Macro Keys
2016 US IG Outlook: How The Dominos Will Fall?

Economics & Macro Strategy

Global

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A shaky foundation lies underneath high-grade corporates

The post-crisis paradigm of Fed QE and the investor bid for yield has escalated risks for high-grade credits. The size of risky BBB non-financial corporates in the high-grade universe has surged to 41%, the highest level ever outside of a recession. Leverage levels easily surpass those seen in 2007, and are closing in on late 1990s levels. And the dearth of non-bank liquidity for lower-quality credits in US high-yield serves as a warning indicator for high-grade investors.

However, high-grade has tailwinds that are distinct from high-yield

Our estimates suggest only a 16% probability of a US recession through Q3'16, providing some comfort that IG spreads will remain relatively insulated from near-term weakness in high-yield. Our recession estimates are low precisely because high-grade firms still face historically low borrowing costs, due to low Treasury yields and a terming out of debt profiles. Lastly, the foreign bid for US IG paper is insatiable and should continue to support medium tenor credits.

Late cycle M&A activity will boost IG issuance regardless of interest rates

One of the common myths perpetuated in the market today is that rising interest rates will cool off a red-hot M&A market. We believe these cycles are driven more by animal spirits and waning earnings. Indeed, the 1999 and 2007 M&A cycles accelerated with rising rates and did not falter until 1 year forward recession probabilities hit 50%. The implications: First, IG issuance will be strong again in 2016 at $1.3tn, a 1% increase from 2015, with upside potential to $1.45tn. Second, credit curves will remain historically steep.

We still prefer banks over non-financials

US banks are a higher-quality segment of the IG universe and they have massively de-levered since the financial crisis. In our view, the main ingredient for US banks to underperform would be a broader downturn in the US economy that fuels rising real-estate losses. We don't think that is a 2016 story.

We prefer A-rated credit, particularly long-duration

BBB spreads do not look cheap. Excluding the impact of the energy/mining sectors, BBB spreads are trading only 7bps wider than A spreads on average. BBB energy spreads provide better pricing, but significant downside looms for pipelines with lower for longer oil prices. We prefer to take extra spread duration in A-rated 10+ credits rather than extra credit risk to generate moderate excess returns. Structurally, investors can hold these bonds *through the credit cycle* as total return instruments by removing the Treasury hedge and positioning for lower Treasury yields as credit cycle risks grow.

Fallen Angels are not a 2016 story, but future risks loom large

We do not expect fallen angels to materialize in 2016, outside of the commodity sectors, as they typically ramp up during US recessions. However, estimates of fallen angel volumes are concerning for the future. In a worst case scenario, we estimate fallen angel volumes could spike to $413bn over a 2-year period, with $117bn of 10+ fallen angel paper hitting a $48bn 10+ HY market. We see this as yet another reason to avoid BBB debt if shorter-run conditions deteriorate more than expected.

Expect wider spreads and modest returns by year-end

We expect IG spreads to remain resilient, though not without spread widening before 2016 is done. YE spread targets are 175-185bps (vs. 170bps currently). We expect excess returns will be between 1.5-2.2%. We expect total returns will be between 1.7%-3.4%, depending on the 2016 trajectory for Treasury yields.

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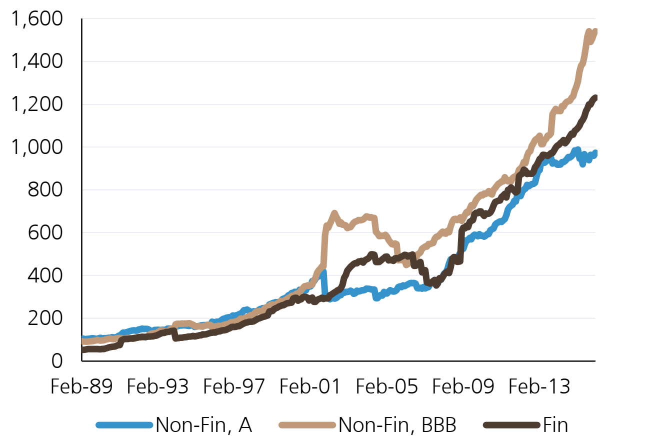
It is no secret to regular readers of our publications that we believe the credit cycle is quite advanced. As discussed in our HY outlook[1], we estimate that nearly $1tn of speculative-grade credits are at risk of default over the next downturn, as the stock of low-quality credit has soared. Recent contagion in US HY from energy woes has severely impacted ex-energy spreads while shutting down bond-market financing for low-quality credits. Our leading measure of non-bank liquidity has now even surpassed the weakness seen during the Eurozone crisis[2]. These developments are a negative headwind for investment-grade corporates in 2016.

