MOODY'S ANALYTICS

Weekly Market Outlook will not publish next week, December 27, due to the holiday schedule.

WEEKLY MARKET OUTLOOK

Moody's Analytics Research

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High Leverage Will Help Set Benchmark Interest Rates

Credit Markets Review and Outlook *by John Lonski*

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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: December's paucity of rated US-dollar denominated business borrowing rekindled memories of 2008-2009's credit crunch.

Credit Spreads	Investment Grade: We see year-end 2019's average investment grade bond spread similar to its recent 141 bp. High Yield: Compared to a recent 503 bp, the high-yield spread may approximate 525 bp by year-end 2019.
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 dip from November 2018's 2.9% to 2.6% by November 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 15.0% to $1.282 trillion, while high-yield bond issuance is likely to plummet by 38.6% to $278 billion for high-yield bond issuance's worst calendar year since 2011's 274 billion.

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Ratings Round-Up

U.S. Downgrades Still Outnumbering Upgrades

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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: Growth and leverage, 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.

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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.

High Leverage Will Help Set Benchmark Interest Rates

Given the Fed's willingness to continue its two-pronged firming of monetary policy amid slower economic growth and below-target inflation, the still benign outlook for corporate credit will be menaced by above-average risk. In view of above-average international and domestic political risk, as well as the uncertainties stemming from trade frictions between China and the U.S., the last thing 2019's outlook needs is elevated interest-rate risk.

Even if Fed rate hikes were halted, a larger supply of publicly-traded U.S. government debt will put upward pressure on U.S. interest rates in 2019. The forthcoming increase in tradeable U.S. government debt will stem from two developments.

One is the projected widening of the U.S. government's budget deficit from fiscal-year 2018's 3.8% to fiscal 2019's 4.6% of GDP, where the latter is the highest such ratio amid a mature economic recovery since fiscal 1985's 5.0%. Prior to the onset of the Great Recession, the federal deficit was a smaller 1.1% of GDP in fiscal 2007.

The other is the planned reduction in the Federal Reserve's holdings of U.S. Treasury bonds and federal agency mortgage-backed securities. If the Fed adheres to a previously announced strategy, the yearlong passive release of maturing Treasury bonds and MBS will reach $360 billion and $240 billion. The amount added to the tradable supply of Treasury bonds by the Fed's ongoing reduction of its bond holdings—or "quantitative tightening" —would approach 1.7% of 2019's projected GDP.

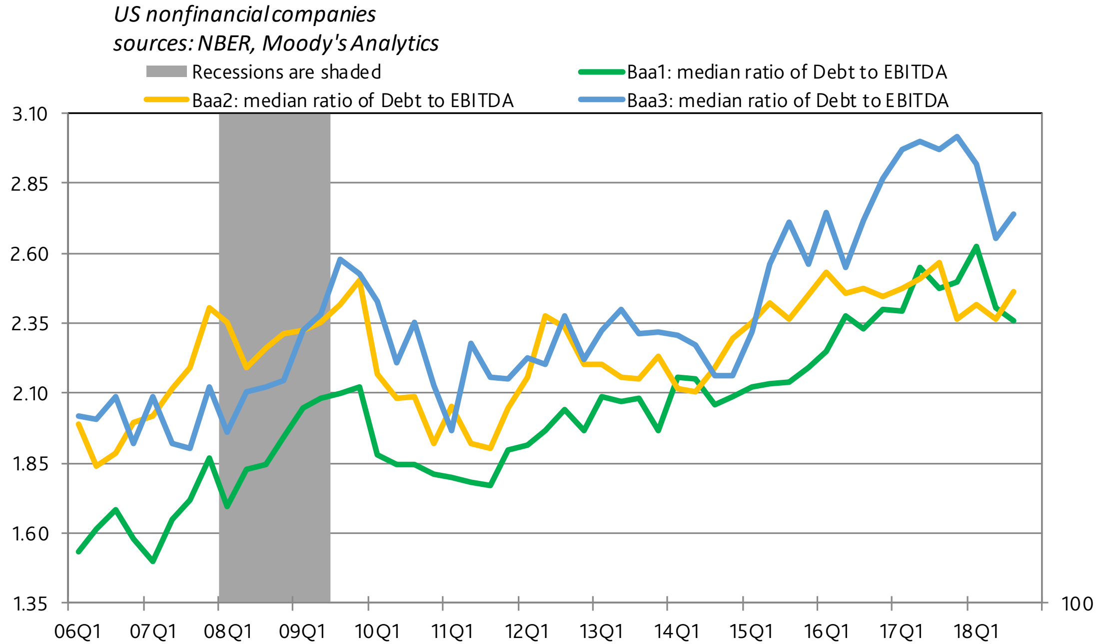
The Fed's unprecedented firming of monetary policy on two fronts—Fed rate hikes and quantitative tightening—increases the danger of an excessive climb by interest rates that materially damages business activity. However, if net borrowing declines elsewhere, a jump by tradable Treasury debt may not drive Treasury bond yields significantly higher. A more subdued pace of business and household borrowing may help the credit market accommodate an expansion of U.S. government borrowing.

Even before the latest episode of global financial market volatility, a number of U.S. companies had reduced their outstanding indebtedness. Corporate deleveraging can be inferred from a deepening of the year-over-year decline by U.S. business borrowing that is graded by at least one of three major credit rating agencies from the 10% decline of 2018's first-half to a prospective 26% decline for the second half.

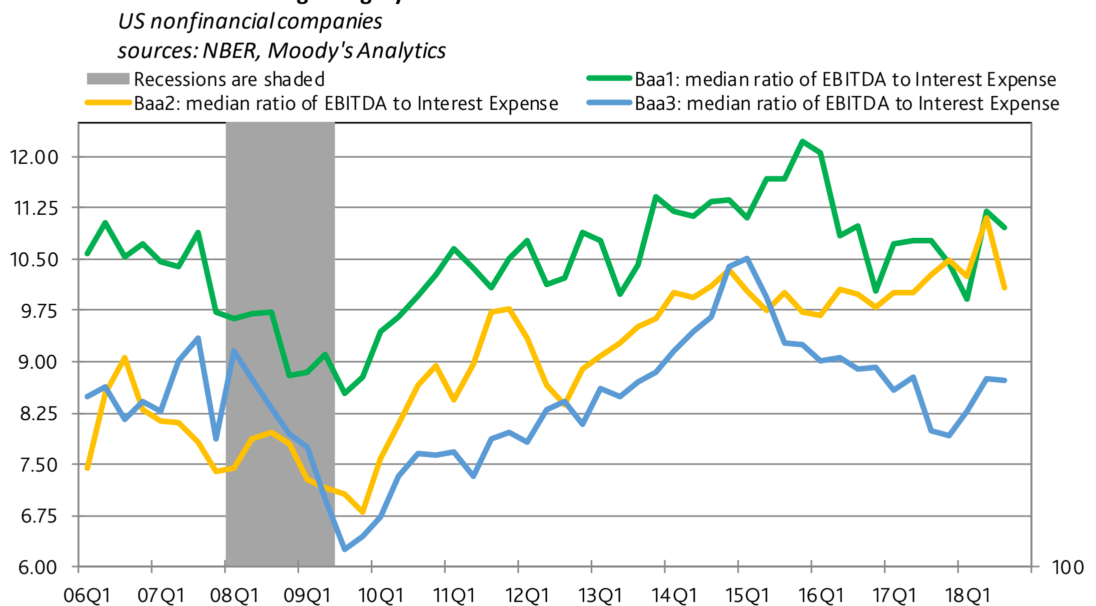
For Baa-Grade Bonds, Improved Interest Coverage Offsets Higher Leverage

A good deal of attention will be paid to the Baa bond rating category if only because of the latter's record size relative to outstandings of high-yield bonds. Worry over the state of Baa credit quality is on the rise. Over the past year, the Bloomberg-Barclays yield spread for all US$-denominated Baa-rated corporate bonds widened from 122 basis points to 187 bp as its yield climbed up from 3.60% to 4.56%, respectively. Similarly, the spread of Moody's long-term Baa industrial company yield ballooned by 73 bp year to year to December 19's 226 bp for the biggest default risk premium since early April 2016.

