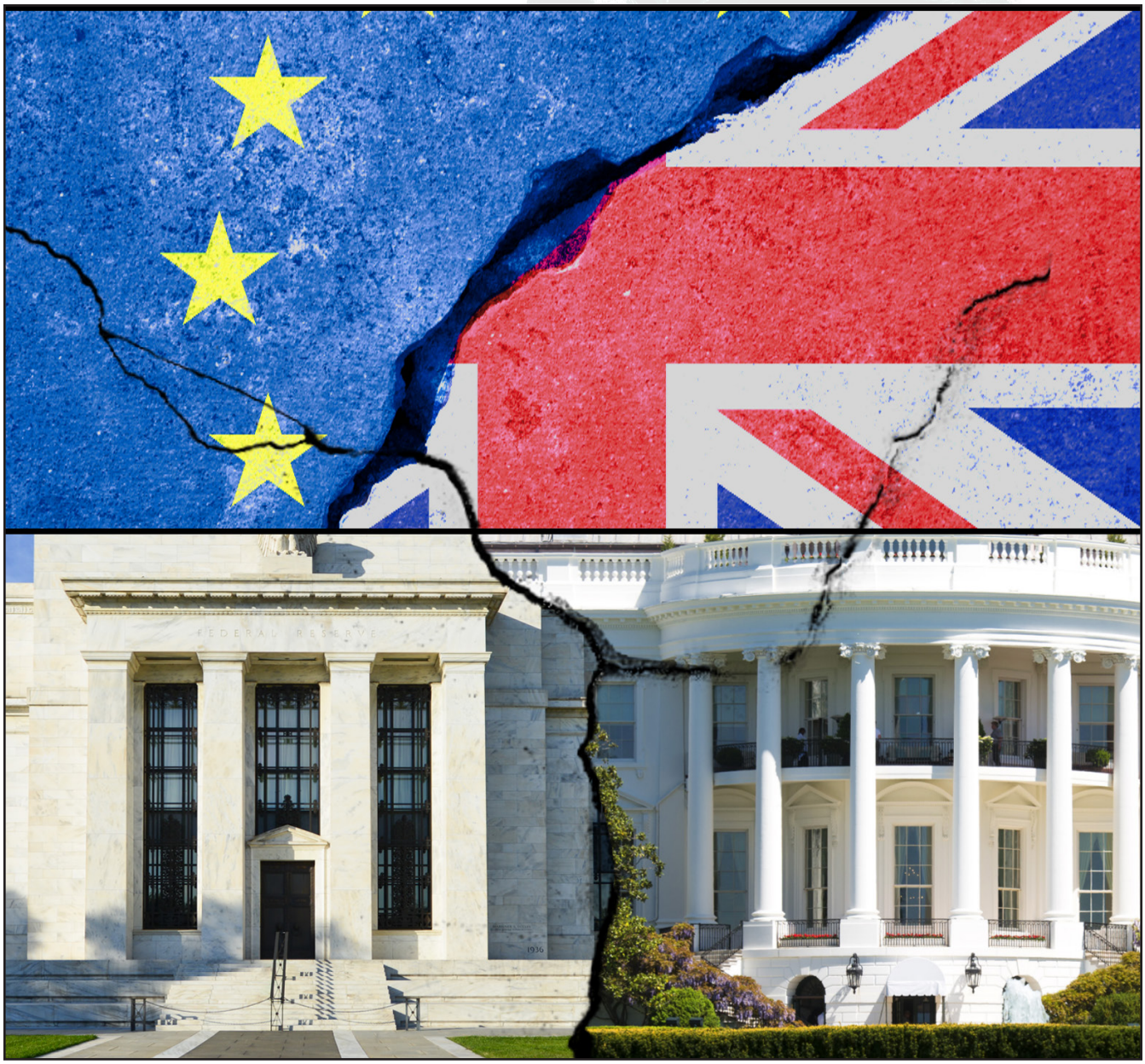
GLOBAL FORESIGHT

FIRST QUARTER 2019

Multiple Divisions

Political conflicts have fueled global growth concerns and created a compelling disparity in sector earnings multiples

BY DAVID P. HARRIS, CFA pages 2-5



Multiple Divisions

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In an increasingly fractured world, our leaders cannot even agree on borders. President Trump forced a partial shut-down of the Federal Government over funding for a border wall between the U.S. and Mexico. By contrast, Prime Minister May has struggled to get a Brexit deal passed that will avoid a partition of Northern Ireland and the Republic of Ireland. The world's multiple divisions also include: trade friction between the U.S. and the European Union and the U.S. and China, as well as political battles within a number of European countries. Within Washington D.C., the friction between the White House and the U.S. Federal Reserve and the White House and the Pentagon has unnerved investors. With the Democrats taking control of the House of Representatives in 2019, we expect the divisions in D.C. will likely get worse.

Escalating geopolitical tension has started to impact economic data in Europe and China. This has led to a massive rotation in equity markets out of the industrial, financial and technology sectors into more defensive ones like consumer staples and utilities, and has created an unusually large disparity in valuations. If we merely see some reasonable resolutions to these geopolitical issues, we expect 2019 could be a rewarding year for equity investors.

