U.S. Midyear Corporate Outlook: Peak, Plateau, Or Peril? As The Cycle Matures, A Stable Outlook For Now

August 6, 2018

Key Takeaways

- The favorable credit cycle looks set to continue amid sustained U.S. economic growth, still-low borrowing costs, and the benefits to corporations of recent tax reform.

- At the end of the first half of 2018, 75% of U.S. corporate borrowers we rate had stable outlooks.

- Median leverage in the ‘BBB’ ratings category increased to 2.3x at the end of last year, from 1.9x in 2008, but this remains in line with our parameters for the category.

- S&P Global Ratings economists forecast U.S. real GDP growth of 3% and 2.5% in 2018 and 2019, respectively, with a low (10%) probability of a recession in the next 12 months.

- Heightened trade tensions, increased financial market volatility, and rising interest rates pose the greatest threats to favorable credit conditions.

As U.S. economic growth continues, helping to extend the cycle toward record length, credit quality among U.S. corporates rated by S&P Global Ratings has improved—even as the amount of debt and leverage these borrowers carry is at an all-time high.

The $1.5 trillion tax package that President Trump signed into law late last year, along with the $1.3 trillion spending bill that funds the federal government through September, has given the world’s biggest economy a near-term boost, all but ensuring that the current expansionary run will be the longest in American history. That said, heightened trade tensions, increased financial market volatility, and rising interest rates pose the greatest threats to favorable credit conditions.

For now, U.S. corporate borrowers’ upcoming maturities appear manageable, the macroeconomic outlook for the second half of the year is largely rosy, and the Federal Reserve Bank seems content to raise benchmark interest rates at a measured pace.
Ratings Trends, The Maturity Wall, And Leverage

We expect ratings to remain generally stable, with pockets of weakness—particularly in consumer products and retail. The proportion of U.S. corporate borrowers with stable outlooks has remained relatively unchanged this year; at the end of the first half, 75% of borrowers we rate had stable outlooks, with many of the 15% of those with negative outlooks in the retail and consumer products sectors (see chart 1). We think continued favorable economic and financing conditions will support corporate creditworthiness through year-end, although the potential for improvement is limited at this late stage in the credit cycle. Indeed, we continue to see further leveraging risk, particularly from mergers and acquisitions (M&A).

Our view is that the credit cycle will last at least a bit longer, unless trade tensions materially escalate, the economy unexpectedly falls into recession, or financial conditions tighten excessively. S&P Global Fixed Income Research forecasts the U.S. speculative-grade default rate to drop to 2.5% by March 2019 (see chart 2). The amount of debt coming due in the near term is manageable, as U.S. corporates have pushed out their maturities since last year. Rated debt maturities now peak in 2022—a year later than our estimates from last year (see chart 3).
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Chart 2

U.S. Trailing-12-Month Speculative-Grade Default Rate And March 2019 Forecast

Note: Shaded areas are periods of recession as defined by the National Bureau of Economic Research.
Sources: S&P Global Fixed Income Research and S&P Global Market Intelligence's CreditPro®.
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On the downside, U.S. corporates are carrying a record amount of debt and leverage on their balance sheets, as many companies took advantage of historically low borrowing costs after the financial crisis by entering into M&A transactions given perceived limited potential for organic growth. As such, excessive leverage is a key headwind—particularly for those at the lower end of the credit spectrum. Periods of volatility, especially this late in the credit cycle, could hamper financing conditions and constrain market access, giving rise to defaults. Debt-to-EBITDA and funds from operations (FFO)-to-debt ratios are just two of the measures S&P Global Ratings uses to calculate leverage among borrowers we rate. And while we take into account sector-specific factors such as earnings volatility when determining a borrower's stand-alone credit profile (SACP), the fact remains that as of July 1, leverage across the universe of more than 2,200 U.S. nonfinancial corporate borrowers we rate was at a historic high. We believe the risks of this debt binge are significant, given that excessive leverage can bring down a company as fast as prudent borrowing can build it up.

**When The Cycle Turns**

Debt in the 'BBB' ratings category (which includes 'BBB+' and 'BBB-') in particular has swelled in the past decade, and investors have become increasingly concerned about what will happen when the credit cycle turns. Specifically, they worry that if sizable 'BBB'-rated issuers fall to speculative-grade in a downturn, it will lead to sharply higher financing costs due to forced selling...
by funds or institutions that can only hold higher-rated debt. Moreover, declining average credit quality and the proliferation of speculative-grade bond issuance since the financial crisis—as well as leveraged lending—could amplify credit stresses if investors become more risk-averse, eroding borrowers’ market access.

