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Credit profile of Brazilian companies benefit from capital markets response despite of long-term economic woes

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- **Flows into credit funds have likely contributed to the downward tapering of credit risk for listed Brazilian corporates, as demonstrated by the NUS-CRI 1-year PD**
- **The downward shift in the NUS-CRI Forward PD indicates a healthier credit outlook for corporates in Brazil, but underlying economic woes remain**

With the third-highest number of COVID-19 cases in the world, Brazil domiciled companies (Brazilian companies) have had to deal with multiple social and economic storms plaguing the nation. Not only is the country battling the pandemic induced economic slowdown, but also it has had to manage a worsening monetary environment. In March 2021, concerns regarding high levels of headline inflation raised prospects of Brazil's central bank hiking interest rates to cool down inflation. The focus of this Weekly Credit Brief shifts to the credit quality of Brazilian companies, which have enjoyed a greater access to the capital markets as investor demand in the space increased. At the same time, long-term risks remain, with a weak pandemic response coupled with high inflation rates serving as headwinds going forward.

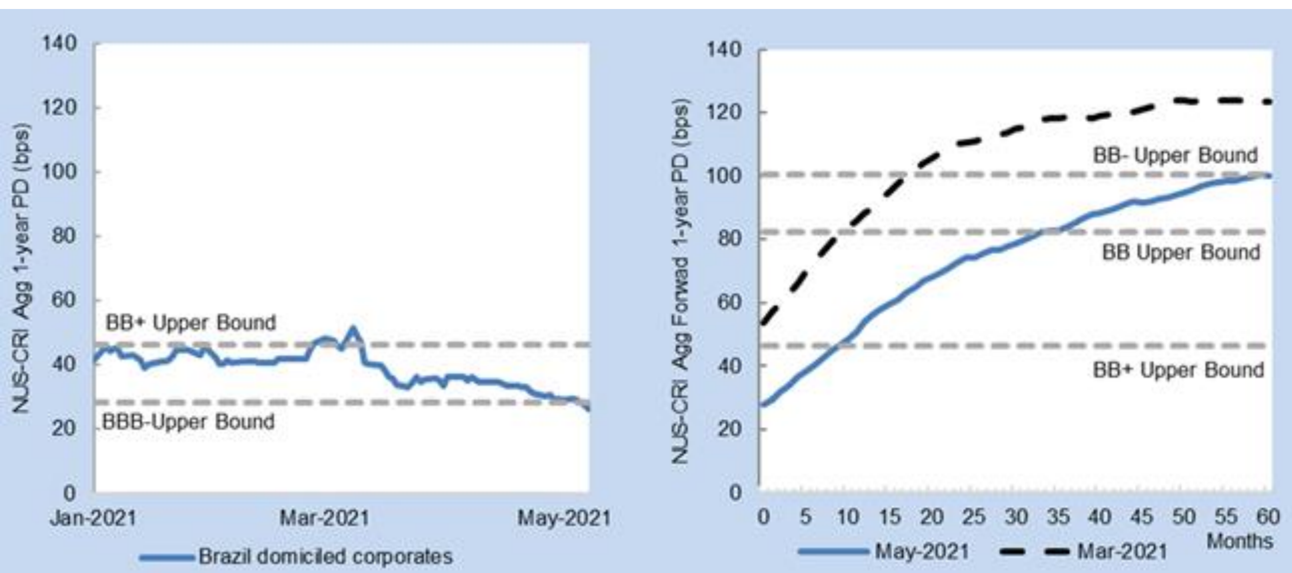

Figure 1a (LHS): NUS-CRI Agg 1-Year PD for listed Brazil domiciled corporates as of May 2021 with reference to PDiR2.0[1] bounds. Figure 1b (RHS): NUS-CRI Agg Forward 1-year PD for listed Brazil domiciled corporates. *Source: NUS-CRI*

The credit quality for listed Brazil domiciled companies has remained stable in the first quarter of 2021 and has been improving since. This is demonstrated by the NUS-CRI Aggregate (median) 1-year PD (Agg PD) falling to 26bps, equivalent to PDiR2.0 rating below the BBB- upper bound, as seen from Figure 1a above. With a sharp rise in fuel costs, inflation in the country has risen sharply to a four-year high of 6.10%. To rein in further inflationary pressures, the central bank of Brazil decided to tighten monetary policy with a 0.75% hike in the key

[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.

rate in May 2021 to 3.5%. Rising benchmark rates bought on to curb rising inflation have provided investors the incentive to re-enter the Brazilian debt capital markets. Issuance of BRL denominated corporate bonds in Brazil increased by 70% compared to last year as of the first week of May. As seen in Figure 2 below, lowering yields on Brazilian corporate bonds allows companies that want to refinance to do it relatively cheaply. This contributes to the improving credit outlook from Mar 2021 to May 2021 as demonstrated by the NUS-CRI Aggregate (Median) Forward 1-year Probability of Default (Forward PD[2]) seen in Figure 1b.

