Slowing demand and shifting consumer spending patterns drive US retailers' credit risk higher

by Amrita Parab

- **NUS-CRI Agg Forward 1-year PD of US retailers heightens as consumer demand slows amidst high inventory levels**
- **Credit risk outlook of consumer discretionary firms is expected to deteriorate faster than consumer staples as demand shifts to essential products, partially due to high household debt curbing excessive spending behavior**

The US retail sector, which experienced a rapid turnaround post-pandemic thanks to government support, may now be staring at a revenue slowdown as a challenging macroeconomic environment threatens to put a spanner in revenue growth during the key holiday season. As seen from the NUS-CRI 1-year Aggregate (median) Probability of Default (Agg PD) of the US retail sector in Figure 1a, since the beginning of 2022, the credit risk for the sector has been steadily increasing and now stands above the key BBB- upper bound, when referenced to PDiR2.0[1], driven by supply chain issues and rising costs. However, with the supply chain constraints now abating, the sector's demand poses a new challenge as it comes under pressure as rising core inflation levels and higher borrowing costs threaten consumer spending. The NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[2]) for US retailers in Figure 1b shows a worsening credit risk outlook over the next 24 months with the Forward PD of even safer firms moving into non-investment grade territory when referenced to PDiR2.0 levels.

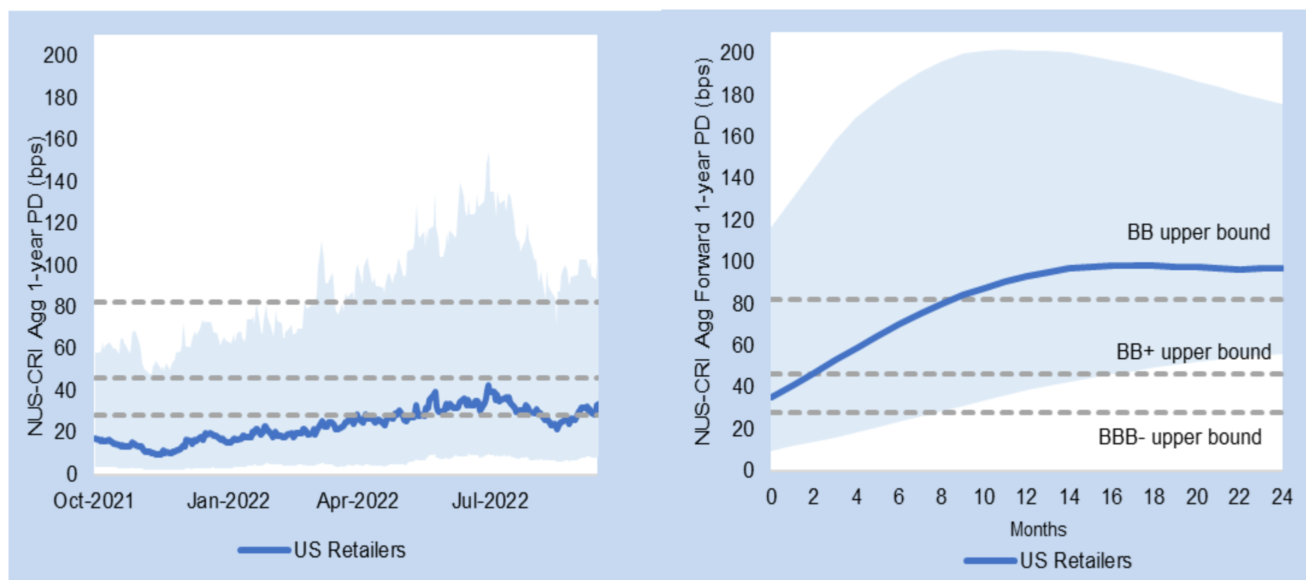

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for the US retail sector and its interquartile range, with reference to PDiR2.0 bounds from Oct-2021 to Oct-2022. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for the US retail sector and its interquartile range as of Oct-2022, with reference to PDiR2.0 bounds. *Source: NUS-CRI*

As rising inflation and borrowing costs throw a dampener on consumer confidence, retail sales in the United States have signaled a slowdown. Growth in retail sales remained flat MoM in Sep-2022, as compared to the marginal, yet still positive, 0.4% growth in Aug-2022. Although US consumers have thus far shown resilience in the face of record inflation as they benefit from a strong labor market and excess pandemic-era savings,

[1] 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.

