Credit Benchmark

COVID-19: Credit and Solvency Trends

July 2020

Executive Summary

- Corporates have deteriorated much more than Financials.
- Travel and Leisure, Airlines and Hotels, Real Estate and Retail are hardest hit. Health Care and Pharmaceuticals, Utilities, Food and Beverages have understandably held up.
- A number of Sovereigns show downgrades, and seven have dropped out of coverage.
- Financials – apart from Real Estate – are improving.
- The “Fallen Angels” rate is well above long run average.
- Investment Grade categories saw few CRA downgrades, but consensus data shows rising risk.
- Migration data suggests that the 2020 default rate may be at the top end of current expectations.

Scientists are still trying to understand the long-term impact of COVID-19 on the human body as the world scrambles to comprehend this novel strain of virus. The longer-term consequences of COVID-19 on the global economy are similarly unknown, but it is evident that significant disruption to manufacturing, trade and consumer sentiment has well and truly been felt.

This paper uses Consensus credit estimates for the past few months to assess the impact of COVID-19 on credit and solvency across the global economy.

The analysis looks at countries, industries, and sectors, as well as individual corporate borrowers. It shows where downgrades are concentrated, and some of the surprising sources of upgrades. The paper shows these effects across the credit spectrum, from the highest to the lowest credit quality; and it shows how many obligors are likely to run into solvency problems, as well as some case studies where solvency simply ran out.

About Credit Benchmark

Credit Benchmark produces a comprehensive view of credit risk by creating Consensus ratings and analytics on the credit quality of companies, financial institutions, sovereigns and funds.

The data is sourced from the risk departments of more than 40 global financial institutions, representing the work of over 20,000 analysts and is also used by regulators to monitor Basel rules on capital adequacy.

Credit Benchmark collects a specific measure of credit risk: a one-year, forward-looking Probability of Default (PD) and forward-looking senior unsecured Loss Given Default (LGD).

The underlying inputs from contributors are subject to a rigorous data quality approval process and derived from models that are approved by regulatory authorities. The resultant accuracy of each PD and LGD leads to a credible market view of credit risk.

After being anonymized and aggregated, the contributed risk estimates are mapped to the appropriate credit category on the Credit Benchmark Consensus scale, which is calibrated periodically and can be used as a comparison to the scales published by the rating agencies.

Credit Benchmark produces regular data updates with history going back to 2015.

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1. Introduction

COVID-19 is the virus that refuses to obey the rules. It is 1000x times more infectious than its closest genetic relatives, it can be asymptomatic or rapidly lethal; it may have long term health consequences and cause multiple organ damage, or it may cause no lasting effects at all. Its source or cause has been variously identified as the Wuhan wet market, Asian rainforests, bat-infested copper mines, Chinese (or American) laboratories and even 5G phone masts.

If reliable vaccines are developed, then the global economy can return to some semblance of normality. But if a frequently mutating virus means that social distancing and local lockdowns really are the new normal, then there will be long term consequences for the structure of the economy, for asset and property values, and for patterns of social interaction.

These changes will have a significant effect on corporate and financial credit risk, and COVID-19 has already left a trail of economic disruption. There are serious concerns about inflation, reflected in gold prices close to all-time highs. These concerns are partly driven by the explosion in Government debt, and partly due to major changes in supply chains. Supply chains will be shorter, more robust, and companies will try to keep their options open by using multiple suppliers. Input costs will probably rise as a result, since there is a cost to removing uncertainty – and this will be reflected in consumer prices. Trade tensions are likely to intensify as Governments aim to protect their economies, so average import prices will probably increase.

But every crisis brings winners as well as losers. Every tragic closure of a long-standing business leaves a potential niche to be filled by a well-funded new entrant. Global investment banks are already seeing Schumpeter[1] -style waves of restructuring M&A; the corporate winners will be those who have stayed sufficiently solvent to continue trading, to invest in one of the newly vacated or created business segments, or to take advantage of financially distressed competitors.

And while Governments are supporting airlines and traditional retailers (and encouraging their populations to return to restaurants, bars and shopping malls) there is clearly a stronger future in businesses such as 3D printing, animated films, online shops, packaging, remote medical technology and delivery infrastructure. And traditional building looks secure for some years as urban-based workers seek more space for remote working or even move out of cities altogether.

Overview

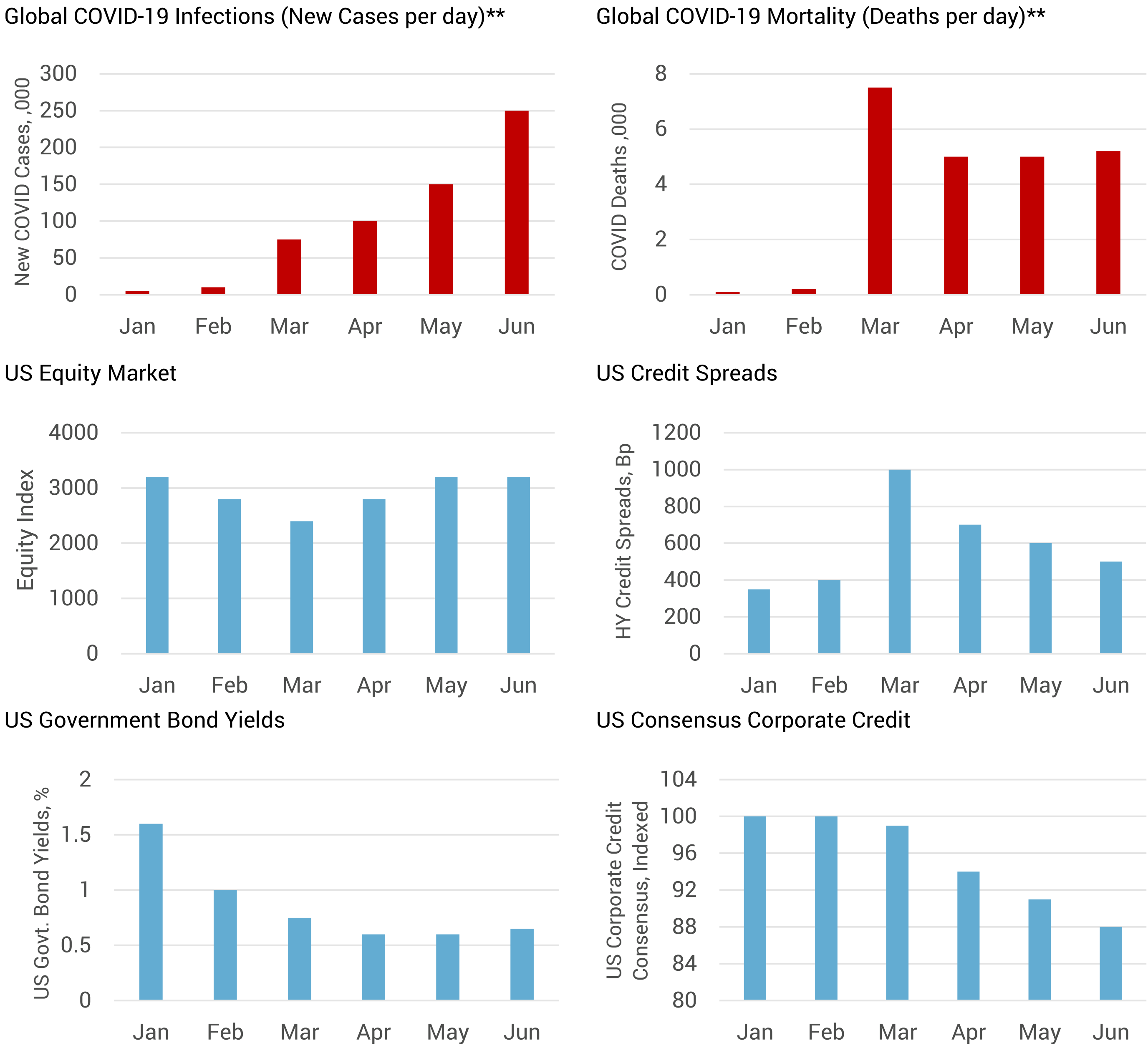
This paper uses Consensus[2] credit estimates for the past few months to assess the impact of COVID-19 on credit and solvency across the global economy. It looks at countries, industries, sectors, as well as individual corporate borrowers. It shows where downgrades are concentrated, and some of the surprising sources of upgrades. It shows these effects across the credit spectrum, from the highest to the lowest credit quality; and it shows how many obligors are likely to run into solvency problems, as well as some case studies where solvency simply ran out.

[1] Joseph Schumpeter, the influential Austrian-born economist, used the expression "creative destruction" to describe how unfettered entrepreneurship and waves of technological innovation can lead to periodic revolutions in economic structures. He did not explicitly mention global pandemics as a potential catalyst but some of the economic impacts seem very similar.

[2] By bringing together the internal credit risk views of the world's leading financial institutions, Credit Benchmark provides an independent and unique measure of credit risk. The data contributed by our partners is subject to rigorous internal ratings systems and/or strict regulatory requirements. Credit Benchmark anonymizes and aggregates the data before releasing it in the form of Consensus ratings ("CBRs") and aggregate analytics. Entity-level credit risk information is available when a minimum of three observations are contributed on that particular entity. The rule of three applies to ensure the anonymity of those contributing credit views to the Credit Benchmark dataset. Basing a Consensus rating on a minimum of three separate observations prevents reverse engineering and enrichens the depth of the data.

