MOODY'S ANALYTICS

# WEEKLY MARKET OUTLOOK

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# Lowest Investment-Grade Industrial Company Bond Yields since 1956

## Credit Markets Review and Outlook *by John Lonski*

Lowest Investment-Grade Industrial Company Bond Yields since 1956

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## The Week Ahead

We preview economic reports and forecasts from the US, UK/Europe, and Asia/Pacific regions.

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## The Long View

Full updated stories and key credit market metrics: Third-quarter 2019's US$-denominated corporate bond issuance is expected to rise by 17% annually for investment-grade and by 25% for high-yield.

| | |
|---|---|
| Credit Spreads | Investment Grade: We see year-end 2019's average investment grade bond spread close to its recent 130 basis points. High Yield: Compared with a recent 489 bp, the high-yield spread may approximate 475 bp by year-end 2019. |
| Defaults | US HY default rate: Moody's Investors Service's Default Report has the U.S.' trailing 12-month high-yield default rate rising from July 2019's actual 3.0% to a baseline estimate of 3.2% for July 2020. |
| Issuance | For 2018's US$-denominated corporate bonds, IG bond issuance sank by 15.4% to \$1.276 trillion, while high-yield bond issuance plummeted by 38.8% to \$277 billion for high-yield bond issuance's worst calendar year since 2011's \$274 billion. In 2019, US$-denominated corporate bond issuance is expected to rise by 3.4% for IG to \$1.320 trillion, while high-yield supply grows by 30.6% to \$363 billion. The very low base of 2018 now lends an upward bias to the yearly increases of 2019's high-yield bond offerings. |

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## Ratings Round-Up

A Downgrade at Rolls Royce, but Its Outlook Lifts

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Credit spreads, CDS movers, issuance.

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## Moody's Capital Markets Research *recent publications*

Links to commentaries on: Corporate credit, Fed moves, spreads, yield collapse, inversions, unmasking danger, divining markets, upside risks, rating changes, high leverage, revenues and profits, riskier outlook, high-yield, defaults, confidence vs. skepticism, stabilization, volatility.

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Click here for *Moody's Credit Outlook*, our sister publication containing Moody's rating agency analysis of recent news events, summaries of recent rating changes, and summaries of recent research.

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# Credit Markets Review and Outlook

By John Lonski, Chief Economist, Moody's Capital Markets Research, Inc.

## Lowest Investment-Grade Industrial Company Bond Yields since 1956

The latest rally by Treasury bonds drove Moody's long-term industrial company bond yields down to new 63-year lows. On August 14, the single-A industrial company bond yield closed at 3.30% and the Baa industrial yield ended at 4.08%. The latter are less than each of their prior month-long averages going back to 1956.

The latest drop by Baa-rated bond yields should lift corporate bond offerings. As shown by each of the following charts, there is significant upside for the issuance of bonds graded Baa1, Baa2 and Baa3. The refinancing of outstanding bonds, loans, and commercial paper should serve as the primary driver of forthcoming investment-grade corporate bond offerings.

**Figure 1: For U.S. Baa1-Grade Corporations, Below-Average Ratio of Bond Issuance to Outstandings and Low Bond Yields May Lift Baa1-Rated Bond Offerings**
*$ billions*
*sources: Dealogic, Moody's Capital Markets Group*

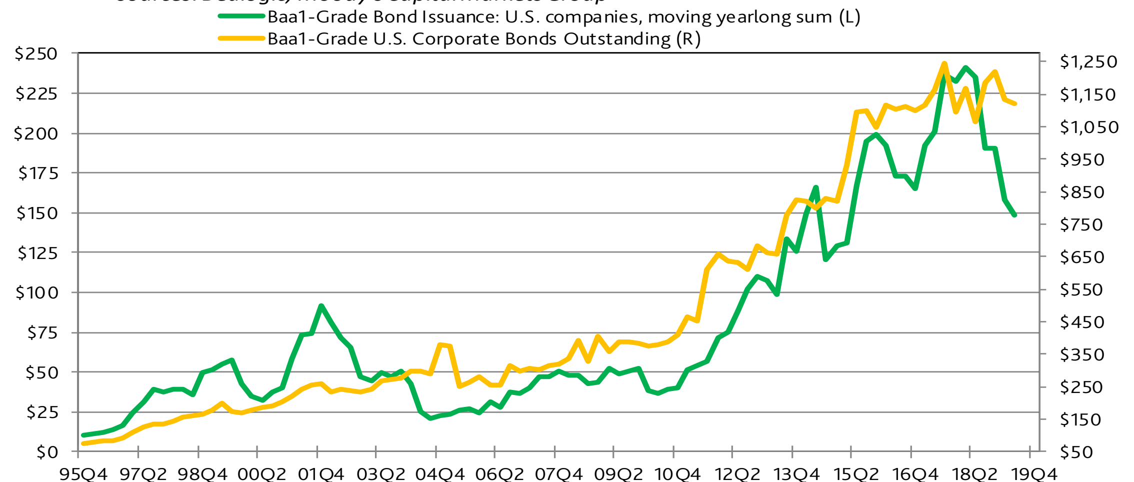



**Figure 2: Yearlong U.S. Baa2-Grade Corporate Bond Offerings Need to Grow by 22.3% In Order To Match Long-Term Ratio of Bond Issuance to Outstandings**
*$ billions*
*sources: Dealogic, Moody's Capital Markets Group*

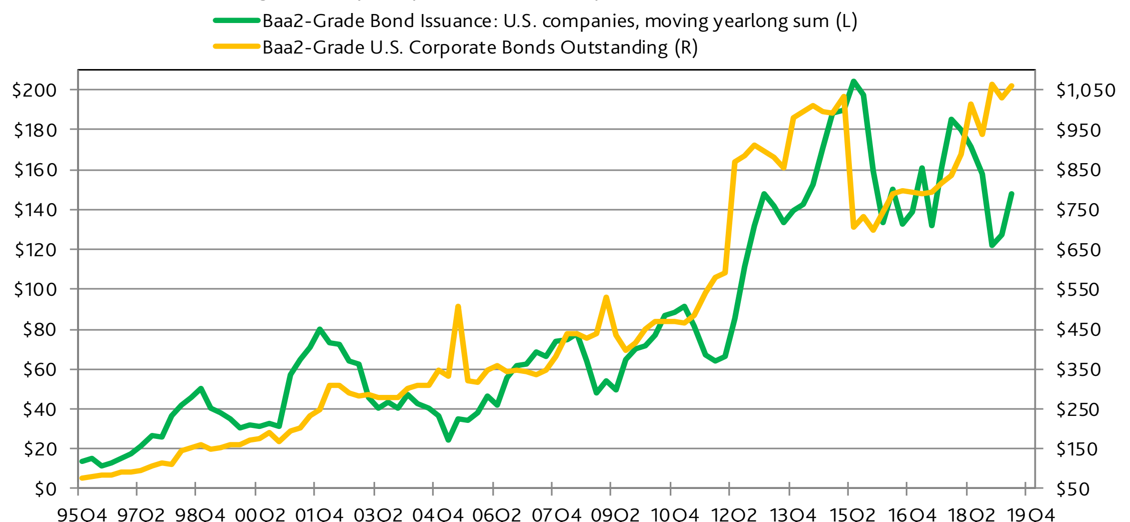
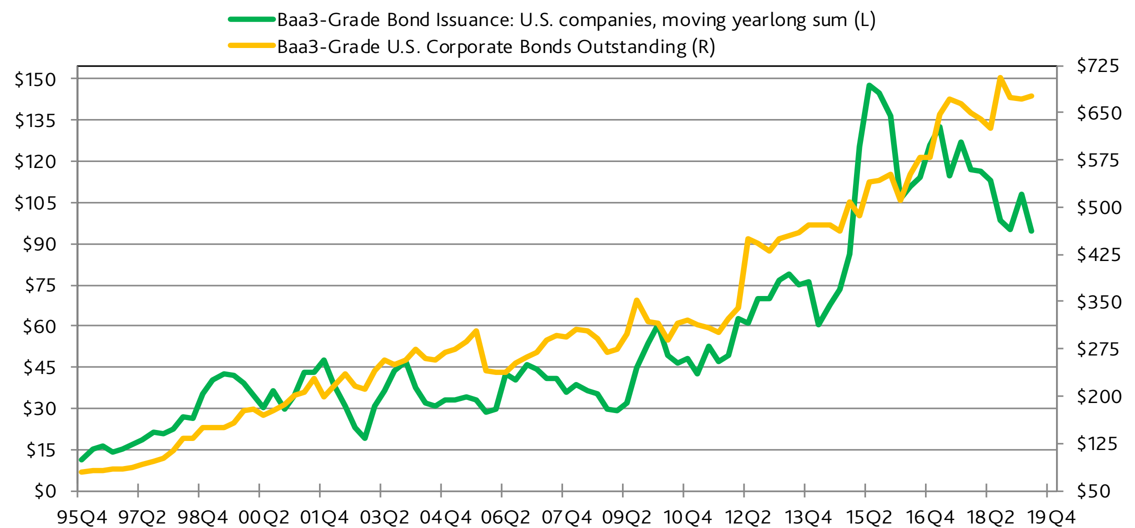