Our analysis of ‘BBB’ risk characteristics shows that median leverage in this category has increased, to 2.3x at the end of last year, from 1.9x in 2008 (excluding real estate, regulated transmission/transport, and regulated utilities, which can handle higher leverage because of the predictable nature of cash flows) (see charts 4 and 5). This remains in line with our parameters for the ratings category. In addition, business risk profiles have strengthened, while free operating cash flow (FOCF) relative to debt for ‘BBB’ issuers is slightly higher.

Often, investor concerns about ‘BBB’ s are company or sector-specific. In the consumer products sector (mostly in packaged goods), where companies have actively engaged in M&A, we have seen average leverage rise above historical levels for large, transformative deals. Specifically, there are ‘BBB’ issuers that have pushed leverage to 3x-4x, and sometimes above 5x on a pro forma basis, at acquisition close.

So, how would these borrowers fare in a stress scenario? We believe ratings could come under pressure, given the high starting leverage of many of these deals. In such a case—wherein we assume EBITDA declines about 10% from our base case—we believe that the deleveraging needed would be delayed. In such a scenario, the median leverage at 24 months after a deal closes would increase to just more than 4x, compared with 3.5x in our base case. To maintain ‘BBB’ ratings, many of these companies likely would need to pull back on shareholder returns or sell assets.

During the most recent recession, many consumer product borrowers were able to maintain
strong discretionary cash flows, and for many, EBITDA actually improved due to cost-cutting and acquisitions. Thus, given the generally stable cash flows of these companies, we believe most could withstand another shock, even as the pace of deleveraging could be slower than anticipated at the outset of the deals.

**Macro And Policy Risk**

The macroeconomic outlook for U.S. corporate credit in the second half of the year is largely favorable. In our base case, we expect the U.S. economy to continue to expand, and financing conditions to remain broadly accommodative. But risks are increasing, particularly from ongoing trade fights that could escalate further.

The U.S. and China have been engaging in tit-for-tat tariffs, as each imposed 25% levies on $34 billion of imports from each other (effective July 6) and on another $16 billion of goods forthcoming. The U.S. has also threatened to impose tariffs of 10%, possibly 25%, on an additional $200 billion worth of Chinese products (subject to review) and that now includes consumer goods—bringing the potential total imports subject to new tariffs to $250 billion or half of U.S. imports from China. President Trump has even floated the idea of imposing levies on all Chinese imports, which last year totaled more than $500 billion. In the latest retaliation, China has indicated it would impose levies of 5%-25% on $60 billion of American goods if the U.S. pushes through with tariffs on $200 billion of its products.

The U.S. is also investigating auto and auto parts imports on national security grounds, and the EU has warned of retaliatory tariffs. But tensions have cooled after President Trump agreed to refrain from imposing car tariffs while the two sides negotiate to lower other trade barriers.

S&P Global Ratings is more concerned that trade clashes could expand beyond tariffs on goods to cross-border investment and other non-tariff actions that would lead to greater operational risk, reduced market access, or decreased revenues for U.S. companies. For example, the Chinese government could persuade the country's consumers to boycott select American products and services, negotiations to liberalize foreign ownership caps for U.S. carmakers operating in China could suffer, and China could delay or make it more difficult for U.S. companies to obtain permits to operate or expand there.

The U.S. administration indicated lately that a North American Free Trade Agreement (NAFTA) deal is close at hand, but an agreement in the near term appears challenging given that negotiators have yet to agree on major provisions. Our base case is that the talks will eventually result in a trade deal that largely preserves cross-border trade and investment links between the U.S., Canada, and Mexico, and contains sufficient transition time. For the auto sector, which is at the heart of the NAFTA manufacturing supply chain, we expect a modest negative (albeit manageable) effect on profitability, as automakers and suppliers bear the costs to reshuffle the supply chain. This assumes higher production costs, preservation of manufacturing for key components in the U.S. and Canada, and an increase in wages for Mexican autoworkers.

In the near term, we see limited ratings impact from the tariffs that have been implemented so far. The levies will lead to higher input costs—some of which will be mitigated by the availability of substitutes or by firms’ passing on the higher costs to consumers. Certain sectors will be (and, in some cases, already have been) hit harder, particularly in the U.S. agriculture sector. To be sure, it’s the potential secondary effects of a trade war—through the hits to confidence and demand—that we see as more significant for the economy and corporate credit.
Solid Footing For The U.S. Economy

S&P economists forecast above-trend U.S. real GDP growth of 3% and 2.5% in 2018 and 2019, respectively. We see a low probability (10%) of a U.S. recession in the next 12 months, notwithstanding the flat yield curve. The curve has yet to invert and, historically, it takes an average of 12 months after curve inversion before the economy enters recession (see chart 5). We think cyclical risks will become more significant later next year and beyond, when fiscal tailwinds fade and monetary policy has tightened further. Against this backdrop, we expect corporate profits to remain fairly strong in the second half of this year, although companies will continue to face cost pressures from higher wages and commodity prices.

