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WEEKLY
MARKET OUTLOOK

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# Medium-Grade's Worry Differs from High-Yield's Complacency

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

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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: Despite a benign default outlook, December's high-yield corporate bond issuance has been practically nonexistent.

| | |
|---|---|
| Credit Spreads | Investment Grade: We see year-end 2018's average investment grade bond spread somewhat thinner than its recent 137 bp. High Yield: Compared to a recent 460 bp, the high-yield spread may approximate 470 bp by year-end 2018. |
| Defaults | US HY default rate: Moody's Default and Ratings Analytics team forecasts that the U.S.' trailing 12-month high-yield default rate will dip from November 2018's 2.9% to 2.6% by November 2019. |
| Issuance | In 2017, US$-denominated IG bond issuance grew by 6.8% to a record $1.508 trillion, while US$-priced high-yield bond issuance advanced by 33.0% to a new record calendar-year high of $453 billion. For 2018's US$-denominated corporate bonds, IG bond issuance may drop by 14.2% to $1.294 trillion, while high-yield bond issuance is likely to plummet by 37.6% to $283 billion for high-yield bond issuance's worst calendar year since 2011's 274 billion. |

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Links to commentaries on: Growth and leverage, buybacks, volatility, defaults, Fed policy, yields, profits, corporate borrowing, U.S. investors, eerie similarities, base metals prices, debt to EBITDA, trade war, Investment grades, higher rates, credit quality, foreign investors.

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# Credit Markets Review and Outlook

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

## Medium-Grade's Worry Differs from High-Yield's Complacency

The investment-grade bond market appears more anxious about the future than the high-yield bond market. A now well above-trend Baa industrial company bond yield spread warns of a wider high-yield bond spread. To the contrary, a trend-like high-yield spread favors a thinner Baa spread. In all likelihood, if the still positive outlook for profits holds, the high-yield bond spread will prove to be more prescient than the now swollen Baa spread.

Moody's recent long-term Baa industrial company bond yield spread of 220 basis points was well above its 174 bp median since late 1987. More specifically, the long-term Baa industrial spread's December-to-date average of 221 bp was wider than 81% of its month-long averages since October 1987.

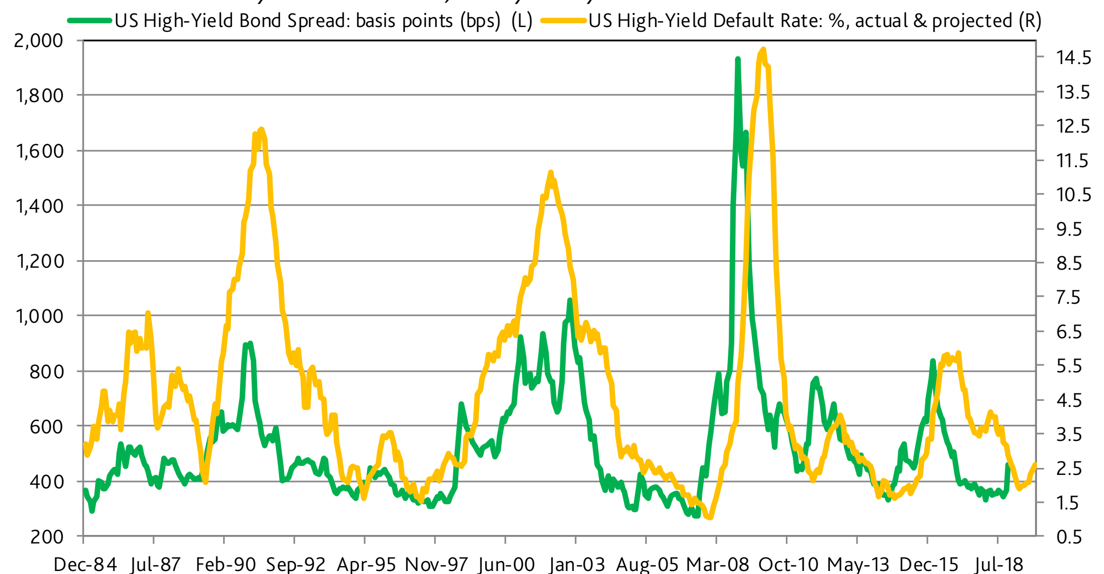
The historical correlation between the long-term Baa industrial company bond yield spread and a composite high-yield bond spread is a very strong 0.92. When the Baa industrial spread was previously between 210 bp and 230 bp, the high-yield bond spread averaged 669 bp, which was much wider than its recent 469 bp.

Unlike the relatively wide Baa industrial spread, the latest high-yield bond spread matches its long-term median of 469 bp. The record shows that when the high-yield spread's month-long average was between 450 bp and 480 bp, the long-term Baa industrial spread averaged 165 bp.

### Baa-Grade Frets More about Defaults than Does High-Yield

The yield spreads of high-yield and medium-grade corporate bonds are at odds regarding the outlook for U.S. corporate credit quality. Both spreads have historically performed well at predicting the high-yield default rate nine months ahead. The latest projections for September 2019's default rate are 3.7% according to the high-yield bond spread and 4.9% according to the long-term Baa industrial company bond yield spread.

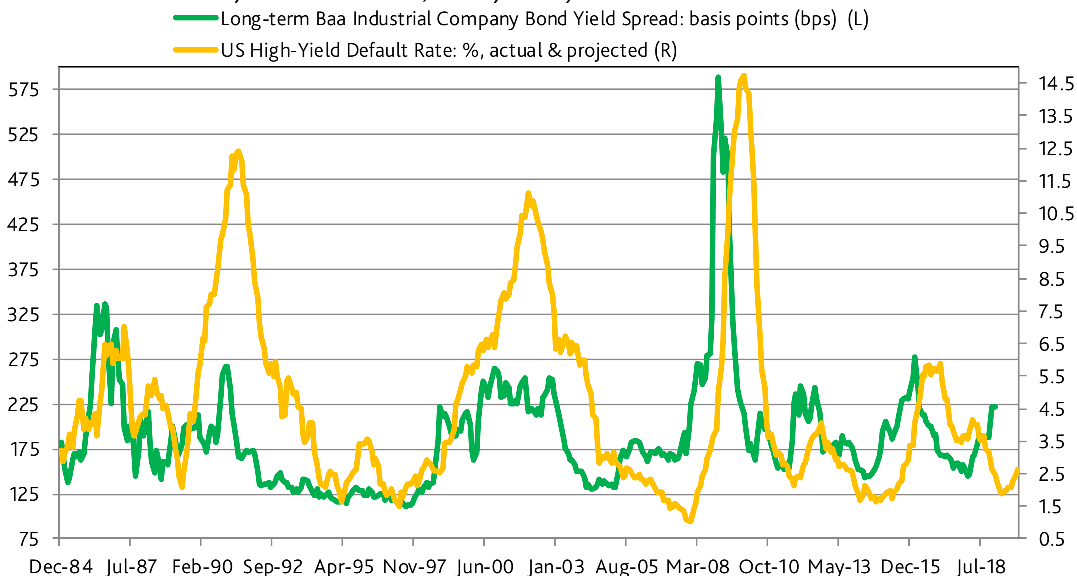
**Figure 1: Recent High-Yield Bond Spread Predicts a 3.7% Midpoint for September 2019's High-Yield Default Rate**
*sources: Moody's Investors Service, Moody's Analytics*




A projected climb by the default rate from November 2018's 2.9% to 4.9% by September 2019 implicitly forecasts flat-to-lower core pretax profits on a year-to-year basis by mid-2019.

