OPEC+ O&G producers' credit profile benefits from rising prices in the face of systemic demand headwinds

by NUS-CRI Market Monitoring Team

- **NUS-CRI Agg PD suggests rising oil prices amidst longer-term deleveraging efforts have improved the credit profile of both OPEC+ and global O&G producers**
- **NUS-CRI Forward PD suggests that systemic recessionary headwinds could converge the credit outlook of both OPEC+ and global producers, despite stress tests suggesting higher sensitivity of non-OPEC+ producers to worsening macroeconomic conditions**

Volatility in the global energy markets has riled up prices that have fluctuated in tandem with the economic conditions globally. Rising geopolitical tensions in the Middle East, in conjunction with a resilient global consumer base, have propped up key oil prices. Following supply cuts in Jul-2023 and in Sep-2023, when Saudi Arabia and Russia decided to cut production by an additional 1mn barrels/day, global oil prices rallied to above USD 90/barrel. The surge in oil prices and the resultant impact it has on the credit health of OPEC+[1] domiciled Oil and Gas producers (O&G firms) can be measured using the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) in Figure 1a. Although the surge in oil prices has contributed to the improving Agg PD globally, it has especially reduced the credit risk associated with those O&G producers domiciled in the OPEC+ regions that are benefiting from the direct impact of the supply cuts, improving the industry's aggregate credit profile in OPEC+ countries to investment grade since the beginning of H2 2023 according to PDiR2.0 bounds[2]. However, as seen in Figure 1b, the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[3]) suggests that systemic headwinds pertaining to a potential global economic slowdown are likely to cause a worsening in the credit outlook for global O&G firms, leading to a potential convergence in the outlook of OPEC+ O&G firms to that of its global peers.

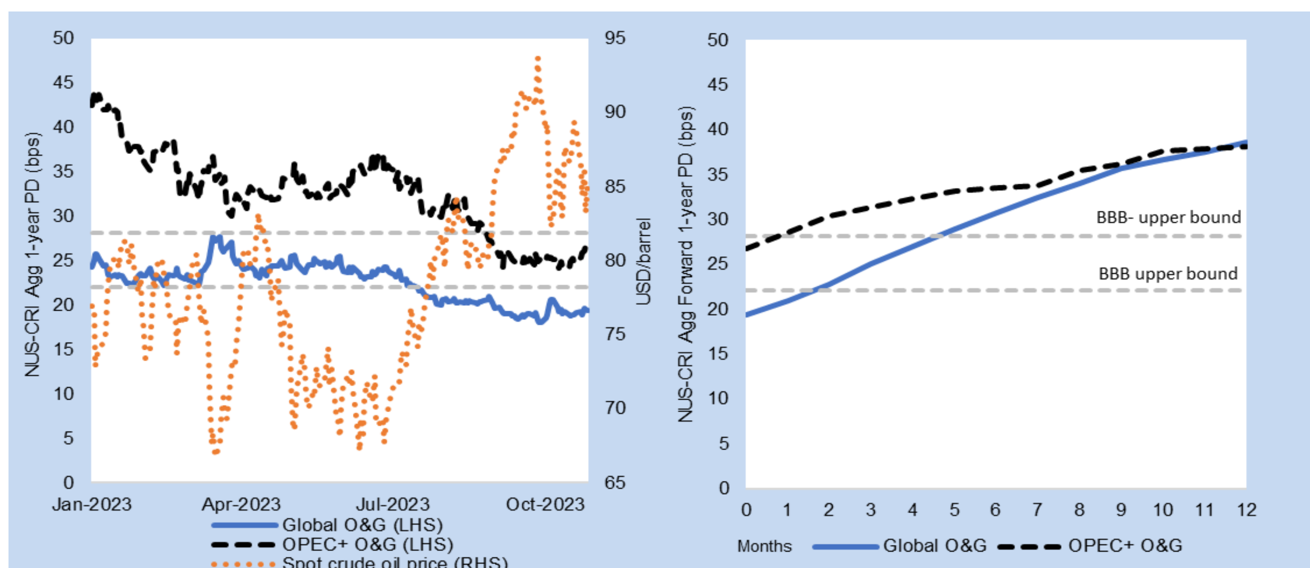

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for the global Oil and Gas producers and the OPEC+ domiciled Oil and Gas producers from Jan-2023 to Oct-2023, with reference to PDiR2.0 bounds (LHS axis); US crude oil WTI spot price from Jan-2023 to Oct-2023 (RHS axis). Figure 1b (RHS): Change in NUS-CRI Forward 1-year PD over the coming 12 months for the global O&G producers and the OPEC+ domiciled O&G producers as of Oct-2023. *Source: NUS-CRI, Bloomberg*

