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# EU corporates' credit profile remains resilient but long-term risks exist

by NUS-CRI Market Monitoring Team

- **Credit risk for European corporates remains muted despite the resurgence of COVID-19 cases due to favourable financing conditions**
- **NUS-CRI Forward PD time series indicates that European corporates' long-term credit outlook remains relatively unchanged from the start of the pandemic**

As winter approaches, many European countries decided to implement a series of new lockdowns and social restrictions in an effort to contain the resurgence of COVID-19 cases. These lockdowns do not bode well with the already beleaguered countries' economies and businesses as the restrictions will inevitably limit economic activities. Despite the fresh blows, the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) indicates that the credit risk for publicly-listed European corporates remains muted (see Figure 1a). Unlike during the initial outbreak, the current credit quality for European corporates remains well within the investment-grade area when referencing to PDiR2.0. This does not mean that all is well for European corporates though. While short-term credit outlook for European corporates has improved over the last few months, the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD) time series in Figure 1b below shows that the longer-term credit outlook remains relatively unchanged when compared to that during the start of the pandemic[1].

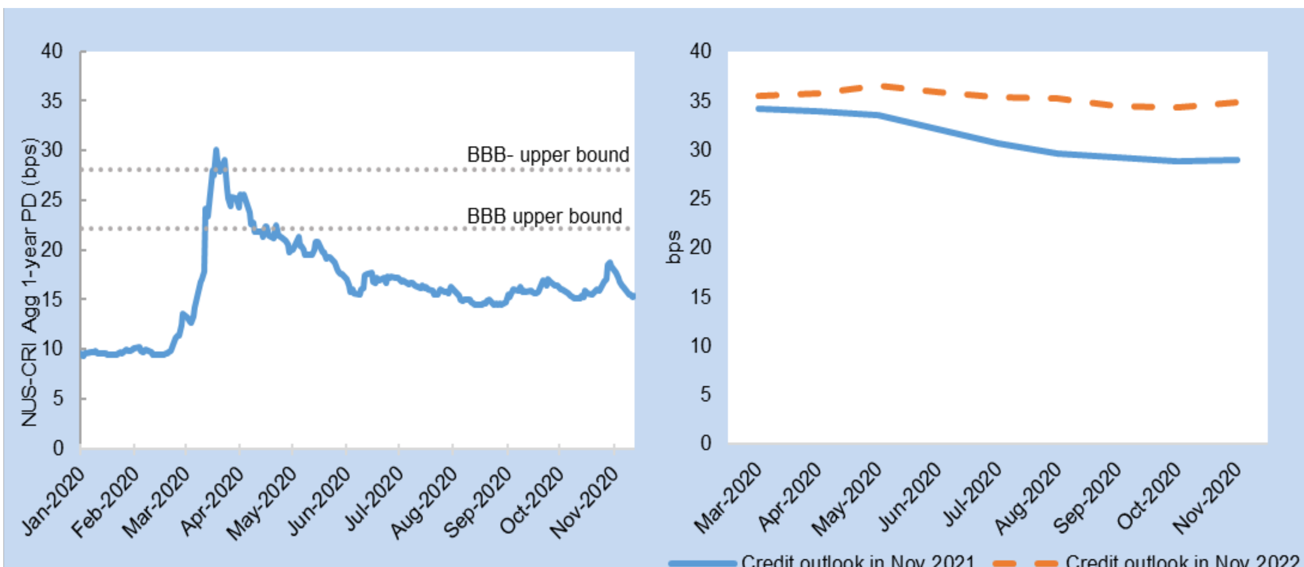


Figure 1a (LHS): NUS-CRI Aggregate 1-year PD of the EU corporates with reference to PDiR2.0[2] bounds. Figure 1b (RHS): NUS-CRI Agg Forward 1-year PD time series for the EU corporates based on information from different historical months looking to Nov 2021 and Nov 2022. *Source: NUS-CRI.*

[1] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. To interpret the time series, take the credit outlook in Nov 2021 in Oct 2020 for instance. This means that in Oct 2020, the probability of a typical European firm to default from Nov 2021 to Nov 2022 is 29bps.

