S&P Global
Ratings

Global Credit Conditions Special Update:

Inflation, War, And COVID Drag On

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Global Credit Conditions Chair

Alexandra Dimitrijevic
London
alexandra.dimitrijevic@spglobal.com

Global Chief Economist

Paul Gruenwald
New York
paul.gruenwald@spglobal.com

Regional Credit Conditions Chairs

Asia-Pacific

Eunice Tan
Hong Kong
eunice.tan@spglobal.com

Emerging Markets

Jose Perez-Gorozpe
Madrid
jose.perez-gorozpe@spglobal.com

Europe

Paul Watters, CFA
London
paul.watters@spglobal.com

North America

David Tesher
New York
david.tesher@spglobal.com

Key Takeaways

- Deteriorating global macroeconomic conditions, combined with heightened geopolitical uncertainty and lingering COVID-19 lockdowns in China, fuel persistently high inflation, market volatility, and rising yields, and pose an increasingly challenging outlook for credit.
- For now, credit ratings are showing resilience, as they benefit from still largely growing economies, consumption supported by household savings, and record corporate cash balances. Rating actions globally in April and May were balanced, outside of countries directly impacted by the conflict, and the net outlook bias, which speaks to forward-looking rating trends, remains close to neutral. The distress ratio for U.S. speculative-grade borrowers, an indicator of future default trends, is increasing but remains well below the five-year average.
- Credit ratings could come under more pressure if the situation persists for more than one or two quarters, or deteriorates further, as households struggle with falling real incomes and rising energy and food prices, businesses face weaker demand conditions and margin erosion, and financing conditions ratchet tighter. Defaults could start picking up toward the end of the year as we get into 2023.

Editor's note: This report is an interim Credit Conditions special update following the revision of our macro forecasts. The identified risks have not materially changed since our previous CCC publication dated March 30, 2022. A more detailed report will be published with the next quarterly CCC update at the end of June 2022.

Headwinds Are Eroding Credit Buffers

On May 17, we announced downward revisions to our global macroeconomic base-case forecasts of between 0.6% and 0.8% in the world's three major economic regions. We now forecast growth of 4.2% in China, 2.4% in the U.S., and 2.7% in the eurozone in 2022. Underpinning our update is the recognition that key forecast assumptions are likely to play out over a longer period and be more damaging than we previously expected. The conflict between Russia and Ukraine and growing tensions with NATO are more protracted than expected. Inflation remains stubbornly high, fueled by food and rising commodity prices. The Chinese authorities are continuing to lock down major cities and regions to stem COVID-19. And the U.S. Federal Reserve and other major central banks are ramping up their fight to rein in inflation pressures.

From a credit perspective, this represents a wind shift as credit prospects become more challenging. While widespread concerns relating to recessionary scenarios in advanced economies have not been realized so far, they are a growing downside risk for later in the year and into 2023, particularly if the war in Ukraine drags on and escalates, or the authorities struggle to contain the pandemic in China. The Fed is also treading a fine line in reining back inflation without destabilizing financial markets, undermining confidence, or triggering a hard landing for the economy.

To date, most rated credits—outside of countries directly affected by the conflict—are showing resilience, as they benefit from still largely growing economies, consumption supported by household savings, and record corporate cash balances accumulated over recent quarters.

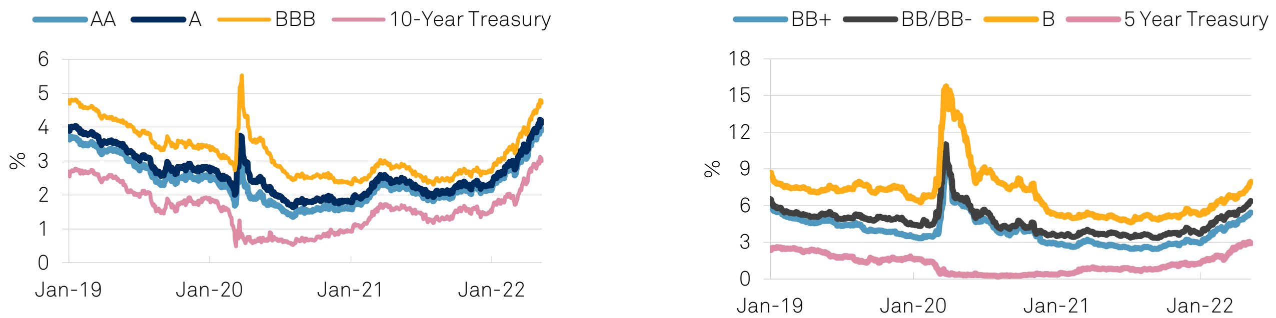
However, the real question is when do we expect this credit deterioration to occur, and which regions and sectors will be most exposed? In a nutshell, given a fair degree of resilience, if this situation persists for more than one or two quarters, or deteriorates further, this could translate into more negative rating actions and a gradual pick-up in defaults That said, uncertainty is very high, and the global economy remains uniquely vulnerable to any further shocks, even in the near term.

