Credit Research Initiative
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Australian coal industry continues to outperform its global peers

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Ever since the British colonists spotted coal in the coastal cliffs north of Sydney in the 1790s, coal has always been one of Australia's leading income generator. Since then, not only Australia has become the world's third largest coal producer (behind India and China), it has also become the world's leading coal exporter (accounting 32% of global coal exports). Nowadays, coal is mined in every state of Australia and about 75% of the coal mined is exported, mostly to Eastern Asian countries. With the support of a government-backed coal-friendly policy and stable demands, the credit profile for the Australian coal mining industry is in a relatively better shape than that of the global average level. As shown in Figure 1a, the NUS-CRI Aggregate (median) 1-year PD (Agg PD) for Australian coal mining firms is consistently below that for global non-Australian coal mining firms and the gap has been widening in recent years. Further illustrated by the NUS-CRI Probability of Default Implied Ratings (PDiR[1]), the proportion of investment-grade firms (rated BBB- or above) in the Australian coal industry is significantly higher than that globally at the end of Aug 2019, standing at 73% compared to 57% globally (see Figure 1b).

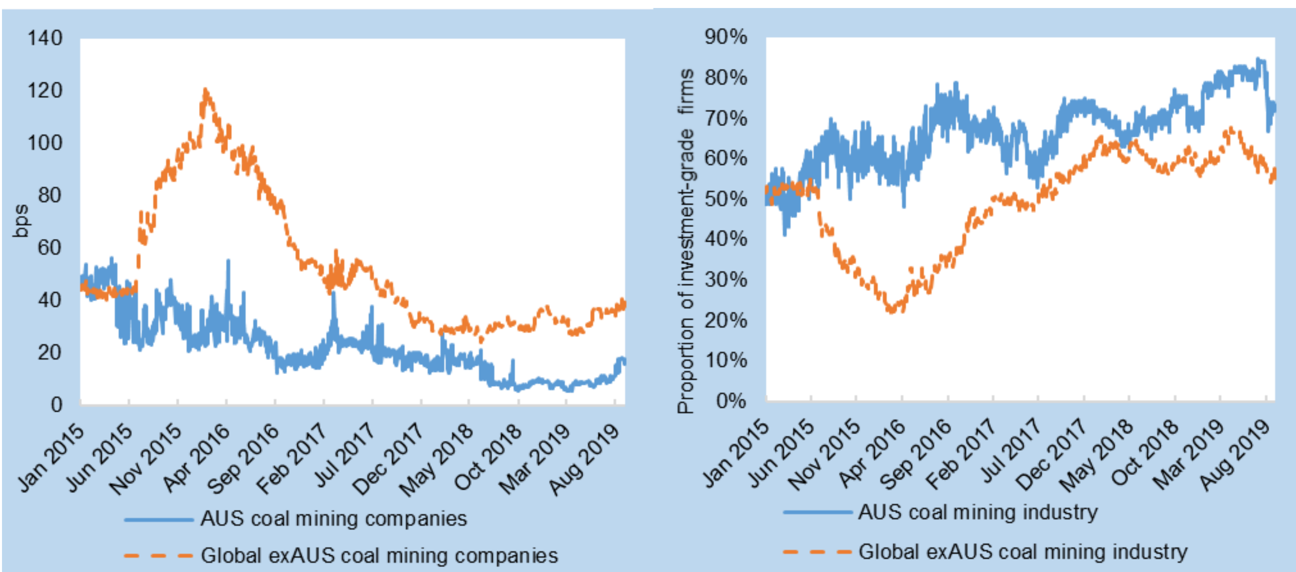

Figure 1a&1b: NUS-CRI Aggregate 1-year PD for Australian and global excluding Australia coal mining firms; Proportion of investment-grade companies for Australian and Global excluding Australia coal industry according to NUS-CRI PDiR. *Source: NUS-CRI*

[1] PDiR provides a more conventional interpretation of PDs – it translates NUS-CRI PDs to letter ratings by taking reference from the historical observed default rates of Standard & Poor's (S&P) rating categories.

