MOODY'S ANALYTICS

WEEKLY MARKET OUTLOOK

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Ratio of Debt to EBITDA a Poor Predictor of the Default Rate

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: July 25's long-term Baa industrial company bond yield spread of 182 bp was narrower than the 188 bp at the start of the latest bout of trade frictions.

Credit Spreads	Investment Grade: We see year-end 2018's average investment grade bond spread resembling its recent 123 bp. High Yield: Compared to a recent 360 bp, the high-yield spread may approximate 420 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 sink from June 2018's 3.4% to 2.3% by June 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 8.5% to $1.38 trillion, while high-yield bond issuance is likely to fall by 12.7% to $396 billion..

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Credit spreads, CDS movers, issuance.

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Moody's Capital Markets Research *recent publications*

Links to commentaries on: Base metals, trade war, Investment grades, defaults, higher rates, profit growth, credit quality, foreign investors, internal funds, tariffs, borrowing restraint, corporate bonds, tax law changes, stocks and spreads, Greek drama, South Korea.

THIS REPORT WAS REPUBLISHED JULY 30, 2018 TO UPDATE ECONOMIC FORECASTS FOR THE WEEK AHEAD.

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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.

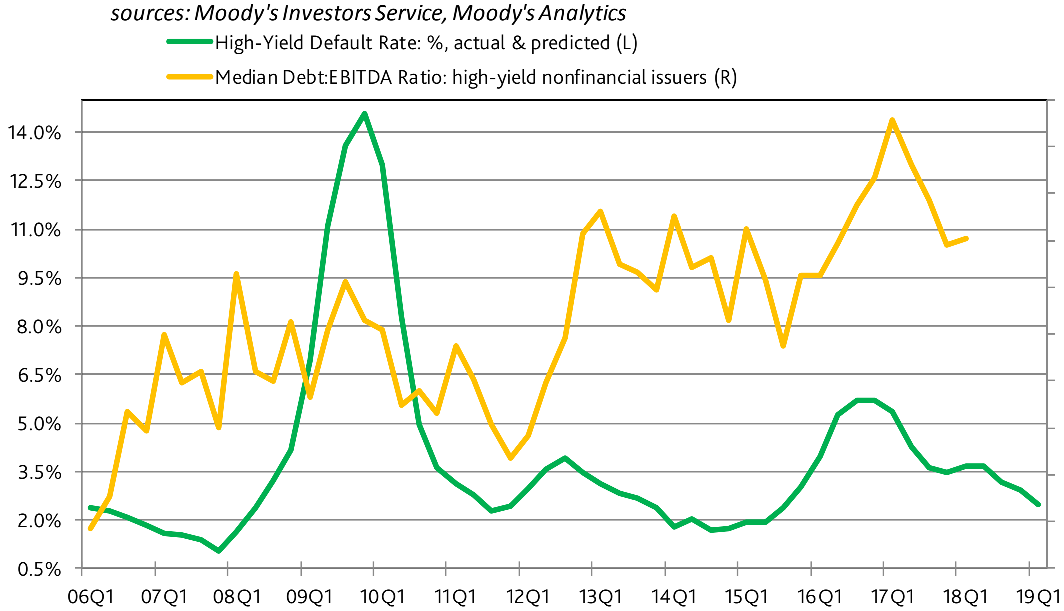
Credit Markets Review and Outlook

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

Ratio of Debt to EBITDA Is a Poor Predictor of the Default Rate

The ratio of corporate debt to EBITDA—corporate earnings before interest expense, taxes, depreciation and amortization—is a frequently used measure of financial leverage. However, since the end of 2005, the median ratio of corporate debt to EBITDA for U.S.-domiciled high-yield issuers has performed poorly for either explaining or predicting the U.S. high-yield default rate. For example, in terms of quarter-long (or quarterly) observations, the high-yield default rate's correlation with the accompanying median ratio of debt to EBITDA for high-yield issuers is a relatively weak 0.12. Moreover, the correlation weakens when attempting to predict the default rate with earlier estimates of the median ratio of debt to EBITDA. Thus, a still historically high median ratio of corporate debt to EBITDA for high-yield issuers may not be reason enough to question forecasts of slide by the default rate into the summer of 2019.

Figure 1: Median Ratio of Debt to EBITDA Performs Poorly as a Predictor of the High-Yield Default Rate
US high-yield issuers
sources: Moody's Investors Service, Moody's Analytics

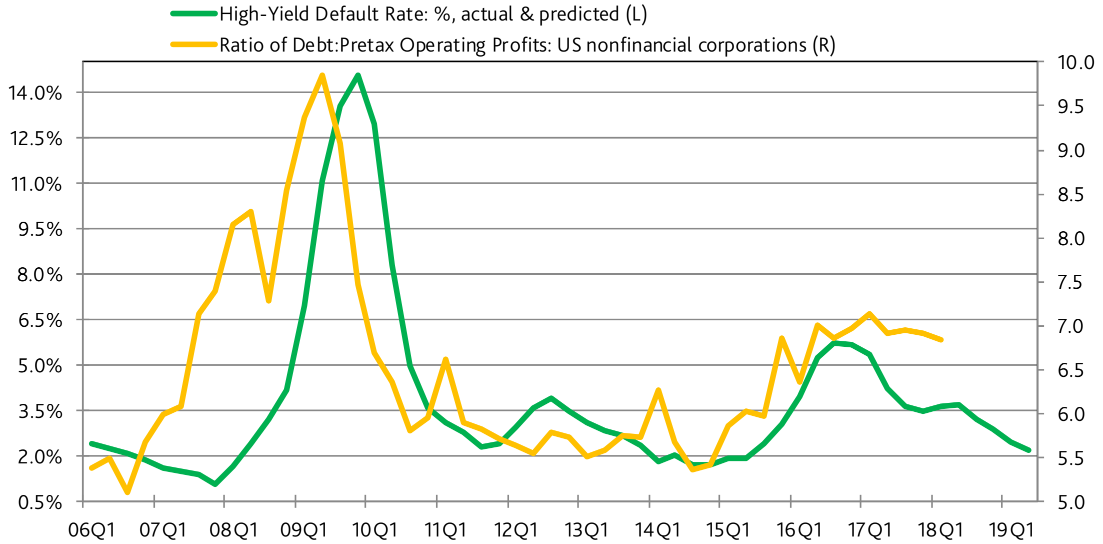


Broad Ratio of Debt to Operating Income Outshines Median High-Yield Ratio of Debt to EBITDA

In stark contrast, since the end of 2005, the ratio of debt to pretax operating profits for all U.S. nonfinancial corporations has performed much better than the median ratio of debt to EBITDA for U.S. high-yield issuers. The quarterly default rate generates a meaningful correlation of roughly 0.83 with the ratio of debt to pretax operating profits from two to three quarters earlier. As far as predicting defaults, the Bureau of Economic Analysis' estimate of the pretax operating profits of U.S. nonfinancial corporations tends to outshine aggregate estimates of EBITDA and cash flow.

Though now declining, a still relatively high ratio of corporate debt to pretax operating profits underscores how critically important a continuation of operating income growth is to the realization of an anticipated drop by the U.S.' high-yield default rate from its 3.7% average of 2018's second quarter to 2.2% by the second quarter of 2019.

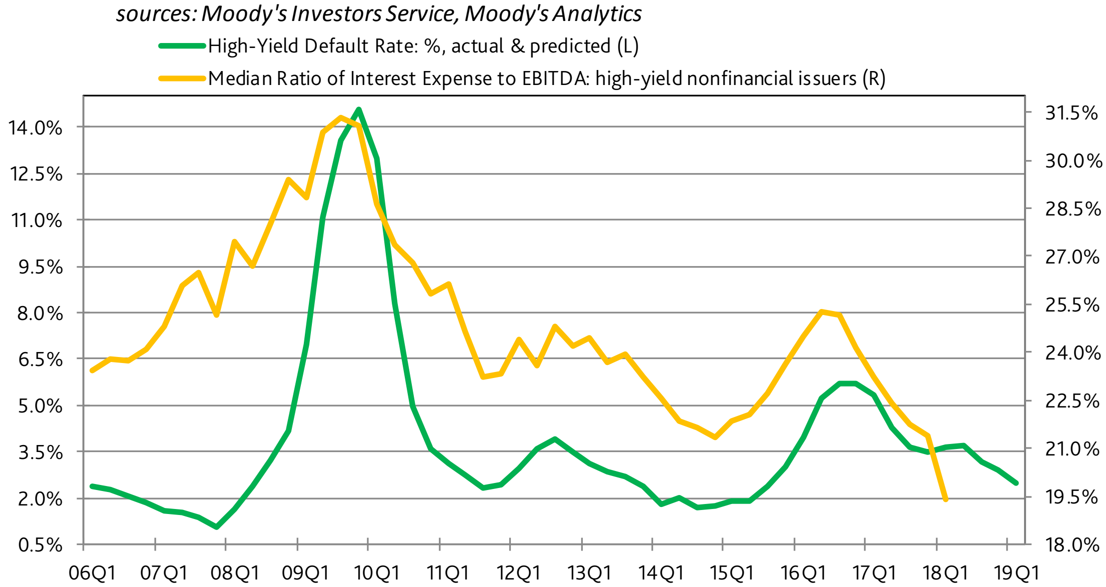
Figure 2: Default Rate Shows Solid Correlation of 0.83 with Ratio of Corporate Debt to Pretax Operating Profits from Two to Three Quarters Earlier
quarter-long averages
sources: BEA, Moody's Investors Service, Moody's Analytics



Ratio of Interest Expense to EBITDA Drops to Sample Low in 2018's First Quarter

The median ratio of interest expense to EBITDA offers another way of explaining the high-yield default rate. This approach fares far better when compared to explaining the default rate with the median ratio of debt to EBITDA. Since year-end 2005, the quarterly default rate generates a relatively meaningful correlation of 0.75 with the median ratio of interest expense to EBITDA from one to two quarters earlier. In 2018's first quarter, the median ratio of interest expense to EBITDA fell a yearlong 2017 average of 22% to 19%, where the latter is a record low for a sample that begins with 2006's first quarter. For purposes of comparison, during the year prior to the start of the financial crisis, the median ratio of interest expense to EBITDA for U.S. high-yield issuers averaged a much higher 26%.

