MOODY'S ANALYTICS

WEEKLY MARKET OUTLOOK

Moody's Analytics Research

Weekly Market Outlook Contributors:

John Lonski
1.212.553.7144
john.lonski@moodys.com

Yuki Choi
1.212.553.0906
yukyung.choi@moodys.com

Moody's Analytics/Asia-Pacific:

Katrina Ell
+61.2.9270.8144
katrina.ell@moodys.com

Moody's Analytics/Europe:

Barbara Teixeira Araujo
+420.224.106.438
barbara.teixeiraaraujo@moodys.com

Moody's Analytics/U.S.:

Ryan Sweet
1.610.235.5000
ryan.sweet@moodys.com

Greg Cagle
1.610.235.5211
greg.cagle@moodys.com

Michael Ferlez
1.610.235.5162
michael.ferlez@moodys.com

Editor
Reid Kanaley
1.610.235.5273
reid.kanaley@moodys.com

Core Profit's Positive Outlook Lessens Downside Risk for Credit

Credit Markets Review and Outlook *by John Lonski*

Core Profit's Positive Outlook Lessens Downside Risk for Credit

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The Week Ahead

We preview economic reports and forecasts from the US, UK/Europe, and Asia/Pacific regions.

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The Long View

Full updated stories and key credit market metrics: The market now expects fed funds' midpoint to rise no higher than 2.625% in 2019.

Credit Spreads	Investment Grade: We see year-end 2018's average investment grade bond spread resembling its recent 132 bp. High Yield: Compared to a recent 445 bp, the high-yield spread may approximate 450 bp by year-end 2018.
Defaults	US HY default rate: Moody's Default and Ratings Analytics team forecasts that the U.S.' trailing 12-month high-yield default rate will sink from October 2018's 3.16% to 2.26% by October 2019.
Issuance	In 2017, US$-denominated IG bond issuance grew by 6.8% to a record $1.508 trillion, while US$-priced high-yield bond issuance advanced by 33.0% to a new record calendar-year high of $453 billion. For 2018's US$-denominated corporate bonds, IG bond issuance may drop by 12.9% to $1.313 trillion, while high-yield bond issuance is likely to fall by 34.4% to $297 billion for the worst calendar year since 2011's 274 billion.

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Ratings Round-Up

Downgrades Dominate

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Market Data

Credit spreads, CDS movers, issuance.

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Moody's Capital Markets Research *recent publications*

Links to commentaries on: Buybacks, volatility, defaults, Fed policy, yields, profits, corporate borrowing, U.S. investors, eerie similarities, base metals prices, debt to EBITDA, trade war, Investment grades, higher rates, credit quality, foreign investors, internal funds.

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Click here for *Moody's Credit Outlook*, our sister publication containing Moody's rating agency analysis of recent news events, summaries of recent rating changes, and summaries of recent research.

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Credit Markets Review and Outlook

By John Lonski, Chief Economist, Moody's Capital Markets Research, Inc.

Core Profit's Positive Outlook Lessens Downside Risk for Credit

Profitability will have the final say regarding the future direction of the corporate credit cycle. Each of the five deep and extended contractions by profits since 1982 helped to lift the high-yield default rate well above 5%. Moreover, three of the five pronounced downturns by profits overlapped each of the recessions since 1982. For now, the outlook for corporate earnings benefits from the surprising containment of employee compensation notwithstanding the lowest unemployment rate in 49 years.

Of all broad estimates of corporate earnings, profits from current production performs best at explaining the corporate credit cycle, especially the all-important high-yield default rate. According to the Bureau of Economic Analysis, profits from current production are not directly affected by changes in tax laws because they are pretax and employ economic depreciation instead of accounting depreciation. Profits from current production also exclude the effect on profits of changes in inventory valuations and are adjusted for unreported and misreported income. Finally, profits from current production exclude (i) dividend income, (ii) capital gains and losses, and (iii) deductions for bad debt. In order to minimize the verbiage, profits from current production will be referred to as core profits henceforth.

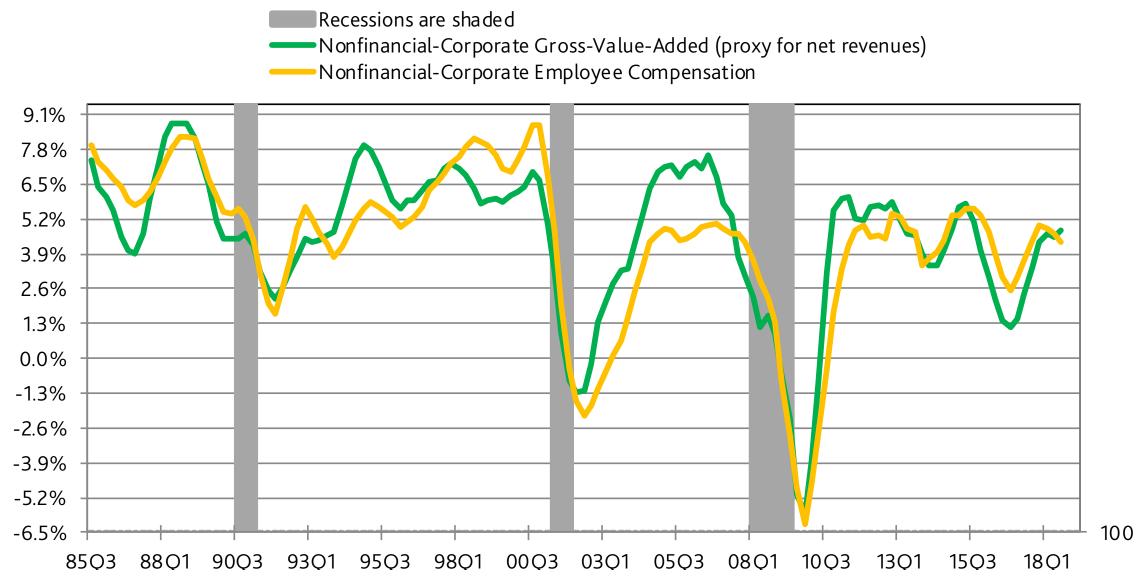
The third-quarter 2018 core profits of U.S. nonfinancial corporations delivered a big upside surprise and advanced by 15.8% year-over-year to a new record high. The metric's previous zenith was set nearly four years back, or in 2014's final quarter. Thereafter, an ensuing bout of industrial commodity price deflation helped to sink the annualized, seasonally-adjusted quarter-long version of core profits by a cumulative 15.2% to its latest bottom of 2016's fourth quarter. Thus, the recent deep setbacks incurred by the price of crude oil and Moody's industrial metals price index warrant attention.

Employee Compensation Is Tame Despite Very Low Jobless Rate

However, for now, core profits thrive. Third-quarter 2018's 15.8% year-over-year surge by nonfinancial-corporate core profits was partly derived from a much faster 5.6% yearly increase by nonfinancial-corporate gross value added, compared to the 4.2% yearly rise by nonfinancial-corporate employee compensation. Gross value added is a proxy for net revenues, wherein the revenues of businesses supplying inputs used in the production of final products are subtracted from total nonfinancial-corporate revenues. In turn, core profits can be roughly approximated by subtracting employee compensation and net interest expenses from corporate gross value added.

Despite the unemployment rate's plunge from its 6.3% average of 2013-2015 to the 4.0% average of the 12-months-ended September 2018, the average annual increase of nonfinancial-corporate employee compensation slowed from 4.7% to 4.4%. At the same time, the average annual increase of nonfinancial-corporate GVA quickened from the 4.3% of 2013-2015 to 4.8% for the year-ended September 2018.

