NUS National University of Singapore | RMI Advancing Risk Management for Singapore and Beyond

Weekly Credit Brief

Sep 11 - Sep 17 2012

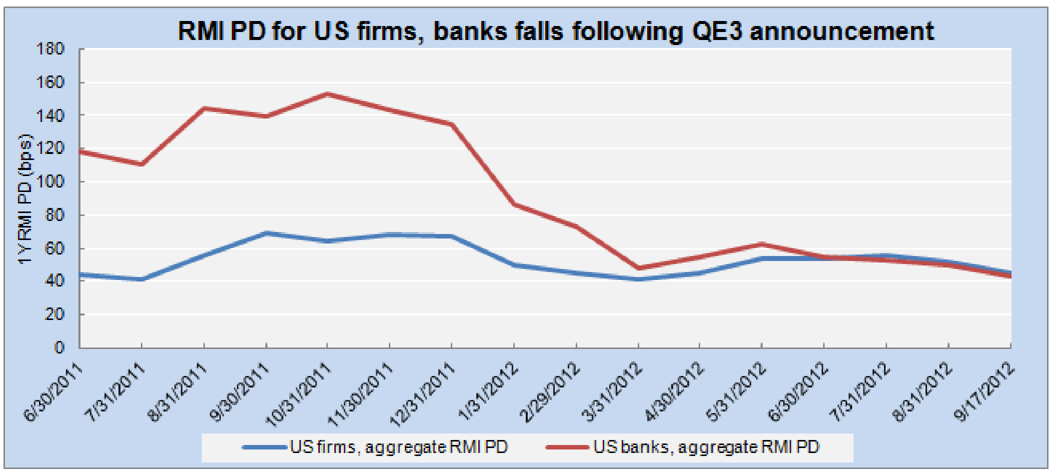
Story of the Week

RMI PD for US firms, banks reaches post-GFC low after QE3 announcement but risks remain

By James Weston

The 1-year aggregate RMI probability of default (RMI PD) for US companies and banks fell last week, as the US Federal Reserve (US Fed) announced a third round of quantitative easing (QE3) on September 13, and said it would likely maintain current low federal fund rate levels at least through mid-2015. The aggregate RMI PDs for US firms fell to a post-Global Financial Crisis (GFC) low on September 17, reflecting an overall improvement in credit quality as the US economy continues to expand moderately. However, the US Fed remains highly concerned about unemployment levels, which remain above 8%. Moreover, data suggests a large number of unemployed have given up looking for work, artificially lowering the unemployment rate.

With this in mind, the US Fed began outright open-ended purchases of US agency mortgage-backed securities (MBS) on September 14, with purchases expected to reach USD 40bn per month. The US Fed will also continue a program aimed at extending the average maturity of its holdings, and will continue to reinvest principle payments into agency MBS, which combined with QE3 purchases, will increase US Fed holdings of longer-term securities by about USD 85bn per month.



Success dependent on transmission mechanisms: The overall aim of QE3 is to lower yields in asset-backed securities markets, in order to push investors towards corporate debt. It is expected this process will lower yields on corporate bonds and encourage new issuance, giving US companies' funds to pursue business expansion and increase hiring. Market yields have fallen to record lows already, with the Bank of America Merilll Lynch US High-Yield Master II index falling below 7% for the first time ever on September 14. Companies may also use these funds to complete stock buybacks or to increase dividends, further transmitting QE3 funds to the real economy. The outright purchases will also provide banks with new cash to lend to businesses and households.

However, the success of QE3 is highly reliant on the aforementioned transmission mechanisms working correctly. There is a risk that US companies will decide to continue to pile up cash, or use cheaper funding to pursue bargain acquisitions in ailing European markets. A survey of US Chief Financial Officers released by Duke University last week suggests the US Fed's actions will do little to change business spending plans. Moreover, many market participants believe the root cause of current high unemployment is anemic demand and a lack of profitable domestic investment opportunities, and not a funding deficiency. US nonfinancial corporations held USD 1.74tr of cash or liquid assets on their balance sheets at the end of Q1.

