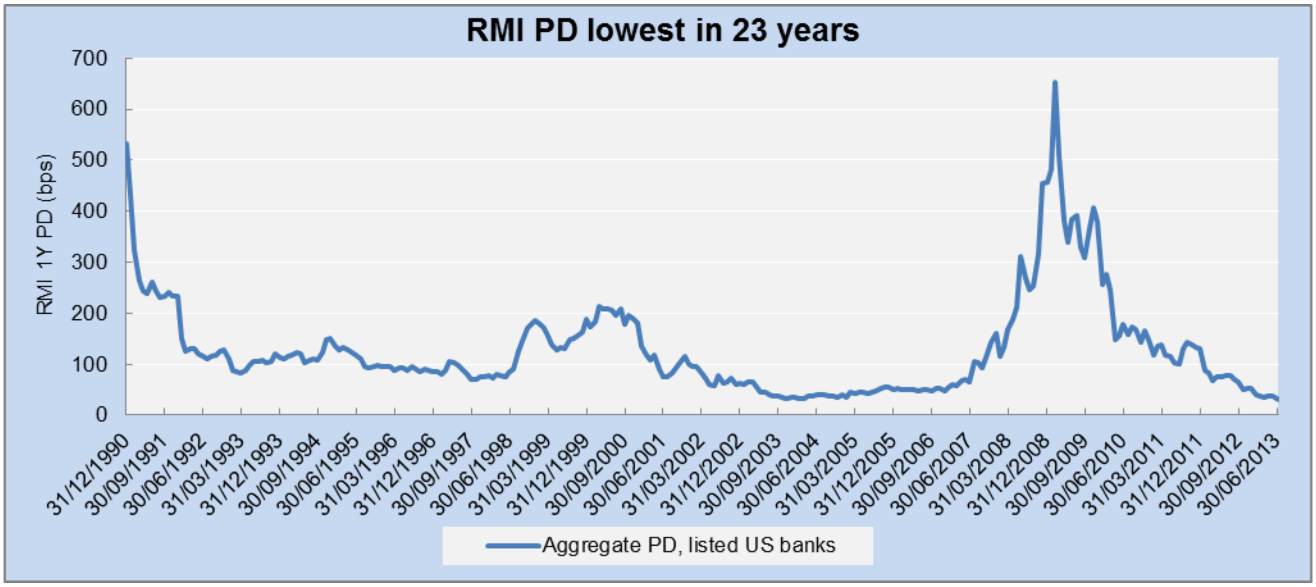
Weekly Credit Brief

Jul 16 - Jul 22 2013

Story of the Week

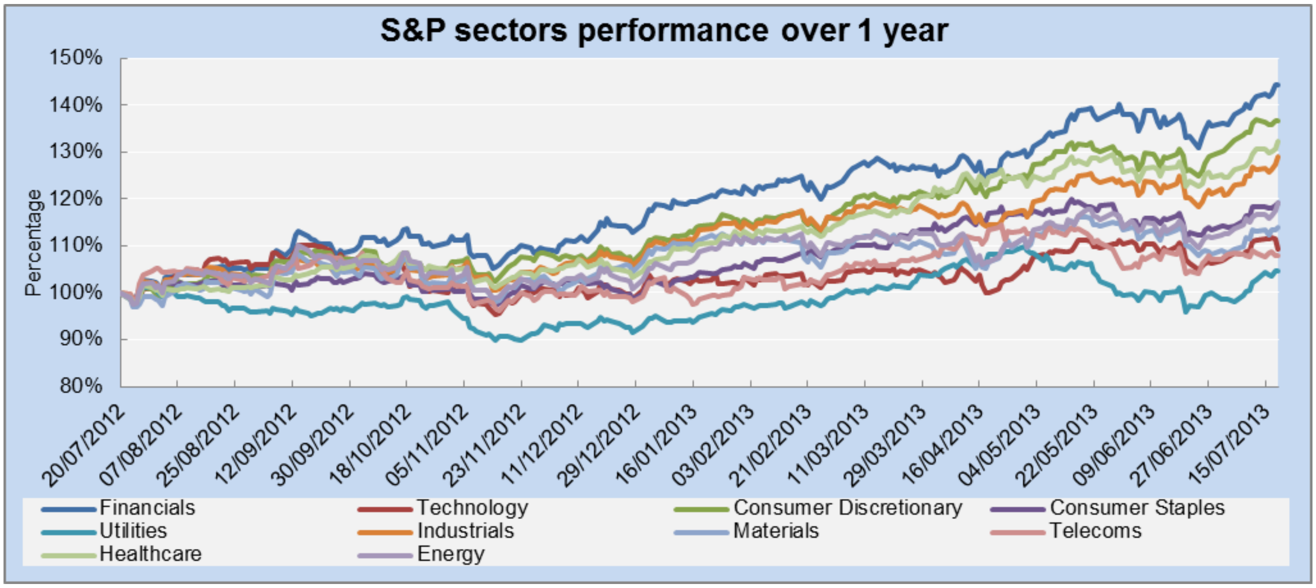
Default risk for US banks at 23-year low