**Figure 3: Yearlong U.S. Baa3-Grade Corporate Bond Offerings Need to Grow by 21.6% In Order To Match Long-Term Ratio of Bond Issuance to Outstandings**
*$ billions*
*sources: Dealogic, Moody's Capital Markets Group*




## July's Retail Sales Hint of a Turnaround for Core Business Sales

A worldwide inventory glut now weighs on global manufacturing activity. For July, U.S. manufacturing output fell by 0.4% monthly and sank by 0.5% yearly. Manufacturing capacity utilization fell by 1.3 percentage points from a year earlier to a disinflationary 75.4%. The annual decline by the capacity utilization rate warns of a possible year-to-year dip by nonfinancial-corporate profits from current production.

However, not all U.S. economic news was bad. July's retail sales topped expectations. Core retail sales which exclude gasoline station sales advanced by an outsized 0.6% monthly for a third consecutive month.

After the year-over-year increase of core business sales slowed from the 5.4% of 2018's second quarter to the 1.9% of 2019's second-quarter, July's retail sales report hints of a livelier 2.3% annual increase by third-quarter 2019's core business sales. Such a quickening would lessen recession risks.

By no means can trade-related issues be blamed for the entire slowing by the year-over-year growth rate of retail sales from the 5.6% of January-July 2018 to the 3.1% of January-July 2019. After excluding gas station sales, the annual increase of core retail sales eased from the 4.8% of January-July 2018 to the 3.3% of January-July 2019.

In addition to trade-related issues, the slowing of core retail sales can be attributed to diminished support from 2018's tax cuts and a jump by short- and long-term borrowing costs.

For example, short-term borrowing costs' benchmarks rose from first-half 2017's 0.8% for the three-month Treasury bill rate and 1.1% for three-month LIBOR to first-half 2019's 2.4% for the three-month Treasury bill rate and 2.6% for three-month LIBOR. Recent rates at the three-month maturity were 1.93% for T-bills and 2.16% for LIBOR. Conceivably, a systemically adequate pace for consumer spending may require a three-month T-bill rate no greater than 1.25%.

## A Coupon Yield Curve Inversion in Name Only

August 14's inversion of the Treasury coupon yield curve was less than convincing. In late trading, the 1.586% 10-year Treasury yield was merely 1/10th of a basis point under the 1.587% 2-year Treasury yield. Thus, by no means was this barely perceptible inversion significant enough to fundamentally justify August 14's $875 billion, or 2.92%, daily plunge by the market value of U.S. common stock to its lowest close since June 4, 2019. As of noon on August 15, the inversion was gone and the 1.54% 10-year Treasury yield eclipsed the 1.51% 2-year Treasury yield.

Oddly enough, despite the equity market's panicked response to a barely inverted Treasury coupon yield curve, the implied probability of a 50 bp slashing of the fed funds rate at the next September 18 meeting of the Federal Open Market Committee rose to a still improbable 30% according to the CME Group's FedWatch Tool. Thus, fed funds futures implicitly disagree with the equity market's fear of an impending recession. Moreover, the futures market assigns a 55% probability to the federal funds rate ending 2019 no greater than 1.375%.

### Fed's Quick Response Nullified the Recession Warning of 1998's Yield Curve Inversion

The month-long averages of June 1998 showed the 5.50% 10-year Treasury yield falling merely 2 bp under the 5.52% 2-year Treasury yield. In July that year, the 2- and 10-year Treasury yields both averaged 5.46% and, by August 1998, the 5.34% 10-year Treasury yield again topped the 5.27% 2-year Treasury yield. Despite June 1998's month-long inversion of the 2- and 10-year Treasury yields, the next recession did not arrive until March 2000.

The 2- and 10-year Treasury yield curve inversion of June 1998 was not followed by a recession partly because the Fed was quick to cut fed funds from the 5.50% of March 1997 through August 1998 to 5.25% in September 1998, 5.00% in October 1998 and 4.75% in November 1998. Those rate cuts occurred amid relatively strong soundings on U.S. economic activity that included a 5.1% annualized surge by U.S. real GDP from the first to the second half of 1998 and second-half 1998's 0.2% average monthly increase by payrolls, where the latter translates into a hefty 303,000 new jobs per month when measured off July 2019's 151.43 million payroll jobs.

### Arbitrage Increasingly Drives U.S. Treasury Bond Yields Lower

To a possibly important degree, the latest plunge by U.S. Treasury bond yields is in response to the sizable very wide premium of U.S. Treasury bond yields over the government bond yields of other advanced economies. Recent and expected declines by the federal funds rate favor a lower cost of hedging the dollar income from U.S. investments into foreign currencies. In turn, risk-averse foreign investors have probably stepped-up their buying of U.S. Treasury bonds and other higher quality dollar-denominated bonds.

Recently, the 1.65% 10-year U.S. Treasury yield towered over the 10-year sovereign government bond yields of Germany (-0.71%), Japan (-0.24%), the U.K. (0.41%), France (-0.43%), Canada (1.14%—a reasonable target for the 10-year U.S. Treasury yield's next bottom), and Australia (0.90%). In turn, Fed rate cuts will move U.S. Treasury yields closer to the ultra-low yields of other advanced economies. As a result, the 10-year Treasury might at least temporarily sink to a range of 1.00% to 1.25% once a fed funds midpoint of 1.125% comes into view.

The 2.00% 30-year Treasury yield was recently 10 basis points under the 2.125% midpoint of the federal funds rate. Apparently, the Treasury bond market now dismisses the FOMC's June 19, 2019 estimate of a 2.5% long-term average for the federal funds rate.

### New Multi-Decade Lows for 10-year Treasury Yield May Boost Mortgage Applications

As of August 9, the Mortgage Bankers Association's weekly seasonally-adjusted index of mortgage applications for the purchase of a home broke a four-week slide and rose by 1.9% from the prior week. Despite the lowest mortgage yields since early November 2016, August 9's moving four-week average of mortgage applications from potential homebuyers was 5.8% under its average of the contiguous 4 weeks ended July 12, 2019, but higher by 7.7% year-over-year.

