Credit Research Initiative
Risk Management Institute, National University of Singapore
NUS National University of Singapore | RMI Advancing Risk Management for Singapore and Beyond
transforming big data into smart data
Weekly Credit Brief Apr 16 - Apr 22 2019

Brazil's reform agenda faces a bumpy road ahead

by [Dexter Tan]

Brazil has emerged from a three-year recession and many firms have returned to growth but its credit outlook has weakened since the formation of the new government. A strong agricultural sector and recovery in private consumption lifted the country out of recession in 2017 but now, a newly formed government has ambitious plans to transform Brazil further into a market driven economy. The newly elected President is promising a reform agenda on two fronts – to revamp the pension system and simplify the tax code, but the credit profiles of publicly listed firms have deteriorated since his inauguration at the start of this year.

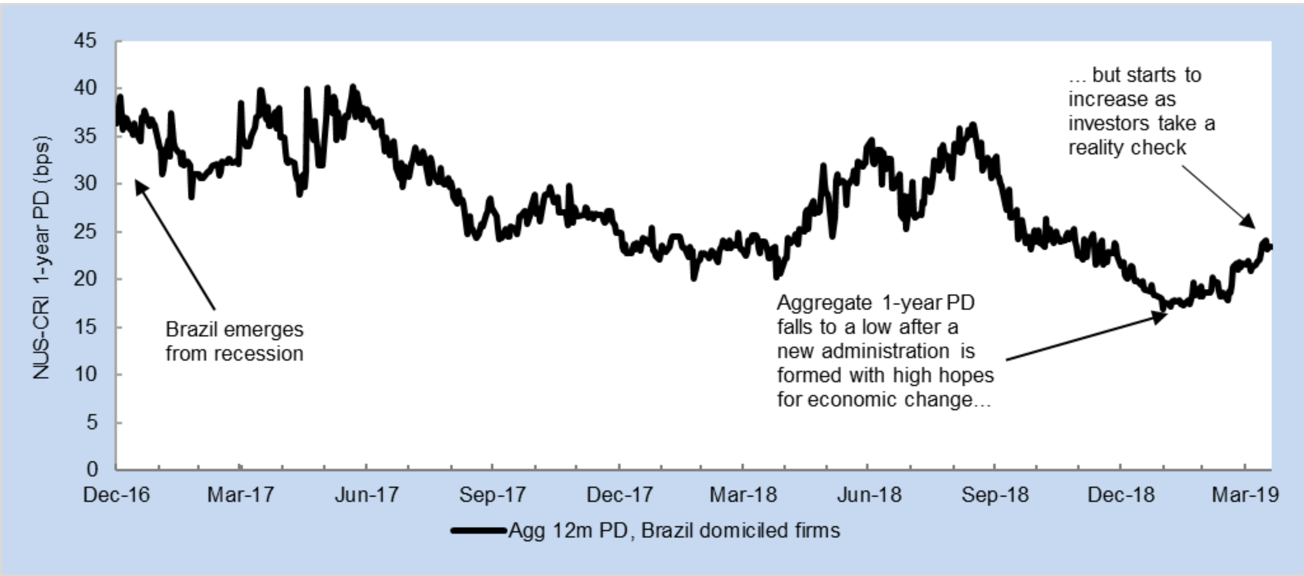
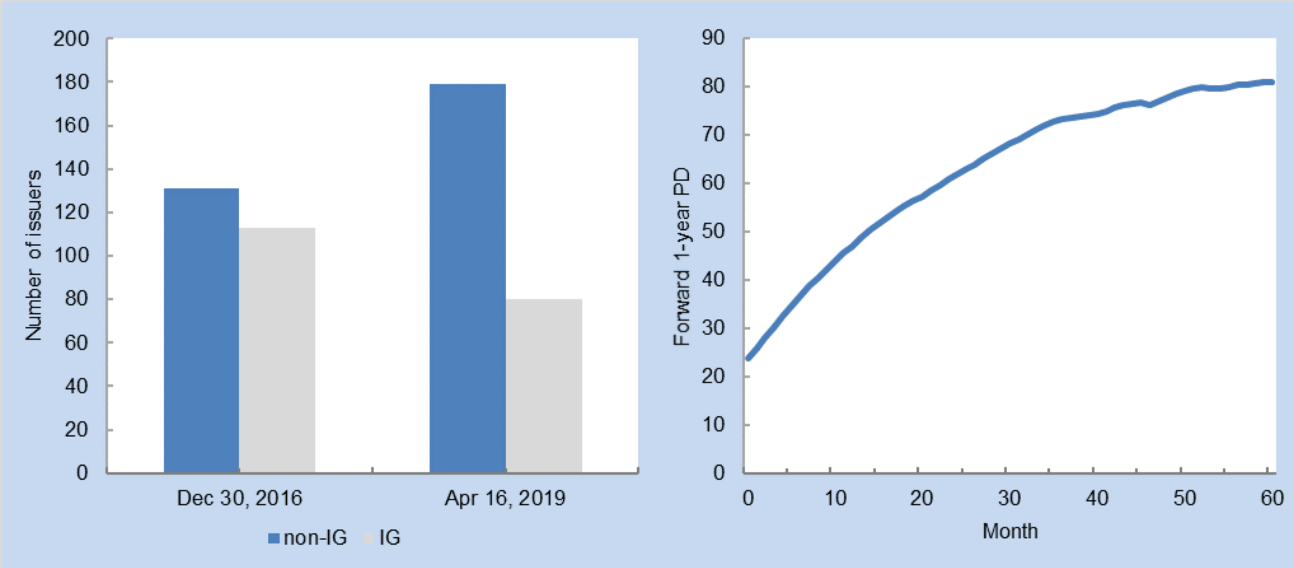


