Where We Are In This Credit Cycle

Bank of America Merrill Lynch

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High Yield Strategy
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Higher rates provide an easy backdrop for HY tightening

HY spreads tightened easily into sharp moves higher in rates this week. The 10yr Trsy touched on 1.79% Thursday afternoon, a 37bp rebound from its recent post-Labor Day lows. HY OAS closed at 385 on Thursday, an impressive 65bps move from mid-August wides. Lower quality outperformed naturally in this environment, with CCCs and single-Bs posting 80bps and 45bps total return outperformance over BBs respectively.

Top sector performers this week were energy, chemicals, retail, and telecoms; on the other side, financials, cable, food producers, and gaming all trailed the index. Energy and chemicals have now outperformed the market for three weeks in a row.

In technicals this week, we saw $1.8bn inflow into HY funds, split half-half between ETFs and mutual funds. The inflow was coupled with negligible coupons ($62mn) and heavy calls/maturities of $7bn. Next week is expected to bring in above-average coupons of $4.5bn and light calls/maturities of $1.2bn. On the supply side, we had $9bn priced for the week, bringing Sep MTD issuance to $13.5bn. The current run-rate of HY issuance implies $28bn total for September. We think this pace is unlikely to be sustained, just like the IG market slowed down after the record week earlier. We expect the monthly total to be closer to $25bn at this point.

So what do we think here? The move higher in rates so far has reversed 37bps on the 10yr scale from its low-tick earlier this month. Our earlier expectation was for a 50-75bps rebound on this scale and we remain comfortable with this view. We recommend adding duration on weakness so far and remain prepared to do more if this continues. HY is now trading 65bps inside of our risk-neutral target but could go temporarily even tighter if the upward pressure in rates persists. Single-Bs remain our preferred quality segment.

Ford was downgraded by Moody's to Ba1 earlier this week, and its $35bn capstructure remains three notches away from going into the HY index. As discussed in our in-depth publication on fallen angels, over the past 20 years, an average fallen angel has come into HY at 250bp over BBs and proceeded to tighten from there. A widening to 250bps over BBs implies a dollar price drop of about 15-20pt for a generic BBB name assuming average 7yr duration.

About 55% of those fallen angels came in relatively tight, in the 0-200bps range over BBs, and failed to show much tightening once in HY. Another 23% came in the 200-400bps range and proceeded to tighten by an average of 170bps from there, providing the best risk-adjusted return once in HY. The widest cohort came in at 400bps+ over BBs (22% of total sample), failed to find immediate bottom, proceeded to widen to an average of 700bps over BBs and experienced a high default rate (32 of the 168 fallen angels defaulted over the past 20 years, most of them originated in this last cohort).

If Ford were to be downgraded into HY, it would become the largest single issuer in our DM USD HY index (currently this title belongs to Charter with $20.4bn). This should be a manageable event for the overall HY market in our view, assuming a Ford downgrade, if it were to happen, takes place in isolation. If this was happening at current index levels and with current risk sentiment, we would expect the HY market to widen initially to the tune of 50-75bps, before recapturing most of this widening back.

Refer to important disclosures on page 10 to 12. Analyst Certification on page 9. 12043373

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Where We Are In This Credit Cycle

Timing the turns in credit cycles is an inherently uncertain exercise that is subject to random events, their mutual interaction, and unforeseen second-order effects. Most such timing forecasts provide little practical value as a result.

And yet there are useful measures and qualitative attributes that could be used to gain a better understanding of where we are in a particular cycle and relate it to earlier experiences. A realistic practical goal of such an exercise is to identify unsustainable trends in their late stages of development. Such trends would then be expected to turn sooner rather than later.

It is common knowledge that this credit cycle is among the longest on record. As our data below shows, it has also seen the record deployment of capital, both in dollar and in percentage terms, a record extension of duration at a time when interest rates are hitting record lows. Measures of credit risk are elevated, whether viewed through the lenses of leverage or growth of lowest-quality segments. The deterioration in covenants is an Achilles' heel of this credit cycle.

