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The Credit View
Newsletter

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UAW STRIKE UPDATE

The United Auto Workers (UAW) have now reached tentative agreements with Ford, Stellantis, and GM, edging closer to ending a 6-week strike on Detroit's Big 3. UAW leaders have called on thousands of strikers to return to work at their respective assembly plants. While the agreements require ratification by the UAW rank and file, workers are returning to work already.

The UAW laid out top-line figures, which include a 25% pay increase, plus regular cost of living increases pegged to inflation. Ford and the UAW came to an agreement on October 26 that would stretch for four-and-a-half years, expiring on April 20, 2028. Stellantis and the UAW agreed on October 28. Details of the GM deal were not announced yet, but sources said the UAW won the same package of wage increases it agreed at the other two automakers, which raises top pay for veteran workers by 33%.

The strikes have collectively cost the Big 3 billions of dollars in lost production. Ford said that the union's strike had cost it $1.3 billion, while GM said the strike had cost it about $800 million. Anderson Economic Group, a boutique economic consultancy based in Michigan, has calculated that the 2023 UAW strike has surpassed $9.3 billion in economic losses for the entire auto industry.

Additionally, a study this month by Moody's Investors Service found that annual labor costs could rise by $1.1 billion for Stellantis, $1.2 billion for GM, and $1.4 billion for Ford in the final year of the contract. The study assumed a 20% increase in hourly labor costs. Ford said the deals will add $850 to $900 in labor costs per vehicle.

Ford, GM, and Stellantis all conducted layoffs amid the UAW strike, and it has caused a ripple effect down production lines. Stellantis recently laid off 100 employees at a Toledo, Ohio, facility, and cut another 570 employees at an engine plant in Michigan. In all, roughly 6,600 workers at GM, Ford, and Stellantis have been temporarily laid off because of the strike, which has targeted factories in Kentucky, Michigan, Ohio, and Missouri, according to figures released by the companies.

The automotive supply chain has also taken a hit, with a new MEMA (Motor & Equipment Manufacturers Association) survey reporting that 39% of suppliers have laid off workers because of the UAW strike. Additionally, over 30% of suppliers surveyed indicate that they will need more than one week and up to over three weeks to ramp up idled production; the greatest challenges to restarting operations are returning labor and material availability. Nearly 80% of suppliers are concerned about the financial viability of their sub-suppliers. Vehicle suppliers employ over 900,000 workers, over six times more than the 150,000 UAW Detroit 3 autoworkers. Additionally, suppliers contribute 2.5% of the U.S. Gross Domestic Product (GDP) and operate in all 50 states.

With the strike likely to end soon, the supply chain will experience hiccups in the next few weeks as assembly plants and distribution centers ramp up production to normal levels. However, the auto industry appears to have avoided a massive shock, as the strike lasted far less long than experts predicted. The lower demand for auto steel certainly added pressure to already lower steel prices. At the beginning of October, the spot-market price for benchmark coiled sheet steel fell 40% since April. However, prices have since stabilized and are hovering above $900/short ton after Nucor and Cliffs raised its hot-rolled coil price minimums to $800/short ton. US Steel then increased its hot-rolled coil prices to $900/short ton the week of October 26. The move was expected by the market after the current strike sounds like it is coming to an end.

As for automotive production, according to Cox Automotive, the October seasonally adjusted annual rate (SAAR), or sales pace, is expected to finish near 15.8 million, up 1.1 million from last year’s pace and a slight gain over last month’s 15.7 million level. The sales strength continues to be remarkable, given the current economic climate and the fact that average new-vehicle auto loans are flirting with 10% interest rates.

A key driver of new-vehicle sales strength has been growing inventory levels across the industry. Despite the UAW strike slowing production across the major Detroit-based automakers, estimates from vAuto in mid-October suggest industry-wide, new-vehicle inventory in the U.S. was at 2.3 million units, up from 2.1 million in mid-September, when the strike began, and well above the estimate of 1.5 million for mid-October 2022. Days’ supply in mid-October reached 62, the highest point since the spring of 2021. A year ago, days’ supply was 48.