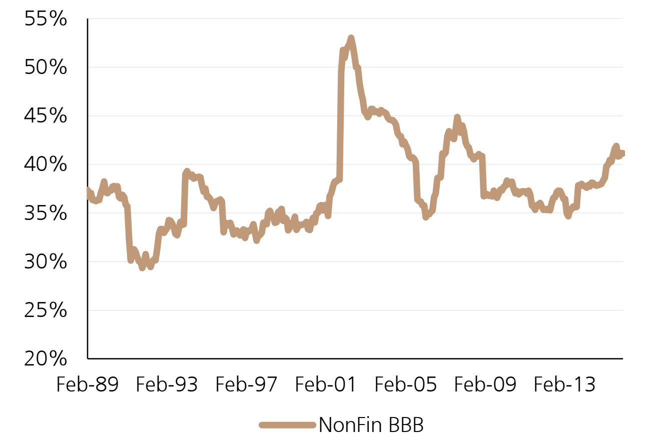
High-grade credits are also not without blemish; the post-crisis macro paradigm of Fed quantitative easing and the investor bid for yield has greatly expanded the size of risky BBB corporates. The total IG corporate universe has grown 110% from $2.08TN in Jan 2009 to $4.35TN today; the amount of BBB debt has ballooned 181% from $0.77TN in Jan 2009 to $2.17TN today (Figure 1). Hence, nearly 63% of the increase in US IG debt has come from the growth of more risky BBB-rated securities. BBB non-financial credits now make up 41% of the total IG market, the highest level ever outside of a recession (Figure 2). Finally, leverage levels are high and climbing higher. The median IG firm's net debt to EBITDA ratio easily surpasses that realized in 2007, and is quickly closing in on late 1990s levels (Figure 3). Combine these headwinds with market volatility and growing market illiquidity and it is no surprise to find IG credit spreads at historically wide levels (Figure 4).

Figure 1: US IG Par Value Outstanding ($bn)



Source: UBS, Yieldbook

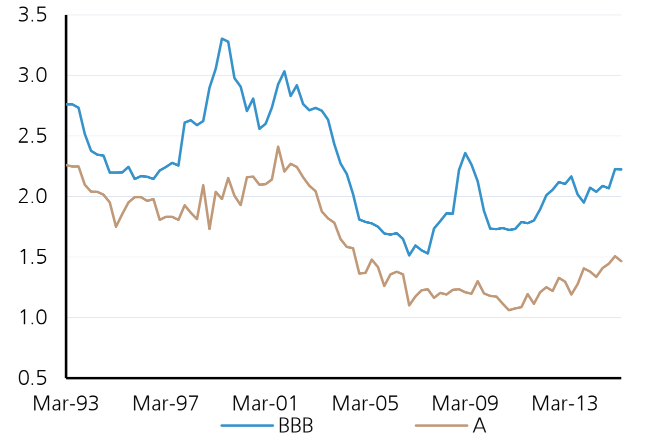
Figure 2: BBB Rated Debt: % of IG Total



Source: UBS, Yieldbook

[1] US high yield outlook: What is the fate of $1tn in stressed credit?, M. Mish, 03-Dec-2016
[2] Non-Bank Liquidity Chilled by Macro Shocks, S. Caprio, 07-Jan-2016

Figure 3: Median Net Debt to EBITDA



Source: UBS, Worldscope

Figure 4: IG Credit Spreads

Source: UBS, Yieldbook

With that said, high-grade issuers do face tailwinds that high-yield firms do not. Our credit based recession indicator is still only signalling a 16% probability of a US recession through Q3'16[3]. This provides some comfort that US IG spreads will remain relatively insulated from near-term weakness in high-yield. In addition, our recession probability is low precisely because high-grade firms still face historically low borrowing costs, due to low Treasury yields and a terming out of debt profiles. The recent uptick in spreads has not materially increased interest burdens for high-grade companies, unlike for junk firms. Lastly, the foreign bid for US IG paper from EUR & JPN investors is currently insatiable and should continue to support medium tenor IG corporates. The foreign bid for US HY cannot compare[4].

