High credit risks remain among emerging market corporate issuers

by Dexter Tan

Last week, central banks in emerging markets initiated a series of measures to curb the decline of their currencies as the Turkish Lira, Indian Rupee and Argentinian Peso fell to record lows against the US dollar. Rising defaults, economic weakness and higher funding costs in India, Turkey and Argentina coincided with weaker credit profiles of firms operating in these countries. RMI-CRI data showed that aggregate corporate credit quality in various domiciles, particularly in emerging economies also declined on a year-to-date basis.

Firms domiciled in Turkey, Argentina and India are among the worst performing emerging market corporate credits year-to-date. In Figure 1, companies are ranked according to the percentage change in RMI-CRI aggregate 1-year Actuarial Par Spreads (AS) with an assumed recovery rate of 40%. Firms with the largest credit deterioration this year are companies within the three domiciles – Turkey, Argentina and India. A fraction of companies in these domiciles may be forced to restructure their US dollar denominated debts as the sharp decline in local currencies elevated their operating leverage. Bank for International Settlements data showed non-bank borrowers in Turkey, Argentina and India had USD 198bn, USD 130bn and USD 104bn in outstanding US dollar debt in Q1 2018.

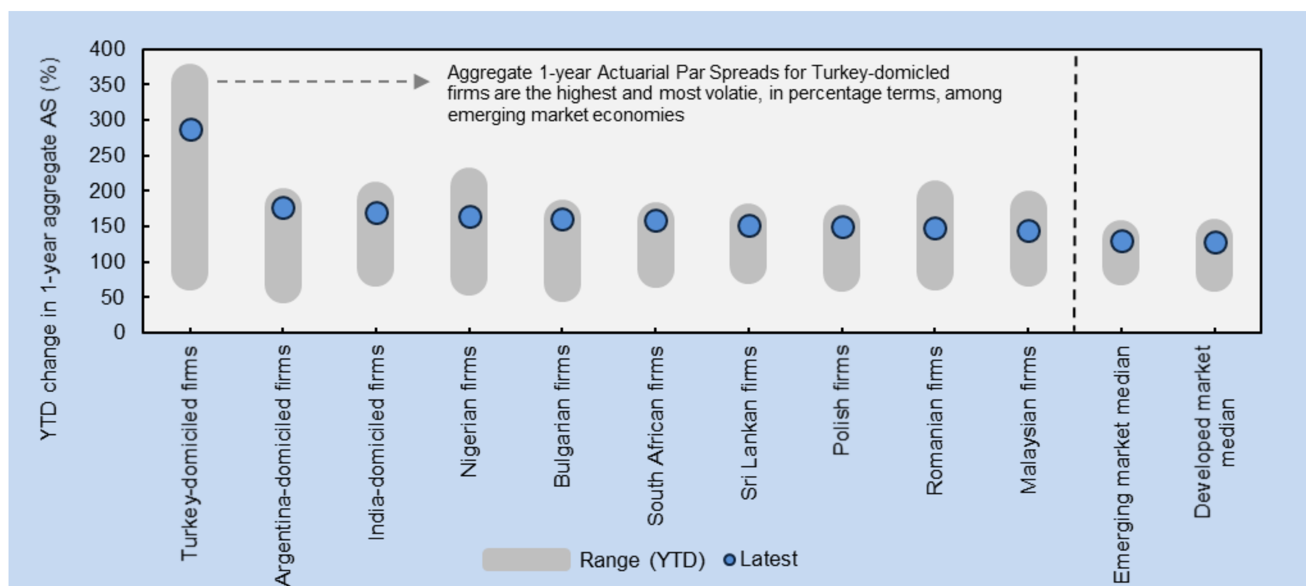
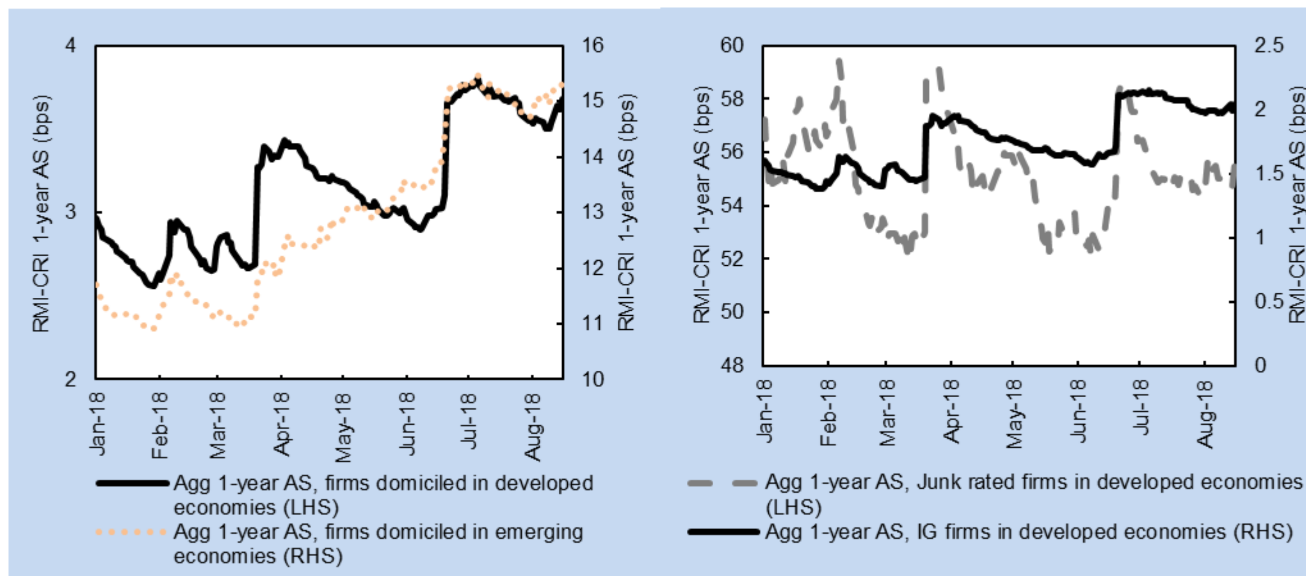


