Amidst rampant inflation, refinancing pressures worsen credit risk outlook for Turkish companies

By NUS-CRI Market Monitoring Team

- **NUS-CRI Agg 1-year PD suggests that the credit profile of Turkish companies has improved on the back of domestic investors parking cash in the country's stock market to hedge against surging inflation**
- **NUS-CRI Forward 1-year PD suggests a deterioration in credit health of the Turkish companies as approaching dollar debt maturity and constrained access to financing threaten repayment ability**

As economies around the world battle rampant inflation using interest rate hikes, Turkey continues to commit to unorthodox monetary policies that have seen its YoY inflation levels continue to rise to new heights amongst global markets peers. Turkey's Jun-2022 inflation levels reached a quarter-century record of close to 79% YoY, while the Turkish central bank continued to lower policy rates by 100bps to 13%[1], spiking fears of uncertainty amongst international investors regarding the health of Turkey-domiciled corporates (Turkish companies). Adding to the woes faced by Turkish companies is the resultant and continued depreciation of TRY. The USDTRY spot rate had risen to a record high of TRY 18/USD last week on the back of the rate cut. Despite macroeconomic headwinds that are set to worsen the credit-risk outlook of Turkish companies as shown by the NUS-CRI Aggregate (median) Forward 1-year PD (Forward PD[2]) in Figure 1b, Turkish companies' current credit profile has benefitted from domestic investors and households ramping up their investment in the Turkish stock market, in an effort to hedge against inflation, which has buoyed the underlying financial health of the corporates in the short term.

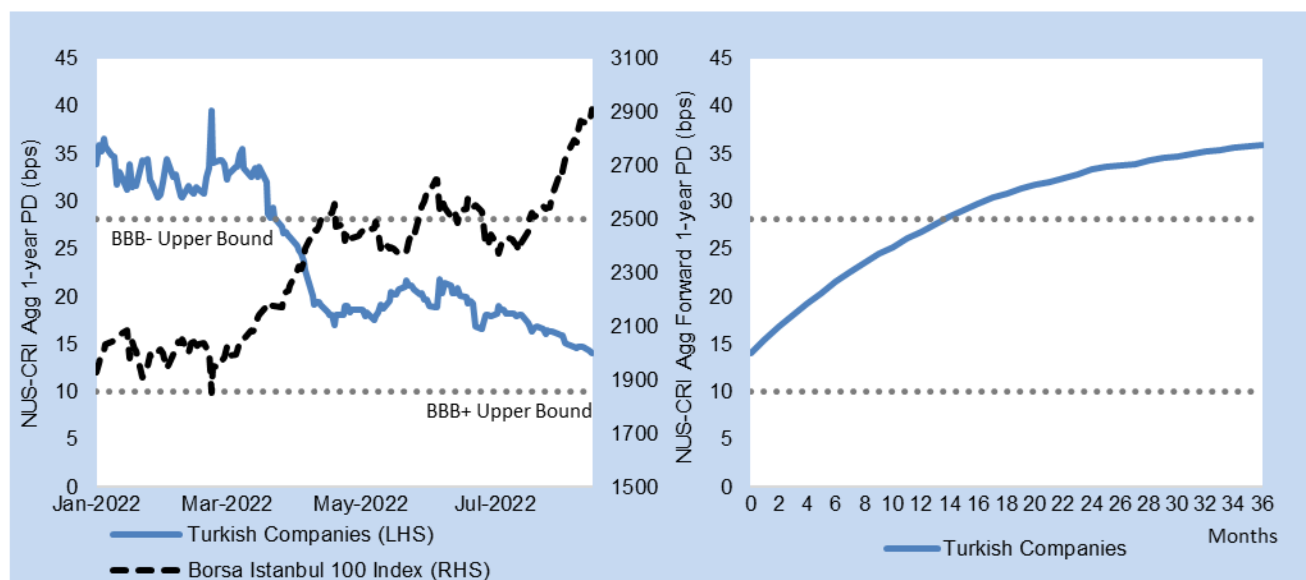

Figure 1a (LHS): NUS-CRI Aggregate (median) 1-year PD for Turkish companies with reference to PDiR2.0 bounds[3] and Borsa Istanbul 100 Index. Figure 1b (RHS): NUS-CRI Aggregate (median) Forward 1-year PD for Turkish companies as of Aug-2022. *Source: NUS-CRI, Bloomberg*

