S&P Global Ratings

Credit Conditions Emerging Markets Q4 2022

Clouds Are Gathering

Sept. 27, 2022

This report does not constitute a rating action

Editor's Note: S&P Global Ratings' Credit Conditions Committees meet quarterly to review macroeconomic conditions in each of four regions (Asia-Pacific, Emerging Markets, North America, and Europe). 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 Emerging Market committee on Sept. 19, 2022.

Key Takeaways

Overall: Tightening financing conditions, slower growth in China, weaker economic prospects in Europe, and a potentially deeper recession in the U.S. than projected signal tough times ahead for emerging markets (EMs).

With core inflation picking up, monetary policy will likely continue to tighten. Coupled with persistently high energy and food prices, we expect the effects on EM households, corporations, and banks to start surfacing.

Risks: A resolution of the Russia-Ukraine conflict seems far off. This--in addition to sustained gas supply disruption in Europe, more aggressive tightening by the Fed, and lower growth momentum in China--could hurt EMs by dampening global economic and trade growth.

Financing will be harder to come by and the strengthening of the U.S. dollar is not helping. Such a situation could fuel tensions and trigger social unrest, particularly for EMs with limited fiscal space or high debt. We believe international support is key to alleviating the pressure.

Credit: We expect our negative outlook bias for rated issuers across EMs to widen over the coming quarters because rising interest rates, persistent inflation, and weakening demand could erode corporate profits, households' purchasing power, and banks' asset quality. Few issuers will continue to benefit from this complex panorama, mainly commodity exporters.

Regional Credit Conditions Chair

Mohamed Damak
Dubai
mohamed.damak
@spglobal.com
+971-4372-7153

Jose M Perez-Gorozpe
Madrid
jose.perez-gorozpe
@spglobal.com
+34-914-233-212

Contents

Top EM Risks 2
Regional Credit Conditions 3
Macroeconomic Conditions 6
Financing Conditions 11
Sovereigns 13
Corporates 18
Financial Institutions 23
Appendix: Economic Data And Forecast Summaries 29
Related Research 32

Top EM Risks

Further monetary tightening in the U.S. weakens financing conditions

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

With the U.S. Federal Reserve (Fed) effectively pledging to do whatever it takes to bring persistent inflation under control, there's a growing risk of interest rates staying higher for longer. This could not only heighten market volatility but also make overall financing conditions tougher for issuers across EMs. Furthermore, the U.S. could experience a deeper recession than we currently expect. This would hamper economic conditions across many EMs, particularly those with high trade links with the U.S. or receive substantial remittances from the U.S. It could also cause financing conditions to deteriorate further, and likely depress investors' appetible for EM debt, while continued dollar strengthening could trigger an increase in capital outflows and lead to a sharp rise in refinancing risk for issuers with dollar-denominated debt. Lower-rated borrowers would be first to feel the impact of tighter financing conditions.

High inflation squeezes the finances of corporations, households, and banks

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

Although moderating, persistently high energy and food prices, and increasing core inflation, are likely to affect EM households, corporations, and banks. Corporates' capacity to pass through higher costs to customers is ebbing, due to households' decreasing purchasing power. The pressure may also increase for some EM sovereigns, since higher commodity prices mean increased subsidies, thereby diminishing their fiscal leeway. If this continues, corporate margins could shrink further, households' credit quality become weaker than we expect, pressure on sovereigns could increase, and ultimately banks' asset quality indicators would suffer.

Increasing geopolitical tensions and difficult domestic socio-political conditions erode credit fundamentals

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

The potential for a near-term resolution of the Russia-Ukraine conflict is waning. Disruption of gas supply from Russia, as a consequence, is weighing on Europe's economic outlook for 2023 and increasing risks for EMs with strong links with Europe (such as trade, tourism, and remittances). Additional escalation and a continued rise of energy and food prices could push down confidence and growth. It could also fuel tensions and trigger social unrest, particularly for EMs with limited fiscal space or high debt, such as in the Middle East and Africa. International support (either bilateral or multilateral) will be key to easing the pressure.

China's soft economic recovery from adherence to a prolonged zero-COVID policy or weak rebound in business and household confidence

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

China's COVID lockdowns and a crackdown on the real estate sector have stalled its economic growth momentum, denting business activity, household confidence, and employment. In particular, the crackdown in recent years on the overleveraged property sector has shaken this significant driver of the world's second-largest economy. Concurrently, the government's mobility restrictions to curb COVID case rises have hit consumption, intensifying credit pressures faced by services sector and SMEs. Even if the policy is lifted (possibly in 2023), China will be emerging into a much less conducive global environment (both economically and geopolitically). Economic losses sustained by corporate and household sectors in 2022 could undermine a rebound of activity in 2023. Additional government spending, if any, is unlikely to be an immediate panacea. These developments will affect EM countries reliant on China for tourism, exports, imports (product components), finance, or the supply chain.

Structural risks

Climate change and rising adaptation costs

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

Larger, more frequent natural disasters increase physical risks for public- and private-sector entities and threaten to disrupt supply chains such as for agriculture and food in some EMs. EMs near the equator are particularly exposed to heatwaves and droughts as global warming increases, while island states are set to face more frequent storms and exposure to higher sea levels. At the same time, stepping up adaptation to climate change may represent an additional fiscal burden for the most vulnerable countries and higher costs for private-sector entities.

Source: S&P Global Ratings.
Risk levels may be classified as very low, moderate, elevated, high, or very high. They are evaluated by considering both the likelihood and systemic impact 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 about whether the risk level could increase or decrease over the next 12 months.

Regional Credit Conditions

We expect credit conditions to worsen for EMs, given the confluence of tightening financing conditions, slowing growth in China and Europe, and the potential for a steeper-than-expected recession in the U.S. While 2022 started well for EMs, growth began to decrease in the second quarter and will likely keep decelerating for most key countries (see chart 1).

We expect our negative bias to deepen over the coming quarters amid rising interest rates, persistent inflation, and weakening demand. At the same time, EM sovereigns will likely start feeling the pinch, particularly those that may require additional funding for measures to offset households' mounting energy and food bills.