By contrast, when the unemployment rate last dipped under 4%, in 2000, nonfinancial-corporate employee compensation soared higher by 8.6% annually, or nearly double today's 4.4% pace. From the perspective of the now much slower growth of employee compensation, it seems reasonable that the recent 3% 10-year Treasury yield is roughly half of its 6.03% average of yearlong 2000. However, in view of yearlong 2000's relatively slower 6.6% annual increase by nonfinancial-corporate GVA, businesses failed to adequately contain labor costs. Making matters worse for profitability was 2000's 23.9% surge by net interest expense. In turn, 2000's core profits of nonfinancial corporations shrank by 12.0% annually, which set the stage for 2001's recession year that included a 20.0% plunge by core profits.



Profits Expand When Net Revenues Outpace Employee Compensation

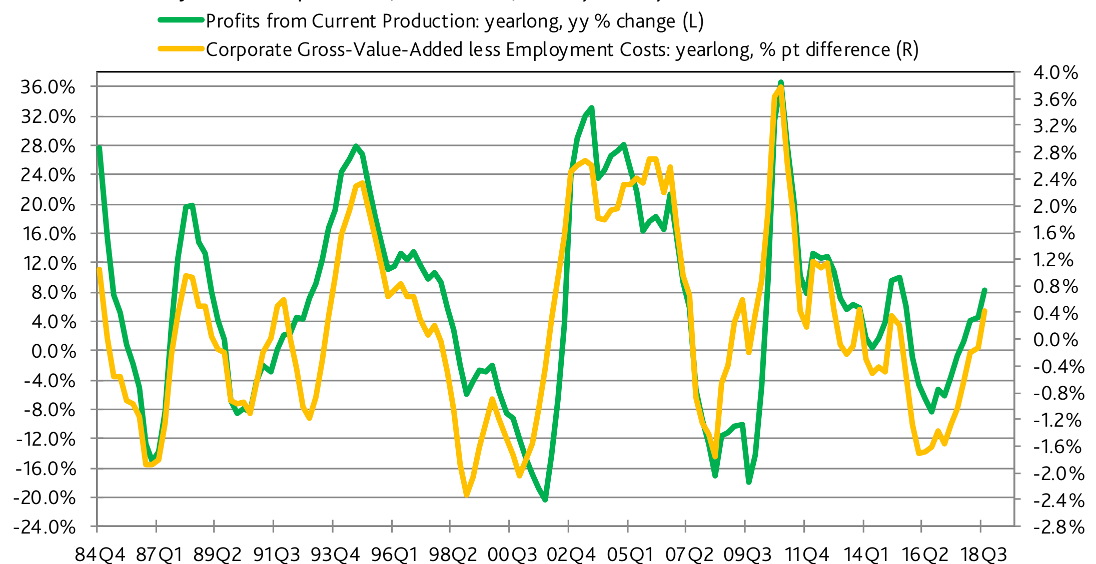
Core profits benefit whenever corporate GVA outruns employee compensation. For the 12-months-ended September 2018, nonfinancial-corporate GVA's 4.8% year-over-year increase outran employee compensation's comparably measured 4.4% annual rise. In response to this constructive difference, core profits grew by 8.2% year-over-year during the 12-months-ended September 2018. For nonfinancial corporations, the correlation between the annual percent change of yearlong core profits and the percentage point difference between the annual percent changes of corporate GVA less employee compensation is a strong 0.83.

The yearlong estimate of core profits grew by 22.5% annually, on average, for each of the 34 yearlong spans since 1984 that show the growth of corporate GVA outrunning the growth of employee compensation by at least a one percentage point.

Core profits grew annually in 29, or 81%, of the 36 observations showing corporate GVA outpacing employee compensation by between 0.0 and 1.0 percentage point. For these 36 observations, core profits' 7.0% average annual increase was joined by a much faster median annual increase of 9.9%.

The faster growth of employee compensation relative to corporate GVA does not assure a contraction by core profits. For example, core profits grew annually in 22, or 65%, of the 34 observations where GVA growth is slower than employee compensation by between 0.0 and -1.0 percentage point. However, when GVA growth trailed employee compensation growth by less than a percentage point, the average and median year-over-year growth rates for core profits were merely 0.2% and 1.7%, respectively. Finally, core profits shrank for 30, or 94% of the 32 instances where the shortfall of GVA growth to employee compensation growth was deeper than one percentage point. For this subset, core profits declined by 7.1% annually, on average.

Figure 2: In terms of Year-over-Year Percent Changes, Core Profits Are Highly Correlated with the Difference Between Corporate Gross-Value-Added Less Employee Compensation
US nonfinancial corporations; source: BEA, Moody's Analytics

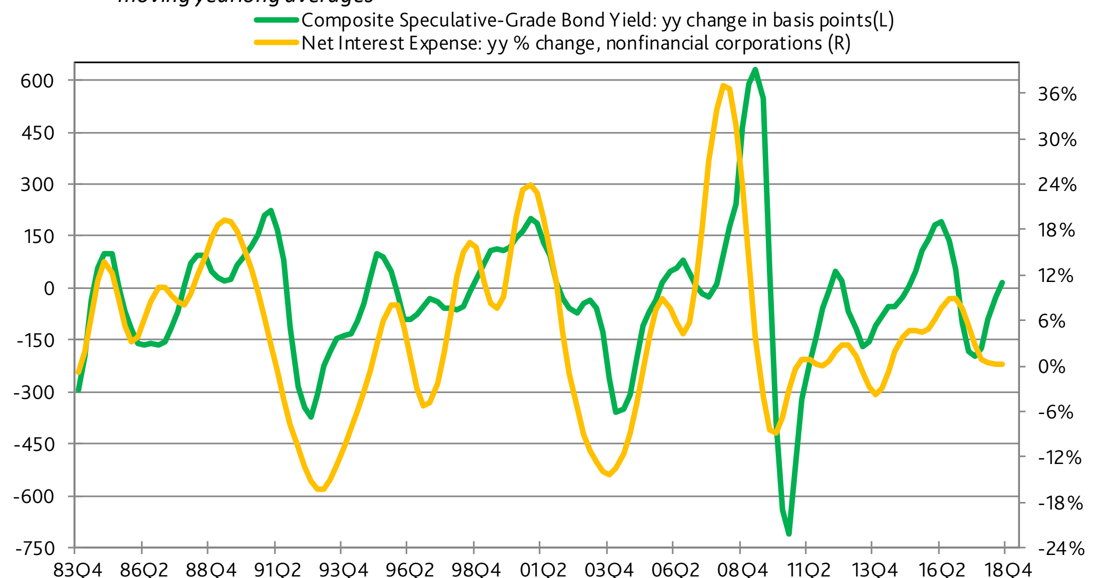


Speculative-Grade Bond Yield's Latest Surge Warns of Faster Growth by Net Interest Expense

Despite higher borrowing costs, refinancings and deleveraging explained the third quarter's 0.6% yearly dip by the net interest costs of nonfinancial corporations. Moreover, net interest expense fell to 24.3% of core profits, which was far under the 32.0% ratio of 2007's final quarter.

Net interest expense's year-over-year percent change generates its strongest correlations of 0.66 with the annual percent change of nonfinancial-corporate debt and of 0.49 with the annual basis point change of the speculative-grade bond yield. From the perspective of moving yearlong averages, second-quarter 2018's annual increase of 5.7% for nonfinancial-corporate debt and annual decline of 25 bp by the speculative-grade bond yield was joined by a surprisingly slow 0.2% annual rise for net interest expense. However, the spec-grade bond yield's 120 bp yearly increase of the fourth-quarter-to-date warns of noticeably faster growth for net interest expense by early 2019.