Credit Markets Review and Outlook

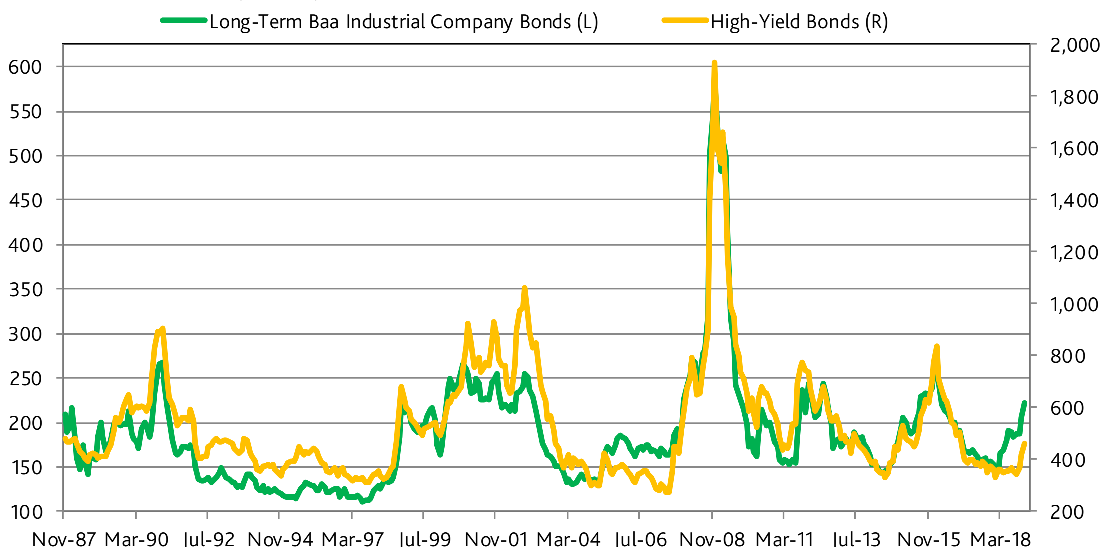
**Figure 2: Well Above-Average Long-Term Baa Industrial Company Bond Yield Spread Warns of a 4.9% Default Rate by September 2019**
*sources: Moody's Investors Service, Moody's Analytics*




## Baa Last Questioned High-Yield's Optimism in 2007

A close inspection of Figure 3 shows just how atypically wide today's Baa industrial bond spread is relative to the high-yield bond spread. The Baa spread was last noticeably wide vis-a-vis the high-yield spread throughout most of 2007, or the span that preceded the Great Recession. January-July 2007's very thin 296 bp average for the high-yield bond spread grossly underestimated corporate credit's approaching upheaval. Although January-July 2007's average high-yield bond spread was far under its long-term median of 469 bp, the average 166 bp spread of the long-term Baa industrials was close to its long-term median of 174 bp.

**Figure 3: Below-Trend High-Yield Bond Spread May Be Unsustainably Thin Compared to an Above-Trend Baa Industrial Bond Spread**
*in basis points (bps)*
*source: Moody's Analytics*



### Record Suggests Ba1 Yields Will Rise Vis-a-vis Baa3 Yields

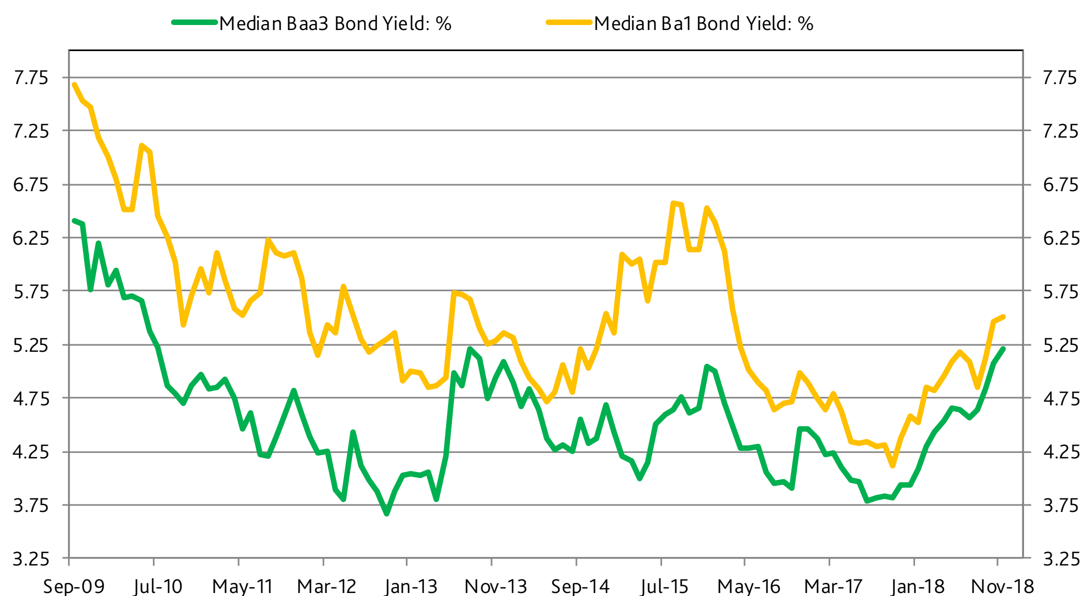
At the end of November, the yield spread over U.S. Treasuries for each of the 10 investment-grade notches exceeded its respective median spread of the past 28 years, where the median of the 10 differences between November 2018's spread and its 28-year median equaled +16 basis points.

By contrast, for U.S. high-yield bond ratings only November 2018's B1 category showed a spread in excess of its long-term median. The median difference between November 2018's high-yield spreads and their respective long-term medians was -22 bp.

The bottom rung of the investment-grade ratings ladder, or Baa3, revealed an end of November yield spread that was atypically close to the accompanying Ba1, Ba2, and Ba3 high-yield spreads. The long-term median difference between the yield spreads over Treasuries of Baa3- and Ba1-grade bonds is -68 bp. However, in November, that difference was a narrower -31 bp. Similarly, November's -71 bp gap between the Baa3 and Ba2 spreads was narrower than its long-term median difference of -107 bp, while November's -98 bp gap between the Baa3 and Ba3 spreads was tighter than its long-term median of -152 bp.

As of the end of November, the median 5.52% Ba1 corporate bond yield was only 31 bp above the 5.21% median Baa3 bond yield. Over time, the Ba1 yield averages 86 bp more than the Baa3 yield. Thus, over the next six months, the Ba1 yield is expected to rise relative to the Baa3 yield.

**Figure 4: Ba1 Bond Yield Is Unsustainably Low vis-a-vis Baa3 Bond Yield**
*source: Moody's Analytics*




An issuer's bond-implied rating can differ from its actual credit rating depending on whether the bond's yield spread is either sufficiently narrower or wider than the range of the spread ordinarily associated with the credit rating. The bond-implied rating is said to be positive when the spread is thinner than the specified range and negative when the spread is wider than the specified range.

As of December 10, 2018, 42.0% of the bond-implied ratings of Baa1-rated issuers were negative (the actual rating was higher than the implied rating) and 28.7% were positive (the actual rating was less than the implied rating). However, for the Baa3 rating, 24.1% of the bond-implied ratings were negative and 38.3% were positive.

## Credit Markets Review and Outlook

**Figure 5: Positive Bond-Implied-Ratings Now Outnumber Negative Bond-Implied-Ratings at the Baa and Ba Rating Categories**

| | Number of US Issuers Having Bond-Implied-Ratings | Negative Bond-Implied-Rating: number of US Issuers whose bond-implied-rating is less than actual rating | Negative Bond-Implied-Ratings as % of Bond-Implied-Ratings | Number of Negative Bond-Implied-Ratings that are High-Yield | Positive Bond-Implied-Rating: number of US Issuers whose bond-implied-rating exceeds actual rating | Positive Bond-Implied-Ratings as % of Bond-Implied-Ratings | Number of Positive Bond-Implied-Ratings that are Investment-Grade |
|---|---|---|---|---|---|---|---|
| | *1* | *2* | *3 = 2/1* | 4 | 5 | 6 = 5/1 | 7 |
| *Rating category:* | | | | | | | |
| **Baa1** | 150 | 63 | 42.0% | 4 | 43 | 28.7% | n/a |
| **Baa2** | 195 | 52 | 26.7% | 12 | 62 | 31.8% | n/a |
| **Baa3** | 162 | 39 | 24.1% | 39 | 62 | 38.3% | n/a |
| **Total Baa** | 507 | 154 | 30.4% | 55 | 167 | 32.9% | |
| **Ba1** | 59 | 22 | 37.3% | n/a | 17 | 28.8% | 17 |
| **Ba2** | 60 | 21 | 35.0% | n/a | 19 | 31.7% | 2 |
| **Ba3** | 81 | 10 | 12.3% | n/a | 49 | 60.5% | 0 |
| **Total Ba** | 200 | 53 | 26.5% | | 85 | 42.5% | 19 |

All negative bond-implied ratings for Baa3-rated issuers necessarily equates to a below-investment-grade rating. Nevertheless, by no means does this imply that all Baa3-rated issuers having a negative bond-implied rating will eventually incur a "fallen-angel" downgrade from investment- to speculative-grade. Nothing more than improved market sentiment can remove a negative bond-implied rating.

