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Brazil domiciled corporates sambaed amid favorable markets conditions

by Anthony Prayugo

For the first time in many years, Brazil was like the rest of the world, a country with low interest rates[1]. With inflation expectations firmly anchored, its central bank is able to cut its target rates to record lows. Furthermore, the recent success of Brazil government's long-awaited pension reforms and market friendly agendas have increased investors' confidence in Brazil's financial markets and therefore enabled Brazil domiciled firms to raise funds more easily. The credit profiles of publicly-listed Brazil domiciled firms, tracked by the NUS-CRI 1-year Aggregate (median) Probability of Default (Agg PD), have continued to display improvements since the end of its 2015-2016 recession. During the same period, the proportion of Brazil domiciled corporates rated as investment grade has risen from around 57% in Dec 2016 to 78% in Jan 2020 according to the NUS-CRI Probability of Default Implied Ratings (PDiR)[2].

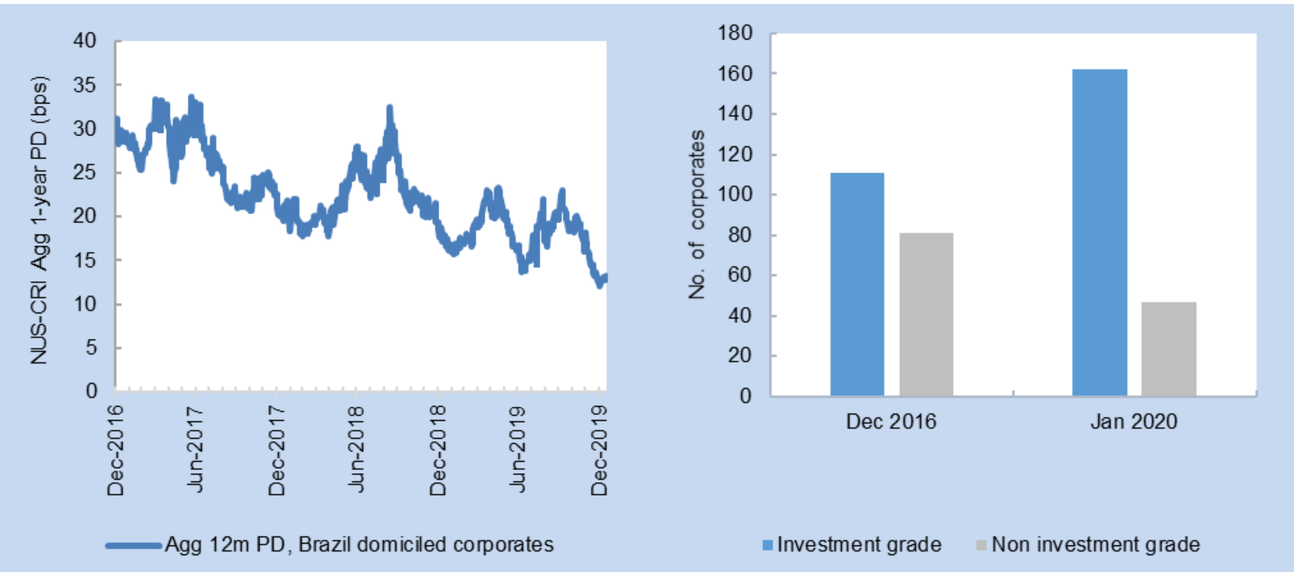

Figure 1a (LHS): NUS-CRI Aggregate 1-year PD for Brazil domiciled corporates from Dec 2016. Figure 1b (RHS): Number of investment and non-investment grade corporates in Brazil according to PDiR. *Source: NUS-CRI*

The easing monetary policies conducted by Brazil's central bank for the past 3 years have pushed Brazil's Selic target rate downwards from 14.25% in Dec 2016 to 4.50% in Dec 2019. Despite the lower target rate, Anefac (National Association of Executives in Finance, Administration and Accounting) reported last year that Brazilian banks would still charge Brazil domiciled corporates at an exorbitant average of 47% a year, which compelled these corporates to seek other means of funding[3]. Fortunately, investors who used to park their money in Brazil banks began to seek alternative assets to invest in as Brazil banks' deposit rates continued to dwindle. Brazil's corporate bond market was one of the main beneficiaries of this policy as yield-starved investors injected their funds into the corporate bond market in droves since 2018. More significantly, the opening up of Brazil's bond market has enabled credit-starved Brazil domiciled corporates — corporates which have no access to

[1] Brazil's Selic target rate reached below 5% for the first time in its history in the end of 2019.
[2] 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 historically observed default rates of S&P's rating categories.
[3] The Brazilian banks federation, Febraban, cited taxes, high default rates and regulation as the reasons why lending rates remain high. For instance, Brazil reserve requirement ratio is currently set at 21%, one of the highest in the world.

international capital markets or receive taxpayer-subsidized loans — to receive the much needed funds at a cheaper cost.