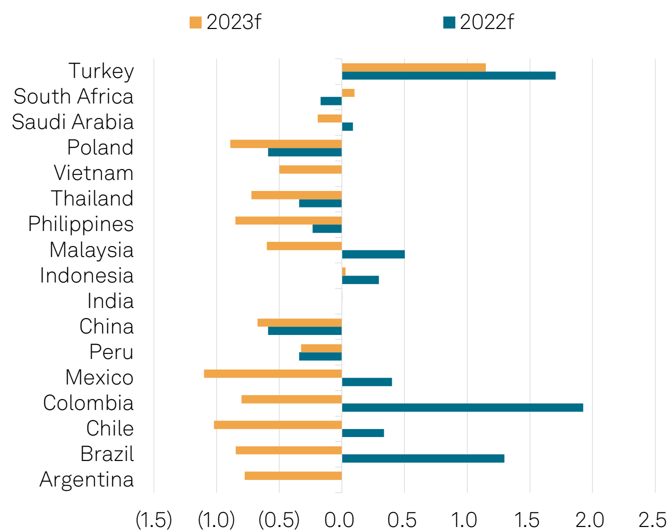
Financing conditions are becoming more difficult

We expect EMs will continue to face a tough environment this year and next. Although spreads eased somewhat in August, yields have started widening amid more hawkish statements by the Fed. This, alongside the strengthening of the U.S. dollar is bad news for EMs, since on average 80% of EM corporates' debt maturing in 2023 (with a global scale rating from S&P Global Ratings) is in U.S. dollars. Central banks in most key EMs have also raised their interest rates. Rising core inflation will add to the pressure, even though headline inflation has moderated in some countries.

A few EMs, most notably within Latin America, are approaching the end of their rate-hike cycles (see chart 2), but this doesn't mean policy rates will go down soon. The cost of financing is increasing for all issuers while access to financing is more difficult. Lower-rated issuers still face hurdles in refinancing their debt. Domestic capital markets and bank financing are feasible alternatives for small issuances, but at shorter terms and higher financing costs. Since some speculative-grade issuers are trading at discounted prices and corporate performance is coming under increasing pressure, we may ultimately see an increase in the number of distressed exchanges.

Chart 1

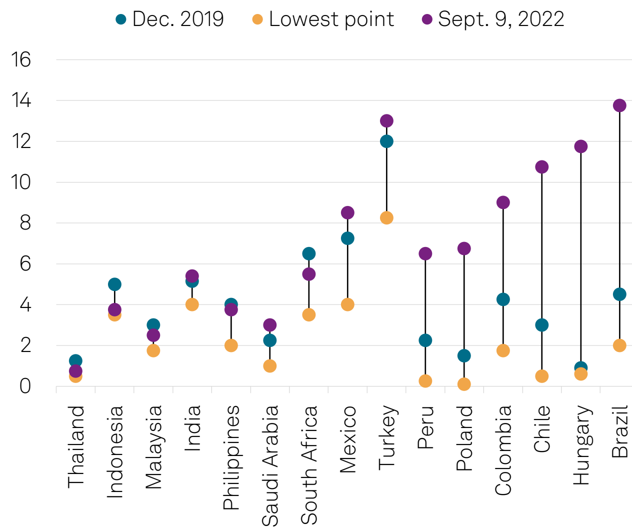
Change in baseline forecast from June 2022



f--Forecast. Source: S&P Global Ratings.

Chart 2

EM central banks have tightened monetary policy



Source: S&P Global Ratings.

Rising core inflation hints at possibly stubborn price increases

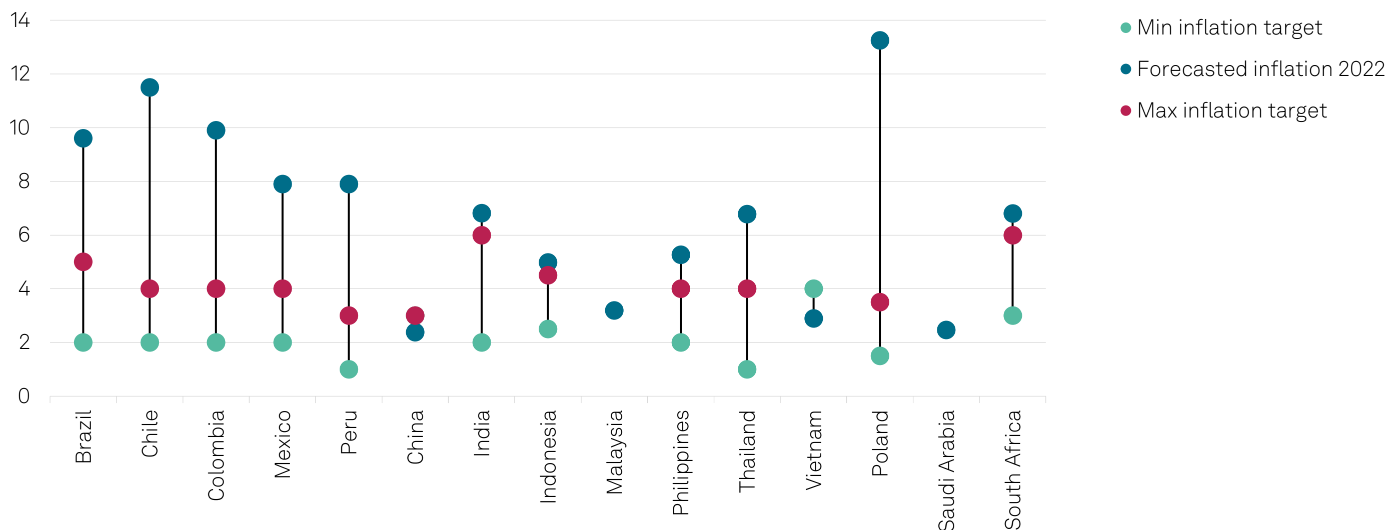
Commodity prices have abated but remain elevated. Although supply-chain pressures have eased, this area is still vulnerable to the implications of China's zero-COVID policy. Current price and external developments have led EM central banks to raise interest rates and, except in a few economies, we expect this will continue. Overall, this could depress corporate margins if producers are unable to pass on price increases due to end customers' weakening purchasing power. Ultimately, this could weigh on banks' asset quality.