In this Global Foresight, we review the current issues, assess likely outcomes, and identify opportunities in 2019. In addition, Michael Seo looks at how many of today's leading companies have evolved and thrived in the ten years since the financial crisis. By contrast, Albert Sindall reviews the deterioration of corporate balance sheets that has transpired over the last several years, driven by stagnant businesses grasping for EPS growth.

FedEx has one of the most storied U.S. corporate histories, famously based on an idea conceived by Yale undergraduate student Fred Smith in the 1960's. Federal Express was created in 1971 and began operating in 1973 with 14 small planes serving 25 cities. Today, known as FedEx, the company has a fleet of 650 aircraft serving 220 countries. In many ways FedEx has become a proxy for the global economy as it serves both corporations and consumers all over the world, which makes it about as useful as any public company for monitoring what is happening real-time in the global economy.

With markets reeling last quarter from fears of an economic slowdown, it was especially timely that FedEx reported its quarterly earnings in December rather than most transport companies which will report in January. On December 18, FedEx posted disappointing earnings guidance for 2019 citing growth concerns in Europe and Asia. Its commentary on trade and political issues was telling "*…most of the issues that we're dealing with today are induced by bad political choices…the good news is, with a change in policy, they could turn it around pretty quick, too.*"

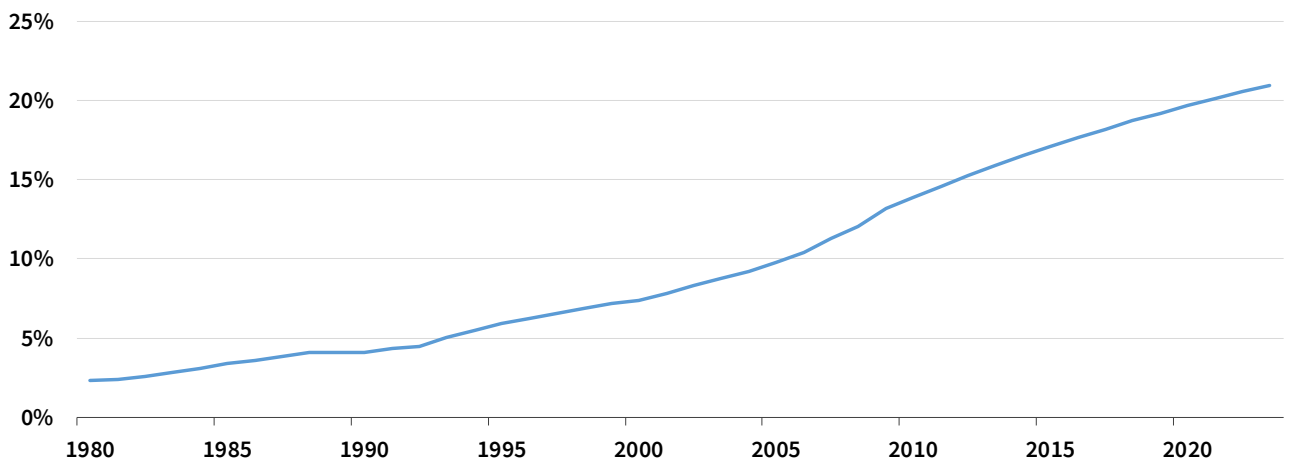
Frankly, we share FedEx's view as we see the U.S. economy as likely to continue expanding in 2019, albeit at a slower pace than the tax-cut fueled growth seen in 2018. The rest of the world has been impacted more by geopolitical issues, which we will address one by one as they are key to our investment outlook.

CHINA TRADE

China has a well-documented history of global trade dating back to the formation of the Silk Road around 200 B.C. In modern times, China traded very little until the 1980s when it began to open its economy and establish some trade deals. China's trade volumes sharply accelerated when it

CHART 1: **CHINA'S SHARE OF GLOBAL GDP** (% OF WORLD)

Source: IMF, GDP based on PPP, share of world (Percent of World)



joined the World Trade Organization (WTO) in 2001. The tariffs that have been imposed in stages in 2018 have marked a change in the constructive view on global trade that has been U.S. policy since the 1980s. The key question for 2019 and beyond is whether a trade deal can be reached that will prevent further escalation in tariffs from a 10% rate on $250 billion of goods to 25% on over $500 billion.

The global economy can ill-afford a slowdown in China. During the 2008-2009 financial crisis, China was roughly 13% of the world's GDP compared to about 19% today (Chart 1). In previous economic downturns before 2008, the Chinese economy was not big enough to make a significant impact on global growth. Most likely some of Europe's recent weakness can be tied to a slowdown in China. As we saw with the recent FedEx report, even U.S. multinational companies are now being impacted by the slowdown overseas.

For most of 2018, the U.S. markets were rising despite the imposition of tariffs, creating a false sense of confidence in the White House on the ability for the U.S. economy to withstand a trade war. Since the U.S. market sell-off deepened in December, the tone from Trump has changed markedly towards China. The current weakness in U.S. equities we believe will increase his willingness to reach a trade accord with China. Trump had set a 90-day deadline on December 1 for imposing additional tariffs which can also be extended if more time is needed. Clearly this bears close watching but our expectation is either a trade deal will be reached or there will be a further pause in the escalation of tariffs.

