The Ringgit Corporate Bond Outlook 2H2010: Market Anomalies: A Reality Check

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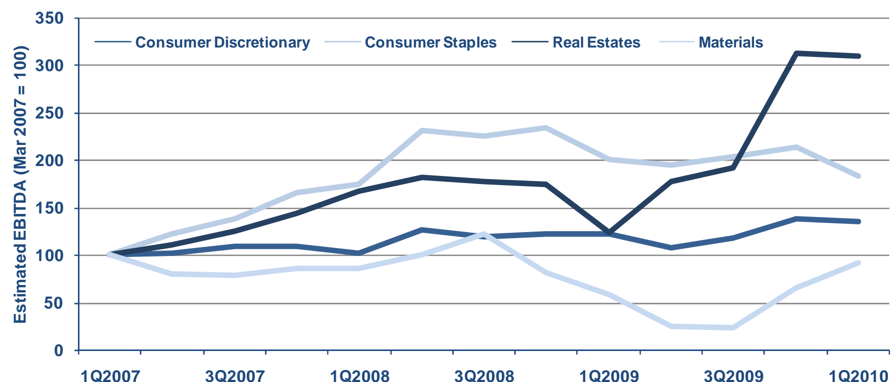
Summary

- We are revising our corporate bond issuance target lower to a range of MYR35 billion to MYR45 billion from the previous call of MYR45 billion to MYR50 billion. The only real catalyst in the issuance level now is the amount of credit wrapping that can be made available to potential corporate bond issuers.
- We maintain our base case corporate default rate call of 3.3% for the whole of 2010, and from the observation of rating migrations in the first five months of 2010 we do not see any new issuers flowing into our distressed pool.
- From a macro perspective, we see a notable improvement in corporate balance sheets which is somewhat expected given the rebound in the economy.
- Downgrades still outpaced upgrades in 1H2010 by a ratio of 2.5:1.0. However, the magnitude has somewhat eased from the level seen over the same period in 2009 which could further mark a turning point in corporate credit quality.
- At this stage, we do not expect the European debt crisis to drag the global economy back into recession, but a short-term spike in market volatility is likely to take place along the line due to knee-jerk reactions arising from "The European Anxiety".
- The ringgit corporate bonds actually present a good buying opportunity, especially along the AA curve, while investors with high risk tolerance may find A names attractive.
- A key downside risk to this outlook is the possibility of an unsustainable global recovery should the fallout from the European debt crisis worsen and trigger another round of confidence crisis.

EBITDA Index For Selected GICS Sector (N = Companies Listed on Bursa Malaysia)



Source: Bloomberg, MARC Fixed Income Research

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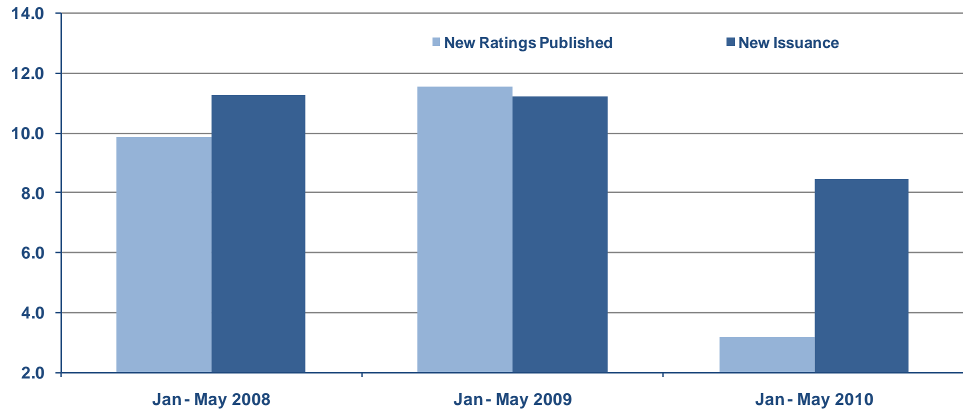
Corporate Bond Issuance

Despite signs of an improving economy which has led to a return of confidence in the global capital market, primary market activity in the ringgit corporate bond market is still lagging thus far with bonds issued in the market in the first half of 2010 standing at MYR14.3 billion as at June 18 compared to MYR21.1 billion issued over the corresponding period in 2009, when the global financial markets were still in disarray amidst the worst global recession since World War II. Excluding the financial services sector, new ratings published by the local rating agencies shrunk to an estimated MYR3.2 billion in the period of January-May 2010 from MYR11.5 billion during January-May 2009.

