U.S. Corporate Credit Outlook 2020

Balancing Act

December 16, 2019

Key Takeaways

- **Three pressure points.** A U.S. economic slowdown, credit-risk differentiation and U.S. policy risks are three pressure points for U.S. corporates going into 2020 and beyond.

- **Economic Slowdown.** Federal Reserve rate cuts have helped ease recession fears and stabilize credit markets. However, economic slowdown concerns are challenging U.S. non-financial corporates as reflected by an increasing negative ratings outlook bias.

- **Credit-risk pricing-differentiation to persist.** In our view, the differentiation in credit risk pricing between stronger and weaker corporate credits will continue. Stronger credits will continue to benefit from favorable financing conditions, while weaker credits will face greater scrutiny and pricing pressures in accessing capital.

- **U.S. policy risks.** The two main policy risks are trade and the presidential election. The U.S.-China 'phase 1' trade deal and progress on USMCA are near-term positives although the former does not fully address the dispute over technology, intellectual property and market access. In respect of the U.S. presidential nomination, sharp differences in policy platforms among candidates increases policy uncertainty.

- **Disruptive trends and regulatory changes may present further challenges.** U.S. non-financial corporates face a challenging operating environment; slowing global growth, rising cost pressures, more regulation particularly in relation to environmental concerns, and uncertainty around trade and supply chains offer a difficult backdrop.

- **Still growing.** Despite these pressures, our base case assumptions point to continued growth for the corporate sector with revenue and cash flow growth still positive even if relatively subdued in comparison to the more buoyant years of this cycle.

Markets enter 2020 precariously balanced. Deteriorating economic momentum has been countered with a renewed monetary easing cycle from the Federal Reserve, helping underpin financing conditions, market confidence and liquidity. While our base case assumption is that the U.S. economy and key global export markets will continue to grow, the rate of expansion is weakening and significant headwinds are emerging for the corporate sector.

Simmering trade tensions have contributed to uncertainty around supply-chains and are raising political tension around tax rates, intellectual property and control over regulation. Cost pressures, notably in labor markets, are starting to build and investment plans are being scaled back. Moreover many industries that are investing are competing intensely for market position as disruptive new technologies encourage new entrants and require investment in new platforms. Many industries are having to adjust to regulatory efforts to tackle environmental concerns. These all bring significant credit risks and represent an uncertain operating environment. The positive news is that S&P Global Ratings analysts expect to see revenues and EBITDA continue to expand.

Late-cycle anxiety has already meant that weaker corporate credits – those rated 'B' or below – are benefitting less than higher-rated companies from interest rates remaining lower for longer. We expect this risk differentiation to persist next year, with weaker credits facing greater scrutiny and pricing pressures in accessing capital. It remains the case that many financial assets are valued relatively generously and thus vulnerable to a decisive change in market perceptions and sentiment regarding the cycle.

In the following pages, we discuss five key themes for U.S. corporate credit in 2020: ‘B-’ rated debt and CLO risk; the rapid growth of ‘BBB’ rated debt; the disruption and uncertainty facing many sectors; prospects for profits growth in this environment; and the likely persistence of uncertainty around trade policy. Following that we look at some core themes – M&A, ratings trends, financing conditions, the default outlook and a detailed analysis of the outlook for leveraged finance.
Top Risks

Table 1
Top North-America Risks

Geopolitical and trade disputes cloud world growth

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<tr>
<th>Risk level*</th>
<th>Very low</th>
<th>Moderate</th>
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<th>Risk trend**</th>
<th>Improving</th>
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<td>Trade and geopolitical tensions continue to dampen business confidence and weigh on growth forecasts. While a mini-deal between the U.S. and China has been announced, we do not think this will address the dispute over technology, intellectual property and market access. Ongoing protests in Hong Kong and the Congressional U.S. response complicates U.S.-China trade negotiations. The United States-Mexico-Canada Agreement (USMCA) is close to being ratified, but other regional trade tensions linger such as the U.S. placing tariffs on EU goods in October. Government interventions via tariffs, subsidies, and regulations continue to cloud capex decisions. Despite trade uncertainty, a resilient U.S. labor market and economy prompted S&amp;P Global Ratings' economists to lower their U.S. recession forecast.</td>
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Mature credit cycle and the potential for volatile liquidity

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<td>Trade tensions and other risks to global growth led the Fed to three quarter-point rate cuts in three consecutive meetings since July. While lower interest rates contributed to a drop in investment-grade funding costs, companies rated 'B-' or lower face widening risk premiums as investors have moved up the credit curve. The build-up in corporate debt over the past decade of economic expansion has led to a growing concentration of investment-grade ratings in the 'BBB' category and speculative-grade ratings in the 'B' category. With debt concentrations growing, investors and regulators continue to focus on liquidity risks, especially among thinly traded instruments within the credit market.</td>
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Cybersecurity threats to business activity

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<td>Increasing technological dependency and global interconnectedness means cyber risk poses a systemic threat and significant single-entity risk. As cyberattacks become increasingly sophisticated, new targets and methods are emerging. Companies face the risk of criminal, proxy and direct state-sponsored cyber-attacks. Governments are also vulnerable, with local governments appearing to be the target with increasing frequency. This rapidly emerging risk has led to a fast-growing cyber-insurance market, though insured losses from cyber-attacks are still small compared with economic losses. Still, the relentlessness of cyber-attacks creates a need for heightened governance measures for all types of issuers.</td>
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Housing imbalances remain a threat for Canada even as credit growth slows

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<td>More stringent government mortgage qualification rules for homebuyers have resulted in decelerating home prices across Canada, with household credit growth slowing more quickly versus other advanced economies. Although consumer debt service burdens have eased with a) less incurrence of new debt and b) a pick-up in income growth, elevated house price-to-income multiples and stretched housing affordability remain a threat to financial stability. However, the Bank of Canada’s dovish policy will support steady debt-service ratios for consumers.</td>
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Sources: S&P Global Ratings.

* Risk levels may be classified as very low, moderate, elevated, high, or very high, and are evaluated by considering both the likelihood and systemic impact of such an event occurring over the next one to two years. Typically these risks are not factored into our base case rating assumptions unless the risk level is very high.

** Risk trend reflects our current view on whether the risk level could increase or decrease over the next 12 months.
Top 5 themes for 2020

1. The Surge In ‘B-’ Debt And Risks For CLOs

Protracted low interest rates and a borrower-friendly debt market have allowed investment-grade and high-quality speculative grade firms across sectors to borrow cheaply and extend their maturity curve. Further down the credit spectrum these benefits are felt less evenly. The speculative grade debt market remains bifurcated, with demand firmly skewed in favor of high-quality names, primarily among ‘BB’ category credits. This is partly a reflection of a more challenging economic environment which could potentially translate to increased defaults and downgrades concentrated at the lower reaches of non-investment grade credit.

