



More defaults expected for US firms despite recovery in capital markets
 by [NUS-CRI Market Monitoring Team](#)

The US Federal Reserve’s (Fed) unprecedented intervention in the corporate bond markets has helped to stabilise the US economy, temporarily restoring confidence in the markets and enticing investors to pour their money back into the bond market. Thus far, the Fed’s actions have managed to relieve liquidity pressure on US firms caused by the COVID-19 pandemic, with the amount of corporate bond issuances by US firms reaching a record high of USD 1.96tn as of Aug 2020. This demand and the lowering of interest rates have reduced the cost of borrowing for US firms, enabling them to refinance their debt at substantially lower costs. However, even as interest rates look likely to remain low in the near future, more firms are expected to default as macroeconomic uncertainties look to hamper their earnings and consequently their ability to repay their higher debt levels.

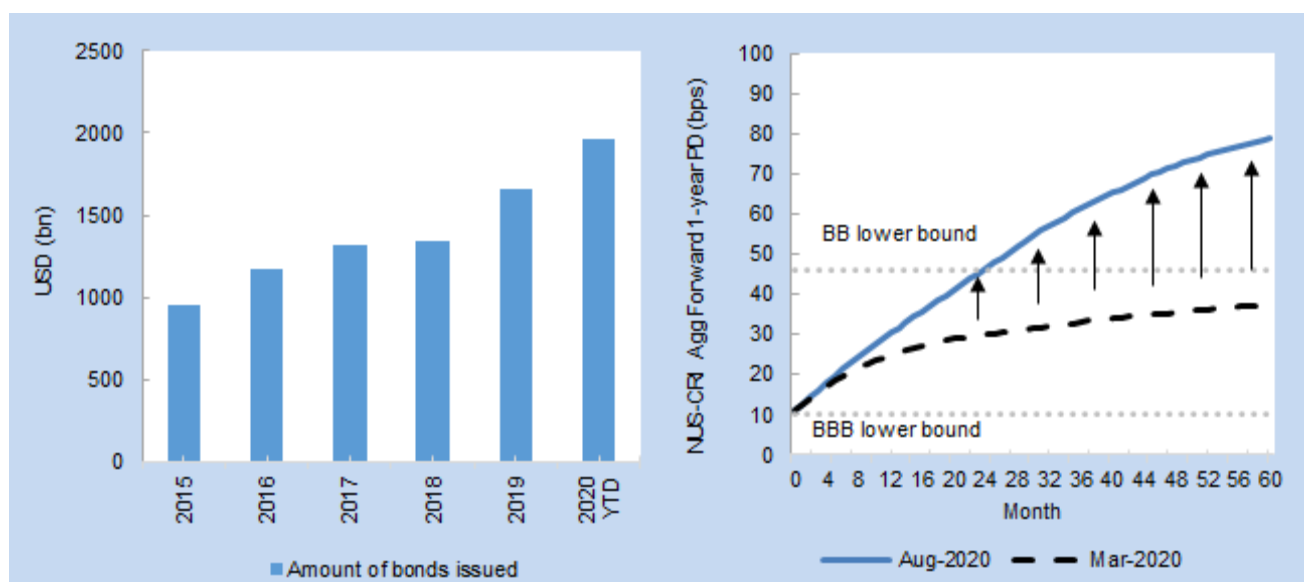


Figure 1a (LHS): Amount of bonds issued by US domiciled firms. Figure 1b (RHS): NUS-CRI Agg Forward 1-Year PD¹ of publicly-listed US firms based on information available in Mar 2020 and Aug 2020 with reference to the Probability of Default implied Rating version 2.0 (PDiR2.0²). Source: Bloomberg, NUS-CRI

The Fed’s support did not come without a cost. While the Fed’s support has allowed firms to issue more bonds to shore up their balance sheets and refinance in the short term, it has increased the risk profile of corporations in the long-run as corporate debt piles up. The increasing amount of debt that needs to be repaid in the future has also inevitably heightened US firms’ vulnerability to an economic downturn. In the first quarter of 2020, total corporate debt grew by 9% while corporate pre-tax profit shrank by 8.5%. Should corporate debt continue to grow faster than corporate profits, firms will face an increasing pressure to pay off their debts. As indicated by

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. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 1 year plus 6 months, 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 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 NUS-CRI Forward 1-year Probability of Default (Forward PD) in Figure 1b above, the deterioration of US companies' long-term credit quality will be more pronounced in the future as it looks to cross the BB lower bound when referencing to PDiR2.0 in 2 years.