ITALY VERSUS EUROPEAN UNION

Our favorite indicator of political stress within the European Union (EU) is the spread between the yields of its fiscally strongest member, Germany, with its most indebted member, Italy. In 2018, the spread widened greatly when the Italian Government proposed a budget for 2019 that violated EU rules, with a deficit-to-GDP target of 2.4% instead of an expected 1.9%. EU leaders threatened to fine Italy if they didn't trim their budget, but Italy held firm. The spread between German and Italian bonds, which began the year at 158 basis points, ballooned to 326 basis points by mid-October. Ultimately, Italy gave in to EU demands and agreed to bring its deficit target to 2.04%. We have subsequently seen bond spreads narrow to 250 basis points by late December.

To have a constructive view on Europe and the euro for 2019, Italy does not need to grow but it does need to be stable. The deal they reached with the EU got drowned out in the financial press by U.S. market declines and Brexit news. However, it was a constructive development coming from a new government in Italy that had shown disdain for EU rules and authority.

U.K. VERSUS EUROPEAN UNION

The U.K. faces a deadline on March 29, 2019 to exit the EU, a deadline that was triggered when they invoked Article 50 of the Treaty on the European Union back in March 2017. The U.K. now has four main options with respect to its relationship with the EU:

1. Parliament ratifies the current deal to which the EU has already agreed.
2. A second referendum where they offer the choice to stay in the EU.
3. Extend or revoke Article 50 which would keep the U.K. as a member of the EU past the current March 29 deadline.
4. Exit the EU with no trade deal in place.

We continue to see the fourth choice as a remote possibility although the failure to close on a Brexit deal has weighed on market sentiment across Europe. While we expect Parliament to vote on the deal in mid-January, it looks unlikely to pass on that first ballot, so Brexit uncertainty will likely persist for weeks longer. We had hoped for the Brexit deal to be finalized and approved by last November, but this is taking longer than most investors had expected. There is still a great deal of uncertainty in terms of how this plays out, but we remain constructive that a hard exit will be avoided potentially spurring a rally in both the U.K. and European markets as well as the pound and the euro.

TRUMP VERSUS THE U.S. FEDERAL RESERVE

Trump's repeated criticism of Fed policy is almost without recent precedent. There are recordings of President Nixon asking Fed Chairman Burns to keep an easy money policy in 1972. In the subsequent 47 years, there has been virtually no public rebuke of a Fed Chair. Trump's badgering of Chairman Powell not to raise rates may have had the unintended consequence of forcing the Fed to raise rates to demonstrate their independence from political interference when they announced a 25 basis point increase at their last meeting on December 19. The Fed justified the increase based on current economic data and their outlook, but this was nonetheless poorly received by the stock market.

The Fed's median forecast is for two more increases in 2019. However, the market based on Fed Fund's futures is no longer pricing in any increases in 2019 and in fact there is now a roughly 40% chance of a rate cut by January 2020. This merits close monitoring as markets typically do not peak until the economy has weakened to a point to where the Fed begins cutting.

TRUMP VERSUS THE PENTAGON

General James Mattis' resignation on December 20 may not have a direct impact on corporate earnings or the economy. However, it adds to uncertainty about the stability of the administration which just lost its arguably most respected cabinet member. Over the last two years we have seen the exodus of Trump's original team, including Herbert Raymond McMaster, Gary Cohn, Rex Tillerson, Nikki Haley, and John Kelly, but General Mattis was considered by many the most important member for stability.

DIVIDE OF CORPORATE BALANCE SHEETS

One of the current investor misconceptions is how flush corporations are with cash. As we have written about in prior issues of *Global Foresight*, there are many companies with astounding stockpiles of cash. However, this cash tends to be concentrated in the technology and healthcare industries. Outside of these sectors, balance sheets are stretched as many companies have been using low-cost debt to buy back shares and sustain their EPS growth. Share repurchases have been used extensively, especially in the telecom and consumer staples industries in the U.S. While we see some great values in the equity market after the recent correction, we caution on balance sheets. For more on this subject, we encourage you to read Albert Sindall's accompanying article.

OIL & EMERGING MARKETS

Investors may view the sharp decline in crude oil prices as a troubling sign of economic weakness. We have been skeptics on the pricing power of the Organisation of the Petroleum Exporting Countries ("OPEC"), as previously discussed in the July issue of *Global Foresight, "Oil & Water"*. In our view, The stunning growth of the supply of oil from the Permian Basin in West Texas has shifted the balance of power in the oil markets.

We do not believe we can read much into the global economy from the decline in oil prices. However, we do view the decline as constructive for emerging markets in Asia that are heavy importers of oil, as well as constructive for the global consumer. One of the issues that surfaced on many earnings calls in 2018 was rising transportation costs, especially for retailers. They should feel the benefit of lower oil prices both from transport costs as well as from consumers who are spending money that they are saving at the pump.

