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US High Grade Focus

Alphabet soup; 2019 spread & return targets

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- **In this note, we provide a brief visual history of the US IG market's unprecedented expansion** and consider **four potential sector risk scenarios.** With a view across 20 years of debt growth, our dot-plots paint a foreboding picture of the credit market's expanding risks, particularly in sectors like media & telecom (Figure 2), where the slide toward lower ratings is unmistakable. A strange brew of fundamental concerns on issuers and latent aggregate momentum in EBITDA growth suggests the best opportunities in a decade may be emerging for corporate bond investors to step into attractively priced risk on a name-by-name basis. We expect spreads to end the year 5-10 bps wider than current levels, which prices in a healthy degree of risk premia and assumes no surge in Asian demand and light fallen angels. Letter ratings may be especially unhelpful as a guide in 2019, particularly in the A3-BBB2 complex, in which we see a disparate mix of risk profiles and deleveraging stories lumped together.

- **As the two major rating agencies reach consensus on credits** they once rated differently, it is more likely for the higher rating to be cut, rather than the lower rating upgraded. We look at this signal over credit cycles and conclude that the driver of the agencies' approach to consensus is a coincident indicator of the level of credit spreads. Times like now when agencies are tending toward bearish over bullish consensus on disputed credits have coincided with much wider spreads relative to even currently elevated figures.

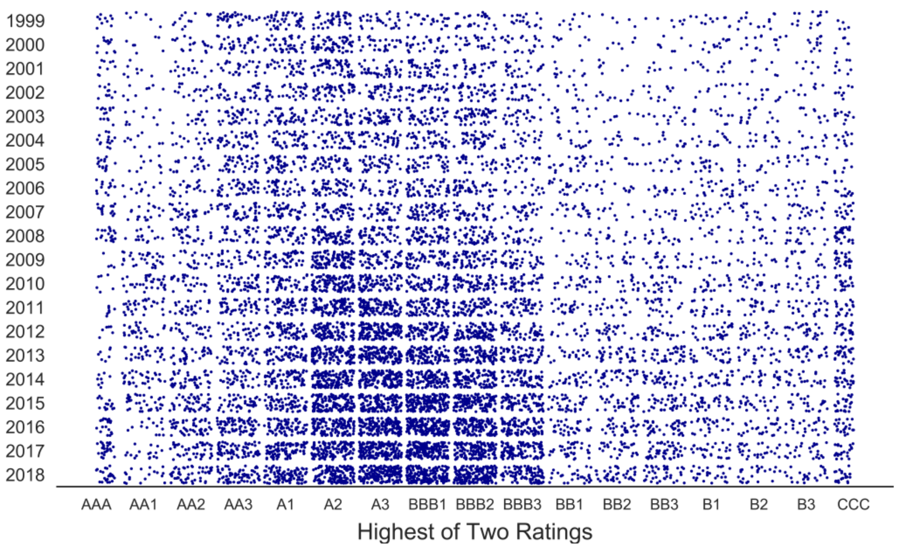
- **Since 2010, US non-financial IG companies have enjoyed 5% average year-over-year EBITDA growth while growing total debt at a year-over-year rate of 10% per year**, a financial feat facilitated in large part by investors outside the United States (and who have done so largely with increasingly expensive short-term dollar funding). The bargain was cut with a tacit understanding that ratings will be largely stable. While not quite a law of nature, the IG market is generally downgraded over time, and conditions are ripe for ratings of US non-commodity industrials to undergo their biggest test of the post-crisis period as the ratings agencies play catch-up and global investors seek alternatives in Europe and at home.

- **The modal outcome for IG excess returns in tight, average or wide spread environments is positive,** but investors undertake a left-tailed distribution with plenty of pain points over the last 20 years. We discuss the distribution for today's starting spread level, and provide spread and return forecasts. Bond issuance projections will follow in a future note.

