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At the end of the 2020 rollercoaster, intermediate-term credit risks of listed corporates remain elevated

by Anthony Prayugo

- **Aggressive monetary and fiscal policies to combat pandemic-induced crisis have improved corporates' short term credit outlook**
- **Higher leverage and resurgence in COVID-19 cases caused corporates' intermediate-term credit risks to remain elevated**
- **NUS-CRI Agg 1-year PD indicates that internet, healthcare products and software corporates had the lowest credit risks, while coal, oil & gas and airlines corporates had the highest credit risks in the past year**

The COVID-19 pandemic elevated the credit risk of publicly listed corporates to their 11-year high, before subsequent governments' and central banks' aggressive policies brought them down (see Figure 1a). Markets further rebounded as the vaccine development brought hope that the end of the pandemic is in sight. While all of the aforementioned developments have contributed to the improvement of corporates' short term credit outlook, the NUS-CRI Aggregate Forward 1-year Probability of Default (Forward PD[1]) time series in Figure 1b below exhibits that the intermediate-term credit outlook remains relatively unchanged compared to that during the start of the pandemic. Among potential risks that might impede intermediate to long-term recovery in the corporates' credit quality are higher leverage and a slower than expected economic recovery.

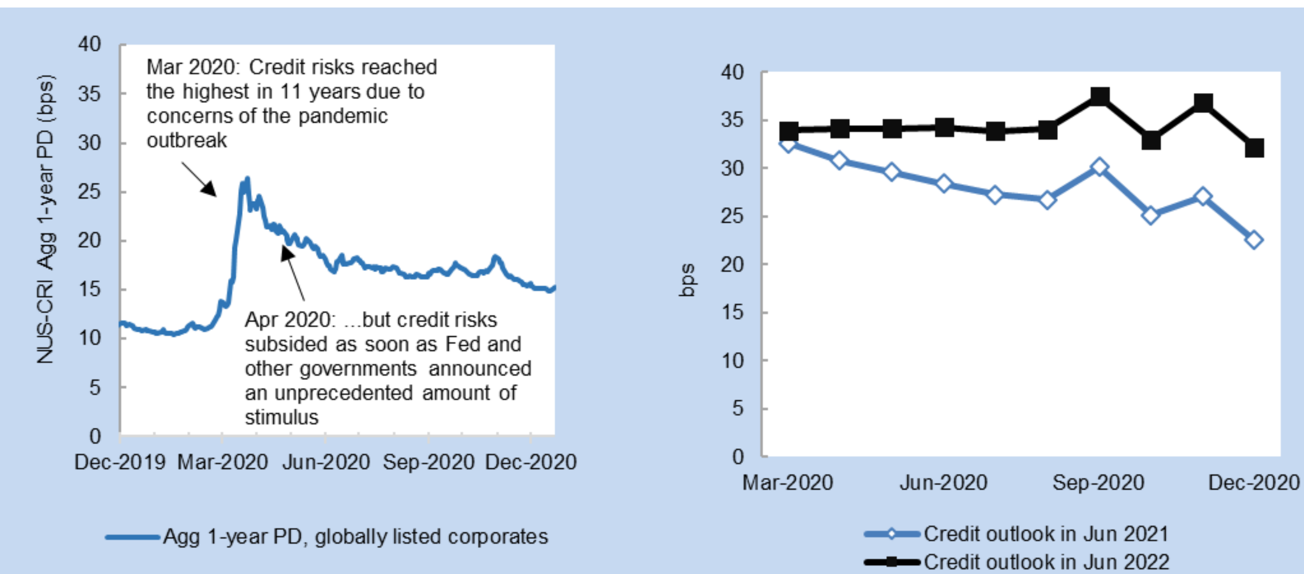

Figure 1a (LHS): NUS-CRI Agg 1-year PD for globally listed corporates since Dec 2019. Figure 1b (RHS): NUS-CRI Agg Forward 1-year PD time series for globally listed corporates based on different historical months looking to Jun 2021 and Jun 2022. *Source: NUS-CRI*

Support measures from governments and central banks around the world have provided companies with a much-needed lifeline. Central banks have cut interest rates and some bought corporate bonds, thus helping to

[1] 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 1 year plus 6 months, conditional on the firm's survival in the next 6 months

lower borrowing costs worldwide. Meanwhile, some governments' [fiscal policies] provided access to cash, which further eased liquidity pressures for corporates. Concurrently, the Forward PD time series in Figure 1b for corporates' credit outlook in Jun 2021 is trending down, indicating that the monetary and fiscal support measures have improved the corporates' short-term credit outlook. The measures have helped quell investors' worry as captured by the Bloomberg Barclays Global Aggregate Corporate Average Option Adjusted Spread (OAS) in Figure 2a. The index, which measures the global aggregate bond spread, has fallen back to its pre-pandemic level.

