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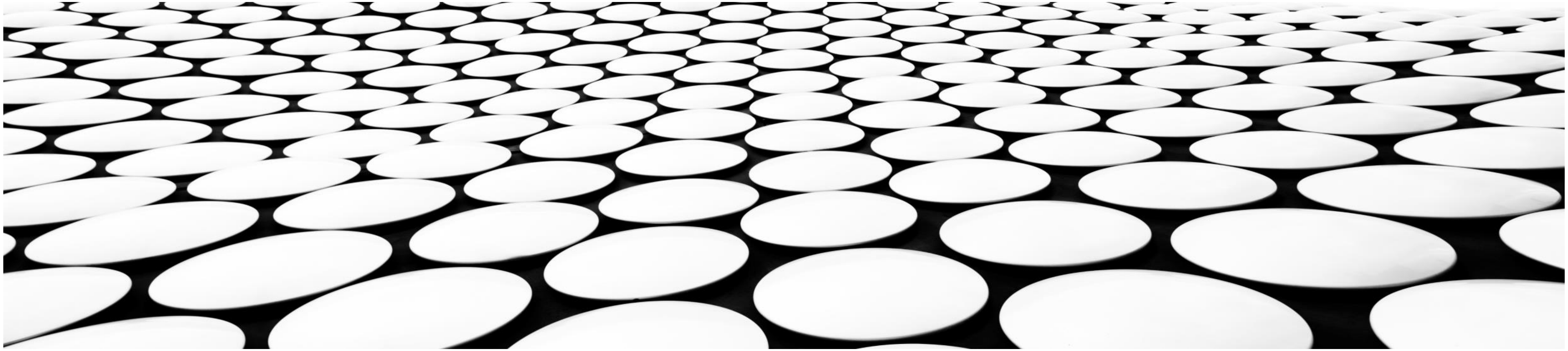
26-27 OCTOBER, 2023

commodities people

GIMME SHELTER: BIGGEST ISSUES FACING CREDIT RISK MANAGERS TODAY

OCTOBER 2023



GIMME SHELTER: BIGGEST ISSUES FACING CREDIT RISK MANAGERS TODAY

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CREDIT MANAGERS FACE MANY EXTERNAL THREATS:

- Rising Interest Rates, Market Uncertainty, Inflation
- Liquidity Issues
- Regulatory risk and the Energy Transition
- Extreme weather events
- Geopolitical Events / Armed conflicts

RISING INTEREST RATES POSE FORWARD CHALLENGES

U.S. corporate borrowers face looming maturity cliff as funding costs reach 13-year high, Moody's says

Marketwatch.com

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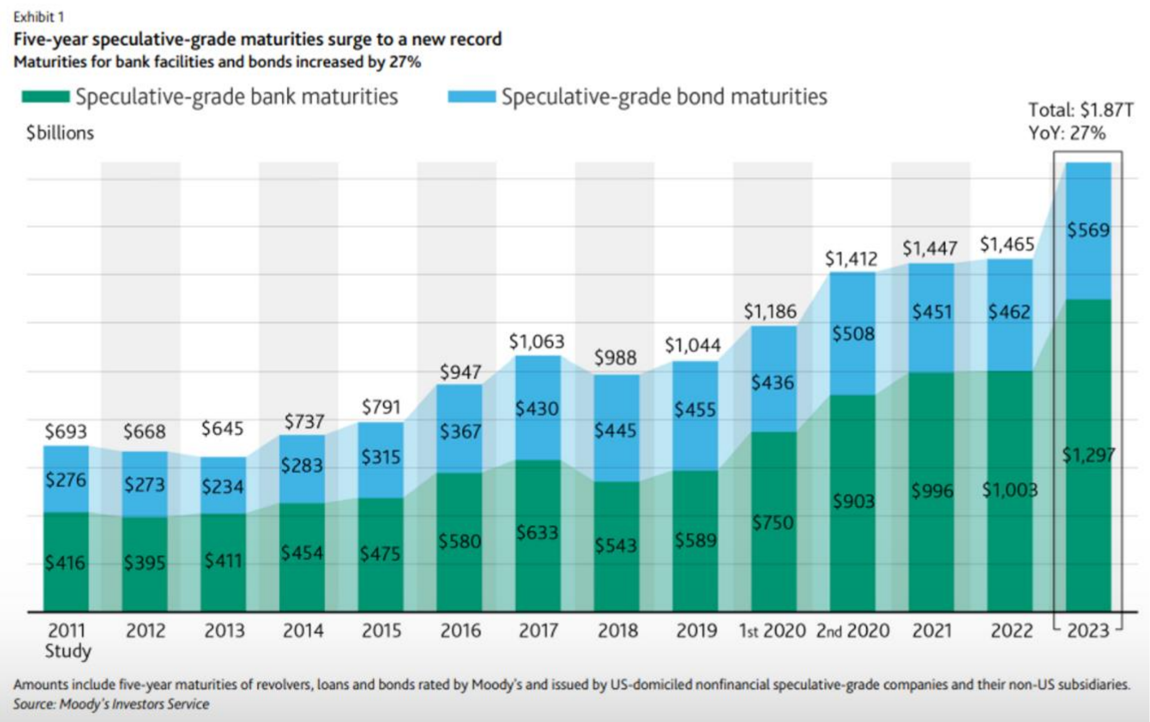

Marketwatch.com

- Issuers of nonfinancial speculative-grade, or high-yield, debt have a record $1.87 trillion of debt maturing in the period running from 2024 to 2028.

- The looming maturity cliff is raising default risk. Moody's is expecting the U.S. speculative-grade default rate to peak at **5.6%** in January of 2024, before easing to **4.6%** by August 2024.