Moreover, the latest moving four-week average for homebuyer mortgage applications was 8.2% under its current cycle high of April 19, 2019. The latter shortfall occurred despite how the moving four-week average of the MBA's effective 30-year mortgage yield fell from April 19's 4.55% to August 2's 4.13%.

The muted response by homebuyer mortgage applications to the lowest mortgage yields since November 2016 strengthens the case favoring an extended stay by a less than 2% 10-year Treasury yield.

August 9's moving four-week average for the MBA's index of applications for mortgage refinancings topped its average of the four-weeks-ended July 12 by 11.0% and soared higher by 118.3% from its low reading of a year earlier, or when the index of mortgage refi applications plunged by 32.9 annually during

the four-weeks-ended August 10, 2018. The deep drop by mortgage refi activity during the summer of 2018 was but one hint of the patent unsustainability of a 10-year Treasury yield of 2.8% or higher.

### Baa-Grade Industrial-Company Bonds Expanded by 11.8% Annualized since March 2014

Since March 2014, the outstanding investment-grade bonds of U.S. industrial companies advanced by 9.1% annualized, on average, to the $3.59 trillion of 2019's second quarter. Baa-grade bonds supplied $885 billion, or 67%, of the $1.31 trillion increase by U.S. investment-grade industrial bonds since March 2014.

Second-quarter 2019's $2.00 trillion of Baa-rated bonds comprised 55.7% of outstanding investment-grade industrial company bonds. Though the share was up from first-quarter 2014's 48.9%, it was down from the 56.9% of 2018's final quarter.

The average annualized growth rates from 2014's first quarter through 2019's second quarter were 10.7% for the Baa1-rated industrial-company bonds (to $757 billion), 13.4% for the Baa2 industrials (to $794 billion), and 10.9% for the Baa3 bottom investment-grade rung (to $450 billion). For investors whose mandate prohibits the holding of below-investment-grade bonds, a downgrade to a rating below Baa3 necessitates the sale of adversely affected bonds at a price that might well be less than par.

### Baa-Grade Financial-Company Bonds Shrank by 10.7% Annualized since March 2014

Second-quarter 2019's $2.00 trillion of outstanding investment-grade bonds from U.S. financial institutions rose at a relatively slow average annualized pace of 1.8% from 2014's first quarter. Partly because of credit rating upgrades, the outstanding Baa-grade bonds of financial institutions plunged by $444 billion since March 2014, wherein the average annualized rates of decline were 5.1% for the Baa1 financials (to $237 billion), 19.8% for the Baa2 financials (to $158 billion), and 2.4% for the Baa3 financials (to $148 billion).

Second-quarter 2019's $544 billion of Baa-rated financial-company bonds were far under the $984 billion of 2014's first quarter. Baa-rated bonds' share of outstanding investment-grade financial-company bonds plunged from first-quarter 2014's 54.1% to the 27.2% of 2019's second quarter, where the share was also less than the 33.9% of 2018's final quarter.

The $566 billion increase in the outstandings of single-A rated bonds more than accounted for the $181 billion increase in the outstandings of U.S. investment-grade financial company bonds from 2014's first quarter through 2019's second quarter, though the A1-rated financial-company bonds contracted by 15.2% annualized (to $104 billion), the A2-rated financials soared higher by 20.5% annualized (to $560 billion) and the A3-rated financials advanced by 17.2% annualized (to $638 billion).

### Baa-Grade Public Utility Bonds Advanced by 10.5% Annualized since March 2014

From March 2014 through June 2019, the outstanding investment-grade bonds of U.S. public utilities grew by 7.4% annualized to $627 billion. Like the industrials, the $127 billion increase in the outstandings of Baa-grade bonds approximated 65% of the $196 billion addition to the total outstandings of investment-grade public utility bonds. Over the aforementioned span, the stock of Baa1-rated utility bonds grew by 12.7% annualized, on average, to $126 billion, Baa2-grade utility bond debt increased by 7.7% annualized to $107 billion as Baa3 utility bonds climbed higher by 11.2% annualized to $79 billion.

Second-quarter 2019's $310 billion of Baa-rated bonds comprised 50.7% of outstanding investment-grade public utility bonds. Though the share was up from first-quarter 2014's 42.9%, it was slightly under the 50.1% of 2018's final quarter.

# The Week Ahead – U.S., Europe, Asia-Pacific

### THE U.S.

By Ryan Sweet of Moody's Analytics

## Eighty percent of the time, It works every time

Intraday on Wednesday, the difference between the U.S. 10- and two-year Treasury yields inverted, fueling concerns about a recession. This is the first time that the spread between the 10- and two-year Treasury yields inverted after the 10-year and three-month. The latter suggests that markets believe monetary policy is too tight.

The spread between the 10- and two-year is mostly following fundamentals. To highlight this, we built a simple model of the yield curve using an ordinary least squares regression. Independent variables include the fed funds rate, the University of Michigan's five- to 10-year median inflation expectations, the Fed's balance sheet as a share of nominal GDP, and the 10-year yield minus the rolling 10-year average of nominal GDP growth.

Our a priori is that the sign on the coefficients on the fed funds rate and the balance sheet share of nominal GDP would be negative. The latter is consistent with our past work showing that quantitative easing reduced long-term interest rates. We expected the coefficients on inflation expectations and the difference between the 10-year yield and the rolling 10-year average of nominal GDP growth to both be positive.

The results were in line with our a priori: All the coefficients had the expected sign. All were statistically significant and had an adjusted R-squared above 0.9. The model results could be interpreted as a fundamental-based equilibrium level of the yield curve. Based on this approach, the fundamental equilibrium yield curve is 0 basis point.

It's important to remember that an inverted yield curve doesn't cause recessions, but the message from the various yield curves is that the economy has weakened. In fact, the traditional catalysts for a recession are not overly threatening. The immediate threat is the trade tensions and the possibility that we talk ourselves into a recession. Business confidence is already fragile; further declines would not bode well for business investment and hiring.

We used Granger causality tests, and despite using various lags, there wasn't any evidence that the yield curve Granger-caused changes in sentiment. Though there may not be a direct causal effect, the yield curve does Granger-cause changes in stock market returns, which by extension can affect business and consumer sentiment. Therefore, we are not completely discounting the psychological impact that an inversion in the yield curve could have.

An inversion in the 10- and two-year Treasury yields has occurred before each of the past five recessions, but there was a false signal in 1998. In mid-1998, the yield curve was slightly negative but the Fed was easing, as is the case now. Therefore, if you buy into the message from the yield curve, the time between an inversion and recession could be longer than normal. The slight inversion in 1998 was a false alarm, as the yield curve would invert more significantly ahead of the recession in the early 2000s.

### Looking ahead

The economic calendar is much lighter. The key data include existing-home sales, new-home sales and jobless claims. The minutes from the July meeting of the Federal Open Market Committee will also be released.

We will publish our forecasts for next week's data on Monday on Economy.com.

EUROPE

By Barbara Teixeira Araujo of Moody's Analytics

## Why Is Euro Zone Inflation Slowing?

It's August, so it is no wonder that the next week will bring almost nothing on the data front. The only major piece of news will be the release of the final euro zone CPI inflation numbers for July. We expect them to confirm that the area's headline inflation rate fell to only 1.1% from 1.3% in June, corroborating our view that the ECB won't hesitate to add more stimulus to the economy in September. Our base case is that the ECB will cut the deposit rate by 10 basis points to -0.4%, though we don't rule out a sharper cut to -0.5%. We are not betting on the bank restarting its quantitative easing programme just yet, but this remains a possibility down the road. Also, our view is that the central bank will announce a tiered system for reserve remuneration to try to ease the pain on banks from negative rates.

