

Credit Conditions Asia-Pacific Q3 2022:

Costs Heighten, China Growth Tightens

June 28, 2022

This report does not constitute a rating action.

Key Takeaways

- **Double blow.** Asia-Pacific issuers are suffering from increased costs and a sharper-than-expected economic slowdown in China. Sticker shock is coming not just via higher input prices (compounded by weaker currencies) but also higher borrowing costs.
- **Costs heighten.** Commodity, energy, and food price inflation are pressing on revenues and profit margins. Households have a limited capacity to absorb even higher prices, curbing corporates' ability to pass on higher input costs. Asia-Pacific central banks, except for China and Japan's, are raising or poised to raise policy rates. Spreads are widening. Speculative-grade issuers are finding it more difficult to refinance.
- **China growth tightens.** China's on-and-off lockdowns of cities have hit economic activity, in particular mobility dependent sectors. Pain in the Chinese real estate sector could persist as sales slow. We have cut China's GDP growth in 2022 to 3.3% from our previous 4.2%.

(Editor's Note: S&P Global Ratings' Credit Conditions Committees meet quarterly to review macroeconomic conditions in each of four regions (Asia-Pacific, North America, Europe, and Emerging Markets). Discussions center on identifying credit risks and their potential rating impact in various asset classes, as well as borrowing and lending trends for businesses and consumers. This commentary reflects views discussed in the Asia-Pacific committee on June 21, 2022.)

Inflation trouble. Asia-Pacific companies are feeling the pain from persistently high commodity and energy prices. Margins and revenues will contract for many companies. In the face of weaker global demand and consumption, passing through higher input costs to consumers becomes increasingly challenging (see "[APAC Corporates: Inflation, Rate Strains Set In](#)", June 21, 2022). Consumers could become more selective on their discretionary spending, weighing down economic growth further. While not yet evident, higher wage demands in labor-short job roles may arise in future.

Risk aversion intensifies. Most Asia-Pacific central banks, with the exception of China and Japan, are likely to follow the Fed along the path of raising policy rates. Not doing so increases the risk of domestic currency depreciation, sparking capital outflows. A strong U.S. dollar increases the debt burden of borrowers with significant foreign currency liabilities. Meanwhile, risk-averse lenders could demand higher risk premiums. Tightening liquidity access weighs on refinancing prospects for speculative-grade borrowers-- particularly small-and-medium enterprises (SMEs). In China and Japan, low policy-rate regimes are encouraging domestic borrowers to rely more on local financing sources.

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China lockdown spillovers. The country's "zero-COVID policy" entails on-again/off-again lockdowns of cities and towns. These create economic drags through subdued consumption, weaker employment and supply-chain implications. Lockdowns are taking a particularly large toll on Chinese consumer-facing sectors, weighing on credit quality (see "[The Heavy Hand Of Inflation On China Consumer Entities--Who Will Be Hit, And How](#)", June 21, 2022). Further spillovers could include deteriorating fiscal balance sheets of local and regional governments as the cost of mass testing and containment mounts, and sluggish property sales hitting developers' already weakened cash flows. Consequently, we have revised down our growth expectations for China in 2022 to 3.3% from 4.2% and Asia-Pacific's to 4.2% from 4.6% (see "[Economic Outlook Asia-Pacific Q3 2022: Overcoming Obstacles](#)," June 27, 2022). A slower China, coupled with the confluence of global and regional credit headwinds could lead to material credit stress.

Geopolitical tensions stick. While the direct impact from the Russia-Ukraine conflict is limited in the region, a prolonged conflict could see many spillovers. Continuing uncertainties around the conflict could further weigh on trade, capital flows, market confidence, and business conditions. Meanwhile, the potential for secondary sanctions and territorial disputes could spook investors, denting cross-border investments and the region's economic growth. While we view this as a tail risk, the buildup of such tensions could see China moving faster down the decoupling route, in areas of imports and de-dollarization of its financial ecosystem.

Weaker rating outlook bias. The net rating outlook bias has worsened to negative 7% (as of end-May 2022). The weakening global economy amid heightened energy and commodity prices point to further downside strains. The outlook bias deteriorated for 12 out of 21 rated corporate sectors as of May 31, 2022, from seven of 21 in Feb. 28, 2022. Higher prices and rates will give a thrashing to profits, rendering more negative rating implications.

Table 1 lists our top Asia-Pacific risks.

Table 1

Top Asia-Pacific Risks

Inability to pass through high input prices hits business revenues and profits, while household discretionary spending narrows with higher energy and food prices

Risk level* Very low Moderate Elevated **High** Very high **Risk trend**** Improving Unchanged **Worsening**

The region, having largely evaded the initial wave of inflation in 2021, is now grappling with higher commodity, energy and food prices, and shortages. Amid fears of slower global demand and still-weak consumer sentiment, businesses are not able to fully pass on higher costs without risking unit volume. Credit quality could worsen for some midstream and downstream industrial producers (particularly SMEs). The dilution of corporate credit headroom could have spillover implications for banks' credit-loss provisioning.

Business strain will limit scope for wage increases, adding to household caution. Increasing food and energy prices are biting into households' discretionary spending, denting economic activities further and could disproportionately hit sectors such as leisure and retail. In extreme situations where segments of populations face constrained access to food, the social divide within the populations could intensify--risking unrest.

Rising borrowing costs and reduced access to financing to hit business operations and debt serviceability

Risk level* Very low Moderate Elevated **High** Very high **Risk trend**** Improving Unchanged **Worsening**

The acceleration of monetary tightening by the Fed and the region's central banks (with the exception of China and Japan) could set off sharp repricing of financial and real assets, and spark capital outflows. In the face of inflationary expectations, investors could demand greater real yields. Concurrently, financiers could tighten lending standards. Higher borrowing costs and tighter funding access would amplify refinancing challenges for lower-rated and highly leveraged borrowers. Shifting foreign exchange rates (e.g., a stronger U.S. dollar, a weaker yen) could cause severe stress for entities with heavy foreign currency debt burdens. Meanwhile, looming maturity walls could intensify financing pressure on Chinese property developers and local government financing vehicles, leading to more defaults.

China's continued pursuit of zero COVID strikes consumption, disrupts supply chains, and weighs on growth

Risk level* Very low Moderate Elevated **High** Very high **Risk trend**** Improving **Unchanged** Worsening

This year's COVID lockdowns of cities and towns, after the 2021 crackdown on the property and technology sectors, have accelerated China's economic slowdown. While lockdowns are easing for some affected cities, any outbreaks of infection could bring new mobility restrictions. Moreover, the economic damage wrought from recent multi-week lockdowns will take time to repair. Credit pressures for SMEs, particularly in the services sector, could intensify--transpiring into a prolonged uptick in unemployment and banks requiring higher loan loss provisions. In turn, corporates and households could borrow more to make up for income shortfalls, hiking debt growth.

Additional government spending, if any, won't likely be an immediate panacea. The likelihood of the negative economic momentum continuing is high. Beyond China, these policy and economic developments may affect others reliant on the country for tourism, exports, or finance (e.g., emerging markets) and supply chain or imports (e.g., component parts).

Confluence of global and regional headwinds to upset global growth and trade

Risk level* Very low Moderate **Elevated** High Very High **Risk trend**** Improving Unchanged **Worsening**

Substantial interest rate increases by the region's central banks, to tame inflation or just match rate increases in the U.S. and Europe, could significantly dampen economic growth and, in worse cases, threaten recession. This would mean lower global demand, slower trade, and weaker investor sentiment. For the region's net trade exporters (i.e., Korea, Taiwan, Hong Kong, Singapore), subdued export and import orders could derail the post-COVID revenue recovery. Fears of recessions and U.S. stagflation could exacerbate investor and consumer caution, and dent discretionary spending.

With the exception of China, most Asia-Pacific countries have adopted a "living with COVID" stance. Nonetheless, new strains of COVID or other viruses could trigger a reversion to 2020-2021 COVID policies involving lockdowns and restrictions on people mobility. We see this risk as elevated but improving as governments and communities accept the trade-off of health versus economic risks.