Figure 3: Dive by Ratio of Interest Expense to EBITDA Supports Expectations of a Lower High-Yield Default Rate
US high-yield issuers
sources: Moody's Investors Service, Moody's Analytics



Credit Markets Review and Outlook

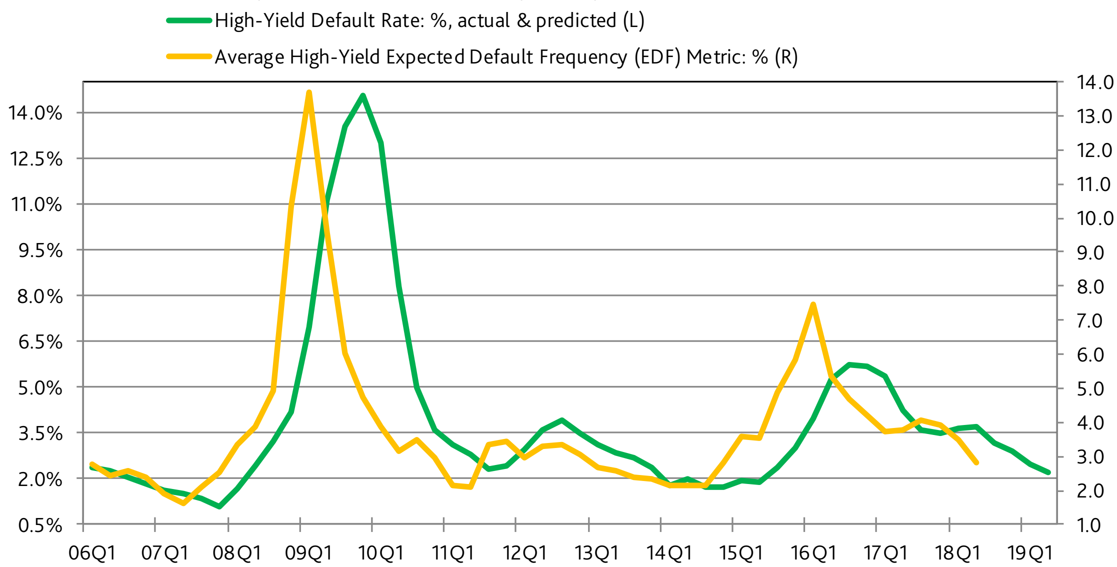
The already low and declining median ratio of interest expense to EBITDA unambiguously supports the likelihood of a declining default rate over the next 12 months. For now, an overly aggressive firming of monetary policy is one of the biggest threats to maintaining a relatively low median ratio of debt to EBITDA. Here, we are reminded that today's relatively high ratios of corporate debt to GDP, EBITDA, and pretax operating profits will probably limit the upside for benchmark borrowing costs by more than the consensus currently expects. Excessive increases by short- and long-term interest rates would risk an upturn by the default rate that could prover ruinous for systemic liquidity, the valuation of business assets, and corporate outlays on staff and equipment.

Average High-Yield EDF Metric Predicts the Default Rate's Path

Among readily available aggregate measures of high-yield credit quality, few match the expected default frequency metric's ability to predict the U.S.' high-yield default rate. The average EDF metric of U.S. high-yield companies is weighted by the market value of individual high-yield issuers. The average high-yield EDF metric will be lower—that is, the likelihood of a higher default rate will be lower—(i) the greater the market value of high-yield companies, (ii) the lower the level of outstanding debt and other liabilities, and (iii) the lower the volatility of the market value of high-yield companies. The latter attempts to account for the risk of a sudden drop in the market value of high-yield issuers.

Limiting the sample to all quarterly observations since the end of 2005 shows a strong correlation of roughly 0.83 between the high-yield default rate and the average high-yield EDF metric of two to three quarters earlier. The latest drop by the average high-yield EDF metric from the 3.8% of 2017's second quarter to the 2.8% of 2018's second quarter is consistent with earlier mentioned expectations of a declining default rate. As it turns out, a declining default rate will help to prevent an equity market sell-off that is severe enough to imperil the adequacy of systemic liquidity. And, provided that systemic liquidity is plentiful, weaker high-yield credits are less likely to default.

Figure 4: High-Yield EDF's Declining Trend Concurs with Predictions of a Lower Default Rate Through Mid-2019
quarter-long averages
source:s Moody's Investors Service, Moody's Analytics

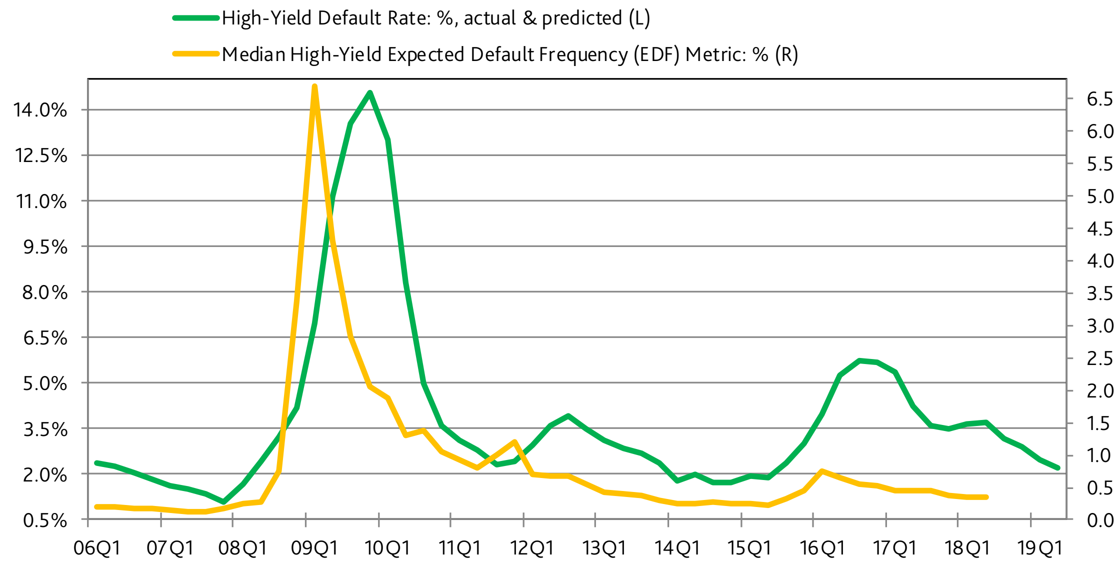


Credit Markets Review and Outlook

Median High-Yield EDF Resembles Average EDF When Predicting Defaults

One of the limitations implicit to the earlier referred to ratios of corporate debt to EBITDA and interest expense to EBITDA is that they both employed the medians of outstanding high-yield issuers. Nevertheless, the median high-yield EDF's ability to predict defaults does not differ significantly from that of the average EDF. In fact, the high-yield default rate's correlation with the median quarterly high-yield EDF of two to three quarters earlier inched higher to 0.84. Thus, even a weighted average version of the corporate debt to EBITDA ratio would probably noticeably underperform the ratio of corporate debt to pretax operating profits of all nonfinancial corporations as far as explaining the high-yield default rate.

Figure 5: Relatively Low Median High-Yield EDF Supports Predictions of a Below-Trend Default Rate Through Mid-2019
quarter-long averages
sources: Moody's Investors Service, Moody's Analytics



Retreat by Home Sales May Rein in Benchmark Treasury Yields

Housing's peak spring selling season ended on a down note. June's much-lower-than expected annualized pace of new home sales was more the consequence of a decline in home affordability than a lack of inventory.

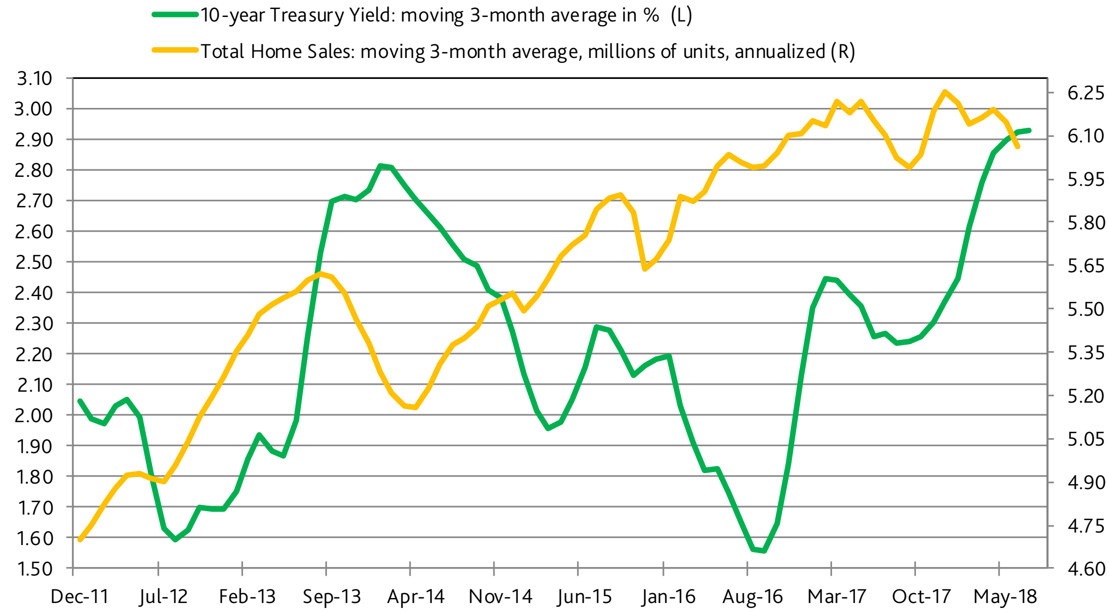
Second-quarter 2018's grand total of new and existing home sales shrank by 2.6% annualized from the first quarter and dipped by 1.5% from 2017's second quarter. In addition to possibly fundamentally excessive home price appreciation, home sales were suppressed by the second quarter's 4.52% average for the 30-year mortgage yield which was up from the 3.99% of the second quarter of a year earlier and was the highest since the 4.66% of 2011's second quarter.

In response to the jump in mortgage yields triggered by 2013-2014's taper tantrum, total home sales' moving three-month average sank by 8.2% from an August 2013 top to an April 2014 bottom. The drop by unit home sales helped to lower the 10-year Treasury yield's month-long average from a December 2013 high of 2.90% to December 2014's 2.22%.

Though it's unlikely that the 10-year Treasury yield is about to mimic its plunge of 2014, the latest retreat by home sales weighs against an extended stay by the 10-year Treasury yield at or above 3%. Moreover, 2018-to-date's 12.8% plunge by the PHLX index of housing-sector share prices, which differs radically from the accompanying 6.5% increase for the overall market value of U.S. common stock, suggests the market does not expect benchmark Treasury yields to fall by enough to reinvigorate home sales.

Figure 6: Flat to Lower Unit Home Sales Now Rein In Treasury Bond Yields

sources: National Association of Realtors, US Census Bureau, Moody's Analytics



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

THE U.S.

