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Credit risk profile of UK domiciled corporates worsens as the pound depreciates amidst impending rate hikes

by Lee Wei Qi

- **NUS-CRI Agg (median) 1-year PD of UK domiciled corporates reflects increasing credit risk as the GBP depreciates alongside inflationary concerns**
- **CriAT's iRAP and OAS spread signal elevated credit risks within the UK energy sector**

The United Kingdom (UK) is the only G7 economy with GDP lagging behind pre-pandemic levels. Impeding the nation's economic recovery are sluggish sentiments amid the surging cost-push inflation, compounded by the recent depreciation of the Great British Pound (GBP) and the rising cost of financing. These factors are seen to have worsened the credit profile of the UK-domiciled corporates and could potentially continue in the near term, as exhibited in the CriAT's iRAP[1] tool (Figure 1a). Moreover, the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) for UK-domiciled corporates has reached its highest-level YTD after the prominent sharp increase in Sep-2022 (Figure 1b). This corresponds with the deteriorating financial conditions for UK-domiciled corporates with insolvencies nearing a 13-year high with an 81% YoY increase.

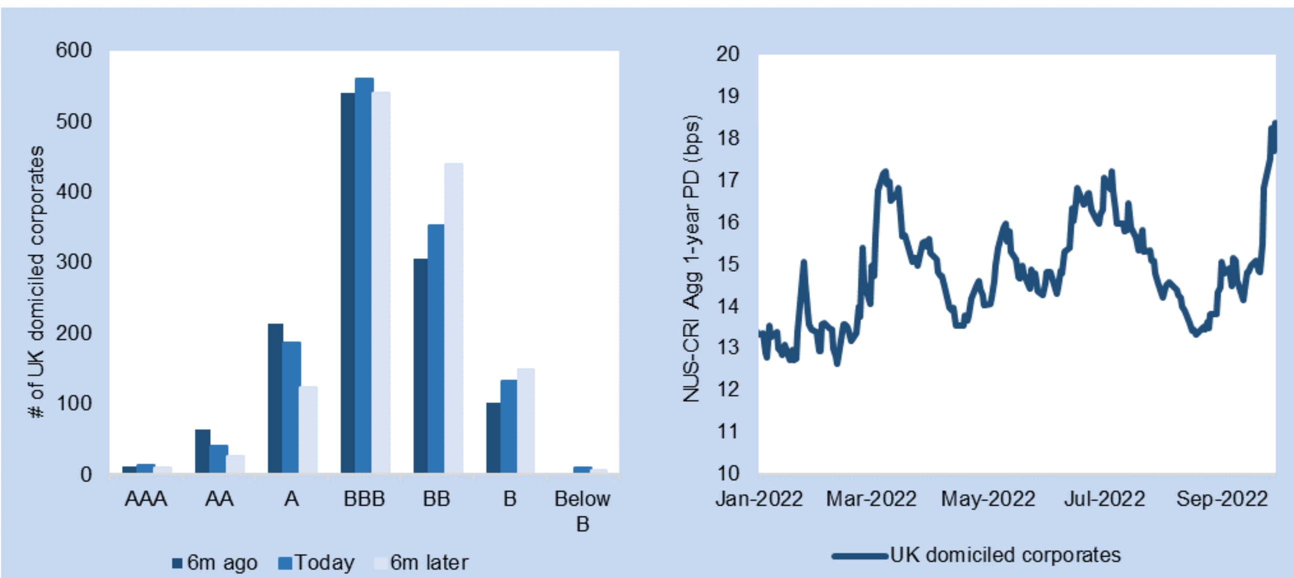

Figure 1a (LHS): Past, present and forecasted credit distributions of UK domiciled corporates, with reference to PDiR2.0 bounds[2]. Figure 1b (RHS): NUS-CRI Agg (median) 1-year PD for UK domiciled corporates from Jan-2022 to Sep-2022. *Source: CriAT, NUS-CRI*