A dot plot for corporate bonds…

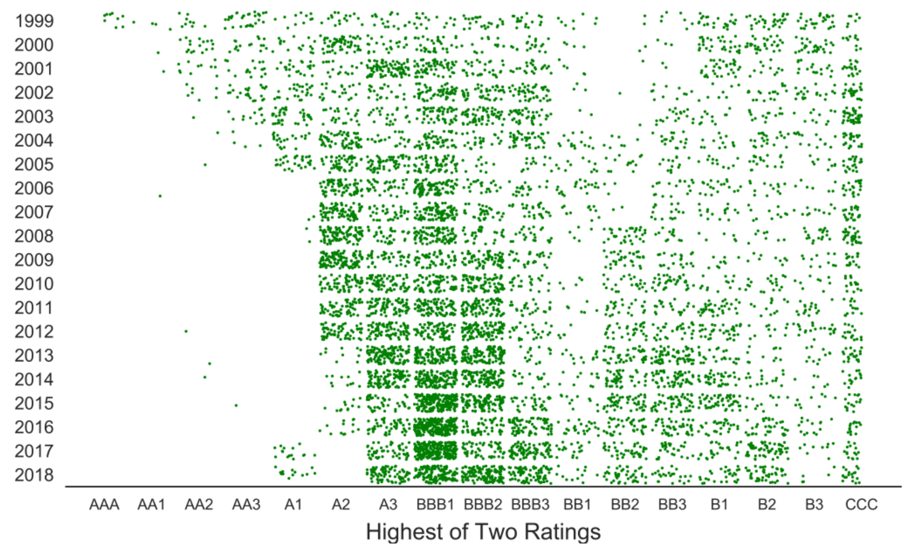
A turning point in the "safe yield" chase… – A narrative of vulnerability will pervade the US corporate bond market in 2019 as an array of mighty US non-financial companies take their turn in the barrel, after spins by financials (2009-12) and energy and metals (2015-16). These fears have crystallized, somewhat surprisingly, in an environment of recently accelerating EBITDA growth for US non-financials overall. This latent momentum suggests the spoils will be earned by the bold, as we foresee the best opportunities in a decade for corporate bond investors to step into attractively priced risk. Fears of high-profile downgrades should remain with us for much of the year, creating entry points for genuine deleveraging stories. We see an internecine battle emerging in both meanings[1] of the word: one fought largely within the IG ratings buckets (as we expect a low rate of net fallen angels); and secondly, one that pains the lenders as much as the borrowers. An environment in which one single-A credit can be carted out into single-B spread territory almost overnight is perilous to ratings-constrained institutional investors, particularly in Asia, that have chased the yields of blue-chip US debt into the low-A/mid-BBB territory. **The explosion of dots in Figure 1, each representing $5 billion of face value**, has fallen like a plinko board toward the mid-single-A to mid-BBB debt categories. Since 2010, US non-financial companies have enjoyed 5% average year-over-year EBITDA growth while growing total debt at a year-over-year rate of 10% per year, facilitated primarily by investors outside the United States. (We previously estimated that nearly one-third of 30-year US telecom debt is held by one set of Asian lifers.) Viewed across 20 years, the dots paint a foreboding picture of the credit market's expanding risks, particularly in sectors like media & telecom (Figure 2), where the slide toward riskiness is unmistakable. The fears, of course, are not only that dots get riskier, but also that the dots are presently misclassified given leverage inflation.

Figure 1. Evolution of the US corporate bond market across the ratings spectrum, 2000 - 2018



Source: Citi Research; FTSE Fixed Income Indexes
Note: each dot represents $5 bn of face value; index-eligible, developed market bonds only

Figure 2. Media & telecom debt growth over time – chased for yield by global investors



Source: Citi Research; FTSE Fixed Income Indexes
Note: each dot represents $1 bn of face value; index-eligible, developed market only; as of 12/2018

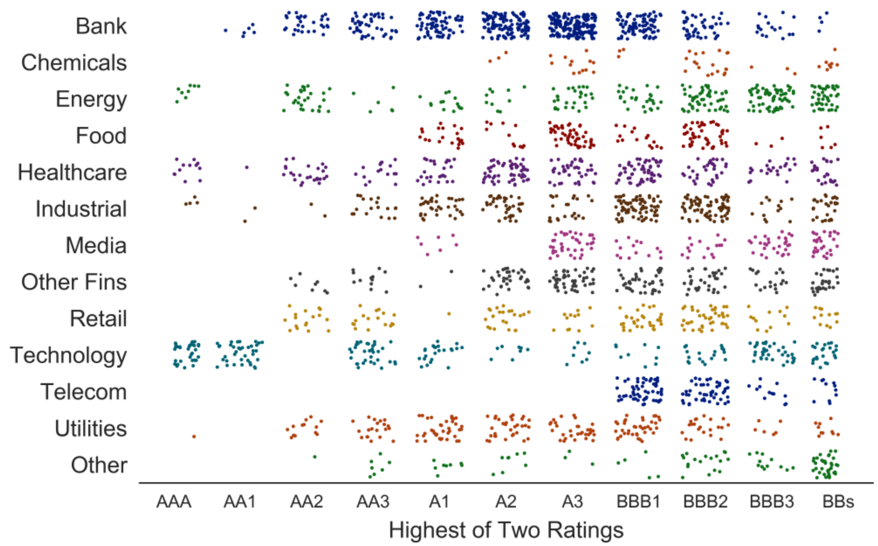
[1] Mutually destructive; also, involving conflict *within* a group