The share of issuers graded Baa2 having a speculative-grade bond-implied rating drops to 6.2%, while the share of Baa1-rated issuers having a high-yield bond-implied rating is an even lower 2.7%. For all Baa-rated U.S. issuers, 10.8% had a bond-implied rating of less than investment grade.

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

THE U.S.
By Ryan Sweet, Moody's Analytics

## Don't Hold Your Breath for U.S. Inflation

There appears to be nothing in the November U.S. consumer price index that would dissuade the Federal Reserve from raising interest rates next week. We are keeping our subjective odds of a rate hike at 90%, but inflation will be key in determining the path of interest rates next year. The CPI was unchanged in November, in line with our forecast and the consensus. Energy was a drag, falling 2.2%, but the Fed normally views swings in these prices as transitory. Food prices increased 0.2% in November after being little changed in the prior two months. Excluding food and energy, the CPI rose 0.2%. On a year-ago basis, the headline and core CPI were each up 2.2%. Overall, inflation is hovering around the Fed's target, but some headwinds are developing.

Inflation is about to get interesting over the next few months. Lower energy prices will remain a drag on the headline CPI and bleed into core prices via lower transportation prices. Also, past appreciation in the U.S. dollar and weaker growth in Chinese producer prices will weigh on core goods prices. Inflation expectations have also drifted lower to the bottom end of the range the Fed would consider to be consistent with price stability.

It would take a noticeable decline in inflation expectations to bleed into realized core inflation, and our past work has shown that food prices and energy prices are important in consumers' inflation expectations. Next, we wanted to gauge how much inflation expectations matter for realized inflation.

Therefore, we updated our past work that modeled year-over-year growth in the core CPI on inflation expectations, the unemployment rate gap, and oil. We used the University of Michigan's long-term inflation expectations measure. Though inflation expectations are currently below their recent peak, that reduces year-over-year growth in the core CPI by only 0.13 percentage point. This isn't much but could become more important; it's a close call as to whether the Fed should raise rates.

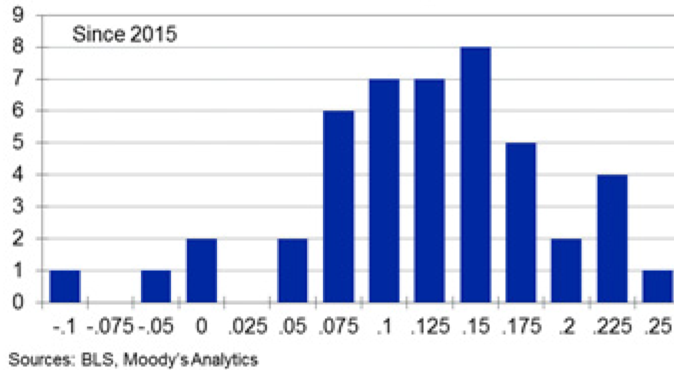
Turning back to November, with the PPI and CPI we have a pretty good idea of what the core personal consumption expenditure deflator did. The PPI is most important regarding medical care pricing in the core PCE deflator, which accounts for 20% of the core index, and close to 85% of the medical care index is derived from PPI inputs. We look for the core PCE deflator to have risen 0.16% in November, barely raising year-over-year growth from 1.8% to 1.9%.

Though we expect a tighter labor market to put upward pressure on inflation, odds are rising that U.S. core inflation will likely fall short of our forecast next year. The recent slide in global oil prices will bleed into core inflation via lower transportation costs. Also, the potential boost from higher U.S. tariffs on imported Chinese goods will likely be postponed until after the 90-day negotiation window has closed.

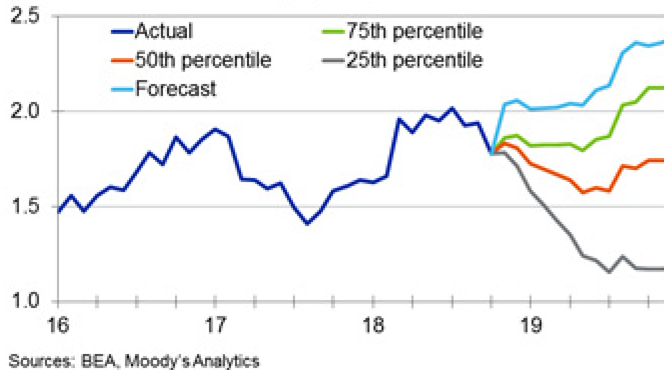
In addition, there is a possibility that the U.S. won't follow through with the threatened higher tariffs on China, which would have added 0.1 percentage point to year-over-year growth in the core PCE deflator. Therefore, it will likely take time before growth in core inflation returns to the Federal Reserve's 2% objective, which may give the central bank reason to pause this tightening sometime next year.

The core PCE deflator was up 1.8% on a year-ago basis in October. There are a few ways to look at inflation, including the level and the first and the second derivatives. The first derivative is the rate of change in the level of the PCE deflator, showing whether it has risen on a year-ago basis. The second derivative tells us whether growth is accelerating or decelerating.

In October, year-over-year growth in the core PCE deflator was up 0.2 percentage point compared with the same time in 2017. Therefore, inflation is still accelerating. Yet this appears set to change, and the bar for inflation returning to 2% is fairly high.




We looked at the distribution of monthly changes in the core PCE deflator over the past three years and applied assumed paths based on constant monthly changes. If we assume that the core PCE deflator increases by 0.175% per month, which is stronger than 75% of the monthly changes since 2015, year-over-year growth won't hit 2% until next August. A constant 0.144% monthly gain, which is stronger than 50% of the changes since 2015, would keep year-over-year growth below 2% throughout 2019.




Our current forecast is for the core PCE deflator to be up 2.4% on a year-ago basis in December 2019. To achieve this, it would require a constant monthly change in the core PCE deflator of 0.198%, which is stronger than 84% of the changes since 2015.

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

EUROPE

By Barbara Teixeira Araujo of Moody's Analytics in Prague

## Will Teresa May Win Enough Support to Pass the Brexit Deal?

While the Brexit chaos should continue to dominate the headlines, we don't think that the vote by Parliament on the withdrawal deal will take place before Christmas, meaning that the uncertainty will be carried over into the new year. We expect the vote to take place during the second or third week of January, after parliament returns from its Christmas recess on January 7. It is still uncertain if the prime minister will manage to gather enough support to see her deal passed by MPs, but our view is that Wednesday's victory on the no confidence vote strengthened somewhat her position.

Elsewhere in the U.K., the Bank of England will meet to decide on its monetary stance on Thursday. While we do think that the strong upturn in wage growth observed over the past couple of months warrants a move by the Monetary Policy Committee, we don't expect that bank Governor Mark Carney and his peers will want to hit the economy with another rate hike amid the current Brexit turmoil. We thus remain of the view that the MPC will want to wait until the risks of a no-deal Brexit have disappeared before moving again. If parliament comfortably passes the withdrawal deal in January, the bank could hike rates as soon as March, but for us a more likely date is May 2019.

The fact that inflation pressures in the U.K. are now fading and should continue to edge sharply down in 2019 give the MPC enough manoeuvre room to keep a strategy of wait-and-see. Accordingly, we expect that the country's headline CPI edged lower to 2.3% in November, from 2.4% in October, as base effects in oil prices should have finally kicked in and started pushing energy inflation down. This trend should continue in coming months, especially because the price of the Brent barrel has fallen sharply since the start of October. Elsewhere, our view remains that the direction of travel in the core rate is to the downside, as retailers have already finished passing higher import prices from the lower sterling to consumers. True, a one-off jump in tobacco inflation, due to the fact that the budget this year was one month earlier than in 2017, represents some upside risk for November, but even if it is the case, this upward effect should disappear from the headline in December. What's more, even if we expect that electricity inflation will continue to edge upward in November and December, that Ofgem will introduce a cap in Standard Variable Tariffs on January 1 means that electricity's contribution to inflation will fall sharply at the turn of the year.