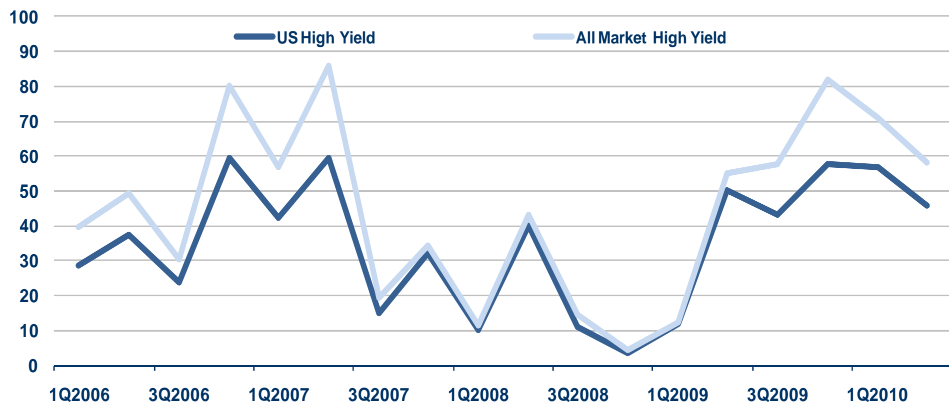
Exhibit 1: New ratings published and new corporate bond issuance point to lethargic primary market activity (excluding financial services)



Source: BPAM, Bloomberg, MARC Fixed Income Research

We previously argued that expectations of increasing economic activity in 2010 should be supportive of fundraising activity among corporations and the fact that skyrocketing financing costs seen eased since late 2009 provides greater incentive for companies to tap the bond market. This hypothesis proved to be correct in the case of global corporate bond markets with even issuers rated along the high yield spectrums were busy raising funds. The high yield market witnessed almost USD150 billion worth of debt being raised in June 2010 YTD, higher than 1H2008 and 1H2009 issuances combined. Meanwhile, investors' confidence appears to have returned as evidenced by the narrowing credit risk premiums with the 5-year BBB Industrial spread to US Treasury reverting to its long-run average of 180 bps.

Exhibit 2: Unlike the local market, global high yield issuance remained at an accelerating pace



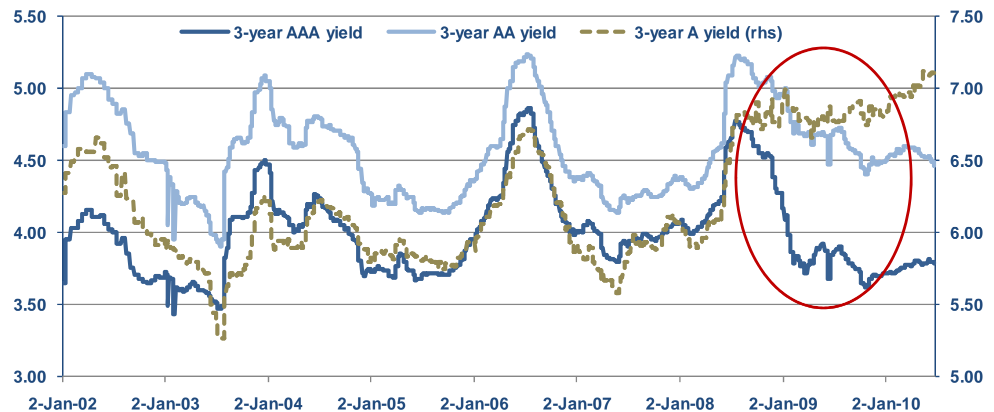
Source: Bloomberg, MARC Fixed Income Research

Corporate Bond Issuance…(continued)

However, a contrasting scenario was observed on the local front with the bond market access to corporations, particularly those rated "A+ & Lower", remaining closed. A continued drought in bond issuance appears to be at odds with the domestic economy resuming its growth trajectory starting from 4Q2009, evidenced by the positive readings of real GDP growth and a rebound in the Business Sentiment Index.

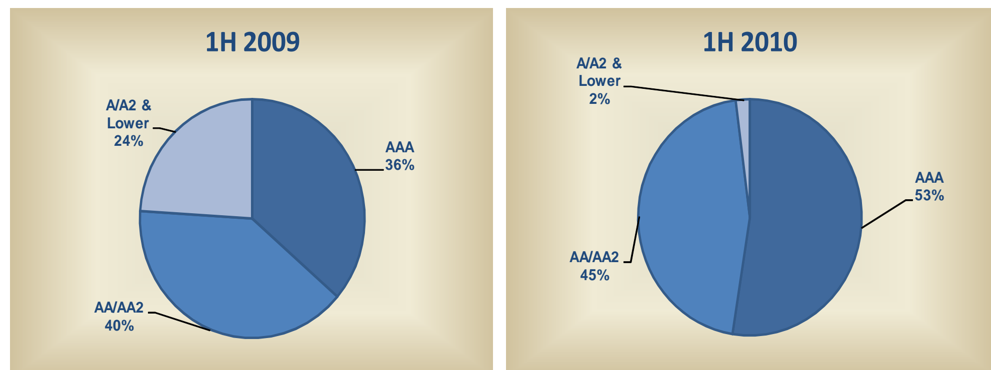
The credit risk premiums along the AAA-rated and AA-rated bonds have retreated by a significant margin from the levels seen a year ago and are likely to remain tight at the current level given the shrinking supply. On the other hand, issuers rated "A+ & Lower" will continue to face difficulty as risk aversion along this rating spectrum has not abated.

