# Situation Room

# Pleasing shareholders

Bank of America Merrill Lynch

13 August 2019

Credit Strategy
United States
Cross Product

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- **Pleasing shareholders**. Our fresh global (equity) fund manager survey (FMS) shows a record 50% of investors saying corporate balance sheets are overleveraged (see: My herd is my bond 13 August 2019). This mirrors the sharp increase in leverage for US IG companies that began in 2015 on US economic weakness and the collapse in corporate yields. Of course the FMS has only been conducted since 2005, which means that the only recession in-sample was the global financial crisis, where corporate leverage never reached high levels. Had the FMS extended back to the early 2000s recession, where corporate leverage was also high, we suspect equity investors would have been pushing back on leverage as much as we see today.

- **What's different this time**. What we think is different this time is that leverage on IG corporate balance sheets reached worrisome levels a number of years prior to the next recession. With equity investors pushing back strongly on leverage - as many of these companies would be too large to continue business as usual should they get downgraded to HY - incentives are aligned for a large number of companies with relatively high leverage - namely BBBs - to successfully pursue debt friendly action to put their balance sheets in better shape before the next recession. In prior cycles there was little time for this as the timing for the trigger in the form of pushback from equity investors was nearly coincident with the actual recession, which makes for an ugly scenario for a deleveraging process.

- **Best of BBBreed**. We track a growing list of currently 23 BBB rated companies that took debt friendly action since November 2017 (see: Credit Market Strategist 02 August 2019). Presently this list accounts for almost $500bn of index eligible IG debt, or 20% of the non-financial, non-Utilities BBB segment. While these companies experienced increasing leverage, ratings downgrades and underperformance in the corporate bond market relative to other BBBs prior to taking debt friendly action, that all changed afterward. From the point they began outperforming materially in terms of credit spreads and leverage stabilized and eventually declined. While there is further downgrade risk for ratings, about six months after the action the ratings trajectory also turns positive. It is because of significant flexibility, time and incentives to deleverage, as well as generally speaking relatively stable cash flows, we are not overly concerned about Fallen Angel risk for the greatly expanded part of the US IG market that is rated BBB in the next recession. – *Hans Mikkelsen, Yunyi Zhang*

- **A delay in tariffs**. Some of the additional tariffs on Chinese goods were delayed until December 15th, while US and China officials had a "very productive" call according to President Trump. Risk assets rallied on this de-escalation of trade tensions, while Treasury curve bear flattened. – *Yuri Seliger*

- **Daily supply update**. $10bn across 6 deals today with an average concession of 9.9bps and 1.5bps of tightening on the break, $21.1bn WTD. Following the FDX example in July, UPS also issued $1.5bn today to make pension contributions and repay CP. – *Yunyi Zhang*

- **Daily foreign demand tracker**. – *Yuri Seliger, Yunyi Zhang*

- **Other reports:** 1) Global Fund Manager Survey: My herd is my bond, 2) Positive surprise in July core CPI, core PCE to rise trend-like 0.2%, 3) BofA on USA: Summer Black Friday.


**Refer to important disclosures on page 10 to 11.**
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# Research Overview — The Situation

