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Argentina-based corporates face heightened credit risk amid uncertain times ahead

by Anthony Prayugo

The defeat of the incumbent market-friendly President Mauricio Macri in Argentina's primary election on in Aug 2019 sent shockwaves to the financial markets as investors fear the return of a populist and protectionist government led by Alberto Fernandez and former President Kirchner. At one-point, the Argentine peso and Merval index lost 30% and 48% of its value respectively while the Argentina sovereign bonds' price tumbled 25% on average. One reason why the markets are anxious is that the former President Kirchner was well-known for her interventionist economic policies — from mandating price controls and limiting exports — during her 8 years tenure. As shown in Figure 1b, the market downturn coincides with the increase in NUS-CRI 1-year Aggregate (median) Probability of Default (Agg PD) data for publicly listed Argentina domiciled firms, indicating a worsening credit outlook for those corporations.

It is important to note, however, that the credit profiles of Argentina domiciled firms have already generally worsened since Argentina economy entered into a recession in 2018 (see Figure 1b). While President Macri delivered reforms such as the removal of currency controls and ending of national default, the inflation remained above 20% and the peso lost around 50% of its value to US dollar in 2018. This was also further compounded by the fact that Fed increased its interest rate during that time. Combining with Argentina's rampant inflation and poor harvests that affected major Argentina's agricultural exports, investors offloaded their Argentina's holdings, hitting the peso harder than most other emerging market currencies. During this period, the term structure of the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD) on Sep 20, 2018 indicated that Argentina domiciled firms default risk would continue rising to around 45bps by Aug 2019 (see Figure 1a). 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. In Figure 1a, the 11-month forward 1-year PD for a typical Argentina domiciled firm standing from Sep 2018 means the probability that the Argentina domiciled firm defaults during the period from Aug 2019 onwards to Aug 2020, conditional on the firm's survival until Aug 2019.