U.S. RECESSION ODDS

While no single indicator can perfectly forecast recessions with sufficient advance notice, arguably the slope of the yield curve has been the most prominent data series scrutinized by investors as a harbinger of a slowdown. The New York Fed has been modeling recession odds for the last 20 years based on the spread of 3-month and 10-year U.S. Treasuries. While the odds of a recession in 2019 based on this model have trended up in the last few months, they are now at roughly 16%, suggesting only a one in seven chance of a recession over the next 12 months (Chart 2). This is only slightly higher than the long-run average and is a cause for concern but not for alarm.

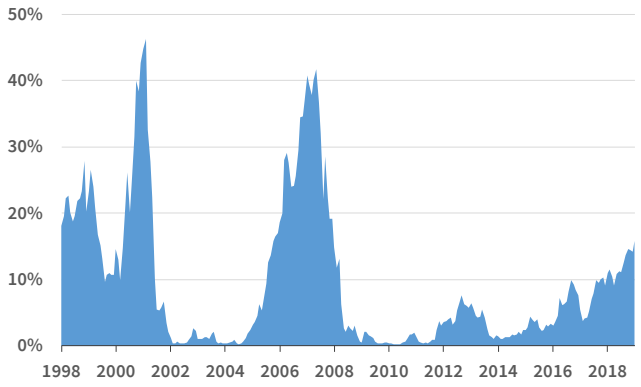
Based on what we see and hear from companies like FedEx, the U.S. economy is currently in good shape with the jobs market still quite strong. Chart 3 continues to show a record number of job openings while unemployment remains at a 50-year low.

We expect U.S. economic growth will likely finish at 3.0% for the full year of 2018, the highest since 2005. Growth should decelerate to a more sustainable 2.0% in 2019, which we believe would be more than sufficient to support corporate earnings, investor confidence and a recovery in the stock market. A risk to the economy is that the fourth quarter market correction may have a dampening effect on consumer and corporate behavior, which we monitor closely but we have yet to see. In early January, companies will report auto sales data as well as airline traffic, which should provide additional insight into the near term impact of the market decline on spending. However, investors may not be convinced of the resiliency of the economy in 2019 until the first wave of companies begin reporting earnings in mid-January. In these earnings calls, companies will typically provide an outlook for their businesses for the next quarter and often for the full year.

DIVIDED MULTIPLES

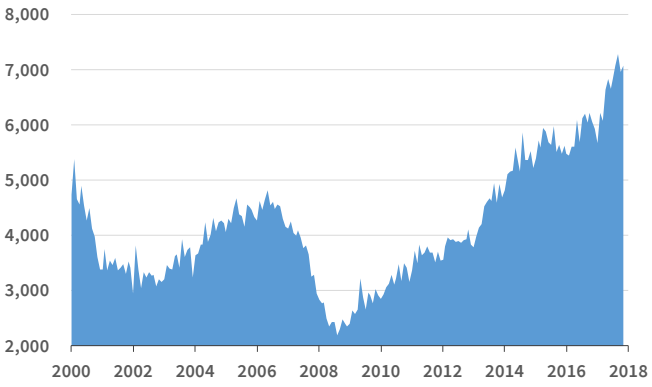
We have seen a stunning collapse in valuations in 2018. Earnings for S&P 500 Index companies will have grown approximately 24% in 2018 while the S&P 500 Index closed down (6.2%) for the year. The P/E ratio on the S&P 500 Index is now roughly 15x 2018 earnings. Even if we assume zero earnings growth in 2019, a P/E of 15x in an environment

CHART 2: **NEW YORK FED PROBABILITY OF U.S. RECESSION IN 2019**



Source: Federal Reserve Bank of New York

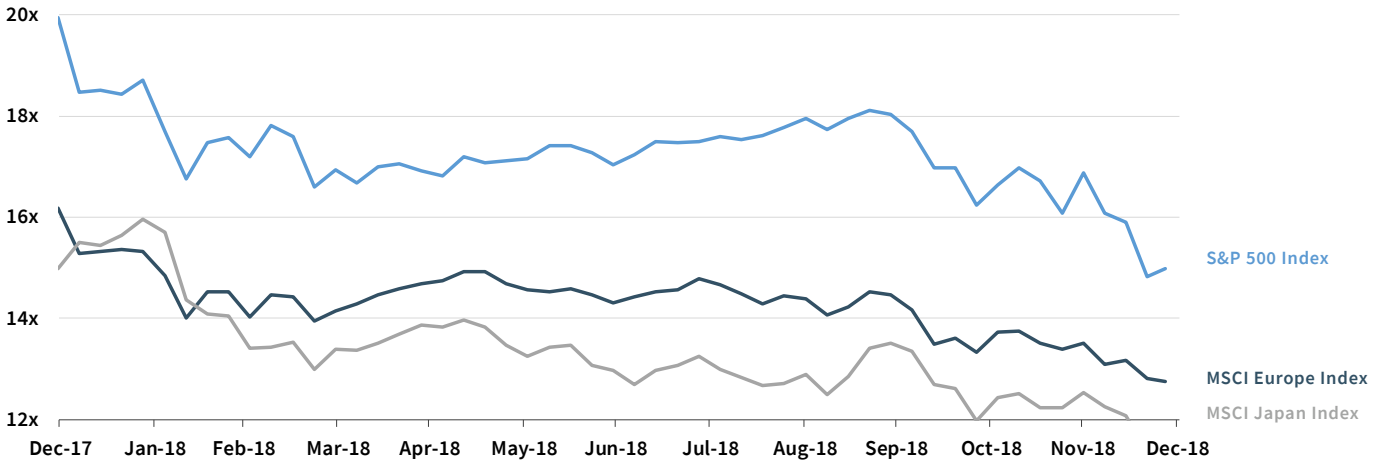
CHART 3: **JOLTS** (JOB OPENINGS AND LABOR TURNOVER SURVEY)



