Credit Research Initiative
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Weekly Credit Brief January 20 - January 26

Tumbling price darkens iron-ore market outlook

by Justin Hsiao

The price of iron ore, the key material in steelmaking, has continued to plunge on concerns about the slowing demand growth of China, the biggest raw material consumer in the world, which accounts for over 60% of the global iron-ore consumption. As Chinese economy introduced its "new normal"- annual GDP growth has slowed down to 7% - 7.5%; the China's annual GDP growth in 2014 was 7.4%, the lowest in 24 years. The slowing economy and the contraction in property market hit steel demand. Figure 1 demonstrates the decelerating China annual iron-ore demand growth YoY (%), showing that the demand growth has been in the slowest pace since financial crisis. And the iron-ore price has been languished from 134.72 USD/MT at the beginning of 2014 and touched a 5-years low of 66.3 USD/MT in December, slumping 47% in 2014.

Even the price has halved over the past year, the world's biggest mining companies did not stop pumping supply into the iron-ore market. Vale, Rio Tinto Group, and BHP Billiton Ltd, the world's top-three iron-ore behemoths, all boost production, expanding the market glut amid weaker demand. Some analysts believe this is a strategy, implemented by big players who can make profit easier when price is low by virtue of economies of scale, by increasing market shares and try to squeeze higher-cost producers out of the business.

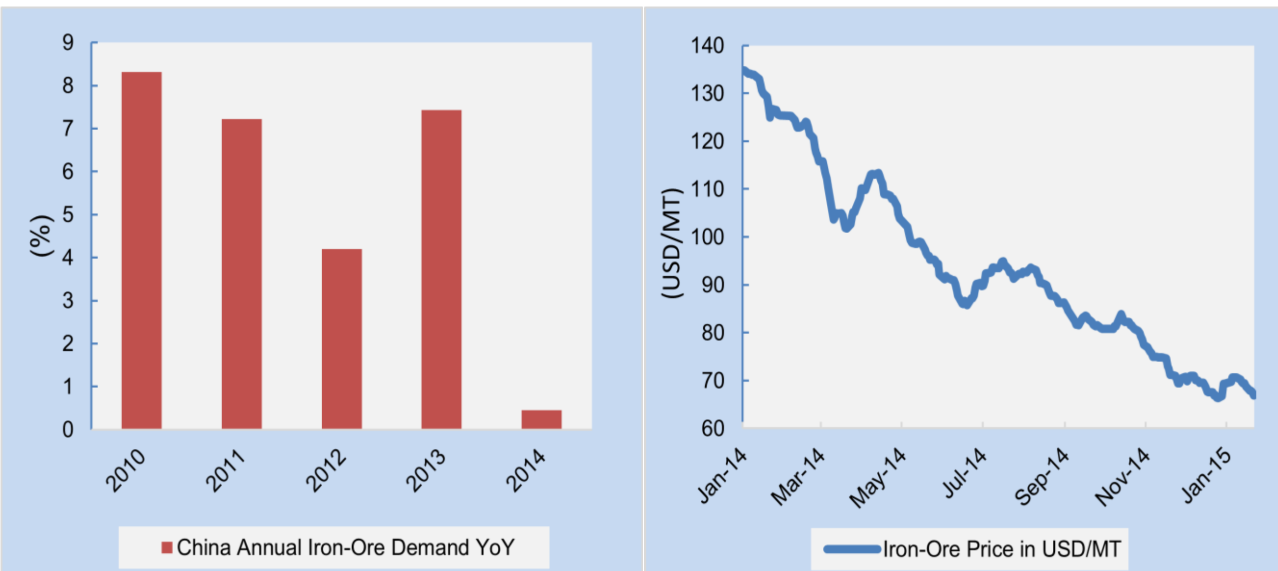

Figure 1. China annual iron-ore demand YoY and iron-ore price in USD/MT. *Source: Bloomberg*