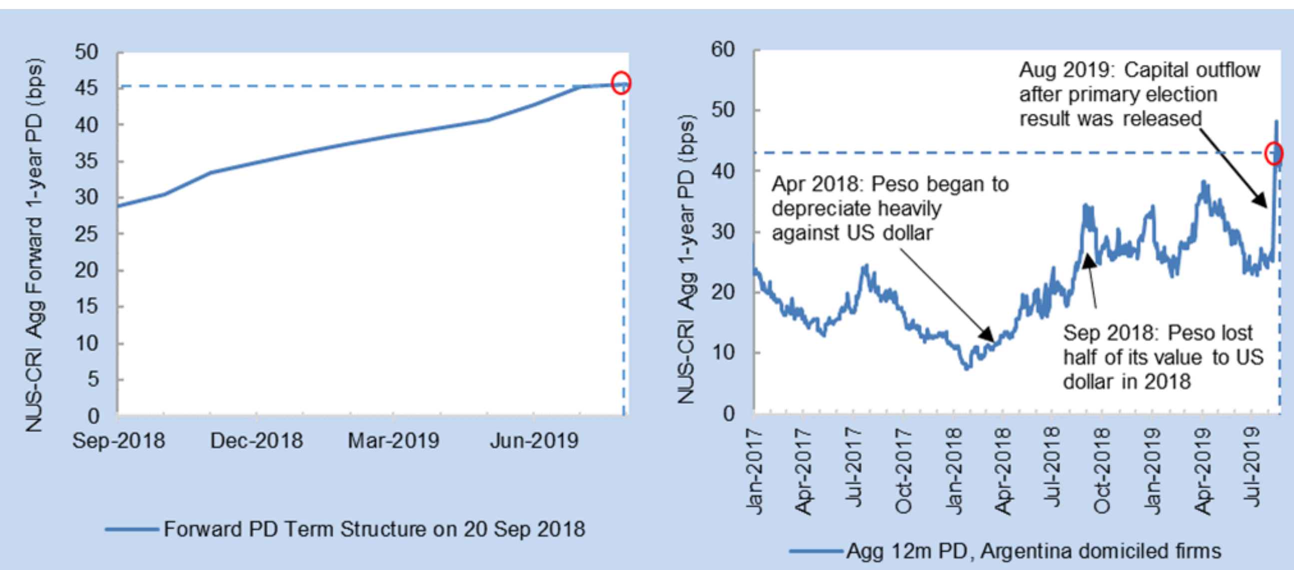
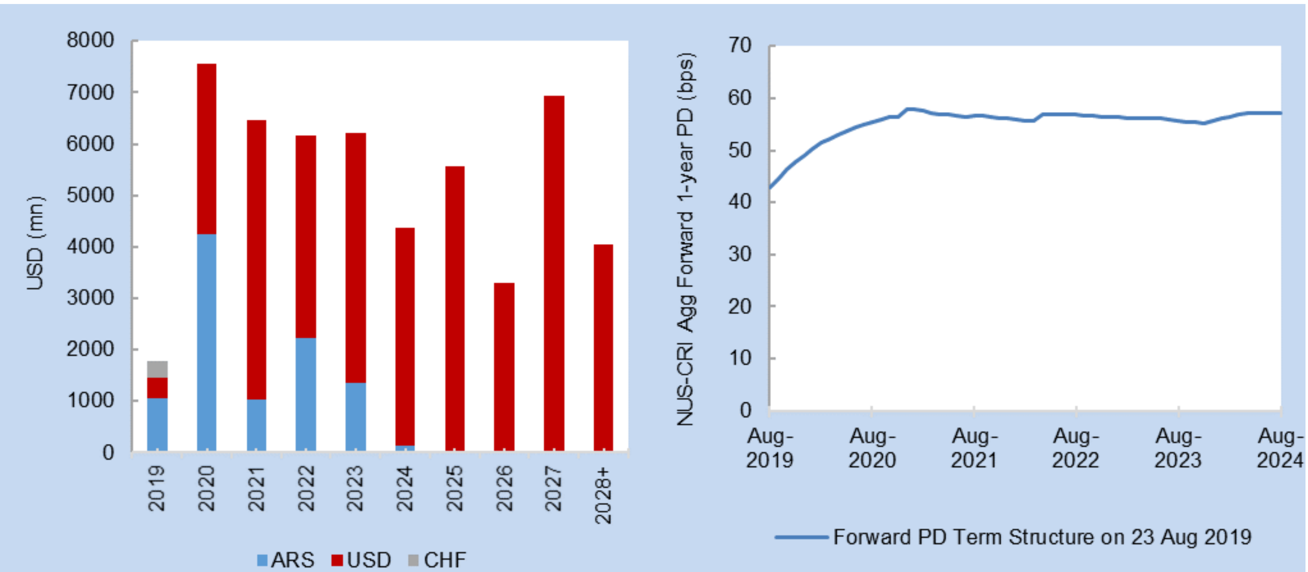


Figure 1a (LHS): Term structure of Forward 1-year PD for Argentina domiciled firms as of Sep 20, 2018. Figure 1b (RHS): NUS-CRI Aggregate 1-year PD for Argentina domiciled firms from 2017. *Source: NUS-CRI*

A brief rally in the Argentina's equity market between April 2019 and July 2019 might have brought down the Agg PD back to around 22bps. However, the 1-year Agg PD has surged to around 42bps as the peso tumbled and stock market crashed once more in 2019, showing the trend of Argentina domiciled firms credit risk was successfully predicted by the Forward PD term structure on Sep 20, 2018. To stem the outflows from its equities, currency and bonds market, the Central Bank of Argentina increased its 7-day Leliq notes rate up from around 64% before the primary election to around 75% in the aftermath of the primary election. While this theoretically might encourage investors to buy the peso denominated Leliq paper and therefore strengthening the peso, it causes Argentina domiciled firms to face higher funding costs in an already ultra-high interest rate environment. In addition, an increase in funding costs would further strain Argentine firms' economic competitiveness and increase their debt risk, resulting in a higher probability of default (PD).



Figures 2a (LHS): Outstanding amount of each currency-denominated bond by Argentina domiciled firms as of issue date. Figure 2b (RHS): Term structure of Forward 1-year PD for Argentina domiciled firms as of Aug 23, 2019. *Source: Bloomberg, NUS-CRI*

The deteriorating credit profiles of Argentina domiciled firms are also reflected in the number of non-investment grade (rated BB+ and below) issuers. According to NUS-CRI Probability of Default Implied Ratings (PDiR), there are currently around 47% of non-investment grade issuers as of Aug 23, 2019, up from 25% in the beginning of 2017. The proportion of non-investment grade issuers in Argentina is higher than that globally, which is currently standing at 19%. 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.