Despite all these concerns, the credit markets are trading close to historical tights as strong investor demand is underpinned by extreme central bank policies and severe shortage of positively-yielding instruments. A number of corporate debt issuers made public statements on strategy shifts towards deleveraging in the aftermath of Q4 2018 market dislocation, although the track record since then remains spotty.

Much is riding on the ability of US corporations to arrest the recent post-tax-reform normalization in earnings growth. The current market consensus forecasts earnings returning to 12-13% growth range in a year from now, up from the latest reading of 1-2% growth. Whether or not consensus is right in this rather optimistic forecast will be the most important determinant of how this credit cycle develops from here, in our view.

The ongoing trade war coupled with political, legal and regulatory pressures on key sectors of the US economy – healthcare and technology – are among the channels that could lead us to the turn in the credit cycle, in our view.

We think constrained liquidity is likely to be the amplifying factor that would transpire in abrupt market moves and make market-timing strategies expensive to execute.

This credit cycle in numbers

Figure 1 measures growth in non-financial US corporate debt in each of the past three credit cycles. Since 2009, the group has added +$4.3trln in new debt, representing +66% of the initial size. These figures set new records on both scales.

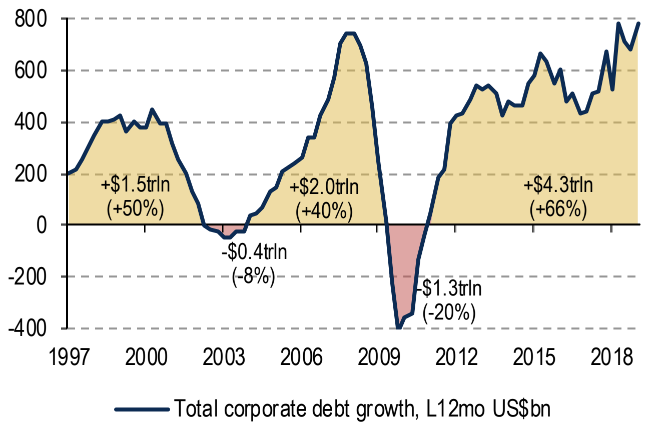
Importantly, the chart also shows that growth in debt has resumed in recent months, following a short pause after the market dislocation in Q4 2018. Corporations owe $475bn more today than they did at this point last year.

Figure 2 provides an asset class breakout of overall debt growth in recent years, where the top contributors were private debt, public IG, and broadly syndicated loan markets, although the latter has slowed down sharply in 2019. The only asset class with a negative growth rate over the past three years was public HY.

The private debt market is now approaching $1trln in size, having grown by over 70% over the past three years alone. This rate exceeds the peak growth levels of any US credit asset class that we have data on over the past 25 years. We define private debt as any form of debt outside of public bond markets, broadly syndicated loans, and loans held on bank balance sheets. This broad definition includes segments such as direct lending and middle-market loans.

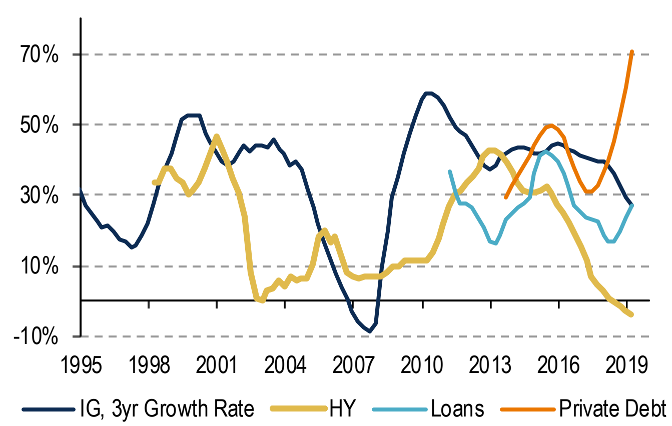
The exact size of this asset class is impossible to establish as the information is mostly private by definition. We estimate its size by starting with overall US non-financial debt stock as reported by the Fed's Flow of Funds and exclude known public debt segments (bonds, syndicated loans and bank-held loans).

