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Upon Further Review, Aggregate Financial Metrics Worsen

WEEKLY MARKET OUTLOOK

Moody's Analytics Research

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Credit Markets Review and Outlook

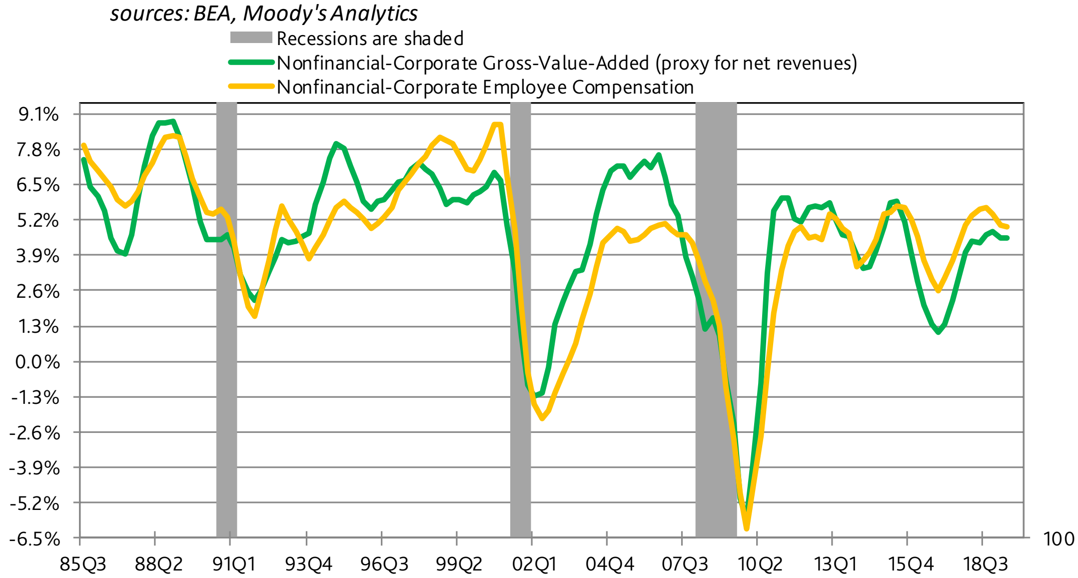
By John Lonski, Chief Economist, Moody's Capital Markets Research, Inc.

Upon Further Review, Aggregate Financial Metrics Worsen

The Bureau of Economic Analysis recently lowered its estimates of corporate profits for 2017 and 2018. The downward revision of nonfinancial-corporate profits mostly stemmed from a major upward revision of employee compensation costs and a slight downward revision of nonfinancial-corporate gross value added, where GVA is a proxy for revenues net of non-labor costs. For example, 2018's estimate of pretax profits from current production was revised downward by a shockingly large 12.1% mostly in response to a percentage point hiking of employee compensation growth to 5.4% and a 0.4 of a percentage point lowering of GVA growth to 4.7%.

The faster growth of employee compensation vis-a-vis GVA explains why 2018's increase by nonfinancial-corporate core profits was slashed from a 10.7% advance to a 0.9% rise. However, the difference between the growth rates of GVA and employee compensation have turned more favorable for profitability. The preliminary results for the year-ended June 2019 showed that the slowdown by GVA growth to 4.5% was milder than the deceleration by employee compensation growth to 4.9%. In turn, the annual increase of core pretax profits rose to 2.2% for the year-ended June 2019.

Figure 1: A Renewed Acceleration by Employee Compensation Might Shrink Core Profits by Enough to Trigger Layoffs
yy % changes for yearlong averages of U.S. nonfinancial corporations
sources: BEA, Moody's Analytics

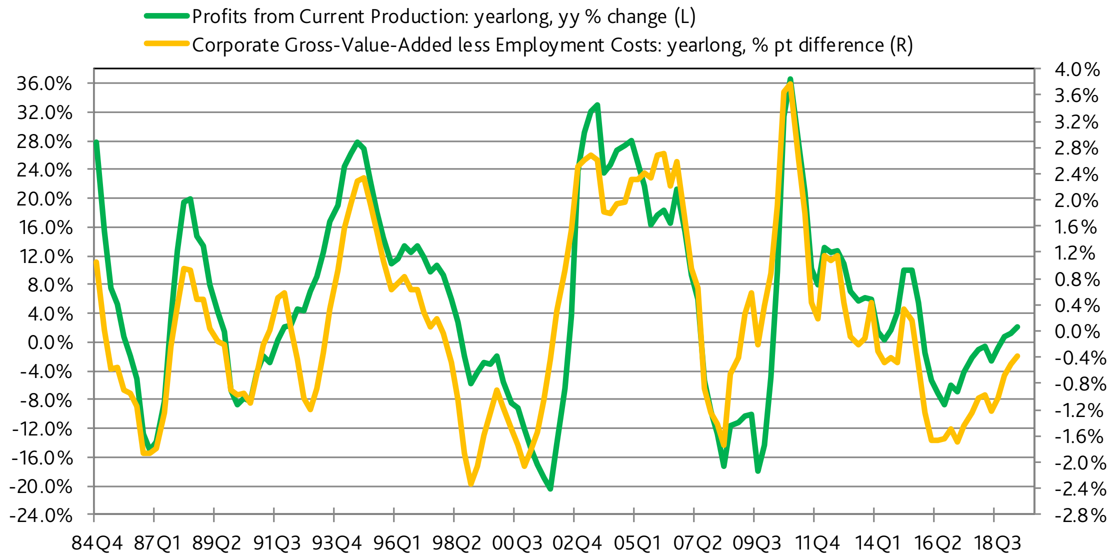


Businesses Cannot Allow Labor Costs to Continue to Outrun Revenues

Since mid-1985, the annual percent change of yearlong nonfinancial-corporate core profits shows a strong correlation of 0.84 with the percentage point difference between the annual percent changes of yearlong GVA and yearlong employee compensation.

The record shows that when the deficiency of GVA growth to employee compensation growth was between -0.3 and -0.5 percentage points, the median annual rise by yearlong core profits was 2.2%. And that happens to exactly match core profits' increase for the year-ended June 2019. The failure on the part of businesses to heed the slower growth of revenues when budgeting for labor costs risks a contraction of corporate earnings, which, if widespread enough, could prompt a wave of layoffs that can end the current business cycle upturn.

Figure 2: In terms of Year-over-Year Percent Changes, Core Profits Show High Correlation of 0.84 with Difference Between Corporate Gross-Value-Added Less Employee Compensation
U.S. nonfinancial corporations
sources: BEA, Moody's Analytics



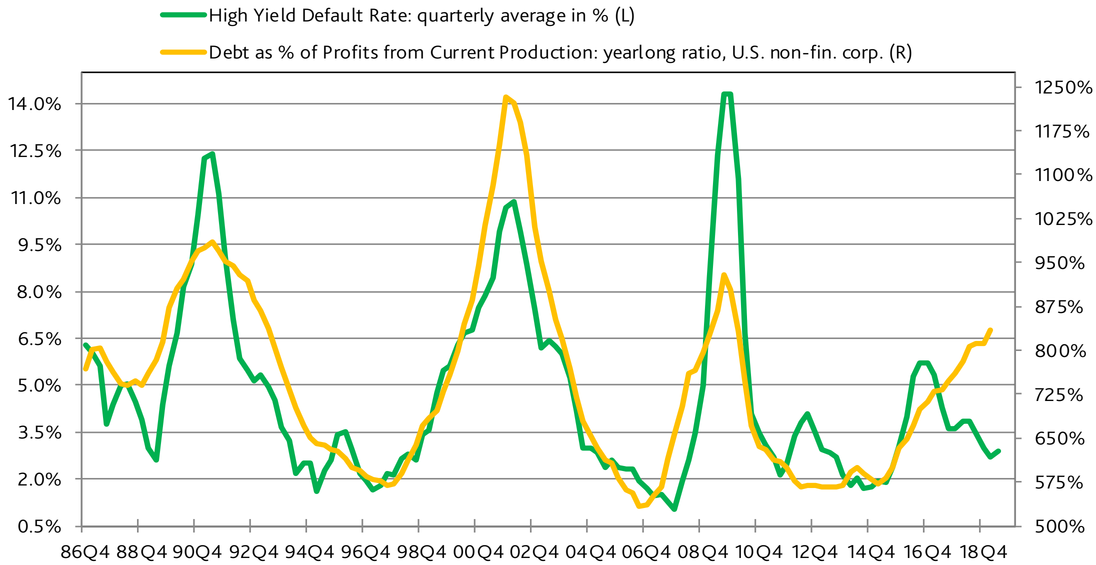
Ratio of Corporate Debt to Core Pretax Profits Was Revised Sharply Higher

The downward revision of core pretax profits triggered a dramatic upward revision for the ratio of nonfinancial-corporate debt to core pretax profits from an earlier 735% to a now 761% for 2017 and from a previous 713% to a restated 811% for 2018.

