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Weekly Credit Brief May 09 - May 15 2023

Recessionary headwinds and higher borrowing costs set to worsen the credit outlook of German manufacturers

by Wang Chenye

- **Recent data released by Germany shows a decrease in industrial output, hinting at weaker demand amidst ongoing macroeconomic headwinds. Decrease in industrial activity is led by a slowdown in automobile and automotive part production**
- **NUS-CRI Forward PD suggests the credit outlook of the German manufacturing sector is set to worsen with potentially squeezed profits and worsened debt servicing ability**

A warm winter in 2022 provided German manufacturing companies with some respite, however, it seems the savings derived from easing energy prices may soon evaporate. As seen in Figure 1a, the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) of the German manufacturing sector[1] steadily went upward during the first half of 2022 due to increasing energy costs and then jumped after the European Central Bank (ECB) started hiking rates in Jul-2022. The Agg PD of the automotive industry, in particular, was almost equivalent to the vulnerable German companies in Nov-2022, as shown by their Agg PD reaching that of the PD for the 75th percentile of all German companies, crossing the BB+ upper bound in Nov 2022.[2] Looking ahead, the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD)[3] suggests a continued deterioration in the credit quality of the German manufacturing sector, as the borrowing costs stay high and as recessionary expectations dominate the market.

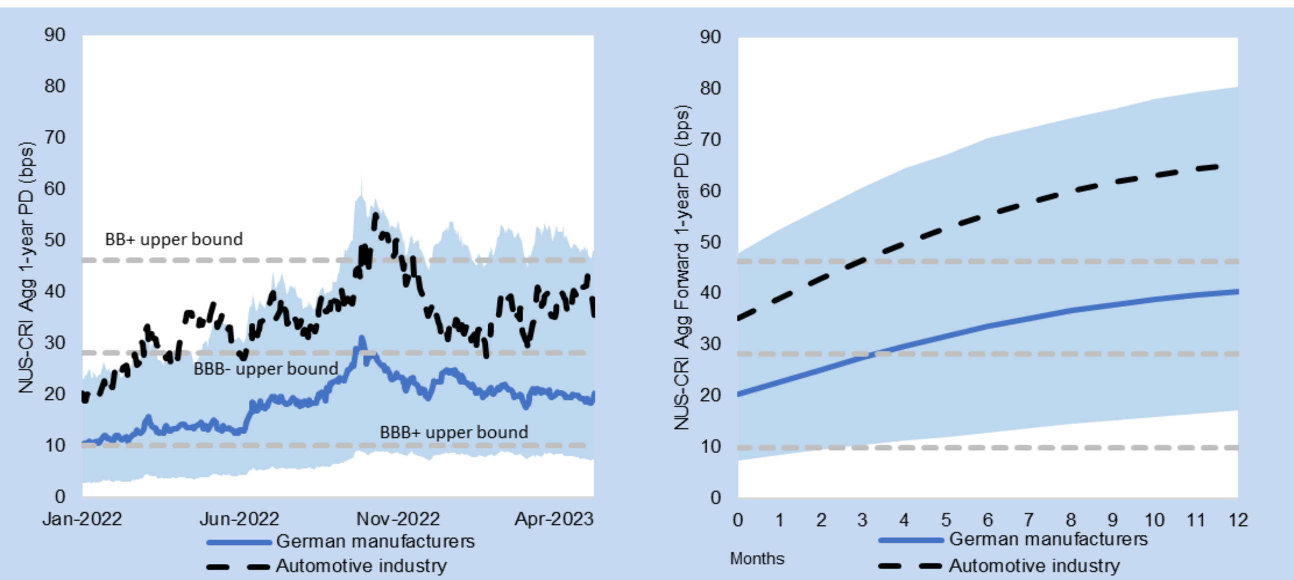


Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for the German manufacturing sector and the German automotive industry with reference to PDiR2.0[4] bounds, as well as the interquartile range of PD for the German companies; Figure 1b (RHS): NUS-CRI Forward 1-year PD for the German manufacturing sector and the German automotive industry with reference to PDiR2.0 bounds, as well as the interquartile range of Forward PD for the German companies. *Source: NUS-CRI*

[1] The sample of the German manufacturing sector includes the automotive industry, chemical industry, and the whole industrial sector.

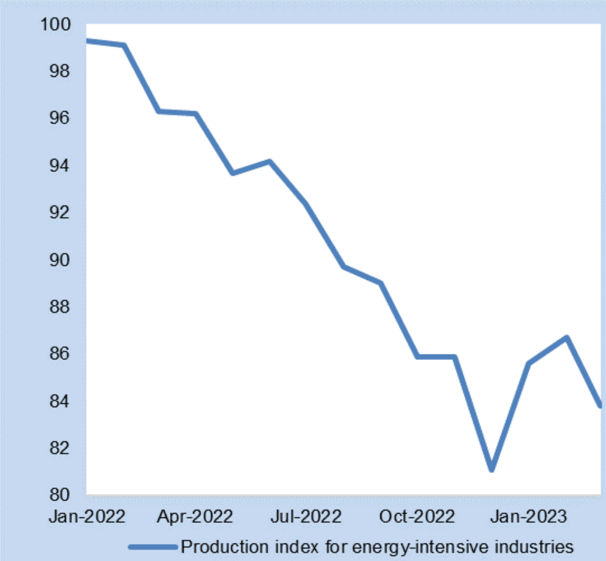
[2] The relative rebound in demand after China's reopening and a reduction in energy dependence from Russia gave reprieve to the manufacturing companies in Dec-2022, the Agg PD of the sector is currently considered investment grade as its above the BBB+ upper bound, with that of the automotive industry deemed as non-investment grade due to the Agg PD fluctuating between the BBB- and BB+ upper bounds.