[2] 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.

expectations of a looming recession in combination with a higher cost of living may potentially alter consumers' spending patterns. Such a shift in consumer behavior is evidenced by the initial signs of a pullback in demand for discretionary products such as automobiles and electrical appliances[3]. Furthermore, even though the Federal Reserve (FED) may reduce the aggressiveness of its rate hikes in 2023, in the likely scenario where high inflation levels persist in the short-term, interest rate hikes over the last quarter of 2022, may potentially bring on a recession and push unemployment higher, resulting in an adverse impact on retail demand. Moreover, US consumer debt has climbed to the highest level on record to USD 16.15tn in Q2 2022, driven by a jump in mortgage, credit card, and auto debt levels. Credit card balances grew by a record 13%, the largest YoY increase in more than two decades, as households turned to borrowings to shore up expenses. With the cost of borrowing on the rise, this upswing in debt levels may potentially squeeze household disposable income further, adding pressure on retail demand.

Though the US retailers generally benefited[4] from the fiscal stimulus provided to both consumers and corporates during the initial onset of the pandemic, the emergence of headwinds such as rising consumer prices affecting retail demand, distribution challenges amidst widespread supply chain constraints, as well as higher energy and labor costs, could worsen the outlook for the sector over the next 24 months, as shown in Figure 1b. Companies that are more vulnerable (depicted as those in the upper quartile in Figure 1b) might face the brunt of these challenges sooner with the Forward PD showing a faster deterioration in their credit profile over the next six-to-eight months compared to the safer firms (those in the lower quartile)[5]. This may be due to the effects of operational and macroeconomic headwinds being compounded by weak capital structures amidst potential profitability woes for weaker firms and rising financing costs (See Figure 2a) witnessed across the sector.