[2] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through 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 European Central Bank (ECB) has managed to keep borrowing costs for European corporates low through bond purchases and cheap credits for banks. Its Pandemic Emergency Purchase Program (PEPP), which was initiated in Mar 2020 to counter the risks to its monetary policy transmission mechanism, buys both private and public sector securities. In terms of fiscal stimulus, European governments have provided corporates across Europe with various stimuli to prevent cash crunches and provide reliefs. Various European countries have implemented their state-backed loans guarantee schemes in which the governments would back a percentage of each loan from accredited lenders to applicants. These policies, in turn, have provided cheap liquidity and the much needed relief to European corporates amid the pandemic-induced economic slowdown.

European corporates took advantage of the availability of cheap funding by issuing a record breaking amount of bonds to refinance their debts and raise cash, solving their liquidity problems at least in the short-term. As of mid-November 2020, the total amount of bonds issued by the EU corporates in 2020 has reached EUR 233.9bn, exceeding the total amount of EUR 203.9bn issued last year (see Figure 2a). In tandem, Figure 2b also indicates that the Pan European bond option adjusted spread (OAS) has returned to the level before the pandemic.

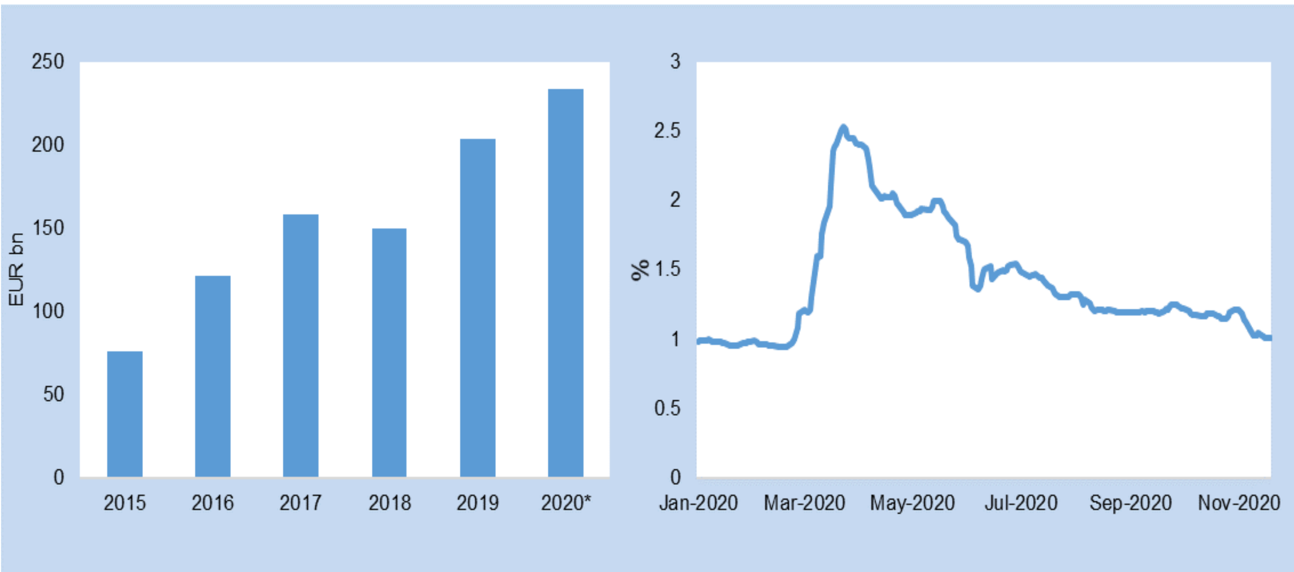


Figure 2a (LHS): The amount of bond issued by EU corporates from 2015 to 2020 YTD. Figure 2b (RHS): European aggregate corporate average OAS since Jan 2020. *Source: Bloomberg.*