The current negative bias, which we define as the percentage of issuers with a negative outlook or ratings on CreditWatch negative, is 16% for the U.S. ‘B-’ population. Risk is particularly pronounced in sectors such as retail and oil and gas where about 15% and 14% of the portfolio are rated in the ‘CCC’ category or lower. Sectors such as aerospace & defense, chemicals, health care, non-durable consumer product companies, capital goods and metals & mining could all potentially confront greater slippages from the ‘B’ to ‘CCC’ category in the event of a sharp slowdown in growth.

In terms of the sector concentration of ‘B-’ rated debt, the technology, business and consumer services, telecommunications and health care sectors together account for more than 55% of the total debt outstanding of all U.S.-based ‘B-’ issuers (see chart 1). Including media and the relatively beleaguered retail and restaurants and oil and gas sectors, this figure jumps to nearly two-thirds of the total. Of some comfort is the observation that the two most prominent sectors – technology and business and consumer services – which represent just under 40% of total ‘B-’ debt outstanding only have debt amounting to 4.5% of the total ‘B-’ pool on negative outlook or credit watch negative. Sectors at the greatest risk of downgrades are autos, telecommunications and consumer products accounting for 16% of total ‘B-’ debt, nearly two-thirds of which is on negative outlook.

Chart 1

Share Of Non-Financial ‘B-’ Rated Debt Outstanding By Sector

Given the sharp rise in ‘B-’ issuers in technology in recent years, as well as the structural headwinds confronting consumer products and retailers, this debt can be a source of investor concern in the event of financial market volatility or an economic downturn. Furthermore, history has shown that even in a strong economic environment, the ‘B-’ segment has much higher ratings volatility and a higher likelihood of both downgrades and default.

This is a cause of concern for many CLO managers and investors. The percentage of ‘B-’ leveraged loans in the S&P/LSTA leverages loan index has passed 13%, and loans from companies rated ‘B-’ now constitute over 19% of assets in U.S. reinvested broadly syndicated loan (BSL) CLO collateral pools, more than doubling the proportion of ‘B-’ assets at the end of 2015. Most BSL CLOs have an
allowable bucket of 7.5% for loans with ‘CCC’ rating in their collateral pool. Once the proportion of ‘CCC’ loans rises above this preset threshold, the par value of the loans will be haircut as part of the calculation of the par coverage test ratios. In such cases, the coverage tests could fail, resulting in payments to the equity tranche holders and subordinate noteholders being halted.

Chart 2
‘B-’ And Lower Issuers Represent A Growing Share Of U.S. Speculative-Grade Issuers

In an effort to shed some light on the potential impact of downgrades and defaults within the cohort of ‘B-’ rated obligors on rated U.S. BSL CLOs, we recently published a scenario-based analysis (see “To “B-“ Or Not To “B-“? A CLO Scenario Analysis In Three Acts”, Nov. 26, 2019). We analyzed three scenarios of increasing severity, based on broad hypothetical outcomes. These scenarios are not meant to be predictive or part of any outlook statement, nor are they meant to reflect any of the stresses outlined in our rating definitions; they are specifically geared to address the questions and concerns voiced to us from CLO market participants. Chart 3 shows the model derived impact of these scenarios on tranches within the broadly syndicated CLO universe rated by S&P Global Ratings.

Chart 3
CLO B- Downgrade Scenario Analysis – Summary Of Shock Scenarios And Ratings Impact

Source: S&P Global Ratings

[Diagram showing the impact of downgrades on tranches within the CLO universe]
2. Lending Conditions and Financial Policy Decisions Support Growth Of ‘BBB’

In the U.S., ‘BBB’ non-financial corporate debt has grown more than over 200% since 2007 (see chart 4), and some 39% between the end of 2015 and mid-2019 (to $2.5 trillion from $1.8 trillion). In terms of their share of the total amount of rated nonfinancial corporate bond debt, the top 10 issuers account for 32% of ‘BBB’ non-financial corporate bond debt in the U.S.

Chart 4
U.S. Corporate ‘BBB’ Debt – 87% of growth since 2007 is from ‘BBB+’ and ‘BBB’ rating levels

![Chart 4](source)

Most of the expansion of the ‘BBB’ rating category has come from higher-rated issuers where downgrades to speculative grade are more rare (‘BBB+’ and ‘BBB’). The proportion of debt rated at ‘BBB-’, the most vulnerable level, is the smallest of the three sub categories and has been on a declining trend since 2015 (see chart 5). Roughly 84% sits 2-3 notches above speculative grade.

Chart 5
U.S. Corporate ‘BBB’ Debt – Lowest Rated ‘BBB-’ Accounts for 16% Of Debt

![Chart 5](source)

Growth of the ‘BBB’ segment has occurred amid favorable global lending conditions, which are largely still intact. This pace of growth in the ‘BBB’ market in recent years is largely attributable to very low interest rates since the financial crisis in both the U.S. and Europe. This low interest rate environment has allowed ‘BBB’ companies to issue at rates once enjoyed by ‘A’ and even ‘AA’ issuers. Some higher-rated firms have made decisions (such as debt-funded mergers, acquisitions, and shareholder returns) that have led to downgrades to ‘BBB’, in part due to the minimal difference in the relative cost of funding.
This large buildup in debt just one rating category above speculative grade (‘BB+’ or lower) is raising concerns among stakeholders over the risk of companies becoming fallen angels (issuers downgraded to speculative grade from investment grade) and the ability of the speculative-grade market to absorb potentially large amounts of downgraded debt. Significant amounts of investment-grade debt is held in Separate Managed Accounts (SMAs) that have stringent ratings eligibility requirements and forced sale provisions tied to downgrades that typically range from 30 to 180 days. That said, the speculative-grade market has shown its ability to absorb large amounts of downgraded ‘BBB’ debt in the past (see "The U.S. Speculative-Grade Market Can Withstand ‘BBB’ Downgradese," April 24, 2019).

Nonetheless, as economic growth slows companies will face challenges, particularly in more cyclical sectors such as auto manufacturers. This is notable because Ford and General Motors account for 29% of the debt outstanding for the top 10 BBB-rated issuers in the region1. Debt levels and leverage for the top 10 borrowers in this rating segment have decreased slightly this year as a result of debt repayments at AT&T and General Electric, which offset United Technologies’ and Broadcom’s borrowing to fund acquisitions. Weighted-average leverage has declined slightly, to 3x in mid-2019 from 3.2x at the end of 2018. We expect credit metrics will continue to improve in 2020, with the majority of the top 10 maintaining relatively stable metrics and a few achieving more notable improvements. We expect leverage to decline at General Electric, CVS Health, and United Technologies in 2020, largely as a result of asset sales, continued debt repayment, and an all-stock merger, respectively.