By Ryan Sweet of Moody's Analytics

The Focus in a Busy Week Is on Employment

It's a busy week on the policy and economic front. The August meeting of the Federal Open Market Committee will mostly be a formality. The FOMC will not make any changes to the target range for the fed funds rate. The committee has preconditioned markets and economists to expect changes to monetary policy only at meetings with a news conference and updated Summary of Economic Projections.

Turning to the economic data, we look for both ISM indexes to have weakened. The focus will be on employment and we will release our forecast after the ADP National Employment Report. Vehicle sales likely slipped in July. With the release of vehicle sales we will begin tracking third quarter GDP. A number of data that could have implications for revisions to second quarter GDP will be released this week, including construction spending, trade and factory orders.

	Key indicators	Units	Moody's Analytics	Consensus	Consensus Range	Last
Mon @ 10:00 a.m.	Business confidence index for 7/28/18	diffusion index				31.0
Mon @ 10:00 a.m.	Pending Home Sales for June	% change	-0.2	0.1	-0.7 to 1.2	-0.5
Tues @ 8:30 a.m.	Employment Cost Index for Q2	% change	0.6	0.7	0.6 to 0.8	0.8
Tues @ 8:30 a.m.	Personal Income for June	% change	0.4	0.4	0.3 to 0.5	0.4
Tues @ 8:30 a.m.	Personal Spending for June	% change	0.4	0.4	0.2 to 0.6	0.2
Tues @ 8:30 a.m.	Core PCE deflator	% change	0.0	0.1	0 to 0.3	0.2
Tues @ 10:00 a.m.	Conference Board Consumer Confidence for July	index		126.0	124.5 to 129.5	126.4
Wed @ 12:00 a.m.	Vehicle Sales for July	mil, SAAR	17.1	17.1	16.1 to 17.35	17.38
Wed @ 8:15 a.m.	ADP National Employment Report for July	change, ths		183	152 to 205	177.0
Wed @ 10:00 a.m.	Construction Spending for June	% change	0.03	0.3	-0.3 to 1.1	0.4
Wed @ 10:00 a.m.	ISM Manufacturing Index for July	diffusion index	59.6	59.5	58 to 61	60.2
Wed @ 2:00 p.m.	FOMC Monetary Policy for August	%	1.75-2.00	1.75-2.00	1.75-2.00 to 2.00-2.25	1.75-2.00
Thur @ 8:30 a.m.	Jobless Claims for 7/28/18	ths	220	220	210 to 228	217
Thur @ 10:00 a.m.	Factory Orders for June	% change	0.7	0.7	0.2 to 2.3	0.4
Fri @ 8:30 a.m.	Employment Situation for July	change, ths		190	150 to 240	213
	Average Workweek	#		34.5	34.4 to 34.5	34.5
	Unemployment rate	%		3.9	3.9 to 4.0	4.0
	Average Hourly Earnings	% change		0.3	0.2 to 0.6	0.2
Fri @ 8:30 a.m.	International Trade for June	$ bil	-46.6	-46.2	-48.0 to -41.7	-43.1
Fri @ 10:00 a.m.	ISM Nonmanufacturing Index for July	diffusion index	58.1	58.7	57.9 to 60.8	59.1

Sources: Thompson Reuters, Moody's Analytics

MONDAY, JULY 30

Business confidence (week ended July 27; 10:00 a.m. EDT)

Forecast: N/A

Global business sentiment is strong, but it is well off its highs earlier in the year. Businesses appear to be growing wary of the escalating global trade war. This is most evident in the erosion in expectations about business prospects into next year, which are about as weak as they have been at any time during this economic expansion. Less than 40% of respondents say that prospects are improving—the lowest percentage since the economy was pulling out of the Great Recession at the start of this decade.

Businesses' other big concern is around regulatory and legal issues, although this concern is receding with about one-third of respondents saying these issues are their greatest worry. Worries about the cost and availability of labor are on the rise and are now the top concerns of nearly one-fourth of respondents.

The four-week moving average in our global business confidence index dropped from 34 to 31 in the week ended July 20, the lowest this year.

TUESDAY, JULY 31

Personal income and spending (June; 8:30 a.m. EDT)

Forecast: 0.4% (nominal income)
Forecast: 0.4% (nominal spending)
Forecast: 0.03% (core PCE deflator)

We look nominal personal income to have risen 0.4% in June following a 0.4% gain in May and 0.2% increase in April. We look for nominal wages to have risen 0.4% in June. The labor income proxy for all private workers increased 0.4% on par with the gain in May. Rental income and supplements are both forecast to have risen 0.2% in June.

Nominal consumer spending likely rose 0.4% in June. Autos will be a support as both retail and unit sales rose in June. The forecast assumes no change in nominal spending at gasoline stations. Services spending likely rose 0.3% in June as a drop in utility output signals some weakness in spending on household utilities. Consumer goods excluding autos should post a modest gain.

Based on our mapping of the CPI and PPI to the personal consumption expenditure deflator, we look for the core PCE deflator to have risen 0.03% in June, lowering year-over-year growth from 2% to 1.9%. Odds are that this is a temporary setback in inflation.

Revisions to personal income, consumption and the PCE deflators will be consistent with those released as part of the comprehensive benchmark revisions. The new information will be the monthly breakdown.

Consumer board consumer confidence (July; 10:00 a.m. EDT)

We will release forecast on Monday.

WEDNESDAY, AUGUST 1

ADP National Employment Report (July; 8:15 a.m. EDT)

Forecast: N/A

The ADP National Employment Report showed private-sector payrolls expanded by 177,000 from May to June. This caps the second quarter, in which job gains averaged 179,000 per month, and while this represents a marked slowdown from first quarter gains, it better represents labor market growth potential in the near term. Goods producers posted their weakest performance of 2018, adding 29,000 jobs. Meanwhile, service providers continue to drive the majority of growth, as payrolls increased by 148,000, in line with gains over the past 12 months.

The average absolute difference between the first print of ADP and the Bureau of Labor Statistics estimate of changes in private employment has averaged 55,000 per months.

ISM manufacturing survey (July; 10:00 a.m. EDT)

Forecast: 59.6

The ISM manufacturing index rose from 58.7 in May to 60.2 in June. The bulk of this gain is unlikely to stick, as historically an ISM index above 60 is difficult to sustain. Also, supply constraints are an issue. The standout was supplier deliveries, which jumped from 62 to 68.2. An increase in supplier deliveries signals slowing, and the index is at its highest since 2004. The rise reflects more respondents are reporting slower deliveries than faster deliveries. The supplier delivery index normally increases when economy is doing well and the increase in activity causes delays in delivery times. Other factors can cause a rise in supplier deliveries, including weather. However, this isn't the main catalyst for the recent jump. We believe solid domestic economic growth, trade tensions, and transportation issues are the primary catalysts. For July, we look for a decline in supplier deliveries and the employment index. We expect the ISM manufacturing index to come in at 59.6 in July. This is our preliminary forecast and we will fine-tune it after the Texas manufacturing survey and the Chicago PMI.

THURSDAY, AUGUST 2

Jobless claims (week ended July 28; 8:30 a.m. EDT)

Forecast: 220,000

We look for initial claims for unemployment insurance benefits to have risen by 3,000 to 220,000 in the week ending July 28. Claims are volatile this time of year because of the Fourth of July holiday and the annual auto plant retooling. With these temporary distortions behind us, new filings should begin to settle down.

FRIDAY, AUGUST 3

International trade (June; 8:30 a.m. EDT)

Forecast: -$46.6 billion

The preliminary numbers show a goods deficit of $68.3 billion, an increase of $3.6 billion from the prior month. Nominal goods exports slid 1.5%, while imports gained 0.6%. Exports in all categories except for industrial supplies fell, with consumer goods suffering the biggest monthly decline. Imports were mixed, with a significant increase in consumer goods imports offsetting a decline in capital goods imports. The World Cup can have an impact on services trade as U.S. broadcasters pay fees for broadcast rights. This will be captured in imports of intellectual property.

Employment Situation (July; 8:30 a.m. EDT)

We will release our forecast after the ADP National Employment Report.

EUROPE

By Barbara Teixeira Arajuo of the Europe staff of Moody's Analytics in London and Prague

We Still Expect the BoE to Hike Rates

The week will be buzzing with data and undoubtedly help investors shake off the summer lull. Not only will we get preliminary GDP data for the euro zone, but also the July flash CPI figures. June retail sales and unemployment data are also scheduled for release. Despite this barrage of euro area publications, though, markets' focus will be on the U.K. On Thursday the Bank of England Monetary Policy Committee will hold its August meeting. This meeting is set to be a decisive one, as we and the consensus expect the bank will hike rates by 25 basis points, the second such move in over a decade. Granted, data published over the past two weeks have come in soft, making the hike hardly a certainty. But while it is a close call, we maintain that the MPC won't want to lose this window of opportunity, as growth is accelerating and inflation remains above target.

That U.K. consumer price inflation was unchanged in June, against expectations of a jump in response to higher electricity and Brent prices, was surprising. The below-consensus headline pushed markets to immediately reprice the chances of a move by the MPC. But the downward surprise was caused mainly by a slide in core inflation, which we had long advocated was due sometime in 2018. Retailers have already finished passing higher import prices—in response to sterling's 2016 depreciation—through to consumers, so base effects were always expected to push the core goods inflation rate to around zero by the end of the year. Similarly, while the 0.5% m/m decline in retail sales in June spooked investors, a correction was warranted after sales rose sharply by 1.8% m/m in April and 1.4% in May. Growth over the quarter as a whole still gained an impressive 2.1% q/q, its strongest in 17 years.

Still, June's easing in wage growth came in below consensus expectations, and this is especially important given that the MPC watches pay gains closely to determine its monetary stance. But the consensus clearly missed the fact that base effects, which boosted pay gains over the previous months, were always expected to depress the growth rate in June. Accordingly, the monthly annualized rate—a measure frequently used by the MPC—jumped past 3%, from zero in the previous month, exceeding the average for the past year. Given that inflation has cooled recently, this allowed for regular real wages to rise for the fifth consecutive month after falling throughout 2017.

May's monthly GDP figures came in strong, suggesting that the U.K. economy likely expanded by 0.4% q/q in the second quarter, up from 0.2% in the previous stanza. While a quarterly gain of 0.2% in the three months to May is modest, the figure was dragged down by March's dismal numbers. The cold weather and heavy snowfalls hit footfall and put on hold several construction projects at the end of the first quarter, causing GDP to flatline. Given that June's figures are expected to come in much better than those for March, particularly on the back of a rebound in production, GDP growth could easily accelerate to 0.4% q/q in the three months to June.