[1] Turkey has a long history of following unorthodox monetary policy in the face of rising inflation. To know more about the impact of such policies on Turkish companies' credit risk in the past, please read our previous issue.
[2] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months – this is conditional on the firm's survival in the next 6 months.
[3] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

The Borsa Istanbul 100 index, Turkey's benchmark index, has soared by close to 51% since the start of the year (See Figure 1a). In 2022, majority of the investment in the Turkish stock market came from domestic investors that are looking to hedge against unrestrained inflation levels by parking their capital in the stock markets, in spite of aversion from international investors that are wary of the government's unorthodox monetary policies. This phenomenon has provided some reprieve for the credit quality of Turkish companies over the past six months, however, should the current macroeconomic environment continue in the medium-to-long term, domestic investor confidence in the stock market as a suitable hedge to inflation may also dissipate as the growth in stock markets is already not sufficient to provide a complete hedge to growth in inflation rates. Using NUS-CRI Bottom-up Default Analysis toolkit (BuDA[4]), the impact of a sell-off in the Turkish stock market, due to it becoming an insufficient hedge against rampant inflation, on Turkish companies' credit profile can be simulated. As seen from Figure 2a, if the stock market falls back to pre-2022 levels over the next 12 months, credit risk of Turkish corporates increases in line with levels suggested by the Forward PD in Figure 1b.