Each of third-quarter 2018's median ratios of adjusted debt to EBITDA for U.S. nonfinancial companies was up from its reading of 2007's final quarter, which immediately preceded the Great Recession. The Baa3 category, or the bottom rung of the investment-grade ratings ladder, showed the biggest jump by the median debt to EBITDA ratio from fourth-quarter 2007's 212% to the 274% of 2018's third quarter. However, the median Baa3 ratio of debt to EBITDA was down from fourth-quarter 2017's sample high of 302%.



Though leverage ratios for each of the three Baa rating's notches are up from 2007's final quarter, each of the three ratios of EBITDA to interest expense—or interest coverage—now tops its respective reading of year-end 2007. From 2007's final quarter to 2018's third quarter, the median interest coverage ratio rose from 9.7:1 to 11.0:1 for Baa1, from 7.4:1 to 10.9:1 for Baa2, and from 7.9:1 to 8.7:1 for Baa3. However, each ratio peaked earlier in the current recovery at fourth-quarter 2015's 12.2:1 for Baa1, second-quarter 2018's 11.1:1 for Baa2, and first-quarter 2015's 10.5:1 for Baa3.



A reduction of interest coverage via some combination of lower earnings or higher interest rates will increase the burden of today's above-trend leverage ratios. The Fed must be very careful not to stoke an increase by interest rates that simultaneously reduces corporate earnings and lifts interest expense. Doing so would probably drive the high-yield default rate well above 7% and spark a recession.

Huge Supply of Baa3 Bonds Imperils High Yield

Because of how third-quarter 2018's unprecedented $705 billion of outstanding Baa3-rated U.S. corporate bonds approximated an unmatched 56.8% of outstanding high-yield bonds, the next deep and extended contraction of corporate earnings may flood the high-yield bond market with fallen-angel downgrades. By contrast, prior to the start of the Great Recession, fourth-quarter 2007's $294 billion of outstanding Baa3-grade bonds equaled a smaller 32.5% of the high-yield bond market.

A potentially huge influx of downgraded bonds could sink the prices and swell the spreads of high-yield bonds by enough to trigger a debilitating credit crunch. A seizing up of the corporate credit market would probably shrink business activity by enough to assure a recession. Such are the risks attendant to an unbending series of Fed rate hikes in a highly leveraged economy.

As systemic leverage increases, business activity becomes more sensitive to interest rate swings. In other words, less of an increase in interest rates is needed to materially slow expenditures.

High-Yield Downgrade Ratio Changes Drastically from 2018's Third to Final Quarter

Downgrades' share of the number of U.S. high-yield credit rating revisions has moved about in 2018. Following tolerable ratios of 54.1% in the first quarter and 55.4% in the second quarter, downgrades sank to only 27.5% of the third-quarter's revisions of high-yield credit ratings. The latter was the lowest such ratio since the 26.7% of 1993's third quarter, or when the 16.8% yearlong surge by the core profits of U.S. nonfinancial corporations far outran the accompanying 2.5% rise by the group's outstanding debt.

By contrast, the 8.2% annual increase by nonfinancial-corporate core pretax profits of the year-ended September 2018 led corporate debt's comparably measured 6.4% rise by a narrower, but still constructive, margin. Though core profits may slow, fourth-quarter 2018's likely 49% year-over-year plunge by the rated borrowing of U.S. businesses suggests profits will continue to outpace corporate debt.

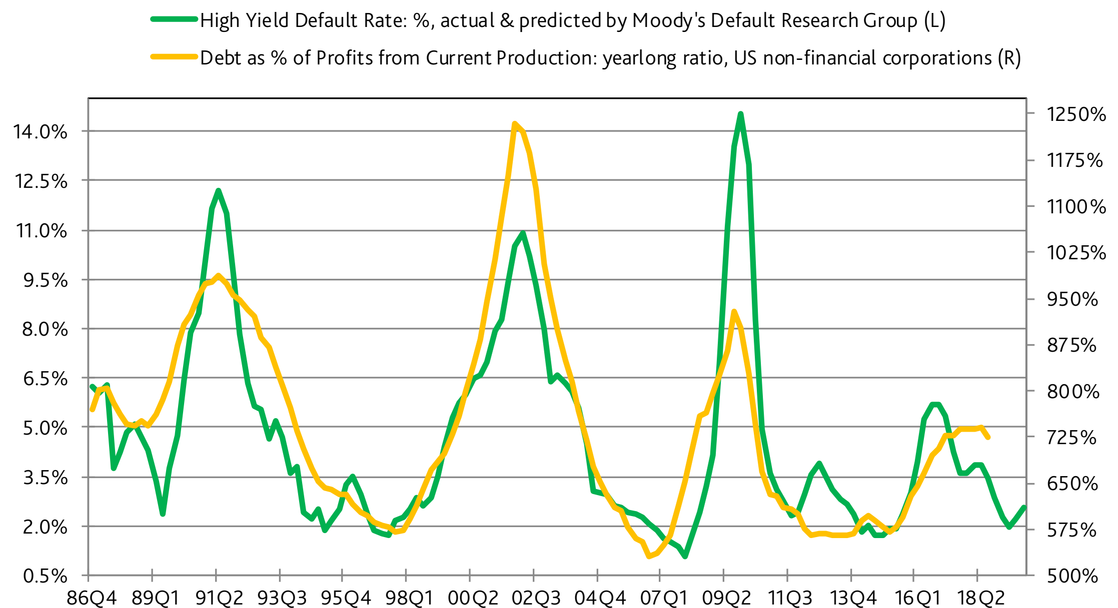
For U.S. nonfinancial corporations, the yearlong ratio of corporate debt to core pretax profits generates a strong correlation of 0.83 with the U.S. high-yield default rate. When corporate debt fell from third-quarter 2009's cycle peak of 928% to first-quarter 2013's current cycle bottom of 565% of core profits, debt's 0.7% average annualized rise lagged far behind profit's 16.0% annualized surge.

Thereafter, the average annualized growth rates advanced to 6.3% for debt and eased to 0.5% for profits up until the ratio formed it latest peak at the 738% of 2017's fourth quarter. During the 2013-2017 span, leveraging was stoked by the profits recession of 2015 and 2016. After peaking in June 2015, the moving yearlong average of core profits would shrink by 6.4% annualized until bottoming during the span-ended March 2017.