Since the MPC is already inclined to hike rates sooner rather than later—it forecasts that there is little slack in the economy—we don't think it will lose August's window of opportunity and risk standing pat while inflation remains above target. Also, if it does not act by then, the next possible move could be in November, which is risky given that is only a month after the U.K. government will need to agree on a final withdrawal deal with the EU. Progress on the Brexit front has been significant this year, but reaching a final deal is not guaranteed; the EU is unlikely to accept Prime Minister Theresa May's softened Brexit plans as they are, while internal political turmoil means that it is still uncertain that May's government will last until the end of the year.

	Key indicators	Units	Moody's Analytics	Last
Mon @ 10:00 a.m.	Euro Zone: Business and Consumer Sentiment for July	index	112.2	112.3
Tues @ 12:05 a.m.	U.K.: Consumer Confidence for July	index	-7.0	-9.0
Tues @ 8:00 a.m.	Germany: Retail Sales for June	% change	1.0	-2.1
Tues @ 9:00 a.m.	Germany: Unemployment for July	%	5.2	5.2
Tues @ 9:00 a.m.	Italy: Unemployment for June	%	11.1	10.7
Tues @ 10:00 a.m.	Euro Zone: Preliminary Consumer Price Index for July	% change	2.3	2.0
Tues @ 10:00 a.m.	Euro Zone: Preliminary GDP for Q2	% change	0.4	0.4
Tues @ 10:00 a.m.	Euro Zone: Unemployment for June	%	8.4	8.4
Thur @ 2:00 p.m.	U.K.: Monetary Policy and Minutes for August	%	0.75	0.5
Fri @ 9:00 a.m.	Italy: Industrial Production for June	% change	0.0	0.7
Fri @ 9:00 a.m.	Italy: Retail Sales for June	%	0.3	0.8
Fri @ 10:00 a.m.	Euro Zone: Retail Sales for June	% change	0.8	0.0

MONDAY, JULY 30

No major economic indicators are scheduled for release.

TUESDAY, JULY 31

Germany: Retail Sales (June; 8:00 a.m. BST)

June likely brought a recovery in German retail sales after they dropped unexpectedly sharply in the previous month. Sales are expected to have increased by 1% from May, when they fell by 2.1%. In year-ago terms, sales continued to grow but the pace remained muted at around 0.5%. The GfK consumer climate indicator for June retreated to 10.7 after falling to 10.8 in the previous month, and held steady at 10.7 for July. Meanwhile, German inflation remained strong in June and stayed marginally above the ECB's target of 2.1%. Consumption expenditure recovered somewhat in the first quarter of 2018 after stalling in the second half of the last year. However, consumers will likely keep a tight grip on their wallets in coming quarters because of the uncertain outlook.

Germany: Unemployment (July; 9:00 a.m. BST)

Germany's seasonally adjusted unemployment rate likely remained at 5.2% in July, after it fell to this record low in May. German businesses are increasing their labour force, despite the uncertainties and geopolitical tensions, such as the continued Brexit negotiations or the introduction of new controversial import tariffs by the U.S. The strong economic expansion has supported job creation over the last year, but the economy cooled at the beginning of this year. The country's GDP growth slowed to 0.3% q/q, after expanding by 0.6% previously. In year-ago terms, the expansion rate decelerated to 2.3% in the first quarter, from 2.9% prior. Business sentiment has also been gradually dropping since the start of this year. The unemployment rate is likely bottoming out. That Germany experienced a vast inflow of refugees, together with a persistent lack of a skilled labour force, will likely push the unemployment rate higher.

Italy: Unemployment (June; 9:00 a.m. BST)

After falling more than expected in May, the unemployment rate in Italy likely increased, ticking up to 11.1% in June. The inactivity rate is falling as improving job prospects draw more people into the job market. However, hiring is not strong enough to absorb all the new entrants, pushing up the unemployment rate. The labour market should continue to improve this year thanks to a strong global economy. But although we are optimistic that labour market conditions will brighten, Italy's labour force has a long way to go on the road to recovery and necessary structural reform may be delayed by political discord.

Euro Zone: Preliminary Consumer Price Index (July; 10:00 a.m. BST)

Euro zone inflation likely rose further above target to 2.3% in July, from 2% in June. A further rise in energy prices is expected to have been the main driver of the headline, though inflation pressures likely intensified across the board. The price of a Brent barrel has soared since March and is now reading in euro terms around 51% higher than in July 2017, which should help push energy inflation up to 8.6% in July, from 8% in June. The contribution of the other components of non-core inflation likely remained strong as well. First, alcohol and tobacco inflation surged in March because of the tax hike in France, and should remain elevated until base effects kick in next year. Second, food inflation is also supposed to heat up slightly over the next few months, in line with the recent rise in food producer prices, even if a small decline in July is warranted following June's jump.

Regarding core inflation, we are penciling in a small rebound in services inflation. Inflation of package holidays corrected in June from an Easter-related jump in May, but the decline pushed it well below its trend, so a small increase is warranted in July. And inflation in the transport services sector is also expected to have accelerated, in line with the recent increase in pump prices. Elsewhere, we look for core goods inflation to accelerate too, likely to 0.5% from 0.4% previously. Weakness in nonindustrial goods inflation has been a main theme in the latest CPI releases, and the sector's inflation rate remains well below trend. The main reasons for the disappointing figures have been persistent deflation in healthcare goods in France, and drops in clothing and shoe prices in most major countries. Our view is that a lagged effect from the stronger euro last year could be depressing durables and semidurables prices, but we look for a recovery in coming months.

Euro Zone: Unemployment (June; 10:00 a.m. BST)

The euro zone's unemployment rate likely held steady at 8.4% in June, its lowest reading since the end of 2008. All leading indicators showed that employment growth remained robust over the month, and the Markit PMI release found that June saw further job creation, with the rate of expansion remaining solid and even picking up slightly compared with the previous month. Employment rose in all of the nations covered by the survey, and in the spotlight was that growth improved in Germany and France. We nonetheless suspect that employment gains are starting to slow in the euro area, in line with the recent dips in the headline confidence numbers. But a slowdown was always expected, particularly in countries such as Germany, Austria and the Netherlands, where little slack remains in the job market.

We expect the downward trend in joblessness to persist in quarters to come, and we forecast that the euro zone's unemployment rate will reach 8% to 8.1% by the end of 2018.

WEDNESDAY, AUGUST 1

No major economic indicators are scheduled for release.

THURSDAY, AUGUST 2

U.K.: Monetary Policy and Minutes (August; 2:00 p.m. BST)

We and the consensus expect the bank will hike rates by 25 basis points, to 0.75%, the second such move in over a decade. Granted, data published over the past two weeks have come in soft, making the hike hardly a certainty. But while it is a close call, we maintain that the MPC won't want to lose this window of opportunity, as growth is accelerating and inflation remains above target. If the committee does not act at this meeting, the next possible move could be in November, which is risky given that is only a month after the U.K. government will need to agree on a final withdrawal deal with the EU.

FRIDAY, AUGUST 3

Italy: Industrial Production (June; 9:00 a.m. BST)

Industrial production in Italy was likely unchanged in June following a 0.7% increase in May. Consumer demand remains sturdy and Italy's June Markit manufacturing PMI ticked up for the first time since January thanks to an increase in both output and new orders, indicating growth will be sustained over the coming months. Still, downside risks loom large. Manufacturing confidence has tumbled amid fears of rising protectionism and concerns over the direction of government economic policies. Rising costs are also a concern.

Italy: Retail Sales (June; 9:00 a.m. BST)

Italy's retail sales likely strengthened further in June, at 0.3%, following a 0.8% m/m increase in May. While business sentiment has weakened amid fears of rising protectionism and concerns over the direction of government economic policies, domestic demand remains healthy. A strengthening labour market and improving wage dynamics are supporting consumer demand. The Italian unemployment rate fell to a six-year low in May as sturdy economic growth and rising household spending push up labour demand and draw more people into the labour market. Consumer confidence ticked higher in June, driven by optimism over future economic conditions, which will bolster retail sales in the coming months.

ASIA-PACIFIC

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

Trade Tensions Likely to Be Felt in Increasingly Tangible Ways Soon

Asia's economic data are packed to the brim. China's manufacturer sentiment declined in June as trade tensions escalated, and further weakening is forecast for July. Firms are already reporting somewhat slower production and new orders, although sentiment remains positive on net so far. Trade tensions have contributed to capital outflows and a lower yuan, and are likely to affect manufacturers' businesses in increasingly tangible ways soon.

The Bank of Japan is expected to keep its policy levers unchanged at the July monetary policy meeting. We believe the recent talks of BoJ tinkering with its stimulus policy at this meeting are likely overstated; if anything, the BoJ will likely change its operations in the way it targets the yield curve. However, it's unlikely to reduce any stimulus. This is key. Recent spikes in the 10-year JGB suggest that the BoJ will reduce stimulus. While we believe this is an unlikely scenario, any changes to operations, even if stimulus is maintained, will require clear communication to ward off concerns about policy tightening.

Modest and patchy improvement is expected for Japan's monthly data dump for June. Gains in Japan's burgeoning labour market are expected to have continued in June. The unemployment rate dropped to 2.2% in May from 2.5% in April. The unemployment rate is hovering at its lowest since October 1992. The jobs-to-applicants ratio rose from 1.59 in April to 1.6 in May, its highest since January 1974. Japanese industrial production likely increased again in June but a buildup of inventories and an easing tech cycle are likely to weigh on production in coming months.

Taiwan's economy likely expanded 2.8% y/y in the second quarter, down from a 3.1% gain in the first quarter. Exports remained solid in the three months to June, up an average of 11.2% y/y after a 10.3% gain in the prior three months. Retail sales grew at a moderate pace in April and May, with the unemployment rate holding steady at around 3.7% since September. Indicators such as imports of machinery and equipment suggest investment likely remained relatively mild in the June quarter.