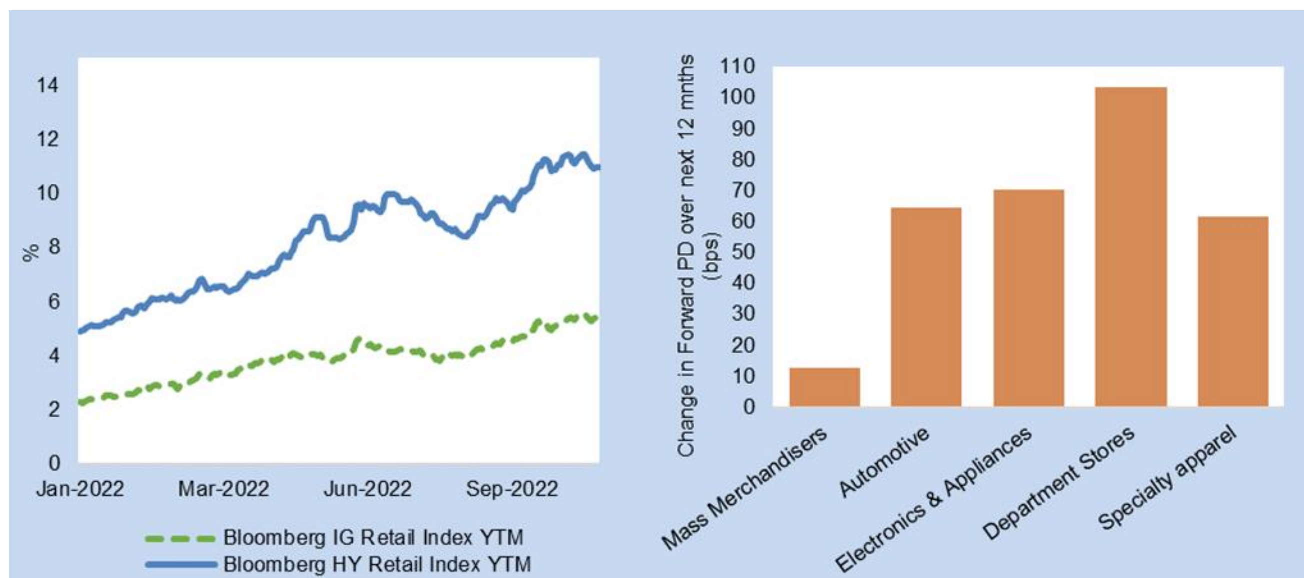

Figure 2a (LHS): Yield-to-maturity of the Bloomberg IG and HY Retail Total Return index. Figure 2b (RHS): Change in Forward PD of US retail sub-sectors over the next 12 months, as of Oct-2022 *Source: Bloomberg, NUS-CRI*

Additionally, as fears of supply chain issues in early 2022 led to industry players stocking up on products, retailers are now saddled with record levels of inventory at a time when consumer demand is slowing down. As a result, retailers have been forced to offer deep discounts on products to entice price-sensitive customers[6], adding to their profitability woes in the short term. Consumers are also opting for cheaper alternatives benefitting mass merchandisers which have seen higher consumer demand for their cheaper brand offerings. On the contrary, firms offering discretionary products face higher risks as consumers shift spending to essential items, leaving the firms potentially grappling with a reduced top line and excess inventory. As a result, the credit risk outlook for mass merchandisers, although still worsening, fares better than their discretionary counterparts (See Figure 2b). Bed, Bath & Beyond is one such discretionary retailer which recently underwent a distressed debt exchange owing to financial troubles stemming from mismanagement of inventory amidst a collapse of demand.

[3] Auto dealers experienced a 0.4% MoM contraction in sales while electronics and appliance stores experienced a 0.8% MoM contraction in sales as of Sep-2022.
[4] Bankruptcies in the sector tracked lower post-2020 and now stand at a 12-year low.
[5] This is notwithstanding the rising risk faced by safer firms as well. Industry heavyweight Amazon, in its latest earnings update, warned of a slowdown in sales growth in the upcoming holiday season as consumers spend more cautiously
[6] The longer the companies hold on to the excess inventory, the higher the discounts they will have to offer on products like electronics which may become outdated faster. Excess inventory prompted another industry behemoth Target to issue a profit warning in Q2 2022 due to a profit squeeze brought on by deep discounting of products.

Presently, consumers' lower household debt service ratio, which remains below pre-pandemic levels, has been instrumental in supporting demand and has limited the pain felt by US retailers. However, with consumers' savings rate on the decline, going forward, should the US economy enter a recession, firms in the retail sector will face tougher operating conditions which may erode their margins and push credit risk higher. Retailers which are unable to adapt to consumers shifting demands may experience financial distress and refinancing troubles as investors avoid risky investments in anticipation of a recessionary environment.

Credit News

Growing pile of distressed debt signals coming us default wave

Oct 28. The amount of distressed debt in the US corporate bond market had reached USD 271.3bn, its highest since Sep-2020, indicating that investors are requiring higher returns on riskier corporate debt. Although compared to the USD 1tn peak in 2020, the level of distressed debt to date is still lower, the high-interest rates and the prospect of such rates further increasing might push those distressed corporates in need of refinancing to default or even bankruptcy. Currently, corporate default rates stand at 1.5% and Bain Capital predicts that the rate could potentially double in the next year. (Bloomberg)

UK's battered corporate bonds rally as a 'grown-up' takes charge

Oct 25. Following Rishi Sunak's appointment as the UK prime minister, sterling-denominated corporate bonds bounced on the back of investors' restored perceptions of credibility. Yields on investment-grade sterling corporate bonds recorded their second-largest daily dip ever on Monday. The markets are currently undergoing unwinds of the turmoil caused by former UK prime minister Liz Truss whose unfunded tax cut plans scared investors. (Bloomberg)

