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Lookout Report
from Global Markets Intelligence

A Dichotomy Illustrates The Current U.S. 2016 Economic And Financial Market Outlook

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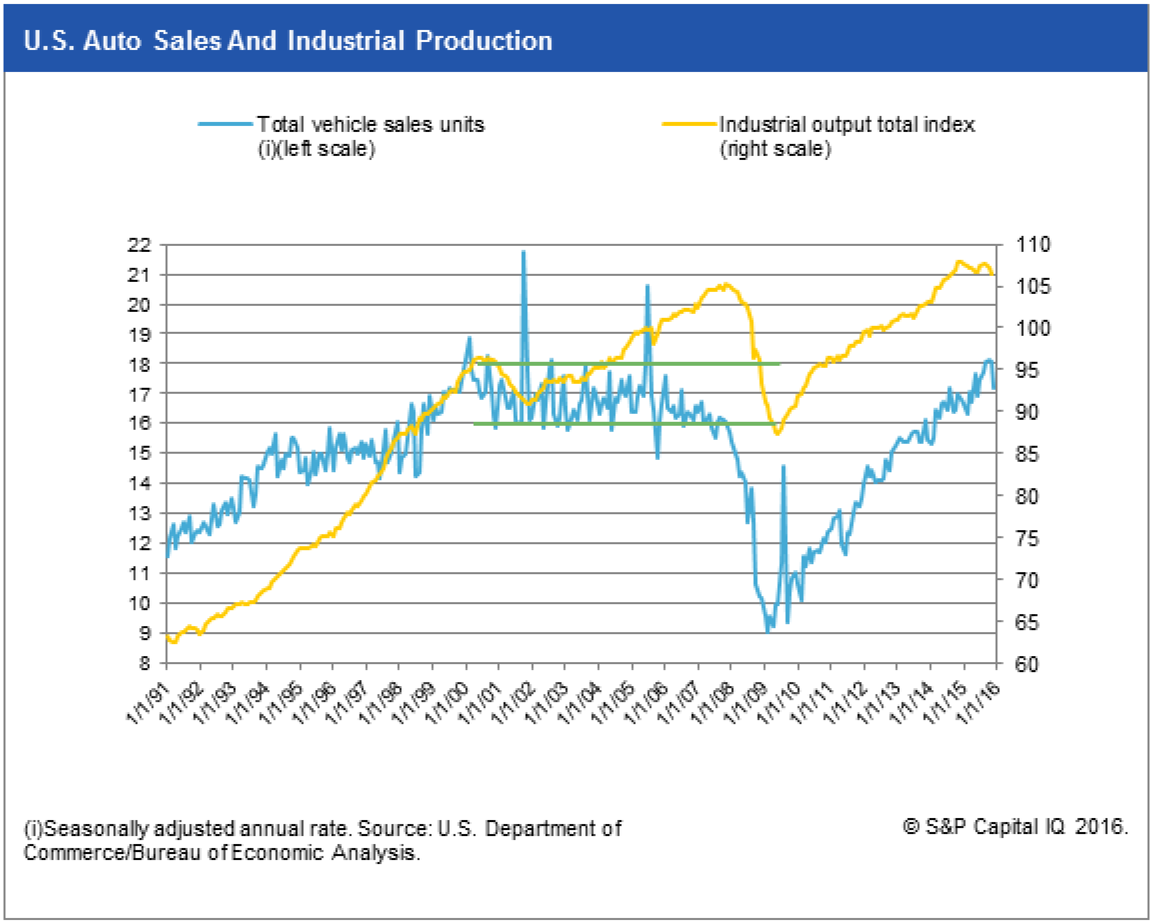
The Lookout Report is a compendium of current data and perspectives from across S&P Capital IQ and S&P Dow Jones Indices covering corporate earnings, market and credit risks, capital markets activity, index investing, and proprietary data and analytics. Published biweekly by the Global Markets Intelligence research group, the Lookout Report offers a detailed cross-market and cross-asset view of investment conditions, risks, and opportunities.

During the opening week of 2016, the U.S. stock market appeared to be taking its directional cues from the Chinese stock market. This observation overlooks the fact that investors are starting to take notice of prevailing mixed signals emanating from the U.S. economy.

Global Markets Intelligence (GMI) Research is both impressed but also somewhat mystified by the existing fabric of the U.S. economy. Although the pace of job creation and light vehicle sales continues to be quite strong, industrial production and retail sales simultaneously don't match up. The stark divergence between industrial production and automobile sales in particular, which at face value would normally be closely related, is striking. Auto sales posted an annual sales pace in excess of 18 million units for three consecutive months between September and November, which is unprecedented for the U.S. economy, before pulling back slightly to 17.2 million in December. Historically, auto sales would spike above the 18 million rate on occasion for a single month or rarely even two, usually in response to temporary sales incentives, before pulling back within the existing established range (i.e., between 16 and 18 million units between 2000 and late 2007). On the other hand, the U.S. industrial production index (106.5 in November 2015) has been in a near constant state of decline since peaking at a record value of 107.9 in December 2014, suggesting that the industrial portion of the economy may actually be in the midst of a mild recession (see chart 1).

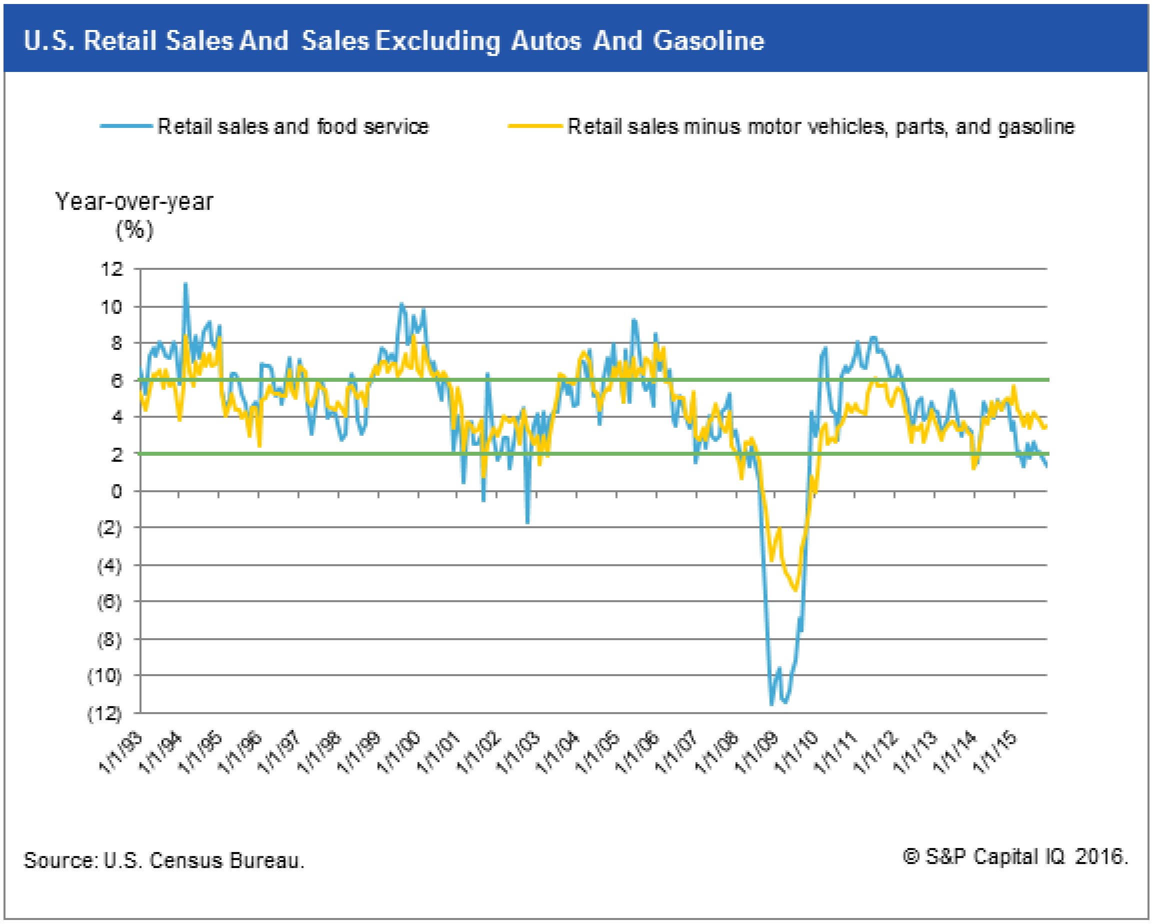
January 8, 2016

Chart 1



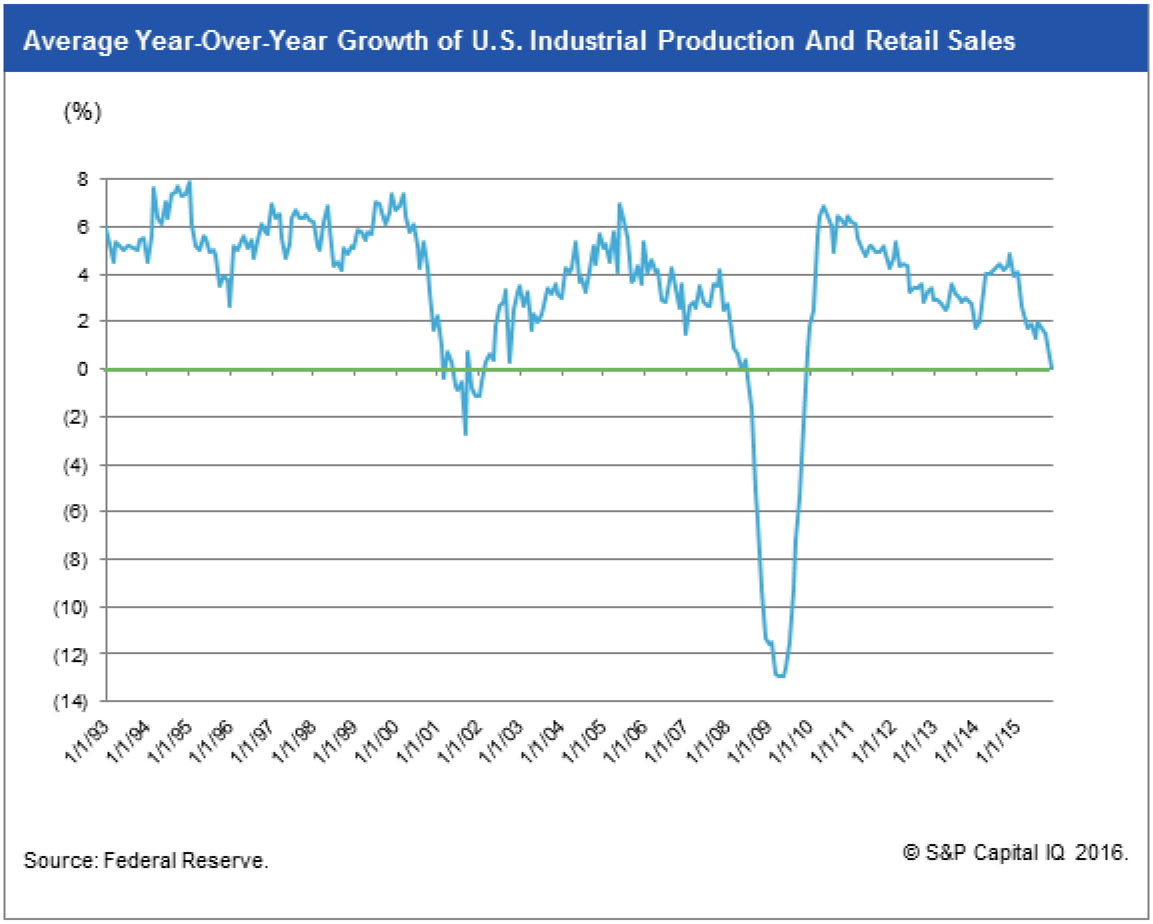
U.S. retail sales have also displayed divergent economic data. The year-over-year rate of change for total headline U.S. retail sales has slipped below a 2% growth rate for the past two months, which traditionally might be interpreted as foreshadowing growing risks of recession for the U.S. economy as it approaches a potential stalling rate. But if we exclude the negative influence of highly volatile and declining gasoline service station sales, as well as the positive influence from historically strong auto sales, the resulting growth rate of what we consider to be a more core reading of retail sales is much healthier at 3.4% and 3.6% in October and November, respectively (see chart 2). We are usually quick to point out the much healthier picture portrayed by retail sales excluding gasoline sales, but such optimism does ignore the fact that the U.S. consumer continues to save, rather than spend, most of the windfall tax cut from steep declines in household energy-related expenditures.

Chart 2



As we press further into 2016, we will be placing increased emphasis on the combined average year-over-year growth rate of headline U.S. retail sales and industrial production. The reasons for this are fairly straightforward. Besides the fact that this customized indicator currently suggests zero growth for the economy as of November 2015 (see chart 3), we are mostly interested to see if and when consumers begin to spend their energy tax cut more freely. Thus, they would start drawing down existing unsold excess business inventories, which in turn should help alleviate downward pressure on U.S. domestic and global industrial-sector activity. Should this occur, the U.S. economy should be perceived to be exhibiting solid GDP growth.

Chart 3



Simply put, it is our preliminary expectation that 2016 will be a good year for the stock market (8%-12% total return for the S&P 500) and risk assets generally, including speculative-grade bonds. We anticipate that a sustained healthy pace of job creation will continue to firm up labor market conditions, thus underpinning wage growth and consumer confidence. These two factors, along with the energy-based tax cut, will in turn support continued healthy retail sales and personal consumption. Any pick-up in global industrial activity should also reinforce crude oil prices and increase chances that West Texas Intermediate will average about $46 per barrel--the forecast of our in-house experts at Bentek Energy-- which would be a positive development for the credit markets. Once the U.S. bond market has priced in an additional two to three forthcoming policy adjustments from the Federal Reserve, investors will likely start to rebalance and diversify their portfolios by adding increased fixed-income exposures.