HIGHER RATES LIKELY TO CUT INTO INTEREST COVERAGE

Fitch Ratings says that interest coverage will remain healthy for most corporate issuers through 2024, but it will decline modestly as rates stay higher for longer. This decline will be driven by the refinancing of lower-cost maturing debt at prevailing market interest rates and by higher costs, floating-rate debt, combined with relatively flat EBITDA as risks to the world economy remain.

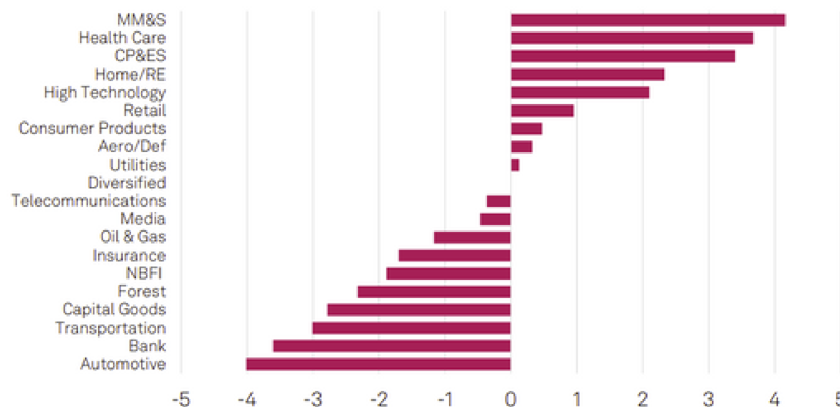
A company with weak interest coverage has a greater chance of failing to service its debt. This creates a risk of rating downgrades, restructurings, or defaults. Refinitiv reports that high-yield companies face shorter maturities, which makes them more reliant on debt capital markets to extend repayment deadlines and stay afloat. Additionally, they typically have a higher proportion of floating-rate debt, which makes them more vulnerable to rising interest rates. "Higher interest rates erode their fundamentals at a much faster pace," creating a "coupon time bomb."

Speculative-grade borrowers have less financial flexibility to navigate headwinds and face more immediate challenges from uncertain financing conditions, higher-for-longer interest rates, and slowing economic growth. As a result, elevated leverage and tightening liquidity will likely exert significant pressure on speculative-grade borrowers. Historic low interest rates prior to the recent tightening cycle enabled many issuers to borrow at costs that benefited coverage ratios, but the trend has reversed, with coverage ratios varying regionally.

Moody's stated that it forecasts interest coverage to drop to 0.91 times this year from 1.32 times at the end of 2022. Moody's also noted that many of these borrowers have private equity owners. The rating agency based its 2023 projection on the current federal funds rate of 5.25% to 5.5%, 2022 debt balances and EBITDA. Ideally, interest coverage should be above 4 times for healthy businesses.

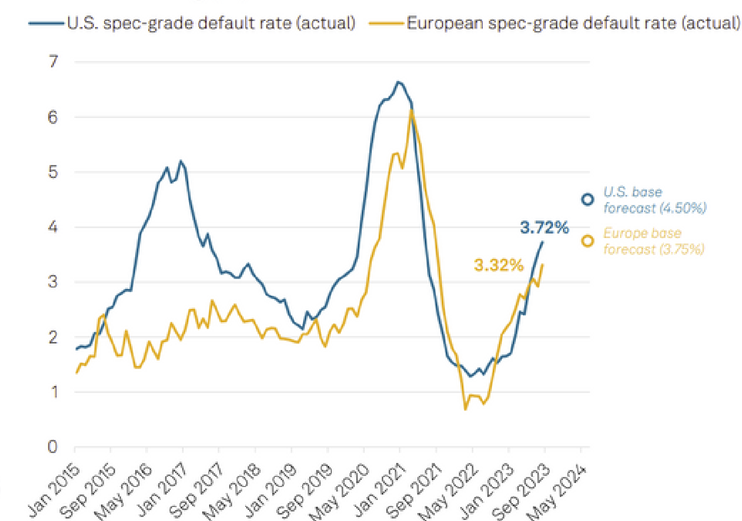
S&P Global Ratings also reported that the count of US leveraged loan Weakest Links (loan issuers rated B-minus or lower by S&P with negative outlooks or implications) increased for a fifth consecutive quarter in September, as leveraged borrowers grapple with costlier financing terms. The number of these at-risk loan issuers tracked by LCD increased to 175 at September 30, up 9% from June, up 22% from last December, and up 52% over the past year. S&P also revealed that metals, mining, and steel had the greatest quarter-over-quarter increase in negative bias in the third quarter of 2023.

