TAKING THE FUNDING PULSE

LARGE CORPORATES STAND TO BENEFIT FROM HIGHLY ATTRACTIVE FUNDING CONDITIONS, ALTHOUGH LONGER-TERM UNCERTAINTIES PERSIST. PAUL WATTERS EXPLAINS

The Brexit vote on 23 June triggered another seismic shock that threatened to knock back the economic recovery in Europe and challenge European integration. So far, however, the economic impact has been surprisingly muted, though uncertainty about the relationship between the UK and Europe presents clear downside risks for growth in the longer run. In contrast, the financial markets have been very volatile.

For fixed income, buoyed by the Bank of England's (BoE's) aggressive monetary easing in early August, we saw long-term gilt yields fall sharply to historic lows, before concerns over the possibility of a hard Brexit caused a further lurch down in sterling (see chart 1, opposite), sending gilt yields back towards pre-referendum levels and supporting the equity market. Moreover, long-term real yields in the gilt market fell to zero, which we've never seen with inflation so low (see chart 2). This speaks to the level of concern over the strength of disinflationary forces in the economy.

A relative sweet spot

This also resonates from the corporate perspective. Speaking in an ACT webinar on funding conditions, Neil Garrod, group treasury director at Vodafone, said: "Operationally, we've not seen a hit to profitability from the Brexit vote so far because, from our point of view, nothing has really changed."

But from a financing viewpoint, conditions are good for lenders and even better for borrowers. Banks are borrowing very cheaply and are still generating good returns, given the still attractive level of credit spreads in the market. Borrowers able to tap into the capital markets are locking in low, long-term yields, helped in part by the BoE's launch of the Corporate Bond Purchase Scheme. Those reliant on banks for funding are finding that they are competing quite aggressively for lending at present.

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Low rates: symptom or cause?

A subject of debate in the market are the reasons for the decline in gilt yields, in what appears to be a long-term structural trend over the past 20 to 30 years. Are low yields the symptom of a deeper problem or are central banks' unorthodox monetary policies stoking an asset bubble? While there is a cyclical element to the fall in long-term yields in response to low headline inflation caused by weak commodity prices, we believe structural factors are playing a bigger role. Whether it is an ageing population, low productivity, lack of investment or a global savings glut, the result is the same: growth in Europe (particularly for the eurozone) is likely to remain subdued, with short rates and long yields stuck at low levels for a considerable period.

"Low, flatter yield curves for longer are what we are expecting," said Garrod. "Since the end of Bretton Woods and the gold standard, debt has gone up exponentially, and rates have gone down to support that level of debt. Today's flatness of the yield curve extending 20 years, combined with the absence of inflationary concerns, is phenomenal."

Larger, better-rated corporates with access to long-dated money can eliminate

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the rollover risk and invest in long-term projects with certainty. Small and midsize enterprises that are the growth engines of Europe are more restricted. If they are looking to fund a project for 20 years, they may only be able to access five-year money, which means effectively rolling over the financing three times over the life of the projects.

"With rates so low, how can you be confident that you will be able to roll over at current levels?" Garrod asked. "I'm not sure whether the BoE's interest rate policy is slightly counterproductive, but it's making it quite difficult to evaluate investment projects from a financing perspective."

M&A: an area to watch

On the supply side, there's no shortage of bank lending for investment-grade corporates in most sectors, except where banks carry concentrated risks, such as in shipping, or where sector performance has been under pressure, for instance in energy and natural resources.

"M&A is one key area to watch, because low rates are certainly acting as an inducement, and banks are keen for such transactions because of the healthy fees they generate," said Garrod. And there are signs of that happening, with Bayer agreeing to buy Monsanto for $66bn in October. This deal relies heavily on debt financing – with potential negative rating implications – with banks more than willing to provide bridge financing.

Red-hot conditions for spec-grade corporates

And that plentiful supply of bank finance even stretches into leveraged finance – speculative-grade loans – conditions continue to be red hot. We're seeing enormous lending appetite from both banks and institutional investors that is outpacing the supply of primary deals. The bulk of refinancing has been carried out, so much of the current activity is focused on capturing lower credit spreads.

