Overview & Objectives

- Provide a macroeconomic overview and thoughts on the risks of the next recession
- Understand the mechanics and risk profile of commercial paper
Is a Recession Coming?

- Business investment slowdown
- Housing sluggishness continues
- Overseas uncertainty
- Fiscal boost fading and monetary policy tightening

Maybe Yes

- Strong labor market and personal income growth
- Solid consumer spending

Maybe No
The State of the U.S. Consumer

Employment growth vs. Unemployment

Source: BLS

Household Debt Service as Percent of Disposable Income

Source: Federal Reserve Board

Wage Measures

Source: BLS

Consumer Confidence

Source: The Conference Board
Corporate and Government Spending

**Equipment Investment**

- % change year ago
- Source: BEA

**Government Spending**

- Federal - Defense
- Federal - Nondefense
- State and local
- Source: BEA

**U.S. Nonfinancial Dividends, Share Repurchases, and Capex (Bil. $)**

- Common Shares Repurchased
- Common Dividends Paid
- Capital Expenditures (Right Scale)
- Source: S&P Global Market Intelligence and S&P Global Ratings. Data: 2752 sampled companies with a Market Capitalization of 100 ($USDmn) or more, excluding Financials. *LTM--last 12 months as of 12/5/2018.
The State of the Housing Market

S&P/Case-Shiller Home Price Indexes

Source: S&P Dow Jones

Source: S&P Global Ratings, Jan. 15, 2019
Global Manufacturing

Manufacturing Purchasing Manager Index (PMI)

- China
- Eurozone
- U.S.

Note: Above 50 is expansion, below 50 is contraction.
The U.S. Monetary Path is More Uncertain

- The Fed is nearing its estimate of the neutral rate of 2.5%-3.0%
- The Fed is ‘data dependent’

Fed Funds Rate Target (upper limit)

Source: New York Federal Reserve
The Federal Reserve Dot Plot

Source: Bloomberg
The Economic Expansion is Mature

<table>
<thead>
<tr>
<th>Peak</th>
<th>Trough</th>
<th>Expansion (trough to peak)</th>
<th>Recession (peak to trough)</th>
<th>Peak to peak</th>
<th>Trough to trough</th>
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<tbody>
<tr>
<td>December 2007</td>
<td>June 2009</td>
<td>73</td>
<td>18</td>
<td>81</td>
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<tr>
<td>March 2001</td>
<td>November 2001</td>
<td>120</td>
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<td>March 1991</td>
<td>92</td>
<td>8</td>
<td>108</td>
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<td>November 1982</td>
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<td>16</td>
<td>18</td>
<td>28</td>
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<td>July 1980</td>
<td>58</td>
<td>6</td>
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<td>March 1975</td>
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<td>16</td>
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<td>November 1970</td>
<td>106</td>
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<td>April 1960</td>
<td>February 1961</td>
<td>24</td>
<td>10</td>
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<td>May 1954</td>
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<td>10</td>
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<tr>
<td>November 1948</td>
<td>October 1949</td>
<td>37</td>
<td>11</td>
<td>45</td>
<td>48</td>
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<tr>
<td><strong>Average</strong></td>
<td></td>
<td><strong>58</strong></td>
<td><strong>11</strong></td>
<td><strong>69</strong></td>
<td><strong>69</strong></td>
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</table>

Source: National Bureau of Economic Research (NBER) and S&P Global Ratings, Jan. 15, 2019
### What Could Stop the Expansion?

<table>
<thead>
<tr>
<th>Possible Scenarios</th>
<th>Leading Indicators</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Monetary policy</td>
<td>- Housing starts/building permits</td>
</tr>
<tr>
<td>- Government policy/political risk</td>
<td>- ISM manufacturing</td>
</tr>
<tr>
<td>- Trade/investment protectionist policies</td>
<td>- S&amp;P 500 Index</td>
</tr>
<tr>
<td>- Asset market declines/volatility</td>
<td>- Consumer sentiment</td>
</tr>
<tr>
<td>- Global growth concerns</td>
<td>- Jobless claims</td>
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<td></td>
<td>- Yield curve</td>
</tr>
</tbody>
</table>
2-Year/10-Year Yields

Source: National Bureau of Economic Research (NBER) and S&P Global Ratings, Jan. 15, 2019
Other Leading Indicators: Flat to Slightly Softer

- Weekly Initial Jobless Claims 4-wk moving average
  - Source: US Employment and Training Administration

- ISM Manufacturing New Orders
  - Source: Institute for Supply Management

- Building Permits
  - Source: Census

- S&P 500 Index
  - Source: Datastream

Source: S&P Global Ratings, Jan. 15, 2019
Is a Recession Coming?

- Yes, but not right around the corner.
- Slowdown in the U.S. economy is the base case outlook.
- Some risk already present; some are amplifying.
- Leading indicators suggest too early to tell.
- Indicating data is widely available.
Total commercial paper market peaked at $2.2T in August 2007.

The total CP market has declined to $1.06T as of Feb 6, 2019, because of smaller ABCP programs.

Source: Board of Governors of the Federal Reserve System (US), Commercial Paper Outstanding, retrieved from FRED, Feb. 12, 2019
An Overview of Commercial Paper (CP)

**What?**
- Unsecured short-term loan for a specific dollar amount and maturity date.
- Tenor is rarely longer than 270 days.
- Generally “secured” or backstopped with liquidity facilities or cash balances.
- Short-term obligations are generally done through a rolling, open-ended program.
- Prime quality, determined by NRSROs.

**Why?**
- Low-cost financing alternative to bank loans for short-term liquidity needs (working capital, acquisitions, etc).
- Exempt from SEC registration that is more costly and takes time for approval.
Why do Investors Like CP?

Safety

Only high-grade issuers have CP programs and are backstopped by a revolving bank facility.

Source: Bloomberg, January 9, 2019
How Does the Credit Team Evaluate CP?

- CP is backed by the full faith and credit of the issuer. The issuer is the focus of the analysis.
- Evaluate the cash flows and profitability.

Resources

- Public filings
- Investor relations
- Sell-side research
- Market data
- Industry research
- Earnings calls/transcripts
- News headlines
- NRSRO research/analysts
- Analyst days/conferences
Below is an assessment of Pepsi’s CP (short-term) ratings as presented to the Credit Committee.

Short-term ratings are “notched” off of the corporate credit rating.

**Ratings Migration Assessment**

S&P Outlook triggers:

**Upgrade** - leverage sustained below 2x, net debt would have to decline by more than $6 billion

**Downgrade** - EBITDA to weaken resulting in leverage of about 3x, no debt financed acquisition or share repurchases of more than $6.5 billion.

The most likely path for a downgrade would be a shift in financial policy where the company would issue more than $6.5 billion of debt to support further aggressive shareholder returns or a sizeable acquisition. CP/Short-term rating is safe even with a one notch downgrade from A+ to A; both result in an A-1 score.

Pepsi doesn’t do acquisitions as often as Coke and the acquisition announcement of SodaStream was viewed as a unique asset outside of Pepsi’s informal ‘no more than $500M of acquisitions per year’ policy. Pepsi has been growing its dividend so the likelihood of leveraging up with debt to solely fund more shareholder returns is unlikely over the next year.
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Public Trust Advisors
717 17th Street, Suite 1850
Denver, Colorado  80202