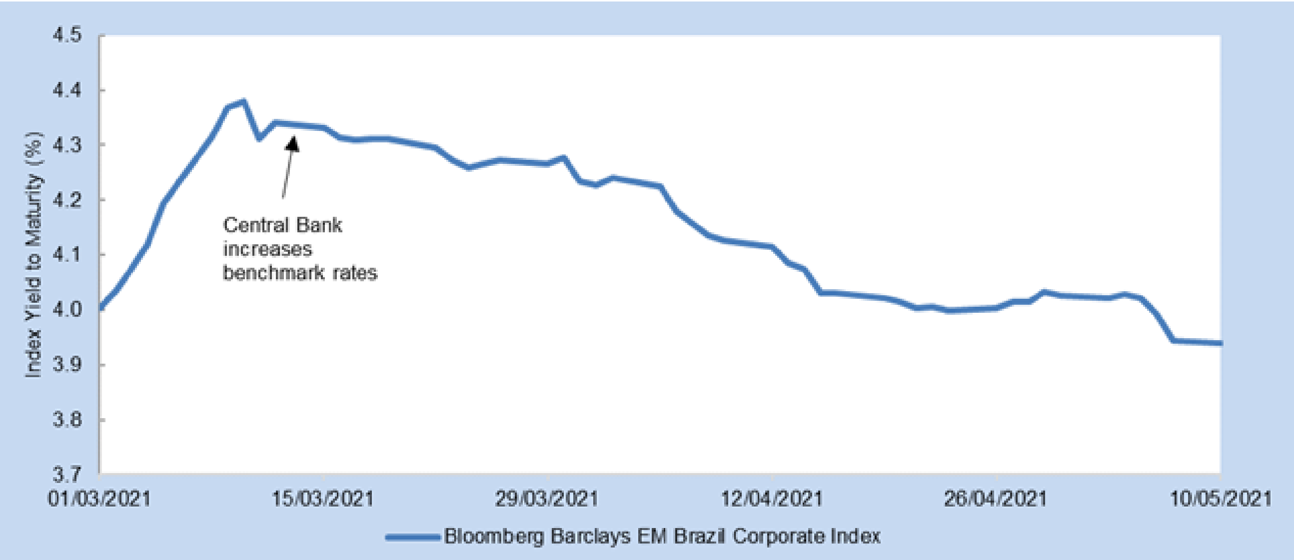

Figure 2: Yield to maturity for Bloomberg Barclays EM Brazil's corporate bond index from Mar 2021 to May 2021. *Source: Bloomberg*

Tapping into the debt capital markets has helped Brazilian companies receive extremely important funding to ensure survival during the incumbent economic slowdown. The intrinsic financial health of Brazilian companies has also been improving since April last year. Prior to the onset of the pandemic, which saw companies all around the world tap unused credit lines and issues more debt to alleviate a potential cash crunch, the median Total Debt to EBITDA ratio for corporates was 3.45 at the end of Q4 2019, compared to 4.27 at the end of Q2 2020. As of Q1 2021, the figure stands at 2.99, indicating that Brazilian companies are deleveraging on aggregate, partially contributing to the downward shift in the Forward PD.

However, there are still long-term economic issues plaguing the country's recovery. With over 15mn cases of COVID-19 and counting as of May 2021, the country endured difficulty handling its crisis, with a potential third wave on the way. Only 11.1% of the country was vaccinated as of 11 May 2021, putting the country in a difficult situation especially since the country does not have a centralized plan to quell the surge in cases. As the country heavily relied on fiscal spending to stem the flow of losses, a ballooning public debt pile may limit its ability to step in to support corporations should the impact of the virus on the economy worsen. Furthermore, with inflation also present in the detrimental rise in food prices, prospects for further rate hikes to curb the impact on the country's poorest may be likely in the future. These hikes may hurt Brazilian corporates as they may lead to increased borrowing costs should they want to refinance soon. This is particularly a threat given that close to 50% of the debt outstanding is due in the next three years.

President Bolsonaro's handling of the COVID-19 pandemic and the resultant economic fallout due to lockdowns and political tensions do not bode well for investor confidence moving forward. Concurrently, an unemployment rate close to 2020's record high of 14.6% and analyst expectations of Brazil slipping into a technical recession in the near future prove to be downside risks for credit outlook moving forward. Investors are also looking for reform on environmental aspects as well. Some corporates in the country are limited in meeting various

[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.

environmental and social criteria, which may put them at risk of being unable to easily source funds moving forward, as capital allocation is now trending towards ESG compliant companies.