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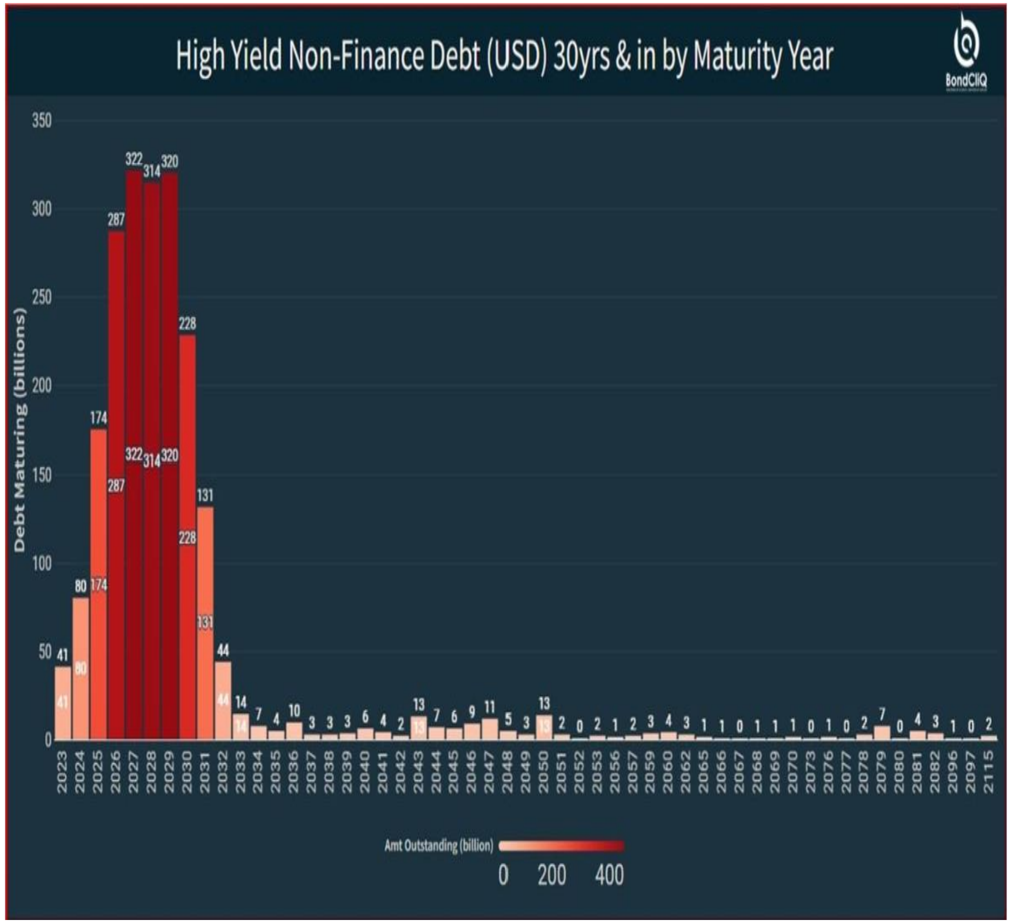
LOWER RATED COMPANIES ARE PARTICULARLY VULNERABLE

- Adding to the overall risk, there's more debt maturing from lower-rated issuers than usual, with the **single B category accounting for 62% of total maturities**

- "Debt from distressed companies — those **rated Caa and lower — accounts for 19% of 2024-25 maturities**, up from 16% due in the first two years of last year's study," Moody's said. "**Companies rated Caa and lower will likely find it difficult to refinance maturities at an interest rate they can afford.**"

- "High-yield issuers were able to sell debt at interest rates of 5% or less during the long period of zero interest rates that preceded the current rate-hike cycle, but they are now having to pay up to 12%."



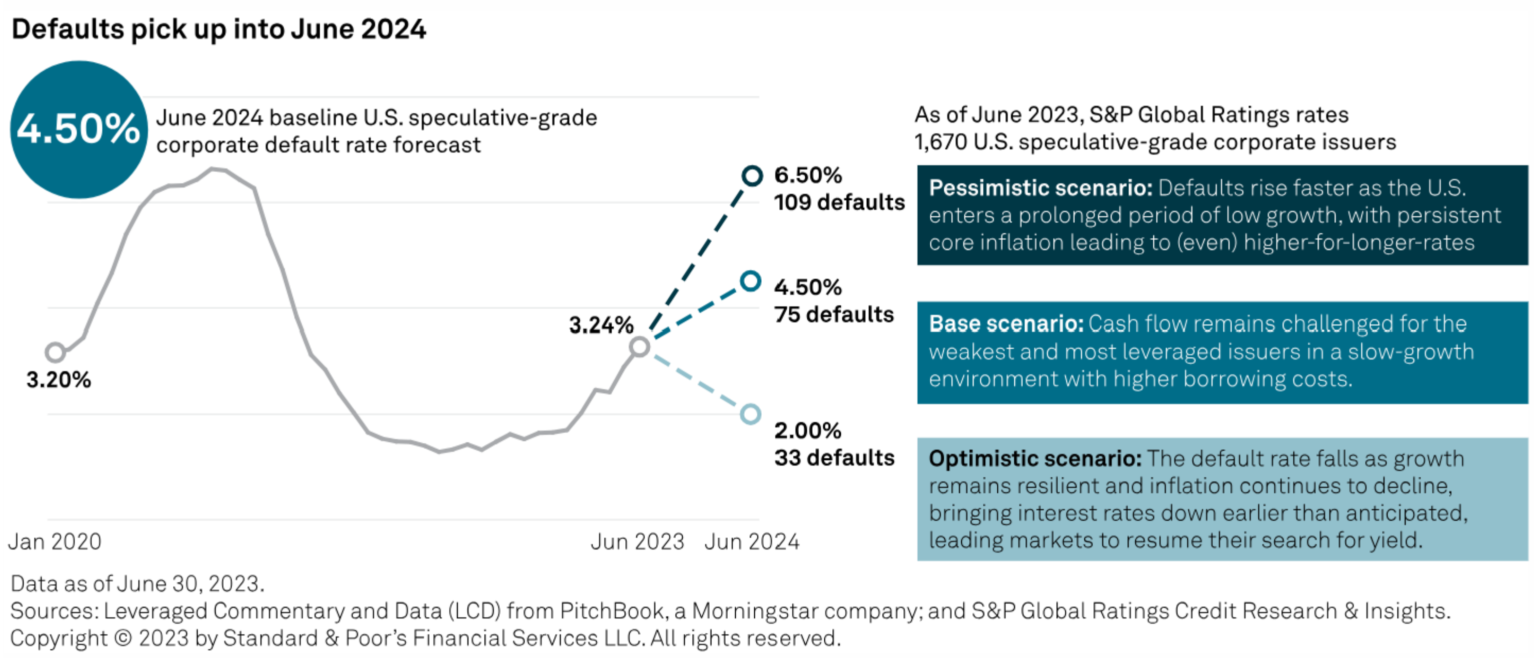
Source: BondCliQ Media Services

CREDIT MANAGERS NEED TO ADJUST DEBT SERVICE RATIOS FOR NEW HIGHER INTEREST RATES.