Key negative considerations that play into this assessment include:

- **Financing conditions have started to tighten across several regions** as rates rise and yield curves reprice (see chart 1) in response to the recent broad-based acceleration in inflation. This is most evident in the increased volatility in financial markets (see chart 2), particularly in the U.S. and other advanced economies, as well as in the hiatus in primary market activity in the high-yield market since the end of February. Shrinking central bank balance sheets could be expected to tighten financing conditions further to the extent that excess bank reserves are drained from the system.

Chart 1

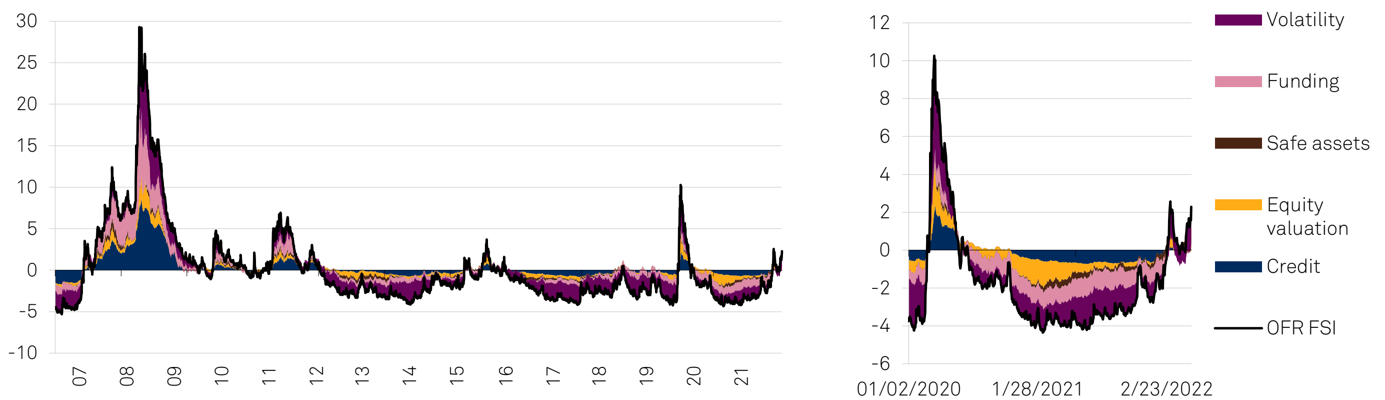
Rising U.S. Treasury Yields Are Pushing Corporate Bond Yields Higher Across The Rating Curve



Data as through May 10, 2022. Source: S&P Global Ratings

Chart 2

Volatility Has Pushed The OFR Global Financial Stress Index Moderately Higher Again In Recent Weeks



Source: Office of Financial Research. https://www.financialresearch.gov/financial-stress-index/ (data as of May. 10, 2022).

- **Shortages and supply disruptions continue to play havoc with supply chains**, particularly with those food products, fertilizers, energy, and raw materials affected by Russia sanctions and the conflict in Ukraine. These primarily feed into higher prices, amplifying inflation pressures. But sporadic supply bottlenecks linked to COVID-containment measures in industrial and logistic hubs in China, and the real risk of gas shortages if the energy embargo extends to Europe in the coming months, would have a material knock-on effect on industrial output and earnings.

- **We view declining consumer and business sentiment as the canary in the coal mine.** For Western economies, where consumer activity is the key driver of economic growth, falling confidence indicators reliably point toward retrenchment ahead in an important segment of the economy. Exorbitantly high rates of inflation outpacing wage growth, combined with rising interest rates, signal a decline in real disposable incomes that will increasingly weigh on consumers' purchasing ability. For China, the continued mobility restrictions will have a pronounced effect on consumption, small and midsize enterprises, and unemployment.
- **It is inevitable that end-customers can only absorb higher prices along the value chain for so long before demand destruction reduces volumes.** As the economic slowdown becomes embedded, it will become harder to pass through cost pressures. As demand eases, we expect profit margins to come under greater pressure. This margin erosion is likely to be an important trigger of future rating actions, particularly for smaller, more highly levered companies generating minimal free operating cash flow. Typically, a high proportion of these are 'CCC' rated corporate issuers, many in the media and entertainment, or consumer product sectors.
- **Currency volatility has returned, with the U.S. dollar benefitting from its safe-haven status** and the more aggressive course correction on interest rates being pursued by the Fed. The U.S. dollar trade-weighted index has appreciated by over 9% since the start of the year, as three-month U.S. dollar LIBOR has risen by 1.2% to stand currently at 1.4%. This benefits foreign companies with U.S. earnings, while making refinancing more challenging for those foreign companies and emerging markets with unhedged U.S. liabilities.
- **Growing cost-of-living pressures, especially for food staples, could spill over into social unrest** in many countries, particularly those where energy and food account for a large portion of the consumer basket and economies have yet to fully recover from the COVID-19 shock. Demonstrations or strikes could require government intervention to provide fiscal relief or additional stimulus, and often delay necessary fiscal consolidation.

