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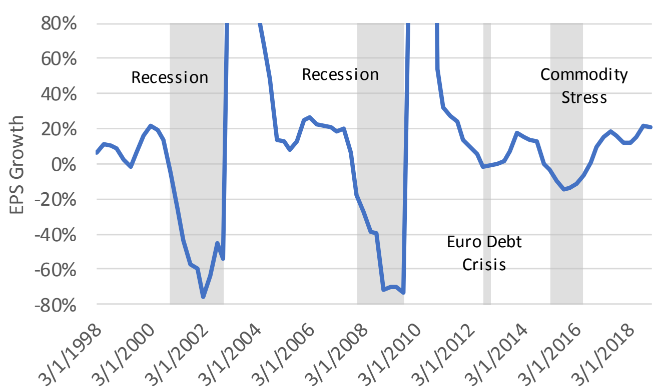
Weekly Briefing

SKYView: Fundamentals

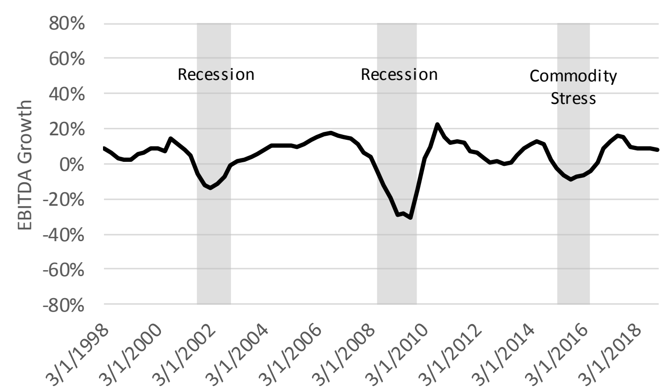
As a somewhat uneventful Q4'18 earnings season nears completion, investor attention will inevitably shift toward probable Q1'19 profitability headwinds. As such, the focus of this *Weekly Briefing* is to translate slowing (and potentially negative) S&P 500 earnings growth expectations into a read-through for US high yield issuers, identifying parts of the market that may be at greater risk for fundamental degradation and spread volatility in the near term.

At the time of publication, 99% of S&P 500 constituents had reported Q4'18 (or equivalent) results. While earnings growth remains positive (+13%), the peak is now behind us (earnings growth had exceeded +20% from Q1 through Q3 2018). More concerning is the consensus view that S&P 500 constituents will report negative earnings growth in Q1'19, the worst results for most companies since recovering from the collapse in commodity prices in 2015 and 2016. Such an inflection would be notable as S&P 500 earnings growth rates have only been negative in four periods over the last 20+ years (shaded below in grey). The numbers, however, are not without noise. The buying back of shares over the last several years has artificially boosted company-reported EPS growth, and the grandfathering of US tax reform make prior-year earnings levels more onerous to exceed from a technical standpoint. Therefore, we think it more appropriate to compare S&P 500 EBITDA growth rates over time, as they largely eliminate distortions associated with the aforementioned factors.

S&P 500 Index EPS Growth
quarterly data, negative growth periods shaded grey



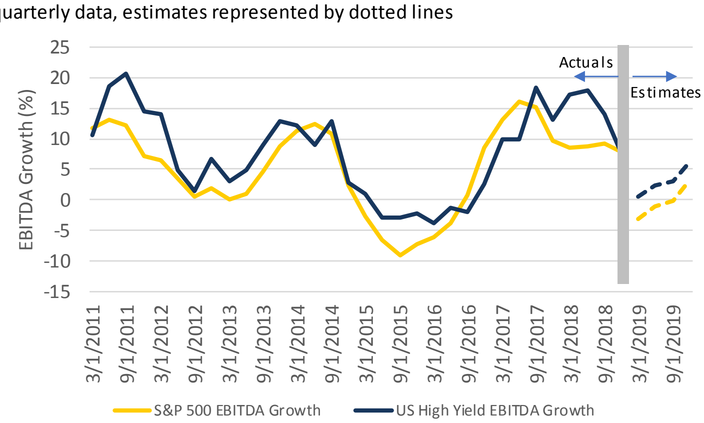
S&P 500 Index EBITDA Growth
quarterly data, negative growth periods shaded grey



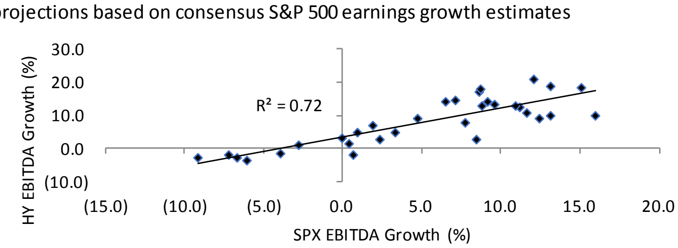
Source: SKY Harbor, Bloomberg, Standard & Poor's, National Bureau of Economic Research