True, growth figures for the third quarter have been extremely upbeat, which in turn should favor a more hawkish move from the bank. We do expect that final GDP figures released next Friday will confirm that the economy grew by 0.6% q/q in the three months to September, up from 0.4% in the second quarter and higher than the euro zone's average of 0.2%. But third quarter growth was boosted by temporary factors; the figures for the fourth stanza have been much less optimistic, pointing to a slowdown to 0.2% to 0.3% q/q in the three months to December.

Across the Channel, all eyes will be on the release of the euro zone's final CPI estimate for November. We expect it to conform to expectations and show that inflation pressures in the currency area eased sharply at the middle of the fourth quarter, to 2% y/y, from 2.2% previously. A decline in energy inflation is expected to have acted as the main drag on the back of base effects in oil prices, but food inflation is also set to have declined to a level much below its trend, mainly due to a plunge in dairy prices. The core rate meanwhile should have eased to 1%, from 1.1%, on the back of volatility in package holidays inflation, which is expected to have depressed services. Core goods inflation, by contrast, likely held steady. We expect energy inflation will cool in coming months, but we continue to see the direction of travel in the core rate as being to the upside.

| | Key indicators | Units | Moody's Analytics | Last |
|---|---|---|---|---|
| Mon @ 10:00 a.m. | Euro Zone: External Trade for October | bil euro | 10.0 | 13.1 |
| Mon @ 10:00 a.m. | Euro Zone: Consumer Price Index for November | % change yr ago | 2.0 | 2.2 |
| Mon @ 2:00 p.m. | Russia: Industrial Production for November | % change yr ago | 2.8 | 3.7 |
| Wed @ 9:30 a.m. | U.K.: Consumer Price Index for November | % change yr ago | 2.3 | 2.4 |
| Wed @ 2:00 p.m. | Russia: Unemployment for November | % | 4.7 | 4.7 |
| Wed @ 2:00 p.m. | Russia: Retail Sales for November | % change yr ago | 1.9 | 1.9 |
| Thur @ 9:30 a.m. | U.K.: Retail Sales for November | % change yr ago | 1.7 | 2.2 |
| Thur @ 12:00 p.m. | U.K.: Monetary Policy and Minutes for December | % | 0.8 | 0.8 |
| Fri @ 7:45 a.m. | France: Household Consumption Survey for November | % change | 0.0 | 0.8 |
| Fri @ 7:45 a.m. | France: GDP for Q3 | % change | 0.4 | 0.2 |
| Fri @ 9:30 a.m. | U.K.: GDP for Q3 | % change | 0.6 | 0.6 |

## ASIA-PACIFIC

By Katrina Ell and the Asia-Pacific staff of Moody's Analytics in Sydney

# Japan Will Have a Trade Deficit for Fourth Straight Month

Asia's economic data calendar is a mixed bag. Adverse weather heavily influenced Japan's foreign sector in the third quarter. Exports rebounded across the board in October after a decline in September, following various natural disasters across Japan. We expect annual export growth hit 8% y/y in November, following October's 8.2% and September's 1.2% drop. The trade balance will remain in deficit for the fourth straight month. The deficit has occurred at the hand of commodity prices and various components of capital equipment such as aircraft, the latter of which tends to be volatile.

It will be a close call whether the Bank of Thailand moves on monetary policy at the December meeting. On balance we expect a 25-basis point hike to 1.75%, marking the first rate movement since April 2015. The lead-up to November's meeting was more interesting than usual with a consensus temporarily brewing that the central bank would deliver a 25-basis point hike. This quickly faded following disappointing foreign trade data for September, when exports surprisingly contracted in annual terms. Exports recovered in October. We expect gradual normalisation to commence from December, as the BoT is wary about the risks of leaving rates low for too long.

We expect the Bank of Japan to keep monetary policy settings on hold in December. The only notable changes at the October policy meeting were to inflation and GDP forecasts. The forecast for GDP in fiscal 2018 was revised down from 1.5% to 1.4%, while inflation was lowered to 0.9% from 1.1%. In fiscal 2019, GDP is unchanged at 0.8% but inflation was revised down to 1.4%, from 1.5% previously. This adds to confirmation that the Bank of Japan has lost faith that the 2% inflation target will be achieved in the medium term. The next big hurdle for the economy is the consumption tax hike in October 2019.

New Zealand's third quarter GDP print will be released. We expect GDP growth softened to 0.5% q/q, following the June quarter's 1%. The September quarter slowdown is partially a pullback from the strong June quarter, which enjoyed a lift from dairy production after poor weather in the first quarter. Agriculture had its strongest performance in the June quarter since mid-2014. Third quarter GDP growth is being supported by household consumption on the back of a relatively tight labour market, improved income growth, and fiscal stimulus, including the Families Package, a program to help low- and middle-income families. But slowing net migration will prove a greater drag in coming quarters, after it reached record levels in 2017. Annual GDP growth is expected to cool to 2.7%, after 2.8% in the June quarter.

## The Week Ahead

| | Key indicators | Units | Confidence | Risk | Moody's Analytics | Last |
|---|---|---|---|---|---|---|
| Mon @ 11:30 a.m. | Singapore Foreign trade for November | % change yr ago | 3 | ← | 6.6 | 8.3 |
| Mon @ 3:00 p.m. | Indonesia Foreign trade for November | US$ bil | 3 | ↓ | -0.96 | -1.82 |
| Wed @ 10:50 a.m. | Japan Foreign trade for November | ¥ bil | 2 | ↓ | -150.1 | -302.7 |
| Wed @ 6:05 p.m. | Thailand Monetary policy for December | % | 3 | ↓ | 1.75 | 1.5 |
| Thurs @ 8:45 a.m. | New Zealand GDP for Q3 | % change | 3 | ↑ | 0.5 | 1.0 |
| Thurs @ 11:30 a.m. | Australia Unemployment rate for November | % | 3 | ↑ | 5 | 5 |
| Thurs @ Unknown | Japan Monetary policy for December | ¥ tril | 5 | ← | 80 | 80 |
| Fri @ 10:30 a.m. | Japan Consumer price index for November | % change yr ago | 4 | ← | 0.9 | 1.0 |

# The Long View
## Despite a benign default outlook, December's high-yield corporate bond issuance has been practically nonexistent.

By John Lonski, Chief Economist, Moody's Capital Markets Research Group
December 13, 2018

### CREDIT SPREADS

As measured by Moody's long-term average corporate bond yield, the recent investment grade corporate bond yield spread of 137 basis points exceeded its 122-point mean of the two previous economic recoveries. This spread may be no wider than 130 basis points by year-end 2018.

The recent high-yield bond spread of 460 bp approximates what might be inferred from the spread's principal drivers, but is much thinner that what is suggested by the long-term Baa industrial company bond yield spread of 220 bp. The adverse implications for liquidity of possibly significantly higher interest rates merit consideration.

### DEFAULTS

November 2018's U.S. high-yield default rate of 2.9% was less than the 3.7% of November 2017. Moody's Default and Ratings Analytics team now expects the default rate will average 2.2% during 2019's third quarter.

### 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.

Third-quarter 2017's worldwide offerings of corporate bonds showed an annual percent decline of 1.6% for IG and an increase of 6.6% for high-yield, wherein US$-denominated offerings dipped by 0.7% for IG and grew by 4.3% for high yield.

Fourth-quarter 2017 revealed year-over-year advances for worldwide offerings of corporate bonds of 17.6% for IG and 77.5% for high-yield, wherein US$-denominated offerings posted increases of 21.0% for IG and 56.7% for high yield.

First-quarter 2018's worldwide offerings of corporate bonds incurred year-over-year setbacks of 6.3% for IG and 18.6% for high-yield, wherein US$-denominated offerings posted sank by 14.4% for IG and 20.8% for high yield.