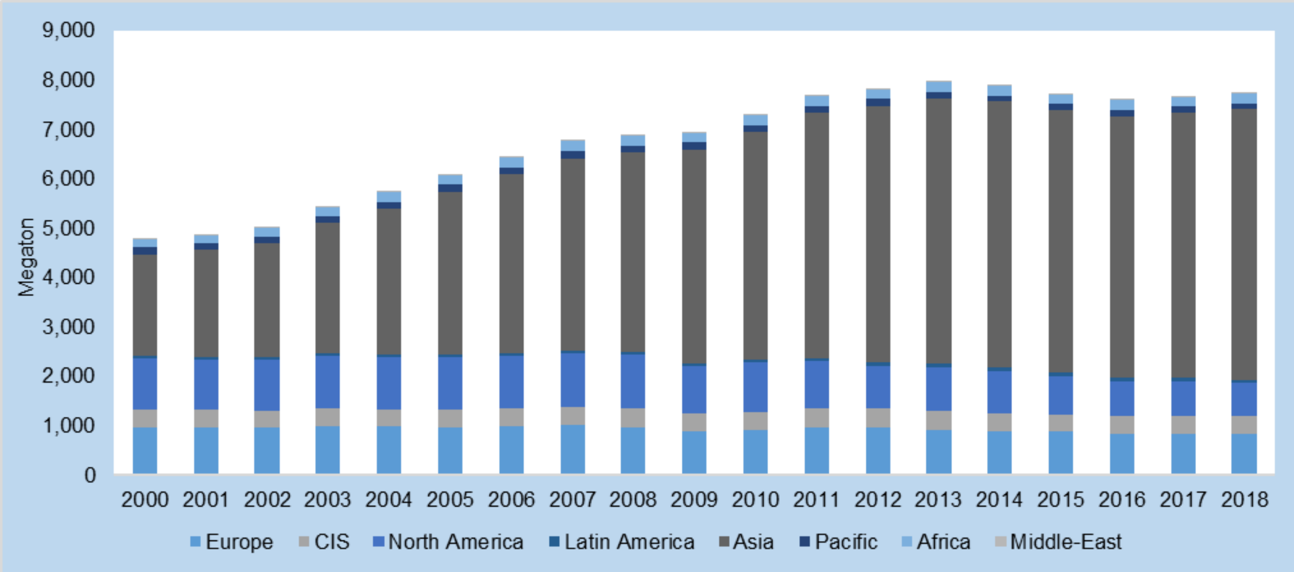

Figure 2: Global coal consumption from 2000 to 2018. *Source: Enerdata*

While some coal producers are facing pressure from the declining coal demand due to environmental concerns, demand from Australian key coal export destinations remain stable. As shown in Figure 2, global coal demand continued to grow by 0.7% in 2018, although this is significantly slower than the 4.5% annual growth rate seen in the 2000-2010 period. The growth was again mainly driven by Asian countries such as India and China, which is the largest and fourth-largest Australian coal importers in 2017 respectively. To highlight the importance of the Indian and Chinese market for the Australian coal industry, coal exports to India and China account for 41% of the total Australian coal exports. Furthermore, while many western countries started to shift away from using coal as a fuel source due to climate change, coal demand from the Asian countries continued to grow as a result of the expansion of several key industries, such as cement and sponge iron production. The sustained growth in coal demand from Asian countries is forecasted to offset the declines in coal demand from the US and European markets, leaving global coal demand stable until 2023 and thus benefiting Australia's coal industry. Lastly, while the role of coal in the global energy mix continues to slowly decline, coal continues to be the largest source of electricity and the second-largest source of primary energy.

