPMorgan Chase, Bank of America (rating: BBB, stable), and Regions Financial.

Potential changes in bank regulation emanating from the incoming Trump administration are unlikely to be known during the first quarter. However, throughout the year, we will be watching for guidance on regulatory provisions relaxing the Dodd-Frank Bank Act, which would most directly impact the eight largest global systemic banks, or GSIBs. We would also expect regulatory guidance on leveraged lending standards, an area that banks have complained regulators are restraining growth. We will also be watching proposals for infrastructure projects that could drive demand for commercial and industrial loans, which would also be beneficial for loan growth.

Contributed by Christopher Baker, CFA

Basic Materials

The basic materials sector's credit trend has been steadily improving in the second half of 2016. The outlook for the credit trend in this sector for the first quarter of 2017 is generally positive considering the rebound in certain commodities in the metals and mining subsector as well as the general stability in the agricultural and chemicals subsectors.

The metals and mining subsector produced the most volatility in 2016. Prices for iron ore, copper, steel, and other commodities slumped in the latter part of 2015 and into 2016, which was after the point many companies had leveraged up their balances pursuing acquisitions or engaging in multibillion-dollar greenfield projects. As a result of these two conditions, many formerly investment-grade issuers were downgraded to high yield in late 2015 and early 2016. Notable examples include ArcelorMittal (rating: BB-, positive), Anglo-American PLC (rating: BB, negative), Freeport McMoran (rating: B-, positive), Teck Resources (rating: B+, positive) and Vale SA (rating: BB, negative). Nevertheless, prices for many commodities in this space have improved substantially over the past several months. For example, coking coal prices have tripled, iron ore and thermal coal have more than doubled, and copper has increased approximately 25% this year.

Additionally, issuers in this subsector have taken steps in 2016 to improve their credit profiles given the negative pricing conditions for their commodities that existed at the beginning of 2016. Improvement for these issuers have taken the form of asset sales and equity issuances to reduce debt as well as debt capital markets activities that have included refinancing of near-term debt maturities. Due to these efforts and the impact of higher commodities prices, many of the above issuers now carry positive rating outlooks.

The agricultural subsector has seen burst of consolidation activity because of lower earnings and cash flows over the past couple of years. Lower crop prices for farmers has directly impacted issuers that participate in the fertilizer, crop protection and seeds segments of this subsector. These companies have sought to capture synergies and pricing power through mergers and acquisitions. However, the outburst of consolidation in this sector has caused regulators throughout the world to cast a skeptical eye on the proposed tie-ups. The combinations of Dow Chemical and DuPont as well as Agrium and Potash Corporation of Saskatchewan are both stock for stock mergers and not leveraging. However, the acquisition of Monsanto by Bayer AG is leveraging and would raise Bayer's debt to 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 continue to have conservative financial policies.

The chemicals subsector outlook is stable due to the expected continuation of stable demand and product pricing for most firms. We expect this trend to continue unless a recession occurs. In addition, we could envision potential M&A activity in this subsector as it has been a consistent cash generator over the past couple of years.

The credit trend in the building materials subsector continues to be positive. Either issuers are posting strong revenue and cash flow gains due to robust demand activity, for example, Martin Marietta (rating: BBB-, stable) or they are deleveraging, for example, LafargeHolcim (rating: BBB-, stable). Additionally, increased infrastructure spending is anticipated in this space due to President-elect Trump's victory, which could further improve cash flows for issuers in this subsector.

Contributed by Sean Sexton, CFA

Consumer Cyclical

Morningstar Credit Ratings, LLC expects credit quality in the consumer cyclical sector to remain relatively stable in early 2017 as consumer spending is supported by lower unemployment and higher wage growth. Year-to-date retail sales through November increased 3.1%, well ahead of annualized GDP growth. Going forward, MCR believes the risks and opportunities arising from shifting consumer spending patterns, online shopping, mergers and acquisitions activity, and international challenges, will have an impact on the industry.

