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Weekly Credit Brief Aug 13 - Aug 19 2013

Story of the Week

European corporate bonds rallied as RMI CVIs suggest lower credit risk in eurozone

The demand for debt issued by European corporations has increased significantly from a year ago, at the same time a stress indicator produced by RMI that measures credit risk in the eurozone fell to a two-month low.

Figure 1 compares the option-adjusted spread (OAS) of high-yield bonds in euros over benchmark government bonds, and the cost of insuring junk debt, against a proxy of the credit risk of the most vulnerable European corporations, the RMI Eurozone Tail Corporate Vulnerability Index (RMI Eurozone CVI-tail). As shown in the chart, the RMI Eurozone CVI-tail, which is the highest 5th percentile PD of companies domiciled inside the 17-nation currency bloc, fell almost 40% to 80.3bps on August 16 from 124.4bps at the end of July 2012. The bid OAS of Bloomberg EUR High Yield Corporate Bond Index narrowed to 393bps from 645bps over the same period, while the Markit iTraxx Crossover Index of credit default swaps (CDS) on 50 speculative-grade companies fell to 409.6bps from 633bps.

The broadly similar trend of the three lines suggests that the decline in the risk premium and protection cost of junk bonds came with a corresponding improved credit outlook for the eurozone companies with the worst credit profiles.

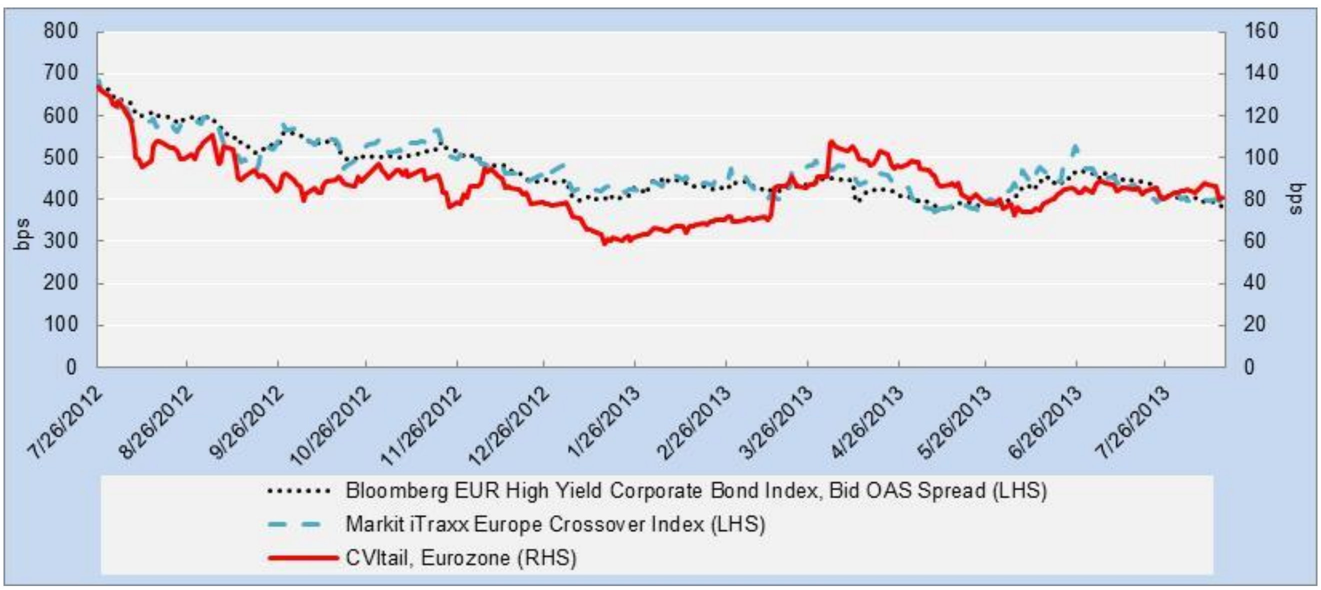

Figure 1: Borrowing costs and credit risk of speculative-grade European corporations fell from a year ago. *Source: Bloomberg; RMI*