We would nonetheless caution against reading too much into July's downtick. A correction in services inflation, itself due to calendar effects related to the timing of holidays, is expected to drag the most on the headline. June had one more holiday this year than last year in several euro zone countries, and this is set to have boosted travel-related inflation (notably of airfares and accommodation services) over the month. So a mean reversion in July was already warranted. We expect some rebound in August, since our view is that the trend in services inflation is a bit higher than July's preliminary estimate of 1.2%.

Another reason inflation is expected to have slowed so much over the month is the further drop in energy inflation. Energy inflation has been cooling on the back of base effects in oil prices. But this trend should continue only until October or November if the price of the Brent barrel remains steady at its current value of around $58. In any case, we expect the ECB to continue to look past noncore inflation developments, which are volatile and tell nothing about the underlying inflation momentum of the economy.

On the upside, core goods inflation is expected to have jumped to its highest level since February. The details should show that inflation in the clothing sector finally gathered some momentum following several months of deflation. Nonetheless, at a preliminary estimate of 0.4% y/y, core goods inflation continues to be extremely low compared with past standards. Elsewhere, food inflation is set to have similarly picked up, as July's lack of rain in several major countries dealt a severe blow to agricultural output, raising prices of fresh produce. We hope August will bring some stabilization, as temperatures fell considerably and there was plenty of rain.

Overall, below-target inflation will be the norm for 2019, especially given that the base effects in oil prices should continue to weigh on energy inflation in coming months. Underlying inflation pressures should pick up—in line with the acceleration in wages—but this will happen only gradually.

| | Key indicators | Units | Moody's Analytics | Last |
|---|---|---|---|---|
| Mon @ 10:00 a.m. | Euro Zone: Consumer Price Index for July | % change yr ago | 1.1 | 1.3 |
| Mon @ 2:00 p.m. | Russia: Unemployment for July | % | 4.5 | 4.4 |
| Mon @ 2:00 p.m. | Russia: Retail Sales for July | % change yr ago | 1.2 | 1.4 |

ASIA-PACIFIC

By Katrina Ell of Moody's Analytics

## Japan's Inflation Is Stuck Below the Target

Japan's inflation is expected to remain uninspiring for July. Core CPI growth likely hit 0.7% y/y, from 0.6% in June. Inflation is subdued and well shy of the Bank of Japan's 2% target, a symptom of the weak state of domestic demand, and adding pressure on the Bank of Japan to up the stimulus ante. Our baseline remains that further action will not be taken. A temporary spike in CPI growth will occur after the implementation of the consumption tax hike in October.

Japan's exports have been under pressure through 2019. Exports likely contracted in July on an annual basis for an eighth straight month. Headwinds include weakness in global demand, the uncertainty surrounding the U.S.-China trade dispute, and more recently the trade dispute with South Korea. Japan's existing export restrictions on South Korea are not expected to have a major aggregate impact, but the stakes are high and if the situation escalates, there could be significant disruptions that further strain global supply chains, particularly related to tech goods.

Thailand's GDP growth likely softened to 2.6% y/y in the June quarter, from 2.8% previously. Household consumption and exports have lost steam and are important drivers of the cooler June quarter conditions. Exports are struggling on two fronts: weakened global demand and a strong exchange rate. It was the latter that forced the Bank of Thailand off the sidelines in August and delivered a 25-basis point interest rate cut, bringing the policy rate to 1.5%. Central banks throughout Asia have boarded the easing bandwagon this year and if the BoT kept resisting, further upward pressure would have been put on the baht, which has appreciated around 5% against the dollar this year.

Thailand's easier monetary stance doesn't address the underlying reasons for the strong baht, including the rising current account surplus and hefty foreign reserves, both attractive to investors in the jittery global environment. Taiwan and South Korea also run current account surpluses, but their currencies haven't had the same strength given their perceived greater adverse exposure to the trade war, particularly as any sort of near-term resolution seems remote.

| | Key indicators | Units | Confidence | Risk | Moody's Analytics | Last |
|---|---|---|---|---|---|---|
| Mon @ 9:50 a.m. | Japan Foreign trade for July | ¥ bil | 2 | ← | -153.0 | -14.0 |
| Mon @ 12:30 p.m. | Thailand GDP for Q2 | % change yr ago | 3 | ↓ | 2.6 | 2.8 |
| Fri @ 9:30 a.m. | Japan Consumer price index for July | % change yr ago | 3 | ← | 0.7 | 0.6 |

# The Long View

## Third-quarter 2019's US$-denominated corporate bond issuance is expected to rise by 17% annually for investment-grade and by 25% for high-yield.

By John Lonski, Chief Economist, Moody's Capital Markets Research Group
August 15, 2019

### CREDIT SPREADS

As measured by Moody's long-term average corporate bond yield, the recent investment grade corporate bond yield spread of 130 basis points is wider than its 122-point mean of the two previous economic recoveries. This spread may be no wider than 130 bp by year-end 2019.

The recent high-yield bond spread of 489 bp is thinner than what is suggested by both the accompanying long-term Baa industrial company bond yield spread of 204 bp and the recent VIX of 26.1 points.

### DEFAULTS

July 2019's U.S. high-yield default rate was 3.0%. The high-yield default rate may average 3.2% during 2020's first quarter, according to Moody's Investors Service.

### US CORPORATE BOND ISSUANCE

Yearlong 2017's US$-denominated bond issuance rose by 6.8% annually for IG, to $1.508 trillion and soared by 33.0% to $453 billion for high yield. Across broad rating categories, 2017's newly rated bank loan programs from high-yield issuers sank by 26.2% to $72 billion for Baa, advanced by 50.6% to $319 billion for Ba, soared by 56.0% to $293 billion for programs graded single B, and increased by 28.1% to $25.5 billion for new loans rated Caa.

Second-quarter 2018's worldwide offerings of corporate bonds eked out an annual increase of 2.8% for IG, but incurred an annual plunge of 20.4% for high-yield, wherein US$-denominated offerings rose by 1.6% for IG and plummeted by 28.1% for high yield.

Third-quarter 2018's worldwide offerings of corporate bonds showed year-over-year setbacks of 6.0% for IG and 38.7 % for high-yield, wherein US$-denominated offerings plunged by 24.4% for IG and by 37.5% for high yield.

Fourth-quarter 2018's worldwide offerings of corporate bonds incurred annual setbacks of 23.4% for IG and 75.5% for high-yield, wherein US$-denominated offerings plunged by 26.1% for IG and by 74.1% for high yield.

First-quarter 2019's worldwide offerings of corporate bonds revealed annual setbacks of 0.5% for IG and 3.6% for high-yield, wherein US$-denominated offerings fell by 3.0% for IG and grew by 7.1% for high yield.

Second-quarter 2019's worldwide offerings of corporate bonds revealed an annual setback of 2.5% for IG and an annual advance of 17.6% for high-yield, wherein US$-denominated offerings sank by 12.4% for IG and surged by 30.3% for high yield.

During yearlong 2017, worldwide corporate bond offerings increased by 4.1% annually (to $2.501 trillion) for IG and advanced by 41.5% for high yield (to $603 billion).

For 2018, worldwide corporate bond offerings sank by 7.2% annually (to $2.322 trillion) for IG and plummeted by 37.6% for high yield (to $376 billion). The projected annual percent increases for 2019's worldwide corporate bond offerings are 2.8% for IG and 23.0% for high yield. When stated in U.S. dollars, issuers based outside the U.S. supplied 60% of the investment-grade and 57% of the high-yield bond offerings of 2019's first half.

### US ECONOMIC OUTLOOK

As inferred from the CME Group's FedWatch Tool, the futures market recently assigned an implied probability of 100% to a cutting of the federal funds rate at the September 18, 2019 meeting of the Federal Open Market Committee. In view of the underutilization of the world's productive resources, low inflation should help to rein in Treasury bond yields. As long as the global economy operates below trend, the 10-year Treasury yield may not remain above 2.00% for long. A fundamentally excessive climb by Treasury bond yields and a pronounced slowing by expenditures in dynamic emerging market countries are among the biggest threats to the adequacy of economic growth and credit spreads.