Chart 5

Treasury Yield Curve (10 Year Less Two Year)

Continued dollar strengthening would weigh on the profits of U.S. exporters and multinationals. Diverging economic performance between the U.S. and economies abroad, as well as safe-haven demand, have buoyed the dollar’s value this year (see chart 6). A further climb in the greenback could also deepen problems in emerging markets, a negative for companies with large or growing exposure to these economies. What’s more, a move higher for the dollar—and a weaker Chinese currency—could add to the trade rift between the U.S and China.
Higher oil prices are a boon to U.S. oil and gas producers, and while higher energy prices would harm some sectors, we think the negative repercussion are manageable for now. S&P economists don't expect oil prices at $70-$80 per barrel to weigh too heavily on the U.S. economy, which is less vulnerable to oil-price increases than it used to be because of increased energy efficiency. For example, household energy consumption as a proportion of income has decreased to 3.5%, from 8.0% in the early 1980s (see chart 7). Nevertheless, the increase in oil prices could erode as much as one-third of consumers’ tax-cut windfall. The greater risk may come from its impact on monetary policy—the Fed could raise rates too quickly if they see a further increase in oil prices as a threat to inflation expectations.
Our economists expect the Fed to continue raising the benchmark federal funds rate at a measured pace, with two more hikes this year (for a total of four), and three increases next year. The European Central Bank has also announced that it would end its so-called quantitative easing by the end of the year, and we expect the first ECB rate hikes in the second half of 2019. Against this backdrop, corporate bond yields have crept up, and the uptrend will likely continue, resulting in higher costs for borrowers. The pressures from rising rates will continue to build across the economy, particularly affecting housing and auto affordability.

**Tax Cuts Mean More Cash, But Limited Ratings Impact**

As expected, U.S. companies have used most of the additional funds freed by tax reform for shareholder returns, and M&A, with minimal material increases in capital investments (see charts 8 and 9).
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Chart 8

Common Shares Repurchased And Dividends Paid

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Although the legislation did improve some credit metrics in nearly all sectors, there have been mixed or negative effects on sectors such as technology and regulated utilities. The divergence is even more apparent when comparing investment-grade to speculative-grade. While we estimate roughly 30% of our speculative-grade universe doesn’t currently pay taxes, these borrowers will on average not benefit nearly as much as their higher-rated counterparts, in part because of their already low to negative tax rate, relatively lower capital spending, and limits on interest deductibility.

As of now, there have been no direct ratings changes as a result of tax reform. But it has altered or accelerated companies’ shareholder-return plans in many cases. (That said, it’s sometimes difficult to directly link this to tax reform, as there may have been other mitigating factors.) We continue to monitor how companies plan to alter their earnings guidance or capital allocation as a result of tax reform. If companies plan to materially change their capital structures or capital spending, this could have a bigger effect on ratings.

Tax reform has paved the way for a massive repatriation of overseas earnings. We expect cash balances to gradually decline as borrowers return formerly "trapped" foreign cash (estimated to be more than $1.3 trillion) to shareholders—though some will surely reinvest those proceeds, make acquisitions, or pay down debt.

With last year’s tax reform and policy uncertainty from the Fed, companies were slower to tap the markets. Issuance in the first half lagged the historic pace set last year—albeit only nominally
While tax reform has boosted cash flows that has afforded many corporates the ability to delay planned debt issuance, continued large M&A could provide a tailwind for issuance.

**Chart 10**

**Total Issuance**

![Graph showing total issuance from 2010 to 2018](source)


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**M&A Generates Credit Risk**

Despite trade tensions, U.S. M&A has rebounded this year, sparked by the return of mega-deals and increased leveraged buyouts—another late-cycle characteristic. The U.S. deal-making landscape is benefiting from continued accommodative financing conditions and the elimination of uncertainties related to U.S. tax reform.