The charts below show the key global health and financial indicators in the context of COVID-19.

Figure 1.1 Key Health and Financial Indicators*



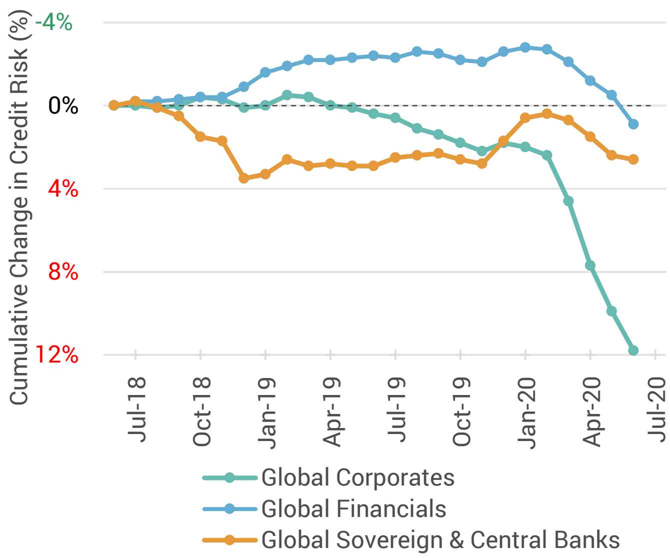
**Over the same period, US GDP has shrunk by c20%.* ***Source* https://www.worldometers.info/coronavirus/

After the initial financial shock that followed the Wuhan lockdown, there has been a recovery in equity markets and credit spreads, strongly driven by Government support packages and monetary easing. Government bond yields dropped rapidly and have remained low while the credit Consensus continues to deteriorate. New COVID-19 cases continue to rise at an increasing rate. The credit Consensus appears to be more closely linked to the infection rate than to the more volatile market view.

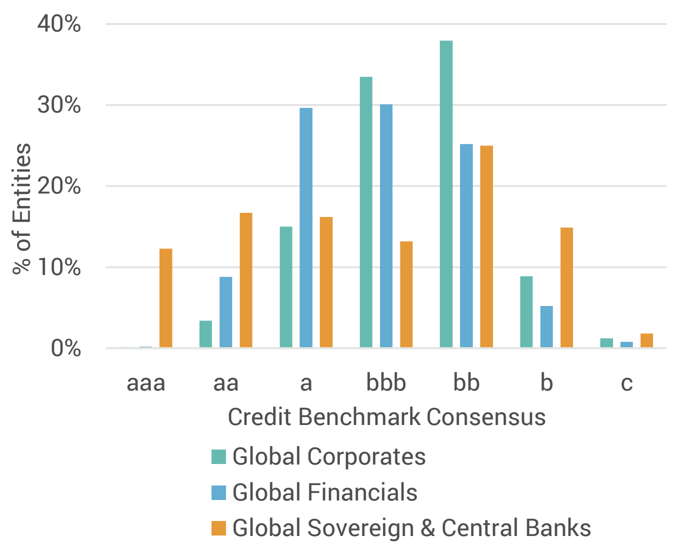
2. Major Trends

Figure 2.1 Corporates, Financials and Sovereigns

Credit Trend

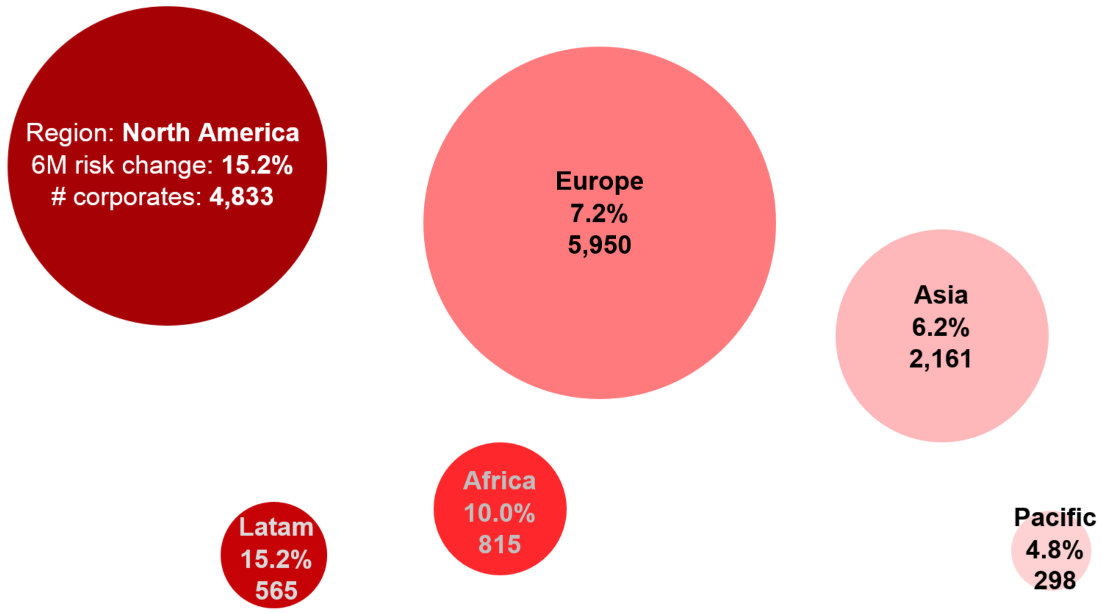


Credit Level



The left-hand chart shows the cumulative change in credit risk (average Probability of Default) from the start date. From the start of the COVID-19 crisis, Global Corporates have deteriorated the most, with a net 9% increase in default risk over the period. Financials and Sovereigns have only dropped a few percent over the same period.

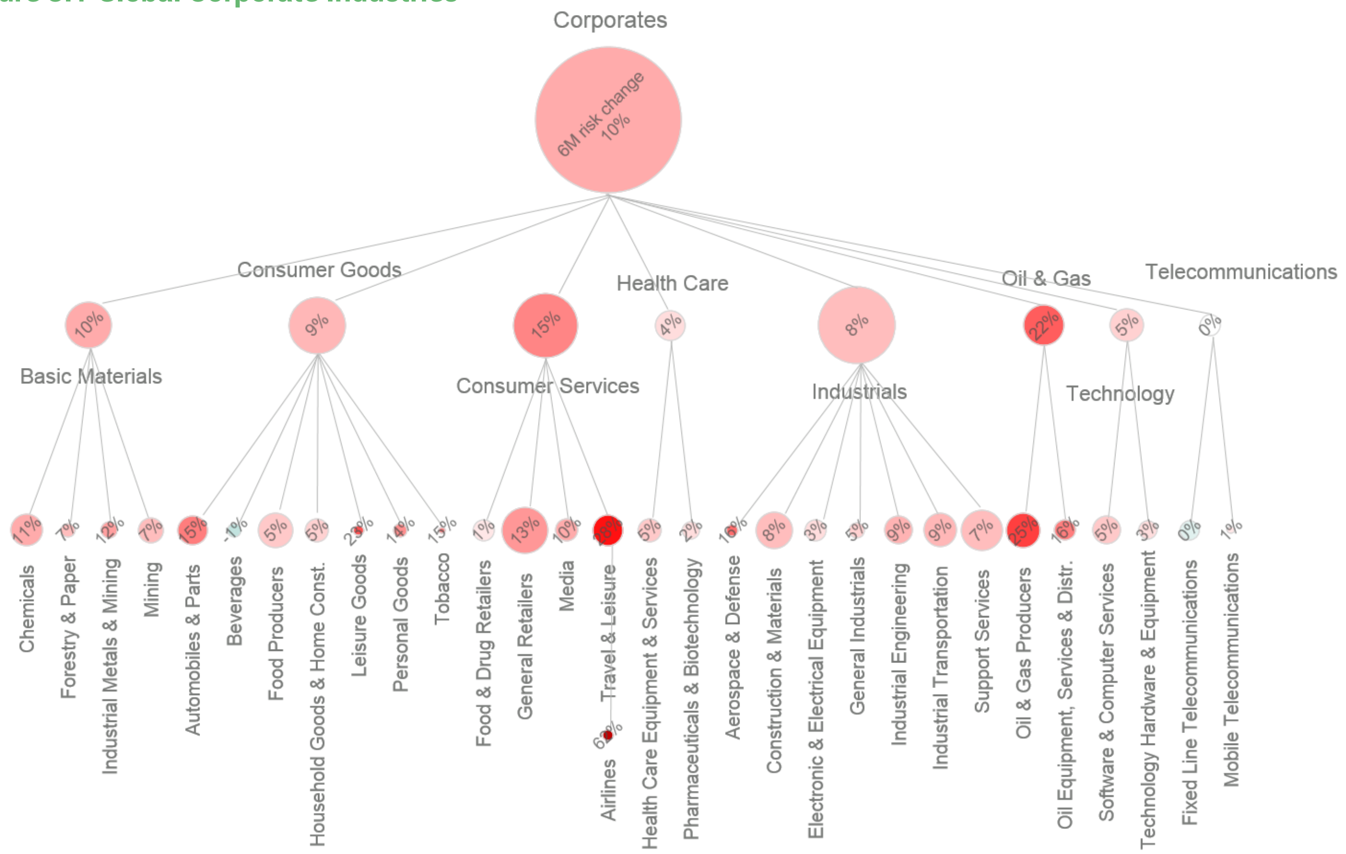
Figure 2.2 Corporates



Within Corporates, North America and Latin America show the largest 6-month deterioration (a risk increase in each case of about 15%), with Africa at 10% while Europe shows about 7%. Asia and the Pacific show the lowest deterioration at 6.2% and 4.8%, respectively.