The gaming, lodging and leisure sector remains a bright spot as consumer preferences have shifted toward leisure, increasing travel demand. Higher bookings have bolstered operating results at online travel agencies and hotel operators. Priceline (rating: A-) and Expedia (rating: BBB-) have consistently posted solid double-digit EBITDA growth as travel purchases are increasingly booked online. Meanwhile, recent credit rating upgrades and positive outlooks for the cruise line industry reflect higher travel demand coupled with lower fuel prices. In early 2016, MCR upgraded both Royal Caribbean Cruises (rating: BB+, positive) and Norwegian Cruise Lines (rating: BB, stable). Carnival Cruise Lines' (rating: BBB, positive) rating outlook reflects improving credit metrics along with a leading position in the oligopolistic and cyclical cruise line industry.

The specialty retail sector is expected to continue to experience generally positive industry demand. Performance has been highlighted by strong double-digit e-commerce growth. Amazon (rating: BBB+) is generating strong revenue growth and free cash flow despite substantial ongoing investments. Meanwhile, a healthy housing market is expected to continue through the end of the decade, supporting continued market share gains by home improvement retailers. Home Depot's (rating: A+, stable) recent upgrade is based on multiyear profitability improvements that have translated to stronger free cash flow generation. Meanwhile, 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 support strong growth trends among auto parts retailers. Merchandising strategy changes that adapt to e-commerce challenges have been important. For example, Best Buy (rating: BB, stable) has increased share in certain electronics categories by enhancing its store-based shipment capabilities, by expanding its online platform, and by expanding store-within-store partnerships.

Department stores remain under pressure and are unlikely to see material relief over the next couple quarters. First, traditional department store retailers continue to lose market share to online retailers that offer better convenience and lower prices. Second, higher investment spending in e-commerce initiatives negatively affect margins and cash flow. Finally, efforts to reduce and reconfigure selling square footage will continue. Within the past year, these trends were reflected in rating downgrades for several department stores. Macy's (rating: BBB-, stable) credit rating was lowered by one notch in early 2016 reflecting deterioration in the company's credit metrics including ongoing same-store sales declines, prompting its decision to close 100 Macy's full-line stores. Kohl's (rating: BBB-, stable) rating was downgraded earlier this year because of a weakened competitive position underscored by declining same-store sales and EBITDA.

MCR believes that the apparel retailing sector is generally stable as they are somewhat less exposed to the variability and declining foot traffic of traditional store-based retailers as they ramp up direct to consumer sales. Still the sector remains burdened by higher operational investments that are required to move merchandise to customers from design more quickly. MCR affirmed the credit ratings on the majority of apparel manufacturers in December, including Nike (rating: AA-, stable), VF Corporation (rating: A, stable), Hanesbrands (rating: BBB-, stable), and Ralph Lauren (rating: A-, negative). Still, Ralph Lauren was assigned a negative outlook reflecting MCR's expectation that its rating could be lowered if the company is unable to demonstrate material operating improvements from its restructuring efforts over the next 12–18 months.

The discounter and grocery segment benefit from defensive characteristics. Nevertheless, similar to all brick and mortar retailers, ongoing e-commerce and distribution infrastructure investments have depressed margins among the discounters, while the grocery segment remains under pressure from food deflation. As such, companies constantly seek to adapt their business model. For example Wal-Mart (rating: AA), which generates roughly 55% of its sales from grocery, is leveraging its massive rural store base as points of distribution for delivery in a handful of U.S. cities and is also testing a $50 membership that offers free one- to three-day shipping. Further, Kroger's (rating: BBB) recent acquisition of Roundy's leveraged its strategy to cluster stores thus creating a strong regional market share position that allows it to operate with a highly efficient cost structure.

Contributed by Wayne Stefurak, CFA

Consumer Defensive

During the fourth quarter of 2016, we took several rating actions within the Consumer Defensive sector; we downgraded one issuer, upgraded two, affirmed eight others, and placed two that were affirmed under review with negative implications.

