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Turkey domiciled corporates' credit profile improves as the Central Bank returns to orthodox monetary policy

by Anthony Prayugo

- **NUS-CRI Forward PD shows that the short-term credit outlook for Turkey domiciled corporates has improved since Agbal became Governor of the Central Bank of Turkey**
- **NUS-CRI BuDA indicates that Turkey domiciled corporates' credit profiles are still vulnerable to the depreciation of the Turkish lira**

The appointment of Naci Agbal to helm Turkey's Central Bank has been a welcome surprise to investors. Since taking charge of the Central Bank in Nov 2020, Governor Agbal has reversed his predecessors' policy of low interest rate in a bid to temper the country's double-digit inflation and stabilize the country's falling lira. As a result of increasing interest rates from 10.25% to 17%, the Turkish lira has appreciated by around 20% against the US dollar since the end of last year, becoming the best performing emerging market currency as of early 2021. The positive development was fuelled by foreign capital returning to the country due to higher domestic interest rates, which, in turn, eased dollar borrowing costs and contributed to the improvement in Turkey domiciled corporates credit quality as shown by the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) in Figure 1a. Short-term credit outlook has also improved compared to the end of last year, which is demonstrated by the NUS-CRI Aggregate (median) Forward 1-year PD (Forward PD) in Figure 1b.

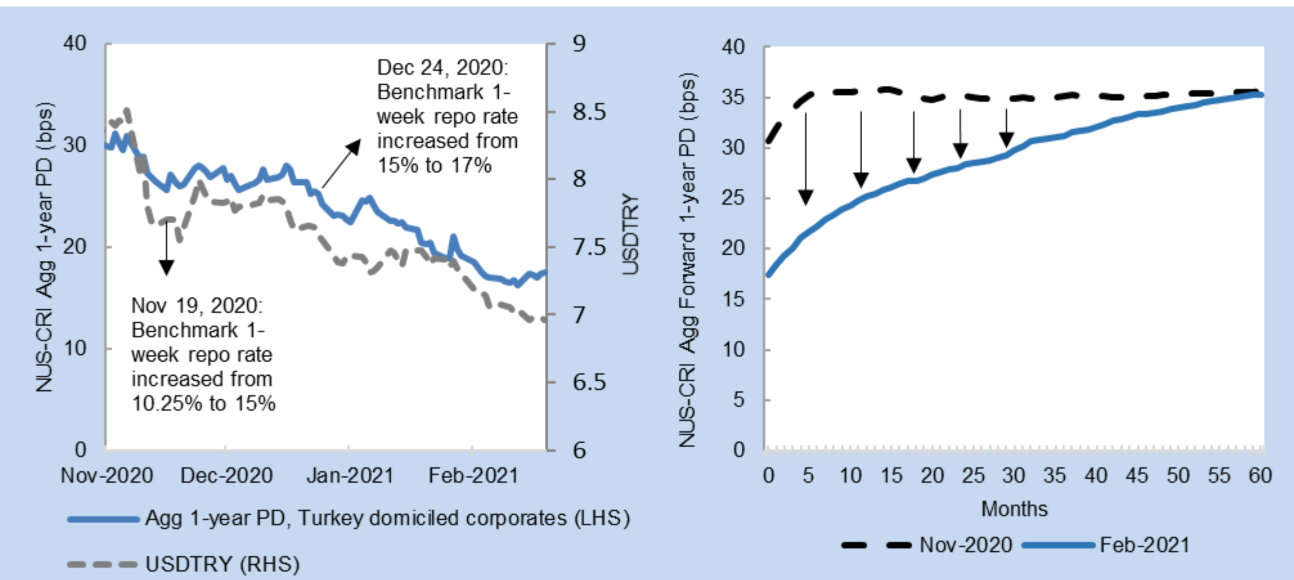

Figure 1a (LHS): NUS-CRI Agg 1-year PD for listed Turkey domiciled corporates and USDTRY[1] spot since Nov 2020. Figure 1b (RHS): NUS-CRI Agg Forward 1-year PD for listed Turkey domiciled corporates[2]. *Source: NUS-CRI, Bloomberg*

[1] Price of 1 US dollar (USD) in Turkish lira (TRY).
[2] 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 18 months – this is conditional on the firm's survival in the next 6 months.

Turkey domiciled corporates have long relied on external financing. Currently, around 68% of the amount of bonds outstanding by Turkey domiciled corporates are denominated in foreign currency (predominately US dollar). The reliance on foreign currency funding has made Turkey domiciled corporates particularly vulnerable to the depreciation of the lira as it will increase the cost for them to repay foreign debts. For the past few years, partially due to President Erdogan's aversion to high interest rates[3] which led to unorthodox monetary policies and credit-fuelled growth, Turkey has experienced high inflation, depreciation of the lira and capital flight. The recent shift in monetary policy, however, improved investors' confidence, leading to an increase in foreign capital influx and confidence in Turkey's financial markets. The NUS-CRI Agg PD indicates that, save for Russia, Turkey domiciled corporates displayed the most improvement in their credit profile among emerging economies since November last year (see Figure 2).