[1] OPEC+ includes all countries in OPEC in addition to Azerbaijan, Bahrain, Brunei, Kazakhstan, Malaysia, Mexico, Oman, Russia, South Sudan and Sudan. Not all countries have active and listed publicly domiciled firms.

[2] 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.

[3] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted as 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.

The decision by OPEC+ to cut the supply of oil came in tandem with signs of a resilient global economy that has fared well despite cooling efforts such as rising interest rates by the Federal Reserve (Fed) and other global central banks. In the face of reduced supply and strong demand for oil and gas products, the rise in oil prices is likely to lead to improved profitability metrics for OPEC+ O&G firms. However, as global central banks continue to tame inflation levels, rising oil prices are likely to lead to a faster economic slowdown moving forward, also suggestive of why the Forward PD term structure rises over the next twelve months.

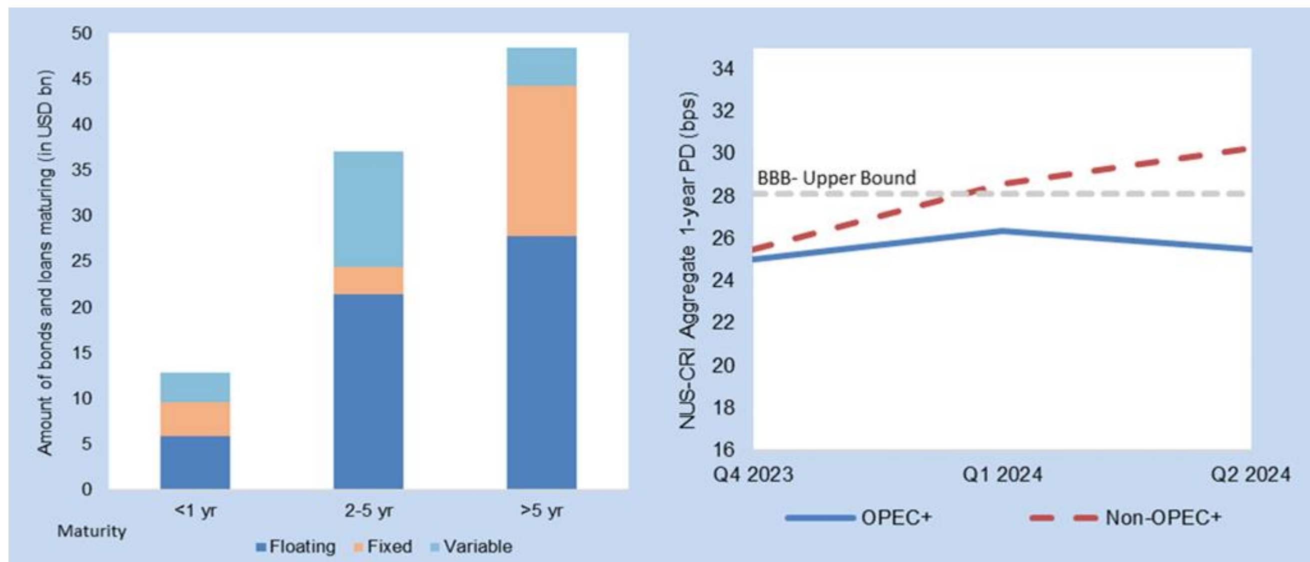

Figure 2a (LHS): Debt maturity distribution of OPEC+ O&G companies broken by coupon type (floating, fixed, and variable). Figure 1b (RHS): NUS-CRI Aggregate (median) stressed 1-year PD on Global O&G firms using oil prices and interest rates to simulate worsening economic climate and tighter credit conditions. *Source: Bloomberg, BuDA v3.5.1*