[3] 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.

[4] 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.

German industrial data published on May 8th, 2023 underscored a widespread decline in the country's industrial activity. In Mar-2023, Germany's industrial production dropped by 3.4% MoM, compared to an increase of 2.1% MoM witnessed in Feb-2023. German companies that produce automobiles and automotive parts, which have been the major contributors to the decline in the country's overall industrial activity, witnessed a substantial 6.5% production decline MoM, and production of machinery and equipment also fell by 3.4%. The unexpected contraction in Mar-2023 stoked concerns over Germany's recessionary outlook, highlighting the deteriorating macroeconomic environment that may impact the manufacturing sector's profitability and debt servicing capabilities.

Since the onset of the energy crisis due to the ongoing Russia-Ukraine war, the German manufacturing sector, being heavily reliant on energy imported from Russia, could face a further squeeze on their operating profits that may hamper their credit risk outlook moving forward. The cutoff of significant energy supplies from Russia has posed a challenge for German companies in finding alternative resources while bearing higher operating costs. Following the gradual completion of backlog orders during the first two months of 2023, a concerning decrease of 10.7% in German manufacturing orders exposed the underlying issue of weak demand, amidst higher operating costs. The Production index for energy-intensive industries has been declining since Jan-2022 and slipped again in Mar-2023 after a temporary increase (see Figure 2a).



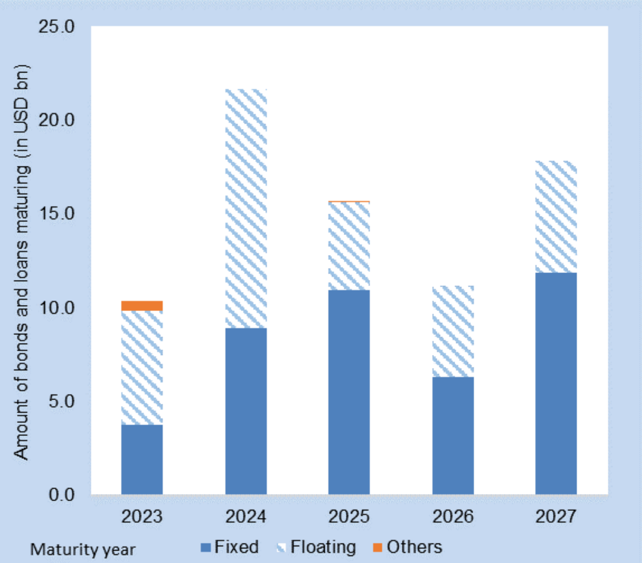


Figure 2a (LHS) Production index of German energy-intensive companies, taking the value in 2015 as 100, seasonally and calendar adjusted; Figure 2b (RHS): Total value of bonds and loans of the German manufacturing sector by maturity, broken down by interest type. *Source: Statistisches Bundesamt; Bloomberg*

To add to their woes, the borrowing cost for German manufacturing companies has been rising in conjunction with the monetary tightening undertaken by the ECB as it continues to raise its benchmark rates. Figure 2b shows that around 70% of the outstanding debt for German manufacturing companies maturing in the coming two years is linked to floating interest rates, increasing the servicing burden for issuers amidst rising borrowing costs. The interest coverage ratio for these companies has been declining since the ECB first started hiking rates in Jul-2022, dropping from around 10x to 6x over the last three quarters[5]. Should the ECB continue with further rate hikes, the liquidity pressure on the German manufacturing companies is set to worsen, directly impacting their ability to service the debt and refinance.

Going forward, the key manufacturing industries in Germany may still face pressure, from both costly energy supply and weak demand, resulting in further squeezed profits. The rising interest rates also give them no ease in servicing their debt in the coming years. The industry also faces severe structural challenges moving forward. The highly international operation layout, which used to be a strategic advantage, is now exposing its vulnerability amidst geopolitical upheavals. The threatened industrial model relying on cheap energy and high-quality industrial exports raises warnings of a deindustrialization trend due to the geopolitical tensions with Russia and the fierce competition from emerging markets such as China. This, combined with macroeconomic recessionary headwinds, cast a shadow on Germany's key industries' future long-term credit quality as the industry faces short-term profitability and liquidity woes.

[5] Data from Bloomberg.