In our base case, we assume most investment-grade corporations across EMs should be able to weather worsening conditions (see Macroeconomic Conditions below). However, their financial metrics will likely deteriorate further. There could be downgrades, rising defaults, or distressed exchanges among speculative-grade issuers. A more acute slowdown than expected in the U.S., Europe, and China would strain financial metrics further and accentuate the pressure on ratings.

Persistently high fuel and food prices could hurt EMs, impairing GDP growth, fiscal performance, and social stability. The potential impact on sovereign credit ratings will depend on, among other things, governments' ability to minimize the social and economic costs, and international efforts to help vulnerable countries. Although many of the sovereigns most exposed already have very low credit ratings, additional downgrades could follow.

Chart 3

Inflation remains high (%)



Source: S&P Global Ratings.

Domestic and international political developments accentuate risks

The global fallout of the ongoing Russia-Ukraine military conflict, more recently disruption of the gas supply to Europe, is also clouding economic prospects for EMs. Simultaneously, many EMs' local political landscape is becoming more complex, either due to election cycles or the impact of high commodity prices on social stability.

A handful of countries, mainly commodity exporters, will benefit from high commodity prices, but higher food prices will continue to hit low-income economies hard. EM sovereigns are facing the trilemma of fiscal consolidation, achieving socio-political stability, and getting the necessary financing on acceptable terms. Bilateral and multilateral support will be key for the latter.

Credit quality is on a downward path

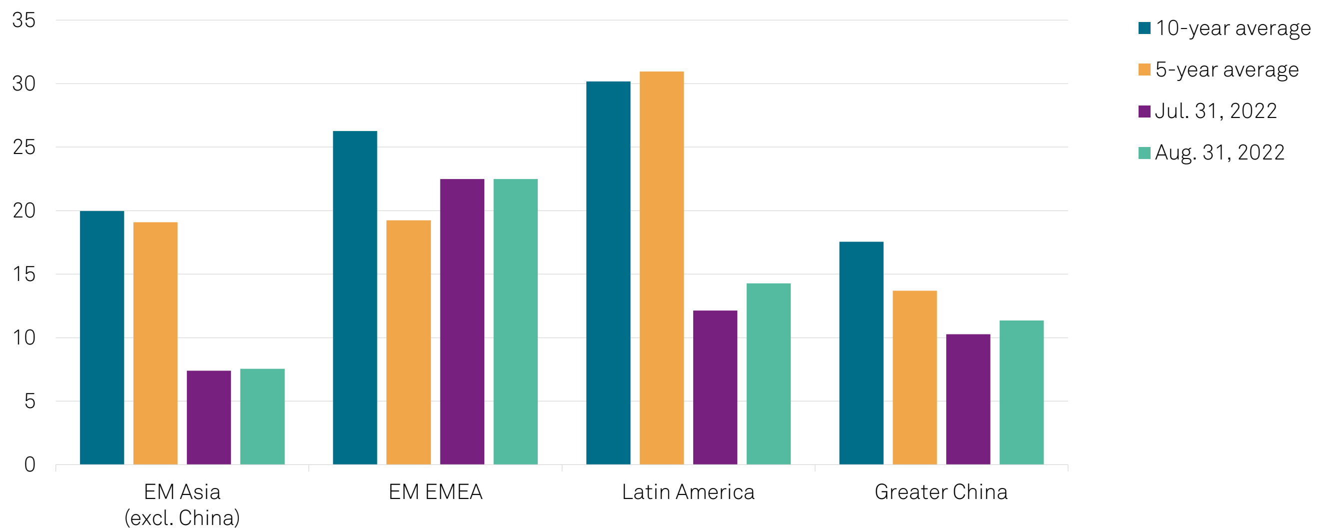
Our negative rating bias will probably widen in most EM economies as confluent risks erode issuers' credit quality.

- EM Asia (excluding China) has the lowest downgrade potential, thanks to expected economic growth stability in most countries.
- EMs in Europe, the Middle East, and Africa (EMEA) have the highest downgrade potential although it remains lower than the 10-year average.
- In Latin America, the negative bias remains noticeably below that in previous years (see chart 4), due mainly to two factors. First, our ratings reflect our assumption of continued economic recovery and falling unemployment in the remainder of 2022. Second, the region saw several downgrades over the past few years, so our ratings are generally much lower than in previous years, reflecting issuers' increased vulnerability.

Chart 4

EM EMEA shows the highest downgrade potential

Negative bias (%)



Data as of Aug. 31, 2022, and exclude sovereigns. Latin America: Argentina, Brazil, Chile, Colombia, Mexico, Peru. Emerging Asia: India, Indonesia, Malaysia, Thailand, Philippines, Vietnam. EM EMEA: Poland, Saudi Arabia, South Africa, Turkey. Greater China: China, Hong Kong, Macau, Taiwan, and Red Chip companies. Source: S&P Global Ratings Research.

Macroeconomic Conditions

Primary contacts

Satyam Panday
New York
satyam.panday@spglobal.com
+1-212-438-6009

Tatiana Lysenko
Paris
tatiana.lysenko@spglobal.com
+33-14-420-6748

Elijah Oliveros
New York
elijah.oliveros@spglobal.com
+1-212-438-2228

Vishrut Rana
Singapore
vishrut.rana@spglobal.com
+65-6216-1008

(Editor's Note: The views expressed in this section are those of S&P Global Ratings' economics team. While these views can help to inform the rating process, sovereign and other ratings are based on the decisions of ratings committees, exercising their analytical judgment in accordance with publicly available ratings criteria.)

