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Credit risk outlook of US companies threatened by potential US debt default

By Raghav Mathur

- **NUS-CRI Forward PD suggests a deterioration in US companies' credit risk outlook brought on by the tightening monetary environment, and accentuated by the risk of a potential sovereign default of the US government**
- **Stress tests suggest that a protracted default by the US is likely to lead to a substantial deterioration in the credit health of both financial and non-financial corporates, compared to the relatively smaller impact under a short default**

As the United States government edges towards the X-date, the date after which the US Treasury runs out of funds to meet their repayment obligations, the risk of sovereign default in the US has substantially risen should the government not increase or suspend the debt limit. A recent article released by the White House's Council of Economic Advisors (CEA) details the potential impacts on the real economy under different debt ceiling scenarios, ranging from political brinkmanship to a protracted default spanning multiple quarters. This issue of the NUS-CRI Weekly Credit Brief will analyze the impact of a potential US default on the country's financial and non-financial corporates. As seen in Figure 1a below, the 1-month US Treasury par-yield surged from the middle of last year, in tandem with the monetary tightening undertaken by the US Federal Reserve (Fed). Adding further pressure to a stressed financing environment, in Jan-2023, the US debt limit took center stage. The market began pricing a higher default risk as seen from the jump in the 1-year US CDS spread (see Figure 1a).

As such, the credit risk outlook of both the US financial and non-financial companies, computed using the NUS-CRI aggregate (median) Forward 1-year Probability of Default (Forward PD[1]) in Figure 1b, suggests that US-domiciled companies are facing a high potential deterioration in their ability to service their debt obligations in the short term. To gauge the impact on corporate credit risk under different default scenarios, in line with those examined by the CEA, the NUS-CRI Bottom-up Default Analysis toolkit is used to stress test the PD of both US financial and non-financial corporates.

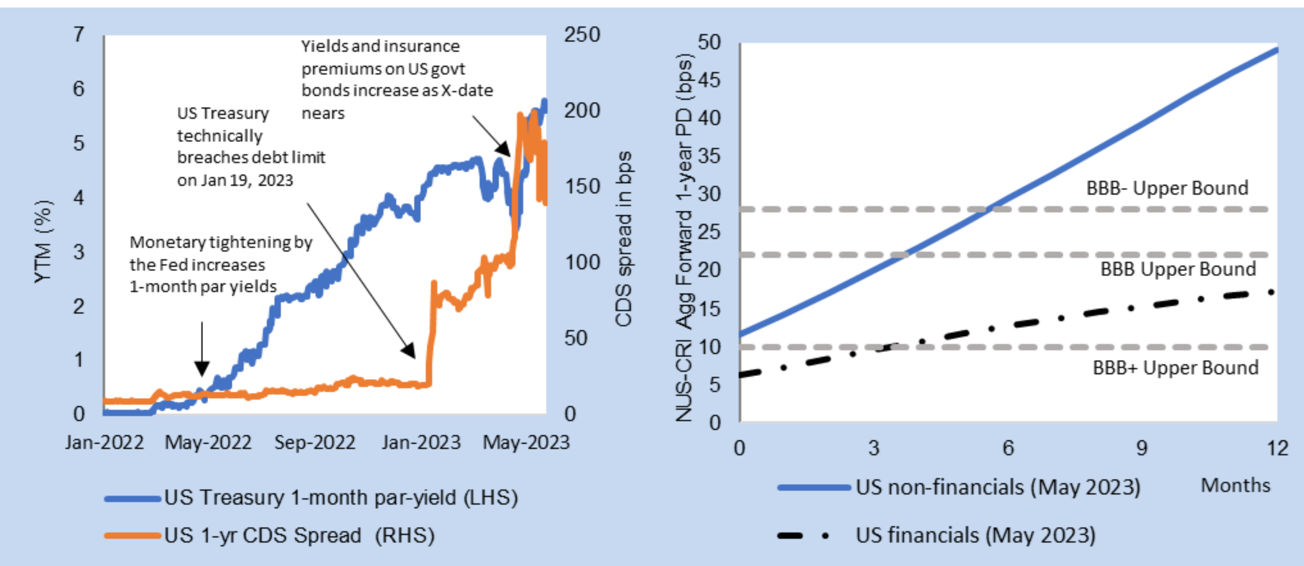

Figure 1a (LHS): US 1-month Treasury par-yield and the US 1-year CDS spread from Jan-2022 to May-2023. Figure 1b (RHS): NUS-CRI Agg Forward 1-year PD of US financial and non-financial companies with reference to PDiR2.0 bounds[2]. *Source: NUS-CRI, Bloomberg*