Figure 3: November's Greater than 125 Basis Points Yearly Increase by Spec-Grade Bond Yield Warns of Faster Growth by Net Interest Expense
moving yearlong averages



The Week Ahead – U.S., Europe, Asia-Pacific

THE U.S.
By Ryan Sweet, Moody's Analytics

Fixing a Rookie Mistake

There was a correction in Federal Reserve Chair Jerome Powell's assessment of where the current fed funds rate is relative to the neutral rate (a rate that neither speeds up nor slows down the economy). In a speech Wednesday, Powell noted that the fed funds rate is still historically low but remains just below the broad range of estimates of the level that would be neutral for the economy. This marks a change from his October comment that rates were a "long way" from neutral. That remark was the catalyst for the tightening in financial markets. We still suspect it was a slip of the tongue rather than a reflection of Powell's personal view. Nevertheless, Powell now has set the record straight.

There is a lot to digest. For one thing, the shift in his assessment comes across as more than it really is. A dovish shift would have been for Powell to hint that the central bank won't push interest rates beyond neutral. Also, Powell didn't say rates were below his estimate of the neutral rate but rather were below a "broad range of estimates" between 2.5% and 3.5%. This is stating the facts, and the Fed is one hike away from hitting the bottom end of that range but three hikes from being at the midpoint.

Fed communication is far from perfect and can shift quickly, particularly now with the central bank removing its explicit forward guidance. This will make it easy for economists to follow elevator forecasting—where changes in their interest rate projections rise and fall with each tweak in Fed rhetoric. We are sticking with our forecast for a rate hike in December and four hikes in 2019, but we recognize the possibility of a pause in 2019—not because of what Powell said Wednesday but because of inflation.

The slide in Brent crude oil prices, which matter more for the CPI, suggests energy's contribution to growth in headline inflation will shift from 0.5 percentage point to -0.4 percentage point over the next 12 months. In fact, if oil prices remain at their current levels, inflation will remain below 2% for most of next year. Lower energy prices will bleed into core inflation as well via lower transportation costs. Also, long-term inflation expectations are falling and are already at the low end of the range that the Fed believes is consistent with price stability. Therefore, inflation could give the Fed a window to justify and follow through with a pause.

The minutes of the November meeting of the FOMC include nothing we didn't already know. A rate hike is coming in December, and the committee will modify its forward guidance for further gradual increases in the funds rate and will make another technical adjustment to the interest on excess reserves. The latter is only a temporary fix.

The effective rate is not trading toward the top end of the range because of a shortage of reserves. If it were, there would be a noticeable increase in the Fed's daylight credit facility, which is used if a bank sends an intraday payment to another bank that exceeds its reserve balances. Usage of this facility remains extremely low. A more likely explanation for the rise in the effective fed funds rate is the Treasury Department's bill issuance binge, which has driven up repo rates and coincided with the narrowing spread between the effective fed funds rate and IOER.

The fed funds market is dominated by Federal Home Loan Banks and foreign banks. FHLBs lend their daily excess liquidity to the fed funds market, as these banks value the early cash return feature and are unable to earn IOER at the Fed. Foreign banks borrow fed funds from the FHLBs below the IOER rate and place them at the Fed to earn interest. Also, the fed funds market is small, with $100 billion in daily trading volumes.

The fed funds market could become more fragile, particularly if FHLB participation diminishes, reducing volumes and driving the effective rate higher. Therefore, the Fed is not likely to be able to fix this issue with technical adjustments to the IOER. Rather it will need help from the Treasury. Through September, the Treasury had sold $1.018 trillion in Treasury bills, compared with the $809 billion in a comparable period in 2016. Though the Fed may make an additional technical adjustment to the IOER, it may only help temporarily.

Turning to the economic data, Real consumption rose 0.4% in October, better than our forecast for a 0.3% gain. October's gain leaves real consumer spending up 3.3% annualized over the prior three months. Gains in consumer spending were broad-based. Real durable goods consumer gained 0.4% from September to October while nondurable spending rose 0.3%. Real services spending was up an above-trend 0.5%.

Our high-frequency GDP model now estimates real consumer spending to rise 3.2% at an annualized rate in the fourth quarter, compared with the 2.9% before the October spending data. Overall, fourth quarter GDP growth is now on track to increase 2.7% at an annualized rate.

Elsewhere, nominal personal income increased 0.5% in October, a touch stronger than our forecast for a 0.4% gain. The forecast error was mostly in proprietors income, which rose 1.6%, the largest gain since 2012. Farm proprietors income jumped 42.5%, the largest gain since the late 1980s. Farm proprietors income was likely boosted by the Trump administration's subsidies to offset the tariffs' impact on U.S. farmers, particularly soybean farmers. These subsidies began to be paid out in September and will total $4.7 billion. The increase in farm proprietors income added 0.1 percentage point to growth in total personal income.

The housing data continued to underwhelm as new and pending-home sales fell. Meanwhile, initial claims for unemployment insurance benefits have weakened recently but they are not raising a red flag yet. We would expect new filings to rise as GDP and job growth moderate. The key for claims is where they are relative to their break-even level, or that consistent with no monthly job growth. By our calculations, the current break-even level of initial claims is 253,000, the lowest this cycle. Initial claims remain below this, suggesting job growth may have cooled but the labor market isn't in any serious trouble. The timing of Thanksgiving likely contributed to some of the recent rise in initial claims.

We will publish our forecasts for next week's data on Monday on Economy.com.

	Key indicators	Units	Moody's Analytics	Consensus	Consensus Range	Last
Mon @ 10:00 a.m.	Moody's Analytics Business Confidence	index, 4-wk MA				28
Mon @ 10:00 a.m.	Construction Spending for October	% change		0.4	-0.4 to 0.8	0.0
Mon @ 10:00 a.m.	ISM Manufacturing Index for November	diffusion index		58	57 to 59.5	58
Tues @ 12:00 a.m.	Vehicle Sales for November	mil, SAAR		17.1	17 to 17.4	17.5
Wed @ 8:15 a.m.	ADP National Employment Report for November	change, ths		200	175 to 214	227
Wed @ 8:30 a.m.	Productivity and Costs for 2018Q3, final	% change, SAAR		2.3	2.2 to 2.4	2.2
	Unit Labor Costs	% change, SAAR		1.1	0.9 to 1.2	1.2
Wed @ 10:00 a.m.	ISM Nonmanufacturing Index for November	diffusion index		59.5	58 to 61	60.3
	Business activity	diffusion index				62.5
Wed @ 2:00 p.m.	Beige Book					
Thur @ 8:30 a.m.	Jobless Claims for 12/1/18	ths				234
Thur @ 8:30 a.m.	International Trade for October	$ bil		-54.9	-55.1 to -52	-54.0
Thur @ 10:00 a.m.	Factory Orders for October	% change		-2.0	-2.2 to -1	0.7
Fri @ 8:30 a.m.	Employment Situation for November	change, ths		205	180 to 240	250
	Average Workweek	#		34.5	N/A	34.5
	Unemployment rate	%		3.7	3.6 to 3.7	3.7
	Average Hourly Earnings	% change		0.3	0.2 to 0.4	0.2
Fri @ 10:00 a.m.	Michigan sentiment for December, preliminary	index		97.0	96.5 to 98	97.5

EUROPE

By Barbara Teixeira Araujo of the Europe staff of Moody's Analytics in London and Prague

Softer Domestic Demand Likely in Euro Zone GDP Results

The final estimate of the euro zone's third-quarter GDP will be focus of attention next week. We expect the estimate to confirm that the currency area expanded by only 0.2% q/q in the three months to September, down from a 0.4% rise in the second quarter and from as much as 0.7% at the start of the year. Yearly growth is similarly expected to be confirmed at 1.7%, down from 2.2% in the second stanza. But we repeat that there is no need to panic. Temporary factors, particularly in Germany, have been the main culprits in this sharper-than-expected slowdown in the third quarter, warranting some mean-reversion in the fourth stanza. We continue to expect that full-year growth will come in at 1.9%, down from 2.5% in 2017 but still a solid and above-average pace of expansion.