- **Macroeconomic headwinds continue to reflect increased global economic policy uncertainty.** China is still doggedly pursuing its zero-COVID policy; Russia's armed conflict with Ukraine is continuing; governments face a tricky trade-off between managing public debt and macroeconomic stability; and major central banks (except in Japan and China) are maintaining a hawkish monetary policy stance to address above-target inflation.
- **Risks outlined in our June forecast, relating to China and Europe's gas supply, have materialized.** In China, economic growth weakened again in the third quarter as new COVID-19 outbreaks and mobility restrictions took hold. The central government has so far refrained from providing significant stimulus and supporting consumption. In Europe, the shutdown of Nord Stream 1's pipeline has disrupted gas flows from Russia.
- **The Fed has become decidedly hawkish in its various communications since August.** The median and trimmed mean CPI inflation data in the U.S. continued their upside surprises. We now project that the Federal funds rate could reach 4.0%-4.25% in the first quarter of 2023, an appreciably swift rate hike, and settle about 50 basis points higher than envisioned just three months ago.
- **In September, S&P Global Ratings further trimmed its growth projections for key large economies**. We now foresee even slower growth next year across most EMs. We cut our forecast for growth in China to 2.7% in 2022 from 3.3%, and to 4.7% in 2023 from 5.4%. In the eurozone and U.S., a recession--loosely defined as two consecutive quarters of contraction--is now more likely within the next 12 months. We revised down our 2023 growth forecasts for EMs by 0.5 percentage points but see substantial risks to those projections.

Economic activity eased in many core EMs in Q2, with private consumption carrying the burden of growth. There were few exceptions, such as Brazil, Colombia, Indonesia, and Turkey. The ongoing cyclical recovery of private consumption and tourism helped such economies weather deteriorating external economic conditions. Household spending was buoyed by ongoing government support, such as a recent decrease in fuel taxes and increased cash transfers in Brazil, or the resilient labor market in Poland.

High-frequency indicators depict a varied picture for Q3. Of the 13 EMs with published data, the manufacturing PMI (S&P Global Market Intelligence Purchasing Managers' Index) in almost half showed expansion and, for many, an improvement versus July, while in Poland, Turkey, Mexico, and China we saw a retreat. There were surprisingly large rebounds for Colombia and South Africa, both moving from contraction to expansion (above 50) in August. Saudi Arabia's oil and non-oil sectors continue to perform strongly, with economy growth set to become the fastest in the G-20.

Already, weaker external demand for goods and souring consumer sentiment seem to be playing an important role. The new export orders PMI declined further--below 50 (signaling contraction)--in August, except in South Africa, India, Vietnam, and Saudi Arabia. In addition, elevated prices of food and fuel have exacerbated households' worries about affordability. The Ipsos Consumer Confidence Index was below the 2019 average in August for most EMs (India and Saudi Arabia were exceptions).

First-quarter growth spurts led to an uptick in our 2022 GDP forecasts for our EM sample, excluding China, but mask a weaker second half. For 2022, we revised downward our projections for Poland (partly due to its proximity to Germany's industrial nexus and the war), South Africa (increased electricity interruptions), Thailand, Philippines, and Peru (weaker-than-expected Q2 domestic demand).

We now see even slower growth in 2023 across most EMs. Slowing growth in China, the eurozone, and U.S. (see table 1), along with a turn in the electronics cycle will weaken trade through next year. Consumption growth will likely remain resilient but moderate as the impetus from post-pandemic reopening fades. However, we've revised up our growth forecast for Turkey in 2023 by more than a percentage point, anticipating additional policy support before its elections and still deeply negative real interest rates. But risks of another bout of financial market volatility, exchange rate depreciation, and abrupt adjustment are mounting.

Table 1

Growth is slowing down in most EMs

	2019	2020	2021	2022f	2023f	2024f	2025f
EM-17	3.7	(2.5)	6.9	4.3	4.0	4.4	4.3
EM-16 (excludes China)	2.5	(5.2)	6.2	5.2	3.6	4.1	4.1
EM-Latin America	0.7	(6.5)	6.7	2.8	0.9	2.2	2.3
EM-Southeast Asia	4.8	(3.7)	3.4	5.4	4.9	5.0	4.9
EM-EMEA	1.2	(3.4)	5.1	5.5	2.3	2.7	2.3

f--Forecast. Source: S&P Global Ratings economists.

But It's Not All Doom And Gloom

We assume that **China**'s likely move away from its zero-COVID policy after the first quarter of 2023 will have a positive economic impact for the year. In particular, Chinese tourists travelling after Q1 should help the tourism sector’s recovery (especially in South-East Asia).

For **energy exporters**, such as **Saudi Arabia**, terms of trade should remain favorable in 2023, assuming the Brent oil price averages $85 per barrel, even though oil prices have come off their peaks. For Saudi Arabia, ongoing fast growth of the non-oil sector should also help offset an anticipated decline in oil production next year. Alongside strong oil-sector dynamics, the economy's structural diversification away from oil and upstream crude production continues, with the non-oil private sector accounting for well over half of GDP, significantly higher than a decade ago (however, much of the non-oil sector is in petrochemicals and hydrocarbon-related activities). The government will continue to pursue its ambitious Vision 2030 diversification program via investment in the non-oil economy, restructuring the workforce (replacing expatriates with Saudis), increasing female participation in the workforce, efforts to improve the business environment, and socioeconomic liberalization.

In **South Africa**, where the government lifted the licensing threshold for small power generation projects to 100 megawatts, private investment in renewable energy is likely to get a boost from 2023. The energy crisis in Europe has led to higher demand for (and increased prices of) alternative energy sources, such as coal, an important export for **Colombia, Indonesia, Brazil, India, Malaysia, and South Africa**. Columbian coal export volumes rose 25% quarter on quarter in Q2 last year (70% in nominal terms). Assuming shortages in natural gas/oil-generated energy continue into 2023, demand for Colombian and South African coal could remain strong.

