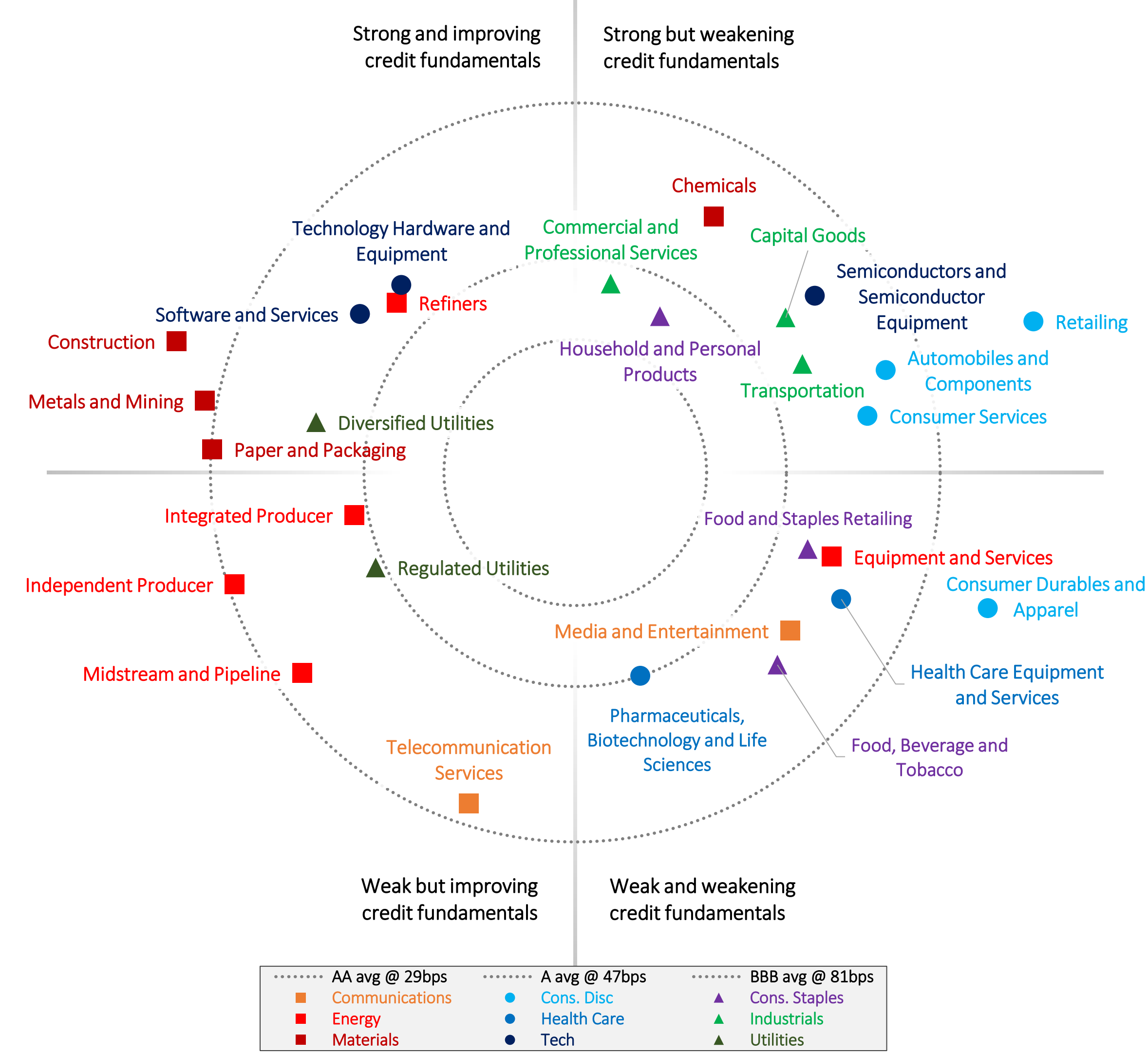
Investment Grade Corporate Credit Cycle Rolls On

The May FOMC meeting statement and press conference confirmed that the Fed will remain patient in policymaking. In our view, the Fed's positioning still leaves room for a pivot back to hawkish, but the window may have already closed for additional hikes as traders are now predicting a greater than 75% chance for a rate cut by the end of the year. Assuming China and the U.S. can mutually resolve their differences, which is our base case, the persistence of relatively easy credit conditions through the end of the year will help to extend the cycle for many investment grade issuers. Robust interest coverage ratios indicate the ability to service debt which offsets corporate leverage metrics that are elevated from a historical perspective, and a favorable financing environment will enable issuance at rates with little to no concession. Nonetheless, it bears mentioning that strong balance sheets and cash flow generation continue to be key drivers of relative value through the cycle.

Credit Cycle for Non-Financials and Average CDS*



* CDS = Average 5YR CDS for developed market IG companies

Source: Capital IQ, Clearwater Advisors

Insights

May 16, 2019

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Noteworthy changes to our credit cycle analysis for non-financial investment grade issuers

Automobiles and Components	Peak auto sales in the U.S. and uncertainty in Chinese demand amid import tariffs have weakened the outlook for the industry. Strong balance sheets and enhanced ability to scale production capacity provide headroom for a downturn.
Chemicals	Margins have been very good from a historical perspective, but projected capacity oversupply and weaker global demand consumption could accelerate a deterioration in leverage metrics.
Consumer Durables and Apparel	Modest revenue growth has led to weaker margins and poor returns. Tit-for-tat tariffs are credit negative as companies will not be able to fully pass on additional costs. Any material decline in consumer sentiment would also slow discretionary spending and further constrain top-line growth.
Consumer Services	Wage growth and higher levels of disposable income resulted in our improved assessment of credit fundamentals for the industry. Revenue and EBITDA growth have resulted in strong margins and returns, but continued growth will be sensitive to changes in consumer sentiment.
Energy Equipment and Services	Credit fundamentals have diverged from the other industry groups within the energy sector due to customers' weaker capital spending levels. We anticipate new well completions and additional pipeline capacity in the U.S. as well as process/technology innovation to enhance profitability, strengthen balance sheets, and accelerate improvement in fundamentals.
Food, Beverage, and Tobacco	Companies are repositioning their product portfolios and aggressively using balance sheets to address secular changes in consumption habits, slower growth in emerging markets, and less favorable demographics in developed markets.
Health Care	A surge in M&A activity and the corresponding willingness to increase leverage has weakened balance sheets across the sector. While demand in the U.S. will remain strong due to aging demographics, the ability to deleverage organically through growth is made uncertain by scrutiny over drug pricing and supply chain structure.
Transportation	Margins and profit growth have weakened due to higher energy prices. Elevated capital expenditures have reduced free cash flow coverage for an already high level of shareholder returns. A softer global growth outlook will require further cost rationalization to support profitability.

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