	Key indicators	Units	Moody's Analytics	Last
Mon @ 9:50 a.m.	Japan retail sales for June	% change yr ago	0.3	0.6
Tues @ Unknown	Japan monetary policy for July	¥ tril	80	80
Tues @ 9:00 a.m.	South Korea retail sales for June	% change	-1.1	-1.0
Tues @ 9:30 a.m.	Japan unemployment rate for June	%	2.2	2.2
Tues @ 9:50 a.m.	Japan industrial production for June	% change	0.4	-0.2
Tues @ 11:00 a.m.	China manufacturing PMI for July	Index	51.3	51.5
Tues @ 3:00 p.m.	Japan consumer confidence for July	Index	43.3	43.7
Tues @ 5:30 p.m.	Thailand private consumption for June	% change yr ago	3.6	5.7
Tues @ 5:30 p.m.	Thailand foreign trade for June	US$ bil	2.9	2.7
Tues @ 6:00 p.m.	Taiwan GDP for Q2	% change yr ago	2.8	3.1
Wed @ Unknown	South Korea foreign trade for July	US$ bil	6.0	6.3
Wed @ 8:45 a.m.	New Zealand unemployment rate for Q2	%	4.5	4.4
Wed @ 9:00 a.m.	South Korea consumer price index for July	% change yr ago	1.4	1.5
Thurs @ 11:30 a.m.	Australia foreign trade for June	A$ mil	677	827
Fri @ 11:30 a.m.	Australia retail sales for June	% change	0.2	0.4
Fri @ 2:00 p.m.	Malaysia foreign trade for June	MYR bil	9.3	8.1

MONDAY, JULY 30

Japan: Retail Sales (June; 9:50 a.m. AEST; Sunday, 11:50 p.m. GMT)

Japan's retail sales edged up 0.6% y/y in May after adding 1.5% in April. However, we expect retail sales to have slowed to 0.3% y/y in June. On a seasonally adjusted, month-ago basis, retail sales fell 1.7%, which suggests that the momentum is fading. The primary driver of retail sales is rising fuel prices, which increased 13.4% y/y in May. Meanwhile, food and beverage sales were up 0.8% y/y, and sales at general merchandise stores fell 2.6%. All told, retail sales growth remains in a downturn despite Japan's strong labour market. Without firmer wage growth, retail sales are unlikely to expand rapidly. Instead, the current pace of slow but steady year-ago increases will remain the norm.

TUESDAY, JULY 31

Japan: Monetary Policy (July; Unknown)

The Bank of Japan is expected to keep its policy levers unchanged at the July monetary policy meeting. The bank will maintain its monthly annualised purchase target of Japanese government bonds at ¥80 trillion. Moreover, the BoJ will target the long-term interest rates through its yield curve control policy; a 0% target for the 10-year JGB and a -0.1% interest rate on excess reserves will target the short-term rate. We believe the recent talks of the BoJ tinkering with its stimulus policy at this meeting are likely overstated. If anything, the BoJ will likely change its operations in the way it targets the yield curve. However, it's unlikely to reduce any stimulus. This is key. Recent spikes in the 10-year JGB suggest that the BoJ will reduce stimulus. While we believe this is an unlikely scenario, any changes to operations, even if stimulus is maintained, will require clear communication to ward off concerns about policy tightening.

South Korea: Retail Sales (June; 9:00 a.m. AEST; Monday, 11:00 p.m. GMT)

South Korean retail sales continued to slide in May, falling in month-ago terms for the second consecutive month. In year-ago terms, retail sales growth decelerated to a four-month low. Sales of passenger cars were weak, as were sales of household appliances and furniture. Sales of nondurable goods were also soft. The only bright spots were clothing, which rebounded solidly, and sales of pharmaceuticals and telecommunication and computer equipment. Overall, the boost from the minimum wage hike at the beginning of the year appears to be fading under the weight of a weak labour market and a related slide in consumer sentiment. Retail sales likely slipped 1.1% m/m in June.

Japan: Employment Situation (June; 9:30 a.m. AEST; Monday, 11:30 p.m. GMT)

Gains in Japan's burgeoning labour market likely continued in June. The unemployment rate dropped to 2.2% in May from 2.5% in April, and likely stayed at 2.2% in June. The unemployment rate is hovering at its lowest since October 1992. The jobs-to-applicants ratio rose from 1.59 in April to 1.6 in May, its highest since January 1974. Labour force growth of 1.5% y/y was outpaced by employment growth of 2.3%. The unemployment rate has been broadly declining since 2010 largely on the ageing population, and the trend has accelerated in the past year as Japanese businesses had their best operating conditions in years. But a sustained and marked improvement in incomes remains elusive, with wage growth cooling to 0.8% y/y in April. We expect modest improvement in income growth over 2018, ensuring consumption stays mediocre. Moreover, full-time job growth is expected to continue; the economy has added on net 800,000 jobs in the first five months of the year so far.

Japan: Industrial Production (June; 9:50 a.m. AEST; Monday, 11:50 p.m. GMT)

Japanese industrial production slipped 0.2% m/m in May after edging up 0.5% in the prior month. Production likely increased again in June, to 0.4% m/m. In May, the decline in production from a month earlier was caused by a 1.9% m/m fall in iron and steel output, a 1% drop in electrical machinery production, and an 8.2% dip in transportation production. Although the strong gain in production in year-ago terms is encouraging, a buildup of inventories and an easing tech cycle are likely to weigh on production in coming months. That said, in June, front-loading purchases in fear of a trade war likely caused production to expand marginally.

China: Manufacturing PMI (July; 11:00 a.m. AEST; 1:00 a.m. GMT)

China's manufacturer sentiment declined in June as trade tensions escalated. Firms are already reporting somewhat slower production and new orders, although sentiment remains positive on net so far. Trade tensions have contributed to capital outflows and a lower yuan and are likely to affect manufacturers' businesses in increasingly tangible ways soon. We expect the official PMI declined by a further 0.2 point to 51.3 in July.

Japan: Consumer Confidence (July; 3:00 p.m. AEST; 5:00 a.m. GMT)

Japan's consumer confidence held up better than expected in June. The headline was 43.7, a whisker shy of the 43.8 recorded in May. However, confidence likely dipped in July, to 43.3, because of increasing uncertainty around trade wars. Employment will likely remain the standout; the strength of the employment category is also reflected in the hard data, as a variety of metrics show the labour market is in its best position in decades. However, the labour market tightening has not resulted in a sustained improvement in wage growth, and this is holding overall consumer sentiment back. Moreover, we expect inflation expectations to remain largely unchanged, as higher fuel costs are driving up near-term price increases.

Thailand: Private Consumption (June; 5:30 p.m. AEST; 7:30 a.m. GMT)

Private consumption growth has been firming in Thailand and picked up to a five-month high in May as sales of passenger cars surged. However, motorcycle sales fell from a year earlier, suggesting consumers at the lower end of the income scale remain restrained. Tourism remains a key source of strength, even as growth of nonresident expenditure eased in its latest reading. Tourist arrivals were up 15% y/y in the first quarter, thanks largely to an increase in Chinese tourists. Private consumption likely grew 3.6% y/y in June.

Thailand: Foreign Trade (June; 5:30 p.m. AEST; 7:30 a.m. GMT)

Despite trade frictions, Thailand’s trade surplus rebounded strongly in May after shrinking sharply in the prior month. Exports continued to grow at a double-digit pace, indicating external demand remains solid. Meanwhile, imports also continued to rise at a double-digit pace, suggesting domestic demand continues to mend. Although that bodes well for second quarter GDP growth, the outlook is clouded by trade frictions between the U.S. and China, which have ratcheted up in recent weeks. If an all-out trade war were to occur, regional supply chains and Thailand's export-manufacturing sector would suffer, as demand from China, which accounts for about a tenth of Thailand's exports, would be undermined. Thailand's trade surplus likely increased to US$2.9 billion in June.

Taiwan: GDP (2018Q2; 6:00 p.m. AEST; 8:00 a.m. GMT)

Taiwan's economy likely expanded 2.8% y/y in the second quarter, down from a 3.1% gain in the first quarter. Exports remained solid in the three months to June, up an average of 11.2% y/y after a 10.3% in the prior three months. Retail sales grew at a moderate pace in April and May, with the unemployment rate holding steady at around 3.7% since September. However, consumer confidence has dimmed in recent months, which may have dampened consumer spending in the second quarter. Growth of fixed asset investment recovered modestly in the first quarter. Indicators such as imports of machinery and equipment suggest investment remained relatively mild in the June quarter.

WEDNESDAY, AUGUST 1

South Korea: Foreign Trade (July; Unknown)

Despite a drop in exports, South Korea's foreign trade surplus remained a healthy US$6.3 billion in June. Much of the decline in exports was because of the high base from a year earlier, when exports rose at a double-digit pace. Exports of semiconductors continued to rise at a double-digit pace, albeit below the pace set in the prior month, while shipments of LCD screens, home appliances, mobile phone equipment, and automobiles continued to decline. Although we expect external demand to stay relatively firm this year, trade tensions remain a key downside risk. Frictions between the U.S. and China have intensified in recent weeks and if an all-out trade war were to occur, South Korea's export-manufacturing sector would not be immune. South Korea's merchandise trade surplus likely narrowed to US$6 billion in July.

New Zealand: Employment Situation (2018Q2; 8:45 a.m. AEST; Tuesday, 10:45 p.m. GMT)

New Zealand's labour market likely ended its impressive run with the unemployment rate rising to 4.5% in the June quarter. In the March quarter, the unemployment rate fell for a fifth consecutive quarter to 4.4%, its lowest rate since the December quarter of 2008. Employment grew 3.1% y/y, after a 3.7% gain in the prior quarter. Domestic conditions have cooled a little and are unable to maintain the pace of labour market tightening. The underutilization rate remained elevated at 11.9% in the March quarter and we don't expect material improvement in the June quarter, confirming that considerable slack remains in the labour market beyond what the headline unemployment rate suggests.

South Korea: Consumer Price Index (July; 9:00 a.m. AEST; Tuesday, 11:00 p.m. GMT)

Headline inflation stayed at 1.5% y/y in June, with inflation excluding fresh food and energy at a five-month low. Transportation prices led the gains, largely on the back of higher fuel prices, while prices at restaurants and hotels rose at a solid pace. Inflation for most other products has eased since May, with food and beverage inflation subdued, and clothing and footwear prices rising by less than 1% for the second straight month. The weak labor market is keeping a lid on price pressures. The unemployment rate remains elevated and job creation is weak. Inflation likely eased to 1.4% y/y in July.

THURSDAY, AUGUST 2

Australia: Foreign Trade (June; 11:30 a.m. AEST; 1:30 a.m. GMT)

Australia's monthly trade surplus likely narrowed to A$677 million in June, following an A$827 million surplus in May. Merchandise export values likely cooled a little, reflecting weaker global prices especially for iron ore. Higher liquefied natural gas prices (given the close link with oil prices) likely provided some offset. Iron ore prices improved in July on higher steel demand in China, alongside production cuts in Tangshan, an industrial hub in China's northern province of Hebei. Imports of consumption goods likely remained firm, while higher oil prices will keep the intermediate import bill relatively lofty.