3. Industry & Sector Highlights

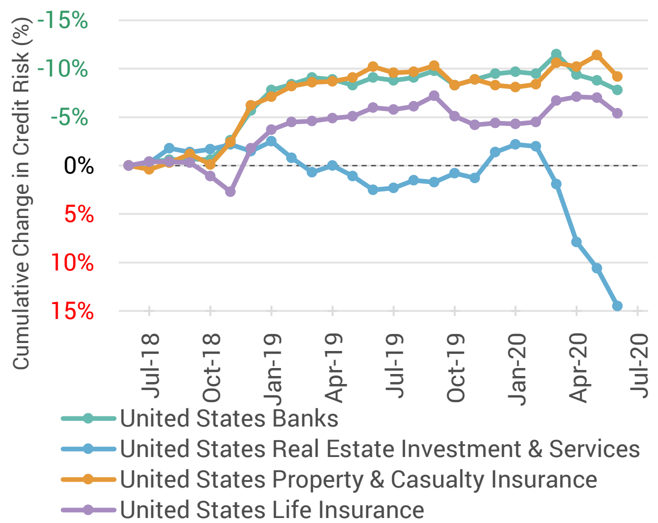
Figure 3.1 Global Corporate Industries



Within Global Corporates, the industry with the largest 6-month deterioration is in Oil & Gas with a 22% increase in default risk, led by Oil & Gas Producers (25%). Consumer Services are next with an increase of 15%, led by Airlines (62%) and Travel & Leisure (28%). Within Consumer Goods (9%), the worst areas are Leisure Goods (23%), Automobiles & Parts (15%) and Personal Goods (14%). Health Care, Technology and Telecoms show limited impact (5%, 4% and zero, respectively).

Figure 3.2 US Financials

Credit Trend



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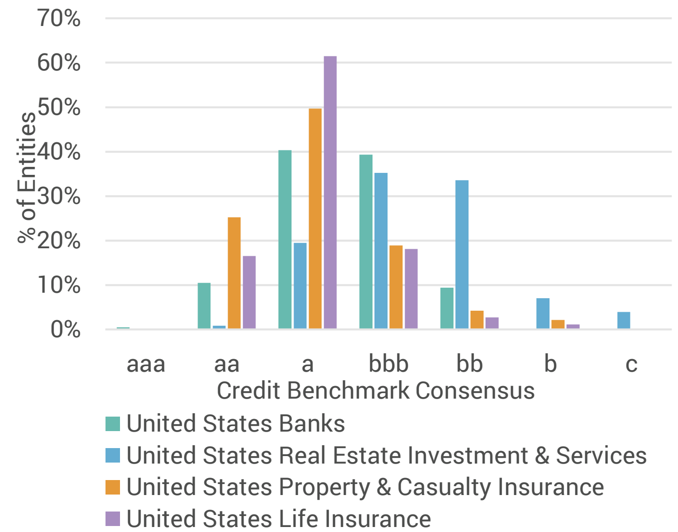
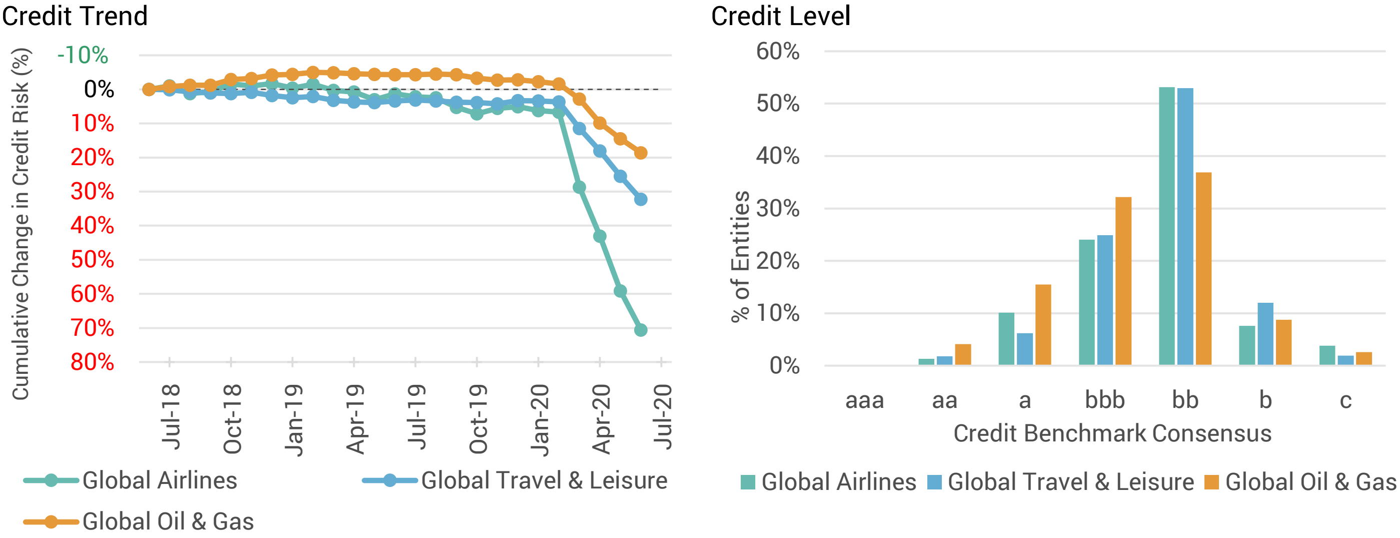


In credit terms, US Financials have held up much more than Corporates. When Real Estate Investment is stripped out of the total, the three large categories – Banks, Property & Casualty Insurance, and Life insurance – all show modest improvements.

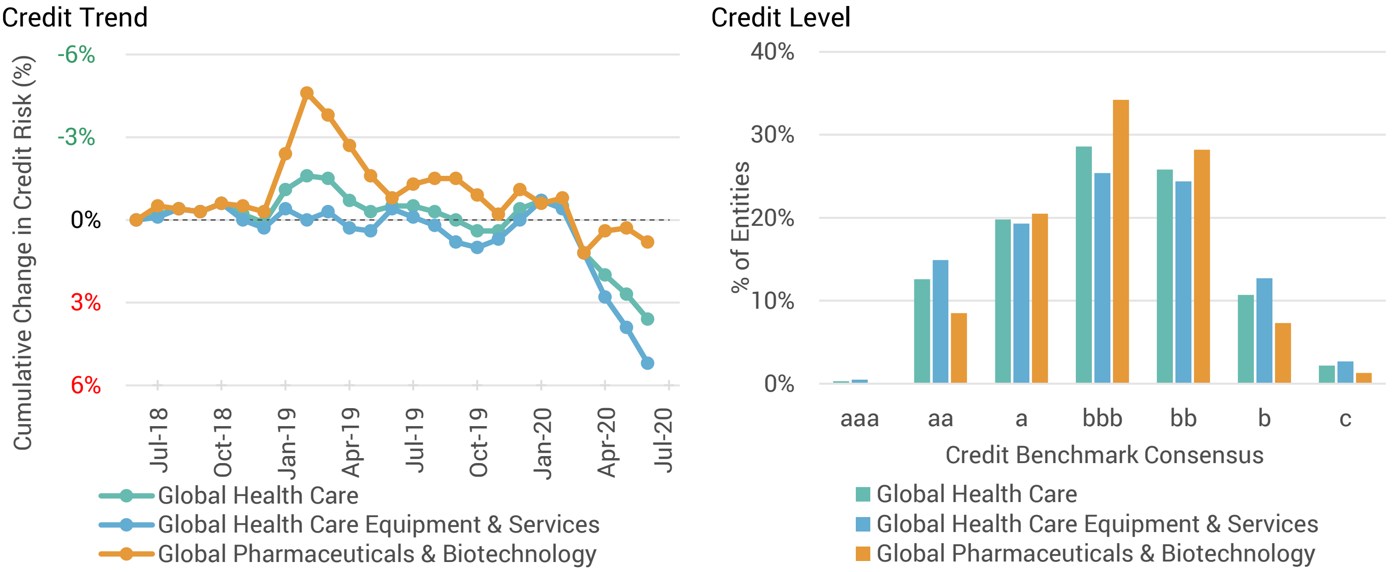
For life insurance companies, the long duration of their liabilities and their assets may mean that they are immune to short term market and rate volatility. Banks enjoy tacit Government support and the COVID-19 crisis probably favours the large, heavily regulated banks over the previously booming shadow banking sector. Property & Casualty Insurance has benefited from a lack of travel – flying and driving – that has effectively earned them a vacation from some categories of losses. So far, this has outweighed the impact of COVID-19-related business interruption pay-outs.

Figure 3.3 Airlines, Travel & Leisure, Oil & Gas



Airlines shows a net 60% increase in risk over the COVID-19 crisis; the overall Travel & Leisure sector has moved about 30%. Following the oil price collapse, Oil & Gas risk also deteriorated with risk rising by about 25%. The right-hand chart shows that – on average – Airlines have moved from investment grade to non-investment grade over the period.

