Downward pressure for global consumer-cyclical firms amid COVID-19 outbreak

by Li Mengyan

Industries within the consumer-cyclical sector, which provide cyclical goods and services to consumers, such as steel, tourism-related and the construction industry, are extremely vulnerable during an economic downturn. After the emergence of COVID-19, tourism has been suspended, construction has been paused and airlines' flights has been cancelled. The credit profile of globally-listed firms in the consumer-cyclical sector deteriorated, as captured by the surge of NUS-CRI Aggregate (mean) 1-year Probability of Default (Agg PD) of all consumer-cyclical firms in Figure 1 below. Looking ahead, considering that there are yet any signs of the virus transmissions slowing down, globally-listed consumer-cyclical firms are facing higher probability of default compared to the global average. Although the NUS-CRI Aggregate (mean) Forward 1-year PD[1] in Figure 1 shows a downward trend for the next 3 month, indicating that all globally-listed firms and consumer-cyclical firms will gradually improve their credit quality from the current status, the Forward PD remains elevated and far higher than the PD level before the virus outbreak.

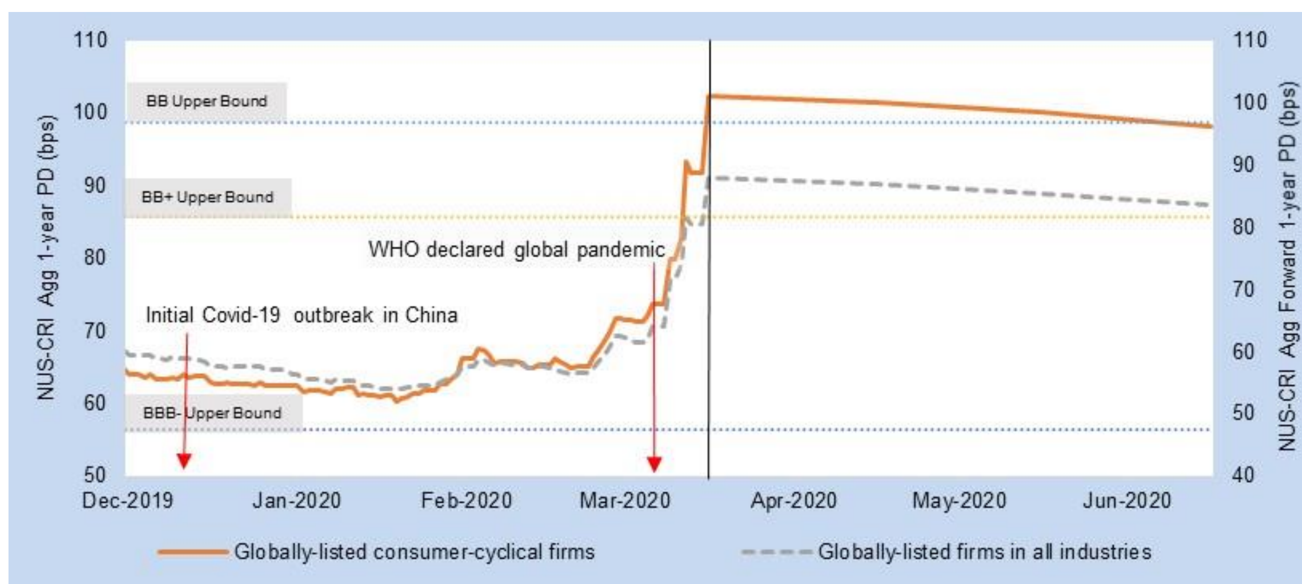

Figure 1: NUS-CRI Agg 1-year PD for globally-listed firms and consumer-cyclical firms (LHS); NUS-CRI Agg Forward 1-year PD for globally-listed firms and consumer-cyclical firms based on information available in Mar 2020 (RHS). *Source: NUS-CRI*

According to the PD model of NUS-CRI[2], liquidity and Distant-to-Default (DtD) are two of the main drivers for PD changes of globally-listed consumer-cyclical firms from Dec 2019 to Mar 2020. Over the past few weeks,

[1] The Forward PD estimates the conditional credit risk a firm faces in its future and works similarly to a forward interest rate. For instance, the 3-month Forward 1-year PD is the probability that the firm defaults during the period from 3 months onwards to 1 year plus 3 months, conditional on the firm surviving the next 3 months.