All of this collective optimism is predicated on a reversal of the current direction of the custom hybrid retail sales and industrial production indicator at some point during first-quarter 2016. This would help alleviate existing simmering concerns that the U.S. economy is in the process of slowing prematurely because of largely unforeseen consequences of the normalization of commodity and financial asset class valuations (see "Lookout Report: Global Asset Class "Normalization" Has Room To Run," published Dec. 18, 2015). Nonetheless, regardless of an unlikely recession for the U.S. economy in the coming year, stalled GDP growth would introduce an entirely new set of global risk mitigation concerns that are not currently priced into global security valuations.

Inside This Issue:

Macroeconomic Overview: A Dichotomy Illustrates The Current U.S. 2016 Economic And Financial Market Outlook

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Economic And Market Outlook: S&P 500 Fourth-Quarter Earnings Expectations Continue Their Slide

It is shaping up to be a less than stellar earnings season for U.S. equities. Fourth-quarter S&P 500 earnings are expected to decline to $28.86 versus the $30.56 reported a year ago, representing a 5.5% decline on the heels of the 1.4% decline recorded in the third quarter of 2015. Even if final reported earnings beat expectations by a historically typical 3%, earnings growth will still end up being negative. The index hasn't seen back-to-back earnings declines since 2009.

S&P Dow Jones Index Commentary: Dividend Payments Set A Record in 2015; Another Record Is Likely In 2016

S&P Dow Jones Indices sees two possible scenarios for the year. On the pessimistic side, commodities would continue down as U.S. economic growth slows; earnings falter with a 0.75% (maximum) 2016 Fed increase which would leave dividend growth in the 3% area for 2016. On the optimistic side, oil and commodities rebound slightly over the year (gyrating); the economy adjusts to the Fed increases (1%-1.25%); inflation picks up, more in the second half of the year; consumers, though still selective, spend more; and earnings increase by low double-digits--allowing dividends to increase roughly 8%-9% for 2016.

Leveraged Commentary And Data: Leveraged Loan Default Rate Rises To Nine-Month High In December

If history is a guide, the timing of the default spike will coincide with an economic downturn. Assuming there is no disruptive outside shock, loan market players generally expect the U.S. economy to grow, albeit sluggishly, in the next 12–24 months. Given the recent turmoil around the globe, it's no wonder the imputed default premium in the market has crept up in recent months. As of Dec. 31, the S&P/LSTA Index was trading at a spread of 624 basis points above LIBOR, suggesting an imputed default rate of 6.5%. That is the highest imputed default premium since December 2011 and is up from 5.60% in November.

R2P Corporate Bond Monitor

The U.S. economy started the new year with a similar blend of mixed data releases, which overall underpinned the good health of the domestic economy. Markets, however, continued to be driven by more global concerns stemming mainly from China. The labor market continued to show strength with the four-week moving average of jobless claims continuing to hold low under the 300,000 mark. The eurozone's recovery appeared to continue following some positive data in the past few weeks. The manufacturing PMI continued its strong rise to 53.2 in December from 52.8 in November because of positive output growth and job creation in all member nations.

Capital Market Commentary: IPOs, M&A, And Debt

When examining the IPO market, GMI took a cue from the adage that yesteryear's laggards could be next year winners. Specifically, we examined the laggards from the IPO class of 2014 and found that in 2015, the 10-lowest performing issues in 2014, in aggregate, saw an average price increase of 1.3%. That outpaced the performance of the S&P 500 in 2015, which saw a fractional loss. While strategic buyers were flocking to do M&A deals in the health care, energy, and financial sectors during 2015, private equity companies were taking a different path. According to S&P Capital IQ data, information technology was the top sector for announced LBOs in 2015 with $31.2 billion in total deals.

Economic And Market Outlook: S&P 500 Fourth-Quarter Earnings Expectations Continue Their Slide

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What's more, even after excluding the energy sector's substantial drag on earnings (-68.6% projected), earnings growth for the index would only be 0.4% as weak growth is anticipated across multiple sectors. Six of 10 sectors are expected to post negative growth, a phenomenon that hasn't occurred since the third quarter of 2009. S&P 500 earnings growth has historically averaged about 8%, a rate not seen since the third quarter of 2014. The decline in corporate earnings growth is not limited to the final quarter of 2015. Calendar-year 2016 S&P 500 earnings have now dropped to $125.43 from $129.30 as recently as the end of the third-quarter 2015 with the anticipated associated growth rate dropping to 7.4% from 10.2% for the current year.

Leading sectors for fourth-quarter earnings growth are telecommunications, consumer discretionary and health care, which are the same sectors that led during third-quarter earnings season. Telecommunication services is the only sector expected to have double-digit growth at 17.9%. Growth rates of 7.4% and 5.6% for consumer discretionary and health care, respectively, are healthy but nonetheless much lower than the 16.4% and 15.1% rates reported in third quarter.

Table 1

Fourth-Quarter Earnings Per Share

Sector	Fourth-quarter earnings per share ($)	Fourth-quarter earnings per share growth (%)(i)
Consumer discretionary	8.04	7.40
Consumer staples	6.06	(3.90)
Energy	2.67	(68.60)
Financials	5.26	0.30
Health care	11.48	5.60
Industrials	7.36	(0.10)
Information technology	11.93	(4.50)
Materials	2.96	(23.30)
Telecommunication services	2.72	17.90
Utilities	2.59	(1.80)
S&P 500	28.86	(5.50)
S&P 500 excluding energy	21.88	0.40

(i)Year-over-year. Source: S&P Capital IQ.

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S&P Dow Jones Index Commentary: Dividend Payments Set A Record in 2015; Another Record Is Likely In 2016

S&P 500 companies paid out 10% more in regular cash dividends in 2015 than in 2014, according to S&P Dow Jones Indices calculations. It was the fifth consecutive year of double-digit increases and the fourth record year for payments. Based on early estimates, 2016 is expected to post a fifth year of record dividend payments, though the increase may be in the mid-single digits.

However, the average dividend increase significantly declined to 13.08% in 2015 from 17.50% in 2014, 20.38% in 2013, and 20.20% in 2012.

From a quarterly perspective, payments for the fourth quarter of 2015 set a record, the seventh in a row. However, the quarter, with $3.6 billion in dividend net increases, showed a massive deceleration from the $12.0 billion increase registered during the fourth quarter of 2015.

Energy issues accounted for 48% of the dividend cuts and 80% of the dollar cuts in the fourth quarter. The dividend cuts to limited partnerships and royalty-related issues, which began near the end of 2014 and continued into 2015, started with small-cap issues and have now moved to the large-cap issues.

Reviewing the U.S. common stock universe (and not just the S&P 500), 755 dividend increases were reported during the fourth quarter of 2015, down from 971 increases reported during the fourth quarter of 2014, a 22.2% decrease. For all of 2015, 2,810 issues increased their payments, down from the 3,308 issues that increased their payments during 2014, a 15.1% decrease.

Meanwhile, 142 companies decreased (defined as either a decrease or a suspension) their dividends in the fourth quarter of 2015 compared with 67 in the fourth quarter of 2014, a 112% difference. For all of 2015, 504 issues decreased their dividend payments, a large jump from 291 decreases in 2014, a 73.2% increase.

The percentage of non-S&P 500 domestic common issues paying a dividend was up to 47.4% from the 46.7% posted in the third quarter of 2015 and the 47.0% rate in the fourth quarter of 2014. The weighted dividend yield for paying issues increased to 2.74% in the fourth quarter of 2015, down from 2.83% in the third quarter of 2015 but up from the 2.45% seen at the end of the 2014.

Within the large-cap S&P 500, 417 issues (82.7%) currently pay a dividend. All 30 members of the Dow Jones Industrial Average pay a dividend. In the S&P MidCap 400, 70.5% of the issues pay a cash dividend, the same as in the third quarter but up from the 68% at the end of 2014. Within the S&P SmallCap 600, 53.6% of the issues pay, down from the 53.9% from third-quarter 2015 but up from 52.7% a year ago.

Yields at the index level continued to vary greatly with large-caps at 2.16%, mid-caps at 1.71%, and small-caps at 1.50%. For paying issues, the yields across market-size classifications continue to be compatible with large-caps coming at 2.56%, mid-caps at 2.42%, and small-caps at 2.50%.

Looking forward to 2016, a key statistic to note is that S&P 500's average dividend increase of 13.08% for 2015 was significantly lower than 2014's 17.50%. This trend is likely to continue given the slow earnings, cash flow, and economic recovery, as well as low inflation. Based on current dividend polices, with an eye on issues that may be straining themselves, as well as those with higher dividend coverage rates and a strong history of annual increases, 2016 would appear to extend the record payment years but with mid-single digit dividend increases.

Here are two possible scenarios, according to S&P Dow Jones Indices: On the pessimistic side, commodities would continue down as U.S. economic growth slows; earnings falter with a 0.75% (maximum) 2016 Fed increase which would leave dividend growth in the 3% area for 2016. On the optimistic side, oil and commodities rebound slightly over the year (gyrating); the economy adjusts to the Fed increases (1%-1.25%); inflation picks up, more in the second half of the year; consumers, though still selective, spend more; and earnings increase by low double-digits--allowing dividends to increase roughly 8%-9% for 2016.

Table 2

Quarterly And Annual Dividend Actions

	No. of positive dividend actions	No. of negative dividend actions	Dividend breadth
Q4 2015	755	142	5.32
Q4 2014	971	67	14.49
Q4 2013	885	51	17.35
Q4 2012	1,266	154	8.22
Q4 2011	649	27	24.04
Q4 2010	696	28	24.86
Q4 2009	484	74	6.54
Q4 2008	475	288	1.65
Q4 2007	792	52	15.23
2015	2,810	504	5.58
2014	3,308	291	11.37
2013	2,895	299	9.68
2012	2,887	275	10.50
2011	1,953	101	19.34
2010	1,729	145	11.92
2009	1,191	804	1.48
2008	1,874	606	3.09
2007	2,513	110	22.85
2006	2,617	87	30.08
2005	2,518	84	29.98
2004	2,298	62	37.06
2003	2,162	104	20.79
2002	1,756	135	13.01
2001	1,668	205	8.14
2000	1,886	137	13.77
1999	2,125	144	14.76

Source: S&P Dow Jones Indices.

Table 3

U.S. Domestic Common Market Changes

Quarterly	Increases (mil. $)	Initials (mil. $)	Decreases (mil. $)	Suspensions (mil. $)
Q4 2009	3,132	1,243	(936)	(137)
Q4 2010	7,992	908	(786)	(71)
Q4 2011	9,284	1,664	(373)	(9)
Q4 2012	10,639	2,554	(4,555)	(242)
Q4 2013	13,003	1,129	(1,185)	(221)
Q4 2014	12,032	1,407	(1,419)	(12)
Q4 2015	9,160	1,145	(5,660)	(1,047)
	Actions (mil. $)(i)	**Change (mil. $)**	**Positive (mil. $)**	**Negative (mil. $)**
Q4 2009	5,447	3,301	4,374	(1,073)
Q4 2010	9,758	8,043	8,900	(857)
Q4 2011	11,330	10,566	10,948	(382)
Q4 2012	17,990	8,396	13,193	(4,797)
Q4 2013	15,538	12,726	14,132	(1,406)
Q4 2014	14,869	12,009	13,439	(1,430)
Q4 2015	17,012	3,597	10,305	(6,707)
Annually	**Increases (mil. $)**	**Initials (mil. $)**	**Decreases (mil. $)**	**Suspensions (mil. $)**
2009	12,075	3,566	(53,904)	(4,104)
2010	25,950	3,426	(2,538)	(298)
2011	43,965	9,696	(2,516)	(922)
2012	43,391	18,638	(7,747)	(909)
2013	54,561	9,909	(6,377)	(1,352)
2014	53,082	8,579	(6,143)	(697)
2015	46,587	8,069	(13,868)	(2,056)
	Actions (mil. $)(i)	**Change (mil. $)**	**Positive (mil. $)**	**Negative (mil. $)**
2009	73,835	(42,367)	15,641	(58,008)
2010	32,211	26,540	29,376	(2,835)
2011	57,099	50,223	53,661	(3,438)
2012	70,685	53,373	62,029	(8,656)
2013	72,200	56,740	64,470	(7,730)
2014	68,500	54,821	61,661	(6,839)
2015	70,581	38,731	54,656	(15,925)

(i)Absolute change. Source: S&P Dow Jones Indices

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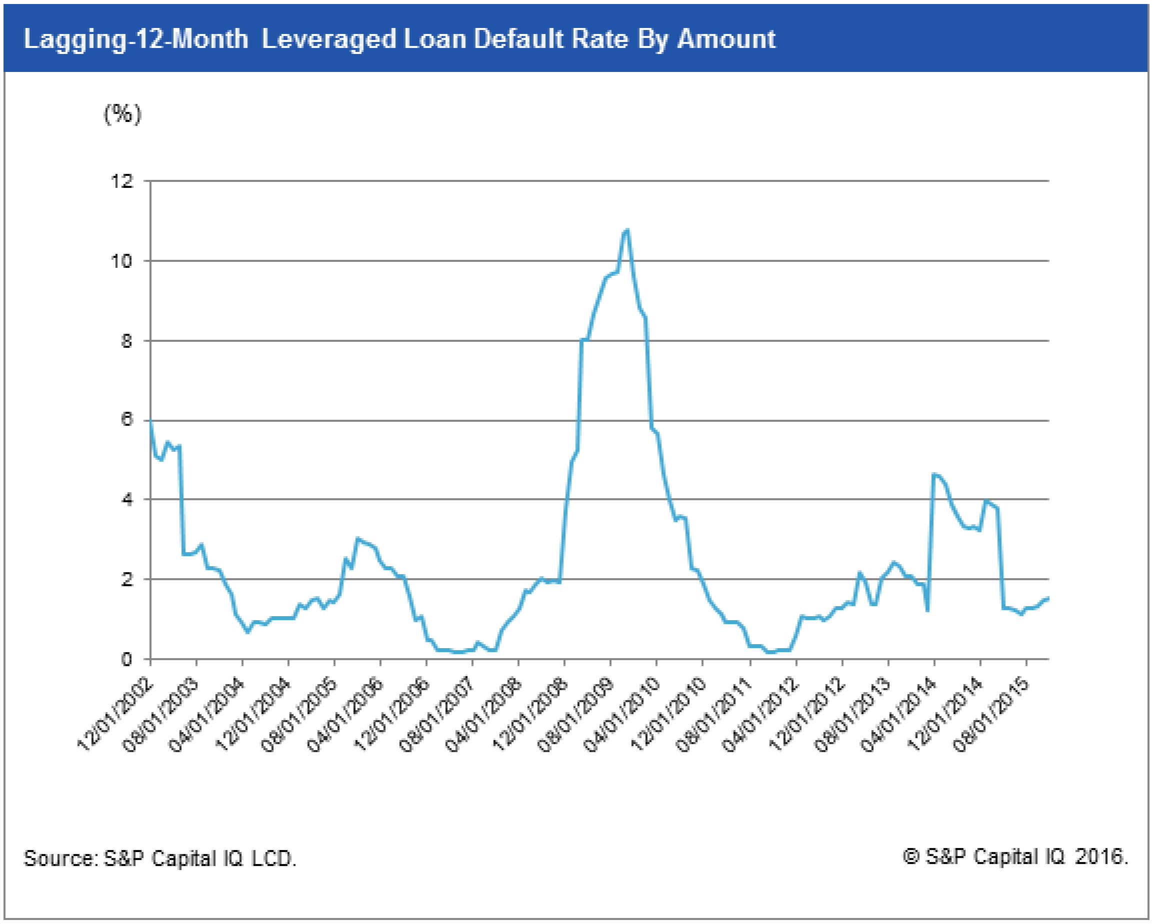
Leveraged Commentary And Data: Leveraged Loan Default Rate Rises To Nine-Month High In December

In December, another default out of the oil patch--Energy & Exploration Partners Inc.--pushed 2015's final default rate to a nine-month high of 1.54% by amount and a two-year high of 1.19% by number from 1.47% and 1.09%, respectively, in November.