Inflation forecasts for 2022 and 2023 are higher than previously. Headline inflation, although still elevated, has reduced in some EMs, in part reflecting a decrease of energy and food prices, helped in some cases by price caps on fuel. In Brazil, in particular, CPI prices dropped on a month-over-month sequential basis two months in a row in August. More generally, supply chain pressures have eased and container shipping costs have fallen from their 2021 peaks. PMIs for supplier delivery times have also improved over the past few months.

Still, we expect core inflation to stay above EM central banks’ targets (except in China, Saudi Arabia, and Vietnam) for the rest of the year and well into next year. This as past increases in energy costs and higher import prices from currency depreciation spill into broader core items. On a sequential basis, inflation appears to have peaked in Latin America in the first half of 2022,

but will remain elevated due to second round effects, as higher energy and food prices flow through to services prices. What's more, we see a significant risk that energy prices could climb further, particularly for economies in Central and Eastern Europe that are highly exposed to elevated and volatile European gas prices. Energy subsidies can alleviate inflationary pressures somewhat but come at a cost. We expect inflation in Poland to peak in Q1 2023 and subside only gradually after that, remaining in double digits next year.

In **Saudi Arabia**, we think headline inflation is close to its peak on a quarter-over-quarter sequential basis and will slow over the fourth quarter and into 2023. Year over year, this translates into inflation peaking in the first quarter and moving back down to 2% by the end of 2023. The Saudi government's cap on local fuel prices will continue to contain energy inflation if global prices start edging up again. In **South Africa**, we also revised up our CPI inflation forecasts to 7%-8% (on a year over year basis) until midyear 2023 and expect it will come down only gradually over the next several quarters. In **EM Asia**, inflation is likely to rise further as domestic demand recovers. We expect core inflationary pressures to pick up even though the headline rate may decline alongside recent easing of global commodity prices.

One exception is **Indonesia**, where the government raised fuel prices to reduce subsidy burdens; we expect this will contribute 2.0 percentage points to 2.5 percentage points of headline inflation in 2023, and now expect inflation in Indonesia to hit 6.2% in 2023 rather than 4%.

Table 2

Inflation remains high

	2019	2020	2021	2022f	2023f	2024f	2025f	Central bank inflation target
Argentina	53.5	42.0	48.4	70.0	90.0	70.0	45.0	No Target
Brazil	3.7	3.2	8.3	9.6	5.1	4.4	3.1	3.5% +/- 1.5%
Chile	2.3	3.0	4.5	11.5	8.0	4.5	3.3	3.0% +/- 1.0%
Colombia	3.5	2.5	3.5	9.9	6.4	3.8	3.0	3.0% +/- 1.0%
Mexico	3.6	3.4	5.7	7.9	6.1	4.1	3.5	3.0% +/- 1.0%
Peru	2.1	1.8	4.0	7.9	5.6	2.9	2.3	1.0% - 3.0%
China	2.9	2.5	0.9	2.4	2.7	2.2	2.2	3%
India	4.8	6.2	5.5	6.8	5.0	4.5	4.5	4.0 +/- 2.0%
Indonesia	2.8	2.0	1.6	5.0	6.2	3.7	3.6	3.5% +/- 1.0%
Malaysia	0.7	(1.1)	2.5	3.2	2.6	2.4	2.4	No Target
Philippines	2.4	2.4	3.9	5.3	4.1	2.8	2.8	3.0% +/- 1.0%
Thailand	0.7	(0.8)	1.2	6.8	3.1	1.1	0.7	2.5% +/- 1.5%
Vietnam	2.8	3.1	1.8	2.9	2.7	2.7	2.5	0.04
Poland	2.1	3.7	5.2	13.3	11.7	4.4	2.5	2.5% +/- 1.0%
Saudi Arabia	(2.1)	3.4	3.1	2.5	2.7	1.8	1.9	No Target
South Africa	4.1	3.3	4.6	6.8	6.4	4.5	4.3	3.0% - 6.0%
Turkey	15.2	12.3	19.6	74.0	40.1	18.0	12.0	5.0% +/- 2.0%
Median	2.8	3.1	4.0	6.8	5.6	3.8	3.0	--
(June forecast)	2.9	3.2	4.5	6.8	4.1	3.2	3.0	--

f--S&P Global Ratings forecast. Source: S&P Global Market Intelligence.

EM central banks will be under increasing pressure to raise rates in the next few quarters in view of higher inflation expectations and the Fed's and other major global central banks' more hawkish stance. Most central banks in **Latin America** have been increasing interest rates for well over a year and are approaching the end of their rate-hike cycles. However, with inflation looking

to stay above targets for some time, EM central banks will tread a cautious path in normalizing monetary policy. We don't expect they will start lowering interest rates at least until the second half of 2023, with their actions continuing to be highly influenced by the Fed's interest rate decisions.

In **EM EMEA**, we still expect Poland's central bank to raise its key rate to 7.5% from 6.75% by the end of 2022 and start lowering it in the second half of 2023 once inflation is firmly heading downward. Turkey's central bank, meanwhile, lowered the policy rate by 200 basis points (bps) to 12% over the third quarter, pushing real interest rates even further into negative territory. There are no signs of a monetary policy reset, and we assume in our base case that the policy rate will remain at 12% this year and next, with a high probability of further cuts before next year's parliamentary and presidential elections slated for around midyear 2023. Considering rising inflation risks and accelerated Fed tightening, we now expect the South African Reserve Bank (SARB) to raise the key policy rate to 6.75% from 6.25% by year's end, and to 7% by the first quarter of next year. As inflation starts moving to the upper bound of the central bank's target (i.e. below 6%), it will begin cutting, but only gradually and with an eye on the Fed. In Saudi Arabia, with the Fed poised to implement further rate hikes in the coming months, we expect monetary policy tightening to be in lock step.

In **Southeast Asia**, central banks have been slower than global peers to tighten monetary policy, since core inflation has been contained. There were capital outflows over the first half of the year, but central banks have buffers to manage them, with some utilizing foreign exchange reserves. Now, however, inflationary pressures are picking up noticeably and U.S. interest rates are set to rise further.