Figure 3.4 Health Care and Pharmaceuticals

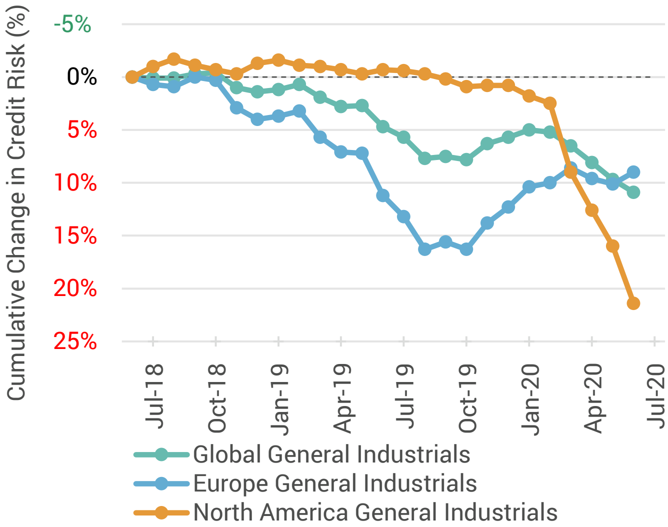


With every nation grappling with their health care systems and with a global search for a COVID-19 vaccine, Health Care and Pharmaceuticals have dominated the news and are likely to be overall beneficiaries of the crisis. They are not immune to global solvency worries, but the deterioration has been small.

4. Regional Sector Comparisons

Figure 4.1 General Industrials

Credit Trend



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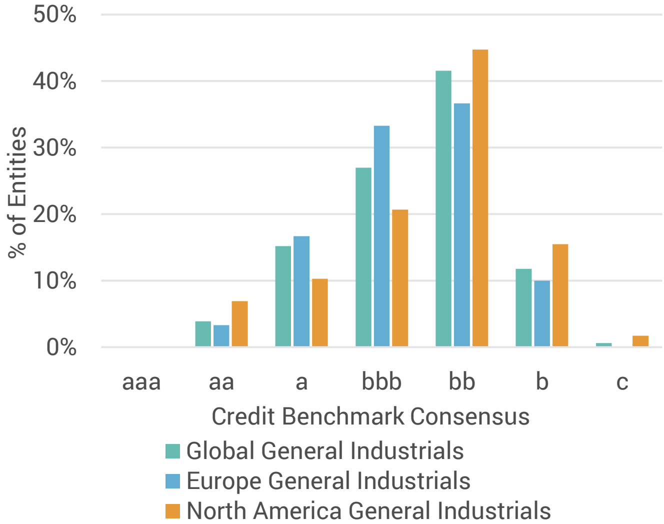
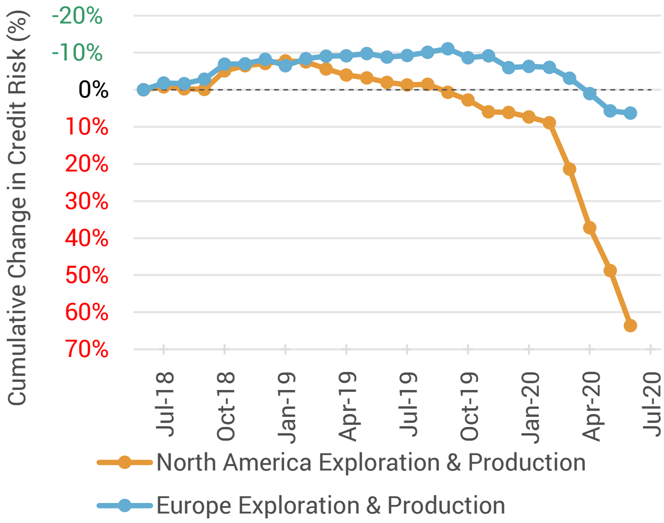


Global General Industrials have understandably deteriorated, but there is a marked divergence between North America (with risk rising a net 11%) whereas Global is about half of that, while Europe has actually improved. This sector is dominated by non-investment grade borrowers.

Figure 4.2 Energy Exploration and Production

Credit Trend



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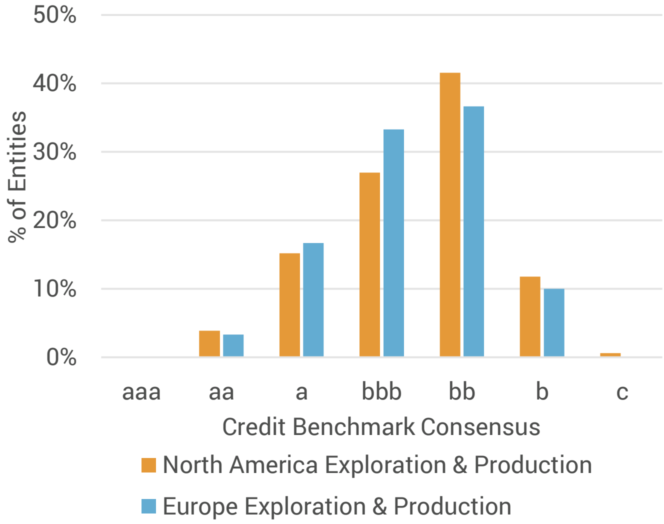
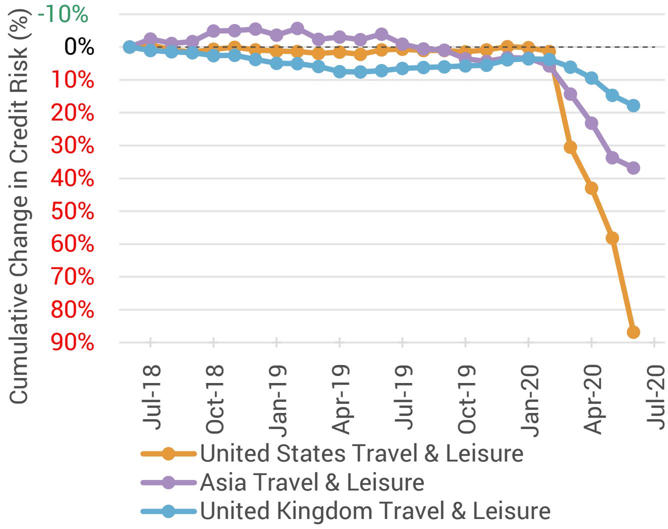


Within the Energy sector, there have been some winners (companies who store oil following an oil price crash, for example), but for the majority – especially heavily indebted shale oil producers – the COVID-19 crisis has been very damaging. North American E&P company credit risk has increased by about 50% over the past few months, moving the entire sector one notch further into non-investment grade. Europe (mainly UK) has fared much better, reflecting a smaller sample of more integrated and less indebted companies.

Figure 4.3 Travel and Leisure

Credit Trend



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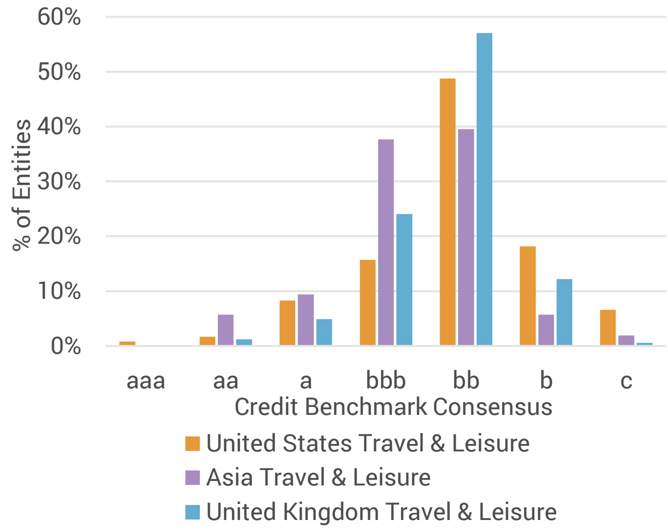
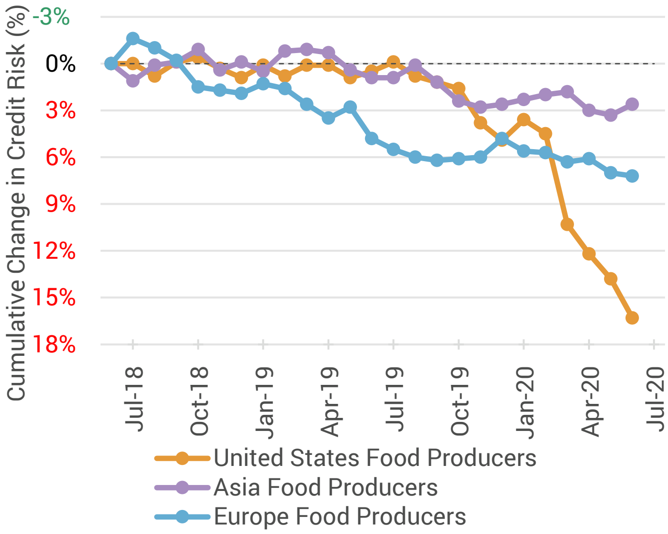


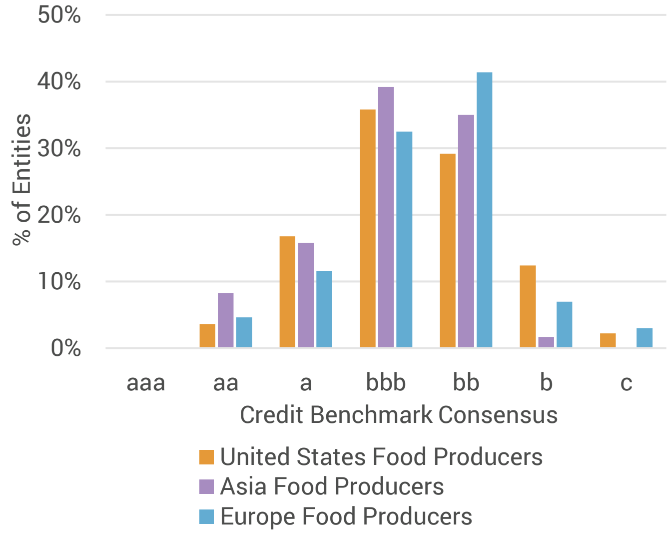
In a now familiar pattern, US Travel and Leisure has suffered significantly more than UK or Asia, with risk almost doubling over the crisis period.

