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Global corporate credit outlook may deteriorate amidst elevated interest rates and sluggish demand

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- **NUS-CRI Forward PD for global publicly listed companies suggests that softening global demand and elevated borrowing costs may negatively impact credit health over the next 12 months**
- **NUS-CRI Forward PD for the companies in the United States and Germany exhibits a potential deterioration into non-investment grade territory over the near term**

As per the International Monetary Fund (IMF), the global GDP growth is estimated to slow to 3% in 2023 as compared to 3.5% in 2022. The past year was marked by tighter financing conditions, slowing economic growth, and waning but stubborn inflation. Rising borrowing costs and faltering demand kept global firms under pressure as their profit margins narrowed. Despite numerous headwinds faced, the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) for global publicly listed companies has remained stable but elevated within the investment grade territory when referred to PDiR2.0 bounds[1], as seen in Figure 1a. Market expectations of rate cuts from major central banks translated into a gradual improvement in the Agg PD for global listed companies in the last quarter of 2023, buoyed by the anticipation of reduced borrowing costs. Nevertheless, the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD) for global publicly listed companies over the next 12 months indicates an ascending trajectory, deteriorating to the BBB- grade while remaining within the investment-grade territory. This may suggest that risk factors such as sluggish global growth and elevated borrowing costs necessitate continued vigilance and financial prudence.

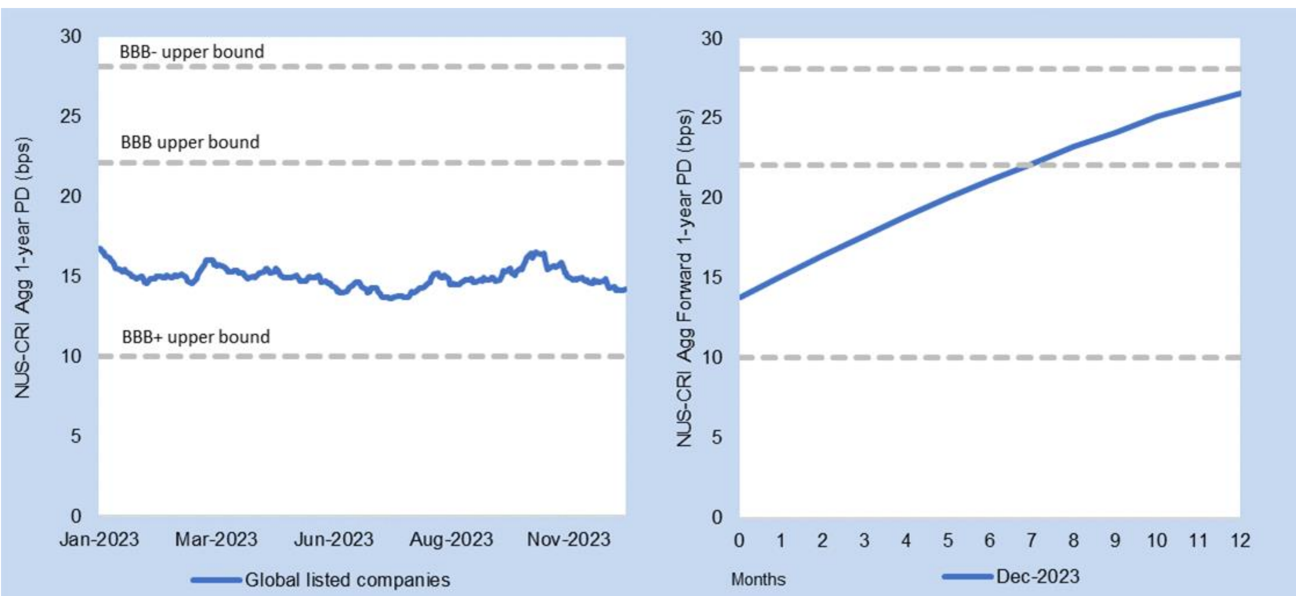

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for global publicly listed companies, with reference to PDiR2.0 bounds. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for global publicly listed companies as of Dec 2023, with reference to PDiR2.0 bounds. *Source: NUS-CRI*