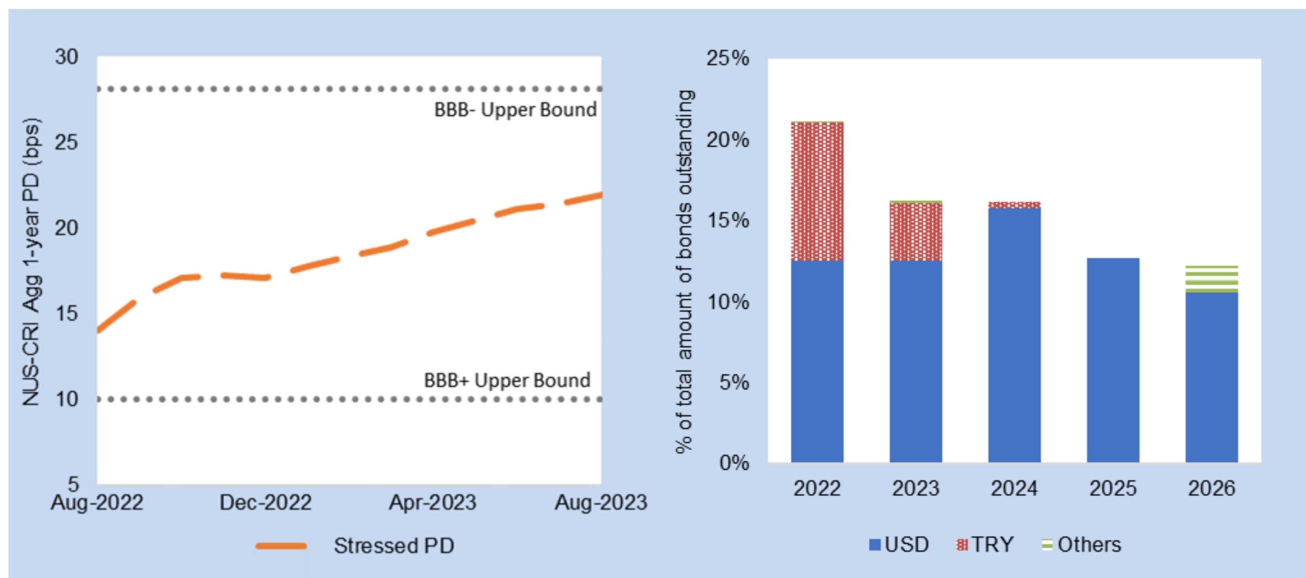

Figure 2a (LHS): Stressed NUS-CRI Agg 1-year PD of Turkish companies with reference to PDiR2.0 bounds. Figure 2b (RHS): Bond maturity as a percentage of total bonds due, broken down by year and currency *Source: BuDA v3.4.2, Bloomberg*

Aside from surging inflation and continued currency depreciation, Turkish companies also face a significant amount of debt maturing over the next three years (See Figure 2b). Concurrent to the approaching debt maturity, the Turkish government has introduced a new loan ban on firms with higher foreign currency holdings. The rule, which is aimed at buoying the value of lira, pushes corporates to liquidate their FX reserves if they want to gain access to TRY-denominated commercial loans, limiting Turkish companies' access to domestic financing opportunities. Furthermore, as 76% of debt maturing over the next 36 months is denominated in USD, servicing this debt using TRY-denominated operating cash flows will become more expensive as the lira continues to depreciate. Additionally, as foreign investors remain wary of investing in Turkish companies, Turkish companies' access to overseas debt markets moving forward could remain curtailed. As of Aug-2022, international debt markets have already witnessed a lower amount of foreign bond issuances amounting to USD 0.5bn, as compared to an average of USD 5.76bn over the past 5 years YTD.

In addition, as a consequence of maintaining higher borrowing rates and diverging from the stance taken by the monetary authority, Turkey's banking sector now faces an onslaught of new rules by the Turkish central bank, compelling it to extend credit to Turkish companies at a rate closer to the policy rate. Notwithstanding the impact on the credit health of these financial institutions that are going to have to take on lower interest income for risky assets, should these institutions choose to limit their lending as a response, Turkish corporates may be faced with fewer financing options from traditional banking institutions, potentially straining their liquidity and limiting their ability to service demand or repay maturing obligations.

Going forward, the Turkish government's ability to reign-in inflation and alleviate financing headwinds faced by corporates will determine the extent of credit risk worsening witnessed by Turkish companies. As long as the Turkish central bank sticks to its unorthodox policy, foreign investors will remain averse to inject capital into Turkish companies. However, one silver lining for Turkish companies that may alleviate a longer-term pressure on their margins and financing capabilities is the country's growing partnership with Russia. Despite Turkey

[4] The Bottom-up Default Analysis (BuDA v3.4.2) is a credit stress testing and scenario analysis toolkit jointly developed by the Credit Research Initiative (CRI) team of National University of Singapore (NUS) and the International Monetary Fund (IMF)

facing a potential threat of sanctions by western economies due to its relatively favorable relationship with the Russian federation, trade between the two countries for key energy-related commodities is growing. As such, Turkish companies may find some breathing room in the Russian markets, which may improve their earnings in the long run and provide some immediate liquidity buffer for upcoming maturities.

Credit News

US junk bond market in powerful rebound on easing inflation worries

Aug 16. The less-than-pessimistic economic figures in the previous week had signaled to some investors that the Fed has successfully controlled inflation and that the US might not be going into a recession after all. With a more positive outlook, the premium required on junk-rated corporate bond holdings has also decreased, resulting in the decline in corresponding yields from an average of 8.94% by the end of June to 7.94%. The recovery can also be seen in other bond markets as liquidity is being injected into investment grade, high yield, and emerging markets debt funds. With this development, corporates might see an opportunity to accelerate debt issuances. However, as the economic condition remains uncertain, any prospective negative data could tip riskier bonds towards the distressed level, considering how quickly the market reacts. (FT)