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## Pleasing shareholders

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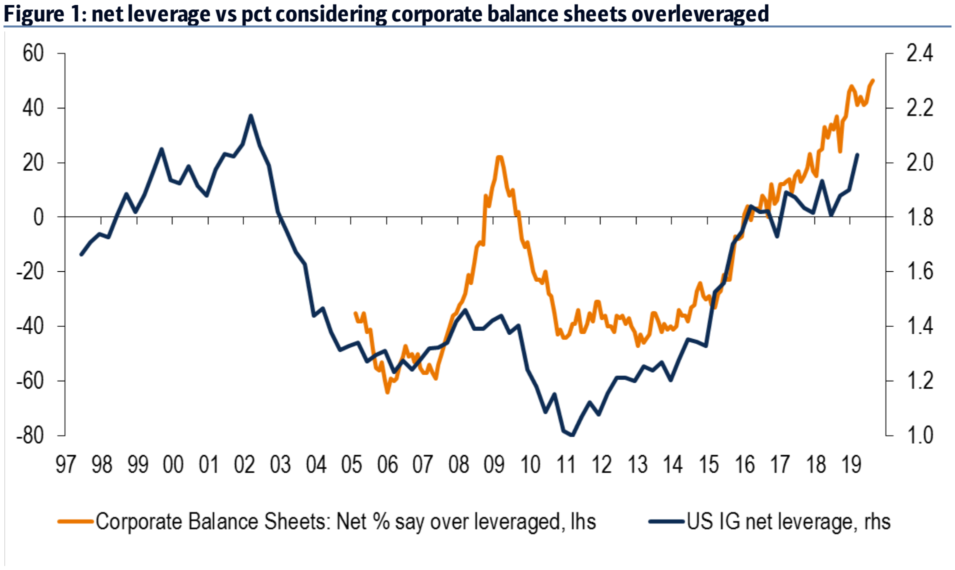
**Figure 1: net leverage vs pct considering corporate balance sheets overleveraged**




Source: BofA Merrill Lynch Global Research, BofA Merrill Lynch Global Fund Manager Survey

### What's different this time

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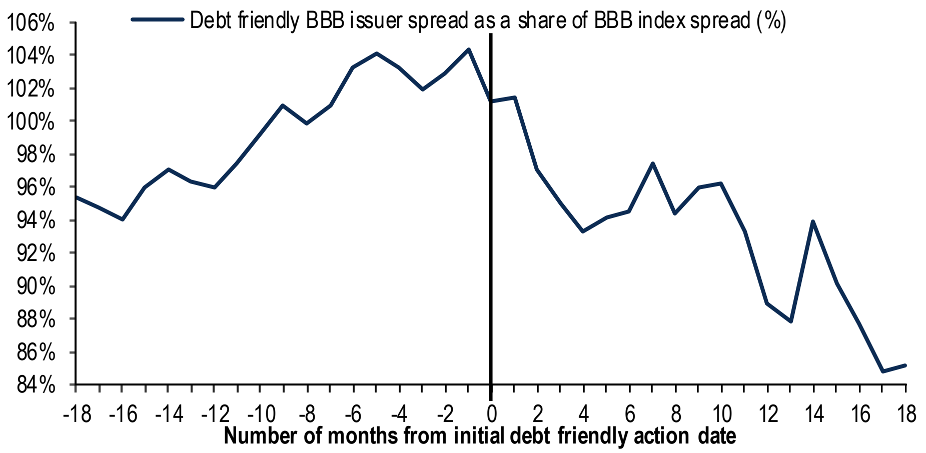
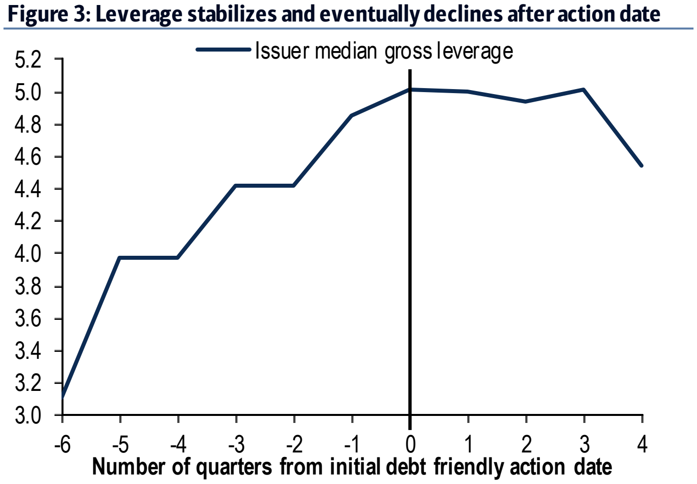
**Figure 2: Non-Financial & Utility BBBs underperform, take debt-friendly action, then outperform**