Exhibit 3: For the first time at least since 2002, we see a divergence between the movement of Single A yield vis-à-vis AAA and AA



Source: Bloomberg, MARC Fixed Income Research

Exhibit 4: Issuance from "A & Lower" rating bands fell drastically as take-up for these bonds is practically non-existent



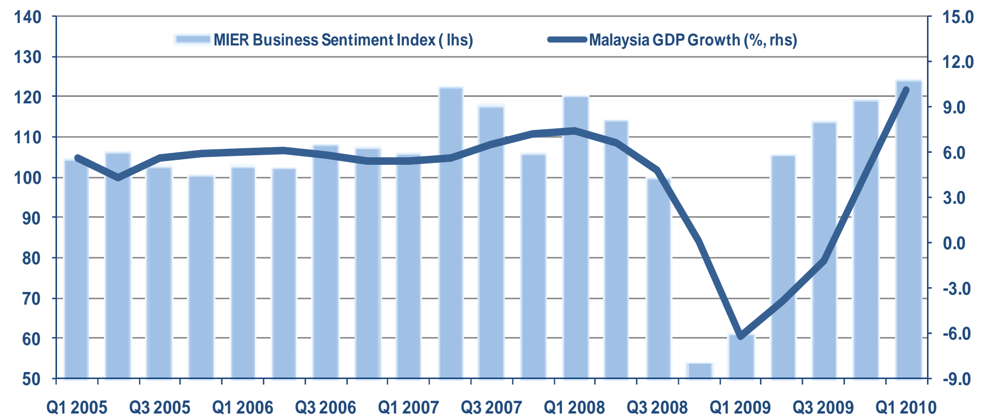
Source: BPAM, MARC Fixed Income Research

Against this backdrop, we are revising our corporate bond issuance target lower to a range of MYR35 billion to MYR45 billion from previous call of MYR45 billion to MYR50 billion. The only real catalyst in the issuance level now is the amount of credit wrapping that can be made available to potential corporate bond issuers as only AAA issuers are granted access currently.

The Story Behind Corporate Credit Quality

One year after nervy and topsy-turvy financial markets sent the global economy dipping deep into recession and compressed corporate profitability, we are now reading a different chapter. The soap opera of economic recovery continued to resonate in the financial markets with the US economy generating growth for three consecutive quarters since 3Q2009. On the local front, the economy rebounded strongly with a growth rate of 10.1% in 1Q2010 after expanding by 4.4% in the previous quarter. Meanwhile, the MIER Business Condition Index rose to 124 from 61 recorded in 1Q2009, and the index has been hovering above its 100 yardstick since 2Q2009.

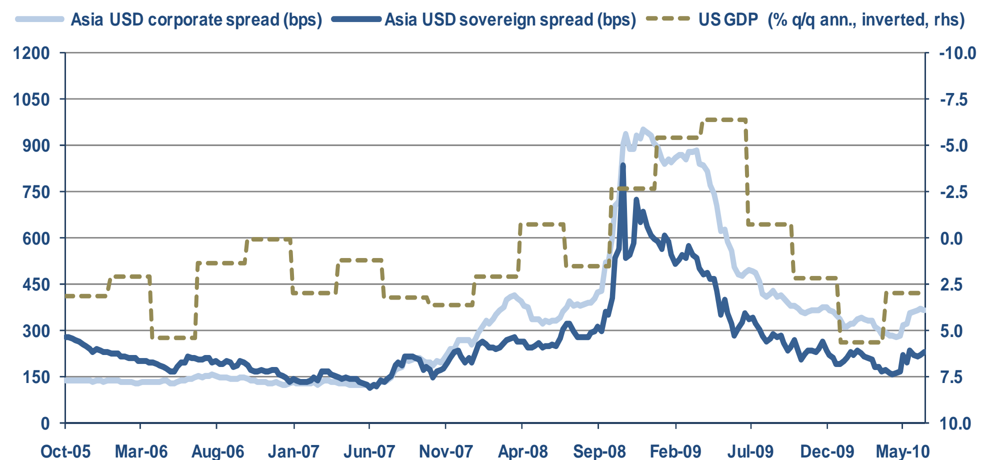
Exhibit 5: Economic recovery driven by fiscal stimulus packages and front-loaded monetary easing



Source: Bloomberg, MARC Fixed Income Research

Although such a sharp increase in GDP growth could also be partly contributed by the lower base effect given the recessionary period in the first three quarters of 2009, we think that the level of economic activity itself has picked up somewhat, judging by the positive readings of explanatory variables such as the industrial productions and exports, thanks to fiscal stimulus packages and front-loaded monetary easing policies implemented by the authorities.

Exhibit 6: A rebound in the global economies triggered normalization in both corporate and sovereign credit spreads in Asia

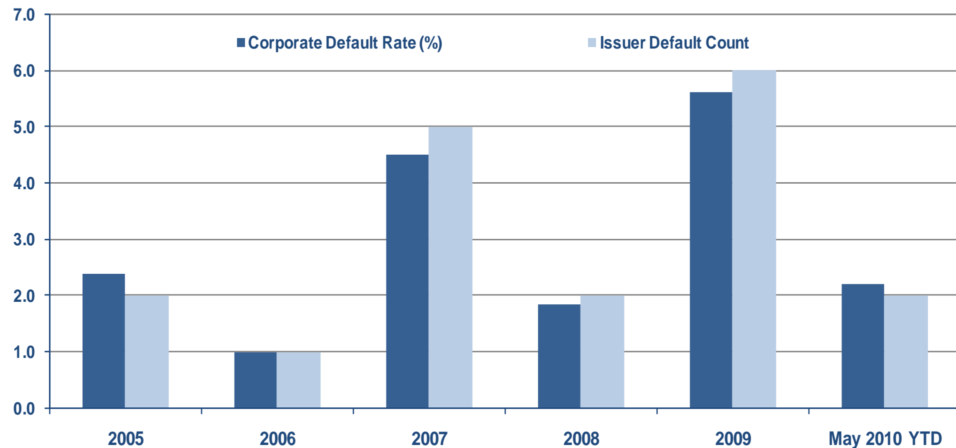


Source: Bloomberg, MARC Fixed Income Research

The Story Behind Corporate Credit Quality (continued)