UK's cost of living crisis is hitting debt of its supermarkets

Aug 18. With UK's CPI registering a YoY increase of 10.1% in July, the nation's supermarkets have taken a hit in the credit markets. Bonds issued by supermarkets have underperformed a broader index of corporate bonds as rising costs of inputs weigh on their finances. With supply chain issues and soaring energy costs squeezing consumer incomes, the supermarkets find it increasingly difficult to pass on the increase in the cost of inputs. The yields of supermarket debt have accelerated to twice the level seen nine months ago. As consumers are expected to face higher energy bills in the coming winter, borrowing costs of supermarkets show no signs of abating. (Bloomberg)

Mortgage lenders' results show 'pockets of concern' in Canada

Aug 19. According to recent earnings from alternative mortgage providers including Home Capital and EQB Inc, lenders are increasingly cautious about Canada's cooling housing sector. Both providers stockpiled more capital than expected to hedge against future loan losses with expectations that a potential recession may cause stress to the financial system. Recently, Canadian home prices fell with the cumulative drop from Feb to Jul coming in at 6% according to the Canadian Real Estate Association. (Bloomberg)

Rising interest rates put the squeeze on fintech lenders

Aug 18. Fintech companies that specialize in consumer lending are experiencing the adverse effects of the Fed's continued interest rate hikes not only in the form of increasing borrowing costs but also increasing bad debts. Overall demand for such companies' bonds has weakened as investors who expect rates to further increase have sold off holdings and are requiring higher yields or spread over government securities, for them to consider the additional risk. With tight financing conditions, the lenders would have to pass on the costs to consumers or slow down lending altogether, sacrificing profitability. The rising consumer prices could also affect the repayment capabilities of their existing borrowers, further slashing their margins. (WSJ)

Bailouts multiply as pressure mounts to stabilize China's housing market

Aug 16. Lenders such as local governments, banks, SOEs, asset management companies, and shareholders have been actively supporting financially distressed Chinese developers and abandoned projects to revive the industry. The existence of the three red line policy and weak investor demand has severely limited the ability of cash-strapped developers to access additional finance, making the rescue funding beneficial to these developers. Some state-run rescues, however, remain wary of bailing out developers as they fear moral hazards may arise for investors betting on other highly indebted companies. (Nikkei Asia)

Bond slide proves irresistible for USD 2.4trn pension sector (Bloomberg)

Chinese property developers' cash flows have plunged by more than 20% (CNBC)

Swedish ESG bonds prove resilient as broader sales fall sharply (Bloomberg)

Regulatory Updates
China cuts benchmark loan, mortgage reference rates, signals 'particular concern' for housing market **Aug 22.** China cut two of its key benchmark rates – the one-year and five-year loan prime rates as it continues to battle an economic slowdown. The one-year loan prime rate which serves as a benchmark rate for new and outstanding loans was cut by 5bps to 3.65% whereas the five-year LPR, a reference rate used to price mortgages, was cut by 15bps to 4.3%. The larger cut in the mortgage rate signifies support for mortgage borrowers and is expected to reduce interest payments for existing loans and lower the cost of new loans. However, the current weakness in demand for mortgages, which stems from lower confidence in the housing market and increased uncertainty linked to China's zero-covid strategy, may not be alleviated using monetary policy alone. (SCMP)
New Zealand sees 4% key rate, remains global tightening leader **Aug 17.** In line with market expectations, the Monetary Policy Committee in New Zealand has lifted the official cash rate to 3%. They also guided that they see it climbing to at least 4%, increasing and bringing forward its forecast rate peak. Like the rest of the world, the country is trying to rein in the fastest inflation in more than a generation while trying to support growth, consumption, and reduce unemployment. (Bloomberg)
Australia to map crypto tokens as part of regulatory ramp-up (Bloomberg) **Bank of England sets out plans to sell USD 23bn corporate bond stockpile** (Reuters)

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