[2] The results were produced with iRAP (intelligent Risk Analysis Platform), which is a software developed by CriAT (https://www.criat.sg/) for conducting both firm-level and portfolio-level credit analysis. iRAP utilizes the NUS-CRI Probability of Default (PD) model and links to the live NUS-CRI database offering PDs on over 70,000 exchange-listed corporates globally.

credit spreads in the corporate bond market have widened substantially according to Morningstar Corporate Bond Index. Corporate bonds are trading at the second-widest level in 20 years, indicating an overall tightened liquidity condition. When the economy suffers, consumer-cyclical firms generally underperform most of the other sectors due to its high sensitivity to consumer spending, which is closely related to consumer's confidence. Since the Covid-19 started to circulate globally, consumer confidence sentiment has dropped drastically across all regions. On top of that, globally-listed consumer-cyclical firms are getting more leveraged, as reflected by the decreasing Distant-to-Default (DtD) from Jan to Mar 2020 in Figure 2a. As a proxy for leverage level, DtD measures the standardized distant between firms' current asset value and their future obligation. The decrease of a positive DtD means getting closer to the default point.

The change in DtD could be partially explained by the drop in market capitalization and a higher level of volatility-adjusted leverage of globally-listed consumer-cyclical firms. In the year 2019, there was a massive amount of debt issuance due to the low interest rate environment. Over USD 246bn bond issued by globally-listed consumer-cyclical firms will mature in 2020, two-third of which are non-investment grade bonds based on Moody's or S&P's (Figure 2b). Over fears of the Covid-19 outbreak, firms are rushing to raise funds to cover their existing debt and facilitate liquidity. However, both corporate and government bond market is now under selling pressure, and the stress in corporate bond market raised up the cost of capital for all borrowers. Central banks around the world have cut key rates and launched stimulus programs to protect the economy against the Covid-19 outbreak. However, despite all the measures taken by policymakers, the global financial markets still perform their worst day in almost 30 years: stock markets collapsed and triggered the circuit breakers, while bond and commodity price fell in a simultaneous selloff. The overall tightened liquidity condition in the global financial market makes consumer-cyclical firms difficult to raise funds and repay current obligations.

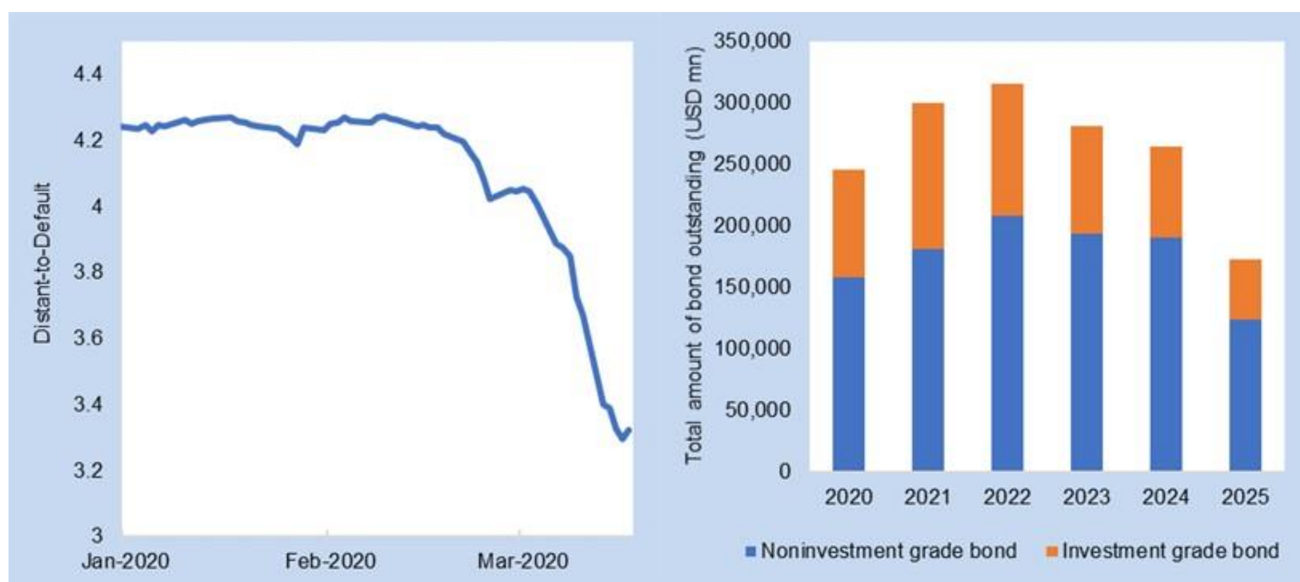

Figure 2a (LHS): Distant-to-Default of globally-listed consumer-cyclical firms from Jan to Mar 2020; Figure 2b (RHS): Total amount of bond outstanding issued by globally-listed consumer-cyclical firms. *Source: NUS-CRI, Bloomberg.*