There is a logic in banks going down the credit curve: isn't that where banks should be, ultimately? With bank lending now being more capital-intensive, it makes sense for larger investment-grade corporates to seek term financing through the credit markets and other routes.

Even so, access for small and midsize corporates has in other ways loosened up from just a few years ago, in Garrod's view, with the development of the private placement market and especially the direct lending market. There are about 70 alternative lenders in Europe, providing upwards of €16-22bn a year in the region.

Regarding credit prospects in the near term, until Article 50 is triggered in March 2017, it's largely business as usual in the UK. However, given what's happened in the financial markets, multinationals, exporters and companies dependent on inbound tourism are better protected than domestic companies, which are likely to face headwinds. Also, consumers' real disposable incomes are likely to get squeezed as the cost of oil and other imported products rise, following the sharp fall in sterling since the 23 June referendum.

More broadly, at a macroeconomic level, the outlook for inflation is certainly not yet a concern. To get rid of Europe's debt pile, central banks are trying to engineer a step-up in the actual level of inflation, which still seems some way off. In combination, higher real growth and a sustained pick-up in inflation would be an effective way to reduce the burden of debt. But it's a tricky thing to achieve. Until that happens, low interest rates and an extended credit cycle seem likely to persist.

Regional and global risks

At S&P Global, the idea that low interest rates are here for the longer run are one of the key global and regional risks that concern us. The global and regional risks to corporate credit that we are tracking not only include additional bouts of credit market volatility, but also geopolitical and political routs.

These risks could destabilise the credit outlook in Europe, not least because key elections in France and Germany next year could stoke up populism, diverting attention away from measures required to support further economic and political integration in the region. There is also the elevated risk that a disorderly deleveraging of China's outsized and growing corporate debt burden could upend heavy global industries suffering from overinvestment, much of which is China-facing. That's a cloud that will be hanging over us for quite a long time.

CHART 1: STERLING WEAKNESS BUOYS FTSE 100 SINCE THE BREXIT VOTE

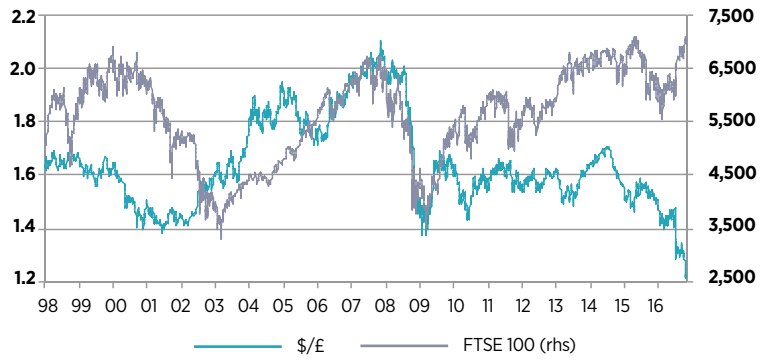
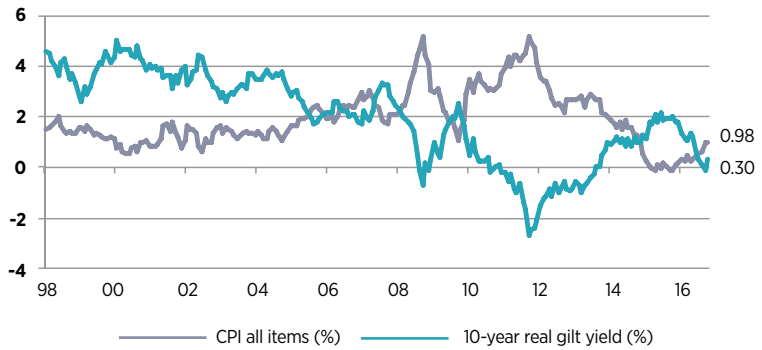


CHART 2: REAL YIELDS PLUMMETED AS HEADLINE INFLATION STABILISES



Source: S&P Capital IQ. For illustrative purposes only

This article is based on a webinar produced by the ACT that took place on 29 September 2016, with Paul Watters, head of corporate research in Europe at S&P Global Ratings, and Neil Garrod, group treasury director at Vodafone. The comments from Garrod are his own and do not necessarily reflect the views of S&P Global Ratings.

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