The sharp decline in peso value against US dollar might force some Argentina domiciled firms to restructure their US dollar denominated debts to reduce their operating leverage. Bank for International Settlements Q1 2019 data showed non-bank borrowers in Argentina have USD 128bn of outstanding US dollar debt securities and bank loans. In 2020, Argentina domiciled firms will face a record number of outstanding bonds that are entering their maturity years and around USD3.3bn out of USD7.5bn of those bonds are issued in US dollar. Given the extremely volatile nature of the Argentine peso (which in recent years tends to depreciate against US dollar), Argentina domiciled firms are increasingly likely to face higher repayment costs for maturing USD denominated bonds especially amid the negative market sentiments. By using the Forward PD, the credit outlook for Argentina domiciled firms is likely to remain weak. As shown in Figure 2b above, the term structure of Forward PD indicates that the credit risk for Argentina firms will increase in the next 16 months before somewhat stabilizing. The increase in credit risk in the first year coincides with the record number of maturing bonds that Argentine firms are facing. Therefore, if a typical Argentine firm can survive till Dec 2020, the credit outlook will stabilize.

The problems that Argentina domiciled firms are facing are nothing new. For the past few years, inflation remained above 20% and interest rate remained higher than most other countries. Lenders would, therefore, be reluctant to provide long-term credit at fixed interest rates because a jump in inflation would destroy the value of their bonds and loans. Consequently, Argentina domiciled firms will likely face higher financing costs compared to their peers in other countries. Compounded by the recent uncertainties from the primary election results, markets will likely continue to have negative sentiments for Argentine firms in the short run. This, in turn, can cause further capital outflows which will then can cause a worsening credit outlook on Argentina domiciled firms.

Credit News

China's companies have unseen foreign debt that's maturing fast

Aug 26. The foreign debt built up by Chinese companies is about a third bigger than official data shows and this adds on to the pressure of repayment obligations which approaches in 2020. An additional USD 650bn in debts has been built up by subsidiaries overseas on top of the existing USD 2tn in liabilities to foreigners captured by official data. About 70% of that debt is guaranteed by entities such as onshore parent companies and their subsidiaries. The amount of maturing debt will rise in coming quarters, with USD 63bn due in the first half of 2020 alone. Chinese companies are rushing to find dollars to service liabilities at a time when authorities already allowed the yuan to sink below 7 per dollar amid a trade war with the US. China now risks a reprisal of what happened after the yuan's devaluation in 2015, when foreign-debt servicing contributed to a rapid decline in the country's foreign-currency reserves. Countries like China which control the flow of cross-border capital are recommended to hold reserves worth 30% of short-term foreign debt, 20% of other external liabilities, 10% of exports and 10% of broad money supply to counter potential outflow risks, according to guidelines by the IMF. Looming repayments and stricter rules for refinancing could lead to defaults, reduction in capital inflows, and even outflows, squeezing domestic credit supply, according to Nomura Holdings. (Bloomberg)

In a world of negative yields, Singapore sovereign bonds still pay interest

Aug 25. Singapore, which pays the highest returns among AAA credit rated economies, will sell reopened July 2029 government debt worth USD 2.9bn which is the second-largest amount on record for 10-year tenors. With trade concerns growing, investors are jumping into safer asset such as bonds which drives up the prices and push down their yields, given that bonds have fixed coupon rates or interest payments. Yields are also decreasing as global central banks rush to cut interest rates. In recent months, the global mountain of negative-yielding sovereign bond has swelled to almost USD 17tn. Countries such as Germany, Denmark and Finland now have their bonds trading at negative yields. The yield premium that investors receive by holding US 10-year notes instead of two-year securities briefly disappeared this month, dropping to minus 1.14bps on Aug 15. (Strait Times)

