Eurozone domiciled firms facing multiple headwinds

by Luo Weixiao

Eurozone has been facing a gloomy outlook this year: inflation slowed to 0.8% in Sep 2019, the lowest in the recent three years; negative interest rate has been pressuring banks' profitability; falling export data amid uncertainties of Brexit and US-China trade war makes export-oriented sectors an increasing weak point of the economy. As fears of a sharp economic slowdown raising, credit profiles of the publicly listed companies domiciled in the region deteriorate accordingly. According to NUS-CRI Probability of Default implied Rating[1], the number of Eurozone domiciled lower-ranked investment-grade (BBB-, BBB, BBB+) firms has increased to 26.4% of the number of total firms domiciled in Eurozone, the highest in the recent two years. This riskiest corner of the investment-grade (IG) market faces the largest downgrade risk if there were a recession.

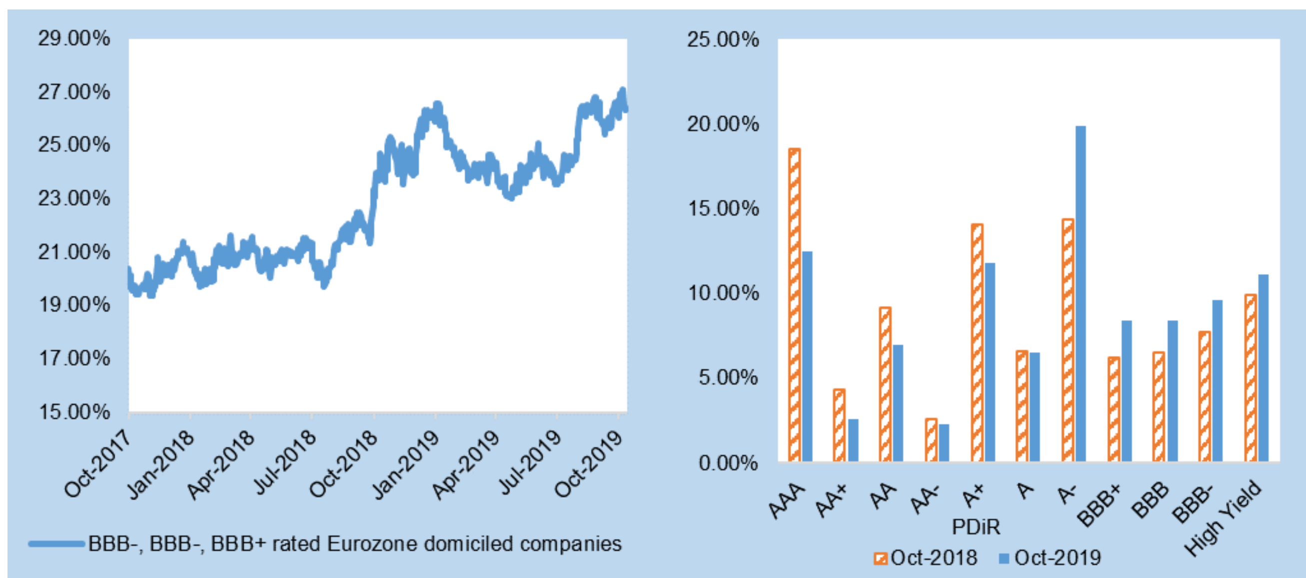

Figure 1a&1b: Proportion of Eurozone domiciled lower ranked IG firms to total firms domiciled in Eurozone according to PDiR. Percentage change of Eurozone domiciled firms within their implied rating categories in Oct 2018 and Oct 2019 *Source: NUS-CRI*

To boost growth, the European Central Bank (ECB) cut its interest rate further in the negative territory to a record low -0.5% this September, the first time since March 2016 and kept a dovish stance where the interest rate will remain low until the inflation outlook improves. ECB also resumed the Quantitative Easing (QE) program as expected. The monthly net purchase of EUR 20bn government and corporate bonds, and other financial assets will be restarted in Nov 2019 to support growth. The new stimulus package and the probable future ones, though welcomed by investors – as shown in the European stock market rally and Bunds yield drop after the meeting of the Governing Council – are questioned about their effectiveness amid the current ultra-low interest rate environment. The heads of the German, French, Dutch and Austrian central banks have publicly opposed the stimulus package and stated the bond-buying program is excessive as the interest rate is already in the negative territory.

[1] 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.

