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INDUSTRIALS & TRANSPORTATION

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2023 Sector Snapshot: US Industrials & Transport

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Executive Summary

- **We provide our Industrials & Transportation sector strategy for 2023, including key themes, picks and pans, and risks for the coming year.**
- **IG Capital Goods (Market Perform).** We expect the Capital Goods sector to be an overall solid performer in 2023, led by increased demand for Aerospace and Defense products. In the Industrial Products segment, we expect lingering supply chain challenges to constrain production and support favorable pricing, which along with a record order backlog should support strong revenue growth and relatively stable margins despite potential weakness in new orders.
- **HY Aerospace (Market Perform).** While we are constructive on balance sheet improvement in 2023, sector spreads and yields are on the tight side relative to history. We think the sector remains a defensive stronghold within high yield.
- **IG Transportation (Market Perform). The IG transportation sector has continued to grind this year and now stands mostly inline with the C0A0 index, having bottomed at a give of 33 bp to the index in 2020.** Our Market perform view on Transportation reflects our expectation the sector will continue to trade as a relative safe haven in an uncertain market.
- **HY Transportation (Outperform). The US airlines sector is experiencing a stronger than expected pandemic recovery as demand exceeds constrained supply.** Fares significantly above prepandemic levels more than cover higher fuel expense to drive EBITDAR back toward 2019 levels. The view is less certain in 2023 in a recession scenario, but there should be sufficient demand/supply imbalance to absorb demand erosion.

Relative Value

US IG & HY vs. Capital Goods and Aerospace	OAS			YTW			$ Price				YTD Returns	
	Current	YE 2021	Change	Current	YE 2021	Change	Current	YE 2021	Change	Duration	Excess	Total
US IG	142 bp	98 bp	44 bp	5.4%	2.4%	306 bp	$89.58	$109.14	-$19.57	6.9 yrs	-1.8%	-15.3%
US IG Capital Goods	**114 bp**	**87 bp**	**27 bp**	**5.1%**	**2.3%**	**287 bp**	**$90.91**	**$110.16**	**-$19.24**	**6.9 yrs**	**-1.1%**	**-14.6%**
Difference	-28 bp	-11 bp	-17 bp	-29 bp	-10 bp	-19 bp	$1.34	$1.02	$0.32	0.0 yrs	70 bp	64 bp
US HY	455 bp	310 bp	145 bp	8.6%	4.3%	430 bp	$87.02	$103.31	-$16.29	4.1 yrs	-2.6%	-10.5%
US HY Aerospace	**298 bp**	**351 bp**	**-53 bp**	**7.4%**	**4.4%**	**305 bp**	**$95.30**	**$103.43**	**-$8.13**	**2.9 yrs**	**1.5%**	**-4.4%**
Difference	-157 bp	41 bp	-198 bp	-119 bp	7 bp	-126 bp	$8.29	$0.12	$8.17	-1.1 yrs	410 bp	616 bp

Source: CreditSights, FactSet, ICE Data Indices, LLC

US IG and HY vs. Transportation	OAS			YTW			$ Price				YTD Returns	
	Current	YE 2021	Change	Current	YE 2021	Change	Current	YE 2021	Change	Duration	Excess	Total
US IG	142 bp	98 bp	44 bp	5.4%	2.4%	306 bp	$89.58	$109.14	-$19.57	6.9 yrs	-1.8%	-15.3%
US IG Transportation	**141 bp**	**114 bp**	**27 bp**	**5.4%**	**2.6%**	**275 bp**	**$89.09**	**$112.58**	**-$23.49**	**9.0 yrs**	**-1.1%**	**-17.6%**
Difference	-1 bp	16 bp	-17 bp	-3 bp	28 bp	-31 bp	-$0.49	$3.44	-$3.92	2.1 yrs	70 bp	-230 bp
US HY	455 bp	310 bp	145 bp	8.6%	4.3%	430 bp	$87.02	$103.31	-$16.29	4.1 yrs	-2.6%	-10.5%
US HY Transportation	**331 bp**	**291 bp**	**40 bp**	**7.4%**	**4.0%**	**348 bp**	**$95.59**	**$106.92**	**-$11.32**	**3.1 yrs**	**1.6%**	**-5.3%**
Difference	-124 bp	-19 bp	-105 bp	-118 bp	-36 bp	-82 bp	$8.58	$3.61	$4.97	-1.0 yrs	420 bp	526 bp

Source: CreditSights, FactSet, ICE Data Indices, LLC

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US Industrials & Transportation

Capital Goods

Executive Summary

- IG Capital Goods (Market perform). We expect the Capital Goods sector to be an overall solid performer in 2023, led by increased demand for Aerospace and Defense products. In the Industrial Products segment, we expect lingering supply chain challenges to constrain production and support favorable pricing, which along with a record order backlog should support strong revenue growth and relatively stable margins despite potential weakness in new orders.
- HY Aerospace (Market Perform). While we are constructive on balance sheet improvement in 2023, sector spreads and yields are on the tight side relative to history. We think the sector remains a defensive stronghold within high yield.
- IG Picks & Pans. Our IG picks include Deere/CNH Industrial (ag upcycle), Parker-Hannifin (deleveraging), and A&D companies Boeing/L3Harris (relative value). Our IG pans are relative value calls on Caterpillar and Carrier Global.
- HY Picks. Our HY picks include Bombardier and Howmet Aerospace based on expected debt reduction and positive rating momentum. We expect Howmet will rise to investment grade in 2023, while Bombardier should be upgraded one notch, to mid-single B, on the back of a strong business jet market.
- New issue outlook. We expect Capital Goods 2023 new issuance of roughly $25 bn (IG) and $3bn (HY Aerospace). Most of the expected new issuance is to refinance debt maturities, although about $8 bn of the IG issuance is to fund an acquisition and shareholder returns.