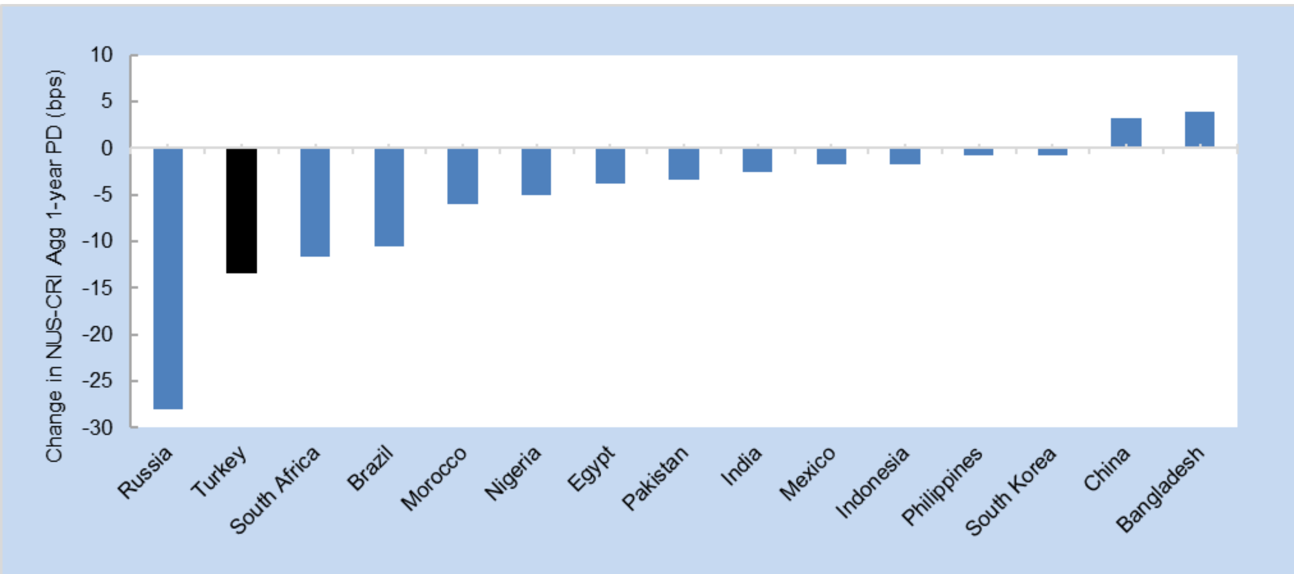

Figure 2: Change in emerging economies' NUS-CRI Agg PD from Nov 2020 to Feb 2021. The definition of emerging economies by BRICS+ Next Eleven is used in this article. *Source: NUS-CRI*

As investors' sentiments brightened, the cost of borrowing in the US dollar for Turkey domiciled corporates fell to its lowest in five years (see Figure 3a). Moreover, an increase in investors' appetite for riskier assets driven by the improvement in the global economic outlook has also contributed to more favourable borrowing conditions in the international market for Turkey domiciled corporates. Turkey's GDP expanded by around 5.9% in Q4 2020, better than all other economies except China. Taking advantage of the favourable conditions, Turkey domiciled corporates are now on track to roll over USD 6.7bn worth of foreign bonds this year, a stark contrast to the conditions they faced in early 2020. Coupled with the likelihood of facing relatively low roll-over rates in the short-run, the short-term credit outlook for Turkey domiciled corporates improved compared to that at the end of last year (see Figure 1b).

In spite of the recent positive developments, Turkey's longstanding current account deficit and significant dependence on external market sentiments continue to make the country vulnerable from capital outflows and thus, could act as a catalyst in the depreciation of the lira. The NUS-CRI Bottom-up Default Analysis (BuDA[4]) toolkit is used to simulate the effects of a possible repeat of Turkish lira depreciation. Therefore, the macroeconomic variable chosen to receive a negative shock for our scenario analysis is the value of the lira, represented by its nominal effective exchange rate (NEER[5]). For the benchmark scenario, the stable trend of the lira is assumed to continue until the middle of this year. As for the stress testing scenario, we take the average monthly depreciation rate of lira during early 2020, with the assumption of a continued monthly change in the NEER of approximately -3.3% for the next 6 months. Figure 3b illustrates that the Agg PD would increase under the stress scenario as the lira depreciates. Meanwhile, under the benchmark scenario of a stable lira, the Agg PD would initially increase slightly before stabilizing.

