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Worsening credit outlook for German automakers amid sluggish demand and heightened supply chain pressure

by Li Mengyan

Amid the US-China trade war, Brexit uncertainties and a global economic slowdown, Germany is inching toward a recession as its economy is forecasted to post a negative growth in Q3 2019 after contracting 0.1% in Q2 2019. IHS Markit published that in October, Germany manufacturing Purchasing Managers' Index (PMI) remained close to a decade-low at 42.1, indicating a contraction. The German automotive sector, which has historically been one of the leading sectors in the German industry, is now facing multifaceted problems as the global economic slowdown has taken toll on its sales figures and caused a potential increase in its supply chain credit risk. Tracked by the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) below (see Figure 1), both publicly listed German automakers and other Germany-domiciled firms saw a general increase in their Agg PD since last year.

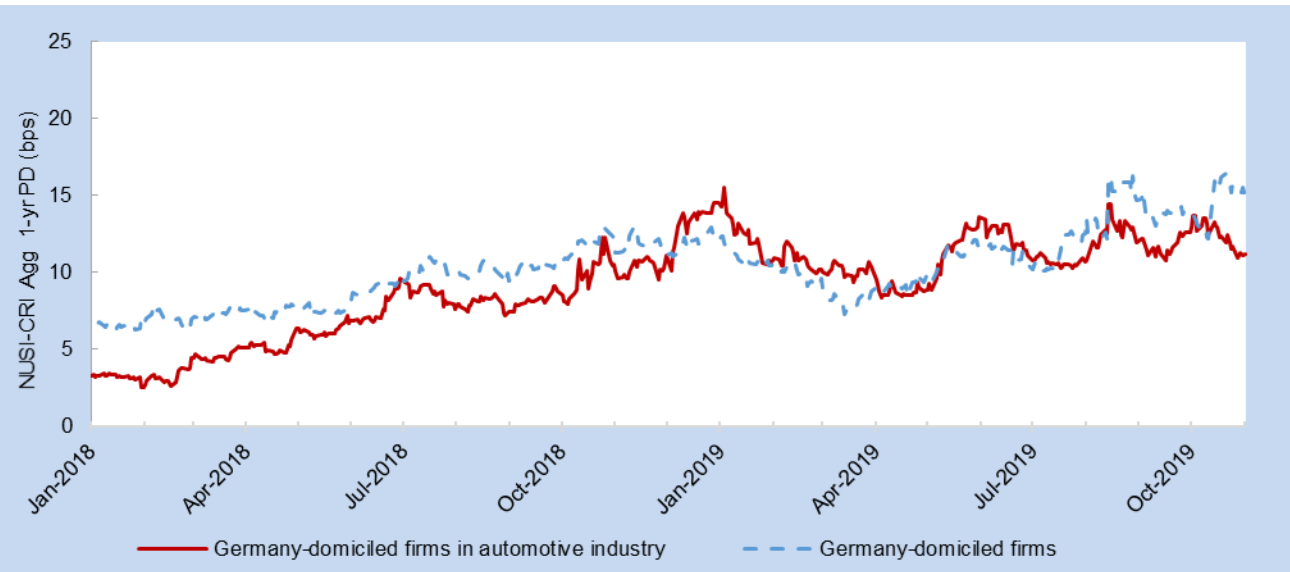

Figure 1: NUS-CRI 1-year PD for German automakers and for all Germany-domiciled firms. *Source: NUS-CRI*