Several of the rating actions throughout the sector were attributed to M&A activity. Anheuser-Busch Inbev (rating: BBB+, stable) was downgraded following its acquisition of SABMiller. We believe that Anheuser-Busch's deleveraging will extend beyond the near-term time horizon. Related to that transaction was Molson Coors (rating: BBB, stable) whose rating was affirmed following its acquisition of SABMiller's 58% stake in MillerCoors for $12 billion. Molson's pro forma total debt/EBITDA was approximately 5.0 times; however, estimated free cash flow in excess of $1 billion annually should allow the company to deleverage rather quickly. The two firms under review with negative implication relate to British American Tobacco (rating: BBB+/UR-), proposal to acquire the remaining 57.8% of Reynolds American (rating: BBB/UR-) that it doesn't already own. The proposal represents an enterprise value of $93 billion and an EBITDA multiple of 16.3 times. The total consideration is estimated at $47 billion, of which approximately $20 billion would be in cash and $27 billion in British American shares.

The ratings upgrades during the quarter were Atria Group (rating: A-, stable), due to improvements in the company's profitability, interest coverage, and returns on invested capital and Constellation Brands (rating: BBB-/ stable), due to its improving credit profile from expanding operating earnings and heightened cash flows from operations generated primarily by its beer business.

The remaining activity across the sectors includes affirmations. In the tobacco industry, Philip Morris International (rating: A-, stable) was affirmed. In the packaged food industry, Mead Johnson Nutrition's (rating: A-, stable) was affirmed. And there were five affirmations in the household products and personal care sector which included; Colgate-Palmolive (rating: AA, stable), Clorox (rating: A-, positive), Church & Dwight (rating: A-, stable), Estee Lauder (rating: A, stable), Unilever (rating: A+, stable). We established a positive outlook on Clorox because of its strong credit profile derived from moderate financial leverage and stable operating margins and cash flows generated from a diversified portfolio of brands.

In the food sector, Danone (rating: BBB+/UR-) credit rating remains under review with negative implications. The company has a definitive merger agreement with WhiteWave (not rated). Danone will acquire WhiteWave for a total enterprise value of approximately $12.5 billion and an adjusted EBITDA multiple of 25 times, excluding estimated annual synergies, which the company expects to grow to $300 million by 2020. The acquisition including assumed debt raises the company's leverage debt/EBITDA to about 5.0 times from 2.7 times, and although we have a positive view of the acquisition, we are anticipating a possible weakening of Danone's Cash Flow Cushion and its Distance to Default scores. We believe the acquisition will invigorate Danone's top-line by doubling the company's U.S. business. Whitewave's brands complement Danone's current dairy portfolio and will significantly expand it to the organic dairy, non-GMO, plant-based alternatives to milk & yogurt, and coffee creamers categories. As consumers are continuously seeking less processed, lower fat, organic and non-GMO foods this acquisition places Danone at the forefront to satisfy that demand. Danone completed the financing for the acquisition during the quarter with a $5.5 billion bond issue and a EUR 6.2 billion multitranche bond issue and is awaiting regulatory approval.

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. However, if the acquisition is successfully executed they can create extraordinary cost savings opportunities and can pave the way for future revenue and earnings growth. An example of this is the Anheuser-Busch acquisition of SABMiller, which provides cost savings opportunities estimated at $1.9 billion and access to Africa, one of the largest emerging markets that will likely provide expansion opportunities for decades. The Danone and WhiteWave tie-up is another example. Mondelez's (rating: BBB) unsolicited and unsuccessful $26 billion bid for Hershey (rating: A) clearly indicates that they, and potentially others within the industry, are in the hunt for a strategic acquisition. Nonetheless, we believe that Hershey remains an attractive target with a leading position in the U.S. chocolate market (45% share), healthy operating margins at approximately twenty percent, high ROIC's 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 is an ongoing tactic that management teams have used to spur the top-line. While it has become a main stay of many sector participants growth strategies, it often take several years for them to make a meaningful contribution to revenues 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. Debt financed acquisitions concurrent with share repurchases tends to increase leverage and will likely lead to negative rating actions.