The credit outlook for US banks has improved significantly in the past year. As shown in the chart below, the aggregate 1-year RMI probability of default (RMI PD) for US banks has reached a 23-year low on the back of rising earnings and greater investor confidence.



The revenue of US banks for the first half of 2013 climbed to USD 215bn from USD 208bn (the figures exclude reported accounting gains and losses tied to the value of the banks' own debt) a year earlier. Goldman Sachs Group led the biggest U.S. lenders with a 13% increase in first-half revenue. Morgan Stanley's rose 8.4%, Citigroup Inc. 4.3%, JPMorgan Chase & Co. (JPM)'s 3% and Bank of America's 0.2%. Of the U.S. banks that reported second-quarter results before July 19, more than 90% beat analysts' estimates. Revenue surpassed forecasts in 70% of the time, compared with 20% in the first quarter.

The promise of better returns and the cleaning up of balance sheets have greatly improved investor expectations of US financials. The financial sector, plagued with lawsuits and falling earnings, has been unpopular with investors over the past few years. As such, many of these stocks were the worst performing in the fall of 2011. However, recent developments have attracted investors back to financial stocks. As such, the prices of bank stocks have risen significantly over the past year. As a proxy, we compare the returns of the Standard & Poor's 500 Financials Index against the other S&P sector indices for the past year. As seen from the chart below, the financials index is the best performing sector with a 1 year gain of 44%.



A larger market cap also has credit implications. An increase in market cap translates to a higher distance-to-default (DTD), or volatility adjusted leverage. The DTD is a key factor in the RMI PD model. Thus, the increase in market cap has resulted in a lower default risk for the sector.

Despite these positive developments, many are concerned that the new bank regulations and capital requirements are likely to hamstring future growth. As such, the visibility into the credit outlook for US banks remains a little unclear.

Sources:
Gorman to Moynihan vindicated as big banks' revenue gains (Bloomberg)
Financial stocks hit 2011 low (CNBC)
BofA to Goldman lead tsunami of bank bond sales (Bloomberg)

In the News

China freeing lending rates puts focus on saver returns

Jul 22. China's central bank removed floor restrictions on lending rates late last week, in a move intended to continue financial reforms away from the current state-directed, subsidized credit model. The floor was previously set at 30% below the benchmark rate. While the change may help less risky enterprises secure cheaper funding after last month's credit crunch, analysts are concerned that banks involved in large corporate lending will suffer from increased interest margin pressure. Freeing up restrictions on deposit rates – seen as the most critical and risky part of interest-rate liberalization – has yet to occur, with the central bank highlighting the country's lack of a deposit-insurance system to protect depositors in the event of bank failure. (Bloomberg)

Indonesia bonds gain, rupiah ends record losing run on inflows

Jul 22. Indonesia's 5-year sovereign bonds posted gains as capital flows into the country reportedly turned higher for the past week. The inflows are attributed to foreign investors purchasing the nation's debt on attraction to the highest 5-year yield in more than 2 years, which hit 7.68% on July 16. Yields of 5-year Indonesian bonds are more than twice as high as similar-maturity bonds of the Philippines and Thailand. (Jakarta Globe)