While ECB offered cheap loans to encourage banks to lend to the real economy, many banks choose to buy their domestic government bonds instead, which doesn't require capital reserve as lending does. The inefficient channel from ECB cheap loan to liquidity injection to non-financial corporates not only marks less-than-expected effectiveness of ECB monetary policy, but it also imposes a new risk to the banks as well. Banks have been buying a net EUR 1bn of government bonds in the trailing 12 months ended in early 2019. Though the large holding of sovereign bonds may offer favourable return amid the risk-off market sentiment, fluctuation of the price will have a large impact on banks' balance sheets. Any fiscal problem priced in the government bond will probably be passed to the banking industry, reviving a fear of "doom loop".

From the geo-economic perspective, Germany, the largest economy in the bloc, has been hit particularly badly by uncertainties such as Brexit and the US-China trade war and its inflation rate slid to 0.9% in Sep 2019 from 2.2% same time last year. German exports contracted by 3.6% in Aug 2019, while Eurozone's exports to the rest of the world fell 2.2% in August compared with the same month last year. The largest Eurozone's exports contraction was from the manufacturing sector, declining by 7.5% from last year, while the German manufacturing production declined the most across the bloc, with its industrial output contacting 5%. Germany's manufacturing PMI has been threading below 50 since Jan 2019 and finally hit 41.7, the lowest value since 2012. The credit profile of the German auto sector (auto manufacturers and auto parts, and equipment producers), which is the leading German manufacturer, has been deteriorating in the recent two years. The NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) for German auto firms increased threefold to 12.77bps in Oct 2019, equivalent to a rating of BBB+. The companies have been considering cutting jobs and costs amid the dim trading environment and the slowdown of China, its largest export market. Germany has been serving as the engine of the bloc's economic growth and is seen as the cyclical bellwether in the recent ten years. Therefore, the downturn in the German economy has added more uncertainty to the region's outlook.

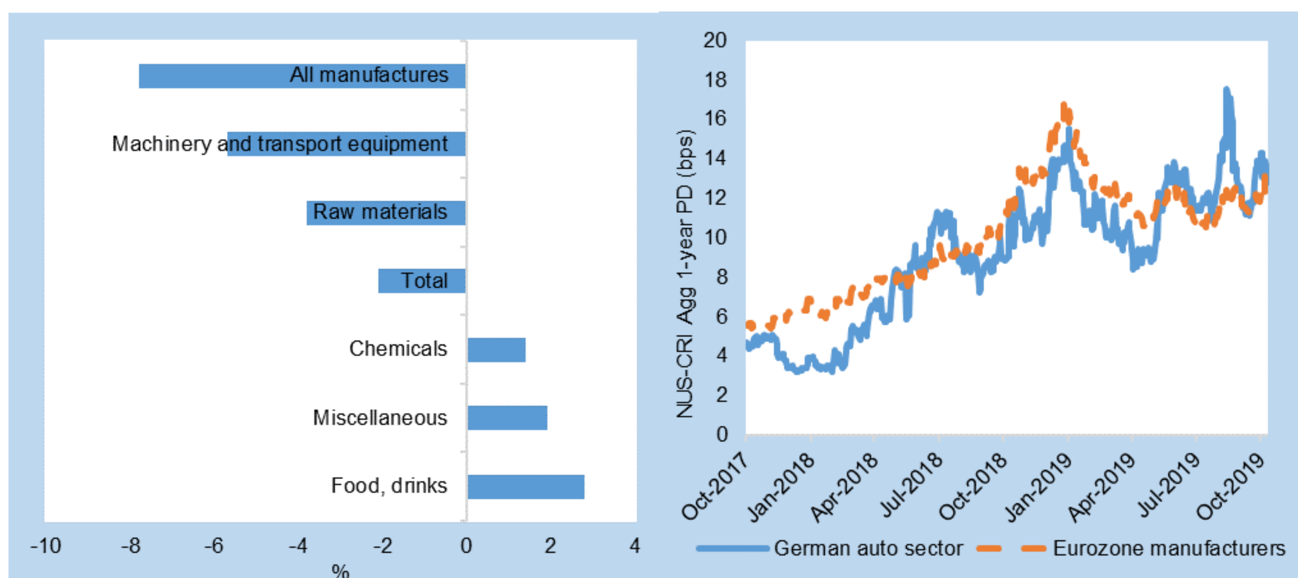

Figure 2a (LHS) &2b (RHS): Eurozone exports to the rest of the world in Aug 2019 (annual percentage change in nominal value); NUS-CRI Agg 1-year PD for German auto sector and Eurozone manufacturers. *Source: Eurostat, NUS-CRI*