Figure 2 examines the prevalence of overall credit risk in the eurozone, as indicated by the RMI Eurozone equally-weighted Corporate Vulnerability Index (RMI Eurozone CVI-ew), and the two-year euro swap spread, a gauge of debt market stress which narrows when investors' appetite for riskier assets increases. These data are plotted together with the OAS to benchmark government securities for EUR-denominated corporate bonds from Bank of America Merrill Lynch index data, which shows the compensation investors demanded to own euro corporate bonds instead of government securities.

We again observed a largely complementary trend between the three measures. The euro swap spread declined to 41.3bps from 69.3bps. The RMI Eurozone CVI-ew fell 35% to 26.2bps over the same period, while the OAS of euro corporate bonds dropped to 135bps from 220bps.

Figure 2: EUR-denominated corporate bonds gained strength as debt market stress eased. *Source: Bloomberg; RMI*

RMI has previously highlighted eurozone's more favorable credit outlook in its quarterly credit report released early this month, where we cited improved manufacturing data and the strengthening balance sheets of euro area banks. The report also suggested that the bloc may be finally exiting the recession that started in early 2012.

Good news came last week as economic data released August 14 showed the eurozone emerging from an 18-month recession in Q2, with GDP growing 0.3% QoQ, although the acceleration still leaves GDP across the euro area 0.7% lower on a YoY basis. Even as the medium-term outlook for growth remains weak, especially in southern Europe where unemployment rates are remarkably high, the recovery at least gives hope that the worst of the sovereign debt crisis may be finally over.

However, Financial Times reported that EUR-denominated bond issuance by banks worldwide is set to be the lowest in 14 years, highlighting the region's economic fragility that is not much helped by a lackluster recovery. The decline may also have been the result of the recent deleveraging movement in the banking system as banks strive to meet higher capital requirements. With so much lost ground to make up and social and political discontent still brewing in the peripheral countries, EU policymakers still have a lot on their plate as they try to guide the region back to real and sustainable growth.

In the News

Indonesia rupiah, stocks plummet on current-account gap

Aug 19. Following Bank Indonesia's announcement of a USD 9.8bn current account deficit on August 16, Indonesia's rupiah depreciated to its lowest level of IDR 10,500 per USD in four years, while both equities and sovereign bonds dove sharply. The Jakarta Composite Index of shares declined 8% over two days, its steepest fall in 22 months, and has now reversed all of its gains this year. The yield on Indonesia's 10-year bonds on the other hand, surged to 8.41%, the highest since March 2011. Economic data released last week also revealed accelerating inflation and slowing GDP growth. Although Indonesia's largest capital account deficit was the largest in at least 24 years, according to Bloomberg's records, John Rachmat of Mandiri Sekuritas expected capital inflows to return once the rupiah becomes sufficiently cheap. (Bloomberg)

RBA sees bank liquidity facility of around AUD 300bn

Aug 16. The Reserve Bank of Australia (RBA) expects a new liquidity facility to amount to around AUD 300bn. The so-called committed liquidity facility (CLF) will allow Australian banks to meet stricter global capital adequacy standards, in particular the Liquidity Coverage Ratio (LCR) under Basel III. A lack of high-quality, liquid assets such as government bonds in Australia means banks could have trouble meeting the prescribed LCR level. The CLF, which starts in January 2015, will allow banks to obtain guarantee of liquidity from the RBA for a set fee, and thus meet the new rules. (Reuters)