Given the highly correlated nature of earnings and EBITDA growth trends between S&P 500 and US high yield constituents (demonstrated in the left-hand chart below), we used statistical analysis to translate the consensus view on large cap equity earnings to our focus market (as EBITDA growth projections for the high yield universe are not as well-articulated). By our estimates, forecasted Q1'19 earnings growth of -3.4% for S&P 500 members likely translates into EBITDA growth of +0.5% for the US high yield universe (even without taking into consideration the typical downward bias of sell-side equity projections).

S&P 500 vs. US High Yield EBITDA Growth
quarterly data, estimates represented by dotted lines



Implied US High Yield EBITDA Growth
projections based on consensus S&P 500 earnings growth estimates



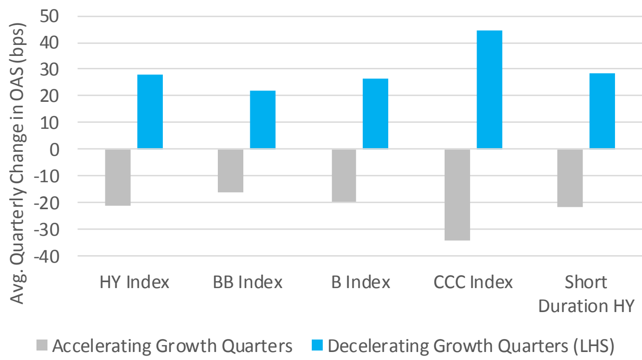
Period	S&P 500 Consensus Earnings Growth (%)	Implied US High Yield EBITDA Growth (%)	90% Confidence Range Lower	Upper
Q1'19	(3.4)	0.5	(0.4)	1.5
Q2'19	0.2	2.3	1.0	3.6
Q3'19	1.7	3.1	1.6	4.5
Q4'19	8.1	6.2	4.2	8.3

Source: SKY Harbor, BofA Merrill Lynch, Bloomberg, FactSet

With a Q1'19 US high yield constituent EBITDA growth estimate range of -0.4% to +1.5%, we can be reasonably sure that the trajectory of profits will slow next quarter, even if they do not turn negative. To better gauge the potential impact such deceleration would have on high yield markets, we bifurcated our data set of quarterly changes in OAS into earnings growth acceleration and deceleration periods (52% and 48% of quarterly observations since 1997, respectively). As expected, spreads tend to widen (on average) during quarters in which earnings growth decelerates on a sequential basis, and vice versa. Furthermore, BBs tend to be more resilient than CCCs in such earnings deceleration quarters, which makes sense intuitively. Noteworthy, however, is the relatively poor upside/downside spread change beta ratio of the BB index, which we largely attribute to the impact of convexity on the rating subset. Since we believe earnings growth will improve in Q2'19, and by virtue of BB outperformance YTD, we remain constructive on Single-Bs.

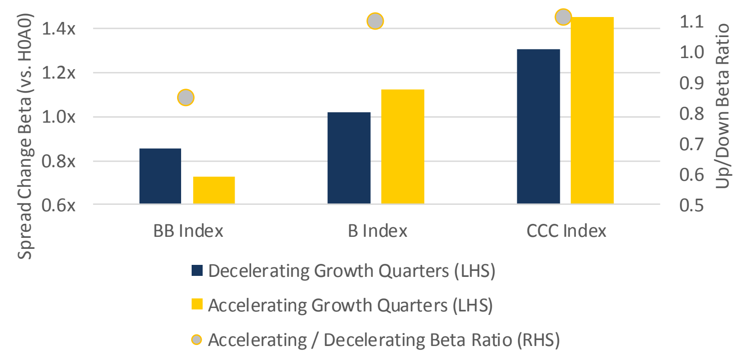
Change in HY Spread vs. S&P 500 EBITDA Growth Trajectory