In Sep-2022, GBP/USD tumbled while yields of long-term gilts soared following the UK treasury chief's announcement to implement over GBP 45bn in unfunded tax cuts. Kwasi Karteng also reiterated his commitment to his pro-growth mandate on top of the formerly communicated support for households' energy bills. The market has expressed concerns about the UK's sovereign credit outlook should public debt continue to pile up while economic growth remains lackluster. On top of facing an elevated cost of borrowing, the government has limited firepower to continuously prop up the economy and the GBP. As of Aug-2022, the nation's gross foreign currency reserves stood at GBP 107.9bn - substantially lagging behind G20 peers.

[1] iRAP (intelligent Risk Analysis Platform) is a software developed by CriAT (https://www.criat.sg/) for conducting both firm-level and portfolio level credit analysis. iRAP utilizes the NUS-CRI Probability of Default (PD) model and links it to the live NUS-CRI database offering PDs on almost 80,000 exchange-listed corporates globally.
[2] 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.

These pro-growth policies are likely to keep inflation higher for longer. In response, expectations of steeper increases in policy rates by the Bank of England (BoE), in terms of timeline and the magnitude of rate hikes, are growing, adding further pressure on borrowing costs for firms that have already witnessed a worsening financing environment due to the macroeconomic challenges pertaining to supply-side challenges[3]. Earlier in Q2 2022, borrowing costs for investment-grade firms had already crossed a key threshold of 5%. This uptrend is likely to continue with the market pricing in a 100bps rate hike in Nov-2022. As such, CriAT's iRAP tool forecasted a notable amount of firms being downgraded over the next 6 months as the cost of financing continues to climb.

Veering away from the UK's controversial fiscal approach, the aggressive and persistent monetary tightening by the Fed has also contributed to the weakening of the GBP driving the GBP/USD pair to new lows, notwithstanding BoE's intervention. Compounded with the unfunded nature of the recent stimulus, the sterling has sold off with the market calling for parity to the USD or even lower. Beyond currency risks attached to GBP-denominated assets, investors are turning increasingly underweight towards the UK, driving stock prices lower. In Sep-2022, following the announcement from Kwasi Karteng, the massive drops in the prices of UK government bonds led to a substantial amount of margin calls faced by the pension funds. This phenomenon has caused forced selling via both debt and equity, signifying costlier financing for corporates moving forward, hence potentially contributing to the sharp spike in the Agg PD (Figure 1b).

Diving into specific sectors, using CriAT's iRAP tool alongside Option-Adjusted Spread (OAS) spread, Figure 2a shows the magnitude of deterioration in the credit health of the UK energy sector relative to other sectors. Prior to the escalation of geopolitical tensions this year, smaller firms within the industry were already highly geared with strained margins as they juggled between the energy price caps and obligations toward developing renewable resources. Today, as the global energy crisis continues to escalate alongside the rising cost of living, energy suppliers are increasingly prone to incurring bad debt from both households and businesses. Moreover, with the BoE set to hike rates further, capital-intensive ventures such as the exploration of alternative energy will become increasingly costly to finance, As such, in the short term, should UK domiciled energy companies continue to operate in an environment where their access to capital remains muted, credit risk outlook, as showcased by the NUS-CRI Aggregate (Median) Forward 1-year Probability of Default (Forward PD[4]), will worsen at a pace faster than the aggregate level of all UK domiciled corporates (See figure 2b).