In the near term, cost cutting and increased efficiency remains a directive for the consumer defensive sector. Industry participants will be closely watching the newly merged KHC (rating: BBB-, positive) and the success the management is having 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 within the consumer defensive sector are examining and scrutinizing their own cost structures. Many of them are undergoing widespread, multi-year restructuring programs to reduce their manufacturing base, improve supply chain management, and squeeze savings out of working capital. Several of these firms are examining their costs 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 the broader strategy employed by 3G and Warren Buffet to become industry consolidators.

Our expectation is 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. In the near-term, we expect an uptick in leisure spending, particularly food consumed away from home, benefiting the restaurant industry and food services firms, at least. 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

Heading in to the New Year, we believe that oil supply/demand fundamentals should continue to improve, supporting price. In the wake of OPEC's Nov. 30 decision to cut oil production by 1.2 million barrels per day, several large, non-OPEC producers, including Russia, Oman, Sudan and Kazakhstan, have agreed to cooperate with OPEC by trimming output by an additional increment of 558,000 barrels oil per day. Collectively, the proposed cuts, all to be implemented on Jan. 1, equate to about 2% of current global oil production. The duration of OPEC's agreement is six months, extendable for another six months. However, since current global oil oversupply is about 1.4 million barrels per day, the impact on oil oversupply from stated cut intentions would be not be as significant as the headlines suggest. Despite this, the reduction agreements have helped to set a more constructive tone in the oil market. We maintain our view that the oil price will continue an overall gradual trend higher, subject to bouts of volatility, ending first quarter 2017 at or about $55 per barrel and $55–$60 per barrel by mid-2017. With support from especially sharp cuts to global E&P expenditures during the past two years and the likelihood for a moderate rebound in upstream spending in 2017, we look for oil pricing to continue to progress next year in a seesaw pattern, or "fits and starts," in anticipation of more balanced global supply/demand fundamentals. Near-term crude oil concerns remain, including:

1. Heightened global inventories of oil, with U.S. commercial crude inventories still hovering near an 80-year high.
2. Reacceleration of Iranian production and exports since U.S.-led economic sanctions were lifted in January, but with further gains more difficult as Iran is excluded from the OPEC cut agreement and Libya and Nigeria are also exempt to allow them to recover from terrorist attacks on oil facilities,
3. History of cheating by OPEC members and other participants on previous production cut agreements.
4. How quickly U.S. shale producers and other non-OPEC producing countries that are not participating in the OPEC-led supply reductions fill the production gap on any oil price trading rally.
5. Subdued Chinese oil consumption growth, the world's largest oil importer.

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

After a brief pause in November, the U.S. spot price for natural gas jumped to $3.75 per million British thermal units in early December on a surge in heating demand as cold early-winter temperatures set in. Since then, the spot gas price has settled back to $3.25/mmBtu. The U.S. underground gas storage inventory is now about 3.8 trillion cubic feet, which is 5% above the five-year average. Domestic gas demand typically peaks during winter. We believe spot pricing will remain over $3.00/mmBtu for the next few months, with the brunt of heating demand still to come, combined with ongoing growth in pipeline and liquefied natural gas exports, causing the U.S. gas storage inventory to normalize as we exit winter. The gas withdrawal season typically runs from late October through early April.

The likelihood for a continued gradual increase in oil and gas pricing 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+), a strong service backlog coming in to the sharp cyclical slowdown and ability to continue winning new orders has 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 (closed April 1) are coming about a bit faster than originally planned. Concho Resources (rating: BB+, positive) is the largest E&P pure play in the Permian Basin of Texas and New Mexico, with a large, repeatable, low-risk drilling inventory there. Our positive outlook on Concho reflects cost and production growth-related synergies coming about from recent acquisitions in the Permian, the company's low debt leverage and no major debt maturity before 2022.

On May 20, we placed our BBB+ credit rating on FMC Technologies under review with positive implications on the joint announcement with Technip (not rated) that the companies plan to merge in an all-stock transaction. By combining two complementary portfolios we believe the merger makes strategic sense and, from FMC's financial point of view, we estimate that gross and net leverage will decline sharply. Following this, 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.

Last, 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.