The annual corporate default rate as at May 2010 came in at 2.2% compared to 5.6% in 2009, which is also the level under our most pessimistic scenario for 2010. The two issuers that defaulted came from a pool of distressed issuers that we formed at the beginning of the year which consists of issuers that have been downgraded to "A & Lower" ratings, experienced multiple downgrades and carry negative outlook and/or MARCWatch Negative.

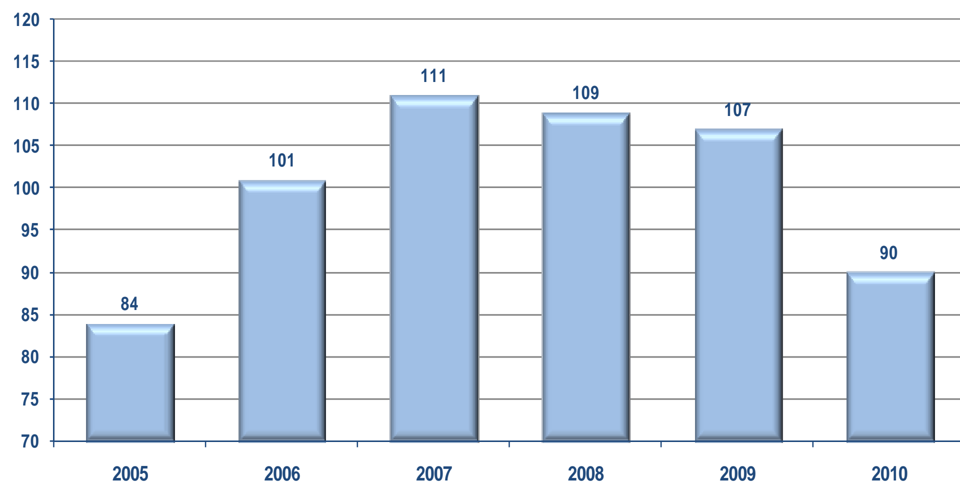
Exhibit 7: Corporate default rates show signs of improvement in credit quality



Source: MARC Fixed Income Research

It is worth noting here that the 2.2% annual default rate recorded during the period mentioned is also contributed by the large number of withdrawn issuers, and the multiplier effect becomes more crucial given the slowing primary market activity. As at January 2010, the total number of outstanding corporate issuers with long-term credit ratings stood at 90 issuers, the level last seen in 2005. At this stage, we maintain our base case default rate call of 3.3% for the whole of 2010, and from our observation of rating migrations in the first five months of 2010, we do not see any new issuers entering the distressed pool.

Exhibit 8: The risk of rising default rate presently is largely driven by the mathematical effect as the slowing bond market shrinks the number of outstanding issuers – (No. of Outstanding Issuers at the Beginning of Year)



Source: MARC Fixed Income Research

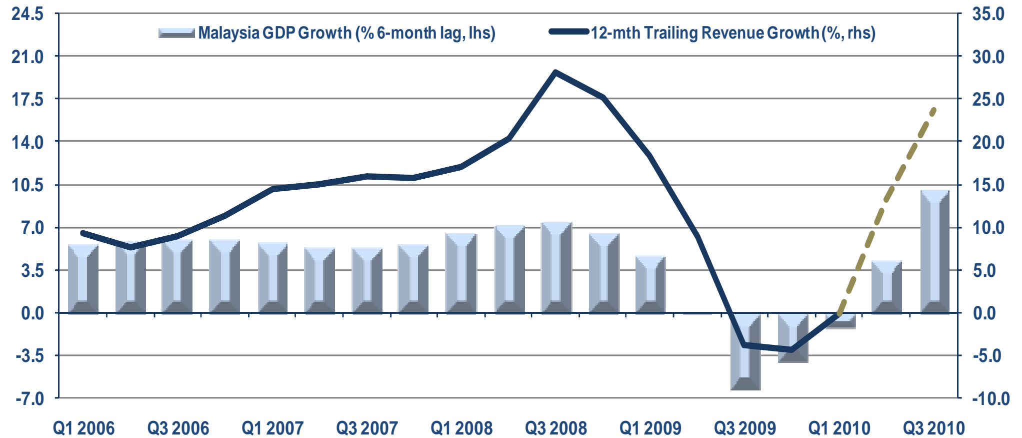
Corporate Balance Sheet and Credit Migration Behavior

From a macro perspective, we see a notable improvement in corporate balance sheets which is somewhat expected given the rebound in the economy and business confidence. Our assessment of company fundamentals, using the balance sheets of all listed companies excluding financial services as proxies, also conclude that the underlying strength of corporations is improving over the same period which is consistent with macroeconomic data.