Figure 4.4 Food Producers

Credit Trend



Credit Level



The impact of lockdown on Food Producers is complex. Local producers that can easily get produce in the distribution network have benefited from import substitution; but those global exporters or those dependent on extended supply chains have suffered. Again, this is particularly marked in the US.

Figure 4.5 US vs. UK: Media

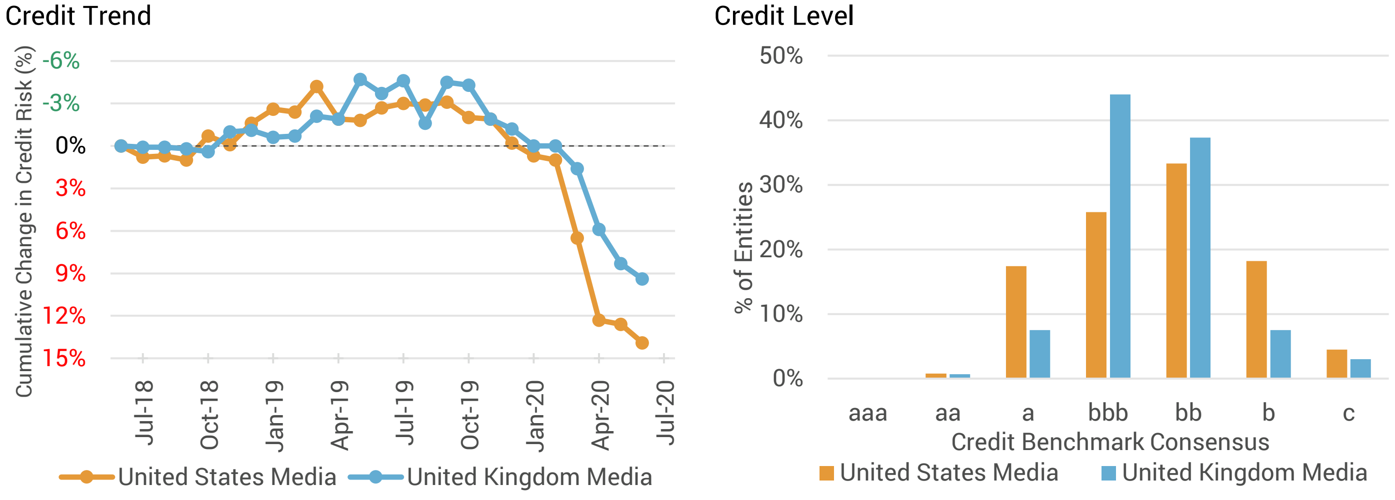


Figure 4.6 US vs. UK Aerospace & Defense

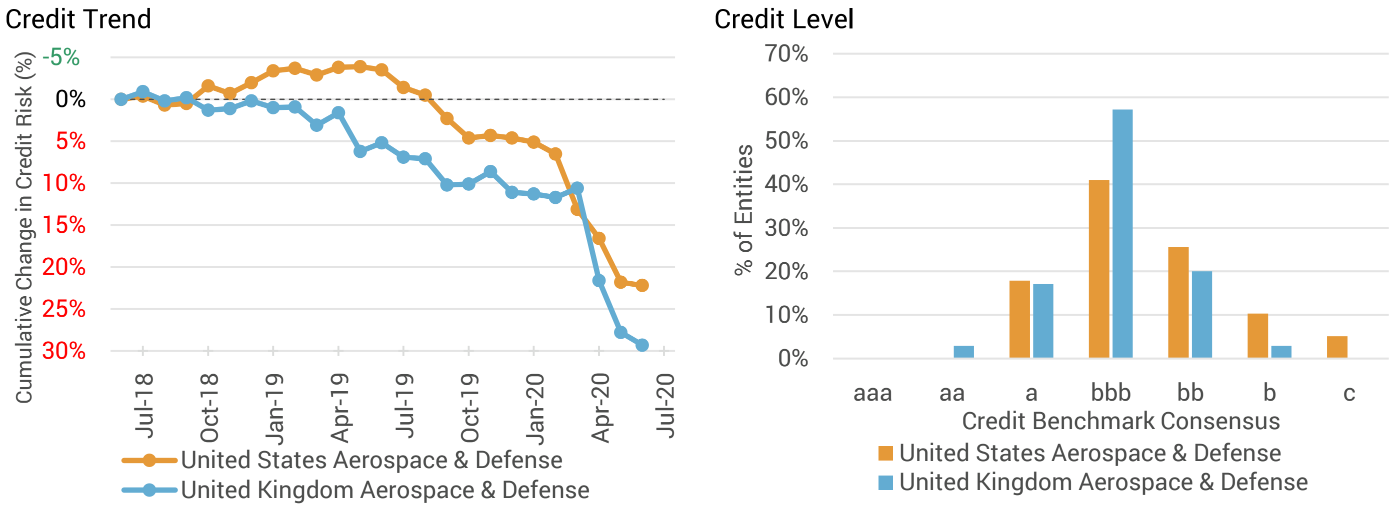
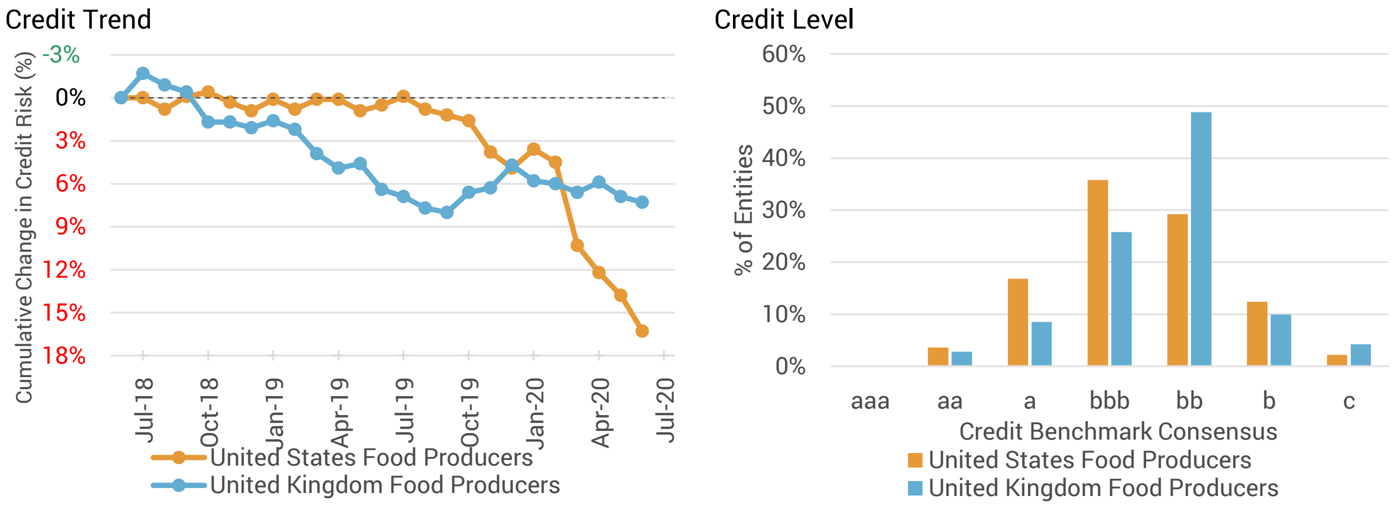


Figure 4.7 US vs. UK: Food Producers



In the US/UK comparisons above, the credit risk increase in the UK and US has been similar in Media and in Aerospace & Defense, but in Food Producers the US again shows a significantly higher deterioration, rising about 10% against about 4% over the same period in the UK.