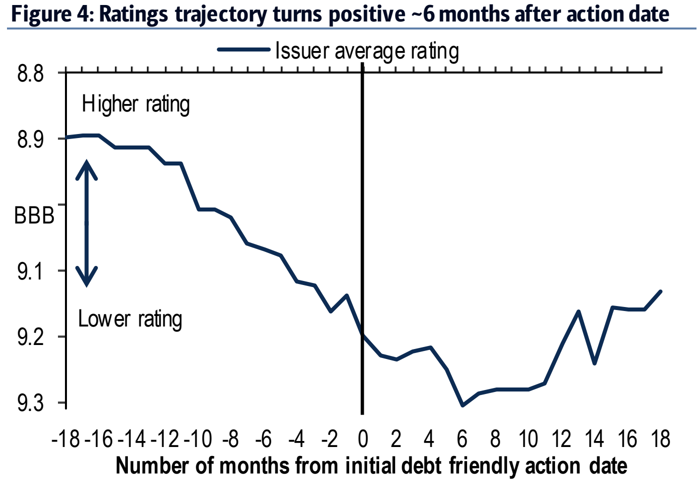

Note: Average issuer bond index spread across 23 events from t=-18 to t=0. From t=1 and onward we start losing events gradually given the more recent timing of many events. We correct for that decline in sample size by estimating every monthly change on an event matched basis. For t=1 we have 22 events, t=6 15 events, t=12 7 events and t=18 3 events.
Source: BofA Merrill Lynch Global Research, Bloomberg, ICE Data Indices, LLC

**Figure 3: Leverage stabilizes and eventually declines after action date**




Note: Median issuer gross leverage across 23 events from t=-6 to t=-1. From t=0 and onward we start losing events gradually given the more recent timing of many events. We correct for that decline in sample size by estimating every monthly change on an event matched basis. For t=0 we have 22 events, t=1 18 events and t=4 7 events.
Source: BofA Merrill Lynch Global Research, Bloomberg, ICE Data Indices, LLC

**Figure 4: Ratings trajectory turns positive ~6 months after action date**




Note: Average issuer ratings across 23 events from t=-18 to t=0. From t=1 and onward we start losing events gradually given the more recent timing of many events. We correct for that decline in sample size by estimating every monthly change on an event matched basis. For t=1 we have 22 events, t=6 15 events, t=12 7 events and t=18 3 events.
Source: BofA Merrill Lynch Global Research, Bloomberg, ICE Data Indices, LLC

# Credit Strategy

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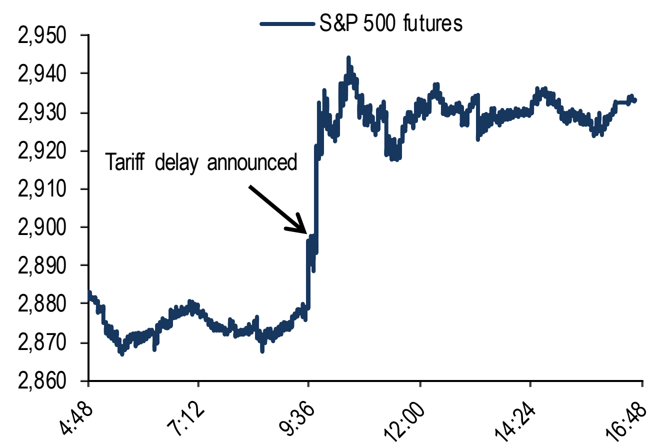
## A delay in tariffs