This will prompt EM central banks to move. We expect almost all of them to raise rates, with the quickest rate hike in the Philippines where we forecast the policy rate at 5% at year-end 2022. In Indonesia, we expect the policy rate to reach 4.5% by year's end and 5.5% by year-end 2023 versus the current 3.75%.

Table 3

Policy rates

End of period (%)

	2019	2020	2021	2022f	2023f	2024f	2025f
Argentina	55.0	38.0	38.0	80.0	70.0	55.0	45.0
Brazil	4.5	2.0	9.3	13.8	10.8	7.5	7.5
Chile	1.8	0.5	4.0	11.5	9.0	6.5	4.5
Colombia	4.3	1.8	3.0	11.0	9.0	6.0	5.5
Mexico	7.3	4.3	5.5	10.0	8.5	6.5	6.0
Peru	2.3	0.3	2.5	7.5	6.0	4.5	3.0
India	4.4	4.0	4.0	5.9	5.3	5.0	5.0
Indonesia	5.0	3.7	3.5	4.5	5.5	5.5	5.5
Malaysia	3.0	1.7	1.7	2.8	3.3	3.5	3.5
Philippines	4.0	2.0	2.0	5.0	4.3	3.5	3.5
Thailand	1.3	0.5	0.5	1.5	3.3	2.3	2.0
Poland	1.5	0.1	1.8	7.5	7.0	5.5	3.5
Saudi Arabia	2.7	1.0	1.0	4.5	4.3	3.5	3.5
South Africa	6.5	3.5	3.8	6.8	6.5	6.0	5.8
Turkey	12.0	17.0	14.0	12.0	12.0	10.0	9.5

f--S&P Global Ratings forecast. Source: S&P Global Market Intelligence.

Maintaining anchored inflation expectations and protecting capital flows are top priority for policymakers. The risk of being unable to do so is especially relevant for net energy-importing EMs already in deficit. This is the case in Chile, Poland, India, the Philippines, and Thailand, where current account deficits are at risk of widening due to sustained elevated energy prices. In the coming quarters, that could more than offset the food trade surplus in some of these countries and the recovery of service exports from tourism. Prices for industrial metals have also declined after the rally earlier this year, affecting metal exporters, like those in South Africa, Peru, Chile, and Brazil. Countries with large current account deficits, most notably Chile, are finding their currencies in the crosshairs, prompting foreign exchange intervention to go with already aggressive monetary policy responses. We acknowledge however that most EM currencies were already under pressure amid the more hawkish position of central banks in developed markets and investors' general risk-off mood. That said, central banks' reserve buffers typically remain healthier than in the past (Turkey, Argentina, Chile, and to a lesser extent Colombia stand out as pockets of concern), which may help slow currency depreciation if needed.

Financing Conditions

Primary contacts

Patrick Drury Byrne
Dublin
patrick.drurybyrne
@spglobal.com
+35-31-568-0605

Luca Rossi
Paris
luca.rossi
@spglobal.com
+33-62-518-9258

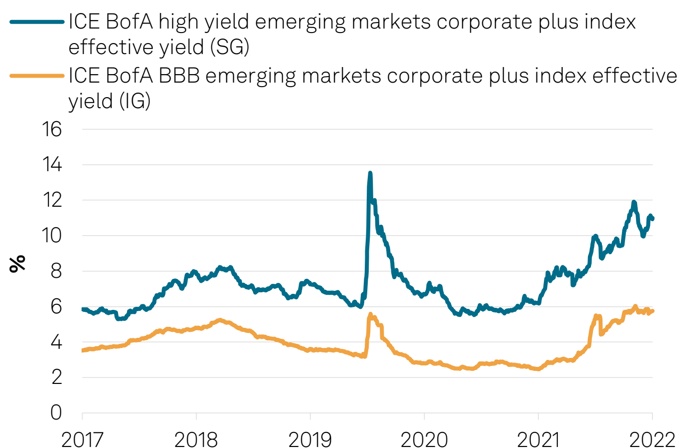
- Rating performance metrics point to increasing pressure on credit quality, albeit unevenly distributed across countries.
- Financing costs continue to rise and are likely to stay higher for longer than previously anticipated.
- An estimated 80% of corporate debt (with a global scale rating) maturing through 2023 is denominated In U.S. dollars.

Idiosyncratic rather than systemic rating pressure will likely prevail. Despite regional and global headwinds, EMs are experiencing different degrees of rating stress. So far this year, the corporate default total is higher than in 2021 and the number of downgrades exceeds upgrades, both pointing to rising credit rating pressure. The net bias for most countries is also negative, indicating the potential for future downside. However, some sectors are being hit harder than others. The one with the largest number of defaults, for the year to date, is homebuilders and real estate, which can be linked to ongoing challenges facing the Chinese property sector, while most downgrades in August related specifically to Mexico's financial sector. Our EM ratings will be far from immune to the rising risks of a U.S. downturn, if not a global recession, but remain fairly stable for now.

External forces are driving up financing costs in EMs. 10-year benchmark yields vary greatly on an absolute basis but are around 100 bps higher in most countries to date in 2022, following on from significant widening in 2021. Recent yield tightening has been undone by higher-than-consensus U.S. CPI numbers, and ongoing efforts to tame inflation in the U.S are likely to keep financing costs elevated, and for longer than previously envisaged. Corporate yields are trending upward after a brief lull, with speculative-grade effective yields recently touching 11% (see chart 5). While this is far below the COVID-19 peaks, high yields are likely to be more than just temporary, raising costs for all and putting pressure on lower-rated borrowers. In addition to rising financing costs, access to capital market financing remains problematic, particularly for lower-rated issuers. With primary issuance down sharply and no obvious catalyst for a material reopening, access will remain challenging.