Simmering geopolitical tensions threaten to boil over affecting the global economy

Risk level* Very low Moderate **Elevated** High Very High **Risk trend**** Improving Unchanged **Worsening**

Strategic confrontations between China and the U.S. and regional neighbors continue to flare up. Disagreements center on trade, finance and investment, and geographic, maritime and airspace territorial rights. The war in Ukraine has placed China's relationship with Russia in focus. Tensions have increased the likelihood of China moving down the decoupling route. Its "dual circulation" policy seeks to reduce reliance on foreign imports. It could also de-dollarize its financial ecosystem. The technology race between the superpowers could further shake supply chains and restrict access to intellectual property and markets. Intensification of disputes would affect cross-border investments and other economies.

Structural Risks

Larger and more frequent natural disasters, and climate change policy demands intensify

Risk level* Very low Moderate **Elevated** High Very High **Risk trend**** Improving Unchanged **Worsening**

For most countries, exposure to, and costs from, the physical impacts of climate change are increasing. These affect local economies, including agriculture production. Government policies and investor initiatives (e.g., ESG) in recent years to address climate change have been redirecting funding away from less climate friendly industries. This has for instance begun to curtail the production capacity of both fossil fuel-extractions and fossil fuel-based power, adding to the current energy pressures amid war-related disruptions. Furthermore, this may lead to societal tension as policymakers struggle to balance short-term social and economic priorities against long-term decarbonization ambitions. Abrupt policy actions in coming years will also disrupt industries with potential implications for business and financial risk in energy intensive sectors.

Digitalization and cyberattacks disrupt business models, add to systemic risks

Risk level* Very low Moderate **Elevated** High Very High **Risk trend**** Improving **Unchanged** Worsening

Increasing technological dependency and global interconnectedness mean cyber risk is a systemic threat and significant single-entity risk. With cybercrimes increasing in number, such attacks threaten the economic capabilities of borrowers and countries (e.g., critical infrastructure). Corporates and governments need to incur additional ongoing and rising costs to combat the threat. On the technology disruption front, borrowers will have to continually adopt and adapt to new technologies (note: not just information technology) to remain competitive. Digitalization of goods and services and decentralized finance are examples of evolving disruptions. Laggards will see their business (and thus credit) profiles decline. This combined defense and adaption risk is elevated and unchanged.

Source: S&P Global Ratings.

* **Risk levels** may be classified as very low, moderate, elevated, high, or very high, and are evaluated by considering both the likelihood and systemic effect of such an event occurring over the next one to two years. Typically, these risks are not factored into our base case rating assumptions unless the risk level is very high.

** **Risk trend** reflects our current view on whether the risk level could increase or decrease over the next 12 months.

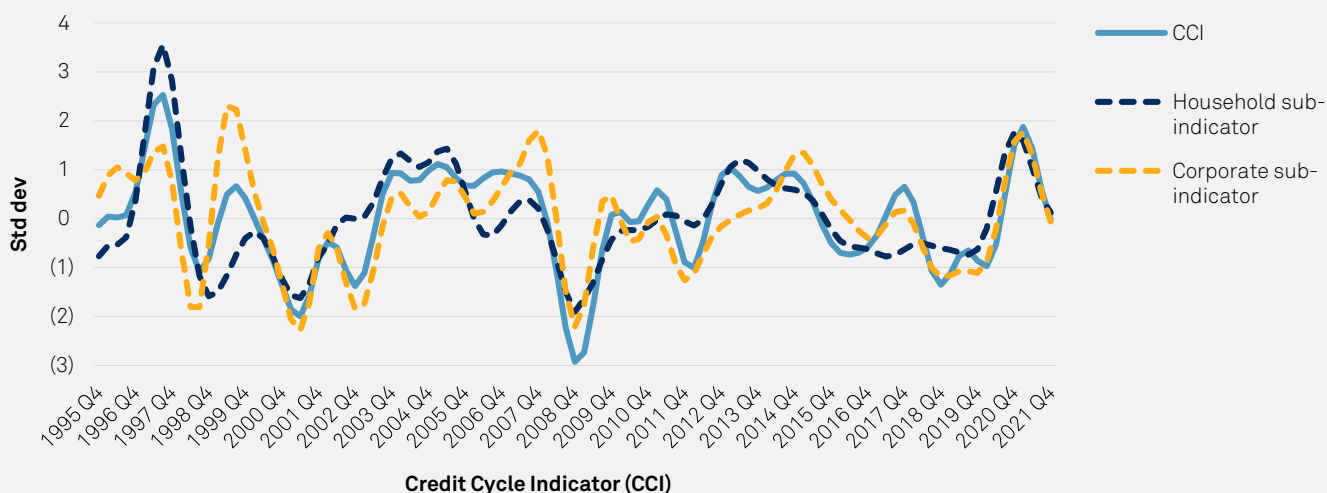
Credit Cycle Signs Point To Heightened Credit Stress In Late 2022 Or Early 2023

We are trialing a proprietary Credit Cycle Indicator (CCI) at the macro geographical level. The CCI has five components: corporate and household debt leverage, equity and house prices, and our proprietary Financing Stress Indicator (FSI) (see "[White Paper: Introducing Our Credit Cycle Indicator](#)," published on June 27, 2022). Our preliminary results show the peaks in the CCI tend to lead credit stresses by six to ten quarters. Moreover, when the CCI's upward trend is prolonged or the CCI nears upper thresholds, the associated credit stress tends to be greater.

Overall. Over four consecutive quarters since Q1 2020, the Asia ex-Japan CCI trended upwards and reached a peak of 1.9 standard deviations (compared to its historical average) in Q1 2021. This suggests potential heightened credit stress in late 2022 or early 2023 (see chart 1). While the CCI is trending downwards--indicating a credit correction is underway--the potential impact of the buildup of nonperforming loans (NPLs) and defaults could linger beyond the stress period across late 2022 and early 2023.

Chart 1

Recent Peak In The Asia ex-Japan CCI Suggests Heightened Credit Stress In Late 2022 Or Early 2023



We view the CCI as a leading indicator for potential credit stress outcomes. The CCI period ends in 2021 Q4. Household and corporate sub-indicators were created by taking the weights in the overall CCI and rescaling such that the sub-components' weights in the sub-indicator sum to 1. Asia-Pacific geographies included in the Asia ex-Japan CCI: China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, Singapore, and Thailand. Australia, Japan and New Zealand have their own standalone CCIs. Source: Bank for International Settlements, Bloomberg, S&P Global Ratings.

Corporates. Corporate debt-to-GDP levels have been dipping over the previous two quarters amid post-COVID repair as economies recover concurrently. While this hints of easing credit stresses (aftermaths of credit correction), bank lending standards and financing access could remain tight--making borrowing difficult. Meanwhile, some groups of corporate borrowers (especially highly indebted SMEs) remain vulnerable with revenues and earnings yet to fully rebuild.

Households. Like the corporate sub-indicator, the household sub-indicator is trending downwards in line with improving GDP, post COVID. However, household indebtedness remains a concern amid still high property price levels. A severe property price correction could complicate the household credit situation. The household debt-to-GDP ratio has soared for Korea and Thailand, and expanded to a lesser extent for Malaysia, Hong Kong and Singapore. In the case of Korea, house price volatility has been increasing, exceeding the 1 standard-deviation threshold as of late. For Hong Kong and Singapore, part of the previous upward CCI movement was due to greater volatility in GDP growth, which has subsequently improved. Having said so, Asia's savings habits could offer some reprieve. In parts of the region, aggregate household financial savings may exceed household debt. However, cash distribution could vary wildly across households with different degrees of indebtedness. Credit risks could still prevail especially for those in more vulnerable cohorts (lower income or with lesser liquidity).