Looking ahead, the global economy remains vulnerable to the adverse impacts of sustained higher interest rates. Elevated borrowing costs will continue to hamper the demand, liquidity, financing, and asset quality of global corporates, exposing them to potential deterioration in credit quality. Although recent optimism in financial markets regarding potential rate cuts has managed to ease financing costs as seen from the decline in yields of global bond indices (see Figure 2a) in the last quarter of 2023, the rates persist at levels higher than those seen

[1] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation by 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.

pre-pandemic. Thus, corporates undertaking refinancing of their existing debt will most probably witness an increase in interest costs. With USD 5.5tn corporate debt expected to mature in 2024, the rising interest burden may push vulnerable firms to the brink. Looking at household-level finances, savings buffers accumulated by households during the pandemic have considerably declined over the past year. This decline in tandem with increasing delinquencies in credit cards points to a potential slowdown in consumer spending in the coming year. At the same time, rising mortgage rates further burden household finances and may also negatively impact consumer spending. Consequently, sectors that are highly dependent on consumer spending such as consumer discretionary and real estate may be vulnerable to a deterioration in credit quality.

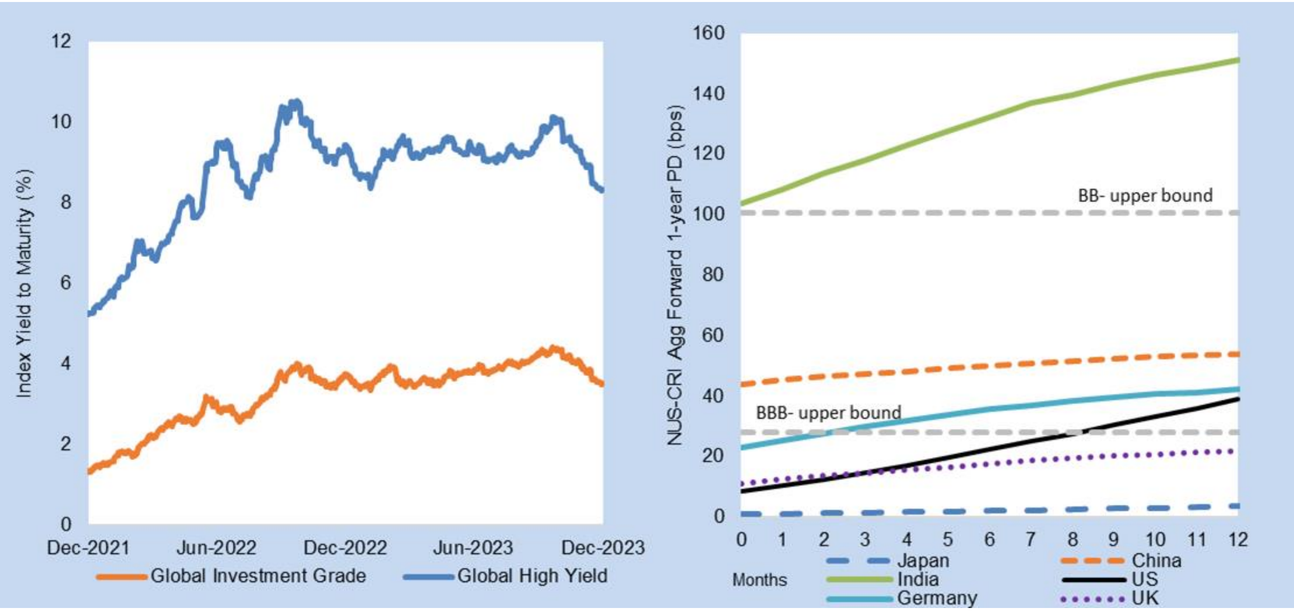

Figure 2a (LHS): Index YTM of Bloomberg Global-Aggregate Total Return Index (Investment Grade) and Index YTM of Bloomberg Global High Yield Total Return Index; Figure 2b (RHS): NUS-CRI Agg (median) Forward 1-year PD for firms listed in US, China, Germany, Japan, India, and the UK, as of Dec 2023, with reference to PDiR2.0 bounds. *Source: Bloomberg, NUS-CRI*