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.

For yearlong 2016, worldwide corporate bond offerings rose by 2.3% annually for IG (to $2.402 trillion) and sank by 7.8% for high yield (to $426 billion). During yearlong 2017, worldwide corporate bond offerings increased by 4.0% annually (to $2.499 trillion) for IG and advance by 41.2% for high yield (to $602 billion). The projected annual changes for 2018's worldwide corporate bond offerings are -5.9% for IG and -36.3% for high yield.

### US ECONOMIC OUTLOOK

The consensus expects that the mid-point for the federal funds rate should finish 2018 at 2.375%. 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 3% 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.

## EUROPE

By Kristopher Cramer and Barbara Teixeira Araujo of Moody's Analytics
December 13, 2018

### UNITED KINGDOM

The U.K.'s effort to break up with the European Union is taking a toll on the economy and financial markets. Prime Minister Theresa May's survival Wednesday of a no-confidence vote by her party, which she won by 200 votes to 117, is a small victory, as she still needs to quickly persuade not only her own party but also those among the opposition to back the departure deal she has struck with Europe.

The Brexit negotiations are having a noticeable effect on the bond market as well as the economy. There is significant uncertainty about how the next several months will unfold, and a no-deal scenario is still a tangible possibility, especially since the March 29 deadline is quickly approaching. For now, the bond market appears to be betting on a deal being reached.

The yield curve flattened over the last two months as investors have sought the safety of longer-dated British yields. The term spread—the gap between the two- and 10-year yields—improved in the third quarter of 2018 as optimism improved on a deal. However, the spread fell nearly 10 basis points from October to November and the spread has fallen to around 50 basis points in recent days. This spread could fall even further if the market believes May will not have the votes for a deal and investors flock to the longer-term yields for safety.

Our baseline scenario is that May's plan is passed. U.K. equity markets would likely rally, as economic and policy uncertainty around Brexit would be removed. Our no-deal scenario would, by contrast, likely weigh heavily on equity prices, but the implications for the bond market are complicated. A reasonable assumption would be that if no deal is reached, stock prices drop, driving prices of 10-year U.K. gilts higher and yields bottoming out in March, leading to cumulative currency-hedged gains of around 10%, as investors reassess their outlook for growth and inflation.

But nothing has been straightforward with Brexit. The Bank of England has already noted that the policy response if no deal is reached is unclear; if the British pound depreciates significantly following the U.K. crashing out of the EU, that would boost import prices and put upward pressure on inflation. This could cause the BoE to raise interest rates.

This seems counterintuitive, as the working assumption by markets would be that a no-deal scenario dims the outlook for growth, which would lead the BoE to lower interest rates and restart quantitative easing. However, the BoE's mandate is price stability and maintaining confidence in the British pound. Therefore, to combat a depreciation in the pound following a no-deal scenario, the BoE might have to raise rates to curb future inflation and defend the currency.

As of now, the only certainty in the central bank's and the bond market's reaction to a no-deal scenario is uncertainty.

### ECB

The European Central Bank's December monetary policy minutes and press conference were in line with our and market expectations. The bank left policy rates unchanged but confirmed that quantitative easing purchases—going on since 2009—will halt at the end of this month. This removal of stimulus didn't read as overly hawkish; the central bank repeatedly stressed its commitment to reinvest proceeds of the maturing securities it purchased (which amount to a huge €2.6 trillion) for an extended period beyond the date when it will start raising interest rates.

ECB President Mario Draghi sounded dovish during his press conference, adding to our view that a rate hike next year (as priced-in by markets) is increasingly unlikely. The bank still assessed risks as being broadly balanced, but at the same it said that the balance of risks is now clearly moving to the downside, and that the disappointing

economic data this year is no longer being considered as a one-off. The ECB now believes there is a permanent component to this loss of pace.

Reflecting this, the bank revised down its growth forecasts for this year and next, as expected. They are now aligned to ours; the euro zone's GDP should grow by 1.9% this year and by 1.7% next year, though this is still considered above potential. As Draghi stressed, most of the growth disappointments this year were due to weakening external demand, which was due to the U.S.-China trade war and volatility in emerging markets, while domestic demand remained more resilient.

Draghi also revised down the ECB's headline and core inflation forecasts for next year, though the higher-than-expected increase in oil prices over the summer pushed it to revise 2018's forecasts slightly up. But core inflation is projected at 1.4% for next year, from 1% this year, still looks a bit optimistic; it is possible but not easy. The lower euro could give a boost to core goods prices, but the trend there still looks flat, and so does that for services inflation.

All in all, then, we haven't changed our story that the prospect of rate hikes next year remains slim. With Draghi set to leave by October 2019, he is unlikely to take action on interest rates before he leaves if he sticks to the ECB's guidance that rates will be unchanged through the summer of 2019. The bank will meet in September, making this a possible date for a move. But the soft growth and core inflation results are unlikely to support a hike by then. The ball should thus be in his successor's court.

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## ASIA PACIFIC

By Veasna Kong of Moody's Analytics
December 13, 2018

### AUSTRALIA

Australia's third-quarter GDP print showed the economy expanded at its slowest pace in two years, as weaker inventory building and investment as well as a slowdown in household consumption weighed on growth. The largest drag was inventories, which subtracted 0.3 percentage point from third-quarter GDP growth. The weaker inventory build partly reflects some pullback from a noticeable run-up of inventories in the three prior quarters, although dimmer business confidence might also have had an impact. Indeed, private business investment fell for the second consecutive quarter, driven by a decline in nondwelling construction activity. Dwelling construction also is coming off the boil with growth decelerating for the third consecutive quarter. Public investment, however, was robust, largely owing to a number of major infrastructure projects throughout the country.

On the surface, the large contribution of net exports to GDP growth was positive. In particular, it was pleasing to see decent growth in rural export volumes over the quarter, since it suggests that the impact of the prolonged drought may be easing. However, most of the surge in net exports was driven by a fall in consumption and capital goods imports, a sign of softness in domestic demand. However, the most worrying data to emerge from the third-quarter national accounts details was the slowdown in household consumption. Household spending made its weakest contribution to GDP growth since the fourth quarter of 2012. While nondiscretionary purchases such as insurance and other financial services, food, and transport services were strong, discretionary purchases fell, on net, over the quarter, suggesting consumers have become more cautious.

### Employment growth has slowed

In some ways the slowdown in household consumption is not that surprising. Although the labour market has been tightening for about two years, with the unemployment rate at multiyear lows, the pace of tightening has slowed over 2018. Overall employment growth has slowed toward 2%, from its 3.6% pace at the start of 2018. New South Wales has enjoyed the strongest trend employment growth in the past year, at 3.5% y/y, comfortably above the national average of 2.3%. This is followed by Victoria, where employment growth was 2.6%. These two states added the most full-time positions of all the states and territories over the past two years.

## The Long View

We have previously questioned the sustainability of the recent lift in household consumption, as income growth remains soft. Indeed, wages improved to 2.3% y/y in the third quarter but not materially improved from the record low 1.8% in mid-2017. Although wage growth looks to have passed its trough, with rising reports of skills shortages in some sectors, we expect only modest improvement in income growth into 2019. This partly reflects the underemployment rate—the number of employed who would like and are available for more hours of work than they have. That rate remains elevated at 8% and may creep up amid the slowed tightening of the labour market. This is worrying, as consumers face increasing headwinds from the now-entrenched slowing of the property market, alongside modest increases in mortgage interest rates, independent of the cash rate.

The housing market weakness is most acute in Sydney and Melbourne, which are also the two cities that experienced the largest run-up in values. House values in Sydney are approximately 8% below their peak in 2017, while those in Melbourne are down almost 5% from their peak. Perth and Darwin are also experiencing falling home values, while cities elsewhere, including Brisbane, Canberra and Hobart, are experiencing weaker home value growth. Ongoing weakness may begin to hurt consumer spending, as households—especially those that have purchased property recently in Sydney and Melbourne—become increasingly risk-averse. Already, household savings-to-disposable income is down at 2.6%, its lowest level since 2007. Absent a more significant rise in incomes, consumers might need to rely on more debt to sustain their spending, adding to an already elevated level of household debt.

