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Credit quality of US investment grade and non-investment grade bond issuers diverged in 2019

by Li Mengyan

The year 2019 was a year to cheer for the US bond market. Despite facing several geopolitical uncertainties that slowed economic growth, US firms were able to issue a record amount of bonds at a relatively cheaper cost as the Fed eased its monetary policies. Tracked by the Bloomberg Barclays US Aggregate Index, the investment-grade bond has seen a 12% annual return, while high-yield corporate bonds posted a solid return of 14% on average. Despite the positive return from the bond market, the year of 2019 also saw the most credit rating downgrades by credit rating agencies for US companies relative to upgrade since 2009, with an upgrade to downgrade ratio of 0.52 for the year, and most of the rating cuts were done to the high-yield corner of the market. In this article, we look at the credit profiles of the US bond issuers and provide some credit analysis on the issuer-level.

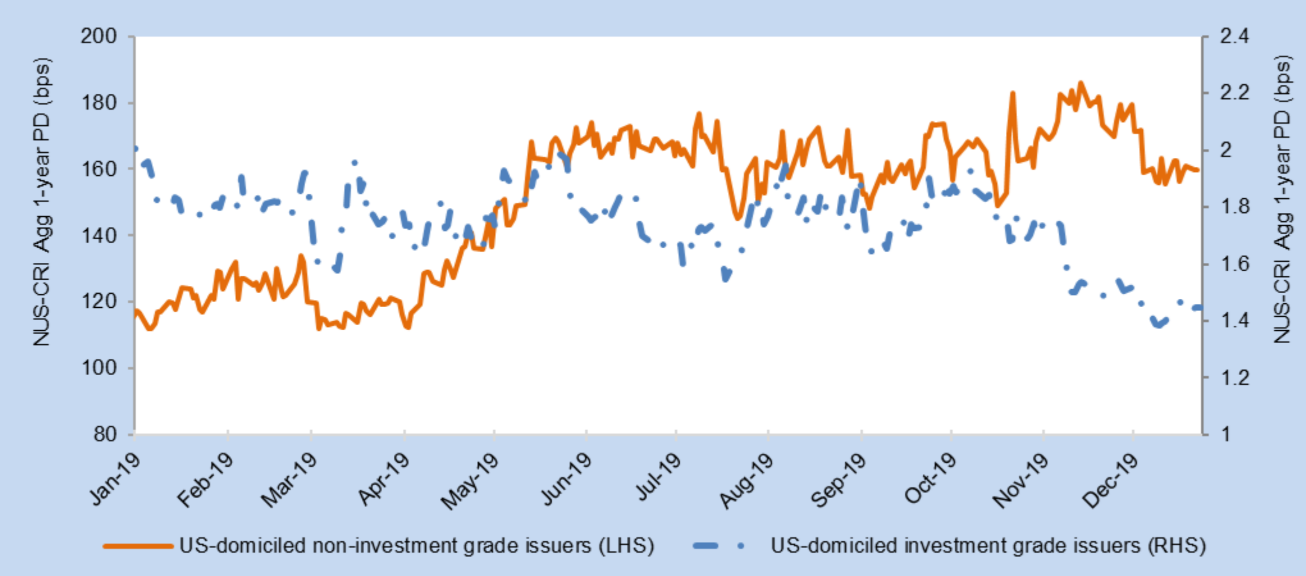

Figure 1: NUS-CRI Agg 1-year PD for US-domiciled investment grade and non-investment issuers from Jan 2019 to Dec 2019. *Source: NUS-CRI.*

Based on the NUS-CRI PD implied Rating (PDiR[1]), we define non-investment grade issuers as those bond-issuing US-domiciled firms with PDiR lower than or equal to BB+. As shown in Figure 1, it is noteworthy that the NUS-CRI Aggregate 1-year Probability of Default (Agg PD) for BB+ and lower rated US-domiciled firms have surged from 120bps in Jan to around 160bps in December 2019, while the Agg PD for the investment grade US bond-issuing firms dropped during the same period. Due to this differing trend, the gap between the Agg PD of all US investment grade and non-investment grade issuers has risen for the past year, indicating a divergence in credit quality between investment and non-investment grade bond issuers.

[1] The NUS-CRI Probability of Default Implied Rating (PDiR) provides a more conventional interpretation of PDs – it translates NUS-CRI 1year PDs to letter ratings by taking reference from the historical observed default rates of S&P's rating categories.