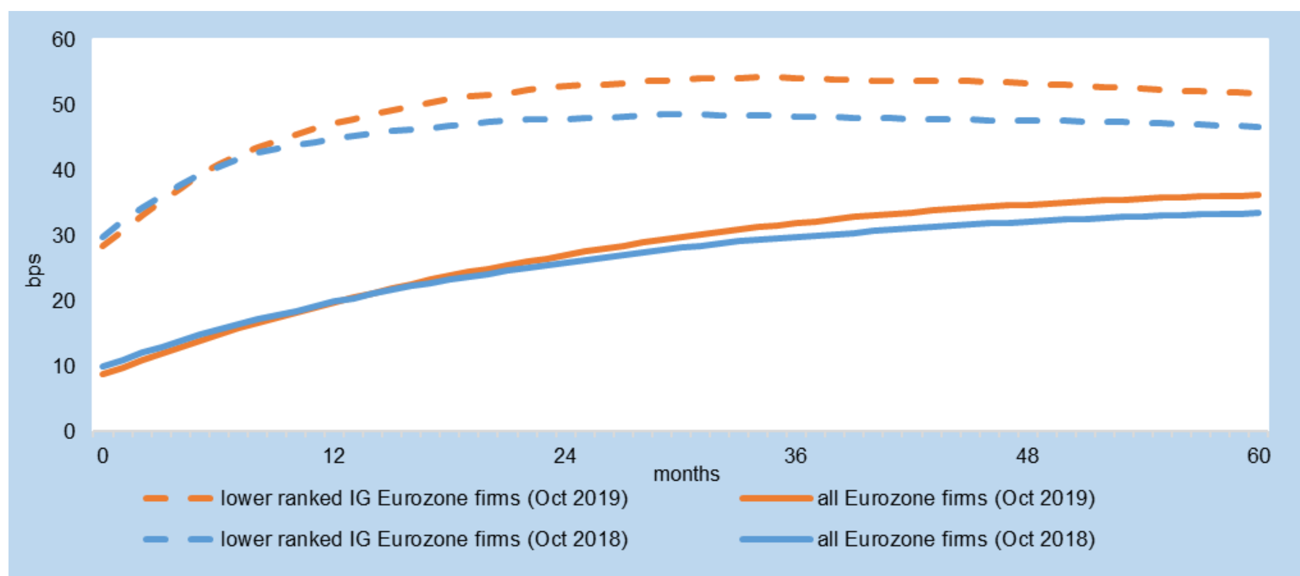

Figure 3. NUS-CRI Forward 1-year PD term structure for lower ranked IG Eurozone firms and all Eurozone based on information in Oct 2018 and Oct 2019. *Source: NUS-CRI*

Looking forward, companies with a lower-ranked IG rating in Eurozone have a more dismal outlook on average compared to the whole economy. As reflected in the NUS-CRI Aggregate (median) Forward 1-year Probability of Default[2] (Forward PD) above (Figure 3), the gap between the lower-ranked IG rated companies and the whole Eurozone domiciled corporates is wider than during the same period last year. Since these lower-ranked companies have a relatively weaker balance sheet, they are more vulnerable to the negative events that have happened this year. Looking to 24 months from now, while the Aggregate Forward PD in that time point for the whole economy doesn't change much from last year, the Aggregate Forward PD for the lower-rated part of the IG market has increased by 5bps. Furthermore, the Forward PD for the current risker part of the IG market increases more sharply than that of the whole Eurozone domiciled firms and will eventually enter into the junk territory next year if the above-mentioned headwinds persist, which can also lead to a vicious circle due to limited demand of junk bonds in Europe. According to Bank of International Settlement, IG corporate bond focused mutual funds' in the EU have increased their holding of lower-ranked IG bonds from 15% of total portfolios in 2010 to 47% in 2019. If there were any downgrade, these mutual funds together with pension funds will have to dump the bonds because they can only hold investment-grade bonds by regulation. Consequently, any large clearing sale may aggravate the crisis further.

Credit News

Collapse in coal prices spurs distress among Indonesian miners

Oct 21. Indonesian coal miners, the top exporter and one of the largest producers of coal in the world, has been hit hard this year as a global coal prices collapse. Bonds from Indonesia's financially weak mining firms suffered more than competitors elsewhere in Asia due to a lack of diversification and state backing which many of their peers enjoy. This year, prices of thermal coal – the kind burned by power plants – have fallen 30%, resulting in at least 4 US coal miners going bankrupt. As some lenders stop financing coal plants – such as Singapore's DBS plan to halt financing of coal power after 2021 – and the pressure on investors to fund more sustainable projects, companies that mine or use coal are left with fewer funding options. (Bloomberg)

[2] The Forward PD computes the credit risk of a company or a portfolio of companies in a future period, which can be interpreted similar to a forward interest rate. In Figure 3a, the 6-month forward 1-year PD for a typical Eurozone domiciled firm standing from Oct 2019 means the probability that the firm defaults during the period from Apr 2020 onwards to Apr 2021, conditional on the firm's survival until Apr 2020.