More worryingly, high yield issuers have not been afforded the same luxury as their investment grade issuers during this crisis. Despite the Fed's injection of liquidity into the market, issuers have still had to scramble to tap on liquidity from a variety of sources. Furthermore, in their great rush to secure funding, bond tenures for loans secured after April this year have a much shorter duration than those secured pre-crisis. This is highlighted by the fact that more than 80% of high-yield notes secured in April need to be [repaid within 5 years](#) a substantial increase when compared to only 20% in March. Defaults also tend to lag instigating events, predominantly due to government interventions, and it is common for credit rallies to be [coupled with high default rates](#) as both tend to follow cyclical downturns. Due to this, it is likely that we will continue seeing more defaults in the coming years as explained by our Forward PD in Figure 1b.

Concerns over the trajectory of the US economy has significantly increased the credit risk of US domiciled firms. A substantial [rise in unemployment levels](#), has dramatically affected the effectiveness of the Trump administration's efforts to increase labour market participation. Furthermore, the resultant increase in unemployment benefits distributed in July 2020 was not enough to reverse expectations surrounding consumer spending significantly, as [warnings of drops in consumer spending](#) arise with potential reduction in future unemployment benefits and drops in income. Therefore, a sense of consumer caution is expected to remain for the near future, especially if unemployment remains at historically high levels. The uncertainty surrounding the length and magnitude of the US's economic position and recovery in the short and medium-term could negatively impact earnings and earnings quality of US domiciled firms. As demonstrated by Figure 1b, the Forward PD demonstrates that the increased 1-year PD, 16-months from now, is going to be reflective of the resultant deterioration in credit quality seen by continued effects of the relatively poor macroeconomic conditions today.

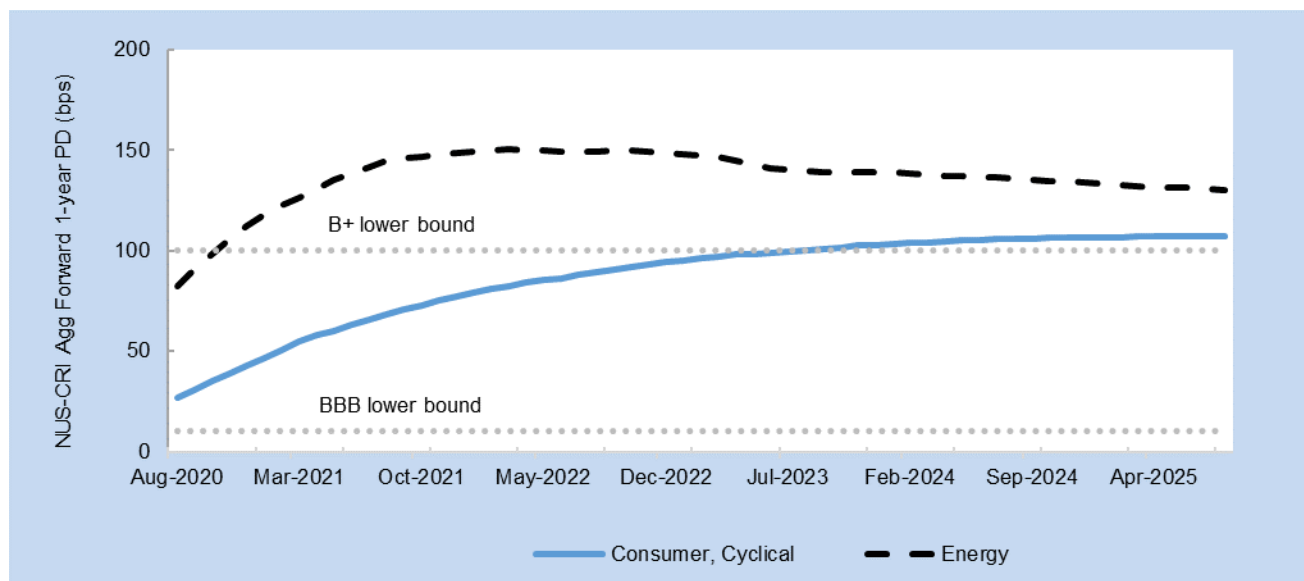


Figure 2: NUS-CRI Agg Forward 1-Year PD of publicly-listed US energy and consumer cyclical firms based on information available in Aug 2020 with reference to PDiR2.0 bounds. *Source: NUS-CRI*

Though the degradation of credit quality has been industry agnostic, our analysis depicts that the US energy and consumer cyclical sectors have suffered the worst from credit deterioration since the start of the pandemic. The [energy](#) sector has been hit hard due to the suppression of the oil price leading to the closing of mining rigs in the US. This coupled with the industry's high capital expenditure and operating expenses result in the sector facing a greater credit risk in the future. The Forward PD in Figure 2 demonstrates that the outlook for energy companies credit quality in the next year will further deteriorate, primarily due to weaker [demand](#). However, demand is expected to pick up in [1H 2022](#), improving the credit outlook after that. Furthermore, the consumer cyclical sector, specifically publicly listed US retail firms, are going to face a tough time in the short-to-medium term due to the inherent loss in consumer demand and diluted spending patterns. The key drivers for continued

credit quality deterioration in the US are the [loss of market share](#) for branded retail players due to the shift to consumer staples, as well as working capital investment needs that eat up available liquidity.