As shown in Figure 2a below, Brazil domiciled corporates have seen their Brazilian real (BRL) denominated bonds issuance significantly increased for the past 3 years. In 2019 alone, Brazil domiciled corporates have issued approximately BRL 183bn worth of bonds denominated in their local currency. Meanwhile in 2018, the figure was around BRL 135bn, which was approximately 70% higher than the total issuance in 2017. The low interest rate environment has provided Brazil domiciled corporates the opportunity to repurchase some of their older bonds and issue new bonds on lower interest rates. Several large Brazil domiciled corporates have retired some of their overseas debts early to borrow in the local market. For instance, Petrobras (largest publicly-listed Brazil domiciled corporates by market capitalization) repurchased its USD 2.8bn overseas debt in Sep 2019 and issued BRL 3bn at its local bond market.

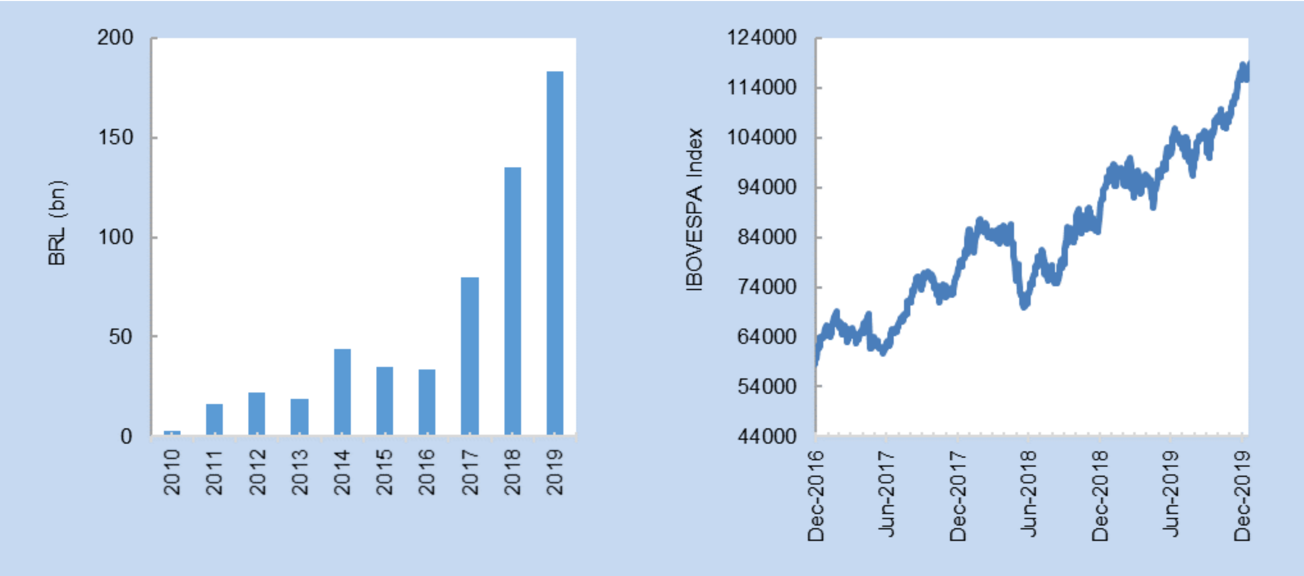

Figure 2a (LHS): Yearly amount of BRL-denominated bonds issued by Brazil domiciled corporates. Figure 2b (RHS): IBOVESPA Brasil Sao Paulo Stock Exchange Index. *Source: Bloomberg*

The recent implementation of reforms in crucial areas such as labor and the successful negotiation of the EU-Mercosur[4] Agreement has bolstered investors' confidence in Brazil's financial markets. However, the most significant legislation that has recently been passed by its congress is probably the long-awaited pension reforms, which is expected to reduce Brazil government's budget deficit. Investors will be further buoyed upon hearing that the upcoming reforms and measures such as reducing import tariffs and increasing the banking sector competition will make Brazil's economy more open to the world. Reaction from Brazil's Stock Market Index has been overwhelmingly positive as it managed to hit record highs at the end of 2019 (see Figure 2b) and the rally in the equity market might have been one of the factors that contributed in the general decrease of Brazil domiciled corporates Agg PD for the past 3 years since firms were able to raise more funds more easily during this period.