As economic tailwinds diminish, still positive considerations providing near-term support include:

- **High levels of employment and significant job vacancies** are supporting the ability of households to maintain consumption and meet mortgage and other debt obligations for now. Employment and real wage levels will be critical to monitor over the coming months as a potential precursor to any recession scenario.
- **Household and business savings in the U.S. and Europe are still high as their economies emerge from COVID hibernation**. Liquidity is not currently viewed as a material rating vulnerability for most segments and sectors, supported by highly favorable financing conditions in recent years that facilitated the extension of debt maturities. This reduces the potential impact of limited access to the high-yield market that speculative-grade issuers have experienced since February, in contrast to the leveraged loan market that remains open for fundraising despite rising interest rates. Areas that warrant attention include companies with hedged commodity exposures subject to margin calls; that are experiencing substantial working capital swings; or are materially affected directly or indirectly by the war in Ukraine.
- **Carryover momentum from the bounce back from COVID is reflected in advance bookings ahead of the northern hemisphere holiday season.** Some discretionary consumer sectors, such as travel, leisure, and entertainment will benefit from the strength in post-COVID pent-up demand over the summer, even as inflation is fueling higher prices.
- **Corporate earnings momentum in Q1 2022 was positive, bolstered by strong pricing power.** Industrial producers with high levels of raw material inventories or feedstocks are likely to experience short-term windfall profits in such a strong inflationary environment.

- **Interest cover ratios remain a credit-positive factor, as nominal (and real) interest rates remain low,** and rates have been fixed with long duration for many borrowers, notwithstanding the recent acceleration in the pace of tightening from most central banks. This will reduce borrowers' sensitivity to rising rates, dampen refinancing activity, and result in the full impact of monetary tightening on the economy not being evident for at least 12-18 months.
- **For banks in developed markets, robust levels of capitalization, solid funding and liquidity, and forward-looking asset quality indicators feed into a broadly stable outlook bias**. Earnings will benefit from rising policy rates, but a more severe downturn could lead to a rebound in impairment charges and a hit to revenues. In this type of scenario there is clearly a higher likelihood of negative rating actions in the most affected banking systems. In emerging markets, the picture is more mixed. Banking systems in commodity exporting countries are benefiting from the surge in commodity prices, while some with a high dependence on external debt will be pressured by the more restrictive financing environment.

Global Top Risks

As detailed in our previous global credit conditions report, the four top global risks remain:

- Persistent price pressures and supply disruptions that have been amplified by rising energy, food, and other commodity prices caused by the Russia-Ukraine conflict. If inflation weighs on demand, profit erosion could hit credit quality.
- Amid increased volatility in financial markets, and with major central banks (except for China) accelerating monetary-policy tightening, investor risk aversion, and reduced market liquidity could trigger a sharp market repricing. This would destabilize exchange rates and capital flows, and cause debt-servicing costs to rise and financing conditions to tighten.
- Beyond a more protracted conflict in Ukraine, an escalation in hostilities potentially drawing in NATO members, or a more comprehensive ban on trade (notably covering oil and gas) with Russia, could materially undermine consumer and business confidence and cause a relapse in global growth.
- Outside of China, we see COVID as a lower, but still important, risk warranting continued monitoring. This is not least because omicron variants remain highly infectious, and waning immunity may require further boosters to avoid renewed consumer caution that could curb economic activity and exacerbate supply-chain constraints, as we have seen before.

Regional Considerations

U.S.:

- As the Federal Reserve continues its cycle of aggressive monetary-policy tightening to combat historically high inflation, we see an increased risk of recession for the world's biggest economy—with S&P Global economists now placing the chance of a U.S. recession in the next 12 months at 30% (in a range of 25%-35%).
- Given heightened uncertainty, financing conditions have started to tighten, but with some way to go. The distress ratio at 4.1% remains well below the five-year average of 8.3% and defaults are currently at their lowest year-to-date levels since 2011. Our model-driven fair value spread on speculative-grade debt was around 490 basis points (bps) at the end of March, about 140bps above actual levels. A sharp rise in borrowing costs could lead to higher volatility, stress market liquidity, and hurt lower-rated borrowers, in particular against the backdrop of high debt.
- At the sector level, downside risks are also building. For example, higher input costs and supply-chain disruptions are maintaining tight conditions for some products in the semiconductor sector. U.S. packaged food companies may suffer some profit erosion

this year and next. And if inflationary pressures rise beyond our base case, credit quality would suffer. Increasing wages and costs for providing services in state and local governments over the longer term are likely to struggle to be matched by the necessary increases in the tax base. Furthermore, the pressures that inflation places on the macroeconomy could exacerbate income inequality, leading to higher spending on social services.