Meanwhile, downgrade risk and upgrade potential for the top 10 are relatively balanced. In fact, two of these companies, Verizon and United Technologies, are rated ‘BBB+’, the highest ‘BBB’ category rating. The rating outlook on Verizon is positive, while the rating on United Technologies is on CreditWatch with positive implications, indicating that these companies could be upgraded to the ‘A’ category in 2020. Three companies are rated ‘BBB-’: Ford, Energy Transfer, and Broadcom. These represent 27% of the top 10 debt. The outlooks are stable.

1 See Credit Trends: ‘BBB’ Pulse: Vitals Remain Stable For The Largest Issuers, Nov.25, 2019
3. Headwinds from tech disruption, regulation, and litigation

S&P Global Ratings recently published the fifth annual series of Industry Top Trends reports covering 25 global corporate and infrastructure industries. These set out the key assumptions, risks, and opportunities seen by S&P Global Ratings analysts for industries in the year ahead. Table 2 provides a summary of these key risks and opportunities in relation to North American companies. One consistent theme that emerges is that almost all industries are battling against powerful headwinds that are constraining growth and posing significant risks to credit quality.

Although highly sector-specific in their nature, technological disruption, environmental, social and regulatory costs, and regulations loom large across many sectors. Many aren’t new, but it is striking how central these risks have become to sector credit conditions and outlooks. There are three broad clusters of risks:

- **Technological disruption** that is threatening market position, altering consumer consumption patterns;
- **Regulations** encompassing a wide spectrum that includes efforts to address environmental concerns and pricing mechanisms to better reflect climate-related risks and impacts, and the governance of emerging technologies;
- **Litigation**, which includes ongoing cases in relation to opioids and health care and emissions breaches for autos.

In all cases, there are significant credit risks posed by these pressures particularly in terms of weaker revenues (new competition, changing preferences, pricing pressures), heightened capital expenditure requirements (for example to meet new regulatory standards, develop new technologies, or compete for market share), and a greater need for M&A (to find new sources of growth or protect market share). These all pose risks to cash flow growth and predictably and often requires substantial funding commitments. An additional layer of uncertainty in reacting to these pressures comes from the upcoming 2020 presidential election, which could alter the political priorities and framing of these challenges, as well as ongoing uncertainties around trade policy which can affect supply-chain decision making.

Some specific sector examples:

**Retail**

Retailers remain under duress from secular changes, including rapidly evolving shopping habits, the impact of e-commerce and a shift from larger department store formats. Key trends include:

- Continued growth in online sales;
- The need for business models to evolve to keep pace with consumer expectations;
- Increasing focus on value and high price sensitivity due to transparency afforded by the internet;
- Competition for consumers' wallet share from autos, rent, health care, technology, and experiences.

As a result of these headwinds, we expect very weak (less than 2%) top-line growth in the department store and apparel segments in 2020. Retailers’ margins will also continue to be pressured due to the requisite investments in omni-channel capabilities in order to compete effectively.

**Consumer Durables**

Retailers are increasing private-label offerings to differentiate themselves and drive loyalty, as well as to shore up profit margins. We expect branded-goods companies to lose some shelf space this year, and will need to focus on managing price gaps with private labels to keep consumers from switching.

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2 See [https://www.spglobal.com/ratings/en/research-insights/topics/corporate-ratings-industry-top-trends](https://www.spglobal.com/ratings/en/research-insights/topics/corporate-ratings-industry-top-trends) for the 25 individual industry reports as well as a single compilation that brings them all into one publication with an overview that highlights the key themes emerging from the sector analysis.
Media
Increasing audience fragmentation, intensifying over-the-top (OTT) competition, and accelerating declines of pay-TV subscribers are driving significant evolution in the media ecosystem. We expect media companies to continue to invest in their own content production. This could pressure operating margins, cash flow, and credit metrics, especially if increased competition drives up content costs.

Real Estate
There is growing pressure on retail assets, particularly lower-quality shopping centers. This is likely to continue in 2020 as retailers remain under pressure from secular changes, including the impact of e-commerce and a shift from larger department store formats. Tenants may resort to store closures to survive.

Environmental (Cross-sector)
Regulators are primarily driving these initiatives. Firms from a few sectors are likely to be influenced by changing legislations. Examples include IMO 2020 regulations reducing sulfur content to 0.5% from 3.5% in marine fuel, which has direct or indirect implications for shipping, oil and gas, airlines and CO2 emissions regulations which are relevant to utilities, autos, and cement manufacturers, among others. Integrated steel producers in North America face increasing pressure to invest significantly to reduce heavy GHG emissions from coal-fired blast furnaces. In the utility sector, renewables are expected to benefit from improved economics, as well as a relatively long runway for the solar Investment Tax Credit, creating a renewable-heavy and demand-uncertain grid that requires more flexibility—weakening the long-term case for baseload generation such as coal and nuclear in wholesale markets. During the next decade, social and environmental agendas will begin to influence consumer behavior, with more focus on plastics, supply chains, and environmental policies.

Regulatory (Cross-sector)
Policy uncertainty amid the 2020 presidential elections is a particular concern for healthcare and midstream energy companies. Other examples include legal and regulatory adversities faced by the tobacco sector, the increasing attention paid to media and tech companies with a focus on user privacy, unsafe content, and antitrust/market-power concerns, opposition to large pipeline projects which will continue to be a risk for midstream companies.

The above examples are not exhaustive, but should illustrate the breadth and depth of the challenges facing the North American corporate sector in relation to this theme. The risks and credit impact are both short- and long-term in nature and present significant threats to both financial and business risk profiles.
## U.S. Corporate Credit Outlook 2020: Balancing Act