Figure 1: US non-financial corporate debt, trailing 12mo change US$bn



Source: BofA Merrill Lynch Global Research, Federal Reserve

Figure 2: US non-financial corporate debt, 3yr growth rate pct



Source: BofA Merrill Lynch Global Research, Federal Reserve

Figure 1 is also helpful in understanding what happens once a credit cycle turns: it shows the total corporate debt stack contracting by $400bn in the 2001-2002 episode and $1.3trln in 2008-2009, representing 8% and 20% of the original market size. If 10% of capital were to leave the corporate credit space in the next credit cycle, this would imply $1trln in potential exodus given the overall debt stack of $10trln. By definition, such exodus must be offset by deleveraging whether through redemptions or defaults.

Late-cycle signs of exuberance

The prevalence of extremely low yields is pushing investors to take on extraordinary risks along the following four axes:

Duration risk

Figure 3 shows record long duration of the ICE BofAML Global Bond Market Index (GBMI), which is coincident with record-low yields. This extreme duo comes on the heels of a major central bank pivot: of the 37 central banks tracked by our economics team, 20 have already loosened policy in 2019 and another six are expected to do so by year-end (70% of total). While the stampede of flows seeking positive yields to this point is understandable, the question remains how much more of this should we expect to happen going forward. We may already be in the early stages of a tactical reversal, with the US 10yr yields backing up by 37bps in the last two weeks alone.

Credit risk

There are multiple ways to show how investors are taking on exceedingly high credit risk, with just the two of them shown in Figure 4 and Figure 5. Figure 4 depicts growth in the BBB segment, which we have covered extensively here. To summarize, BBBs have grown to record size in absolute sense ($2.3trln on non-financial DM USD BBB bonds), as a percent of IG (60%), or as a percent of HY (220%, Figure 4).

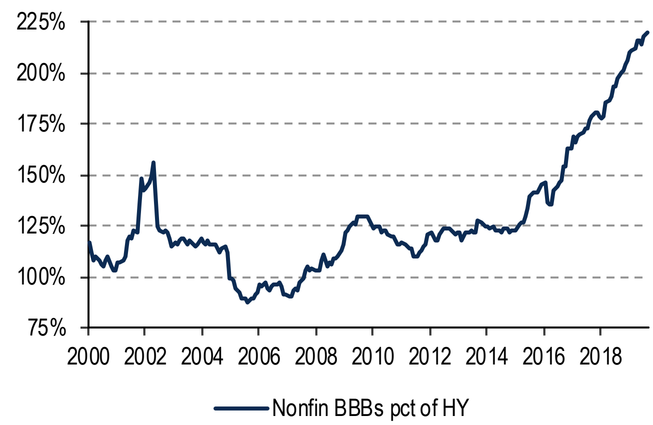
On the debt leverage size, Figure 5 goes on to show that the HY market currently measures 5.0x in total debt/EBITDA, an elevated level for this point in the credit cycle. Recall that each previous peak in leverage in 1991, 2001, and 2009 was achieved as a function of EBITDAs dropping 20-30% in a recessionary environment. If an event like that were to take place at current debt levels, we would be looking at leverage jumping to 6-7x matching and even exceeding peaks of the previous credit cycles.

This is why the point we made earlier on earnings and the consensus estimates of their rebound is so critical: the current debt burden simply does not allow any room for a scenario of contracting earnings, where the credit market would be able to maintain its cool. As Figure 6 shows, our work questions whether such a rebound in earnings growth is imminent. At the same time, our earnings estimates are not yet showing a deep contraction either, so the jury is still out on this perhaps the most crucial element of understanding the cycle dynamics.