Since year-end 2017, profits' 8.9% annualized increase outran debt's 6.4% annualized pace and the ratio of corporate debt to core profits subsided to the 725% of the year-ended September 2018.

Given the default rate's tendency to move in the direction taken by the ratio of debt to profits, projections of a decline by the default rate from the 3.5% of 2018's third quarter to the 2.2% of 2019's third quarter will require the avoidance of an upturn by the debt to profits ratio.

Figure 3: Benign Default Outlook Assumes Profits from Current Production Will Not Contract Materially
sources: Moody's Analytics, Federal Reserve, Bureau of Economic Analysis



After the third-quarter's atypically large number of upgrades relative to downgrades, the distribution of the U.S.'s high-yield credit rating revisions deteriorated in 2018's final quarter. Though the final tally is not in, the fourth quarter shows the 90 downgrades of high-yield issuers surpassing the 56 upgrades. Thus, downgrades supplied 61.6% of the fourth quarter's high-yield credit rating revisions. When the sample is narrowed to rating revisions stemming mostly from changes in fundamentals—as opposed to special events or revised capital structures—downgrades' share rises to 67.3% of high-yield rating changes.

The negative implications for credit quality of fourth-quarter 2018's 34 more high-yield downgrades than upgrades is offset by the previous quarter's 41 more upgrades than downgrades. In turn, the moving two-quarter ratio of downgrades to high-yield rating changes barely rose from September 2018's 45.5% to December's prospective 48.5%.

Moreover, a moving two-quarter high-yield downgrade ratio between 60% and 70% has been accompanied by an often tolerable 514 bp median for the high-yield bond spread. For purposes of comparison, the long-term medians are 471 bp for the quarterly average of the high-yield bond spread and 54.8% for the moving two-quarter high-yield downgrade ratio. However, when the high-yield downgrade ratio climbs to the 70% to 80% range, the median spread widens to a troublesome 652 bp. It is then that an intractable corporate credit cycle downturn often takes hold.

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

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

Are You Not Entertained?

The FOMC delivered a dovish hike, but it appears it may not have been as dovish as markets had hoped. However, we find plenty of dovishness. Still, the FOMC passed on opportunities to deliver larger dovish surprises by not hiking, taking a March hike off the table, eliminating "further gradual increases" entirely, or describing risks as tilted to the downside.

There were still of plenty of dovishness to go around. For example, the Fed lowered its expected path for the fed funds rate, signaling two rather than three hikes in 2019. Markets are pricing in less than one hike next year, and any anticipation that the Fed would share a similar view is unrealistic. Still, there were plenty of other subtle dovish signals. The committee cut its estimate for the equilibrium fed funds rate and lowered its estimate of the unemployment rate consistent with full employment.

There were a few key changes to the statement but they didn't pack as much of a dovish punch as markets anticipated. Gone is the language "further gradual increases in the target range" and it was replaced with a more vague "some further gradual increases." The Fed is signaling that this tightening cycle is closer to the end than the beginning but by not dropping gradual, the Fed isn't sending as clear of a message they are increasingly data dependent. If the Fed has a mulligan, they would likely remove gradual from the statement. There is clearly more uncertainty in FOMC forecasts for rates, and the statement swapped "expects" for "judges" in reference to future rate hikes.

The statement still notes that risks are roughly balanced but added that the central bank will be monitoring global economic and financial developments and will assess their impact on the economic outlook. At least in the near-term, this broadens the Fed's reaction function.

The current rate hike puts the fed funds rate at the low end of the range of estimates for the neutral rate. Monetary policy doesn't need to be as accommodative as in the past, because the economy is strong. Also, something that appears to have been forgotten is that the normalization of monetary policy is supposed to be painful. The Fed is attempting to cool the economy, which is growing comfortably above its potential growth rate. Therefore, to prevent the economy from overheating or imbalances from developing (either in the economy or financial markets), the Fed has been and will continue to raise interest rates. Fed Chair Jerome Powell has stressed in the past that imbalances emerge in other than inflation.

Overall, the Fed is in an uncomfortable position. It is trying to slow the economy and trying to stress that it will be more data dependent. There will be a communication test for the Fed soon, as inflation is set to moderate because of the slide in global oil prices. The deceleration in inflation could dial up the heat on the Fed, particularly among those arguing that the central bank has been raising rates too aggressively.

We don't believe the Fed will be deterred immediately from any deceleration in inflation, particularly if it is attributed to transitory factors, including lower global prices. The Fed has referenced transitory factors in assessing fluctuations in oil prices. The central bank has been on the right side of the transitory bet over the past several years. Still, because the Fed lowered its interest rate projections for 2019 as we anticipated, a pause could come as early as March (we believe the Fed will continue to hike only at meetings with an updated Summary of Economic Projections).

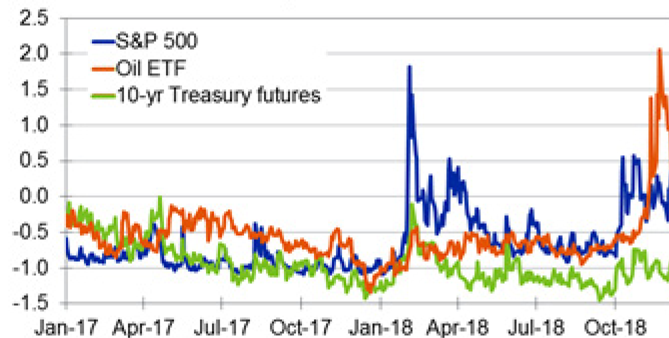
The case for pausing could be fairly compelling, as inflation will remain below target and the hike would

be occurring around the Brexit deadline. Also, the 90-day negotiating window between the U.S. and China on trade will be ending. The Fed could pause, wanting more clarity on the potential impact on U.S. financial market conditions and the economy, assuming no resolution on trade before the meeting.

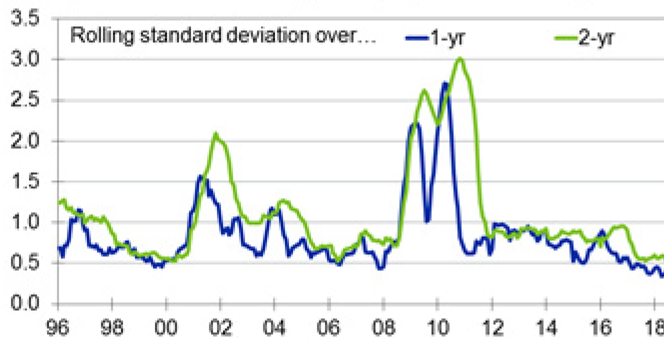
Financial markets continued to tighten this week. A lot appears to be rattling markets, including Fed policy, trade tensions, slower domestic and global growth, and the possibility of a federal government shutdown. This has clearly weighed on the stock market; the Standard & Poor's 500 is down around 13% from its recent peak. Global oil prices have taken a big hit, down nearly $30 per barrel since the beginning of October.

The stock market and oil appear to be taking the brunt of the recent turbulence in financial markets, but there are some other signs of strain. Corporate credit spreads have widened, including across ratings and maturities, including for Aaa, Aa and A. None of these spreads have blown out, thus not raising any red flags. The Baa corporate bond spread has widened, but this puts it in line with the average since the late 1990s. Also of note, leveraged loan prices have dropped this month.