Chart 4


Lagging-12-Month Leveraged Loan Default Rate By Amount
(%)
12
10
8
6
4
2
0
12/01/2002
08/01/2003
04/01/2004
12/01/2004
08/01/2005
04/01/2006
12/01/2006
08/01/2007
04/01/2008
12/01/2008
08/01/2009
04/01/2010
12/01/2010
08/01/2011
04/01/2012
12/01/2012
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04/01/2014
12/01/2014
08/01/2015
Source: S&P Capital IQ LCD.
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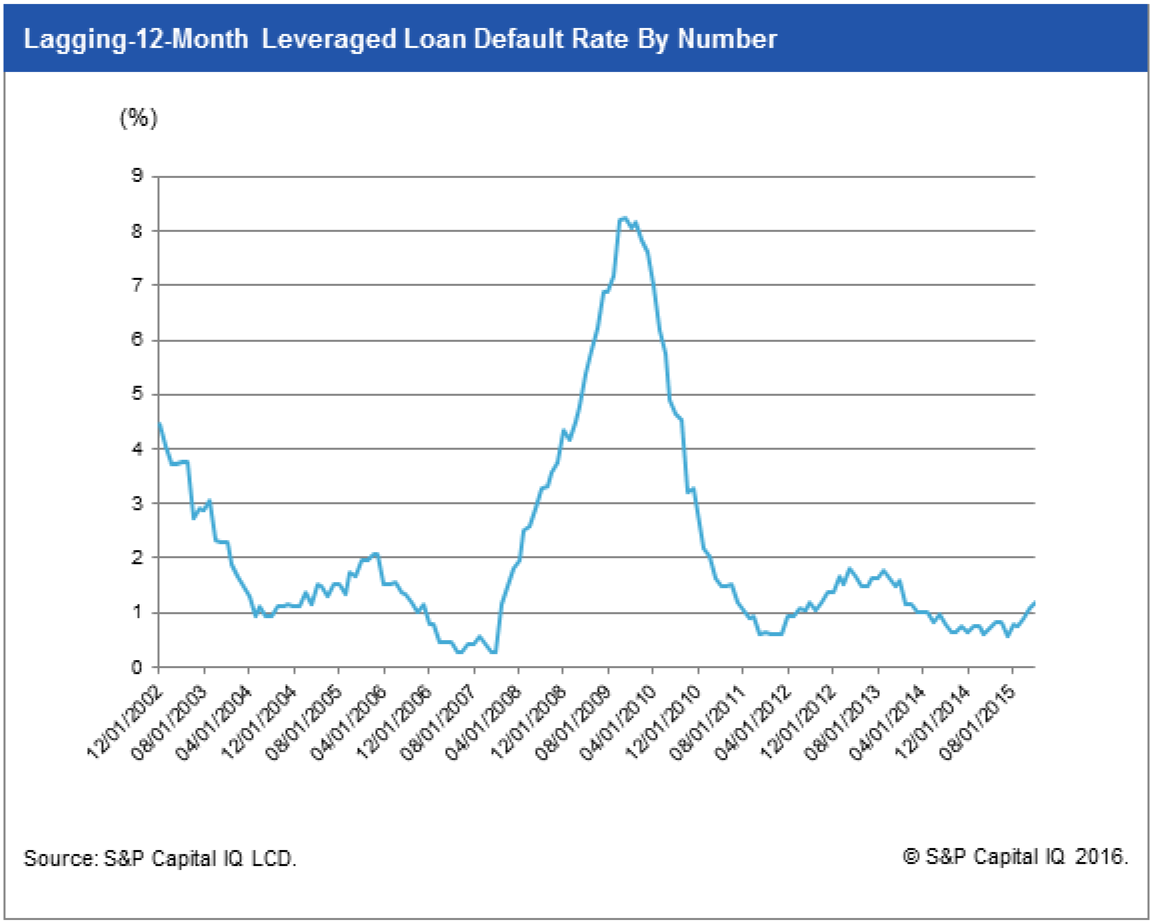
Chart 5



As these charts illustrate, default rates went in opposite directions in 2015. By amount, the rate has trended down from 3.24% at year-end 2014, while it has increased from 0.62% by number. The reason is the outsized impact of Energy Future Holdings Corp., which dropped off 12-month rolls in April and single-handedly reduced the rate by amount by 2.76 percentage points while only nicking the rate by number by 0.13 percentage points.

In 2015, 11 issuers defaulted on a total of $12.5 billion of loans. Two loans accounted for more than half of the year's default volume: Caesars Entertainment Operating Co. (CEOC) at $5.4 billion, or 43%, and Millennium Health LLC at $1.8 billion, or 14%. That skewed default volume away from the leveraged market's most troubled sectors: energy and metals and mining. These sectors, however, accounted for eight of 11 issuers that defaulted during the year.

Chart 6

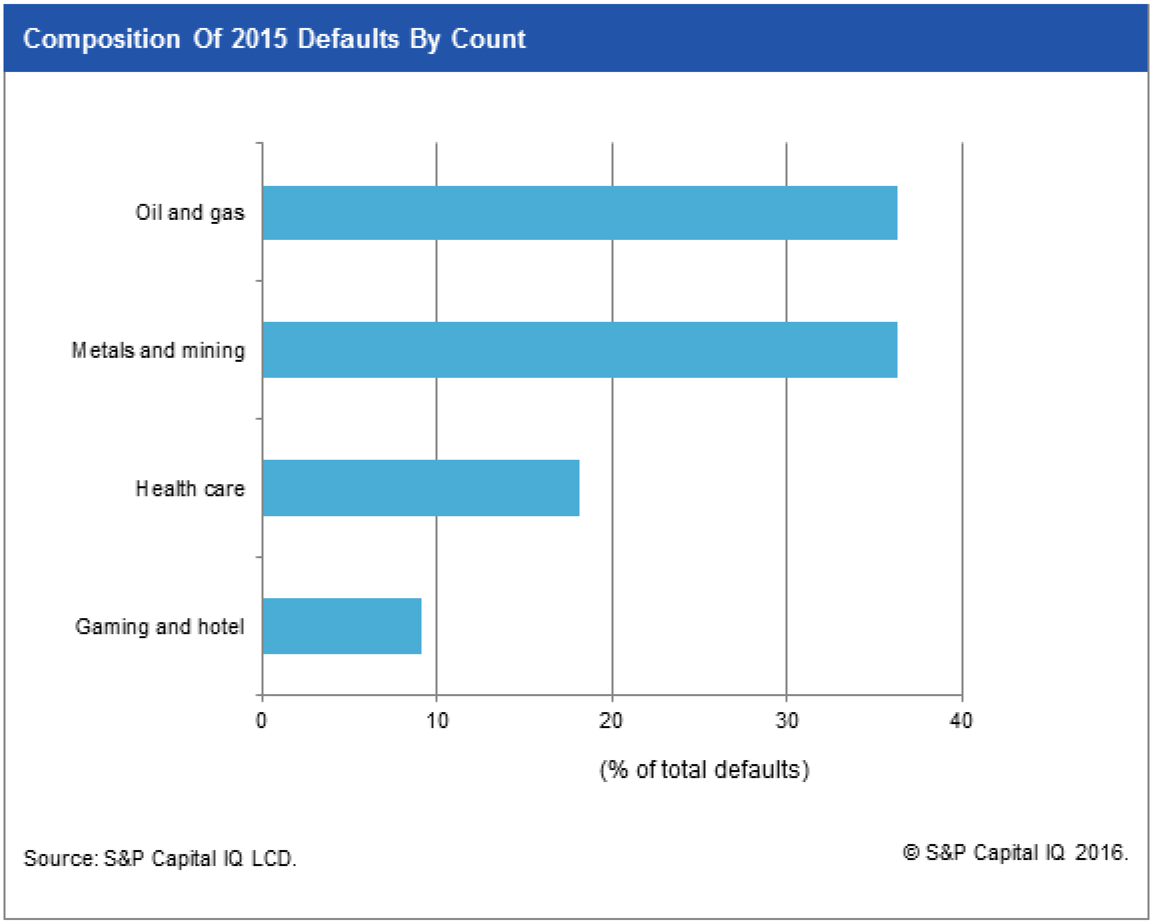

Composition Of 2015 Defaults By Count
Oil and gas
Metals and mining
Health care
Gaming and hotel
0
10
20
30
40
(% of total defaults)
Source: S&P Capital IQ LCD.
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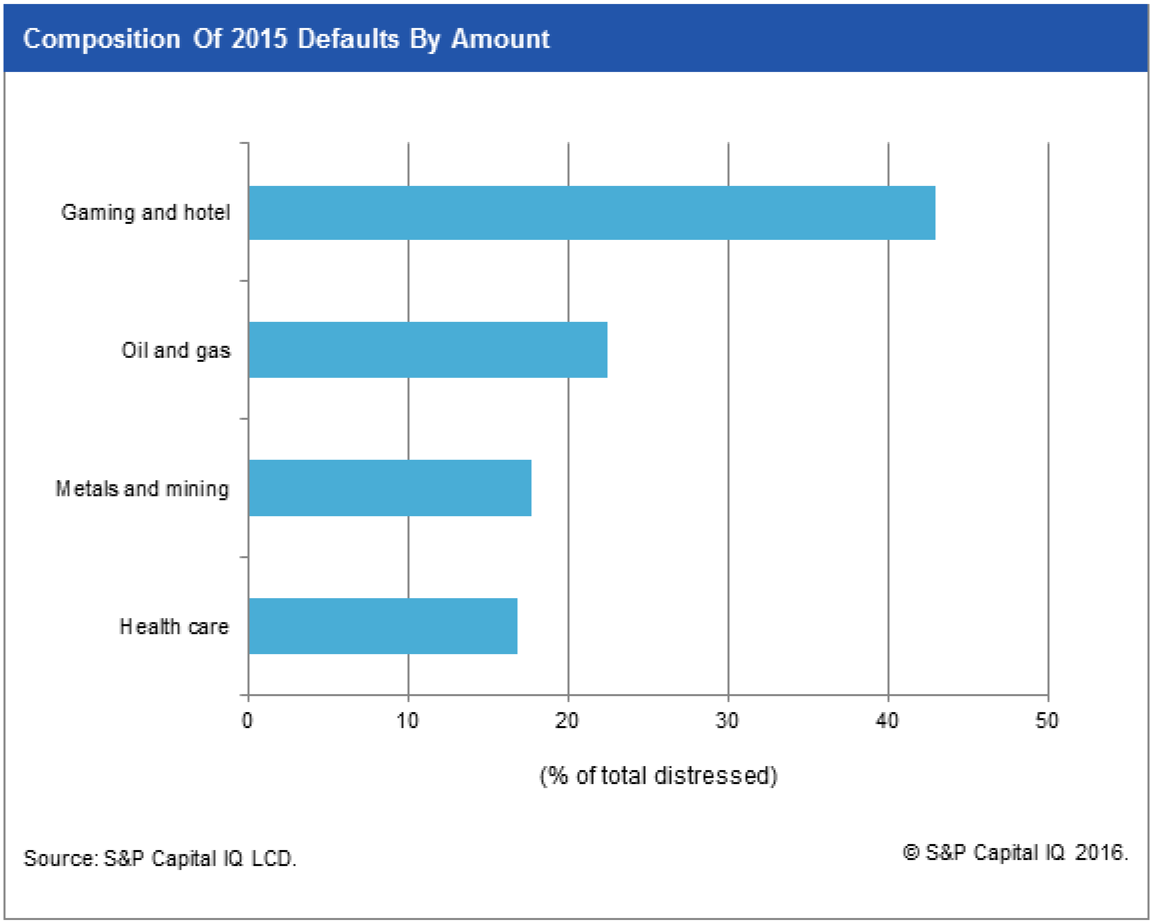
Chart 7



Woes in energy notwithstanding, the default rates in 2015 were well inside the historical average of 3.14% by amount and 2.79% by number. These below-trend levels reflect the fact that the U.S. economic recovery continued, albeit sluggishly, in the past year. In a note dated Dec. 3, Standard & Poor's Ratings Services U.S. Chief Economist Beth Ann Bovino estimated that when all beans are counted, GDPs will have expanded 2.5% in 2015. That was enough to help issuers outside of troubled sectors or with declining business models maintain cash flow growth and service debt.

Looking ahead, managers are constructive on the outlook for 2016. On the whole, managers judge that the credit cycle is now in the second half if not the fourth quarter, but the game is not over yet. In fact, the loan default rate by amount will remain below trend in the next 12 months before creeping up to the historical average of 3.1% by the end of 2017. Indeed, managers on average say that the loan default rate by amount will climb to 2.35% by year-end 2016 and to 3.24% by year-end 2017, according to Leveraged Commentary And Data's (LCD's) latest quarterly buyside survey conducted in early December. For the record, results were tightly clustered at 1.65%-3.00% for 2016 and 2.50%-4.00% for 2017.