There are also concerns over the [rising number of US zombie firms](#) in recent years. According to the Bank of International Settlements (BIS), zombie firms are firms that had not earned enough profit to make even in interest payments on their debt over the previous three years. Zombie firms have detrimental effects on the economy as they will divert investments away from productive firms and block the entry of new companies. Should an economic downturn happen, zombie firms will naturally be more prone to defaulting their debt due to their unprofitability. The increase in zombie firms might also lead to a decrease in efficient labour allocation, as such companies that are efficient engines of the US economy will not be producing at optimum level of outputs.

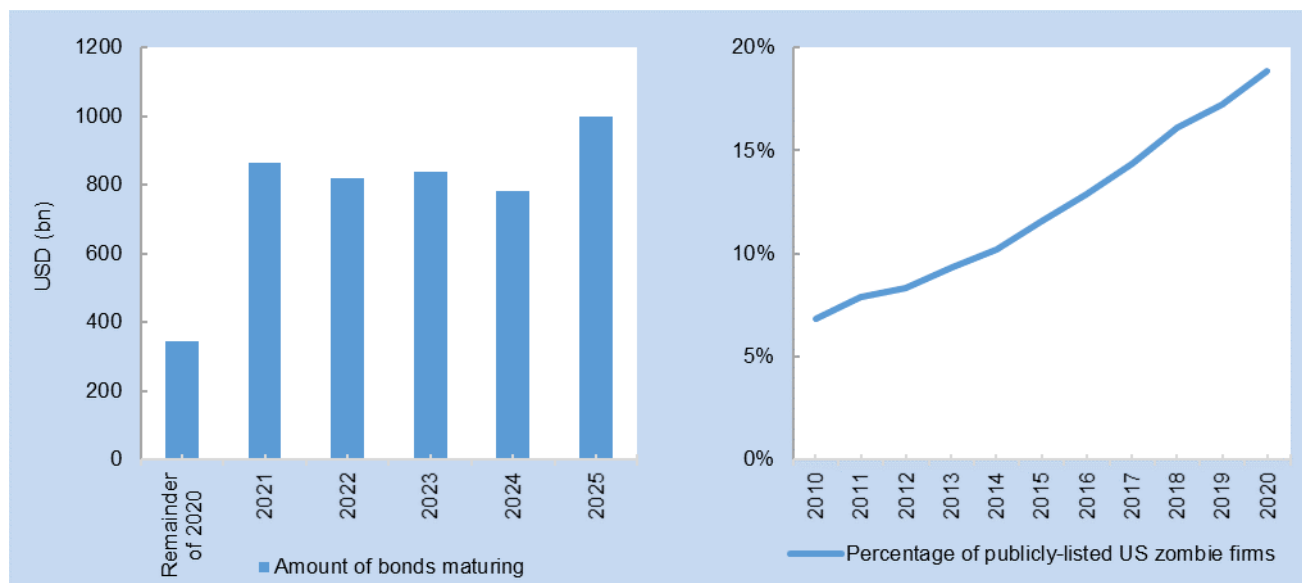


Figure 3a (LHS): Outstanding amount of US firms' bonds as of August 2020. Figure 3b (RHS): Percentage of publicly-listed US zombie firms. Source: Bloomberg, Deutsche Bank Research

Conclusively, there is great uncertainty in the future, especially due to the potential impact of upcoming elections in November as [bipartisan cooperation](#) to pass further rounds of stimulus into the markets seems ambiguous. The continued presence of uncertainty, which will reduce consumer expenditure during stressed times, could further deteriorate the credit quality of US domiciled firms. However, there is still a sense that the Fed may continue to prop up the market as they have made it clear that they will [support struggling US businesses](#). The Fed's announced lending facilities still have [not been heavily used](#) and they have also recently announced that the lending facilities will be extended to the [end of the year](#). However, it only targets investment grade bonds and only a small amount of 'fallen angel' bonds. It is likely that more defaults will follow as companies continue to struggle with overhanging debt and soft demand even with the Fed's measures, especially as investors still avoid risky sectors such as energy and consumer cyclical. This could lead to more 'zombie companies' being around for the foreseeable future, further limiting the impact of the Fed's future stimulus on improving the real state of the economy.