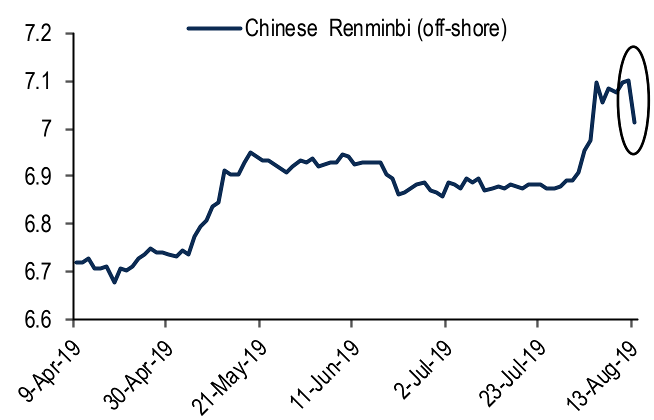
This morning USTR (the Office of the United States Trade Representative) announced that some of the additional tariffs on approximately $300bn of Chinese goods will be delayed until December 15th. Originally all tariffs were scheduled to go into effect on September 1st. Our economists estimate that the value of the goods on which tariffs were delayed accounts for over half of the total. In addition in an interview Trump called "very productive" a call between Chinese Vice Premier Liu He and U.S officials that was held earlier today. Both sides agreed to talk again within two weeks, according to news reports. Not surprisingly stocks took this de-escalation of trade tensions positively. The S&P 500 index rallied 1.0% immediately following the announcement and closed 1.50% higher on the day (Figure 5). Chinese currency (off-shore) appreciated by 1.3% (Figure 6). The Treasury curve bear-flattened, with 2, 5, 10 and 30-year Treasury yields increasing 8, 9, 6 and 3bps, respectively. CDX IG closed 4.95pbs tighter on the day, while CDX HY was $0.87pts higher. IG bond spreads opened unchanged to a few bps wider. Then following the trade headlines spreads improved to a few bps tighter on the day, on average.

**Figure 5: S&P 500 index rallied 1.0% immediately following the announcement and closed 1.50% higher on the day**




Source: Bloomberg

**Figure 6: Chinese currency (off-shore) appreciated by 1.3%**




Source: Bloomberg

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## Daily supply update

USD IG new issuance continues to be heavy with another $10bn priced across 6 deals today, bringing us to $21.1bn week-to-date (Figure 7). Following the FDX example in July, UPS also issued $1.5bn today to make pension contributions and repay CP. The average new issue concession remains elevated at 9.9bps today versus 9.7bps yesterday, while the average break performance improved to 1.5bps tighter today from 0.9bps tighter yesterday. This week's new issues are trading 1.2bps tighter from pricing. Note that despite the heavy supply volume, dealer inventories declined by about $70mn today, driven by client buying in the front-end and affiliate buying in the intermediate to long-end. Risk assets rallied on positive trade-related macro headlines (see piece above). Liquid credit secondaries also rallied with US banks 1-3bps tighter, TMT 1-4bps tighter, consumer retail unchanged to 2bps tighter, health care 3bps tighter to 2bps wider, and energy 1-3bps tighter, and general industrials unchanged to 3bps tighter on the day.