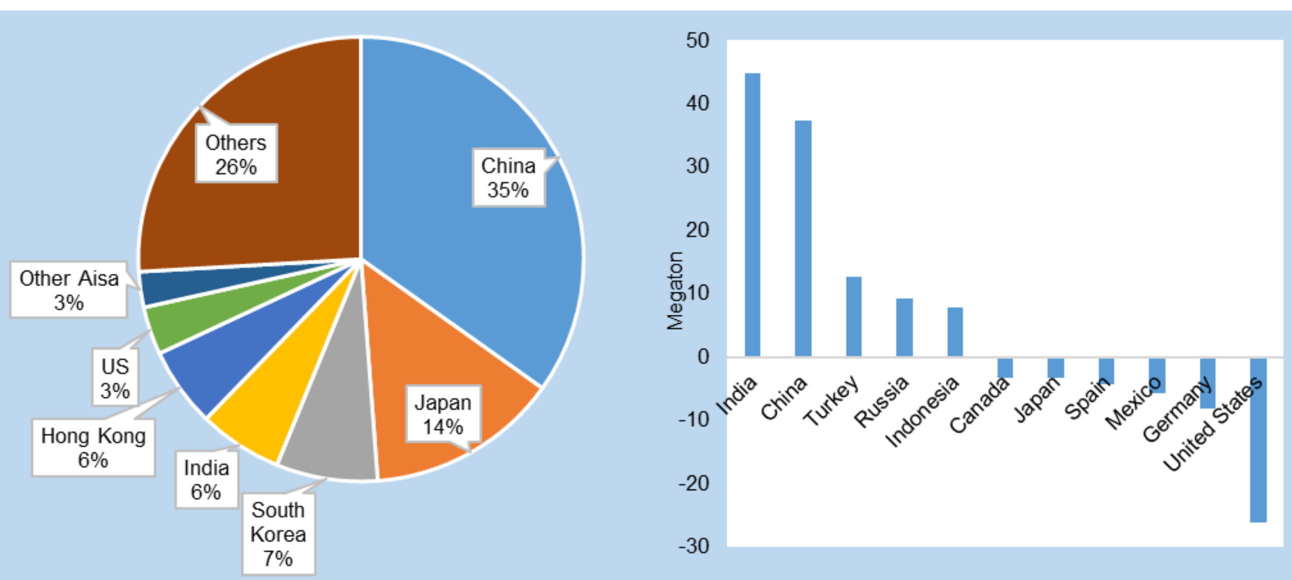

Figure 2a&2b: Australia key coal export destinations in 2017; Top 5 countries with the largest increase or decrease in coal consumption in 2018. *Source: OEC, Enerdata*

For the past few years, the Australian coal mining industry has also seen a broad political support which helped Australian coal producers to survive when global coal consumption fell in 2015 and 2016. Compared to its competitors, who experienced a crisis between mid-2015 and the beginning of 2017, the Australian coal industry was not only able to keep the variance of its probability of default (PD) to a minimum, it also actually managed to lower its median PD in a time where the Agg global PD for the coal mining industry tripled from 40bps to 115bps (Figure 1a). During that period, the Australian coal industry was heavily subsidized because coal exports contributed significantly to Australia's economy. For instance, the federal government provided subsidies for the usage and production of fossil fuel to support the Australian coal mining and natural gas industries. Until now, estimated by IMF, annual fossil fuel subsidies in Australia is around USD 29bn, representing 2.3% of the Australian GDP. Moreover, Australia remains one of the few OECD countries that continues to promote investments in new domestic coal-fired power plants and to expand coal mining for export.

The re-election of Prime Minister Scott Morrison from the coal-friendly Liberal party in May 2019 was seen as a sign of continued stability in the government's energy policy. The energy minister, Angus Taylor, has confirmed that the Morrison government will continue to assess and provide fiscal support for viable new coal generation projects. Entering into the second half of 2019, the Australian coal industry continues to face similar pressure as before. The increasingly popular usage of renewable energy can squeeze the energy market share, putting pressure on coal companies' revenue. However, the strong policy support and the relatively stronger demand from Asian countries will likely continue to make Australian coal companies better off than its global peers.