FRIDAY, AUGUST 3

Australia: Retail Sales (June; 11:30 a.m. AEST; 1:30 a.m. GMT)

The lift to Australian retail trade from the late start to winter is expected to have largely faded by June. We look for retail trade to have cooled to 0.2% m/m, after the 0.4% rise in May and 0.5% gain in April. Trend retail trade is hovering around 0.3% m/m, which is below its historical average of 0.5%. Consumers are holding back because of weak income growth and more recently, wealth effects from the housing market cooling. We expect only modest improvement in income growth heading into 2019, which should keep gains in consumption relatively capped given the tight causal relationship.

Malaysia: Foreign Trade (June; 2:00 p.m. AEST; 4:00 a.m. GMT)

Malaysia's trade surplus likely widened to MYR9.3 billion in June, after narrowing to MYR8.1 billion in May. Export and import growth slowed dramatically in May, largely because of high base effects. An added drag for exports was pronounced weakness in palm oil shipments on both a value and a volume basis, a situation unlikely to have eased in June as prices have remained low and demand to the important India market has been weak. Electronics will remain the main strength in exports, but are also cooling in annual terms on high base effects. Preliminary estimates suggest net exports made a similar contribution to June quarter GDP growth as in the first quarter.

The Long View

July 25's long-term Baa industrial company bond yield spread of 182 bp was narrower than the 188 bp at the start of the latest bout of trade frictions.

By John Lonski, Chief Economist, Moody's Capital Markets Research Group,
July 26, 2018

CREDIT SPREADS

As measured by Moody's long-term average corporate bond yield, the recent investment grade corporate bond yield spread of 123 basis points resembles its 122-point mean of the two previous economic recoveries. This spread may be no wider than 140 bp by year-end 2018.

The recent high-yield bond spread of 360 bp is less than might be inferred from the spread's macroeconomic drivers and the long-term Baa industrial company bond yield spread. The adverse implications for liquidity of possibly significantly higher interest rates merit consideration.

DEFAULTS

After rising from January 2018's latest bottom of 3.4% to March's 4.0%, the U.S. high-yield default rate has returned as of June to 3.4%. Moody's Default and Ratings Analytics team now expects the default rate will average 2.5% during 2019's first 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.

Second-quarter 2017's worldwide offerings of corporate bonds showed an annual decline of 6.3% for IG and an increase of 8.3% for high-yield, wherein US$-denominated offerings fell by 6.4% for IG and grew by 5.8% for high yield.

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.

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 0.0% for IG and -11.6% for high yield.

The financing of acquisitions and shareholder compensation will stand out among 2016's uses of funds obtained via bond issues and newly-rated bank loan programs. Companies will resort to acquisitions and divestitures in order to better cope with the US's subpar recovery. To the degree companies fear significantly higher bond yields, pre-fundings will rise.

US ECONOMIC OUTLOOK

The consensus expects that the mid-point for the federal funds rate should finish 2018 at 2.125%. In view of the considerable 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 Reka Sulyok of Moody's Analytics
July 26, 2018

SPAIN

Spain's new government led by Pedro Sánchez upwardly revised the deficit target for this year from 2.2% to 2.7%. At first sight, the new figure still sits comfortably below the 3% target mandated by the EU's stability law. But with GDP growth set to decelerate, the treasury can hardly count on an ongoing increase in revenues. The quandary is that even the higher deficit goal could require taking on credible fiscal measures, and those are not yet in the offing.

Welfare spending will balloon in 2018 thanks to an increase in pensions and public sector salaries announced earlier this year. Austerity measures are politically sensitive for the incumbent government, which came to power after an unprecedented ousting of its predecessor in a no-confidence vote in June. Pushing through any serious fiscal reform, given the political motives, is improbable. Yet that complacency towards fiscal slippage may not fly with the European Commission, which called for a hefty 0.65% of GDP structural correction this year.

Slacking off at fiscal efforts

In 2017, Spain failed to exit the excessive deficit procedure which it had been under since 2009. True, the headline deficit had been cut by a cumulative 3.9% of GDP since 2013, but that was largely thanks to a GDP expansion of more than 3% in the last three years. During the same period, the debt-to-GDP measure declined a paltry 2 percentage points per year, exactly the minimum required by the Spanish stability law. The commission's estimate on Spain's structural shortfall, which strips out the favorable effect of the cycle, shows why the decline was so meagre: The structural measure worsened through 2015-2016 and barely improved in 2017, while other peers under the excessive deficit procedure forged ahead with fiscal correction.

A rising structural balance signals that Spain's fiscal stance in fact turned mildly expansionary, and only the virtuous cycle helped mask that by reducing the headline deficit. But the government can't afford to turn a blind eye to the debt figures forever. The debt-to-GDP ratio is currently at 98.8%, which renders Spain vulnerable to turns in the economic cycle. And the real headache begins once the asset purchases of the European Central Bank end this year, because Spain will have to dump around €220 billion into debt markets to meet its rollover obligations while also facing a rise in borrowing costs. Tellingly, the Spanish risk premium jumped by 10 basis points on the news of a higher deficit for this year, and it may stay elevated at around 100 basis points throughout the year.

The government promised to continue working on the details of a fiscal package aimed at delivering a 0.4% deficit cut as a share of GDP, still shy of the commission's demand. For that they have two possible tactics. The one which hurts the economy the least is a rein on spending, which effectively is political suicide. The second option is to increase the tax burden across the board. Working against the tax option is that it could cool the economy just when the broader European momentum is already easing. Even more worrying is that the collection of revenues comes with a lag, so that option is in any case insufficient to avoid fiscal slippage this year.

Fork in the road

Assuming no policy change, Spain's structural shortfall will sharply exceed 2% in years to come. That is a bad place to be, since it would mean Spain not only breaches its own medium-term stability guidelines but breaks the European rules too. That breach could heat up the debate over Europe's macroeconomic stability goals, but more important is that another miss may prompt the commission to feel less charitable than it did in 2016, when it let Spain get away with a slippage. Stepping into the same river twice, Spain has little to no bargaining power. After a strong run of GDP growth that outpaced that of its euro zone peers, the commission will likely impose fines and freeze Spain's structural funding.

But a slippage this year seems inevitable. The Spanish government will need to make up for it in 2019 and will probably agree to tougher targets with the EU from next year onwards. It's by no means easy, but 0.7 to 1 percentage point of GDP deficit correction will likely be needed in 2019. And the government has few options on the table to achieve that. Without tax hikes, we do not see Spain capable of reaching the 3% headline target or balancing its structural budget in accordance with its stability target. Any attempt to increase revenues runs up against the problem that taxes typically distort economic activity. Assuming the authorities opt for consumption tax hikes, we estimate that Spain's GDP growth would slow by around 0.3 percentage point and print at around 2% by 2019.

ASIA PACIFIC

By Faraz Syed of Moody's Analytics
July 26, 2018

JAPAN

Increasing downside risks are unlikely to derail short-term growth prospects in Japan despite the slow start in the March quarter. The first quarter disappointment was inevitable given that GDP expanded steadily for eight quarters prior, a streak last achieved in the late 1980s.

In an economy that is aging, with its human capital declining, GDP is unlikely to rise forever. Therefore, a contraction every so often can be expected, especially after 2017 when the economy expanded above potential. A more comprehensive barometer for Japan's economy is GDP per capita, or GDP per worker, which have consistently outpaced GDP growth.

Setting the first quarter disappointment aside, Japan's economy is expected to recover modestly and expand 0.3% over the June quarter. Steady job growth will support incomes; on net, the economy added 800,000 jobs in the first five months of 2018. Cyclical indicators point to a steady upswing over the coming months; however, the pace of growth from last year is unlikely to return as export demand quells.

Moody's Analytics forecasts Japan's GDP to rise 0.9% in 2018, followed by 0.7% in 2019. Clouding the sanguine outlook is the prospect of trade wars; recent trade escalation between China and the U.S. could spill over to the global economy, with Japan susceptible to adverse trade sentiment.

Services and manufacturing shine

Japan's manufacturing, which accounts for 21% of gross value added, tends to be a star performer when GDP growth is rising. However, the burgeoning growth in 2017 was shared among various sectors of the economy. Encouragingly, the services industry outperformed, as evidenced by the increase in employment over the last 17 months; total employment rose 3.3% over this period. For example, scientific research and the medical industry added most to nonagricultural job growth during this period.

This is partly due to easing of Japanese immigration laws, which allows trainees and workers to enter the country in these industries if they have the designated skill set. Over the last five years, one out of every four workers has been foreign-born. Though it's too early to wax lyrical about Japan opening its immigration, it does suggest that the government is aware of its ageing population and willing to obtain an overseas skill set.

Shortage of skilled labor

Overall, foreign workers are most representative in research and medical industries where there is a shortage of skilled labour. This trend is expected to persist over the coming year, as local labour supply is unlikely to fill the skills shortage. Japan's labour market has tightened, with the unemployment rate falling to 2.2% and the jobs-to-application ratio rising to 1.6—158 job seekers for every 100 jobs advertised. Thus, we expect employment to increase throughout 2018.

That said, Japan's traditional manufacturing hub remains in good order. Purchasing Managers' Indexes point to steady improvements in June, although the sharp rises from late last year have slowed. Exports tend to be closely correlated with manufacturing performance; the rise in the manufacturing PMI matches Japan's merchandise export growth closely.

As long as PMIs remain positive with a reading above 50, exports will likely expand at a solid clip. The recent trade tensions have taken a shine off global demand, but Japanese exports remain resilient. An improved U.S. economy, coupled with a recovery in the euro zone, will keep export demand positive this year.

Loss of sentiment from trade wars will be partially offset by Japan's recent announcement of a free-trade agreement with the euro zone, which will give Japanese manufacturers greater penetration into the European market. Near-term trade surpluses will likely remain the norm over 2018 and 2019. But the rate of growth from 2017 is unlikely to be repeated.

Ripe for wage hikes?

With the labour market tightening, Japanese wages have their best opportunity of the past three decades to rise. Fundamentally, there's little reason why wages shouldn't increase. After a poor 2016, corporate Japan staged a comeback in 2017, with both manufacturing and nonmanufacturing profits rising thanks to export growth. Overall, total profits increased more than 20% in 2017. Profits are unlikely to keep pace in 2018, although Japanese manufacturers remain flush with cash.

The shunto—spring wage—negotiations kicked off in early 2018. Large manufacturers agreed to increase wages for the fifth year in a row, although the increase fell short of the government's 3% goal. But overall, average earnings in Japan, which account for majority of wages, have increased in 2018.

The positive momentum in wage growth lifted core inflation to 0.8% in June. The current level of wage growth will prevent Japan from falling back into deflation, but it's unlikely to boost inflation above the central bank's original 2% target.