The yearly decline in revenue growth slowed to 0.1% in 1Q2010 after dipping by 4.3% in the previous quarter, and assuming a 6-month lag of GDP effect on corporate revenue, the growth in revenue is expected to turn positive by 2Q2010. Along the same line, EBITDA growth also rebounded in the third quarter of 2009 while operating margins, which plummeted to as low as 5.0% in late 2008, climbed to 9.7% in 1Q2010, above its 21-quarter average of 8.3%.

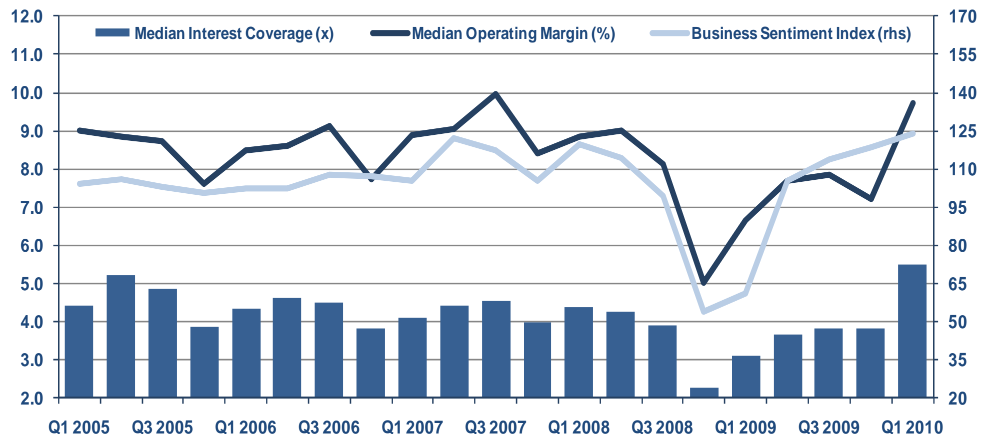
Coverage measures such as EBIT to interest expense climbed to 5.5x in 1Q2010 from 3.1x registered a year before while cash balances to total debt rebounded to 42.6% in the first quarter of 2010, with the size of cash balance among companies in our sample standing at almost MYR150 billion.

Exhibit 9: The rate of decline in revenue has eased somewhat given the rebound seen in the level of economic activity



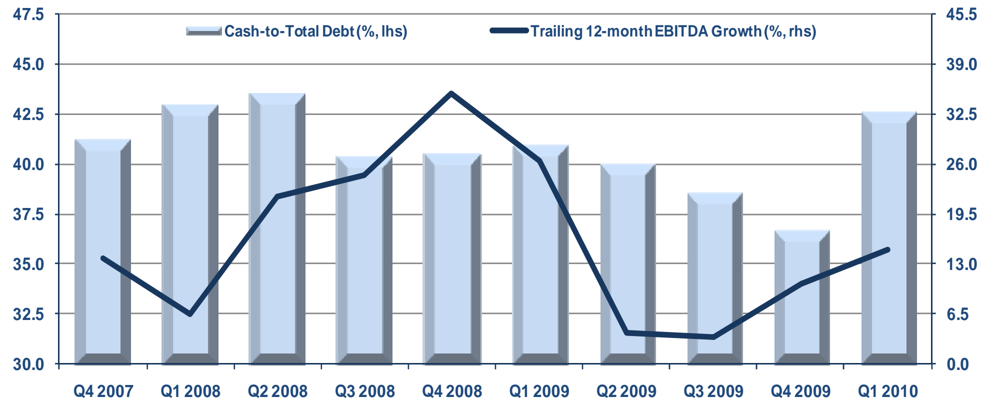
Source: Bloomberg, MARC Fixed Income Research

Exhibit 10: Corporate profitability and interest coverage soared after a few quarters of margin compression in late 2008 and early 2009



Source: Bloomberg, MARC Fixed Income Research

Exhibit 11: A rebound in EBITDA helped to enhance liquidity position with cash to total debt measure climbing to the pre-crisis level

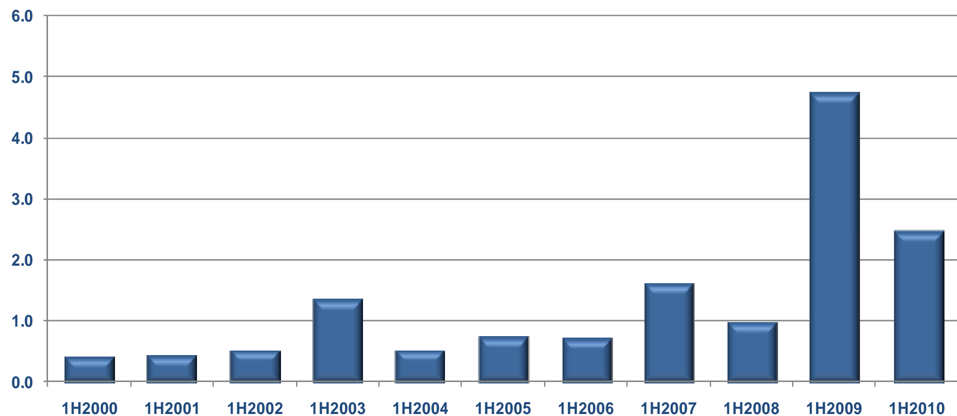


Source: Bloomberg, MARC Fixed Income Research

Using rating migration data compiled by Bloomberg (rather than data based on MARC-rated entities due to limited sample size), we find that downgrades still outpaced upgrades in 1H2010 by a ratio of 2.5:1.0. However, rating migration activity has eased somewhat from the level seen over the same period in 2009, which could further mark a turning point in corporate credit quality.