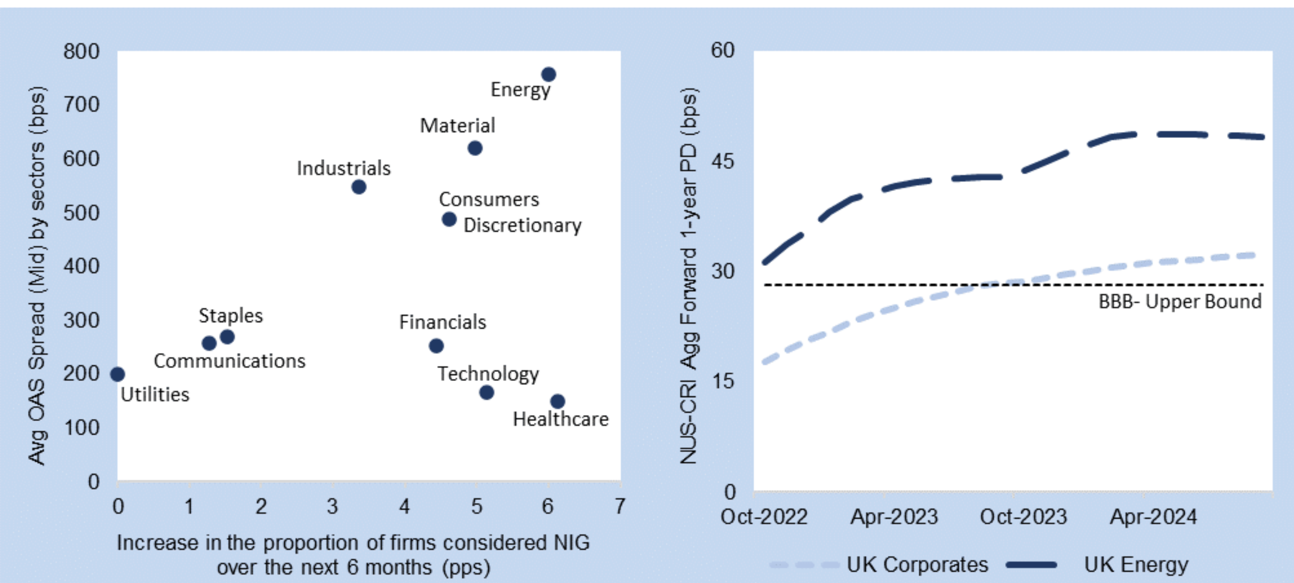

Figure 2a (LHS): Increase in the proportion of firms considered non-investment grade (NIG) over the next 6 months (percentage points - pps) and the average OAS of UK domiciled corporates by sectors as of Oct 3, 2022. Figure 2b (RHS): NUS-CRI Forward 1-year PD of UK domiciled corporates and UK energy companies as of Sep-2022, with reference to PDiR2.0 bounds. *Source: CriAT, Bloomberg, NUS-CRI*

While the government has scrapped their plan to do away with the 45% income tax rate on the nation's highest earners, there remain concerns about long-term fiscal sustainability given the government's pro-growth approach amid the current multi-decade high inflation. Sentiments remain apprehensive on BoE's ability to quell the incumbent volatility seen in the market as credibility on a measured response from both the central bank and the government has been shaken. Since the end of last year, the monetary policy guidance has been seen as

[3] The corporate debt financing environment in the UK from public markets has been worsening as capital flight towards higher yields in the United States gathers steam.
[4] 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.

conflicting with no clear path ahead. With reduced real household incomes, consumer and business activities are likely to slow down resulting in another hiccup in the UK's path to recovery. With greater pressure on assets and higher yields, the Forward PD of UK domiciled corporates in Figure 2b reflects a deteriorating credit outlook, breaching the investment-grade threshold of BBB- upper bound, proxied by PDiR2.0.

Credit News

Outflows from emerging market bond funds reach USD 70bn in 2022

Oct 03. Emerging market bond funds have witnessed record outflows of USD 70bn YTD as rising interest rates and a strengthening dollar make investments in emerging markets unattractive, highlighting an increase in risk for emerging markets. A strong dollar means an increase in import costs as well as an increase in debt service burdens of corporates with dollar-denominated debt. Investors' decision to withdraw from emerging markets is in stark contrast to the previous six years which saw positive fund inflows. (FT)