Figure 4.8 US Corporates and Financials: Top 25 Sectors by 6-month Increase in Credit Risk

Aggregate Name	Entity Count	Credit Risk 6m Change	Region	Country	Entity Type	Industry	Sector
United States Hotels	33	140.5%	North America	United States	Corporates	Consumer Services	Travel & Leisure
United States Travel & Leisure	121	86.9%	North America	United States	Corporates	Consumer Services	Travel & Leisure
United States Exploration & Production	162	66.5%	North America	United States	Corporates	Oil & Gas	Oil & Gas Producers
United States Oil & Gas Producers	273	52.8%	North America	United States	Corporates	Oil & Gas	Oil & Gas Producers
United States Broadline Retailers	42	42.0%	North America	United States	Corporates	Consumer Services	General Retailers
United States Oil & Gas	413	41.7%	North America	United States	Corporates	Oil & Gas	
United States Oil Equipment & Services	39	38.4%	North America	United States	Corporates	Oil & Gas	Oil Equipment, Services & Distribution
United States Large Oil & Gas	302	37.4%	North America	United States	Corporates	Oil & Gas	
United States Retail REITs	28	34.9%	North America	United States	Financials	Financials	Real Estate Investment Trusts
United States Large Consumer Services	521	33.5%	North America	United States	Corporates	Consumer Services	
United States Integrated Oil & Gas	111	33.2%	North America	United States	Corporates	Oil & Gas	Oil & Gas Producers
United States Consumer Services	594	32.0%	North America	United States	Corporates	Consumer Services	
United States Automobiles & Parts	114	29.9%	North America	United States	Corporates	Consumer Goods	Automobiles & Parts
United States Automobiles	63	28.3%	North America	United States	Corporates	Consumer Goods	Automobiles & Parts
United States Real Estate Investment Trusts	144	25.5%	North America	United States	Financials	Financials	Real Estate Investment Trusts
United States General Retailers	280	25.1%	North America	United States	Corporates	Consumer Services	General Retailers
United States Specialty Retailers	106	24.2%	North America	United States	Corporates	Consumer Services	General Retailers
United States Oil Equipment, Services & Distribution	137	23.4%	North America	United States	Corporates	Oil & Gas	Oil Equipment, Services & Distribution
United States General Industrials	52	23.2%	North America	United States	Corporates	Industrials	General Industrials
United States Industrial Transportation	114	21.6%	North America	United States	Corporates	Industrials	Industrial Transportation
United States Aerospace	33	21.1%	North America	United States	Corporates	Industrials	Aerospace & Defense
United States Mining	44	19.7%	North America	United States	Corporates	Basic Materials	Mining
United States Consumer Goods	433	19.3%	North America	United States	Corporates	Consumer Goods	
United States Large Consumer Goods	379	18.1%	North America	United States	Corporates	Consumer Goods	
United States Corporates	3,517	17.4%	North America	United States	Corporates		

The US Hotel sector has suffered an increase in credit risk of around 140%. This represents more than a three-notch downgrade for a typical borrower in this already challenged sector. The broader Travel and Leisure sector has seen average credit risk increase by more than 90% over the same period.

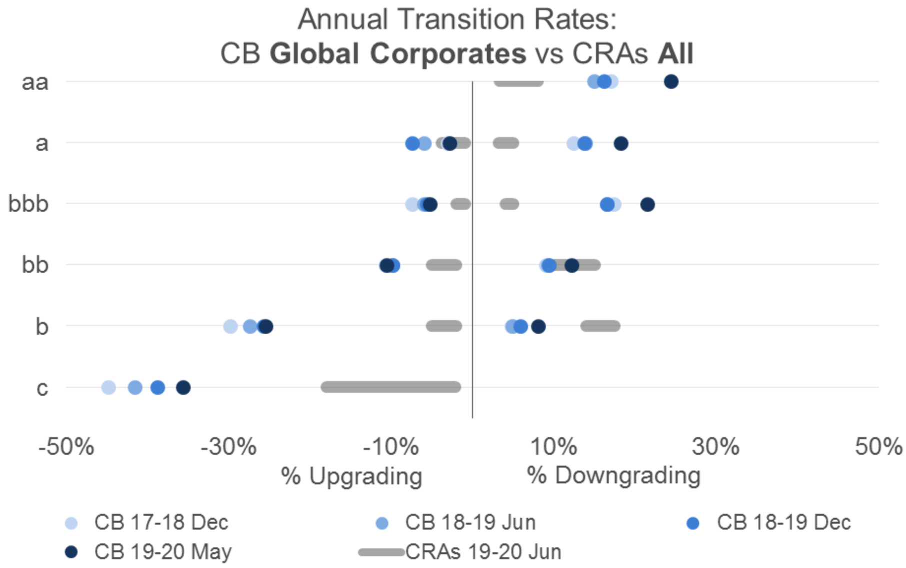
Figure 4.9 US Corporates and Financials: Top 25 Sectors by 6-month Increase in Credit Risk

Aggregate Name	Entity Count	Credit Risk 6m Change	Region	Country	Entity Type	Industry	Sector
United Kingdom Broadcasting & Entertainment	46	19.3%	Europe	United Kingdom	Corporates	Consumer Services	Media
United Kingdom Aerospace & Defense	35	16.3%	Europe	United Kingdom	Corporates	Industrials	Aerospace & Defense
United Kingdom Aerospace	29	15.9%	Europe	United Kingdom	Corporates	Industrials	Aerospace & Defense
United Kingdom Automobiles	85	15.8%	Europe	United Kingdom	Corporates	Consumer Goods	Automobiles & Parts
United Kingdom Oil Equipment & Services	32	15.3%	Europe	United Kingdom	Corporates	Oil & Gas	Oil Equipment, Services & Distribution
United Kingdom Restaurants & Bars	59	15.1%	Europe	United Kingdom	Corporates	Consumer Services	Travel & Leisure
United Kingdom Automobiles & Parts	110	14.5%	Europe	United Kingdom	Corporates	Consumer Goods	Automobiles & Parts
United Kingdom Water	44	13.9%	Europe	United Kingdom	Corporates	Utilities	Gas, Water & Multi-utilities
United Kingdom Large Oil & Gas	148	13.5%	Europe	United Kingdom	Corporates	Oil & Gas	
United Kingdom Broadline Retailers	52	13.5%	Europe	United Kingdom	Corporates	Consumer Services	General Retailers
United Kingdom Travel & Leisure	345	13.4%	Europe	United Kingdom	Corporates	Consumer Services	Travel & Leisure
United Kingdom Exploration & Production	57	13.0%	Europe	United Kingdom	Corporates	Oil & Gas	Oil & Gas Producers
United Kingdom Building Materials & Fixtures	135	12.6%	Europe	United Kingdom	Corporates	Industrials	Construction & Materials
United Kingdom Large Basic Materials	199	12.4%	Europe	United Kingdom	Corporates	Basic Materials	
United Kingdom Specialty Chemicals	101	12.2%	Europe	United Kingdom	Corporates	Basic Materials	Chemicals
United Kingdom Large Consumer Services	803	11.8%	Europe	United Kingdom	Corporates	Consumer Services	
United Kingdom Oil & Gas Producers	130	11.7%	Europe	United Kingdom	Corporates	Oil & Gas	Oil & Gas Producers
United Kingdom Oil & Gas	178	10.9%	Europe	United Kingdom	Corporates	Oil & Gas	
United Kingdom Chemicals	156	10.9%	Europe	United Kingdom	Corporates	Basic Materials	Chemicals
United Kingdom Media	134	10.8%	Europe	United Kingdom	Corporates	Consumer Services	Media
United Kingdom Travel & Tourism	129	10.6%	Europe	United Kingdom	Corporates	Consumer Services	Travel & Leisure
United Kingdom Integrated Oil & Gas	73	10.6%	Europe	United Kingdom	Corporates	Oil & Gas	Oil & Gas Producers
United Kingdom Business Support Services	213	10.6%	Europe	United Kingdom	Corporates	Industrials	Support Services
United Kingdom Recreational Services	61	10.3%	Europe	United Kingdom	Corporates	Consumer Services	Travel & Leisure
United Kingdom General Retailers	538	9.9%	Europe	United Kingdom	Corporates	Consumer Services	General Retailers

Deterioration in the UK has so far been more modest than the US, with the worst sector being Broadcasting and Entertainment, where risk has risen nearly 20%. Close behind are Aerospace, Autos, Restaurants & Bars, and Oil & Gas.

5. Credit Transitions

Figure 5.1 One-Year Transitions by Credit Category vs. CRA, Quarterly, 2018 – mid-2020



These were already changing when COVID-19 hit.

The **aa** category was already showing that 10% of the sample had downgraded, notably accelerating in the most recent observation which reflects the downgrades after February 2020. The **a** category shows a slight bias to downgrades, accelerating in the recent data.

The **bbb** category shows a marked bias to downgrades, again accelerating. The **bb** category is almost balanced between upgrades and downgrades, with limited change. The **b** category shows a bias towards upgrades, with no obvious slowing in the most recent period.

In the **c** category there is a marked slowdown in upgrades in the most recent data.

Some key conclusions:

- Consensus data appears to be more dynamic than CRA data.
- Consensus data shows an increased downgrade rate especially for IG entities
- CRAs mainly focused on HY downgrades, especially in the **bb** and **b** categories.

Figure 5.2 summarises the transition behaviour:

Figure 5.2 Leading and Off-Diagonal Transition Matrix Summary[3], Quarterly, 2018 – mid-2020.