Source: Bureau of Labor Statistics

CHART 4: **PRICE-EARNINGS RATIOS FOR THE U.S., EUROPE, AND JAPAN**

Source: Bloomberg



where inflation is 2.0% and interest rates are 3.0% is an attractive valuation for the broader market.

However, if we decompose valuations at the sector level, we see some significant disparities. Utilities and staples are trading at a premium to the S&P 500 Index as investors have embraced them for their economic resilience. However, these tend to be two of the slowest growing and most indebted sectors. If we strip out utilities and staples from the S&P 500 Index, we find a vast array of companies at depressed valuations that we have not seen in years. Many industrial, consumer, and financial service companies are selling for high single-digit PE multiples which seems unwarranted to us. Within the U.S. equity market, we believe there are enough attractive opportunities that you can largely avoid companies that have been reliant on cheap debt and share buy backs to grow their earnings.

Outside the U.S., most markets and sectors look inexpensive. As Chart 4 illustrates, P/E ratios in Japan have been trending lower for years. Within Europe, P/E ratios are close to 2010 levels when Europe was still in the early stages of the Greek financial crisis. Europe still has to navigate through Brexit as well as deal with strife in places like France. It is hard to paint any kind of growth scenario for Europe, given its aging demographics, and the inherent challenges of having a currency union without a political union. But Greece, Italy and now the U.K. are realizing how hard it is to leave the single market for trade despite threats by various leaders over the years. Our outlook for Europe is that it should remain stable even if the EU is an imperfect concept. When you have many stocks priced for recession, slow, stable growth should be more than sufficient for a market recovery.

CONCLUSION

After a spectacular year of corporate earnings and the best year of economic growth in the U.S. since 2005, global equities suffered a major rout in the fourth quarter as investors abruptly lost confidence in the global economy. At this time last year, the multiple on 2017 S&P 500 Index earnings was approximately 20x, while today it is roughly 15x on expected 2018 earnings. As previously discussed, when we strip out sectors like utilities and staples that trade at a premium to the market and generally look fully priced to us, we see the shares of many quality businesses trading at high single-digit or low double-digit earnings multiples. Outside the U.S., valuations are even lower.

We have to be alert for signs that the selloff has damaged confidence in businesses and consumers to a threshold where it leads to their retrenchment. In that scenario, earnings estimates would have to be reduced for 2019. Even with zero earnings growth in 2019, equities look attractively valued to us.

The world enters 2019 with multiple divisions, but many of these issues are fixable with some important deadlines to accelerate the process, especially the trade issues between the U.S. and China as well as a resolution to Brexit. Ironically, the political divide will likely intensify in the U.S., which has been a source of economic stability in the world since the financial crisis. Fortunately, we have some outstanding companies in the U.S. with business models that should endure for many years beyond the current battles in Washington, D.C. Outside the U.S. we see some attractive opportunities and prospects for improved political stability in 2019.

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THE INNOVATORS

Many leading technology companies emerged from the depths of the Financial Crisis

This past September 15, Wall Street reflected on a critical time in our economic history, the 10-year anniversary of Lehman Brothers' bankruptcy. The damage created by loose consumer lending standards would haunt the global markets as institutions worked through excess leverage and insolvency. The collapse of a major investment bank despite various efforts to keep it afloat would continue to plague the banking system and stock markets in the months ahead. Coordinated efforts by central banks eventually stabilized the markets, and the U.S. economy returned to positive growth a year later.

Lost in the anniversary of Lehman Brothers' 2008 demise is an underappreciated decade that speaks to the innovation and entrepreneurship found in the American economy. On July 10, 2008, about a year after the release of the first iPhone, the Apple App Store opened to the public with 500 apps available for download. In hindsight, Apple's iPhone not only altered the mobile phone market, it dramatically changed the way humans live and sowed the seeds for new businesses that have become critical to daily lives around the world.

There were plenty of entrenched doubters, such as then Microsoft CEO Steve Ballmer in what is now an infamous interview where he brushed off Apple's entry into the smartphone arena. Mr. Ballmer stated during the 2007 interview: "That is the most expensive phone in the world. And it doesn't appeal to business customers because it does not have a keyboard. Which does not make it a very good email machine." Ballmer was not alone, many underestimated Apple. Some contributing factors may have been that:

1. It is challenging to forecast with precision the next three years, let alone 10 years.
2. Incumbent businesses are perpetually at risk of displacement, a sign of a healthy system and capital markets.
3. Investments in software and artificial intelligence will continue to be critical in maintaining an edge against the competition.

