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The credit outlook of German companies deteriorates amidst weakened economic growth

by Amrita Parab

- **NUS-CRI Forward PD for publicly listed German companies suggests that weak economic growth and elevated borrowing costs may lead to deterioration in credit health in the near term**
- **NUS-CRI Forward PD for German non-financials shows a steeper deterioration into non-investment grade territory as compared to financials, which remains within the investment grade region**

The German government forecasts that the country's economy will shrink by 0.4 percent in 2023, making it the only advanced economy to experience a GDP contraction in 2023. This anticipated contraction is attributed to ongoing inflation, rising energy costs, and a downturn in global trade. As a consequence of the numerous headwinds faced, the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) for publicly listed German companies has remained elevated, although within the investment grade territory when referred to PDiR2.0 bounds[1], as seen in Figure 1a. The interquartile spread, however, highlights the underlying distress as it continued to widen over H2 2023. Looking ahead, with economic growth expected to remain lackluster over the next 12 months, the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[2]) for publicly listed German companies shows a sharp deterioration into the non-investment grade territory.

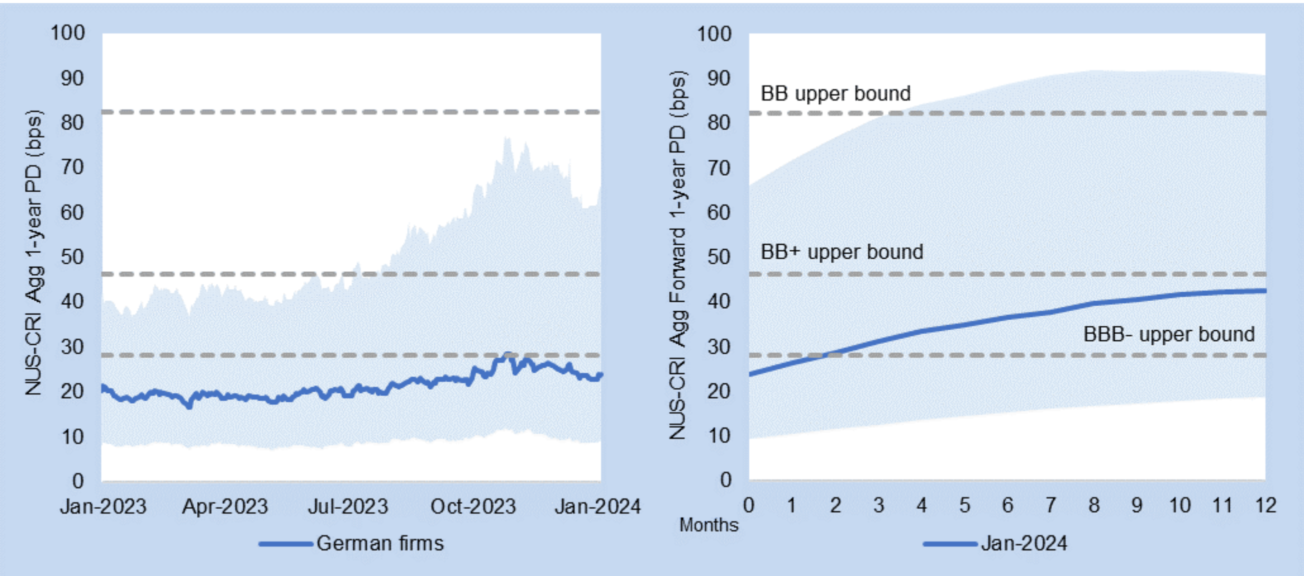

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for publicly listed German companies and its interquartile spread, with reference to PDiR2.0 bounds. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for publicly listed German companies as of Jan-2024 and its interquartile spread, with reference to PDiR2.0 bounds. *Source: NUS-CRI*

A combination of internal and external challenges has contributed to the weakening economic prospects of Germany. The ongoing war in Ukraine is a major factor in Germany's economic challenges, particularly because of the nation's considerable reliance on Russian energy imports. The lack of availability of cheap natural gas has led to increased energy costs for businesses operating within Germany. The higher energy costs have pushed an increasing number of German firms, especially firms with energy-intensive operations, to move their operations outside the country. Additionally, structural issues such as a high dependence on exports, a lack of investment, and a labor shortage are exacerbating Germany's economic woes. Germany's economy, which is heavily reliant on exports, has been particularly affected by the economic slowdown in China. As of Oct 2023,

[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

[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

Germany saw a 9% YoY decline in YTD exports to China, as a consequence of sluggish demand. With economic prospects bleak, German companies are notably reducing their investment plans. A survey by the Ifo Institute, which included feedback from 5,000 businesses, revealed a substantial decrease in investment intentions, with the manufacturing sector showing the most significant drop. Particularly hard hit are the energy-intensive industries, such as chemical manufacturers, who are anticipated to make drastic reductions in their capital spending.