From a regional perspective, over the next 12 months, the credit outlook differs and diverges based on regional drivers and economic conditions as seen in Figure 2b which exhibits the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[2]) of listed companies in the world's largest economies (by GDP). For German corporates, the situation is particularly tough as Germany is expected to be the only advanced economy to experience a contraction in GDP. The ifo Business Climate Index, which is a gauge of business sentiment, fell in Dec-2023 signaling pessimism on behalf of companies about the business climate in Germany. The ifo index for German manufacturers shows the highest decline as high energy costs and weaker global demand are expected to dampen profit generation. As for the United States, the impact of one of its most aggressive rate hike cycles may potentially push the country into a recession. A slowdown in consumer spending and an uptick in jobless claims already foretell a fall in demand. China, another large emerging economy, has faced numerous challenges over the past few years, the property sector crisis being the most formidable one. Thus, the Agg Forward PD of Chinese firms remains in non-investment grade territory. However, a further severe deterioration may not be seen as the Chinese government ramps up assistance. Both central and local governments have been directing financial institutions to enhance support for the real economy, including reducing credit costs and extending long-term credit lines. The Agg PD for India also shows an increasing trend potentially stemming from declining revenues for export-oriented industries such as IT which may be negatively impacted due to the global demand slowdown.

The swift escalation of interest rates not only intensified financial distress, hastening the insolvency of highly leveraged companies but also prompted a shift in investment strategies and asset allocation among global investors. As the market began factoring in potential rate cuts in Q4-2023, there have been indications of a rebound in asset prices, evident in the decreasing yield of the bond index since Nov-2023. While the increase in asset prices may enhance corporate balance sheets and alleviate leverage ratios to some extent, the short-term debt repayment pressures persist given flagging global demand and high refinancing costs which impact their cash generation capabilities and liquidity management, as highlighted by the elevated Forward PD depicted in Figure 1b.

[2] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar 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, conditional on the firm's survival in the next 6 months.

Credit News

Rate cuts may offer a lifeline for highly indebted companies

Dec 28. In 2024, heavily indebted US companies may evade bankruptcy due to anticipated Federal Reserve rate cuts, following the 2020 borrowing surge when interest rates were near zero. Despite 2022 and 2023 rate hikes causing bankruptcies like Bed Bath & Beyond and WeWork, market expectations of 2024 rate cuts offer optimism. The average cost for highly indebted firms to borrow has dropped, and Moody's predicts improved borrowing capabilities for 2024. However, companies with low credit scores may still face challenges in refinancing. Technology and venture capital-backed firms could encounter financial hurdles, while private credit and liability management exercises may offer solutions. Economists caution against a new borrowing spree, fearing it could sustain unproductive companies, potentially hindering economic growth. (WSJ)

Japan banks boost funding to late-stage startups

Dec 30. Japanese banks are increasing capital support for late-stage startups, aiming to address a funding gap hindering growth and contributing to Japan's scarcity of unicorns. Sumitomo Mitsui Trust Bank plans to offer JPY 50bn (USD 350mn) from fiscal 2023 to 2025 to mature startups nearing initial public offerings. Its affiliate, Sumitomo Mitsui Trust Asset Management, will establish a crossover fund investing in pre-IPO businesses. Japan faces a shortage of late-stage funding, with such companies receiving less than 40% of venture capital, unlike 70-90% in the U.S. and China. Japanese startups often go public at smaller valuations, creating challenges for institutional investors and fostering a short-term management perspective. Major banks, including Sumitomo Mitsui Financial Group, Mitsubishi UFJ Financial Group, and Mizuho Financial Group, are increasingly investing in mature startups, signaling a shift in their funding strategies. (Nikkei Asia)