Figure 1: NUS-CRI Aggregate 1-year PD for Brazil domiciled firms from 2017. *Source: NUS-CRI*

The credit profiles of Brazil-domiciled firms, tracked by the NUS-CRI 1-year Aggregate Probability of Default (Agg PD), have generally improved between 2016 (which marks the end of Brazil's recession) and December 2018. A rally in equity values brought the default benchmark to a new low in January this year, coinciding with the end of the election campaign and the appointment of a newly formed administration. However, the 1-year Agg PD has increased in the last few months as the Bolsonaro administration is likely to face significant legislative hurdles and could under deliver on investor's expectations for higher fiscal savings.



Figures 2a & 2b: Number of investment grade (IG) issuers and the terms structure of Forward 1-year PD for Brazil domiciled firms as of Apr 16. *Source: NUS-CRI*

Even as the aggregate credit profile of Brazilian firms appeared to be improving on the surface, the number of non-investment grade (rated BB+ and below) issuers have outnumbered investment grade (BBB- and above) issuers, according to NUS-CRI Probability of Default Implied Ratings (PDiR). PDiR provides a more conventional interpretation of PDs – it translates NUS-CRI PDs to letter ratings by taking reference from the historical observed default rates of Standard & Poor's (S&P) rating categories. As of Apr 16, approximately 30% of all rated corporates are investment grade, down from 46% at the end of December 2016.

By using the NUS-CRI Forward 1-year Probability of Default (Forward PD), the credit outlook for Brazil domiciled firms is likely to remain weak. As seen in Figure 2b above, the term structure of Forward PDs indicate that the credit risk for Brazil firms will increase in the next 60 months, albeit at a slightly higher rate in the initial few months. The Forward PD computes the credit risk of a company or a portfolio of companies in a future period, which can be interpreted similar to a forward interest rate. For example, the 10-month forward 1-year PD is the probability that the firm defaulted during the period from 10 months onwards to 1 year plus 10 months, conditional on the firm's survival in the next 10 months.

Brazil's economic minister has big plans for the economy. In an interview cited by the FT, the minister promised to overhaul the pension system, implement tax reforms and sell at least USD 20bn in assets of state-owned companies including parts of Petrobras and Banco do Brasil. The municipal service tax (ISS), state tax (ICMS) and other taxes will be streamlined into a single federal value added tax, or *Imposto sobre Bens e Servicos*.

The minister also planned to change the pension system that would lead to decreased social security spending and lower the fiscal deficit to save the government USD 270bn over a 10 year period. Furthermore, the updated Investment Partnership Program between the government and the private sector will supposedly foster competiveness and facilitate the participation of foreign capital, a move that would invite capital inflows into its energy, telecommunications, transportation and oil sectors.

Admittedly, these pro-business plans are positive for Brazilian companies in the long run but implementing these reforms may not be easy and more importantly, the timeframe in which these bills are passed in Congress could disappoint investors in the short term. Investors may be optimistic about the new government and the default risk of Brazilian issuers did fall to a fresh low on hope that the new President will follow through with his pledges to fix the economy. Yet there are others who are skeptical about what can be achieved in the next few months. After all, Brazil has maintained a track record of under delivering on the policy front during the past decade.

Credit News

Rate cut may not save ringgit bond rally as index outflow looms

Apr 22. The sentiment for Malaysian bonds is weakening due to a falling ringgit and global funds selling off Malaysian stocks. At the same time, FTSE Russell said that it may remove Malaysia from its world bond index due to concern on market liquidity. The outflows may total almost USD 8bn if Malaysia is dropped out of the index. Foreign holdings of Malaysian debt are already at a two-year low. Some analysts are expecting the central bank to cut rates due to the weaker than expected inflation data. The prospect of a rate cut has given some respite for the country's bonds as it lodged its best quarter since 2016. However, inflation may surge back given the higher oil prices and the weaker ringgit. (Business Times)