Looking into the sectoral level, firms within the energy, communication and consumer sectors have the highest proportion of non-investment grade issuers in the US. Firms within these sectors also issued most of the riskiest and lowest rated bonds in the market. Furthermore, the ratio of net debt to earnings before interest, taxes, depreciation and amortization of US non-investment grade firms has reached record highs last year, indicating an overall worsening credit quality. Highly-leveraged healthcare companies, under the category of consumer non-cyclical sector, were faced with earning pressures while US retailers (which are classified under the consumer sector) were also pressured by the lower-than expected consumer spending.

The worst sector in the US, however, is the energy sector. Bonds within the US energy sector comprised more than half of bonds with a price lower than 80 cents per dollar last year. Moreover, the Agg PD of US firms within the energy sector, which currently stands at around 26bps, remains the highest among other sectors in the US. Facing the persistently low oil prices and the intense price competition from cheap natural gas and renewable energy sources, this industry took the brunt of most downgrades of companies by S&P in 2019, posting an upgrade to downgrade ratio of 0.28, the lowest of all industries in the US. After the unprecedented boom in American oil production, US oil production has been growing, which might drive down the oil prices to the level well below the breakeven points of many drillers. The steep increase in borrowing costs make energy companies hard to repay their debts. In the other part of the energy sector, the US coal industry also faces the threat of default, as natural gas and renewable energy resources cut into coal's share of the US power market amid the declining domestic demand. According to the Energy Bankruptcy Reports and Surveys, there were 50 energy companies filed for bankruptcy during the first nine months in 2019, while the number was only 43 for the whole year of 2018.

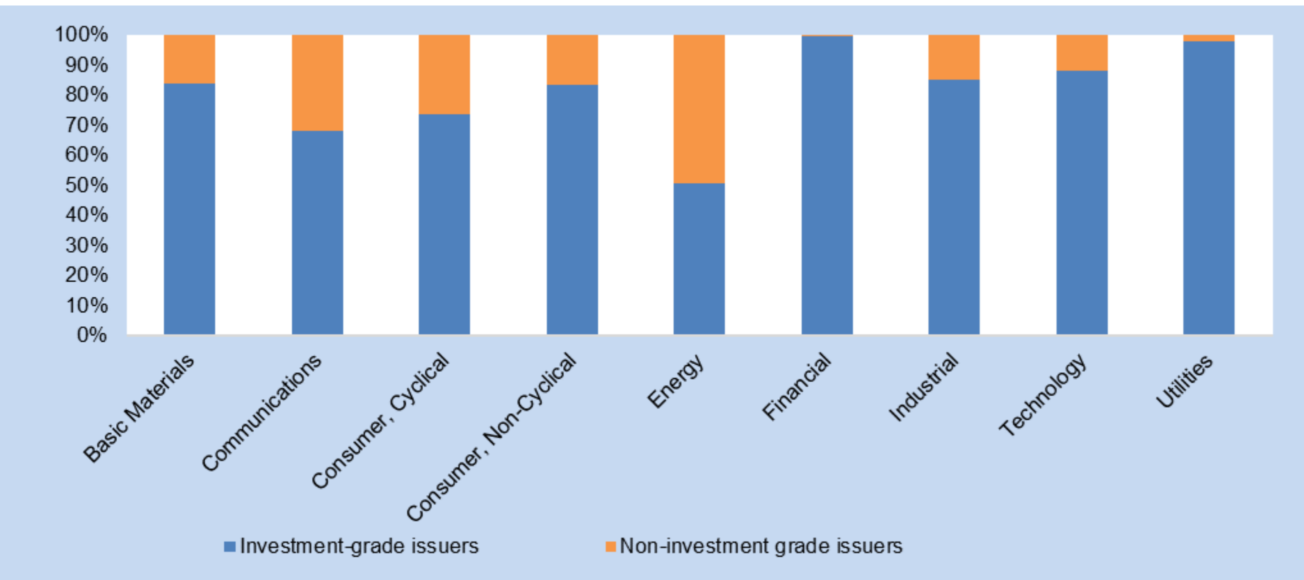

Figure 2: US-domiciled non-investment grade and investment grade issuer composition by sector as of Dec 2019 according to NUS-CRI PDiR. *Source: NUS-CRI.*

On the other hand, US firms within the financial, utilities and technology sectors have continued to exhibit a strong credit profile. More than 90% of the firms within these sectors are categorized as investment grade issuers according to the NUS-CRI PDiR. In addition, the Agg PDs of firms within these sectors were stable and remained at around 5bps last year. Firms within the technology sector have benefited from the continued robust consumer spending, which is expected to hit record levels in the US this year. As a defensive sector, the utilities sector also tends to be more resilient when facing economic uncertainties.

