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Coronavirus exposes global financial market vulnerabilities

Global credit conditions are deteriorating because of the coronavirus outbreak and oil price shock, which will likely lead to an increase in rating downgrades and defaults in the coming months. The economic turmoil, along with significant financial market volatility, is creating a severe and extensive credit shock across many sectors, regions and markets. The combined credit effects of these developments are unprecedented. The sectors with the largest exposure to the coronavirus outbreak are those that are most sensitive to consumer demand and sentiment, including global passenger airlines, lodging and cruises, automotives, and segments of the oil and gas sector, as well as certain commodity exporters. Negative credit effects will be the largest for companies and governments with high debt levels, heavy reliance on external financing and weaker credit profiles. Speculative-grade companies and governments represented close to 40% of all Moody's-rated debt in 2019, up from 16% in 2009. Moody´s expects the G-20 economies to experience a major shock in the first half of this year and will contract in 2020 as a whole, before picking up in 2021.

Nevertheless, there remains sizeable downside risk to our forecasts given the significant uncertainty as to the length and magnitude of the coronavirus outbreak. The monetary and fiscal response has been significant and continues to grow, and we expect it to help cushion the economic and financial market impact of the shock. In some cases, these policy measures will allow for a faster recovery once the shock recedes. Fiscal stimulus will also lead to further increases in sovereign debt, which is already high in many countries, including in the European Union. Emerging market currencies have sharply depreciated vis-a-vis the US dollar because of safe-haven flows, increasing vulnerabilities for emerging countries that are dependent on external financing.

While the European Union has been slow to devise a coordinated response, one is emerging that may start to employ some of the policy tools devised during the euro area sovereign debt crisis. However, more broadly, global policy responses have thus far been disjointed, favouring more nationally focused approaches.

Even before the coronavirus, global economic growth was slowing as a result of cyclical and structural factors, including aging populations, weak productivity, global trade tensions and geopolitical risks. A lasting trade deal between the US and China will remain elusive, with disputes extending into technology, investment and geopolitics. The outcome of US-EU trade talks, potential auto tariffs and Brexit-related uncertainty also remain risks. Lower-for-longer interest rates also increase financial stability risks and weigh on profitability for banks and insurers. They encourage risk taking as investors reach for yield that may have contributed to high financial volatility and sharp asset declines in recent weeks. Low rates can encourage excessive borrowing as evidenced by elevated corporate leverage in the US and Europe.

Many high-yield companies took advantage of easy market access and have successfully weakened investor protections. The increase in low-rated companies with weaker credit profiles will likely lead to more defaults and lower recoveries even if the current downturn were to be milder than the one in 2008. High levels of Baa-rated corporate debt globally increases the risk of downgrades to speculative grade in a recession, although this risk in and of itself is not likely to disrupt the high-yield market. The market for leveraged loans and collateralized loan obligations (CLOs) has expanded significantly, which poses risks during periods of tight credit conditions. In Moody's view, junior tranches of CLOs would be at risk of significant credit quality deterioration under a severe downturn scenario. However, senior tranches would likely avoid impairments because of credit enhancement and other structural features. Investors are increasingly incorporating climate and cyber risks into their decision-making. Moody's expects these areas to become bigger credit considerations that in some cases will weigh on credit availability, putting further pressure on carbon-intensive sectors. ●