Recession risk amidst rising interest rates threatens to increase the number of US Fallen Angels

by Raghav Mathur

- **Rising NUS-CRI Forward PD suggests that the credit profile of Fallen Angels is likely to see a larger short-term deterioration compared to that of Rising Stars**
- **Sectoral breakdown of Fallen angels shows increased vulnerability in the US Healthcare sector, whereas Consumer discretionary and Technology sectors have fared better**

US corporates have been beleaguered with increasing interest burden on the back of rising borrowing costs and increasing refinancing pressures that have built up due to the pandemic-catalyzed debt binge since 2020. These pressures are shown through the deterioration across the credit profiles of companies in the US, combined with an unfavorable operating environment as the economic impact of rising debt servicing costs burden profitability and liquidity profiles. As seen from Figure 1 below, NUS-CRI's Probability of Default implied ratings v2.0 (PdiR2.0[1]) rating migration since the start of 2023 shows the impact of a worsening credit environment on investment-grade companies by measuring the number of fallen angels[2] in the US due to leverage and liquidity pressures felt by US corporates. As expected, the majority of fallen angels are companies that were already on the brink of downgrade with a PDiR2.0 rating of BBB-. However, not all companies in the US felt the same downward pressure on their credit risk profiles, as seen in the figure below. The number of rising stars[3] over the same period is higher than the number of fallen angels, potentially supporting the narrative that despite the worsened inflationary environment, companies in the US are benefitting from a relatively robust workforce and consumer demand that is buoying and improving the credit profiles of US corporates.

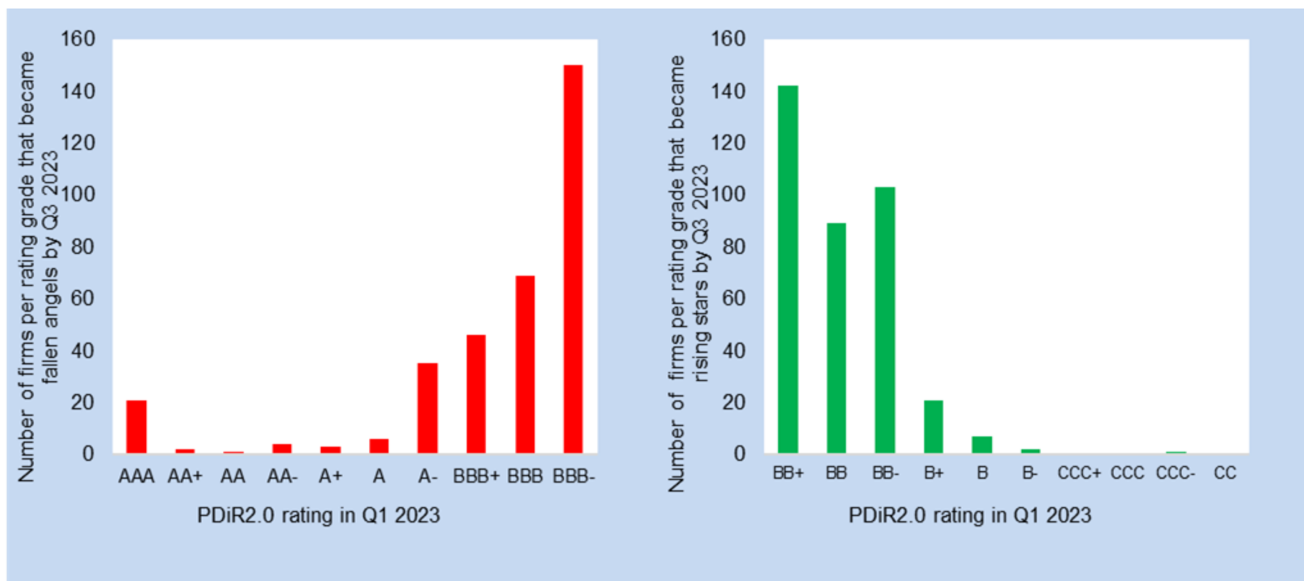

Figure 1: PDiR2.0 migration from Q1 2023 to Q3 2023 indicating the number of fallen angels and rising stars in the US economy. *Source: NUS-CRI*