Unlike past instances in this expansion when there have been bouts of financial turbulence, the strains appear to be more concentrated this time. Still, the tightening in broader financial market conditions, if sustained, will reduce GDP growth next year by 0.5 to 0.75 percentage point. Helping minimize the economic cost is that volatility, though higher, has not skyrocketed. In fact, the VIX should likely be higher than it current is.



We used the Chicago Board Options Exchange volatility indexes for the S&P 500, oil exchange-traded fund, and 10-year Treasury note futures. We then calculated z-scores, a measure of the standard deviations above or below the mean, for each volatility index. The z-score shows how many standard deviations each volatility index is from its mean. The results show that volatility in the S&P 500 is a touch higher than its mean while volatility for the oil ETF has jumped. However, volatility on 10-year Treasury note futures is lower than normal. Our past work has shown that spikes in volatility can have economic costs, weighing on hiring and investment. For now, the recent increase in volatility is unlikely to have any noticeable economic costs.



Volatility had been low recently, so it may just be normalizing. However, financial market volatility could increase because of heightened economic volatility, but this doesn't appear to be occurring. Both the one- and two-year rolling standard deviation of changes in year-over-year growth in our estimate of monthly U.S. GDP are among the lowest since the inception of the series in the mid-1990s. Economic volatility will likely increase over the next couple of years, but it remains low for now.

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

EUROPE

By Barbara Teixeira Araujo of Moody's Analytics in Prague

Euro Zone Headline Inflation Will Slow in 2019

The two holiday weeks ahead will be extremely light on the data front. There will be three major economic releases: Germany's unemployment rate and euro zone's preliminary CPI inflation estimate for December, as well as Spain's final third-quarter GDP estimate. No surprises should come from Germany or Spain; we expect that the latter's statistical office will only confirm that activity in the country rose by 0.6% q/q in the three months to September, the same rate as in the previous stanza. The details should confirm that domestic demand drove most of the gains. Household and government spending are expected to have accelerated sharply from the previous stanza. Investment likely eased, though we caution that a slowdown there was always expected following the strong 3.5% q/q jump in the second quarter. Net trade, by contrast, likely dragged on growth as exports plunged over the month—on the back of a broad-based slowdown in external demand—and offset a lesser decrease in imports.

In Germany, the unemployment rate should hold only steady at 5% in the final month of the year—note that the EU-harmonized is reading at a much lower 3.3%—down from 5.4% in January. While we estimate that Germany's labour market is already at full employment, claimant count data continue point to further gains ahead, and that's despite the recent deterioration in confidence numbers.

Euro zone's preliminary CPI release for December should show that inflation pressures accelerated slightly in the final month of the year, to 2%, from 1.9% in November. Chances are nonetheless tilted towards a no-change reading. The breakdown should reveal that food inflation accelerated somewhat

following two months of unimpressive readings (as seasonal factors depressed fresh produce and dairy prices during autumn); we expect the food gauge to have risen to 2.3%, from 2% in November. Services inflation should also have risen, after it declined by 0.2 percentage point to 1.3% in November. Volatility in package holidays and accommodation prices depressed the services headline at the middle of the fourth quarter, but we expect base effects to have pushed services inflation back up in December, likely to 1.5% to 1.6%. Core goods inflation, meanwhile, should have remained steady at 0.4%, though we caution the lagged effect of the lower euro has the potential to push it slightly up, to 0.5%.

By contrast, the only downward pressure on the headline is expected to have come from energy prices, as base effects in oil prices should have pushed inflation in the sector further down in December, after it already declined in November. This trend should continue into 2019, provided that Brent prices remain steady at around $55.

All in, we maintain that the euro zone's headline inflation will slow in 2019 to around 1.6%. While we still see the direction of travel in the core rate as being to the upside, in line with the upbeat developments in the labour market, the expected decline in energy inflation is more likely than not to take the upper hand and ensure that headline inflation in the currency areas remains below the European Central Bank's target all through next year. This means that the chances of a rate hike taking place next year have diminished lately, notably as growth has slowed sharply.

	Key indicators	Units	Moody's Analytics	Last
Week of 24 Dec				
Thur @ 8:00 a.m.	Spain: Retail Sales for November	% change yr ago	1.90	0.90
Thur @ 5:00 p.m.	France: Job Seekers for November	mil, SA	3.4	3.4
Fri @ 7:30 a.m.	Russia: GDP for Q3	% change yr ago	1.5	1.9
Fri @ 8:30 a.m.	Spain: GDP for Q3	% change yr ago	0.6	0.6
Week of 31 Dec				
Fri @ 9:00 a.m.	Germany: Unemployment for December	%	5.0	5.0
Fri @ 10:00 a.m.	Euro Zone: Preliminary Consumer Price Index for December	% change	2.0	1.9

ASIA-PACIFIC

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

Japan's November activity data likely to be mediocre

The economic data calendar is for the next two weeks given the holiday period. Japan's November activity data will be a highlight, but the results are likely to be mediocre. Japan's industrial production is forecast to record another decent monthly expansion for November, but this is more related to payback after a spate of natural disasters caused significant disruption in the third quarter, rather than a product of underlying strength in the economy.

The labour market is a bright spot in Japan. The November unemployment rate is expected to hold at 2.4%, but this will be less of a focus. Instead, the job-to-applicant ratio will be a highlight, after creeping lower in October to 1.62 from 1.64 previously, its highest since the 1970s. Japan's tightening labour market has had some positive spillover to wage growth and consumption in 2018. Income growth has enjoyed modest improvement over the past year, while consumption has also performed strongly in the third quarter. Indeed, retail trade enjoyed its strongest growth in October in 10 months. However, it's important to note that consumption has not enjoyed the same strength that was experienced in 2017.

The Week Ahead

In the first week of January, the highlight will be China's official manufacturing PMI. This survey has been the most sensitive to the trade war with the U.S. and more broadly softer global and domestic conditions. In the December quarter, the new export orders subcategory deteriorated to around three-year lows. We expect further overall softening in December, as local stimulus has had only a modest lift on domestic demand and the pause button was not pressed on the trade war until early December, at the sidelines of the G-20 summit.

	Key indicators	Units	Confidence	Risk	Moody's Analytics	Last
Week of 24 Dec						
Thurs @ 8:00 a.m.	South Korea Consumer sentiment index for December	Index	3	←	92	96
Fri @ 10:00 a.m.	South Korea Retail sales for November	% change	3	↓	-1.0	0.2
Fri @ 10:30 a.m.	Japan Unemployment rate for November	%	4	↓	2.4	2.4
Fri @ 10:50 a.m.	Japan Retail sales for November	% change yr ago	3	↓	2.5	3.5
Fri @ 10:50 a.m.	Japan Industrial production for November	% change	2	↑	1.1	2.9
Week of 31 Dec						
Mon @ 10:00 a.m.	South Korea Consumer price index for December	% change yr ago	3	←	1.8	2.0
Mon @ 12:00 p.m.	China Official manufacturing PMI	Index	3	←	49.8	50.0
Mon @ 6:30 p.m.	Thailand Foreign trade for November	US$ bil	2	↓	2.1	1.3
Wed @ Unknown	South Korea Foreign trade for December	US$ bil	3	↓	4.0	5.1
Fri @ 3:00 p.m.	Malaysia Foreign trade for November	MYR bil	2	↑	9.8	16.3

The Long View

December's paucity of rated US-dollar denominated business borrowing rekindled memories of 2008-2009's credit crunch.