Under the circumstances, it was not surprising that the Reserve Bank of Australia kept the cash rate at 1.5% at its December meeting this week. The RBA maintained an optimistic tone in its statement, expecting GDP growth to average 3.5% over the next two years, firmly above potential, which is estimated to be around 3%. We are less optimistic and expect that potential growth will be achieved, at best, over the medium term. Although we maintain that the RBA will not begin a mild interest rate hike cycle until mid-2020, should economic activity continue to soften, the case for interest rate hikes will also fade.

## Ratings Round-Up

# U.S. Downgrades Dominate for the Latest Week

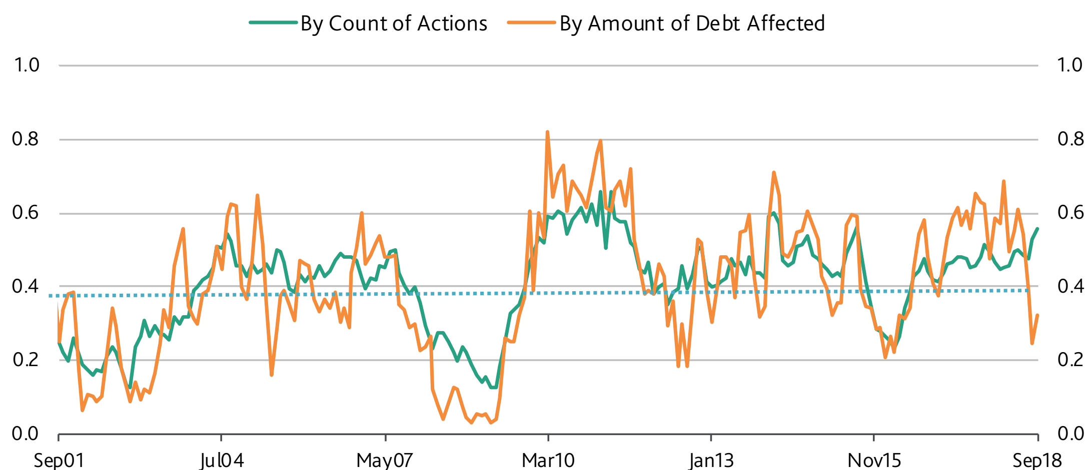
By Michael Ferlez

U.S. rating change activity weakened for the latest week, continuing a recent upward trend in downgrades. For the period ending December 11, positive rating changes accounted for 23% of total activity down from 40% in the prior week. Activity was concentrated to smaller firms, with only a total of $6.2 billion of affected debt. On the upgrade side, two mortgage services, Ocwen Financial Corporation and Freedom Mortgage Corporation received upgrades along with utility NRG Energy, INC. Downgrades were concentrated in the industrial sector and included USG Corporation, which was downgraded from Ba1 to Ba2.

In Europe, rating change activity was evenly split between upgrades and downgrades, though downgrades impacted a substantially higher amount of debt. Notable downgrade includes Anheuser-Busch INBEV SA/NV which had its senior unsecured debt rating cut from A3 to Baa1, impacting roughly $111 billion in debt. The downgrade reflecting the Moody's Investor Services expectation that Belgian brewer's leverage will remain high over the next few years. On the upgrade side, Bank of Ireland Group PLC was upgraded to A3 from Baa1.

FIGURE 1

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




* Trailing 3-month average

*Source: Moody's*

## Ratings Round-Up

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 |
|---|---|---|---|---|---|---|---|---|
| 12/6/18 | MACK-CALI REALTY CORPORATION | Financial | SrUnsec/Sub/PS | 575 | D | Ba1 | Ba2 | SG |
| 12/6/18 | NRG ENERGY, INC. | Utility | SrUnsec /LTCFR/PDR | 3,853 | U | B1 | Ba3 | SG |
| 12/6/18 | RGIS HOLDINGS, LLC (OLD) -RGIS SERVICES, LLC | Industrial | SrSec/BCF/LTCFR | | D | B3 | Caa1 | SG |
| 12/6/18 | FORM TECHNOLOGIES LLC | Industrial | SrSec/BCF /LTCFR/PDR | | D | B1 | B2 | SG |
| 12/7/18 | MIDAS INTERMEDIATE HOLDCO II, LLC | Industrial | SrUnsec/SrSec /BCF/LTCFR/PDR | 375 | D | Caa1 | Caa2 | SG |
| 12/7/18 | ROAD INFRASTRUCTURE INVESTMENT HOLDINGS, INC. | Industrial | SrSec/BCF /LTCFR/PDR | | D | B1 | B3 | SG |
| 12/7/18 | GULF FINANCE, LLC | Industrial | SrSec/BCF /LTCFR/PDR | | D | B3 | Caa2 | SG |
| 12/7/18 | LSF9 ATLANTIS HOLDINGS, LLC | Industrial | SrSec/BCF /LTCFR/PDR | | D | B1 | B2 | SG |
| 12/10/18 | USG CORPORATION | Industrial | SrUnsec /LTCFR/PDR | 850 | D | Ba1 | Ba2 | SG |
| 12/10/18 | CARESTREAM HEALTH, INC. | Industrial | SrSec/BCF | | D | Caa1 | Caa2 | SG |
| 12/11/18 | OXFORD FINANCE LLC | Financial | LTCFR | | U | Ba3 | Ba2 | SG |
| 12/11/18 | OCWEN FINANCIAL CORPORATION -OCWEN LOAN SERVICING, LLC | Financial | SrSec/BCF | | U | B3 | B2 | SG |
| 12/11/18 | MOBILE MINI, INC. | Financial | LTCFR | | U | B1 | Ba3 | SG |
| 12/11/18 | PENNYMAC MORTGAGE INVESTMENT TRUST | Financial | LTCFR | | U | B1 | Ba3 | SG |
| 12/11/18 | NEW RESIDENTIAL INVESTMENT CORP. | Financial | LTCFR | | U | B1 | Ba3 | SG |
| 12/11/18 | PRIVATE NATIONAL MORTGAGE ACCEPTANCE COMPANY, LLC | Financial | LTCFR | | U | B1 | Ba3 | SG |
| 12/11/18 | FREEDOM MORTGAGE CORPORATION | Financial | SrSec/BCF | | U | B1 | Ba2 | SG |
| 12/11/18 | WILLIAMS SCOTSMAN INTERNATIONAL INC. | Financial | SrSec | 600 | D | B2 | B3 | SG |

*Source: Moody's*

## Ratings Round-Up

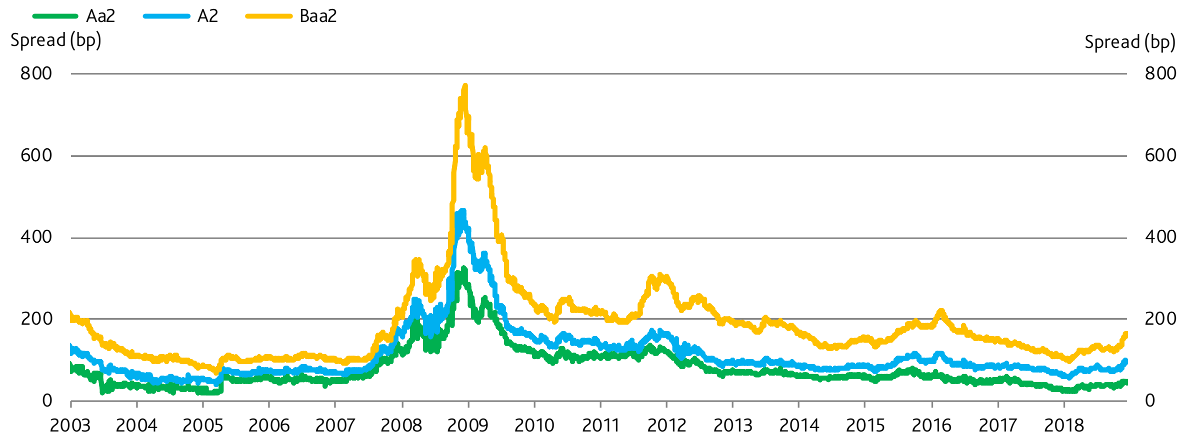
FIGURE 4
### Rating Changes: Corporate & Financial Institutions – Europe