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## EUROPE

By Ross Cioffi and Andrea Pinelli of Moody's Analytics
August 15, 2019

### GERMANY

The flash estimate of second quarter GDP released on Wednesday sparked further fears about the German economy, as it showed that the economy contracted by 0.1% q/q in the three months to June, following a 0.4% gain in the previous quarter. This is the first contraction recorded in over four years. The details are not out yet, but comments from Destatis suggest that domestic demand supported the economy over the quarter, with household and government final consumption each increasing from the first stanza. Business investment also grew, but the bad news is that gross fixed capital formation in construction, a sector that had been thriving in the first quarter, declined.

By contrast, net exports were down in the three months to June as faltering external demand weighed on the economy. Risks are tilted to the downside from continued external risks, but even the domestic economy is not immune since sentiment among service providers and consumers has steadily deteriorated over the summer. Furthermore, the German government is unlikely to go on a spending spree to pick up any further slack in aggregate demand. Since 2009, the constitution enforces a 'debt-brake' that limits the structural deficit to only 0.35% of GDP.

In yearly terms, GDP growth halved to just 0.4% in the second quarter, from 0.8% in the previous stanza. This compares with a much stronger 1.5% average reading for 2018. Unless the economy gains substantial momentum in the coming two quarters, our forecast for full-year growth of 1% looks increasingly unattainable. The leading data for the third quarter are not promising; the full-year figure will come in at around 0.5% to 0.7%.

### ITALY

Italy is facing a new government crisis. On August 9, the far-right League presented a no-confidence motion in the government and called for fresh elections, pulling the plug on its ruling coalition with the anti-establishment Five Star Movement. But the League's plan is not going smoothly; playing for time, the newly formed alliance between center-left parties and the Five Star Movement voted to push the debate of the no-confidence motion until next week.

But it remains to be seen if the debate will happen at all. Prime Minister Giuseppe Conte is due to addresses the Senate on August 20 and parliament the following day. One possibility is that the prime minister will resign at the end of the speech, opening a formal crisis and paving the way for early elections in the fall. But given that a key piece of legislation—a long-awaited reform to cut the number of lawmakers—is expected to be debated on August 22, it is unlikely that the prime minister will want to dissolve the government beforehand and kill the reform. In any case, President Sergio Mattarella has made it clear he will not sanction new elections until the reform is fully bedded in the constitution, and that could take many months.

But the possibility remains that the League will increase pressure and manage to take down the government in the next few weeks. At that point, President Mattarella would be required to create a new stable government. One option is that the Five Star Movement teams up with some center-left parties, a nightmare scenario for the League. Although they do have the numbers to control parliament, it is still to be seen if these parties could overcome their differences and form a coalition. If a government is not formed, then new elections would be called and probably held in late October. The polls largely suggest that the League would gather the most votes, but Deputy Prime

Minister Matteo Salvini would still need the support of more moderate center-right parties to control majority. This could lead to a period of prolonged political instability.

Uncertainty lies on the course of economic policy. In November, the Italian government will be called to submit its 2020 budget plan to EU authorities. Although an Excessive Deficit Procedure was averted in July, Salvini recently stated that a new government led by the League would push forward with expansionary fiscal policy. During its 2018 electoral campaign the League promised the introduction of a flat tax, which would weaken Italy's fiscal stance and lead to further disagreements with the EU.

Financial markets reacted unfavourably to the news. The spread between Italian and German 10-year government bond yields has increased by around 20 basis points since August 9. But while persistent uncertainty is likely to harm Italy's fragile economic recovery, the rest of the euro zone should feel few effects for now. We do not expect a repeat of the 2010-2012 sovereign debt crisis, even if political tensions escalate in Italy in the coming weeks. Foreign investors' holdings of Italian government bonds have been declining over the past few years, while the European Central Bank currently makes up for about 20% of the Italian sovereign debt market. This should limit the systemic impact of political instability in Italy and help prevent a new euro zone existential crisis.

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## ASIA PACIFIC

By Katrina Ell of Moody's Analytics
August 15, 2019

### CHINA

China's woeful July data show an economy struggling to balance the challenges abroad and at home. Only measured and targeted stimulus is being released. The weakened and cautious economic environment means that easier credit conditions aren't being exuberantly adopted. The potency of easier credit conditions is limited by the unfavourable backdrop, notably the U.S.-China trade war.

The issues of soft credit demand and credit supply not being free-flowing were demonstrated in July. China's M2 money supply cooled to 8.1% y/y from 8.5% in June. The rule of thumb is that credit growth normally slows in July, but this year the deceleration was more than expected and across the board. Total social financing, a good gauge of overall conditions, slowed to 10.7% y/y in July from 10.9% in June, the fastest pace in a year. It's not just a case of the People's Bank of China releasing too little stimulus. The weighted average lending rate for corporates and households was 5.66% in the June quarter, 3 basis points lower than in the March quarter.

Industrial production was particularly disappointing, hitting a 17-year low at 4.8%, from down from 6.3% in June. This is a clear sign that China's manufacturing sector is buckling under the pressure of continued escalations in the trade war, which is creating mass uncertainty and depressing demand. The U.S.'s new 10% tariff schedule that had been set to begin 1 September has been delayed, providing slight relief. The export-facing sectors will remain under pressure with global demand cooling alongside the enduring trade war.

### Auto sales disappointed

Fixed asset investment growth cooled to 5.7% y/y YTD in July from June's 5.8%. Public investment increased by 7.1%, slightly higher than the 6.9% rise prior, while private investment was 5.4% from 5.7%, suggesting the government picked up part of the slack left by the private sector. Investment in manufacturing remained modest at 3.3% and mining continued to surge, up 27.4%.

Retail spending cooled to 7.6% y/y, from 9.8% in June. A big chunk of the disappointment in July's retail trade print came from the auto sector, where car sales contracted by 2.6% y/y. Retail trade excluding automobiles was up by 8.8% y/y, 1.2 percentage point higher than the headline 7.6% y/y expansion. Automobile spending accounts for around 10% of total retail trade in China.

Two factors are driving weak auto spending. The first is that authorities have scaled back subsidies on "new energy vehicles," which includes hybrids and fully electric cars. Another important driver is the broader slowdown in consumption. Auto spending is a discretionary consumer item and the slowdown coincides with the tougher conditions for households in China. The government is releasing piecemeal and measured

stimulus to help navigate the more challenging times, but it is certainly not alleviating the pain, a situation that will remain a theme into 2020.

Our baseline is for further monetary stimulus measures heading into 2020 to support those sectors adjusting to weak demand, as well as more restricted credit supply as shadow banking continues to consolidate. Further reserve requirement ratio cuts will also happen as we move into 2020, with private, smaller firms remaining the target.