By John Lonski, Chief Economist, Moody's Capital Markets Research Group
December 20, 2018

CREDIT SPREADS

As measured by Moody's long-term average corporate bond yield, the recent investment grade corporate bond yield spread of 141 basis points exceeded its 122-point mean of the two previous economic recoveries. This spread may be no wider than 140 bp by year-end 2019.

The recent high-yield bond spread of 503 bp is wider than what might be inferred from the spread's principal drivers, but is much thinner that what is suggested by the accompanying long-term Baa industrial company bond yield spread of 226 bp and a VIX of 26.3 points. The adverse implications for liquidity of possibly significantly higher interest rates merit consideration.

DEFAULTS

November 2018's U.S. high-yield default rate of 2.9% was less than the 3.7% of November 2017. Moody's Default and Ratings Analytics team now expects the default rate will average 2.2% 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 -6.3% for IG and -37.0% for high yield.

US ECONOMIC OUTLOOK

As inferred from the CME Group's FedWatch Tool, the futures market implicitly assigns only a 50% probability to a year-end 2019 federal funds rate that exceeds its current 2.375%. In view of the underutilization of the world's productive resources, low inflation should help to rein in Treasury bond yields.

The Long View

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 and Marc Korobkin of Moody's Analytics
December 20, 2018

UNITED KINGDOM

December's Bank of England monetary policy decision conformed to expectations. The Monetary Policy Committee was unanimous in deciding to leave rates unchanged, after it raised them for the second time in a decade in August. At the same time, the MPC reaffirmed that it is in no rush to hike again in coming months, or at least until the Brexit saga is resolved. The bank's minutes included a blunt warning that Brexit-related uncertainties have intensified considerably, and that they are leading to heightened volatility and tighter financial conditions. We maintain that the bank won't dare kick the economy when it is down; Brexit waters are already difficult to navigate the way they are, so the bank is likely to wait until a transition period is secured before moving again. This makes May the most likely date for a next hike.

That the bank's short-term growth forecasts were revised down only added to our view. Although this month's decision wasn't accompanied by an inflation report—meaning that there were no revisions to the bank's major forecasts—the BoE highlighted in the meeting's minutes that its nowcasting model for fourth quarter GDP points to growth slowing to only 0.2% q/q, down from an estimate of 0.3% previously. The main drag on growth was expected to come again from investment, which remains subdued on the back of the prolonged uncertainty.

The short-term inflation forecasts were also revised lower, in line with the recent decline in oil prices. The bank now expects the U.K.'s CPI headline inflation will fall below target by January, which would further support its wait-and-see strategy. True, wage growth has picked up strong momentum recently—it jumped to 3.3% y/y in the three months to October, its highest in a decade—but this has not yet translated into stronger underlying inflation pressures. Accordingly, the ONS's measure of core inflation eased further in November, to only 1.8%.

On the upside, the MPC now estimates that the government's looser fiscal policy will add 0.3% to GDP growth over the forecast period. This warrants an upward revision to the bank's GDP forecasts when the MPC meets on February 7. Moreover, the vote on Theresa May's withdrawal deal is expected to take place on January 15, which means that the GDP forecasts could be revised even higher if parliament passes the deal by then. We see scope for a strong rebound in U.K. growth next year, provided a transition period is secured.

TURKEY

Turkey's economy is heading for recession. GDP shrank by 1.1% on a quarterly basis in the third quarter of 2018, in line with our forecast of a 1.2% drop. The economy is undergoing a painful transition after years of very high current account deficits and a heavy reliance on foreign financing. Rising interest rates in the U.S. have diminished investor appetite for emerging market assets, which is bad news because Turkish banks and companies have borrowed heavily from abroad in U.S. dollars. Turkey's banking system is also heavily dollarized. The Turkish lira has fallen by more than 40% against the dollar this year, and the plunging currency has increased debt service costs for Turkish firms. The Turkish Central Bank hiked interest rates to 24% earlier this year after the lira plunged and inflation skyrocketed.

Domestic demand fell across the board in the third quarter. Fixed investment declined by 3.6% as higher debt service payments on both dollar and lira loans caused businesses to curtail capital expenditures. The government tightened its belt following the June election, and real government spending dropped by about 3%. Real consumer spending plunged by 3.9% in the third quarter. The decline in output also weighed on the labor market, with the unemployment rate rising to 11.2% in the third quarter compared with 10% at the start of 2018. The one bit of good news is that the large trade and current account deficits are adjusting to a weaker lira and lower oil prices. Real exports posted a 4% gain in the third quarter, and imports fell by 6%. The current account deficit soared past 6% of GDP by the end of 2017, but in recent months has narrowed to an annual pace of about 1.2% of GDP.

High-frequency indicators suggest that the contraction continued into the fourth quarter. Industrial production slipped by 2% in October from the previous month and is down by 6% since July. The decline in industrial production is problematic since manufacturing accounts for 20% of industry output, much higher than in the U.S. and in the developed countries in the euro zone. Nominal retail sales dropped by 6% in October from the previous month and are now 12% below their August peak. Falling nominal retail sales, at a time when annual inflation sits at 24%, bodes poorly for real consumer spending.

The Turkish economy will continue to contract in coming quarters. Output will fall by nearly 2% in the fourth quarter of 2018 and by 0.6% in the first quarter of 2019. The central bank will keep interest rates elevated in order to support the lira and to curtail high inflation. High borrowing costs on dollar- and lira-denominated loans will weigh on investment spending. Meanwhile, private consumption will fall as job losses and high inflation reduce real spending. Fortunately, the lira will stabilize in coming quarters as the already sharp fall in the currency facilitates a rebalancing of the current account. The stabilizing currency will enable annualized inflation to fall back into single digits by the middle of 2019. At that point, the central bank will begin to lower interest rates, and an export-led recovery will commence. A narrower current account deficit will give foreign investors more confidence to lend to Turkish entities.

ASIA PACIFIC

By Katrina Ell of Moody's Analytics
December 20, 2018

CENTRAL BANKS

An unexpected development in 2018 was the pace at which some central banks in Asia tightened monetary policy in order to stem capital outflows and shore up external positions. Bank Indonesia was amongst the most aggressive in the region, delivering 175 basis points worth of hikes since mid-May. Indonesia's large fourth quarter trade deficit adds to pressure on the already wider current account deficit, making it too early to say with confidence that the tightening cycle is over for Indonesia.

Bangko Sentral ng Pilipinas also delivered the same magnitude of hikes in 2018. But unlike Indonesia, the primary motivator was to temper inflation from its decade high after poor weather and excise tax changes caused it to spike.

The Bank of Thailand hiked rates in December for the first time since August 2011, and the Bank of Korea moved in December after also not hiking for seven years. Thailand's December move was viewed as a dovish hike with further movements unlikely in the first half of 2019, given subdued inflation and slower GDP growth.

While financial conditions remain easy in most economies in Asia, we expect monetary tightening to gather pace in 2019 and 2020. The tightening cycle will be gradual given the elevated debt that some pockets are carrying. In particular, household debt as a proportion of GDP is elevated by historical standards in Australia, New Zealand, South Korea and Malaysia, making economies more sensitive to higher interest rates than prior tightening cycles. Central banks in Australia and New Zealand are not forecast to commence normalization until mid-2020 given the slowing growth outlook and subdued inflation.