According to estimates by S&P, non-financial corporates in the wider North America region have seen their trailing 4Q YoY growth in interest payments increase by close to 17% in Q2 2023, approximately 15 percentage

[1] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation by 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.
[2] Fallen angels in this context are classified as those entities that were rated investment grade using PDiR2.0 as of Q1 2023, but as of Q3 2023, have a non-investment grade (junk) rating.
[3] Rising stars in this context are classified as those entities that were rated non-investment grade using PDiR2.0 as of Q1 2023, but as of Q3 2023, have an investment grade rating.

points higher than the end of Q1 2022 when the Federal Reserve (Fed) started hiking interest rates. While the increasing interest burden is expected to temporarily affect the profitability and liquidity of US corporates, the delayed consequences of a prolonged high-interest environment are likely to manifest in the medium-to-long term, impacting corporate solvency and potentially resulting in an uptick in default rates. Using the two-year horizon for default rate distributions calculated by NUS-CRI, the distribution of defaults as of Oct 13, 2023, shows an increase in the expected number of defaults in the US economy (peak probability of 88-98 public companies defaulting over the next two years) compared to at the end of Mar-2022, as the Fed began its tightening campaign (peak probability of 32-47 public companies defaulting over the next two years). The build-up in medium-to-long-term credit risk for US-domiciled corporates suggests that default risk could materialize if the Fed's fight against inflation sufficiently slows down real economic activity.

As seen in figure 2a, the Forward PD[4] as of Oct-2023 for the credit risk outlook of fallen angels and rising stars suggests that US corporates are going to feel the pressure of tighter credit conditions over the next 24 months. The trend of the Forward PD term structure for fallen angels suggests that a further short-term deterioration in their credit profile is imminent as limited access to cheap financing and relatively lower liquidity are likely to continue straining their repayment ability. The Forward PD term structure also suggests a worsening credit outlook for rising stars, likely pricing in the potential impact of a slowdown in consumer demand. The Conference Board consumer expectation index shows that consumers' short-term outlook for income, business, and labor market conditions declined to 73.7 in Sep-2023, where the index value below 80 signals a recession coming over the next 12 months. As such, though rising stars have seen their credit profile improve substantially over the past three quarters, their credit outlook is masked by heightened recession risk that is likely to slow profitability growth and add pressure to liquidity metrics.