Some smaller miners have already revealed impacts of this severe price slump. Risk Management Institute detects that some small-cap companies like Atlas Iron, Mount Glibson Iron, and BC Iron have experienced significant RMI 1-year Probabilities of Default (RMI 1-year PDs) surges over the past one year, translating to a deteriorating credit profile. These companies have faced various forms of distress, such as write-downs, layoffs, and closures of mines. Even some mid-sized miners have become victims under this price plummet. Cliffs Natural Resources Inc, the largest US iron-ore producer, announced that it has shut down production at Bloom Lake iron-ore mine and ended the flawed expansion in Canada on Jan 23. On the same day, Australia's forth iron-ore miner, Arrium Ltd, said it had been forced to close one of its two mines, slash 580 jobs, and would book USD 1.07bn write-down.

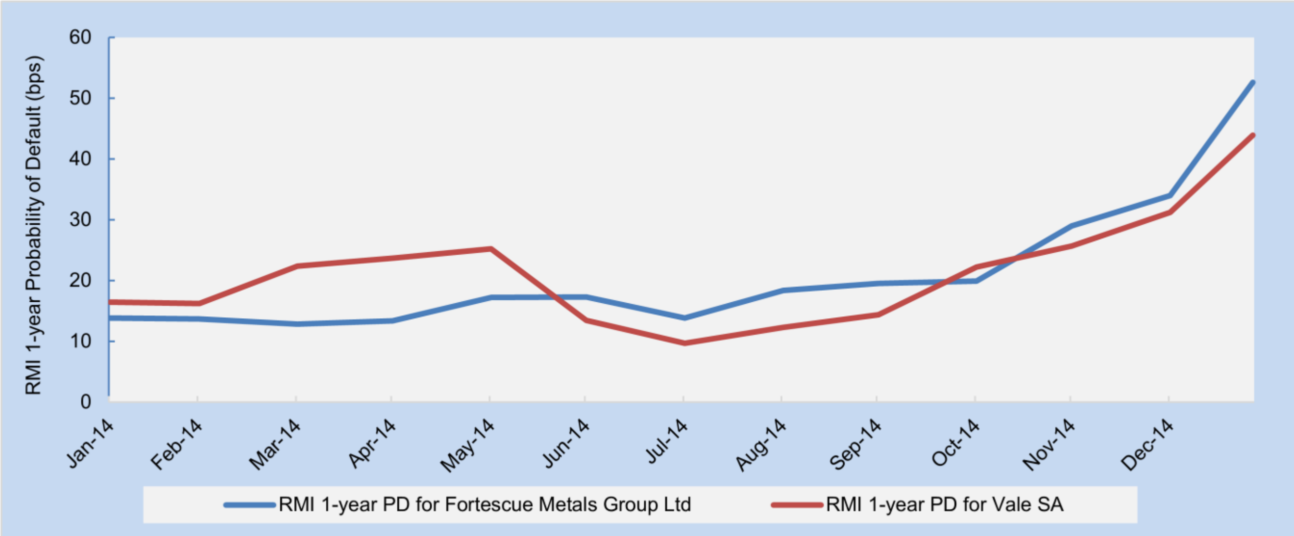

Figure 2. RMI 1-year PDs for Fortescue Metals Group Ltd and Vale SA. *Source: Risk Management Institute*

The big players' attempts to expel the smaller miners from the business may work out to some degree, but it also caused some pains for the majors. On Jan 24, S&P cut its rating on Vale, the world's biggest iron-ore producer, concerning the weakness in the iron-ore market will erode the company's ability to generate cash thus boosting the company's debt burden. In addition, Australia's third largest iron-ore miner, Fortescue Metals Group Ltd, a pure iron-ore play, has seen its market cap crumble more than 64% from 2014 to date. Figure 2 displays RMI 1-year PDs for Vale and Fortescue Metals Group from the beginning of 2014 to Jan 26, 2015, which have risen to 43.92bps and 52.61bps. Although the increments of PDs are not as high as smaller ones, they have arrived at a three-year and a five-year high respectively. Nonetheless, as cheaper energy reduces the cost of mining and shipping, the swelling low-cost supply and a maturing steel appetite of China will drive the price even lower in 2015, spurring a glut.

