Previously published in the U.S. Credit Alpha
5 April 2019

Signs of Good Health from Supply

Shobhit Gupta
+1 212 412 2056
shobhit.gupta@barclays.com
BCI, US

James K Martin
+ 1 212 412 2345
james.k.martin@barclays.com
BCI, US

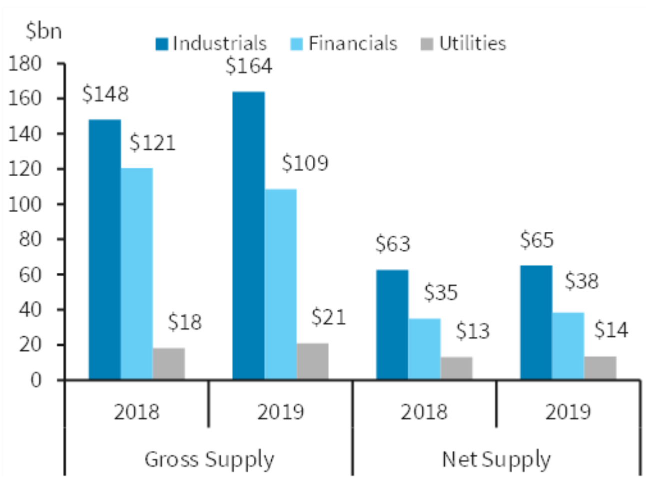
Bradford Elliott, CFA
+1 212 526 6704
bradford.elliott@barclays.com
BCI, US

Through the first quarter of 2019, gross and net fixed corporate supply were up marginally year-over-year (+2% and +5%, respectively). Financial gross supply is down 10% from 1Q18, driven largely by a 15% decline in issuance from the big six financial institutions, which have shifted to maintaining TLAC issuance as it rolls down and avoided issuing in January, when spreads were wider. Industrial gross supply is up 11% from the same time last year; however, January 2018's industrial supply was the lowest total since 2010 (at a paltry $18.1bn), as US companies were adjusting to a new corporate tax regime after the Tax Cuts and Jobs Act passed in December 2017. In fact, 2019 industrial supply is about 10% lower than in the first three months of 2016 or 2017, and it is somewhat remarkable that issuers have not taken further advantage of the benign spread and yield environment, since the volatility in 4Q18 likely delayed some primary activity as well.

One reason that supply has not been higher has been the dearth of debt-funded M&A. Even with the recent $11bn of bonds that Broadcom brought to fund its acquisition of CA Technologies, M&A supply is down 44% year-over-year. While one might consider last year exceptional, given the $40bn CVS printed for its Aetna purchase, the average 1Q M&A supply since 2015 has totaled over $50bn; this year has reached only $34bn. There has not, however, been a commensurate drop in the volume of announced M&A deals; over the past twelve months, it is actually up 7% from the same time last year (we look at the trailing 12-month total, as bond issuance can lag deal announcement by 2-3 quarters).

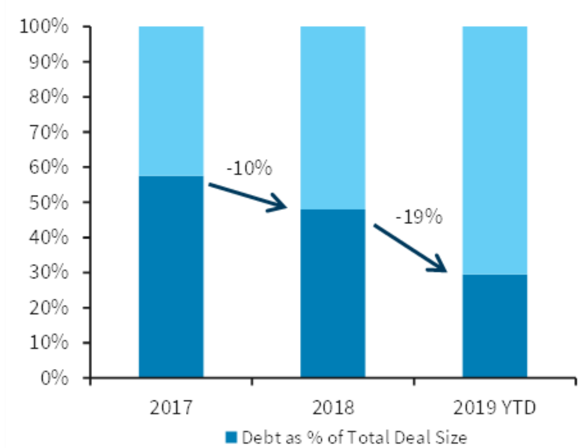
Instead, the funding mix for M&A has continued to tilt away from debt. Figure 2 shows the funding mix of the ten largest M&A deals in 2017, 2018, and thus far in 2019; in each year, debt as a percentage of the transaction size has decreased. While the 2019 number may be somewhat exaggerated by the smaller overall sample size of deals, we believe this trend should continue. As discussed in *Debt Funded Acquisitions Lose Their Luster*, companies that issued debt to fund M&A used to outperform peers in equity markets, but more recently that trend has reversed, and companies that executed all-stock transactions have actually outperformed.