Property market hits inflection point as debt cost outpaces rent

Oct 28. The cost of debt on commercial properties has increased, with financing costs rising above the returns earned by homeowners. Leverage levels for commercial mortgage-backed securities (CMBS), where leverage is taken as the cost of debt over projected earnings of investment, was negative for 28% of CMBS in the US in Q3 2022, drastically higher than the 8% seen a quarter prior. The increase in leverage has been driven by a decrease in demand and renters reaching affordability limits. According to Moody's, 84% of CMBS with negative leverage are backed by Apartments, and more than 83% were securitized into government-guaranteed deals backed by Freddie Mac. One could witness a surge in default events in the coming future, especially if earnings continue to dip further and investors become more likely to let go of the underlying property. (Bloomberg)

Foreign investors yanked billions from Chinese bonds as yuan slumped

Oct 28. Amid continued pessimism over China's economic outlook, foreign investors continued to sell Chinese yuan-denominated bonds as the yuan continued to weaken. International investors' total holdings of Chinese government bonds and other yuan-denominated debt dropped to CNY 3.4tn in September – the lowest level since Dec 2020. Last month's pullback was led by foreign institutions' cutting their positions in Chinese sovereign debt, which saw a net outflow of USD 5bn. (WSJ)

Financial crisis haunts Korea as it confronts a credit meltdown

Oct 29. The default of Legoland Korea's developer stoked fears that even government-backed institutions are not immune to the impact of rising interest rates. The sentiment had snowballed into South Korea's debt and money markets, pushing yields to a 13-year high. To ease volatility and resolve liquidity concerns, the government pledged a KRW 50tn support package for the credit market. Likewise, the BOK is expanding the bonds that it will accept as collateral. Meanwhile, a measure to require financial institutions to replenish the stock market stabilization fund is also being considered. The similarity between the current credit crunch and the crises in the 1990s and 2011 triggered an urgent and proactive response from the government to prevent any possible contagion. (Bloomberg)

Musk becomes media baron with Twitter deal amid Big Tech sell-off (FT)

UK gilts rout since July is worse than losses in EM bonds (Bloomberg)

India's government, corporate bond yield spread to widen on rising supply (Reuters)

Regulatory Updates

ECB raises rates by 75bps as markets detect 'dovish pivot'

Oct 27. The ECB raises rates again by 75bps to curb the surging inflation in the eurozone amid bond market speculation that an earlier-than-expected pivot might be imminent as Lagarde acknowledged a possibility of a recession. As a result, the EUR/USD fell by 9%. German 10-year yields also declined by 0.24%, while riskier eurozone government bonds railed even sharply. The ECB had emphasized its commitment to further increase interest rates, but the scale and pace of which would depend on the outlook of inflation and the lagged impact of the previous rate hikes. Aside from the rate hikes, the ECB has also initiated measures toward reducing its balance sheet. At the same time, it had also reduced interest rates on minimum reserves in alignment with money market conditions. (FT)

BoE rate bets point to growing doubts of a big November hike

Oct 27. Investors are pricing in a smaller-than-expected surge in BoE's interest rates as the UK government rebounds from the market upheaval seen earlier this month. With the new prime minister delaying his budget announcement, and investors expecting the budget to be in line with austerity measures to reign in public spending, the market for short-term interest rate swaps tied to BoE's policy dates has dropped to less than 75bps, from a high of 200bps earlier this month. Monetary policy tightening is expected to continue, but at a relatively slower speed, after the Bank of Canada increased rates at a slower pace for the second consecutive month. (Bloomberg)

Debt ceiling fights aren't new. The next one could unleash 'Armageddon' (CNN)

Yen weakens as BOJ sticks with ultra-low rates policy path (Bloomberg)

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