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The bifurcation of credit risk

Dr Robert Gay | Fenwick Advisers | 10 February 2016

Numerous explanations have been offered for the latest bout of volatility in financial markets, ranging from the obvious ones associated with loans for oil and gas exploration, to the slowdown in China, to less likely outcomes including the possibly of a global recession. The simplest way to think of this crisis in confidence is that an environment of slow growth and little inflation does not facilitate debt repayment.

The collapse in oil prices was just the tip of the iceberg. Most oil-producing countries are large creditors to the rest of the world with substantial reserves and as such, pose little credit risk. The banks that lend to oil and gas producers are a different matter - especially those whose regulators restrict the amount of reserves they can hold against future losses until the loans are designated 'non-performing'. (The US has some constraints, albeit generous, whereas Canada has very restrictive limits.).

Banks, of course, are the Achilles heel of capitalism and are the most common source of financial instability (for a good summary of this perspective see Hyman Minsky, "The Financial Instability Hypothesis".

The troubles of the oil patch, however, are not even close to posing a systemic risk to the financial sector. Certainly, there will be loan losses, but projects have been shut down to minimise any additional drawdown on credit lines. Oil-producing countries have slashed budgets and are selling assets. Only a handful of oil countries with poor governance, wasteful spending or widespread corruption, are at risk of default. Credit markets so far have recognised this bifurcation of credit risk between the creditor nations of the Middle East and elsewhere, and the debtors that have few options such as Nigeria, Azerbaijan and Venezuela.

Of much greater concern is the mountain of the roughly US$4 trillion in debt taken out by corporations in emerging countries over the past three years, about half of which were domiciled in China.

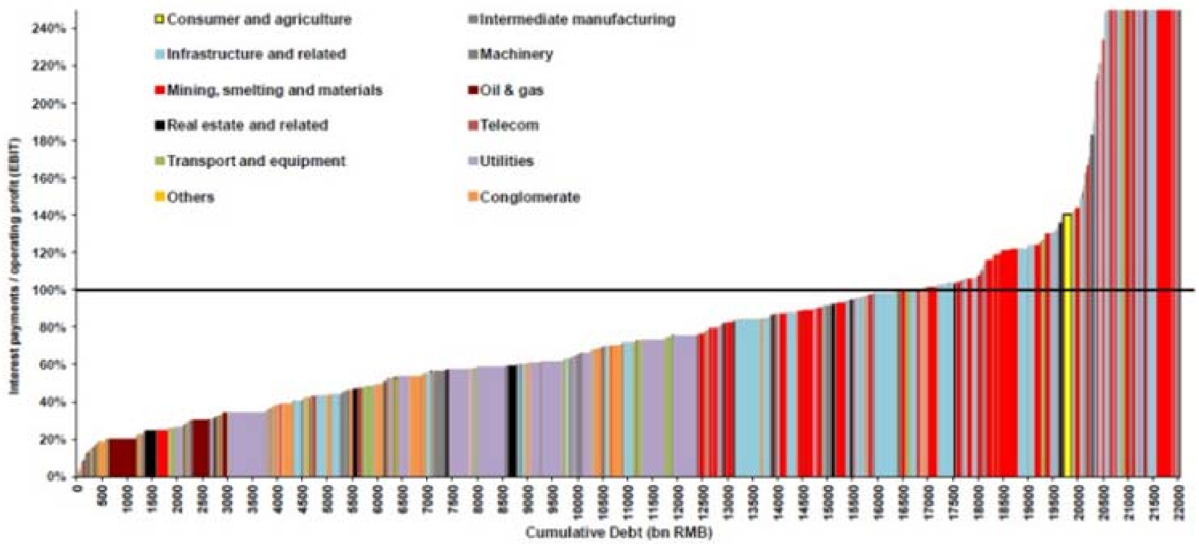
The problems with this debt go well beyond its magnitude. Many of these liabilities are denominated in foreign currency, mostly US dollars, and hence debt burdens have risen as their currencies have declined. Worse yet for commodity countries, the value of exports and thus the inflow of hard currency have declined with prices.

Even these risks are manageable for wealthy emerging countries, especially those that have diversified away from a heavy dependence on commodity exports and have avoided the temptation of borrowing at low interest rates.

The trouble arises with loans to debtor countries with limited reserves and uncertain access to foreign exchange and extends to companies in the emerging world whose finances are far from transparent. The latter characterise many Chinese companies whose sales prospects are either unknown or uncertain. Some sectors, notably steel and coal mining, are known to have excess capacity and some heavily indebted firms undoubtedly will fail.

Figure 1 gives a sense of the huge bifurcation in the quality of Chinese company debt. Macquarie analysts estimated the cash flows of 780 companies that had issued new bonds as of 2014. Debt service on roughly one-fourth of those bonds exceeds the free cash flow of the issuer. For one-tenth of the companies, the shortfall in cash flow appears to be intractable (i.e. those whose debt service is greater than twice cash flow).

Figure 1: China's Corporate Debt
EBIT-debt coverage in 2014



Source: Wind, Macquarie Research, September 2015. Note: Debt coverage at 780 bond issuers - EBT basis, 2014.

While the recent re-pricing of risk premiums may be warranted, especially for banks, one gets the sense that this sell-off has been amplified by illiquid markets for both CDS and equities. To compound the dearth of brokers' inventory, institutional investors who own a disproportionate share of bank equities have used bank CDS as a hedge for their equity positions, thereby adding circularity to the sell-off, as prices jumped sharply for both securities.

The end result has been a huge disparity in performance between the bonds of creditor and debtor nations and companies domiciled in those countries. The creditors seem to be perceived as safe havens, along with the euro and yen. The strong performance of those currencies should not be a surprise. The US dollar is overvalued and both the EU and Japan have very large current account surpluses that anchor their access to hard currencies. Their banks may have problems with negative interest rates and non-performing loans, but their currencies are value plays.

The one unmistakable message from this market volatility is that it is all about credit. Nonperforming loans will increase in the months ahead.

As Warren Buffett supposedly said (or at least it is attributed to him): "Only when the tide goes out, do you discover who's been swimming naked."

The tide finally is going out on debtors, and that has opened the door to some bargain-hunting among those companies and countries that are not saddled with too much debt. I doubt, however, that this episode marks the end of this economic expansion or even this investment cycle.

There is no doubt that we have reached a critical juncture, as we are approaching critical support levels in equity markets. Watch closely for the next phase - as nonperforming loans rise, banks tend to tighten lending standards to cut their losses. Only when banks finally refuse to roll over loans, even to good customers, will this cycle turn into a recession. Look for Chair Yellen to comment on the re-pricing of risk premiums in her Congressional testimony, and to argue that credit conditions have tightened far enough for the time being.

Dr Robert Gay is managing partner of Fenwick Advisers, a financial consultancy serving global investment banks, hedge funds, and other fund managers and financial institutions. Prior to forming Fenwick Advisers, Dr Gay served as international economist and global strategist Morgan Stanley, Bankers Trust and Commerzbank AG. He spent eight years as Senior Economist with the Board of Governors of the Federal Reserve System in Washington, DC, primarily during the chairmanship of Paul Volcker.