Notwithstanding the jump by the yearlong ratio of corporate debt to core profits from March 2018's 781% to March 2019's 833%, the U.S. high-yield default rate still dipped from first-quarter 2018's 3.8% to first-quarter 2019's 2.7%. The decline by the default rate despite a notable climb by the aggregate measure of nonfinancial-corporate leverage very much contradicts what might be inferred from the strong 0.81 correlation between the quarterly default rate and the yearlong ratio of corporate debt to core profits.

When nonfinancial-corporate debt previously climbed up to 833% of core profits in 2009's first quarter, 2000's second quarter, and 1989's final quarter, the small sample's relatively high median default rate of 6.6% was joined by a 1.8 percentage point median yearly increase for the default rate. Moreover, each of the three mentioned quarters either coincided with a recession or was within 18 months of a recession's start. All of this reinforces expectations of at least a full percentage point increase by the default rate from its recent 3.0% by the spring of 2020. Already elevated leverage heightens the imperative for businesses to maintain profit margins and contain indebtedness.

Figure 3: Drop by High-Yield Default Rate Defies Jump by Ratio of Corporate Debt to Core Pretax Profits
sources: Moody's Analytics, Federal Reserve, BEA

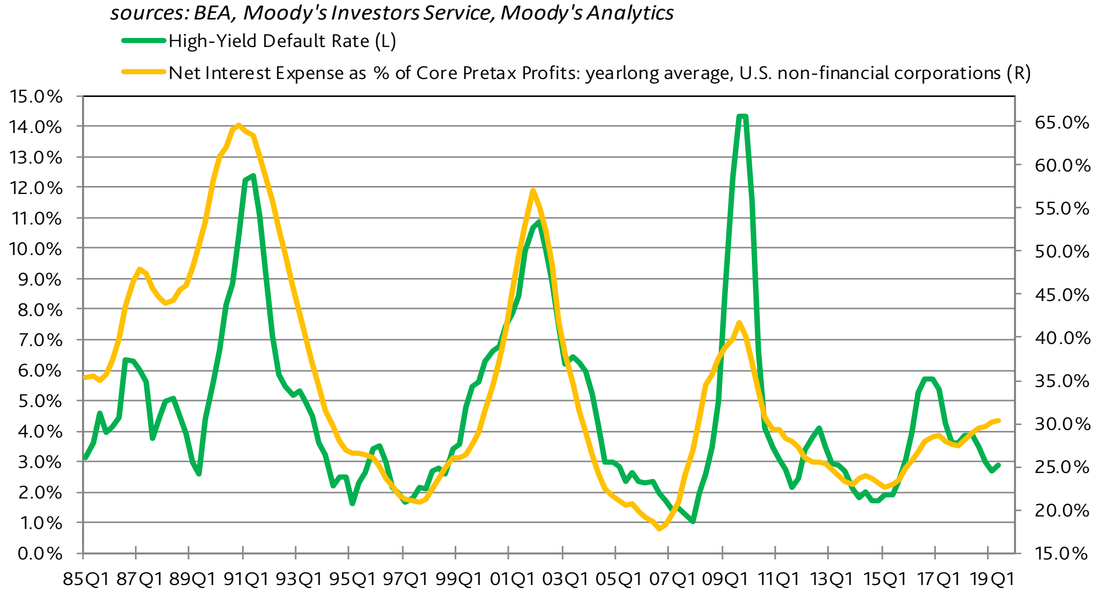


Upwardly Revised Net Interest Costs Failed to Alarm

Yearlong 2018's annual increase by nonfinancial-corporate net interest expense was revised up from an earlier 0.7% to a restated 8.7%. Nevertheless, despite the faster growth of net interest costs and the slower growth of core pretax profits, the ratio of nonfinancial-corporate net interest expense to core profits was a tolerable 30.3% for the year-ended June 2019. The latter closely resembled its long-term median of 29.3%.

The slower growth of outstanding corporate debt and lower corporate bond yields help to explain why the year-over-year increase of net interest expense slowed from yearlong 2018's 8.7% to the 2.9% of 2019's first-half. Though the relative containment of net interest costs vis-a-vis core pretax profits has offset the upward pressure put on the default rate by a relatively high ratio of corporate debt to core pretax profits, the default rate shows a stronger correlation of 0.81 with the yearlong leverage metric compared with its 0.73 correlation with the yearlong ratio of net interest expense to core profits. An already high ratio of debt to pretax profits warns that even a seemingly slight increase by benchmark interest rates risks a destabilizing rise by the default rate

Figure 4: Low Benchmark Borrowing Costs Rein In the Ratio of Net Interest Expense to Core Pretax Profits
sources: BEA, Moody's Investors Service, Moody's Analytics



High-Yield EDF Outperforms the High-Yield Bond Spread at Predicting Defaults

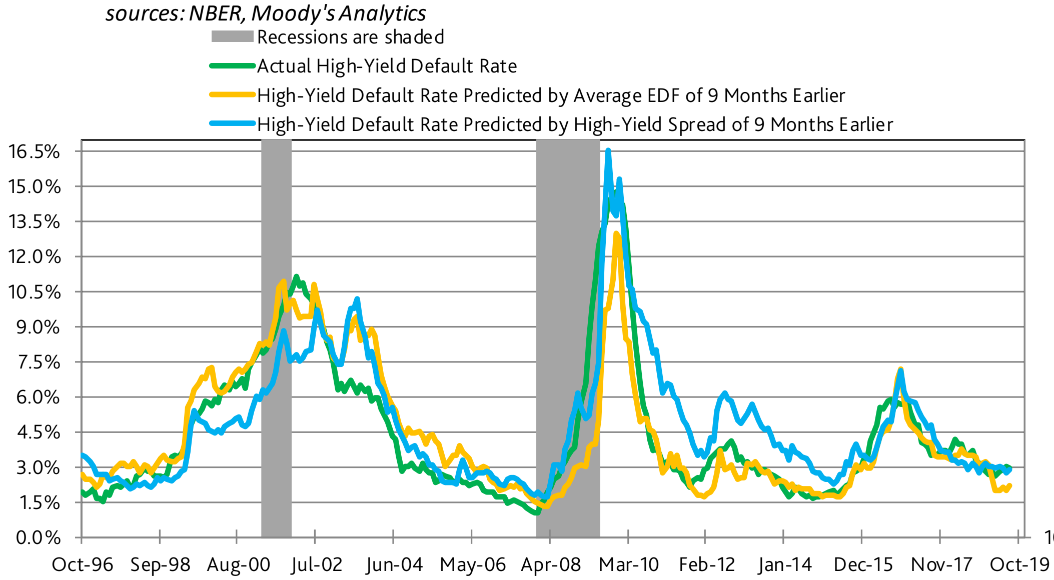
Though the high-yield bond spread has yet to signal elevated recession risk, high-yield's expected default frequency warns of both a wider high-yield spread and a percentage point increase by the high-yield default rate by the spring of 2020.

As inferred from a time series commencing in April 1996, August 28's average high-yield EDF metric of 4.63% and its 56 bp increase since three months earlier have been associated with a 528 bp midpoint for the high-yield bond spread. By contrast, August 28's actual composite high-yield bond spread was 461 bp.

The latest high-yield EDF predicts a 4.0% midpoint for the high-yield default rate of April 2020, which differs from the accompanying high-yield bond spread's prediction of a 3.7% default rate for April 2020. Both projected default rates are up from the 3.0% of July 2019.