Credit News

Chinese junk bonds are sliding in the longest streak since July

May 12. China's high-yield dollar bonds are experiencing their longest losing streak of the year, raising concerns in the junk debt market that has been impacted by a property firm's default and another company's liquidation. In May, these bonds have lost 3.6% in value, causing average prices to drop to distressed levels of around 69 cents. This decline follows a 3.8% drop in April, marking the worst streak since July 2022. Monitoring the developments in China's credit markets will be crucial as investors assess the risks and implications for their portfolios. (Bloomberg)

Swedish real estate sector rattled as refinancing worries surface

May 11. Hedge funds have escalated their bets against Sweden's real estate sector, expecting that rising interest rates will have a detrimental impact on domestic property prices and expose the industry's vulnerability. The concerns were exacerbated by the recent downgrade of Swedish landlord SBB's credit rating to junk territory by S&P, which highlighted the company's high leverage and the tightening liquidity in the market. This downgrade has raised fears that the industry as a whole will struggle with the effects of increasing interest rates and cooling real estate prices. Short positions taken by hedge funds in the Swedish real estate sector have surged to their highest level in over a decade. (FT)

Bonds backed by apartments are under stress as housing market cools

May 09. Rising interest rates are raising prospects of defaults by mortgage bonds, especially those used for apartment-building purchases. Close to two-thirds of CLOs, also known as collateralized loan obligations, are made up of rental apartments in 2021, increasing to approximately 80% in 2022. In the context of the ongoing economic slowdown and monetary tightening, landlords do not make sufficient rental yields to service their borrowing costs. For example, the Applesway Investment Group defaulted on floating-rate loans. Close to USD 88bn of MBS are at risk of default, with close to 40% backed by apartment buildings. The number of CLO delinquencies has increased to 1.4% as of the end of Apr-2023, compared to 0.4% as of Jul-2022. Construction and insurance costs have also increased, with many developers running out of funds to finish properties, posing a liquidity crisis for struggling developers and property managers. (WSJ)

Credit crunch fuels 48-hour bankruptcy rush with seven filings

May 15. Seven companies filed for Chapter 11 bankruptcy protection at the second weekend of May-2023. It marks the largest number of bankruptcy filings on record during a two-day period since 2008. The bankrupt companies are as follows: Vice Media LLC, Envision Healthcare Corp, Monitronics International Inc, Venator Materials PLC, Cox Operating LLC, Kidde-Fenwal Inc., and Athenex Inc. These defaults emerge amidst a potential slowing down by the US FED in their monetary tightening campaign. The defaults also highlight the challenges faced by corporates in the current macroeconomic environment to refinance their loans and bonds that have been plagued by higher borrowing and servicing costs. (Bloomberg)

Bond traders laser-focused on Washington as debt-cap risks grow

May 14. Traders of the US treasury are keeping a close eye over the coming weeks on whether the United States will default on its debt or increase the debt ceiling in time to calm the markets. As of May 10th, 2023, the US Treasury warned that it had just USD 88bn in liquid assets, raising the prospects of default by early Jun-2023. Yields of treasuries maturing in Jun-2023 have already risen as market participants price in a higher chance of default, in line with Treasury Secretary Yellen's expectations. Even though the yields, and the insurance on these bonds, are pointing to heightened stress, the possibility of the US defaulting on its debt is still considered to be a low-probability event. The implications of the US defaulting are profound, and the fallout in the global markets is likely going to be large should the above-mentioned scenario takes place. (Bloomberg)

Turkish default protection costs soar as Erdoğan leads presidential vote (FT)

Bond selloff adds to the pressure on regional banks (WSJ)

US households show signs of stress as new delinquencies rise (Bloomberg)

Regulatory Updates

BOE matches Fed's rate rise, signals there may be more

May 11. The Bank of England (BOE) has raised its key interest rate for the 12th consecutive time. The rate was increased from 4.25% to 4.5%, marking the highest level since October 2008. This move follows the BOE's decision to tighten monetary policy in December 2021 when the borrowing costs were at 0.1%. The cumulative increase over the 12 rate hikes is the largest since the late 1980s. The BOE suggested that it might raise rates further if there are indications that inflation will persist longer than expected. The initial market reaction saw U.K. government-bond yields rise, and the pound recover some losses. (WSJ)

US risks falling behind Europe without crypto rules, warns SEC commissioner

May 11. Hester Peirce, a member of the US Securities and Exchange Commission (SEC), cautioned that the United States is at risk of lagging behind the European Union and the UK in the absence of regulations governing crypto markets. Peirce suggested that the regulatory frameworks established by Brussels and London could serve as a blueprint for US lawmakers. The EU has devised a comprehensive set of regulations known as the Markets in Crypto Assets (Mica) that is expected to be implemented next year. Meanwhile, earlier this year, the UK introduced a regulatory regime for cryptocurrencies aimed at aligning the rules governing digital tokens with those already in place for traditional financial assets. (FT)

China holds rates, adds more liquidity as recovery struggles (Reuters)

Audit finds holes in ECB's management of bank credit risk (Reuters)

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