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Weekly Credit Brief Jul 24 - Jul 30

Geopolitical risk is on the rise in oil markets

by Dexter Tan

The price of crude oil has inched up amid geopolitical and supply disruption concerns last week. ABC news, citing senior Australian government officials said the United States could bomb Iran's nuclear facilities as soon as next month. The report cited high level administration representatives who say that Australian intelligence units would likely cooperate with the US in identifying strike targets in Iran. Rising geopolitical concerns – attacks in the Bab el-Mandeb Strait and threats by Iran to shut down the Straits of Hormuz could disrupt the supply of oil and push oil prices higher.

Oil prices may have risen to their highest level in more than three years but analysts still expect prices to keep falling through the rest of 2018. RMI-CRI 1-year Probability of Default Implied Ratings (PDiR) show that the proportion of investment grade firms within the oil and gas sector has declined since 2014. The PDiR provides a letter grade to a firm's 1-year forward looking credit quality, using the S&P classification. For example, a firm having a CRI 1-year PD in the range between 0 and 0.85bps can be understood as a firm with similar creditworthiness as a representative S&P AAA rated firm. Junk-rated firms, or companies carrying implied ratings 'BB+' and below accounted for nearly 26% of the sector in Jan 2014 but this proportion has climbed to 35% in Jul 2018. The fraction of firms with the highest implied ratings on their debt has also decreased from 16.1% to 10.8% over the years.

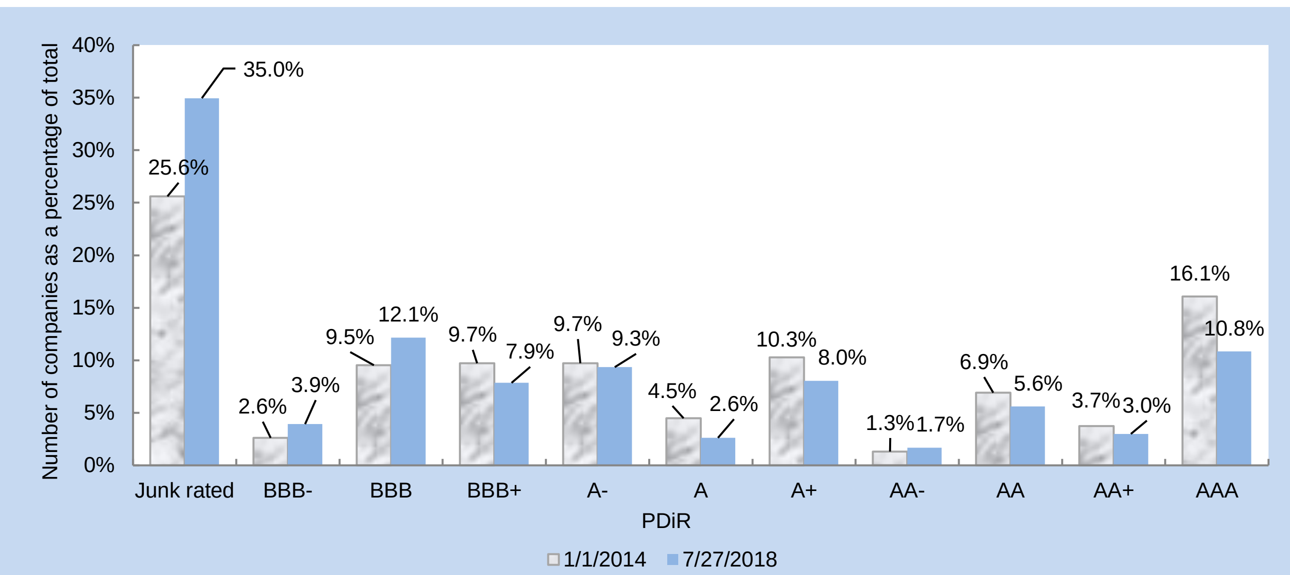

Figure 1: Percentage of oil and gas firms rated investment grade and junk based on PDiRs. *Source: RMI-CRI*

