US tail corporate vulnerability at record high since 2016

by Yao Xuan

The poor performance of stocks and bonds in the United States in the late 2018 has raised investors' concerns about the US economy. The RMI-CRI tail Corporate Vulnerability Index (CVI_{tail}) has surged to a record high since 2016. CVI_{tail}, which is the upper 5th percentile of RMI-CRI 1-year Probability of Default (PD), focuses on the riskiness of the most vulnerable firms in a group. A high CVI_{tail} indicates low creditworthiness of tail firms of a group within the next one year. Figure 1 shows that by the end of Dec 2018, the CVI_{tail} of the United States has surged to more than 400bps, a level last seen in Jan 2016.

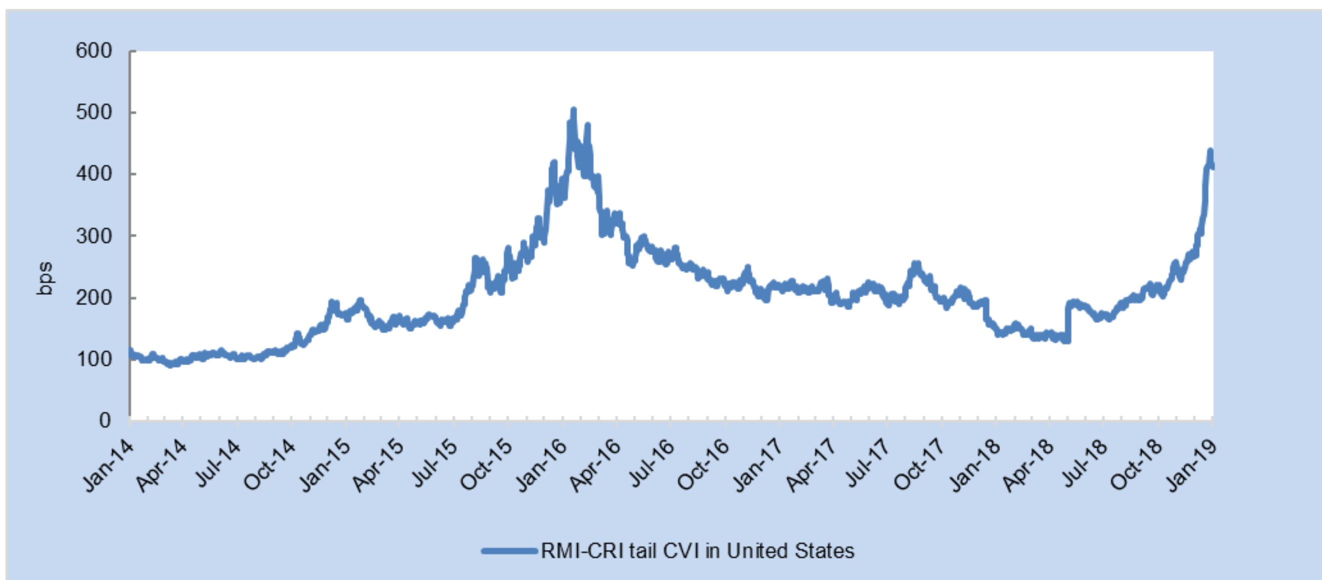

Figure 1: RMI-CRI Tail Corporate Vulnerability Index of US companies. *Source: RMI-CRI*

These vulnerable US companies loaded up their balance sheets with debt either to fund mergers, leveraged buyouts, or other economic activities. Figure 2 demonstrates the median financial leverage of the US companies contained in CVI_{tail} on Dec 31, 2018 for the past three years.