The divergence in credit outlook can also be seen from the NUS-CRI Aggregate (median) Forward 1-year PD[2] (Forward PD). Figure 3 below compares the spread of the Forward PDs of publicly-listed US issuers based on information available in December 2018 and December 2019. The curve based on the Dec 2019 information is consistently above the curve based on the Dec 2018 information, which indicates an increasing difference between the investment and non-investment grade issuers' credit outlook. What is more, the Forward PD spread series both show an upward trend within the 12-month horizon before receding, implying that while the difference between the credit quality of investment and non-investment grade firms would be more pronounced in the short run, it will eventually decline.

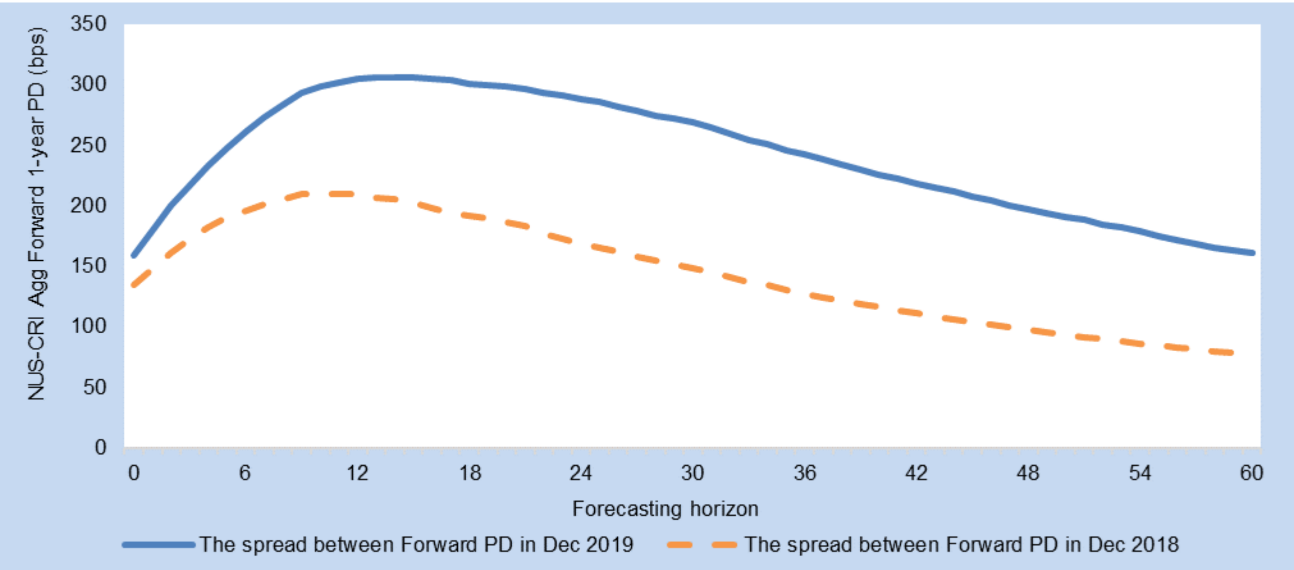

Figure 3: The spread between the NUS-CRI Forward 1-year PD of US-domiciled non-investment grade and investment grade issuers based on information available in Dec 2019 and Dec 2018. *Source: NUS-CRI*

Credit News
Zombie firms aren't feeding off low rates and cheap money **Jan 5.** A recent research of the central bank in Copenhagen indicates that the amount of zombie firms has decreased under low interest rate environments, which goes against the conventional wisdom. The central bank's study also shows that not only has Denmark's zombie count fallen amid record monetary stimulus, but the overall level of such firms is low, even compared with its Nordic neighbors Finland and Sweden. A number of factors are pointed out by the Danish central bank as being more important than a low interest rate, including well-functioning insolvency laws and a robust framework to protect workers facing unemployment. These observations are consistent with findings made by the European Central Bank. (Bloomberg)
US syndicated loan issuance tumbles as confidence drops **Jan 4.** US Syndicated lending decreased sharply by 20% from the prior record-year tally, due to Sino-US trade war, uncertainty about Brexit, and a potential looming recession. Drop in corporate confidence reduced