Figure 3: Global bond market effective duration, years

Source: BofA Merrill Lynch Global Research, ICE Data Indices, LLC

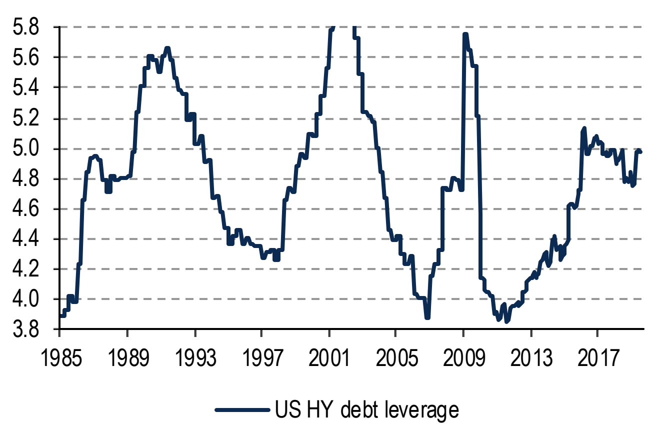
Figure 4: US non-financial corporate BBBs, pct of HY



Source: BofA Merrill Lynch Global Research, ICE Data Indices, LLC

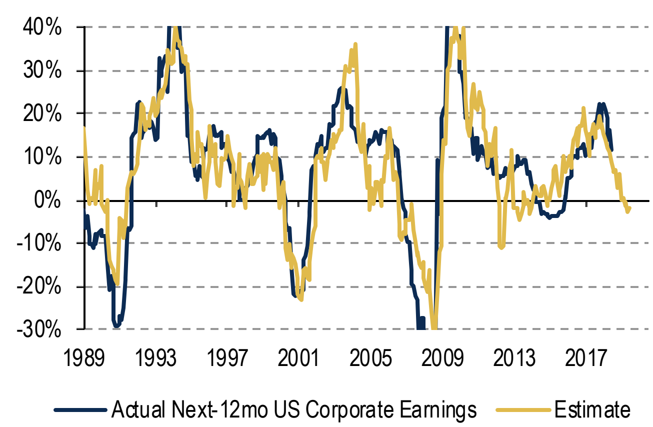
Loose debt covenants have also become a poster child of this credit cycle, with the reach of poor investor protections in recent years going far beyond the maintenance-test that originally gave the name to cov-lite deals. The new crop of cov-lites has moved to new frontiers, such as EBITDA add-backs, weakening of asset liens, and loss of control over additional debt incurrence among the most relevant examples.

Figure 5: US HY debt leverage ratio, total debt/EBITDA



Source: BofA Merrill Lynch Global Research, Federal Reserve

Figure 6: US corporate earnings growth, actual vs estimate



Source: BofA Merrill Lynch Global Research

Note the key difference between these two groups: whereas absence of maintenance covenants arguably has limited implications for potential recovery in default, the covenants listed above represent key instruments of value preservation in a distressed situation.

Moody's classifies EBITDA adjustments into four groups: minimal (the original EBITDA definition, which was given a new title, "pristine"), conservative (add-backs limited to non-cash and extraordinary items), aggressive (add-backs limited to a particular transaction and capped at 20-30% of EBITDA), and very aggressive (uncapped add-backs allowed).

The rating agency has found that _none_ of the deals priced so far this year fit into minimal or conservative definitions, with 2/3rds classified as aggressive and 1/3rd as very aggressive. This actually represents an improvement from 2018, when very aggressive deals accounted for 48% of total, also achieved on record dollar volume.

Liquidity risk

The inflow of $4.3trln into US corporate credit during this credit cycle was accommodated by a well-oiled new issue machine, which has no equivalent on the other side. Of this total, $1trln is now in private debt, which offers virtually zero secondary market liquidity. We devote a separate section below to our thoughts on this important aspect of risk.