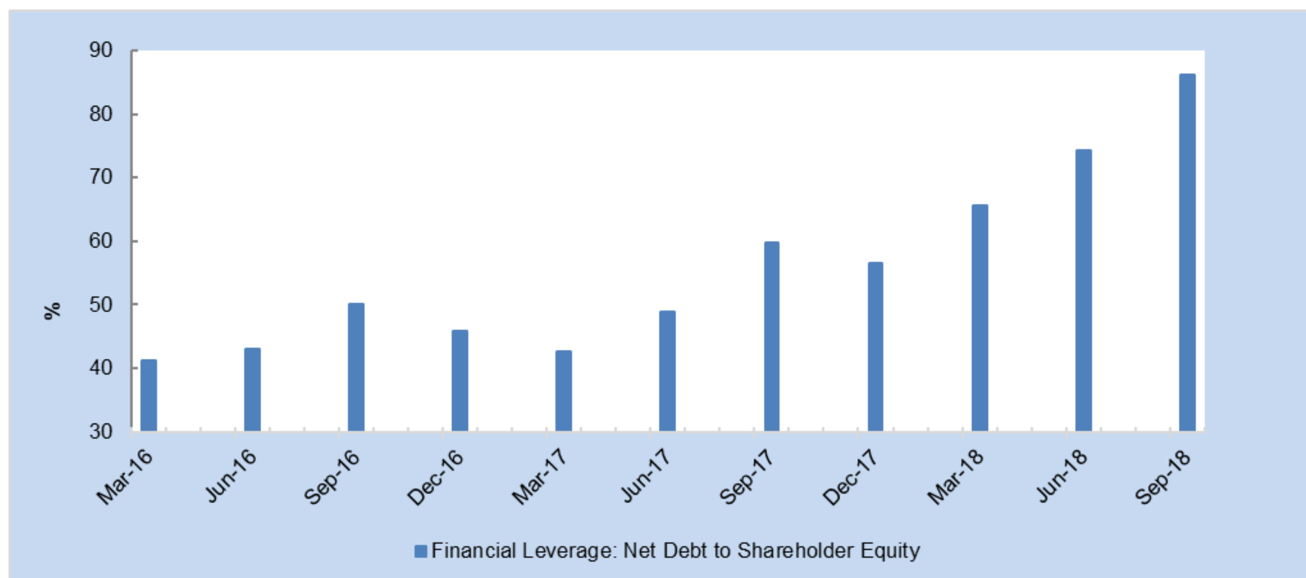

Figure 2: The median financial leverage of US companies contained in CVI_{tail} on Dec 31, 2018. *Source: Bloomberg.*

In addition to CVI_{tail}, data from the US high-yield bonds market (also known as junk bonds market) reflect the junk rated corporates in the United States as well. Since 2017, the US high-yield spreads have remained stable at an average of 359bps. However, since Oct 2018, when Fed increased interest rate for the fourth time in 2018 and oil prices plunged, the US high-yield index spread surged and ended in 2018 at 526bps, just shy of the 30-month peak. Credit spreads on energy high-yield bonds, hit by the dramatic fall in oil prices, widened most sharply, doubled from 352bps to 717bps (see Figure 3a). Energy companies accounted for about 23% of the junk bonds outstanding, contributes partly to the soaring credit spread. We can also see the increase in credit risk for the energy industry in the US as the RMI-CRI 1-year PD rose to 27bps at the end of Dec 2018 from 12bps in Oct 2018.

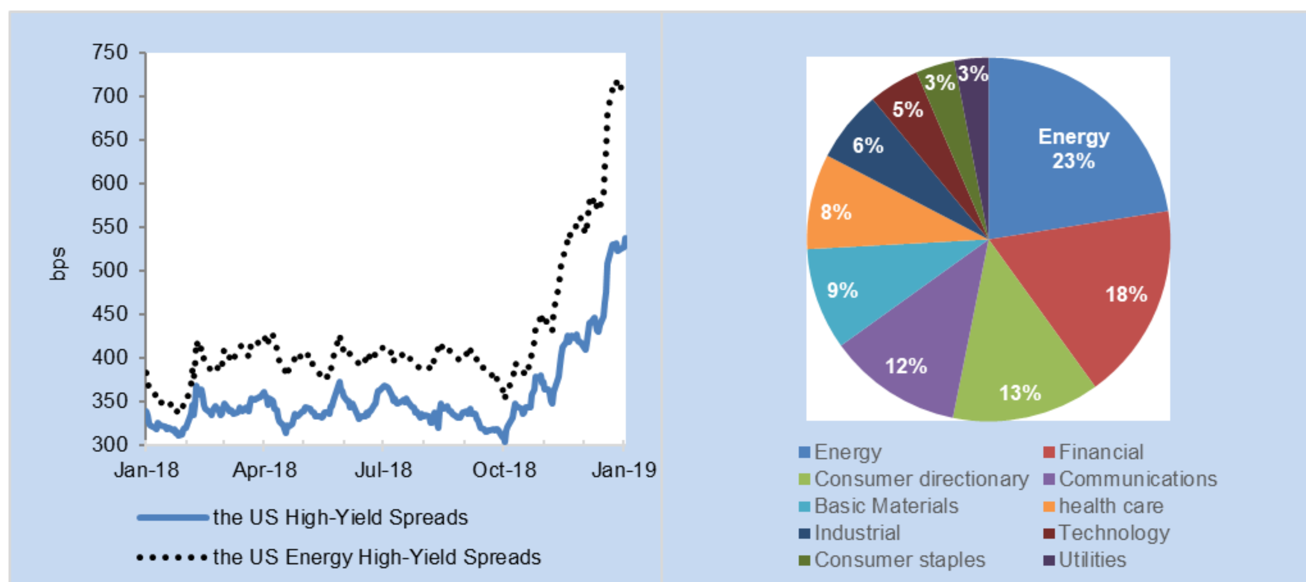

Figure 3a and 3b: Bloomberg Barclays U.S. Corporate High Yield Index Option Adjusted Spreads and Sector Allocation by Volume. *Source: Bloomberg*

The US high-yield bonds returned -2.1% in 2018, the worst performance since a 4.5% loss in 2015, and the second negative year since the 2008 financial crisis, according to the Bloomberg Barclays US corporate High Yield Index (Table 1).