### Table 2

#### Industry Top Risks – North America

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| Aerospace and Defense       | - The grounding of the MAX has gone on longer than we expected. If delays continue well into 2020, Boeing could decide to further cut or even suspend MAX production temporarily.  
- We expect U.S. defense spending to increase only modestly for the next few years with declines in defense spending possible after fiscal 2021.  
- Air traffic in 2018 has trended below the long-term average of 5% due to trade tensions and slowing economic growth, a trajectory that is likely to continue and could accelerate if the global economy weakens further. |
| Autos                       | - Global autos could face considerable pressure from prolonged trade disputes given potential disruptions to supply chains.  
- Non-deferrable capex and R&D-linked electrification, connectivity, and autonomous driving will limit the scope of restructurings to accommodate softer market conditions and could drive some suppliers out of the market.  
- Funding access is an additional risk, as the clouded industry outlook lowers creditor confidence on the suppliers. |
| Building Materials          | - A slowdown in economic growth will increase competition in an industry that is already at overcapacity.  
- Companies facing operating cash flow squeezes will see tighter liquidity and increasing difficulty in refinancing.  
- Building materials generally still face overcapacity. The price recovery in 2017-2019 was primarily from the rationalization of production between producers, for example cement producers in China, without shutting down excess capacity |
| Capital Goods               | - We expect divestments and acquisitions to continue as large U.S., European, and Japanese capital goods companies seek to simplify their structures and invest in higher growth technologies.  
- We expect large capital goods companies to be able to withstand the downturn well.  
- We expect to see negative rating transitions and a potential increase in defaults in the lowest "B" and "CCC" rating categories. |
| Chemicals                   | - A recession in one or more regions is a key risk that could result in lower-than-anticipated demand and earnings.  
- We could see little change in shareholder rewards, M&A, or elevated capital spending. This could hurt credit quality in an environment of weaker earnings and cash flows.  
- Companies rated 'B' or below or those concentrated in fewer end markers are more susceptible to demand and other shocks. |
| Consumer Products           | - Technology and changes in consumers' behavior, tastes, and preferences have increased the pace of change in the consumer products industry and branded goods companies have been focusing on being more agile to repositioning their portfolios to meet these changes.  
- The U.S.-China dispute has hurt the smaller, speculative-grade durable and apparel companies and some seafood processors in Canada that rely heavily on imports from China.  
- Speculative-grade credit quality will erode rapidly in case of a recession. |
| Health care                 | - Disruption in the industry creates risk but also opportunities. Health care systems are rapidly expanding their service offerings and expanding out of the hospital and into lower-cost delivery settings.  
- Pharma ratings have little capacity for M&A following this year's deals. |
| Homebuilders and developers | - Deteriorating affordability causes new home volumes and prices to fall  
- Balance sheets appear to be in better shape than just a few years ago, sparking our positive credit bias for U.S. homebuilders. Overall, leverage appears to have peaked in 2016, after which leading homebuilders started taking a more conservative stance on debt usage for growth and shareholder returns.  
- Share buybacks could erode a growing credit buffers. |
| Hotels, Gaming, and Leisure | - We expect the legalization of sports betting in U.S. states to continue gradually following the prior announced Supreme Court decision, with euro online gaming companies set to capitalize.  
- Hotel managers and franchisors weather a U.S. downturn better than owners.  
- We expect fuel expense for all cruise operators to increase in 2020, due to an expected shift in consumption toward more expensive marine gas oil (MGO), from lower-priced fuels like heavy fuel oil (HFO). |
| Media and entertainment     | - Several large media companies are embarking on new OTT launches as they look to mitigate the effects of declining pay-TV subscribers by establishing direct-to-consumer (DTC) OTT services.  
- We expect more than $3 billion in political advertising revenue for local television in 2020 (largely in the second half of the year) given the U.S. presidential election and intensifying political climate.  
- Ad agency holding groups have chosen different approaches to owning data. While Publicis and Interpublic recently acquired large data assets, WPP and Omnicom are focused on developing internal and open-data analytics platforms. |
| Metals and mining           | - We are forecasting slower global economic growth in 2020, and a sharper decline could worsen the deterioration in metals markets.  
- Shareholder returns or new investments consume precious capital.  
- We estimate average steel producer margins will improve modestly in 2020 from currently weak levels. |
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Midstream Energy

- We believe opposition to large pipeline projects will continue to be a significant risk for midstream companies, even if the Atlantic Coast Pipeline and Mountain Valley Pipeline projects receive a favorably ruling by the U.S. Supreme Court.
- Producer credit quality is under pressure from financial and operational restructurings, and in some cases bankruptcies.
- We think most midstream companies will stay on a more disciplined financial path and focus only on the highest return projects, while scaling back capital spending.

Oil and gas

- One of the major sector risks is the debt maturity wall facing speculative-grade companies and their ability to meet maturities. The
- A sharp downturn in the global economy would clearly result in a pronounced decline in demand and therefore in oil and natural gas prices.
- With the E&P portfolio so highly weighted to the lower end of the high yield universe, especially in the U.S., anticipating an increasing wave of defaults and bankruptcies is a normal reaction.

Real estate

- Retail properties globally are seeing rent and occupancy pressure from store closures and weak performance of retail tenants resulting from intense e-commerce competition.
- Uncertainties around the U.S.-China relationship, trade disputes, and geopolitical risks will likely dampen global growth, with the manufacturing sector exhibiting growing weakness.
- We expect real estate issuers to shift focus towards growth vs. enhancing credit quality given access to low-cost debt.

Retail and restaurants

- Rapidly changing shopping habits, including the shift to e-commerce, mean retailers have to innovate quickly and effectively while they compete with bigger, better capitalized players like Amazon.
- Tariffs will increase the pressure on retailers, exacerbating a difficult situation for issuers who don’t have the financial flexibility to absorb the supply chain shock.
- In the U.S., the broader economy is not likely to provide offsetting support to the sector. Despite wage growth and low unemployment, some indicators suggest a modest slowdown in consumer spending.

Technology

- Both tariff- and non-tariff related actions have been disruptive to tech companies, adding to business uncertainties, and resulting in the decelerating IT spending growth.
- China’s economy has slowed through 2019 and could slow further amid a bitter trade war between it and the U.S., hurting consumer demand for IT products ranging from smartphones to semiconductors used in autos in the world’s largest market.
- Deteriorating credit quality and rising leverage over the past few years and increased recession risk will likely lead to further downgrades among lower-rated credits.

Telecommunications

- The benefits from 5G investments are uncertain.
- S&P Global Ratings' economists have increased their forecast of the risk of a U.S. recession to 30%-35%, which could pose a risk for telecom operators that have exposure to small businesses.
- A T-Mobile-Sprint merger could have meaningful industry ramifications.

Transportation

- Airlines appear better positioned, particularly in North America, to withstand an economic slowdown than in the past due to their more prudent capacity decisions, the less aggressive strategies by the big low-cost airlines (Southwest and WestJet), and their ability to save cash by cutting back on share repurchases.
- Sluggish demand trends, most notably stemming from the ongoing U.S.-China trade dispute, and additional trade tariffs could impede the rebalancing of supply and demand conditions.
- Operating efficiency improvements to continue following the successful implementation of precision scheduled railroading (PSR).

Merchant Power

- We think incremental retirements of coal-fired generation announced in 2020-2021 will be a surprise as coal is rapidly becoming the fuel on the margin (highest variable cost) as gas production continues to impress.
- Regional risks pertain either to milder weather-influenced demand destruction, or negative demand trends, such as in the PJM and ISO-NE.
- Historically, an economic slowdown has sent demand sharply lower by 5%-6%, which is meaningful enough to result in negative cash flow generation for some IPPs.

