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US corporate vulnerability at highest levels since the Great Financial Crisis

by KHAW Ker Wei

The top 5th percentile of the RMI-CRI Corporate Vulnerability Index (CVI_{tail}) for the US corporate sector has surged to levels last seen during the aftermath of the Great Financial Crisis. CVI_{tail}, which is constructed with the RMI-CRI 1-year Probability of Default (PD), is a stress indicator for the group of companies that are most likely to run into credit issues within the next one year. A higher CVI_{tail} measure indicates greater financial distress. The index value more than doubled from 147.1bps at the beginning of the year to 335.25bps as of 31 December 2015 (see Figure 1), capping off a year of strong headwinds in the global economy and tectonic-scale disruptions in major industries.

In 2015, companies tracked by CVI_{tail} lost about 70% of their market capitalization on aggregate, compared to the beginning of the year. The bulk of these losses came from the energy and the mining industries, with more than USD 70bn in market value wiped off the balance sheets of once-mighty companies like Freeport-McMoRan, a global mining company and SunEdison, one of the largest renewable energy companies in the world.

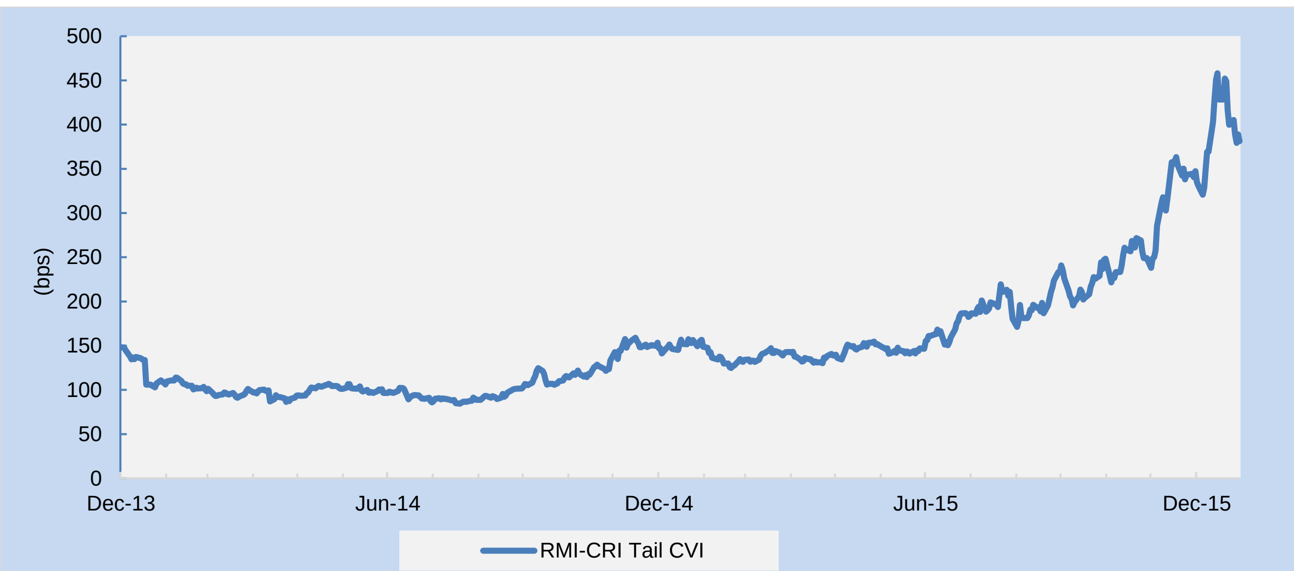

Figure 1: RMI-CRI Tail Corporate Vulnerability Index *Source: RMI-CRI*

The US became the world's largest oil producer in 2014, after the exploration and production of shale oil accelerated earlier this decade. Just before 2014 came to a close, the Organization of Petroleum Exporting Countries (OPEC) announced that it would maintain its production output, despite the prospect of global oversupply. The OPEC members had decided that the decision was necessary to protect their market share, by squeezing out producers of costly oil pumped from ultra-deep sea wells or the tar sands. As expected, the price of crude oil plunged. The price of US light crude was slashed by almost half as 2015 ended and traded near the USD 30 mark in January 2016.

Just as intended by OPEC, the oil and gas industry turned into a game of attrition. At present price levels, most oil exploration and production projects do not make sense. Consequently, the PDs for these upstream businesses, especially the smaller players, have increased significantly. Some companies, including Swift Energy and Quicksilver Resources, have already defaulted. Others, such as Linn Energy, have actively worked on repairing their capital structure – often at the expense of existing creditors. Still, industry watchdogs have warned that the number of oil and gas companies in financial distress would increase this year and that, in turn, could set off consolidation activities in the industry.