Bond ratings firms go easy on some heavily indebted companies

Oct 20. Amid a boom in corporate borrowing, rating firms such as Moody's and S&P have given leeway to big borrowers, allowing their balance sheets to expand and letting them keep their investment-grade bond ratings. Low-interest rates have driven debt owned by US non-financial companies up about 60% from pre-crisis level and non-financial companies' leverage hit a high in the second quarter of this year. Despite a flood of cash into the investment-grade debt, investors are skeptical of some of the ratings as more than USD 100bn worth of those bonds trade with a yield like junk. However, bond rating firms say their ratings are accurate and appropriate in line with their methodologies, considering the rated companies' solid financials and cash-generating ability. (WSJ)

Investors balk at green bond from group specialising in oil tankers

Oct 18. Bermuda-headquartered company Teekay Shuttle Tankers' newly-issued green bond was met with poor reception as investors baled at the notion that a company specialising in oil tankers can qualify for green financing. Although Teekay was seeking between USD 150mn to USD 200mn to finance the construction of four new fuel-efficient tankers, it was only able to sell USD 125mn worth of bonds instead. This phenomenon was uncommon in the green bond market, which has been especially hot this year. Global issuance has been on a record-setting with many green bonds oversubscribed by investors. Teekay's sale highlights an ongoing struggle to define terms in the world of sustainable financing. London Stock Exchange announced last week that it was tightening standards on green bonds and the EU is working to publish an official taxonomy to define different types of sustainable assets. (FT)

Cathay Pacific puts dollar bond sale on ice after cool reception from investors

Oct 18. Cathay Pacific canceled its plan to sell its first US dollar bonds in two decades after receiving lukewarm interest from potential investors. Since Cathay Pacific does not have credit ratings from large global rating firms, the airline and its bankers had to gauge how much yield investors would likely ask for it to borrow in the dollar market. Considering the pressure the airline is under, however, an investor expected the yield for Cathay Pacific's bonds to be over 7% or higher, which is usually equivalent to the yield required for speculative-grade bonds. Recently, the airline has seen a steep declines in passenger numbers and the airline's Hong Kong-listed shares have lost around a quarter of their value in the past 6 months. (WSJ)

Low interest rates fuel financial risk-taking, IMF warns

Oct 16. Consistently low-interest rates around the world are urging investors to take dangerous risks to achieve financial returns, raising concerns that the current lacklustre performance of the global economy might not be sustainable. This behaviour is especially prevalent for non-banking financial companies such as insurers, asset managers, and pension funds, where IMF stated that regulators should demand greater oversight of and disclosures about the risks they are running. About USD 15tn worth of bonds have negative yields, and the amount has risen since the start of the year, implying the market expects interest rates to stay lower for longer. Low rates have also pushed up other asset prices so that many bonds appear overvalued, raising the chance of a sudden correction. (FT)

Oil-patch deals fuel energy bond gains (WSJ)

Chinese developer woos US investors with 12% yields (WSJ)

WeWork bonds fall to new low (WSJ)

Regulatory updates

Fed kicks off balance sheet expansion effort with T-bills purchases

Oct 16. The New York Fed embarked on the first round of Treasury bill buying last Wednesday to expand its overall balance sheet after having also injected USD 75bn in overnight liquidity into the financial markets. While the Fed repo operations successfully helped to tame the spiking short-term borrowing cost in September, the Fed decided to grow its balance sheet to fix the current shortage of reserves in the banking system. Unlike the bond-buying during the financial crisis, however, the Fed stressed its current Treasury bill purchases are purely technical and not intended to stimulate the economy. Nevertheless, there had been some worry among market participants that the Fed might not find enough willing sellers. (WSJ)

BOJ on course to shrink bond pile even as Fed, ECB boost theirs

Oct 15. The Bank of Japan (BOJ) would see its bond holdings shrink next year for the first time in a decade. This shift is juxtaposed against the Fed's and ECB's moves to increase their balance sheets again. The BOJ bond purchases are part of its efforts to boost the economy by controlling short and long term interest rates through its yield curve control policy, which includes a 0% target for 10-year yields on Japanese government debt. A global bond rally sees Japanese rates go even more negative, spurring BOJ to scale back purchases in an attempt to steepen the yield curve. The BOJ signalled deep purchase cuts for October, and said it may even skip buying debut maturing in 25 years or more. (Bloomberg)

Bank Indonesia's Waluyo says room for rate cut "still open" (Business Times)

China places cap on private corporate bonds to stem credit risks (Bloomberg)

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