Regulated Utilities

- Over the past decade, utilities have reduced their regulatory lag through the use of forward looking test years, formula rate plans, multi-year rate orders, increasing use of rider mechanisms, and decoupling.
- Our base-case outlook for credit reflects our view that most North American utilities would withstand a change to the credit cycle.
- Annual capital spending for the industry remains robust at about $140 billion. The industry is primarily focused on smaller projects that enhance safety, reliability, productivity, and reduce carbon emissions.

Transportation Infrastructure

- For ports we anticipate volume will soften in 2020 due to slower U.S. and global economic growth, with trade or tariff disputes possibly further depressing cargo volumes.
- Competition from technology used by transportation network companies such as Uber and Lyft is beginning to destabilize the business model of carparks.

Source: S&P Global Ratings.
Risks and opportunities have been simplified and standardized relative to the originals for cross-section clarity. No rank ordering is implied between the risks/opportunities.
4. Profits Growth Outlook Still Positive For 2020

The U.S. corporate sector has faced a more unsettled operating environment over the past year, with heightened uncertainty around trade and supply chains, ongoing disruption, regulatory pressures (see prior section), and deteriorating domestic economic momentum. Our heat map of market and economic leading indicators (see chart 7) shows the clouding of the outlook. A recession in the next 12 months is not our base case given ongoing monetary policy stimulus and positive consumer and labor trends in particular.

Chart 7

U.S. Leading Indicators Growth Signal Heat Map

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<tr>
<td>Term spread</td>
<td>Neutral</td>
<td>Negative</td>
<td>Neutral</td>
<td>Neutral</td>
<td>Positive</td>
<td>Neutral</td>
<td>Neutral</td>
<td>Neutral</td>
<td>Neutral</td>
<td>Neutral</td>
<td>Neutral</td>
</tr>
<tr>
<td>Credit spread</td>
<td>Neutral</td>
<td>Neutral</td>
<td>Neutral</td>
<td>Neutral</td>
<td>Positive</td>
<td>Neutral</td>
<td>Neutral</td>
<td>Neutral</td>
<td>Neutral</td>
<td>Neutral</td>
<td>Neutral</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>Neutral</td>
<td>Neutral</td>
<td>Neutral</td>
<td>Negative</td>
<td>Neutral</td>
<td>Neutral</td>
<td>Neutral</td>
<td>Neutral</td>
<td>Positive</td>
<td>Positive</td>
<td>Positive</td>
</tr>
<tr>
<td>Freight transportation index</td>
<td>Neutral</td>
<td>Neutral</td>
<td>Neutral</td>
<td>Neutral</td>
<td>Neutral</td>
<td>Positive</td>
<td>Positive</td>
<td>Positive</td>
<td>Positive</td>
<td>Positive</td>
<td>Positive</td>
</tr>
<tr>
<td>Building permits (single-family)</td>
<td>Neutral</td>
<td>Negative</td>
<td>Negative</td>
<td>Neutral</td>
<td>Neutral</td>
<td>Positive</td>
<td>Positive</td>
<td>Positive</td>
<td>Positive</td>
<td>Positive</td>
<td>Positive</td>
</tr>
<tr>
<td>ISM (manufacturing) new orders index</td>
<td>Negative</td>
<td>Neutral</td>
<td>Positive</td>
<td>Positive</td>
<td>Positive</td>
<td>Positive</td>
<td>Positive</td>
<td>Positive</td>
<td>Positive</td>
<td>Positive</td>
<td>Positive</td>
</tr>
<tr>
<td>Fed’s loan survey</td>
<td>Negative</td>
<td>Negative</td>
<td>Negative</td>
<td>Negative</td>
<td>Neutral</td>
<td>Neutral</td>
<td>Neutral</td>
<td>Neutral</td>
<td>Neutral</td>
<td>Neutral</td>
<td>Neutral</td>
</tr>
</tbody>
</table>

Source: S&P Global Ratings

Nevertheless, anxiety around the cycle remains acute. This is reflected in the most recent survey of S&P Global Ratings U.S. corporate and infrastructure analysts of the greatest areas of perceived risk for the credits that they follow (see chart 8). The risk of a turn in the economic cycle is seen as the biggest concern, followed by the more structural pressures (regulation, trade, pricing pressure) discussed above.

Chart 8

Top Risks U.S. Non-Financial Corporates

The impact of uncertainty has been felt in investment intentions especially. We flagged the impending downturn in our annual capital expenditure (capex) survey (see Global Corporate Capex Survey 2019: Curbed Enthusiasm, June 19, 2019) and capex-sensitive sectors such as capital goods expect 2020 to be difficult. Multiple key demand drivers for this sector – including autos and commodities – are stagnating or in decline, while construction has peaked. The deterioration can be seen in consensus forecast revision trends (see chart 9), where 12-month forward capex projections are being cut sharply. Nevertheless, while North American capex is likely to decline 1%-2% in 2020, it is unlikely to fall more dramatically without a drastic change in the economic outlook. Many sectors are still increasing capex (see chart 10) and indeed need to in response to technological and competitive pressures. Media, retailing and transportation are all examples of sectors increasing spending in order to improve digital platforms, content, and logistics.

![Chart 9](image1)

**YOY Change In 12m Forward Consensus Capex Index**

North America Monthly 12m Fwd Consensus Capex Index (YOY%)

![Chart 10](image2)

**Capex Growth Forecast 2020: North America Non-Financial Corporate Capex Growth By Sector (Rated universe only)**

<table>
<thead>
<tr>
<th>Capex Growth 2020 (Nominal, USD, %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Media Buis. &amp; Cons. SVcs</td>
</tr>
<tr>
<td>Aerospace &amp; Defense</td>
</tr>
<tr>
<td>Retailing</td>
</tr>
<tr>
<td>Technology</td>
</tr>
<tr>
<td>Transportation</td>
</tr>
<tr>
<td>Capital Goods</td>
</tr>
<tr>
<td>Healthcare</td>
</tr>
<tr>
<td>Chemicals</td>
</tr>
<tr>
<td>Telecoms</td>
</tr>
<tr>
<td>Consumer Products</td>
</tr>
<tr>
<td>Metals &amp; Mining</td>
</tr>
<tr>
<td>Eng. &amp; Const.</td>
</tr>
<tr>
<td>Paper &amp; Packaging</td>
</tr>
<tr>
<td>Building Materials</td>
</tr>
<tr>
<td>Autos</td>
</tr>
<tr>
<td>Oil &amp; Gas</td>
</tr>
<tr>
<td>Hotels Rest’s &amp; Leisure</td>
</tr>
</tbody>
</table>


For the corporate sector as a whole, the impact of adverse developments over the past year can be seen in sharply weaker growth rates for revenues and EBITDA (see charts 11 and 12).