Diagonals	**aa**	**a**	**bbb**	**bb**	**b**	**c**	**No change**	Upgrades	Downgrades
Dec 17 - Dec 18	83.05%	84.53%	75.29%	80.19%	65.34%	55.05%	443.45%	96.15%	60.41%
Mar 18 - Mar 19	84.52%	81.37%	77.17%	80.21%	65.88%	55.52%	444.67%	97.99%	57.34%
Jun 18 - Jun 19	85.08%	80.16%	77.46%	80.89%	67.72%	58.41%	449.72%	91.02%	59.26%
Sep 18 - Sep 19	86.19%	79.15%	76.79%	80.39%	67.20%	58.80%	448.52%	91.92%	59.57%
Dec 18 - Dec 19	83.83%	78.78%	77.85%	80.71%	68.48%	61.19%	450.84%	87.59%	61.56%
Mar 19 - Mar 20	81.09%	81.76%	76.84%	79.76%	69.65%	64.11%	453.21%	79.90%	66.88%
May 19 - May 20	75.66%	78.99%	73.17%	77.16%	66.39%	64.28%	435.65%	80.12%	84.20%

[3] Each row adds to 600% - the upper table shows the leading diagonal values (the proportion of obligors that remain in the same credit category over the period) and the lower table sums all of the off-diagonal elements, split into Downgrades (the lower left triangle of each matrix) and Upgrades (the upper right triangle of each matrix).

Obligors in the **aa** and **a** categories are now less likely to remain in those categories; those in the **bbb**, **bb** and **b** are also less likely to remain but the magnitude of the shift is small; those in the **c** category are much more likely to remain there (rather than upgrade).

The overall Downgrade % has moved from around 60% to 84%; the overall Upgrade propensity has moved from 96% to 80%.

As Figure 5.1 shows, rating agency downgrades have hit unprecedented levels over the past few months, but the majority of these are companies that were already classed as high yield. While there have been some Fallen Angels – companies that cross the boundary from Investment-Grade to non-Investment Grade – many of these are yet to formally cross the boundary; agencies (and their corporate clients) display an understandable reluctance to avoid the "BBB cliff".

Figure 5.3 shows the Fallen Angel rate for a global sample of 6,894 companies.

Figure 5.3 Fallen Angels by Global Sector, March – June 2020

Sector	Sample of IG companies end-Feb 20	Cumulative # Fallen Angels Mar - Jun 20	Cumulative % Fallen Angels Mar - Jun 20
Travel & Leisure	189	65	34.4%
Leisure Goods	22	5	22.7%
Industrial Metals & Mining	64	13	20.3%
Automobiles & Parts	384	55	14.3%
Media	151	19	12.6%
Oil & Gas Producers	492	61	12.4%
Chemicals	388	44	11.3%
Forestry & Paper	63	7	11.1%
General Retailers	605	66	10.9%
Personal Goods	65	7	10.8%
Aerospace & Defense	76	8	10.5%
Construction & Materials	316	30	9.5%
Full Sample	6894	578	8.4%
Household Goods & Home Construction	169	14	8.3%
Industrial Transportation	346	28	8.1%
Support Services	469	29	6.2%
Food Producers	396	24	6.1%
Software & Computer Services	253	15	5.9%
Electronic & Electrical Equipment	204	12	5.9%
Technology Hardware & Equipment	104	6	5.8%
Beverages	87	5	5.7%
Industrial Engineering	219	12	5.5%
Mining	220	12	5.5%
Oil Equipment, Services & Distribution	168	9	5.4%
Food & Drug Retailers	77	4	5.2%
Pharmaceuticals & Biotechnology	142	5	3.5%
General Industrials	62	2	3.2%
Gas, Water & Multi-utilities	303	7	2.3%
Health Care Equipment & Services	227	5	2.2%
Fixed Line Telecommunications	141	3	2.1%
Electricity	448	6	1.3%
Mobile Telecommunications	19	-	0.0%
Tobacco	25	-	0.0%

Consensus data shows that a growing number of companies are falling over the cliff edge, providing clues to likely future default rates.

In the past few months, 578 (about 8%) have migrated to and remained in sub-Investment-Grade.

The sector showing the most significant deterioration is Travel & Leisure, with more than a third of firms now classified as Fallen Angels (note that over the same period last year, this number was about 7%). Leisure Goods (23%) and Metals & Mining (20%) also show very high rates.

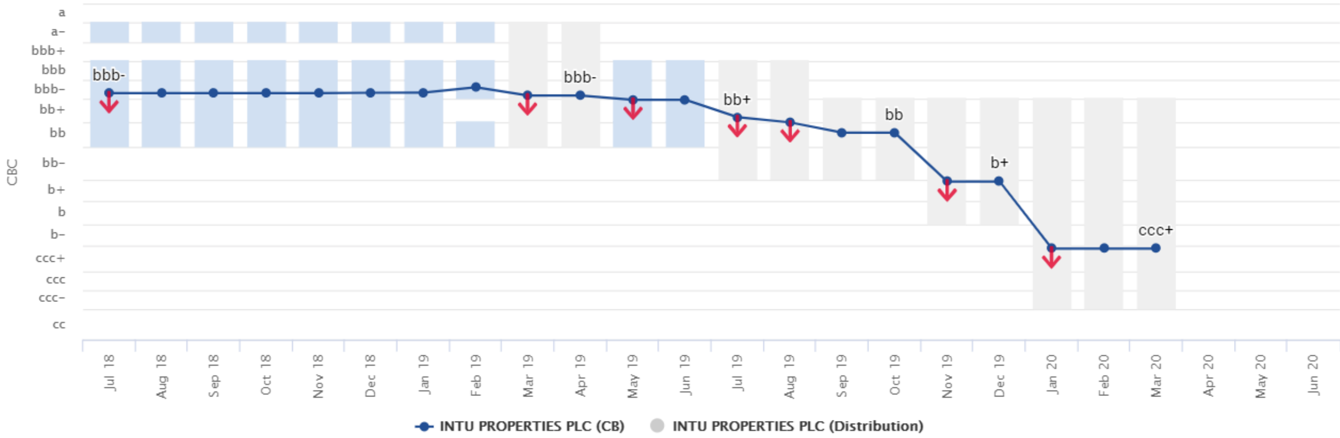
Other sectors with double digit rates include Automobiles & Parts (14%), Media (13%) and Oil & Gas Producers (12%). Only two sectors – Mobile Telecommunications, and Tobacco, have no Fallen Angels.

6. Solvency is Key: Intu, Gavilan Resources

As the previous sections have shown (General Industrials, E&P, Media), credit risk has been increasing in a number of sectors long before the appearance of COVID-19. For companies with heavy debt burdens, lockdown has been the last straw and creditors have been unwilling to continue to be flexible. These charts show two examples, from the UK Retail and US Shale Oil sectors respectively.

Figure 6.1 shows the trend for Intu, who entered administration in June 2020.

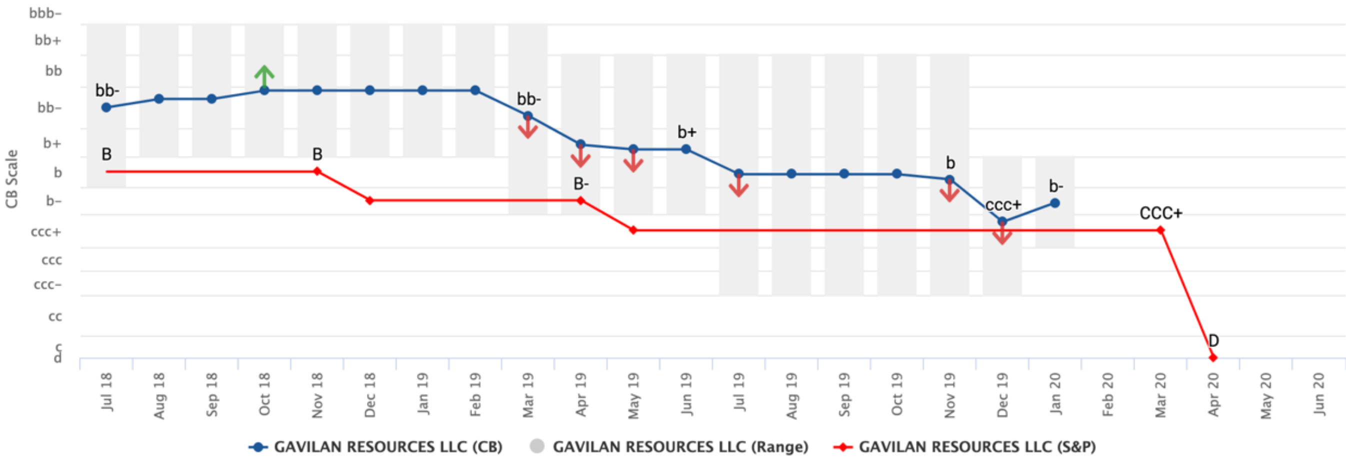
Figure 6.1 Intu



The Consensus was hovering around the Investment Grade boundary in 2018 and the first half of 2019. At least one contributor to the Consensus had moved to a more negative stance in March 2019 (the red arrow), and this was followed by a series of similar negative opinion changes in July and August. The lower end of the range dropped in July 2019, further in November 2019, and again in January 2020. Covered ceased completely in March 2020 (implying that some contributors had decided to cease extending credit) and the company entered administration in June 2020.

Figure 6.2 shows Gavilan Resources who filed for Chapter 11 in May 2020.