The key detail from the coming release will be publication of the expenditure breakdown of growth. We expect that softer domestic demand was behind the headline's loss of pace. First, machinery and equipment investment likely slowed sharply given the introduction of the EU's new emissions tests for the auto industry on September 1. High-frequency figures have all but showed that car production declined in August, September and October, as manufacturers struggled with the transition to the new system. This was true particularly in Germany, but we think it was a feature of the euro zone as a whole, adding to the gloom from deteriorating new export orders due to the slowdown in global trade. On the bright side, we expect that construction investment continued to grow solidly, even if we wouldn't be surprised to see the pace of expansion slowing marginally from the previous stanza.

By contrast, we look for consumer spending to have remained relatively steady. First, while spending on new cars jumped in July and August as retailers slashed prices to get rid of their pre-new regulation stocks, we expect this jump was almost completely offset by a big correction in September. Similarly, even if energy spending is expected to have rebounded somewhat from a weather-related plunge in the second quarter, that temperatures remained above their long-term averages in July and August likely kept a lid on the increase. Adding to this picture, high-frequency data suggest retail sales remained only steady over the quarter, while leading data indicate that services spending may have pulled back somewhat.

Slightly better news should come from net trade, though we expect that the sector only modestly contributed to growth, as imports and exports are each expected to have remained subdued. The good news is that the weaker euro and the fiscal boom in the U.S. suggest that the euro zone's trade surplus is set to rebound in the fourth quarter. Elsewhere, we expect that inventories subtracted sharply from growth, mainly because of the destocking in the auto industry.

Individual country figures show that the main disappointment came from Germany, with its GDP declining by 0.2%, following a 0.5% rise in the second stanza. Italy's economy meanwhile stalled, while Spain's GDP growth held steady at 0.6%. By contrast, France's GDP accelerated to 0.4% q/q, from 0.2% in the second quarter.

	Key indicators	Units	Moody's Analytics	Last
Wed @ 8:00 a.m.	Spain: Industrial Production for October	% change	0.2	-0.7
Wed @ 10:00 a.m.	Euro Zone: Retail Sales for October	% change	0.5	0.0
Thur @ 2:00 p.m.	Russia: Consumer Price Index for November	% change	3.8	3.5
Fri @ 7:00 a.m.	Germany: Industrial Production for October	% change	-1.0	0.2
Fri @ 7:45 a.m.	France: Industrial Production for October	% change	0.7	-1.8
Fri @ 9:00 a.m.	Italy: Retail Sales for October	% change	0.3	-0.8
Fri @ 10:00 a.m.	Euro Zone: GDP for Q3	% change	0.2	0.4

ASIA-PACIFIC

By Katrina Ell and the Asia-Pacific staff of Moody's Analytics in Sydney

Australia's GDP Growth Likely Cooled in the Third Quarter

Australia's long-awaited third quarter GDP print will be the highlight. GDP growth likely cooled to 0.3% q/q, following an impressive performance through the first half of 2018 when GDP growth averaged 0.95%. A slowdown is expected across the board with preliminary estimates suggesting household final consumption added 0.1 percentage point to GDP growth, following a 0.4 percentage point contribution. After funding discretionary spending in the first half of the year by dipping into their savings, households turned more frugal in the third quarter amidst still soft income growth. Net exports likely subtracted 0.1 percentage point, following a 0.1 percentage point addition in the June quarter. There's greater uncertainty around investment; with weak third quarter construction volumes as well as capital expenditure, private investment could be a drag. Construction volumes were a particular downside surprise in the September quarter due to treatment of liquefied natural gas projects.

Elsewhere, the second estimate of South Korea's GDP growth will likely hit 0.5% q/q in the third quarter, weaker than the advance estimate of 0.6%. Poor retail sales are the main driver. The earlier minimum wage hike kept employment growth flat through the third quarter and discouraged households from loosening their purse strings. Further deterioration in consumer sentiment in the December quarter suggests consumption will remain weak into 2019. Cuts to government infrastructure outlays in favour of increased welfare spending have also been weighing on construction activity, but provided some reprieve to the import bill. Business sentiment in manufacturing fell in the third quarter, but exports were resilient in the face of international protectionism measures with continued strong demand for semiconductors, petrochemicals, and machinery and equipment.

On the policy front, the Reserve Bank of Australia will keep the cash rate at 1.5% in December and isn't expected to begin tightening for more than a year. The bottom line is that inflation is low and forecast to only gradually rise given soft unit labour costs. The RBA struck an optimistic tone in its November statement, but we are less sanguine. The central bank expects GDP growth to average an above-potential 3.5% over the next two years. We think that the central bank is overestimating the strength of the household sector. We expect consumption to underperform over the next year as the weak housing market, alongside rising lending rates, becomes a greater drag, ensuring that GDP growth averages closer to 3%. This could push out policy normalization, which we expect to begin in mid-2020.

	Key indicators	Units	Confidence	Risk	Moody's Analytics	Last
Mon @ 11:00 a.m.	South Korea Foreign trade for November	US$ bil	3	←	6.3	6.6
Tues @ 10:00 a.m.	South Korea GDP for Q3 - second estimate	% change	3	←	0.5	0.6
Tues @ 10:00 a.m.	South Korea CPI for November	% change yr ago	3	↓	2.1	2.0
Tues @ 2:30 p.m.	Australia Monetary policy for December	%	5	←	1.5	1.5
Wed @ 11:30 a.m.	Australia GDP for Q3	% change	2	↑	0.3	0.9
Wed @ 3:00 p.m.	Malaysia Foreign trade for October	MYR bil	3	↓	4.1	15.3
Thurs @ 11:30 a.m.	Australia Foreign trade for October	A$ bil	3	↑	1.67	3.02
Thurs @ 11:30 a.m.	Australia Retail sales for October	% change	4	←	0.3	0.2

The Long View
The market now expects fed funds' midpoint to rise no higher than 2.625% in 2019.

By John Lonski, Chief Economist, Moody's Capital Markets Research Group
November 29, 2018

CREDIT SPREADS

As measured by Moody's long-term average corporate bond yield, the recent investment grade corporate bond yield spread of 132 basis points exceeded its 122-point mean of the two previous economic recoveries. This spread may be no wider than 130 basis points by year-end 2018.

The recent high-yield bond spread of 445 bp is less than what might be inferred from the spread's macroeconomic drivers and the long-term Baa industrial company bond yield spread of 213 bp. The adverse implications for liquidity of possibly significantly higher interest rates merit consideration.

DEFAULTS

October 2018's U.S. high-yield default rate of 3.16% was less than the 3.46% of October 2017. Moody's Default and Ratings Analytics team now expects the default rate will average 2.1% during 2019's third quarter.

US CORPORATE BOND ISSUANCE

Yearlong 2017's US$-denominated bond issuance rose by 6.8% annually for IG, to $1.508 trillion and soared by 33.0% to $453 billion for high yield. Across broad rating categories, 2017's newly rated bank loan programs from high-yield issuers sank by 26.2% to $72 billion for Baa, advanced by 50.6% to $319 billion for Ba, soared by 56.0% to $293 billion for programs graded single B, and increased by 28.1% to $25.5 billion for new loans rated Caa.

Third-quarter 2017's worldwide offerings of corporate bonds showed an annual percent decline of 1.6% for IG and an increase of 6.6% for high-yield, wherein US$-denominated offerings dipped by 0.7% for IG and grew by 4.3% for high yield.

Fourth-quarter 2017 revealed year-over-year advances for worldwide offerings of corporate bonds of 17.6% for IG and 77.5% for high-yield, wherein US$-denominated offerings posted increases of 21.0% for IG and 56.7% for high yield.

First-quarter 2018's worldwide offerings of corporate bonds incurred year-over-year setbacks of 6.3% for IG and 18.6% for high-yield, wherein US$-denominated offerings posted sank by 14.4% for IG and 20.8% for high yield.