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return	-30.32%	45.87%	14.08%	4.86%	14.68%	7.18%	2.42%	-4.57%	15.81%	7.24%	-2.10%

Table 1: Bloomberg Barclays US Corporate High Yield Index Return. *Source: Bloomberg*

The increasing financing cost made high-yield debt markets less attractive to companies who rely on debt markets to stay afloat. High-yield issuers also have to face with President Donald Trump's tax bill which will limit how much companies can deduct interest expense from its earnings and thus reducing the cash available to repay interest and debt. Together with the concerns on economic growth, the total issuance of the US junk bonds market for 2018 got down to a low level since 2009 at USD 163bn. Specifically, the issuance in Dec 2018 dropped to zero for the first time since at least a decade. Nevertheless, these junk-rated companies still have to deal with debts repayment coming due over the next few years. Maturities for US high-yield debt will ramp up to USD 104bn in 2019, according to Moody's Investors Services and it will close to double to USD 182bn in 2020.

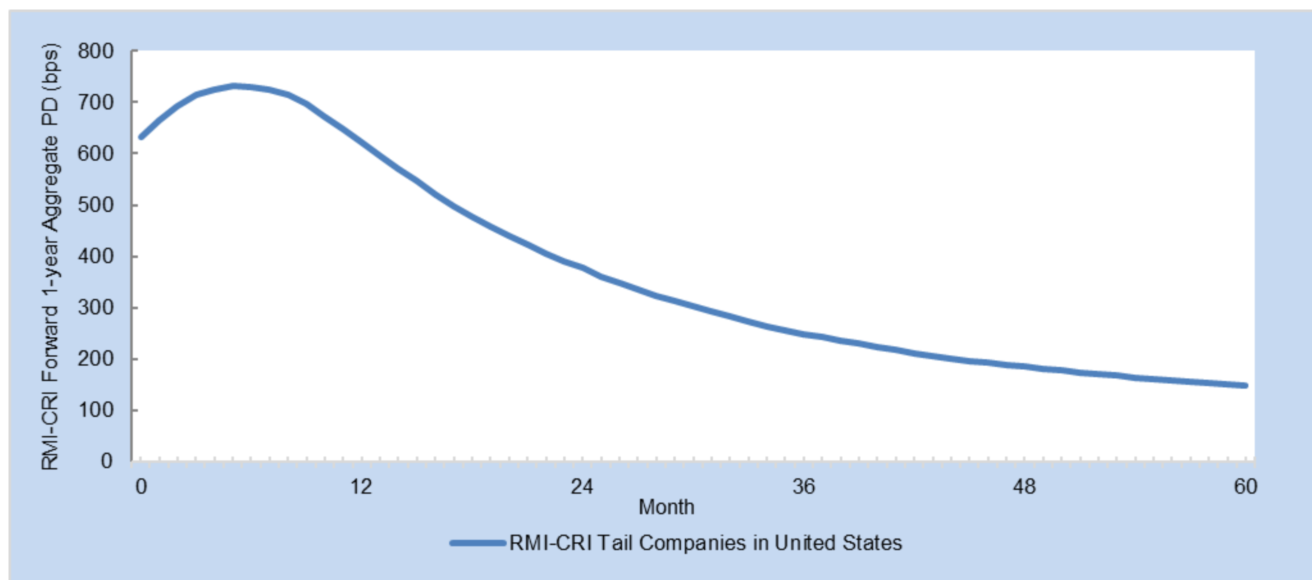

Figure 4: RMI-CRI Forward 1-year Aggregate PD of US most vulnerable companies on 9 Jan 2019. *Source: RMI-CRI*

Looking ahead, Figure 4 illustrates the RMI-CRI Forward 1-year Aggregate Probability of Default (Forward PD) of companies which are contained in CVI_{tail} on the last day of 2018. The Forward PD computes the credit risk of a company in a future period. For instance, 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 surviving the next 6 months. As can be seen in the figure, the credit profile for these US vulnerable companies could deteriorate in the first half of 2019 and the situation could get better only if they survive the following year.

With concerns about economic slowdown and increasing interest rates, the credit risks of those most vulnerable US firms is heightened as displayed by the RMI-CRI CVI_{tail} and the US high-yield bond market. Looking into the future, the forward PD of these firms shows that the credit profile could deteriorate in the near term as these companies face the oncoming economic headwinds with their debt burden.