The balance of quarterly changes in negative bias across sectors is roughly even (%)



Data as of Sept. 30, 2023. Includes financials and nonfinancial corporates. Negative bias is the share of issuers with negative outlooks or ratings on CreditWatch negative.

The U.S. and European speculative-grade default rates are climbing (%)



Data as of Aug. 31, 2023. Forecasts are as of June 30, 2023. . Sources: S&P Global Ratings Credit Research & Insights. S&P Global Market Intelligence's CreditPro.

LIQUIDITY CHALLENGES CAUSE RISING DISTRESS

Liquidity is a key metric for evaluating a company's creditworthiness. In times of crisis, access to liquidity is paramount to the survival of business operations.

The International Monetary Fund reports that many businesses faced headwinds during the pandemic, while others emerged with healthy cash buffers thanks to fiscal support in many countries. Firms were also able to protect their profit margins despite rising inflation. However, in a higher-for-longer world, many firms are drawing down cash buffers as earnings moderate and debt servicing costs rise. Defaults are on the rise in the leveraged loan market, where financially weaker firms borrow. These troubles are likely to worsen in the coming year as more than $5.5 trillion of corporate debt comes due. Elevated inflation means that central banks may have to keep policy rates higher, which could stretch borrowers' capacity to repay debt.

Fitch Ratings released similar findings, noting that liquidity challenges and limited refinancing opportunities remain among the main drivers of issuer additions to its Market Concern List, which consists of high-yield issuers it expects to default within two years.

Although access to capital markets is still favorable, issuance remains confined to higher-rated businesses and has largely favored secured borrowing. Higher-risk companies with liquidity issues will likely find it difficult to refinance or obtain new capital. This is a key item to monitor as we head into 2024.

U.S. MARKET OUTLOOK

U.S. real GDP growth accelerated to 4.9% at a seasonally-adjusted annualized rate in the third quarter of 2023, surpassing forecasts and reaching its fastest pace since the fourth quarter of 2021.

Preston Caldwell, Chief U.S. Economist for Morningstar, stated that rate hikes have hit housing activity, but the rest of the economy seems largely unaffected. He noted that overall GDP growth has been propelled upward by free-spending consumers and a manufacturing building boom. However, Caldwell still believes that the impact of high interest rates has yet to fully play out and expects growth to slow in 2024 before bouncing back in 2025 and following years as the Fed eases monetary policy.

Because of the Fed's aggressive monetary tightening, inflation has fallen significantly in 2023 and there is a chance the pace could get down around the 2% target rate.

The expectation is that with the federal funds rate falling to 5.1% by the end of 2024 and 3.9% by the end of 2025, the central bank's main measure of inflation is projected to drop to 3.3% by the end of this year, to 2.5% next year and to 2.2% by the end of 2025.

Comerica Bank also noted that the UAW strike, which now looks like it is nearing resolution, will still weigh on industrial production in the fourth quarter. A potential government shutdown would be a further incremental negative for growth.

PROFITGUARD LLC

30200 Telegraph Rd.
Suite #450
Bingham Farms, MI 48025

T: 1-866-990-1099
www.eprofitguard.com