Second-quarter 2018's worldwide offerings of corporate bonds eked out an annual increase of 2.8% for IG, but incurred an annual plunge of 20.4% for high-yield, wherein US$-denominated offerings rose by 1.6% for IG and plummeted by 28.1% for high yield.

Third-quarter 2018's worldwide offerings of corporate bonds showed year-over-year setbacks of 6.0% for IG and 38.7 % for high-yield, wherein US$-denominated offerings plunged by 24.4% for IG and by 37.5% for high yield.

For yearlong 2016, worldwide corporate bond offerings rose by 2.3% annually for IG (to $2.402 trillion) and sank by 7.8% for high yield (to $426 billion). During yearlong 2017, worldwide corporate bond offerings increased by 4.0% annually (to $2.499 trillion) for IG and advance by 41.2% for high yield (to $602 billion). The projected annual changes for 2018's worldwide corporate bond offerings are -5.9% for IG and -34.2% for high yield.

US ECONOMIC OUTLOOK

The consensus expects that the mid-point for the federal funds rate should finish 2018 at 2.375%. In view of the underutilization of the world's productive resources, low inflation should help to rein in Treasury bond yields. As long as the global economy operates below trend, the 10-year Treasury yield may not remain above 3% for long. A fundamentally excessive climb by Treasury bond yields and a pronounced slowing by

expenditures in dynamic emerging market countries are among the biggest threats to the adequacy of economic growth and credit spreads.

EUROPE

By Barbara Teixeira Araujo of Moody's Analytics
November 29, 2018

EURO ZONE

Thursday brought a load of economic releases for the euro zone and the U.K. On balance, they were rather mixed. Retail sales figures for France and Spain surprised on the upside—offering some respite following the recent barrage of disappointing confidence numbers—while the unemployment rate for Germany fell even further to another record low. The latter came in line with our view that the employment gains will remain strong in the currency area over the coming months and quarters even if growth is set to slow further, since the labour market responds with a lag to the economic momentum.

In contrast, confidence figures fell further for both the U.K. and the euro zone. In the spotlight was the U.K.'s GfK consumer confidence measure, which plunged to -13 in November, from -11 in October. This is its lowest since the wake of the 2016 referendum. This decline shouldn't have come as a surprise, though, as Brexit negotiations recently reached a climax, and U.K. households are fretting over the deal that Prime Minister Theresa May obtained. It is still uncertain that the deal will win approval in Parliament, which means that the risks of a no-deal Brexit remain substantial.

In the euro zone, economic sentiment figures as reported by the European Commission also softened further. As in the U.K., the main drag came from a sharp decline in consumer confidence to its lowest since March 2017. On the bright side, retail and industrial sentiment rebounded somewhat over the month, but we caution that the latter remains extremely low compared with the previous-year average.

UNITED KINGDOM

A figure of note this week was the jump in the U.K.'s reported retail sales balance—calculated by the Confederation of British Industry—to 19 in November from 5 in October, well above the consensus for a modest improvement. The upbeat figure suggests that growth in retail sales volumes finally rebounded in the middle of the quarter following two consecutive months of declines; we expect it was up by 0.7% m/m. But risks are tilted to the upside, since the survey covered only the first half of the month, before the start of the Black Friday sales period. This means that the rise in the official number might be even stronger if more consumers than usual decided to postpone their purchases until Black Friday week.

That said, other parts of the survey were less promising. Business expectations for the next three months sank to their lowest level since May 2017, while the balance of retailers expecting sales to rise in December was lower than in any other November since 2011. Similarly, retailers continued to report that sales for this time of the year have been poor, with the balance remaining in negative territory for the third consecutive month. What's more, employment in the retail sector declined for the eighth quarter in a row in the year to November.

This broad-based weakness doesn't surprise us, though. Consumer confidence remains in the doldrums and is likely to stay there as long as there is no final agreement on the Brexit withdrawal deal. Real wage growth, meanwhile, is barely recovering, savings intentions remain high, and the housing market is going from bad to worse. It is not for nothing, then, that investment intentions in the sector have been weak for several quarters already.

ASIA PACIFIC

By Katrina Ell of Moody's Analytics
November 29, 2018

ASIA-PACIFIC REGION

Household leverage has increased across the Asia-Pacific region. This is a rising concern as central banks begin scaling back the extraordinary stimulus released with the 2009 financial crisis, exposing households to higher debt-servicing costs. Although financial conditions remain largely accommodative, they are tightening and are forecast to do so at least through 2019. In economies with a relatively large stock of household debt, central banks must proceed with caution when normalizing policy.

High household debt ultimately holds back consumption because while there may be an initial increase in spending when the debt is taken on, this fades as consumers allocate a portion of their income to servicing the debt, rather than making new purchases.

Consumers are critical to economies across the Asia-Pacific region. Often in developed economies households represent the largest expenditure share of GDP, and in developing economies consumers are of rising importance. Typically, household debt tends to be higher in developed economies, while in emerging markets across Asia consumer loans tend to be of short durations, with fixed long-term rates uncommon, so higher debt-servicing costs can be quickly felt with higher lending rates.

AUSTRALIA

Australia's economy is highly regarded for its 27 years of recession-free growth, an enviable run by developed-economy standards. But the downside risks from Australia's hefty household debt loom large. Australia's ratio of household debt-to-disposable income has been on an uptrend for the past 30 years and is running at almost 200% of GDP, according to the Reserve Bank of Australia.

Australia's household debt is closely linked with the property market, where home values have gained significantly in recent years. The Australian dream of homeownership has largely not wavered, even with prices being well above estimates of fair value, especially in the most desirable markets of Sydney and Melbourne. The result: As dwelling values have risen, so has household debt.

A few factors keep the panic around the large stock and run-up in household debt at bay. The first is the regulatory environment. Australia's financial regulator, the Australian Prudential Regulation Authority, has introduced a number of restrictions on bank lending, including to the housing market, in recent years to stem the continued upward trend in household leverage and house prices. This action has contributed to lending rates modestly rising independent of the RBA's official cash rate in 2018 and contributed to the national housing market cooling.

Regulatory measures have driven improvement in the quality of banks' mortgage lending. For instance, the stock of interest-only loans (where borrowers tend to carry relatively higher leverage than other loan types) has fallen by 10 percentage points since June 2017 to just less than 30% of outstanding loans, according to the RBA's Financial Stability Review for October 2018.

Moody's Analytics forecasts that national housing values will continue cooling through most of 2019. It's impressive that APRA has been able to engineer a likely soft landing in house prices, and if the market were on a faster-than-desired cooling trend, the regulatory lending restrictions could be reversed quickly, if need be. If the effort is ultimately successful, Australia's housing market will remain one of only a handful developed housing markets to have avoided a sizeable correction.

The second comfort is that Australia's macroeconomic outlook remains favourable. GDP growth is expected to remain around potential at 3% for about the next two years. A healthy economy will keep employment growth ticking over, while the Reserve Bank of Australia isn't forecast to begin tightening the cash rate until mid-2020 at the earliest.

But there is still cause for concern. Given that most household wealth is in the relatively illiquid asset of housing, there would be greater systematic implications if debt repayment difficulties suddenly became a broader concern. For example, if unemployment were to rise, many households would be forced to sell at

once. So while regulators can have a handle on managing local risks, households and the economy are still vulnerable to a broader economy-wide shock.

SOUTH KOREA

South Korean households are well known for their high leverage. Household debt-to-disposable income was 186% in 2017, according to the OECD. The most recent acceleration in household loan growth occurred in 2014 after mortgage loan requirements were eased to bolster domestic demand. This involved reducing loan-to-value and debt-to-income ratios; this is a problematic strategy in the medium term because those enabled into the market by relaxed restrictions have a higher probability of problems servicing the loans.