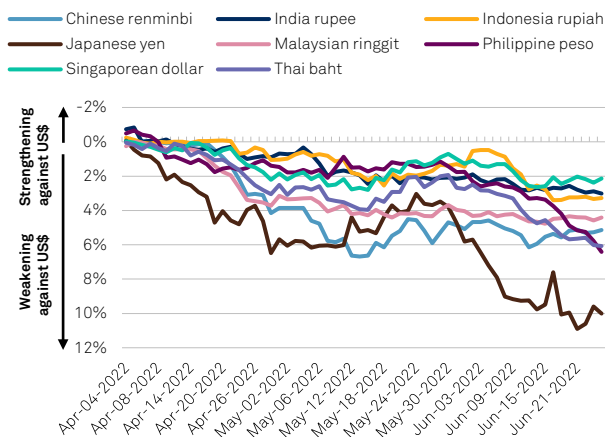
Governments. Sovereign risk is not included as a formal part of the CCI.

Credit Conditions Asia-Pacific Q3 2022

Chart 2

Asia-Pacific Currencies Pitch Downward...

Percentage change in Asia-Pacific currencies since April 1, 2022



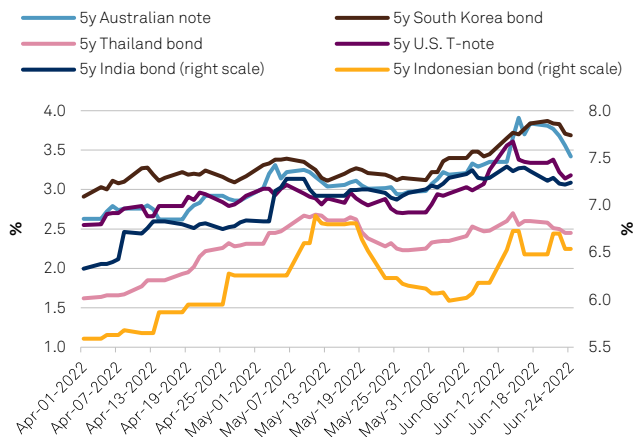
Data as of June 24, 2022.

Source: S&P Capital IQ.

Chart 3

...While Bond Yields Take A Hike

Movement in 5y Asia-Pacific bond yields since April 1, 2022



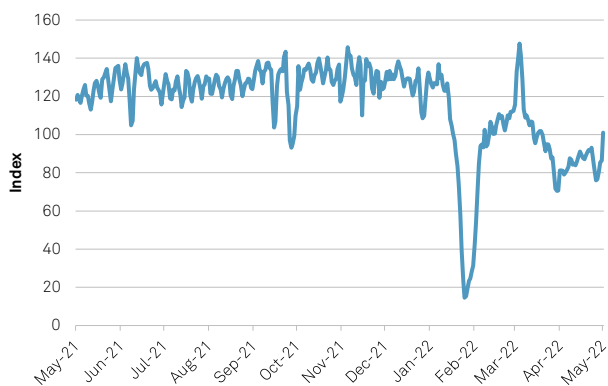
Data as of June 24, 2022.

Source: S&P Capital IQ.

Chart 4

China's 2022 Lockdowns Have Hit Mobility

Vehicle freight flow index since May 2021



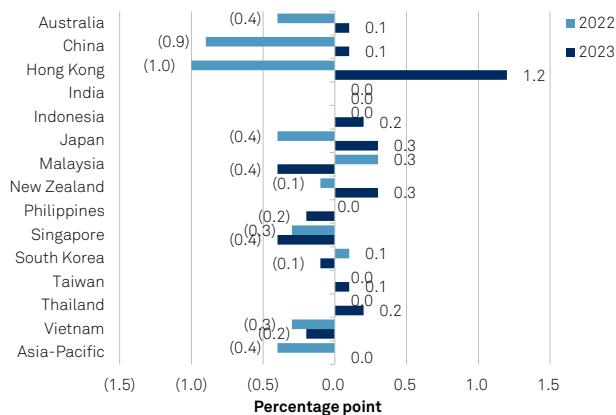
Data as of May 8, 2022.

Source: Wind.

Chart 5

Asia-Pacific: Changes In Economic Forecast

Current real GDP forecast versus March 2022



For India, 2022 = FY 2022 / 23, 2023 = FY 2023 / 24. We compare the current forecast versus our May 2022 interim update for China, India, and the regional Asia-Pacific aggregate.

Source: S&P Global Economics.

Macroeconomic Outlook

Asia-Pacific's Growth Will Slow To 4.2%

Globally, a number of negative factors have intensified since the previous Credit Conditions Committee round. The key ones are a longer than expected Russia-Ukraine conflict; higher energy and commodity prices; higher and more sticky inflation, especially in the U.S.; faster monetary policy normalization in the U.S. and Europe; and economic damage from COVID lockdowns and restrictions in China.

Fast-moving events led us to make an interim update in May, when we downgraded our GDP growth projections for the U.S., China, and Europe by 0.7-0.8 percentage points and raised inflation forecasts. In our current global forecast round we have further reduced our growth projections for the U.S., Europe and China and raised our inflation projections for a range of economies.

The two key changes are the weaker growth in China due to stringent lockdowns and the higher projected U.S. interest rates.

Outside China, growth prospects remain broadly favorable. The post-COVID domestic recovery is generally continuing and we expect solid economic growth in 2022-2023. But rising CPI inflation has been a key factor behind the start of monetary policy normalization in many economies. The other key factor is staving off external pressure amid rising global interest rates. In Asian emerging markets, capital outflows and currency depreciation against the U.S. dollar have so far generally remained contained. But we expect most central banks to continue to raise their policy rates to anchor inflation expectations and guard against external vulnerability.

Given the weak Q2 and with the COVID stance unlikely to change soon, the official "around 5.5%" growth target announced in March 2022 will likely be missed by a large margin. With the impact of lockdowns and restrictions easing in H2 and some stimulus kicking in, activity should pick up steam, bringing whole-year GDP to 3.3%. But even with restrictions now easing, downside risks are substantial--especially that of new COVID lockdowns.

China's lockdown weakness has lowered demand for other countries' exports. The fact that consumer spending is hit harder by the lockdowns than investment and industrial production mitigates the impact on other economies, as China's consumption is less import-intensive. Nonetheless, China's imports have weakened severely. This is in part because of the impact of the property downturn on commodity imports, which has weighed on exports of economies such as Australia.

Despite the external headwinds, outside of China growth projections remain robust. Economic expansions generally eased in early 2022 after the bounce-back in 2021 and with global trade growth softening. But, with the domestic recovery from COVID largely remaining intact, overall growth has slowed only modestly. This is especially so where growth is more domestic demand-oriented, such as in Australia, India, Japan, Indonesia and the Philippines. We cut India's GDP forecast by half a percentage point to 7.3% for fiscal 2023 (ending March 2023) compared to three months ago.

Our forecast for Asia-Pacific ex-China GDP growth in 2022 is now 4.9%. This is revised down by 0.3 percentage points compared with our March forecast.

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Output will remain below its pre-COVID trend for a long time in several Asia-Pacific economies. In 2022, this "scarring" will be the largest in the Philippines, India, Malaysia and Thailand. Nonetheless, with growth of around 4.6% in 2023-2025 by our forecast, Asia-Pacific will remain the world's fastest growing's region.

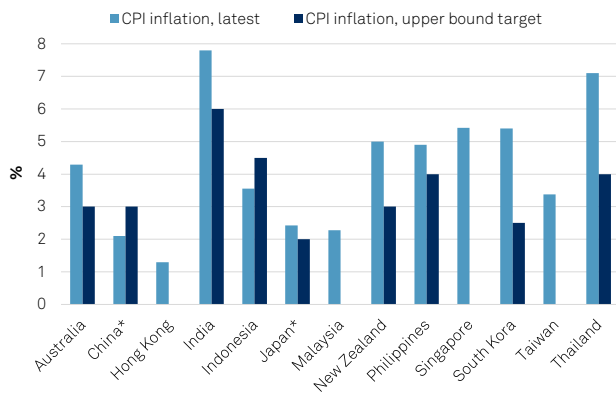
CPI inflation has generally risen and we have lifted our projections in several economies, especially in Australia, India, Indonesia, New Zealand, Singapore, South Korea and Thailand. These revisions are driven by higher energy and commodity prices and, in a few cases, larger pass-through as economies recover and slack eases.