Key Themes for 2023

- Slowing global growth – Demand for capital goods, especially Industrial Products, is aligned with global and regional GDP growth, which is expected to slow in 2023 compared to 2022 and 2021.
- Record backlogs – Demand has outstripped industrial production the past two years as demand recovered following the onset of the pandemic, while supply chain challenges constrained production and led to the buildup of record order backlogs in most segments.
- Supply Chain / Labor – Engines, rocket motors and electronics have been in short supply in the Aerospace & Defense industry. Labor has been tight and has been a key factor constraining production ability.
- Covid-related recovery – The ongoing recovery in air travel has led to improved aftermarket and services businesses, while aircraft production continues to increase as well.
- US Government Funding – Lack of approved funding from the United States, which is operating under a continuing resolution, and other governments has tempered growth rates for defense companies.

Top Risks for 2023

- Margin pressure – While the supply-demand imbalance has supported strong pricing the past two years, supply chain normalization and production recovery could weaken the strong pricing environment and margins.

- Global recession risk – A global recession could constrain government budgets and result in a sequestration environment for defense. Air travel would be impacted, along with growth rates for aftermarket and service businesses.

- A&D demand durability – Resolution of the Russia/Ukraine war could temper near term demand for weapons, while an escalation could increase it.

Picks, Pans & Recommendations

Investment Grade Picks

- Deere (A2/A/A) – We expect demand for Deere's agricultural equipment to remain strong in 2023 based on low grain stocks and expectations for sustained elevated grain prices and farm incomes. Our Outperform recommendation is based on management's robust FY23 revenue and profit guidance based on strong customer demand for large ag equipment, an extended equipment replacement cycle, its order book that extends into F3Q23, and relative value. **Deere Company Page**

- Parker-Hannifin (Baa1/BBB+/BBB+) – We maintain an Outperform recommendation on Parker-Hannifin notes based on our expectation for intermediate-term deleveraging following the close of its $7.2 bn Meggitt acquisition in September 2022, credit rating stability, its financial policy that targets a strong investment grade rating and 2x leverage, and relative value. **Parker Hannifin Company Page**

- CNH Industrial (Baa2/BBB/BBB+) – We maintain an Outperform recommendation on CNH Industrial notes based on its streamlined portfolio that is now focused on the agriculture and construction equipment markets, an agricultural upcycle that we believe is supportive of steady equipment demand over the intermediate term, its financial policy that targets an investment grade credit rating, and relative value. **CNH Industrial Company Page**

- Boeing (Baa2/BBB-/BBB-) – We view the 100-130 bps spread pickup in Boeing bonds relative to peers (Airbus, GE and Raytheon Technologies) as attractive and see the agencies stabilizing ratings by 4Q23. Boeing has the potential for multi-notch upgrades at each of the agencies over the next several years as the aerospace market recovers and deliveries expand. We expect gradual debt paydown along the way. We are cognizant of beta-related risks to the credit, however given our expectation of improvement, we maintain our Outperform view. **Boeing Company Page**

- L3Harris (Baa2/BBB/BBB+) – As a technology company, LHX sports industry high margins supported by highly diversified exposures that are mostly platform agnostic. We expect LHX will be in the market with $750 mn of bonds to refinance a June 2023 maturity. It has obtained a $2.25 bn 3-year term loan to fund an acquisition. Spreads are attractive relative to the defense group, up to 60 bp pickup to defense prime peers. **LHX Company Page**

Investment Grade Pans

- Caterpillar (A2/A/A) – We maintain our Underperform recommendation on Caterpillar Inc. and Caterpillar Financial Services Corp. (Cat Financial) notes based primarily on relative value. Other relative considerations include its financial policy that targets maintaining its mid-A credit rating, its scale and geographic diversification within the heavy equipment industry, and our view that revenue growth should persist into 2023 based on healthy orders and a strong backlog despite the softening macroeconomic backdrop. **Caterpillar Company Page**

- Carrier Global (Baa3/BBB/BBB-) – We maintain an Underperform recommendation on Carrier Global notes based on relative value and our view its credit rating is likely to remain below its HVAC peers Johnson Controls and Trane Technologies in the near- to intermediate-term, partially offset by the company's solid diversification in the HVAC, Refrigeration and Fire & Security industries, healthy operating margins, relatively low leverage, and financial policy that targets a rating upgrade by Moody's and Fitch. **Carrier Global Company Page**

US IG Capital Goods Company Recommendations		
Outperform	**Market Perform**	**Underperform**
Boeing (BA)	Lockheed Martin (LMT)	General Electric (GE)
L3Harris (LHX)	Raytheon Technologies (RTX)	Caterpillar (CAT)
Deere (DE)	General Dynamics (GD)	Carrier (CARR)
CNH Industrial (CNHI)	Airbus (AIRFP)	
Parker-Hannifin (PH)	Huntington Ingalls (HII)	
	Eaton (ETN)	
	Textron (TXT)	

Source: CreditSights

High Yield Picks

- Bombardier (B3/B-/NR) – We remain positive on the Bombardier (B3/B- S/S) story with an Outperform view. Having achieved low B ratings in 2022, the company is now eyeing even higher credit ratings. Debt paydown could total $1.25 bn over the next year, with an additional $500 mn in 2024. Debt to EBITDA, currently 7.8x, could reach 4.3x by 2023 and 3.4x by 2024, as the company continues to execute on its profitability improvement plan. Services flow though has been a strong contributor, and we expect this to continue to grow strongly given recent investments made in the area. **Bombardier Company Page**