[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

The long road to a US debt deal[3] has impacted financial markets, increasing short-term borrowing costs for the US Treasury, while simultaneously influencing US corporates' financing capabilities. Yields on US Treasuries due Jun-2023 have increased over the past few weeks as the market braces for a potential default. The 1-month Treasury par yield increased by 1.53 percentage points to 6.02% from May 1, 2023 to May 26, 2023. As investors rush away from investing in short-term treasuries towards other assets, yields on riskier corporate bonds have reduced. Additional risk premium demanded for investing in both investment grade (IG) and non-investment grade (HY) corporate bonds has decreased (decrease in IG OAS in May-2023: 9bps; decrease in HY OAS in May-2023: 43bps). However, should the US government default on its obligations, borrowing costs for both investment grade and non-investment grade corporate bonds are likely to increase, possibly due to the market's risk-off sentiment that reduces their overall exposure to US-domiciled assets.

The impact of the US' default on the real economy poses a structural threat that may suggest the increasing term structure of the Forward PD in Figure 1b. The CEA estimates that the loss in real GDP in the case of a short default is likely to be a decrease of 0.6% YoY by Q3 2023, whereas the impact of a protracted default may lead to a fall in real GDP of close to 6.1% YoY over the same period. The resultant impact on US employment in both scenarios is estimated to be an increase in the unemployment rate by 0.3 percentage points and 5.0 percentage points respectively. In the unlikely, but severe, case of a protracted US default, corporate credit health is likely to worsen substantially. NUS-CRI Bottom-up Default Analysis toolkit (BuDA Toolkit v3.5.1[4]) can be used to assess the resultant impact on both financials' and non-financials' PD (see Figure 2).

