Investment Grade Credit Insights:

The Potential Impact of Hurricane Harvey on Investment Grade Issuers

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As the damage done by Hurricane Harvey continues to add up, it will almost surely rank as the most costly storm in US history, possibly exceeding the combined costs of hurricanes Katrina in 2005 and Sandy in 2012. While the federal government isn't expected to release its initial estimate of Harvey's harm until October 6th, efforts to assess the storm's economic impact are well underway. Harvey is expected to reduce third quarter GDP by approximately 0.25%. However, the massive recovery work that is now required will boost economic output in the near and medium terms. Meanwhile, the environmental havoc wreaked by the storm may have the positive effect of reducing the political turmoil in Washington that threatens to produce a government shutdown in September. The need to sustain federal relief efforts is putting significant pressure on both the Trump administration and Congress to strike a deal regarding the federal debt ceiling and keep the government operating.

Impact on Insurers and Banks

Property & Casualty insurers operating in the affected areas of Texas will bear significant costs related to Hurricane Harvey. The overall economic losses from Harvey could exceed $100 billion and it will take weeks for the insurers to assess damage and estimate insured losses. The majority of the losses in the Houston area were caused by flooding, which limits the impact on homeowners' insurers as flood coverage is typically excluded from homeowners' policies and is purchased from the federal government's National Flood Insurance Program. However, flood losses are covered by personal auto policies and therefore insurers would have losses on the cars that were destroyed in the flood. The largest personal lines insurers in Texas are State Farm, Allstate, Farmers, USAA, Liberty Mutual, Progressive, Berkshire Hathaway, Texas Farm, Nationwide, Travelers, and Chubb.

Commercial insurers and reinsurers will likely experience significant catastrophe losses from Harvey due to energy industry and other business concentration in the area. Flooding in commercial centers will lead to large commercial claims, particularly for business interruption, as well as flood losses that are often covered by commercial insurance policies. Commercial lines insurers with the largest exposure to Texas include Liberty Mutual, AIG, CNA, Chubb, Travelers, Texas Windstorm, Nationwide, Farmers, Zurich and Hartford.

Insured losses for Harvey are expected to account for approximately 25 to 30% of overall economic losses. While we believe 3Q17 earnings impact for the insurers involved will be significant, we do not expect ratings downgrades or balance sheet and capital impacts on major P&C insurers. The U.S. P&C industry is very well capitalized with over $700 billion in capital which allows insurers to manage catastrophe losses such as those resulting from Hurricane Harvey. In the long-term insurers' pricing power often improves following a major hurricane.

Harvey will have a minimal credit impact on the large money center banks given their strong balance sheet metrics as well as business and geographic diversification.

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Smaller local and regional banks with large concentration in Texas will be negatively affected through increased loan loss provisions, lost fee income and expenses for cleanup of branches. A significant share of residential mortgages is owned or guaranteed by GSEs which limits exposure of banks. Furthermore, bank losses are mitigated by the presence of property insurance, including federal flood coverage.

Impact on Energy and Chemical Industries

Initially, Harvey took 3mm barrels per day of refinery capacity offline, 16.5% of total US capacity. The loss will hurt Houston's refineries, but will increase margins for refineries in areas not impacted by the storm. As a result, credit spreads are only slightly wider and equity prices for large diversified refiners like Marathon, Phillips 66 and Valero are actually higher.

The loss of refinery capacity and reduced demand is likely to cause crude oil inventories to build and prices to fall. At the storm's peak on August 28th, approximately 1MM barrels per day of crude oil and 2bcf (billion cubic feet) per day of natural gas were shut-in. The hurricane impacted offshore Gulf of Mexico producers who shut-in their wells as a precautionary measure and the Eagle Ford shale which was shut-in both as a precaution and due to flooding. The production disruptions have been declining and we expect operations to quickly return to normal.

Pipelines connecting to gulf coast refineries were taken offline due to shut-ins of those plants and we do not expect the hurricane to have a meaningful credit impact on pipeline operators since the asset bases for most IG pipelines are quite large and geographically diversified. Because of the tail risk of catastrophic events such as Hurricane Harvey, we have not invested in single asset pipelines.

Several major chemical companies including Dow and Lyondell Basel have plants in Houston that were either shut down or run at reduced rates. While this will negatively impact their earnings, it will not be a credit event due to the size and diversification of these firms' operations.

Impact on Transportation Industries

Cox Automotive has estimated that as many as 500,000 vehicles may have been destroyed during the storm. Harvey will hurt sales for August and early September but will likely provide a temporary boost from late September through November as customers replace vehicles. Auto sales appear to have peaked earlier this year and inventories remain high which is leading to higher incentives. We remain neutral on the automotive sector due to historically large inventories, high incentives and weak used car pricing.