Compared with the high-yield bond spread, the average high-yield EDF metric has tended to supply more reliable forecasts of the high-yield default rate nine months into the future. From the sample's January 1996 start through July 2019, the absolute value of the difference between the predicted and actual default rates averaged 91 bp for the high-yield EDF metric and a wider 119 bp for the high-yield bond spread. For the current business cycle upturn, the average absolute value of the forecasting error fell to 72 bp for the high-yield EDF but rose to 130 bp for the high-yield spread.

Figure 5: Average EDF Outperforms High-Yield Spread at Predicting Default Rate During Current Business Cycle Upturn
in %
sources: NBER, Moody's Analytics



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

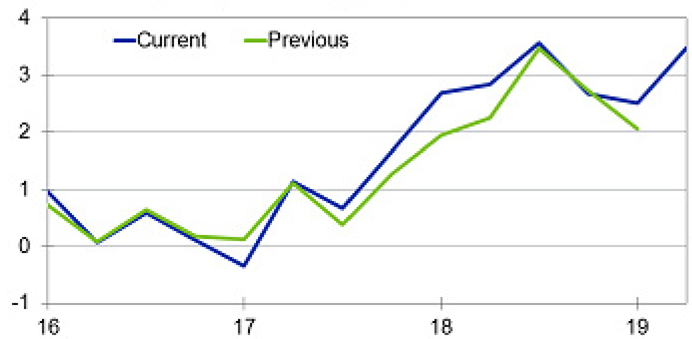
THE U.S.
By Bernard Yaros of Moody's Analytics

About That Budget

Annual revisions to the U.S. national income and product accounts reveal that federal spending in 2018 was stronger than previously thought. Real spending rose 2.9% in 2018, up from the Bureau of Economic Analysis' prior estimate of 2.6%.

Federal Spending Was Stronger in 2018

Real federal spending, % change yr ago



Sources: BEA, Moody's Analytics

The upward revision was entirely in nondefense spending, which grew nearly a percentage point faster than the prior estimate. Over the past year, Moody's Analytics has been puzzled as to why nondefense spending was barely picking up in light of the massive spending increases authorized by the Bipartisan Budget Act of 2018. The upward revision alleviates this confusion. Further, a sharp uptick in nondefense spending in the second quarter of 2019 suggests nondefense programs are still working through the increase in appropriations.

Two-year budget deal

Congress and the White House have signed into law the Bipartisan Budget Act of 2019, which provides the U.S. economy and financial markets much-needed certainty on two key fiscal issues for the next two years.

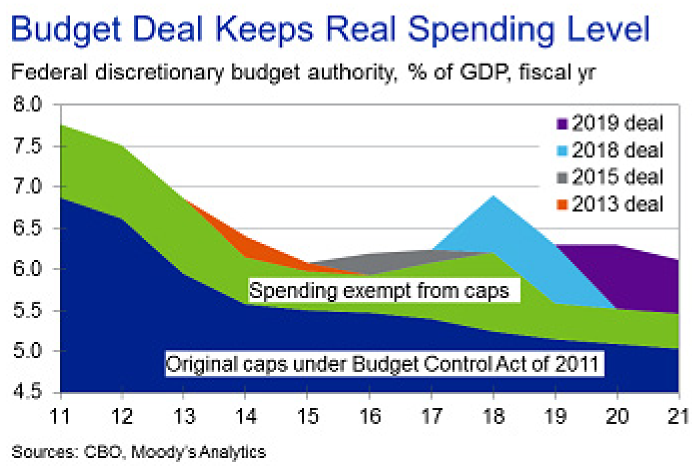
The first issue at stake was the federal budget. In 2011, lawmakers passed the Budget Control Act, which set stricter limits, or caps, on federal discretionary spending through fiscal 2021 to rein in deficits. In 2013, Congress allowed the budget cuts under these caps to take place but quickly realized how punitive they were to the economy. Since then, lawmakers have repeatedly enacted two-year budget deals that raise the caps above the levels stipulated under the BCA. The BBA of 2019 is the fourth such deal.

Had politicians failed this time around to pass a two-year budget deal to lift the BCA caps, $125 billion in automatic spending cuts—0.6% of GDP—would have kicked in next year. A fiscal consolidation of that size would have come at a time when the U.S. seems to be at a greater risk of a recession than at any other point in this expansion.

Under the BBA of 2019, the defense budget will expand from $716 billion currently to $738 billion in fiscal 2020 and $741 billion in fiscal 2021. The nondefense budget will increase from its present level of

$620 billion to $632 billion in fiscal 2020 and $635 billion in fiscal 2021. All told, the BBA of 2019 authorizes $320 billion in spending above the BCA caps through fiscal 2021.

In real terms, the BBA of 2019 keeps the fiscal 2020 budget virtually the same as before.



Therefore, much of the Trump-era spending stimulus will be limited to 2018 and 2019. In these two years, the government will have already spent most of the extra money authorized under the BBA of 2018 and disbursed most disaster relief funds that were allocated for Hurricanes Harvey, Irma and Maria, and other disasters.

The BBA of 2019, like its predecessors, was a downright compromise that did not give Democrats or Republicans everything they wanted. Democrats accepted less nondefense spending, including a smaller adjustment for the 2020 census, than House Democrats had sought earlier this year. Similarly, Republicans assented to less defense spending than Senate Republicans had earlier proposed. Fiscal hawks, who wanted the BCA caps to be extended beyond fiscal 2021, had to hold their noses, as the BBA of 2019 effectively put an end to the 2011 law. Finally, the White House agreed to only $77 billion in savings to offset the cost of the deal rather than the $150 billion in cuts it had wanted.

Debt-limit suspension

The second issue the BBA of 2019 resolved was the debt limit, which is the legal maximum amount of Treasury debt outstanding. The statutory limit was reinstated on March 2 with little fanfare, because the Treasury can stay under the debt limit by resorting to accounting gimmicks and dipping into its cash on hand. However, these acrobatics do not last indefinitely. Moody's Analytics had long projected that the drop-dead date for Congress to address the debt limit or risk a catastrophic default by the federal government would fall in October. However, in July, Moody's Analytics noted that there was an emerging risk that the drop-dead date could fall in the first half of September.

Weaker than expected revenue growth was to blame for this risk. Fiscal 2019 revenues are up only 3% from last year's totals, whereas the Congressional Budget Office projected in May that revenue would grow more than 5%. The main culprit has been the corporate tax cuts under the 2017 tax law.

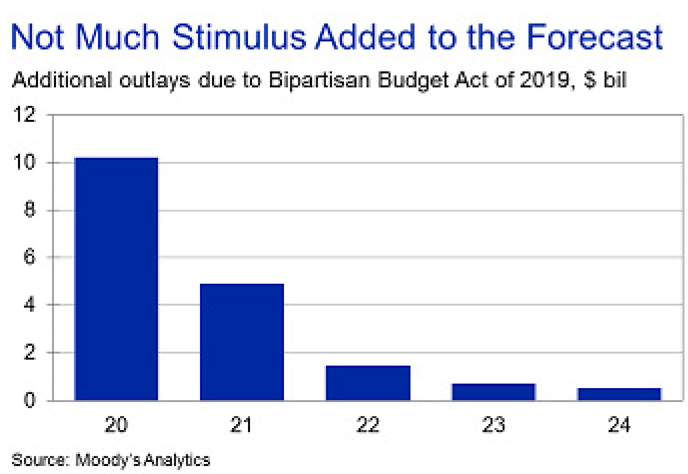
The risk of a September drop-dead date, which Treasury Secretary Steven Mnuchin highlighted to congressional leaders in a July 12 letter, seems to have played a big role in the swift passage of the BBA of 2019. The bipartisan compromise suspends the debt limit until July 31, 2021, removing a key risk for financial markets. Throughout July, Treasury markets were craving a resolution to the debt-limit impasse, with yields elevated on Treasury bills maturing in September.

From a political perspective, the two-year suspension ensures the debt limit will not be a powder keg before the 2020 election.

Outlook

The Moody's Analytics baseline forecast has changed little in response to the BBA of 2019. The baseline assumption had long been that lawmakers would arrive at a bipartisan compromise to prevent the automatic budget cuts from happening. However, the BBA of 2019 does add a bit more stimulus than expected. Prior forecasts assumed lawmakers would authorize little more than $300 billion in spending above the BCA caps in fiscal 2020 and fiscal 2021. As a result, the BBA of 2019 included $18 billion in spending that Moody's Analytics did not anticipate.