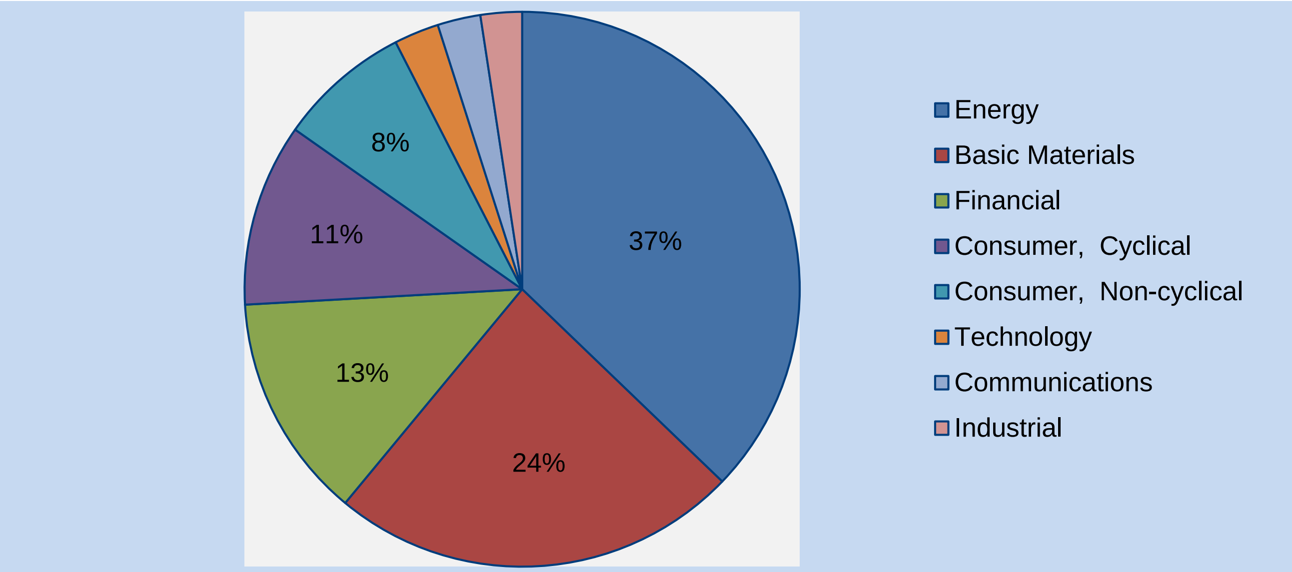

Figure 2: Top 5th percentile companies in the RMI-CRI CVI by industry (based on market capitalization as of 31 December 2015)
Source: RMI-CRI

Steelmakers in the US also had a bad run in 2015. While the US steel demand was already contracting, the influx of cheap steel from China heaped further pressure on the local steel companies. China, as the global manufacturing powerhouse, has propped up commodity prices for years. The economic engine appeared to have finally run out of steam during the first half of the decade, as demand and production slowed. With the decline in steel consumption in the domestic Chinese market, the extra capacity flowed into the global markets. For the first nine months of 2015, total steel exports from China expanded by about 27% year-on-year. The pricing pressure and weak demand affected even the biggest players in the industry. The PD of United States Steel, the largest steel company in the US, climbed to a 6-year high in 2015 as a result of revenue loss and shrinking market capitalization. However, these companies may finally find some relief this year when the anti-dumping duties come into full swing, shielding the local steel market from cheap Chinese imports.

Beyond the commodities space, a number of companies in the US retailing industry look to be in financial distress as their traditional business models continue to be challenged by technological and trend disruptions. For instance, Aéropostale, once a popular teen fashion, has lost its appeal over the years. The company was too slow in modernizing its business and was left behind after its target audience jumped onto the fast-fashion bandwagon. The company concluded the year 2015 with its PD hovering at record high levels, as a result of its loss-making business. The retailing sphere in the US is likely to witness further credit events and industry consolidations this year, continuing the trend from 2015, when big names like American Apparel and Quiksilver filed for bankruptcy protection.

Within the first month of 2016, the US corporate sector was pummeled by shocks in the global stock markets. The S&P500 Index, which measures the performance of the broad US economy, retreated by almost 10% before paring part of its losses to end at 1,940.24 points in January 2016. The US Federal Reserve, which raised interest rates for the first time since 2006 in November 2015, now faces the prospect of backpedaling on its decision. Industry watchers have suspected that the interest rate hike came a tad too late, just as the economy was already running its final leg in the "new normal" environment. Indeed, as the US corporate sector begins to look increasingly fragile, the tardy action could prove to be costly, now that the central bank is left with little to respond to a recession, which stands at a notable 20% chance according to leading global economists.