A USD 1tn burden looms for world borrowers refinancing debt

Oct 03. An unprecedented surge in refinancing costs poses a threat to corporates and governments alike, with most vulnerable entities expected to be pushed to the brink of default. With investors pricing in a recession, refinancing has become tricky, especially for weaker entities as rising borrowing costs and a drop in investor demand threaten solvency. Although a major proportion of governments and companies currently remain resilient, continued fund outflows, higher market volatility and expectations of steeper hikes in interest rates paint a bleak picture. (Bloomberg)

Global dealmaking plunges as financing market hits rock bottom

Sep 30. Global M&A volumes are experiencing a sharp contraction globally as steeper interest rates and weak macroeconomic forecasts keep investors away. The US, Europe, and Asia have respectively seen a drop of 63%, 42%, and 52% in third quarter M&A volumes. Additionally, rising borrowing costs have also driven companies to abandon plans of strategic buyouts. Corporate confidence has fallen as the market expects a recession in the near term. (Reuters)

Credit Market moves toward breaking point as investors flee, sales flop

Oct 01. Global credit markets are starting to feel the pressure of rising yield and capital outflows as economic growth decelerates globally. Both junk-rated and investment-grade debt funds saw cash withdrawals in Q3 2022, marking the biggest increase in spreads since the onset of the COVID-19 pandemic in 2020. Year-to-date return on a U.S. investment-grade bond index dropped close to -20%, as credit stress tracked by Bank of America reached a borderline critical zone, raising fears of an imminent recession. One of the worst-rated bonds, CCC, is leading the drop in high-yield markets with a YTD loss of close to 17%, compared to a loss of 15% in the rest of the junk market. The drop is not only limited to the bond market, other credit markets such as CLOs also witnessed a drop in their prices, with floating rate loans dropping close to 92 cents on the dollar. (Bloomberg)

UK banks set for bumper profits despite mortgage market freeze

Oct 01. The market mishap caused by the UK's fiscal policy announcement prompted the BoE to go against its tightening policies. The impact, the market expects, could be higher interest rate hikes in the future to compensate. While the high-interest rates are generally unfavorable for the economy, it would be beneficial for UK banks as it would lift their margins, after a decade of a low-rate environment. For Q2 2022 alone, about 85% of the sector had beaten analyst estimates on pre-tax profits. However, this could also mean a potential increase in borrowers' default risk would not be able to afford excessively high mortgage rates amid the high inflation. Nonetheless, the government's measure to cap energy bills might provide some support on the cost-of-living pressures, and therefore, mitigate the increase in default rates. (FT)

SMBC Nikko's issues let small firms grab credit market share (Bloomberg)

China property stocks, bonds rally after report of USD 85bn lifeline (Bloomberg)

Euro zone bond yields rise as German inflation flares; UK gilts flag (Reuters)

Regulatory Updates

Bank of England goes into full crisis management mode

Sep 29. The UK markets went haywire after the government's fiscal policy announcement last week, causing the GBP to plunge and bond yields to surge. In response, the BoE urgently intervened and assured the public that it was prepared to increase the money supply if required, and at "whatever scale necessary". The BoE also purchased long-term government bonds to ease the panic, and to prevent the negative sentiment from wreaking havoc on pension funds. However, the bond acquisition contradicts the tightening policies it had been imposing as of late and could instead propel inflation higher. The inconsistencies between the stance of the government and the central bank undermine the credibility of the UK economic policy and raise market concerns as the BoE's move could signal willingness to print money and finance the government's fiscal policy even at the cost of further fueling the already surging inflation. (FT)

ECB officials back another big rate increase to tame inflation

Sep 28. The ECB has reinforced its stance on controlling the persistent inflation in the euro area, signaling a potential 75bps increase in interest rates, even though these subsequent hikes would already hit the neutral rate which no longer stimulates economic growth. The neutral rate is estimated to be around 1% to 2%, and the expectation that the rates will rise further beyond the range to 3% by next year has increased propelled government bond yields higher. (FT)

Financial stability keeps Thai rates from rising fast (Bloomberg)

RBA set for one last outsized hike before Lowe slows tightening (Bloomberg)

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