As a rule of thumb, little more than half of an additional dollar in congressional appropriations is spent in the first year. Slightly more than a quarter of that dollar is then spent in the second year, with the remainder paid out in the subsequent three years. Based on this spendout rate, provided by the CBO, Moody's Analytics has added $10.1 billion to nominal federal spending in fiscal 2020, $4.9 billion in fiscal 2021, and $1.5 billion in fiscal 2022.



After that, the amounts of annual spending added to the forecast are less than $1 billion. These adjustments to the forecast are not game changers. For perspective, the extra $10.1 billion in fiscal 2020 spending comes to only 0.05% of GDP.

The BBA of 2019 all but ensures trillion-dollar deficits in the next years. The Moody's Analytics baseline forecast puts the deficit at $930 billion in fiscal 2019, $1 trillion in fiscal 2020, and $1.2 trillion in fiscal 2021. In contrast, the CBO's May budget projections do not pencil in trillion-dollar deficits until fiscal 2022. The CBO assumes current law and did not bake into its May forecast the possibility that lawmakers would raise the BCA caps through fiscal 2021. Now that the BBA of 2019 is current law, the CBO will most likely revise its deficit forecast closer to that of Moody's Analytics. Moreover, in the CBO's next update, we would expect it to raise its projected debt-to-GDP ratio for fiscal 2029 from 92% to about 98%.

Risks

In September, Congress will have to agree on specific funding levels for each agency whose budget relies on the annual appropriations process. If lawmakers cannot agree on the details of the fiscal 2020 budget, then Washington DC would be at risk of another partial government shutdown on October 1.

The BBA of 2019 does reduce the risk of a shutdown. However, in past budget battles, averting automatic budget cuts—and establishing top-line spending numbers—has been the easiest part. Where partisan conflict has flared up the most is when lawmakers start digging into the details of a budget. Take the most recent shutdown as an example. The president's $5.7 billion request for a southern border wall was less than 0.5% of the current budget. However, its political significance was large enough to shut down part of the government for a record 35 days.

Though the debt limit will not be an issue for the next two years, it will remain a persistent threat in the long run. Debt-limit impasses cost the U.S. taxpayer, imperil the full faith and credit of the government, and are not effective in controlling federal outlays. No matter which party controls the White House after the 2020 election, Congress is expected to be divided. Therefore, lawmakers are not guaranteed to address the debt limit in a reasonably graceful manner after it is reinstated in July 2021.

Looking ahead

The economic calendar remains busy next week. The key data include employment, vehicle sales, ISM surveys, interntional trade and jobless claims.

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

EUROPE

By Barbara Teixeira Araujo of Moody's Analytics

A Crucial Week for Brexit

Next week is crucial for Brexit. In an extremely controversial move, U.K. Prime Minister Boris Johnson announced Wednesday that he will suspend parliament by mid-September and until October 14, significantly reducing the time available for lawmakers to attempt legislation preventing a no-deal Brexit on October 31. Several Members of Parliament already announced that they will do their best to legislate rapidly before the start of the suspension to prevent the worst-case scenario. That's because Johnson's agenda is to take the U.K. out of the EU on October 31 with or without a deal. Given that the chances of a breakthrough deal in the next two months are slim, the most likely way forward for him would be to the cliff edge. No one doubts that Johnson would go through with it, even if a majority of parliament is clearly against no deal.

A no-confidence vote on the government remains a possibility, as we think that Labour would not hesitate to call for one if attempts to pass legislation have failed. If the vote takes place, it is highly likely that the government would lose. We expect the opposition to present a united front against Johnson, while several Conservative lawmakers have also announced they would vote against their party if this is what it takes to avoid the cliff edge. Indeed, an important number of Tory MPs have demonstrated they are extremely unhappy with Johnson's move. They claim that closing parliament in such a crucial moment is undemocratic.

If the government lost a no-confidence vote, there are two scenarios. First, Labour leader Jeremy Corbyn could get enough support to form a short-term caretaker government with the sole purpose of asking the EU for a further extension of Article 50. We think that the EU would not refuse the U.K.'s request. Corbyn would then call a general election, to be held by November. And if Corbyn fails to get support, a general election would be called anyway. While this would complicate the request for another extension of Article 50, we think that ultimately the EU and U.K. would find some way to avoid no deal. The other option is for Boris Johnson to call an election in the aftermath of a successful no-confidence vote. We think this is the most likely scenario, because Johnson would want to stop Labour from coming to power even short term.

The problem is that support for the Conservatives has risen lately. The Conservatives had lost a lot of vote intentions to the Brexit Party over the past year. But with hardliner Johnson coming to power, Leave voters are now saying they would support the Torys once again. Election results could be close, and what would matter most are the platforms on which the opposition parties would run. We think it is more likely than not that Labour and the Liberal Democrats would run on putting the vote back to the people in a form of a new referendum or a vote on a new Brexit deal. This would raise the chances of Brexit being cancelled.

If MPs' legislative efforts next week fail, and Johnson doesn't face a confidence vote (or faces it and wins), parliament would be back on October 14 for a Queen's speech setting out Johnson's domestic priorities and likely a new proposal for a Brexit deal. Three days later, Johnson would attend the European Council with the sole objective of making EU leaders agree to his new deal. Given recent comments from EU politicians, the chances of a breakthrough are slim, since as of now Johnson hasn't presented a solution to the deadlock. If no deal is agreed, the default option would be the no-deal exit on October 31. If there is a breakthrough, the deal would be put to parliamentary vote in the U.K. A majority of MPs would need to vote for it in order to avoid no deal on October 31. And again there will also be the possibility of a no-confidence vote being called by the opposition in the last two weeks of October.

All in, the possibilities are many, but the main story is that the chances of a no deal Brexit have increased. We still don't make it our baseline, though, since we think that the chances of Johnson losing a no-confidence vote are high. We currently have them at 30%, up from 25% previously.

	Key indicators	Units	Moody's Analytics	Last
Wed @ 10:00 a.m.	Euro Zone: Retail Sales for July	% change	-0.6	1.1
Thur @ 2:00 p.m.	Russia: Consumer Price Index for August	% change	4.6	0.2
Fri @ 7:00 a.m.	Germany: Industrial Production for July	% change	-0.4	-1.5
Fri @ 9:00 a.m.	Italy: Retail Sales for July	% change	-1.0	1.9
Fri @ 10:00 a.m.	Euro Zone: GDP for Q2	% change	0.2	0.4
Fri @ 11:30 a.m.	Russia: Monetary Policy for September	%	7.25	7.25

ASIA-PACIFIC

By Katrina Ell of Moody's Analytics

Hard Commodity Exports Boost Australia's Economy

Australia's June quarter GDP data will likely show the economy grew 0.6% q/q, stronger than the 0.4% expansion in the March quarter. Net exports will remain a bright spot, thanks to the strength of hard commodity exports receiving an additional boost from the subdued Australian dollar. Ongoing strength in the hard commodity sector is such that Australia is on track to record its first current account surplus in 46 years. While Australia's export sector is exposed to weakened global conditions, around 80% of what is exported to China stays there and China's pickup in fiscal spending including via infrastructure spending will continue to support demand for Australia's iron ore exports.

The Reserve Bank of Australia will leave the cash rate at 1% in September, after also staying put in August. It has reduced the cash rate by a cumulative 50 basis points in 2019, with the latest reduction occurring in July. The RBA has a tough task in trying to fire up wage growth, reduce spare labor market capacity, and provide a broader lift to underperforming GDP growth. The stimulus it has provided, alongside more expansionary fiscal policy, will not do that, particularly with the undesirable global backdrop of rife uncertainty. We expect a 25-basis point reduction in October, bringing the cash rate to 0.75%. The general consensus is that some form of quantitative easing will be introduced when the cash rate hits 0.5%. More expansionary fiscal policy is needed to shore up the particular weak spots, especially the household sector.

South Korea's August foreign trade data will be closely watched, as it is a reasonable barometer for Asia's other large exporters. Exports are expected to stay weak, after they contracted for an eighth straight month in July, with an 11.1% y/y fall after a 14.9% drop in June. Tech products are an important source of weakness; semiconductors were down by 28% in July, and shipments to China also struggled and fell by 16.3% y/y. Trade tensions with Japan are a dark cloud on the already weak export outlook.