According to the mapping of NUS-CRI Probability of Default Implied Rating (PDiR)[3], there were 44.68% of consumer-cyclical firms in the globe that fall into the category of junk-rated firms on Jan 2020, which had its PDiR lower than or equal to BB, while currently the percentage has increased to 56.57%. The PDiR migration is skewing towards the non-investment grade, showing the deterioration of credit profiles of corporates across the board. Looking into the future, although the mean of Forward PD is declining, more firms would see its PD increased. The proportion of junk-rated globally-listed consumer-cyclical firms is expected to further rise to 59.36% in Jun 2020 based on Forward 1-year PD. Within the non-investment category, more firms are falling into B and CCC class, while there will be fewer firms in the lowest C and CC class. This observation can explain the

[3] The NUS-CRI Probability of Default Implied Rating (PDiR) provides a more conventional interpretation of PDs – it translates NUS-CRI 1-year PDs to letter ratings by taking reference from the historical observed default rates of S&P's rating categories.

downward trend of Forward PD as shown in Figure 1. Despite all the measures taken by governments around the world, the credit risk of global consumer-cyclical firms remains elevated due to the gloomy economic outlook and stagnant consumer spending, when fears of a recession and worries of surging debt default risk awake.

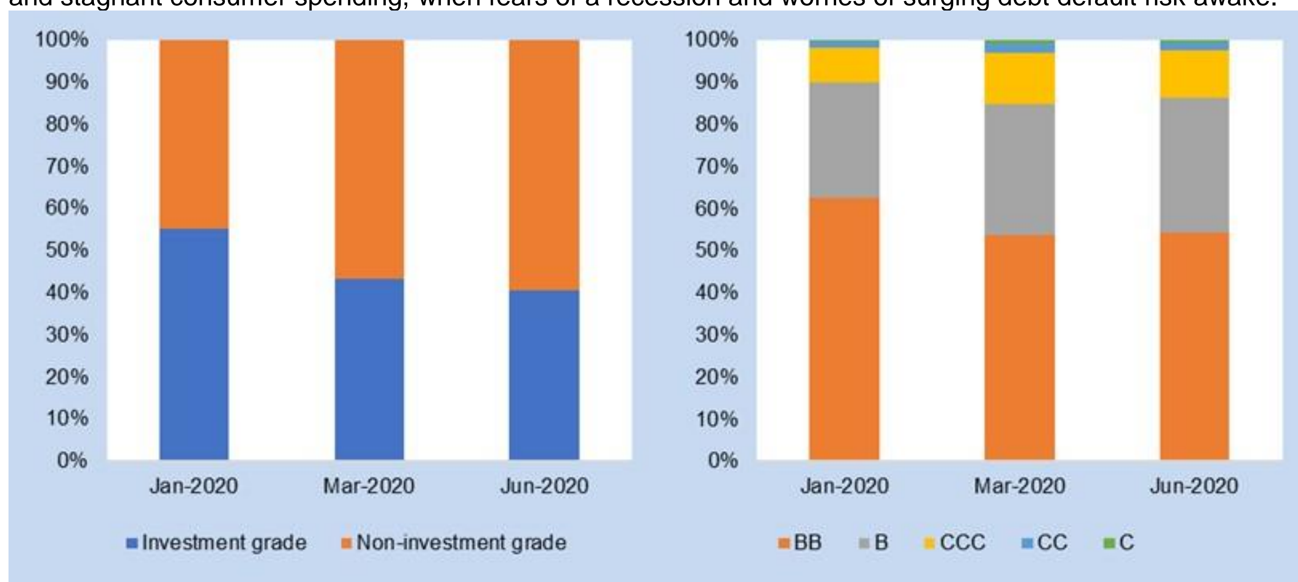

Figure 3a: Investment grade and Non-investment grade consumer-cyclical firms based on PDiR on different time points; Figure 3b: Non-investment grade consumer-cyclical firms based on PDiR on different time points. *Source: NUS-CRI*

Credit News

Coronavirus threatens USD 32tn of Asia corporate debt

Mar 23. Since the global financial crisis to 2019, companies across the Asia-Pacific outstanding corporate debt has doubled to USD 32tn. Because of the coronavirus-caused cash crunch, companies of all industries face a higher risk of default. As a consequence, some of them try to raise equity as they struggle with debt repayment. Other companies draw down all their available liquidity lines or take new loans to prevent running out of cash even though this type of debt may be expensive. Directors of already insolvent businesses consider invoking so-called safe harbor laws that give legal protection during restructuring proceedings. Another way out is being bailed out by the government like what New Zealand did, which bailed out the country's national airline with a loan since only governments can prevent these businesses from failing. (FT)