Meanwhile, the Fed's policy tightening raises the potential for capital outflows from Asia's economies, especially its emerging markets. Exchange rate movements suggest that markets have so far generally focused more on the divergence of monetary policy and energy price increases than on potential EM vulnerability. However, rising U.S. interest rates pose a risk of heightened capital outflows and emerging market central banks will want to guard against such pressure.

Against this backdrop, Asia-Pacific central banks are weighing the desire to support growth against the need to tighten policy to anchor inflation expectations or to head off financial instability. Many are tightening to rein in inflation. Central bankers in emerging markets that are vulnerable to capital outflows may also have to raise policy rates. Where neither inflation nor external pressure is a major constraint on monetary policy, we expect central banks to focus on supporting growth and tightening policy as little as possible, or not at all.

Chart 6

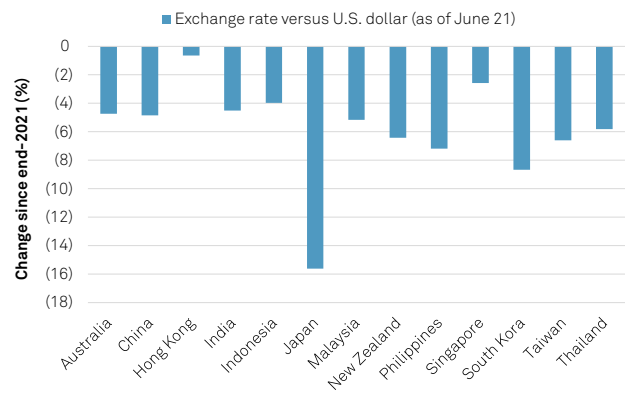
CPI Inflation Is Now Above Target In Many Economies



*Means only a central target, no band. CPI--Consumer price index. Source: CEIC, S&P Global Economics.

Chart 7

The More Hawkish U.S. Fed Puts Pressure On Currencies



Data as of June 21, 2022. Source: CEIC, S&P Global Economics.

The views expressed here are the independent opinions of S&P Global Ratings' economics group, which is separate from but provides forecasts and other input to S&P Global Ratings' analysts. S&P Global Ratings' analysts use these views in determining and assigning credit ratings in ratings committees, which exercise analytical judgment in accordance with S&P Global Ratings' publicly available methodologies.

Financing Conditions

Market Volatility Further Tightens Offshore Financing Conditions

Benchmark yields and spreads have trended up since April, raising nominal financing costs. Market turbulence was initially driven by fears around spillovers from China's real estate sector and lockdowns, as well as the tightening cycle; now it has been exacerbated by strong inflation readings and the Fed's unexpected 75 basis points (bps) rate hike. So far in June, benchmark yields have risen by more than 50 bps in Australia, New Zealand, Singapore, Korea and Indonesia, and credit spreads have resumed their upward trends after a brief two-week calm in May.

Developments in financing costs have been amplified by currency and capital outflow pressures. The much more hawkish Fed, especially relative to Asia-Pacific's central banks, has led to faster currency depreciation across the region. Flight-to-quality could deepen due to a combination of expectations for deteriorating rate differentials and increased market fears about a potential recession in the U.S. This coincides with portfolio outflows seen in recent months. Weaker currencies put even more upward impetus on the region's external financing costs.

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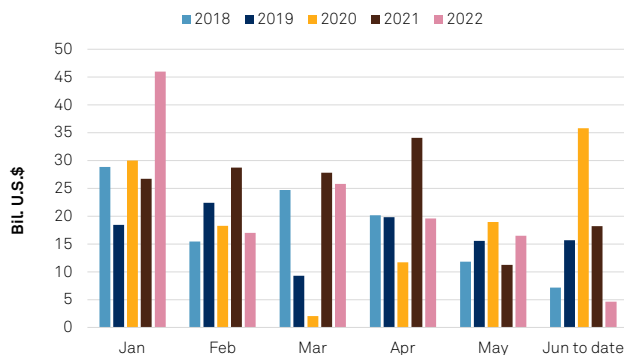
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Chart 8a

Asia-Pacific Investment Grade Issuance

Volumes still holding up



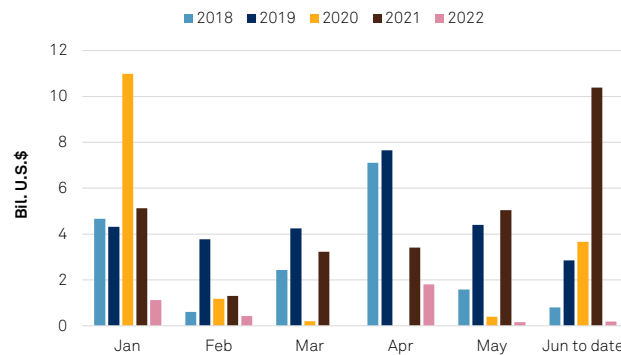
Data as of June 16, 2022. Includes financial and non-financial corporates incorporated in Asia-Pacific.

Source: Refinitiv; S&P Global Ratings Research.

Chart 8b

Asia-Pacific Speculative Grade Issuance

The tap remains virtually shut



Data as of June 16, 2022. Includes financial and non-financial corporates incorporated in Asia-Pacific.

Source: Refinitiv; S&P Global Ratings Research.

Refinancing risks remain the focus for offshore borrowing as market volatility

continues. Access to external markets has become even more difficult for all borrowers but particularly those at the lower end of the credit spectrum. Indeed, the region's speculative grade issuers have been mostly inactive in primary markets through most of the year, while investment grade issuance has also declined steadily since March. Anecdotally, some issuers have tried to shift foreign currency borrowing to domestic banks, but these remain highly expensive. Current market conditions will likely only heighten offshore financing difficulties especially for lower-rated issuers with higher costs and lower demand. And if the market volatility drives much sharper risk repricing, the financing challenges could spread further up the credit quality spectrum.