Credit News

Russia downgraded to 'junk' by S&P

Jan 26. Russia's credit rating was cut to "junk" by Standard & Poor's on Monday night, underscoring the dramatic economic deterioration in the world's largest energy exporter. Moody's and Fitch have also cut their ratings for Russia in the past month, but both still rate it at one notch above junk. Traders said that since two of the three major agencies still rated Russia at investment-grade, the S&P downgrade should not trigger a wave of automatic selling. However, economists are anticipating a painful recession in Russia this year, with the IMF predicting a 3% contraction followed by a 1% drop in 2016. (FT)

As oil slides, Singapore oilfield service firms struggle to refinance debt

Jan 26. Two Singapore oilfield service firms are finding it tough to refinance debt maturing later this year as the slump in crude prices has made investors and lenders hesitant, banking sources said. Singapore's oilfield services sector saw its fixed assets more than triple in five years, according to Thomson Reuters data, but is being threatened by cost-cutting at oil companies that will likely reduce demand for oilfield services. "We continue to actively bid for new projects in our target markets and remain confident of the group's business prospects as well as our ability to meet existing debt obligations when these come due," Swiber said in an emailed statement. (Reuters)

Euro, stocks fall as anti-austerity party wins Greek election

Jan 26. The euro skidded to near an 11-year low on Monday as Greece's Syriza party promised to roll back austerity measures after sweeping to victory in a snap election, putting Athens on a collision course with international lenders. US stock futures fell 0.6% while the Nikkei futures also dropped about 0.5% from the local close on Friday on heightened concerns the Greek election results could lead to renewed instability in Europe. The ECB's plan to pump more than a trillion euro to the banking system in the coming year and a half is underpinning risk sentiment, which boosted European share prices to seven-year highs on Friday. (Reuters)

Property cash crunch worsens as trusts pull funds

Jan 26. China's investment trusts are pulling financing for the real estate industry as Kaisa Group Holdings Ltd.'s missed payments heighten default concerns. While Premier Li Keqiang's relaxation of property curbs has helped underpin a rebound in home sales, investors are speculating more developers may be caught up in an anti-corruption drive. "We are bearish on the property industry," said Cheng Peng, head of investments at Beijing-based Genial Flow Asset Management Co. Chinese property developers have sold only CNY 6.5bn of bonds in onshore and offshore market so far this month, set to make it the slowest January since 2010, according to data compiled by Bloomberg. (The Business Times)

S&P to pay USD 77mn to settle US civil charges over ratings

Jan 21. Standard & Poor's will pay USD 77mn and be barred for one year from rating commercial mortgage-backed securities, in an unprecedented settlement with US and state regulators who accused the US credit rating agency of misleading investors. S&P neither admitted nor denied wrongdoing in the settlement announced on Jan 21. "While the one-year suspension is a black eye for S&P, it will likely have minimal financial impact given S&P's low share in this niche segment," a Piper Jaffray report said. Asked on a call with reporters whether the SEC was investigating other credit rating agencies for similar violations, Ceresney said the commission is very focused on the issue. (Reuters)

Debt and deflation darken China's economic outlook (SCMP) (Subscription required)

Korean economy grows at slowest pace in more than two years (Bloomberg)

Regulatory Updates

European banks warns capital rules will blunt QE

Jan 26. The effects of the European Central Bank's EUR 1.1tn quantitative easing are expected to be blunted by tough capital rules designed to curb risks in securitizations. Deutsche Bank, Germany's largest bank, and Société Générale, France's second-biggest bank, expressed the concern most forcefully, as put by bankers meeting in private sessions at the World Economic Forum in Davos. (FT)

UBS deferred bonuses, Barclays lawsuit

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Shanghai CBRC seeks stress test on property loans (Bloomberg)

China looking to ease foreign-investment rules covering internet companies (WSJ)

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