[3] President Erdogan believes that raising interest rates is inflationary and would harm economic growth.
[4] The Bottom-up Default Analysis (BuDA) is a credit stress testing and scenario analysis toolkit jointly developed by the Credit Research Initiative (CRI) team of National University of Singapore (NUS) and the International Monetary Fund (IMF).
[5] Turkey JP Morgan nominal broad effective exchange rate index is used as the NEER for the BuDA simulation.

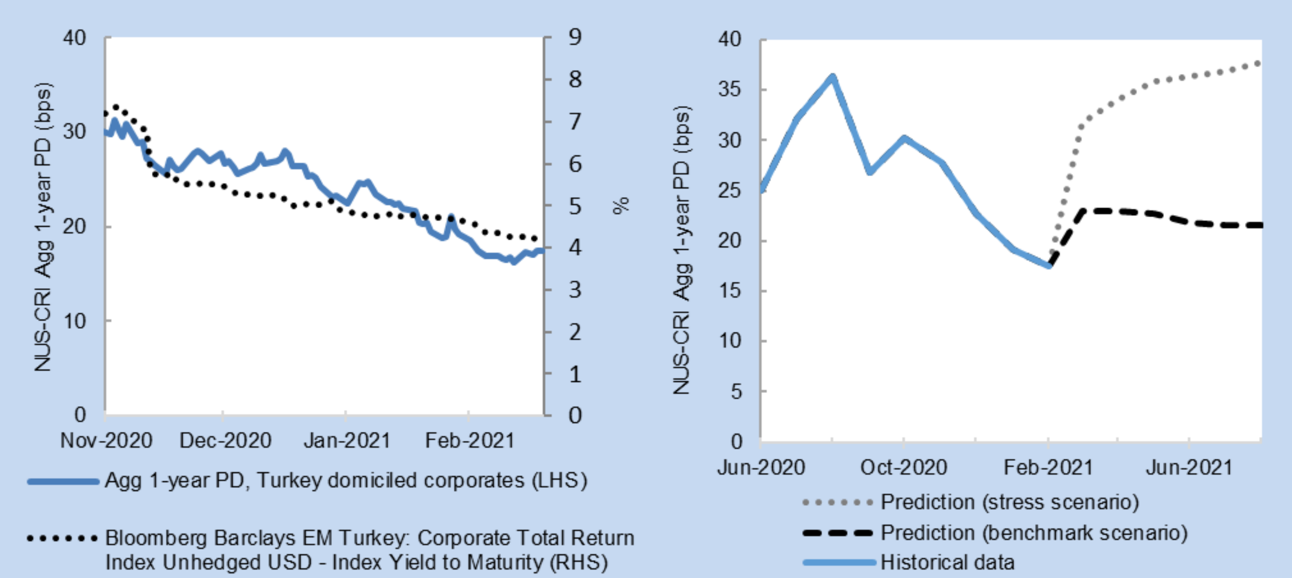

Figure 3a (LHS): NUS-CRI Agg 1-year PD for listed Turkey domiciled corporates and yield to maturity for Turkey's corporate bond index since Nov 2020. Figure 3b (RHS): Historical and predicted development of the Turkey domiciled banks Agg PD for the stress testing and benchmark scenario. *Source: NUS-CRI, Bloomberg*

It seems that Governor Agbal's policy has so far boded well for most investors. The return of an orthodox monetary policy after years of seeming mismanagement has brought investors' confidence up to a level not seen in many years. Caution remains, however, as Turkey has a history of overshooting inflation targets and credit-fuelled macroeconomic volatility. In addition, just as Governor Agbal has apparently gained investors' trust, President Erdogan espoused his long-standing aversion to high interest rates and thus temporarily halted the Turkish lira rally. Unless Turkey succeeds in rebuilding its credibility among investors, any signs of significant political intervention on the central bank's autonomy could send the lira back into a downward spiral and increase the credit risk for Turkey domiciled corporates.

Credit News

Warren Buffett warns of 'bleak future' for foreign debt investors

Feb 28. A panicked sell-off in the bond market has led Warren Buffet to warn investors about the troubles that lie ahead for debt securities. Treasury prices fell last week, as investors are now pricing in stronger future economic growth. This is compounded with fears of inflation control. However, to find larger returns, investors have picked up riskier debt, which is a concern to Berkshire Hathaway. The firm had reduced its corporate debt exposure and holds USD 113bn in short-term treasury bills. They also posted a 23% bottom-line gain as compared to the year before. However, many of these changes were a result of derivatives as well as mark-to-market fluctuations in the price of Berkshire's holdings. In order to further provide returns to investors, they used a portion of their cash balance on share buybacks, which were met with positive reception. (FT)