The Reserve Bank of India is likely to be an exception to the forecast tightening over the next year or so. The RBI turned dovish from December, with the mandate to bolster domestic demand appearing a greater priority than previously. This stance has been enabled by softer inflation, which cooled to a 17-month low in November at 2.3% y/y, and coming in below the RBI's 4% medium-term target for a fourth straight month.

Our baseline is for the RBI to keep the repo rate at 6.5% in 2019, but the odds of easing have increased after 50 basis points worth of hikes in 2018 to help shore up the rupee, which has struggled amidst emerging market outflows in 2018.

Ratings Round-Up

U.S. Downgrades Still Outnumbering Upgrades

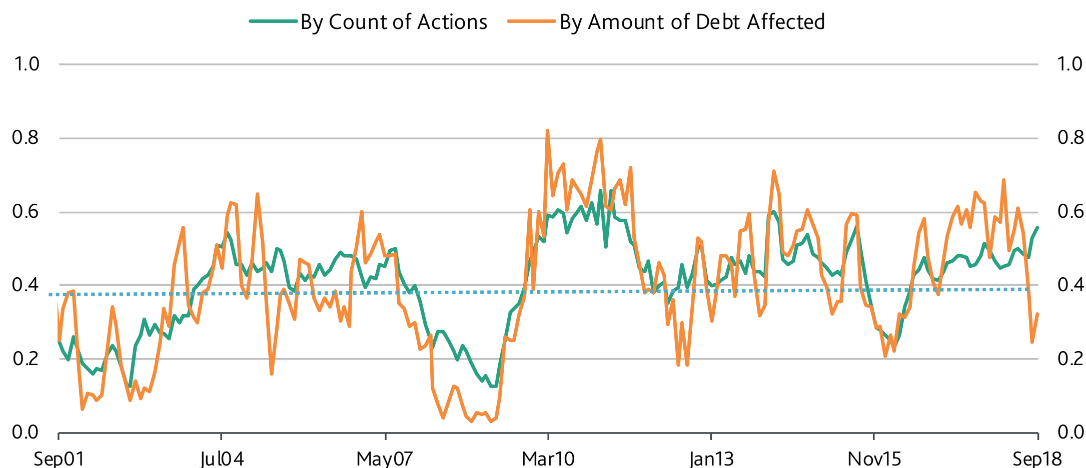
By Michael Ferlez

U.S. rating change activity remained weak, though both the ratings volume and the amount of affected debt increased. For the period ended December 18, positive rating changes accounted for 24%, up slightly from 22% in the prior week. On the upgrade side, Kinder Morgan Inc.'s senior unsecured debt was upgraded from Baa3 to Baa2, impacting $38 billion of debt and reflecting the firms improving leverage. Although downgrades outnumber upgrades, the amount of impacted debt for downgrades was less. Notable downgrades included Lowe's Companies Inc., which saw its senior unsecured credit rating cut to Baa1 from A3.

In Europe, rating change activity was light with only two changes, one upgrade and one downgrade. Total debt impacted by the Europe rating changes, $535 million, was minimal.

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

Ratings Round-Up

FIGURE 3

Rating Changes: Corporate & Financial Institutions – US

Date	Company	Sector	Rating	Amount ($ Million)	Up/ Down	Old LTD Rating	New LTD Rating	IG/ SG
12/12/18	LOWE'S COMPANIES, INC.	Industrial	SrUnsec	14,843	D	A3	Baa1	IG
12/12/18	PARKER DRILLING COMPANY	Industrial	SrUnsec /LTCFR/PDR	585	D	Caa2	Ca	SG
12/12/18	BUNGE LIMITED	Industrial	SrUnsec /LTIR/PS	4,394	D	Baa2	Baa3	IG
12/12/18	AFFINION GROUP HOLDINGS, INC.-AFFINION GROUP, INC.	Industrial	SrUnsec/SrSec /BCF/LTCFR/PDR	533	D	Caa3	Ca	SG
12/12/18	CT TECHNOLOGIES INTERMEDIATE HOLDINGS, INC.	Industrial	SrSec/BCF /LTCFR/PDR		D	B2	Caa3	SG
12/13/18	KINDER MORGAN, INC.	Utility	SrUnsec/Sub /JrSub/PS/CP	38,146	U	Baa3	Baa2	IG
12/14/18	XEROX CORPORATION	Industrial	SrUnsec /BCF/CP	5,688	D	Baa3	Ba1	IG
12/14/18	COMMUNITY CHOICE FINANCIAL INC. -COMMUNITY CHOICE FINANCIAL ISSUER, LLC	Financial	SrSec	42	U	Caa2	Caa1	SG
12/14/18	ENERGY SOLUTIONS, INC. -ENERGYSOLUTIONS, LLC	Industrial	SrSec/BCF /LTCFR/PDR		D	B2	B3	SG
12/14/18	AKORN, INC.	Industrial	SrSec/BCF /LTCFR/PDR		D	B3	Caa1	SG
12/14/18	PDM INTERMEDIATE HOLDINGS B CORP. -CHECKOUT HOLDING CORP.	Industrial	SrSec/BCF /LTCFR/PDR		D	Caa2	C	SG
12/14/18	MILLENNIUM PARK HOLDCO, INC.	Industrial	SrSec/BCF /LTCFR/PDR		D	B2	Caa1	SG
12/17/18	FERRELL COMPANIES-FERRELLGAS, L.P.	Industrial	SrUnsec /LTCFR/PDR	1,657	D	B3	Caa2	SG
12/17/18	OHIO NATIONAL MUTUAL HOLDINGS, INC -OHIO NATIONAL FINANCIAL SERVICES, INC.	Financial	SrUnsec/IFSR	550	D	Baa1	Baa2	IG
12/17/18	METROPISTAS	Industrial	SrSec	435	U	B1	Ba3	SG
12/17/18	SOUTHCROSS HOLDINGS LP -SOUTHCROSS ENERGY PARTNERS, L.P.	Industrial	SrSec/BCF /LTCFR/PDR		D	Caa2	Caa3	SG
12/17/18	KORE WIRELESS GROUP INC.	Industrial	SrSec/BCF		D	B2	B3	SG
12/17/18	CHAMP ACQUISITION CORPORATION	Industrial	SrSec/BCF		U	B2	B1	SG
12/18/18	DOVER CORPORATION	Industrial	SrUnsec	2,967	D	A3	Baa1	IG
12/18/18	CIRQUE DU SOLEIL HORIZONS INC.-CDS U.S. INTERMEDIATE HOLDINGS, INC.	Industrial	SrSec/BCF /LTCFR/PDR		D	B1	B2	SG
12/18/18	KESTREL ACQUISITION, LLC	Industrial	SrSec/BCF		U	B1	Ba3	SG