[2] The Forward PD computes the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 12-month Forward 1-year PD is the probability that the firm defaults during the period from 12 months onwards to 1 year plus 12 months, conditional on the firm's survival in the next 12 months.

potential merger and acquisition transactions to USD 465.2bn, a 28% decrease from the year of 2018. As macroeconomic uncertainty made investors additionally wary, their appetite for leveraged loans dwindled, volumes of which hit USD 807.9bn last year, down from USD 1.24tn in 2018. Though lenders and investors in syndicated loans expect that last year's resolution of geopolitical events may bring in some corporate consolidation, they will still remain watchful in the new year, as recent US action against Iran has paved the way for a new geopolitical volatility. (Reuters)

The "transition" bonds bridging the gap between green and brown

Jan 4. Marfrig, the world's second-largest beef producer, is planning to raise USD 500mn with a green-tinged bond in August. The debt, marketed as a "transition" bond, would encourage the firm to clean up its act by channeling proceeds towards cattle farmers who had not encroached on the rainforest. The deal could be a sign of things to come, since only a limited number of such bonds have been sold around the world, and analysts expect more to come due to rising demand for such products. However, the surge in interest in transitional instruments has attracted some criticism. Sceptics fear that "transition" bonds provide polluting companies an easy boost to their images without necessarily requiring them to change their business practices. Environmental groups also question the needs to distinguish "green" between "brown". (FT)

Corporate debt issuers to kick off sales with up to USD 35bn

Jan 3. Sales of US investment grade bonds are projected to total between USD 30bn and USD 35bn next week, based on an informal study of Wall Street's biggest banks. With funding costs at the best levels for the start of the year, and to avoid a potential rocky market in March due to the foreboding US elections, the market remains inviting for issuers to aggressively issue debt. About USD 120bn of issuance is forecasted for January, an increase of 9% from last year. In general, the majority of bond issuance in January comes from the financial sector as banks try to fulfill their funding needs following their earnings announcements. The investment-grade bond spread tightened to 93bps last Tuesday, the tightest level since February 2018. (Bloomberg)

China muni bond sales start sooner than ever as growth slows

Jan 2. China has for a second year ordered local government to move the timetable of bond issuance forward to speed up spending in areas like transport and energy infrastructure. This acceleration comes as policy makers seek to manage the pace of a long-term slowdown in the nation's economy. According to a markets economist, the demand for local-government notes will be high since its yields are higher than central-government bonds but of the same sovereign ratings. More local governments are expected to announce bond-issuance programs in early January, and the total quota for 2020 is predicted to be as high as CNY 3tn, according to the head of China macro strategy in Standard Chartered Bank. (Bloomberg)

Apollo-backed security firm in talks for debt restructuring (Bloomberg)

Builder blames delayed rent by India for missed debt payment (Bloomberg)

S&P takes most bearish stance on US corporate debt since 2009 (Bloomberg)

Regulatory Updates

SGX's regulatory arm to review retail bond framework

Jan 3. The regulatory arm of the Singapore Exchange, known as SGX RegCo, has set up a committee of industry professionals and investors to review the current regulatory framework around the listing of retail bonds – including possibly tightening the admission criteria for issuers. This move follows the high-profile default by Singaporean water treatment firm Hyflux in 2019. Further, SGX RegCo also made key changes to delisting rules to protect independent and minority shareholders. The committee will also be looking at continued obligations of issuers and ways to protect bondholders in the event of default or restructuring. The working group is expected to present its recommendations by mid-2020, with a public consultation by the end of the year. (Straits Times)

PBOC sets policy pace for 2020 with reserve cut to aid credit

Jan 1. The People's Bank of China (PBOC) will lower its required reserve ratio for commercial banks by 50bps from 6 January 2020, injecting about CNY 800bn of liquidity into the financial system. The cut aims to help banks reduce their lending rate to businesses. The current required reserve ratio is 13% for large banks and 11% for smaller ones. Since the announcement of the upcoming cash injection, Chinese equities are headed for their best start to a year since 2015, with the benchmark Shanghai composite index rising by 1.2% to 3,087.2 mid-day. The interbank 7-day repo rate also dropped below 2.1% mid-day, down the most in at least 5 years. (Bloomberg)

China unveils revised regulations for foreign banks (China Daily)

RBI announces third round of operation twist (BloombergQuint)

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