Investment Grade: Spread and Basic Fundamentals

BI Credit Strategy, North America Dashboard


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1. Corporate Debt Can Tighten Despite Decade-Low Spread to Leverage

(Bloomberg Intelligence) -- Ebitda growth is driving modest deleveraging across investment grade, but is being outpaced by tightening spreads. This leaves spreads relative to leverage at the lowest levels in more than a decade. With leverage approaching record highs and interest coverage near cyclical lows, primary markets may become more focused on refinancing for corporate investment grade issuers. A deleveraging environment, whether led by debt reduction or Ebitda expansion, could support incremental spread tightening.

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Spreads on the Bloomberg Barclays U.S. Corporate Bond Index of about 112 bps are at the lowest levels since 2014, yet 20-30 bps above the lows preceding the 2007-09 recession. Leverage is higher, but global central bank policy remains accommodative, supporting spread products. (06/28/17)

Topics

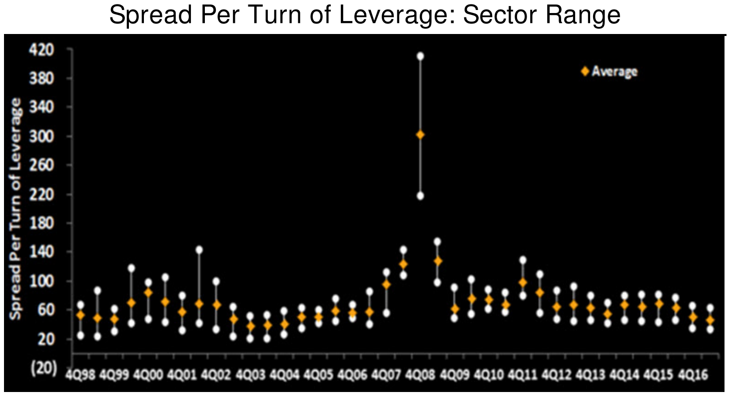
Index Trends

2. Investment Grade Risk Premiums Are at Lowest Levels in 12 Years

Average spread per turn of leverage is at its lowest levels since 2Q05, with total debt-to-Ebitda at 2.9x vs. 1.9x, and a trimmed-mean option-adjusted spread across investment grade of 132 bps vs. 100 bps 12 years ago. Capital goods' spread per turn is tightest at about 35 bps, while the consumer cyclicals sector, at twice that level, is widest.

The spread per turn differential between the highest and lowest sectors is in-line with the five-year average of 39 bps and comparable with levels seen in 2014. This reflects a relatively broad-based demand for investment grade, particularly following the sell-off in energy in early 2016. (06/28/17)

Spread Per Turn of Leverage: Sector Range



3. More Debt Keys Tightening in Sector Spread-Per-Leverage Turn

Sectors assuming added leverage have generally outperformed on a spread-per-turn basis amid a broad-based compression in option-adjusted spreads. The dynamic is most pronounced in the energy sector, where leverage is higher by nearly 1.6 turns from the end of 2014 amid oil price-led Ebitda declines. Consumer staples and cyclicals have had the lowest relative declines in spread per turn of leverage, while leverage gains were the smallest among all sectors except communications. (06/28/17)

Historical Spread Per Turn of Leverage by Sector

	Current	2016	2015	2014	2013	2008	2003	1998
Basic Industry	53	60	82	79	78	412	38	49
Capital Goods	34	43	55	57	54	283	29	40
Communications	57	60	78	73	81	302	46	59
Consumer Cyclical	71	70	93	86	78	382	39	58
Consumer Non-Cyclical	39	40	43	46	47	251	45	68
Energy	38	35	64	71	56	286	53	62
Technology	41	55	79	79	81	292	43	61
Transportation	64	66	82	80	60	218	22	61
All	46	49	67	67	63	301	41	57