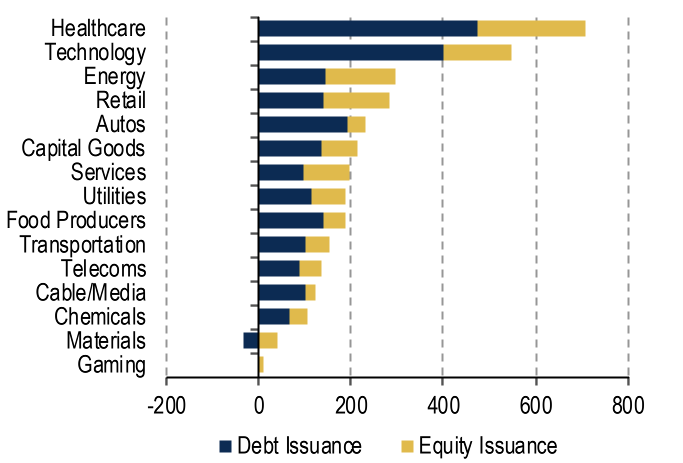
FX risk

US credit markets are a direct beneficiary of very strong foreign flows seeking positive yields. Given that FX hedging costs are very high for longer tenors as they are in turn a function of interest rate differentials, foreign investors are forced to routinely under-hedge their true FX risk exposures by either rolling shorter hedge tenors or setting lower notional hedge exposures. A sharp move in currencies could trigger such foreign flows to exit the US credit market nearly simultaneously, in our view.

Capital allocation by sector

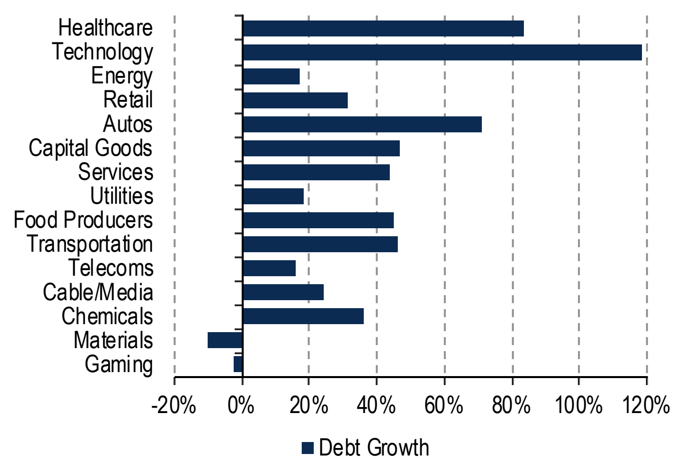
We update our framework on capital allocation trends by sector, originally introduced a year ago here. As a reminder, we aggregate the total capital raised by sector over the previous five years, including both debt and equity as shown in Figure 7. Our debt-raised measure includes public bonds (HY and IG) and broadly syndicated loans.

Figure 7: Capital allocation by sector, last 5yrs US$bn



Source: BofA Merrill Lynch Global Research

Figure 8: Debt growth by sector, last 5yrs pct of initial debt outstanding



Source: BofA Merrill Lynch Global Research

The argument here is essentially two-fold: first, to be able to attract excess capital, a sector needs to offer better expectations of returns to investors. Many growth sectors naturally start that way; however, after years of offering above-market returns, expectations continue to run high with an increased probability of those expectations not being met at some point in the future.

The second part of the argument is that once the capital is raised, firms within the sector need to compete for investment opportunities. This often leads to higher multiples paid and eventual overcapacity. Neither of these two outcomes is helpful to future returns on investment.

The two sectors that stand out on this scale today are healthcare and technology. Note how they are the only two of the top-five sectors in Figure 7 that have not yet entered the period of active deleveraging, others being energy, retail, and autos. Figure 8 goes on to show that these two sectors also happen to exhibit the highest growth rates of debt over the same five-year time horizon.

These excessive capital allocation trends are also colliding with numerous political, legal and regulatory issues faced by the two sectors today. Overall, we think this combination calls for a significant degree of caution in allocating risk budgets to these sectors, although such decisions must be taken with consideration of a view on fundamentals and valuations, which are outside the scope of this report.