CREDIT DEFAULTS ARE SET TO INCREASE

- "A perfect storm of rising interest rates, bleaker economic outlook, weakening credit quality are setting the stage for speculative-grade downgrades and defaults in the year ahead," – Moody's Investors Service

- In S&P Global Ratings' base case, defaults continue rising as corporates grapple with higher interest rates and slower growth ahead. Rising rates are eroding profitability, and second-quarter earnings estimates forecast declining profits relative to a year ago, in aggregate.



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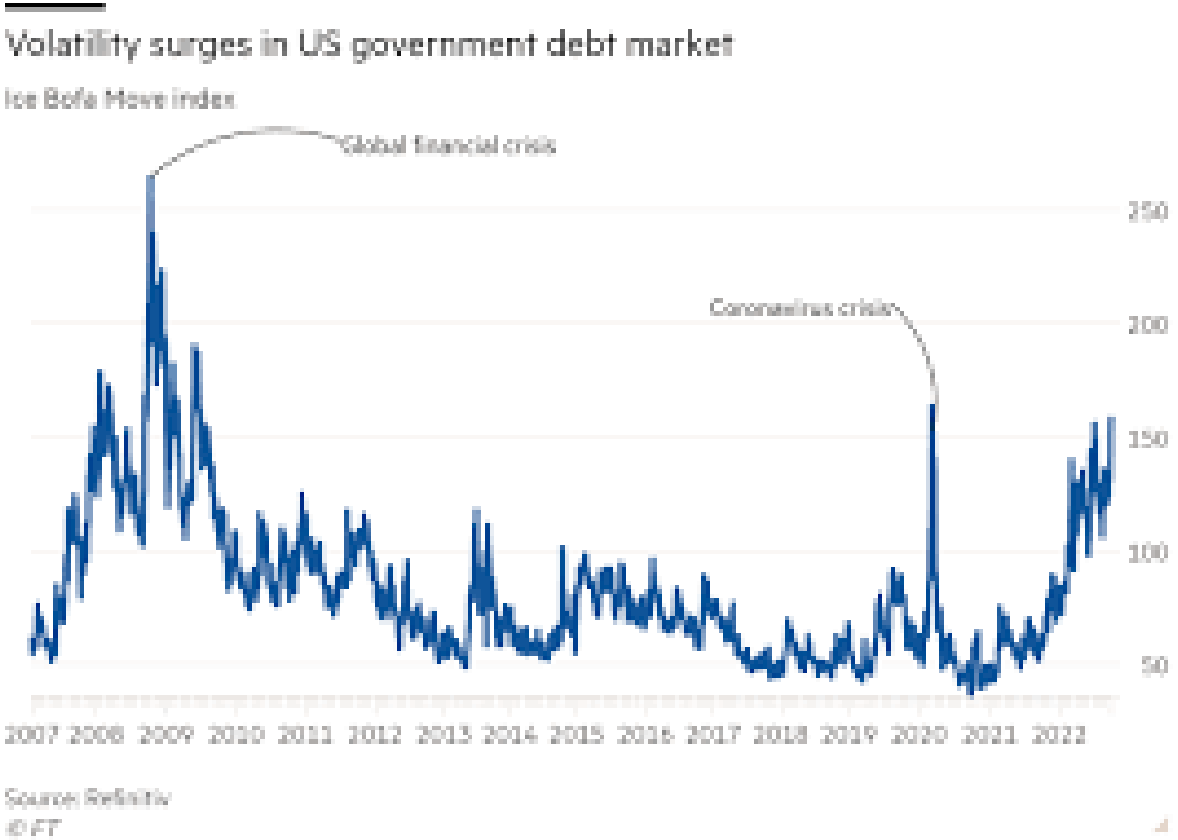
MARKETS REMAIN VOLATILE

Mohamed El-Erian, Allianz chief economic advisor and president of Queens' College, Cambridge, commented on surging Treasury yields: The bond market is critical for other markets, for the housing market, for the economy and **the bond market has lost its 'policy, technical and economic' anchors**" Source: Bloomberg, Isabelle Lee and Jonathan Ferro, 10/13/2023



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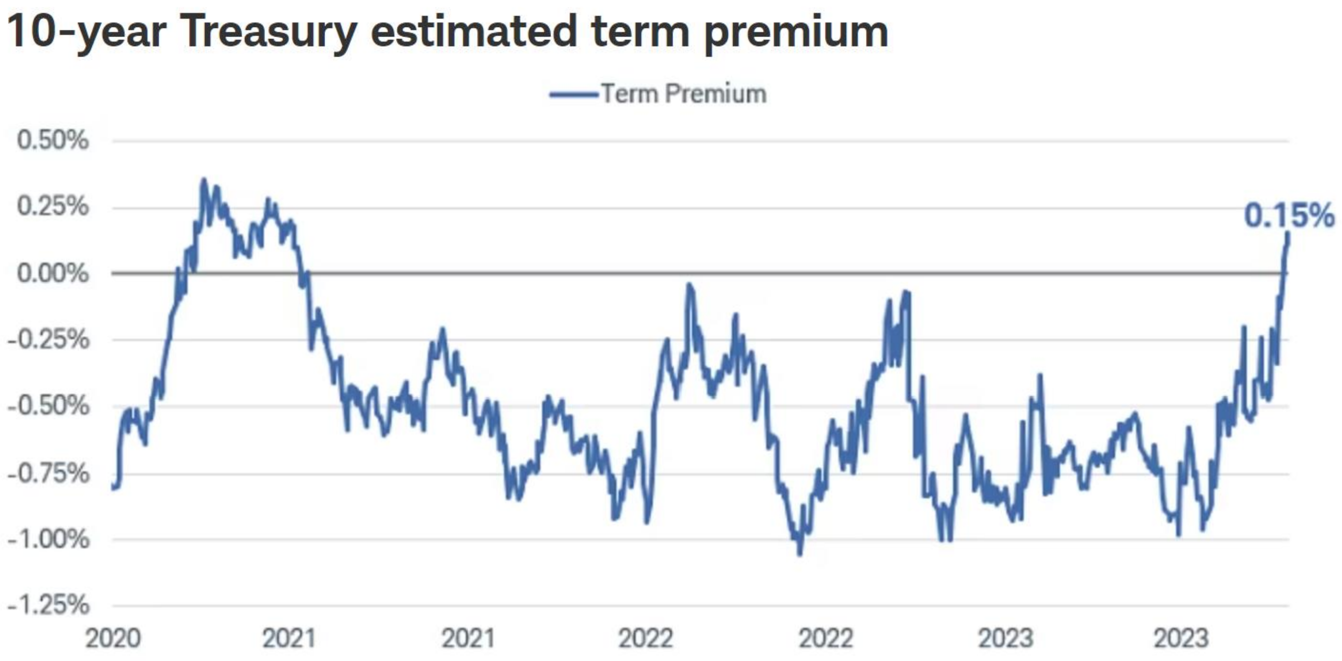
MARKETS REMAIN VOLATILE