- Howmet (Ba1/BB+/BBB-) – Howmet has differentiated itself with an ability to consistently produce the most highly engineered and difficult-to-produce parts and components for commercial aerospace, defense aerospace, and commercial transportation. As a result, Howmet is well positioned for the cyclical recovery of the aerospace industry. Given its projected performance, we expect Howmet to reach Moody's and S&P's financial metric requirements for an upgrade to Baa3 or BBB- by mid-year 2023. Ultimately, we expect Howmet to solidify a position at mid BBB at all three agencies, by YE25 if not before. **Howmet Company Page**

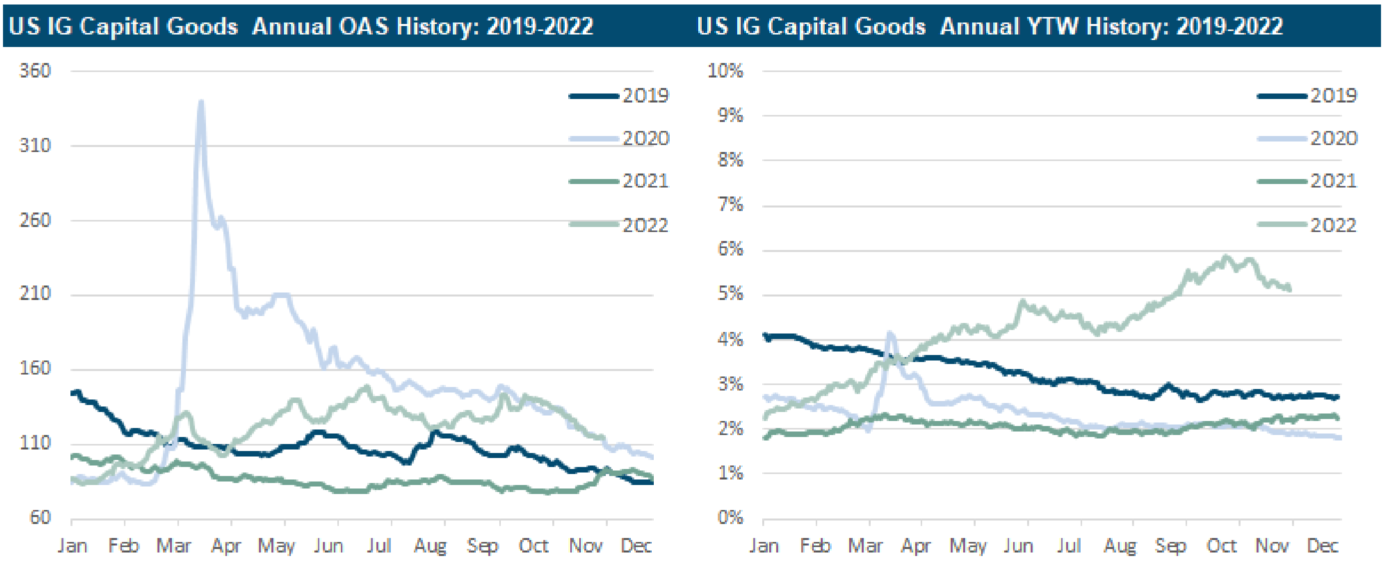
High Yield Pans

US HY Aerospace Company Recommendations		
Outperform	**Market Perform**	**Underperform**
Bombardier (BBDBCN)	Transdigm (TDG)	
Howmet Aerospace (HWM)		