Furthermore, the potential recession risk also impacts global O&G companies' ability to service their debt obligations. Since the start of the pandemic, the industry has been steadily decreasing its net debt exposure[4] in an effort to deleverage, largely improving its debt servicing capabilities. However, rising rates and borrowing costs may start pinching the liquidity profiles, and vis-a-vis the credit profiles, of global O&G companies that have so far fared well with strong free cash flows. Rising rates are likely to hinder new capital expenditure decisions as lines of credit used to cover working capital before rigs start to operate become more expensive. Notably, the OPEC+ O&G firms, being the primary beneficiaries of the rising oil prices, have witnessed improvements in their credit profiles throughout 2023, evidenced by the convergence of their financial leverage and interest coverage ratios to global median levels. While the short-term debt repayment pressure on OPEC+ oil and gas firms is not significant, longer-term debt, nearly half of which is floating-rate, remains substantial (see Figure 2a). Higher interest rates could potentially increase their interest costs and simultaneously erode demand and profitability.

The US Energy Information Administration (EIA) estimates that OPEC+ are going to continue cutting up to 0.3mn barrels/day into 2024, contributing to an increase in oil prices to USD 95/barrel. To see how the credit risk profile of OPEC+ producers compares to their global peers under such a scenario, the NUS-CRI Bottom Up Default toolkit (BuDA v3.5.1) can be used. We assume that oil prices continue to increase to EIA estimates by the middle of next year (Jun-2024) due to supply cuts and deteriorating demand prospects, amidst rising global geopolitical tensions in both Russia and the Middle East. Furthermore, to simulate the tightened credit conditions and higher-for-longer interest rates, we assume that the short-term funding rate increases by 10bps MoM. As seen in Figure 2b, in such a scenario, the deterioration in credit health for non-OPEC+ producers is larger than their OPEC counterparts. Surprisingly, we also see that in Q1 2024, OPEC+ producers see potential normalization in their credit risk profiles, suggestive of further potential corrective supply cuts boosting oil prices further and buffering the profitability of OPEC+ producers.

Moving forward, oil prices, and their resultant impact on the industry's credit risk profile, are likely to be determined by the strength and protractedness of a potential global recession. Exogenous shocks to the energy markets in the form of the ongoing conflict in the Middle East catalyze the boost in oil prices, increasing the likelihood that prices could increase above USD 100/barrel. However, dwindling demand from weaker recovery in large oil markets such as China still poses price threats, anchoring oil prices despite rising supply concerns.

[4] According to S&P, net debt for the S&P Oil and Gas exploration and production select industry index, net debt of the constituents have fallen close to 48% in two years since the start of the pandemic in 2020.

Regardless, OPEC+ and global oil companies' credit profiles have fared relatively well in the current economic climate due to their intensive deleveraging campaigns over the past three years, supporting recovery in the credit profile of the sector this year in the face of structural headwinds moving forward.

Credit News

Big asset managers snap up Treasuries after bond rout

Oct 28. Prominent investors are making bold moves by purchasing long-term US government bonds, believing that the turbulence in the Treasury market is subsiding and that a US economic slowdown might be looming. Despite the robust current state of the US economy, these investors are looking ahead and anticipating potential consequences as rising bond yields increase borrowing costs. They expect that a slowdown could push bond prices higher. Money managers, including Pimco, Janus Henderson, Vanguard, and BlackRock, are increasing their exposure to longer-dated bonds. Confidence in a bond market rebound is spreading, with significant inflows into long-dated US sovereign debt funds. While the outlook for the 10-year bond is uncertain in the short term, investors believe the next major yield movement is likely to be lower, making bonds an attractive option for portfolio protection. (FT)