Credit News

Global steel industry likely to return to growth

Jan 31. The global steel industry is expected to edge back into growth this year in spite of waning Chinese demand and low metal prices. World production of crude steel will rise by 0.15% in 2016, according to a Financial Times survey with renewed expansion in the US and Europe offsetting a second consecutive year of contraction in China, which makes nearly half of all steel. A supply glut and faltering demand made steel cheaper in 2015 than at any time in the past decade. Some relief could come from a reversal in the surge of cheap exports from China. (FT)

Taiwan GDP shrinks in fourth quarter as slower China drags

Jan 29. Taiwan's economy contracted on a yearly basis for a second straight quarter as China's economic slowdown dragged on the island's exports. Gross domestic product fell 0.28% in the three months through December from a year earlier. The economy grew 3.22% at a seasonally adjusted annualized rate, the most since the third quarter of 2014, as lower crude prices helped consumers. Domestic consumption grew 1.64% last quarter, compared with 0.5% in the prior period and 2.81% a year ago. While both shares and home prices fell last year, lower crude prices helped consumers in the oil-importing economy save some cash. (Bloomberg)

Total bank lending in Singapore declines in December

Jan 29. Bank lending increased 1.1% from a year ago in December, marking the slowest growth rate since 2002. Data from the Monetary Authority of Singapore showed that the amount of loans issued to commerce and manufacturing firms dropped 5.5% and 3.2% respectively. Business loans decreased 3.7% from a year ago while consumer loans fell 2.7% in the same period. Economists expect a tepid loan growth rate moving forward as economic activity is poised to slow down during the first half of 2016. (Straits Times)

Fortescue says it is determined to shed debt load

Jan 28. Fortescue Metals Group Ltd. could buy back hundreds of millions of dollars' worth of debt in the coming months, taking advantage of record-low prices on some of its bonds and continuing a strategy of reducing its indebtedness. Investors have previously cited Fortescue's large debt pile as a burden on the stock that made the miner more vulnerable to plummeting commodity prices. Last year, the company refinanced some of its debt, accepting an eye-watering 9.75% interest rate on its newest bonds to push out its earliest maturity to 2019 from 2017. (WSJ)

IMF and World Bank move to forestall oil-led defaults

Jan 27. The IMF and the World Bank are in discussion to rescue distressed oil companies in emerging markets. Representatives from both organizations are meeting in Azerbaijan between Jan 28 and Feb 4 to draft a possible USD 4bn financing package, which will be used to fund companies in financial difficulty. The World Bank estimated that oil prices will average USD 37 per barrel this year and warned of the significant risks to both producers and commodity markets. (FT)

Singapore home-price drop in 2016 might prompt reversal of curbs (Bloomberg)

Fonterra cuts milk price forecast on weak global market (Bloomberg)

Verso Corp. files for Chapter 11 bankruptcy protection (WSJ)

Regulatory Updates

British regulators help Iranian banks come in from the cold

Jan 31. The Bank of England reactivated the operating licenses of three Iranian banks – Persia International Bank, Melli Bank and Bank Sepah International after world powers dropped international sanctions against Iran. Regulators have been working with the banks to prepare for a reintegration into the financial system but it could take several more months before they become operational. Many of the Iranian lenders have yet to improve their internal controls and corporate governance to meet present standards. The Iranian banking system has also not adopted any of the Basel III recommendations and lenders would have to revise their capital and solvency requirements. (FT)

Bank of England boosts capital rules for big retail lenders

Jan 29. Lloyd Banking Group Plc and other big UK retail lenders face new regulatory capital requirements as the Bank of England moves bolster the industry's ability to withstand shocks without hurting the economy. The buffer, which must be met with the highest quality capital, will be set at 0% for lenders with less than GBP 175bn of total assets, rising to 2.5% of risk-weighted assets for the biggest firms. That equates to an increase of about 0.5% in equity requirements for the UK financial system on aggregate. The new capital requirement will be applied in 2019. (Bloomberg)

Taiwan to punish nine banks on yuan derivative business

Jan 27. Taiwan's Financial Supervisory Commission (FSC) will punish nine banks for inappropriately selling yuan derivative products to clients. Local banks have been forced to realise the losses stemming from client-traded target redemption forward (TRF). The yuan's sharp depreciation this month has turned against their clients as they had bet the currency would rise. Worries of growing defaults have hit banking stocks, which are hovering at their lowest level in more than two years. (Reuters)

SGX to relook minimum trading price, quarterly reporting in sweeping review (Business Times)

RBNZ says further easing may be needed to boost inflation (Bloomberg)

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