One reason for the relatively upbeat 2016 outlook is that $5.4 billion of Caesars defaulted loans will fall from the lagging-12-month data in January, which will subtract 0.67 percentage points from the rate by amount. That amount, however, is likely to be rapidly replaced by two names that are teetering on the brink--Arch Coal Inc. and SuperMedia Inc./Dex One. Corp.--that together total $3.4 billion, or 0.41% of performing loans.

Outside of these specific situations, managers say the immediate fundamental trend lines remain solid. Here's why:

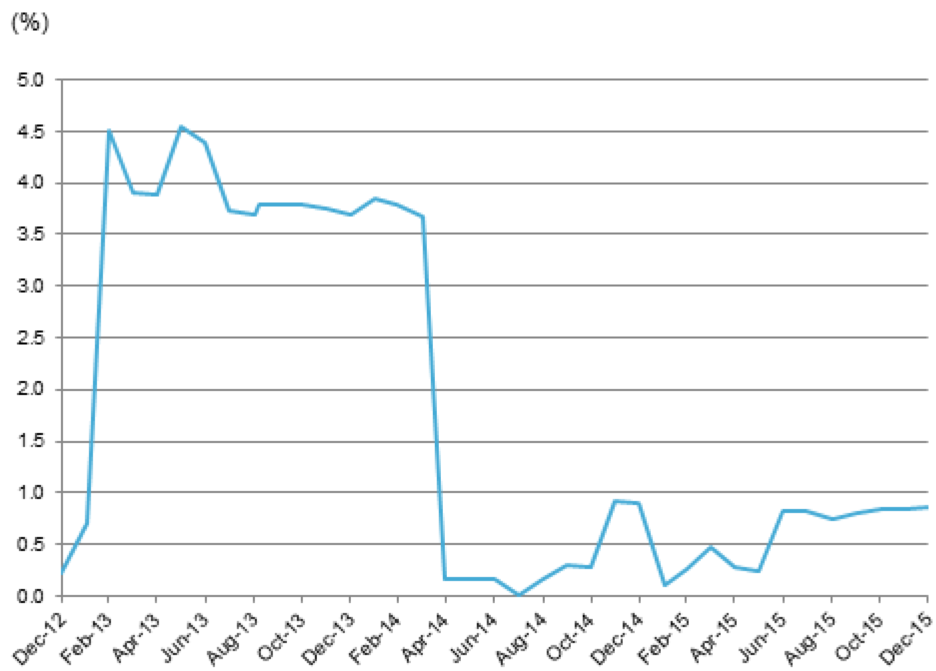
- Watch lists, though growing lately, are relatively short;
- Energy/commodity exposure is limited;
- Immediate maturities are sparse;
- Solid, though slowing, cash flow growth persists; and
- The economy remains in Goldilocks territory.

Relatively short watch lists

LCD's shadow default rate--a measure of performing S&P/LSTA Index issuers that have missed a bond payment, entered a forbearance agreement, or hired bankruptcy counsel--ended 2015 at 0.87%, effectively unchanged from 0.85% in November and down slightly from 0.91% a year earlier.

Chart 8

Shadow Default Rate (Including Energy Future Holdings Corp.)



Source: S&P Capital IQ LCD.

December's shadow default rate comprises: Arch Coal, Atlas Iron Ltd., The Gymboree Corp., NewPage Corp., Paragon Offshore Finance, Peabody Energy Corp., and R.H. Donnelley Corp./SuperMedia Inc.

In addition to the names on the shadow list, participants say that Caesars Entertainment Corp. (CEC), the parent company of bankrupt issuer CEOC, may be headed for bankruptcy in the months ahead, depending on the outcome of pending lawsuits against CEC by bondholders. According to media reports, Caesars and its bondholders could be headed to trial. If CEC files, the issuer would add another $2.5 billion to the default total--pushing up the default rate by amount by 0.31 percentage points on a pro forma basis.

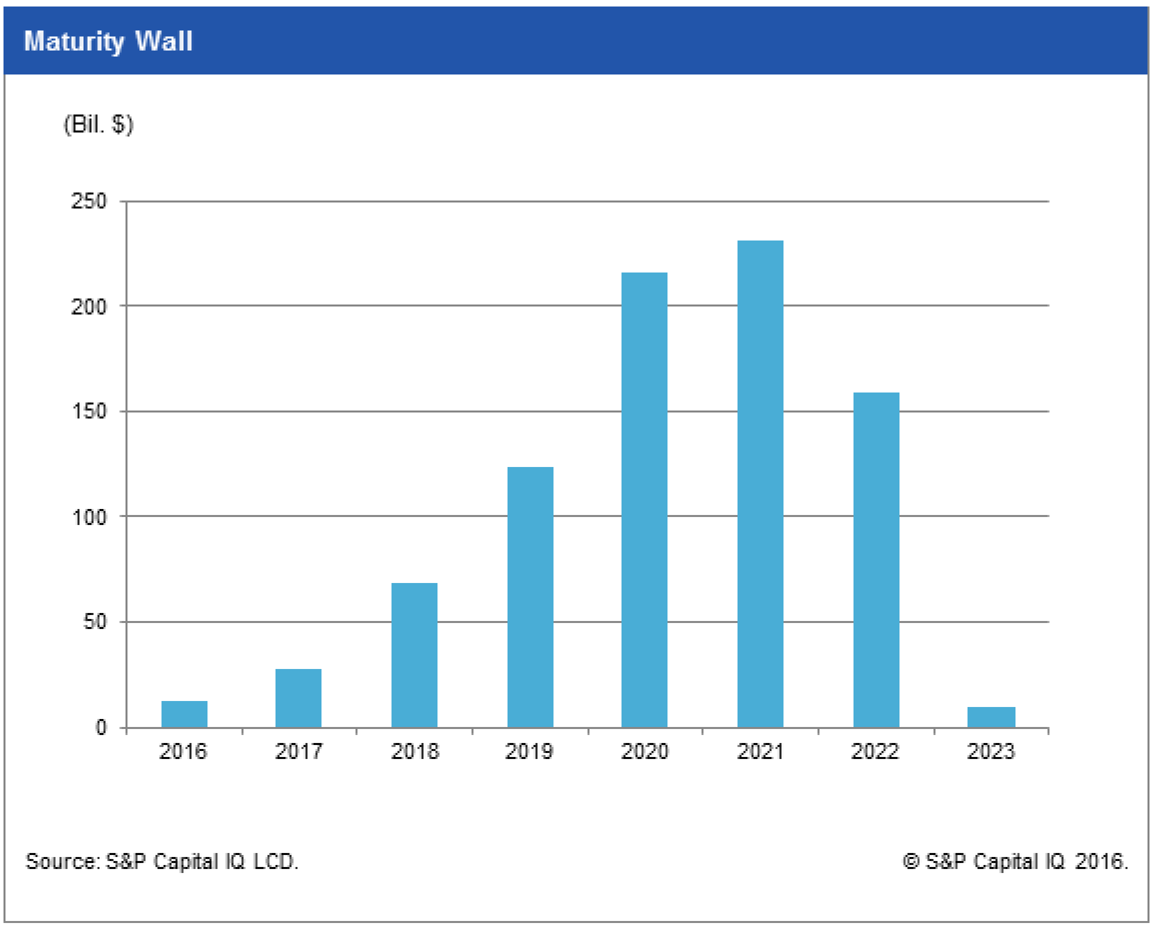
Limited energy/commodity exposure

The potential pain from the challenged sectors of energy and commodities appears limited. For one thing, just 6.5% of performing index loans are from those sectors. Oil and gas accounts for 4.3%; mining and metals accounts for 1.4%; and steel (mainly Fortescue Metals Group) is 0.8%. For another, these loans already are trading at distressed levels with average bid prices of 66 for energy, 77 for mining and metals, and 78 for steel. That compares to an average of 95 across all other industry categories.

Dearth of immediate maturities

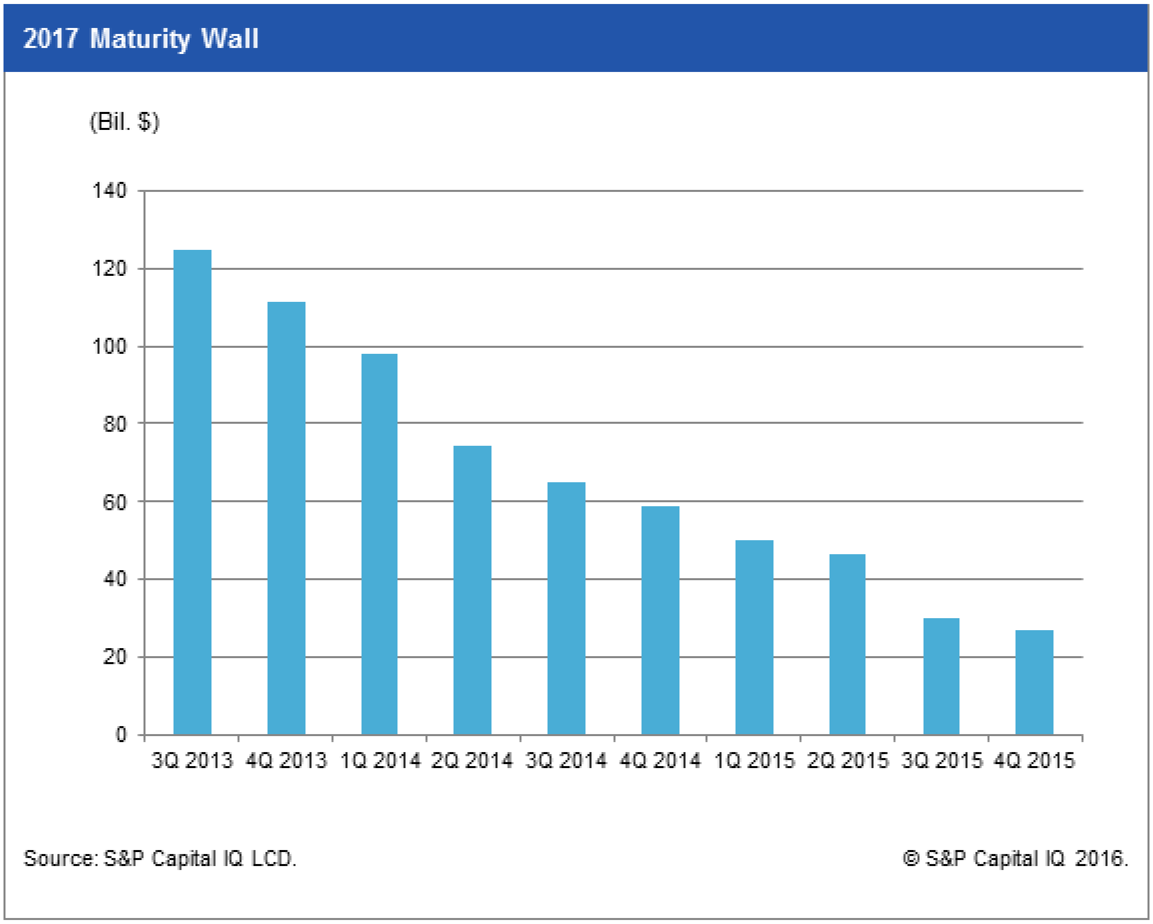
Loan maturities across the index are limited in the next several years. As of Dec. 31, the amount of S&P/LSTA index loans due through year-end 2016 was $12.4 billion, or 1.46% of performing loans outstanding, down from $52.4 billion, or 7.9%, at the end of 2013.

Chart 9



With regard to longer-term maturities, issuers have taken advantage of hot market periods in 2014 and 2015 to whittle down the 2017/2018 maturities that make up the next significant repayment wall. The total amount of S&P/LSTA Index loans that come to term in 2017 fell to $27.4 billion on Dec. 31, or 3.2%, from $59 billion at year-end 2014. This activity has slowed since August in the teeth of choppy new issue market conditions.