Germany, as the second largest export-driven economy, is vulnerable to the global economy and to an anti-trade backlash. The German Association of Automotive Industry announced that yearly passenger car exports and domestic production in Oct 2019 decreased 10% and 5% respectively. Given the fact that over 78% of car manufactured in Germany are destined for export purpose, the automotive industry in Germany has suffered from the negative effects of Brexit and the long-lasting US-China trade dispute. Further compounding the problem that German automakers are facing; the US, China and UK markets account for over 50% of Germany's Big Three automakers (Volkswagen, Daimler AG and Bayerische Motoren Werke AG) car sales revenue, which highlights the importance of those regions. As shown Figure 2 below, German automakers saw a decline in total sales of passenger cars in their major export destinations. Car sales to China has witnessed a dramatic drop since 2018 as cars demand in China decreased 14.4% in 2019 amid the economic slowdown in China, which was partly caused by the US-China trade war. Meanwhile, the low consumer confidence caused by Brexit-related uncertainties might have contributed to the German automakers' sales decline in the UK market. As one of German's largest export markets, a hard Brexit could cause a significant increase in barriers and tariffs on

German car imports, meaning that the German automotive industry could face higher costs and lower profits if this scenario happen in the future.

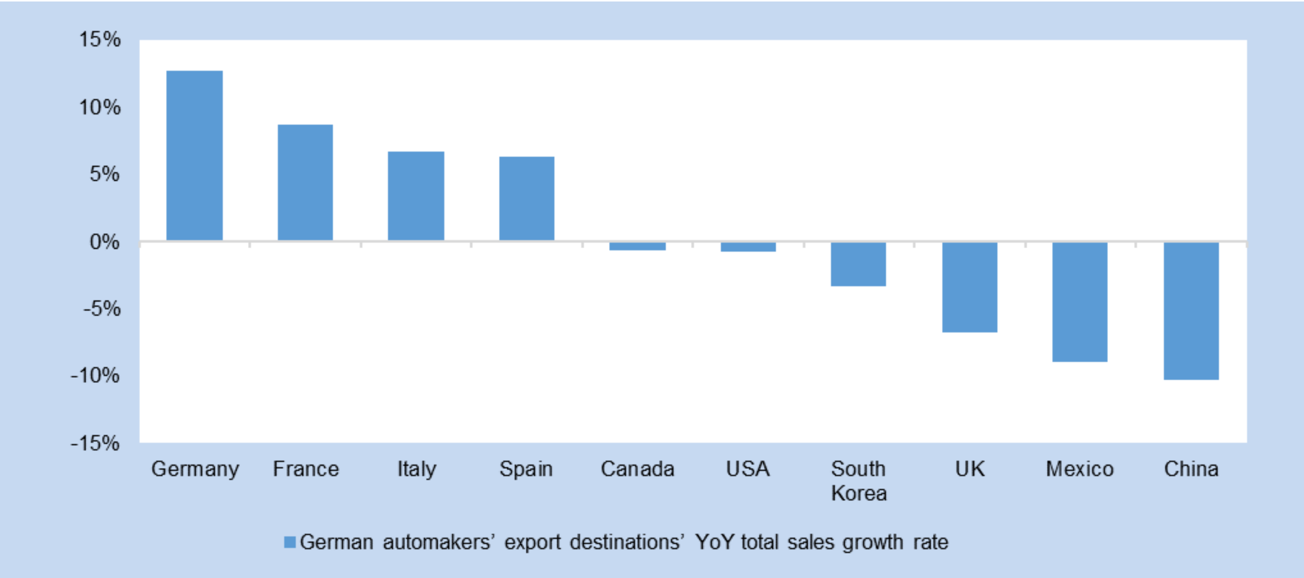

Figure 2: German automakers' export destinations' YoY total sales growth rate in October 2019. *Source: Bloomberg*

Amid the sluggish demand from German automakers' major export markets, German automakers need to extend more generous payment terms to their clients to stimulate sales. Consequently, the German automotive industry has in general seen its days sales outstanding gone up since last year (see Figure 3). At the same time, however, the German automotive industry has also seen its days payable outstanding number gone down due to receiving stricter credit terms from its suppliers. Furthermore, German automakers have increased their stockpiles of cars in the UK ahead of Brexit, causing days inventory outstanding numbers to increase. In short, German automakers will need more time to receive cash from customers after they have invested in their inventories. Considering that they will need to face their maturing bonds next year, they might need to find other funding source to service their debts.