Going forward, we still see lingering downgrade risk among certain groups of issuers whose ratings are already in the speculative grade band and carry a negative outlook. Nevertheless, excluding the multiple downgrades of the same names, we do not see a repeat of the outcome in 2009.

Exhibit 12: Although downgrades are still outpacing upgrades, the magnitude is lower than 2009*



Source: Bloomberg, MARC Fixed Income Research
**Based solely on migrations data in the ringgit corporate bond market compiled by Bloomberg.*

The European Debt Crisis - Contained vs. Contagious

It is an undeniable fact that global credit market conditions improved significantly and issuers are now tapping the market as if the global economy is riding on an extremely certain growth trajectory. Volatility in risky asset classes measured by the S&P VIX index is now nowhere near the crisis level, while the once cheap spread has now become expensive as lower yields offered by the government bonds forced investors to seek yields elsewhere.

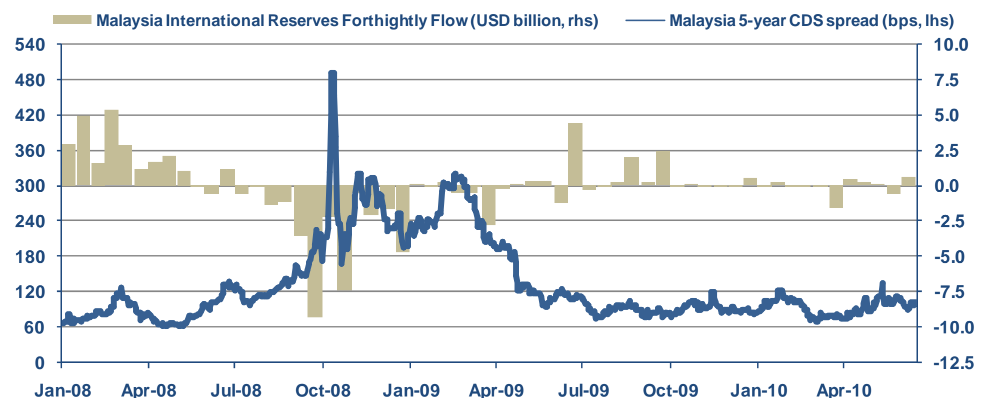
Exhibit 13: Global market volatility and credit risk premiums still reflect a normal market environment despite the risk from the European debt crisis.

Source: Bloomberg, MARC Fixed Income Research

The question is whether there will be a contagion effect from the fallout of the European sovereign debt crisis. This reminds us of early 2007, when many speculated about the possibility of a contagion effect from the subprime crisis before it imploded and triggered the worst economic slowdown since World War II.

Looking at the level of the Credit Default Swap (CDS) spread, we do not see a full-scale spillover risk to Malaysia given that the 5-year CDS spread is nowhere near the crisis level while the international reserves flow has not shown any signs of extreme volatility. At this stage, we do not expect the European debt crisis to pull the global economy into recession again, but a short-term spike in market volatility is likely to take place due to knee-jerk reactions arising from “The European Anxiety”.

Exhibit 14: International reserves flow and CDS spreads have not shown signs of risk of fund withdrawals ala late 2009 and early 2010.



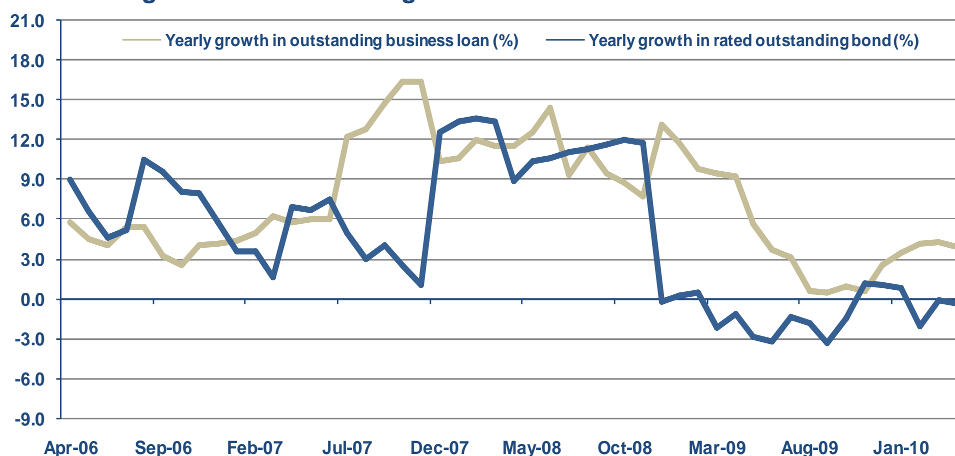
Source: Bloomberg, MARC Fixed Income Research