Source: Moody's

FIGURE 4
Rating Changes: Corporate & Financial Institutions – Europe

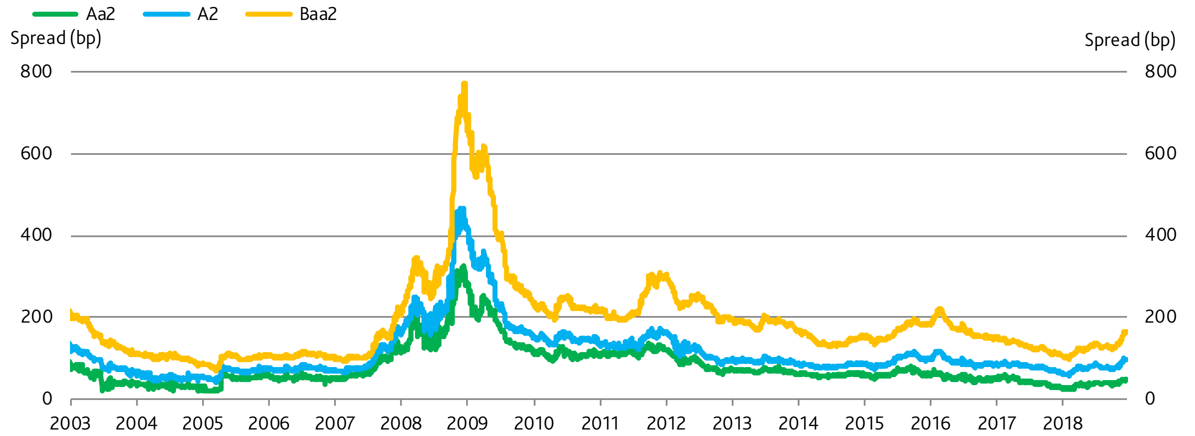
Date	Company	Sector	Rating	Amount ($ Million)	Up/ Down	Old LTD Rating	New LTD Rating	Old STD Rating	New STD Rating	IG/ SG	Country
12/12/18	SUEDZUCKER AG	Industrial	LTIR /JrSub/CP	791	D	Baa2	Baa3	P-2	P-3	IG	GERMANY
12/12/18	ABBEY INTERNATIONAL FINANCE LIMITED	Financial	LTCFR		U	B1	Ba3			SG	IRELAND
12/13/18	COGNOR S.A.	Industrial	LTCFR/PDR		U	Caa1	B3			SG	POLAND
12/14/18	GETIN NOBLE BANK S.A.	Financial	LTD		D	B1	B2			SG	POLAND
12/14/18	GRUPO ALDESA S.A.	Industrial	SrSec /LTCFR/PDR	282	D	B2	B3			SG	SPAIN
12/14/18	CYBG PLC -VIRGIN MONEY PLC	Financial	LTIR /LTD/MTN		U	Baa2	Baa1			IG	UNITED KINGDOM
12/17/18	ALPHA SCHOOLS (HIGHLAND) PROJECT PLC	Industrial	SrSec/BCF	252	U	A3	A2			IG	UNITED KINGDOM

Source: Moody's

Market Data

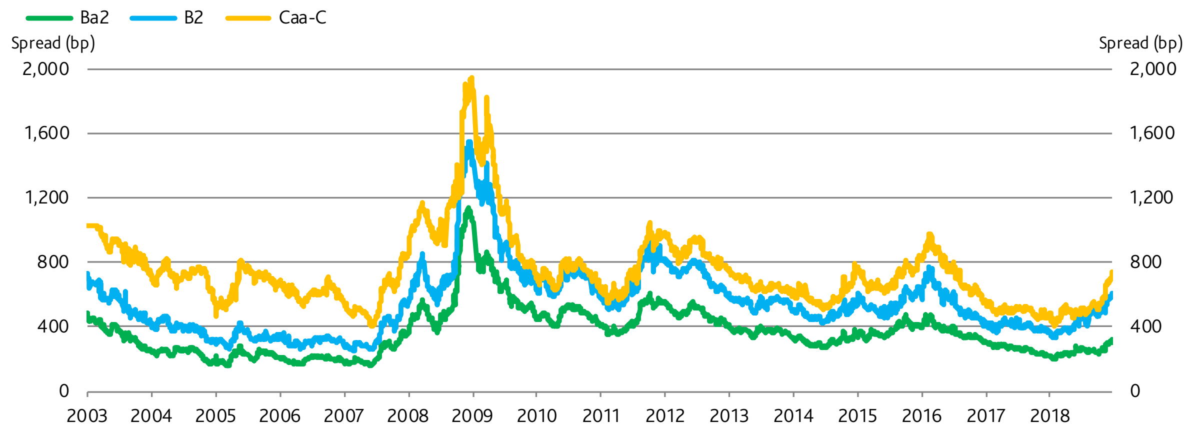
Spreads

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

CDS Movers

Figure 3. CDS Movers - US (December 12, 2018 – December 19, 2018)

CDS Implied Rating Rises	CDS Implied Ratings		
Issuer	Dec. 19	Dec. 12	Senior Ratings
Hertz Corporation (The)	Caa2	Ca	B3
Talen Energy Supply, LLC	Caa1	Caa3	B3
AK Steel Corporation	Caa2	Ca	B3
AT&T Inc.	Baa3	Ba1	Baa2
Philip Morris International Inc.	A2	A3	A2
Dish DBS Corporation	Caa1	Caa2	B1
Kroger Co. (The)	Baa2	Baa3	Baa1
Crown Castle International Corp.	Baa3	Ba1	Baa3
Plains All American Pipeline L.P.	Baa3	Ba1	Ba1
Praxair, Inc.	Aa2	Aa3	A2

CDS Implied Rating Declines	CDS Implied Ratings		
Issuer	Dec. 19	Dec. 12	Senior Ratings
Cigna Corporation	A2	Aa2	Baa1
Radian Group Inc.	B2	Ba2	Ba2
MGIC Investment Corporation	B2	Ba2	Ba2
Ford Motor Company	B2	Ba3	Baa3
CSC Holdings, LLC	B2	Ba3	B2
Altria Group Inc.	Baa2	A3	A3
Sprint Communications, Inc.	B3	B1	B3
Xerox Corporation	B3	B1	Ba1
MGM Resorts International	B2	Ba3	Ba3
Exelon Corporation	A1	Aa2	Baa2

CDS Spread Increases		CDS Spreads		
Issuer	Senior Ratings	Dec. 19	Dec. 12	Spread Diff
Penney (J.C.) Corporation, Inc.	Caa2	3,618	3,121	497
Weatherford International, LLC (Delaware)	Caa1	2,100	1,701	399
Windstream Services, LLC	Caa2	3,087	2,873	214
K. Hovnanian Enterprises, Inc.	Caa3	2,639	2,425	214
Frontier Communications Corporation	Caa1	2,440	2,259	181
Neiman Marcus Group LTD LLC	Ca	1,887	1,722	166
Chesapeake Energy Corporation	B3	800	668	133
Dean Foods Company	B3	876	753	124
Rite Aid Corporation	Caa2	1,241	1,140	101
Diamond Offshore Drilling, Inc.	B3	613	526	87

CDS Spread Decreases		CDS Spreads		
Issuer	Senior Ratings	Dec. 19	Dec. 12	Spread Diff
General Electric Company	Baa1	186	202	-17
Arconic Inc.	Ba2	397	411	-15
Baker Hughes, a GE company, LLC	A3	112	123	-10
Talen Energy Supply, LLC	B3	730	737	-7
Meritor, Inc.	B1	302	308	-6
NRG Energy, Inc.	Ba3	135	139	-4
FCA US LLC	Ba2	129	134	-4
Comcast Cable Communications, LLC	A3	42	46	-4
International Game Technology	Ba2	255	259	-4
TRW Automotive Inc.	Baa3	47	51	-4