In tandem with the recent favorable market conditions, Brazil domiciled corporates' credit outlook has also improved for the past few months. Figure 3 exhibits Brazil domiciled corporates' credit outlook looking to Jun 2020 based on information from Apr 2019 to Jan 2020. As time draws closer to Jun 2020, the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD) of Brazil domiciled corporates has seen a decreasing trend, indicating an improved credit outlook. For instance, the 14-month Forward PD in Apr 2019 was around 44bps, which means that the 1-year PD of a typical Brazil domiciled corporate conditioning on its survival till Jun 2020 was expected to be 44bps. Meanwhile, the 5-month Forward PD in Jan 2020 is at around the 18bps level, lower than the one in Apr 2019.

[4] Mercosur is an economic bloc formed by Brazil, Argentina, Uruguay and Paraguay.

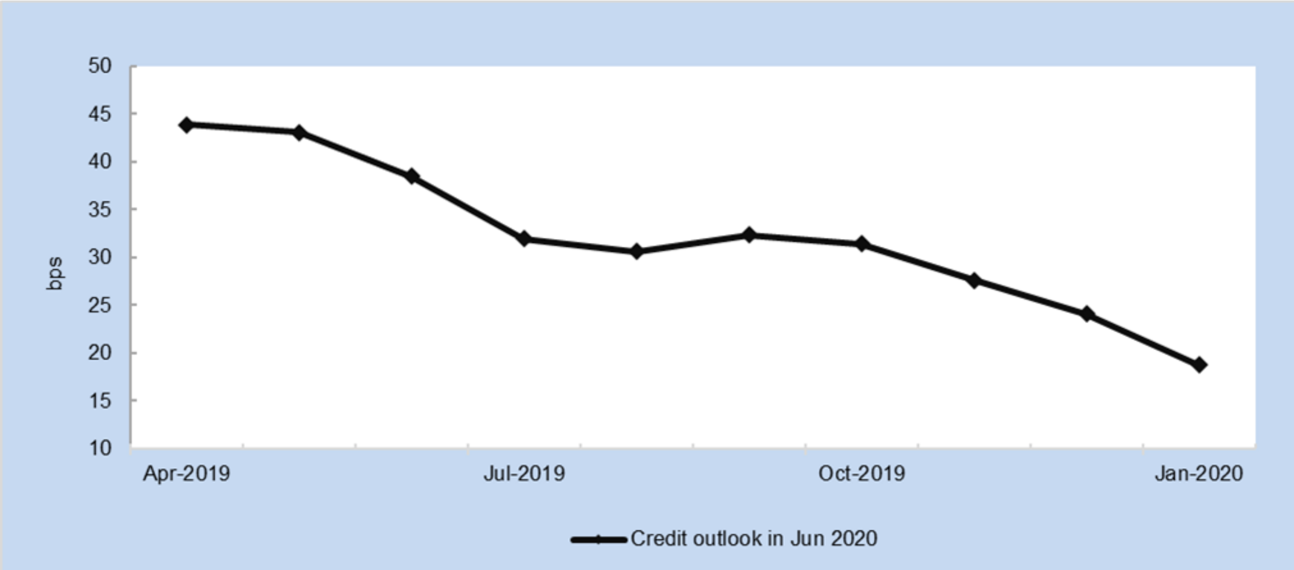

Figure 3: NUS-CRI Agg Forward 1-year PD time series for Brazil domiciled corporates based on information from different historical months looking to Jun 2020. *Source: NUS-CRI*

However, it is important to note that Brazil's current road of economic recovery is still vulnerable to major geopolitical events that could shake investors' confidence in its financial markets. Amid signs of global uncertainties last year, foreign investors, up to Dec 9, 2019, withdrew a net of BRL 13.6bn from Brazil's equity market, which is the largest retreat on the record. The World Bank warned of a potential global debt crisis amid borrowing build-up among countries which also include emerging markets' economies such as Brazil. A turmoil in financial markets, particularly in big emerging markets, could prompt investors to sell their assets (such as bonds) in Brazil. This, in turn, could drive up the borrowing costs of Brazil domiciled corporates and lead to a worsening credit outlook on Brazil domiciled corporates.