By the end of 2009, Nokia was still the largest mobile phone manufacturer with 36% market share and the dominant smartphone operating system was Symbian. Do you remember Symbian? How about Sony-Ericsson, Research in Motion or Motorola? These were some of the preeminent players within the handset space that have disappeared or devolved into insignificant companies trying to survive. The iPhone was less than 2 years old at that time and sold about 25 million units while Apple's App Store was an infant at less than a year old. Today, Apple is estimated to sell about 190 million iPhones annually and serves its customers with approximately 2 million apps in its store.

Over the past 10 years, new businesses have blossomed to take advantage of the surge in global smartphone penetration. The proliferation of mobile computing devices and accelerating data speeds have dramatically enhanced our productivity by making information and services instantly accessible. Today, the average American is spending less time at the local strip-mall in favor of shopping on Amazon by talking to "Alexa", ordering food on GrubHub in lieu of cooking, and grabbing a ride to the airport using Lyft. These changes in consumer behavior all began to take off after the financial crisis thanks to the smartphone.

Technological advancements have fostered an era of distributed computers which requires native and cloud-based computing needs. Businesses that have emerged since the financial crisis are often less capital intensive and faster to markets when compared to traditional manufacturing or service-oriented businesses. These asset-light disruptors typically possess robust margins, low leverage, and market share that are gained at the expense of incumbents that are dragged down by heavy legacy assets.

Chances are high that the average American has utilized the services of at least one of the companies on Exhibit A. These young companies possess robust valuations given the growth rate and margin potential. Instagram is estimated to contribute $15 billion to Facebook's revenues in 2018 and may represent at least 40% of the incremental revenue growth for Facebook in the near future. Facebook's 2018 revenue forecast of $55 billion is quite extraordinary when we consider that in 2009 the company generated less than $1 billion.

Since Facebook's founding in 2004, the company was able to breakthrough the $50 billion revenue mark in 14 years. By contrast, Disney was founded 1923 and it was not until 2015 that it managed to achieve this feat with an employee base of 185,000. When factoring in capital required and employees needed to generate such substantial sums of revenue, the new companies of today are hyper-efficient (Exhibit B).

The dynamic growth of startups in Silicon Valley along with the maturation of elder technology firms have propelled the S&P 500 Index Information Technology sector weighting from 15.3% in 2008 to over 25% this year. Perhaps there is an element of risk-seeking behavior that is stoking valuations within the group, but the profitability of the businesses are undeniably attractive. Whether or not the group can maintain the lion's share of the weighting may depend on the pace in which the "Internet of Things" (IoT) proliferates our world. IoT is the process of providing connectivity and computing capability to various distributed devices and equipment in the physical world. In effect, the morphed devices can now be controlled and regulated remotely by operators and Artificial Intelligence (AI).

Businesses are still in the initial stages of investments dedicated to IoT and automation. Last November, I had the privilege of being seated next to Blake Moret, CEO of Rockwell Automation, during its Automation Fair. What became evident in our discussion was that Rockwell's customers were seeking agility from its asset base. Its customers want to produce more from the same production footprint. Rockwell wants to be able to respond to adapting customer preferences with minimal disruption and minimize unplanned downtime. All of which requires a digitization of the physical plants, which likely becomes part of the next great wave of technology investments.

CONCLUSION

We have seen an incredible evolution of technology from the depths of the financial crisis. Some of today's leading businesses barely existed just 10 years ago as the most innovative companies tend to emerge stronger from periods of uncertainty. We expect the current decline in technology shares could be an opportunity for investors, even if the recent rapid growth in the global economy moderates. As history has shown, technology will evolve in interesting and unforeseen ways, the one certainty is that over time it grows in importance to both businesses and consumers.

EXHIBIT A

Company	Founded (Year)	Market Cap $B (Last Funding Valuation*)	Annual Revenue $B (Most Recent)
Airbnb	2008	$30.0*	$2.6 (2017)
Square	2009	$24.0	$3.0 (Trailing 12M)
Uber	2009	$70.0*	$6.5 (2016)
Instagram	2010	Acquired by Facebook for $1 Billion	$10.0 (2017 Estimate)
Snap Inc.	2011	$7.5	$1.0 (Trailing 12M)
Lyft	2012	$16.0*	$1.0 (2017)

Source: Bloomberg, www.sharepost.com

EXHIBIT B

	Latest 12 Months 9/30/2018	Fiscal Year 9/29/2018	Latest 12 Months 9/30/2018
	Facebook	Disney	Comcast
Revenue	$51.9 billion	$59.4 billion	$88.6 billion
Employees	34K	201K	164K
Revenue/Employee	$1.5 Million	$296K	$540K

	Fiscal Year 9/30/2018	Fiscal Year 1/31/2018	Fiscal Year 2/3/2018
	Amazon	Walmart	Target
Revenue	$178 billion	$500 billion	$72 billion
Employees	566K	2.3 Million	345K
Revenue/Employee	$314K	$218K	$208K

Source: Bloomberg

BBB Debt: Golden Ticket or Fool's Gold?

