A looming credit crunch threatens the credit health of US non-financial corporates

by Amrita Parab

- **NUS-CRI Forward PD suggests a decline in the credit health of the US non-financial corporates due to tightening credit conditions**
- **A sector-level analysis indicates that the differential deterioration in NUS-CRI Forward PD may be driven by sector characteristics such as cyclicality and indebtedness**

A sharp contraction in the availability of credit to the economy may be imminent as nearly half of the US banks tighten their credit terms. With First Republic Bank being the latest victim, the US banking crisis continues to throw light on the vulnerability of US lenders. Furthermore, as inflationary pressures continued to weigh on the economy, the Fed remained committed to hiking interest rates, with the latest rate hike being the tenth since 2022. Although the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) for US-domiciled publicly-listed non-financial corporates remained stable over the past 12 months, there is growing apprehension that the weakness in the banking system in conjunction with rising borrowing rates may trigger a credit crunch. Looking ahead, the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[1]) for US non-financial corporates crosses the BB+ upper bound in the near term, possibly reacting to the narrowing funding sources, higher refinancing costs, and a potential slowdown in demand.

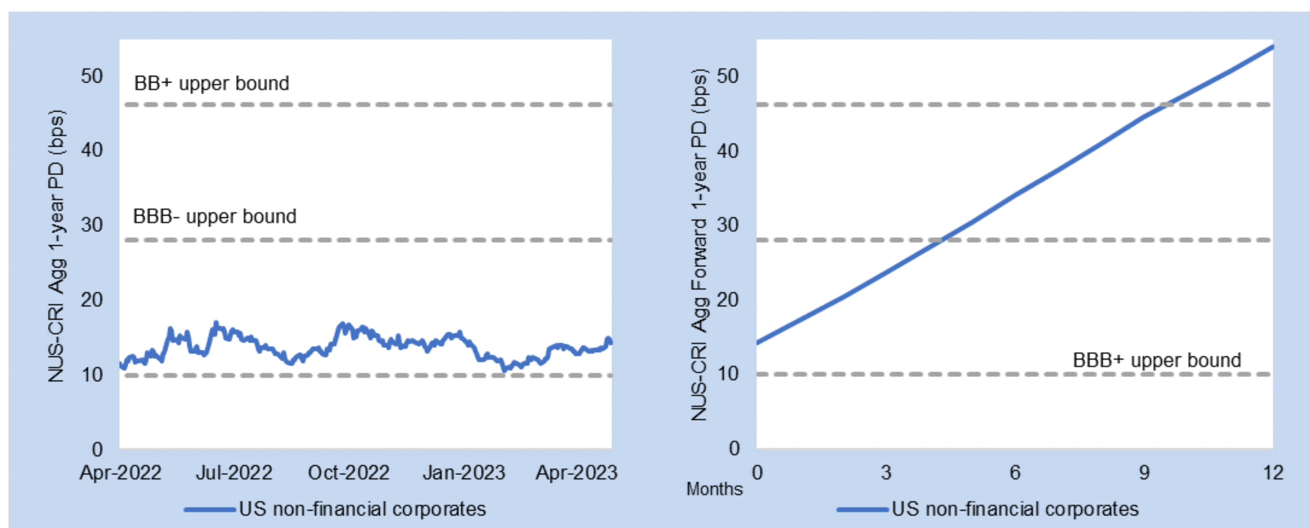

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for US non-financial corporates with reference to PDiR2.0[2] bounds. Figure 1b (RHS): NUS-CRI Forward 1-year PD for US non-financial corporates with reference to PDiR2.0 bounds. *Source: NUS-CRI*

Even before the US banking crisis began, US banks had already started to curtail lending due to recessionary headwinds facing the economy and mounting funding costs. Quarterly growth in credit extended by commercial banks sequentially slowed from a 2-year high of 11.4% in Q4 2021 to 1.9% in Q1 2023. This pullback in lending was further exacerbated by the banking crisis and led to a record contraction of USD 105bn in the last two weeks of Mar 2023. Regional banks, wounded by the crisis, have seen their funding sources deplete rapidly as they reel under a more severe confidence crisis. Regional bank loans account for more than a third of US bank loans and play a key role in providing credit to small businesses, consumers, and commercial real estate projects. Thus, a credit contraction might have a disproportionate impact on the credit health of small and mid-sized US non-financial corporates and the real estate sector. Additionally, lending standards have witnessed a tightening

[1] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months – this is conditional on the firm's survival in the next 6 months.
[2] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation by mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

across the board as seen from the latest data from the Federal Reserve's Senior Loan Officer Opinion Survey (see Figure 2a). Banks attributed the tighter standards to several reasons, such as lower risk appetite, weak loan demand across commercial and household segments, an uncertain economic outlook, and banks' funding and liquidity positions.