What is our prognosis then for 2016? Investors should remain cautious about lower-quality credits and energy names that will expose them structurally to either a broader downturn in the credit cycle or lower for longer commodity prices. For us, that means investors should underweight BBB-rated securities, particularly longer-dated issuers at risk of fallen angel status (i.e. pipelines). We maintain a relative preference for lower beta US banks. Lastly, we believe that A-rated 10+ paper looks attractive, on an excess return basis (Treasury-hedged) tactically and a total return perspective structurally. Against this backdrop, we flesh out our views on the top 2016 themes likely to face high-grade investors and their implications for desired positioning next year.

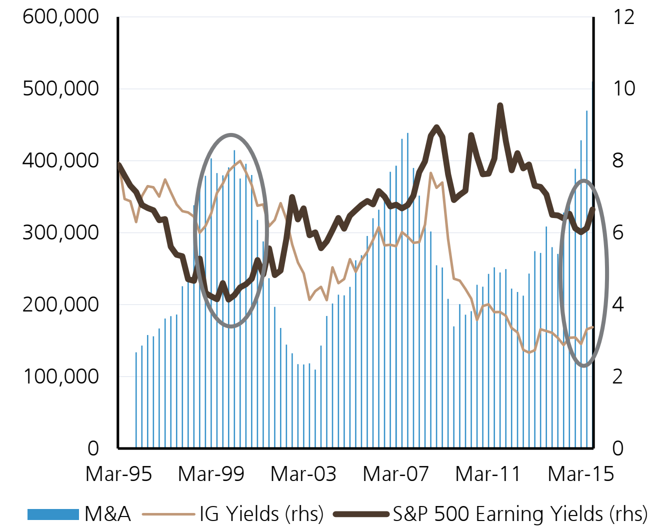
1) M&A will NOT be slowed by rising rates: IG issuance to hit new record

One of the common myths perpetuated in the market today is that rising interest rates will cool off a red-hot M&A market. After all, low rates are spurring on the recent merger boom right? Not quite. In fact, one can make an argument that the presence of both significant M&A activity and low interest rates is more of an historical accident than explaining a fundamental relationship. We believe this cycle, along with those in the past, is driven more by animal spirits and the lack of

[3] Focusing the Credit Lens on the US Economy, S. Caprio, 29-Oct-2015
[4] Is US corporate credit about to catch the flu?, M. Mish, 18-Nov-2015

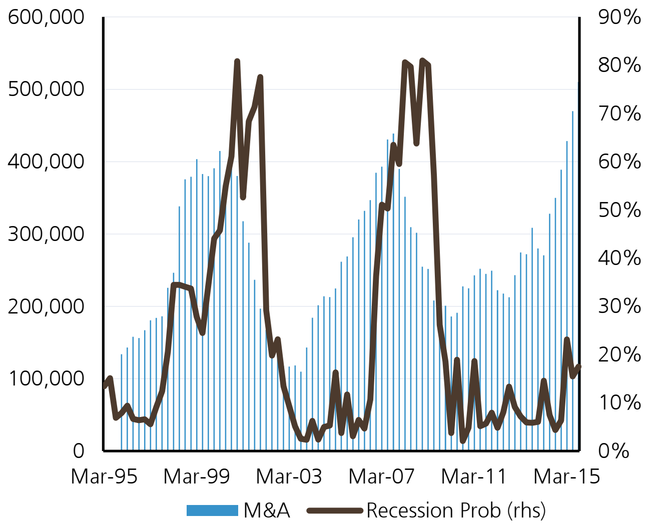
viable alternatives for CFOs who are unable to grow earnings organically[5]. The two charts below illustrate the considerable staying power of these animal spirits. Today's environment fits the current narrative that M&A activity is buoyed by low rates and high expected returns (proxied by the S&P 500 earnings yield). The problem is that the exact opposite occurred in the late 1990s; *M&A activity surged even with high rates and low expected returns (Figure 5)*. An increase in high-grade yields from 2005-2007 also did not temper M&A volumes. Finally, the past two M&A cycles did not peter out until 1 year forward recession probabilities hit 50% (Figure 6). Bottom line, it takes a sufficient shock to the economy to derail an M&A cycle. A Fed rate hike cycle will not nearly be enough.