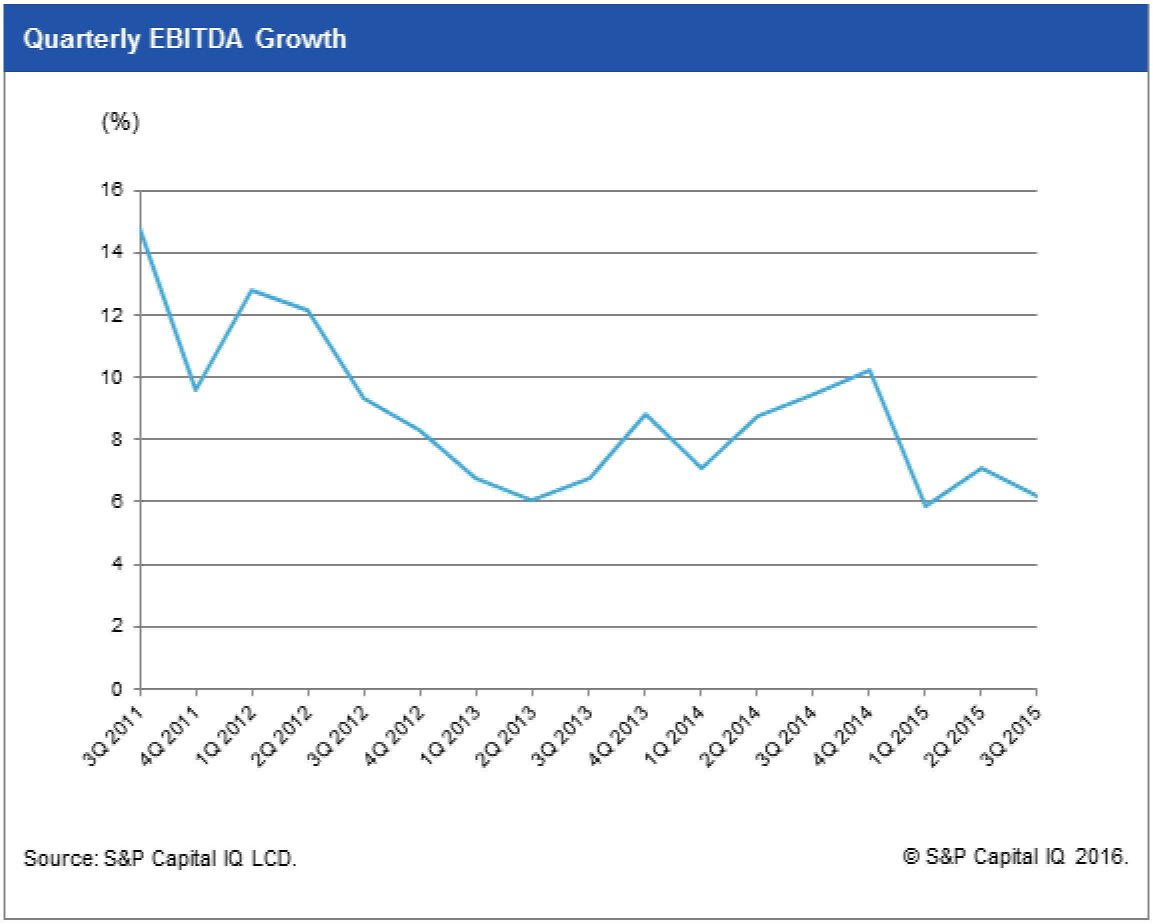
Chart 10



Solid, though slowing, cash flow growth/fat coverage cushions

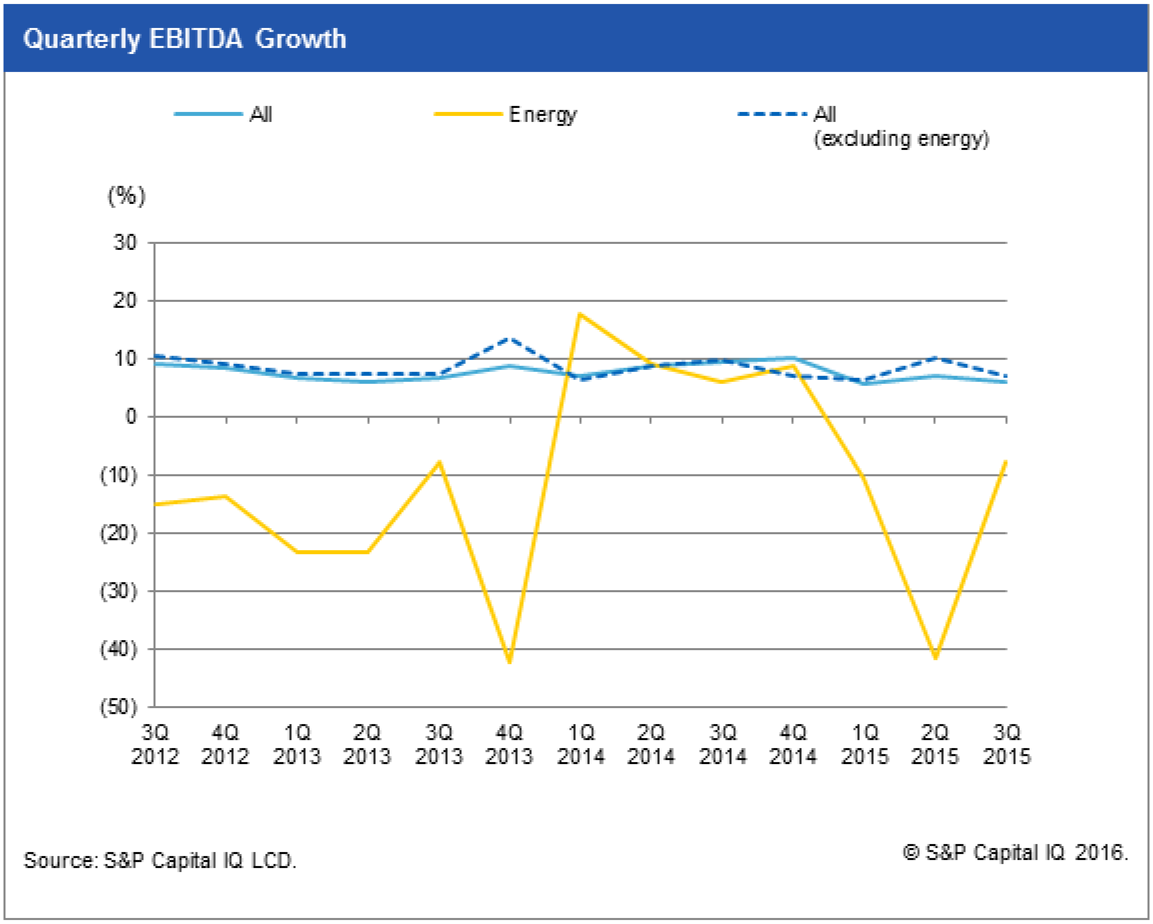
Year-over-year EBITDA growth among S&P/LSTA Index issuers that file publicly sagged to a still-solid 6.2% in the third quarter from 7.1% in the second quarter, according to data from S&P Capital IQ.

Chart 11



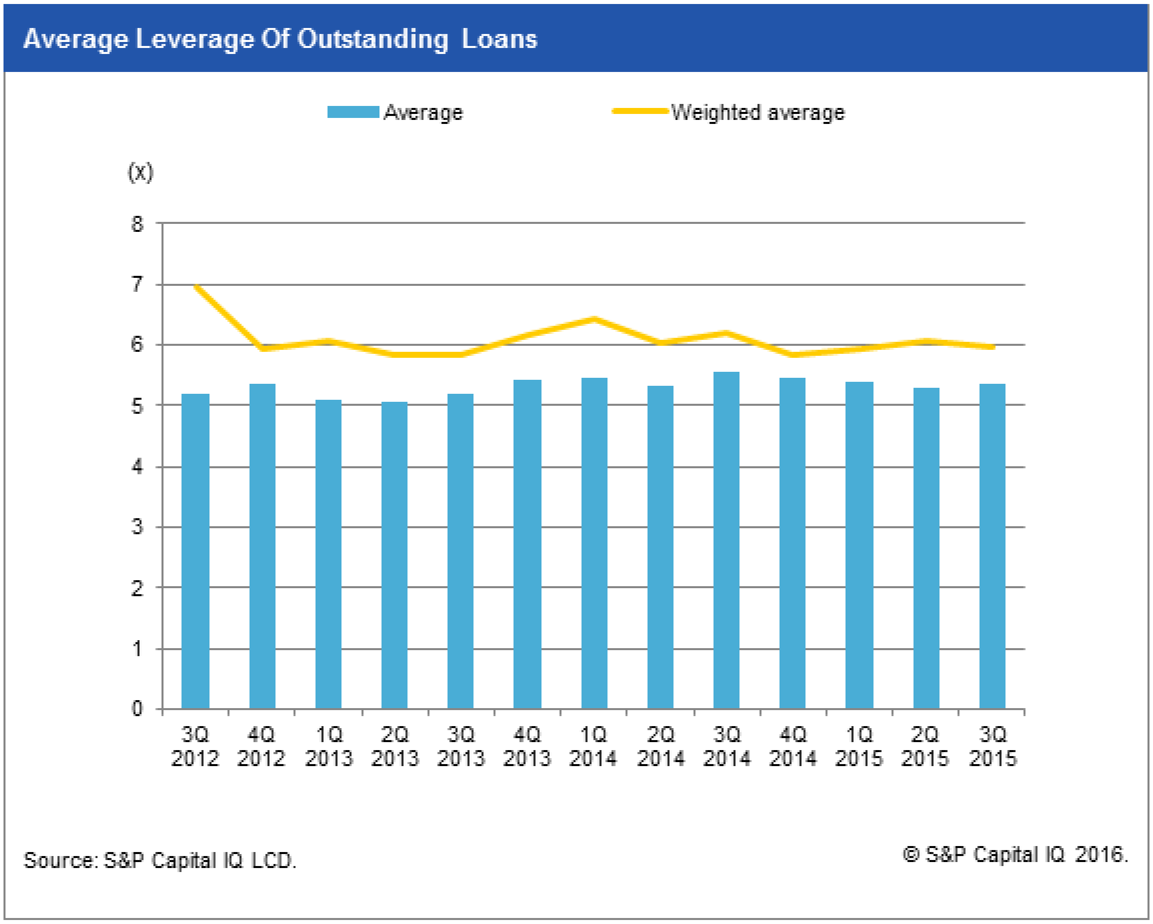
Energy continued to weigh on the broader average in the third quarter, though less so than during the prior three months. Excluding energy, the average year-over-year EBITDA growth was 0.91 percentage points higher in the third quarter at 7.07%. In the second quarter, by comparison, excluding energy EBITDA grew by 2.93 percentage points more at 10.03%.

Chart 12



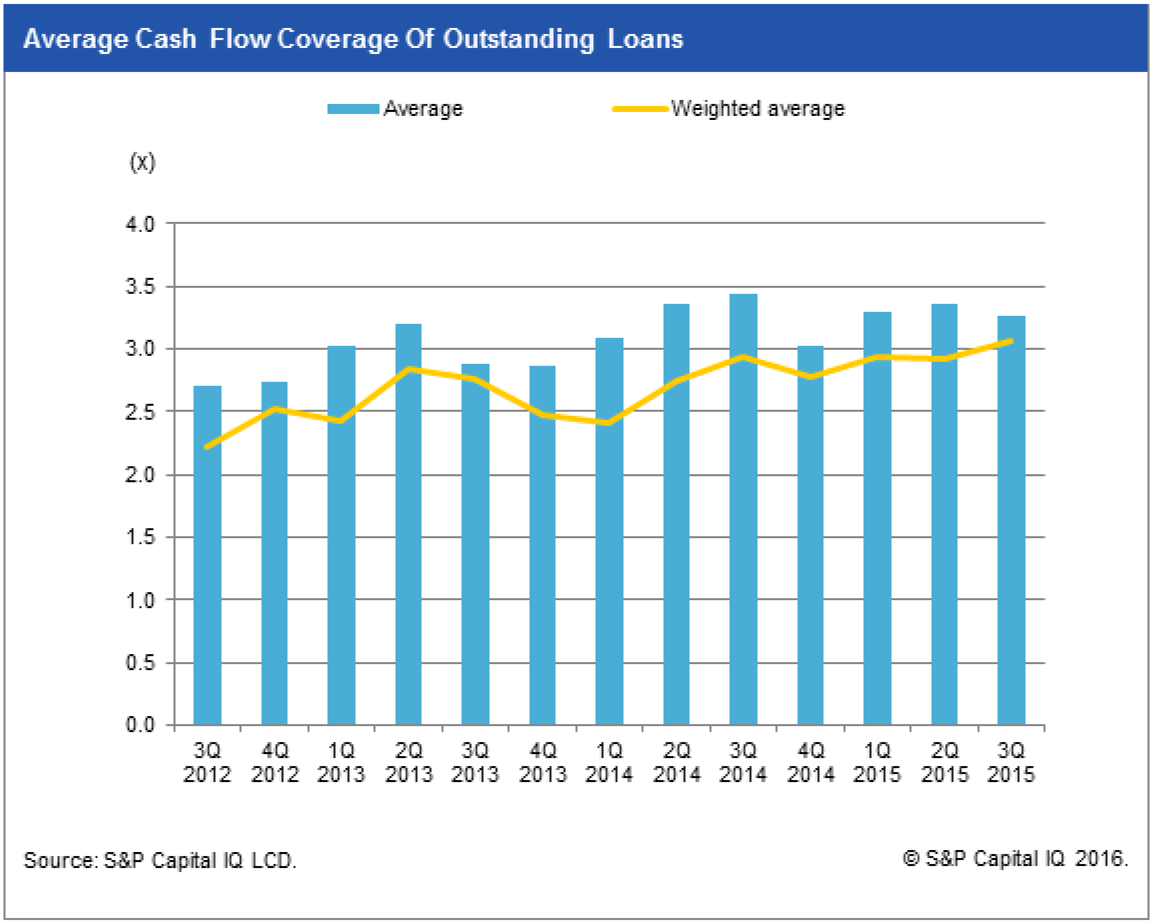
For publicly filing S&P/LSTA Index issuers, the third-quarter's cash flow results didn't move the needle on credit stats. The average debt-to-EBITDA multiple, for instance, ticked up to 5.35x in the third quarter from 5.29x in the second quarter even as the average weighted by loan amount eased to 5.98x from 6.06x. In both cases, the third-quarter figure was within the post-credit-crunch band.

Chart 13



The story was similar for coverage. The average ratio of EBITDA minus capital expenditures (CAPEX) to cash interest in the sample inched down to 3.26x in the third quarter from 3.36x in the second but increased on a weighted basis to 3.07x from 2.91x. Coverage ratios remain near their historical highs (see chart 14).