Credit News

Investors who chased Asia's highest-yielding bonds end up last

Sep 2. Asia's highest-yielding sovereign bonds provided the worst returns in August. The intuition behind this observation is that diminishing global growth and heightening trade tensions saw investors avoid the debt of less creditworthy nations, causing prices to plummet and investors to incur capital losses. According to a portfolio manager from Aviva, if global growth expectations continue to deteriorate and negatively impact risk appetite, it is likely to weaken emerging market currencies and the bond markets which correlate with those currencies, such as Indonesian bonds. Global funds offloaded US$281 million Indonesian bonds in August. Indian bonds also fared badly, returning 0.1% even though their real yields – which are inflation-adjusted bond yields - offered as much as 4.04%. The attractiveness of Asian bonds will be tested later in the week with the release of inflation data for five local markets: Indonesia, Thailand, South Korea, the Philippines and Taiwan. Annual CPI is expected to slow in South Korea, Indonesia and the Philippines, which should push up real yields and make those countries' debt more attractive. (Business Times)

China's mountain of bad debt climbs 10% in 6 months

Aug 31. China's debt market is a cause for concern: almost 5% of all lending is close or in default, with sub-performing loans totaling CNY 3.63tn and nonperforming loans (NPLs) growing at 10% during the first half of the year, amounting CNY 2.24tn. These bad debts weigh unfavorably on smaller banks that lack cash reserves as compared to their state-backed compatriots. The country's authorities have been engaging in efforts to curb and reduce the amount of bad debts in the country through pushing financial institutions – evident in the more than CNY 700bn bad debts disposed by China's publicly traded banks last year. Large institutions, despite having to dispose of bad loans, remain profitable given the wide margins between their lending and deposit rates. The story is different at smaller banks: total NPLs rose by more than CNY 100bn at city commercial banks, most of which are small and midsize businesses serving areas outside China's big cities. The profits reaped by major banks protected by the country's regulations have, perhaps, come at the expense of regional financial systems. (Nikkei Asian Review)

Siemens just borrowed billions and its corporate bonds had the lowest yield ever

Aug 30. Siemens borrowed USD1.6bn without paying a cent in interest. It is another indicator that investors are betting that rates are going to decrease. Siemens this week borrowed USD3.8bn from investors in a record lowest-yielding bond issuance ever by a company. Siemens borrowed USD1.6bn over two and five years and these bonds offered zero coupon and were priced with negative yields, which means that if investors held the bonds to maturity, they would be paying the company to lend money to them. The two-year note, whose yield reached minus 0.315% was "the most negative yielding corporate bond ever to be priced in the primary market". The Siemens sale highlights the unusual state of the global bond markets. Corporations and governments, especially in Europe, have the opportunity to tap incredibly cheap borrowing as investors chase rapidly diminishing returns, or simply a relatively safe place to park their cash. A quarter of all corporate bonds in Europe now have negative yields according to Jonathan Gregory, head of UK Fixed income and senior portfolio manager at UBS Asset Management. At this time, negative-yielding corporate bonds might be even better than government debt. German government bonds have hit record low yields as demand shoots up, indicating concern about the rising risk of recession**.** (CNN)

US corporate bonds are having the best August in four decades

Aug 29. Investors in US investment grade corporate bonds are on track for the best August in 37 years as their yields spike in response to the rally in Treasuries. According to Bloomberg, investment grade bond returns stand at 3.3% so far this month, which resulted in high-grade bonds gaining the most out of all major fixed-income assets with 14.1% this year. That result was the highest return year-to-date for any year since 2009. The surge comes as investors shy away from high-risk assets amid global economic growth issues and the US-China trade war, while also seeking returns in a negative-yielding world. While trade tensions and central bank easing have fuelled a lot of the movement in rates, perhaps the key factor is the growth in the amount of negative yielding debt globally that has made US fixed income look much more attractive to foreign investors, said Jon Duensing, director of investment-grade credit at Amundi Pioneer. There is now more than $16 trillion of debt with yields below zero, according to Bloomberg Barclays index data. (Bloomberg)

