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Some Weakness at the Margins

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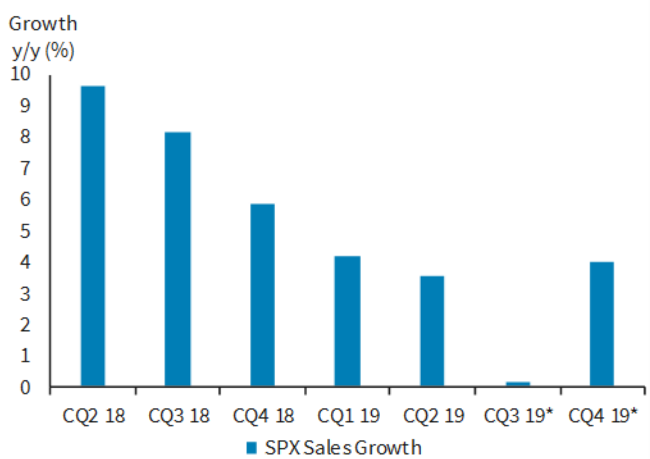
US companies have experienced positive growth, albeit at a declining rate, over the past several quarters, as slowing global growth has weighed on top-line revenues – a trend that is expected to continue in 3Q earnings (Figure 1). Indeed, expectations for economic activity this year have been tempered, and Barclays Economics Research has revised down its 2019 global GDP estimate from 3.7% at the beginning of the year to 3.1%.

In line with the downward revision in the growth outlook, investment grade corporates' 2019 sales estimates have come down, and 2019 earnings growth forecasts have been revised downward as well. Figure 2 shows how investment grade industrial sales and EBITDA growth estimates for 2019 have changed since the beginning of the year for As and BBBs. In fact, As had earnings growth expectations dip slightly below sales growth expectations – a phenomenon that implies margin compression through year-end. Margin expectations have also been lowered significantly for BBBs, but are still expected to improve year-over-year.

Coming into 2019, investment grade margins were at all-time highs, and after the downward revisions, they are now expected to remain flat year-over-year, but at elevated levels. Furthermore, despite the downward revision in domestic growth, our US GDP forecast is still 2.2% and 1.6% for 2019 and 2020, respectively, which should be sufficient to sustain positive, albeit slowing, revenue growth. With corporates also terming out debt, which is a meaningful credit positive (see *Terming Out Debt is Good for Credit Health*), we believe overall corporate fundamentals remain robust even with the projected slowdown in EBITDA growth.

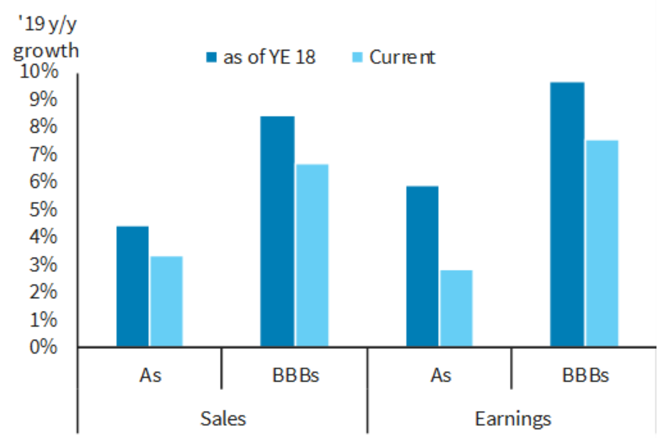
That said, as discussed in *Beyond Leverage: Fundamental Factors That Matter*, EBITDA margin is the most important fundamental driver of underperformance in a sell-off. Therefore, we believe margin trends are important to monitor, particularly in sectors/ portions of the index where margins are facing downward pressure. While the decline in A rated margins supports our preference for BBBs in general, sector margins can differ greatly as well, and we next examine margin forecast revisions by sector.