Source: CreditSights

Relative Value

Investment Grade

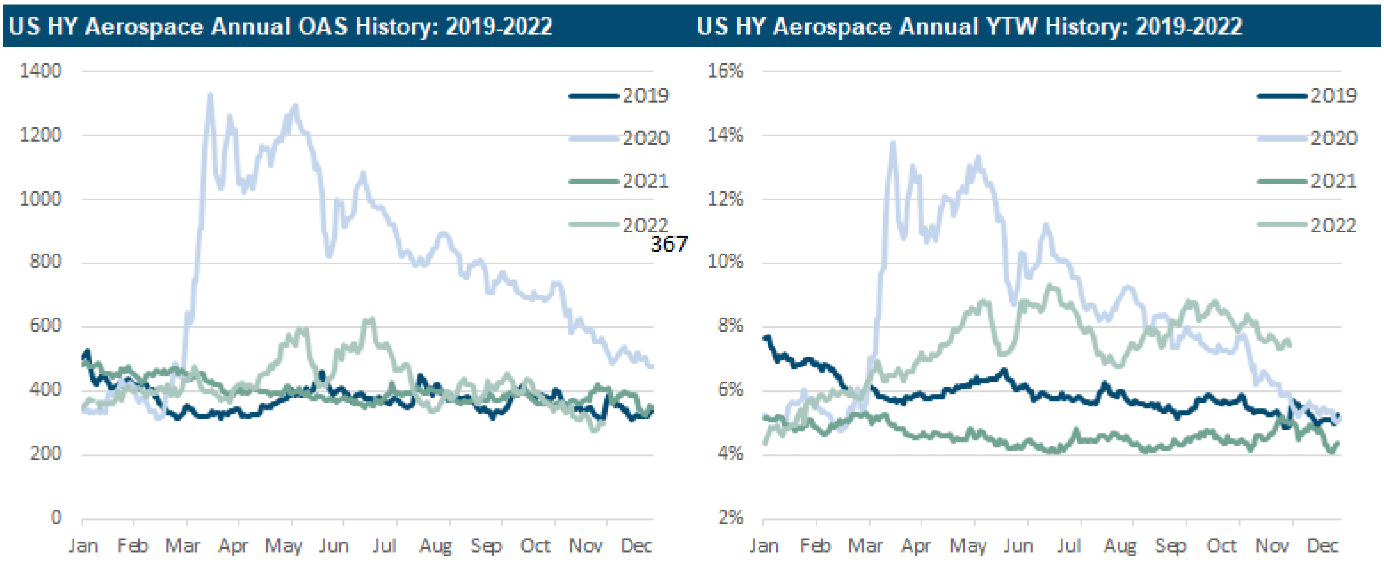


Source: CreditSights, FactSet, ICE Data Indices, LLC

The IG Capital Goods sector – comprised of Industrial Products and Aerospace & Defense (A&D) subsectors – has outperformed the broader market on both an absolute and excess return basis in 2022 YTD, consistent with its status as a safe haven sector. We expect A&D product demand to remain robust in 2023, augmented by unrest in Ukraine and rising concerns in Taiwan. While we expect weaker global GDP growth in 2023 to result in softer demand and weakening new orders for Industrial Products, we expect this weaker demand to be largely offset by record order backlogs that should support sustained revenue and profit growth. Our Market perform recommendation on the Capital Goods sector is based on expected increased demand for A&D products and improving order fulfillment within the Industrial Products subsegment, limited M&A activity, partially offset by slowing Industrial Products new orders.

No surprise, IG Aerospace & Defense has performed well this year. GE has been a standout performer, as spreads tightened into the company's $7 bn tender and the company executed on its deleveraging plan. Boeing's performance has been notable as well, solidly trouncing the BBB index despite lowering cash flow expectations for 2023. The key to Boeing though has been the guidance for $17 bn of year-end cash, taking a liquidity crunch off the table, and bullish long-term commentary from management. Overall, the Aerospace & Defense sector (USAE Index) has returned to more typical trading levels inside the IG index. There appears to be more room to run in the intermediate term and will primarily be driven by continued improvement at Boeing.

High Yield



Source: CreditSights, FactSet, ICE Data Indices, LLC

HY Aerospace (HOAE index) has been a safe haven in the market. While TDG has performed defensively, as expected, overall sector performance has primarily been driven by Bombardier, which broke into the B index this year after upgrades at Moody's and S&P. We expect continued improvements at Bombardier; however, sector yields are now at the skinniest seen in over a decade when compared to the broader HY index. We have a Market perform view overall for HY Aerospace. While sector yields are on the tight side of historical averages, we believe the sector will perform ok in 2023 given its defensive nature and large improving credit stories in Bombardier and Howmet.

Fundamental Outlook

Investment Grade

IG Capital Goods Largest Issuer Fundamental Snapshot					
	Total		Net Leverage		
Issuer	Outstanding ($B)	Current	YE 2021	YTD Change	FY2023 Leverage Direction
Boeing	$57.2	14.6x	11.6x	3.0x	Lower
Raytheon Technologies	$33.2	2.8x	2.4x	0.4x	Lower
General Electric	$30.4	4.7x	5.4x	-0.7x	Lower
John Deere	$23.6	0.7x	0.4x	0.3x	Flat
Caterpillar	$22.8	0.4x	0.1x	0.3x	Higher
Siemens	$20.0			0.0x	Lower
Northrop Grumman	$12.9	2.4x	1.9x	0.5x	Flat
Lockheed Martin	$12.8	1.1x	0.9x	0.2x	Higher
Parker-Hannifin	$9.1	3.6x	2.3x	1.3x	Lower
Carrier	$8.3	1.8x	2.1x	-0.3x	Higher

Source: CreditSights, FactSet, ICE Data Indices, LLC, Company Filings

The IG Capital Goods sector is comprised of the Industrial Products (CSIP, 52%), Aerospace & Defense (USAE, 36%), and Packaging (CIPP, 12%) segments. Demand for products and services in the Industrial Products segment is cyclical and is generally aligned with global and regional GDP growth. While demand has largely recovered from the slump experienced in the aftermath of the onset of COVID in March 2020, production continues to be hampered by supply chain challenges. The International Monetary Fund (IMF) projects global GDP growth of 2.7% in 2023, down from an expected 3.2% in 2022 and 6.0% in 2021. In line with the IMF's global growth forecast, we expect global demand growth for Industrial Products to slow in 2023. However, we expect lingering supply chain challenges to constrain production and support favorable pricing, which along with a record order backlog should support strong revenue growth and relatively stable margins in 2023.

The post-Covid Aerospace recovery will continue in 2023, and we expect key capital goods constituents Boeing, Raytheon Technologies and General Electric will all deleverage on improving results. Boeing will be in debt paydown mode as well – we expect the company to pay down its $5 bn in 2023 maturities, and likely more. General Electric has $3 bn of 2023 maturities that will be paid down next year, following a $7.2 bn tender that was completed in December. We expect GE's $5.9 bn of preferred stock will be right sized or potentially entirely paid down.

We expect defense primes to keep leverage mostly flat as shareholder rewards offset EBITDA gains. Lockheed Martin is a primary candidate to increase leverage from its current low level near 1x.

High Yield

HY Aerospace Largest Issuer Fundamental Snapshot					
	Total		Net Leverage		
Issuer	Outstanding ($B)	Current	YE 2021	YTD Change	FY2023 Leverage Direction
TransDigm	$19.8	6.4x	6.6x	-0.2x	Lower
Bombardier	$6.1	6.0x	8.4x	-2.4x	Lower
Howmet	$4.2	3.0x	3.1x	-0.1x	Lower

Source: CreditSights, FactSet, ICE Data Indices, LLC, Company Filings

In High Yield Aerospace, we expect most credits to benefit from continuing improvements from Covid bottoms. Bombardier will continue to pay down debt, as will Howmet. We expect Howmet will rise to investment grade in 2023, while Bombardier should be upgraded a notch as well, to mid-single B, on the back of a strong business jet market.