Sector Trends

Brace For Impact: Inflation And China

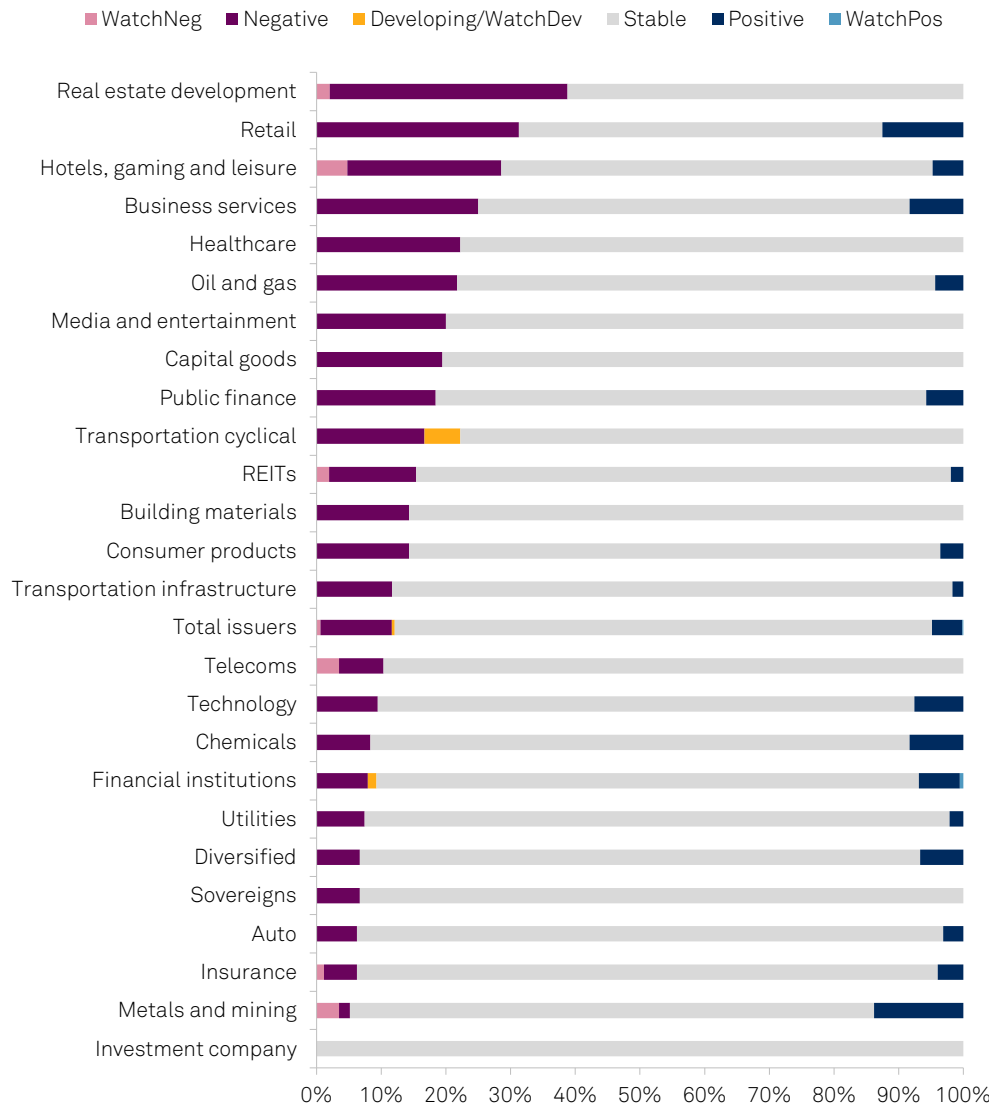
More pain to come. Asia-Pacific is facing swelling inflation, funding challenges, declining global demand and trade, and ensnarled consumption and supply chains driven by China's strict COVID policy. Cracks are forming and widening along the already uneven recovery path for the region's rated issuers. Our net rating outlook bias across asset classes deteriorated to negative 7% as of end-May (see chart 9), on the heels of credit stabilization stalling between end-2021 and first quarter of 2022. The number of corporate sectors with a worsening outlook bias has been inching upwards over the past quarters, reaching 12 out of the 21 sectors we cover as of May 31, 2022 (Feb 2022: 7).

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Chart 9

Outlook Distribution Of Asia-Pacific Issuers By Sector



Data cut-off is at May 31, 2022.

Source: S&P Global Ratings.

Margin compression. Surging input costs will make it harder for companies to pass through costs to consumers. In addition, investor demand for greater nominal yields loads up borrowing costs. Higher debt servicing fees and tightening lending standards could exacerbate already tight financing access.

Spillovers abound. Banks' asset quality could deteriorate as corporate and household creditworthiness turn vulnerable. Weakening borrower profiles also have implications for structured finance markets. Meanwhile, fiscal burdens are on the rise for local and regional governments (LRGs) in China as COVID containment costs mount. For insurers, capital market volatility and slowing growth will narrow profits.

What's changed?

Inflation hits corporates and consumers. Deteriorating profit margins could exacerbate cost curtailment. Households could limit discretionary spending as higher food and energy prices bite. Behavioral changes would likely weigh heaviest on consumer discretionary sectors (such as hotels, gaming and leisure, and retail).

Sharp reset in asset pricing. Fears of global recession and U.S. stagflation have sparked market volatility. The region's currencies are vulnerable to further depreciation as the Fed embarks on more aggressive monetary tightening. Concerns of capital outflows and repricing of risks could crimp funding access further for weak credits. Pain may be pronounced for borrowers with sizeable foreign currency obligations due or upcoming debt maturity walls over 2022 and 2023.

Key risks

Funding access continues to deteriorate. Volatile investor sentiment amid rising interest rates and growing macro uncertainties, compromises funding access and threatens credit quality especially for weaker-rated issuers.

Outbreaks test China's strict COVID policy. While most Asia-Pacific economies are adapting to "live with COVID", China is adhering to its strict dynamic zero-COVID policy. The latest series of COVID outbreaks, leading to returning testing and containment measures in cities such as Shanghai, constitute further downside risks to consumption and growth.

Key assumptions

Inflation and investor sentiment are main drivers of credit risks. Rising input and consumer prices, on top of increasing market volatility, present immediate and material credit risks for Asia-Pacific issuers.

What to look for

Narrowing buffers. Surging input costs, in tandem with subdued private consumption and limited pass-through ability, points to continued erosion of credit and financial headroom for the region's corporates.

Geography and sector differentiation deepens. Asia-Pacific had already been navigating a lopsided recovery, with repercussions of the Ukraine conflict dividing the region into haves and have nots. A more uncertain external environment and pockets of slowdown across the region could widen this rift.

Nonfinancial Corporate

Downside Pressures Building Up

Key Takeaways

- Moderating revenue growth, cost inflation, and volatile investor sentiment limit broad-based upside for credit ratings in Asia-Pacific.
- Lockdown effects, slowing growth and rising unemployment as well as high energy and commodity prices are also weighing more specifically on rated companies in China.
- Investor sentiment remains tepid amid rising interest rates, increasing geopolitical tensions, persistent inflation and evolving COVID-19 variants.

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What's changed?

The credit trajectory of rated companies in Asia-Pacific remains tilted to the downside.

We still have negative outlooks on about one-in-seven companies that we rate. We see more downside risks building heading into the second half of 2022 as cost inflation compresses margins and slowing growth reduces revenue prospects in the region.

Zero COVID and weakening growth outlook in China. The recent COVID-related restrictions in China have had a significantly more severe economic hit than most prior lockdowns in the country. Lockdowns in major cities including Shanghai have been constraining China's domestic consumption and adding greater pressure to global supply chains. While lockdown measures have started to ease, we do not expect the government's COVID stance to shift substantially any time soon.

Cost inflation, rising funding costs are reducing rating headroom amid slowing revenues. In a recent sensitivity analysis (see "[APAC Corporates: Inflation, Rate Strains Set In](#)," June 21, 2022), we estimated that about 16% of rated companies in Asia-Pacific could breach downside financial rating triggers under a mild scenario of rising interest rates and current cost inflation persisting in 2022. Asset-heavy or leveraged sectors--infrastructure, transportation, power, real estate--or those with lower ability to pass through higher costs to customers--consumer discretionary, autos, infrastructure, capital goods (see chart 10)--have higher risks of rating downside over the next 12 months.