Liquidity aspects

The gap between investor expectations and market reality of secondary liquidity is wide. This cognitive dissonance comes as a result of investors experiencing relatively smooth entry into the market as its well-oiled new issue machine helps absorb the inflow. However, there is no equivalent tool to help manage the withdrawal of capital at face value, which then must find a new clearing level to attract distressed buyers.

Constrained liquidity is not likely to be a factor that turns the cycle in and of itself: it would only become evident once consensus risk appetite changes, which must be a function of an earlier catalyst playing out. And yet this factor is likely to exacerbate the market reaction in a scenario of an ongoing cyclical turn.

The following datapoints could be helpful in properly scaling the liquidity risk in HY:

- Nominal bid-ask in a functioning market often ranges between 1/4pt to 1/2pt on most liquid paper; 1pt+ on less liquid stuff.
- Under somewhat stressed conditions the roundtrip costs rise to 1pt+ on most liquid stuff; 5pts+ on less liquid paper (see our in-depth piece on liquidity here). Think about Q4 2018 as a good example of such an environment.
- Under most stressed situations – think back to Jan 2016 (energy meltdown), May 2012 (EU crisis peak), Oct 2011 (US downgrade) – liquidity premiums could be approaching 10pts+ for most bonds, based on peak levels of our liquidity premium indicator described here.
- We expect these estimates to be exceeded temporarily in a full-blown cyclical turn scenario.

We think passive ETFs are likely to make their mark on the next cyclical turn as this would be the first such event in their existence (some credit ETFs were launched before 2008 but were too small to matter back then).

Four major credit ETFs have $68bn in combined AUM[1], or less than 1% of the $10trln in non-financial corporate credit. In a normally functioning market environment, they arguably reflect the true price of liquidity risk better than any other set of instruments out there, being some of the most heavily-traded and highly correlated (as opposed to basis-prone CDX) proxies in credit.

The flip side of this coin is that in a stress scenario, they are likely to set the price for the whole space as this is where the flow of a marginal dollar will be most visible. Essentially, the 1% of AUM basket is going to set the low-tick price on the $10trln asset class.

As any other kind of risk, liquidity should be thought of as a spectrum of outcomes rather than a point estimate. If the price of liquidity is steep in HY, which is relatively liquid compared to loans and even more so private debt, one needs to appreciate the degree of potential markdowns in those segments in a cyclical turn scenario.

[1] We include LQD ($36bn), HYG ($17bn), JNK ($10bn), and BKLN ($5bn) in this total.

How it ends

Timing cyclical turns is a highly uncertain exercise with little practical value. Our best realistic goal here is to identify unsustainable trends in their late stages of development. Such trends would then be expected to turn sooner rather than later. Here is our short list of such potential catalysts.

Demand for yield

The extreme pressure to find positive yielding assets has provided significant support to credit asset prices. This can change for one of the two reasons: either credit fundamentals deteriorate or interest rates go higher.

A scenario of a meaningful and sustained increase in rates seems remote at this juncture, given the prevailing narrative of major central banks. This statement does not contradict with our tactical view of US 10yr rebounding by 50-75bps from recent lows, as this is likely to represent a temporary reversal in an ongoing pressure on rates.

A sustainable move higher in rates may take a long time to materialize, with possible catalysts including trade tariffs finding their way into CPI measures and/or market pressure on central banks to step back from extreme and ineffective policies. The former is a more immediate risk whereas the latter will probably take some time to play out.

The turn in credit fundamentals is thus a more immediate risk to the current credit cycle, in our view.

Issuer fundamentals

As we outlined earlier, the current credit market already features elevated debt leverage metrics coupled with signs of investor exuberance. The glue that holds it together is growth in earnings, which remained in positive territory for more than three years now, driven to a significant degree by debt-funded share buybacks (see our in-depth piece on this topic here).