Ratings Round-Up

# A Downgrade at Rolls Royce, but Its Outlook Lifts

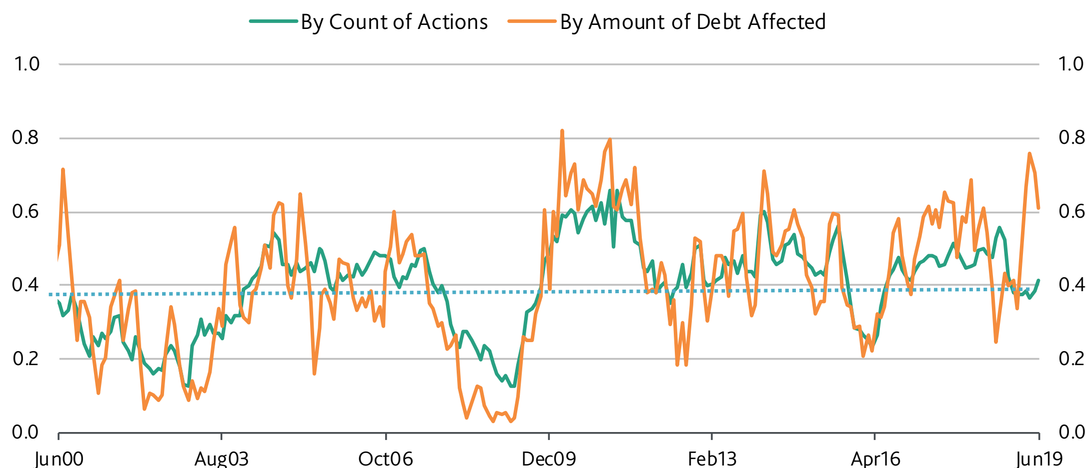
By Michael Ferlez

U.S. rating change activity weakened substantially last week, with upgrades accounting for only 21% of total activity, down from 50% in the prior period. Breaking with recent trends, upgrades were limited to smaller firms that accounted for none of the $38 billion of affected debt. Last week's downgrades were headlined by United Parcel Service Inc., which saw its senior unsecured credit rating cut to A2 from A1. The downgrade reflects Moody's Investors Service view that UPS will be unable to generate sufficient cash to strengthen its balance sheet while the firm undertakes a period of capital-intensive investments and necessary pension funding. In total, the downgrade affected $19 billion in debt. Despite last week's relatively poor performance, rating change activity is not raising any red flags for broader U.S. economy.

European rating activity remained light, with only two changes, both downgrades. The most notable was the downgrade to U.K. manufacturer Rolls-Royce PLC. The company saw its senior unsecured credit rating downgraded from A3 to Baa1, while the outlook was changed from negative to stable. The downgrade of the firm's senior unsecured notes reflects high Moody's-adjusted leverage and low free cash flow generation, as well as the expectation that 2019 and potentially 2020 free cash flow gains will include working capital gains that are not considered sustainable. On the positive-side, the rating also reflects the firm's improving performance, expected aftermarket earnings growth, and the long-run stability of its engine program.

FIGURE 1

**Rating Changes - US Corporate & Financial Institutions: Favorable as % of Total Actions**




* Trailing 3-month average

*Source: Moody's*

FIGURE 2

## Rating Key

| | | | |
|---|---|---|---|
| BCF | Bank Credit Facility Rating | MM | Money-Market |
| CFR | Corporate Family Rating | MTN | MTN Program Rating |
| CP | Commercial Paper Rating | Notes | Notes |
| FSR | Bank Financial Strength Rating | PDR | Probability of Default Rating |
| IFS | Insurance Financial Strength Rating | PS | Preferred Stock Rating |
| IR | Issuer Rating | SGLR | Speculative-Grade Liquidity Rating |
| JrSub | Junior Subordinated Rating | SLTD | Short- and Long-Term Deposit Rating |
| LGD | Loss Given Default Rating | SrSec | Senior Secured Rating |
| LTCF | Long-Term Corporate Family Rating | SrUnsec | Senior Unsecured Rating |
| LTD | Long-Term Deposit Rating | SrSub | Senior Subordinated |
| LTIR | Long-Term Issuer Rating | STD | Short-Term Deposit Rating |

## Ratings Round-Up

FIGURE 3

### Rating Changes: Corporate & Financial Institutions – US

| Date | Company | Sector | Rating | Amount ($ Million) | Up/ Down | Old LTD Rating | New LTD Rating | IG/ SG |
|---|---|---|---|---|---|---|---|---|
| 8/7/19 | HALCON RESOURCES CORPORATION | Industrial | SrUnsec /LTCFR/PD | 625 | D | Caa3 | Ca | SG |
| 8/8/19 | TURNING POINT BRANDS, INC. | Industrial | SrSec/BCF | | U | B1 | Ba3 | SG |
| 8/8/19 | NEP GROUP, INC-NEP/NCP HOLDCO, INC | Industrial | SrSec/BCF /LTCFR/PDR | | D | B1 | B2 | SG |
| 8/9/19 | UNITED PARCEL SERVICE, INC. | Industrial | SrUnsec | 19,441 | D | A1 | A2 | IG |
| 8/9/19 | LOUISVILLE & JEFFERSON CNTY, REGNL. ARPT. AUTH., K | Industrial | LTD | | D | A1 | A2 | IG |
| 8/9/19 | JACK COOPER ENTERPRISES, INC. -JACK COOPER VENTURES, INC. | Industrial | SrSec/BCF/LTCFR /PDR | | D | B3 | Ca | SG |
| 8/9/19 | DIPLOMAT PHARMACY, INC. | Industrial | SrSec/BCF /LTCFR/PDR | | D | B2 | B3 | SG |
| 8/9/19 | DYNATRACE INTERMEDIATE, LLC | Industrial | LTCFR/PDR | | U | B2 | B1 | SG |
| 8/12/19 | FRONTIER COMMUNICATIONS CORPORATION | Utility | SrSec/SrUnsec /BCF/LTCFR/PDR | 13,472 | D | B2 | B3 | SG |
| 8/12/19 | BASIC ENERGY SERVICES, INC. | Industrial | SrSec/LTCFR/PDR | 300 | D | B3 | Caa2 | SG |
| 8/12/19 | CROSSMARK HOLDINGS, INC. | Industrial | PDR | | D | C | D | SG |
| 8/12/19 | SANCHEZ ENERGY CORPORATION | Industrial | SrSec/SrUnsec /LTCFR/PDR | 4,000 | D | B2 | Caa1 | SG |
| 8/13/19 | OPPENHEIMER HOLDINGS, INC. | Financial | LTCFR | | U | B2 | B1 | SG |
| 8/13/19 | KKBS GROUP HOLDINGS LLC-KELLERMEYER BERGENSONS SERVICES, LLC | Industrial | SrSec/BCF /LTCFR/PDR | | D | B2 | B3 | SG |

*Source: Moody's*

FIGURE 4

### Rating Changes: Corporate & Financial Institutions – Europe

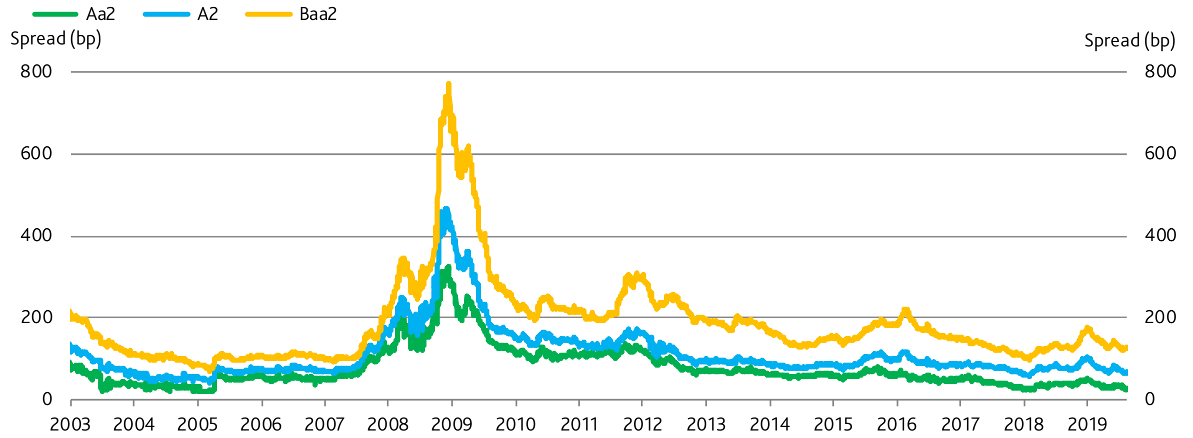
| Date | Company | Sector | Rating | Amount ($ Million) | Up/ Down | Old LTD Rating | New LTD Rating | IG/ SG | Country |
|---|---|---|---|---|---|---|---|---|---|
| 8/7/19 | DKT HOLDINGS APS | Utility | SrSec/SrUnsec /BCF/LTCFR /PDR/MTN | 2,660 | D | B3 | Caa1 | SG | DENMARK |
| 8/13/19 | ROLLS-ROYCE HOLDINGS PLC-ROLLS-ROYCE PLC | Industrial | SrUnsec | 4,025 | D | A3 | Baa1 | IG | UNITED KINGDOM |

