

## THE U.S. ECONOMIC EVOLUTION: INSIGHTS FROM THE IG MEDIA, CONSUMER STAPLES, AUTO, AND ENERGY SECTORS

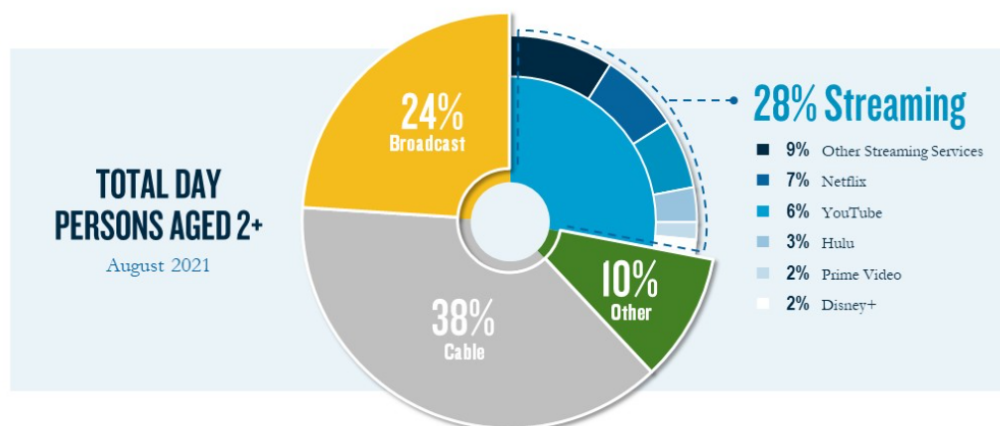
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Our recently published [Q4 Outlook](#) described a rapidly evolving, yet increasingly uncertain, macro backdrop highlighted by persistent inflation, supply chain gridlock, virus mutations, and soaring energy prices. As a complement to our market perspectives, the following industry outlooks reveal the extent to which investment-grade credit conditions are evolving across specific industries.

### Media - Outlook Moves from Stable to Strong

The media sector continues down the path of shifting video consumption from traditional linear television to various Direct-to-Consumer (DTC) streaming alternatives (Figure 1). Most industry players began this secular transition from positions of strength. Thus far, they have managed through the initial negative financial impact of streaming as well as the impact from COVID-19 by remaining disciplined on capital allocation and choosing to reinvest in their businesses vs. returning money to shareholders. While EBITDA and free-cash flow face pressure from increased programming and production costs, we also expect accelerating revenue growth to result in generally higher year-over-year EBITDA and free-cash flow levels in 2022 and 2023.

**FIGURE 1: STREAMING CLOSING IN ON CABLE AFTER ECLIPSING BROADCAST VIEWING**



Source: Nielsen's The Gauge as of August 2021.

Disney has been an exception within the sector due to its theme park exposure, its leveraging acquisition of Fox's studio and other assets in March 2019, and the elevated costs associated with the Disney+ streaming service. After credit rating downgrades from S&P and Fitch, Disney's desire to avoid further downgrades likely contributed to the decision to suspend its dividend, and management recently stated that it does not anticipate paying a dividend or repurchasing stock until the company returns to a more normal operating environment and its leverage is more consistent with a single A credit profile. Elsewhere, ViacomCBS has also been proactively paying down debt with free-cash flow and asset sale proceeds while recently raising equity capital to support elevated DTC spending, while Discovery will make debt reduction a top priority upon completion of its Warner Media acquisition.

The key to our Media investment thesis remains investing in names that have strong content portfolios and the means to get that content in front of consumers. As companies continue experimenting on content placement (i.e., theatrical, linear TV, DTC, licensing), they need to carefully manage access in order to maximize lifetime revenue streams. Following announcement of the Discovery / Warner Media combination, we believe other industry player are considering M&A and/or partnership alternatives to enhance their competitive streaming position vs. industry leaders Netflix and Disney.

### **Consumer Staples - Outlook Moves from Stable to Weak**

As consumer behavior has evolved with the pandemic, some habits, such as more at-home-meals appear to be sticking amid hybrid work arrangements, while other trends, such as stockpiling and frequent, broad disinfecting, seem to be behind the sector. Therefore, consumer staples companies are facing tough comparisons to last year, while they are also contending with higher costs for raw materials, transportation, and labor. We could see the higher costs resulting in margin compression and reduced operating income in 2021, in selected cases back to 2019 levels or even below. From a valuation perspective, consumer staples is one of the tightest trading investment grade sectors on a spread basis.