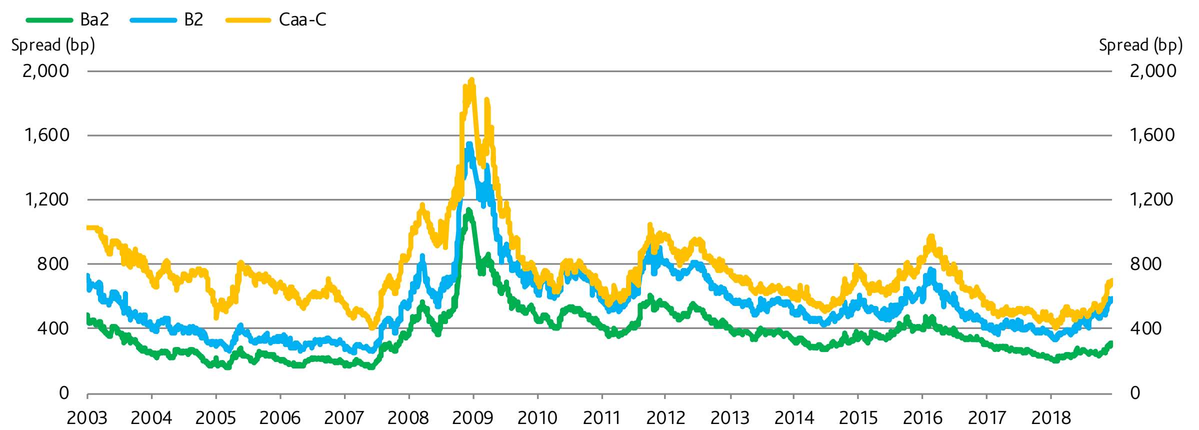
| Date | Company | Sector | Rating | Amount ($ Million) | Up/ Down | Old LTD Rating | New LTD Rating | Old STD Rating | New STD Rating | IG/ SG | Country |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 12/6/18 | DOGUS HOLDING A.S. | Industrial | LTCFR/PDR | | D | B1 | B3 | | | SG | TURKEY |
| 12/7/18 | A.P. MOLLER -MAERSK A/S | Industrial | SrUnsec/LTIR/MTN | 7,341 | D | Baa2 | Baa3 | | | IG | DENMARK |
| 12/7/18 | PIZZAEXPRESS FINANCING 1 PLC | Industrial | SrSec/SrUnsec /LTCFR/PDR | 850 | D | B2 | B3 | | | SG | UNITED KINGDOM |
| 12/7/18 | ALTICE NV -ALTICE FRANCE S.A. | Industrial | SrSec/SrUnsec /BCF/LTCFR/PDR | 25,689 | D | B1 | B2 | | | SG | FRANCE |
| 12/10/18 | REPSOL S.A. | Industrial | SrUnsec/LTIR /JrSub/MTN | 8,409 | U | Baa2 | Baa1 | | | IG | SPAIN |
| 12/10/18 | ANHEUSER-BUSCH INBEV SA/NV | Industrial | SrUnsec/LTIR/MTN | 111,416 | D | A3 | Baa1 | | | IG | BELGIUM |
| 12/10/18 | CONSOLIDATED ENERGY LIMITED-CONSOLIDATED ENERGY FINANCE, S.A. | Industrial | SrUnsec/SrSec /BCF/LTCFR | 1,125 | U | B2 | B1 | | | SG | LUXEMBO URG |
| 12/10/18 | PAPREC HOLDING | Industrial | SrSec/LTCFR/PDR | 911 | D | B1 | B2 | | | SG | FRANCE |
| 12/11/18 | ASML HOLDING N.V. | Industrial | SrUnsec | 3,415 | U | Baa1 | A3 | | | IG | NETHERLA NDS |
| 12/11/18 | SOCIETE DES AUTOROUTES PARIS -RHIN-RHONE - APRR | Industrial | SrUnsec/MTN | 626 | U | Baa1 | A3 | | | IG | FRANCE |
| 12/11/18 | BANK OF IRELAND GROUP PLC -BANK OF IRELAND | Financial | SrUnsec/LTIR/STD /LTD/MTN/CP | 1,329 | U | Baa1 | A3 | P-2 | P-1 | IG | IRELAND |

*Source: Moody's*

# Market Data

## Spreads



# CDS Movers

**Figure 3. CDS Movers - US (December 5, 2018 – December 12, 2018)**

| CDS Implied Rating Rises | CDS Implied Ratings | | |
|---|---|---|---|
| Issuer | Dec. 12 | Dec. 5 | Senior Ratings |
| Eaton Corporation | Aa2 | A1 | Baa1 |
| McDonald's Corporation | Aa1 | Aa2 | Baa1 |
| Ford Motor Company | Ba3 | B1 | Baa3 |
| Enterprise Products Operating, LLC | A3 | Baa1 | Baa1 |
| Medtronic, Inc. | Aa1 | Aa2 | A3 |
| Anthem, Inc. | Aa2 | Aa3 | Baa2 |
| Sprint Communications, Inc. | B1 | B2 | B3 |
| Cigna Corporation | Aa2 | Aa3 | Baa1 |
| Tyson Foods, Inc. | Baa1 | Baa2 | Baa2 |
| E.I. du Pont de Nemours and Company | Aaa | Aa1 | A3 |

| CDS Implied Rating Declines | CDS Implied Ratings | | |
|---|---|---|---|
| Issuer | Dec. 12 | Dec. 5 | Senior Ratings |
| Hertz Corporation (The) | Ca | Caa2 | B3 |
| Talen Energy Supply, LLC | Caa3 | Caa1 | B3 |
| Nabors Industries Inc. | Caa3 | Caa1 | B1 |
| Anheuser-Busch Companies, LLC | Baa2 | A3 | Baa1 |
| AK Steel Corporation | Ca | Caa2 | B3 |
| Dean Foods Company | Caa3 | Caa1 | B3 |
| Lexmark International, Inc. | Caa3 | Caa1 | B3 |
| JPMorgan Chase & Co. | A3 | A2 | A2 |
| Citigroup Inc. | Baa1 | A3 | Baa1 |
| AT&T Inc. | Ba1 | Baa3 | Baa2 |

| CDS Spread Increases | | CDS Spreads | | |
|---|---|---|---|---|
| Issuer | Senior Ratings | Dec. 12 | Dec. 5 | Spread Diff |
| Frontier Communications Corporation | Caa1 | 2,259 | 1,965 | 294 |
| Neiman Marcus Group LTD LLC | Ca | 1,722 | 1,499 | 222 |
| K. Hovnanian Enterprises, Inc. | Caa3 | 2,425 | 2,340 | 86 |
| Genworth Holdings, Inc. | B2 | 538 | 471 | 67 |
| Dean Foods Company | B3 | 753 | 686 | 67 |
| SLM Corporation | Ba2 | 474 | 418 | 56 |
| Nabors Industries Inc. | B1 | 687 | 633 | 54 |
| Weatherford International, LLC (Delaware) | Caa1 | 1,701 | 1,648 | 53 |
| Hertz Corporation (The) | B3 | 866 | 814 | 52 |
| Springleaf Finance Corporation | B1 | 384 | 337 | 47 |

| CDS Spread Decreases | | CDS Spreads | | |
|---|---|---|---|---|
| Issuer | Senior Ratings | Dec. 12 | Dec. 5 | Spread Diff |
| Staples, Inc. | B3 | 482 | 528 | -46 |
| AutoNation, Inc. | Baa3 | 419 | 455 | -36 |
| DPL Inc. | Ba1 | 330 | 357 | -28 |
| First Industrial, L.P. | Baa2 | 232 | 253 | -21 |
| Embarq Corporation | Ba2 | 295 | 314 | -19 |
| Realogy Group LLC | B1 | 439 | 455 | -16 |
| Avery Dennison Corporation | Baa2 | 176 | 191 | -15 |
| Sysco Corporation | A3 | 59 | 73 | -14 |
| L Brands, Inc. | Ba1 | 273 | 287 | -14 |
| United States Cellular Corporation | Ba1 | 159 | 174 | -14 |