Figure 6.2 Gavilan Resources



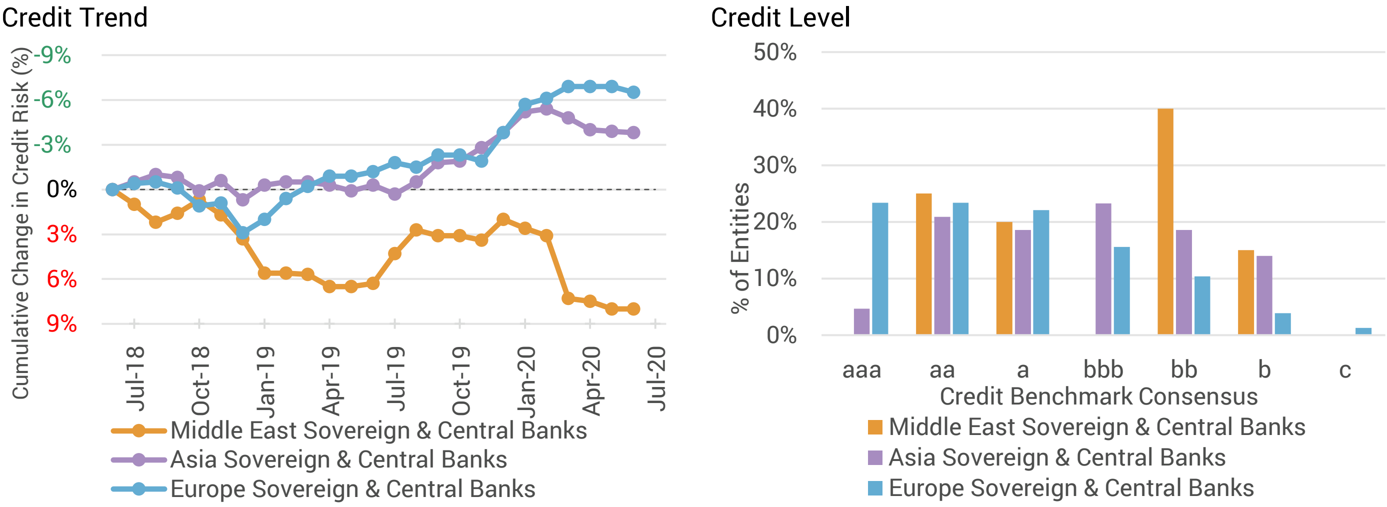
Gavilan Resources has been rated as non-Investment Grade for the past few years, but the Consensus began to show signs of downward revisions in March 2019. The lower end of the range has matched and at times been lower than the S&P view, although there was a brief apparent recovery in January 2020 before coverage of Gavilan ceased altogether due to an insufficient number of contributors to the Consensus having exposure to them. This apparent recovery could be due to Gavilan actively seeking other sources of finance or it could reflect increasing lender caution. The company filed for Chapter 11 in May.

7. Sovereign Credit: Solvency Concerns Follow Debt Explosion

Figure 2.1 showed that Sovereign credit has been more or less stable in the early months of the COVID-19 crisis. But the struggle to contain the various effects of the virus has much in common with a global war. Growing casualty lists, business shutdowns, retooling of factories, trade disruption, and social restrictions leading to huge and lasting debt burdens.

It is estimated[4] that the G20 Governments have collectively deployed $7trn (at end May) in the form of direct spending, tax relief and loans. This represents an increase of 60% on the global Government debt total of $11.4trn in 2019. Figure 7.1 shows the regional trends in Sovereign credit risk.

Figure 7.1 Sovereign Trends



The overall effect on Sovereign credit has been muted so far, with only the Middle East Sovereign aggregate – dominated by the **bb** credit category - showing any material change, with risk increasing by 6% (US and Canada also show no change).

But there has been a lot of activity within single Sovereign names, summarized in Figure 7.2.

Figure 7.2 Changes in Sovereign Consensus, Feb 2020 to June 2020

	Bahamas	
	Brunei Darussalam	
	Cayman Islands	
	Costa Rica	Belarus
	Gabon	Belgium
Albania	Morocco	Dominican Republic
Barbados	Oman	Egypt
Fiji	Peru	Jamaica
Guatemala	Saint Kitts and Nevis	Malawi
Lebanon	United Arab Emirates	New Zealand
Montenegro	Uruguay	Russian Federation
Sierra Leone	Zambia	Swaziland
No longer covered	One notch downgrade	One notch upgrade

A long list of countries has seen single notch Consensus downgrades over this period, including UAE, Uruguay, Zambia and the Cayman Islands. Singapore, Belgium and New Zealand. Seven have dropped out of coverage (including troubled Lebanon). Upgrades include Belgium, New Zealand, and Russia.

[4] Center for Strategic and International Studies, June 2020

8. Corporate Solvency: Credit & Equity Correlations

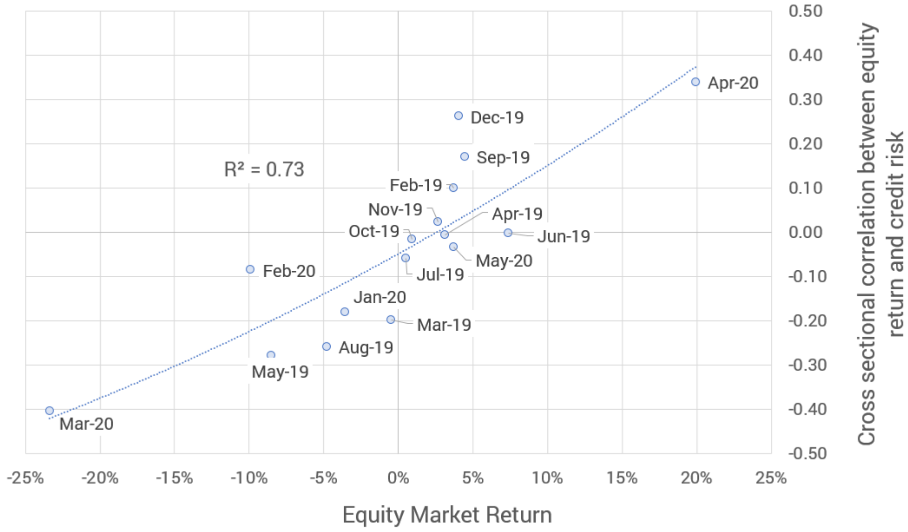
Equity markets usually focus on sales and earnings, not credit risk: when a company becomes a "cash cow" with no avenues for new business investments, it is typically seen as ex-growth and ripe for takeover. High ratings are for high growth firms, frequently making liberal use of leverage.

But COVID-19 has raised the spectre of widespread corporate insolvency, following a rapid and widespread collapse in revenues. Government and bank lifelines have favoured essential firms, or those with strong balance sheets and sustainable business models in the post-virus economy.

Equity markets initially plummeted, but they have now pivoted to a more direct focus on corporate solvency; economic and corporate data is now minutely dissected for clues to the short-term outlook. Markets have oscillated between Risk On and Risk Off, with solvency risk as one of the key issues.

The chart shows the relationship between equity market movements and credit risk for 771 US Corporates over a 17-month period.

Figure 8.1 Correlation Between S&P500 Changes and Credit Risk 2019-2020



From an overall equity market perspective, the first three months on 2020 all appear in the lower left quadrant – negative index returns, and a negative correlation between individual equity performance and credit risk.

For example, across 771 US Corporates, the correlation between credit risk and share price performance in March 2020 is -0.4, with an index return of about -23%. This means that listed companies with high credit risk were much more likely to underperform the market – a classic flight to quality, where "quality" is defined by creditworthiness. By contrast, in December 2019 the correlation was +0.26, with a mildly positive market return of +4%. Other months fit this overall pattern; there are no months in the upper left quadrant (positive credit risk / share price return correlation and a falling index) and those in the lower right quadrant are very close to the axes.

The fit is 73%; this drops to 52% if the March 2020 data is excluded, but is still significant. This was also a period of extraordinary weakness in oil stocks, but excluding them does not change the fit significantly.

The conclusion is that rising markets do not just ignore solvency risk, they almost embrace it; but when markets turn down – especially in the current environment – they will pivot towards companies with the highest credit quality and lowest risk of insolvency. When solvency risk is "on" one week and "off" the next, Consensus risk data shows which stocks are likely to win or lose in each phase.

9. Conclusion and Outlook

- Corporates have deteriorated much more than Financials.
- Travel and Leisure, including Airlines and Hotels, as well as Real Estate and Retail have been hardest hit. Health Care and Pharmaceuticals have understandably held up.
- Some US sectors show very steep deterioration, which may in part reflect a particularly cautious stance by US contributors to the Consensus.
- Sovereigns show limited deterioration overall, but a number of countries show single notch downgrades and seven have dropped out of coverage altogether.
- Financials – apart from Real Estate – are actually improving.
- The "Fallen Angels" rate is highest in the hard-hit sectors, at least where there are still some Investment Grade companies left to downgrade.
- Consensus data is typically more dynamic than CRA data and shows the true extent of potential solvency issues in the Investment Grade categories, which is normally obscured by the "BBB Cliff".
- Migration data suggests that the full 2020 default rate may be at the top end of current expectations.
- New supply chain structures and new patterns of consumption are likely to create new opportunities for firms with strong balance sheets or access to investment funding. Consensus data should begin to detect these emerging COVID-19 winners in H2 2020.

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