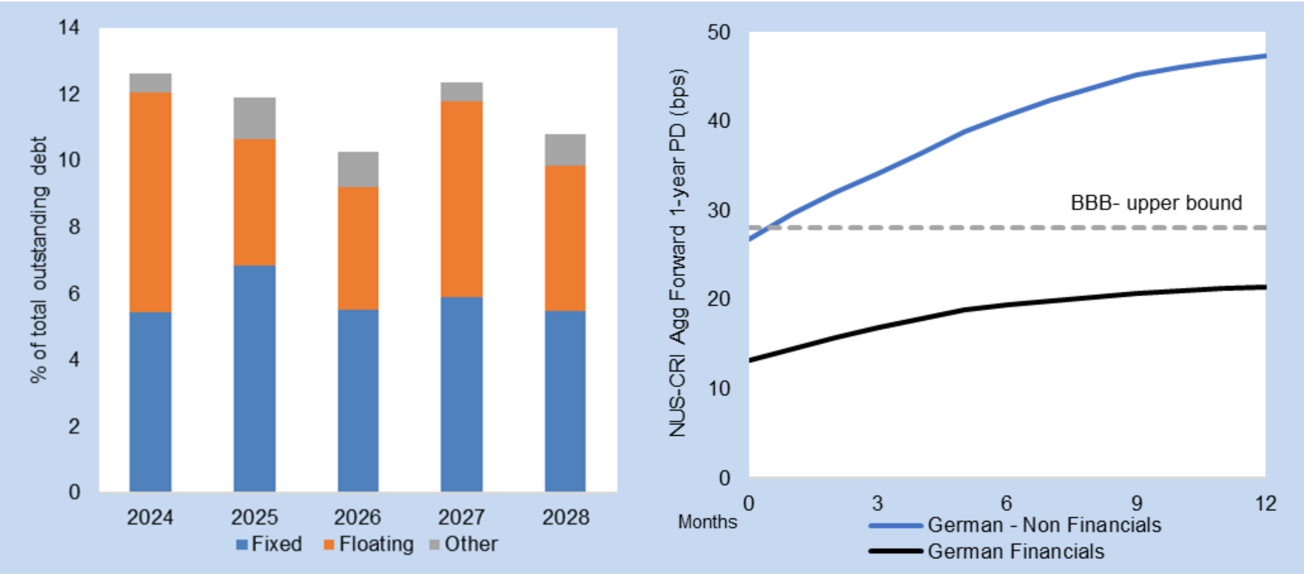

Figure 2a (LHS): % of total debt outstanding for German non-financial companies; Figure 2b (RHS): NUS-CRI Agg (median) Forward 1-year PD for German non-financial and financial companies, as of Jan-2024, with reference to PDiR2.0 bounds. *Source: Bloomberg, NUS-CRI*

In addition to weak economic demand and high energy costs, German companies have also been contending with increased borrowing costs brought on by the steep rate hikes undertaken by the European Central Bank (ECB). With around 30%[3] of the total debt outstanding of German non-financial corporates linked to floating rate coupons, a sizeable segment of firms may already be burdened with higher interest costs. The interest expense faced by non-financial corporates is set to increase further as around 25% of total outstanding debt will mature over the coming 2 years and is expected to be refinanced at higher rates. (see Figure 2a) The drag on profitability resulting from sluggish demand and increased costs may have an adverse impact on the debt serviceability of non-financial corporates. In a sign of ongoing stress, bankruptcies amongst German companies grew by 25% YoY in the period from Jan-Sep. According to the Weil European Distress Index report, German companies experienced the most distress in Western Europe during 3Q 2023, with the real estate sector being the most distressed German industry. As seen from Figure 2b, the Agg Forward PD of German non-financial corporates crosses into non-investment grade territory. On the other hand, German financials, especially banks, have seen positive benefits from rising interest rates which may be linked to the comparatively lower level of the Agg Forward PD seen in Figure 2b. However, as corporate distress remains high, banks may need to strengthen their balance sheets in anticipation of a potential increase in non-performing assets.

Going forward, although the German government strives to support its industry by offering support in the form of policy measures such as corporate tax relief, its focus on green transition may hamper the competitiveness of its companies as it may lead to a further increase in costs. At the same time, with European inflation registering an increase in Dec-2023, the ECB may not resort to rate cuts in the near term, thus, the pressure on German companies linked to higher interest costs is expected to persist, potentially leading to an increase in credit risk for the companies, as seen from Figure 1b.