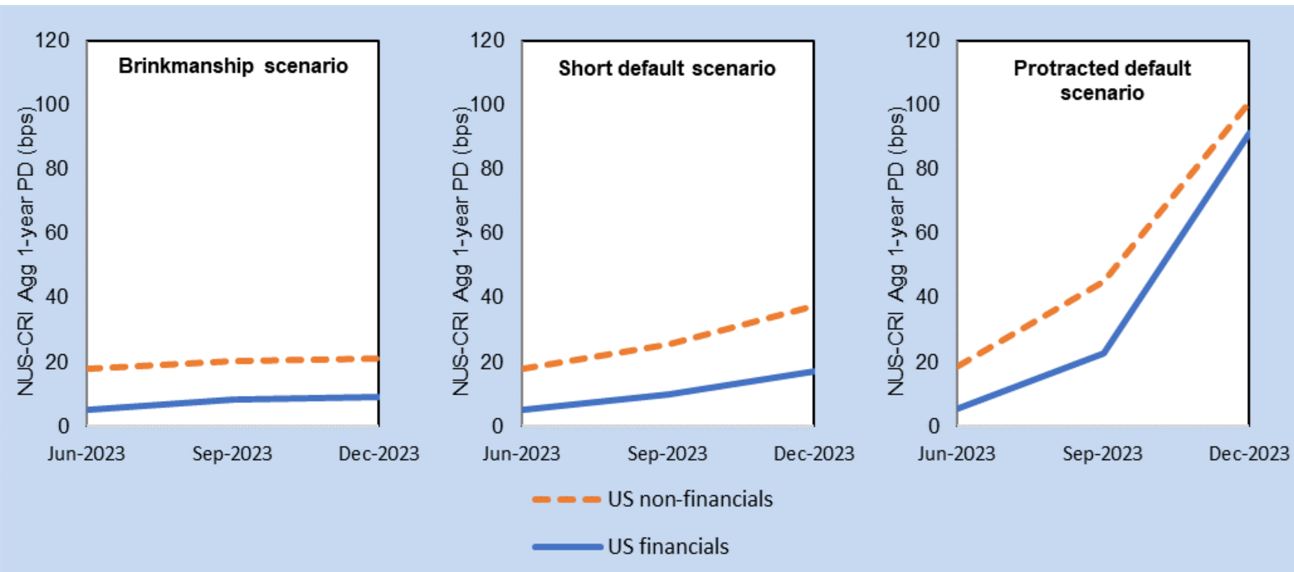

Figure 2: Stressed NUS-CRI Agg (median) 1-year PD of US financial and non-financial firms based on CEA's scenarios on brinkmanship, short default, and protracted default. *Source: BuDA V3.5.1*

In the Brinkmanship scenario, where the debt deal is accepted by Congress before the X-date, stressed NUS-CRI Agg PD suggests that the impact on both financial and non-financial firms is going to be marginal. Should the US Congress not agree on the debt deal before the X-date and the Treasury's default be short with a relatively quick cure, the resultant impact on stressed PD is going to be relatively higher, with a fall in real GDP accompanied by an increase in unemployment rates increasing the Agg PD of US-domiciled non-financial and financial firms. In a more severe scenario where the US Treasury faces a more protracted default, the credit health of US-domiciled companies deteriorates substantially. In the Protracted default scenario, the increase in stressed PD post Q3 2023 for financial firms is larger than that of non-financial firms, suggesting that financial institutions might face an additional lagged impact possibly due to the compounded impact on their asset quality.

[3] With the X-date potentially approaching next week, the agreement of the debt deal between President Biden and Speaker of the House Kevin McCarthy needs to be approved by the US Congress.
[4] The Bottom-up Default Analysis (BuDA v3.5.1) is a credit stress testing and scenario analysis toolkit jointly developed by the Credit Research Initiative (CRI) team of the National University of Singapore (NUS) and the International Monetary Fund (IMF). In the Brinkmanship scenario, US real GDP falls by 0.3% YoY in Q3 2023 and 0.1% YoY in Q4 2023, whereas unemployment rate increases by 0.1 percentage points QoQ over the same period. In the short default scenario, US real GDP falls by 0.6% YoY in Q3 2023 and 0.4% YoY in Q4 2023, whereas unemployment rate increases by 0.3 percentage points QoQ over the same period. In the Protracted default scenario, US real GDP falls by 6.1% YoY in Q3 2023 and 3.5% YoY in Q4 2023, whereas unemployment rate increases to 8.5% in Q3 2023. In all scenarios, control variables are added where the 1-month Treasury yield and yields on IG and HY corporate bonds increase.

Given that a debt deal between President Biden and Speaker McCarthy has been reached, it is unlikely that the US is going to face a protracted default spanning multiple quarters. However, the impact of even a short default is going to have a substantial effect on the credit health of US companies due to weakened access to public markets and other financing channels. The US government is likely to face an extreme brinkmanship scenario, especially due to a divided Congress, that is likely going to elevate the stress felt in the markets over the next week. However, as the stress tests conducted using the BuDA toolkit suggest, in such a scenario, the resultant impact over the next few quarters on US corporates' fundamental credit health remains limited. Nevertheless, wider implications of the US' default are going to reverberate through global markets, potentially causing volatile swings in all asset classes.

Credit News

US money market funds see big inflows amid debt ceiling caution

May 26. US money market funds experienced significant inflows in the week leading up to May 24, as investors sought safer options ahead of the deadline for a potential increase in the country's debt ceiling. Data from Refinitiv Lipper reveals that US money market funds received a net inflow of USD 39.9bn, marking the largest week of net buying in four weeks. US President Joe Biden and congressional Republican Kevin McCarthy are reportedly nearing a two-year agreement to raise the government's USD 31.4tn debt ceiling, but time is running short as the U.S. Treasury estimates that it will run out of funds within a week. (Reuters)