FIGURE 1
1Q Gross and Net Fixed Corporate Supply, 2018 versus 2019



Source: Bloomberg Barclays Indices, Barclays Research

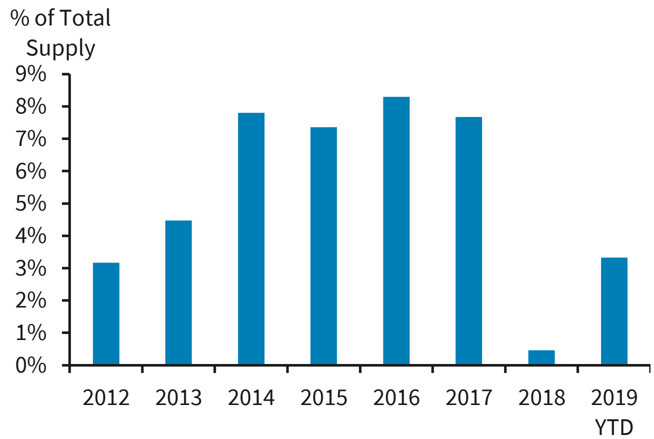
FIGURE 2
Funding Mix of the Largest M&A Deals



Source: Bloomberg, Barclays Research

FIGURE 3

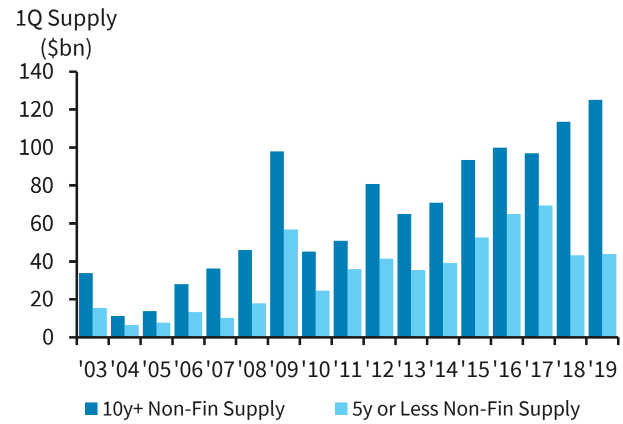
Percent of Supply from Companies with Overseas Cash



Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 4

Long- and Short-Dated Non-Financial Supply



Source: Bloomberg Barclays Indices, Barclays Research

Furthermore, US companies with large cash balances abroad were significant contributors to supply prior to having overseas earnings deemed repatriated at the end of 2017, another facet of the Tax Cuts and Jobs Act. Figure 3 tracks dollar debt issuance from companies with large overseas cash balances; prior to tax reform, they would issue debt to have access to cash that was tied up overseas, but in 2018, their issuance was effectively non-existent. Issuance from these companies this year has remained subdued, with the only two deals among this cohort in 1Q coming from Merck and Pfizer, which both refinanced short-term debt and extended duration.

Extending duration has been a popular tactic thus far in 2019. Non-financial companies have issued a record amount of longer-dated securities: $125bn of 10y+ notes in the first quarter (Figure 4), which puts 2019 on pace to be the largest year for 10y+ supply on record. As we discussed in *Love Me Tender*, the historically flat yield curve and benign spread environment provide fertile ground for companies to reduce their shorter-term debt burdens and extend maturities beyond a potential cycle turn, so they will be less likely to face issuance needs in a more unfavorable environment. The increase in longer-dated supply has been complemented by the absence of front-end issuance for non-financials. First-quarter supply of bonds with a maturity of five years or less as a percent of total non-financial supply hit its lowest level since 2007. We expect this trend to continue as long as spread and yield curve conditions remain near current levels.

Since 2012, April-December fixed-rate corporate supply has totaled less than $700bn on average. If we do not exceed this historical trend, issuance would land below $1trn for the second consecutive year. The slowing pace of supply, specifically from M&A issuers, should be supportive of valuations. The front end of the curve should see a particularly positive technical, as we expect companies to continue to term out debt.

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