We do not forecast a contraction in earnings, although we do find consensus estimates for 12-13% growth in the next 12 months overly optimistic, as we show in Figure 6. We simply state our belief that if earnings were to contract even modestly, say to the tune of 5-10%, this could be sufficient to trigger a cyclical turn and an even bigger subsequent drop in earnings as a second-order effect. A protracted trade war coupled with political, legal, and regulatory pressures in healthcare and technology could potentially lead to this scenario, in our view.

Also note the connection between elevated leverage, weak covenants, and risk of earnings contraction: nominal data tells us the market is 5x levered and yet we know many capstructures are allowed to apply aggressive EBITDA add-backs, so the real leverage must be higher. And if a standard cyclical hit to EBITDA was going to push the leverage to 6-7x area before accounting to EBITDA add-backs, then the real impact is bound to be greater.

Again, no other question is more important to understanding the cyclical dynamic here than the ability of corporations to turn the corner on anemic earnings growth in coming months and quarters.

Channels

Within the broader context of the next cyclical turn, there will likely be areas of particular weakness, as is usually the case in any credit cycle. The next one is likely to be associated with the following areas, in our opinion:

- **Private debt and loans**, given their excessive growth rates in recent years, pressure to deploy capital, elevated leverage, weakness in covenants, and exposure to less stable foreign flows. For details, please see our original research on this topic from last year here, with most arguments continuing to develop in the same direction, as described there.

- **Fallen angels**: as we argued in the original piece on fallen angels, a cyclical peak annual downgrade rate of 6-8% is on the conservative side, the current cohort of 500 non-financial BBB issuers with $2.3trln of bonds outstanding is expected to produce 30-40 fallen angels amounting to $140-180bn in face value of downgrades per annum. The next batch of fallen angels is also likely to be top-heavy: we expect 3/4s of dollar volume to be driven by the top quartile of names (6-8 issuers with $15bn+ cap structures each).

- **Healthcare and technology** – credit cycles are rarely uniform in their sector impact and the next one is unlikely to become an exception. We think there is a good chance of it being driven by these two sectors based on the capital allocation argument described above.

How to navigate the next downturn?

First, stay conservative in credit quality. Even as CCCs spreads nearly doubled to 1,000bps+ over the past year, we remain cautious about the space, raising it to a marketweight recently more as a reflection of our tactical negative view on rates. We do not find lowest quality wide enough for the risk it carries at this stage in the credit cycle. In the context of a tactical reversal in rates, we continue to like our single-B overweight.

The enhanced liquidity profile of HY over loans and private debt is likely to be an asset in the next downturn, as liquidity premiums are likely to set their new wides. Within HY, we prefer smaller capstructures that are outside of reach of ETFs and passive money and thus less likely to be affected by the turn in tourist flows. An average small cap single-B issuer offers a 200bps premium over an average large cap single-B today (large vs small defined as top vs bottom quartile of issuers by debt face value, $1.5bn+ and $400mn-and-in respectively).

We remain underweight interest rate duration here as a tactical trade but adding on recent weakness and thinking this episode of reversal is probably about half way through its course. On the other side of it, we would want to be fully exposed to interest rate duration again and lighten up on credit risk. This is best achieved via a combination of short-duration HY coupled with off-benchmark higher quality/IG/rates positions, in our view.

Sector positioning is going to make a key difference in coming quarters and years and we are predisposed to stay conservative in healthcare and technology given their overextended capital allocation profiles, although this view must also be complemented by fundamental and valuation analysis, both of which are outside the scope of this report. On the other side of this spectrum, we think chemicals, energy, cable, real estate, and gaming – all areas of capital under-allocation in recent years – could be relative safe havens with a caveat of tight current valuations in some of those.

Lastly, credit segments with higher exposures to foreign inflows in recent years could be more susceptible to their eventual withdrawal. Foreign flows predominantly targeted higher-rated CLOs, IG industrials and higher quality HY. The interaction between the two latter segments is also likely to transpire through the fallen angel channel.