Credit News
Fed officials signal readiness to pause interest rate increases **Jan 11.** A pair of influential Federal Reserve officials said on Wednesday that the Fed should pause to assess economic conditions before considering additional hikes in interest rate, reinforcing the message delivered last week by Fed chairman Jerome Powell. The speeches and the meeting minutes published by the Fed also indicate that the Fed would not raise its benchmark interest rate at its January meeting and is unlikely to do so at the following meeting in mid-March. Nevertheless, most Fed officials still expect that economic growth will be strong enough to justify rate increases later in the year. (The Business Times)

China banks' bad loan ratio climbs to 10-year high at end-2018

Jan 11. China commercial banks' non-performing loan (NPL) ratio hit a 10-year high of 1.89% at the end of 2018 as the economy slows. The total NPLs of commercial banks amounted to CNY 2tn at the end of 2018. As China faces a weakening domestic demand and a persisting trade tension with the United States, the Chinese economy grew around 6.6% in 2018 which is the weakest since 1990. In order to shore up capital to fend off risk arising from bad loans, Chinese banks are turning to unconventional measures such as asset-backed securities and debt-for-equity swaps and increased their loan loss reserves by CNY 676bn over the prior year to CNY 3.7tn. (Reuters)

Warning of possible cut to US credit rating if government shutdown continues

Jan 10. The US political gridlock that has shut down part of the government has a possibility of running into a deadline that would limit the Treasury's borrowing ability and potentially threaten America's top-credit standing. According to some ratings analysts, a prolonged standoff over the country's debt limit well past Mar 1, the date when the debt limit suspension ends, would increase the risk of a technical default and raise the probability of a downgrade. Talk to end the government shutdown fell apart on Jan 9 after President Trump, who has shown no sign of backing down on his demand for border wall funding, stormed out of a White House meeting. Meanwhile, the Democrats have said they would not negotiate until the president agrees to re-open the government. (The Straits Times)

HNA touts assets for sale as funding crunch intensifies

Jan 9. China's indebted HNA Group held an investor meeting to put up some of its assets for sale ranging from a hotel project in Harbin, stakes in online lender Dianrong and insurer Bohai Life as it looks to raise funds and fight off an intensifying cash crunch. Facing increasing debt and increased government scrutiny of its deal-making, HNA has pushed ahead with asset sales that have so far included real estate and stakes in hotels groups. China Development Bank is leading a team to supervise asset disposals as HNA looks to scale back operations to have core assets remaining. (The Business Times)

UAE bank bailout points to restructuring, mergers

Jan 8. Following the property downturn that forced UAE to lead a bailout of Invest Bank last month, smaller banks in UAE are facing regulatory pressures to merge. Analysts expect mergers in the banking sector to accelerate as the economy slows and house prices slide. Fitch stated that smaller banks are losing grounds to the country's top four lenders, which presently control around 65% of banking sector loans. Although many smaller banks owners have resisted mergers, there are signs that these owners are becoming more open to consolidation. Smaller banks also tend to have more exposure to small and mid-sized corporates which have been more affected by the slowing economy. This exposure meant that smaller banks may need to scale up to meet sizeable investment requirements related to compliance, digitalization, and new accounting standards. (The Business Times)

Saudi Aramco will probably issue USD 10bn Bond for Sabic deal (Bloomberg)

Italy government leaders talk of nationalizing lender Carige (FT)

Prompt payment by Singapore firms falls for 3rd straight quarter (The Straits Times)

Regulatory Updates

Hedge fund leverage risk comes under scrutiny

Jan 13. Global regulators are still struggling to understand whether hedge funds could endanger the stability of financial markets after the near collapse of Long-Term Capital Management (LTCM) two decades ago. Global regulators want to analyze hedge funds' use of leverage to see whether more investment managers should be deemed "systematically important" and henceforth subjected to increased supervision. Although the hedge fund industry has more than tripled to USD 3.2tn and the use of borrowed money has reduced since the LTCM debacle, the role of derivatives, sometimes known as synthetic leverage, remains less well understood. Regulators in Europe and UK plans to conduct a more comprehensive and consistent monitoring of the leverage of these hedge funds to gather more information. (FT)

China central bank says to step up policy support for economy

Jan 9. The China central bank is planning to support the economy by improving its policy transmission mechanism from both supply and demand sides and by establishing an incentive mechanism for banks. Amid a trade dispute with the United States, policymakers are committed to step up support of measures in 2019 such as fast tracking infrastructure projects and cuts in banks' reserve requirement and taxes. China will stick to its structural deleveraging path as financial risks remain despite a steady macro-leverage ratio. Chinese regulators wants to prevent various unforeseen events and maintain stability in the country's stock market, bond market and foreign exchange markets. (Reuters)

Treasury rejects calls to reform UK laws on business loans (FT)

Big banks lobby APRA over AUD 75bn 'too big to fail' capital requirements (AFR)

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Contributing Editor: Liu Hanlei