[3] Data from Bloomberg

Credit News

The hidden force pushing mortgage rates down

Jan 04. Mortgage rates, which surged over the past two years, are now showing a downward trend due to a shrinking spread between average 30-year fixed mortgage rates and benchmark Treasury yields. The spread has been decreasing for eight consecutive weeks and is currently at its lowest since March. The 30-year mortgage rate has dropped over a percentage point to 6.62%, with the narrowing spread contributing to about one-sixth of the decline. While the spread remains larger than its historical average, the trend is welcomed by homebuyers, lenders, and real estate agents. The shift is attributed to factors like reduced investor concerns and the Federal Reserve signaling potential rate cuts. This positive development is reviving investor demand for mortgages, potentially stimulating the mortgage industry. (WSJ)

UK debt chief warns excessive borrowing risks investor backlash

Jan 04. The outgoing head of the UK's Debt Management Office, Sir Robert Stheeman, advises British politicians to exercise caution in increasing borrowing rapidly, as it may trigger a backlash in financial markets. With an eight-fold rise in the UK's debt pile during his 21-year tenure, Stheeman warns that issuing bonds is becoming more challenging, and investors could act as a restraining influence on fiscal policy. Reflecting on a past market upheaval, he emphasizes the interconnectedness of policymaking and market realities. Stheeman, confident in the resilience of the gilt market, highlights the importance of maintaining proximity to, but not being captured by, the market. (FT)

Largest US banks set to log sharp rise in bad loans

Jan 08. A surge in non-performing loans, expected to reach USD 24.4bn in Q4 2023, threatens to dampen investor optimism in major US banks, including JPMorgan Chase, Bank of America, Wells Fargo, and Citigroup. Analysts anticipate a 13% drop in earnings for the six big banks, attributing it to unpaid loans and the impact of higher interest rates on deposit costs. Despite this, bank shares have risen 20%, influenced by the Federal Reserve's signal to halt interest rate increases. Concerns persist about a potential jump in bad loans, impacting profits, especially as delinquencies on consumer loans, like credit cards and car debt, rise. (FT)

US healthcare bankruptcies soar as costs mount

Jan 05. A record number of large healthcare companies, facing challenges such as rising costs and tougher regulations, filed for Chapter 11 bankruptcy in the US last year. Eighteen companies, including Envision, American Physician Partners (APP), and Akumin, sought court protection to reduce debts, marking a nearly fivefold rise from 2022 and exceeding the pandemic peak in 2020. The healthcare sector's struggles are attributed to deferred issues exacerbated by low interest rates and government funding during the pandemic. The bankruptcies underscore challenges for private equity-backed healthcare businesses grappling with higher interest rates, costs, and a reduction in patient numbers. Regulatory changes, including the "No Surprises Act," have also impacted healthcare providers, leading to tougher reimbursement negotiations and unpredictable cash flows. The outlook remains challenging, with the withdrawal of Medicaid protection potentially affecting millions of individuals. (FT)

US corporate bond issuance to slow after strong start to 2024

Jan 06. Following a bustling start to 2024, the U.S. corporate bond market is expected to slow next week as economic data provides mixed signals, affecting expectations of a March interest rate cut. The first week of the year witnessed nearly USD 59bn in high-grade bond issuance, surpassing forecasts. The rush, led by top-rated companies capitalizing on lower borrowing costs, may be tempered by volatility in Treasury yields and upcoming bank earnings releases. Bond syndicate desks anticipate an average issuance of USD 35bn next week. Despite a potential easing in supply, January is predicted to witness a steady flow of new bond issuances. (Reuters)

FirstFT: US companies dive into convertible debt (FT)

US loan growth shifted lower in 2023 despite mounting credit card debt (FT)

Wall Street doubles down on bonds (WSJ)

Regulatory Updates

BOJ easing exit in first half still on table despite earthquake

Jan 05. Market optimism persists regarding the Bank of Japan's potential end to its negative interest rate policy in the first half of the year, contingent on robust wages and inflation. However, caution is anticipated in the first rate hike in 17 years. The recent earthquake in Japan reduces expectations for immediate policy shifts at the upcoming board meeting. Spring could witness a significant likelihood of ending negative rates, with a 40% probability by April. The BOJ aims to exit its decade-long monetary easing program upon achieving sustained 2% inflation and wage growth. The central bank may scrutinize wage trends through March negotiations, potentially scrapping negative rates in April. (Nikkei Asia)

Wave of debt sales adds to January nerves in euro zone bond markets

Jan 05. Euro area bond markets are unsettled by a massive EUR 150bn (USD 165bn) government bond sales in January, signaling concerns over the potential record public debt issuance this year. Rising yields, following a slump in November and December, are influenced by reduced investor expectations of early central bank interest rate cuts. ING predicts a EUR 150bn debt issuance this month alone, accompanied by EUR 72bn in net supply after factoring in redemptions. Investors are worried about the market's ability to absorb substantial government debt, especially as the European Central Bank reduces its bond purchases, potentially requiring markets to absorb a record EUR 675bn of government debt this year. (Reuters)

Fed revives investors' hopes of end to 'quantitative tightening' (FT)

Top bank regulator takes on 'drive fast, crash' risk culture (WSJ)

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