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The retail industry in EU is facing higher credit risks relative to its peers in the US

by Liu Hanlei

Despite the festive season, the retail industry ranging from ecommerce retailers to bricks and mortar retail stores (BM) have less to cheer about this time. From Figure 1 below, the RMI-CRI 1-year aggregate Probability of Default (Agg PD) for the European Union-domiciled (EU) retailers is higher than the US-domiciled retailers and the RMI-CRI 1-year Agg PD for EU retailers has been on an increasing trend since Q4 2017, signifying higher credit risk.

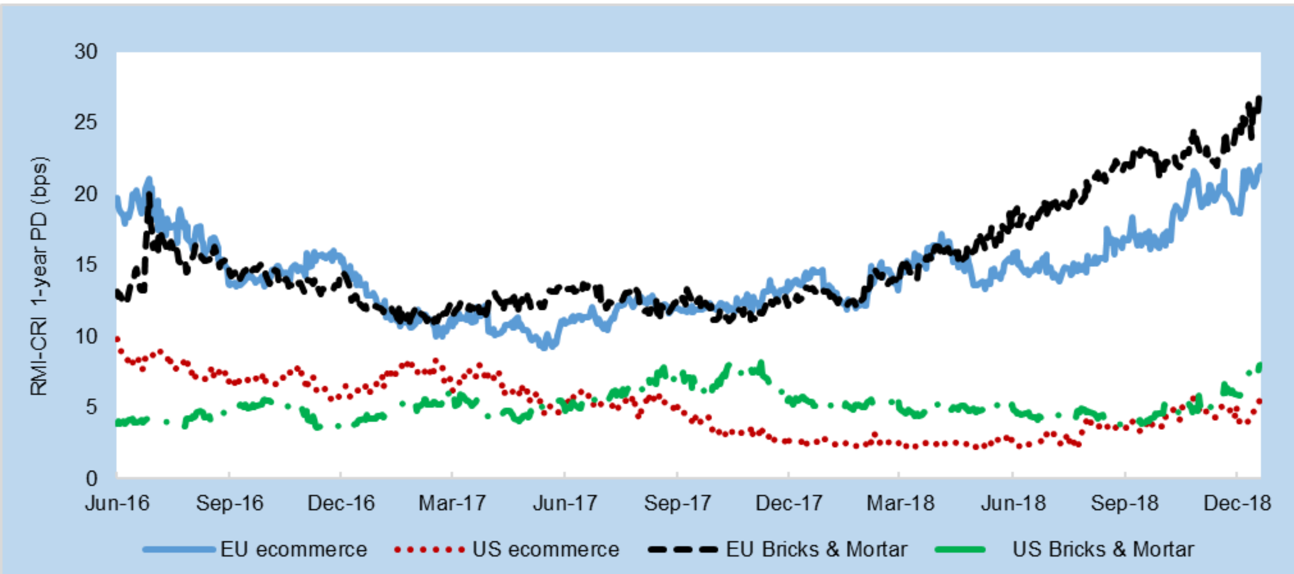
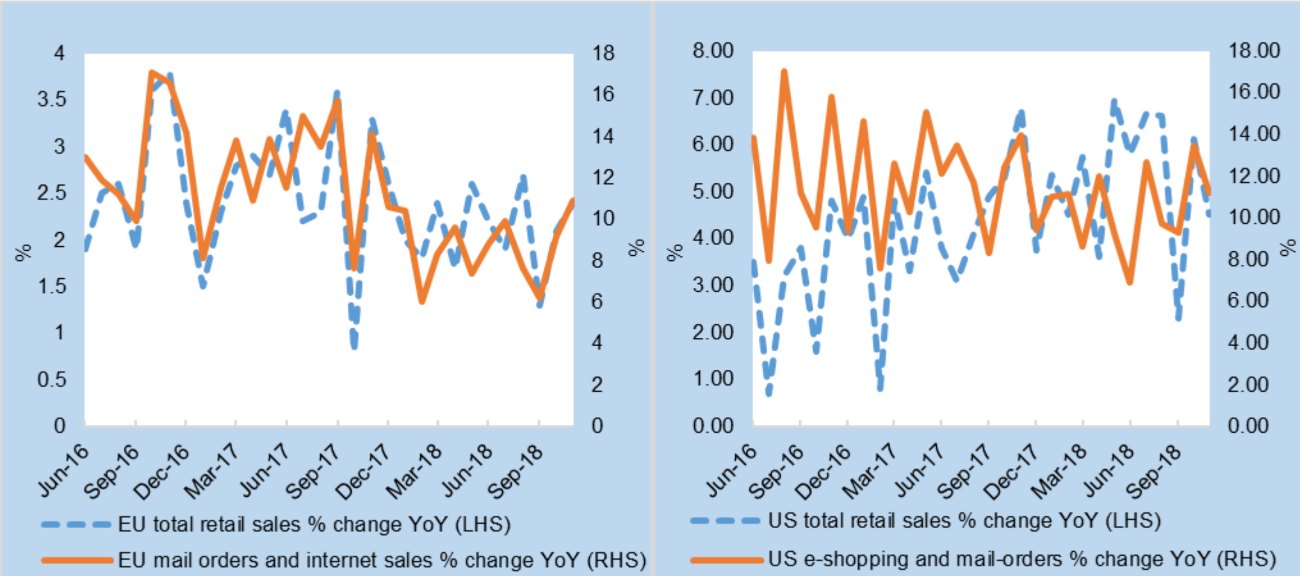