![Chart 11](image3)

**North America Non-Financial Corporate Revenue Growth**

Sales Growth (YOY%)

![Chart 12](image4)

**North America Non-Financial Corporate EBITDA Growth**

EBITDA Growth (YOY%)

S&P Global Ratings estimates that revenues for rated North American companies will only have grown 3.8% in 2019 vs. 10.2% the prior year; for EBITDA, the 2019 growth rate is also projected at 3.8% vs. 12.1%. Importantly though, in our base assumptions we expect revenue and EBITDA to expand in 2020 and 2021, with 4%-5% revenue growth and 6%-8% EBITDA growth. Chart 13 shows the breakdown of these assumptions by sector. All sectors are expected to see positive revenue growth – albeit very modestly so in some companies – and likewise profit margins are expected to edge higher for most sectors. Critical to these assumptions are the assumed resilience of U.S. GDP growth (1.9% next year) and a stabilization of growth in some key export markets (Europe, China), which have lost economic momentum in recent quarters.

While our base case assumptions suggest positive trends for corporate cash flow growth and broadly supportive financing conditions, the risk of a serious downturn in either the economic or credit cycles is not negligible, particularly in the context of a long period of expansion and exceptionally low bond yields. To assess the risks here, we have published extensive analysis of the impact that a downturn involving deteriorating economic and credit fundamentals--with rising defaults and scarce liquidity--may have on ratings and market conditions. For full details, please see: [https://www.spglobal.com/ratings/en/research-insights/topics/when-the-cycle-turns](https://www.spglobal.com/ratings/en/research-insights/topics/when-the-cycle-turns).
5. Trade Tensions Likely To Linger

Trade conflict has been a persistent source of uncertainty and market volatility over the last year. In tandem with worries about global growth, this has been a key factor in inhibiting business investment and has raised more structural concerns about international supply chains.

Recent developments have suggested a more positive trend – the U.S. and Canada are anticipated to ratify the USMCA imminently, and the U.S. and China have potentially reached a Phase 1 agreement on trade. The latter is likely to mean that List 4B tariffs are delayed (see chart 14) and reductions in tariffs already in place3.

![Chart 14](chart14.png)

United States imposed tariffs on remaining US$300 billion of Chinese imports – List 4B Likely Deferred By Phase 1 Deal

Nevertheless, it appears premature to think that trade conflict will not continue to remain a theme over the coming year. With regard to U.S.-China negotiations, the next steps in negotiation remain difficult, with uncertainty and tensions likely to persist. Specifically, the next phase of negotiations that are striving to resolve the tension over technology, intellectual property and market access will continue to be challenging. This dispute is consequently likely to be a long running one. It is also likely that the deal may provide for a “snap back” of tariff rates and coverage if either side fails to make good on commitments. Furthermore, the protests in Hong Kong and the recent U.S. Congressional response add political complexity to the negotiations.

Wider escalations (for example European autos, Brazilian and Argentinian steel and aluminum) remain possible. So while the mood music may improve from time to time as agreements edge forward, complete certainty around trade policy is likely to be absent. As such risks of market volatility and knock-on effects on corporate planning and investment are likely to persist into 2020.

Cautious Boardrooms

While global M&A activity slowed, deals in the U.S. crossed $1 trillion in Q3 and are poised to end the year at the levels seen in 2018 (see chart 15). IT and healthcare accounted for more than half of deal volumes, as acquisitions in these sectors were largely driven by industry consolidation and increased leveraged buyouts. While we expect M&A activity to remain high in sectors such as healthcare and pharmaceuticals due to increasing level of disruption, the deal volume in 2020 is likely to dip, given the cautious environment in corporate boardrooms. Potential buyers are likely to wait-and-watch amid uncertainty about the outcome of the presidential election and trade negotiations. Also, following the recent burst of consolidation and collaboration in sectors such as metals & mining, automobiles and media, the activity is expected to slow this year, as these sector move into a digestion and consolidation mode.

Holding back

We expect borrowing conditions to remain favorable for acquisitions in 2020. However, this may not be enough to propel volumes beyond the levels seen in 2018 and 2019. Rising risk tolerance among investors has been a key driver for sponsors embarking on leveraged buyouts and endorse debt-funded acquisitions. For instance, U.S. technology companies that have engaged in M&A and leveraged buyouts have seen significant deterioration in credit quality, with leverage rising to more than 10x on average from 8.5x in 2016–2018 period. With credit markets displaying late-cycle characteristics, investors could turn cautious toward such transactions and lean in favor of deals where there is a clear path for deleveraging.

Unconventional approach

Though deal activity is likely to be impacted by policy uncertainty in the U.S., we believe that the current slow-growth environment could sway a few firms to pursue transformational deals to derive greater efficiencies and broaden their revenue channels. As with capex, though, much of the recent jumbo M&A deals reflect how challenging organic revenue prospects and operating conditions are for many industries, with growth low, margins under pressure, and intense disruption. On a more positive note, some companies in sectors such as capital goods are seeking to gain exposure to new technological capabilities in terms of digitalization, software and A.I., while U.S. automakers look to collaborate on battery development for electric vehicles and autonomous driving capabilities. Advertising agencies will continue to acquire technology and data businesses that could help them enhance their data-driven analytics. In contrast, sectors such as healthcare and pharma, which continue to face increased pricing pressure, will pursue horizontal mergers in 2020 given the increasing levels of disruption in the healthcare industry.
Ratings Trends

Downgrade potential continues to build

U.S. corporate downgrade potential has risen consistently in the past year, with risk rising broadly across sectors. The growing downgrade potential has coincided with the deceleration in U.S. economic growth and the recent buildup of low-rated debt.

As a measure of downgrade potential, the negative bias shows the percentage of ratings with negative outlooks or on CreditWatch with negative implications. The negative bias for North American nonfinancial corporates has risen by four percentage points in the past year, reaching 15% as of Oct. 31, and marking a ninth consecutive quarter of decline. This incremental rise in the negative bias has been spread across sectors, with negative biases rising in 12 (out of 16) U.S. nonfinancial corporate sectors.