Fed rate pivot leaves stocks and bonds with 'no room for error'

Dec 26. A powerful rally fueled by the Federal Reserve's shift in interest rate policy has raised concerns among major fund managers who fear market vulnerability to disappointing economic news. The surge in stocks and bonds, boosted by the Fed hinting at rate cuts, has left assets priced for perfection, assuming a world where central banks lower rates without an economic recession. Investors worry this optimistic outlook may not align with reality in a year filled with economic, political, and geopolitical risks. US government bond prices, particularly 10-year Treasuries, play a pivotal role, and the market's reaction to the Fed's messages has been surprising. Some investors anticipate conflicting signals and express concerns about stocks and bonds being exposed. Despite differing views, the market's unpredictability, influenced by factors like inflation, potential rate cuts, and upcoming elections, leaves fund managers cautious about making significant directional bets. (FT)

Ethiopia defaults on sovereign debt after deadline expires on USD 33mn payment

Dec 28. Ethiopia has officially defaulted on its debt, becoming the third African country to do so in three years by missing a USD 33mn interest payment on its only international bond. Fitch Ratings downgraded its credit rating to "restricted default" after the grace period ended. Economic challenges, including the pandemic and conflict, led Ethiopia to seek debt relief in 2021. Although an agreement was reached with sovereign creditors, talks with private creditors stalled. The default aligns with a global trend post-pandemic, with 18 sovereign defaults in the past three years. Ethiopia aims to renegotiate through the G20's common framework, anticipating an IMF program in the first quarter of next year. (FT)

China struggles to disperse cheap loans to businesses in economic slowdown

Dec 31. Chinese authorities face challenges in disbursing USD 740bn in cheap loans to businesses, as banks express credit risk concerns amid a slowing economy. Half of the 14 People's Bank of China loan programs, initiated since 2020, have utilized less than 50% of their quota. The slow adoption reflects the difficulty in identifying eligible borrowers in government-prioritized industries. Policymakers aim to revive the economy with targeted lending, but private sector reluctance and economic uncertainties hinder progress. While authorities assert the effectiveness of targeted monetary policy, there is internal skepticism. Banks, despite encouragement, maintain cautious lending criteria, prioritizing borrowers' repayment ability over lower cost of funds. (FT)

Adler 'significantly overstated' value of old debt, German watchdog finds (Bloomberg)

Bank of Korea's Rhee eyes warning signs of prolonged monetary tightening (Reuters)

Real estate stress is brewing in Asian markets other than China (BT)

Regulatory Updates

China aims to ease property crunch via new affordable housing push

Dec 30. Chinese policymakers are renewing efforts to boost affordable housing construction, aiming to reverse a three-year decline in the property market. The real estate sector accounts for about 14% of China's GDP and falling sales and developer defaults are impacting the economy. Despite previous measures, potential buyers remain hesitant. The government is now emphasizing the construction of low-cost housing and urban renovation projects as part of a new development model. However, challenges include the historical focus on commercial housing, a wealth gap affecting housing consumption, and financial pressures on local authorities for sustained affordable housing investment. (Nikkei Asia)

Central banks poised for rate cuts in 2024, investors and economists predict

Dec 31. Leading central banks, including the Federal Reserve, European Central Bank, and Bank of England, are expected to cut interest rates in 2024 as falling inflation and slowing economies provide room for policy easing. After a period of aggressive rate hikes, central banks paused their tightening programs in the second half of 2023. The pressure to cut borrowing costs is set to increase as headline inflation rates decline in G7 countries. Investors anticipate rate cuts from the Fed in March, with the ECB and BoE expected to follow suit. The shift comes as growth weakens, and policymakers aim to address economic challenges. (FT)

Central banks rethink forecasting after failures on inflation (FT)

Fed liquidity drains moves spotlight to usage of new lending facility (Reuters)

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