Figure 1: Year-to-date performance of RMI-CRI Aggregate 1-year AS for firms in various domiciles in emerging economies with an assumed recovery rate of 40%. *Source: RMI-CRI*

The credit risk profiles of firms domiciled in emerging and developed markets, tracked by their RMI-CRI aggregate 1-year AS have gradually increased over the last eight months. The RMI-CRI Actuarial Par Spreads provide a perspective on a company's credit quality as it reflects the risk profile of the firm using information in the RMI-CRI Probability of Default term structure and the risk-free discount rate. In other words, the actuarial par spread is similar to the credit default swap (CDS) spread but using the "actuarial" probabilities of default, i.e., the term structure of physical PDs estimated by RMI-CRI.



Figures 2a and 2b: RMI-CRI Aggregate 1-year AS for firms domiciled in emerging and developed economies, and aggregate 1-year AS for investment grade and junk companies in advanced economies with an assumed recovery rate of 40%. *Source: RMI-CRI*

As shown in Figure 2a, relative to firms domiciled in developed economies, the deterioration in credit quality of firms domiciled in emerging markets is modestly higher. The RMI-CRI Aggregate 1-year AS for companies in emerging markets increased by 3.6bps to reach 15.3bps in August and is on track to exceed the previous high set in July this year. In contrast, the aggregate 1-year AS of firms in developed economies moved slightly higher by 0.71bps.

Figure 2b illustrates the credit performance of junk (rated BB+ by Standard and Poor's and below, denoted as HY) and investment grade (IG) firms domiciled in developed markets. The aggregate risk measures for HY and IG firms were derived using the median RMI-CRI 1-year actuarial par spreads following their respective daily Probability of Default Implied Ratings (PDiR). The PDiR gives an intuitive overview on the credit quality of a firm by assigning a letter grade to a firm's 1-year forward looking credit quality, using the Standard's & Poor credit rating classification. For example, a firm having a 1-year PD in the range between 0 and 0.85bps can be understood as a firm with similar creditworthiness as a representative S&P AAA rated firm. In Figure 2b, the credit profiles of IG companies have weakened slightly since the start of the year while the credit profiles of HY firms remained at an elevated level above 55bps, albeit lower than the July high level.

It remains to be seen if the events in Turkey or the deteriorating business conditions in emerging markets would lead to further recessionary economic weakness. With higher interest rates on the horizon and as central banks resume their gradual policy normalization, credit quality for companies within developed economies may outperform low quality firms in emerging markets. Firms with weak credit profiles such as those domiciled in Turkey may remain susceptible to volatility until there is a restoration of financial credibility, resolution to political instability and commitment to fiscal discipline in its economy.