Concerned about the run-up in household debt and against a backdrop of favourable global growth lifting domestic demand, the government tightened consumer credit conditions in 2017 to dampen household debt growth. The Financial Services Commission announced new guidelines late in 2017 for home mortgage loans, requiring financial institutions to examine a borrower's income for two years, higher than the prior one-year requirement. The financial regulator also released guidelines for loans to self-employed workers aimed at protecting those at risk of becoming overleveraged.

The next looming challenge for households is rising servicing requirements. Pressure is rising on the Bank of Korea to tighten rates; we expect gradual rate hikes from early 2019, with the policy rate forecast to increase from 1.5% to 2.5% by the December quarter of 2020. Weakened domestic demand, alongside the uncertain and cooling global outlook, is holding back more aggressive tightening, as is hefty household leverage.

Ratings Round-Up

Downgrades Dominate

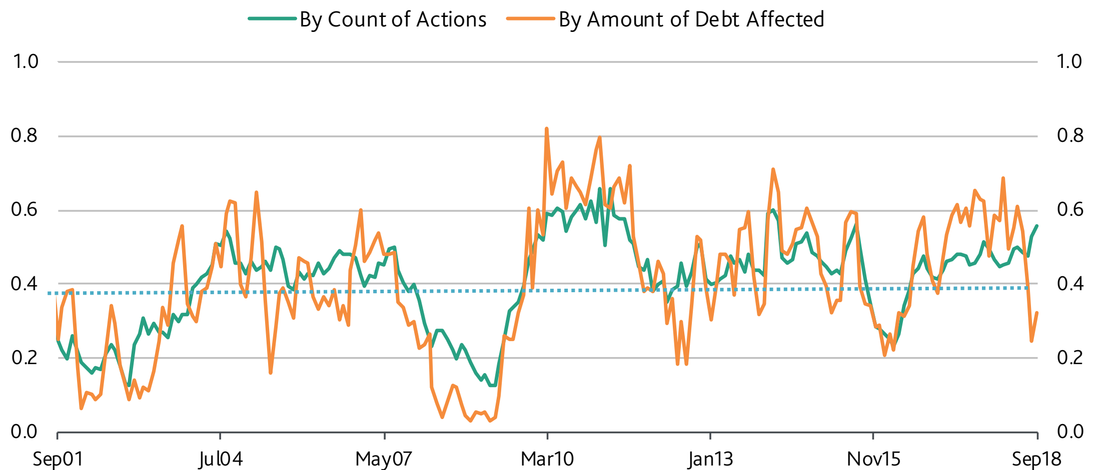
By Michael Ferlez

U.S. rating change activity weakened over the past two weeks. For the period ending November 20, positive rating changes accounted for only 26% of total activity down from 60% the prior week. Rating activity was headlined by two major downgrades: Coca-Cola Co. and PG&E Corp. Coca-Cola saw its senior unsecured credit rating cut from Aa3 to A1, affecting $28.6 billion in debt. Meanwhile, PG&E was downgraded to Baa2 from Baa1. The rating downgrade was a reflection of the West Coast utility's exposure to potential liabilities stemming from the Camp Fire which devastated parts of California earlier this month. Moving to last week, which was shortened by the holiday, rating change activity was light. There were only four rating changes in the U.S., all downgrades.

In Europe, ratings change activity was mixed over the past two weeks. For the week ending November 20, the ratio of positive rating changes fell to 33%. Activity was spread across several European countries and industries, with total downgrades impacting $2 billion in debt. Rating change activity rebounded the following week, with upgrades accounting for 69% of total activity. Activity was concentrated in the U.K., which accounted for half of rating changes.

FIGURE 1

Rating Changes - US Corporate & Financial Institutions: Favorable as % of Total Actions



* Trailing 3-month average

Source: Moody's

Ratings Round-Up

FIGURE 2

Rating Key

BCF	Bank Credit Facility Rating	MM	Money-Market
CFR	Corporate Family Rating	MTN	MTN Program Rating
CP	Commercial Paper Rating	Notes	Notes
FSR	Bank Financial Strength Rating	PDR	Probability of Default Rating
IFS	Insurance Financial Strength Rating	PS	Preferred Stock Rating
IR	Issuer Rating	SGLR	Speculative-Grade Liquidity Rating
JrSub	Junior Subordinated Rating	SLTD	Short- and Long-Term Deposit Rating
LGD	Loss Given Default Rating	SrSec	Senior Secured Rating
LTCF	Long-Term Corporate Family Rating	SrUnsec	Senior Unsecured Rating
LTD	Long-Term Deposit Rating	SrSub	Senior Subordinated
LTIR	Long-Term Issuer Rating	STD	Short-Term Deposit Rating

FIGURE 3

Rating Changes: Corporate & Financial Institutions – US

Date	Company	Sector	Rating	Amount ($ Million)	Up/ Down	Old LTD Rating	New LTD Rating	IG/ SG
11/21/18	OUTPUT SERVICES GROUP, INC.	Industrial	SrSec/BCF /LTCFR/PDR		D	B1	B2	SG
11/26/18	LBI MEDIA HOLDINGS, INC -LBI MEDIA, INC.	Industrial	LTCFR/Sub/PDR	323	D	Caa2	Caa3	SG
11/26/18	GALLERIA CO.-COTY INC.	Industrial	SrUnsec/SrSec /BCF/LTCFR/PDR	1,458	D	B2	B3	SG
11/27/18	99 CENTS ONLY STORES LLC	Industrial	SrUnsec/SrSec /BCF/LTCFR/PDR	250	D	Caa3	Ca	SG

Source: Moody's

FIGURE 4

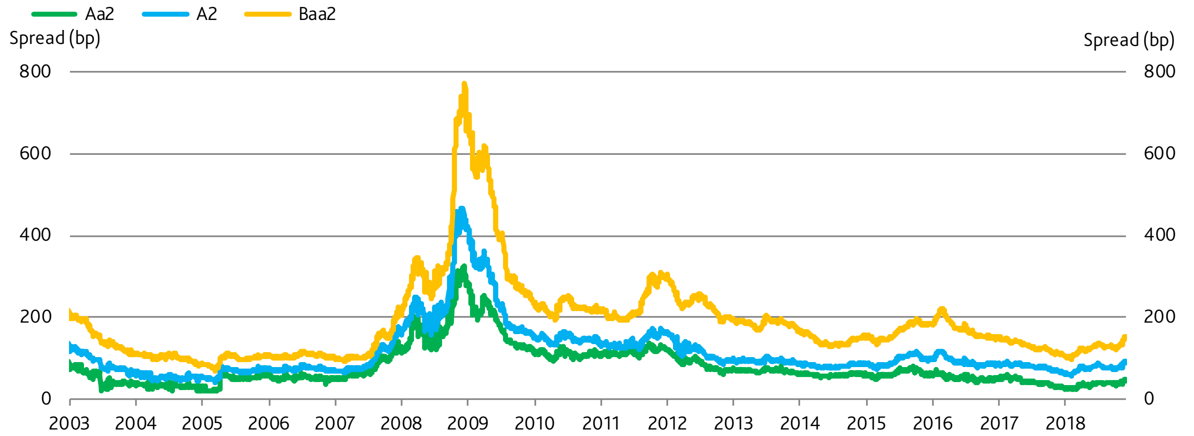
Rating Changes: Corporate & Financial Institutions – Europe