Market uncertainty further raises borrowing costs particularly for longer maturities:



Source: Federal Reserve Bank of New York. Monthly data as of 9/29/2023.

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INFLATION HAS DECLINED BUT REMAINS A THREAT

- IMF Warns of Stubborn Inflation and Weaker Global Growth in 2024[1]

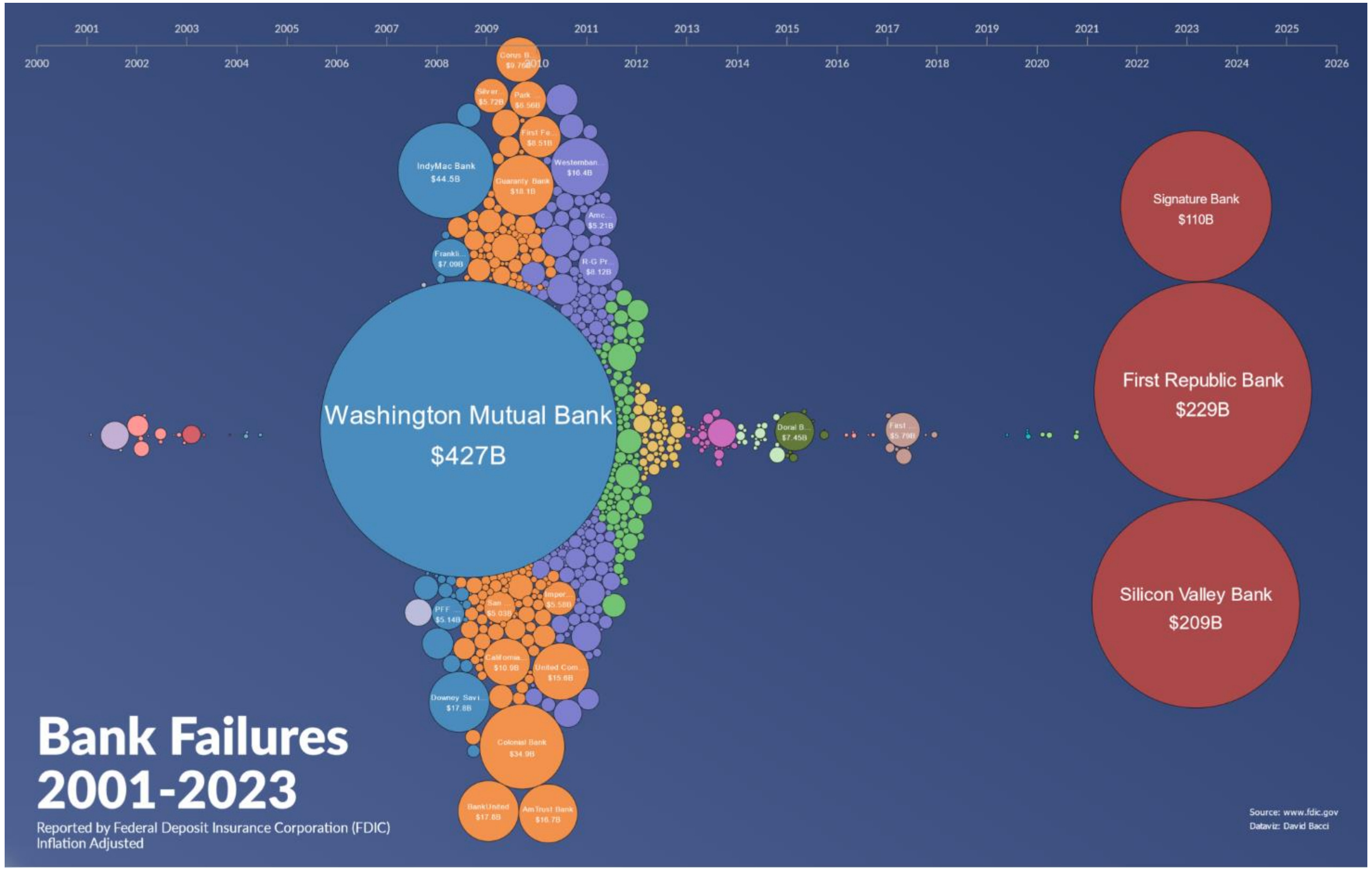
Source: Bloomberg

- Increasing supply costs and wages pressure margins:
  - In recent months, workers across industries have fought for — and, in a handful of cases, won — around 50% wage increases over the next four to five years, as they call out years of stagnant wages and robust company profits. Source: NPR.org, Danielle Kaye, 9/20/2023

[1] Source: Bloomberg, Eric Martin, 10/10/2023

REGIONAL BANKING CRISIS PRESSURES CORPORATE LIQUIDITY

- 2023 regional bank failures limited in number but large in assets:



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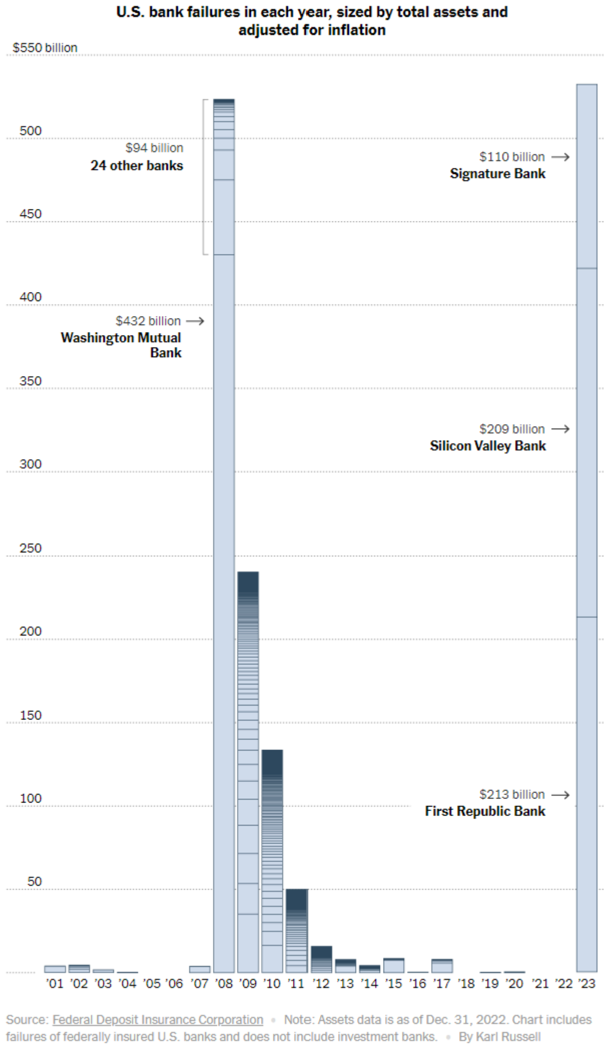

- Unlike financial crisis of 2010, credit quality was not at issue – impact of HIGHER INTEREST RATES.

- Poor duration management of interest rate risks led to large losses in treasury portfolios and loss of confidence spurred liquidity crisis.

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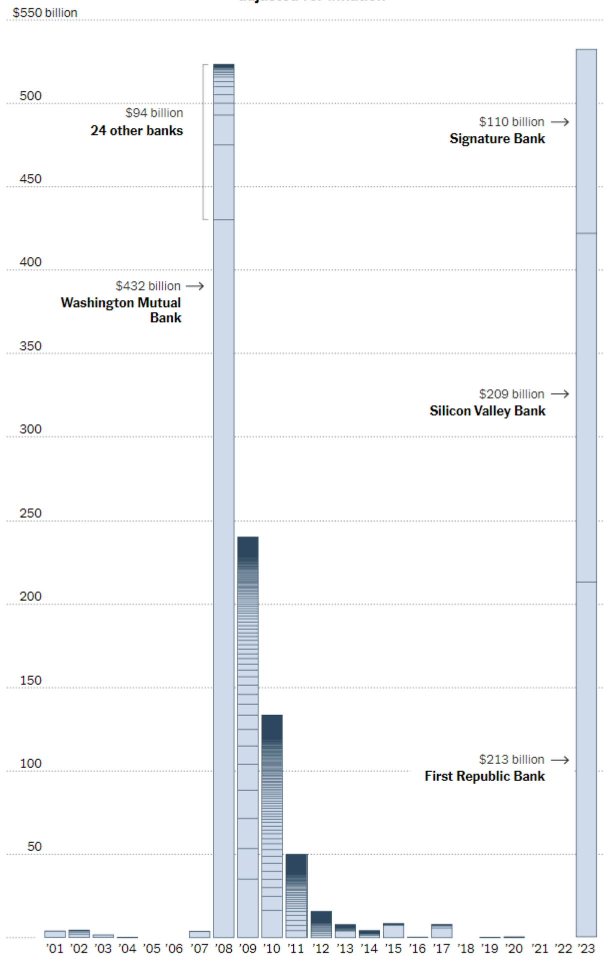
U.S. bank failures in each year, sized by total assets and adjusted for inflation



Source: Federal Deposit Insurance Corporation • Note: Assets data is as of Dec. 31, 2022. Chart includes failures of federally insured U.S. banks and does not include investment banks. • By Karl Russell

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- Poor duration management of interest rate risks led to large losses in treasury portfolios and loss of confidence spurred liquidity crisis.
- Fed took unprecedented actions to stop further bleeding in the sector.
  - Extend FDIC insurance to all depositors.
  - Lending against bonds at par
  - Extend stress testing for liquidity from SIFI's to regional banks

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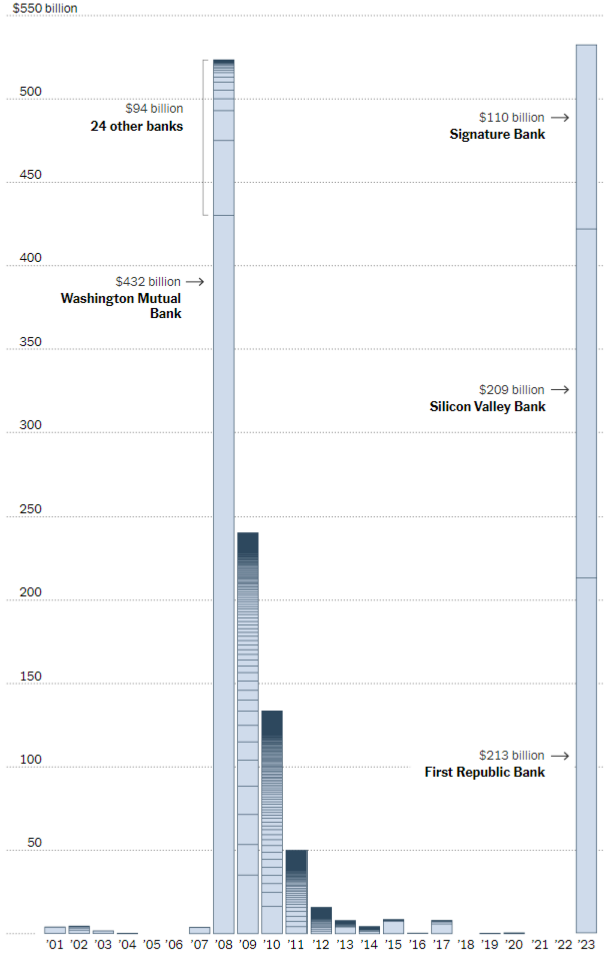