*Source: Moody's*

# Market Data

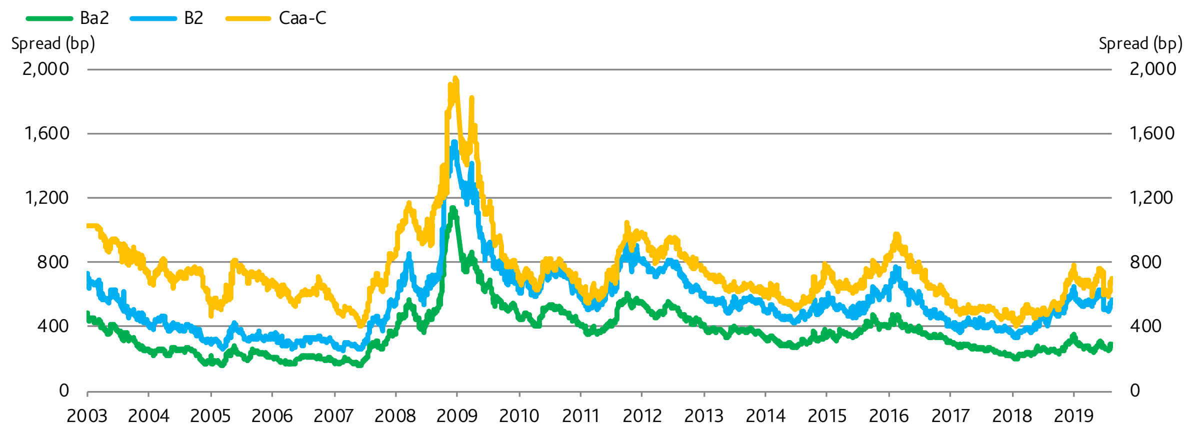
## Spreads

Figure 1: 5-Year Median Spreads-Global Data (High Grade)




*Source: Moody's*

Figure 2: 5-Year Median Spreads-Global Data (High Yield)




*Source: Moody's*

## Market Data

# CDS Movers

**Figure 3. CDS Movers - US (August 7, 2019 – August 14, 2019)**

| CDS Implied Rating Rises | CDS Implied Ratings | | |
|---|---|---|---|
| Issuer | Aug. 14 | Aug. 7 | Senior Ratings |
| Ashland LLC | A2 | Baa2 | Ba3 |
| Walmart Inc. | Aa1 | Aa2 | Aa2 |
| Walt Disney Company (The) (Old) | Aaa | Aa1 | A2 |
| Burlington Northern Santa Fe, LLC | Aa1 | Aa2 | A3 |
| Cisco Systems, Inc. | Aaa | Aa1 | A1 |
| Southern Company (The) | A2 | A3 | Baa2 |
| Norfolk Southern Corporation | Aa1 | Aa2 | Baa1 |
| Northrop Grumman Corporation | Aa1 | Aa2 | Baa2 |
| Tyson Foods, Inc. | A1 | A2 | Baa2 |
| CBS Corporation | Baa2 | Baa3 | Baa2 |

| CDS Implied Rating Declines | CDS Implied Ratings | | |
|---|---|---|---|
| Issuer | Aug. 14 | Aug. 7 | Senior Ratings |
| YRC Worldwide Inc. | Caa3 | Caa1 | Caa1 |
| Computer Sciences Corporation | Ba3 | Ba1 | Baa2 |
| Citigroup Inc. | Baa2 | Baa1 | A3 |
| Ford Motor Company | B1 | Ba3 | Baa3 |
| Occidental Petroleum Corporation | Ba1 | Baa3 | Baa3 |
| Kraft Heinz Foods Company | Ba1 | Baa3 | Baa3 |
| Bank of America, N.A. | A3 | A2 | Aa2 |
| FedEx Corporation | Baa3 | Baa2 | Baa2 |
| CCO Holdings, LLC | Ba2 | Ba1 | B1 |
| Dish DBS Corporation | Caa1 | B3 | B1 |

| CDS Spread Increases | | CDS Spreads | | |
|---|---|---|---|---|
| Issuer | Senior Ratings | Aug. 14 | Aug. 7 | Spread Diff |
| Frontier Communications Corporation | Caa3 | 6,268 | 5,173 | 1,095 |
| Dean Foods Company | Caa2 | 4,448 | 3,687 | 761 |
| Neiman Marcus Group LTD LLC | Ca | 4,954 | 4,391 | 563 |
| Penney (J.C.) Corporation, Inc. | Caa3 | 6,717 | 6,334 | 383 |
| Rite Aid Corporation | Caa2 | 1,870 | 1,718 | 152 |
| Mattel, Inc. | B3 | 410 | 276 | 134 |
| McClatchy Company (The) | Caa2 | 1,546 | 1,414 | 132 |
| Pitney Bowes Inc. | Ba2 | 701 | 605 | 96 |
| Unisys Corporation | B2 | 418 | 327 | 91 |
| Nabors Industries Inc. | B1 | 763 | 707 | 55 |

| CDS Spread Decreases | | CDS Spreads | | |
|---|---|---|---|---|
| Issuer | Senior Ratings | Aug. 14 | Aug. 7 | Spread Diff |
| Realogy Group LLC | B2 | 881 | 1,010 | -129 |
| Office Depot, Inc. | B3 | 503 | 562 | -59 |
| Talen Energy Supply, LLC | B3 | 864 | 906 | -42 |
| EOG Resources, Inc. | A3 | 66 | 91 | -24 |
| Ashland LLC | Ba3 | 47 | 71 | -23 |
| TEGNA Inc. | Ba2 | 134 | 156 | -22 |
| PolyOne Corporation | Ba3 | 77 | 99 | -22 |
| Avon Products, Inc. | B3 | 362 | 384 | -22 |
| United States Steel Corporation | B2 | 606 | 626 | -21 |
| Embarq Corporation | Ba2 | 270 | 291 | -21 |