The number of PDiR upgrades and downgrades across the oil and gas sub-sectors is displayed in Figure 2. Over the last four years, oil exploration firms and oil drillers witnessed the largest ratio of downgrades to upgrades (201 downgrades to 106 upgrades; 25 downgrades to seven upgrades), while integrated oil majors and oil refiners had a higher proportion of upgrades to downgrades. Firms in the upstream business of exploration and production were likely more negatively impacted by falling crude prices, as many firms borrowed heavily during the oil boom years and found themselves struggling with liquidity problems when prices nosedived. Oil majors in the downstream segments were also dragged down by falling oil prices but managed to offset some losses in the refining margins of turning crude oil into commercial products like petroleum.

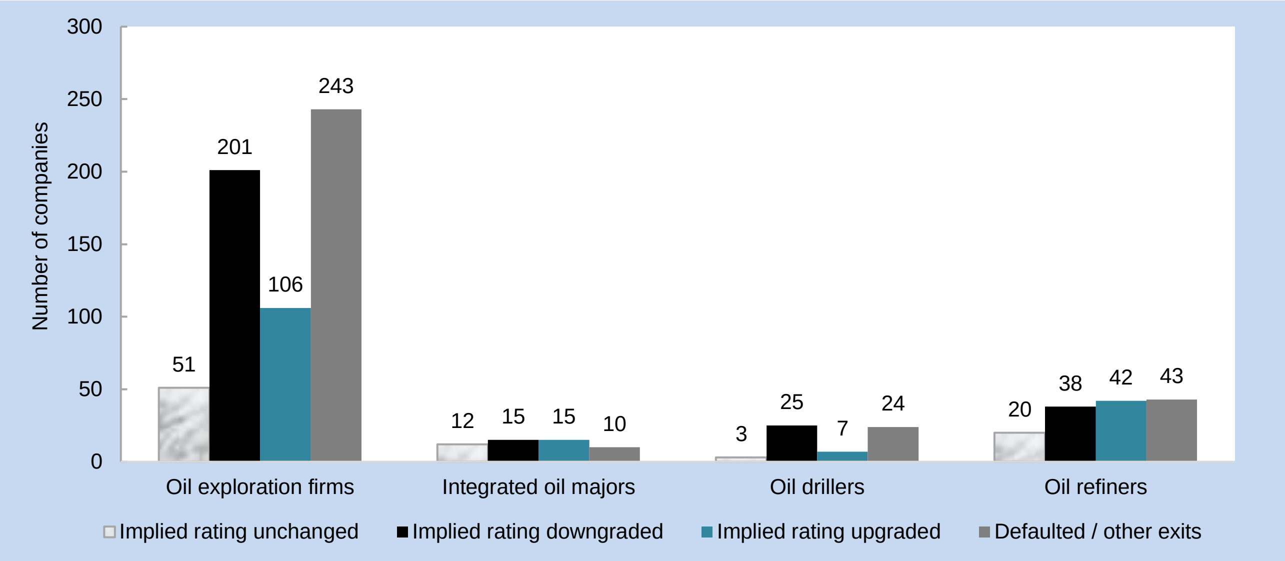

Figure 2: Number of upgrades and downgrades across sub-sectors between January 2014 and July 27, 2018. *Source: RMI-CRI*

Interruptions to the supply of crude oil could decrease barrels delivered to consumers in the next few months but analysts appear to be more concerned about the tariff impositions between the US and China and how it might weaken oil demand. At the same time, OPEC's pledge to increase oil production might outweigh the effect of US sanctions against Iran. Against the backdrop of frequent geopolitical supply shocks and lower long term oil demand, analysts are expecting lower Brent crude prices till Dec 2019. Bloomberg mean consensus foresees a drop in oil demand with higher production from oil suppliers till the end of 2019, where Brent crude prices are forecasted to fall to USD 71.56 per barrel in Q3 2018 and decline further to USD 68 per barrel by the end of 2019.