Credit News

Yield-starved investors snap up muni bonds

May 9. Investors looking for higher returns and lower tax expenses are turning to municipal bonds, which have beaten the returns of corporate bonds and treasuries. Mutual funds that deal with these assets have seen an increase of USD 39bn in inflows this year, the highest level since 2008. This jump in demand is a reversal from the middle of 2020, where even safe municipal bonds endured large sell-offs as investors feared that tax revenue would fall. At the same time, municipal bond sales have boomed, with USD 124bn sold so far this year. Yields have fallen to close to their lowest since 1993 due to this increased demand, with the average yields on AAA-rated municipal bonds falling to 0.82%. (WSJ)

Wall Street bracing for USD 45bn of high-grade deals on tap

May 9. Wall Street is expecting a flurry of new debt offerings next week, with high-yield issuance poised for a record first-half. Blue-chip companies may boost USD 40-45bn next week and two jumbo deals are expected early in the week. The high end of the projection is almost double this week's supply volume of USD 26.15bn, making it the busiest week since uninterrupted bank deals led to a record-breaking USD 52bn week in mid-April. Amid the record-low borrowing costs and huge investor appetite for risky assets, the issuance blitz in the U.S. corporate high-yield primary market almost seems unstoppable. Supply is around USD 1.5bn short of surpassing the current record USD 210.44bn set in H1 2020. Investors are also flocking to the U.S. leveraged loan market, which has seen the longest positive streak since 19 weeks between Feb and Jun 2018. (Bloomberg)

Securitized debt has been oasis for yield, but it's running dry

May 8. As yields fall in the corporate bond market, the investors are looking for returns in the commercial mortgage-backed securities (CMBSs) market. For example, the AAA prime RMBS paper offers a 3% yield, similar to BBB corporate bonds of the same duration. Collateralized Loan Obligations (CLOs) are also attractive, with some of the highest spreads in the capital markets at the moment. Investors are also interested in single-asset, single borrower trades, which provide higher rates and may also be floating rate, which would be lucrative in a rising interest rate environment. While spreads on non-traditional Asset-Backed Securities (ABSs) have tightened significantly, auto and consumer lending ABSs still have the potential to rally. (Bloomberg)

Singapore banks set tone for ASEAN peers in reducing bad debts

May 7. After a tough period in 2020 caused by COVID-19, Singapore banks are reducing bad debts. In the Association of Southeast Asian Nations, nonperforming loans accumulated due to poor economic conditions during the pandemic. Singapore banks, including DBS, UOB and OCBC, however, reported lower NPL ratios, indicating their sound loan book. These banks also saw their net profit increases as Singapore's economy reopened. Should Singapore's economic growth surpass 6% in 2021, Singapore's financial institutions could repeat their stellar first-quarter showings ahead. The lenders' prospects elsewhere in ASEAN, such as Thailand, Indonesia and the Philippines, however, appear mixed as their ability to push back NPLs depends on each country's progress of vaccination and economic reopening. (Nikkei Asia)

Chinese banks accused of funding deforestation around world

May 4. Chinese banks have provided USD 15bn in loans and underwriting services to companies linked to deforestation globally from Jan 2016 to Apr 2020. Chinese companies that deal with commodities such as paper and rubber operate overseas are mainly financed by Chinese banks. The Industrial and Commercial Bank of China provided the highest amount of loans to environmentally detrimental causes amounting to USD 2.2bn. Data from Forests & Finance found a correlation between the increase in funding in such segments and the increased focus of Chinese authorities to achieve carbon neutrality by 2060. As such, pressure is being exerted on these institutions to reduce funding to causes that lead to deforestation. (FT)

Cathay Pacific launches its first US dollar bond in 25 years (Reuters)

US corporate bond spreads hit three-year low amid demand surge (Bloomberg)

Bank of England does not see COVID bankruptcy wave: Haldane (Reuters)

Regulatory Updates

Yellen says debt-limit measures could be exhausted in summer

May 8. Treasury Secretary Janet Yellen said the fiscal tools to keep the debt under limit may run out this summer. The current suspension of the U.S. borrowing limit expires Jul 31 and should Congress fails to act, the administration would have to shift federal funding to repay the debts. This adds pressure on lawmakers to raise or suspend the ceiling before it returns. Some analysts estimate the government will have enough cash to operate well into Q4. Yellen will need Congress to refrain from political brinkmanship and avoid any disruption which would jeopardize the recovery from the pandemic. The Democratic Party, widely expected to raise the debt ceiling using a fast-track budget tool, would have to unify behind a grand compromise before Treasury measures run out. (Bloomberg)

US benchmark rate committee sets out path for SOFR forward rate

May 7. Investors are stuck with a deadline to stop basing loans and trades on LIBOR and shift to SOFR and other new benchmarks at the end of 2021. In light of this, they hope to see a forward-looking SOFR rate to help manage their loans and derivatives using the new benchmark. However, the ARRC says that it cannot provide a SOFR term rate by the middle of 2021. The committee states that increased liquidity in SOFR-linked derivatives, and interest rate volatility products, will better help them determine a term rate for the benchmark. The increase in loans and cash products linked to the rate will also be crucial to identify how term rates will be structured in the future. (Reuters)

Bank of England slows pace of bond-buying on growing hopes for recovery (Reuters)

ECB's Lagarde calls for green capital markets union (Reuters)

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