Announced transactions in the first half exceeded $700 billion, representing almost 500 deals. While the deal count is up only marginally from the same period last year, the dollar volume surged about 65% (see chart 11). Health care, consumer discretionary, and energy were the most active sectors (see chart 12). The factors driving transactions continue to be low organic growth, disruptive technologies, and the desire for efficiencies of scale. We expect the busy M&A landscape to continue in the second half, and we see the approval of the AT&T Inc.-Time Warner Inc. merger spurring more megadeals in the telecom and media sectors, as well as elsewhere. M&A has been a key ratings mover for the past few years, and we expect it to remain an important rating risk. The downward migration to 'BBB' from 'A' as a result of M&A highlights this risk.
Trade disputes have also manifested in foreign investment, particularly in U.S.-China cross-border transactions. Several M&A deals involving Chinese companies acquiring U.S. entities have been blocked or terminated for national security reasons. Meanwhile, Qualcomm abandoned...
its planned takeover of NXP Semiconductors N.V after the deal failed to get timely approval from Chinese authorities. The primary sources of U.S.-China trade friction, in our view, are China’s practices related to intellectual property transfer; and its policy of limiting foreign owners in joint ventures to minority stakes. Restrictions on foreign investment and cross-border deals could have direct credit effects by tempering companies’ growth prospects and limiting their preferred strategies.

**Industry Outlook**

We see the highest downgrade risk in retail and consumer nondurables, where we hold negative sector outlooks (see table 1). In addition to trade tensions and the path of interest rates, the main risks for corporates are higher input costs, particularly for labor (as well as labor shortages in some industries), technological/secular disruption, and M&A (see table 2).

- **Consumer Nondurables:** We lowered our sector outlook to negative for consumer nondurables—with organic top-line growth continuing to be soft. We expect margins to be flat to down slightly amid cost inflation and retailers’ pushing back on price or requesting changes in packaging. In addition, we've seen companies rated ‘B-’ and below having to refinance under less favorable pricing conditions.

- **Metals and Mining:** U.S. tariffs on steel and aluminum imports should support the profitability of U.S.-based metals assets, with potentially higher domestic prices and volumes providing potentially stronger earnings and cash flow. That said, we don’t expect that tariffs and retaliatory actions will have a meaningful effect on ratings, because issuers we rate are mostly exposed to domestic metal trade. Moreover, tariffs are unlikely to improve the competitive positions of U.S. producers, enabling just a few restarts of assets that are among the industry’s least profitable. Downstream metals consumers and processors are feeling the pinch, however, with lower margins and weaker cash flow from sharply higher working capital investments.

- **Retail:** Secular change is a main driver of weak business conditions. Serious distress characterizes specialty apparel and department stores. Regional grocers are also under pressure and are increasing their focus on e-commerce. Capital markets are cautious on apparel and department store financing. And while a few retailers will increase capital spending, many others are shrinking their footprint.

- **Oil and Gas:** The rebound in oil prices has stabilized credit metrics and allowed issuers to demonstrate financial profiles that are more in line with ratings. The sector’s maturities increase significantly in 2019-2021, but absent another meaningful price decline, refinancing should be manageable (at currently higher oil prices).

- **Telecom:** In wireless, price competition, mature industry conditions, and rising capital spending to support the buildout of spectrum and increase network density, could weigh on ratings. Wireline providers continue to lose high-margin voice access lines and DSL customers in the residential segment while spending by business customers remains weak. The cable sector outlook is relatively stable, despite pressures for OTT (over-the-top) video services, because these companies have a natural hedge with broadband.
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## Sector Credit Conditions Survey

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<tr>
<td>Aerospace &amp; defense</td>
<td>Satisfactory</td>
<td>Somewhat stronger</td>
<td>Same</td>
<td>Stable</td>
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<tr>
<td>Auto OEMs &amp; auto suppliers</td>
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<td>Somewhat weaker</td>
<td>Same</td>
<td>Stable</td>
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<tr>
<td>Building materials</td>
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<td>Stable</td>
</tr>
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<td>Capital goods</td>
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<td>Higher</td>
<td>Stable to Negative</td>
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<td>Consumer durables</td>
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<tr>
<td>Consumer non-durables</td>
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<td>Negative</td>
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<td>REITs</td>
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<tr>
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</table>

**Change indicators:**  
- [ ] Stronger since last quarter  
- [ ] Weaker since last quarter

Note: Business conditions outlook, financial trends outlook, and sector outlook are for the next 12 months.  
Source: S&P Global Ratings. S&P Global Ratings corporate analysts are surveyed quarterly as part of the S&P Global Credit Conditions Committee process.  
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#### Aerospace & defense
- Exogenous shocks that would severely affect airline customers (major terrorism, wars)
- Ability of the supply chain to meet growing production rates and pricing pressure from OEMs
- Federal budget decisions, effect of continued sequestration (which has inefficiencies beyond lower total spending)

#### Auto OEMs & auto suppliers
- Cycle turns negative
- Rising interest rates, lowered vehicle pricing and tougher financing terms have a larger than expected impact on demand
- Raw material spike could hurt automaker margins
- NAFTA renegotiations could lead to sourcing risk and also upside to margins for some