Figure 5: M&A cycles feed on animal spirits, not low rates



Source: UBS

Figure 6: US M&A activity ($mn) vs. US recession probabilities (Q3'15 – Q3'16)

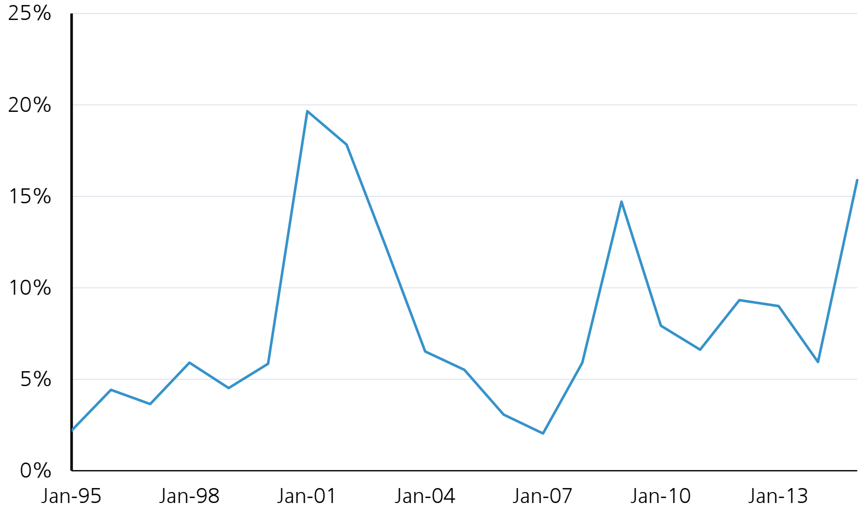


Source: UBS

The major implications are twofold. First, IG issuance will hit a new record in 2016 at $1.3tn[6], a 1% increase from 2015 levels ($1.29tn). Upside estimates of $1.45tn (+11%) are possible, particularly if episodic bouts of volatility subside more than expected. Last year, roughly $260bn of IG issuance (~18% of total) was due to M&A activity, and we expect similar numbers for 2016. Second, credit curves will remain historically steep; those investors positioning for a material flattening of the curve will be disappointed. Nearly 15% of all M&A activity last year was financed in the IG bond market, a high point outside of an economic downturn (Figure 7). And the majority of this debt (56% last year) is funded via long-term paper (> 9 years). This new issuance will continue to saturate a buyer base that primarily consists of US life insurers and pensions needing to hit yield bogeys that are higher than current market rates. There is not a clear catalyst in our view to flatten spread curves absent 1) a unexpected reduction in M&A activity or 2) a material increase in 30yr Treasury yields (to the mid 3% range) that increases demand from insurers and pension funds.

[5] Where Will $1Tn Per Year in Corporate Cash Go? A Post-Crisis Corporate Balance Sheet Tale, J. Emanuel, Feb 2015
[6] Interactive IG and HY Gross Issuance Forecast Model, S. Caprio, 13-Jan-2016