Chart 5

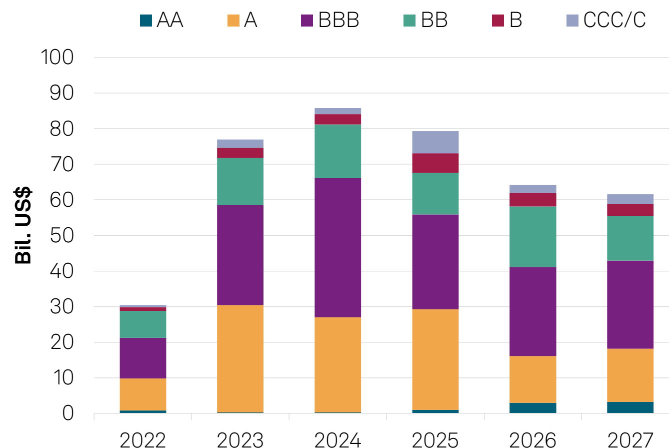
Corporate yields are rising



Data as of Sept 13, 2022. SG--Speculative grade. IG--Investment grade. Source: FRED, The Federal Reserve Bank of St. Louis

Chart 6

EM U.S. dollar debt maturities by rating



Data as of July 1, 2022. Near term maturities could be lower due to recent refinancing and data reporting lags. Includes bonds, loans, and revolving credit facilities that are denominated in USD and rated by S&P Global Ratings (with a global scale rating) from financial and nonfinancial issuers. Source: S&P Global Ratings Research.

The stronger dollar is complicating near term refinancing risk. Nearly 50% of corporate debt (instruments with a global scale rating) is scheduled to mature over the next five years, with 15% due before Dec. 31, 2023. Investment-grade debt accounts for 77% of financial and nonfinancial corporate maturities through 2023. Although EM speculative-grade maturities seem manageable (23% of debt over the same period), most of these issuers are in Latin America, and tighter financing conditions will make it increasingly difficult for them to refinance. Furthermore, an estimated 80% (see chart 6 above) of EM corporate debt maturing through 2023 (with a global scale rating from S&P Global Ratings) is denominated in U.S. dollars, increasing exchange rate risk for issuers not adequately hedged.

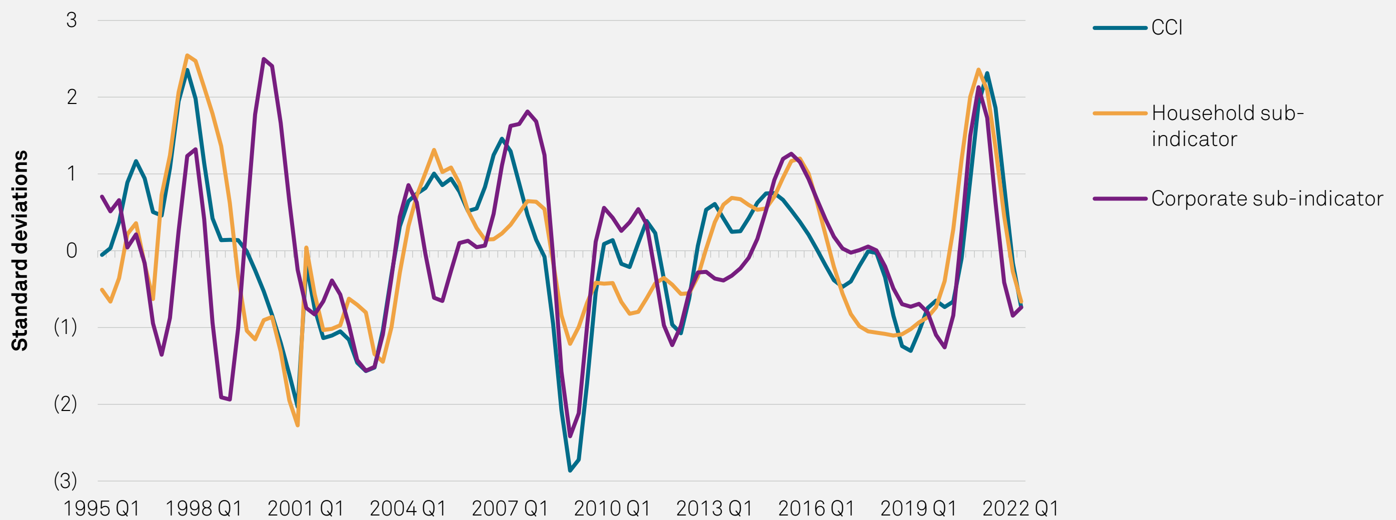
Credit Cycle Indicator

Signs of heightened credit stress in late 2022 or early 2023

Over four quarters since Q1 2020, the EM ex-China Credit Cycle Indicator (CCI) trended upward and reached a peak of 2.0 standard deviations in Q1 2021. This suggests potentially greater credit stress in late 2022 or early 2023 (see chart 7). Although the CCI's downward trend indicates a credit correction is underway, the potential impact of the buildup of nonperforming loans (NPLs) and defaults could linger beyond the stress period. For more details about our proprietary CCI, see "White Paper: Introducing Our Credit Cycle Indicator," published on June 27, 2022.

Chart 7

Recent peak in the EM (excluding China) CCI suggests heightened credit stress in late 2022 or early 2023



Note: We view the CCI as a leading indicator for potential credit stress outcomes. The CCI period ends in 2022 Q1. 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. Emerging Markets geographies included in the EM ex-China CCI: Brazil, Chile, Colombia, India, Indonesia, Malaysia, Mexico, Poland, South Africa, Thailand, and Turkey. Source: Bank for International Settlements, Bloomberg, and S&P Global Ratings.

Corporates. The corporates sub-indicator is trending downward in line with slowing GDP growth in many EMs. Bank lending could be a viable alternative to a lack of access to capital markets but would come at a higher cost and shorter maturity. The decline of this sub-indicator indicates that lending standards and financing access may become tighter for specific groups of borrowers (such as highly indebted SMEs).

Households. Household credit to GDP is relatively low in most EMs in our sample, except for Thailand where we have signaled household leverage as a key concern, and Malaysia where we assess credit risk as high but household assets offset household debt to some extent. In our view, financing conditions are also becoming tighter for households as high inflation squeezes their creditworthiness. Ultimately, this will dent banks' asset quality.