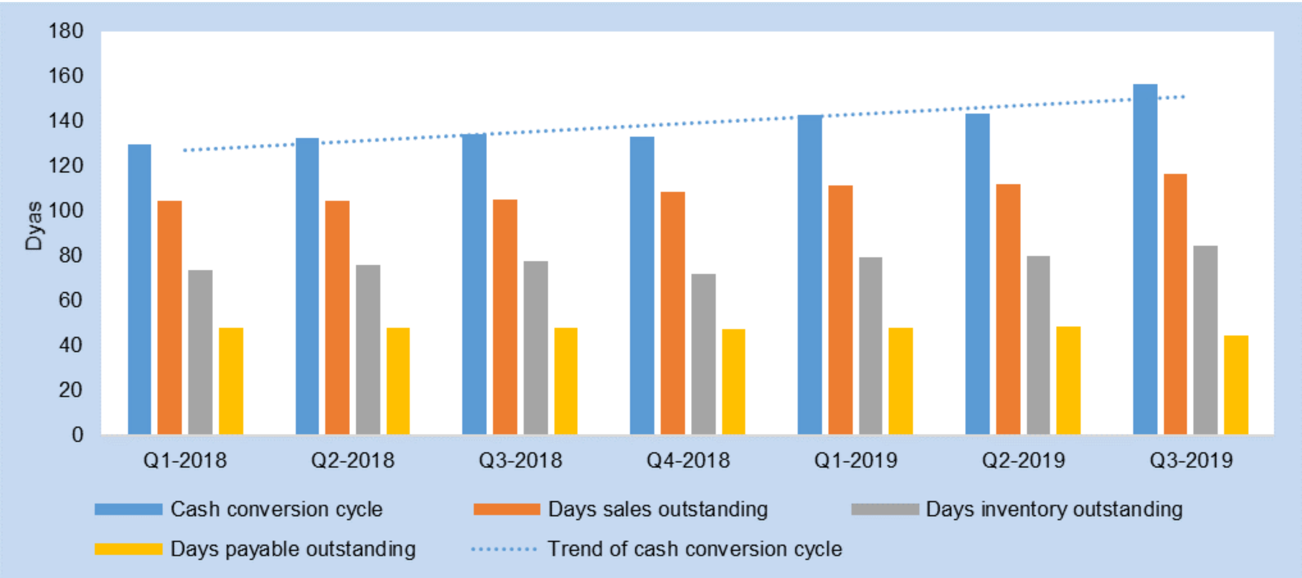

Figure 3: Weighted average cash conversion cycle, days sales outstanding, days payable outstanding and days inventory outstanding of Germany-domiciled firms in automotive industry in Nov 2019. *Source: Bloomberg*