Bonds upended as AAA yields exceed AAs on tapering

Aug 16. The highest-rated corporate bonds in a Bank of America Merrill Lynch index yielded 0.27 percentage point more than bonds graded a tier lower on August 13, a divergence that last happened in early 2009. Analysts attribute the divergence in pricing to the fact that investors were more attracted to credit risk than interest rate risk. The effective duration for all AAA rated debt, which measures the sensitivity of bond prices to changes in interest rates, has risen to 8.1 in August, higher than the 6.16 duration seen for AA graded bonds. Bond yields of AAA rated Johnson & Johnson yielded an average of 3.1% as of August 14, 1.2 percentage points more than the bonds issued by Google Inc, which is rated two notches lower. (Bloomberg)

EU wants one definition of bad loans for bank tests

Aug 16. An upcoming review of the asset quality of major banks across the EU will implement a common definition for nonperforming loans, to ensure the stress tests this time around have more credibility and to provide easier comparison of the financial health of European banks across jurisdictions. The review, which will take place later in the year, will determine whether the banks have sufficient provisions for bad loans. A past review in 2011 was widely criticized for understating the banks' need for additional capital. (Reuters)

Rice eating hole in budget, swells bank spread

Aug16. The increasing burden of Thailand's rice-buying programme to boost rural income has placed strain on the nation's finance. From the first year of the programme to September 2012, the Thailand government lost THB 137bn on the subsidy. Most of the THB 90bn of debt sold by the state-owned bank for farmers, Bank for Agriculture and Agricultural Cooperatives (BAAC), was used to buy rice at above-market rates to boost rural incomes. The increasing burden has in turn undermined demand for bonds issued by BAAC; BAAC's last four auctions have not been fully sold. In addition, the spread between its government-guaranteed notes due February 2016 and sovereign paper maturing December 2015 widened 8bps this year to an unprecedented 34bps on Aug 13. (Bangkok post)

Bolivia said to plan second bond sale after century-long absence

Aug 15. Bolivia is said to be seeking to sell USD 500mn of 10-year bonds to yield about 6.25%, after its first sale of overseas bonds in almost a century in October, when USD 500mn of bonds yielded 5.52% were sold. Bolivia, the poorest country in Latin America, is rated three notches below investment grade by the three major credit rating agencies and in line with Nigeria, Suriname and Bangladesh. Bolivia's bonds returned 0.8% this quarter, topping debt from Brazil, Colombia and Chile, as interest rates rise on speculation that the US Federal Reserve would taper its asset-purchasing program soon. (Bloomberg)

Economic growth sends German borrowing costs soaring

Aug 14. Yields on 10-year German sovereign bonds rose to an 18-month high of 1.80% on August 14. Demand for longer-dated German bonds has slid over recent months, with previous issuances of the same bond recording yields of 1.17% in May and 1.57% in July. Analysts said that the weak demand was mostly expected as the recent improving outlook of the eurozone economy put pressure on the German yield curve. Positive GDP data was released just prior to the bond auction, as the country recorded Q2 growth of 0.7% QoQ, in line with expectations. At the same time, improving economic conditions in weaker neighbors such as Spain and Italy may be sapping the demand for safe haven German Bunds. (Wall Street Journal)

Argentina bonds easing back into favor after election

Aug 13. Argentina's 2-year bonds rose to 96.15 cents to USD on August 13, the highest recorded for this year, after the weekend's local elections showed signs of a potential regime change in the country's next general election. Expectation of a defeat of the party headed by Argentina's president, Cristina Kirchner, has driven the yield on the bonds down since mid-July, to 9.446% at their current price. Investors are hopeful that a new president could rise to power and establish policies that provide structural support to potential foreign investors. (Wall Street Journal)

Build America suffering most as sequestration bites (Bloomberg)

China banks' bad loans rise for seventh quarter as economy slows (Bloomberg)

China moves towards market remedy for bad loans (Financial Times)

Costliest Mickey Mouse bonds refuting Detroit shock (Bloomberg)

Europe set 'illusionary' deadline for bank health checks: source (Reuters)

European banks shaping up five years after Lehman (Bloomberg)

Japan's exports rise most since '10 as deficit swells: economy (Bloomberg)

Portugal emerges from its deepest recession in more than 40 years (Financial Times)

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