Date	Company	Sector	Rating	Amount ($ Million)	Up/ Down	Old LTD Rating	New LTD Rating	IG/ SG	Country
11/21/18	ERSTE GROUP BANK AG -CESKA SPORITELNA, A.S.	Financial	LTD		U	A2	A1	IG	CZECH REPUBLIC
11/21/18	SOCIETE GENERALE-KOMERCNI BANKA, A.S.	Financial	LTD		U	A2	A1	IG	CZECH REPUBLIC
11/21/18	KBC GROUP N.V.-CESKOSLOVENSKA OBCHODNI BANKA, A.S.	Financial	LTD		U	A2	A1	IG	CZECH REPUBLIC
11/21/18	NEW LOOK RETAIL GROUP LIMITED	Industrial	SrSec/SrUnsec /LTCFR/PDR	1,593	D	Caa1	Caa3	SG	UNITED KINGDOM
11/21/18	JOHNSTON PRESS PLC	Industrial	SrSec/LTCFR/PDR	282	D	Caa3	Ca	SG	UNITED KINGDOM
11/22/18	EVRAZ PLC - EVRAZ GROUP S.A.	Industrial	SrUnsec /LTCFR/PDR	750	U	Ba3	Ba2	SG	LUXEMBOURG
11/22/18	DISTRIBUIDORA INTERNACIONAL DE ALIMENTACION, S.A.	Industrial	SrUnsec/LTCFR /PDR/MTN	1,248	D	Ba2	B2	SG	SPAIN
11/22/18	DAKAR FINANCE S.A. -AUTODIS S.A.	Industrial	SrSec /LTCFR/PDR	879	D	B2	B3	SG	FRANCE
11/26/18	ANGLIAN WATER PLC -ANGLIAN WATER SERVICES FINANCING PLC	Utility	SrSec	781	U	A3	A2	IG	UNITED KINGDOM
11/26/18	STIRLING WATER SEAFIELD FINANCE PLC	Utility	SrSec	132	U	Baa1	A2	IG	UNITED KINGDOM
11/26/18	ABERTIS INFRAESTRUCTURAS S.A.-SANEF S.A.	Industrial	SrUnsec/BCF		U	Baa1	A2	IG	FRANCE
11/26/18	DERBY HEALTHCARE PLC	Industrial	SrSec	572	U	A3	A2	IG	UNITED KINGDOM
11/26/18	ASSURED GUARANTY LTD.-ASSURED GUARANTY (UK) PLC	Financial	IFSR		U	A3	A2	IG	UNITED KINGDOM
11/26/18	ASPIRE DEFENCE FINANCE PLC	Industrial	SrSec	937	U	A3	A2	IG	UNITED KINGDOM
11/26/18	DIRECTROUTE (LIMERICK) FINANCE LIMITED	Industrial	SrSec/BCF		U	Baa1	A2	IG	IRELAND
11/26/18	COVENTRY AND RUGBY HOSPITAL COMPANY PLC (THE)	Industrial	SrSec	521	U	Baa1	A2	IG	UNITED KINGDOM
11/26/18	HEALTHCARE SUPPORT (NORTH STAFFS) FINANCE PLC	Industrial	SrSec/BCF	243	U	Baa1	A2	IG	UNITED KINGDOM
11/26/18	ILIM TIMBER CONTINENTAL S.A.	Industrial	LTCFR/PDR		U	B3	B2	SG	SWITZERLAND
11/26/18	COMPAGNIE EIFFAGE DU VIADUCT DE MILLAU CEVM S.A-VERDUN PARTICIPATIONS 2 S.A.	Industrial	SrSec/BCF		U	Baa1	A2	IG	FRANCE
11/26/18	BEFESA S.A.	Industrial	SrSec/BCF /LTCFR/PDR		U	Ba3	Ba2	SG	LUXEMBOURG

Market Data

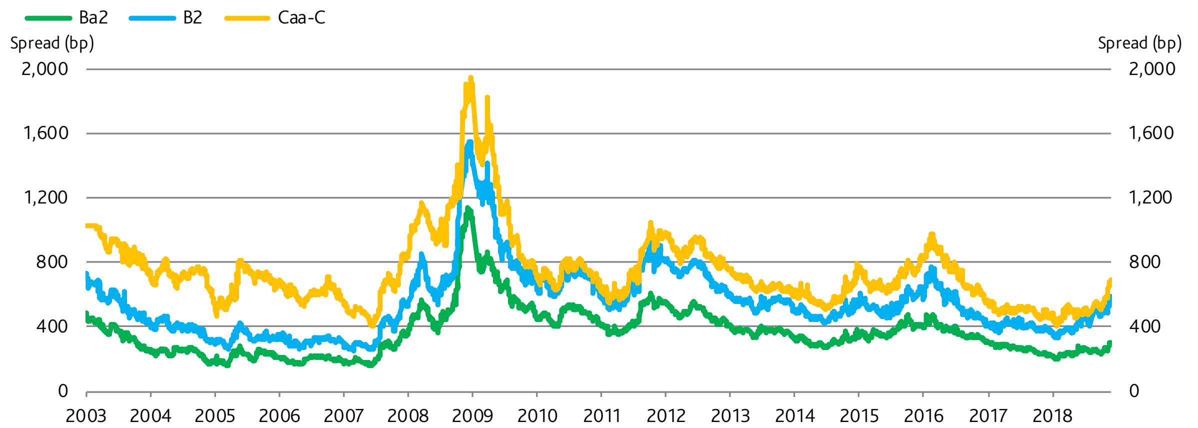
Spreads

Figure 1: 5-Year Median Spreads-Global Data (High Grade)



Source: Moody's

Figure 2: 5-Year Median Spreads-Global Data (High Yield)



Source: Moody's

Market Data

CDS Movers

Figure 3. CDS Movers - US (November 21, 2018 – November 28, 2018)

CDS Implied Rating Rises	CDS Implied Ratings		
Issuer	Nov. 28	Nov. 21	Senior Ratings
Ford Motor Company	Ba3	B2	Baa3
United Airlines, Inc.	Ba2	B1	Ba3
Hertz Corporation (The)	Caa2	Ca	B3
Humana Inc.	Aa2	A1	Baa3
Bear Stearns Companies LLC. (The)	Aa2	A1	A3
JPMorgan Chase & Co.	A2	A3	A3
Citigroup Inc.	A3	Baa1	Baa1
Morgan Stanley	Baa1	Baa2	A3
Wells Fargo & Company	A2	A3	A2
JPMorgan Chase Bank, N.A.	Aa3	A1	Aa3

CDS Implied Rating Declines	CDS Implied Ratings		
Issuer	Nov. 28	Nov. 21	Senior Ratings
Occidental Petroleum Corporation	A2	Aa2	A3
Pioneer Natural Resources Company	Baa2	A3	Baa2
American Express Credit Corporation	A2	A1	A2
Amgen Inc.	A3	A2	Baa1
Chevron Corporation	Aa2	Aa1	Aa2
Intel Corporation	Aa2	Aa1	A1
Time Warner Inc.	Baa3	Baa2	Baa2
Kinder Morgan Energy Partners, L.P.	Baa1	A3	Baa3
Altria Group Inc.	A3	A2	A3
Welltower Inc.	Baa3	Baa2	Baa1

CDS Spread Increases		CDS Spreads		
Issuer	Senior Ratings	Nov. 28	Nov. 21	Spread Diff
AK Steel Corporation	B3	763	681	82
United States Steel Corporation	B2	372	294	78
Nabors Industries Inc.	Ba3	602	540	62
Windstream Services, LLC	Caa2	2,855	2,796	59
Diamond Offshore Drilling, Inc.	B3	532	487	45
Chesapeake Energy Corporation	Caa1	623	593	30
Devon Energy Corporation	Ba1	160	133	27
Neiman Marcus Group LTD LLC	Caa3	1,328	1,306	22
Dean Foods Company	B3	672	651	22
SLM Corporation	Ba2	399	377	21

CDS Spread Decreases		CDS Spreads		
Issuer	Senior Ratings	Nov. 28	Nov. 21	Spread Diff
Penney (J.C.) Corporation, Inc.	Caa2	3,078	3,405	-327
Frontier Communications Corporation	Caa1	1,959	2,191	-232
K. Hovnanian Enterprises, Inc.	Caa3	2,026	2,203	-177
Weatherford International, LLC (Delaware)	Caa1	1,696	1,860	-164
Hertz Corporation (The)	B3	728	851	-123
Parker Drilling Company	Caa2	4,099	4,189	-90
Enbridge Energy Limited Partnership	Baa2	105	155	-50
Beazer Homes USA, Inc.	B3	601	633	-33
Tenet Healthcare Corporation	Caa1	462	490	-28
Realogy Group LLC	B1	450	476	-26