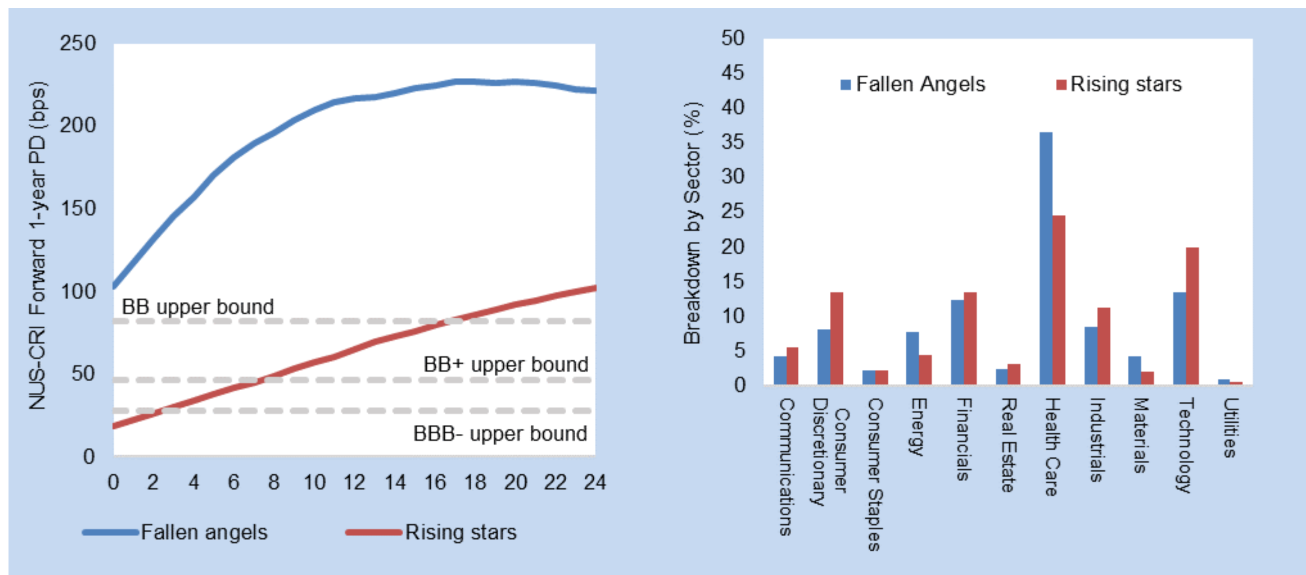

Figure 2a (RHS): NUS-CRI Agg (median) Forward 1-year PD for US Fallen Angels and Rising Stars as of Oct-2023, with reference to PDiR2.0 bounds. Figure 2b: Sectoral breakdown of US Fallen angels and Rising stars Source: *NUS-CRI*

Figure 2b breaks down all the fallen angels and rising stars into their respective sectors. As the figure suggests, most sectors such as Consumer discretionary and Technology saw relative improvement in credit conditions with more rising stars than fallen angels. Stronger than expected US job market has likely seen consumer spending on discretionary products increase, however, high household credit card debt is likely to weigh on the sector's outlook as interest payments rise. Though the US technology sector's sales growth has remained relatively stagnant since the start of this year, the sector's profitability growth after a slew of cost-cutting measures has boosted its credit profile, despite demand side challenges providing headwinds moving forward. On the other hand, a larger proportion of fallen angels arise from the healthcare sector, which has seen an uptick in default risk, with high-profile healthcare services and technology providers filing for Chapter 11 bankruptcy protection.

The policy response from the US government to the rising cost of living and the impact it has on the real economy is likely vital to determine whether an upcoming potential recession has protracted implications on domestic growth. Regardless, rising yields and increased borrowing costs are likely to continue pressuring the liquidity

[4] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar 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, conditional on the firm's survival in the next 6 months.

and debt servicing ability of US corporates in the near future. Although those companies that have become fallen angels in 2023 see their credit outlook worsen substantially in the short term compared to their rising stars counterparts, tapering in the medium-term credit outlook of fallen angels could suggest that it might take up to a year for vulnerable companies to adjust to higher-for-longer borrowing costs. US-domiciled corporates also face rising geopolitical risk in the near future, with the Middle East conflict escalating and the US House of Representatives struggling to find a new speaker after Rep. McCarthy's exit, making any fiscal policy response to tapering inflation risk tougher to enact. As such, as the Forward PD in Figure 2a suggests, both rising stars and fallen angels are going to face a tougher operating and financing environment in the short-to-medium term.

Credit News

Private credit funds step in for companies facing mountains of debt

Oct 13. Companies, burdened with imminent debt maturities, are increasingly resorting to the USD 1.5tn private credit industry to avert defaults. PetVet, a KKR-owned veterinary hospital operator, is in talks with private credit funds to refinance over USD 3bn in loans maturing from 2025. Fractures in the syndicated loan market are pushing businesses towards alternatives, with private credit funds like Blue Owl and Ares stepping in. These funds are filling a gap left by traditional investors, including collateralized loan obligations (CLOs), hesitant to take on riskier debt. Concerns persist, but private equity finds a temporary solution in private credit amid an uncertain public market. (FT)

These companies are being squeezed by higher rates

Oct 15. A growing number of companies with low credit ratings are grappling with red bottom lines as soaring interest rates impact loans with floating rates. Businesses like PowerSchool, Cooper-Standard, and Sabre are witnessing a substantial increase in interest expenses, driven by the recent surge in yields. Concerns arise as companies, racing to borrow during ultralow interest periods in 2020 and 2021, face rising expenses as short-term rates influenced by the Federal Reserve reset quarterly. The challenging financing environment raises hurdles for lower-rated bond issuers, making new bonds pricier and signaling potential economic challenges amidst a backdrop of rising corporate bankruptcies. (WSJ)