…with a heterogeneous risk profile across sectors

We anticipate four narratives will dominate discussion of sector risk… – First, single-A sectors with the greatest leverage inflation since 2015: healthcare, manufacturing, chemicals and transportation sectors, implying the greatest downside risk if economic headwinds increase and/or rating agencies redraw the lines. Second, failed deleveraging stories, dominated by the food, media and capital goods sectors, centered in the BBB1-2 range; this second group provides the greatest potential upside if deleveraging is realized, but their lower starting ratings also imply the greatest cost of downgrades, which become exponentially more costly as one moves below BBB2. Third, concerns of a flush in sectors with the heaviest concentration of A1 and better debt (Figure 3) subject to M&A risk: healthcare and technology. Fourth, the concentrated BBB sectors – chems, telecom, and media – where M&A stories are well known, but which (in the case of media/telecom) have retained the reputation as the IG market's best source of quick yield or spread enhancement when risk needs to be cut elsewhere. We favor strategies of finding reasonably priced shorts in the first and third categories.

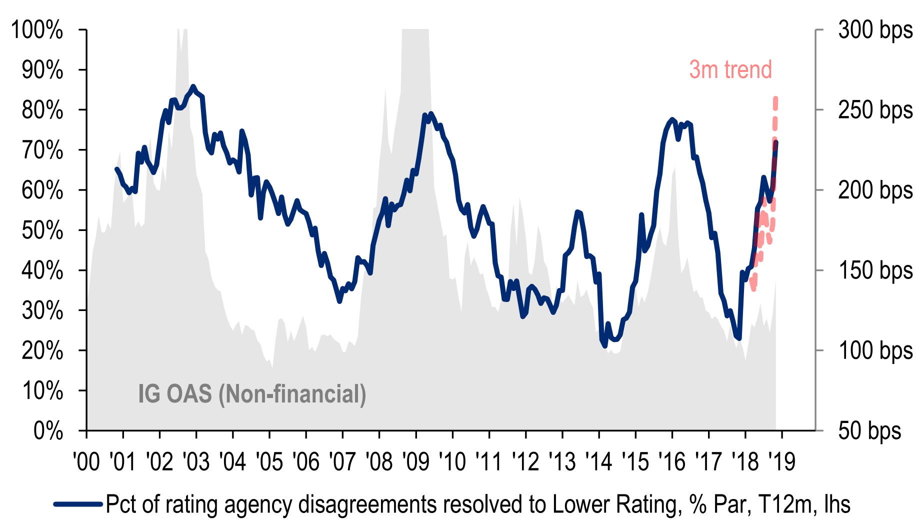
- **… while rating agencies are sending an early-warning signal** – The two largest rating agencies disagree on an issuer rating about as often as they agree, and are separated by at least two rating notches on roughly 10%-15% of credits. These disagreements offer a natural experiment as their resolution – either through one agency's downgrade, or the other's upgrade (observed in the last 12m across >60 issuers with $450 bn in debt) – serves as a coincident indicator for credit risk premia. Rating agency disagreements resolved through the higher rating being cut spiked to 80% of the face value of all such resolutions in 2003, 2009, 2013, and 2016 and coincided with spread moves toward 250 bps and beyond at the index level in three of the four years. They are spiking again now, although spreads in Figure 2 don't reflect it.

Figure 3. Current distribution of high-grade corporate debt across sectors and ratings demonstrates the heterogeneity of risk across industrial groups within the asset class



Source: Citi Research, Bloomberg Financial; FTSE Fixed Income Indexes
Note: each dot represents $1 bn of face value; index-eligible, developed market bonds only

Figure 4. Disagreements between credit rating agencies are being resolved through downgrades by the more optimistic agency. Similar trends historically coincided with spread widening.