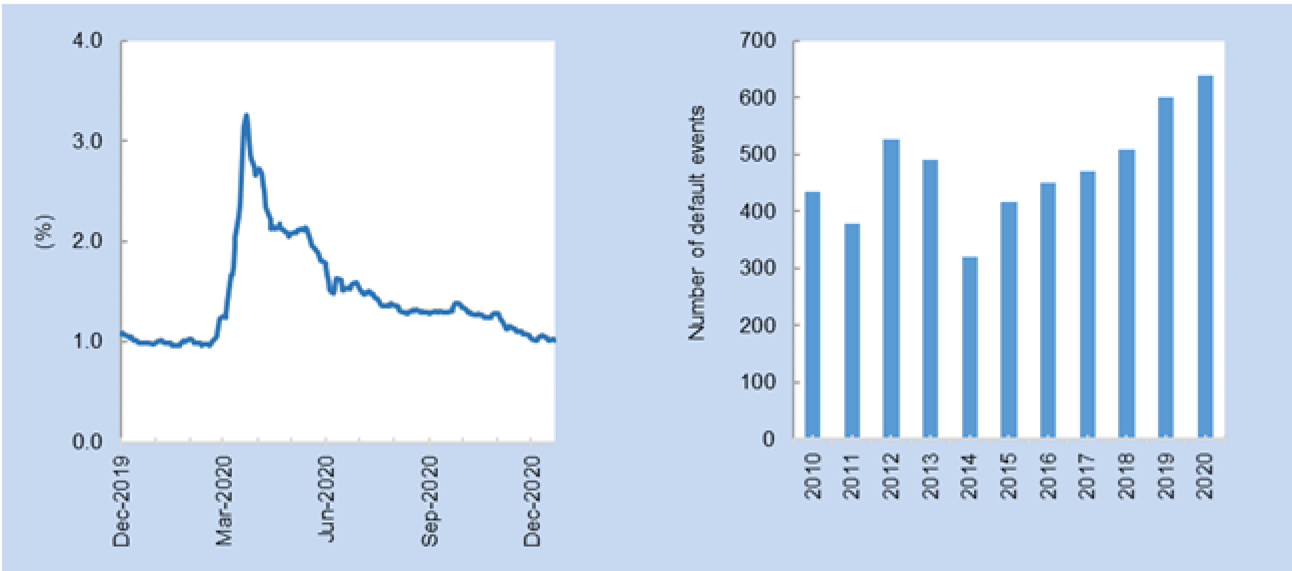

Figure 2a (LHS): Bloomberg Barclays Global Aggregate Corporate Average OAS. Figure 2b (RHS): Number of defaults in publicly listed corporates since 2010. *Source: Bloomberg, NUS-CRI*

Ironically, the same support measures might hamper future economic recovery. Taking advantage of the low interest rate environment, corporates around the globe have issued an unprecedented amount of debt this year. Fuelled by the drop in earnings and increase in debt (total level of global indebtedness has increased to USD 15tn in 2020), the Institute of International Finance estimated that the ratio of global debt to gross domestic product will rise from 320% in 2019 to an all-time high 365% in 2020. In addition, the institute reported that the global economy will struggle to reduce borrowing without adverse economic implications. Without sufficient earnings momentum, companies may not be able to sustain their debt levels. The continued presence of those risks might explain why the Forward PD time series credit outlook in Jun 2022 decreased at a slower pace and remains largely elevated compared to its credit outlook in Jun 2021 as in Figure 1b.

As the global pandemic ravaged the world economy, default numbers also crept up. The NUS-CRI database (see Figure 2b) shows that the number of default events in publicly listed corporates is trending upward since 2014 and has reached an 11-year high in 2020. This happened despite the extensive government support schemes that subsidised costs and thus helped suppress the number of default events during the pandemic. Government supports are unlikely to last forever and when these stimuli end, credit pressures will particularly affect highly leveraged corporates. Furthermore, the discovery of a new and more infectious strain of the COVID-19 virus further threw the prospect of economic recovery into doubt as it could result in an extended period of containment measures which could in turn detrimentally affect the credit quality of firms in some industries and geographies.

