# IIF Weekly Insight
# COVID-19 infects corporate debt markets

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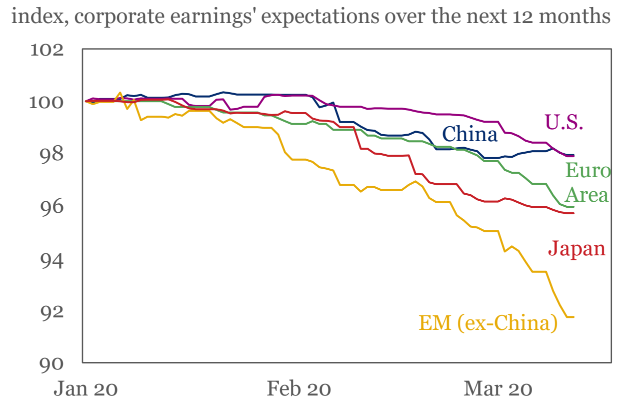
- COVID-19 fears prompt sharp downgrades to corporate earnings estimates; growing risk of fallen angels and fire sales
- Signs of stress in corporate funding markets, rising liquidity risk for oil and gas, utilities and across high-yield markets
- Biggest vulnerabilities: small and medium sized firms, BBB-rated corporates and EM firms with heavy reliance on FX debt

**Catalyst for a meltdown?** As we note in our Global Debt Monitor, angst over the corporate debt bubble is nothing new. But the current high-uncertainty, high-volatility backdrop has struck directly at the outlook for economic growth and corporate profitability. The speed of the decline in market confidence is also a reflection of massive financial imbalances—notably high and rising corporate debt. The prospect of prolonged economic disruption from COVID-19 has prompted policymakers around the world to take steps to bolster market liquidity and support growth. However, the ongoing rout in risk assets suggests that these measures aren't seen as sufficient. Against this backdrop, fears of supply chain disruption are exacerbating downgrades to earnings estimates (Chart 1). These have been particularly sharp in emerging markets—hit also by plummeting commodity prices (now at their lowest level since 1986).

While the Fed's 50bp rate cut may provide some breathing room for debt markets, volatility across asset classes is now at the highest level since the 2008 financial crisis. Despite markets expectations of an additional 75bp of Fed rate cuts *by next week*, the high-yield market continues to bleed; EM sovereign and corporate bond markets have fallen in lockstep, with sharp losses for EM currencies (down nearly 10% year to date). With growing concern about a "sudden stop" in EM capital flows, this currency weakness has fueled a rush to buy protection against default in credit derivatives markets—EM CDS spreads have jumped by over 140bps year-to-date to over 300bps.

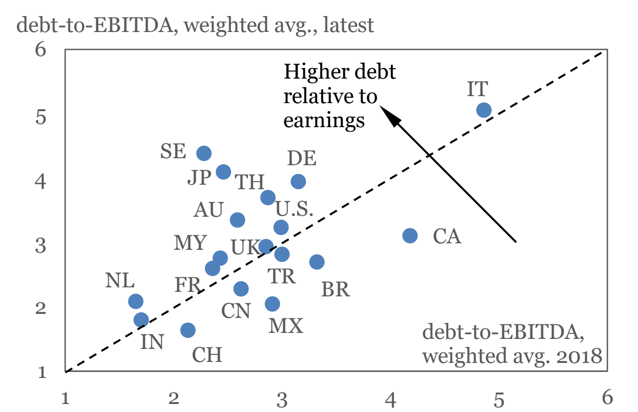
**Corporate debt is already very high relative to earnings—and earnings prospects are deteriorating:** At nearly $75 trillion, the fast-growing mountain of global corporate debt (ex-financials) is around 93% of global GDP—vs 75% in the run-up to the 2008 global financial crisis. With high-debt corporates increasingly exposed to refinancing risk as the global growth outlook dims, firm-level data highlight a rapid buildup in corporate sector leverage in many

**Chart 1: Rapid downgrades to corporate earnings estimates as analysts struggle to price in COVID-19 impact**




*Source: Bloomberg, IIF*

**Chart 2: Sharp increase in corporate debt levels, particularly in mature markets; earnings growth has not kept pace**




*Source: Bloomberg, IIF*

mature markets (relative to earnings) since 2018 (Chart 2). Some of the highest debt burdens are in sectors with weak and volatile earnings profiles. If analysts continue to mark down earnings forecasts as the impact of COVID-19 becomes clearer, debt-to-EBITDA ratios could surge—pushing credit spreads higher still (just since mid-February, high-yield spreads are up 300bp to over 650bp).