Chart 17
North American Non-Financial Corporate Net Outlook Bias

<table>
<thead>
<tr>
<th>Year</th>
<th>Negative Bias (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>18</td>
</tr>
<tr>
<td>2014</td>
<td>14</td>
</tr>
<tr>
<td>2015</td>
<td>10</td>
</tr>
<tr>
<td>2016</td>
<td>6</td>
</tr>
<tr>
<td>2017</td>
<td>2</td>
</tr>
<tr>
<td>2018</td>
<td>0</td>
</tr>
<tr>
<td>2019</td>
<td>0</td>
</tr>
</tbody>
</table>

North America

Chart 18
North American Non-Financial Corporate Ratings Outlook

Outer ring
Dec 2018

<table>
<thead>
<tr>
<th>Rating Outlook</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Positive</td>
<td>5%</td>
</tr>
<tr>
<td>Negative</td>
<td>17%</td>
</tr>
<tr>
<td>Stable</td>
<td>88%</td>
</tr>
</tbody>
</table>

Inner ring
End-Oct 2019

<table>
<thead>
<tr>
<th>Rating Outlook</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Positive</td>
<td>3%</td>
</tr>
<tr>
<td>Negative</td>
<td>18%</td>
</tr>
<tr>
<td>Stable</td>
<td>89%</td>
</tr>
</tbody>
</table>

Further clouding the ratings outlook, fewer North American nonfinancial issuers now show upgrade potential than they did one year ago. The positive bias (the percentage of ratings with positive outlooks or on CreditWatch with positive implications) has fallen by two percentage points, to 3%, in the same period. In rating actions, U.S. corporate downgrades rose for a fourth consecutive quarter in the third quarter, led by the oil and gas and consumer products sectors.

Auto, Oil & Gas, and Retail & Restaurants Show Highest Negative Biases

The auto sector had the steepest increase in negative bias, with an increase of 22 percentage points, to 31%. Downgrade potential within the sector has risen in recent quarters as pressures in the aftermarket and operational missteps by some tier-1 auto suppliers have driven most of our negative rating actions. While S&P Global Ratings expects U.S. light-vehicle sales to decline nearly 3% year-over-year in 2019 before stabilizing in 2020 and 2021, overall, we don’t expect this modest dip (in our base-case) alone to lead to downgrades for automaker and supplier ratings in 2019-2020. Firstly, our forecast sales levels remain healthy enough for most automakers and suppliers to operate with healthy EBITDA margins, and secondly we believe significant new product launches will support automakers’ current product mix in favor of trucks.

The oil and gas sector follows with a negative bias of 26%, up 5 percentage points in the past year, including an increase of 2 percentage points in the third quarter. Credit stress in oil and gas has been on the rise as companies cope with volatile energy prices, liquidity issues, and high leverage. Moreover, capital market access has not been favorable for this sector, especially those deep speculative-grade issuers, and some issuers are conducting distressed exchanges for debt that is trading at very low prices.
Meanwhile, the negative bias for the retail sector also remains elevated, at 26%, though it has fallen 4 percentage points in the past year. This sector continues to face challenges from rising tariffs and changing consumer preferences.
Financing Conditions

U.S. financing conditions have seen little change in the past 2-3 months, remaining broadly neutral-to-supportive. Some slight improvements have been observed recently against the backdrop of both an improving tone in the U.S.-China trade dispute and the Fed’s recent interest rate cuts. Markets appear to be ending the year with optimism, and potentially a renewed hunt for yield among investors.

For credit markets, risk assessments have become more positive toward the majority of the market, with investment-grade spreads falling to 136 bps, from 173 bps at the end of 2018. In general, the ‘BB’ segment has seen its spread run a similar trajectory. However, some lingering risk-aversion from a year ago alongside expectations for a slowing economy appear to be keeping ‘B’, and ‘CCC/C’ spreads elevated, and on an upward trajectory this year (see chart 21). We expect this spread gap between the weakest and strongest credits to persist next year, as late-cycle credit concerns warrant a higher risk premium on credits with ratings at ‘B’ or below.

For 2020, S&P Global Ratings expects monetary policy to remain unchanged through the year with the next policy action a hike in 2021. This could change if our downside risks come to fruition and the central bank may be forced to cut rates again in March if economic growth slows to below potential and inflation recedes further. In this context, and with policy makers worldwide looking to rekindle economic growth after a period of lost momentum, we would expect the policy context for funding conditions to remain supportive and conducive to refinancing at favorable rates outside of the riskier end of the corporate credit spectrum. Market volatility – and periods when access to funding may be more difficult – is most likely to stem from event risk (politics, trade) or from risk premiums rising in the face of an unexpectedly sharp deterioration in the economic outlook, which is not our base case.

Chart 21

Some Stress At The Low-End
Investment-Grade and Speculative-Grade Corporate Bond Spreads (bps)

Default Outlook

S&P Global Ratings models the speculative-grade spread to the risk-free rate using various economic and financial indicators. Since the start of 2018, this implied spread has exceeded the actual in 17 of 22 months. This could imply that despite the spread’s increase, fixed-income markets are still overly optimistic relative to fundamental indicators and an uncertain outlook. That said, the upcoming maturity profile for U.S. spec-grade issuers appears largely manageable, although a few sectors may be facing greater funding risk in the future (see chart 22).

Chart 22
U.S. Speculative-Grade Maturity Wall For Oil & Gas And Telecommunications

Speculative-Grade Default Rate Heading Back Up Toward Long-Term Average

S&P Global Ratings Research projects the speculative-grade default rate to come in at 3.9% through September 2020 (see chart 23). This is up from 2.8% at the end of September of this year, inching closer to the long-term average of 4.2%. We anticipate corporate profits to come under pressure, with slower economic growth, with the ratings mix continuing to deteriorate. By sector, we still expect energy and consumer-reliant sectors (such as retailers and consumer products) to lead in terms of defaults, given their ongoing external stressors, structural changes, and possible funding challenges.

Chart 23
U.S. Trailing-12-Month Speculative-Grade Default Rate And June 2020 Forecast
Leveraged Finance

Economic Uncertainty Weighs on Weaker Corporate Credits

The slowdown in U.S. economic growth coupled with the uncertainty around the trade dispute with China has cast rainclouds over the U.S. economic outlook and the leveraged finance market, particularly the lower end of the speculative grade spectrum. Corporate earnings forecasts have also trended down as a result of global uncertainties as well as increases in wages and input costs. The performance pressure is amplified for weaker borrowers who have seen deterioration in their creditworthiness reflected in ratings downgrades and price declines on their debt in the secondary market, as well as higher spread requirements in the primary market.

Issuance Trends – Leveraged Loans Down, Speculative-Grade Bonds Up

The leveraged loan market has not recovered from the precipitous drop in issuance experienced in the fourth quarter of 2018. Despite an encouraging third quarter this year that saw the highest issuance of institutional loans in more than a year, issuance has fallen from the highs seen in 2017 and 2018. At $308 billion, institutional loan issuance through early December 2019 was down roughly 30% from the same period one year ago. The downward direction of Fed's policy rates has facilitated a net outflow from retail loan funds and into spec-grade bond funds. Retail loan mutual funds have seen an outflow of about $29 billion in loans for the year. For the year, spec-grade bond issuance is $262 billion as of Dec. 9—an increase of about 50% from the same span in 2018.