FIGURE 1
Quarterly S&P Sales Growth Continues to Slow in 2019



Note: *Estimates. Source: Bloomberg

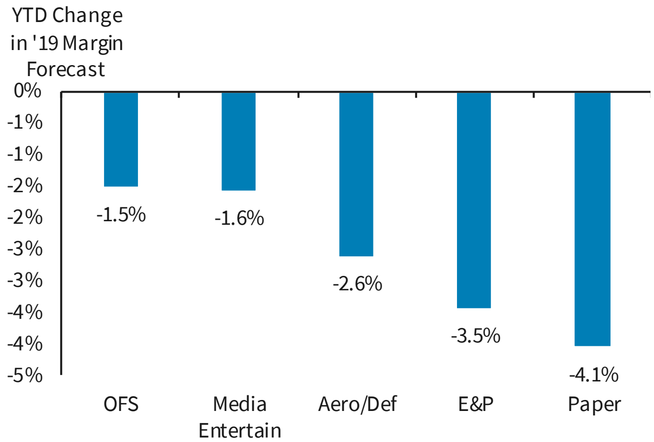
FIGURE 2
2019 US Investment Grade Sales and EBITDA Estimates, December 2018 and Present



Note: Excludes tickers with M&A driving large y/y changes
Source: Factset, Bloomberg, Barclays Research

FIGURE 3

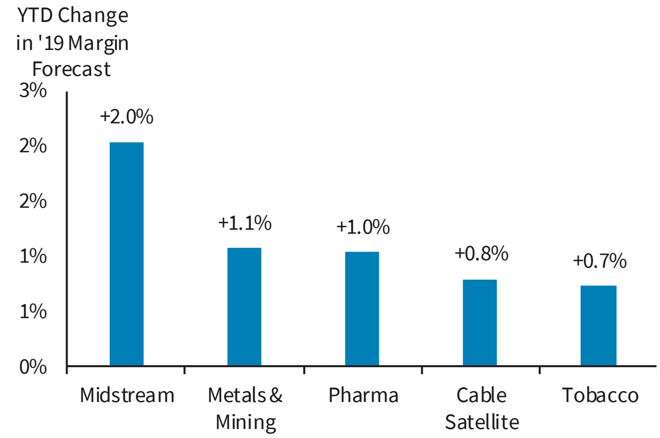
Year-to-Date Change in FY2019 Margin Expectations



Source: Factset, Bloomberg, Barclays Research

FIGURE 4

Year-to-Date Change in FY2019 Margin Expectations



Source: Factset, Bloomberg, Barclays Research

Figure 3 highlights sectors that have had the largest downward revision in 2019 margin forecasts since the beginning of the year. The paper sector has had the largest, driven by capacity addition in containerboard, the industry's major product, plus weaker pricing in white paper and pulp. E&P and oil field services margin expectations have been lowered, in line with lower expectations for oil prices, although the former continues to be one of the highest-margin sectors across all of investment grade. Boeing has been the main driver of lower margins in aerospace & defense, while Disney's margin expectations have come down as well because of its investment in OTT services, pulling sector margin expectations lower for media & entertainment as a whole.

Not all sectors have experienced a downward revision in margin expectations; in fact, some of the wider-trading sectors should have margin improvement through year-end (Figure 4). Unlike the more commodity-sensitive parts of the energy value chain, margin expectations for the midstream sector have improved this year as management teams have cut costs and benefited from EBITDA growth with new assets ramping up. As much as higher production volumes are a headwind for commodity pricing, they benefit infrastructure owners. Harry Mateer recently upgraded the sector to Overweight, given attractive valuations, with a preference for higher-beta names (see *Diagnosis: Midstream*). Margin improvement in metals is tied primarily to significantly stronger pricing for iron ore (driven by supply disruption) and gold (driven by rates), partially offset by lower commodity prices elsewhere (copper, cobalt). Cable and satellite providers have had margin expectations improve as they continue to shift from low-margin video to higher-margin broadband services.

We continue to expect valuations to remain range-bound through year-end and have a preference for the wider-trading parts of the market, particularly low- and mid-BBB paper. With global central banks remaining accommodative, funding conditions are benign and the likelihood of a recession in the near future remains low, which should be supportive of corporate fundamentals. However, amid slowing growth and trade uncertainty, sectors facing margin compression warrant a more cautious approach. Should this trend continue, we believe valuations of these sectors, and some of the most exposed names in particular, could come under pressure.

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