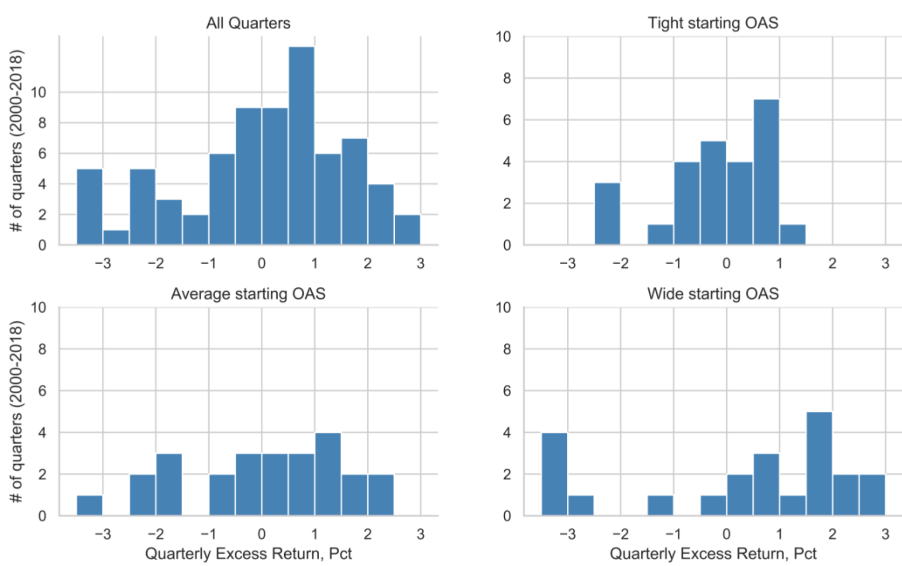


Source: Citi Research, US Treasury; Moody's; S&P; Bloomberg Financial LP; FTSE Fixed Income Indexes

2019 spread and return forecast

The modal outcome for IG excess returns in tight, average or wide spread environments is positive, but investors undertake a left-tailed distribution with plenty of pain points over the last 20 years. In Figure 5 we show the frequency of quarterly excess returns over Treasuries for DM IG back to 2000, with all periods shown in the top left, and the other three histograms reflecting starting index OAS levels below 125 bps, above 160 bps, or in between. The starting point for current sits smack in the middle of the average category. Returns in periods such as these have a random quality historically, with quarterly returns just as likely to bounce 2% higher in a quarter as drop 2.5%. Our expectation for the year's spreads and returns appear in Figure 6, in which we project a spread level of 150 bps, +6 from DM IG. Using a Treasury hedge, and assuming 5y and 10y yields of 285 bps, we back out a 0.4% excess return for the year, and a total return of 4.1%. Our forecast is consistent with spreads reaching levels associate with a regression against cross-asset volatility measures that have recently implied a fair value on spreads in the 150-range. In prior years we have adjusted that model to account for persistent inflows from abroad, but given our concerns around single-A issuers and further rates curve flattening, we think those flows may be slower to resume. Our regression implies a fair value of 130 bps should a robust global demand picture re-emerge.

Figure 5. Frequency of quarterly IG corporate bond excess return outcomes in tight, average, and wide credit spread regimes, 2000-2018



Source: Citi Research; Refinitiv; Note: outliers above/below +3.5%/-3.5% are included in left/right-most bins; Tight/average/wide regimes defined percentile ranks of starting period OAS within sample

Figure 6. Spread and return forecasts, US developed market IG, 2019

	Credit	Treasury		
Weightings	IG	5Y	10Y	*5Y/10Y*
Duration	7.1	4.6	8.5	
Weight	*1*	*0.37*	*0.63*	
Coupon	398	288	313	
Spot Levels				
Yield	434	281	299	
Price	98.7	100.3	101.1	
Spread	144			
12m Projected Levels				
Yield	433	285	285	
Price	98.7	100.1	102.3	
OAS	**150**			
12m Projected Changes				
Credit Spread	+6 bps			
Treasury Yield		+4 bps	-14 bps	
12m Returns (%)				
Income	+4.0	+2.9	+3.1	*+3.0*
Price	+0.1	-0.2	+1.2	*+0.7*
Total Return %	**+4.1%**	+2.7	+4.3	+3.7
Excess Return %	**+0.4%**			

Source: Citi Research; Thomson Reuters

Appendix A-1

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