Chinese company endorsed by premier embroiled in USD 800mn defaults

Apr 19. China Minsheng Investment Group (CMIG) has seen cross-defaults triggered on USD 800mn in bonds after a missed debt payment earlier this year. CMIG is China's largest private investment company and its foundation was supported by China's premier Li Keqiang in 2014. The troubles of the Group highlight waning government support for state-owned companies and other high-profile institutions with strong political backing. Several state-backed groups have failed to fulfil debt obligations over the past year, including a default on USD bonds by a state-owned company in February, the first of its kind in 20 years. The cross-defaults by CMIG are also connected to Yida's debts because of the keepwell deeds. Keepwell deeds have long been used by Chinese companies for the function as comfort letters to investors but do not have the legal standing of full guarantees. However, keepwell deeds were broken last year by defaults by CEFC and China Energy Reserve and Chemicals Group, leading to new scepticism over the strength of the corporate promises. (FT)

Bondholders take on forex risk as hedging costs soar

Apr 18. With the trade-weighted dollar near its most expensive levels in 20 years and US interest rates high compared to Europe and Japan, the cost for foreign investors to hedge against fluctuations soared, spurring more foreign investors to buy US bonds "unhedged". The effect is to turn US treasuries into a negative-yielding investment for many foreign buyers where hedged European and Japanese investors now earning roughly -0.5% and -0.3% yield respectively on a 10-year US Treasury on a three-month rolling basis, compared to an unhedged yield of 2.58%. Some analysts fear that a weaker US dollar could trigger losses for unhedged investors and spur those investors to flee, weakening the dollar further and triggering a feedback loop. A strategist at Citi stated that the combination of this "reach for yield" in lower-rated corporate bonds and widespread unhedged currency risk pose a danger to the broader financial system. (FT)

Bankers tap direct lenders on tough deals

Apr 18. As the distinction between syndicators and private money narrows, leveraged loan bankers are approaching direct lenders in a bid to sell down difficult deals. For instance, banks have approached a number of direct lenders on a EUR 300mn term loan backing Platinum Equity's acquisition of a majority stake in Spain's Iberconsa after failing to attract interest from CLOs and credit funds during a pre-marketing process. Competition between banks and direct lenders in the European leveraged loan market has intensified as the former look to do smaller deals while the latter stretches to do larger deals. Both bankers and direct lenders are also increasingly being shown the same deals especially in the mid-market space. Direct lenders, however, can charge at least 200bp more for their money compared with CLOs and credit funds but the practice of syndicating to a direct lender could cause a bank to maximize any agreed flex on a deal and book a loss. (Business Times)

Turkey props up reserves with eye on shaky lira

Apr 18. After a sharp drop in foreign reserves caused lira to briefly tumble last month, the recent move by Turkey's central bank to bolster its foreign currency reserves with billions of dollars of short-term borrowed money has raised fears among analysts and investors that the country is overstating its ability to defend itself in a fresh lira crisis. Financial Times' calculations indicate that without the unusual surge in the use of short-term borrowing or swaps since March 25, the total of Turkey's foreign net reserves are less than USD 16bn. Even if the use of swaps is included in Turkey's net foreign net reserves calculation, the reported number only stood at USD 28.1bn, a sum investors already believed to be inadequate. Furthermore, the boost to reserves does not precisely match the scale of borrowing through swaps, raising questions about whether some of the borrowed funds were used to support the lira. (FT)

Bond sales running at record pace (FT)

Goldman sees lower credit costs for Indian lenders (Business Times)

China Evergrande tops Asia borrowers with fresh dollar bond tap, raises USD 6.6bn so far (Reuters)

Regulatory Updates

China's Dagong rating agency taken over by state-owned investor

Apr 19. Dagong, one of China's three largest bond rating agencies, has been taken over by a Chinese state-owned investment company. About 12% of the China's 5791 corporate issuers still carry outstanding credit ratings from Dagong before regulators suspended its licences for lax corporate governance and conflicts of interest. Out of these firms being rated by Dagong, 70% of the firm's rating are rated AA or higher and experts have said that regulators' requirements on the credit rating on bond issuers may have driven this outcome. As China's USD 12.5tn bond market seeks to attract foreign capital and as Chinese bonds are integrated into global benchmarks, the quality of Chinese ratings is taking on a greater international importance but the uniformly positive ratings make foreign investors cautious. (FT)

UK's financial watchdog announces rethink on 'future of regulation'

Apr 17. UK's Financial Conduct Authority said that it is supporting an orderly transition after Britain's exit from the EU and it plans to embark on a wide-ranging examination of the future of regulation to ensure that the regulatory landscape is fit for the upcoming challenges. The challenges include the shift to digital and use of data that would not harm markets or consumers and new business models in the financial industry. There would be a prioritization of work on operational resilience, financial crime and the role of technology in the financial sector as the watchdog moves beyond the burden of Brexit. (FT)

China to cut financing costs and boost lending to small firms (Bloomberg)

Fed may need to buy more bonds than before crisis to manage US rates: official (Business Times)

Published weekly by Risk Management Institute, NUS | Disclaimer
Contributing Editor: Liu Hanlei