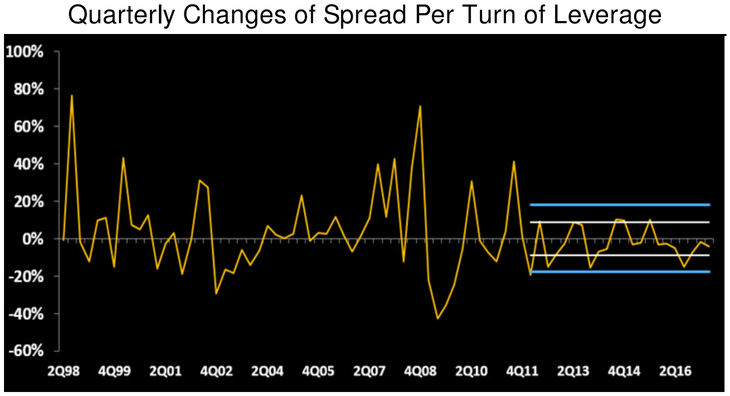
Note: Option Ajusted Spread / Total Debt to Ebitda
Source: Bloomberg Barclays Index, Merrill Lynch Index

4. Spread Change Volatility Remains Muted Across Investment Grade

Quarterly changes in corporate investment grade spread per turn of leverage -- defined as total debt-to-Ebitda -- remain muted by historical standards. The standard deviation of the periodic rate of change for the last five years is near 9%, down from 30% in 2012 and 24% over the long term. While spreads have been cast in a broad range of 100-200 bps over this horizon, the reduced volatility is also due to an increase in the denominator, with leverage having risen nearly a turn to just over 3x as of mid-June.

Through June, spreads have compressed for six consecutive quarters relative to leverage. While the magnitude of the spread tightening is different, it's the longest such stretch of relative compression for at least the last 20 years. (06/28/17)

Quarterly Changes of Spread Per Turn of Leverage

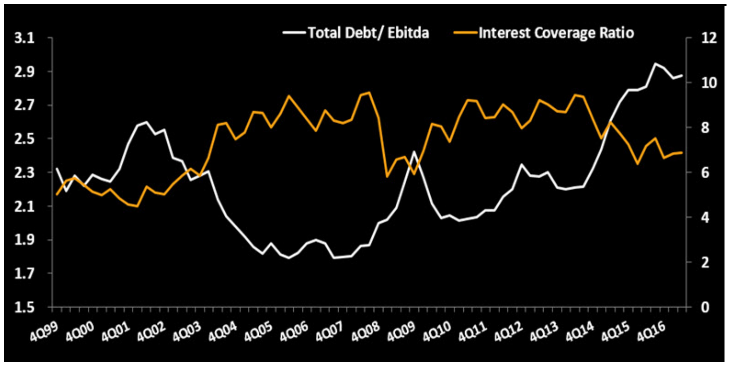


5. Investment Grade Corporates Have Limited Capacity for Added Debt

With the Federal Reserve taking the front end of the Treasury curve higher, the low interest rate environment that enabled increased leverage without materially impairing the ability to service debt may be ending. Interest coverage is near the lowest levels since the 2007-09 recession for investment grade corporate issuers, while total debt-to-Ebitda holds near two-decade highs. Interest coverage near current levels has usually indicated a pivot to deleveraging, led by Ebitda growth and added spread tightening.

Corporate spreads are well above 2003-07 levels. A neutral debt environment, with Ebitda growth, may enable further tightening. Central bank policy could be the defining factor, with near-record duration in the investment grade index, as rate fears may pace a rotation away from longer-dated issues. (06/28/17)