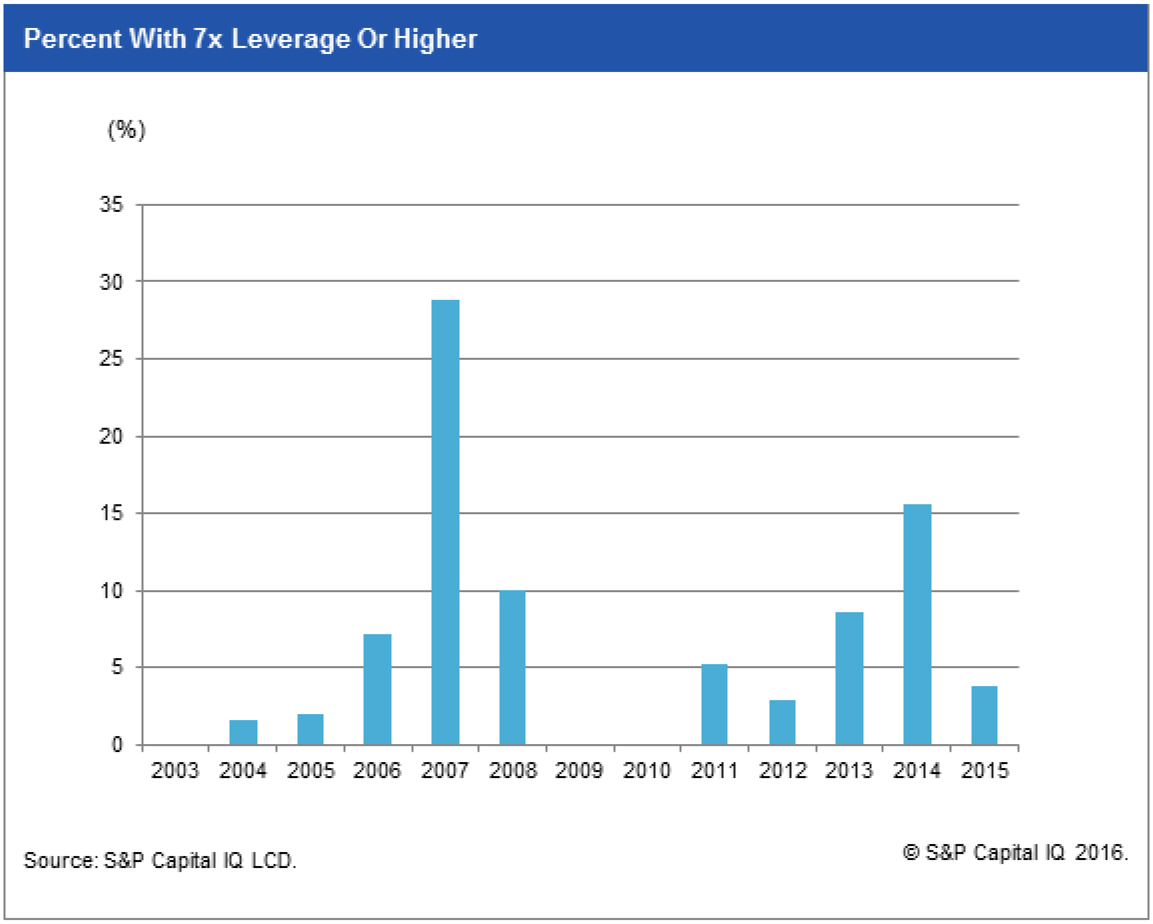
Chart 14



These coverage figures suggest that even if the U.S. economy slumps, most leveraged loan issuers--with the clear exception of those with revenue tied to commodity prices--are armed with a decent coverage cushion to service debt, at least for a while.

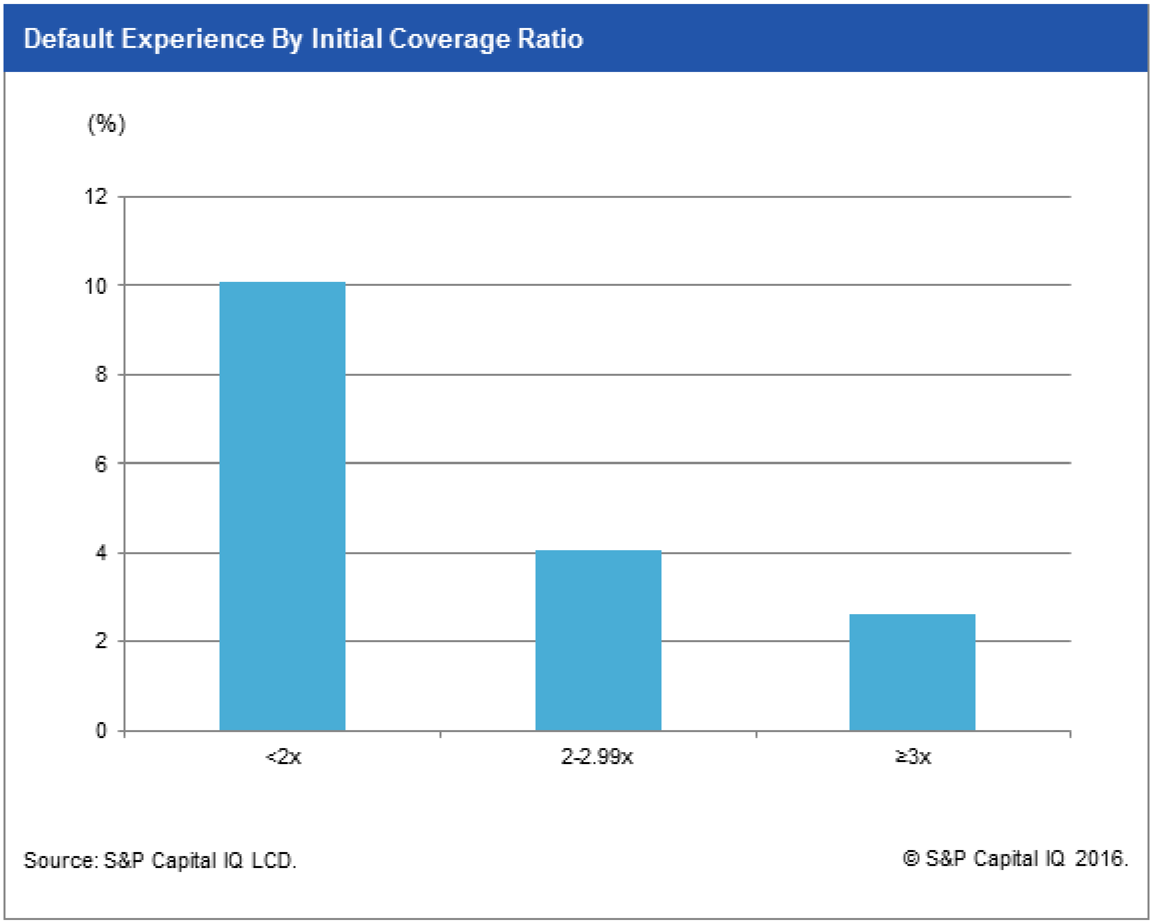
Even in the new issue market, with regulatory pressure being what it's been, the market is seeing fewer deals with ultra-high debt multiples--those that clearly are the most vulnerable to default during a downturn--and thus, the portion of leveraged buyouts (LBOs) structured with debt multiples of 7x or higher out of the blocks has recoiled to 3.8% in 2015 from a post-credit-crunch high of 15.5% in 2014. During the peak boom year of 2007, by comparison, 30% of new LBOs were struck at 7x or higher.

Chart 15



Historically, understandably, deals that were geared higher out of the blocks produced, on average, higher ultimate default rates.

Chart 16



The road ahead

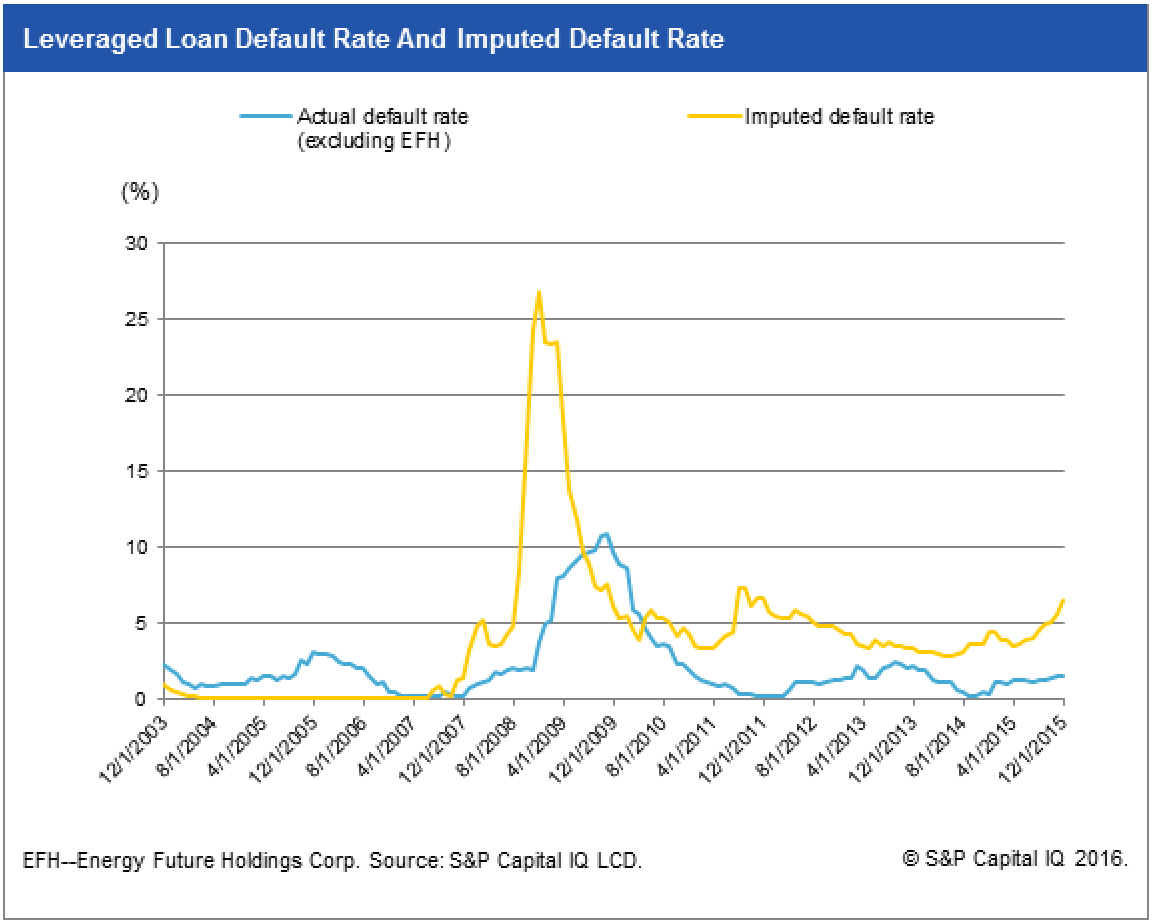
If history is a guide, the timing of the default spike will coincide with an economic downturn. Assuming there is no disruptive outside shock, loan market players generally expect the U.S. economy to grow, albeit sluggishly, in the next 12–24 months.

Standard & Poor's Bovino stated on Dec. 3, "Standard & Poor's expects U.S. real GDP to expand by 2.7% in 2016, helped by the recent compromise on Capitol Hill that reduces risk of a fiscal shock into 2017. The jobs market will continue to strengthen next year. The unemployment rate will reach 4.6% by 2016 year-end, as more people entering the workforce looking for work are absorbed. Wages will grow at a 3.2% annual rate by the end of next year, the strongest pace since the end of 2008. With fatter paychecks, consumer spending will likely be the main engine of growth next year, helped by housing market strength, thanks to built-up demand, would-be buyers jumping off the fence to get ahead of higher rates, and increased household formation. These positive indicators continue to point to an anticipated Federal Reserve rate hike in December. We expect policymakers will take it slowly next year, raising rates four times, with the fed funds rate finishing 2016 in a range around 1.25%."

Wall Street analysts concur. The consensus 2016 EPS growth forecast for S&P 500 companies is 7.8%, according to S&P Capital IQ's Robert Keiser.

Still, given the recent turmoil around the globe, it's no wonder the imputed default premium in the market has crept up in recent months. As of Dec. 31, the S&P/LSTA Index was trading at a spread of 624 basis points above LIBOR, suggesting an imputed default rate of 6.5%. That is the highest imputed default premium since December 2011 and is up from 5.60% in November. Moreover, it shows that investors are demanding a clear margin of safety over both November's rate and the consensus forecast for the next 12 months. And who can blame them, given the combination of recent volatility across the capital markets and the previously noted steady increase in loans rated 'CCC+' or lower and those on LCD's shadow default list?

Chart 17

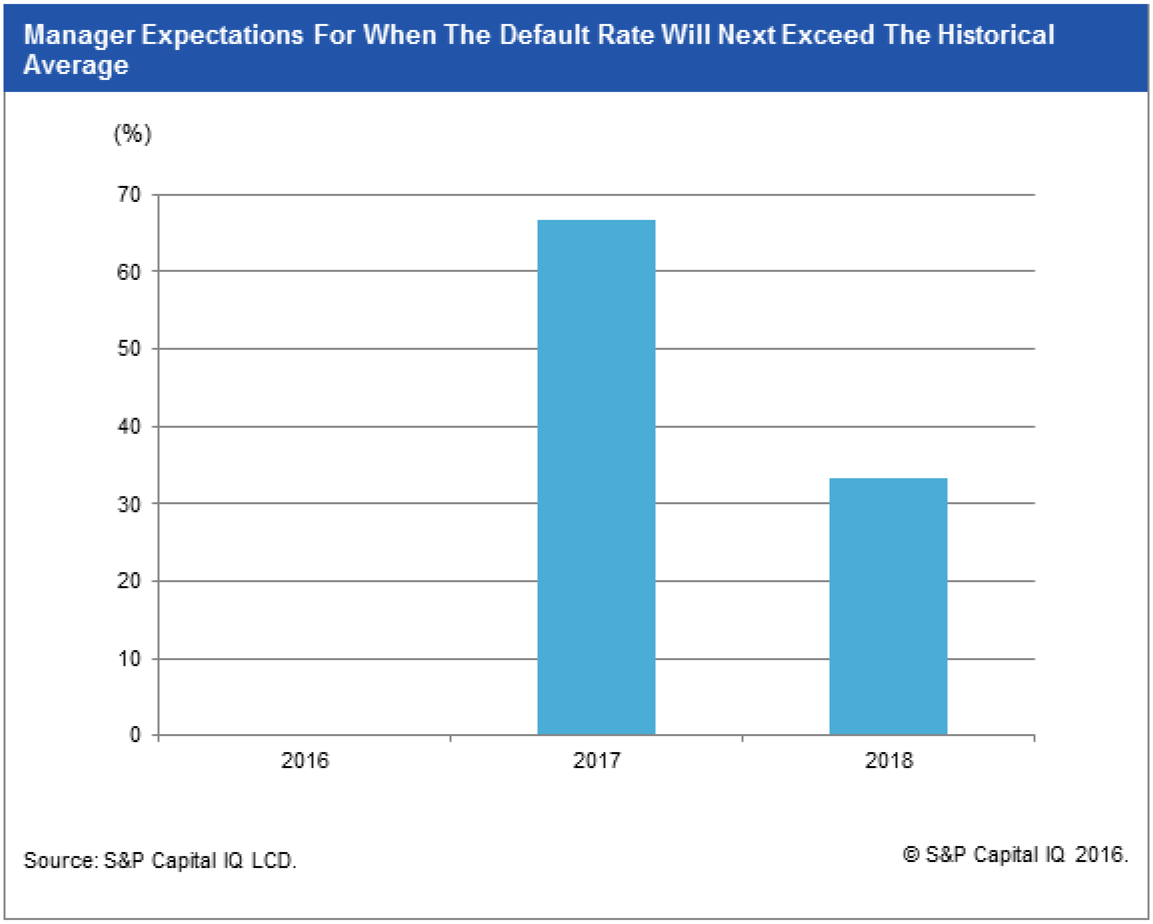


Looking beyond the near-term horizon, there is consensus that the next default cycle could come as early as 2017, when loan maturities start to climb and regulatory pressure on banks and collateralized loan obligations may well limit issuers' refinancing options.