Europe:

- A key development is a change in our assumptions about the duration of the war in Ukraine. We believe that this is turning into a war of attrition, with no indication as to how negotiations can restart without a cessation in hostilities and Russia withdrawing back behind February 24 contact lines in Ukraine.
- As a result, European sanctions against Russia will continue to intensify, and energy supply will dominate the debate. A likely EU oil embargo would keep oil prices and risk premiums high, while the gas market will remain very tight as Europe rebalances away from overreliance on Russian-sourced natural gas. In a downside scenario, failure to replenish gas storage facilities over the summer could lead to rationing for industrial users in some countries next winter if the Russian pipeline supply was cut off prematurely.
- Rating activity trends have been reasonably balanced in recent months reflecting, for instance, for corporates the combination of stronger (especially nominal) growth and ability to pass through costs that has, in turn, translated to solid earnings performance and improved rating headroom. However, early signals point to building downside pressures. Slower growth, elevated and persistent inflation requiring a recalibration of monetary policy, and tighter financing conditions are clear headwinds. Household real disposable incomes will contract significantly this year, with unions already agitating for strike actions. Businesses are starting to rein in headcount and discretionary expenditure and are reviewing capex plans. Governments have little flexibility to provide further fiscal support given that debt levels and budget deficits remain high following the pandemic. In this context, if these pressures persist, or get more severe looking ahead three to six months, then we could expect the credit buffers supporting credit quality to start to be eroded.

APAC:

- As the last major economy to pursue a zero-COVID policy, China's continuing strict lockdown of major cities and regions will dampen economic activity, particularly consumer spending. Consequently, this is leading to weaker economic growth. As China's consumption is less import-dependent, the spillover effect on other Asia-Pacific economies will be mostly contained. However, we see China's COVID approach as a key development affecting investor sentiment, supply chains, and broader capital markets.
- Meanwhile, the refinancing access for weaker APAC credits could turn acute in the face of cautionary global investor sentiment. Capital flight and weakening domestic currencies, as monetary policies diverge from that of the Fed, could further impede the credit quality of sovereigns and issuers alike.

Emerging Markets:

- Issuers in emerging markets (EM) could face material risks in a scenario of sustained inflationary pressures, lingering high prices, increasing interest rates domestically and abroad, and prevalent supply-chain disruptions. While some EM commodity exporters might benefit from such conditions as global demand holds up, domestic demand is highly sensitive to rising prices, especially food given its high weight in household expenditure. This will place rising pressure on fiscally constrained governments to provide additional stimulus to avoid social unrest. In turn, this would weaken sovereign fundamentals for many EMs.
- So far, EM corporates have been able to transfer rising costs to their products and services, and EBITDA margins follow a positive trend. Furthermore, leverage for EM

corporates is manageable, with net debt to EBITDA below 3.5x in most markets. On the other hand, tightening financing conditions make it difficult for high-yield issuers to refinance or issue new debt. We could expect increasing defaults in the lower rating spectrum ('B' category and below). EM banks could benefit from a higher interest rate environment, with net interest margins increasing, although persistent high inflation could lead to weaker asset quality as households' payment capacity erodes.

Related Research

- China's COVID Policy To Further Weigh On Economy, Credit , May, 16, 2022
- Credit Trends: Risky Credits: The Number Of European 'CCC' Issuers Rises, While Liquidity And Leverage Indicators Point To Potential Future Stress, May 11, 2022
- Cyber Threat Grows As Russia-Ukraine Conflict Persists, May 11, 2022
- Credit Trends: 'BBB' Pulse: Credit Risks Diverge Between The U.S. And EMEA On Russia-Ukraine Conflict, May 5, 2022
- Credit Trends: Global Financing Conditions: Bond Issuance Looks Set To Contract Almost 5% In 2022 As Conditions Tighten Quickly, Apr 27, 2022
- Default, Transition, and Recovery: Corporate Defaults Inch Up In Europe, Apr 25, 2022
- The Russia-Ukraine Conflict: European Banks Can Manage The Economic Spillovers, For Now, Apr 21, 2022
- Rising Inflation Will Normalize U.K. Banks' Domestic Credit Losses In 2022, Apr 20, 2022

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