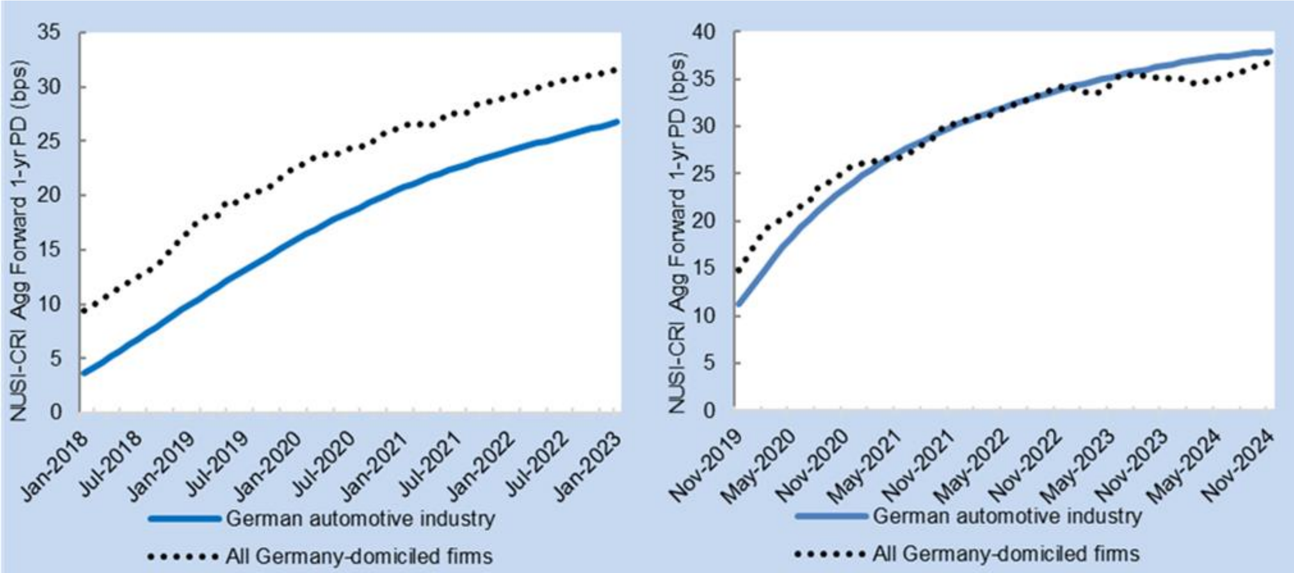

Figure 4a (LHS) & 4b (RHS): NUS-CRI Forward 1-year PD for German automakers and for all Germany-domiciled firms in Jan 2018 (LHS) and Nov 2019 (RHS). *Source: NUS-CRI.*

The NUS-CRI Aggregate (median) Forward 1-year PD[1] (Forward PD) above (Figure 4a & 4b) compares the credit outlook between German automakers and other Germany-domiciled firms. In Jan 2018, the credit outlook for all Germany-domiciled firms is consistently worse than that of German automakers' (see Figure 3a). Despite initially having a slightly better credit outlook (as of Nov 2019), the Forward PD of German automakers will eventually surpass the Forward PD of Germany-domiciled firms in around 2021 as the German manufacturing industry remains in a contraction amid the sluggish global economic growth. This indicates that German automakers are likely to be more affected by the ongoing global economy slowdown as it is highly reliant on exports.

Credit News
Rising yields quiet bond market's key recession alarm **Nov 10.** Yields on longer-term US Treasury securities climbed above those on their shorter-term counterparts in recent weeks – suggesting that there will be no immediate pullback in growth and inflation. The yield curve was completely uninverted this week for the first time in a year and this provides relief to investors, as an inverted yield curve is a well-known proxy for an impending recession. Many investors stated that this phenomenon is due to the recent interest rate cuts by the US Federal Reserve and improvement in US-China trade relations. While some investors said that the Fed's rate cuts may have been enough to forestall a recession, some cautioned that the rise in long-term yields relative to shorter-term ones does not mean that the economy's in the clear since the yield curve sometimes uninverted ahead of a recession. (WSJ)
The red alert is now flashing on the bond trader's radar screen **Nov 9.** Term premiums – the extra compensation for holding longer-term debt instead of simply rolling over a shorter-tenor security – have rallied from last quarters' record lows, and is riding an uptrend. Signs of

[1] The Forward PD computes the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 12-month Forward 1-year PD is the probability that the firm defaults during the period from 12 months onwards to 1 year plus 12 months, conditional on the firm's survival in the next 12 months.

progress in US-China trade talks helped push the 10-year Treasury yield to a 3-month high, sapping demand for the safety of sovereign debt. Easing economic anxiety raises the prospect of a switch of risk appetite from haven assets to risk assets, which drives up long-term yields. Combined with the Federal Reserve's signal that it will hold interest rates steady, term premiums see a sizeable boost of 42bps since the end of August. (Bloomberg)