Companies securitize everything as investors reach for yield

Aug 28. With falling borrowing costs for their higher-quality counterparts, riskier businesses have been incentivized to pledge their assets to win investment-grade credit ratings on their debt and cut financing costs, making their bonds higher quality even if their overall companies are still relatively risky. This year, more than USD 6.9bn of such whole-business bonds, according to Bloomberg. Conventionally issued by fast-food restaurants, the issuer base of such bonds have been expanding, now including preschools, massage provider and music royalties' distributors. Issuers have been incentivized by investors seeking a combination of safety and strong returns in a world with more than USD 16tn negative-yielding debt. Issuers are also attracted by the cash savings from the move away from high-yield borrowings to investment grade. (Bloomberg)

UOB prices USD 500mn covered bonds due 2022 at 1.625% (Straits Times)

Canada energy bonds could get boost from a Tory win (Bloomberg)

Argentina begins to restructure USD 101bn of debts (FT)

Regulatory Updates

Singapore banks to switch from interest rate benchmark SOR

Aug 30. Singapore's central bank is looking to conduct an industry-wide interest rate benchmark transition from the Singapore dollar (SGD) Swap Offer Rate (SOR) to the Singapore Overnight Rate Average (SORA).

The change will take place over the course of two years and it comes on the backdrop of a likely discontinuation of the London Inter-bank Offered Rate (Libor). SOR is a key interest rate benchmark in Singapore used in the pricing of SGD interest rate derivatives, commercial and retail loans and other financial products. The three-month SOR is a benchmark used to price corporate loans. SOR relies on the USD Libor in its computation methodology. MAS announced that the likely discontinuation of the USD Libor will impact the sustainability of SOR and Association of Banks in Singapore (ABS) and the Singapore Foreign Exchange Market Committee (ABS-SFEMC) has concluded that financial contracts that reference SOR should transition to reference SORA. ABS-SFEMC had studied various options and found SORA to be the "most robust and suitable alternative", as it is a transaction-based benchmark underpinned by a deep and liquid overnight funding market. For SGD cash products that reference SOR, ABS-SFEMC recommends that these products can continue to reference various interest rate benchmarks, including Sibor, SORA or banks' internal funding rates. (Straits Times)

Lagarde reveals dovish ECB view in hint of post-Draghi policies

Aug 29. Incoming European Central Bank President Christine Lagarde signalled that she is ready to emulate her predecessor Mario Draghi's ideology to keep monetary policy remarkably loose to alleviate regional inflation. She remarked on Thursday that ECB has the tools to handle a downturn and must be ready to use them if needed – the euro weakened slightly after the remarks were published. Lagarde's comments come at an apt timing – 2 weeks before the ECB's next policy meeting, where the Governing Council is expected to initiate another round of stimulus. Interest rate cuts are predicted, and some economists expect to see a relaunch of quantitative easing. Lagarde takes the helm in November, during a period where growth is slowing and inflation subdued. Yet interest rates remain low and there are concerns on whether central bankers have the ability to defend a harsher economic downturn. That's prompted many to say governments need to step in with fiscal stimulus to fill the gap. In written answers to a European Parliament questionnaire, Lagarde acknowledged the difficult backdrop. She said the economy faces downside risks, inflation is subdued and it's "therefore clear that monetary policy needs to remain highly accommodative for the foreseeable future." (Bloomberg)

Bank of Korea hints at future rate cut as risks to economy rise (Bloomberg)

Argentina imposes capital controls as reserves drain away (Bloomberg)

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