Primary Market Outlook

IG Capital Goods 2023 Primary Market Expectations				
Issuer	**Rating**	**Est. Amount ($B)**	**Use of Proceeds**	**Anticipated Timing**
DE	A2/A/A	$7	GCP, Refinance	1Q/2Q/3Q/4Q
CAT	A2/A/A	$6	GCP, Refinance	1Q/2Q/3Q/4Q
NOC	Baa1/BBB+/BBB+	$3	$1 bn Refi, $2 bn Shareholder Reward	2Q/3Q
CNHI	Baa2/BBB/BBB+	$3	GCP, Refinance	2Q/3Q
LMT	A3/A-/A-	$2	Share Repurchase	2Q
RTX	Baa1/A-	$1	Refi, Share Repurchase	3Q/4Q
LHX	Baa2/BBB/BBB+	$1	$750 mn Refi	2Q

Source: CreditSights, Bloomberg, L.P.

We expect Industrial Products segment 2023 new issuance to be dominated by Caterpillar, Deere, and CNH Industrial, each of which maintains a captive finance subsidiary to support the sales of their large equipment. While most of our 2023 new issue estimate of $16 bn consists of issuance to refinance maturing debt, CNH management also expects increased issuance to support growing finance receivables as it anticipates a higher penetration rate in the face of higher interest rates. We believe upside to our new issue forecast exists related to potential opportunistic M&A, most of which would likely be bolt-on in nature, or to fund shareholder returns within the context of extant financial policies and rating targets.

HY Capital Goods 2023 Primary Market Expectations				
Issuer	**Rating**	**Est. Amount ($B)**	**Use of Proceeds**	**Anticipated Timing**
TDG	Ba3/B+	$1.1	Refi $1.1 bn 8% '25 Notes	2Q
TGI	B3/B-	$1.1	Refi 8.875% '24 and 6.25% '24 Notes	4Q
BBDBCN	B3/B-	$0.5	Partially Refinance 7.5% '25 Notes	1Q/2Q

Source: CreditSights, Bloomberg, L.P.

Aerospace & Defense issuance in 2022 was light and consisted of $2.3 bn issued by LMT in April for refinancing and $4.0 bn issued in October to fund an accelerated share repurchase. We expect LMT will issue a further $2 bn, in 2023, although there could be material upside to that figure. We expect NOC will issue $3 bn. LHX has obtained a $2.25 bn 3-year term loan to finance its acquisition of Viasat's Tactical Data Link business. We anticipate NOC will seek to conduct an ASR.

Triumph Group (TGI) is facing a maturity wall in 2024 and we expect the company will look to refinance its $1.1 bn of debt in 2023. TransDigm should be in the market to refinance 8% 2025 notes as well, after extending its TLG in December. We expect Bombardier will look to partially refinance its $1.3 bn of 3/'25 notes in 2023, while paying down the rest.

Event Risk/M&A Landscape

The Industrial Products segment has undergone significant structural change over the past decade that has transformed the industry from one dominated by diversified conglomerates to one comprised of players primarily focused on one or two core segments. We expect most of the M&A activity to be focused on bolt-on acquisitions to expand one's geographic footprint or technical capabilities, although occasional transformational acquisitions could occur such as Parker-Hannifin's $7.2 bn acquisition of Meggitt in 2022. While we believe the more streamlined business structures generally lend themselves to a tighter focus on operational performance, we do not rule out potential activist involvement and will continue to monitor such activity.

Large scale consolidation is not expected within the defense sector, where the DoD has discouraged acquisitions in recent years. We think Lockheed Martin will remain in the hunt for acquisitions post the terminated acquisition attempt of Aerojet Rocketdyne. An acquisition in the area of data security could make sense for them. L3Harris has announced the $2 bn acquisition of Viasat's Tactical Data Link business that is expected to close in 1H23. We expect L3Harris will remain acquisitive in the years to come.

Within Aerospace, we expect General Electric will look to bolster its core aerospace engine business via acquisitions post the spin-offs of Healthcare in January 2023, and Vernova in 1Q24. A large merger is possible is well, but we think this could occur further down the line in the 2024/2025 timeframe. We also expect GE to rid itself of its legacy insurance exposure, which we believe could require funding in the $4-$6 bn range.

ESG Considerations

The Industrial Products segment has seen several green bonds and sustainable bonds issued to fund initiatives such as more efficient cooling and heating systems (HVAC players) and green energy (electrical and HVAC players). We expect continued issuance of green bonds and sustainability bonds from an increasing set of companies within Industrial Products as most companies maintain a robust set of near-term and long-term sustainability and ESG targets.

While we doubt many investors own General Electric for its Renewables business, its appeal as an environmentally friendly business will be lower post the spin of GE Vernova in 1Q24. Various low environmental impact technologies continue to be developed in aerospace including electric vertical takeoff vehicles and next generation aircraft engines.

Transportation

Executive Summary

- IG Transportation – We have a Market perform view. The IG transportation sector has continued to grind this year and now stands mostly inline with the IG index, having bottomed at a give of 33 bp to the index in 2020. Our Market perform view on Transportation reflects our expectation the sector will continue to trade as a relative safe haven in an uncertain market.
- HY Transportation – We have an Outperform view. The US airlines sector is experiencing a stronger than expected pandemic recovery as demand exceeds constrained supply. Fares significantly above prepandemic more than cover higher fuel expense to drive EBITDAR back toward 2019 levels. The view is less certain in 2023 in a recession scenario, but there should be sufficient demand/supply imbalance to absorb demand erosion.
- Our Investment Grade picks include Kansas City Southern for its pickup to Canadian Pacific and CSX Corp for its solid relative value. IG Pans are Canadian National which we expect will adopt a more aggressive financial policy and Canadian Pacific for spreads that are flat compared with lower leveraged peers.
- Our High Yield Picks favor American Airlines and United Airlines versus Delta Air Lines as we expect relative spread compression trends to continue.
- We expect IG issuance to come in around $11 bn in 2023, down slightly from 2022 levels. We expect UNP, UPS, CNRCN, NSC and BNSF will be in the market.
- HY issuance should be low as the US airlines built up excess liquidity at the onset of COVID. Depending on how this excess liquidity is utilized for debt maturities and aircraft capex in 2023, there could be increasing EETC offerings as new aircraft deliveries ramp up, especially at UAL and DAL.