Market performance recap

Sharp movements in rates continued this week with both 10yr and 5yr Trsy up by 28bps. The US HY index absorbed the higher yields by tightening 31bps wow. The combined moves in spreads and rates delivered a total return of 0.45% and an excess return of 1.33%. Among qualities, CCCs outperformed BBs by 80bps and single-Bs by 30bps respectively.

All sectors tightened for the week, led by energy (CHK, WLL, QEP), telecoms (INTEL, S, TITIM), and cable/media (DISH, CHTR, NFLX).

In technicals this week, we saw $1.8bn inflow into HY funds, split half-half between ETFs and mutual funds. The inflow was coupled with negligible coupons ($62mn) and heavy calls/maturities of $7bn. Next week is expected to bring in above-average coupons of $4.5bn and light calls/maturities of $1.2bn. On the supply side, we had $9bn priced for the week, bringing Sep MTD issuance to $13.5bn.

In rating actions this week, Moody's downgraded Ford to Ba1/Stable on Monday. According to Moody's, the downgrade reflects Ford's lower-than-expected cash flows/profit margins and their likelihood to remain weak through 2020/2021 as the company undertakes its $11bn restructuring program. So far S&P and Fitch maintain their IG rating on Ford with negative outlook. Our auto analysts detailed their thoughts on the downgrade here. The issuer has $35bn outstanding in the IG index and is 3 notches away from becoming a fallen angel. Its 5.875s of 2021 traded down by 0.7pts since Monday.

Rating agency HY actions in the past week

Company Name	Agency		New	Old	Country	Industry	Total Debt
Ford Motor Credit Co LLC	Moody's	▼	Ba1	Baa3	US	Autos	141,470
Host Hotels & Resorts LP	S&P	▲	BBB-	BB+	US	Services	3,715
TEGNA Inc	Moody's	▼	Ba3	Ba2 *-	US	Cable/Media	3,043
TEGNA Inc	S&P	▲	BB	BB *-	US	Cable/Media	3,043
B&G Foods Inc	S&P	▼	B+	BB-	US	Food Producers	1,848
CommScope Inc	Moody's	▼	B3	B1	US	Technology	1,348
Edgewell Personal Care Co	S&P	▼	BB-	BB *-	US	Retail	1,235
Edgewell Personal Care Co	Moody's	▼	B1	Ba3 *-	US	Retail	1,235
Donnelley Financial Solutions Inc	Moody's	▲	B2	B3	US	Technology	504
CommScope Technologies LLC	Moody's	▼	B3	B1	US	Technology	345
Ashland LLC	S&P	▲	BB+	BB	US	Chemicals	
Codere Finance 2 Luxembourg SA	Moody's	▼	B3	B2	LU	Gaming	
Core & Main LP	Moody's	▼	B3	B2	US	Retail	
Ford Holdings LLC	Moody's	▼	Ba1	Baa3	US	Autos	
Mallinckrodt International Finance S	Moody's	▼	Caa1	B2	LU	Healthcare	
Topaz Solar Farms LLC	Moody's	▲	Caa1	Caa2	US	Energy	

Source: BofA Merrill Lynch Global Research, Fitch, Moody's, S&P

On the macro calendar for this week, PPI came in strong – Core PPI grew by 0.3% mom and core core PPI grew by 0.4% mom, reversing the 0.1% decline from the prior month.

After a strong month of spending in July, retail sales ex-autos, as measured by the aggregated BAC internal credit/debt card data, dropped 0.5% mom in August. However, our economists think the promotions in July effectively pulled forward demand into July, so the drop was not without solid reason.

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Marketweight: Spreads and/or excess returns are likely to perform in-line with the relevant and comparable market over the next three months.
Underweight: Spreads and/or excess returns are likely to underperform the relevant and comparable market over the next three months.

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Neutral: No purchase or sale of CDS is recommended.
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