#### Building materials
- Higher interest rates likely to be detrimental to homebuyers and homeowners who borrow to fund improvements
- Refinance risk, but most have taken advantage of debt markets to push out maturities another 3-7 years

#### Capital goods
- Trade disruptions, particularly if retaliatory actions hurt exports of capital goods
- Rising input and labor costs could pressure profitability
- Significant drop in volatility of oil prices could hurt revenue growth

#### Chemicals
- Geopolitical events are a risk if they translate into demand or oil and raw material price volatility
- M&A continues to be a risk factor
- Rising interest rates and the impact they may have on capital market activity, including refinancing and cov-lite deals

#### Consumer durables
- Housing market softens
- Pressure from retailers to reduce prices and absorb costs

#### Consumer non-durables
- Weakening negotiating power with traditional grocers and mass retailers
- Increasing inroads from smaller brands
- Activists accumulating stock and seeking change as companies struggle with top-line growth

#### Forest products
- Currency swings could affect the import-export balance for lumber and pulp
- Canada-U.S. softwood lumber trade friction can cause large swings in prices and volumes on both sides of the border
- Natural factors like weather, fires, or insect infestations are a threat for timber REITs and lumber producers

#### Healthcare services
- Accelerating pressure on volumes
- Adverse U.S. regulation

#### Leisure & sports
- M&A and development opportunities could lead to moderate incremental leverage
- U.K. govt plans to limit betting amounts could hurt retail operators that get majority of cash flow from gaming machines
- Nontraditional hospitality options
- Security risks

#### Media & entertainment
- Geopolitical instability/terrorism that shakes consumer and corporate confidence
- Regulatory changes
- Technology disruption/disintermediation

#### Metals & mining
- U.S. tariffs on steel and aluminum imports support US output for primary producers, but will cause some cost pressure for downstream operators
- Slower demand in China could exacerbate overcapacity in steel and aluminum
- Coal is exposed to declining U.S. consumption
- A stronger U.S. dollar is typically inversely related to metals prices, including gold

#### Midstream energy
- Regulatory/environmental opposition to pipeline projects
- Instability for some midstream companies to issue cost effective equity

#### Oil & gas
- OPEC abruptly unwinds 1.8 million barrels of production back into the market
- U.S. shale production grows to levels that send the market back into an imbalance
- Price differentials in Canada become more problematic if Mexican infrastructure to take Permian gas is not built in a timely manner

#### Oil refineries
- IMO 2020 regulations to dramatically reduce sulfur in bunker fuels used in the shipping industry
- OPEC decisions to restrict production or geopolitical shocks cause crude prices to spike and temporarily squeeze margins

#### Pharmaceutical
- Drug pricing pressures
- M&A uptick as companies aim to restock pipelines and address potential changes in marketplace

#### Real Estate - homebuilders
- Declining home affordability amid price appreciation
- Labor shortages and higher land costs could pressure margins

#### REITs
- Occupancy and rent pressure in retail REIT sector, resulting in growing negative rating bias in the mall subsector
- Rising rates and decelerating fundamentals could pressure property values modestly in 2018
- Rising interest rates could have an impact on spending (versus saving)

#### Retail
- Acceleration of existing pressure on apparel and department stores from lack of demand
- Death of capital market interest

#### Technology
- Trade tensions with China, where technology could be targeted from an unfair business practice perspective
- M&A activity could decrease if China delays or rejects M&A applications as a result of trade tensions

#### Telecommunications
- Securitization risks (e.g., wireless substitution, pay- TV declines)
- Technology risk/shifts in consumer preferences
- Aggressive competition in wireless

#### Transportation
- Higher fuel expense, which hurts some subsectors
- Reduced international trade due to tariffs or other restrictions is moderately negative for freight companies
- Interest rates that rise too quickly will hurt leasing companies, and capital markets disruption

#### Unregulated power
- Stagnation in load growth, proliferation of distributed generation, and abundant natural gas production
Related Research

- When The Cycle Turns: Will Consumer Companies' M&A-Related Debt Result In An Exodus From Investment Grade?, July 25, 2018
- When The Cycle Turns: U.S. 'BBB' Corporate Profiles Remain Firm Despite Rising Debt, July 25, 2018
- As the Rising Price Of Oil Filters Through To U.S. Consumers, Many May Shrug--for Now, June 29, 2018
- Credit Conditions: North America March 2018--Trade Tensions, Market Swings Pose Risks To Benign Conditions, March 28, 2018
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013

This report does not constitute a rating action.

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