**Figure 7: Recent new issue pricing and new issue concessions**

| Date | Ticker | Name | Tenor | Size ($mm) | Moody's/S&P Rating | Coupon (%) | Px Spread (bps) | New Issue Conc. (bps) | * Break performance | Current spread (bps) |
|---|---|---|---|---|---|---|---|---|---|---|
| 2019-08-12 | CNP | CenterPoint Energy Inc | 5 | $500 | Baa2/BBB | 2.5 | 105 | 14 | -3 | 103 |
| 2019-08-12 | CNP | CenterPoint Energy Inc | 11 | $400 | Baa2/BBB | 2.95 | 135 | 1 | -2 | 134 |
| 2019-08-12 | CNP | CenterPoint Energy Inc | 30 | $300 | Baa2/BBB | 3.7 | 163 | n.a. | -1 | 162 |
| 2019-08-12 | DAIGR | Daimler Finance North America LLC | 3 | $1,500 | A2/A | FRN | 3mL+90 | n.a. | n.a. | n.a. |
| 2019-08-12 | DAIGR | Daimler Finance North America LLC | 3 | $1,250 | A2/A | 2.55 | 105 | n.a. | -2 | 100 |
| 2019-08-12 | DAIGR | Daimler Finance North America LLC | 5 | $750 | A2/A | 2.7 | 125 | n.a. | -3 | 121 |
| 2019-08-12 | DAIGR | Daimler Finance North America LLC | 10 | $500 | A2/A | 3.1 | 150 | 29 | -6 | 142 |
| 2019-08-12 | DUK | Duke Energy Carolinas LLC | 10 | $450 | Aa2/A | 2.45 | 82 | 6 | -2 | 82 |
| 2019-08-12 | DUK | Duke Energy Carolinas LLC | 30 | $350 | Aa2/A | 3.2 | 110 | 1 | -2 | 110 |
| 2019-08-12 | EVRG | Westar Energy Inc | 30 | $300 | A2/A | 3.25 | 117 | 13 | -1 | 118 |
| 2019-08-12 | LNC | Lincoln National Corp | 10 | $500 | Baa1/A- | 3.05 | 142 | 9 | 5 | 147 |
| 2019-08-12 | OKE | ONEOK Inc | 5 | $500 | Baa3/BBB | 2.75 | 130 | 10 | -2 | 126 |
| 2019-08-12 | OKE | ONEOK Inc | 10 | $750 | Baa3/BBB | 3.4 | 180 | 14 | -1 | 180 |
| 2019-08-12 | OKE | ONEOK Inc | 30 | $750 | Baa3/BBB | 4.45 | 235 | 12 | -1 | 234 |
| 2019-08-12 | PNW | Arizona Public Service Co | 10 | $300 | A2/A- | 2.6 | 98 | 4 | -2 | 96 |
| 2019-08-12 | SHW | Sherwin-Williams Co/The | 10 | $800 | Baa3/BBB | 2.95 | 135 | -1 | 1 | 134 |
| 2019-08-12 | SHW | Sherwin-Williams Co/The | 30 | $550 | Baa3/BBB | 3.8 | 170 | 7 | 1 | 170 |
| 2019-08-12 | VTR | Ventas Realty LP | 10 | $650 | Baa1/BBB+ | 3 | 140 | 14 | 3 | 144 |
| 2019-08-13 | AMTD | TD Ameritrade Holding Corp | 10 | $500 | A2/A | 2.75 | 108 | -2 | n.a. | n.a. |
| 2019-08-13 | BRX | Brixmor Operating Partnership LP | 10 | $350 | Baa3/BBB- | 4.125 | 165 | 15 | n.a. | n.a. |
| 2019-08-13 | DRE | Duke Realty LP | 8 | $175 | Baa1/BBB+ | 3.375 | 113 | 7 | n.a. | n.a. |
| 2019-08-13 | REG | Regency Centers LP | 10 | $425 | Baa1/BBB+ | 2.95 | 127 | 8 | -2 | 125 |
| 2019-08-13 | UPS | United Parcel Service Inc | 5 | $400 | A2/A | 2.2 | 65 | 6 | n.a. | n.a. |
| 2019-08-13 | UPS | United Parcel Service Inc | 10 | $400 | A2/A | 2.5 | 85 | 15 | n.a. | n.a. |
| 2019-08-13 | UPS | United Parcel Service Inc | 30 | $700 | A2/A | 3.4 | 130 | 18 | n.a. | n.a. |
| 2019-08-13 | XOM | Exxon Mobil Corp | 3 | $750 | AAA/AA+ | FRN | 3mL+33 | n.a. | n.a. | n.a. |
| 2019-08-13 | XOM | Exxon Mobil Corp | 3 | $750 | AAA/AA+ | 1.902 | 30 | -1 | n.a. | n.a. |
| 2019-08-13 | XOM | Exxon Mobil Corp | 5 | $1,000 | AAA/AA+ | 2.019 | 45 | 9 | n.a. | n.a. |
| 2019-08-13 | XOM | Exxon Mobil Corp | 7 | $1,000 | AAA/AA+ | 2.275 | 65 | 18 | n.a. | n.a. |
| 2019-08-13 | XOM | Exxon Mobil Corp | 10 | $1,250 | AAA/AA+ | 2.44 | 75 | 13 | n.a. | n.a. |
| 2019-08-13 | XOM | Exxon Mobil Corp | 20 | $750 | AAA/AA+ | 2.995 | 85 | n.a. | n.a. | n.a. |
| 2019-08-13 | XOM | Exxon Mobil Corp | 30 | $1,500 | AAA/AA+ | 3.095 | 95 | 13 | n.a. | n.a. |

* We define the break performance as the difference between the new issue spread and the initial secondary market spread on the first day of trading.