Source: Moody's, CMA

Market Data

Figure 4. CDS Movers - Europe (November 21, 2018 – November 28, 2018)

CDS Implied Rating Rises	CDS Implied Ratings		
Issuer	Nov. 28	Nov. 21	Senior Ratings
Italy, Government of	B1	B2	Baa2
Portugal, Government of	Baa2	Baa3	Ba1
Natixis	Aa3	A1	A1
DZ BANK AG	A3	Baa1	Aa1
Telecom Italia S.p.A.	B2	B3	Ba1
Bank of Scotland plc	A1	A2	Aa3
Ukraine, Government of	B3	Caa1	Caa2
HSBC Bank plc	Aa2	Aa3	Aa3
Piraeus Bank S.A.	Caa3	Ca	Caa2
Yapi ve Kredi Bankasi A.S.	Caa1	Caa2	B1

CDS Implied Rating Declines	CDS Implied Ratings		
Issuer	Nov. 28	Nov. 21	Senior Ratings
Societe Generale	Baa1	A3	A1
Deutsche Bank AG	Ba2	Ba1	A3
Credit Agricole Corporate and Investment Bank	A3	A2	A1
Electricite de France	Baa1	A3	A3
Commerzbank AG	Baa3	Baa2	A1
Swedbank AB	A2	A1	Aa2
Bank VTB, PJSC	B2	B1	Ba1
ENGIE SA	A2	A1	A2
Credit Suisse AG	Baa2	Baa1	A1
BASF (SE)	Aa2	Aa1	A1

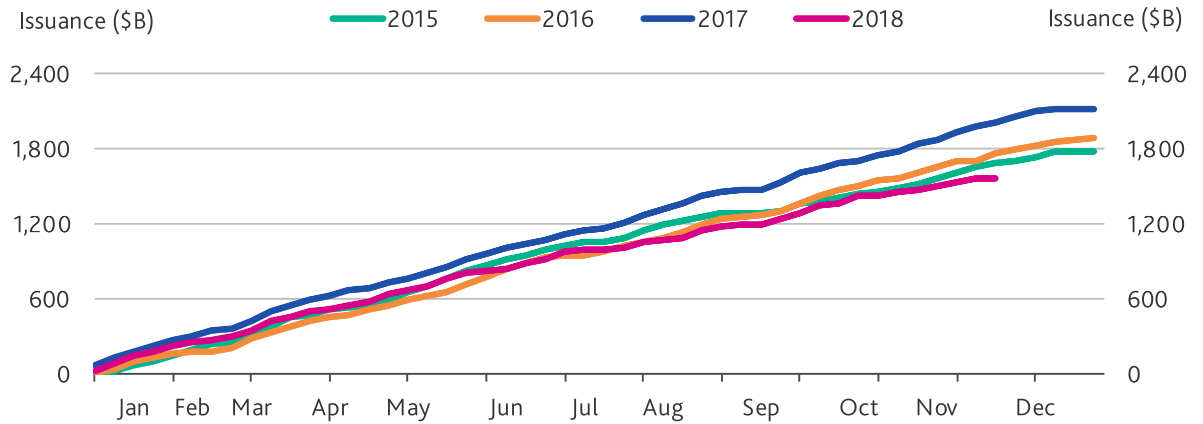
CDS Spread Increases		CDS Spreads		
Issuer	Senior Ratings	Nov. 28	Nov. 21	Spread Diff
Galapagos Holding S.A.	Caa3	6,352	5,144	1,209
PizzaExpress Financing 1 plc	Caa1	2,493	2,096	397
Novafives S.A.S.	Caa1	759	488	272
Boparan Finance plc	Caa1	1,277	1,146	132
Novo Banco, S.A.	Caa2	813	685	128
Russian Standard Bank	Caa2	983	911	71
CMA CGM S.A.	B3	734	677	57
Eurobank Ergasias S.A.	Caa2	892	838	54
Piraeus Bank S.A.	Caa2	883	829	53
Selecta Group B.V.	Caa1	361	309	53

CDS Spread Decreases		CDS Spreads		
Issuer	Senior Ratings	Nov. 28	Nov. 21	Spread Diff
Unipol Gruppo S.p.A.	Ba1	241	298	-57
Italy, Government of	Baa2	233	257	-24
Telecom Italia S.p.A.	Ba1	296	310	-14
Hammerson Plc	Baa1	105	118	-12
Fiat Chrysler Automobiles N.V.	Ba3	176	185	-9
Vue International Bidco p.l.c.	B2	267	276	-9
Standard Chartered PLC	A2	109	114	-5
Assicurazioni Generali S.p.A	Baa2	132	137	-5
Casino Guichard-Perrachon SA	Ba1	541	546	-5
RCI Banque	Baa1	141	145	-5

Source: Moody's, CMA

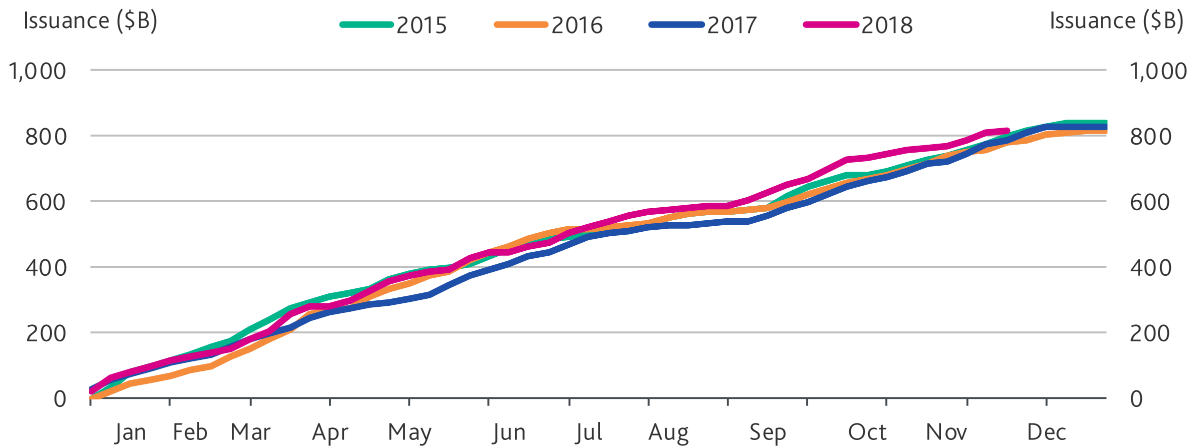
Issuance

Figure 5. Market Cumulative Issuance - Corporate & Financial Institutions: USD Denominated



Source: Moody's / Dealogic

Figure 6. Market Cumulative Issuance - Corporate & Financial Institutions: Euro Denominated



Source: Moody's / Dealogic

Figure 7. Issuance: Corporate & Financial Institutions

	USD Denominated		
	Investment-Grade	High-Yield	Total*
	Amount $B	Amount $B	Amount $B
Weekly	7.780	2.055	10.085
Year-to-Date	1,224.173	272.503	1,569.559

	Euro Denominated		
	Investment-Grade	High-Yield	Total*
	Amount $B	Amount $B	Amount $B
Weekly	8.030	0.000	9.172
Year-to-Date	699.146	84.687	817.833

* Difference represents issuance with pending ratings.

Source: Moody's/ Dealogic

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Editor
Reid Kanaley
reid.kanaley@moodys.com

Contact Us

Americas:	1.212.553.4399
Europe:	+44 (0) 20.7772.5588
Asia:	813.5408.4131

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