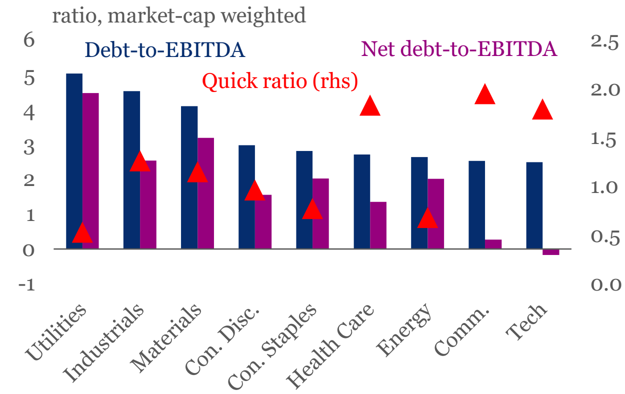
**Oil and gas industry—double trouble:** The sharp drop in energy prices as the COVID-19 crisis escalates has left some oil and gas companies at high risk of default. Although the average level of debt for energy sector firms is fairly low relative to other industries, many energy companies have limited cash buffers, making it harder for them to ride out prolonged disruptions from unexpected shocks (Chart 3). This is especially true in lower echelons: for example, the CCC-rated energy firms in our sample have debt-to-EBITDA of 15.5x—vs. just 3.3x for BBB-rated energy companies.

**Fear of falling:** Given already-high levels of debt relative to earnings (i.e., weak fundamentals), there is clearly a risk of abrupt and widespread downgrades from the sizeable BBB category to junk status if more pessimistic forecasts of the COVID-19 impact materialize. The universe of tradable non-financial corporate bonds has more than doubled since 2008, to nearly $12 trillion. BBB-rated bonds drove most of this rise, quadrupling to over $4.6 trillion. At present, BBB-rated bonds comprise around half of the U.S. and European corporate bond universe (Chart 4). However, a wave of downgrades from BBB to sub-investment grade could force institutional investors with strict investment grade mandates to reduce exposures abruptly, resulting in "fire sales."

**Risks for small and medium-size enterprises:** With generally higher debt burdens and lower cash buffers, small- and medium-sized enterprises (SMEs) would be particularly hard pressed to meet their financing needs if funding market strains persist. Among the 7,200 firms in our sample, small and medium-sized firms have the highest levels of net debt-to-EBITDA of 1.9x and 2.5x. In contrast, substantial cash holdings at large- and mega-sized firms provide a buffer against extreme tail risks, leaving their net debt-to-EBITDA ratios at 1.7x and 0.9x, respectively.

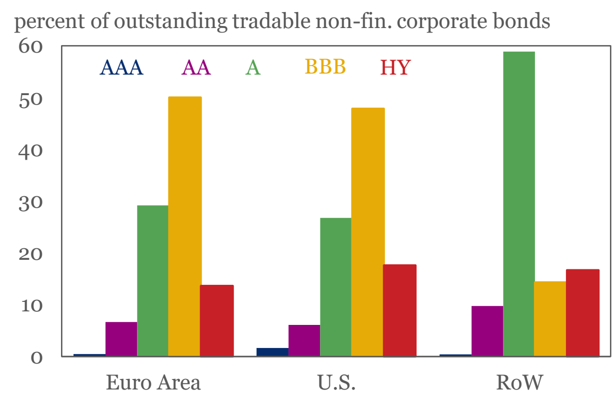
**Debt vulnerabilities in emerging markets:** Stronger growth and some deleveraging in recent years have brought down EM non-financial corporate debt-to-GDP to 94% in Q3 2019, from an all-time high of 98% in 2016. However, these are still very high levels, and vulnerabilities persist—especially in countries with heavy reliance on FX debt and limited policy space (Chart 5). Given the importance of state-owned-enterprises in the EM corporate sector, prolonged economic disruption from COVID-19 could also accelerate the SOE-driven debt buildup.

**Chart 3: Utilities, industrials have high debt relative to earnings; energy and utilities have limited cash buffers**



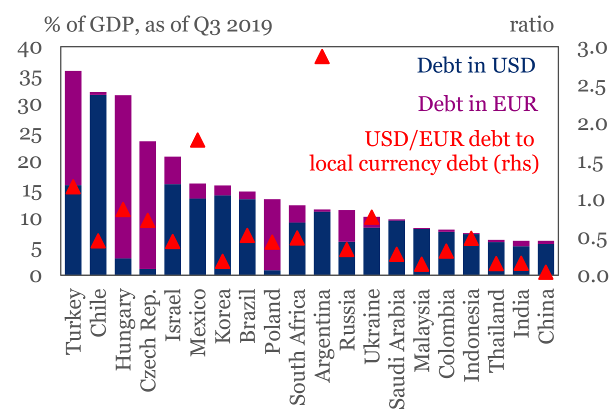

*Source: Bloomberg, IIF; quick ratio: liquid assets over short-term liabilities*

**Chart 4: Growing risk of downgrades from BBB to junk; fallen angels could trigger widespread "fire sales"**




*Source: Bloomberg, IIF*

**Chart 5: Further currency weakness would hit hardest for EM countries with high levels of FX debt**




*Source: IIF Global Debt Monitor*

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