Contributed by Andrew J. O'Conor

Healthcare

With the election of Republican Donald Trump as U.S. president and Republican majorities keeping both houses of Congress, the healthcare industry is bracing for a change of the status quo after the political handover is made in the first quarter. While uncertainty surrounds repeal/replace efforts, we think significant changes to the Affordable Care Act are likely. Specifically, we see a high probability of a reconciliation bill passing through Congress and being signed into law by Trump. Based on previous reconciliation bill attempts by Republicans that were thwarted by Obama, there is risk that many people could lose their insurance coverage. If that happens, there could be negative fundamental implications for service providers, specifically hospitals on our coverage list that have benefited from a surge in insured patient volumes in recent years under the ACA. Also, medical technology companies may see demand headwinds in this scenario, especially if their hospital customers are stressed by the changes.

However, because of the potential political fallout that could come to Republicans by a large number of Americans losing health insurance, we see significant incentive for government officials to provide an alternative way to gain insurance coverage. Key initiatives in previous Republican proposals are to provide more choices while also lowering costs and providing more flexibility for consumers. For example, one of the key proposals is to increase insurance competition and portability of coverage across state lines, which could negatively affect both the top and bottom lines of the insurers. So while we see the potential for less regulation on medical loss ratios as a potential positive to ACA reform on managed-care organizations, other changes to the status quo could have negative implications for health insurers.

For pharmaceutical and biotechnology companies, changes in the ACA may be more muted than in other sectors of the healthcare industry, but pricing concerns have not disappeared. Without giving specific details, President-elect Trump has vowed to bring down drug prices, and we think pricing concerns will remain on the front-burner in the U.S. for the foreseeable future. If successful, price control efforts could have trickle down effects to other sectors, such as the drug distributors, as well, since they generate revenue as a percentage of drug sales.

Also of note, during the lame duck session, President Obama signed the 21st Century Cures Act into law on Dec. 13 that will dedicate $5 billion for biomedical research under the National Institutes of Health, including $2 billion devoted to cancer projects. The landmark legislation amounting to $6 billion in total also allocates funding to address opioid addiction, neurological disorders like Alzheimer's disease, and mental health issues. In addition, the new law provides the FDA with funding to hire and retain highly-skilled staff and to develop new ways to modernize and increase efficiencies in the drug and medical device approval processes. While it is too early to tell, the pharmaceutical industry would clearly benefit from any streamlining of drug development, which currently takes eight to12 years to accomplish. The Cures Act also grants a six-month patent extension to existing medicines that gain an indication in rare disease states, which the CBO estimates will favorably affect 15% of brand sales expiring through 2025.

Mergers and acquisitions will also remain in focus for healthcare companies in the first quarter. Specifically, we expect rulings in the antitrust trials on the pending managed care mergers of Anthem (rating: BBB-/UR+)/Cigna (rating: BBB-/UR+) and Aetna (rating: BBB+)/Humana (rating: BBB+/UR-) during that period. Our current ratings assumed that the planned mergers would close as expected, so our ratings may change if the mergers are not allowed.

Contributed by Julie Utterback, CFA and Michael Zbinovec

Industrials

Although industrial firms are too disparate to paint with the same broad brush, a few trends emerged this quarter that we believe have the potential to alter credit profiles meaningfully over the next few quarters. We think three are worth highlighting: the debt burden of pension plans, the unlocking of overseas "trapped" cash, and the prospect for lower corporate tax rates.

First, pension plans. Although mostly a relic of a bygone era, defined benefit pension plans are still common within our industrials coverage. With the recent rapid ascent in interest rates, underfunded pension positions should abate, with higher discount rates resulting in companies reporting lower benefit obligations. Already, Honeywell (rating: A, stable) and United Technologies (rating: A, stable) have communicated pensions tailwinds relative to their previous expectations for 2017. We expect this improvement should manifest itself throughout 2017 through higher corporate earnings and lower pension contribution requirements; factors that will improve corporate credit profiles. Defense credits could also be beneficiaries of lower pension burdens, as higher rates lower the benefit obligations while likely strong market returns improve the funded status. During the quarter, we affirmed seven aerospace/defense credits, and these ratings could be more solidly positioned in their respective rating categories given lower pension liabilities.