The increase in debt amid the current downturn, however, has also caused corporates' to be increasingly leveraged. Increased leverage also means rising insolvency risk, as highly leveraged corporates tend to be more vulnerable to economic declines. Europe corporates' Debt-to-GDP ratio is projected to increase from 79% in 2019 to 95% in 2020 and the ratio is forecasted to remain above 90% until 2023. Moreover, ECB stated an abrupt end to the government support measures could also lead to an increase in financing and rollover risks. As a result, corporates vulnerabilities could increase above the level observed at the height of the financial crisis. Companies in sectors hit hardest by the pandemic (such as airlines, leisure, and oil and gas), in particular, are stated to be more prone to failing to service their debts.

The profits of the EU corporates in the third quarter of 2020 fell by 30% year-on-year. Facing the worst economic crisis since World War II, the Eurozone economy is likely to contract 7.4% this year. Even though the new restrictions are milder than those in spring, the measures are still expected to cause another downturn in the economy, which remains well below pre-pandemic levels. The high Eurozone unemployment of 8.3% in September will likely have a large impact on consumer spending and thus corporates' sales.

In her speech kicking off the central bank's strategic review, ECB President Christine Lagarde recognized that under the current circumstances, in addition to monetary stimulus, fiscal stimulus will also be needed. Therefore, more fiscal stimulus will be crucial to many firms surviving the new wave of COVID-19. From a growth perspective, the EU's recovery fund is emphasizing productive investments such as digitization and more environmentally sustainable production. Fiscal spending in those areas is more likely to boost competitiveness, productivity, and thus potential growth, especially given the investment gaps that have opened up in recent years.

The ECB is currently preparing a stimulus package for December and there have been calls for ultra-cheap loans to be at the core of the next stimulus package. The PEPP by itself might not be the best tool to provide further support and Lagarde has said that the ECB will focus on its EUR 1.35tn emergency bond purchases and targeted longer term loan operations for the next wave of the COVID-19 stimulus. Furthermore, the EU is to sign a deal to secure up to 300 million doses of the experimental coronavirus vaccine developed by BioNTech and Pfizer. This comes after the announcement by the two companies that their experimental vaccine was more than 90% effective. The vaccine is expected to be ready for distribution within weeks of final regulatory approval. This will alleviate pressure on the economy and allow European corporates to reduce their credit risk.

**Credit News**

**Muni market faces test with cut to Fed lifeline that ended crash**

**Nov 21**. The Federal Reserve's intervention in the municipal bond market in March and April helped to reverse a record-setting crash when panicked investors fled over concerns of the financial impact of the COVID-19 pandemic. The central bank's commitment to lend to states and local governments helped bond prices to rally and has left yields hovering around their lowest levels in decades. However, that support could soon end as Treasury Secretary Steven Mnuchin announced a decision to allow some of the Fed's novel lending programs to lapse at the end of the year as scheduled. This decision might be due to the market benefitting from optimism about the initial results of two COVID-19 vaccines. That's eased worries about the financial outlooks for a broad swath of borrowers that were badly affected by the pandemic. (Bloomberg)

**Over USD 6bn in bond sales cancelled across China as default scare spreads**

**Nov 20.** A recent wave of corporate bond defaults in China pushing domestic businesses to cancel new issuances. More than 57 companies have called off plans to issue a combined USD 6.72bn of new fixed income securities in the domestic market after state-owned Huachen Automotive group defaulted on their debt. Lack of investor appetite has even resulted in failed issuances as Pingxiang Changxing Investment, a municipal vehicle from a small city in southern Jiangxi Province could not raise its CNY 200mn minimum lot. More defaults could be on the way as Chinese authorities refocus on deleveraging their state-owned enterprises now that the worst of the pandemic has passed. This could lead to a spillover effect on the sovereign market and broader economy. (Nikkei Asian Review)