	Key indicators	Units	Confidence	Risk	Moody's Analytics	Last
Mon @ Unknown	South Korea foreign trade for August	US$ bil	2	←	2.9	2.4
Tues @ 9:00 a.m.	South Korea Consumer price index for August	% change yr ago	3	←	0.6	0.6
Tues @ 11:30 a.m.	Australia Retail sales for July	% change	3	↑	0.2	0.4
Tues @ 2:30 p.m.	Australia Monetary policy for September	%	3	↓	1.0	1.0
Wed @ 11:30 a.m.	Australia GDP for Q2	% change	3	↓	0.6	0.4
Wed @ 2:00 p.m.	Malaysia Foreign trade for July	MYR bil	3	←	8.9	10.3
Thurs @ 11:30 a.m.	Australia Foreign trade for July	A$ bil	3	←	6.3	8.0

The Long View

Current pockets of speculative excess are marked by elevated costs and outright losses.

By John Lonski, Chief Economist, Moody's Capital Markets Research Group
August 29, 2019

CREDIT SPREADS

As measured by Moody's long-term average corporate bond yield, the recent investment grade corporate bond yield spread of 125 basis points is wider than its 122-point mean of the two previous economic recoveries. This spread may be no wider than 130 bp by year-end 2019.

The recent high-yield bond spread of 461 bp is thinner than what is suggested by both the accompanying long-term Baa industrial company bond yield spread of 198 bp and the recent VIX of 17.9 points.

DEFAULTS

July 2019's U.S. high-yield default rate was 3.0%. The high-yield default rate may average 3.2% during 2020's first quarter, according to Moody's Investors Service.

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.

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.

Fourth-quarter 2018's worldwide offerings of corporate bonds incurred annual setbacks of 23.4% for IG and 75.5% for high-yield, wherein US$-denominated offerings plunged by 26.1% for IG and by 74.1% for high yield.

First-quarter 2019's worldwide offerings of corporate bonds revealed annual setbacks of 0.5% for IG and 3.6% for high-yield, wherein US$-denominated offerings fell by 3.0% for IG and grew by 7.1% for high yield.

Second-quarter 2019's worldwide offerings of corporate bonds revealed an annual setback of 2.5% for IG and an annual advance of 17.6% for high-yield, wherein US$-denominated offerings sank by 12.4% for IG and surged by 30.3% for high yield.

During yearlong 2017, worldwide corporate bond offerings increased by 4.1% annually (to $2.501 trillion) for IG and advanced by 41.5% for high yield (to $603 billion).

For 2018, worldwide corporate bond offerings sank by 7.2% annually (to $2.322 trillion) for IG and plummeted by 37.6% for high yield (to $376 billion). The projected annual percent increases for 2019's worldwide corporate bond offerings are 2.4% for IG and 21.5% for high yield. When stated in U.S. dollars, issuers based outside the U.S. supplied 60% of the investment-grade and 57% of the high-yield bond offerings of 2019's first half.

The Long View

US ECONOMIC OUTLOOK

As inferred from the CME Group's Fed Watch Tool, the futures market recently assigned an implied probability of 96% to a cutting of the federal funds rate at the September 18, 2019 meeting of the Federal Open Market Committee. 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 2.00% 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 Michael Grammatikopoulos of Moody's Analytics
August 29, 2019

GREECE

With the escalating U.S.-China trade war and Brexit creating so much uncertainty, an upcoming recession in the global economy seems quite plausible. The Federal Reserve cut its interest rates for the first time in 10 years, while a plethora of countries have deeply negative money market rates. But while the rest of the world is on rocky ground, Greece seems to be moving toward a more stable path for its economy and its politics.

The last decade treated Greeks roughly, to say the least. Skyrocketing unemployment, heavy taxation, an exodus of the most productive labour force seeking employment abroad, four years of capital controls, and multiple clashes with its European partners combined with a referendum that pushed Greece to the brink of a euro zone exit did not bode well for the future. The country's GDP contracted by a painful 25%, one of the sharpest in history during peacetime, comparable only to the Great Depression. But now, the tide seems to be turning.

The regional and European parliamentary elections in May left the ruling left-wing Syriza party defeated, setting the stage for a government change. Promises of an improved investment environment, tax cuts, and new jobs landed liberal-conservative Kyriakos Mitsotakis as the winner in the snap national elections on July 7. While in Europe it is customary to have coalition governments, Prime Minister Mitsotakis' New Democracy party gained almost 40% of the ballot, with voters entrusting them the absolute majority in parliament.

A grand re-entrance

Markets received these developments well, as Greece is now bucking the global trend. Stock prices have been rising to levels seen before 2015, with the Athex index now stabilized at a new mean.

After a prolonged absence from markets, Greece successfully issued five-year bonds in January, setting firm ground for further normalization. Following its credit rating upgrade in March, Greece issued 10-year government bonds—its first 10-year benchmark since 2010. Offers far exceeded initial projections, showing that investor trust had been gradually returning, an essential factor to boosting the recovery. Just three months after, the 10-year bond interest slid to about 2% in July from 3.88% in March, while the five-year benchmark stands at about 1.2%.

The national election results further brightened the country's positive outlook. The Bank of Greece felt confident enough to add another point to the yield curve, issuing seven-year bonds with a yield of 1.9% and a coupon of 1.875%. The country's Public Debt Management Agency reports that these are the lowest yields and coupons Greece has achieved in a euro-dominated syndication. This also marks the first time since 2010 that Greece has managed to borrow from markets with three benchmarks in the same year.

Rising expectations should prevent Greece from getting dragged into the global slowdown in the short run, but for the economy to maintain its upbeat outlook in the long run, the government needs to enact pivotal structural reforms. Granted, the former government had already set to work on enforcing stricter penalties to crack down on shadow employment, reducing VAT, investing in infrastructure, and cutting bureaucratic red tape. All of these will benefit the economy if the new government delivers on its pledge to build upon them and on its promise to prioritize investment.

The Long View

Betting on Elliniko

A case in point is the investment in the former Elliniko airport in Athens, where development has been stalled for years because of bureaucratic red tape. The project aims to build a complex of luxury residences, hotels, and a yacht marina to the tune of about €8 billion and would bring employment to more than 70,000 people. The previous government had laid the ground for the project, and the current minister of Development and Investment has promised to fast-track it so that construction can begin at the end of 2019.

Investment into Elliniko is pivotal. It is seen as a benchmark by domestic and foreign investors regarding Greece's ability to create a viable, friendlier business environment. The ministry aims to remove some of the hurdles to creating new businesses by minimizing bureaucracy and increasing automation and technology, in the hope that this will improve efficiency and encourage entrepreneurship.

Regarding fiscal policy, the government has announced VAT cuts while parliament has voted for a new progressive tax cut for property owners. The new law shaves 30% off the tax burden on small-property owners, grants medium to large properties a 20% reprieve, and offers very large properties a tax cut of 10%.

Tax cuts to the rescue

The parliamentary bipartisanship and populist trends seem to be fading, as former Prime Minister Alexis Tsipras and his Syriza party voted with Mitsotakis in favor of these tax cuts. Minister of Finance Christos Staikouras further announced a decrease of the targeted primary budget surplus, while the discrepancy between the interest rates of government and private debt will vanish, with both rates equalizing to 3%.

Bank of Greece Governor Yannis Stournaras asked for the complete removal of capital controls from the government, as the central bank sees no further need for the measure. Prime Minister Mitsotakis recently announced that these restrictions will be completely removed by September. The aim is to regain depositors' trust and to return the billions of withdrawals that took place in 2015 back to the banks' coffers.

The additional income these tax cuts provide will boost consumption and have positive spillovers to deposits, meaning more capital can be accumulated. Eventually, enough trust will be earned for banks to grant more small-business loans. All this will allow more bond issuance with even lower interest rates, and in the medium to long run the debt-to-GDP ratio will start to decrease as GDP growth will be greater than debt accumulation.

The raft of measures aims to heat up the first quarter's lukewarm GDP growth of just 1.3%. We are cautiously optimistic and have revised up our full-year GDP estimate for Greece to 1.5% from 1.4%. But just how successful the numerous reforms and the bond issuances will be in helping the economy take off in the last quarter of this year depends on how effectively the reforms are implemented and on how the trade war plays out.