Risks remain for US corporates: Two major near-term risks continue to shadow the credit profiles of US companies, despite an expected easing in funding profiles. The eurozone sovereign debt crisis will likely continue to weigh on US exports to the EU. The looming fiscal cliff may lead to another recession if the US Congress is unable to avert tax increases and automatic spending cuts. The Congressional Budget Office has estimated that around two million jobs will be lost in such an eventuality.

Inflation remains a longer-term risk to US corporates, as demand for real assets will likely place upwards pressure on input costs, including commodities, reducing corporate earnings. Furthermore, there is a risk of unanticipated inflation if the US Fed does not manage the eventual transition to more traditional monetary policy effectively.

Bank profitability likely to improve: An expected surge in bond offerings and a rally in asset prices, as investors seek inflation hedges, could lead to stronger earnings growth at US banks. Lenders with a greater focus on mortgage origination, including San Francisco-based Wells Fargo and other smaller players, will also benefit from increased demand for loans, and a higher spread between the average 30-year fixed-rate mortgage and yields on MBS. However, higher earnings arising from the former may be limited by the ability of lenders to process mortgage applications. Originators are said to have large backlogs of loans awaiting approval.

Sources:
Press release: FOMC monetary policy action (Federal Reserve)
CFOs to Bernanke: don't bother with QE3 (Fox Business)
CFOs: Hiring and spending plans weaken, Fed policy viewed as ineffective (Duke University)
QE3 hit by mortgage processing delays (FT)

In the News

India cuts reserve ratio to boost growth while holding rates:
Sep 17. The Reserve Bank of India (RBI) unexpectedly cut the Cash Reserve Ratio (CRR) from 4.75% to 4.5%, infusing INR 170bn (USD 3.1bn) into the banking system, in a move aimed at supporting the government's efforts to revive slowing growth. RBI kept key interest rates unchanged to curb inflation, which has climbed to 7.5%, and is expected to continue to increase as commodity prices soar. For example, recent cuts to diesel subsidies by the government, aimed at reducing the fiscal deficit, have placed upwards pressure on consumer prices. The RBI said it would continue to use monetary policy to reinforce positive government action aimed at promoting growth. Last week the government changed foreign direct investment (FDI) rules, allowing foreign retailers to own majority stakes in domestic businesses. (Bloomberg)

Investors pile into riskier Singapore bonds
Sep 13. Issuance of SGD-denominated bonds has soared to SGD 19.7bn this year, up 62% from the same period in 2011. Investors' quest for higher yield and an increasing preference to invest funds closer to home have driven both local firms and foreign firms to enter the SGD bond market. Foreign and local issuance has grown 78% and 26%, respectively. Issuance of comparatively riskier securities like perpetual bonds and subordinated debt has also picked up substantially, respectively making up at least 20% and 42% of total SGD bond issuance this year. (WSJ)

New dim-sum bond index on tap
Sep 12. Deutsche Bank and S&P Dow Jones Indices will together launch an index to follow offshore CNY-denominated bonds. The Deutsche Bank S&P index will include offshore CNY bonds and certificates of deposit with minimum maturities of 1 year and issuance size of at least CNY 1bn. Offshore CNY bonds have attracted foreign investors due to foreign exchange controls in China, as the bonds are one of the only ways the CNY can circulate outside of China. Offshore CNY bonds also allow investors to speculate on the future movement of the CNY. The market has shrunk this year as expectations of further CNY appreciation cooled. Market participants expect issuance will increase towards the end of the year, as foreign banks look to expand in China. Deutsche Bank expects a number of exchange-traded funds will track the newly-launched index. (WSJ)

EU banks get leeway over derivatives rules roll-out
Sep 11. European banks will be granted more time to prepare for sweeping reform of derivatives markets, as regulators said they would roll out new rules gradually over several months. Regulators had previously indicated all of the measures would become effective in January. The regulations will require electronic trading, clearing, and reporting of derivatives trades previously conducted away from exchanges. European regulators said implementation must be delayed because the new rules and banks themselves will not be ready in time. Banks have already started clearing some standardized derivatives, as incoming capital charges and margin requirements will make trading derivatives more expensive. Banks are seeking as much information as possible so they can begin adapting systems to the new rules. Regulators are expected to

allow banks time to settle into the new rules. Reuters)

Published weekly by Risk Management Institute, NUS | Disclaimer
Contributing Editor: James Weston