Harvey has affected railroads such as Union Pacific, BNSF and Kansas City Southern by reducing customer and shipment volumes and creating delays as schedules are pushed back while waiting for water to recede. They also face higher diesel prices which will be passed along to consumers over the coming weeks. Tighter capacity will lead to higher rates for rail capacity over the short term and we remain overweight rails because of these companies' stable credit profiles, high cash flow and fair valuation.

Additional Sectors Affected By Harvey

Beyond the industries where Harvey has had the most direct impact, the storm has implications for a variety of other types of firms. For example, building products maker Owens Corning could benefit from increased sales of roofing and insulation materials as rebuilding ticks up in the wake of Harvey.

Waste disposal companies including Waste Management and Republic Services are likely to benefit from the need to clean up and remove debris, but they also face higher landfill expenses due to flood water and other disruptions to their operations.

Real estate investment trusts with properties in Houston will almost certainly have some damage, but most carry insurance which covers natural disasters. Furthermore, most REITs have less than 5% of their operations in Houston.

Finally, retailers will feel impacts with most national IG rated retailers having at least 5% of their operations in Texas (not specifically Houston) and operations closed or halted for an unknown time period. Stores in the Houston area starting to reopen depending on the extent of their damage, but supply chains will remain disrupted. On the other hand, we expect many retailers to benefit from the recovery, particularly those in the home improvement sector.

As of this publication, we are closely monitoring the path of Hurricane Irma which has the potential to be southern Florida's strongest storm since 2005. Given the frequency of storms in this region, Florida's homeowners' insurance market is concentrated with smaller state-specific insurers and mutual insurers that maintain large reinsurance programs. That said, with Harvey's costs still waiting to be assessed and Irma yet to make landfall, spreads in the P&C insurance sector have widened modestly.

August Market Update

Performance:

Corporates underperformed in August due to a combination of heavy issuance, concerns regarding North Korea and uncertainty related to the US budget and debt ceiling. In the US, spreads were 8bps wider, resulting in excess returns of -0.62% and total returns of 0.78%. Subordinated Bank spreads were 10bps wider on the month as the senior/sub relationship came off the YTD tights and widened for the first time since April. Industrials underperformed with spreads +10bps wider as Pharma (+17bps) and Cable (+23bps) were the biggest drags. With WTI down almost 6% on the month energy names leaked wider as well with selling across Independents (+17bps), Midstream (+14bp) and Refiners (+14bps). Lower volatility Utilities (+4bps) and REITs (+2bps) both held in better than the index. The credit curve steepened with the long end underperforming at +11bps wider while intermediates and the front end were only +8bps and +3bps, respectively. Year-to-date, US corporate spreads are 12bps tighter.

European corporates also underperformed in August as Insurance (+13bps) and Sub Banks (+11bps) ended their strong rallies. Overall the European corporate index was 8bps wider, resulting in excess returns of -0.33% and total returns of 0.55% for the month. Year-to-date, European corporate spreads are 24bps tighter.

Supply:

August is typically a seasonally slow period for issuance as many market participants are away from their desks on holiday. However, this August was exceptionally active. In the US, $103 billion priced which represents the second busiest August on record, only behind August 2016. The two largest transactions came from BAT and Amazon who had M&A related deals of $17 billion and 16 billion respectively. Year to date, supply is now above $1 trillion for the 6th consecutive year. At $1.024 trillion, year-to-date supply is only 1% behind last year's record breaking pace.

In Europe, primary market activity was much more subdued. Issuance was €20.1 billion in August, unchanged from the previous year. Financials represented 60% of the issuance. Year to date, issuance is now 4% below last year's pace at €364.5 billion.

Outlook:

We believe spreads will trade in a range for the remainder of the year with the majority of return coming from carry.

Technicals: The technical picture is mixed for the next couple of months. While we anticipate continued strong demand for IG credit, it will be offset by what we believe to be an extremely busy upcoming new issue calendar.

Fundamentals: Corporate earnings were strong in the second quarter. Revenue and EBITDA were both up nicely. While still well above historical averages, leverage declined slightly on the quarter as debt increased less than EBITDA for the first time in 5 years. Earnings strength should continue for the balance of the year due to positive economic growth and a weaker dollar.

Valuation: Despite being on the lower end of the historical range, we believe valuations are fairly valued given our constructive view on fundamentals.

Potential Risks:

1. U.S. policy uncertainty
2. Geopolitical instability
3. Monetary policy mistake

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