Credit Trends – Defaults Are Rising

While widespread distress may not have manifested yet and most forecasts of default rates remain fairly benign for 2020, late-cycle credit risks are becoming more apparent with the rise in idiosyncratic stories and “one-off” credit issues. The increased credit stress is evidenced by more downgrades and defaults, as well as a ballooning of S&P’s negative CreditWatch or outlook on companies. For 2019 (through early December), U.S. corporates have seen a total of 69 defaults (including distressed exchanges), surpassing the 47 defaults in all of 2018 and 54 for 2017. In the spec-grade universe, aggregate downgrades based on issuer count for the year through the third quarter stand at 107, compared to 22 upgrades—for an upgrade-downgrade ratio of one-to-five. Further, the amount of debt affected by downgrades was $1.5 billion, which is 3 1/2 times the amount of upgraded debt. The number of U.S. issuers that have their credit ratings at ‘B-’ or below with ratings on a negative
outlook or negative credit watch is at 179, portending more downgrades into the ‘CCC’ range and defaults. This is the highest this metric has been in more than a decade.

Leverage and Recovery Trends – The Inverse Relationship Continues

Leverage has been on the rise since the end of the financial crisis, stemming from a protracted period of low interest rates and a hunt for yield by investors that spurred easy borrowing conditions. Companies exploited such favorable conditions and issued debt for M&A, LBOs, and share buybacks, as well as re-pricings and refinancing. These conditions have also led to an expansion of the rated corporate universe and institutional loan market with newly rated companies typically being smaller, highly leveraged, and often private-equity-owned.

Based on data from LCD, average debt leverage for transactions closing in the 30 days ending on Nov. 22 is at 5.3x. We note that this number is a market statistic that incorporates “EBITDA addbacks” or “marketing” EBITDA, which generally significantly overstates EBITDA and understates leverage because these addbacks include business optimization, synergies, and cost savings—much of which is unlikely to be realized (see When The Cycle Turns: The Continued Attack Of The EBITDA Add-Back, published on Sept. 19). While we look beyond these add-backs to rate to our view of EBITDA and leverage, they can increase credit risk because they can allow companies to raise more debt than they otherwise could. Looser definitions of EBITDA can also increase future event risk by providing more covenant flexibility (through basket-exceptions and incurrence-tests based on adjusted EBITDA) to raise additional debt or make restricted payments.

The increase in leverage coupled with reduced debt cushion (less junior debt in the capital stack) has resulted in lower expectation of recoveries. Based on S&P’s recovery ratings, the average estimated recovery levels for senior secured first-lien loans outstanding is now in the mid-60% area. Historically, first-lien senior secured loans have yielded average recovery rates of about 80% based on companies that filed and emerged from bankruptcy from 2007–2017 (see A 10-Year Lookback At Actual Recoveries And Recovery Ratings, published Feb. 4).

In recent years, a recovery rating of ‘3’ (50%-70%) has been the most represented among first-lien senior secured loans. For 2019, the quarterly average of first-lien new issues with a recovery rating of ‘3’ is 61%, an almost 50% increase from 42% of the new issues that had a recovery rating of ‘3’ in the first quarter of 2017. Correspondingly, the numbers for issuances with recovery ratings of ‘1’ (90%-100%) and ‘2’ (70%-90%) have dropped from 52.6% in the first quarter of 2017, to 34% for 2019, reflecting higher total leverage and first-lien leverage ratios, in large part due to high LBO and M&A activity and high purchase price multiples. Covenant-lite loans have a higher risk of loss given default than loans with financial maintenance covenants, and our recovery methodology will typically produce lower recovery outcomes for companies with cov-lite loan structures, all else equal.
Market Price and Spreads – Rising Discounts For Weak Credits

Based on LCD data, loan prices have declined materially for many underperforming and low-rated credits. A total of 5.87% of the loans in the S&P/LSTA Leveraged Loan Index have traded at less than 80 cents on the dollar—the highest in the past three years. Similarly, a total of 2.49% of the loans traded at less than 70 cents on the dollar, again the highest in three years. The rising share of distressed loans could put active CLO managers to the test, as they have constraints on the proportion of distressed loans they can hold in portfolios without a haircut to par. The fear of not being able to trade out in the secondary market makes investors more reluctant to pile on risky loans from weak performers, especially at a time when worries about an earning recession mount. This is evidenced by the gap between 'BB' and 'B' new-issue spreads in the institutional market now being the highest since January 2012. Similarly, the bifurcation was also present in the secondary market, the average new-issue yield to maturity for ‘B+’ or higher deals dropped to its year-to-date low in September and stays low while the average of ‘B’ or lower-rated deals climbed.
Leveraged Finance Outlook for 2020

An important dynamic to watch will be whether demand from CLOs and spec-grade bond funds (and increasingly private credit) will continue to step up to fill the space left by continuing declines in holdings by retail loan investors. With the economy losing its momentum, there is a renewed focus on borrowers’ stability and resilience during a downturn. We anticipate that access to the credit market could remain a challenge for borrowers at or near the bottom tier of credit ratings. For example, we see anecdotal evidence of more successful investor pushback against some of the most egregious loan terms.

On the other side, the fact that CLOs as an investment vehicle lock in capital commitments for a long period could be crucial during a downturn. Given their long-term focus and non-mark-to-market feature, we expect CLOs to continue to function as a market stabilizer, as they were put to the test in the December 2018 sell-off, allowing the leveraged loan market to withstand episodes of market volatility without triggering a fire sale or sending the secondary market into a downward spiral. In 2020, we believe the new issuance volume of leveraged loans may remain subdued, mostly as investors continue to prefer fixed-rate spec-grade bonds, and low-rated credits find loan markets less accessible. Meanwhile, we expect the middle-market space will stay crowded with lenders dipping their toes into deals that are larger and more levered than what were traditionally seen in the space.

Related Research

- As The ‘B-’ Universe Expands, Timing Is Everything, Dec. 06, 2019
- Industry Top Trends 2020: Compilation and Key Themes, Dec. 3, 2019
- Credit Conditions North America: Recession Risk Has Eased Slightly – For Now, Dec. 3, 2019
- U.S. Business Cycle Barometer: Walk The Line, Nov. 25, 2019
- CLO Spotlight: To ‘B-’ Or Not To ‘B-’? A CLO Scenario Analysis In Three Acts Nov 26, 2019
- Credit Trends: The Expansion Of The ‘B-’ Segment Is Feeding Growing Vulnerabilities, Sep. 25, 2019

This report does not constitute a rating action