U.S. Corporate Issuers: Lending Surges Amid A Decline In Credit Risk In 1Q17

S&P Global Fixed Income Research

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Downgrades have declined since 2016 and credit weakness is more broadly distributed by sector:

• U.S. corporate downgrades are down 64% in the first quarter of 2017 (through February) compared to the same period in 2016, while upgrades were relatively unchanged. This decline in downgrades is largely due to the fall of downgrades for oil & gas and metal, mining and steel sectors.

• Though the oil and gas sector continues to show elevated credit weakness (with a speculative-grade negative bias of 50%), downgrades in this sector have fallen by 89% compared to last year. Meanwhile, downgrades have been increasing for the retail and restaurants and consumer products sectors.

• The speculative-grade default rate fell to 4.4% in February, (down from 5.1% in December). Excluding energy and natural resources, the default rate would have been just 2.4% in February. We forecast the rate will fall to 3.9% by year end 2017. We expect the defaults to peak in the first half of the year and decline in the second half of 2017.

• Since December, the negative bias (the proportion of ratings that have negative outlooks or are on CreditWatch with negative implications) for speculative-grade corporates has declined by 2 percentage points (to 20%), while investment-grade has remained at 13%.

The U.S. credit market has continued to show improving risk pricing and lending activity:

• U.S. corporate issuance is off to a strong start in 2017, up over the prior year by 30% -- as investment-grade issuance was up by 25%, while speculative-grade issuance was up 84% from prior year.

• Since mid-February of last year, credit spreads have been tightening across rating categories, though the lower-rated categories have contracted more rapidly as investor risk aversion has waned.
Rating Actions and Outlooks
Rating Actions Continue To Moderate For U.S. Corporates

• Downgrades reached a peak in 2016 Q1 and have since been steadily declining
• In 2017, YTD through February, downgrades are nearly 64% lower than over the same period in 2016, and are equal to the number of downgrades in 2015

*Data as of 2/28/17. Note: Downgrades shown as a negative number. Source: S&P Global Fixed Income Research
Downgrades Show Less Concentration By Sector Than In 2016

- Consumer products sector now accounts for 22% of U.S. corporate speculative-grade downgrades in 2017 (through February)

- The oil and gas sector accounts for 16% of U.S. corporate speculative-grade downgrades in 2017 (through February), down from 35% for full year 2016

*Data as of Feb. 28, 2017. Note: Downgrades shown as a negative number. CP&ES -- Chemicals, packaging, and environmental services; Home/RE -- Homebuilders/real estate companies; Forest -- Forest products and building materials; Financial Institutions includes brokerages, finance cos, mortgage institutions and S&L. Rating changes exclude entities with no rated debt. Source: S&P Global Fixed Income Research.
Declining Negative Bias Indicates Fewer Potential Downgrades

The negative bias for speculative-grade is currently 20%, while investment-grade negative bias is 13%.

Since August, the speculative-grade negative bias has declined by 4 percentage points, while investment-grade has fallen by 1 percentage point.

Data as of Feb. 28, 2017. Shaded areas are periods of recession as defined by the National Bureau of Economic Research. Source: S&P Global Fixed Income Research
Negative Bias Shows Continued Elevated Downgrade Potential For Commodity-Related Sectors

- **Speculative-grade commodity-related sectors have the highest negative bias:**
  - Oil and gas is at 50% in February (down from 56% at the end of October)
  - Metals, mining, and steel is at 27% (down from 33%)
  - Aerospace and defense is at 28% as orders have slowed in this sector, and some companies must invest to support new aircraft programs

- **Investment-grade negative bias is led by:**
  - Telecommunications’ negative bias is at 29% following announced mergers or acquisitions
  - Retail negative bias is at 23%, as companies face structural challenges and increased competition

Data as of Feb. 28, 2017. Note: Sector median ratings shown in parentheses. Net bias is the positive bias minus the negative bias. Metals = metals, mining, & steel; CP&ES = chemicals, packaging, & environmental services; Forest = forest products and building materials; Source: S&P Global Fixed Income Research.
Negative Bias Is Highest Above Trend For Oil And Gas And Aerospace And Defense

- Oil and gas and aerospace and defense are the sectors with current negative biases that are highest above historical average.

S&P Global Fixed Income Research forecasts the U.S. trailing-12-month speculative-grade default rate will fall to 3.9% by December 2017 (with 70 defaults), down from 5.1% in December 2016 (with 91 defaults).

In February, we estimate that the speculative-grade default rate declined to 4.4%, if we excluded the energy and natural resources sector, then the overall default rate would have been just 2.4%.

Data as of February 28, 2017. Shaded areas are periods of recession as defined by the National Bureau of Economic Research (NBER).