For inflation to reach the elusive 2% mark, wages will likely have to rise at 3% on a consistent basis. There's little indication that this will occur over the coming year. Auto manufacturers such as Toyota remain the barometer for wage increases, and they fell short of delivering union demands. Companies remain wary of increasing worker wages because they are unconvinced that the growth momentum will last. While this could prove a self-fulfilling prophecy, investors are also coy on the earning potential of Japanese companies.

For example, while the Nikkei225 has risen around 15% over the past 12 months, bets against the stock market have increased. Open positions between a put and a call option on the Nikkei225 have increased to record highs in recent months. A put option is an investment or hedging strategy where a profit is realized if the price of the underlying security falls. Overall, the hedging on the Nikkei225 showcases the inherent pessimism or the 'deflation mindset' in the Japanese economy.

Trade wars

Moody's Analytics has utilised its global macroeconomic model to quantify the impact of trade wars. The first scenario, which carries a 60% probability, is being played out. Tariffs totaling $250 billion have been announced for Chinese imports to the U.S. Thus far, China has imposed tariffs on $50 billion of U.S. exports to China.

If tensions don't escalate further, these current measures will have only a minor impact on the Japanese economy; GDP growth will be nearly 0.1 percentage point below the baseline estimate of 0.9% in 2019. The yen could increase on risk-off sentiment if trade jousting between the U.S. and China continues, which will lead to lower export receipts.

The second scenario, the threatened trade scenario, has a 30% probability of occurring. This involves a 10% tariff on an additional $400 billion of Chinese imports and a 25% hike on $275 billion in vehicle imports. This would cause the yen to rise compared with the baseline; risk-off sentiment and lower demand from China, which is Japan's largest export partner, would hurt overall export receipts and regional trade.

Moreover, fears would increase that the U.S. administration could turn towards Japan on its crusade against trade deficits: The U.S.-Japan bilateral trade deficit sits at $69 billion. Under this scenario, Japan's GDP would grow 0.4 percentage point below baseline in 2019. The stock market would also fall as anxiety around trade intensified.

The final scenario is trade collapse, which has a 10% chance of occurring. This scenario involves a blanket 25% tariff on the bilateral trade between U.S. and China, which amounts to $650 billion. In this scenario, regional trade would drop dramatically, with Japanese shipments to Asia falling precipitously. A drop in sentiment and a risk-off appetite would cause the yen to rise by the end of 2019.

The yen's appreciation would add to a further decline in export values, while volumes would be hit hard by lower global demand. Japanese firms would become anxious about growth prospects, leading to an increase in layoffs as production and manufacturing dropped. Overall, as the unemployment rate rose, GDP growth would slow by 0.7 percentage point compared with the baseline.

Overall, while we expect growth to persist in Japan's baseline scenario, the threat of trade wars could cause growth to slow sharply. That said, continued accommodative policies by the BoJ, along with Japan's overseas investments, will somewhat cushion the ill effects.

Ratings Round-Up

By Michael Ferlez

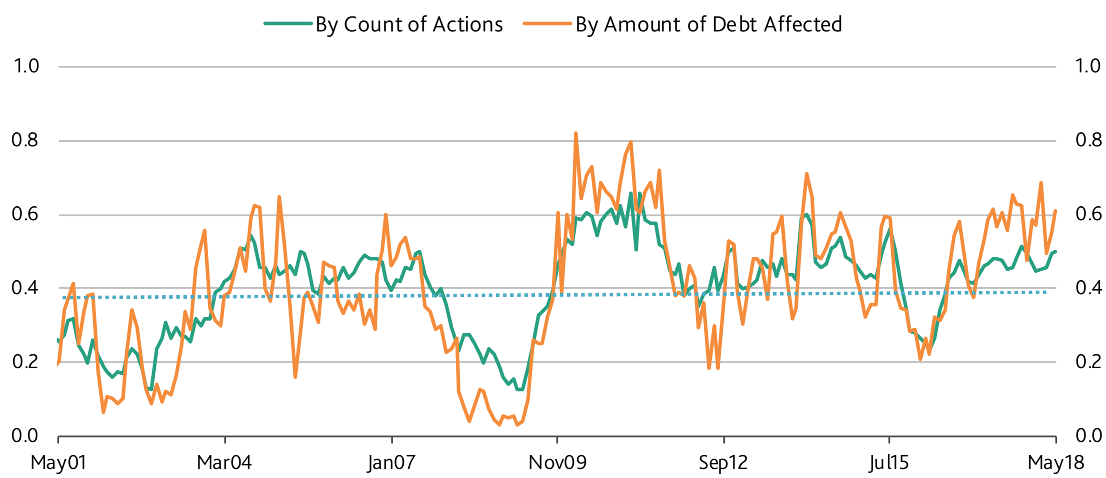
U.S. Retail and Building Materials Lead Positive Rating Changes

The U.S. retail and miscellaneous sectors were the main contributors in pushing the contribution of positive rating changes to 63% in the past week. Other sectors to experience upgrades in the U.S. included funeral services, hospital, and building materials. This marks the second straight week the positive contribution has exceeded 60%. In the retail and miscellaneous space, a strengthening economy and strong labor market positively reflect the number of upgrades. Likewise, in the building materials sector, the continued growth of the economy, construction spending and the tightening labor market are all supportive of continued strong performance in recent weeks. On the downgrade side, Koch Industries – Koch Resources LLC had its issuer Rating to A1 from Aa3. The rating change action reflects Koch Resources intent to dividend a substantial portion of liquidity to Koch Industries as part of a plan to optimize capital structure.

Rating change activity in Europe was light last week with only two changes, both downgrades.

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

FIGURE 3

Rating Changes: Corporate & Financial Institutions – US

Date	Company	Sector	Rating	Amount ($ Million)	Up/ Down	Old LTD Rating	New LTD Rating	IG/ SG
7/18/18	WOLVERINE WORLD WIDE, INC.	Industrial	SrUnsec /LTCFR/PDR	250	U	Ba3	Ba2	SG
7/19/18	INGLES MARKETS, INCORPORATED	Industrial	SrUnsec /LTCFR/PDR	700	U	B1	Ba3	SG
7/19/18	HILLENBRAND, INC.	Industrial	SrUnsec	150	U	Ba1	Baa3	SG
7/19/18	HERCULES COMBINED HOLDCOS -VARSITY BRANDS HOLDING CO., INC.	Industrial	SrSec/BCF /LTCFR/PDR		D	B1	B2	SG
7/19/18	WIRECO WORLDGROUP INC.	Industrial	SrSec/BCF /LTCFR/PDR		U	Caa1	B3	SG
7/20/18	ASCENT CAPITAL GROUP, INC. -MONITRONICS INTERNATIONAL, INC.	Industrial	SrUnsec/SrSec /BCF/LTCFR/PDR	585	D	Caa2	Caa3	SG
7/23/18	KOCH INDUSTRIES, INC. -KOCH RESOURCES, LLC	Industrial	LTIR		D	Aa3	A1	IG
7/23/18	PC NEXTCO HOLDINGS, LLC -PARTY CITY HOLDINGS INC.	Industrial	SrUnsec /SrSec/BCF	350	U	B2	B1	SG
7/23/18	HI-CRUSH PARTNERS LP	Industrial	LTCFR/PDR		U	B3	B2	SG
7/24/18	PROPULSION ACQUISITION, LLC	Industrial	SrSec/BCF /LTCFR/PDR		D	B2	B3	SG
7/24/18	EAGLEVIEW TECHNOLOGY CORPORATION	Industrial	PDR		U	Caa1-PD	B3-PD	SG

Source: Moody's

Ratings Round-Up

FIGURE 4
Rating Changes: Corporate & Financial Institutions – Europe

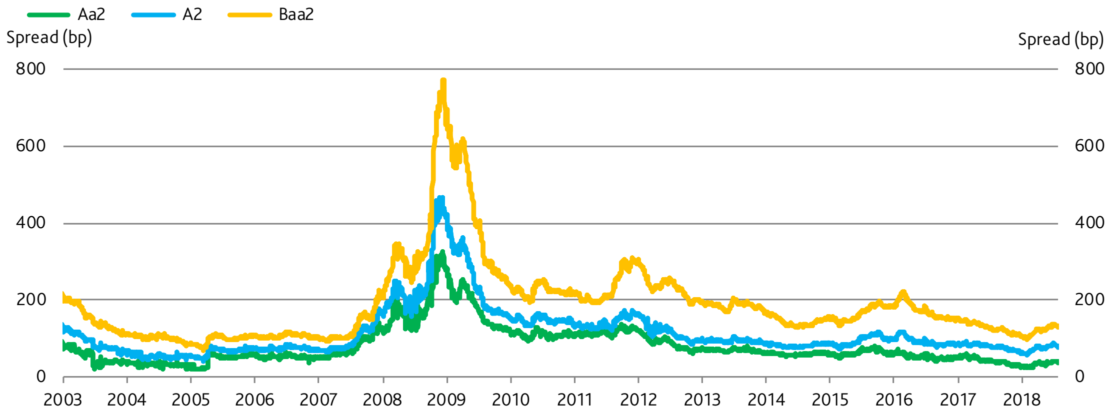
Date	Company	Sector	Rating	Amount ($ Million)	Up/ Down	Old LTD Rating	New LTD Rating	IG/ SG	Country
7/24/18	SUEDZUCKER AG-SUEDZUCKER INTERNATIONAL FINANCE B.V.	Industrial	JrSub	820	D	Ba2	Ba3	SG	NETHERLANDS
7/24/18	HOUSE OF FRASER (UK & IRELAND) LIMITED-HOUSE OF FRASER (FUNDING) PLC	Industrial	SrSec/LTCFR/PDR	216	D	Caa1	Caa2	SG	UNITED KINGDOM

Source: Moody's

Market Data

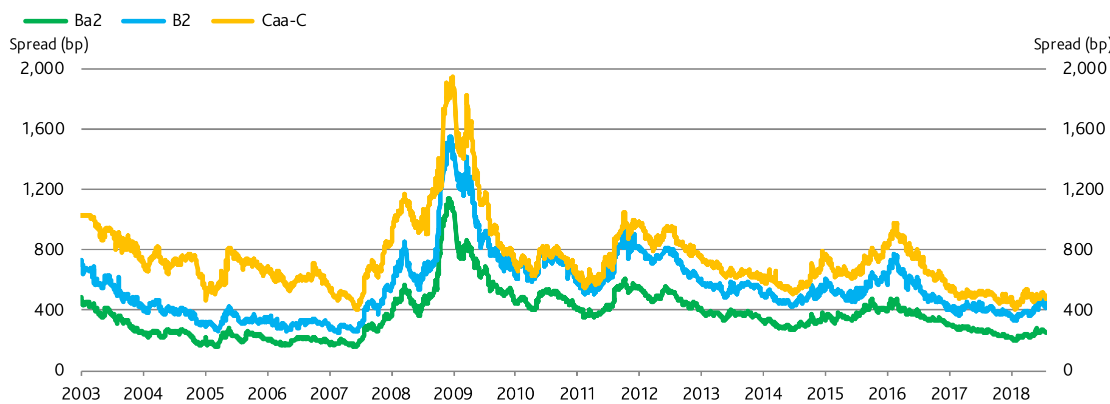
Spreads

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 (July 18, 2018 – July 25, 2018)