Credit News

The hidden factor making junk bonds less risky

Jan 26. Over the past two decades, average durations have generally been increasing for investment-grade bonds and shortening for speculative-grade bonds, and this trend has recently accelerated since the end of 2018. The shortening durations of speculative-grade bonds is one hidden factor making them less risky, as longer-duration corporate bonds have more time for their value to be hurt and their prices are more volatile than those of shorter-duration bonds, given all else being equal. Although most of the speculative-grade bonds are still riskier than investment-grade bonds due to a greater chance of default, considering the yield they offer to compensate for that added risk and factors such as duration, they are still relatively attractive for investors. (WSJ)

Investors build war chests to buy bonds of distressed European companies

Jan 24. With European economic growth expected to be subdued and default rates to rise, the number of companies that will struggle to service their debt is expected to increase. This creates an opportunity for investors to buy the bonds of a troubled company at a discounted price, while making big profits if the company manages to turn itself around and the bond price recovers. Asset managers and private equity groups are creating so-called special situation funds to identify suitable targets for these high-risk and potentially high-reward bets. (Reuters)

Banks race to sell first post crisis managed synthetic CDO

Jan 24. JP Morgan, Nomura and BNP Paribas are among the banks racing to sell the first managed synthetic collateralized debt obligation since the financial crisis. The move would represent a further landmark in the rehabilitation of this controversial breed of structured credit investment that associates with excessive financial engineering that led to the financial crisis of 2008. The volume of collateralized synthetic obligations (CSO) has surged in recent years, as historically low interest rates have encouraged money managers to turn to more complex investments. Banks are now looking to change the short-dated CSOs by crafting longer-dated, managed CSOs that would offer higher yields. (Reuters)

Hunt for yield boosts corporate bond sales and prices

Jan 24. New bond sales by US high-yield and investment-grade companies are on track for one of their biggest Januarys in years and issuance of investment-grade corporate bonds has reached USD 140bn this month, the second strongest January in the past decade behind 2017. Buying of some investment-grade corporates is outpacing strength in the treasury markets, where the 10-year yield fell from 1.739% to 1.680%, from Thursday to Friday, amid concerns about China's coronavirus outbreak and weakness in European economies. Fall in yields boosts the bond prices. Spreads have declined in recent months thanks to strong investor appetite. (WSJ)

Shadow banks come into the light in global lending

Jan 23. According to Bank for International Settlements, nonbank financial institutions are leading the growth in cross-border lending, with cross-border banking claims in the third quarter up 17% from a year earlier. The increase raises concerns on how they'll behave in a sharp slowdown or financial crisis. Research last year from the Barcelona Graduate School of Economics suggested that raising bank capital requirements spurred activity by nonbank lenders and some of them tended to make the crisis worse because they lacked stable funding sources. Nonbank financiers also tend to be less well hedged against international risks than banks, according to International Monetary Fund research published last year. (WSJ)

China CDS stuck at 6-week high on virus threat (Reuters)

Bond Investors Just Keep Piling on the Risks (Bloomberg)

'Peak Greed' Fuels Record Junk Bond Sales in Europe (Bloomberg)

Regulatory updates

ECB's Lagarde launches policy overhaul that will leave no stone unturned

Jan 23. After launching increasingly aggressive stimulus measures, the European Central Bank (ECB) has fallen short of its inflation target of 2% for years. The euro zone's central bank launched a broad review of its policy, showing the new president redefines the ECB's main goal and how to achieve it. How the formulation of price stability is changed will be crucial to anticipate future policy moves. However, the ECB rate-setters did not make any policy change on Thursday. It is widely expected that the ECB will leave its monetary policy on hold until the review is completed. ECB will also look closely at how it can incorporate the economic impact of climate change into its policy. (Reuters)

Indonesia central bank to maintain accommodative policy to bolster growth

Jan 22. Indonesia's central bank is set to continue its accommodative monetary policy this year to support economic growth. Bank Indonesia has targeted the economic growth rate at 5.1%-5.5%. A large majority of economists expected the central bank to hold the 7-day reverse repurchase rate steady at 5%, and all policy instruments are focused on keeping and strengthening the economic growth momentum. Stronger economic growth, low inflation and foreign inflows have led to a strengthening in the rupiah: the rupiah has gained around 1.6% so far this year to trade near its firmest in two years. (Reuters)

Swiss bond yields fall as SNB governor says negative yields "a necessity" (Reuters)

ECB launches review, keeps policy on hold (Reuters)

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