Key Themes for 2022

- Railroad operations were disrupted by the labor shortage issues through the year. They have taken steps to attract and retain talent, as evident from the rising average employee numbers and available trainee pipelines. For many, including Union Pacific, Norfolk Southern, Canadian Pacific and CSX, train speed decreased due to congestion and terminal dwell increased due to limited workers.

- Congress stepped in to prevent a strike by enforcing the employment terms established by a Presidential Emergency Board, limiting the ultimate impact to the economy. Key outstanding labor agreements to be resolved over the next year include the west coast dock workers as well as UPS' agreement with the Teamsters.

- Rail volumes were weak in the first half of 2022, while they were flat to modestly positive in the second half. Pricing power remained strong throughout.

- Package and air freight companies have seen decreasing volumes in 2022 due to slower economic growth as well as post-covid normalization of ecommerce trends. Pricing has been strong and both UPS and FDX are looking to chase price as opposed to volume looking forward.

- Airline traffic exceeds prepandemic levels in the domestic and Caribbean sectors. Corporate is catching up, probably about 80-90%, along with Atlantic and Latin America while Asia still lags.

- Airline capacity constraints are driven by chronic labor shortages across the airline infrastructure: pilots, ground facilities, and air traffic control staffing. We expect these issues to continue through 2023 into 2024.

- Airline traffic recovery in 2021 was attributed to pent-up demand. Continuing strong traffic in 2022 indicates positive secular changes as the hybrid work model allows more weekend and short vacation excursions as well as leisure extensions on recovering work travel.

Top Risks for 2023

- Economy – A recession would negatively impact volumes for transportation companies.

- Air freight recession – FDX has seen significantly lower air freight volumes in 2022. Post-Covid normalization of Air freight volumes could continue well into 2023.

- Cost inflation – Fuel and labor expenses historically run 50% of airline operating costs, and both are trending significantly higher.

- Airline demand erosion – Airfare price elasticity remains untested as well as potential recessionary demand erosion.

Picks, Pans & Recommendations

Investment Grade Picks

- Kansas City Southern – KSU has been acquired by CP. The basis between the two structures is about 30 bps today. We think investors should take this pickup and look for bonds to converge with CP levels as KSU is integrated into CP. Ultimately, we expect KSU bonds will be guaranteed by CP or an exchange will occur, likely in 1Q23 when the STB is expected to approve the transaction. **Kansas City Southern**

- CSX Corp – We prefer CSX to BBB+ peers at mostly flat levels. We expect CSX capital allocation to be more credit friendly than their Eastern rail peer NSC. We recommend taking the 15-20 bps pickup in CSX compared to UNP (A3/A-/A-). CSX enjoys a slightly less levered balance sheet than UNP, and its operations are running a bit better as well. **CSX**

- Southwest Airlines – LUV has an exceptionally strong liquidity position with $5 bn negative net debt and a dominant position in the strong domestic demand recovery. Its bonds enjoy technical support as the only US IG airline credit. **Southwest Airlines**

Investment Grade Pans

- Canadian National – We expect an update on CNR (A2/A) financial policy at its upcoming May investor day. Current trading levels are inline with low A credits such as UNP and BNSF. Given uncertainty around future financial policy, and likelihood of significant supply in 2023, we are Underperform on Canadian National. **Canadian National Railway**

- Canadian Pacific – CP has posted tough results in 1H22, after lower-than-expected volumes and a strike impacted its operations. We took down our expected pace of deleveraging for the credit by 0.4x for each of 2022 and 2023. We would prefer to see a decent premium in CP bonds to its lower levered peers at this stage, instead levels are mostly flat. **Canadian Pacific**

US IG Transportation Company Recommendations

Outperform	Market Perform	Underperform
Kansas City Southern (KSU)	United Parcel Service (UPS)	Canadian National (CNRCN)
CSX Corp (CSX)	FedEx (FDX)	Canadian Pacific (CP)
Southwest Airlines (LUV)	Union Pacific (UNP)	
	Burlington Northern (BNSF)	
	Norfolk Southern (NSC)	

Source: CreditSights

High Yield Picks

- American Airlines – AAL is our top pick in the airline sector. Spreads widened out well beyond other airline credits in 2020 due to its higher leverage, but government support, continued access to capital markets, the strong traffic recovery, and low capex schedule, significantly reduce credit risk. A rating upgrade out of CCC should be possible.

- United Airlines – UAL maintained its complete widebody fleet in storage during the pandemic and now enjoys a leading position in the international travel recovery.

- Airline Mileage Bonds – Bonds secured by major airline affinity programs (AAdvantage, SkyMiles, and Mileage Plus) have an effective first lien on strong incoming cash flows as well as program IT and intellectual property. As these programs as core marketing initiatives of the airlines, we expect continuing underlying cash flow growth.