ASIA PACIFIC

By Katrina Ell of Moody's Analytics
August 29, 2019

THE FRAGILE GLOBAL ECONOMY

Expectations guide economic behavior. Assumptions about the future influence the decisions of households, firms and governments in the present. If economic conditions are expected to worsen, actions are adjusted accordingly. Businesses and households are less likely to take advantage of lower borrowing costs and make expansion plans for the future. Instead, they will buckle down and prepare for deterioration.

The global economy is fragile, and fears of a global downturn have increased in recent weeks. Concerns that the cyclical global slowdown could evolve into something more severe have been driven by the U.S.-China trade war moving back to escalation phase, alongside other geopolitical risks that include Brexit and renewed tensions in the Middle East. In recent weeks, our odds of a global recession in the next 12 months have increased to 50%.

Falling bond yields track the deteriorating outlook

Long-term government bond yields provide a useful way to track downward revisions to the economic outlook. When 10-year government bond yields fall, it is a symptom of higher risk aversion amid current economic conditions. Global 10-year bond yields have fallen across developed markets, including in Asia, as a consequence of lower growth and inflation forecasts and expectations for central bank policy rates.

Long-term yields have been trending lower for years on structural factors such as slowing productivity and aging population. But the downward slope has steepened this year. The downtrend led Japan's 10-year yield to fall in mid-August below the Bank of Japan's preferred range of 0.2% to -0.2%.

A vicious cycle has emerged. The downtrend in global bond yields is being exacerbated by negative yields in Europe and Japan, forcing funds into alternative bonds, and pushing down yields on those alternatives.

Asia's in rate-cut mode

Central banks in Asia are in rate-cut mode. In August alone, New Zealand, Thailand, the Philippines and India all cut their policy rates. A common theme was that they are concerned about the implications of the growing trade war between the U.S. and China. Three out of these four central banks surprised with a greater-than-expected rate cut. On the one hand these central banks are easing monetary policy to shore up domestic demand. But they are also using lower policy rates to put additional downward pressure on their currencies. For many Asian economies, exports are a critical driver of overall economic performance. With exports already struggling, the weaker exchange rate is an important channel for stimulus.

Thailand is a good example. The Bank of Thailand joined the easing bandwagon earlier than expected, with its Monetary Policy Committee voting 5-2 to cut rates in August. The strength of the baht appeared to be the primary driver. The BoT had only recently stated that easing policy wouldn't do much for the baht given that real interest rates were already low. But with so many central banks in Asia and farther abroad turning even more dovish, the BoT apparently felt backed into a corner. The baht has been Asia's best-performing currency this year by appreciating almost 5% against the dollar. So, the baht probably would have strengthened further had the central bank not eased amid the ultra-dovish environment. This would be problematic for Thailand's struggling export sector. Exports fell by 6.1% y/y in the June quarter, unchanged from the pace in the March quarter. But Thailand's easier monetary settings don't address the underlying reasons for the strong baht, including the rising current account surplus and hefty foreign reserves, both attractive to investors in the jittery global environment.

The yen and Japan's ailing exports

We used our global macroeconomic model to examine the impact of a sharp depreciation in the yen on Japan's exports. We took the extreme circumstance where the yen falls by 10% in the December quarter of 2019 and a further 5% in the March quarter of 2020, with no rebound incorporated. This has significant benefits for Japan's important export sector. In the depreciation scenario, exports are forecast to rise by 3.7% in 2020, stronger than the baseline forecast of 2.9%. Annual export growth remains stronger than the baseline in the depreciation scenario through 2024.

A weaker yen could help lift exports from their current funk. Exports fell by 1.6% in July, marking the eighth straight decline, from a 6.7% slide in June. The decline in exports was fairly broad-based but weighed down by sharp contractions in electrical machinery (including semiconductors) and other machinery, along with double-digit declines in transport equipment such as auto parts and motorcycles.

A weaker yen has broader economic spillovers than exports. These include lifting company profits for large export-facing firms such as automakers and tech producers, and there are consequent spillovers to higher income growth, consumption and imported inflation.

This sensitivity analysis bolsters the argument for the Bank of Japan to follow the lead of other central banks in Asia by increasing the stimulus taps. Doing so could bring downward pressure on the yen, which has appreciated by 3% year to date and 4.5% against the dollar in the past year. The yen's haven status means that it remains attractive during the global doom and gloom.

Ratings Round-Up

Downgrades for the Majority of U.S. and Europe Rating Activity

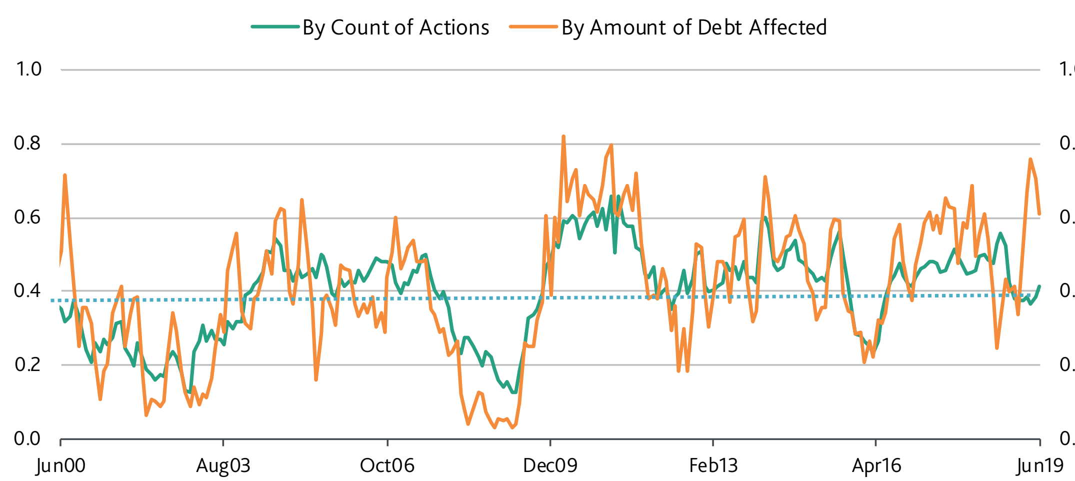
By Steven Shields

U.S. rating change activity was primarily negative for the period ending August 23. Positive rating changes accounted for only 20% of total activity, significantly less than the trailing three-month average. Downgrades were limited to just one investment-grade firm with other downgrades occurring to highly and extremely speculative-grade companies. Downgrades also accounted for 70% of total affected debt in the period. Last week's upgrades included Keysight Technologies Inc., which saw its senior unsecured debt rating upgraded to Baa2 from Baa3. The rating change reflects the firm's leading position in the Electronic-test-instrument industry among other segments and strong liquidity due to its consistent generation of positive free cash flow. The upgrade affected $1.8 billion in debt. Meanwhile, the largest downgrade in terms of debt affected was Realogy Group LLC. The real estate services company saw a slight downgrade from B2 to B3, largely stemming from high leverage and the volatile and cyclical nature of its business. The credit outlook remained negative. The recent trend in rating change activity is symptomatic of an economy navigating the later stages of economic expansion. Over the past year, weekly rating changes have been mostly concentrated among smaller, speculative-grade companies. Although these rating actions have been mostly negative, the downgrades are largely the result of idiosyncratic factors and not a weakness in the broader economy. Overall market issuance in U.S. corporate and financial institutions is on track to outpace last year but is trending 15% below its August 2017 level.

European rating activity was similarly weak during the period, with downgrades outnumbering upgrades 3:1. Downgrades were responsible for more than 90% of total affected debt. The most significant negative rating change, in terms of impacted debt, was to German industrial firm Thyssenkrupp AG. The company's credit downgrade to Baa3 from Baa2 mirrors the company's recent decline in corporate earnings, increased leverage, and continued negative free cash flow. The lone European upgrade was assigned to manufacturer Dometic Group AB. The firm's credit rating saw an upgrade on its senior unsecured debt to Ba2 from Ba3 supported by favorable industry trends, leading market position across niche markets, and consistently high profitability.