Figure 1: RMI-CRI 1-year Aggregate PD for EU and US-domiciled ecommerce retailers and Bricks & Mortar retailers. *Source: RMI-CRI*

One reason for the relatively stronger credit profile for the US retail industry could be attributed partly to stronger retail sales growth in the US. As seen from Figures 2a and 2b below, US total retail sales over the past 2.5 years have been on a general uptrend, its sales growth rate is also of a higher growth rate as compared to the EU region. For the EU region, there is a slight downtrend in its total retail sales growth rate starting from Q4 2017 which coincides with the trough in the 1-year Agg PD for EU retailers in the same quarter.



Figures 2a & 2b: EU and US retail sales % change YoY. *Source: Bloomberg*

Another economic indicator that can potentially affect retail sales is the consumer confidence index. The consumer confidence index tracks consumers' expectations on business, income and labor conditions which will have an impact on their consumption decision. In Figure 3 below, the EU consumer confidence index improved from mid-2016 but has been trending downwards since Jan 2018. The trend in EU's consumer confidence index over the past 2.5 years is similar to the trend in 1-year Agg PD for EU retailers. The declining EU consumer confidence index also goes in line with the slowing retail sales growth since Q4 2017. On the other hand, the US consumer confidence index is on an uptrend over the past 2.5 years.