Source: Moody's, CMA

Market Data

Figure 4. CDS Movers - Europe (December 12, 2018 – December 19, 2018)

CDS Implied Rating Rises	CDS Implied Ratings		
Issuer	Dec. 19	Dec. 12	Senior Ratings
Alpha Bank AE	Caa1	Caa3	Caa2
UniCredit Bank Austria AG	Aa3	A2	Baa1
Piraeus Bank S.A.	Caa2	Ca	Caa2
National Bank of Greece S.A.	Caa1	Caa3	Caa2
CMA CGM S.A.	Caa1	Caa3	B3
Novafives S.A.S.	Caa1	Caa3	Caa1
Spain, Government of	Baa1	Baa2	Baa1
Intesa Sanpaolo S.p.A.	Ba1	Ba2	Baa1
Deutsche Bank AG	Ba1	Ba2	A3
UniCredit S.p.A.	Ba1	Ba2	Baa1

CDS Implied Rating Declines	CDS Implied Ratings		
Issuer	Dec. 19	Dec. 12	Senior Ratings
Natixis	A2	Aa2	A1
Nationwide Building Society	Baa1	A2	Aa3
Bank VTB, PJSC	B2	Ba3	Ba1
Unipol Gruppo S.p.A.	B2	Ba3	Ba2
Virgin Media Finance PLC	B2	Ba3	B2
Evraz Group S.A.	B2	Ba3	Ba2
Premier Foods Finance plc	B3	B1	Caa1
Lloyds Bank plc	Baa1	A3	Aa3
Abbey National Treasury Services plc	A3	A2	Aa3
Turkey, Government of	B3	B2	Ba3

CDS Spread Increases		CDS Spreads		
Issuer	Senior Ratings	Dec. 19	Dec. 12	Spread Diff
Galapagos Holding S.A.	Caa3	6,093	5,429	664
Marks & Spencer p.l.c.	Baa3	221	183	38
Matalan Finance plc	Caa1	948	913	35
Russian Standard Bank	Caa2	1,102	1,068	34
Stena AB	B3	657	624	32
Suedzucker AG	Baa3	165	136	30
NEXT plc	Baa2	158	131	27
CMA CGM S.A.	B3	739	718	20
Metsa Board Corporation	Ba1	106	86	20
Eurobank Ergasias S.A.	Caa2	945	930	15

CDS Spread Decreases		CDS Spreads		
Issuer	Senior Ratings	Dec. 19	Dec. 12	Spread Diff
PizzaExpress Financing 1 plc	Caa2	2,696	2,778	-82
Sappi Papier Holding GmbH	Ba2	288	352	-64
Boparan Finance plc	Caa1	1,227	1,273	-46
Care UK Health & Social Care PLC	Caa1	172	205	-33
Turkey, Government of	Ba3	341	366	-25
Intesa Sanpaolo S.p.A.	Baa1	161	179	-18
Akbank TAS	B1	457	473	-17
UniCredit S.p.A.	Baa1	160	175	-16
Banco Sabadell, S.A.	Baa3	118	134	-16
Novo Banco, S.A.	Caa2	964	980	-16

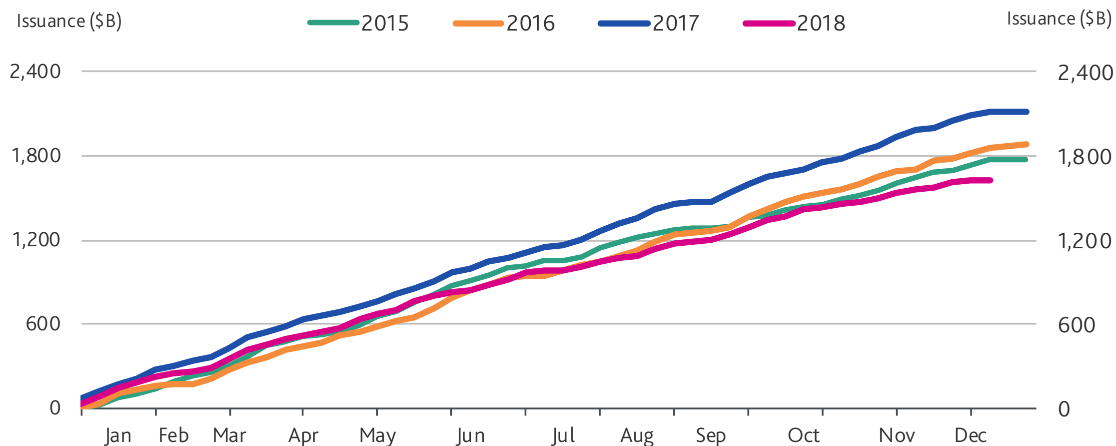
Source: Moody's, CMA

Market Data

Issuance

FIGURE 5

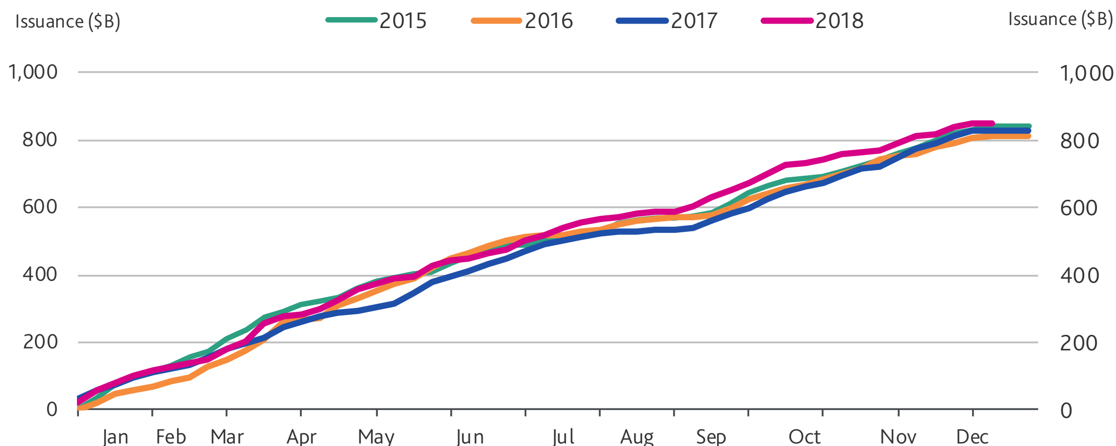
Market Cumulative Issuance - Corporate & Financial Institutions: USD Denominated



Source: Moody's / Dealogic

FIGURE 6

Market Cumulative Issuance - Corporate & Financial Institutions: EURO Denominated



Source: Moody's / Dealogic

Market Data

FIGURE 7

Issuance: Corporate & Financial Institutions

	USD Denominated		
	Investment-Grade	High-Yield	Total*
	Amount $B	Amount $B	Amount $B
Weekly	7.285	1.130	9.802
Year-to-Date	1,274.951	275.683	1,632.002

	Euro Denominated		
	Investment-Grade	High-Yield	Total*
	Amount $B	Amount $B	Amount $B
Weekly	0.637	0.000	0.685
Year-to-Date	728.629	85.735	848.009

* Difference represents issuance with pending ratings.

Source: Moody's/ Dealogic

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