FIGURE 1

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



* Trailing 3-month average

Source: Moody's

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
8/14/19	DEAN FOODS COMPANY	Industrial	SrUnsec /LTCFR/PDR	700	D	Caa2	Caa3	SG
8/14/19	OMNIMAX HOLDINGS, INC.-OMNIMAX INTERNATIONAL, INC.	Industrial	LTCFR/PDR		D	Caa1	Caa2	SG
8/14/19	REALOGY GROUP LLC	Industrial	SrUnsec/SrSec /BCF/LTCFR/PDR	1,600	D	B2	B3	SG
8/14/19	KEYSIGHT TECHNOLOGIES, INC.	Industrial	SrUnsec/LTIR	1,800	U	Baa3	Baa2	IG
8/14/19	Q HOLDCO, LLC-Q HOLDING COMPANY	Industrial	PDR		U	Caa1	B3	SG
8/14/19	LSC COMMUNICATIONS, INC.	Industrial	SrSec/BCF /LTCFR/PDR	450	D	B2	B3	SG
8/15/19	DOMINION ENERGY, INC. -QUESTAR GAS COMPANY	Utility	SrUnsec/MTN/CP	100	D	A2	A3	IG
8/16/19	DELUXE ENTERTAINMENT SERVICES GROUP, INC.	Industrial	SrSec/BCF /LTCFR/PDR		D	B3	Caa2	SG
8/16/19	MCDERMOTT INTERNATIONAL, INC.-MCDERMOTT TECHNOLOGY (AMERICAS), INC.	Industrial	SrUnsec/SrSec/BCF/LTCFR/PDR	1,300	D	B3	Caa1	SG
8/19/19	ZEBRA TECHNOLOGIES CORPORATION	Industrial	LTCFR/PDR		U	Ba2	Ba1	SG
8/21/19	CAMPING WORLD HOLDINGS INC. -CWGS ENTERPRISES, LLC	Industrial	SrSec/BCF /LTCFR/PDR		D	B1	B2	SG
8/22/19	CPK HOLDINGS, INC.-CALIFORNIA PIZZA KITCHEN, INC. (CPK)	Industrial	SrSec/BCF /LTCFR/PDR		D	B2	B3	SG
8/23/19	CHIEF POWER FINANCE, LLC	Industrial	SrSec/BCF		D	B3	Caa1	SG

Source: Moody's

Ratings Round-Up

FIGURE 4

Rating Changes: Corporate & Financial Institutions – Europe

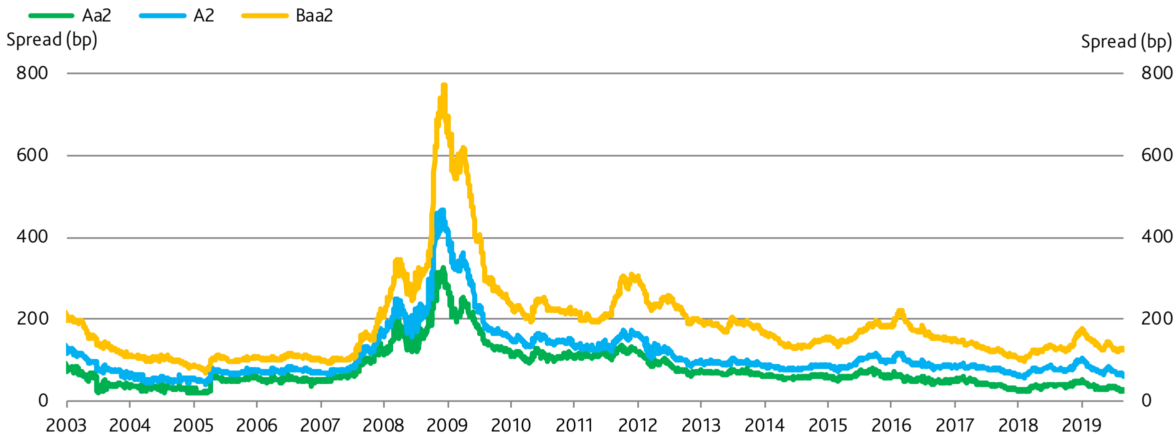
Date	Company	Sector	Rating	Amount ($ Million)	Up/ Down	Old LTD Rating	New LTD Rating	IG/ SG	Country
8/14/19	THYSSENKRUPP AG	Industrial	SrUnsec/LTCFR /PDR/MTN	5,597	D	Ba2	Ba3	SG	GERMANY
8/14/19	PERI-WERK ARTUR SCHWOERER GMBH & CO. KG-PERI GMBH	Industrial	LTIR		D	Baa2	Baa3	IG	GERMANY
8/14/19	LECTA S.A.	Industrial	SrSec /LTCFR/PDR	666	D	B2	B3	SG	LUXEMBOURG
8/19/19	DOMETIC GROUP AB	Industrial	SrUnsec/LTCFR /PDR/MTN	666	U	Ba3	Ba2	SG	SWEDEN

Source: Moody's

Market Data

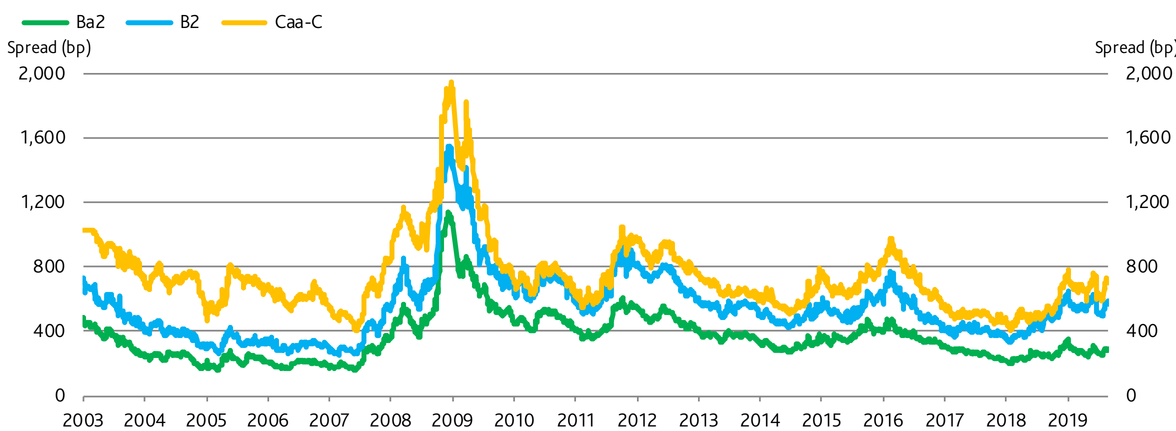
Spreads

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

Market Data

CDS Movers

Figure 3. CDS Movers - US (August 21, 2019 – August 28, 2019)

CDS Implied Rating Rises	CDS Implied Ratings		
Issuer	Aug. 28	Aug. 21	Senior Ratings
Altria Group Inc.	A2	Baa1	A3
Bank of America Corporation	A2	A3	A2
HCA Inc.	Baa3	Ba1	Ba2
Johnson & Johnson	Aa2	Aa3	Aaa
Target Corporation	Aa1	Aa2	A2
Welltower Inc.	Baa3	Ba1	Baa1
Archer-Daniels-Midland Company	Baa2	Baa3	A2
ERAC USA Finance LLC	Baa2	Baa3	Baa1
Boston Scientific Corporation	Aa2	Aa3	Baa2
Lennar Corporation	Baa3	Ba1	Ba1

CDS Implied Rating Declines	CDS Implied Ratings		
Issuer	Aug. 28	Aug. 21	Senior Ratings
Pride International, Inc.	C	Caa2	Caa1
Ford Motor Credit Company LLC	B1	Ba3	Baa3
Comcast Corporation	A2	A1	A3
Ford Motor Company	B1	Ba3	Baa3
Amgen Inc.	A2	A1	Baa1
General Electric Company	Ba3	Ba2	Baa1
U.S. Bancorp	Aa3	Aa2	A1
National Rural Utilities Coop. Finance Corp.	A1	Aa3	A2
International Paper Company	Baa1	A3	Baa2
Cardinal Health, Inc.	Ba2	Ba1	Baa2