Similarly, US non-financial corporates' access to funding via capital markets also remains pressured. As borrowing costs soar, bond issuances have declined and are below historical average levels, with issuances of investment grade and high yield bonds 15% and 45% below 5 years average levels respectively. Lower credit access and high borrowing costs have significantly raised refinancing risk for US non-financial corporates and may push vulnerable ones to default. Following the start of the banking crisis, the amount of US corporate debt trading at distressed levels[3] jumped to USD 300bn in Apr 2023 as compared to USD 79bn in the prior year. At the same time, bankruptcy filings in the economy jumped 24% YoY in Mar 2023, with Chapter 11 filings jumping to the highest level seen since 2018.

Further, from a profitability standpoint, US corporates continue to anticipate weaker earnings amidst the current economic uncertainty, and their profits fell by 2% in Dec 2022, the highest fall in the past 2 years. The trend is expected to persist as profit warnings from companies ticked higher in 2023. The slowdown in economic growth and tighter lending standards (see Figure 2a) may add a drag on corporates' revenue growth as consumers and corporates curtail spending. At the same time, the labor and non-labor costs for firms have been consistently increasing. Firms have thus far been able to pass on higher costs to consumers in the form of price hikes as consumer spending remains supported by a strong labor market. However, the rising corporate layoffs and a jump in unemployment claims indicate a potential cooling in the job market which may squeeze corporate profits further due to diminished pricing power and demand declines.

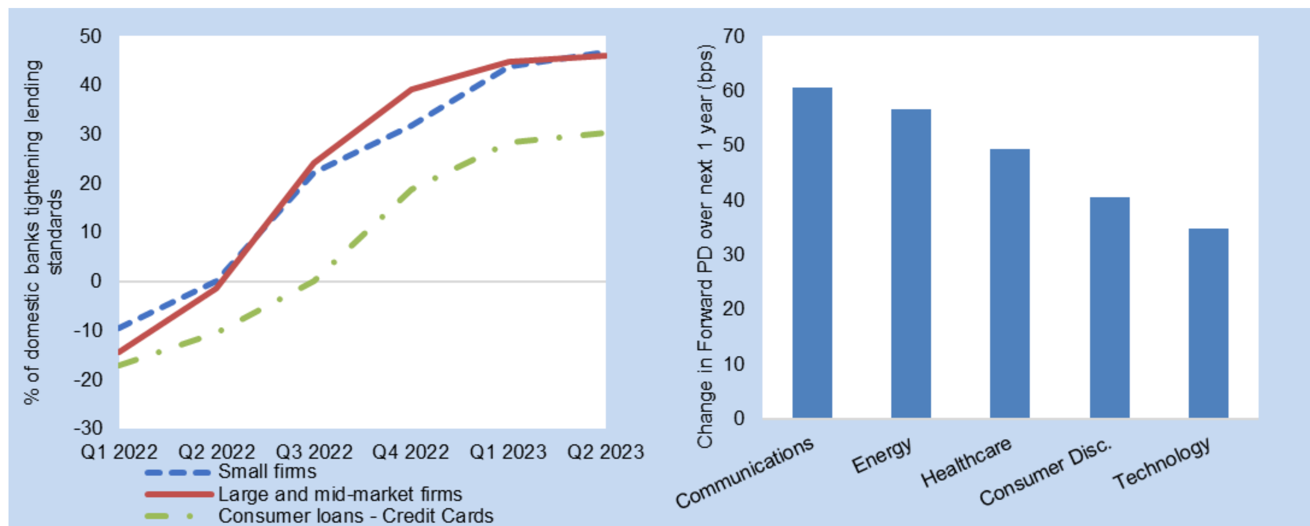

Figure 2a (LHS): Net percentage of domestic banks tightening standards for credit card loans and commercial and industrial loans to small, middle-market and large firms on quarterly basis; Figure 2b (RHS): Change in the NUS-CRI Agg (median) Forward 1-year PD for specific sectors over the period of 1 year. *Source: FRED, NUS-CRI.*

A sector-based analysis of US non-financial corporates further underscores that sectors experiencing the most significant decline may be those with capital-intensive operations or those that rely heavily on economic cycles. The NUS-CRI forward PD indicates that the credit health US communications sector, which covers both media and telecom, is expected to deteriorate the most among US non-financial sectors. The high dependence of the telecom sector on debt financing to fund its recent capital expansion plans to build 5G infrastructure have left it highly sensitive to changes in borrowing costs. The media sector on the other hand, is suffering from a dual conundrum as a weakening economy erodes its advertising revenues and a structural change in consumer behavior leaves traditional cable and satellite companies in losses. On the other hand, the heightened credit risk in the energy sector may be caused due to a direct impact of the banking crisis as oil prices weakened on expectations that tighter credit conditions may trigger a recession which would depress demand. Similar trends of diminished demand following a slowdown in economic growth may be pushing the Forward PD of consumer discretionary and technology sectors higher.

Going forward, as banks expect lending standards to remain stringent throughout 2023, US non-financial corporates will continue to face higher refinancing risk. The tighter lending standards may even be accompanied by further interest rate hikes by the Federal Reserve as core CPI continues to persist at a higher level.