Figure 7: US M&A Activity: % IG Bond Market Financed

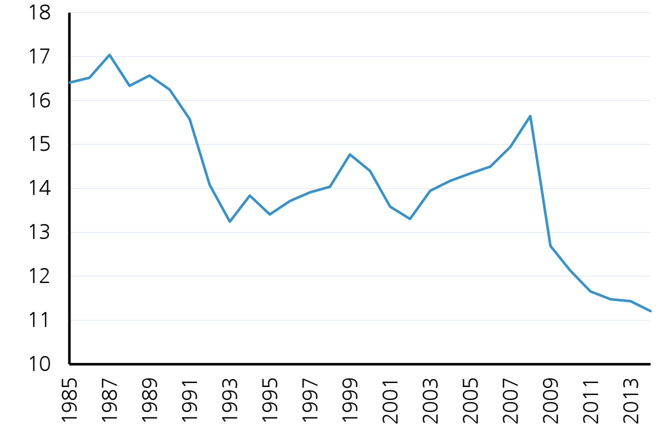


Source: UBS, Dealogic

2) We prefer US Banks over Non-Financials

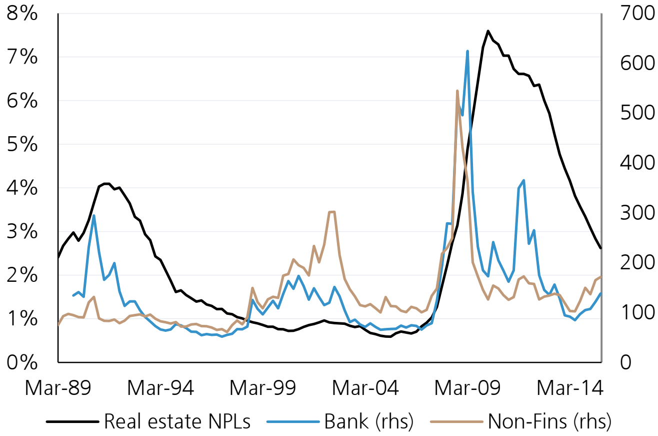
We express this view with some consternation as US bank spreads are not cheap and they are coming off a year where they significantly outperformed non-financials (1.76% total return vs. -2.84%). However, absent a broader downturn in the US economy, we still believe that US banks will continue to relatively outperform. US banks are a higher-quality segment of the IG universe and they have massively de-levered since the financial crisis, in direct contrast to their non-fin counterparts (Figure 8). Empirically, bank sector spreads also typically weaken relative to the non-financial sector when a severe economic downturn fuels increased real estate losses. One can see this clearly in Figure 9 below, where bank spreads suffered under the burden of rising real-estate NPLs in 1990 and 2008. However, banks outperformed during the early 2000s recession, when corporates faced the brunt of losses, while real estate markets exhibited strength.

Figure 8: US Bank Leverage (Tangible Assets/Equity)



Source: UBS, FDIC

Figure 9: US Bank vs. Non-Fin Spreads vs. Real Estate NPLs



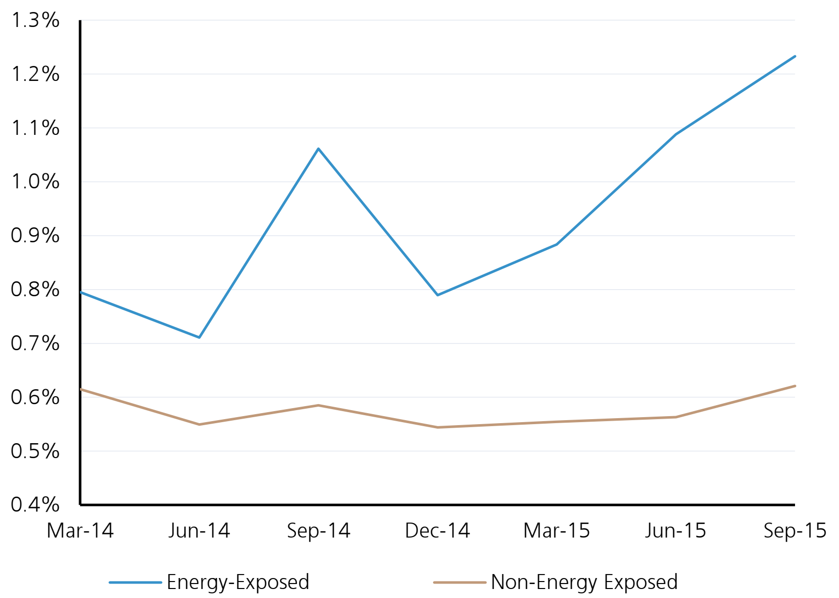
Source: UBS, Yieldbook, FDIC

We are not ready to proclaim that real-estate NPLs will not be a problem during the next downturn. However, the current evidence suggests it is mainly corporate losses that are beginning to tick higher; real estate NPLs continue to fall, primarily for residential properties. An intermediate concern persists in commercial real-

estate, where even though NPLs are near record lows, risks are elevated. If these begin to rise, we would expect more pressure on REIT spreads to develop.

The increase in corporate NPLs is not solely due to energy sector woes. Banks that are less exposed to the energy sector are still displaying a modest uptick in overall C&I loans from last December (Figure 10). The increase is slight, but this is why we bring it up. The first increases in bank NPLs are really the only early warning indicator you get. Hence, with most weakness showing up in US corporates at this time, plus subdued probabilities of a broader US downturn, we believe a relative overweight on Fins still makes sense in 2016.