Credit News

Burned by China default, Korea investors have new target: Qatar

Aug 20. Korean money managers have increased purchases of short-term securities backed by deposits at Middle East banks by 23% in the first half of 2018, mainly from Qatar and amount to USD 9.2bn. Meanwhile, investments in products linked to Chinese bank deposits have plunged 43% as increasing defaults in China has ruined demand for Chinese debt. After a Saudi Arabia-led group cut commercial links with Qatar last year, the country may need more funding. Analysts are optimistic that Middle East deposits will continue to appeal to investors due to its higher yield. These structured products backed by Middle Eastern deposits typically carry yields of about 2.4% with a one-year maturity after hedging for currency moves, as compared to 1.8% yield on similar maturity won government debt. (Bloomberg)

JPMorgan shops rescue loan for ATM-maker Diebold

Aug 19. JPMorgan, one of Diebold Nixdorf Inc.'s largest lender, is sourcing for financing of at least USD 500mn to rescue the cash-strapped company and has asked distressed-debt funds to consider investing in a new loan. Diebold faced liquidity problems after an unexpected second-quarter loss. The problem is worsened after it had to buy-up some outstanding shares of a company it took over in 2016 which Diebold has already spent USD 255mn on those redemptions and might have to fork out another USD 185mn. In addition, Diebold is seeking another loan to pay down portions of its two other loans, a term loan and a revolving line of credit, USD 425mn and USD 140mn outstanding respectively as of June 30. (Bloomberg)

Turkey cut deeper into junk as S&P sees recession next year

Aug 18. S&P Global Ratings and Moody's Investors Service have cut Turkey's foreign-currency rating to B+ and Ba3 respectively, a few notches below the investment grade. According to both rating agencies, Turkey's key vulnerabilities include weak currency, runaway inflation and current-account deficit. In particular, the weakening currency is putting pressure on the indebted corporate sector and has substantially increased the funding risks for Turkey's banks. However, the policy response from Turkey has been limited despite the increasing economic risks. Given the bleak outlook, S&P forecasted a recession next year, with the inflation peaking at 22% over the next four months. (Bloomberg)

Singapore banks' loans growth outlook cut on property curbs, trade tensions

Aug 15. Facing headwinds from the government's recent property cooling measures and trade tension between the US and China, Singapore's banking sector may see its loan growth under pressure. Fitch Solutions Macro Research said it has lowered its 2018 and 2019 loan forecasts for Singapore banks to 5% and 4.5%, from 6.4% and 6% respectively. Cooling measures on property market are likely to dampen the credit growth since 30% of loans in Singapore are housing and bridging loans. In addition, the ongoing US-China trade tension is likely to weigh on Singapore's export-oriented manufacturing sectors. Real growth in the manufacturing sector has already slowed down to 8.6% YoY in Q2 2018 from 9.7% YoY in Q1 2018. (Straits Times)

Chinese regional investment arm in landmark bond default

Aug 14. Sixth Agriculture State-Owned Assets Management Co, an investment arm of western China's Xinjiang region, has failed to repay a USD 73mn bond. This marks the first public default by a Chinese government-linked holding company, signaling end of implicit state bailout. This year, bond defaults has risen sharply in China due to Beijing's effort to reduce excessive debts. The central government severely restricts direct fiscal borrowing by local governments but has allowed them to seek financing via investment vehicles such as Sixth Agricultural. However, authorities affirmed that such financing vehicles must operate on a commercial basis with no expectation of a bailout from the government in the event of default. (FT)

China's new yuan loans higher than expected (Straits Times)

China regulator asks financial institutions to support infrastructure investment (Business Times)

Venezuela debt wreck marks new milestone as USD 6.1bn unpaid (Bloomberg)

Regulatory Updates

In rare step, China punishes major ratings agency for violations

Aug 17. Dagong, one of China's biggest rating firms, has been punished by China's Securities Regulatory Commission (CSRC) and National Association of Financial Market Institutional Investors (NAFMII), for providing false statements, information and poor business practices. Dagong is being banned from taking on new securities rating business and business related to debt-financing instruments for non-financial firms for a year. Credit rating agencies in China have a reputation of providing favorable ratings for local issuers and downplaying risks, even as international watchdogs warn about debt levels. In China, issuers with ratings of AA or higher are behind more than 90% of outstanding credit bonds by value. This may hamper investors' confidence as risk differentiation is difficult. The China authority is trying to regulate the rating industry and is expected to take more action against local rating agencies in order to boost investors' confidence. (Business Times)

Trump seeks SEC study of 6-month reporting instead of quarterly

Aug 17. A change on public companies' quarterly reporting might take place in US after Donald Trump asked the Securities and Exchange Commission to research ending quarterly reporting for US businesses to ease regulation and spur growth. One criticism on quarterly report is that if companies strives to report profit gains quarterly, they are more likely to buy back shares and cut costs than invest in businesses. However, quarterly reporting by public companies has been a foundation of US capital market with analysts making investment recommendations. In addition, the removal of quarterly guidance may also see resistance from shareholders who demands transparency from public companies. (Business Times)

Australia central bank governor signals lower for longer rates (Reuters)

Chinese shadow banking contraction set to moderate – Moody's (FT)

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