**Pandemic fuels global 'debt tsunami'**

**Nov 19**. Global debt rose at an unprecedented pace in the first 9 months of the year due to the COVID-19 crisis. The pace of debt accumulation has left the global economy struggling to reduce borrowing in the future without significant adverse implications for economic activity. Total global indebtedness increased by USD 15tn this year as total indebtedness is on track to exceed USD 277tn by the end of this year, 375% of global GDP. This is particularly true for emerging markets with debt rising 26% this year, with China contributing a large portion of it. USD 7tn will have to be repaid from these emerging markets by the end of next year, of which a large 15% is in USD, exposing debtors to the risk of currency fluctuation. This increase in debt without a corresponding change in the pace of output growth suggests that there is a significant reduction in GDP generating capacity of debt. (FT)

**Falling 'real' yields drive investors to junk bonds**

**Nov 17.** After the Federal Reserve cut interest rates to near zero, accounting for inflation meant investors could expect to lose money holding U.S. Treasurys to maturity. This is driving some investors to seek opportunities in the high yield market. Demand for speculative-grade bonds also has improved following the U.S. presidential election and signs of progress toward a vaccine for Covid-19. Adjusted for options, the spread demanded to hold speculative-grade U.S. corporate bonds fell to 4.27 percentage points, around 0.2 percentage points from the Nov. 9 close—the lowest level since late February. (WSJ)

**Major Chinese chip company defaults on debt**

**Nov 17**. Tsinghua Unigroup Co., a key player in China's push for self-reliance in semiconductors, has defaulted on a bond, adding to a recent spate of trouble in the country's corporate debt markets. China is investing heavily in computer chips and stepping up efforts to cultivate homegrown talent as it accelerates its quest for technological self-sufficiency. Unigroup has been an active borrower internationally and has at least USD 2.45bn of bonds in dollars. Some of these come due in December, with others maturing in 2021, 2023 and 2028. Chengxin, the rating company, estimates Unigroup at the end of September had debts of

CNY 52.8bn, equivalent to USD 8bn, and cash of CNY 4bn, or about USD 608mn. More than 60% of the debt is short-term. (WSJ)

**Carnival to sell USD 1.6bn unsecured bonds as virus pressure eases** (FT)

**Indonesia's Garuda shareholders approve USD 600mn bond plan** (Reuters)

**Aramco raises USD 8bn bond to fund dividend pledge** (WSJ)

## Regulatory Updates

**US aims to put pressure on banks to keep up fossil fuel lending**

**Nov 21.** Given the rule set up by the Trump administration, US banks that cease lending to the fossil fuel industry on political grounds will be penalized. The official stated that the banks have to be independent of political pressure and should only cease lending based on financial and risk management concerns. The aforementioned action is a notable resistance to the striving Environmental, Social and Governance movement – work towards building ESG factors into financial and risk decisions. Similarly, other segments of the public sector like the Labour Department looked to new rules which run against the incorporation of ESG funds into retirement saving plans. (FT)

**Dollar Libor left behind in shift away from tainted benchmark**

**Nov 19.** UK regulators are working under a time crunch to move USD 200tn of Libor linked contracts by the end of 2021. The Intercontinental Exchange would provide aid to the market with regards to the transition away from Libor rates with impact extending to the short term lending market. The action included Libor rates in Sterling, Franc, Euro and Yen, excluding USD. The exclusion is a serious testament to what is to come for the financial industry. The transition of the Dollar Libor has been relatively lagged as its replacement Sofr is a completely new rate. One which faces doubts due to its lack of sensitivity towards bank credit risk. (FT)

**Bank Indonesia cuts benchmark rate to record low** (Bloomberg)

**Bank chief picked by Erdogan returns to policy mainstream** (Bloomberg)

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