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In the months after three shocking bank failures, **regional banks began a lending pullback of historic proportions** [from 34% of the market for new commercial loans to 25%] — **one that promises to continue.** source: Bisnow.com, Matthew Rothstein, 9/27/2023

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COMMODITY FUNDING SOURCES ARE STRAINED

ESG concerns limit funding availability from the banking sector for fossil fuel companies:

- Several major EU banks have exited or pared back commodity finance including ABN Amro and BNP.

PE funds are also pulling back from new investments, after aggressively moving into energy space in 2021

- Weak IPO market has a number of startups canceling IPO's, delaying funding from exit strategies[1]
  - The value of U.S. private-equity exits approached its lowest level in more than a decade in this year's third quarter, according to industry researcher PitchBook Data.
- With credit costs at the highest level in years, companies that provide debt for private-equity deals are asking firms to chip in additional equity when they look to refinance[2]
- Higher debt service costs limit PE firms' ability to leverage portfolio companies
- Some U.S. public pension and investment funds are pulling back on private equity after a decade of state and local retirement systems aggressively pursuing the asset class.[3]

[1] source: Financial Times, George Hammond, Tabby Kinder and Ivan Levingston, 10/1/2023
[2] source: Wall Street Journal, Chris Cumming, 10/20/2023 [3] source: Wall Street Journal, Heather Gillers, 3/20/2023

REGULATORY REGIME UNCERTAINTY ADDS COSTS

An IEA analysis in 2017 showed that the risk premiums of **climate change and regulatory uncertainty can add 40% to construction costs of plants** for power investors, and **10% of price surcharges to electricity end-users**.

The Biden administration has set clear policy goals to establish effective corporate net-zero strategies on the one hand, yet there has also been growing pushback against the climate aspect of ESG in many red states, particularly Florida and Texas.

- **West Virginia vs. EPA –** SCOTUS ruled that the EPA can't establish emission standards for existing coal plants. This does not limit the EPA from using other tools, but the ruling was a big blow for regulatory authority.

- Regulations including most notably the **SEC Climate-Related Disclosure Rules** are still in development. How they wind up, whether it will just cover Scope 1 and 2, or also potentially Scope 3 disclosures remains to be seen.

At the same time that we have experienced this anti-ESG backlash over the last year in the U.S., **the EU has moved full speed ahead on many ESG initiatives with significant consequences for businesses**, including the EU Taxonomy, the Sustainable Finance Disclosure Regulation, the Corporate Sustainability Reporting Directive (CSRD), and the Corporate Sustainability Due Diligence Directive (CSDDD).

Source: Inside Energy and Environment, Jayni Hein & Daniel Feldman, 9/12/2023

EXTREME WEATHER THREATENS MUCH OF THE ENERGY SECTOR

92%

92% of the world's largest companies have at least one asset at high exposure (score >75 out of 100) to a climate change physical hazard by the 2050s, rising to **98%** by the 2090s under a BAU scenario

Index constituent data current as of 29 July 2022. Source: S&P Global Sustainable1

S&P Global

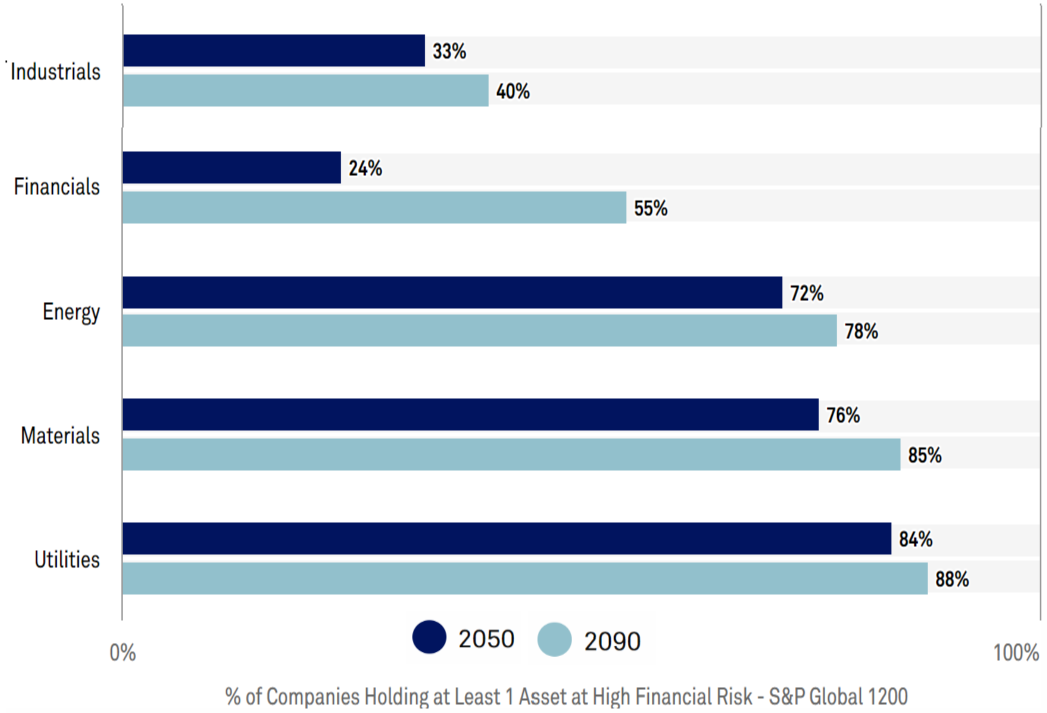
70%

More than 70% of S&P Global 1200 companies in the Utilities, Energy and Materials sectors have at least one asset where the physical risks of climate change are equivalent to **20%** or more than that asset's value under the BAU scenario

Index constituent data current as of 29 July 2022. Source: S&P Global Sustainable1

Financial Impact by Sector

Physical risk financial impact exposure is not evenly distributed across sectors. Within the S&P Global 1200, companies in the Utilities, Energy and Materials sectors are most likely to hold assets at high financial risk.