Second, much of the corporate cash sitting on our coverage list's balance sheets resides overseas and is subject to taxation upon repatriation. Should the incoming administration propose a tax holiday we'd expect much of this to return home at a nominal tax expense. However, we believe a tax holiday would generally have negative ramifications for creditors: research from the National Bureau of Economic Research showed that nearly every dollar repatriated under the Homeland Investment Act of 2004 was returned to shareholders.

Last, early discussions indicate that the incoming administration will look to simplify the U.S. tax code. Economic theory suggests that eliminating deductions and lower tax rates should lift overall output. However, we envision a less meaningful decline in tax for our multinational firms since their effective tax rates are already below statutory levels. Still, companies with heavy U.S. exposure are likely to benefit while the impending decline may result in more domestic-based acquisition targets.

Outside of these trends, we experienced modest acquisition spending toward the end of the year. Aerospace supplier Rockwell Collins (rating: A-/UR-) was placed under review with negative implications on its pending $6.4 billion leveraging acquisition of B/E Aerospace (not rated). We expect a potential downgrade as pro forma leverage moves to 4 times from 1.5 times. Parker-Hannifin (rating: A/UR-) purchased filtration technology company Clarcor for $4.3 billion in an all-cash transaction in December. We put our rating under review with negative implications since we estimate that the deal will boost gross leverage to 3.6 times from 2.2 times. Roper Technologies (rating: BBB, stable) announced a $2.8 billion deal for project software company Deltek. Praxair's (rating: A, stable outlook) discussions with Linde (unrated) fell apart earlier this year, but the firms recently announced their intention to combine in a merger-of-equals deal. We wonder if rising rates will catalyze deal-making, as many of the diversified companies have hinted at acquisition spending throughout much of 2016. The apparent bottom in energy prices should eventually help fuel a recovery in the general manufacturing sector, although we imagine profitability will be permanently lower. There has also been much fanfare regarding the potential benefit from a government-inspired infrastructure boom. Although studies suggest that U.S. infrastructure needs improving, we think converting such rhetoric into spending will take longer than many anticipate.

Finally, in the auto space we continue to monitor domestic auto sales, which look likely to remain at peak levels this year with a SAAR around 17.4 million units. However, profitability is coming under pressure due to incentives and other actions. While we affirmed our five auto dealers with four stable outlooks and one negative outlook, we note that four of the five are now engaged in ramping up stand-alone used car stores. This appears to be a defensive response to peak new car sales and potentially the longer-term change in mobility. Ford (rating: BBB, stable) for one is also guiding to weaker profitability and cash flows based on its investment in mobility. We expect the suppliers to be the primary beneficiaries of new technologies and the electrification of vehicles.

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

Technology, Media, and Telecommunications

We estimate that issuance of investment-grade, U.S. dollar-denominated senior debt in tech, media, and telecom totaled $148.4 billion for the year to date, up nearly 10%, year over-year. Issuance in the fourth quarter ended Dec. 21 was $3.6 billion, composed of two deals: Analog Devices' (A+/UR-) $2.1 billion multitranche issuance and Time Warner's (BBB/UR-) $1.5 billion 10-year note. The quarter's issuance was down 81% from a year ago, but follows a 98% increase, year over year, in the third quarter, driven by merger and acquisition funding.

For the year to date, the largest deals are still Microsoft's (AA+, stable) $20 billion issue in August to fund its acquisition of LinkedIn (not rated). In second place is Oracle's (rating: AA-, stable) $14 billion June issuance to fund its acquisition of Netsuite (not rated). Still pending in the sector is Analog Devices' merger with Linear Technology (not rated). Analog Devices recently raised $2.1 billion of notes to fund this transaction.

The media and telecom subsectors of the Morningstar Corporate Bond Index tightened by 6 and 2 basis points, respectively, during the fourth quarter, while technology tightened by 13 basis points. Over the same period, Morningstar's Corporate Bond Index tightened by 11 basis points. However, for the full year-to-date period, technology has underperformed the broader investment-grade market, with a total return of just 2.1% compared with 4.8% for all of corporates. Over the same period, the media and telecom sectors both outperformed the Index, returning 7.0% and 5.5%, respectively.