Source: S&P Global Fixed Income Research; S&P CreditPro®
The Oil And Gas Sector Continues To Lead Defaults And Weakest Links

- U.S. speculative-grade corporate defaults total five YTD through February, led by the oil and gas sector with two

- The oil and gas and consumer products sectors have the most companies that are ‘weakest links’, and show elevated default risk

- ‘Weakest Links’ are issuers rated ‘B-’ or lower with either a negative outlook CreditWatch, and these issuers maintain an important role as potential default indicators because they have greater default risk than higher-rated issuers

Defaults data as of Feb. 28, 2017. Weakest links as of 1/19/2017. CP&ES -- Chemicals, packaging, and environmental services; Home/RE -- Homebuilders/real estate companies; Metals -- Metals, mining, and steel; Forest -- Forest products and building materials; Financial Institutions includes banks, brokerages, finance cos, mortgage institutions and S&L. Source: S&P Global Fixed Income Research.
Distress Among Retail And Restaurants Has Surpassed Oil And Gas

- The distress ratio (the share of speculative-grade issues with option-adjusted composite spreads of more than 1,000 basis points (bps) relative to U.S. Treasuries) has declined in recent months, and is back down to 6.9% in February (down from 34% one year ago).

- Retail and restaurants is now the sector with the highest distress ratio (21%), having just surpassed the oil and gas sector in January.

Data: Feb. 15, 2017. CP&ES -- Chemicals, packaging, and environmental services; Home/RE -- Homebuilders/real estate companies; Metals – Metals, mining, and steel; Forest -- Forest products and building materials; Financial Institutions includes, finance cos, mortgage institutions and S&L (Note: banks and brokers excluded due to small sample size). Source: S&P Global Fixed Income Research.
U.S. Corporate Debt Maturities Should Be Manageable In The Near Term

U.S. companies have $4.2 trillion in rated debt maturing through 2021, annual maturities rise to a peak of $1.03 trillion in 2021

- 31% of the maturing debt (through 2021) is speculative grade ('BB+' and lower)
- Speculative-grade debt is higher is more susceptible to refinancing risk, though maturities are modest in 2017 and 2018

U.S. Nonfinancial Corporate Speculative-Grade Maturities Peak In 2021

- Though $1.16 trillion in U.S. nonfinancial corporate speculative-grade is scheduled to mature through 2021, the majority of this debt will not mature until 2020-2021.
- Of the maturing debt, 47% is in the highest speculative-grade category of 'BB'.
- We view it as a positive that lower-rated debt has a longer window before it reaches peak maturity.

Issuance And Market Overview
U.S. Corporate Bond Issuance Is Off To A Stronger Start Over 2016

- U.S. corporate investment-grade bond issuance is up 25% YoY (through February), and is up 6% over issuance in the same period in 2015

- Speculative-grade corporate issuance is up to $29 billion in 2017 (through February), from just $16 billion over the same period in 2016

Data as of Feb. 28, 2017. Source: S&P Global Fixed Income Research; Thomson Reuters
Yields Show Little Change So Far In 2017

- Ten-year Treasury yields rose by 56 bps to 2.43% from the election to the end of the year, and the yield stood at 2.35% at the end of February

- The investment-grade yield is currently 3.99%, while the speculative-grade yield is 6.14%, each is little changed since the beginning of the year

- Since year end, credit spreads have tightened modestly across rating categories, though the lower-rated categories have contracted more rapidly as investor risk aversion has waned

Data as of February 28, 2017. Source: S&P Global Fixed Income Research; Thomson Reuters
• Investment grade corporate composite spreads contracted in 2017 (through February) for all sectors except retail and restaurants (which widened by just 3 bps)

• Speculative-grade spreads for the retail and restaurants sector widened by 26 bps in 2017, to 486 bps, and this sector now shows the widest spread

*Data as of Feb. 28, 2017. Note: Investment-grade spreads calculated for bonds with a 10-year maturity; speculative-grade spreads calculated on bonds with a five-year maturity. Note: CP&ES -- Chemicals, packaging, and environmental services; Home/RE -- Homebuilders/real estate companies; Forest -- Forest products and building materials; S&P Global Fixed Income Research
Investment-And Speculative-Grade Returns Gain In First Quarter

- Investment-grade credit gained 6% (on a total return basis) in 2016, even with a decline of 3.5% in the fourth quarter; returns have rebounded 1.6% in 1Q 2017 (through February)

- Speculative-grade returns were up 17% in 2016, including a gain of 1.6% in the fourth quarter; returns climbed to 2.5% in the 1Q 2017 (through February)

*Data as of February 28, 2017. Source: S&P Global Fixed Income Research*
Total Returns Positive Across Sectors, Though Retail Lags

Returns for metals, mining, and steel showed the strongest returns in 2016, with speculative-grade rebounding 51% as investment-grade gained 14%, followed by oil and gas with a speculative-grade return of 32% and investment-grade gain of 13%.

In 2017 (through February), the retail and restaurants sector had the lowest return for both investment- and speculative-grade, with 0.7% and 0%, respectively.

*Data as of Feb. 28, 2017. Note: CP&ES -- Chemicals, packaging, and environmental services; Home/RE -- Homebuilders/real estate companies; Forest -- Forest products and building materials; S&P Global Fixed Income Research.*
Rating Distributions
In 2016, the number of newly-assigned U.S. corporate ratings is up modestly in 2016 (to 316) from 265 in 2015.

The sectors that saw increases over 2015 included high technology, consumer/services, and energy and natural resources.

Note that these newly-assigned ratings include issuers receiving new ratings post-default.

Corporate Rating Distributions

- 56% of U.S. corporate ratings are speculative grade
- Nonfinancials have a much higher proportion of speculative-grade companies (at 66%) vs. financials (at 21%)
- As credit conditions become more challenging, those companies in the lower-rating categories are more likely to experience funding challenges