Bad quality loans halved since 2015: EU banking watchdog

Nov 8. Non-performing loans (NPLs) – which harms a bank's profitability and lending capacity – have nearly halved across EU banks from about EUR 1.15tn to EUR 636bn, or from 6% of total loans to about 3%. The decrease was due to regulatory intervention, the boost from economic growth, and low-interest rates. However, some countries continue to struggle with a stubborn legacy of NPL stockpiles – Greece NPL ratio was at 39% in June 2019, while Cyprus was at 21.5%. On the other hand, Italy posted the biggest drop in 4 years with its NPLs down EUR 145bn, followed by Spain (EUR 81bn), Britain (EUR 60bn), and Germany (EUR 43bn). (Reuters)

Apple raises EUR 2bn in green bonds

Nov 8. Apple has priced its first-ever Euro-denominated green bonds, in which its proceeds will be used to develop more energy-efficient and recyclable products, and to cut carbon emissions by Apple's suppliers. The company claims to be the largest US corporate issuer of green bonds, having raised USD 1bn in 2017 and USD 1.5bn in 2016. Moving forward, Apple is expected to release an annual report on the effectiveness of the use of green bond proceeds and estimates of how much carbon is being saved as a result. So far in 2019, USD 185.9bn of green debt has been priced, already eclipsing the 2018 full-year total of USD 171.1bn; it is speculated that green bond issuance can hit USD 250bn by the end of this year. (FT)

RBS plans 'social bond' to boost regional UK economy

Nov 6. In a move to support some of the most economically deprived regions in the United Kingdom (UK), the Royal Bank of Scotland (RBS) plans to issue what it says the first "social bond" by a UK financial institution. The bond proceeds would be use to back lending and refinance loans to small-and medium-sized enterprises in areas with high unemployment. As investors are increasingly hungry for bonds that are issued to fund sustainable projects, the amount of such debt in global markets surpassed USD 1tn last month. Unlike green bonds, however, social bonds require more complex reporting on how the proceeds are used. (FT)

Global Bond Sell-Off Persuades Some Investors to Buy the Dip (Bloomberg)

China's waning appetite for stimulus weighs on global economy (FT)

Euro zone bond yields higher as trade optimism knocks safe havens (Reuters)

Regulatory updates

Australia's CBA selling first bond not referencing LIBOR-equivalent rate

Nov 7. Australia's Commonwealth Bank is planning to sell AUD 1bn worth of residential mortgage bonds in the country's first public deal that will not use the local LIBOR-equivalent benchmark, the bank bill swap (BBSW) rate. Given that Libor is due to be decommissioned by the end of 2021, bankers and investors are starting to switch to other benchmarks, including those more closely linked to government or risk-free rates. Regulators, however, still expect a local transition into alternative benchmarks such as the Australian Overnight Index Average (AONIA) which is based on the central bank's official cash rate. Medallion, which is the top-rated portion of the Commonwealth Bank's deal, is expected to pay 125bps over the compounded daily AONIA rate. (Reuters)

China trims a key bank lending rate for first time in over 3 years

Nov 5. The People's Bank of China (PBOC) lowered the interest rate on its one-year medium-term lending facility (MLF) by five basis points to 3.25% amid a slowdown in the world's second-biggest economy. Analyst said the move was intended to push down the loan prime rate (LPR) to help support small-to-medium-sized businesses that are struggling amid the economy's slowdown. PBOC's announcement prompted stocks to trade higher and bond yields to fall as investors are expecting further stimulus may be ahead. However, the scope of further easing measures could be constrained by fears that unleashing new liquidity could inflate a property bubble or further increase inflation, which recently hit a six-year high. (FT)

Egypt inflation at nine-year low gives scope for more rate cuts (Bloomberg)

Euro zone vows to be responsible in regulating banks' sovereign holdings (Reuters)

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Contributing Editor: Anthony Prayugo