Source: BofA Merrill Lynch Global Research

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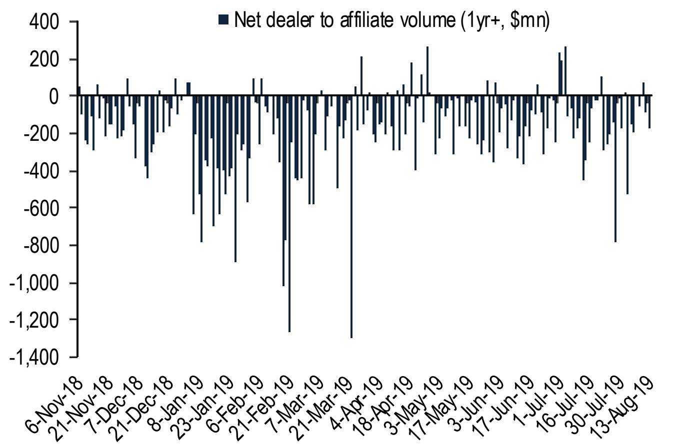
## Daily foreign demand tracker

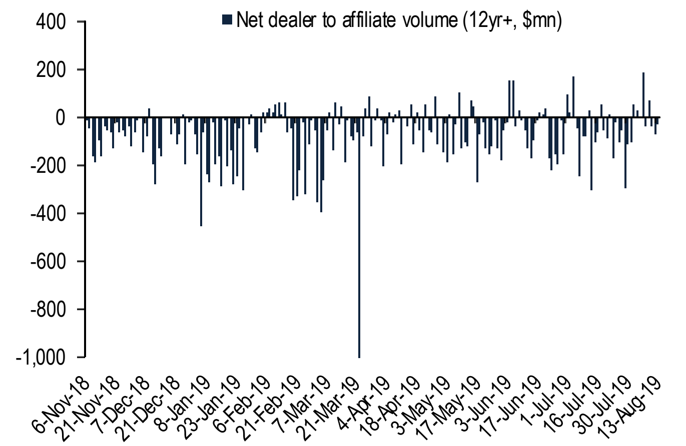
We believe net dealer-to-affiliate volumes from Trace are correlated with foreign buying of US HG corporate bonds - i.e., negative numbers mean foreign investor buying (US dealers taking down inventory in favor of foreign affiliates). For supporting material see our "primer" on tracking foreign inflows (See: Credit Market Strategist: One year round-trip in spreads 15 July 2016). Figure 8 shows the overall daily dealer-to-affiliate volumes while Figure 9, Figure 10 and Figure 11 show subsets of this data. In particular Figure 9 shows net dealer-to-affiliate volumes for longer maturity (12+ years) bonds, Figure 10 displays volumes reported to Trace before 8am NY time (biased toward Asian buying) and Figure 11shows the subset of net trades reported between 8am and noon (biased toward European buying). Figure 8 and Figure 9 include data from today, whereas Figure 10 and Figure 11 run through the previous business day.

**Figure 8: Net dealer buying from affiliate (1yr+)**



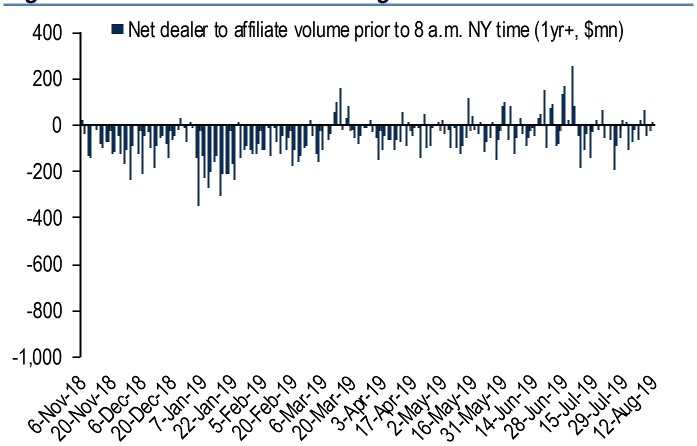

Note: Net dealer-to-affiliate volumes are correlated with foreign buying/selling. Negative numbers indicate foreign buying.
Source: Bloomberg, TRACE