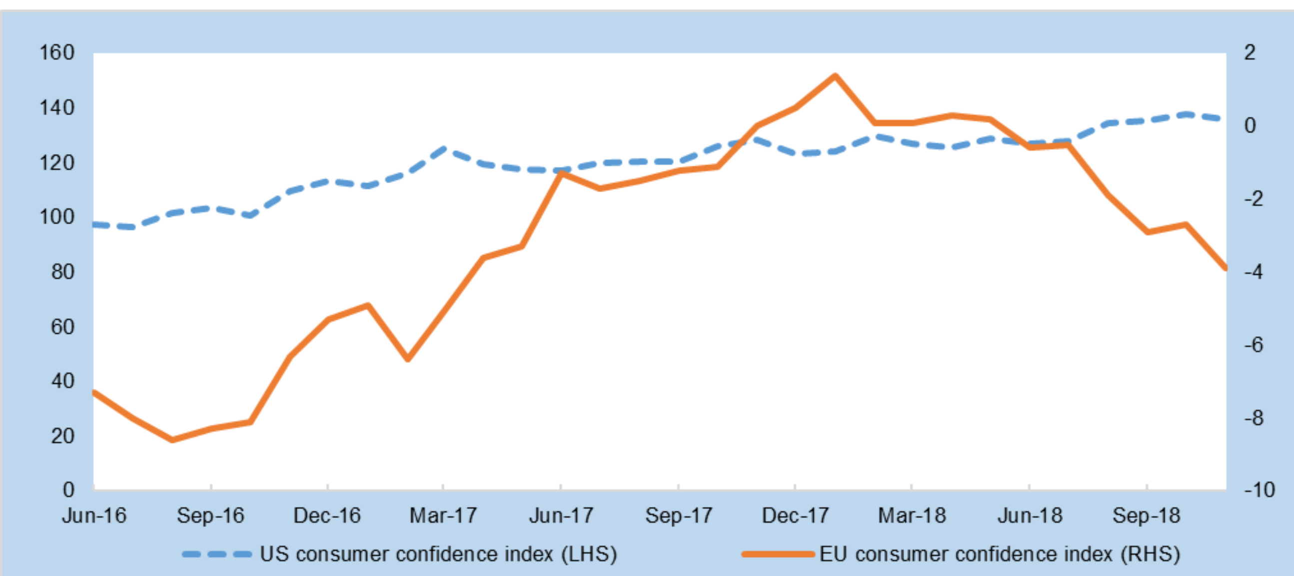


Figure 3: EU and US consumer confidence index. *Source: Bloomberg*

From Figure 1, it is also observed that the trend of the RMI-CRI 1-year Agg PD for BM retailers and ecommerce retailers is quite similar especially for the EU region. There have been talks by analysts that [BM retailers are dying and online retailers will be the future](). However, [share prices of some online retailers have plunged]() over the past week with Asos Plc falling the most, by about 45%. Asos plunged after cutting its full-year sales growth guidance and its expected [profit margin from 4% to 2%](). Asos' key rivals, UK's Boohoo and Germany's Zalando, also plunged about 20% as a result. Zalando already warned on weak profits back in Sep 2018. Traditional bricks and mortar retailers such as Debenhams and Marks and Spencer, which were in the midst of turnaround plans, were also dragged down. Even huge international retailers such as Hennes & Mauritz AB and Inditex SA, which runs Zara chain, and both having about 40% revenue segment in the EU, have pointed out weaker than expected sales growth.

Although the US retail scene is relatively better than in the EU, it may be losing steam. The RMI-CRI 1-year Agg PD for US retailers has been rising since Sep 2018. The US consumer confidence index also dipped in Nov 2018 after increasing for 7 straight months. Shares in US retailers represented by the S&P index of 95 leading listed retailers have since dropped 20% in the current quarter and could be the biggest quarterly sell-off since the financial crisis. There are concerns being raised related to the ongoing trade tensions as some retailers may sell its inventories at a discount to accelerate shipments in order to avoid being subjected to higher tariffs, previously to be levied on Jan 2019 before the 90-day trade truce agreement between the US and China that took place in Dec 2018. Weak economic data from Europe and Asia, as China's retail sales grew the slowest pace in 15 years, have also weighed on sentiments and added fears about a global economic slowdown.

Looking from a firm's perspective and highlighting the industry's fundamentals, the median operating margins for both US and EU ecommerce firms are quite similar at -3% while the median total debt to total capital for US ecommerce firms is 12.2% and the EU is 14.3%. The median US BM firm has a higher total debt to total capital at 34.5% compared to 30.2% for the EU. However, the median operating margin for the US BM firms is higher at 4.4% as compared to 3.2% for the EU region.

As exhibited in some of the macroeconomic indicators that reflect retail sales and consumers' confidence and the RMI-CRI 1-year Agg PDs, US retailers have a relatively stronger credit profile compared to its EU peers. However, the credit outlook for both ecommerce and BM retailers in both regions are worsening, with retailers in the EU region facing a grimmer outlook. As global economic growth is set to slow with forecast for EU's GDP growth to slow to 2.1% in 2019 and 2% in 2020, retailers in EU may be in for a tougher challenge.

Credit News

Dollar costs too high? China bond issuers return home for funds

Dec 21. Facing heavy amounts of bonds due next year, Chinese borrowers turn to domestic market for funding due to its cheaper costs. For Chinese corporations, the average domestic borrowing cost has plunged to a two-year low of 4.2% while yields on dollar bonds are near a five-year peak of around 5.44%. An increasing number of Chinese companies are taking advantage of lower local yields for refinancing next year. The People's Bank of China has also released measures to support refinancing of foreign currency debt. According to Bloomberg, the industrial sector faces the highest amount of bonds due next year at CNY 1.2tn. More stimulus policies are expected for Chinese government to help prop up the economy. (Bloomberg)