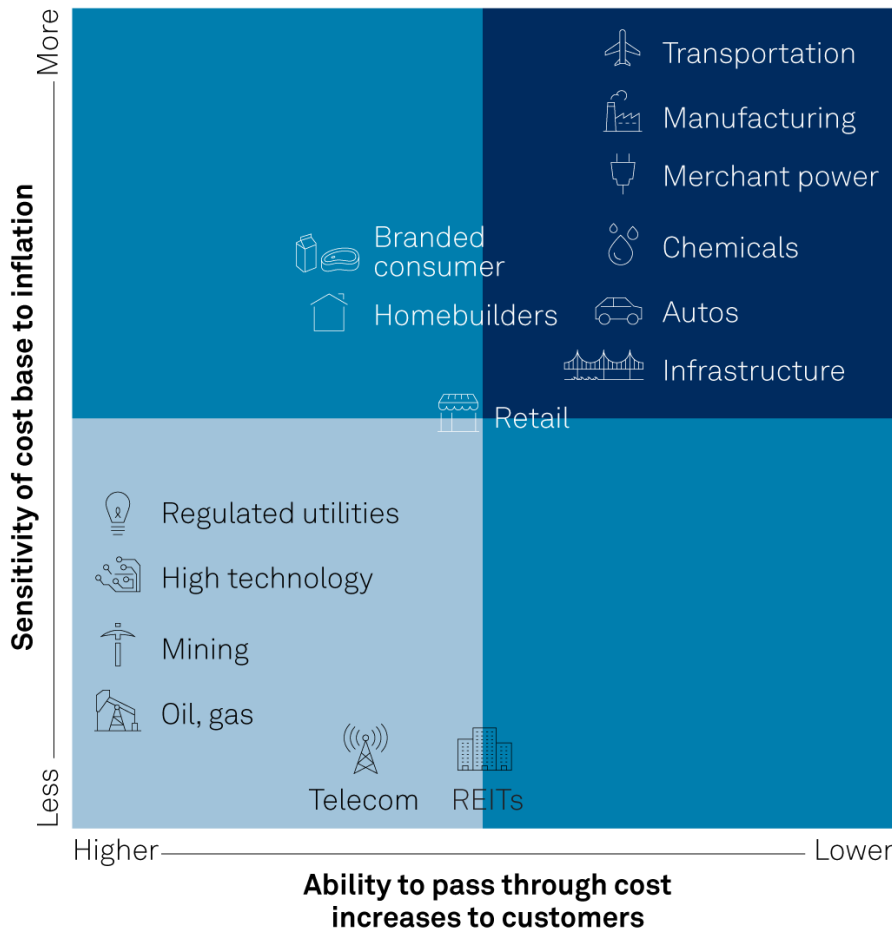
Key risks

Bigger than expected interest rate hikes and a further bout of inflation. We estimate that ratings on about 25% of companies in Asia-Pacific could face credit downside under a stressed scenario of a doubling of credit spreads from current levels and more substantial earnings drop from inflationary pressures.

Funding availability reducing further because of poor external conditions. The prevalent risk-off sentiment from investors and increasingly selective capital markets are exacerbating cost inflation and refinancing risk for entities rated in the 'B' category and below. Liquidity and funding are likely to stay major differentiators of credit quality in Asia-Pacific, with increasingly volatile investor sentiment, short fund-raising windows in capital markets and higher funding costs, even for more solid credits. Funding by domestic banks is also likely to stay selective heading into the second half of 2022. Currency volatility in Southeast Asia--almost a "forgotten" risk during and post COVID--is likely to come back to center stage amid U.S. rate hikes and prospects for capital outflows.

Chart 10

Lower Earnings Due To Input Cost Inflation



Source: S&P Global Ratings.

Key assumptions

Moderating revenue growth, margin pressure on cost inflation in 2022. We forecast revenues and profits will remain flat or rise by mid-single digits in 2022 for nearly 80% of the companies we rate. That contrasts to a more pronounced growth of a high single digit for most rated companies in 2021. Margin erosion by cost inflation (especially in the energy, commodities, raw materials, and transportation sectors) could occur for almost 70% of companies we rate in Asia-Pacific, compared with about 60% three months ago.

What to look out for

Capital market volatility. Volatility is likely to persist, with the threat of faster-than-anticipated tightening of U.S. monetary policy, or a return of currency volatility in Southeast Asia taking turns in testing investor sentiment. A prolonged Russia-Ukraine crisis is further adding to this volatility as persistent inflationary pressures, driven by elevated commodity prices and higher input costs, may force central banks to frontload their tightening measures.

Financial Institutions

Economic Headwinds Will Challenge Banks

Key Takeaways

- The notably weaker growth outlook and prospects for higher inflation in many jurisdictions will increasingly burden bank borrowers and in turn banks' asset quality.
- While most banking systems have some resilience at current rating levels, financial institutions in Malaysia, Indonesia, Thailand, and New Zealand face greater challenges.
- A further economic step-change towards the downside may prove to be a more broad-based test of ratings and outlooks for both banks and nonbank financial institutions.

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What's changed?

Economic pressures are building. Weaker economic conditions and tighter financial conditions will increasingly strain banks. We expect a lag between when the stresses currently being felt by borrowers will hit banks. Should economic drags be more severe or persistent beyond our base case, negative ratings momentum would seem inevitable.

Negative trends may become more broad-based. Of the 19 Asia-Pacific banking jurisdictions we cover, economic trends negatively impacting banks may spread beyond the four jurisdictions we currently identify where bank ratings are most vulnerable (Indonesia, Malaysia, Thailand, and New Zealand). Further, greater credit differentiation could arise between strong, systemically important banks versus small banks. Also, typically smaller, and lower rated, certain nonbank financial institutions may also fare worse as economic prospects deteriorate.

Key risks

Economic downside risks intensify. Materially weaker economic prospects outside our base case, including weaker growth and higher-than-anticipated inflation and borrowing costs, would eventually hurt banks. These higher risks are superimposed upon already more-highly-levered corporate and government sectors compared to pre-pandemic levels, and some property markets already under stress, notably China. While some negative risks may take longer to manifest upon banks compared with other sectors, they could eventually be significant especially if the downside scenario takes center-stage.

Key assumptions

Revised economic base case holds. While our base case has been revised negatively during 2022, the negative effect on banks so far is constrained to a few jurisdictions. We expect many banking sectors to continue to show some resilience; nonetheless, this assumption will be tested should our downside scenario become the new normal.

Highly supportive governments. We expect extraordinary government support would be extended to many systemically important banks, in the unlikely event it were required.

What to look for

Severity and timing. A more severe or prolonged downturn is likely to be the key precursor for more broad-based and less-nuanced negative ratings momentum across the sector.

Insurance

Volatile Capital Markets Strain Profitability

Key Takeaways

- Stable credit trends should largely prevail, but lower asset valuation will dampen capital buffers.
- Volatile share market and heightening counterparty risk could strain overall profitability.
- Slowing economic growth in some markets could impede premium recovery.

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What's changed?

Fluctuating capital market dents earnings prospects. This will in turn narrow insurers' capital buffer. Those that previously increased their appetite for credit risk could be exposed to rising defaults. Rate hikes in many markets (though not in China) will knock asset valuation. Further, a gradual rise in interest rate differential could hike hedging costs. Insurers' unhedged FX exposure could also add to earnings volatility. On the other hand, higher rates will ease demand on reserve positions for life insurers. Meanwhile, COVID insurance policies in Taiwan and Thailand could see mounting losses, diluting insurers' capital buffer.

Uneven growth recovery. China's zero COVID stance constrains new business momentum, evident from the limited sales activity during the Shanghai lockdown. Meanwhile, insurers undergoing product and channel reform could face slower interim growth.

Key risks

Persistent market volatility. Spillovers from slowing growth in the region's major economies and the Ukraine war could increase market volatility. Sharp and prolonged market fluctuations and asset impairments could dent insurers' capital and earnings.

Increasing frequency of natural disasters. Climate change and rapid urbanization in emerging Asia calls for more regular updates on catastrophe models. Increasing reinsurance costs could weigh on non-life insurers' profit margins.

Key assumptions

Capital buffer will narrow. Asset valuation declines eat into capital buffers, despite being shored up from previously realized investment gains. Pressure for reserve provisioning will gradually ease amid rising interest rates (except in China).

What to look for

Evolving regulatory and accounting developments. These signify prospective changes in business and investment strategies, resulting in rising operational costs.

Public Finance

Fiscal Consolidation Amid External Challenges

Key Takeaways

- Energy price shocks, inflation risks, and rate hikes will hit local governments and their associated enterprises.
- China to face additional challenges amid property strains as well as extensive lockdown to contain COVID cases.
- Local governments in Australia, New Zealand, and China are using large infrastructure projects to stimulate economies, a practice that will persist until at least 2023.

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What's changed?

Reopening of borders in most parts of Asia-Pacific. Most localities are easing border restrictions to live with the virus while China continues its low tolerance policy.

China's strict containment slows growth. Extensive lockdown in major cities, like Shanghai, have led to weakening macro factors since March, and social discontentment.

Key risks

Economic shock. Unexpected external factors or resumption of COVID restrictions beyond China could further pressure local consumption, supply chains and economic growth. This would shrink or delay revenue growth for local and regional governments (LRGs). China's pursuit of zero-COVID weakens fiscal strength for its LRGs.

Delayed fiscal recovery. To prevent slowdown or restore social confidence, selective LRGs could resume aggressive fiscal stimulus, including tax cuts and more spending that will disrupt fiscal recovery and lift debt burdens. In China, prolonged weak land demand will slow local growth, prompting LRGs to focus fiscal stimulus on new infrastructure projects.