EU becomes 'real player' in debt markets but faces investor scepticism

Oct 12. The EU's debt is on track to reach €900bn by 2026, propelled by COVID-19 recovery and support for Ukraine. Despite a rapid rise, EU bonds face challenges as they are less appealing than those of individual European countries. Political reluctance to continue large-scale debt issuance post-2027 and exclusion from sovereign indices contribute to investor uncertainty. Efforts to enhance liquidity include plans for a repo facility and futures market. However, questions persist about the market's size after 2027. The European Commission aims for inclusion in indices to bolster bond demand, but this is a gradual process. Increasing interest rates present fiscal hurdles for the EU. (FT)

Israel-Hamas war sends jitters through neighbours' debt markets

Oct 15. The Israel-Hamas conflict is elevating borrowing costs in nearby nations, with widened spreads on Jordan's and Egypt's dollar bonds against US Treasuries. Jordan's 2030 bond yield, reaching 9.45%, reflects concerns about a refugee crisis impacting its tourism-reliant economy. Egypt faces increased debt pressure, its 2031 bond dropping to 51 cents, adding to challenges amid high financing needs. Lebanon's debt restructuring talks falter amid fears of Hezbollah involvement. Gulf nations with robust finances experience a subdued market response, though a broader regional impact could escalate credit spreads, warns Fidelity's Paul Greer. (FT)

Sri Lanka reaches preliminary debt restructuring deal with China's Exim Bank

Oct 12. Sri Lanka announces a crucial preliminary debt restructuring agreement with China's Export-Import Bank, marking a key move in securing the next IMF funds amid its financial turmoil. As China is the largest bilateral creditor, covering about USD 4.2bn of Sri Lanka's debt, this undisclosed deal is seen as pivotal for economic recovery and creating fiscal room for reform. The announcement, made during the IMF meetings in Marrakech, intensifies pressure on other creditors. Negotiations are complicated by a lender split, with China negotiating separately. Global attention focuses on how Beijing, a major creditor, responds to Sri Lanka's debt crisis amid an economic downturn. (FT)

BlackRock targets more double-digit growth in private credit (Nikkei Aisa)

Time is running out for the 'Year of the Bond' as losses mount (Bloomberg)

Zambia, bilateral creditors agree debt rework memorandum of understanding (Reuters)

Regulatory Updates

PBOC offers most cash support since 2020 as debt sales surge

Oct 16. China's central bank, the People's Bank of China, has taken significant steps to support the country's economic recovery and facilitate debt sales. It recently injected the largest amount of cash into the financial system since 2020, providing CNY 289bn (USD 39.6 bn) through one-year policy loans. This cash injection aims to boost economic growth, especially in the face of reduced demand and a property market downturn. Additionally, it will ensure that financial institutions have ample funding as the government and local authorities plan to sell more bonds for stimulus programs, and the tax payment season approaches. (Bloomberg)

Banks told to review clients in historic ESG crackdown in EU

Oct 16. European banks are adapting risk assessments due to new environmental, social, and governance (ESG) regulations mandated by the European Banking Authority (EBA). EBA is revising the Pillar 1 framework, which dictates capital requirements for lenders, to include ESG factors. Some obligations will be immediate, while others will be phased in, potentially leading to new legislation. Banks will need to reassess default and loss probabilities, along with risk weights for capital allocation. This could significantly impact high-emission industries like oil, gas, cement, steel, and mining. The EU is leading in establishing firm ESG requirements, while global organizations are also evaluating reporting and capital frameworks. The Basel Committee on Banking Supervision plans to propose a climate-related financial risk reporting framework by year-end. (Bloomberg)

Bank of England wants tougher rules for money-market funds (WSJ)

Higher yields "not a substitute" for monetary policy action, Bank of Canada governor says (WSJ)

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