Corporate borrowing costs soar amid default fears

Mar 21. Despite bank interest rate cuts, borrowing costs for companies are rising as external shocks such as the coronavirus pandemic, oil price crash and asset price drops are causing investors to pull out funds from corporate bonds and put their money into short term government bonds instead. The average yield for investment-grade corporate debt has risen from 2.26% to 4.7% in just two weeks. With many companies focusing on increasing liquidity amidst the uncertain economic environment, there was roughly USD 60bn bonds sold by investment-grade companies in the US in the past week. Those issuers, however, are limited to high-quality names and those outside the very top tier still shut out from the capital markets. (FT)

Federal Reserve buys more mortgage bonds as rates rise above 4%

Mar 21. The Federal Reserve accelerated its purchases of mortgage bonds on Friday, after purchasing more than USD 14bn on Thursday and USD 17bn between Monday and Wednesday. These purchases were part of the Fed's plan to buy at least USD 200bn in mortgage-backed securities in the next month to promote

from what it called “smooth market functioning”. However, despite the Fed’s intervention, mortgage-backed bond markets still faced great selling pressure. The difference in yields between mortgage-backed bonds and comparable Treasury securities reached 1.3% on Thursday, the highest level since 2009 while the national average rate for a 30-year mortgage rose to over 4% in the past week. The disorder in the mortgage bond market can be attributed to the investors’ growing need to raise cash, according to analysts. (FT)

Federal Reserve takes steps to support US municipal bond market

Mar 20. The Federal Reserve announced to expand a program to support local government financing through a lending facility for money market mutual funds. Borrowing costs have surged by nearly one percentage point in the past week since investors pulled USD 12.2bn from municipal mutual funds within a short period. The Federal Reserve plans to widen up the money market mutual fund liquidity facility to backstop money market funds that face redemptions and to provide loans that are secured by high-quality municipal debt with maturities up to a year. (FT)

US oil companies race to restructure debt

Mar 19. As oil prices collapse and bond yields soar, independent US energy producers need to find new ways to restructure debts and stay afloat in the market. Investors of shale bonds are demanding higher risk premiums for the rising default risk caused by an unprecedented drop in oil demand due to the coronavirus pandemic and the Russia-Saudi Arabia oil price war. Investment budgets of energy companies are cut down to preserve liquidity while capital spending is reduced as well. This means production volumes are set to taper off, closing revenue opportunities even if oil prices rebound. As yields have increased, replacement debt also becomes more costly and oil and gas firm bankruptcy risks will rise. (FT)

Long-duration bond funds thrive amid market carnage (WSJ)

Banks take far less than offered in repo operations (WSJ)

Bond market cracks open for blue-chip companies — then slams shut (WSJ)

Regulatory Updates

Fed, other regulators ease constraints for virus-hit borrowers

Mar 23. The Federal Reserves and other U.S. agencies allow banks to have more leeway to ease the debt burdens for borrowers that were hit hard by the coronavirus. This includes allowing banks in reducing interest rates or giving borrowers more time to repay their debt without being labeled as TDR (troubled debt restructuring). In other words, the status of those loans will not be automatically downgraded. This should encourage the credit flow and ease burdens on businesses and consumers during the outbreak. Also, national banks are allowed to extend their maturity limits temporarily and regulators are also working on relaxing accounting rules that affect banks. (Bloomberg)

ECB to launch EUR 750bn bond-buying programme

Mar 19. Facing the worsening economic and financial turmoil caused by the coronavirus pandemic, the European Central Bank (ECB) planned to buy an extra EUR 750bn of bonds and issued a “no limits” commitment to defend the Eurozone on Wednesday night. The ECB also planned to expend the range of assets eligible for purchase and to ease collateral standards to allow banks to raise money against more of their assets, which triggered a rally in Europe’s equity and bond markets on Thursday morning. European governors and economists expressed their supports for the ECB’s measures and considered that it was now time to put forward aggressive fiscal policy to repair market confidence. The ECB was also thinking of

relaxing the self-imposed limits to buy more sovereign bonds in proportion to the weight of each country's investment in its capital to calm the European bond markets. (FT)
MAS sets up USD 60bn swap facility with US Federal Reserve (The Straits Times) **Fed to buy commercial paper to ease market turmoil** (FT)

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