**Figure 9: Net dealer buying from affiliate (12yr+)**



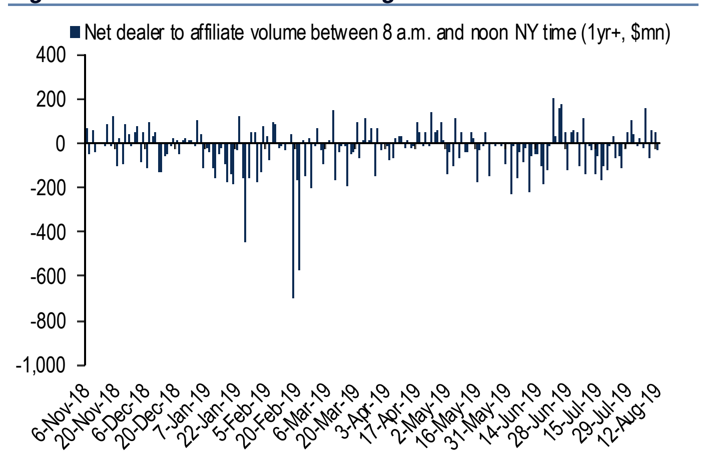

Note: Net dealer-to-affiliate volumes are correlated with foreign buying/selling. Negative numbers indicate foreign buying.
Source: Bloomberg, TRACE

**Figure 10: Net dealer-to-affiliate trading volumes before 8 a.m. NY time**




Note: Morning share of daily trading volume is correlated with secondary market activity of foreign investors due to different time zones.
Source: BofA Merrill Lynch Global Research, TRACE

**Figure 11: Net dealer-to-affiliate trading volumes 8 a.m. - noon NY time**

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Source: BofA Merrill Lynch Global Research, TRACE

# Global Investment Strategy


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Previously published here
Global Fund Manager Survey: My herd is my bond 13 August 2019

## Global Fund Manager Survey: My herd is my bond

**The BofAML August Global Fund Manager Survey**

The nut: August BofAML FMS most bullish on rates since 2008 as trade war concerns send recession risk to 8-year high; investors slash exposure to cyclicals to buy US Treasuries & US growth stocks; with global policy stimuli at a 2.5-year low, onus is on Fed/ECB/PBoC to restore animal spirits.

On growth: 1/3 of FMS investors expect a global recession in the next 12 months, the highest since 2011.

On policy: FMS investors say global fiscal & monetary policy mix is the most hawkish since Nov'16; only 9% see higher bond yields in the next 12 months, the most bullish stance on rates since 2008.

On leverage: 1/2 of FMS investors say corporates are excessively leveraged, a new record; investors want corporates to use cash to improve balance sheets > capex or buybacks.

On risk appetite: in contrast to June, the FMS cash level did not surge as growth expectations plunged...August cash levels fell from 5.2% to 5.1%; BofAML Bull & Bear Indicator holds at 3.7 (not extreme bearish though record net % say they have taken out protection).

On rotation: FMS investors sold cyclical value (Japan at 7-year low, industrials 2nd biggest MoM drop ever), bought defensives/growth (staples, tech) & bonds (#1 most crowded FMS trade = long US Treasuries); "growth over value" highest since GFC.

On US: FMS investors say US equities are the most preferred region over the next 12 months despite 78% saying the region is overvalued; note combination of two 2nd most extreme on record (#1 Aug'18).

On bubbles: FMS investors say biggest central bank-induced bubble risk in: #1 corporate bonds (33%), #2 Govt bonds (30%), #3 US equities (26%), #4 gold (8%).

FMS contrarian trades: contrarians should be long inflation vs. deflation assets (equities>bonds, Japan>US, industrials>pharma).