Total Debt-to-Ebitda vs. Interest Coverage



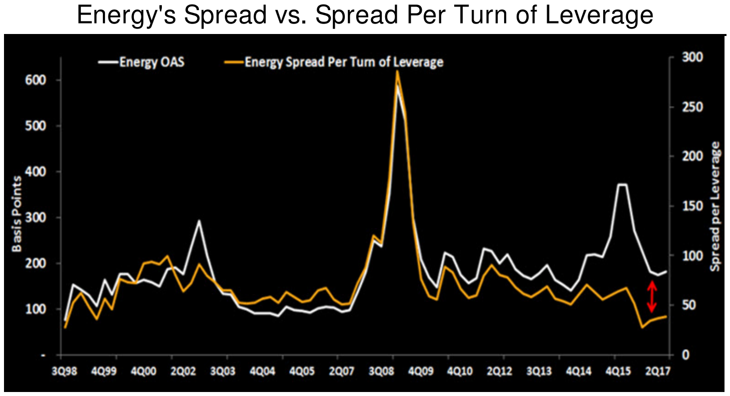
Sector Trends

6. Tightened Energy Spreads Now Awaiting Recovery in Fundamentals

Option-adjusted spreads for the energy sector have retraced much of the widening from 120 bps in June 2014 to 350 bps at year-end 2015. At about 150 bps, spreads are the tightest since 3Q14, when leverage was almost two turns lower. With total debt-to-Ebitda historically elevated at 4.6x, spread per turn of leverage has fallen to near 40 bps, below that of the broader investment grade index and the lowest for the sector in nearly two decades. Nominal spread is the widest for high grade sectors.

If S&P Energy sector Ebitda increases 24% through year-end as expectations indicate, that may lower leverage by about 1x, provided that total debt holds steady. Given current OAS, spread per turn would remain tight to the broader index. (06/28/17)

Energy's Spread vs. Spread Per Turn of Leverage

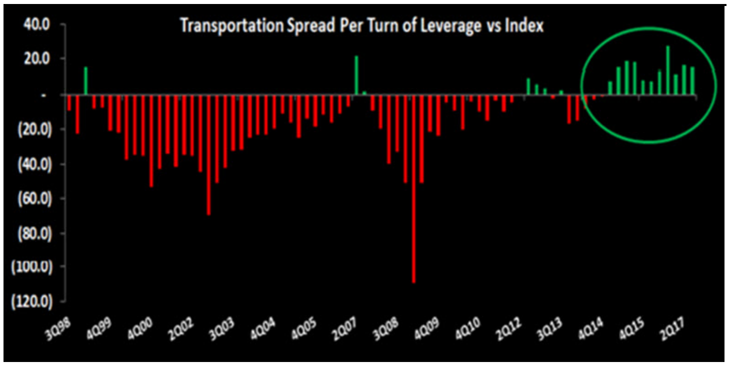


7. Steady Rail Leverage Holds Transport Spread / Turn Wide to Index

Muted compression in spread per turn of leverage for railroad operators has partially offset gains in airlines, where the metric is lower by half. With railroads accounting for almost 60% of transportation bonds, the overall sector spread per turn has tightened less than the broader investment grade index (IG), resulting in transport debt trading wider than the index since 2014. Nominal spread remains tight to all of the IG index, but total debt-to-Ebitda is up by only 0.25x vs. 0.6x for all of IG.

With industrial production forecast to accelerate in 2H, fundamentals for the rail sector may improve. Operators will need to balance improved oil sector trends against deceleration in autos and continued softness across much of the retail channel. (06/28/17)

Transportation Spread Per Turn vs. IG Index

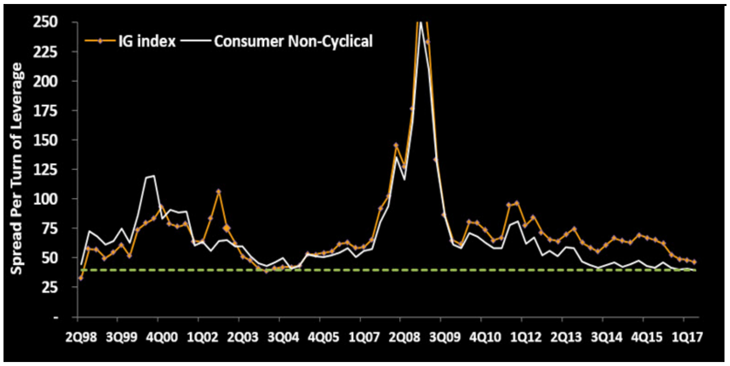


8. Consumer Non-Cyclicals Are First to Set New Spread-Per-Turn Lows

Consumer staples is the first sector to set a record low in spread per turn of leverage amid the broader tightening trend of the last several years. The compression has come from both tighter spreads and increased leverage. Total debt-to-Ebitda is hovering near its highest level in at least two decades at 2.9x, led by the food and beverages subsectors, with leverage of 3.4x and representing 25% of non-cyclical bond issuance.