quarterly data, since 1997



Spread Change Beta in Various S&P 500 EBITDA Growth Environments

quarterly data, since 1997

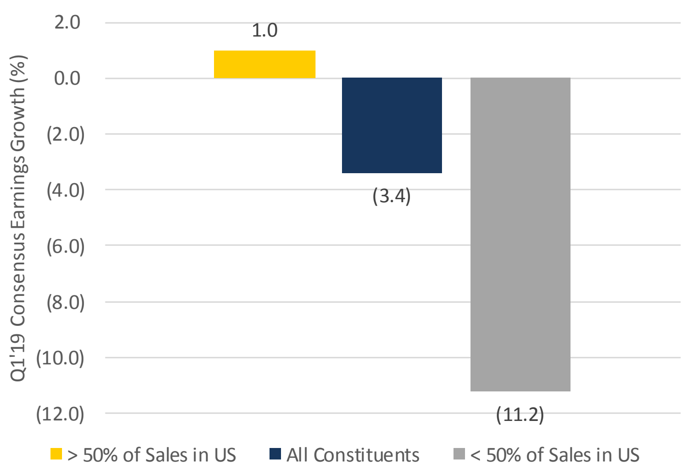


Source: SKY Harbor, ICE BofAML Indices, Bloomberg, Standard & Poor's

Digging into management commentary following the release of Q4'18 results, a couple of themes emerge. First, domestic demand appears markedly stronger than ex-US, with inventory destocking and concerns surrounding slowing China and European economies inhibiting the issuance of high-conviction guidance. S&P 500 constituent earnings growth expectations for Q1'19 appear to echo this sentiment, with analysts expecting US-centric businesses to encounter less severe headwinds (left chart below). Additionally, many management teams have hinted at reducing capex in order to limit y/y declines in free cash flow. Given the highly negative correlation between large corporation capital expenditures and US high yield index spreads and fundamentals, the news has made us more cautious on sectors with sales and EBITDA generation more closely tied to business investment (right chart below).

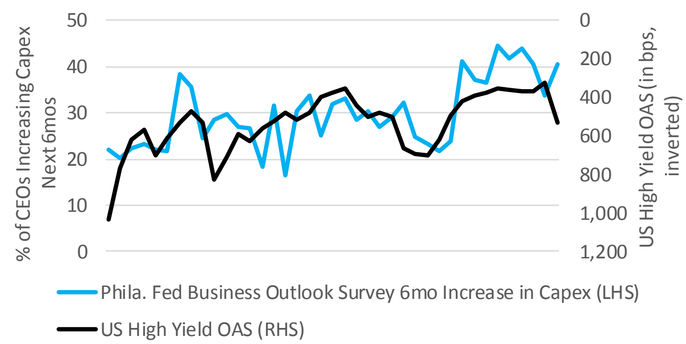
S&P 500 Earnings Expectations by Geographic Exposure

Q1'19 consensus expectations



Large Corporate Capex Negatively Correlated to HY Spreads

quarterly data



US High Yield Sector EBITDA Correlation to Large Corporate Capex	
Highest Correlation	Lowest Correlation
Energy	Food
Materials	Healthcare
Capital Goods	Consumer Products

Source: SKY Harbor, FactSet, ICE BofAML Indices, BofA Merrill Lynch, Philadelphia Federal Reserve

In conclusion, investor focus will likely shift toward decelerating (and potentially negative) earnings growth expectations in Q1'19. While this has not historically augured well for US high yield spreads, the trend is expected to reverse by the second quarter. In general, BBs tend to be more resilient in spread-widening environments (as expected) but have historically demonstrated weak upside/downside spread change capture, particularly relevant as earnings improvement for the balance of the year remains our base case assumption. Finally, companies with limited non-US exposure and those less reliant upon larger corporate capex should fare better in the near term, in our view.

On the Calendar

Occurred

Event	Release Date	Period	Survey	Actual	Prior
Markit US Services PMI	5-Mar-19	Feb	56.2	56.0	56.2
New Home Sales	5-Mar-19	Dec	600k	621k	657k
Initial Jobless Claims	7-Mar-19	2-Mar	225k	223k	225k

Upcoming

Event	Release Date	Period	Survey	Actual	Prior
Phila. Fed Business Outlook	21-Mar-19	Mar	4.0		-4.1
Markit US Mfg. PMI	22-Mar-19	Mar	54.0		53.0
Existing Home Sales	22-Mar-19	Feb	5.10m		4.94m

Source: SKY Harbor, Bloomberg

Recommended Reading

Fidler, Stephen and Norman, Laurence (2019, March 14). UK Parliament Votes to Delay Brexit as Turmoil Drags On. *The Wall Street Journal* (subs. req.), Retrieved from https://www.wsj.com/articles/u-k-lawmakers-set-to-delay-brexit-as-political-turmoil-drags-on-11552571318?mod=hp_lead_pos3

Kennedy, Simon and Schneeweiss, Zoe (2019, March 13). Why the Worst May Already Be Over for the Global Economy. *Bloomberg*, Retrieved from https://www.bloomberg.com/news/articles/2019-03-14/the-case-for-the-world-economy-s-defense-even-as-growth-slows