Our colleague Marty Fridson wrote in a comment for LCD that the default rate for high yield bonds will likely push above the long-term average of 4.5%--versus 3.2% for the S&P/LSTA Index--by year-end 2016. Even if that proves true, the outcome may be different for loans, what with high yield's exposure to energy more than three times that of loans.

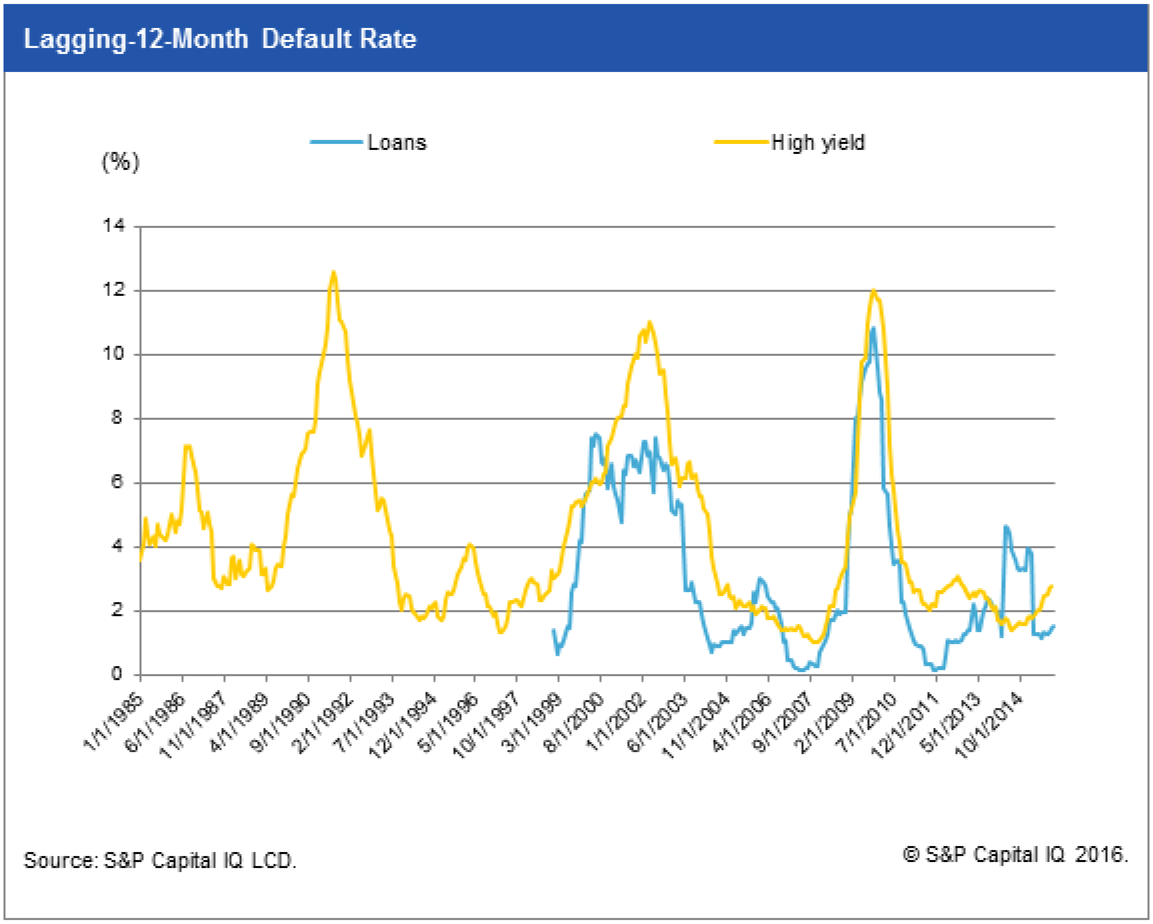
To get a sense of when loan market players expect to see loan default rates push above the historical average, LCD asked managers in its latest buyside poll that very question. Here's how they responded (absent a disruptive outside shock that sets off a financial crisis):

Chart 18



The reason managers are concerned that the credit cycle is in late innings, the fourth quarter, the final rounds--pick your sports metaphor here--is, in part, macro-driven. The current run of below-average default rates, for instance, is getting long in the tooth at six years and counting. Since the modern era of high yield finance began in the mid-1980s, the prior low-default periods have run six years from 1985–1990; eight years from 1992–1999; and six years from 2003–2008.

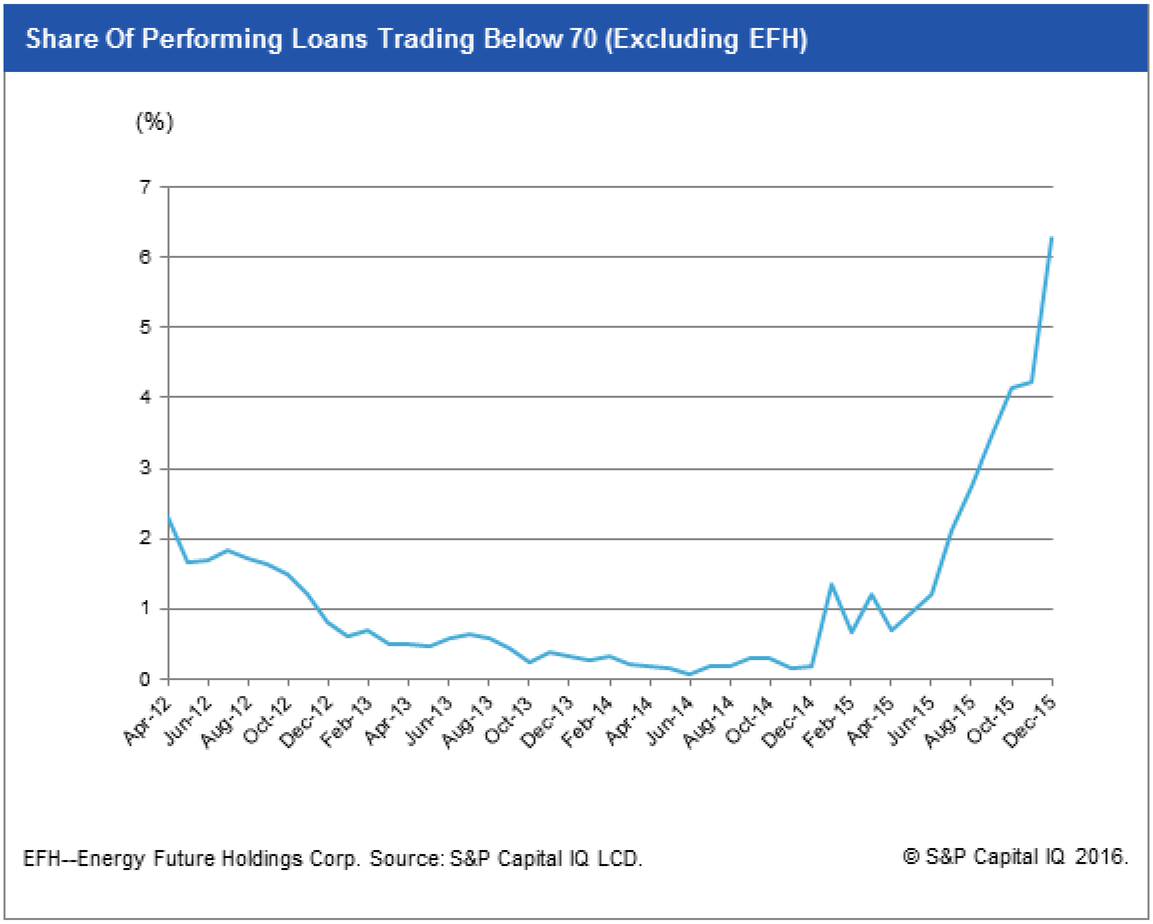
Chart 19



Not coincidentally, the lengths of the economic recovery and bull market in stocks are also pushing toward the wide end of their historical ranges. Since World War II, the average bull market has lasted 8.7 years, and economic expansions have run nearly 5.75 years, on average. Averages, of course, are only guideposts, and even if it appears late in the game for the current cycle, many of the prior cycles went into overtime (and sometimes double OT). The longest economic expansion since 1945, for instance, lasted from 1991–2001, and the longest bull market stretched 12.8 years, from 1988–2001.

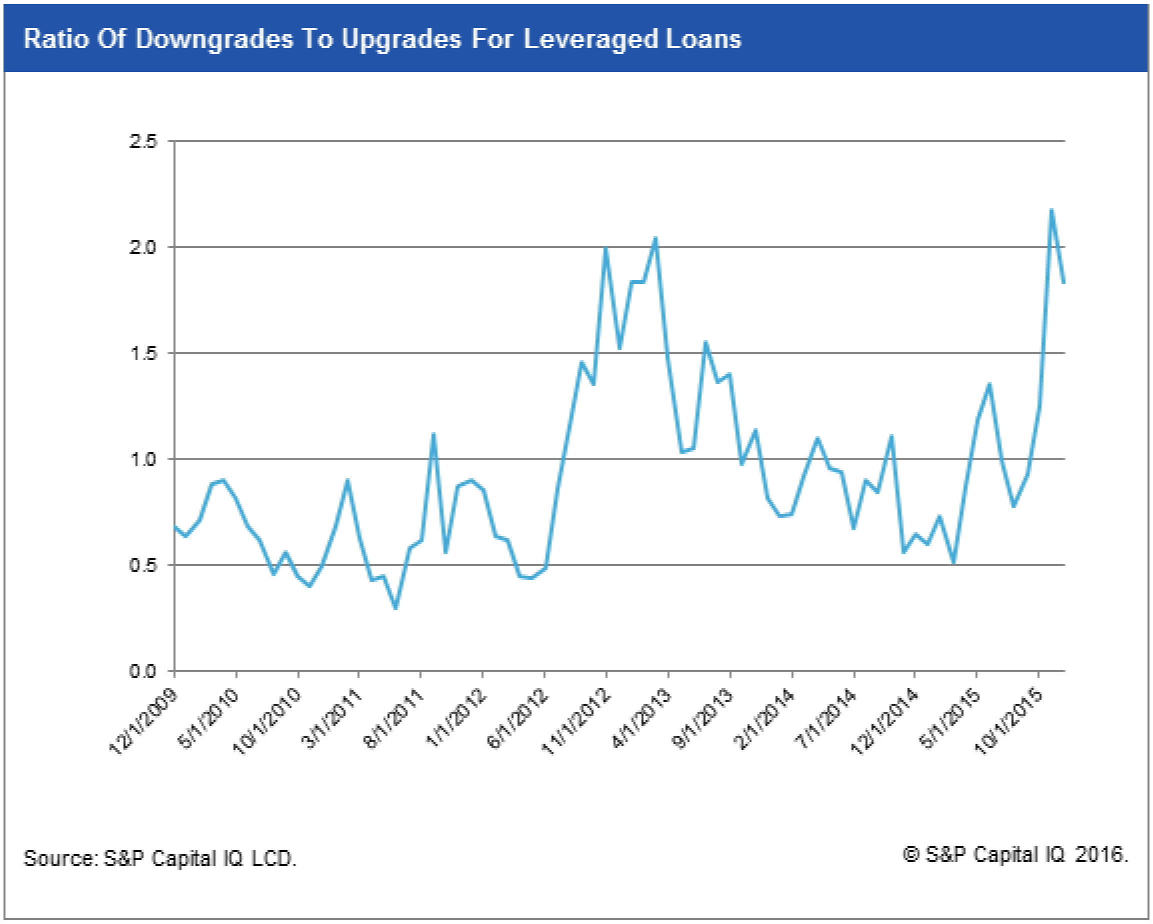
Another cause of concern is from several micro indicators that are showing some wear and tear. First, the percent of performing index loans trading below 70, a level normally associated with high default risk, hit a near-four-year high of 6.28% in December, up from 4.23% in November. Needless to say, some of this increase was technical in nature, what with the market trading off and issuers with any hair legging lower. Still, a trading price inside of 70 has historically been a reliable indicator of heightened default risk.