*Source: Moody's, CMA*

## Market Data

**Figure 4. CDS Movers - Europe (December 5, 2018 – December 12, 2018)**

| CDS Implied Rating Rises | CDS Implied Ratings | | |
|---|---|---|---|
| Issuer | Dec. 12 | Dec. 5 | Senior Ratings |
| Evraz Group S.A. | Ba3 | B2 | Ba2 |
| Care UK Health & Social Care PLC | Ba2 | B1 | Caa1 |
| Italy, Government of | Ba2 | Ba3 | Baa3 |
| Turkey, Government of | B2 | B3 | Ba3 |
| Nationwide Building Society | A2 | A3 | Aa3 |
| Standard Chartered Bank | A2 | A3 | A1 |
| Swedbank AB | Aa3 | A1 | Aa2 |
| Bank VTB, PJSC | Ba3 | B1 | Ba1 |
| Landesbank Baden-Wuerttemberg | Aa1 | Aa2 | Aa3 |
| Telecom Italia S.p.A. | B1 | B2 | Ba1 |

| CDS Implied Rating Declines | CDS Implied Ratings | | |
|---|---|---|---|
| Issuer | Dec. 12 | Dec. 5 | Senior Ratings |
| Alpha Bank AE | Caa3 | Caa1 | Caa2 |
| Eurobank Ergasias S.A. | Ca | Caa2 | Caa2 |
| BASF (SE) | A1 | Aa2 | A1 |
| Piraeus Bank S.A. | Ca | Caa2 | Caa2 |
| National Bank of Greece S.A. | Caa3 | Caa1 | Caa2 |
| Novo Banco, S.A. | Ca | Caa2 | Caa2 |
| Novafives S.A.S. | Caa3 | Caa1 | Caa1 |
| ABN AMRO Bank N.V. | A3 | A2 | A1 |
| Credit Agricole Corporate and Investment Bank | A3 | A2 | A1 |
| NatWest Markets N.V. | Aa3 | Aa2 | Baa2 |

| CDS Spread Increases | | CDS Spreads | | |
|---|---|---|---|---|
| Issuer | Senior Ratings | Dec. 12 | Dec. 5 | Spread Diff |
| PizzaExpress Financing 1 plc | Caa2 | 2,778 | 2,591 | 187 |
| Novo Banco, S.A. | Caa2 | 980 | 870 | 109 |
| Vue International Bidco plc | Caa3 | 394 | 287 | 107 |
| Russian Standard Bank | Caa2 | 1,068 | 986 | 82 |
| Eurobank Ergasias S.A. | Caa2 | 930 | 889 | 42 |
| Piraeus Bank S.A. | Caa2 | 921 | 879 | 41 |
| Alpha Bank AE | Caa2 | 692 | 661 | 31 |
| National Bank of Greece S.A. | Caa2 | 693 | 662 | 31 |
| Unipol Gruppo S.p.A. | Ba2 | 246 | 224 | 22 |
| Premier Foods Finance plc | Caa1 | 305 | 286 | 19 |

| CDS Spread Decreases | | CDS Spreads | | |
|---|---|---|---|---|
| Issuer | Senior Ratings | Dec. 12 | Dec. 5 | Spread Diff |
| Galapagos Holding S.A. | Caa3 | 5,429 | 5,480 | -50 |
| Care UK Health & Social Care PLC | Caa1 | 205 | 246 | -41 |
| Eksportfinans ASA | Baa3 | 436 | 474 | -37 |
| CMA CGM S.A. | B3 | 718 | 755 | -37 |
| Deutsche Bank AG | A3 | 174 | 206 | -32 |
| Selecta Group B.V. | Caa1 | 372 | 400 | -28 |
| Telecom Italia S.p.A. | Ba1 | 267 | 291 | -24 |
| Jaguar Land Rover Automotive Plc | Ba3 | 633 | 651 | -19 |
| Permanent tsb p.l.c. | Ba2 | 212 | 227 | -15 |
| Virgin Media Finance PLC | B2 | 245 | 260 | -14 |

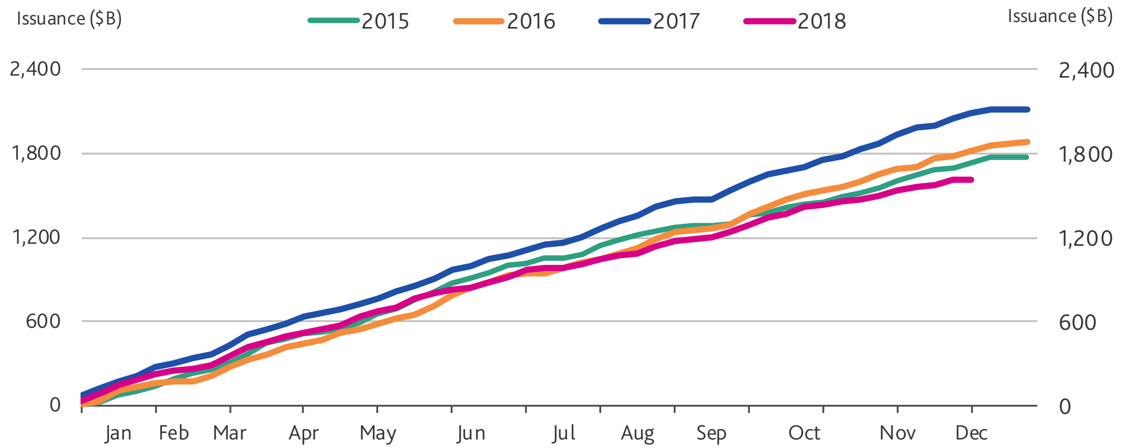
*Source: Moody's, CMA*

Market Data

# Issuance

FIGURE 5

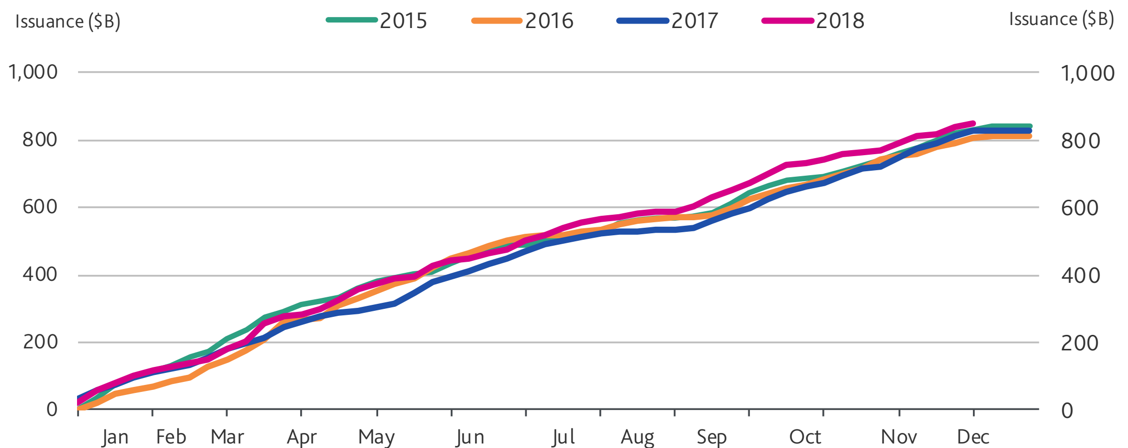
**Market Cumulative Issuance - Corporate & Financial Institutions: USD Denominated**




*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 | 5.860 | 0.450 | 7.135 |
| Year-to-Date | 1,268.230 | 274.553 | 1,620.509 |

| | Euro Denominated | | |
|---|---|---|---|
| | Investment-Grade | High-Yield | Total* |
| | Amount $B | Amount $B | Amount $B |
| Weekly | 5.932 | 0.000 | 6.472 |
| Year-to-Date | 727.839 | 85.735 | 847.019 |

* Difference represents issuance with pending ratings.

*Source: Moody's/ Dealogic*

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