Japanese life insurers wade into unhedged foreign bonds

Oct 27. Four major Japanese life insurance companies are planning to increase their foreign bond holdings without currency hedges, indicating confidence in the stability of the yen. Meiji Yasuda Life Insurance, Sumitomo Life Insurance, Taiju Life Insurance, and Daido Life Insurance are all looking to invest more in "open" foreign bonds for the second half of the fiscal year ending in March 2024. While they acknowledge the risk of a sudden yen jump, they see this as an opportunity due to anticipated U.S. interest rate stability and steady dollar-yen levels. The move comes as three-month dollar hedging costs remain high, and insurers are carefully navigating investment choices amid uncertainty in U.S. economic and interest rate conditions. (Nikkei Asia)

Foreign investors lead Japan bond sell-off as yields near decade high

Oct 28. Rising yields are driving a sell-off of Japanese government bonds (JGBs) as foreign investors anticipate potential adjustments to the Bank of Japan's (BOJ) monetary policy at its upcoming meeting. Yields on 10-year JGBs reached 0.885%, the highest since 2013, nearing the 1% cap set by the BOJ in July. Foreign investors sold a net 904.2 billion yen (USD 6bn) in long-term Japanese bonds, with speculation that the BOJ may revise its yield curve control (YCC) policy, possibly raising the long-term yield cap to 1.5%. This uncertainty has led to a surge in the overnight index swaps market, reflecting concerns about potential policy changes. (Nikkei Asia)

UK mortgage approvals fall to lowest since January as rate hikes bite

Oct 30. In September, British lenders approved the lowest number of mortgages since January, with 43,328 approvals, below economists' expectations of 45,000. Net remortgaging approvals also dropped to their lowest point since January 1999, and there was a net repayment of BNP 940mn (USD 1.14bn) in mortgage debt, the lowest since April. The Bank of England's rate hikes, from 0.1% to 5.25% between December 2021 and August, have increased borrowing costs, potentially impacting the property market. Some economists fear this trend might lead Britain into a recession, though the bank is expected to keep rates steady in its upcoming decision. (Reuters)

US companies shy away from debt markets as Treasury rout drives up costs

Oct 26. The turmoil in government bond markets has led to a slowdown in October debt issuance for US companies, marking the quietest October for such activities in over a decade. Data from LSEG shows that US firms have raised just under USD 70bn from bond and leveraged loan sales this month, with the fewest deals in any October since 2011. The surge in Treasury yields over the past month, which has increased corporate borrowing costs, has discouraged companies from entering the debt markets unless absolutely necessary. The uncertainty surrounding Federal Reserve policy and rising rates have made companies cautious, but some see the rising yields as a reason to accelerate debt plans before costs rise further. (FT)

Casino slashes earning forecast as sales fall and debt rises (FT)

Evergrande told to submit debt plan by Dec. 4 or face liquidation (Nikkei Asia)

Sri Lanka leans on IMF and China as crucial budget test looms (Nikkei Asia)

Regulatory Updates

Inflation trends keep Fed rate hikes on pause

Oct 27. Inflation's decline slowed last month as the US personal-consumption expenditures price index rose by 0.4% in September, matching August's pace. Core prices, excluding food and energy, increased by 0.3%, marking a shift from a 0.1% rise in August. The Federal Reserve, which has raised interest rates aggressively over the past 20 months, is closely monitoring underlying price trends to gauge their impact on the economy and inflation. While recent reports indicate a slowing inflation trend, some areas like services and underlying prices still exhibit strength. The Fed is expected to keep rates steady at its upcoming meeting, but future rate hikes remain an option. (WSJ)

BoE expected to leave rates unchanged as inflation remains strong

Oct 30. The news report discusses the likelihood of the Bank of England (BoE) maintaining its current interest rates, which are at their highest levels since before the financial crisis. Financial markets suggest the BoE will keep the benchmark rate at 5.25%. The decision is influenced by the challenge of addressing high inflation without causing a recession. The recent year-on-year consumer price inflation was 6.7%, and the BoE aims to return inflation to its 2% target sustainably. The central bank has raised rates repeatedly since 2021, and there's a consensus that it will maintain its current monetary policy for the foreseeable future. (FT)

Europe's top banking supervisor says fragmenting market raises risks (FT)

Maldives' new president set to take office as debt alarms intensify (Nikkei Asia)

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