Credit News**Asia's biggest market for ESG debt hit by 'greenwashing' concerns**

Aug 16. South Korea, Asia's fastest-growing market for ESG debt has been met with criticism after data revealed that most of the funding has gone towards raising jobs for housing instead of funding environmental projects. Since May 2018, USD 54.7bn has gone to such South Korean ESG notes. A reason for this may have been South Korean regulators not setting up a framework to verify ESG issuance, resulting in few checks into where the funding ultimately ends up. There is currently no established globally-applied sustainable label to prevent greenwashing – leakage of proceeds towards less sustainable uses than advertised. ([FT](#))

Commodity traders face rising finance costs as big banks pull out

Aug 15. European Banks around the world are leaving the market of Commodity Trade Financing at a rate not seen in the past 20 years. This move follows a series of defaults by trading houses and an exposure to a series of frauds. The reductions in the letter of credit, a vital component to mitigate counterparty risk, have led to a dramatic increase in credit cost. Market participants are signaling wide-spread market failure due to traders pushing for cheap and unsecured revolving credit facilities (RCFs) but speculators believe that the pinch of lower competition would be felt once the market recovers, especially since 1H2020 has been extremely volatile and usage of leverage has decreased. While Asian Banks and capital markets are sought to plug the gap, however, doubts are raised regarding the suitability of such institutions as appropriate substitutes. ([Reuters](#))

Fed stimulus is resuscitating the high-yield bond market

Aug 14. US corporate high yield debt issuance peaked at USD 44bn this month. This phenomenon can be accredited to the Fed's bond purchase spree which granted a significant boost to the credit market. Since May 2020, the Fed has bought into over USD 8bn worth of Exchange Traded Funds and high yield bonds. Today, we see the effective yield of junk issuances at around 5.6%, this came down significantly from its high of 11.4% in Mar 2020. Amidst the low cost of funding, credit rating agencies remain cautious as they predict that the default rate for junk-rated US corporates will top 12% in the following year. ([WSJ](#))

Credit investors go 'all in' rather than fight central banks

Aug 14. European credit investors have poured money into the economy as central bank's measures of low-interest rates and massive asset-buying programs limit the economic damage of the Covid-19 pandemic. This led to the net percentage of investors who overweight top-rated bonds reaching a record 62%, giving insight into the high demand for corporate bonds in Europe. Consequently, this has pushed the yield on European investment-grade corporate debt to 1.81% from 0.56% in April. However, these measures have propped up "zombie companies" and suppressed defaults. This situation could change when the companies are weaned off support measures towards the end of the year. ([FT](#))

Ball Corp breaks new ground with junk bond offering just 2.9%

Aug 11. Junk debt experiences a rally through income-starved investors that are chasing high-yield bonds that resulted in July being the best month for high-yield bonds since 2011. Aluminum Can Maker, Ball Corporation secured the lowest borrowing cost for a US junk-rated company in history, as it raised USD 1.3bn through a 10-year bond, paying annual coupons at 2.875%. Ball Corporation holds the highest junk rating assigned by credit agencies at BB+, just one notch below investment grade. To satisfy the strong demand for yield in investors, Goldman Sachs and other banks were able to lower Ball's coupons to below 3% and increase the deal size by around USD 300mn. The average yield on junk bonds has dropped by

more than 6% to 5.36%. However, this rate is still significantly higher than investment-grade bonds, such as Amazon, Alphabet and Visa, who have raised at record-low costs recently. ([FT](#))

Debenhams appoints advisers to draw up plans for possible liquidation ([Reuters](#))

Brazil's Oi amends restructuring plan aiming higher offers ([Reuters](#))

India credit woes ease further as dollar loan pipeline rebounds ([Bloomberg](#))

Regulatory Updates

Beijing plans to scrap mandatory ratings to help companies hit by coronavirus issue bonds and raise new funds

Aug 13. In light of the pandemic induced economic slowdown, the world's second largest economy witnessed its first contraction of 6.8%. This left many corporates in urgent need to revitalize their balance sheets with fresh funds. In the bid to do so, Beijing removed the mandatory ratings pre-requisite. By loosening the procedures for debt issuance, China would be more aligned with the practice in the US. This change would also empower local investors to strengthen their risk and credit assessment capabilities. ([South China Morning Post](#))

Brazil central bank grasps new tool in crisis fight: forward guidance

Aug 12. Brazil's central bank has adopted a new "forward guidance" strategy to keep interest rates and bond yields low, bringing inflation up to target and targeting the economy's fragile recovery from the COVID-19 crisis. This occurred as the bank cut its Selic rate to a low 2%. Forward guidance is usually used in developed economies to sustain monetary stimulus when interest rates trend towards zero. This explains why some experts are uncomfortable with this being implemented in this situation. However, Copom, the bank's rate-setting committee, still believes that this measure provides the best cost-benefit ratio and has clarified that the measure will be contingent on inflation expectations and fiscal stability of the country. ([Reuters](#))

Congo central bank more than doubles key interest rate to 18.5% ([Bloomberg](#))

RBI moves to prevent misuse of bank funds; stop routing term loans via current accounts ([Financial Express](#))