Key assumptions

Public finance systems largely stable. Most regions seek transition to a post-COVID world and gradual recovery of fiscal performance. Australian and New Zealand LRGs continue to utilize their spending discretion to fund an economic and fiscal recovery, but expansionary policies weigh on their finances. Easing border restrictions in Australia are supporting the higher-education sector. China's LRGs can still rely on large cash transfers and new borrowings, subject to support from the central government. The finances of Indian LRGs remain stretched and are handicapped by limited financial flexibility. That said, support from the Reserve Bank of India has been providing states with sufficient external liquidity. Japanese LRGs continue to look to the central government to undertake nationwide economic stimulus, as they seek to shift budgets to a fiscal recovery phase.

What to look for

Policy shifts. Any aggressive LRG fiscal expansion, either to sustain growth or to maintain social stability, could erode credit quality. Chinese LRGs will see additional debt burden risks if they turn to leveraging their SOE investments to stimulate local economic growth, while concurrently providing support to their SOEs.

Sovereign

Inflation Takes Center Stage

Key Takeaways

- The war in Ukraine has stoked inflation and increased risks to growth. These developments could slow the credit improvement among Asia-Pacific sovereigns.
- The recovery from the pandemic should continue despite these headwinds.

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What's changed?

Intensifying sanctions on Russia prop up commodity and food prices. Some governments have increased subsidies to cushion rising living costs, with a few imposing food export restrictions. These moves may curtail credit improvements if they become persistent.

Rising interest rate expectations. Expectations of monetary tightening in the U.S. and Europe have also pushed up interest rates in Asia-Pacific. Exchange rate volatility, especially on the yen and won, has increased.

Outside China, COVID restrictions have eased markedly. Reduced border controls have allowed a return of tourism and business, relieving burdens on services industries across the region. Investment spending should strengthen and domestic consumption should benefit from these changes, offsetting downward growth pressures from negative external developments.

Key risks

Sudden capital swings. An unexpected deterioration of geopolitical risks or interest rate expectations could see investors withdraw from emerging markets in Asia-Pacific, making financing conditions significantly more challenging for some. Steep exchange rate depreciations could also worsen imported inflation.

Growth and fiscal recoveries interrupted. High inflation, weaker demand and increased uncertainty arising from the Russia-Ukraine war and continued supply-chain disruptions may slow the economic and fiscal recoveries much more than expected.

Key assumptions

Global economic activity recovers, albeit less robustly than earlier expected. Economic recoveries continue but are slowed by higher inflation and uncertainties associated with the Russia-Ukraine conflict. Governments can still lower fiscal deficits meaningfully although a return to pre-COVID fiscal performances will take longer.

What to look for

Widening geopolitical tensions that affect Asia-Pacific more materially. If the war in Europe expands or involves more parties, it would seriously damage investor sentiment and stoke further price increases. Knocks on economies and financial markets in the Asia-Pacific may worsen significantly.

New variants that may prolong the pandemic. Vaccines may be less effective against new variants of COVID, prolonging the pandemic.

Structured Finance

Inflation Spillovers Could Temper Outlook

Key Takeaways

- Mixed outlooks in the region in relation to COVID, interest rates and inflation.
- Unemployment remains steady supporting our stable outlook for consumer asset classes.

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What's changed?

COVID-19 disruptions in China. Borrowers may see some liquidity stress as a result of lockdowns and related knock-on effects to employment, especially in the hardest-hit most sectors and for self-employed borrowers.

Key risks

Inflation and its impact on households. Households are well placed with high and stable employment across most markets in the region. Inflation dynamics are mixed across markets; however, price pressures may start to undermine household balance sheets and purchase decisions. Interest rates have started to increase in some markets across the region which we expect will slow house price growth in those markets.

Effect of COVID policies in China. We expect that any prolonged restrictions on mobility in China may see some impact on delinquency. These effects may vary given the scope of any lockdowns and different geographical distribution of the securitized pools.

Key assumptions

Structural supports. We expect ratings to remain stable, with low numbers of speculative-grade ratings and structural supports to cushion some deterioration. Broadly stable employment trends and low interest rates support debt serviceability on residential mortgage-backed securities (RMBS).

What to look for

ESG in securitization. We are seeing further development of ESG in securitization markets and are likely to see assets with an "E" factor, including for "green" housing assets in Australian RMBS. An increase in new energy vehicles (NEV) sales in China may see increased NEV assets in auto ABS.

Appendix 1: Ratings trends

Table 1

Net Outlook Bias Of Asia-Pacific Issuers By Sector, May 31, 2022

	May 2021	Aug 2021	Oct 2021	Feb 2022	May 31, 2022	No. of entities	Notional average rating
Auto OEM and suppliers	-42%	-24%	-12%	-3%	-3%	32	BBB
Building materials	0%	-6%	-6%	-7%	-14%	14	BBB-
Business services	-21%	-8%	-25%	-23%	-17%	12	BB+
Capital goods	-19%	-17%	-17%	-29%	-19%	36	BBB
Chemicals	-20%	-13%	-7%	0%	0%	36	BBB-
Consumer products	-3%	-4%	-4%	-8%	-11%	28	BBB
Diversified	0%	13%	13%	20%	0%	15	A-
Healthcare	-14%	-14%	-14%	-11%	-22%	9	BB+
Hotels, gaming and leisure	-45%	-25%	-20%	-19%	-24%	21	BB+
Investment company	-11%	0%	0%	0%	0%	8	A-
Media and entertainment	-22%	-20%	-20%	-20%	-20%	10	BBB+
Metals and mining	-9%	5%	11%	9%	9%	58	BB+
Oil and gas	-16%	-21%	-21%	-26%	-17%	23	BBB+
Real estate development	-13%	-12%	-18%	-32%	-39%	49	BB-
Real estate investment trusts	-11%	-8%	-12%	-12%	-13%	52	BBB+
Retail	-29%	-29%	-29%	-31%	-19%	16	BBB
Technology	-8%	0%	0%	0%	-2%	53	BBB-
Telecommunications	-26%	-24%	-21%	-7%	-10%	29	BBB+
Transportation cyclical	-32%	-26%	-11%	-11%	-17%	18	BBB-
Transportation infrastructure	-20%	-10%	-8%	-7%	-10%	60	A-
Utilities	-2%	-4%	-5%	-4%	-5%	94	BBB+
Total corporates	-15%	-10%	-9%	-9%	-10%	673	BBB
Financial institutions	-6%	-1%	1%	3%	-1%	378	BBB+
Insurance	-3%	-2%	-1%	-3%	-2%	176	A
Public finance	-19%	-16%	-14%	-13%	-13%	87	A+
Sovereign	-14%	-10%	-7%	-7%	-7%	30	BBB+
Total issuers	-11%	-7%	-5%	-5%	-7%	1,344	BBB+

We calculate the net outlook bias by deducting the percentage of negative outlooks and CreditWatch negative listings against the percentage of positive outlooks and CreditWatch positive listings. A minus figure indicates that the former exceeds the latter, and a positive figure, vice versa. OEM--Original equipment manufacturer.

Light blue colored cells indicate improvement from prior period, navy blue, deterioration.

Appendix 2: Economic data and forecast summaries

Table A1

Australia--S&P Global Ratings Economic Outlook

	2021a	2022f	2023f	2024f	2025f
Real GDP %	4.7	3.6	2.8	2.7	2.7
Inflation %	2.8	5.0	3.0	2.5	2.4
Unemployment rate %	5.1	4.0	3.9	3.9	3.9
Policy rate % (EOP)	0.1	1.75	2.5	2.75	2.5
Exchange rate (US\$ per A\$)	0.73	0.70	0.71	0.72	0.73

Inflation and unemployment rate shown are the period average. a--Actual. f--Forecast. EOP--End of period. A\$--Australian dollar.

Sources: Oxford Economics, S&P Global Ratings.