Figure 10: US Bank C&I NPLs (%)



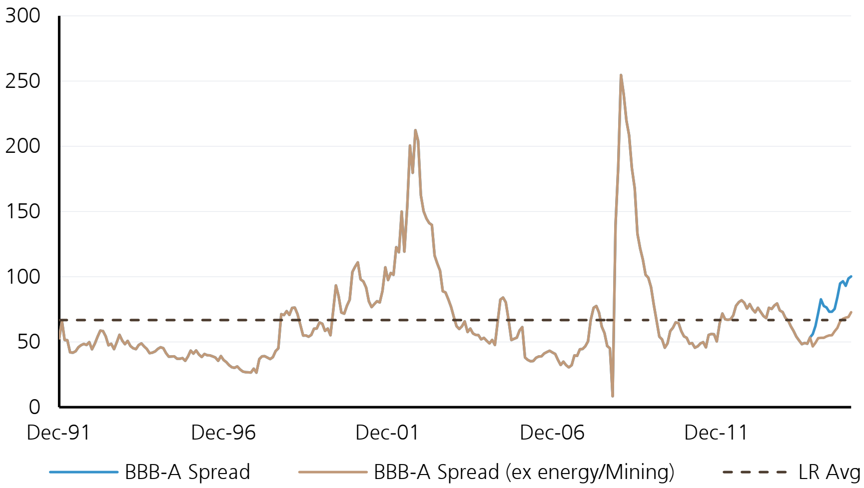
Source: UBS, Dealogic

3) We prefer A-rated credit, particularly long-duration, in 2016

Even though overall credit curves will remain steep due to our prior discussion on M&A activity and worsening bond market liquidity, there is still room in investor portfolios to hold A-rated 10+ paper. First, we attack the credit quality question by debunking the notion that BBB spreads are trading cheap. At face value, BBB credits are trading 100bps wider than A credits, vs. an average of 67bps back to the 1990s. However, once we exclude the impact of the energy/mining sectors, BBBs are trading only 73bps wider than A's, in-line with fair value historically. **At this stage of the credit cycle, a 7bp premium on BBB credit spreads is far from an attractive risk premium (Figure 11).**

What about BBB energy? While valuations appear more attractive, we are still neutral to negative on the space. Oil forecasts continue to be marked lower. Our own UBS forecast for WTI has just been marked down by 20% *out to 2017* (new 2017 target of $52). Gas pipelines in particular face significant danger as a swath of names are rated BBB- and are peering over a large gap in spreads to high-yield status. Many BBB rated E&P spreads also appear expensive and sit tenuously near a ledge (Figure 12). However, even if oil prices bounce, it is difficult to get excited about IG energy when the backdrop of a late stage credit cycle looms. If BBB's *in general* widen out relative to A's (as we expect), the tide should take out energy names as well before too long.

Figure 11: US BBB – A Spreads



Source: UBS, Yieldbook

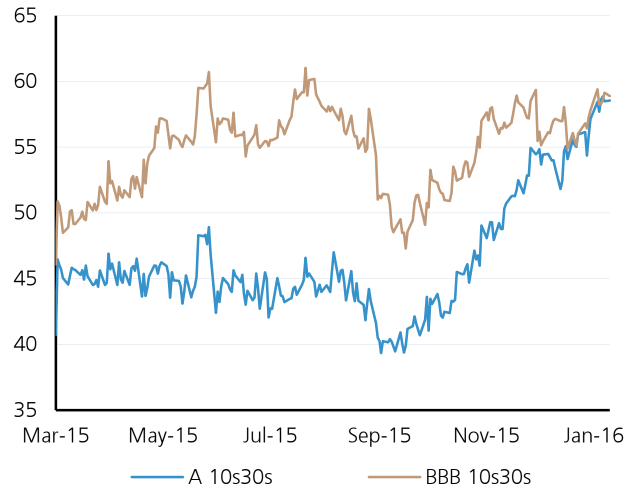
Figure 12: Energy Sector Spreads By Rating

Sector	BBB	BBB-	BB+	BB
Gas Pipelines	425	477	634	770
Oil Services	-	854	784	1147
Exploration and Production	450	824	840	997