[3] Defined as a 1000 bps spread over the benchmark for bonds and a price of less than 80 cents on the dollar for loans.

Additionally, as the US approaches the debt ceiling, there may be higher volatility in the equity and corporate bond markets. This, in turn, could hinder firms' capacity to secure financing and undertake operations and investments that may be crucial to support the real economy growth.

Credit News

Strong labor market data sparks bond selloff

May 05. A midweek rally in the bond market was cut short on Friday following the release of strong US jobs data, which caused a sell-off of treasury bonds. The surge in hiring and wages prompted the two-year yield to rise to 3.92%, up from 3.727% on Thursday, while the 10-year note yield finished at 3.445%, up from 3.35%. The mixed signals have left investors uncertain about the direction of interest rates, particularly following the Fed's decision to raise rates by 0.25 percentage points last week. Analysts have warned that the outlook for the economy remains hazy as banks struggle with declining lending and inflation remains strong. (WSJ)

Flood of bond sales pushes up UK borrowing costs

May 05. Investors say that a flood of gilt sales is driving up the UK government's borrowing costs, as markets are asked to absorb record volumes of bonds without the Bank of England (BoE) stepping in to hoover up supply. Many fund managers argue that the UK's hefty borrowing needs, exacerbated by the BoE selling government bonds that it bought under its quantitative easing program, are adding to the pressure on gilts. The government plans to sell BNP 241bn of gilts in the current financial year, with issuance net of BoE purchases expected to be about three times more than the average over the past decade. (FT)

China's local governments struggle with hidden debt

May 08. As China's economy bounces back from the COVID-19 pandemic, local government debt has once again become a major concern for policymakers. A significant portion of this debt is tied to bonds issued by state-owned companies established to fund local government investments. To avoid the risk of large-scale defaults, which could potentially destabilize the financial system, the government has proposed a series of measures. These include consolidating the responsibility of provincial-level governments for uncovering and addressing hidden debt, intensifying efforts to dispose of outstanding debt, and optimizing debt maturity structure. While there is no official data on the extent of hidden debt, analysts have estimated it to be anywhere between CNY 30tn and over 70tn. (Nikkei)

Best of India bond rally may be over with sales deluge coming

May 08. India's sovereign bonds rally may end soon, as traders focus on heavy debt issuances expected in the coming months and the lack of rate cut expectations in the near term. India plans to sell around INR 9tn (USD 110bn) of bonds in the six months to Sep, which may face resistance from buyers after the recent rally and with banks holding bonds well above their regulatory limits. The government sold bonds at higher-than-expected cut-off yields at an auction on Thursday, showing cracks in demand. Experts recommend shorter-maturity bonds in this scenario, as they offer better returns than longer ones. (Bloomberg)

Banks tighten credit terms, see loan demand drop, Fed survey shows

May 08. A recent survey by the Federal Reserve of bank loan officers in the US has found that credit conditions for businesses and households are continuing to tighten, reflecting the accumulating impact of Fed monetary tightening. Banks are reporting concerns over the deterioration in the credit quality of their loan portfolios, customers' collateral values, risk tolerance, and bank funding costs, as well as deposit outflows, as reasons for tightening lending standards. Economists expect credit to continue tightening in the coming months and believe that it could work its way into slowing economic activity and could even be a precursor to a downturn. (Reuters)

US debt ceiling debacle adds to economists' fears of turmoil (FT)

Japan life insurers to raise JGB holdings with eye on BOJ policy (Reuters)

Bond traders bet on biggest Fed shift in decades on credit risks (Bloomberg)

Regulatory Updates

Federal Reserve warns of credit crunch risk after US bank turmoil

May 08. The US Federal Reserve has issued a warning that recent banking turmoil could lead to a broad credit crunch, potentially slowing down the economy. The Fed's financial stability report suggests that despite attempts to tackle recent bank crises, concerns about credit quality, economic outlook, and funding liquidity could lead to banks contracting the supply of credit to the economy. This would drive up the cost of funding for businesses and households, resulting in a slowdown of economic activity. A credit crunch is among the biggest current risks to the financial system, with a possible US debt default looming as well. (FT)

ECB raises rates as Christine Lagarde warns of 'more ground to cover'

May 04. The European Central Bank (ECB) has raised interest rates by 0.25% to 3.25% but warned that the fight against inflation was not yet over. ECB President, Christine Lagarde, has indicated that this is unlikely to be the last such move this year, and many economists are predicting further rate rises, pushing the deposit rate to 3.75% by July. However, Lagarde has acknowledged that borrowing costs are now in "restrictive territory", and signs of a credit crunch have been a significant factor in the ECB's decision to slow the pace of rate rises. The ECB is also expected to cut its bond purchases by EUR 25bn per month from July. (FT)

Fed raises rates, opens door to pause in tightening cycle (Reuters)

China's debt-to-GDP ratio rises to record 279.7% on credit boom (Bloomberg)

Published weekly by Credit Research Initiative – NUS | Disclaimer
Contributing Editors: Anyi Wang, NUS-CRI Market Monitoring Team