Technology

Generally, operating performance in technology remains stable, with semiconductor firms reporting sequential improvement in both revenue and operating margins during their calendar third quarters compared with the prior quarter. Meanwhile, many equipment and software firms continue to face soft top-line growth, but generally stable margins and cash flow. Total debt/EBITDA ratios have been ticking steadily higher in the software sector over the past year, with a sharp uptick in the third quarter. We attribute this jump to merger financing at Microsoft and Oracle. Meanwhile, total debt remained generally flat in the quarter among Hardware firms and we noted a sequential decline in leverage among our Semiconductor coverage as revenue growth and margin have been trending modestly higher.

For 2017, we expect corporate actions and event risk to remain key themes in the sector. We also expect tax and regulatory policy changes in the United States which could have a material impact on the sector, some positive and some with the potential to be negative. We attribute at least some of the technology sector's corporate bond underperformance relative to the index this year to post-election uncertainty. In particular, the market appears concerned around the U.S. president-elect's rhetoric during the campaign against existing trade policies with China and for immigration reform, some of which has carried over into post-election policy statements. The tech industry relies heavily on well-established China-based manufacturing and supply-chain networks as well as a stable supply of employees holding H1-B visas, either of which may face disruption over the next four years. However, a Republican majority in the House of Representatives and Senate may bode well for the multinational tech firms harboring substantial overseas cash hoards, which may directly benefit from a repatriation tax holiday as well as other corporate tax reforms. However, while some tech executives have publicly indicated that money repatriated would be earmarked for R&D and capital investment, we remain skeptical given the recent trend among companies of paying out excess internal cash flow through share repurchases.

Media

In the Media sector, our chief concern remains corporate actions. Sector leverage has generally risen over the past year as many companies increased their focus on share repurchases and took advantage of attractive borrowing rates to issue debt, particularly Discovery Communications (BBB, negative). Event risk is also likely to remain an overhang for some firms, including Viacom VIAB (BBB, negative) and CBS (BBB, stable) following Sumner and Shari Redstone's Dec. 12 recommendation to the boards of both CBS and Viacom that they terminate discussions around a re-merger of the two companies. We believe pressure to restructure operations will remain elevated for Viacom now that the CBS merger is off the table. Viacom has been working with a financial advisor to explore capital restructuring alternatives. It announced a 50% dividend cut and the resignation of its interim CEO during the third quarter. In the past month, the company named Robert Bakish as its new interim CEO.

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. However, in the most recent quarter, advertising revenue took a hit for many networks as a result of weakness in Europe as well as a slowdown in TV spending around the Summer Olympics. For 2017, the major ad firms are projecting growth of between 4% and 5%. However, spending comparisons will likely be tough coming out of a major U.S. election year. Meanwhile, programming costs continue to rise, but media companies with strong portfolios have been increasingly enhancing revenue growth through international and streaming licensing.

Telecommunications

We believe the credit profiles of Telecommunications issuers will remain mixed, with large dividends, acquisitions, and heavy capital spending plans likely to keep pressure on credit metrics. AT&T (BBB/UR-) announced on Oct. 24 that it plans to acquire media conglomerate Time Warner (BBB+/UR-) for around $85 billion of cash and stock. We believe the transaction is likely to receive significant political scrutiny in the months ahead, keeping uncertainty elevated. Meanwhile, the broadcast wireless spectrum auction continues to grind on. Wireless industry blog FierceWireless reported on Dec. 6 that demand for the 600MHz spectrum has been fading, with bids from carriers in the third round coming in at around half of the minimum value of $40.3 billion required to finish the auction. We expect Verizon (BBB, Stable) to be a significant bidder in the auction, along with T-Mobile (BB, Stable), and possibly even Comcast (A-, Stable). However, given AT&T's pending merger, as well as industry speculation that it may be selected as the designated contractor to build out a national broadband network for first responder emergency professionals (FirstNet), its involvement in the spectrum auction may be less than we had originally anticipated. M

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