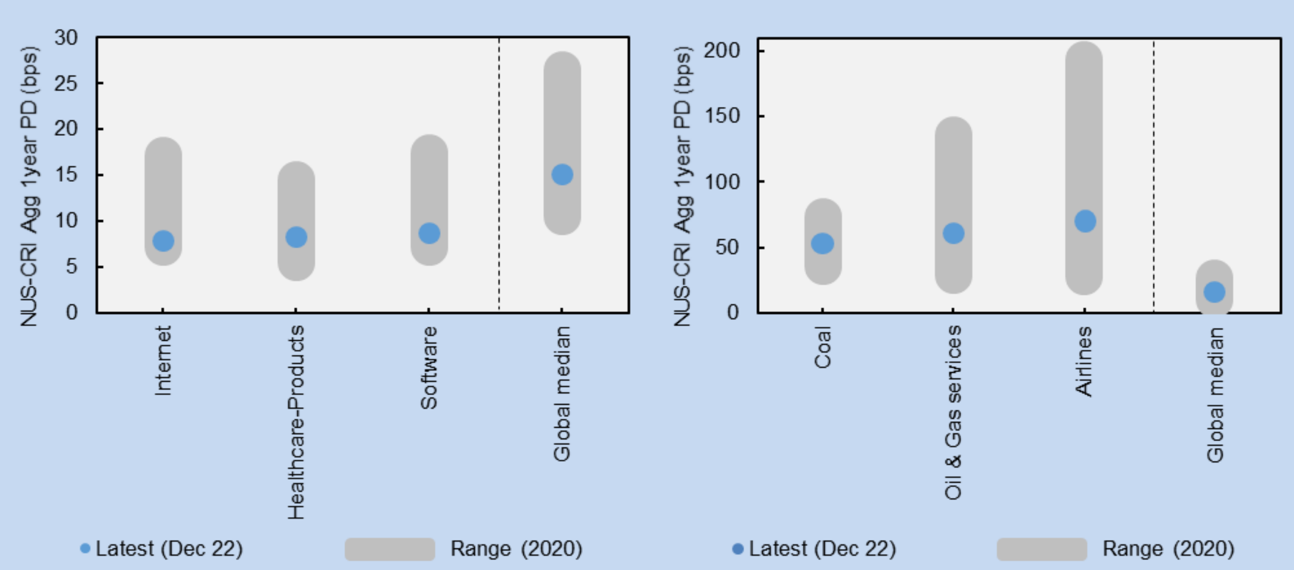

Figure 3a (LHS): NUS-CRI Agg 1-year PD for industry groups with the lowest default risks in 2020. Figure 3b (RHS): NUS-CRI Agg 1-year PD for industry groups with the highest default risks in 2020. *Source: NUS-CRI*

At the industry group level, the Agg PD in Figure 3a indicates that companies in the internet, healthcare products and software industry groups have the lowest credit risks in 2020. The COVID-19 pandemic has accelerated digital transformations and caused shifts in consumer behaviour that would benefit internet companies. For instance, given their asset-light nature and the increased consumers' propensity to shop online amidst the pandemic, it is unsurprising that e-commerce companies' credit quality was more resilient than their brick-and-mortar counterparts this year. The social restrictions have also forced (or encouraged) employers to let their employees work from home, thus increasing demand for cloud infrastructure services and other specialised software. For companies in the healthcare products, increased demand for protective personal equipment and ventilators might have helped offset their revenue loss from their other products and keep their credit profile relatively healthy.

At the same time, companies in the coal, oil & gas services and airlines industry groups continue to have higher credit risk this year (see Figure 3b). For instance, the fall in coal demand, which was exacerbated by the COVID-19 outbreak, has shrunk coal miners' earnings and weakened their credit quality. Similarly, supply and demand shocks in 2020 have driven oil prices to record lows, thus leaving highly leveraged oil & gas companies struggling to break even. Concerns over environmental, social and governance (ESG) issues have also made capital markets less accessible for both coal miners and oil & gas firms due to investors' commitment to sustainable investing. Meanwhile, the newly-imposed travel restrictions have devastated airlines and the industry has since been on life support from governments. However, airlines' risk of failure remains high due to increased debt, uncertain recovery and high cash burn rate.

The recent rise in COVID-19 infections will continue to put the global economy in a tenuous position, while recovery will hinge on several factors. Firstly, it is unlikely that governments would keep providing similar stimuli, and an untimely withdrawal of stimuli could trigger an increase in default events. Secondly, a slower than expected vaccine rollout and continued pandemic-related restrictions could delay economic recovery, dampen earnings and thus weaken corporates' credit quality. More importantly, this could also shake the market confidence and trigger market volatility, which could restrict corporates' access to capital and put their financing at further risk. Risks of continued geopolitical tensions – such as the US-China trade war – could further disrupt businesses and reduce investors' confidence, thus, altogether, setting the tone for markets in 2021.