Refinancing conundrum

There is no doubt that global capital markets conditions have been supportive for issuers since mid-2009 but as we highlighted earlier, this was not reflected in the ringgit corporate bond market with only AAA rated issuers having the flexibility to tap the market. At the current pace of primary market activity, this s is likely to persist. Even if the economic data continues to be positive in the coming months, reliance on credit enhancement by issuers in lower-investment grade bands would be crucial in the coming months. There has been no visible repricing of credit risk at the lower end of the credit curve and the current level is not reflective of improvements in credit fundamentals. Early this year, we published a special report on the refinancing capacity of issuers at the lower end of investment grade *(see MARC Fixed Income Analysis, "Refinancing Access of Issuers at the Lower End of Investment Grade: The Gathering Storm?" published March 30, 2010, available at www.marc.com.my).*

The silver lining that we can see at this stage is improved liquidity positions of corporates based on an analysis of data from almost 1,000 listed companies. This, together with the availability of credit enhancement, in particular, through Danajamin Nasional Berhad, is expected to at least ease the concerns. Secondly, there may be a substitution effect from corporate bonds to corporate loans as evidenced by our findings of outstanding amounts in these two markets. We used the year-on-year growth in business loan data compiled by the central bank as the best available proxies for corporate loans and mapped them against the estimated size of outstanding corporate bonds.

Exhibit 15: Primary activity in the corporate bond market remained sluggish hence making the role of financial guarantee and loan market even more crucial



Source: Bloomberg, MARC Fixed Income Research

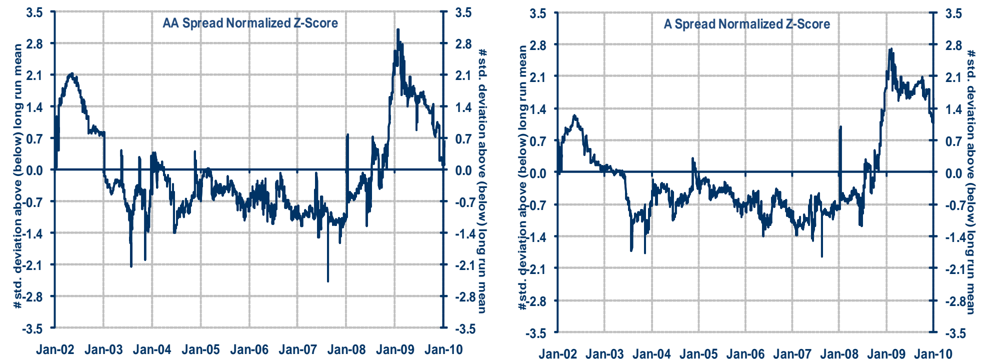
While both markets were affected during the crisis as corporations scaled down production, a rebound in the economy caused demand for credit to resurface, and the yearly growth in loans as at April 2010 has been rising for five consecutive months since November last year. On the other hand, the corporate bond market continued to show signs of lethargy, and only the AAA rating band recorded growth in the outstanding size. Therefore, we believe that the corporate loan market is even more crucial at this stage as a source of financing for corporations if the sluggish primary bond market seen in 1H2010 were to persist.

Bond market liquidity risk in the local credit may only arise from another round of skyrocketing financing costs should the conditions in the European market worsen. If this happens, even the local AAA market may face limited credit access as international investors will certainly cut their exposure to emerging currencies, resulting in increasing financing costs at the sovereign level which will directly affect corporate yields across the board.

Ringgit corporate bonds: A buying opportunity?

Solely from a theoretical point of view and assuming that there will not be a contagion effect from the European debt crisis to the country's fundamentals, we think that the ringgit corporate bonds actually present a good buying opportunity to investors, especially along the AA curve, while investors with high risk tolerance may find A names attractive. Credit spreads along these rating bands, despite narrowing from their historical highs in early 2009, are still attractive considering the improvement seen in corporate balance sheets and macroeconomic data.

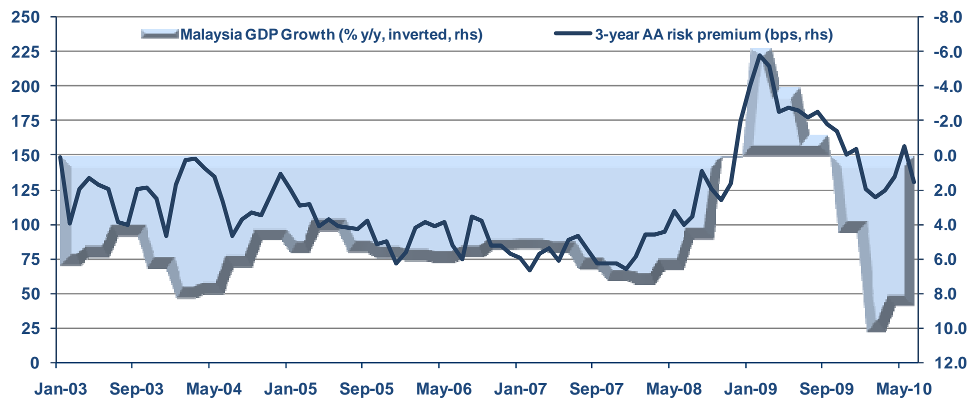
Exhibit 16: The normalized scores of credit spreads indicate that AA is about fairly valued but A remains cheap



Source: Bloomberg, MARC Fixed Income Research

The 3-year AA yield differential against MGS of similar maturity peaked at above 200 bps when the economy contracted by 6.2% in 1Q2009, and has since tightened to circa 120-130 bps. At the GDP level of 10.1% in 1Q2010 and with the economy expected to grow at 6.8% for the full year of 2010, the implied spread is certainly less than the 100 bps mark. The only explanation that we can think of at this juncture is that investors are not confident as to the strength of sustainability of economic recovery.