UK to launch first green savings bond to boost climate credentials

Feb 28. The United Kingdom is set to launch its first sovereign green savings bonds, allowing retail investors the chance to buy into green projects such as renewable energy schemes. The current size and structure of the bond offering are yet to be disclosed by the UK Treasury, though many speculate that the timing of the offering is opportune as the UK hosts the international climate summit in November 2021. The appropriation of funds will be based on the UK sovereign green bond framework, which is yet to be finalized. UK's inaugural green gilt is expected to sell later this year. This follows a global trend of public and private green bond issuance, with 2021 issuance projected to surpass USD 500bn according to SEB. Though 'Green gilts' will be attractive for investors, investors may not want to pay too much of a premium for a green sovereign bond relative to the standard Gilt. (FT)

Ardagh Metal sells largest-ever green junk bond

Feb 27. Ardagh Metal Packaging sold USD 2.8bn worth of green bonds last Friday, marking the biggest green bond issuance in the high-yield market ever. This was triple the size of the previous largest green issuance recorded by Paprec in 2018. Its initial offering of USD 2.65bn was denominated in both USD and EUR. It raised an equivalent USD 1.1bn due 2028, and USD 1.7bn due 2029. This 'significant' green-bond deal allowed investors to gauge whether pricing benefits associated with green bond issuance can be witnessed in the high-yield market. Ardagh Metal will provide the vast majority of funds raised to its parent Ardagh Group, which will use the funds in the short term to repay debt and provide potential dividends. Within three years, the funds raised through the bonds proceed will then be put to eligible green projects such as procuring recycled aluminum and using renewable energy. (Reuters)

Municipal bond yields rise, wept up in Treasuries surge

Feb 26. Municipal bond yields rose earlier this week following a rise in US treasury yields. The 10-year yield on Municipal market data's (MMD) benchmark triple-A scale rising by 45bps to 1.14%. Net inflows into municipal bond funds reduced to USD 37.68mn from USD 2bn between the last two weeks of February 2021. Low supply of new debt in January amid high demand from investors heavy on cash aided in keeping municipal bond yields relatively lower than their treasury counterparts. Prospects of income-tax hike and new stimulus from the White House and Congress also anchored municipal bond yields. (Reuters)

Corporate 'junk bonds' stumble as Treasury yields spike

Feb 25. After the ten-year treasury yield spiked to a one-year high of 1.513% on February 25th, prices of corporate 'junk bonds' stumbled. Amid the spike in yield, only a few U.S. high-yield issuers traded on the green Thursday. Both the USD 9.2bn SPDR Bloomberg Barclays High Yield Bond ETF and iShares iBoxx $ High Yield Corporate Bond ETF fell as the major US stock indexes sold off more sharply. Although the upward drift in interest rates is hard to accept for market participants, some analysts say long-term real yields may continue to drift higher as economic data improves. (MarketWatch)

Tullow Oil reaches USD 1.7bn reserve-based loan agreement with banks (Reuters)

EasyJet raises EUR 1.2bn bond after UK reveals plan to lift lockdown (FT)

US bank regulators say pandemic drove up risk in leveraged lending (Reuters)

Regulatory Updates

ECB signals rising concern about Eurozone bond market sell-off

Feb 26. The European Central Bank (ECB) has indicated that it will increase the pace of its emergency bond purchases to counter the recent sell-off in Eurozone's sovereign markets. The asset purchases will be conducted 'to maintain favorable financing conditions over the pandemic period'. The pandemic emergency purchase programme allows the ECB to spend up to EUR 1.85tn by March 2022, allowing the central bank to spend almost an additional EUR 1tn over what they have already spent. This policy stance comes after government bonds of major Eurozone countries, such as Germany and France, saw a dramatic sell-off in their markets, propping up yields. This may lead to a 'mutually-reinforcing adverse loop' in which banks interpret lower borrowing demand as a negative signal about the economy and the corporates interpret tightening lending conditions as a bleak outlook. (FT)

BOJ to highlight climate risks as key theme of bank tests this year

Feb 26. Climate change will be a key issue for the Bank of Japan this year, as the central bank aims to work with Japan's banking regulator to assess the impact the financial system has on the environment. This follows the trend of countries looking to stress-test the impact that financial institutions have on climate risks. Japan's Prime Minister stressed that green investing will be a pillar for the country's growth, which led the BOJ to take action. However, Japan faces issues with a lack of models and data, as well as a potentially slow rollout of plans, as policymakers work out the details. Overall, the tests may take another year before it sees the light of day. (Reuters)

Colombia regulator urges banks to hold profits due to loan portfolio deterioration (Reuters)

China securities regulator publishes corporate bond trading measures (Reuters)

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Contributing Editors: Emir Hrnjic, Raghav Mathur