# Economics

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Previously published here
[US Economic Watch: Positive surprise in July core CPI, though core PCE to rise trend-like 0.2% 13 August 2019]

## Positive surprise in July core CPI, core PCE to rise trend-like 0.2%

### Core CPI starts a strong streak

Core CPI posted a second consecutive 0.3% pickup (0.29% unrounded) in July, which bumped up yoy inflation to 2.2% from 2.1%. Headline CPI also posted a 0.3% increase mom as energy rose 1.3%. Looking at the components, the upside surprise owed to likely transitory influences. Transportation services increased 0.3% bolstered by an outsized 2.3% pop in airline fares. Education & communication commodities jumped 1.1%, as computers saw a record increase of 2.8% mom. Other goods rebounded 0.6% mom after a 0.3% drop in June, supported by a 0.6% jump in personal care products which was the strongest gain since October 2015. Personal care services also accelerated to 0.5% mom after averaging a more tepid 0.1% over the prior 6 months.

That said, stickier sources of inflation were healthy. Although there was some cooling in rents as primary rents grew 0.28% and owners' equivalent rent (OER) grew 0.25%, both were quite robust in June and the moves in July put them closer to sustainable trends. Broader shelter prices held at 0.3% mom as lodging away from home jumped 0.9%, offsetting rents. Meanwhile, medical services inflation accelerated to a 0.5% mom clip from 0.4% previously, and we continue to be positive on medical services going forward.

Elsewhere, household furnishings & supplies picked up 0.3% mom for a third straight month, likely reflecting tariff pressures from the recent hike on Chinese imports. Healthcare goods, recreation services, education & communication services, water, sewer, & trash collection services all rose 0.2% mom. Apparel, used cars, and household operations slowed from July but posted gains of 0.4%, 0.9%, and 0.6%, respectively. New cars decreased 0.2% mom and recreation commodities fell 0.4%.

What does this mean for core PCE? The PPI data last week suggested flat healthcare PCE and a modest increase in financial services. Coupled with CPI, we predict a 0.2% (0.17% unrounded) mom rise in core PCE, keeping % yoy steady at 1.6%. This eases some concern for the Fed but won't dramatically change their easing bias.

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BofA on USA: Summer Black Friday 13 August 2019

## BofA on USA: Summer Black Friday

### A promotional July

Consumers continued with their shopping spree in July. Based on BAC aggregated credit and debit cards, retail sales ex-autos climbed 0.8% month-over-month (mom) seasonally adjusted (SA) in July, following the strong gain in June. Before we break out the champagne, we caution that there are two reasons for such exceptional spending in the month: 1) Amazon Prime Day and promotions from other retailers and 2) the historic heatwave which hit much of the country.

For the past five years, Amazon has offered promotions in mid-July called "Prime Day". It first started with just 24 hours of promotions and has expanded to a full 48 hours in 2019. This year, Amazon's Prime Day promotions were matched by large-scale promotions from other retailers with advertisements suggesting that it was the "Black Friday" of the summer. Consumers noticed and ramped up spending during this period. Indeed, the Chart of the month shows an aggregate for such discretionary spending on a daily basis, with July 1st 2016 level indexed to 1. We shaded the dates where the Prime Day promotions hit this year. There is clear level shift higher in spending over these dates. Importantly, the impact has increased over the years - it was negligible in 2016 and 2017, modest in 2018 and large this year. We can use this proxy to estimate the boost on total spend - we find that incremental spending in this category over the prime day period added 0.4% to the MOM growth rate of retail sales ex-autos, all else equal.

The weather also played a role in supporting spending but by a lesser degree. More than half of the continental United States experienced historically hot weather. We created two samples: one with states that were impacted by the weather and the other with the "typical" weather states. We find that spending was higher in the impacted states, particularly in groceries, utilities and gasoline. Indeed, once the heat wave started on July 13th, the growth rate in spending in the impacted states diverged (Chart 3).

Bottom line: consumer spending was robust, aided by the special factors mentioned above. Looking ahead, we will be closely monitoring to see if strong spending continues into August without promotions and in the face of an escalation in the trade war.

# Disclosures

## Important Disclosures

Due to the nature of strategic analysis, the issuers or securities recommended or discussed in this report are not continuously followed. Accordingly, investors must regard this report as providing stand-alone analysis and should not expect continuing analysis or additional reports relating to such issuers and/or securities.
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