Exhibit 17: Risk premiums are still relatively wide considering the improving economy and corporate fundamentals



Source: Bloomberg, MARC Fixed Income Research

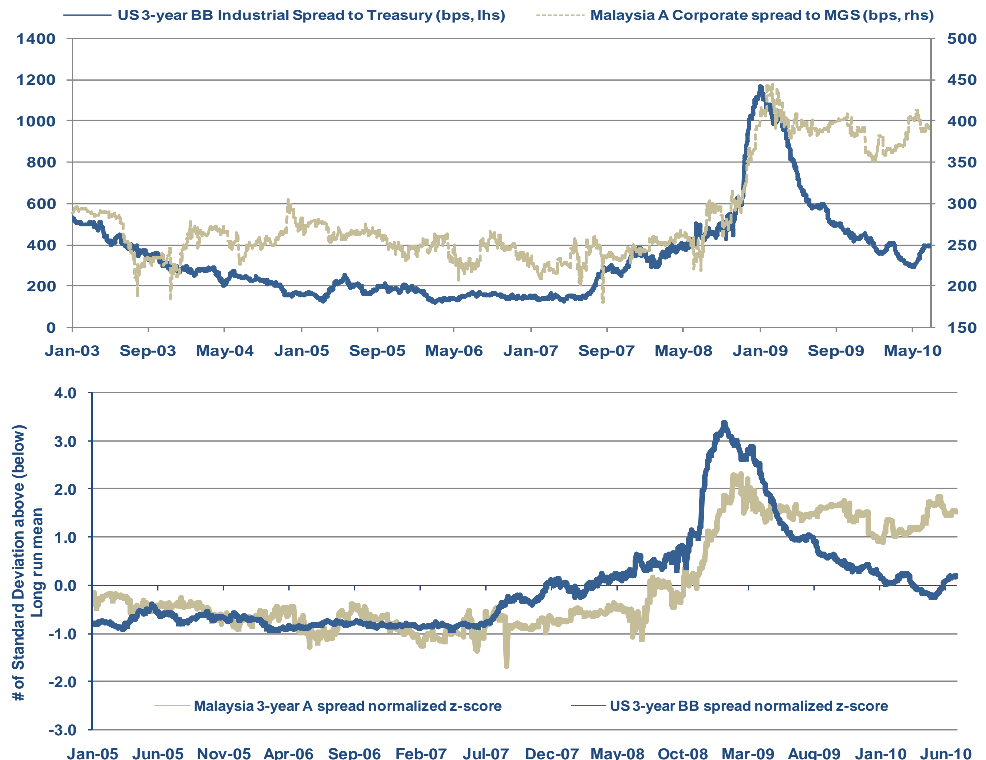
It does not appear that confidence has made a comeback along the single A rating band despite the tightening spread seen in the global high yield market which, if prolonged, could continue to restrict the access of domestic issuers to the ringgit corporate debt market. The 3-year A rated bonds are now yielding circa 395 bps above the risk-free notes, just 20 bps lower than the level seen during the peak of global crisis a little more than a year ago, but as we explained previously, corporate balance sheets have improved significantly over the same period.

A rough mapping of domestic ratings against international ratings, would reduce local A ratings to the equivalent of non investment grade BB ratings on an international rating scale. To bring things into perspective, we look at the credit risk premiums along these rating bands in the respective credit markets. As can be seen in the first panel of Exhibit 18, the BB industrial spread against Treasury skyrocketed above the 10.0% bps mark when the crisis peaked in the early part of 2009, and along the same line, the same spike was also observed in the local market where the A spread against MGS spotted above the 400 bps mark over the same period.

Before we proceed further, it is worth noting here that the significantly larger premiums in the international market during this period were due to their direct exposure to the subprime credit crisis, in contrast to the local market which was only affected after the second order effects through contractions in the economy. Now that growth has resurfaced in the respective economies, also boosting corporate bond sales in the global high yield market, high yield spreads have converged to the pre-crisis level. In contrasts, spreads in the local credit market are remaining wide in the 350-400 bps range.

For further comparison between these two markets, we normalized them into z-score readings and as shown in the second panel of Exhibit 18, the z-score of the US BB spread converged to its long-run average despite ongoing concerns about the European debt crisis. On the other hand, the z-score for the spread in the local market remains wide at approximately 2.0x above the long-run average. With economic and corporate fundamentals rebounding in both areas, risk aversion in the local high yield market appears excessive and indicatively, the current spread level for local high yields is extremely rich. Our opinion rests on two important assumptions that economic recovery is sustainable and the spillover risk from the European debt crisis is contained.

Exhibit 18: Mapping the international BB credit spread against local A spread: Broken correlation post 2008-2009 Market Turmoil



Source: Bloomberg, MARC Fixed Income Research

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