US HY Transportation Company Recommendations

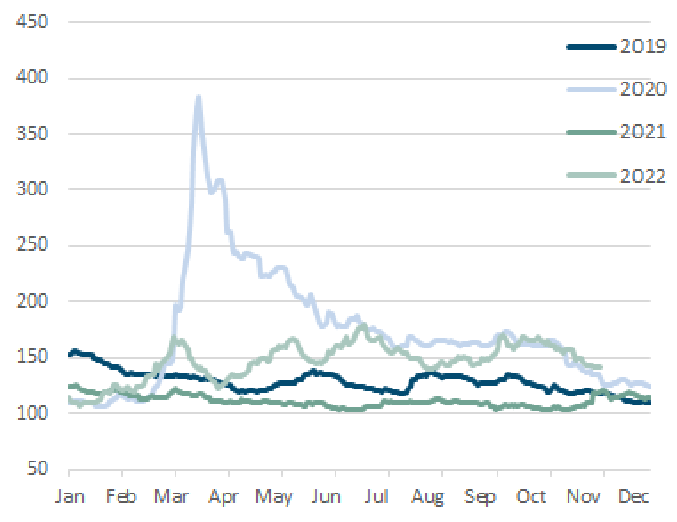
Outperform	Market Perform	Underperform
American Airlines (AAL)	Delta Air Lines (DAL)	
United Airlines (UAL)		

Source: CreditSights

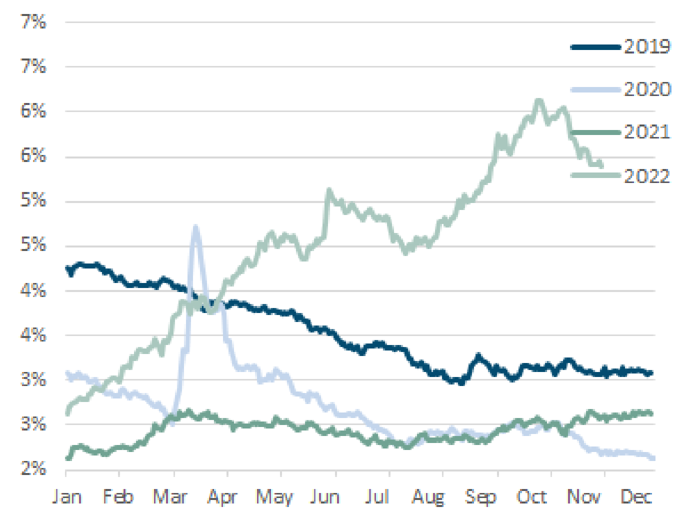
Relative Value

Investment Grade

US IG Transportation Annual OAS History: 2019-2022



US IG Transportation Annual YTW History: 2019-2022

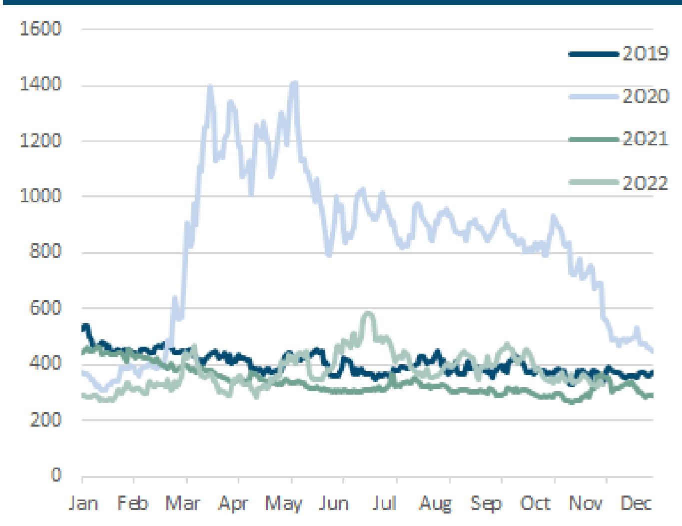


Source: CreditSights, FactSet, ICE Data Indices, LLC

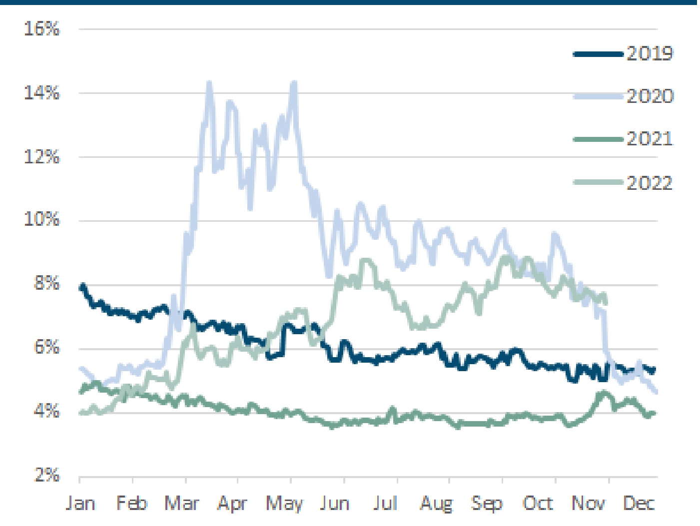
IG transportation credits have performed well this year on an excess return basis. Among our coverage, FDX is the lone exception, after weak results in September and pulling its full year guidance. The IG transportation sector has continued to grind this year and now stands mostly inline with the C0A0 index, having bottomed at a give of 33 bps to the index in 2020. This is typically the case when the market expects a recession. We have a Market perform view on Transportation given our expectation the sector will continue to trade as a relative safe haven in an uncertain market.