Fitch affirms Brazil's ratings at 'BBB'; outlook stable

Jul 18. Fitch Ratings affirmed Brazil's investment-grade sovereign credit rating, despite structural weaknesses in its public finances, relatively high government indebtedness, low savings and investment rates and a lack of substantive reforms to improve competitiveness and fiscal flexibility. The credit rating agency said recent policy missteps can be corrected and cited Brazil's economic diversity, strong shock-absorption capacity underpinned by a robust external balance sheet and an adequately capitalized banking system as its key rating drivers. Fitch also said that the stable outlook reflects its assessment that upside and downside risks to Brazil's rating are currently balanced. (Reuters)

ECB tweaks collateral rules to increase ABS eligibility

Jul 18. Funding to European small and medium enterprises (SMEs) are set to expand after the ECB announced last week that it was expanding the eligibility of asset-backed securities (ABS) for use as collateral. The required credit assessment on “plain vanilla” ABS will be relaxed from ‘AAA’ ratings from two rating agencies to ‘A’ ratings from both agencies. However, retained covered bonds will be subject to valuation markdowns to compensate for the EUR 20bn that will be freed up by the change. The move underscores the ECB’s continuing efforts to boost bank lending, with the total value of assets eligible as collateral at EUR 14.5tn in Q1 2013 as compared to EUR 9.4tn in 2007. (Reuters)

Argentina bond prices rise on IMF move in debt case

Jul 18. Argentina’s USD-denominated discount bond prices rose sharply after the IMF surprised investors by saying it plans to ask the US Supreme court to review Argentina’s case in its legal battle with holdout creditors, because of the implications it could have on sovereign debt restructurings. Five-year credit default swaps (CDS) fell more than 700bps from their July 17 close to 2079bps and one-year CDS fell almost 500bps between July 16 and 17. Argentina is seeking to void an October 2012 ruling by the 2nd US Circuit Court of Appeals in New York that requires it to treat all creditors equally. (Reuters)

Liquidity myth seen by JPMorgan as trading gains

Jul 18. Data from the Financial Industry Regulatory Authority and the Federal Reserve showed that average daily trading volumes in US investment grade corporate bonds have increased 18% since the end of April from a year ago. Bond dealers on the other hand, reduced their holdings of the bonds by 54% in the five weeks ended July 3. Analysts say that the recent volatility in US corporate bonds has not significantly affected the trading volumes or the bid/ask spreads of the largest US corporate bonds, which shows that broker dealers have become a lot more efficient and can sustain a high volume of bond trading even with a small inventory. Bond brokers and dealers are now focused on trading on behalf of clients instead of betting on the direction of the market. (Bloomberg)

NongHyup issues KRW 40bn in illicit loans

Jul 17. South Korea’s financial regulator, the Financial Supervisory Service (FSS) recently discovered that NongHyup Bank has been engaging in a series of illegal activities, adding on to the bank’s loss of KRW 55bn announced last week. It was found that within a short period of three months in 2012, 37 insurance agents of NongHyup Bank had engaged in KRW 41.4bn of unauthorized lending. The FSS also revealed that NongHyup Bank lost KRW 345.8bn on real estate project loans worth KRW 655bn, which was attributed to lax screening of project financing applications. NongHyup Bank had also engaged in unfair lending to its affiliate company, the National Agricultural Cooperative Federation (NACF); the bank had provided NACF with a discounted loan rate of 5.27% from the initially calculated rate of 5.79%.
(The Korea Herald, GlobalPost)

Malaysia bonds, ringgit slide this week on inflation speculation (Bloomberg)

Ireland passes IMF-EU bailout review (Reuters)

Fitch cuts European Financial Stability Facility to ‘AA+’ (Reuters)

BOJ policymakers agree flexible operations curb bond volatility (GlobalPost)

Freddie Mac said to plan USD 400mn sale of risk sharing debt (Bloomberg)

Fitch downgrades French banks, regions (Bloomberg)

Singapore exports in longest slump since global crisis (Bloomberg)

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