Source: UBS, Yieldbook

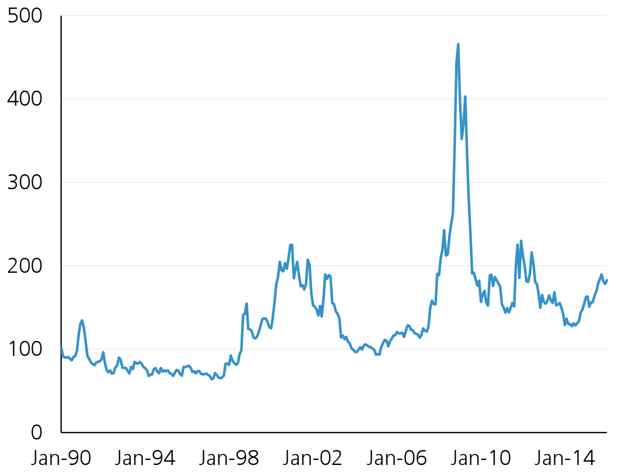
Tactically, we believe the prospect for near-term gains in high-grade on an excess return basis (Treasury-hedged) is reasonable, assuming no fallout in the US or Chinese economy. But instead of taking extra credit risk to boost returns, we would rather take extra spread duration in higher quality credits. A-rated 10s30s curves have just now steepened to a record high 60bps and have surprisingly converged to BBB 10s30s curves over Q4'15 (Figure 13). Much of this steepening represents significant gains in A-rated 10-year paper; 30yr A-rated spreads are still marginally tighter than October levels, holding in reasonably well during the latest selloff. However, 30yr A-rated spreads are still near historically wide levels (Figure 14).

Figure 13: A 10s30s vs. BBB 10s30s Spread Curve



Source: UBS, Yieldbook

Figure 14: A 10+ Spreads



Source: UBS, Yieldbook

In addition, investors will NOT need to sell A-rated paper in the event that the credit cycle worsens: They will simply need to remove the underlying Treasury hedge and hold these bonds as total return instruments. This is not the case for BBB credits, where fallen angel risk is far from trivial (see next section). We strongly believe that 30yr Treasury yields have room to drop in the event of downturn, providing a significant tailwind to long-duration IG credits. This is echoed by our rates team in their 2016 outlook where risks in longer-dated Treasury yields are skewed to the downside[7]. In a China hard-landing scenario that leaves the US unscathed, 30yr Treasury yields could fall to 2% as inflation expectations are reduced. At current yields of 4.6% and a duration of 13.6, returns are positive as long as 10+ A-rated spreads do not widen more than 126bps over a year. That has not happened outside of the financial crisis. In short, we would suggest going long A-rated 10+ spreads to position for moderate excess returns over the next 3-6 months. As we enter into the latter half of 2016, we would recommend removing the Treasury hedge to position for total return gains, as we expect US credit cycle issues to become more apparent.

4) Fallen angels are not a 2016 story, but forward risks loom large

In recent days, many investors have voiced concerns about the potential impact of fallen angels for global credit markets. We do not expect US fallen angels to materialize as the story of 2016, outside of the commodity sectors, as they typically ramp up during US recessions. But fallen angels are a significant issue that will surely garner more headlines down the road. And it is a fundamental reason why we want to avoid long-duration BBB-rated debt at this point in the cycle. Figure 15 below provides context for one-year fallen angel transition rates[8] over time, and how the risk is significantly greater for BBB-rated credits than A-rated credits.

[7] The Global Rates Landscape, Nov 2015, J. Knight
[8] Probability of an IG credit being downgraded to BB+(or worse), or defaulting

Figure 15: One-year fallen angel probabilities (%) by credit rating

Credit Rating	Debt Out ($bn)	2014	Avg (1983-2014)	2001	2002	2008	2009
A+	230	**0.5**	**0.6**	0.0	0.0	1.2	1.9
A	765	**0.0**	**0.7**	0.9	3.2	0.7	0.2
A-	579	**0.0**	**1.1**	1.4	1.5	0.0	1.5
BBB+	1015	**0.0**	**2.1**	2.2	7.6	2.0	3.1
BBB	634	**1.2**	**3.5**	4.3	11.1	2.7	4.7
BBB-	542	**6.4**	**10.0**	10.4	20.5	11.8	14.3
Fallen Angel Estimate ($bn)		43	111	121	292	110	153

Source: UBS, Moody's

To estimate the potential impact for 2016, we use the average one-year fallen angel probabilities from Moody's, **both from 2014 alone and the average from 1983-2014**. (Implicit in this assumption is that 2016 moves us from below average risk to near average downgrade risk.) This assumption would get us $77bn of fallen angels (average of $43bn and $111bn in Figure 15) falling into a $1.05tn HY market. However, $21bn of those fallen angels would be 10+ paper splashing into a $48bn 10+ HY market. Herein lies the problem: The proliferation of longer duration BBB debt could hit a HY market that is fractions its size.