China's effort to cut USD 10tn of 'hidden debt' faces uphill climb

May 23. As China's economy rebounds, addressing the issue of hidden debt accumulated by local governments has become a top priority for policymakers. Concerns have risen that declining income growth and increased spending in recent years could lead local authorities to engage in off-the-books borrowing, limiting their ability to repay the debt. These hidden debts are estimated to be nearly USD 10 tn, approximately double the GDP of Japan. The urgency to ensure the sustainability of local finances has grown due to the impact of the COVID-19 pandemic and a prolonged property crisis, which have strained local government budgets. (Nikkei Asia)

Brazilian households default grow amid high interest rates

May 28. A significant number of Brazilians are facing challenges in repaying their debts, as four out of every ten adults are at risk of default. Overdue debts have increased by 18.42% in April compared to the previous year, and the number of individuals facing default has grown by approximately 8%. Most of the debt issues involve local banks. Household debt in Brazil has remained at all-time highs for several months. To combat inflation, the central bank, led by Roberto Campos Neto, has maintained a tight monetary policy, keeping the benchmark Selic rate at 13.75% after a series of rapid rate hikes. The high borrowing costs are also negatively impacting businesses, leading to difficulties in financing loans and contributing to a rise in corporate bankruptcies. The credit squeeze is evident in the expensive local debt markets and declining new issuances in domestic and international capital markets. (Bloomberg)

Canada's big banks log 13-fold rise in loan loss provisions

May 28. Canada's five largest banks have collectively set aside the highest amount of money for loan losses since 2020, reflecting concerns about an economic slowdown and increased defaults in commercial real estate. In the first three months of 2023, the banks allocated a combined CAD 3.37bn for credit loss provisions, surpassing the previous quarter by CAD 1 bn and marking a nearly thirteen-fold increase compared to the same period last year. The banks attributed the heightened risks in North America's commercial real estate sector as the primary reason for increasing their credit loss reserves. (FT)

US credit squeeze triggers rise in corporate bankruptcies

May 26. A growing number of large US companies are seeking refuge in bankruptcy court, indicating a tightening credit squeeze as interest rates increase and financial markets become less favorable for borrowers. In 2023, 27 significant debtors have filed for bankruptcy so far, compared to 40 in the entirety of 2022, according to data from bankruptcydata.com. Recent companies succumbing to their creditors include Envision Healthcare, Vice Media, and Kidde-Fenwal. The surge in bankruptcies follows a period of calm markets and rising valuations, which allowed financially distressed firms to secure debt and equity capital to survive. (Bloomberg)

Weakest European firms face highest amount of maturing debt since 2015 - DB (Reuters)

Investor bets on Greek debt send yields to record gap with Italy (Bloomberg)

Municipal bond issuers on edge as debt ceiling deadline nears (WSJ)

Regulatory Updates

New Zealand central bank ups rates to 14-yr high, signals hikes done

May 24. The Reserve Bank of New Zealand (RBNZ) has indicated that it has completed its tightening cycle after raising interest rates by 25 basis points to 5.5%, the highest level in over 14 years. This decision surprised market analysts, as many anticipated that the RBNZ might project further rate hikes. As a result, the New Zealand dollar declined by 1.25%. According to the RBNZ's monetary policy statement, the official cash rate (OCR) is expected to remain at its current level to ensure inflation returns to the target range of 1% to 3%, at least until the middle of 2024. (Nikkei Asia)

ECB says most banks don't reflect environment in new risk tools

May 26. According to the European Central Bank (ECB), a majority of European banks do not consider environmental factors when implementing additional measures to enhance their loan loss frameworks. The ECB conducted a survey revealing that 80% of lenders either do not consider or did not respond to the question about incorporating environmental factors into their risk assessment methods. The ECB has been urging banks to prepare for potential losses associated with climate change, such as extreme weather events or the financial risks faced by polluting businesses. The survey's results are part of the ECB's broader assessment of banks' readiness to tackle emerging risks, including those related to energy, supply chains, inflation, and geopolitics. (Bloomberg)

Companies face stricter supply finance disclosures after Greensill collapse (Reuters)

Former BOE hawks say UK interest rates headed to 6% pain level (Bloomberg)

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