*Source: Moody's, CMA*

## Market Data

**Figure 4. CDS Movers - Europe (August 7, 2019 – August 14, 2019)**

| CDS Implied Rating Rises | CDS Implied Ratings | | |
|---|---|---|---|
| Issuer | Aug. 14 | Aug. 7 | Senior Ratings |
| Bankinter, S.A. | A3 | Baa2 | Baa1 |
| Bankia, S.A. | Baa2 | Baa3 | Baa3 |
| Nordea Bank Abp | Aa1 | Aa2 | Aa3 |
| Deutsche Telekom AG | Aa2 | Aa3 | Baa1 |
| Anheuser-Busch InBev SA/NV | A1 | A2 | Baa1 |
| ENGIE SA | Aa1 | Aa2 | A3 |
| Veolia Environnement S.A. | Aa2 | Aa3 | Baa1 |
| Telia Company AB | Aa2 | Aa3 | Baa1 |
| Bayer AG | Baa2 | Baa3 | Baa1 |
| Deutsche Post AG | Aa1 | Aa2 | A3 |

| CDS Implied Rating Declines | CDS Implied Ratings | | |
|---|---|---|---|
| Issuer | Aug. 14 | Aug. 7 | Senior Ratings |
| Casino Guichard-Perrachon SA | Ca | Caa2 | B1 |
| Matalan Finance plc | Caa3 | Caa1 | Caa1 |
| Italy, Government of | B1 | Ba3 | Baa3 |
| Societe Generale | Aa3 | Aa2 | A1 |
| Barclays PLC | Ba1 | Baa3 | Baa3 |
| Lloyds Bank plc | A3 | A2 | Aa3 |
| Portugal, Government of | A2 | A1 | Baa3 |
| Banco Bilbao Vizcaya Argentaria, S.A. | A3 | A2 | A3 |
| Intesa Sanpaolo S.p.A. | Ba2 | Ba1 | Baa1 |
| HSBC Holdings plc | Baa2 | Baa1 | A2 |

| CDS Spread Increases | | CDS Spreads | | |
|---|---|---|---|---|
| Issuer | Senior Ratings | Aug. 14 | Aug. 7 | Spread Diff |
| PizzaExpress Financing 1 plc | Caa2 | 6,709 | 6,335 | 373 |
| Boparan Finance plc | Caa1 | 4,338 | 4,036 | 301 |
| Novafives S.A.S. | Caa1 | 648 | 559 | 89 |
| CMA CGM S.A. | B3 | 1,467 | 1,418 | 48 |
| Stena AB | B3 | 617 | 579 | 38 |
| Italy, Government of | Baa3 | 207 | 175 | 32 |
| UniCredit S.p.A. | Baa1 | 130 | 105 | 25 |
| Jaguar Land Rover Automotive Plc | B1 | 698 | 673 | 25 |
| Intesa Sanpaolo S.p.A. | Baa1 | 133 | 109 | 24 |
| Matalan Finance plc | Caa1 | 900 | 877 | 23 |

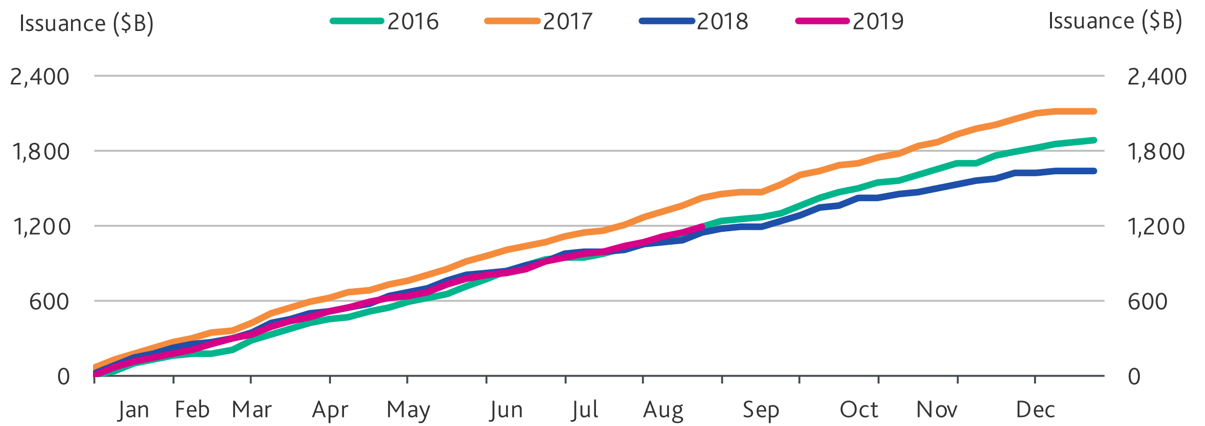
| CDS Spread Decreases | | CDS Spreads | | |
|---|---|---|---|---|
| Issuer | Senior Ratings | Aug. 14 | Aug. 7 | Spread Diff |
| Eksportfinans ASA | Baa1 | 489 | 506 | -16 |
| Eurobank Ergasias S.A. | Caa1 | 765 | 779 | -14 |
| Altice Finco S.A. | Caa1 | 300 | 315 | -14 |
| National Bank of Greece S.A. | Caa1 | 592 | 603 | -11 |
| TUI AG | Ba2 | 375 | 386 | -11 |
| Bankinter, S.A. | Baa1 | 53 | 63 | -10 |
| Permanent tsb p.l.c. | Baa3 | 205 | 214 | -9 |
| EWE AG | Baa1 | 104 | 112 | -8 |
| Bayer AG | Baa1 | 74 | 80 | -7 |
| Bankia, S.A. | Baa3 | 72 | 78 | -6 |

*Source: Moody's, CMA*

## Market Data

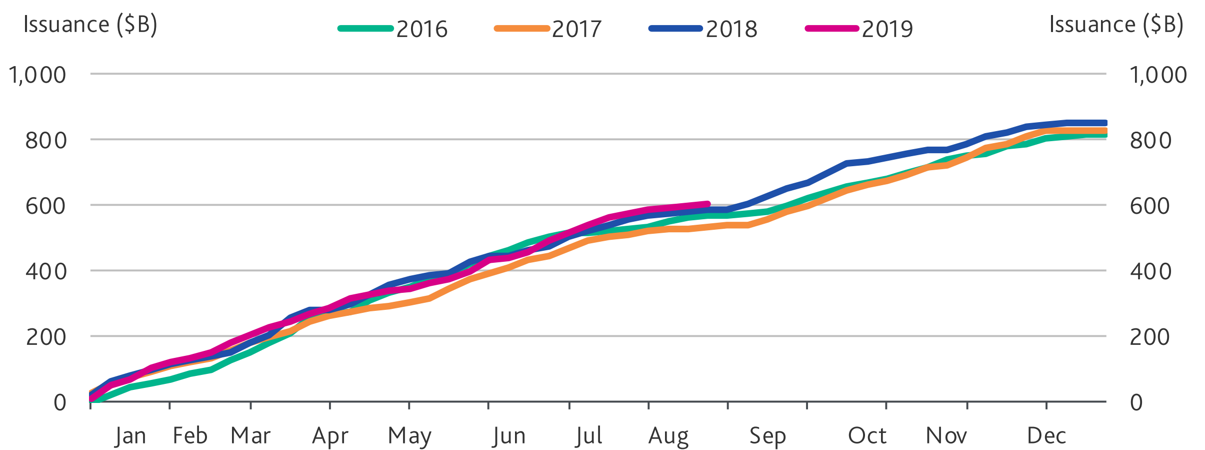
# Issuance

### Figure 5. Market Cumulative Issuance - Corporate & Financial Institutions: USD Denominated




*Source: Moody's / Dealogic*

### Figure 6. Market Cumulative Issuance - Corporate & Financial Institutions: Euro Denominated




*Source: Moody's / Dealogic*

## Market Data

### Figure 7. Issuance: Corporate & Financial Institutions

| | USD Denominated | | |
|---|---|---|---|
| | Investment-Grade | High-Yield | Total* |
| | Amount $B | Amount $B | Amount $B |
| Weekly | 37.583 | 2.450 | 42.684 |
| Year-to-Date | 864.868 | 260.529 | 1,191.632 |

| | Euro Denominated | | |
|---|---|---|---|
| | Investment-Grade | High-Yield | Total* |
| | Amount $B | Amount $B | Amount $B |
| Weekly | 0.560 | 0.739 | 1.300 |
| Year-to-Date | 525.801 | 56.942 | 602.390 |

* Difference represents issuance with pending ratings.

*Source: Moody's/ Dealogic*

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