CDS Spread Increases		CDS Spreads		
Issuer	Senior Ratings	Aug. 28	Aug. 21	Spread Diff
Pride International, Inc.	Caa1	1,211	656	555
Rite Aid Corporation	Caa2	1,996	1,842	154
Nabors Industries Inc.	B1	773	709	64
Unisys Corporation	B2	458	403	55
AK Steel Corporation	B3	888	845	43
Office Depot, Inc.	B3	505	466	39
Frontier Communications Corporation	Caa3	5,178	5,145	33
Chesapeake Energy Corporation	B2	1,233	1,201	32
American Axle & Manufacturing, Inc.	B2	467	438	29
Mattel, Inc.	B3	378	356	22

CDS Spread Decreases		CDS Spreads		
Issuer	Senior Ratings	Aug. 28	Aug. 21	Spread Diff
Dean Foods Company	Caa3	3,662	4,350	-688
Neiman Marcus Group LTD LLC	Ca	4,727	5,055	-328
Penney (J.C.) Corporation, Inc.	Caa3	4,483	4,636	-153
Pitney Bowes Inc.	Ba2	572	663	-91
R.R. Donnelley & Sons Company	B3	691	771	-80
DPL Inc.	Ba1	319	352	-33
Realogy Group LLC	B3	792	821	-29
SLM Corporation	Ba2	230	251	-21
International Game Technology	Ba2	188	209	-21
Univision Communications Inc.	Caa2	336	355	-19

Source: Moody's, CMA

Market Data

Figure 4. CDS Movers - Europe (August 21, 2019 – August 28, 2019)

CDS Implied Rating Rises	CDS Implied Ratings		
Issuer	Aug. 28	Aug. 21	Senior Ratings
Spain, Government of	A1	A2	Baa1
Deutsche Bank AG	Baa2	Baa3	A3
Portugal, Government of	A1	A2	Baa3
ING Bank N.V.	Aaa	Aa1	Aa3
Credit Agricole S.A.	Aa1	Aa2	A1
Bankia, S.A.	Baa2	Baa3	Baa3
Credit Agricole Corporate and Investment Bank	Aa1	Aa2	A1
CaixaBank, S.A.	Baa2	Baa3	Baa1
Nationwide Building Society	A3	Baa1	Aa3
Bankinter, S.A.	Baa1	Baa2	Baa1

CDS Implied Rating Declines	CDS Implied Ratings		
Issuer	Aug. 28	Aug. 21	Senior Ratings
Valaris plc	C	Caa2	Caa1
ING Groep N.V.	A2	A1	Baa1
Danske Bank A/S	A1	Aa3	A2
Standard Chartered Bank	Aa3	Aa2	A1
UniCredit Bank Austria AG	Baa1	A3	Baa1
DZ BANK AG	Baa2	Baa1	Aa1
UniCredit Bank AG	Baa2	Baa1	A2
Siemens Aktiengesellschaft	Aa1	Aaa	A1
Altice Finco S.A.	B3	B2	Caa1
Italy, Government of	Ba3	Ba3	Baa3

CDS Spread Increases		CDS Spreads		
Issuer	Senior Ratings	Aug. 28	Aug. 21	Spread Diff
Valaris plc	Caa1	1,115	604	511
PizzaExpress Financing 1 plc	Caa2	6,333	6,223	111
Jaguar Land Rover Automotive Plc	B1	760	724	36
Matalan Finance plc	Caa1	904	884	20
Altice Finco S.A.	Caa1	304	286	18
Eurobank Ergasias S.A.	Caa1	784	769	15
National Bank of Greece S.A.	Caa1	607	595	12
Hammerson Plc	Baa1	174	165	9
Iceland Bondco plc	Caa2	435	429	6
Anglo American plc	Baa2	89	86	3

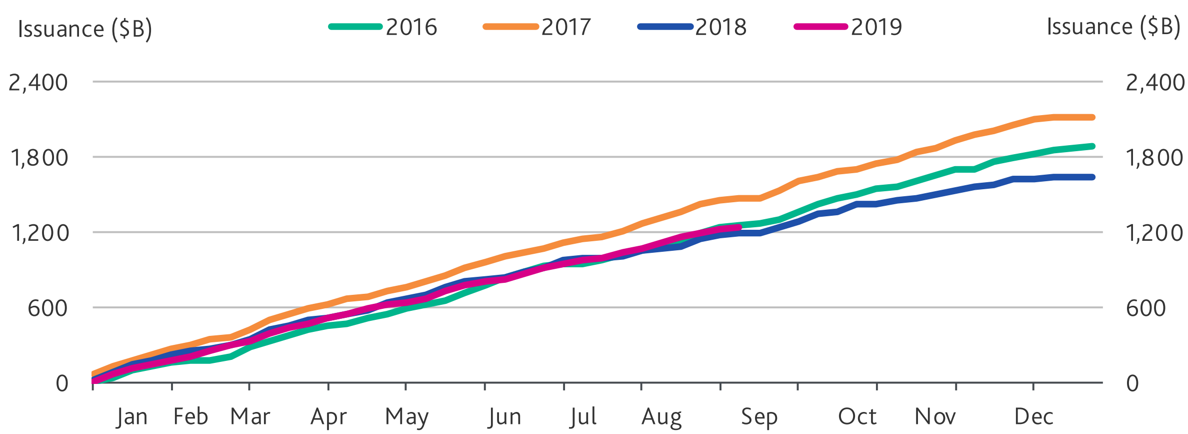
CDS Spread Decreases		CDS Spreads		
Issuer	Senior Ratings	Aug. 28	Aug. 21	Spread Diff
Boparan Finance plc	Caa1	3,467	3,854	-386
Vedanta Resources Limited	B2	434	509	-75
Novafives S.A.S.	Caa1	527	571	-44
Casino Guichard-Perrachon SA	B1	794	827	-33
Selecta Group B.V.	Caa1	236	262	-27
Greece, Government of	B1	251	276	-25
Italy, Government of	Baa3	163	185	-21
Intesa Sanpaolo S.p.A.	Baa1	100	114	-14
UniCredit S.p.A.	Baa1	95	109	-14
CMA CGM S.A.	B3	1,386	1,400	-14

Source: Moody's, CMA

Market Data

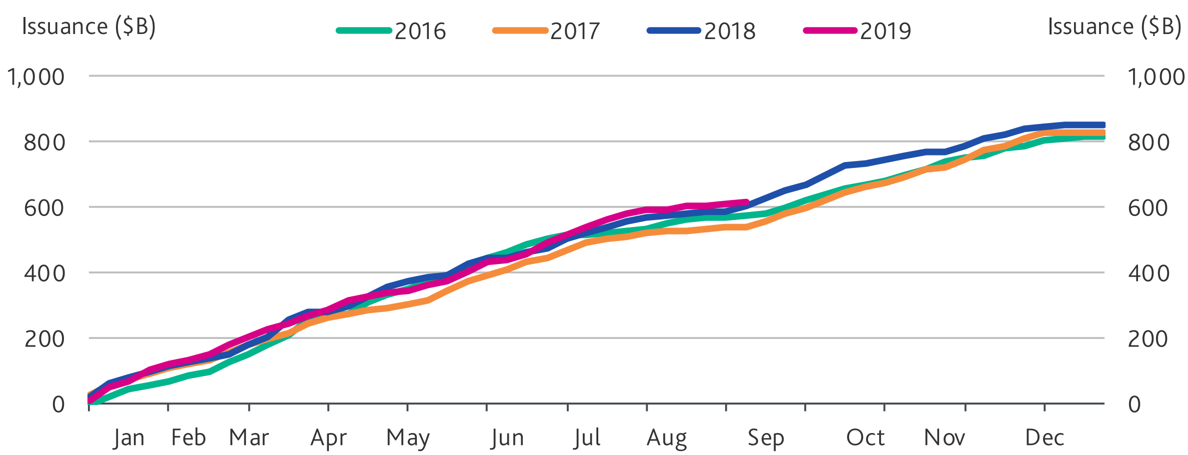
Issuance

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	10.603	1.277	12.176
Year-to-Date	901.129	277.370	1,243.717

	Euro Denominated		
	Investment-Grade	High-Yield	Total*
	Amount $B	Amount $B	Amount $B
Weekly	4.713	0.000	4.863
Year-to-Date	536.939	58.594	613.530

* Difference represents issuance with pending ratings.

Source: Moody's/ Dealogic

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