The nominal spread for non-cyclicals remains about 15 bps wider than recent cycle lows reached in 2014 and 2011, and almost 30 bps wider than those that persisted for much of 2003-07 when leverage was roughly half today's levels. (06/28/17)

Consumer Non-Cyclicals vs. Index Spread Per Turn

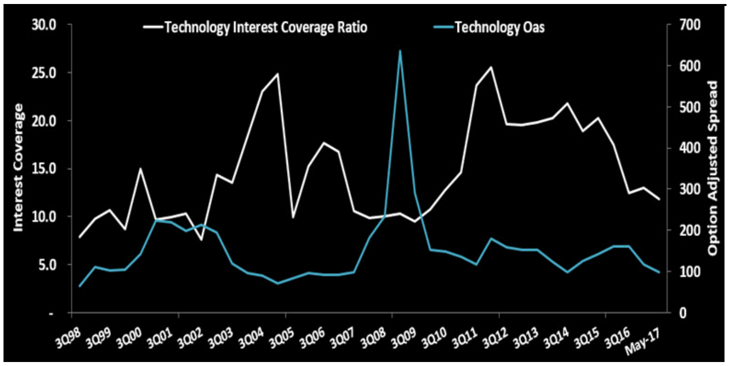


9. Technology Spreads Narrow While Interest Coverage Ratio Weakens

Technology's Ebit-to-interest has fallen by half since 2012, as industry leverage has risen to 2.4x from 1.6x. Alternatively, option-adjusted spreads continue to tighten and are at levels 20% lower than the last time interest coverage ratios stood at about 11x. That may be largely attributable to composition, as higher-quality companies have become more prolific issuers. This has lowered net debt across the sector from 0.4x to minus 0.4x over the last five years.

With the methodology being equal-bond weighted vs. par weight, the larger principal bond issuance that is prevalent among strong A and AA rated companies is under-represented in terms of the impact on ratios and average spread. (06/28/17)

Technology Interest Coverage vs. Spread Per Turn



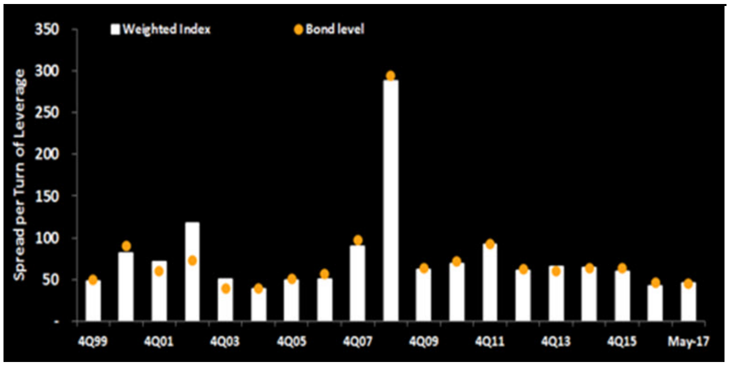
Methodology

10. Investment Grade Sector-Level Spread vs. Leverage: Methodology

Bond-level option-adjusted spreads (OAS) are aggregated on an equal-weight vs. par-weight basis in a Bloomberg Intelligence study. The net effect underweights the idiosyncratic risk that large issuance can exert, delivering a lower-volatility data set that's more representative of the average bond-level performance. OAS-per-turn of leverage ratios are calculated by dividing the mean numerator by the mean denominator, with the lowest and highest 10% (as determined by the denominator) eliminated.

Bloomberg Barclays Corporate Index membership is used starting in 2014. Prior membership uses Merrill Lynch Corporate Index membership reclassified by Barclays' system. Auto companies with large captive finance operations are excluded from consumer cyclicals. (06/28/17)

Equal vs. Par-Weighted Spread Per Turn of Leverage



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