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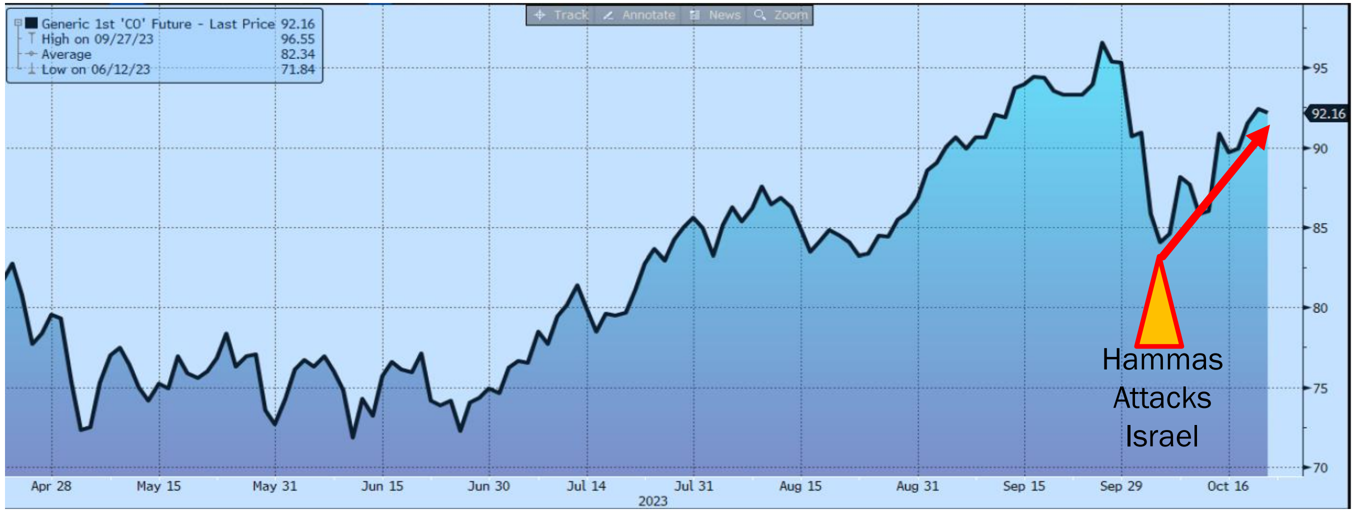
ISRAELI CONFLICT IMPACTING MULTIPLE MARKETS

Rising tensions in the Middle East as a result of the Israel-Hamas war **are increasing the oil market's geopolitical risk premium and pushing the price of Brent to in excess of $93 a barrel**.

- OPEC data signal a record crude deficit in 4Q <u>even as signs of softening demand emerge</u>.

- The worst-case Middle East scenario, unlikely but not impossible, would be stronger sanctions leading Iran to retaliate by attacking Saudi oil installations.
  - The last time Saudi installations were attached in September 2019 by Houthi Rebels, Brent jumped 20 percent in one day.



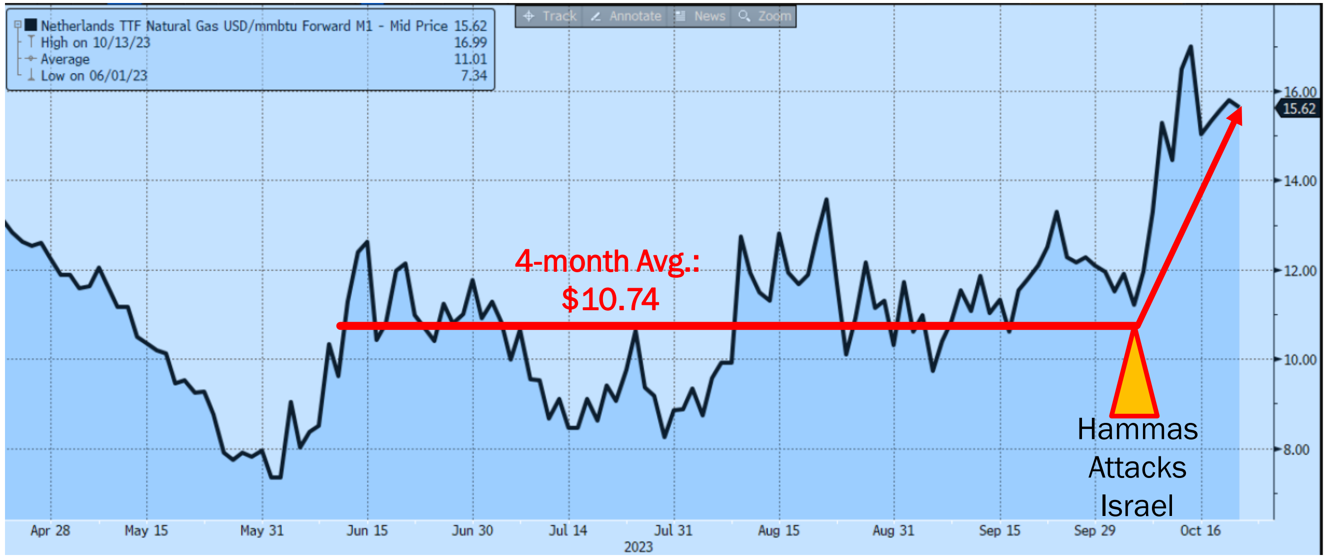
Source: Bloomberg

Source: Bloomberg Intelligence, Salih Yilmaz, 10/20/2023

ISRAELI CONFLICT IMPACTING MULTIPLE MARKETS

On the natural gas side, **TTF is up 45% as compared to before the October 7 attack**.