Shale bond buyers get picky as more producers default

Aug 20. Bond buyers are getting more picky amid a rise in defaults and cash being burnt by many explorers. While Exxon Mobil Corp. and Occidental Petroleum Corp. have recently sold a combined USD 20bn of investment-grade debt, junk rated issuers have been getting a different reception. Issuance in the junk bond market was up about 30% which lags the issuance by high-yield energy companies which sold about 50% of the corporate debt they had at the same time in 2018, according to data by Bloomberg. Wary investors are pushing for more focus on cash-generating businesses, a shift away from growth-focused business. Although oil prices has doubled from 2016 low, trading has not been stable. In early August, an oil benchmark suffered the steepest one-day drop since February 2016, as the escalating trade war between US and China affected financial markets. Falling crude prices hurt revenue and make it difficult for companies to continue spending on projects. At current price levels for crude oil, some companies are finding it hard to pay creditors. Recent bankruptcy fillings have taken the US high-yield energy default rate to 5.7% from 4.1% at the end of July, according to Fitch. (Bloomberg)

McKinsey sees 'ominous' signs of another Asian debt crisis

Aug 20. The current increased indebtedness, repayment stresses, lender vulnerabilities and shadow banking practices are among some of the concerns raised by McKinsey & Co. that may trigger the next Asian debt crisis. McKinsey's warning comes amidst a slowing global economy that is putting pressure on the balance sheet of Asian companies; the US-China trade war that is increasing the risk-averseness of debt investors. Evaluation of more than 23,000 companies in the Asia Pacific region found firms facing "significant stress" in servicing their debt obligations. The evaluated metric is the share of long-term debt at corporations with an interest coverage ratio of less than 1.5 times, which means that corporations are using a significant portion of their earnings to repay debt. According to McKinsey, indicators of a potential crisis that should be monitored include defaults in debt repayment, liquidity mismatches and exchange rate fluctuations. (Bloomberg)

Yield curve inversion hammers US small banks

Aug 20. The profits of US small banks or asset sensitive banks – with significant amount of businesses relying on floating-rate loans – have taken a hit from the drop in yields, which pulls down the interest they will receive. Their shares have also been mimicking the movement of the yield curve, raising suspicion in a portfolio manager that macro hedge funds and algorithmic traders are targeting these small banks. The yield curve inversion is leaving asset sensitive banks with little means to make money, as they cannot offset falling income from floating rate loans by cutting the rates they pay depositors, with the latter already hits rock bottom. Larger banks, on the other hand, are less sensitive to the yield curve because they can tap on their other fee-based businesses such as wealth management or payment. Banks that have suffered from the yield curve inversion include Silicon Valley Bank, Comerica and Zion Bankcorp. (FT)

Billionaires are facing a corporate debt reckoning in India (Bloomberg)

HNA Group repays dollar bond after missing Yuan note payment (Bloomberg)

Germany prepares to sell 30-year bond with no coupon (FT)

Regulatory Updates

China's central bank unveils new mortgage loan policy

Aug 25. The People's Bank of China (PBOC) adjusted interest rate mechanisms on August 25, 2019, stating that mortgage rates will be based on Loan Prime Rate (LPR) – or the new benchmark rate – in an attempt to bring price closer to market rates and also to prevent property price bubble. The new policy came one week after the central bank announced a new benchmark interest rate system aimed to more closely align with market signal. The PBOC said that new mortgage loans will also be priced based on LPR from October 8, 2019, onwards. New mortgage loan rates for first-home buyers will not be lower than related LPRs, while that for second-home buyers and commercial properties will be at least 60 bps higher than LPRs. According to the latest LPRs released last week, the new policy could bring new mortgage loan rates lower than the current floors; economists have also estimated that LPRs will trend down in coming months as the government tries to stimulate borrowing amid a domestic slowdown and re-escalating trade tension with the US. (WSJ)

ECB extends timescale for banks to make bad loan provisions

Aug 23. The European Central Bank allows more time for banks to set aside funds to cover losses from non-performing loans (NPLs). This applies only to loans issued after April 26, meaning that banks will have three years instead of two to book provisions fully covering the value of any unsecured loans that go bad. They will also have nine years instead of seven to fully provision any non-performing exposures (NPEs) completely secured by property. This rule change was brought by the new Italian head of the ECB's Single Supervisory

Mechanism (SSM) and provides a huge relief to Italian politicians and banking executives. The country is among the top host of bad loans in the world which has been hurting banks' balance sheets and discouraging them from providing extra credit. (FT)

The trouble with rate cuts in China (WSJ)

FDIC approves tweak of Volcker Rule, easing trading regulations for Wall Street banks (WSJ)

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