US leveraged loan exodus deepens as outflows top USD 3bn

Dec 21. Investors are pulling money out of US loan funds at a record pace amid market turmoil. A more dovish outlook for rate hikes are eroding the incentive to buy the asset. Fears of trade-war tensions, slowing growth and sharp declines in energy price have also drained investors' appetite to take on risk. New collateralized loan obligations (CLO) issuance has also slowed and it is not expected to return in the short term. With the upcoming holiday break, some money managers have sold loans in big chunks to get ahead of the liquidity squeeze and manage any redemptions, which weighed on secondary prices. Taking advantage of the current market volatility, private debt funds have stepped in to buy some of these loan deals on the cheap. (Bloomberg)

Federal Reserve raises lending rate; signals slower pace ahead

Dec 20. On December 19, the US Federal Reserve raised the benchmark interest rate for the fourth time this year by 0.25 point, with 2.5% at the high end. According to their revised forecasts, central bankers can expect just two increases next year in the short-term lending rate which is used to set the cost of borrowing from cars to homes. However, it also signalled caution moving forward, especially as it keeps an eye on international developments given that some economies around the world have seen a moderating economic growth. Given that inflation has remained moderate in the US that allows the Fed to be patient in raising rates going forward. (Business Times)

India to spend INR 830bn by March on bad loan clean up

Dec 20. India will inject INR 830bn into state-run banks by March next year, bringing the total infusion in state-run banks to INR 1.06tn this fiscal year. Indian banks are currently struggling to lend to new projects and reverse an economic slowdown. Furthermore, the sector is saddled with the world's worst bad-loan ratio after Italy, having more than USD 210bn of stressed debt on their balance sheets. However, the Ministry of Finance stated that four to five banks could come out of the PCA framework, rules that mandate banks to focus on recovering bad debts rather than lending and expanding branch networks, in fiscal year 2019. (Business Times)

Europe's borrowers brace for death of easy money

Dec 18. As the ECB ends its Corporate Sector Purchase Programme (CSPP) in Dec 2018 and political threats loom - Brexit, Italian fiscal angst and trade woes, credit markets will see higher borrowing costs amid worsening financial conditions. Sales of new bonds have dropped about 18% to EUR 277bn in 2018 and some companies have postponed deals in the past couple of months citing market conditions. January 2019 will be the first time in two years when the ECB's CSPP ends, which have been buying nearly EUR 180bn worth of corporate bonds in the primary and secondary markets. Nevertheless, it is believed that once it is accepted that credit spreads are not returning to early 2018 levels there will be a number of deals coming back to the market. The UK's March 29 exit from the EU may also spur issuers to conduct their deals early to avoid volatility. (Business Times)

Fitch cuts Pakistan credit rating deeper into junk territory (FT)

Global investors make record shift into bonds (FT)

Chinese bonds struggle to go green (Nikkei Asian Review)

Regulatory Updates

China central bank offers low-cost funding to help businesses

Dec 21. The People's Bank of China has cut one-year lending rates for commercial banks willing to lend to small businesses as it tries to support the economy amid the trade war with the US. The PBOC lowered the annual interest rate for a medium-term lending facility from 3.3% to 3.15% and raised the amount of loans to small businesses it will accept as collateral by CNY 100bn. The PBOC's announcement highlighted its support for bank financing of small businesses, but the market believes that eventually the bank would lower the rate for the medium-term facility with no conditions attached. (Nikkei Asian Review)

US bank regulators sign off on 'living wills' for foreign banks

Dec 21. On Thursday, US banking regulators had signed off on "living wills" for four foreign banks, detailing how they could safely be dissolved in a crisis without disrupting the broader financial system. The regulators said the banks needed to improve their communications between US operations and foreign parents in times of stress. The regulators also noted that the firms have become smaller and less risky since the 2007-2009 financial crisis. Separately, Credit Suisse was told to improve how it estimates the liquidity needs of its US intermediate holding company. From the viewpoint of the Federal Reserve and Federal Deposit Insurance Corporation, there are some shortcomings on the resolution plans submitted by the banks but nothing significant enough to demand stricter rules or additional restrictions on bank activity. However, the banks must address these concerns in their next resolution plan submissions due in mid-2020. (Reuters)

Japan to cut JGB issuance by JPY 4.8tn in 2019/20 (Reuters)

Sweden's Riksbank lifts rates for first time since 2011; krona rallies (FT)

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