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In Roald Dahl's famous children's book, *Charlie and the Chocolate Factory*, the eccentric chocolatier Willy Wonka invites children to come tour his factory after they find a golden ticket in a Wonka Bar. There are five tickets to be found, but the first to find a golden ticket is the gluttonous, obese, greedy boy Augustus Gloop. Similar to Augustus, over the past 15 plus years, corporations have found their golden ticket with ultra-loose monetary policy providing their sugar high in the form of debt. Within the United States investment grade corporate bond market, the BBB ratings cohort of the market has grown significantly post financial crisis and could be a potential headwind in the next economic downturn.

At the end of 2005, investment grade debt as defined by the Bloomberg Barclays U.S. Corporate Index was $1.5 trillion. Despite the household debt reduction that occurred after the financial crisis, investment grade corporate debt has continued to increase. Since 2005, investment grade debt was up 70%, 179% and over 230% for the periods ending 2010, 2015, and 2018, respectively. While there are some nuances to the contributors of growth, such as the regulatory requirements of the financial sector, a significant amount of the increase can be credited to the growth of industrial debt, specifically the lower-rated BBB cohort (Chart 1).

Companies and bond market participants have embraced the BBB rating and the size of the BBB market has continued to grow. The strong demand for investment grade debt, has allowed firms to continue to issue new debt, leading the BBB market to eclipse the entire U.S. corporate high yield debt market. BBB debt, as of year end 2018, was over 50% of the investment grade index and was over $2.5 trillion outstanding. This compares with the Bloomberg Barclays U.S. Corporate High Yield Index with $1.17 trillion outstanding and the lowest-rated portion of the BBB market, BBB- now has over $700 billion outstanding, greater than the entire highest level of high yield, BB, at $540 billion (Chart 2).

In previous business cycles, many corporations coveted an A rating or above from the ratings agencies. However, during the financial crisis, many companies were downgraded out of the A cohort into BBB, as leverage increased due to rising debt levels and were accompanied by lower earnings. Many of these companies came to a realization that the stigma of holding a BBB rating no longer held. In the environment of quantitative easing and lower rates, coupled with improving earnings, numerous firms realized they could add more debt to complete acquisitions or reward shareholders with little change from the ratings agencies and only a slight financial penalty from investors for holding a BBB rating. Concerning, at this late stage in the economic cycle, companies are still being downgraded into BBB, and during the fourth quarter of 2018, over $150 billion of debt has migrated into BBB territory from the A bucket, the second largest move since 2010. Most evident of this downgrade was Anheuser Busch InBev, which recently was downgraded into BBB due to a lack of debt reduction and slowing cash flows.

With companies realizing that they could achieve only incrementally more expensive financing with a BBB rating versus an A rating, they have started to see how much they could stretch the guidelines with the agencies in order to keep from falling into high yield. While this has occurred across many sectors of the market, many companies have increased leverage, and some are now in excess of 4.0x net debt/EBITDA with a BBB rating from 2.5x just a few years ago. Leverage has continued to increase as companies need to find ways to grow, so they embark on debt-fueled acquisitions. To boost share prices, whether it be to

CHART 1: **U.S. INVESTMENT GRADE DEBT BREAKDOWN BY RATING**

Source: Bloomberg Barclays US Corporate Bond Index

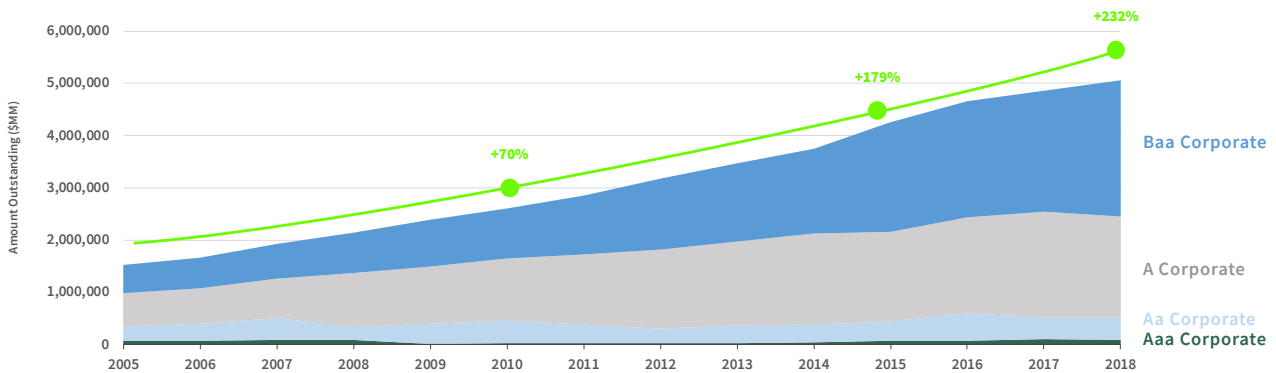
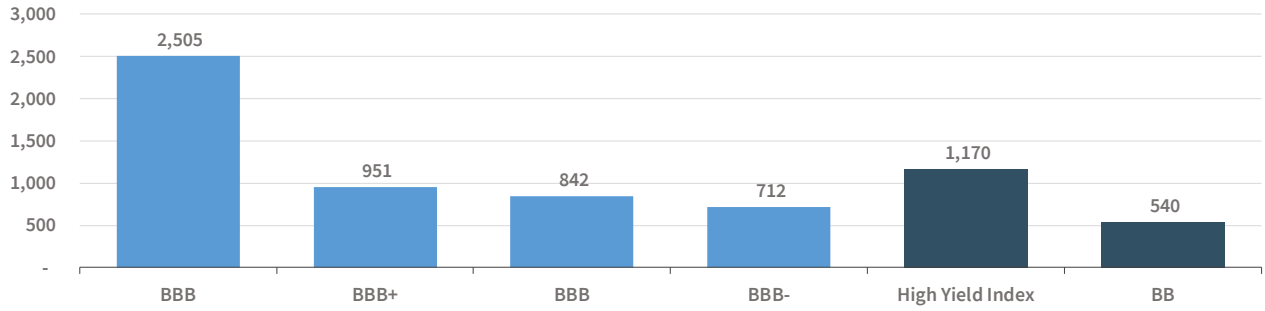