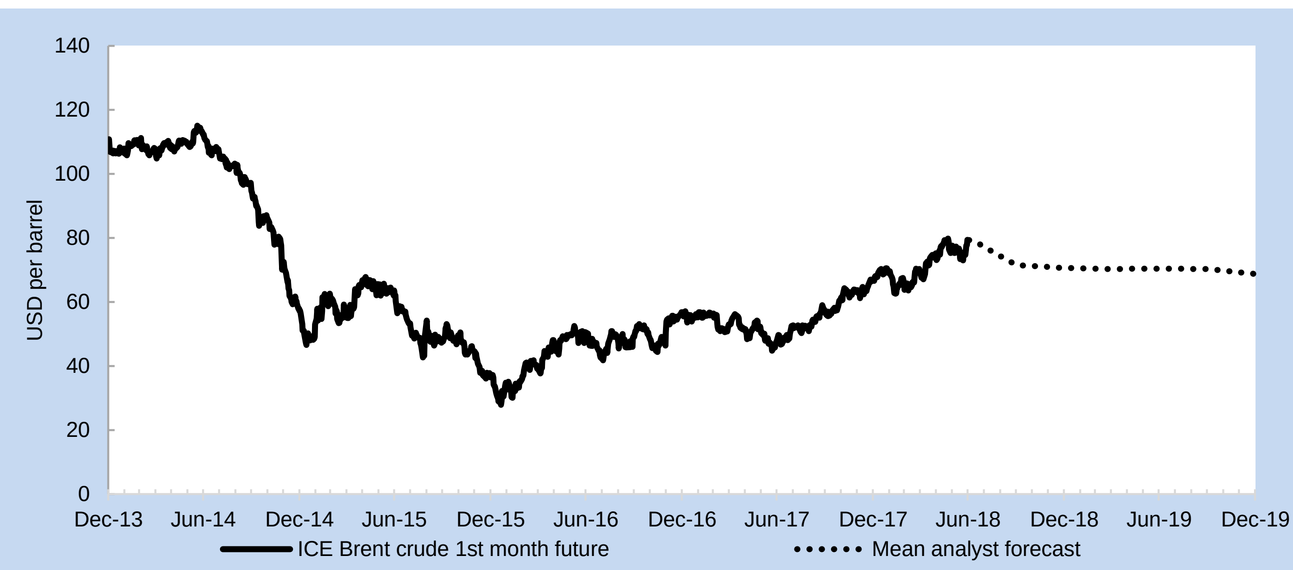

Figure 3: ICE Brent 1st month future and mean analyst forecast. *Source: Bloomberg compilations, Jul 27, 2018*

That said, managers of oil companies have likely learnt their lessons in the last downturn. Firms have improved cost structures and should be able to generate meaningful capital efficiency moving forward. With a renewed focus on financial discipline and liquidity management, new and approved oil projects are likely to be more lucrative as contractors negotiate better terms. A gradual slump in oil prices is likely to increase the default risk of the oil and gas sector but could have a minimal impact on their aggregate credit risk profiles.

Credit News

China shifts from greenback detractor to record seller of US dollar bonds

Jul 30. Chinese companies, banks and even the government sold bonds denominated in dollars at a record pace last year, and it is expected that the issuance will continue for years. For Chinese borrowers, the dollar market is easier to raise funds and easier to use to fund acquisition and investment abroad. The offshore bond market is also set to provide a stake in President Xi Jinping's "Belt and Road" initiative (BRI) that envisions deepening trade and investment ties with countries across the Eurasian landmass and beyond. As the trade tension between US and China is escalating, China will focus more on the BRI, which is expected to result in an increase of new Chinese dollar-bond issuance related to the BRI, according to a chief investment officer for Asia-Pacific fixed income at Invesco Hong Kong Ltd. (Business Times)