CDS Implied Rating Rises	CDS Implied Ratings		
Issuer	Jul. 25	Jul. 18	Senior Ratings
Bunge Limited Finance Corp.	Ba1	B1	Baa2
Verizon Communications Inc.	Baa1	Baa2	Baa1
American Express Credit Corporation	Aa2	Aa3	A2
Comcast Corporation	A2	A3	A3
Philip Morris International Inc.	A3	Baa1	A2
HCA, Inc.	Ba1	Ba2	Ba2
First Data Corporation	Ba1	Ba2	B2
Mondelez International, Inc.	A2	A3	Baa1
Kinder Morgan Energy Partners, L.P.	A2	A3	Baa3
CSX Corporation	Aa2	Aa3	Baa1

CDS Implied Rating Declines	CDS Implied Ratings		
Issuer	Jul. 25	Jul. 18	Senior Ratings
Rite Aid Corporation	Ca	Caa2	Caa1
United States of America, Government of	Aa1	Aaa	Aaa
John Deere Capital Corporation	Baa1	A3	A2
PepsiCo, Inc.	Aa3	Aa2	A1
Exxon Mobil Corporation	Aa3	Aa2	Aaa
General Electric Company	Baa3	Baa2	A2
HSBC Finance Corporation	Baa1	A3	Baa1
Anthem, Inc.	A2	A1	Baa2
Time Warner Inc.	Baa1	A3	Baa2
FedEx Corporation	A3	A2	Baa2

CDS Spread Increases		CDS Spreads		
Issuer	Senior Ratings	Jul. 25	Jul. 18	Spread Diff
Windstream Services, LLC	Caa2	2,502	2,182	320
Sears Roebuck Acceptance Corp.	C	2,126	2,021	105
Sears Holdings Corp.	C	1,769	1,681	87
Frontier Communications Corporation	Caa1	1,496	1,425	72
Rite Aid Corporation	Caa1	722	676	45
Goodyear Tire & Rubber Company (The)	Ba3	246	218	28
Beazer Homes USA, Inc.	B3	392	365	27
American Axle & Manufacturing, Inc.	B2	325	302	23
Dish DBS Corporation	B1	634	614	21
Whirlpool Corporation	Baa1	102	83	19

CDS Spread Decreases		CDS Spreads		
Issuer	Senior Ratings	Jul. 25	Jul. 18	Spread Diff
Parker Drilling Company	Caa2	1,373	1,459	-86
Bunge Limited Finance Corp.	Baa2	132	188	-56
Tenet Healthcare Corporation	Caa1	340	376	-37
AK Steel Corporation	B3	390	423	-32
Weatherford International, LLC (Delaware)	Caa1	481	512	-31
K. Hovnanian Enterprises, Inc.	Caa3	1,096	1,122	-26
Talen Energy Supply, LLC	B2	729	754	-24
Lexmark International, Inc.	Caa1	1,198	1,220	-22
Arconic Inc.	Ba2	241	261	-20
AutoNation, Inc.	Baa3	413	433	-20

Source: Moody's, CMA

Market Data

Figure 4. CDS Movers - Europe (July 18, 2018 – July 25, 2018)

CDS Implied Rating Rises	CDS Implied Ratings		
Issuer	Jul. 25	Jul. 18	Senior Ratings
E.ON SE	Aa3	A1	Baa2
Heineken N.V.	Aa3	A1	Baa1
EDP - Energias de Portugal, S.A.	Baa1	Baa2	Baa3
TDC A/S	B1	B2	B1
Airbus SE	Aa2	Aa3	A2
NN Group N.V.	A2	A3	Baa1
Bertelsmann SE & Co. KGaA	Aa1	Aa2	Baa1
Unipol Gruppo S.p.A.	Ba2	Ba3	Ba1
Brisa Concessao Rodoviaria S.A.	Baa2	Baa3	Ba1
Ineos Group Holdings S.A.	B1	B2	B1

CDS Implied Rating Declines	CDS Implied Ratings		
Issuer	Jul. 25	Jul. 18	Senior Ratings
Nationwide Building Society	A2	Aa3	Aa3
Publicis Groupe S.A.	Baa2	A3	Baa2
Storebrand ASA	B1	Ba2	Baa3
Italy, Government of	B2	B1	Baa2
Rabobank	Aa3	Aa2	Aa3
The Royal Bank of Scotland Group plc	Ba1	Baa3	Baa2
Santander UK plc	A3	A2	Aa3
Intesa Sanpaolo S.p.A.	Ba2	Ba1	Baa1
CaixaBank, S.A.	Baa3	Baa2	Baa2
Danske Bank A/S	A2	A1	A1

CDS Spread Increases		CDS Spreads		
Issuer	Senior Ratings	Jul. 25	Jul. 18	Spread Diff
Galapagos Holding S.A.	Caa3	3,395	3,051	344
Astaldi S.p.A.	Caa1	1,878	1,761	117
CMA CGM S.A.	B3	646	600	46
PizzaExpress Financing 1 plc	Caa1	1,157	1,132	25
Storebrand ASA	Baa3	187	164	23
Altice Finco S.A.	B3	417	399	19
Fiat Chrysler Automobiles N.V.	Ba3	175	161	14
Vue International Bidco p.l.c.	B3	243	230	13
Italy, Government of	Baa2	201	194	8
Nationwide Building Society	Aa3	46	38	8

CDS Spread Decreases		CDS Spreads		
Issuer	Senior Ratings	Jul. 25	Jul. 18	Spread Diff
Boparan Finance plc	Caa1	578	647	-69
Eksportfinans ASA	Baa3	431	451	-20
TDC A/S	B1	191	206	-16
Sappi Papier Holding GmbH	Ba2	336	352	-16
Ineos Group Holdings S.A.	B1	191	206	-15
Anglo American plc	Baa3	141	155	-14
Leonardo S.p.a.	Ba1	169	182	-13
Selecta Group B.V.	Caa2	339	351	-12
Peugeot S.A.	Ba1	116	128	-11
Unipol Gruppo S.p.A.	Ba1	158	169	-11

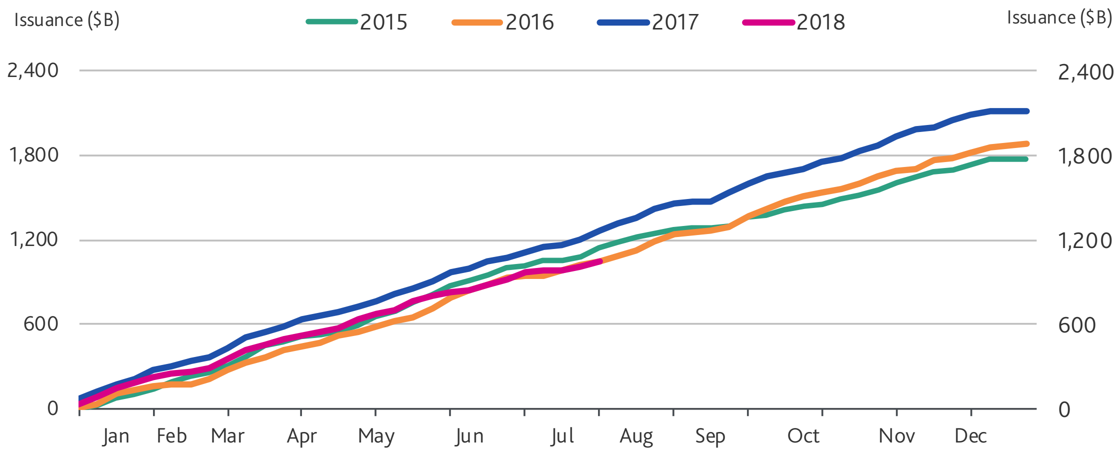
Source: Moody's, CMA

Market Data

Issuance

FIGURE 5

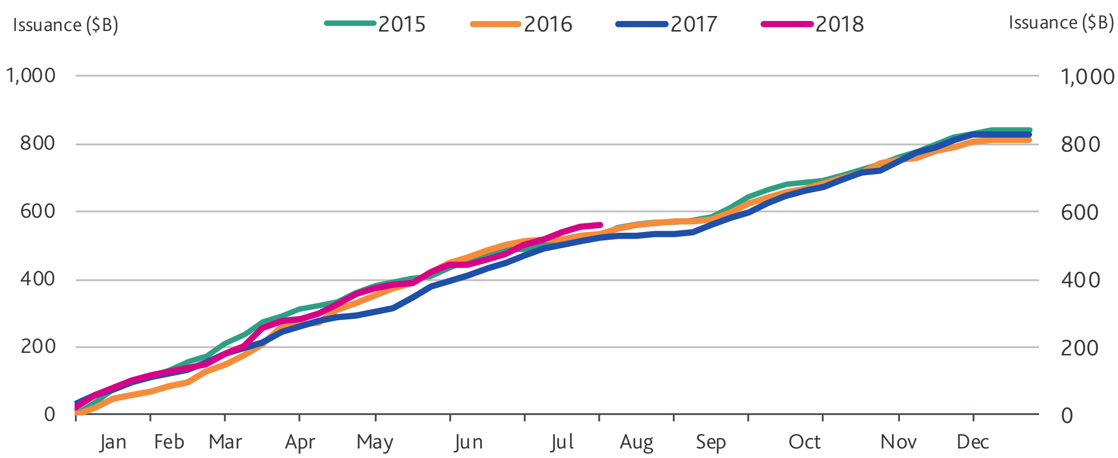
Market Cumulative Issuance - Corporate & Financial Institutions: USD Denominated



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	32.936	5.908	39.770
Year-to-Date	803.881	195.114	1,047.187

	Euro Denominated		
	Investment-Grade	High-Yield	Total*
	Amount $B	Amount $B	Amount $B
Weekly	6.679	1.463	9.120
Year-to-Date	471.076	65.487	562.954

* Difference represents issuance with pending ratings.

Source: Moody's/ Dealogic

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