CHART 2: **BBBS BY THE NUMBERS AS OF NOVEMBER 30, 2018 (IN BILLIONS)**

Source: Bloomberg Barclays Indices



offset stagnant net income, for an activist investor in the company, or for management's own personal enrichment, a firm's commitment to return capital to shareholders funded by new debt or by existing cash flow that could have been used for deleveraging might prove to be a bad omen. These management teams use many phrases to help placate the ratings agencies and investors to hold companies at an investment grade level. Phrases include: "We are committed to deleveraging", "We are committed to being an investment grade issuer" or, "We are committed to returning to pre-acquisition leverage levels."

Only recently have the rating agencies started to question these deleveraging commitments. As cash flows have been less steady than in years past, intended deleveraging has been delayed.

One of the first companies to truly take advantage of the less punitive reactions from the rating agencies and the market by adding significant levels of debt was Verizon. In 2013, the firm made the acquisition of Vodafone's share of their U.S. wireless business. To finance this acquisition the company issued $49 billion of debt bringing the company's total debt to over $100 billion. The $100 billion of total debt outstanding was a first for a U.S. industrial firm, but would help pave the way for additional large debt funded deals and firms going over the $100 billion of total debt within the investment grade universe. A few years later AT&T would subsequently complete two separate acquisitions to end up the most indebted U.S. industrial company with a total debt greater than $180 billion. Despite the loss of their A ratings due to acquisitions, investors have continued to buy additional debt in the names despite the firms missing their initial forecasts to return to pre-acquisition leverage targets. But does it come to a point where investor sentiment changes and the names become unloved? Only time will tell, but it could lead to significantly higher financing levels for both companies if investors change their tune.

ALL B(AD) B(AD) B(ONDS)?

Expectations for a disorderly economic correction is not our base case, and we believe credit selection towards managements and businesses that have the ability to manage these over levered credits does seem attainable. While there is risk within the current credit landscape generated by the increases in leverage and overall corporate debt rising, negative sentiment is driving the perception of risk so far that it has created its own reality. Even though growth in BBB rated bonds has continued, it will be tough for the cohort to continue on its current meteoric rise. The expectation is that the ratings agencies will have a less positive view on over levered credits, and in order to avoid becoming fallen angels, these firms will have to make capital allocation decisions to repair the balance sheet. These allocation decisions will most likely be met with the dismay of equity holders as companies will be prioritizing debt holders with the repayment of debt using cash flow, whether from operations or divestitures. For companies that do prioritize leverage reduction, they might be rewarded with upgrades into the A cohort, but for those who do not, they could be the next fallen angels. All which could lead to a smaller BBB ratings segment.

Not all of the companies that are highly indebted will be downgraded, although pricing volatility most likely will increase as investor uncertainty rises. The perception of potential fallen angels is as much a risk to pricing as actual downgrades. Prior to the financial crisis, this would have been an opportunity for the broker/dealer banks to step in, provide liquidity, and take advantage of dislocations in price, but times have changed.

Dealer balance sheets have shrunk dramatically and they no longer have the ability to come in and benefit during times of distress. Dealer inventories are only a small percentage of the overall index, so in times of credit volatility prices may dislocate quickly providing potential opportunities to investors.

CONCLUSION

Over the last decade plus, U.S. companies have taken advantage of low rates and an insatiable global demand for debt. Companies have been aggressive with earnings projections, and in previous consultation with the ratings agencies, agreed that these projections would allow for them to reduce leverage, but for some, this reduction has not occurred. While a lot of these firms received their golden ticket to raise leverage over the last 10 plus years with lower rates and a strong demand for credit, a lot of their balance sheets became like Augustus Gloop in the debt markets: gluttonous, obese, and greedy. As we approach the later stages of the current credit cycle, there will be some BBB companies that have gorged on debt and become fallen angels, but at the same time there could be opportunities for investors to take advantage of unjustified pricing dislocations for companies that are able to navigate debt loads and profitability permitting, reduce leverage.

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