MARKET INSIGHT

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XAVIER LEDRU
HEAD OF CORPORATE ADVISORY
& STRUCTURING

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LET'S DANCE - THE RISKS LYING AHEAD

When the Covid crisis hit, the world braced for a violent wave of bankruptcies and restructurings. However, this did not come to pass, or at least not to the extent first anticipated due to the unprecedented support measures the international community implemented to avoid a financial hecatomb. Instead, we saw increases in the price of real assets, rallies in equity markets as well as an accelerated transition towards greater digitalisation.

But now that the Federal Reserve has announced that it would start scaling back its massive USD 120bn-a-month bond buying programme, we are approaching a critical milestone.

RISKY BUSINESS

A risk to examine is one that the IMF refers to as "asynchronous and divergent global economic recovery". This means that the world remains what it is despite globalisation: heterogenous.

Emerging economies, with their uneven access to vaccines, are experiencing slower recoveries and may even find themselves subject to further lockdowns. Most emerging economies have (also) accumulated debt, and most will need to refinance in a context where inflation is starting to rise. Low-income countries are likely to be the most sensitive, and rising interest rates may cause debt servicing or debt sustainability concerns, according to the Global Financial Stability Report, with nearly 60% near or already in high debt stress.

Whether or not this indicates a global financial issue remains to be seen, given that the rise in inflation might be temporary and linked to international business recovery. International commerce seems to be slowly stabilising with queues reducing at ports of international commerce - the Baltic Exchange Dry Index was down a third in the past month - and certain production delays could begin to reduce from Q1-Q2 2022. However, these signs alone are not enough to definitively conclude that inflation will stay contained.

The world, however, remains fragmented, and in most economies the corporate sector has emerged more indebted than before the pandemic.

THE ROAD AHEAD

Recovery has been uneven between sectors directly affected by Covid-19 and others, and between larger and smaller firms. These inequalities vary depending on the countries, the maturity of their economies, the way the banking system operates and, importantly, the extent to which non-bank financial intermediaries (such as private debt and equity funds) are active and can assume a larger variety of risks that traditional banks are increasingly reluctant, or unable, to take.

Private-equity funds worldwide closed on USD 459 billion through June 2021, the highest number in the past five years, according to Preqin Ltd. This figure is about 51% above the amount raised at the same period last year... By mid-2021, the sector has amassed a record USD 3.3 trillion of unspent capital, including USD 1 trillion held by buyout funds, giving it significant firepower for new transactions.

On the M&A market, ongoing trends show increasing sales of non-core activities by all market players, strategics and financials. Private equity focus has shifted to sectors that were most affected by the Covid-19 crisis such as travel or hospitality. Non-financial intermediaries are acting as stabilisers even before bankruptcies are declared, when certain pockets of the market are undergoing difficulties and need capital.

On the subject of systemic risk, all eyes turn to China where the resurgence of Covid-19 and financial difficulties of a growing number of Chinese developers are causing concerns. This sector is weak and, indeed, of a certain magnitude. Chinese developer Evergrande's liabilities alone totalled USD 306bn as at the end of June 2021. Its creditors included 128 banks and 121 non-banking institutions, including various categories of contractors and enterprises in its supply chain.

Late repayments and formal defaults could cause cross-defaults and, in turn, trigger systemic risk on the Chinese financial system according to the Chinese central bank (PBOC). The PBOC issued a statement on 15 October 2021 whereby it reassured financial markets that it would be able to ring fence the risk of Evergrande collapsing. Still, others (Fantasia, Kaisa) are currently looming. If we were looking for signs of something serious, it may well be cascading from there in the coming months.

Although the future is largely unknown (and to some extent we are navigating unchartered waters), it seems that the party is not over yet.

So for the time being, let's dance, although no song lasts forever...