Chart 20



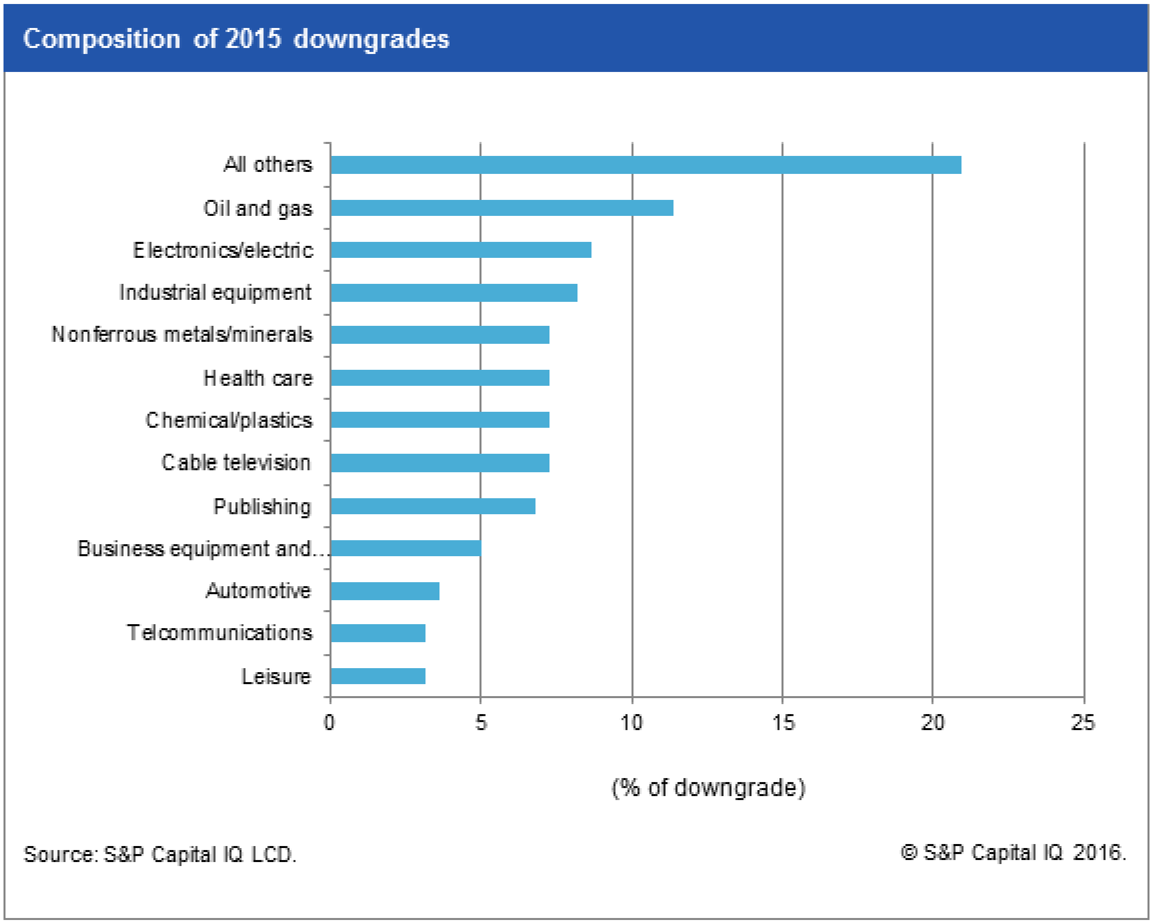
In addition, the pace of downgrades has accelerated in recent months. All told, Standard & Poor's downgraded 81 S&P/LSTA Index loans during the fourth quarter, the biggest three-month total since May 2009-July 2009. Moreover, the ratio of downgrades to upgrades in the past three months is 1.84x, also the highest since the first three months of 2013.

Chart 21



Needless to say, energy was the biggest source of downgrades in 2015 at 11%, or 25 of 220. Managers say, however, the problem is not just quarantined to oil and gas. Downgrades in the year were broadly felt (see chart 22).

Chart 22



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Follow Steve on Twitter (@millerLCD) for an early look at LCD analysis and for market commentaries.

R2P Corporate Bond Monitor

The U.S. economy started the new year with a similar blend of mixed data releases, which overall underpinned the good health of the domestic economy. Markets, however, continued to be driven by more global concerns stemming mainly from China. The labor market continued to show strength with the four-week moving average of jobless claims continuing to hold low under the 300,000 mark, despite rising slightly above this level during the holiday period. Negatively, the Institute for Supply Management (ISM) Manufacturing Index's figures appeared to cool further in December from recent lows in November, reaffirming the sector's declining trend since a brief expansion between May and July 2015. Growth contracted faster in December, registering 48.2 compared with 48.6 in November. Both new orders and production negatively affected the index, along with softer employment. The ISM Non-Manufacturing Index also moderated, continuing its slide from October. The index read 55.3 for December, down from 55.9 in November; however, this remains robust, in our view, following a number of months with more-elevated levels.

Table 4

North America Risk-Reward Profiles By Sector*

	Scores (%)	OAS (bps)	PD (%)	BP Vol. (%)
Consumer discretionary	(12)	7	0.100	0.178
Consumer staples	(10)	4	0.008	0.165
Energy	(32)	60	0.564	0.689
Financials	(11)	5	(0.009)	0.105
Health care	(8)	8	0.150	0.176
Industrials	(17)	1	(0.281)	0.167
Information technology	(15)	2	(0.066)	0.180
Materials	(14)	(5)	(0.614)	0.187
Telecommunications services	(8)	5	0.048	0.241
Utilities	(15)	3	(0.159)	0.315
Average	(14)	9	(0.026)	0.240

*One-month average Risk-to-Price score and components changes to Dec. 31, 2015. OAS--Option-adjusted spreads. bps--Basis points. PD--Probability of default. BP Vol.--Bond-price volatility. Source: S&P Capital IQ.

The eurozone's recovery appeared to continue following some positive data in the past few weeks. The manufacturing Purchasing Manager's Index (PMI) continued its strong rise to 53.2 in December from 52.8 in November because of positive output growth and job creation in all member nations. The report also underpinned improving industrial production and construction output data, which grew 0.6% and 1.1%, respectively, in October, indicating that we may finally see some meaningful strengthening within these industries. In addition, the composite PMI remained strong, ticking up slightly to 54.3 for December from 54.2 in November, and the services PMI remained unchanged at 54.2. This culminated in a fairly strong end to an up-and-down year for the currency bloc. On a negative note, inflation continued to stall despite continued efforts from the European Central Bank (ECB) to boost price levels. The inflation rate was 0.2% in December for the second month in a row, and core inflation also remained stable at 0.9% in the month, still far from the ECB's objective of 2%.

Table 5

Europe Risk-Reward Profiles By Sector*

	Scores (%)	OAS (bps)	PD (%)	BP Vol. (%)
Consumer discretionary	(6)	22	(0.033)	0.107
Consumer staples	(10)	19	0.002	0.151
Energy	(14)	(5)	0.012	0.092
Financials	(6)	12	(0.004)	0.078
Health care	(2)	(2)	(0.015)	0.060
Industrials	(8)	15	(0.005)	0.070
Information technology	(3)	11	0.015	0.116
Materials	(14)	51	0.019	0.302
Telecommunication services	(14)	13	0.007	0.064
Utilites	(15)	13	0.023	0.111
Average	(9)	15	0.002	0.115

*One-month average Risk-to-Price score and components changes to Ded. 31, 2015. OAS--Option-adjusted spreads. bps--Basis points. PD--Probability of default. BP Vol.--Bond-price volatility. Source: S&P Capital IQ.

In the context of global concerns continuing to heavily influence financial markets, risk-reward profiles, as measured by average Risk-to-Price scores, worsened in both North America and Europe in the month ended Dec. 31, 2015.

In North America, the risk-reward profile deteriorated overall as a result of higher market risk (as measured by bond-price volatility), which more than offset moderate widening of spreads and fairly stable credit risk (as measured by the probability of default [PD]). The energy sector was a big contributor to the decline as it saw the highest increase in volatility, as well as the highest spike in PD levels, which offset (and justified) the wider spread levels.

Europe's overall risk-reward profiles also suffered in the month with worsening market risk again the driver.

For more of our market views and sector credit opinions, please see our monthly Fixed-Income Strategy last published on Dec. 2, 2015: "More Quantitative Easing Looms For The Eurozone; The U.S. Case For Fed Action Strengthens."

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Capital Market Commentary: IPOs, M&A, And Debt

IPOs

When examining the IPO market, GMI took a cue from the adage that yesteryear's laggards could be next year winners. Specifically, we examined the laggards from the IPO class of 2014 and found that in 2015, the 10-lowest performing issues in 2014, in aggregate, saw an average price increase of 1.3%. That outpaced the performance of the S&P 500 in 2015, which saw a fractional loss. Leading the way was a better than 200% increase in the share price of Recro Pharma Inc. during 2015 following a 64% drop in 2014. Still, although the group of 2014 laggards managed to eke out a gain last year, half of the 10 issues profiled below saw further declines in 2015 following their 2014 performance.

Table 6

2015 Performance Of 2014 IPO Laggards

Effective date	Issuer	Total transaction value (mil. $)	Price per share ($)	Day close price on Dec. 31, 2014 ($)	2014 change (%)	Day close price on Dec. 31, 2015 ($)	2015 change (%)
02/12/2014	Amedica Corp.	20.13	5.75	0.80	(86.09)	0.12	(85.13)
11/12/2014	Capnia Inc.	10.73	6.50	1.49	(77.08)	1.85	24.16
10/08/2014	MOL Global Inc.	168.75	12.50	3.05	(75.60)	0.69	(77.44)
02/04/2014	Biocept Inc.	19.00	10.00	2.48	(75.20)	1.38	(44.35)
06/17/2014	Signal Genetics Inc.	8.50	10.00	2.54	(74.60)	0.75	(70.55)
06/19/2014	Eclipse Resources Corp.	818.10	27.00	7.03	(73.96)	1.82	(74.11)
02/20/2014	Semler Scientific Inc.	10.01	7.00	1.96	(72.00)	2.56	30.61
03/20/2014	A10 Networks Inc.	187.50	15.00	4.36	(70.93)	6.56	50.46
03/06/2014	Recro Pharma Inc.	30.00	8.00	2.86	(64.25)	9.00	214.69
05/13/2014	ServisFirst Bancshares Inc.	56.88	91.00	32.95	(63.79)	47.53	44.25

Source: S&P Capital IQ.

Table 7

2015 IPO Laggards

Effective date	Target/issuer	Price per share ($)	Day close price on Dec. 31, 2015 ($)	Change (%)
03/05/2015	MaxPoint Interactive Inc.	11.50	1.71	(85.13)
01/26/2015	Zosano Pharma Corp.	11.00	2.28	(79.27)
02/13/2015	Bellerophon Therapeutics LLC	12.00	2.96	(75.33)
05/05/2015	HTG Molecular Diagnostics Inc.	14.00	4.36	(68.86)
02/18/2015	Check-Cap Ltd.	6.00	1.89	(68.50)
05/04/2015	OpGen Inc.	6.00	1.90	(68.33)
05/12/2015	Jaguar Animal Health Inc.	7.00	2.25	(67.86)
06/24/2015	Ritter Pharmaceuticals Inc.	5.00	1.70	(66.00)
02/04/2015	Nexvet Biopharma Public Ltd. Co.	10.00	3.41	(65.90)
07/31/2015	TerraForm Global Inc.	15.00	5.59	(62.73)

Source: S&P Capital IQ.

M&A

While strategic buyers were flocking to do deals in the health care, energy, and financial sectors during 2015, private equity companies were taking a different path. According to S&P Capital IQ data, information technology was the top sector for announced leveraged buyouts (LBOs) in 2015 with $31.2 billion in total deals. That figure represents 42% of last year's $74 billion in U.S. LBO activity. In contrast, of the $2.08 trillion in strategic acquisitions announced last year, information technology saw $304.6 billion in activity, or less than 15% of total deal value. As for individual deals by sector, consumer discretionary was the top choice for private equity buyers as 334 deals were announced last year, representing almost 31% of activity last year. As for strategic buyers, financials was the top sector with 7,492 individual transactions, or about 40% of all strategic acquisition by deals last year.

We have noticed one striking observation for average valuations paid by strategic buyers versus private equity purchasers. S&P Capital IQ data shows that a typical multiple paid for an acquisition by a strategic buyer is 16.1x a target's 12-month trailing EBITDA. In contrast, a typical LBO valuation was pegged at 13.6x EBITDA.

Table 8

2015 U.S. Leveraged Buyout Summary

Transaction screening aggregates

Sector	No. of transactions	Transaction ranges	No. of deals
Energy	20	Greater than $1 billion	14
Materials	60	$500 million-$999.9 million	12
Industrials	229	$100 million-$499.9 million	29
Consumer discretionary	334	Less than $100 million	116
Consumer staples	60	Undisclosed	913
Health care	103		
Financials	61		
Information technology	165		
Telecommunication services	2		
Utilities	16		
No primary industry assigned	34		

Table 8

2015 U.S. Leveraged Buyout Summary (cont.)

Most active buyers/investors by number of transactions

Company name	No. of transactions	Company name	Total transaction size (mil. $)
Audax Group Inc.	8	Canada Pension Plan Investment Board	9,943.1
Gladstone Management Corp.	8	The Carlyle Group L.P.	8,628.7
The Carlyle Group L.P.	8	GIC Pte. Ltd.	8,000.0
ABRY Partners LLC	7	Lone Star Funds	7,786.5
The Riverside Co.	7	Vista Equity Partners	7,102.0
Kinderhook Industries	6	Permira Advisers Ltd.	5,343.1
Vista Equity Partners	6	Salesforce Ventures	5,343.1
Gladstone Investment Corp.	5	Silver Lake	5,339.8
Marlin Equity Partners LLC	5	Thoma Bravo LLC	4,639.8
Salt Creek Capital II LLC	5		

Valuation summary

Total deal value (mil. $)	74,056.62
Average deal value (mil. $)	423.18
Average total economic value/revenue	2.27
Average total economic value/EBITDA	13.57
Average day prior premium (%)	19.19
Average week prior premium (%)	20.06
Average month prior premium (%)	18.56

Source: S&P Capital IQ.

Debt

Security identifier requests for several debt-related offerings in December saw a retreat based upon information provided by Committee on Uniform Security Identification Procedures (CUSIP) Global Services. Of the categories profiled below, the two largest asset classes, domestic corporate debt and municipal bonds, saw a drop in CUSIP requests in December. Demand for security identifiers for upcoming domestic corporate debt issues dropped to 533 in December, which ranks as the lowest monthly count for 2015. The Federal Reserve interest rate hike last month likely dissuaded a number of potential corporate borrowers from taking steps to raise capital at this time. Similarly, municipal bond CUSIP requests dropped to 1,037 in December from 1,147 identifier orders in November. That stands as the slowest pace of monthly CUSIP orders for this asset class since September when 926 CUSIPs were sought.

Table 9

Selected CUSIP Requests

Asset type	December 2015	November 2015	2015	2014	% change
Domestic corporate debt	533	705	9,192	9,410	(2.32)
Municipal bonds	1,037	1,147	14,802	12,749	16.10
Short-term municipal notes	111	96	1,410	1,464	(3.69)
Long-term municipal notes	19	15	349	605	(42.31)
International debt	156	180	2,808	2,720	3.24
PPN domestic debt	237	142	2,135	2,385	(10.48)
Total	2,093	2,285	30,696	29,333	4.65

Table 9

Selected CUSIP Requests (cont.)

CUSIP--Committee on Uniform Security Identification Procedures. PPN--Private placement number. YTD--Year-to-date. Source: CUSIP Global Services.

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Leveraged Commentary and Data

Delivers insight into the leveraged loan market through a combination of data, commentary, analysis, and real-time news.

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