- “The war seriously threatens the regional natural gas market and could impact Europe’s LNG supply as winter approaches.” according to Stephen Innes, an analyst at SPI AM,
    - Many long-term LNG contracts are tied to the above referenced Brent Crude oil price.
- “While European gas inventories are almost full, they are not sufficiently high to get through winter if all imports stop.” warned Giovanni Staunovo of UBS.



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CONFLICT IN THE MIDDLE EAST AND SURGING TREASURY YIELDS ARE TAKING PRECEDENCE IN EQUITIES

Despite being earnings reporting season, when stocks tend to move on company-specific news, **S&P 500 Index constituents are increasingly moving in unison as global events sway markets broadly**.

- In four of the six trading sessions since the earnings reporting cycle kicked off on Oct. 13, at least 400 members in the S&P 500 have moved in the same direction. It's a frequency that didn't appear once in comparable weeks the past three earnings periods.
- All-or-nothing days, a feature of the stock-market rout in 2022, have become more pronounced since the breakout of war in the Mideast, and they've been staging a comeback since mid-September.

"With headwinds building, from the prospect of additional Federal Reserve interest-rate increases to the power vacuum in the US House of Representatives, it's easy to see why measures of co-movements are on the rise again after hitting a multi-year low in July." – Stuart Kaiser, Citigroup's head of US equity trading strategy

Source: Bloomberg, Elena Popina and Jessica Menton, 10/20/2023

FOOD PRICE IMPACTS RAISE POLITICAL RISK

Food has the power to make or break a country's leadership. With war in Ukraine and now the Middle East, how nations secure their staples is looming large in elections across the world:

- Starting with New Zealand and Poland last weekend, **at least a quarter of the global population will head to the polls over the next eight months or so.** Those countries will be followed by Argentina, the Netherlands and Egypt, and then Indonesia, India and the US in 2024.

- Food price spikes can trigger food riots around the world. In 2011, they contributed to the Arab Spring uprisings in Egypt and elsewhere in the Middle East, a region in turmoil again.

- **Within about a week of Russia crossing into eastern Ukraine, prices for grains like soybeans and some vegetable oils spiked about 50% to 60%,**[1] Those prices have since stabilized to pre-war levels, as surpluses from the rest of the world made up for the difference in what Ukraine was no longer able to export; the global food supply "dodged a bullet".

The fact that the dollar has remained strong means that Americans have not felt the full scale of food price increases around the world, Glauber said. But that could change. There is not a lot of crops in reserve, leaving the world food supply without a cushion.

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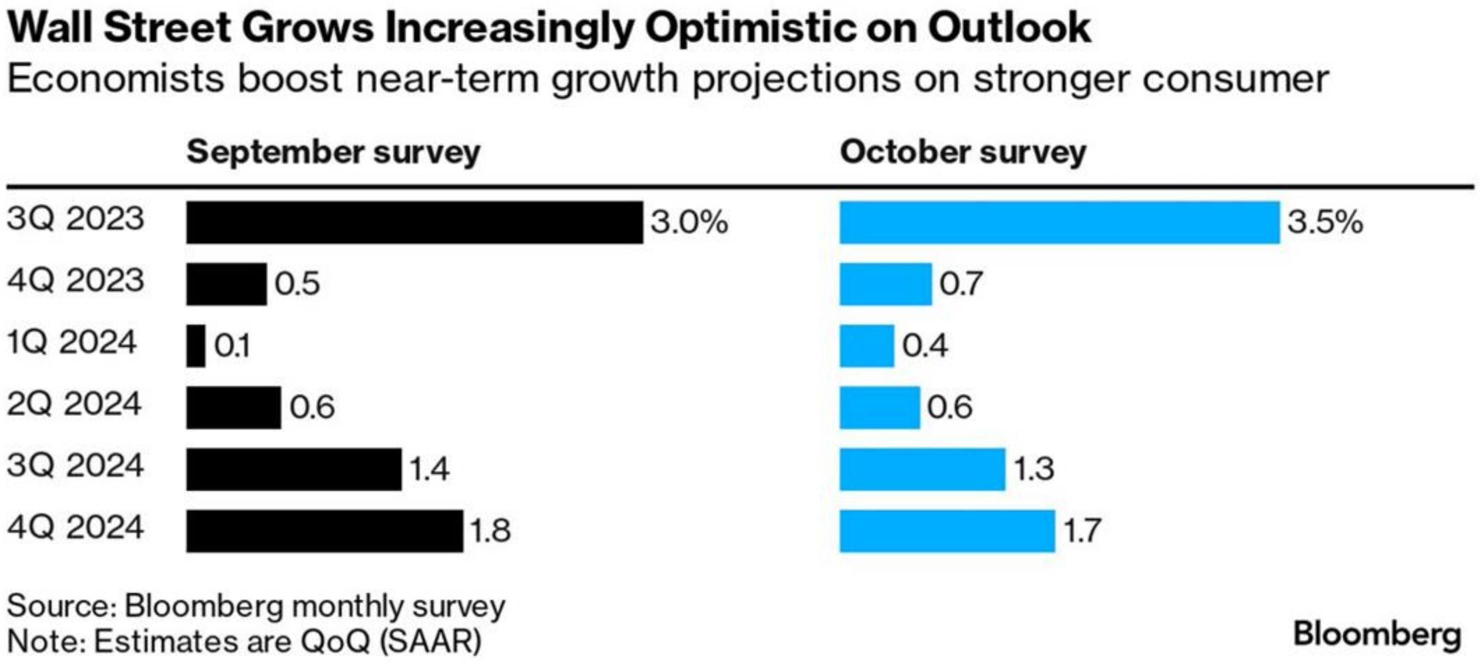
[1] Source: Joseph Glauber, a senior research fellow at the International Food Policy Research Institute, told ABC News.

IT'S NOT ALL BAD NEWS! – SOFT LANDING?

Bloomberg reported that "Economists [have] raised their US growth projections through early 2024 and trimmed the odds of any downturn to a one-year low as consumers continue to spend."

- The American economy probably expanded at an annualized 3.5% rate in the third quarter, the fastest in nearly two years



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Questions?

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