Housing downturn puts USD 20bn Indian bank loans at risk

Jul 25. Coupled with the struggle to recover USD 20bn loans given to troubled realty developers, the prospect of Indian lenders becomes worse amidst a home sales slump. Banks are taking control of land parcels and unfinished projects to be sold along with loans in an attempt to recover the dues. In the first half of 2018, residential property prices declined and sales did not improve even though project launches increased, partially because of an oversupply of land parcels in the market. The delay of some property deals could be due to banks' reluctance to take steep haircuts as they do not have the expertise in handling stressed realty projects. India's central bank has since urged lenders to quickly restructure loans or take defaulters to bankruptcy court and it is expected to trigger a bout of property deals. (Business Times)

China's downgrade-free defaults put focus on rating firms

Jul 24. Wintime Energy Co, which has defaulted earlier this month, did not have a single rating downgrade by Chinese rating firms. This highlighted China's credit rating firms' problem in transmitting information regarding worsening credit quality in Chinese companies. Until recently, China did not allow companies to default. Currently, there are no clear guidelines on which companies still have implicit guarantees and some state-backed firms may bail out defaulted firms which makes it tricky for rating companies to provide accurate ratings. Unreliable ratings have deterred foreign funds to enter into China's credit market despite its onshore bond market being the world's third largest. (Bloomberg)

Cost to insure Tesla's debt rises on growing default fears

Jul 24. The cost to insure Tesla's debt, in the form of credit default swap contract, jumped by 13 cents to a second highest level of USD 5.96 per USD 100 of Tesla debt on Monday, reflecting a higher default risk. This followed a clarified report that Tesla had asked some suppliers to decrease capital expenditure project spending to improve future cash flows. According to analysts, the market believes that the company can raise cash if required, maintaining Tesla's implied risk of default below similarly rated junk bonds and supporting its bond price. Tesla has been burning cash in order to ramp up production of its Model 3 sedan and had fallen short of production targets prior to July. (Reuters)

Loan covenant quality hits record low, says Moody's

Jul 24. The weakening in leveraged-loan covenants, which are meant to protect lenders' collateral, has been gaining pace due to the rising demand for floating rate securities such as loans. 80% of leveraged loans issued in the first quarter of 2018 were considered to be covenant-lite. These are loans that do not have covenants requiring borrowers to have certain financial standards such as the maximum level of indebtedness and the seniority of lenders' claims. Based on a study done on companies that came out of bankruptcy between 2014 and 2017, weaker protection can lead to lower recovery rates for lenders. (FT)

Regulatory Updates

Draghi's pledge on low interest rates hits euro, lifts bonds

Jul 26. The European Central Bank has reaffirmed to keep interest rates on hold despite the expectation of inflation rising by end of the year. The recent Purchasing Managers' index indicated slowing growth but the Euro-area economic growth is expected to remain strong and broad-based. The recent weaker PMI data could have pushed back thoughts about raising rates sooner. Government bond yields across the euro region trimmed rises on the confirmation of the low rate outlook. Despite the dovish pledge, economists expect ECB to raise rates just before Mr Draghi's term ends next October. (Business Times)

China said to ease bank capital rule to free up more lending

Jul 25. On July 25, the People's Bank of China (PBOC) told some banks that a specific capital requirement will be eased to support lending. Such actions are taken to ease the pressure from China's deleveraging campaign and to mitigate increasing risks to the economy from the trade tension with US. The PBOC has cut reserve-requirement ratios three times this year, while announced tax cuts and infrastructure projects on July 23. While China's USD 10tn shadow-banking system has been a target of deleveraging, the supply of new credit through shadow-banking to the real economy has also been under pressure. The PBOC's reduction could significantly relieve the pressure and encourage bank lending, according to Nie Wen, an economist at Huabao Trust Co. in Shanghai. (Bloomberg)

Italy government delays, amends reform of small lenders (Reuters)

UK watchdog proposes tougher rules for peer-to-peer lending (Reuters)

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