High Yield

US HY Transportation Annual OAS History: 2019-2022



US HY Transportation Annual YTW History: 2019-2022



Source: CreditSights, FactSet, ICE Data Indices, LLC

HY airline spreads backed up in 2022, first temporarily on the Ukraine situation which affected all aviation credits, and then again in the summer on recession fears. However, 2Q and 3Q22 results were exceptionally strong with many metrics above prepandemic levels. 4Q22 outlook is a similar strong demand outlook for holiday bookings. Longer-term issues of cost inflation and recessionary demand erosion still weigh on the 2023 credit outlooks, but we believe continuing supply constraints will support sufficient fare strength to overcome both issues—hence out continuing our Outperform recommendation.

Fundamental Outlook

Investment Grade

IG Transportation Largest Issuer Fundamental Snapshot					
	Total		Net Leverage		
Issuer	Outstanding ($B)	Current	YE 2021	YTD Change	FY2023 Leverage Direction
Union Pacific	$33.4	2.6x	2.5x	0.1x	Flat
Burlington Northern Sante Fe	$23.3	1.9x	1.9x	0.0x	Flat
United Parcel Service	$20.7	0.5x	0.7x	-0.2x	Flat
Federal Express	$20.0	1.2x	1.4x	-0.2x	Higher
Canadian Pacific	$18.8	4.1x	4.0x	0.1x	Lower
CSX Corp	$18.1	2.2x	2.1x	0.1x	Flat
Norfolk Southern	$15.1	2.3x	2.3x	0.0x	Higher
Canadian National	$11.2	1.8x	1.6x	0.2x	Higher

Source: CreditSights, FactSet, ICE Data Indices, LLC, Company Filings

We expect our investment grade transportation coverage will see mostly flat to modestly higher leverage levels in 2023 as compared to 2022 as companies return cash to shareholders and maintain their stated financial policies. Canadian National will be evaluating its financial policy in 2023, and we expect leverage will go higher. Federal Express will see higher net leverage on lower EBITDA due to the challenged air freight markets, and lower cash reserves.

High Yield

HY Transportation Largest Issuer Fundamental Snapshot					
	Total		Net Leverage		
Issuer	Outstanding ($B)	Current	YE 2021	YTD Change	FY2023 Leverage Direction
American Airlines	$36.9	8.3x	NA	NA	Lower
Delta Air Lines	$23.2	3.8x	NA	NA	Higher
United Airlines	$8.7	3.8x	NA	NA	Higher
Southwest Airlines	$31.6	-1.6x	NA	NA	Flat

Source: CreditSights, FactSet, ICE Data Indices, LLC, Company Filings

The US HY airlines will maintain higher leverage than prepandemic. Significant levels of debt raised at the onset of COVID now provide excess liquidity as the sector recovers, but capex funding will increase as DAL and especially UAL ramp up new aircraft deliveries over the next several years. With its fleet renewal substantially complete, AAL should begin delevering. Additionally, the risk environment for the airline industry is higher with the ongoing pandemic, recessionary, and geopolitical issues essentially unknown before the pandemic. We expect limited rating improvement unless the agencies pivot to a higher risk model. At the margins, DAL's Baa3 rating should be under pressure and AAL a candidate to move up from CCC across the board to at least low-B.

Primary Market Outlook

Investment Grade

IG Transportation 2023 Primary Market Expectations				
Issuer	Rating	Est. Amount ($B)	Use of Proceeds	Anticipated Timing
UNP	A3/A-/A-	$3.5	Refi & Share Repos	1Q/2Q
UPS	A2/A	$2.2	Refi	1Q/4Q
CNRCN	A2/A	$2.0	Refi & Share Repos	2Q
NSC	Baa1/BBB+	$2.0	Refi & Share Repos	1Q
BNSF	A3/AA-	$1.5	Refi	1Q/3Q

Source: CreditSights, Bloomberg, L.P.

2022 IG Transportation issuance totaled $11.65 bn. UNP issued $3.5 bn in February and came back for an additional $1.9 bn in September of which $2 bn was used for refinancing and the remainder funded share repurchase. NSC, BNSF, CSX and CNRCN were also active issuers in 2022. New issues generally performed poorly, widening 12 bp on average by November end, partially due to a heavy 1H calendar that was issued during better market conditions.

We expect UNP will highlight the new issue calendar once again in 2023, with $1.3 bn of refinancing and an additional ~$2 bn for share repurchase. UPS, CNRCN, NSC and BNSF are expected to round out the year's issuers. We do not expect CP, KSU or FDX to be in the market.

High Yield

We do not expect any meaningful unsecured debt issuance by the US airlines in 2023 as they are all in excess liquidity positions. Depending on how they draw down this excess liquidity during the year, there should be EETC issuance funding aircraft capex as they ramp up fleet renewal delayed during the pandemic.

Event Risk/M&A Landscape

Event risk is low in the US airline sector. Concentration is high with AAL, DAL, UAL, and LUV equally sharing 80% of the market with the other airlines not moving the needle. The JBLU/SAVE merger flies under the concentration radar as the DoJ focuses on the potential of majors entering joint ventures with smaller airlines to increase market penetration. The AAL/JBLU Northeast Alliance is an example under judicial review.

ESG Considerations

Railroads remain a favorable environmental play for transportation relative to their truck competitors due to significantly lower carbon emission generation per load. UNP issued a $600 mn green bond in September 2022 to fund green investments. We expect others will do the same in the coming years.

The major US airlines are greenwashing with small investments in electric aircraft, carbon capture, and sustainable fuel ventures, but none of these in total will dent the industry's issue with CO2 generation over any foreseeable time horizon. Green initiatives prevalent in Europe—carbon taxes, elimination of short flights in favor of rail, and flight shaming—have not made it over the ocean. The industry's main source of carbon reduction is new technology aircraft that are 15% more fuel efficient. Global demand for these aircraft is well above fleet replacement levels. UAL has the largest orderbook of US airlines followed by DAL and LUV.

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