Credit News

Risk takers bet asset-backed bonds will catch up

Jan 3. Asset-backed bonds have been trading at a discount after the pandemic. As their recovery lagged behind the rally in 2020, managers are expecting high returns to come. This is compounded by the optimism brought about by the vaccine. While these commercial real estates and corporate loans backed securities temper along with the non-investment grade range, analysts revealed that the sharp discount within the class provides a sort of downside protection. Today, we see low rated CLOs yielding greater than their high yield corporate counterparts. (WSJ)

US corporate bond sales line up amid high-stakes vote

Jan 3. US corporates were expected to resume sales of corporate bonds next week. Investment-grade companies may borrow as much as USD 30bn in the next five trading days. The high-yield primary market was also expected to see more activities next week. Junk bond issuance in 2020 has reached the highest level in history. Meanwhile, the leveraged loan market will see a slow start in 2021. Finally, private credit will likely continue to grow in 2021. The uptick in volume is expected to be driven by the optimism surrounding the launch of the Covid-19 vaccine and the demand accumulated after the stagnation period in the early stages of the pandemic. (Bloomberg)

Corporate debt sales to shrivel in 2021 after record boom

Dec 31. While the global debt market has grown by USD 5.35tn year-to-date as compared to 2019, US-investment grade issuances are forecasted to drop by over 76% next year. Companies trying to improve earnings and reduce leverage are both factors as to why the slowdown is expected to occur. This, coupled with the unpredictability regarding the US-China trade war, Brexit as well as the COVID-19 vaccine are likely to cause companies to shy away from the debt market in the coming year. At the same time, central banks have pushed interest rates negative, leading investors to search for yield in riskier companies. (FT)

Pandemic-stoked corporate bond sales set new bar for emerging markets

Dec 30. As recovery prospects seem to pick up in emerging markets (EM), EM governments and companies are set for another big year of hard-currency bond sales in 2021. Governments will borrow heavily to fund health-care and poverty relief, while companies are set to borrow cash to fund growth as loose monetary policy aids with liquidity. EM Governments and companies sold a total of USD 757bn in dollar and euro-denominated bonds in 2020. Furthermore, investment-grade governments and companies constituted 70% of total debt sales, up 10 percentage points from last year. Financial companies made up most of the new corporate bonds issued, followed by energy and materials. In the upcoming year, major emerging countries are looking to further raise finances in the capital markets. The junk bond markets, in particular, could see a flurry of activities as investors look for better yield. Further emphasis on ESG and social bonds is expected in the coming year following the COVID-19 pandemic. (Bloomberg)

China state asset regulator sees progress in crackdown on ‘zombie’ firms

Dec 30. In its campaign against poorly performing enterprises, China has turned around more than 2000 loss-making “zombies” and heavily indebted companies based on the goals it set back in 2016 for end-of-year 2020. These firms have primarily survived on bank loans and local government backing. Chinese news agency Xinhua said that China had cleared up more than 95% of zombie companies by the end of last year. At the end of 2019, 2041 companies previously classed as ‘zombies’ managed to make up their operational losses, with about 700 zombie companies and hardship hit-firms exiting the market. This year has been particularly difficult as companies have had to deal with the COVID-19 pandemic while the country's corporate bond market has been shaken by the defaults of some high-profile state-owned enterprises. (Reuters)

French media group Lagardere gets EUR 465mn state guaranteed loan (Reuters)

Munis set for seventh straight year of gains amid record supply (Bloomberg)

AMC fighting bankruptcy, to offer 50 million more shares (Bloomberg)

Regulatory Updates

China unifies disclosure requirements for corporate bond issuance

Jan 3. Given the ongoing debacle with regards to the defaults of state-owned enterprises, the central bank, and regulatory institutions have released a series of disclosure requirements. This is geared to unify the debt capital markets, increase transparency, and governance. Corporates are now required to release prospectus, historical financial statements, and credit reports. Any major events affecting the solvency of the firm are to be reported with explanations. The new rules also draw up the responsibilities of issuers, underwriters, and credit rating agencies. (Regulation Asia)

UK regulator tweaks derivatives rules hours ahead of Brexit deadline

Dec 31. UK regulators are modifying financial policies to reduce concerns regarding post-Brexit trading in the derivative markets. As of now, UK banks are still regulated under EU rules, which have led to confusion as they are forced to operate under differing sets of regulations. Going forward, financial authorities are now working with authorities in the EU, identifying the best recourse to reduce friction for investors in the future. At the same time, this will help banks operating in the UK to avoid opposing regulations between the two parties. (FT)

Peru Congress passes law allowing central bank to cap interest rates on bank loans (Reuters)

Fed extends Main Street loan program as last minute applications surge (Reuters)

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