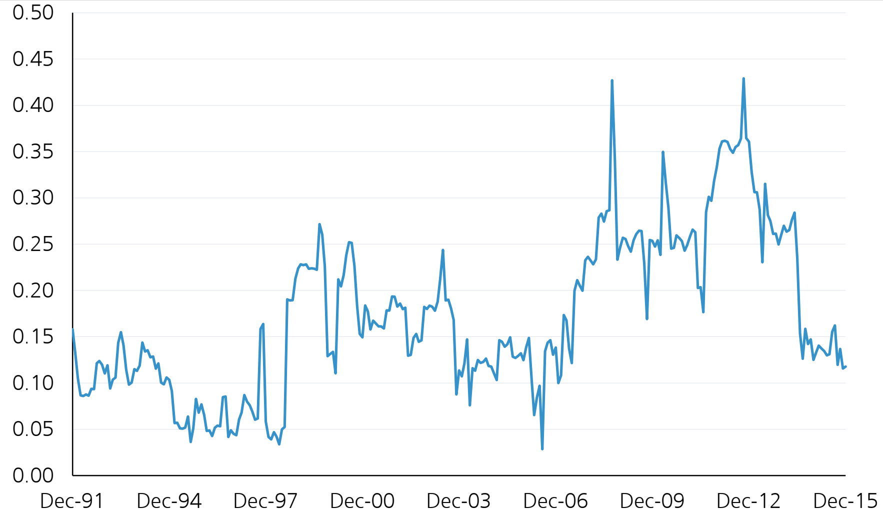
The problem would compound later in the cycle when risks could surge. As a potential worst case scenario, we use the simple sum of probabilities from 2001-2002 and the current debt stock as an example of what could happen during a protracted downturn. If this comes to fruition, we estimate fallen angel volumes over 2 years could spike to $413bn, with $117bn of 10+ fallen angel paper (again crashing into a 10+ HY market that is only $48bn in size). This is an ugly spectre that the high-grade markets would need to face in future years.

5) In sum, what are our spread/return forecasts for IG?

As we suggested in 2015[9], the sensitivity of IG spreads to HY spreads has indeed dropped sharply in recent months (Figure 16). IG spreads are only widening about 10-15 bps for each 100bps widening in HY, which is down from 25-35bps earlier in the post-crisis period (particularly when banking sector risk was still elevated). With relatively better fundamentals, more financials exposure, and the prospect for significant HY commodity related defaults, we expect IG spreads to remain resilient, though not without spread widening, before 2016 is done. Our 2016 forecast for HY spreads is currently 800-850bps. Based on the change from current spreads (763bps) and applying a beta of 0.15 (in-line with that experienced recently), IG spreads should end the year between 175-185bps. Returns will be marginally stronger than last year, though still historically weak. Excess returns (Treasury-hedged) will be between 1.5-2.2% (vs. -1.63% in 2015), aided significantly by rolling down a steep IG curve. Total returns will vary depending on your assumptions for Treasury yields. If our 2016 UBS forecasts for 10yr Treasuries yields are correct (2.5%), IG total returns would equal 1.7-3.4%. If current market expectations from the forward curve are correct (2.35%), IG total returns should fare better and range between 2.7-3.4% (vs. -0.75% in 2015).

[9] US: A roadmap for IG/HY Decompression, M. Mish, 18-Mar-2015

Figure 16: Rolling 12m Slope of IG spread to HY spread changes



Source: UBS, Yieldbook

Figure 17: US IG Excess Return Forecast

	Forecast
Current Spread	1.71%
Forecast Spreads (midpoint)	1.80%
Duration	6.9
+ Mark to Market	-0.64%
+ Roll Return	0.75%
= Excess Return (midpoint)	1.82%

Source: UBS, Yieldbook

Figure 18: US IG Total return Forecast

	UBS Tsy	Forward Tsy Curve
Current Yield	3.55%	3.55%
Forecast Yields (midpoint)	4.01%	3.87%
Duration	6.9	6.9
+ Mark to Market	-3.22%	-2.20%
+ Roll Return	1.68%	1.68%
= Total Return (midpoint)	2.00%	3.02%

Source: UBS, Yieldbook

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