Table A2

China--S&P Global Ratings Economic Outlook

	2021a	2022f	2023f	2024f	2025f
Real GDP %	8.1	3.3	5.4	4.9	4.7
Inflation %	0.9	2.3	2.5	2.2	2.2
Unemployment rate %	5.2	5.9	5.8	5.7	5.6
Exchange rate (US\$)	6.35	6.82	6.75	6.69	6.62

Inflation and unemployment rate shown are the period average. a--Actual. f--Forecast. EOP--End of period.

Sources: Oxford Economics, S&P Global Ratings.

Table A3

Hong Kong--S&P Global Ratings Economic Outlook

	2021a	2022f	2023f	2024f	2025f
Real GDP %	6.4	1.0	4.2	2.4	1.9
Inflation %	1.6	2.1	2.2	2.1	2.0
Unemployment rate %	5.2	4.7	3.6	3.5	3.4
Exchange rate (US\$)	7.8	7.85	7.8	7.8	7.8

Inflation and unemployment rate shown are the period average. a--Actual. f--Forecast. EOP--End of period.

Sources: Oxford Economics, S&P Global Ratings.

Table A4

India--S&P Global Ratings Economic Outlook

	2021a	2022f	2023f	2024f	2025f
Real GDP %	8.7	7.3	6.5	6.7	6.9
Inflation %	5.5	6.8	5.0	4.5	4.5
Policy rate % (EOP)	4.00	5.65	5.25	5.00	5.00
Exchange rate (US\$)	76.5	78.0	79.5	81.0	82.0

Inflation and unemployment rate shown are the period average. For India, 2021 means fiscal 2021/2022 (year ending March 31, 2022); 2022 means fiscal 2022/2023 (year ending March 31, 2023); and so forth. a--Actual. f--Forecast. EOP--End of period.

Sources: Oxford Economics, S&P Global Ratings.

Table A5

Indonesia--S&P Global Ratings Economic Outlook

	2021a	2022f	2023f	2024f	2025f
Real GDP %	3.7	5.1	5.0	5.0	5.0
Inflation %	1.6	4.1	4.0	3.6	3.6
Unemployment rate %	6.3	5.6	5.4	5.2	5.2
Policy rate % (EOP)	3.50	4.00	4.75	5.25	5.50
Exchange rate (US\$)	14,253	14,800	14,900	15,000	15,100

Inflation and unemployment rate shown are the period average. a--Actual. f--Forecast. EOP--End of period.

Sources: Oxford Economics, S&P Global Ratings.

Table A6

Japan--S&P Global Ratings Economic Outlook

	2021a	2022f	2023f	2024f	2025f
Real GDP %	1.7	2.0	2.0	1.1	1.0
Inflation %	-0.2	2.2	1.4	1.0	1.0
Unemployment rate %	2.8	2.6	2.5	2.5	2.4
Policy rate % (EOP)	-0.10	-0.10	0.00	0.00	0.10
Exchange rate (US\$)	115.0	135.0	131.0	127.1	123.3

Inflation and unemployment rate shown are the period average. a--Actual. f--Forecast. EOP--End of period.

Sources: Oxford Economics, S&P Global Ratings.

Table A7

Malaysia--S&P Global Ratings Economic Outlook

	2021a	2022f	2023f	2024f	2025f
Real GDP %	3.1	6.1	5.0	4.6	4.6
Inflation %	2.5	2.9	2.2	2.3	2.3
Unemployment rate %	4.6	3.9	3.6	3.3	3.2
Policy rate % (EOP)	1.75	2.50	3.00	3.25	3.25
Exchange rate (US\$)	4.18	4.32	4.22	4.12	4.04

Inflation and unemployment rate shown are the period average. a--Actual. f--Forecast. EOP--End of period.

Sources: Oxford Economics, S&P Global Ratings.

Table A8

New Zealand--S&P Global Ratings Economic Outlook

	2021a	2022f	2023f	2024f	2025f
Real GDP %	5.0	2.6	3.3	2.6	2.5
Inflation %	3.9	5.7	2.6	2.5	2.3
Unemployment rate %	3.8	3.3	3.4	3.7	3.8
Policy rate % (EOP)	0.75	3.00	3.25	3.25	3.00
Exchange rate (US\$ per NZ\$)	0.68	0.64	0.65	0.66	0.67

Inflation and unemployment rate shown are the period average. a--Actual. f--Forecast. EOP--End of period. NZ\$--New Zealand dollar.

Sources: Oxford Economics, S&P Global Ratings.

Table A9

Philippines--S&P Global Ratings Economic Outlook

	2021a	2022f	2023f	2024f	2025f
Real GDP %	5.6	6.5	6.6	6.9	6.6
Inflation %	3.9	4.6	3.7	2.6	2.6
Unemployment rate %	7.8	6.4	5.6	5.0	4.4
Policy rate % (EOP)	2.00	3.00	3.25	3.75	3.75
Exchange rate (US\$)	50.8	53.35	53.75	52.94	52.48

Inflation and unemployment rate shown are the period average. a--Actual. f--Forecast. EOP--End of period.

Sources: Oxford Economics, S&P Global Ratings.

Table A10

Singapore--S&P Global Ratings Economic Outlook

	2021a	2022f	2023f	2024f	2025f
Real GDP %	7.6	3.3	2.6	2.9	2.8
Inflation %	2.3	5.0	2.7	2.0	1.9
Unemployment rate %	2.7	2.2	2.1	2.1	2.0
Exchange rate (US\$)	1.35	1.38	1.35	1.34	1.34

Inflation and unemployment rate shown are the period average. a--Actual. f--Forecast. EOP--End of period.

Sources: Oxford Economics, S&P Global Ratings.

Table A11

South Korea--S&P Global Ratings Economic Outlook

	2021a	2022f	2023f	2024f	2025f
Real GDP %	4.0	2.6	2.5	2.4	2.2
Inflation %	2.5	5.0	2.4	1.8	1.6
Unemployment rate %	3.6	3.6	3.5	3.4	3.3
Policy rate % (EOP)	1.00	2.25	2.50	2.50	2.50
Exchange rate (US\$)	1,185	1,296	1,270	1,245	1,220

Inflation and unemployment rate shown are the period average. a--Actual. f--Forecast. EOP--End of period.

Sources: Oxford Economics, S&P Global Ratings.

Table A12

Taiwan--S&P Global Ratings Economic Outlook

	2021a	2022f	2023f	2024f	2025f
Real GDP %	6.6	2.8	2.7	2.6	2.5
Inflation %	2.0	3.2	2.6	1.1	0.8
Unemployment rate %	4.0	3.6	3.5	3.5	3.5
Policy rate % (EOP)	1.13	1.75	1.88	2.00	2.00
Exchange rate (US\$)	27.7	29.5	29.2	28.7	28.3

Inflation and unemployment rate shown are the period average. a--Actual. f--Forecast. EOP--End of period.

Sources: Oxford Economics, S&P Global Ratings.

Table A13

Thailand--S&P Global Ratings Economic Outlook

	2021a	2022f	2023f	2024f	2025f
Real GDP %	1.5	3.2	4.2	3.8	3.6
Inflation %	1.2	6.0	2.3	1.0	1.0
Unemployment rate %	1.9	1.8	1.7	1.4	1.3
Policy rate % (EOP)	0.50	1.00	1.50	1.75	2.00
Exchange rate (US\$)	33.4	35.1	35.5	35.9	36.3

Inflation and unemployment rate shown are the period average. a--Actual. f--Forecast. EOP--End of period.

Sources: Oxford Economics, S&P Global Ratings.

Table A14

Regional--S&P Global Ratings Economic Outlook

Real GDP (%)	2021a	2022f	2023f	2024f	2025f
Asia Pacific	6.6	4.2	5.0	4.7	4.6
Eurozone	5.4	2.6	1.9	1.8	1.6
Latin America 5	6.5	1.9	1.7	2.2	2.2
U.S.	5.7	2.4	1.6	1.9	2.1

Asia-Pacific and Latin America 5 aggregate GDP growth numbers are based on current purchasing power parity GDP weights. U.S. percentages are annual average percentage changes. a--Actual. f--Forecast.

Source: Oxford Economics, S&P Global Ratings.

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