### **Autos - Outlook Moves from Strong to Stable**

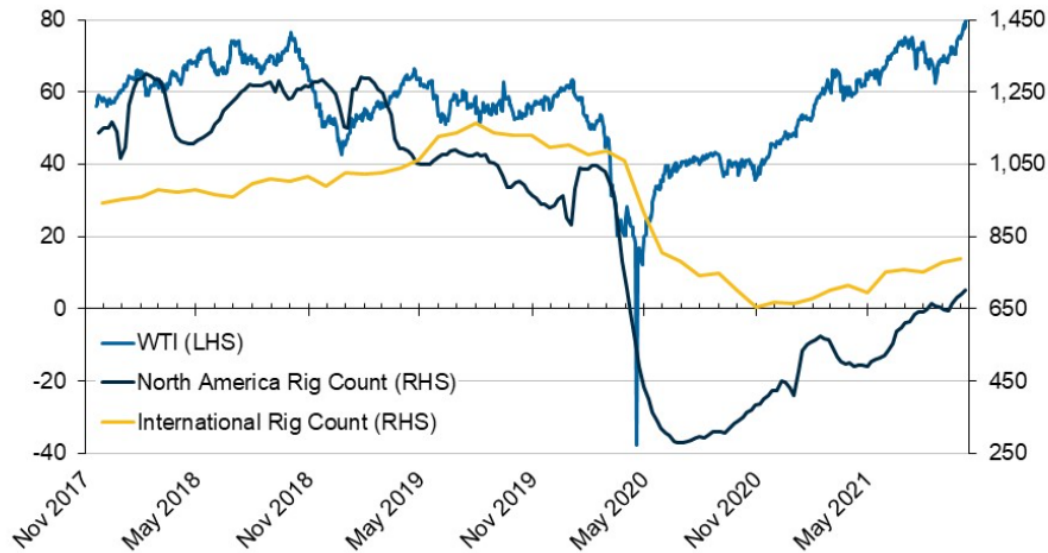
Our changed outlook reflects recalibrated expectations around the industry's semiconductor shortage. The lack of sufficient semiconductor supply has led to constrained auto production levels and extremely tight dealer inventory, with sales numbers falling well below normal due to the lack of available vehicles, rather than a lack of demand.

Initially expected to resolve itself over the course of 2021, the semiconductor shortage is now projected to last well into 2022. The situation is a frustrating one for management teams given the lack of supply chain visibility and the inability to capitalize on demand. That said, industry conditions are very strong for automakers that can execute with scant dealer inventory resulting in all-time high pricing for new and used vehicles. We expect that the supply situation will normalize slowly given the need to replenish dealer inventories to more normal levels while also satisfying retail demand. Although the normalization should provide a good runway of strong results once automakers procure the chip supplies needed to run production at normal levels - even as they contend with rising material costs - we will need to see further improvements in the global supply chain before we can confidently project an industry rebound.

### **Energy—Fundamentals Move from Weak to Stable<sup>1</sup>**

The energy sector posted significant excess returns in 2021, and we expect the sector's fundamentals to remain supportive of credit through the balance of the year thanks to bondholder friendly management choices and rallying commodity prices. While the stunning recovery in oil and gas prices continues to generate headlines, management teams' disciplined behavior is of equal importance, if less discussed. Indeed, almost every management team in the sector has allocated a significant portion of this year's windfall to strengthening their balance sheets.

They also remain disciplined about capital spending, and the typical urge to drill into the rally (i.e., the industry's historical reaction to elevated prices) has been set aside given the combination of lingering COVID concerns, worries about OPEC+ spare capacity, shareholder pressure, and ESG activism (see Figure 2). For now, commodity prices and the management choices have created the best fundamental backdrop for energy bonds in at least a decade.

**FIGURE 2: NORTH AMERICAN DRILLERS SHOWING SOME RESTRAINT AMID RALLY IN CRUDE OIL PRICES**

Source: Bloomberg

Going forward, we expect the oil market to remain in deficit through year end with lower-than-average inventory levels continuing to support oil and gas prices. In 2022, we expect the oil supply / demand balance to gradually loosen up as OPEC+ production steadily increases. While we also expect 2022 capital budgets to increase due to higher required maintenance spending and inflationary pressures, it is unclear if the extra spending will translate into production increases. Meanwhile, most of the industry will have completed balance sheet repair work by the end of 2021, and if current oil / gas prices hold up, shareholder rewards (rather than credit improvement) will likely become a prevalent theme in 2022. Although the near-term picture looks favorable, it is difficult to imagine energy spreads replicating this year's epic performance in 2022.

<sup>1</sup> Our Fundamental view is regarded as a snapshot at an industry's fundamentals, while the sector Outlook consists of a forward-looking view. Our outlook for the energy sector remained Strong heading into Q4.

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