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

Sovereigns

Primary contacts

Frank Gill
Madrid
frank.gill
@spglobal.com
+34-91-788-7213

Joydeep Mukherji
New York
joydeep.mukherji
@spglobal.com
+1-212-438-7351

KimEng Tan
Singapore
kimeng.tan
@spglobal.com
+65-6239-6350

EM Asia

We see high prices and interest rates but recovering activity. Sanctions on Russia will keep commodity and food prices elevated. 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 persist. Expectations of monetary tightening in the U.S. and Europe have pushed up interest rates in the region. Exchange rate volatility, especially on the yen and won, has also increased. Outside China, COVID-19-related restrictions have continued to ease. Reduced border controls have allowed a return of tourism and business, relieving pressure on services industries across the region. Rebounding activity and job market improvements have reduced governments' fiscal burdens.

There is a risk of sudden capital swings, alongside interruption of growth and fiscal recovery. An unexpected escalation of geopolitical risks or surge in interest rates could see investors withdraw from the region, making financing conditions significantly tougher for some. Steep exchange rate depreciation could also stoke imported inflation. Ultimately, this may slow the economic and fiscal recoveries much more than expected. Global economic activity is set to weaken amid higher inflation and uncertainties associated with the Russia-Ukraine conflict, but not so sharply that it creates financial volatility. Governments are still expected to reduce fiscal deficits meaningfully, although a return to pre-COVID-19 fiscal performance will take longer.

Widening geopolitical tensions and new coronavirus variants could deepen the impact. If the impact of the Russia-Ukraine conflict expands further or tensions in Asia-Pacific intensify, the consequences would seriously damage investor sentiment and fuel further price increases in the region. Knocks on economies and financial markets in Asia-Pacific may worsen significantly. What's more, new coronavirus variants may prolong the pandemic. Although the pandemic has faded as a concern in most places this year, the potential emergence of more deadly strains remains a risk.

EM EMEA

The economic and fiscal outlook for the majority of EMs in EMEA (except hydrocarbon exporters) will remain strained until it becomes clear when the Fed's tightening cycle will end and there's a ceasefire in Ukraine. Since neither appears imminent, large net energy importers will continue to feel the pinch. Indeed, Russia's response to Ukraine's recent battlefield successes is more likely to be escalation, given the complexities of managing domestic political pressure alongside rising discomfort from key allies.

Yet, for the larger EMs in EMEA, since the summer, the watch word has been resilience. Tourism and remittance inflows have surged. Although financial accounts are still, as a rule, in deficit, and net domestic assets, in many cases, less than zero; consumption, employment, and exports have held up relatively well, all things considered. The enormous external surpluses accumulating in the Gulf Cooperation Council (GCC) and Russia will have to be recycled somewhere and, at least in the case of Russia, investing in Western European/North American property and fixed-income markets is no longer an option.

EMs' resilience looks likely to be particularly tested as we enter the winter months. This is not least because private consumption during the summer looks unlikely to continue since households have burned most of their savings, and high inflation continues to depress disposable incomes. The way the Fed's $95 billion of monthly quantitative tightening (equivalent to over 11% of Turkey's annual GDP per month) is manifesting itself in a large number of EM economies--via an acute foreign currency shortage amid rising energy import bills, financial account deficits (including portfolio outflows), and currency volatility--has led to some dollarization of domestic deposits (albeit perhaps not as much as we anticipated).

Egypt

As has been the case across EM EMEA, the terms-of-trade shock (particularly to wheat and other agricultural imports) has led to a widening trade deficit, while quantitative tightening has triggered very sizeable portfolio outflows from Egypt's domestic bond market. This in turn has eroded the value of the local currency, translating into higher inflation. As a consequence, the balance of net foreign assets at the Central Bank of Egypt turned negative in March this year, and weakened further through June. Meanwhile, core inflation hit 16.7% as of the end of August, and above regulated price inflation reached 11.0%, a difference largely explained by multiple fiscal interventions. Nevertheless, in our view, the worst impact of the shock is behind Egypt, which has managed to retain a primary budgetary surplus over the last 12 months (although the cost of debt continues to consume over 50% of tax collection). While net reserves have declined, gross reserves have stabilized, reflecting the inflow earlier this year of GCC deposits, estimated at about $13 billion. Tourism receipts (as in Turkey) have surged, as have remittances inflows. Moreover, Egypt is now a net energy exporter, for an estimated annualized 1.4% of GDP. Wheat and other commodity prices have also softened recently, as more Russian wheat was delivered to international markets.

Ghana

Ghana remains in talks with the IMF regarding a potential program, given the spike in inflation; no access to sizeable, long-dated external financing at reasonable rates; and limited domestic financing capacity. High refinancing requirements for domestic debt mean that most of the financing for the budget in the first half of 2022 came from the central bank's overdraft, while high refined petroleum imports and the dollarization of deposits continue to exert pressure on the exchange rate. The consequence of a precipitous balance-of-payments situation, dwindling foreign currency reserves, and monetization of still large deficits is high inflation. The Bank of Ghana has responded by raising rates 300 bps to 22% in August, despite the slowdown in household and corporate spending that suggests tepid growth for the remainder of 2022 and into 2023.

Nigeria

Nigeria is also suffering from a foreign currency squeeze despite the country being a major oil producer. Governance and corruption challenges largely explain why August oil production, at an estimated 1.2 million barrels per day, was about half of its peak in 2006. Nigeria, the most populous country in Africa, is also providing subsidies on petrol and propane to the tune of around 2% of GDP. Other long-standing challenges, such as structurally low tax collection and a weak investment climate, have deterred investment in non-commodity sectors, while the multiple exchange rate regime complicates operations for the export sector.

Hungary

Between 2010 and 2015, when Hungary's private sector was deleveraging sharply and credit growth averaged -4.7%, EU funds totaling over 3% of GDP per year supported its economy and balance of payments. Were all EU budgetary and Next Generation EU Fund disbursements to be permanently suspended, due to EU concerns regarding procurement corruption and the rule of law, the loss of that source of critical financial support would hurt the country's growth prospects, even as we expect a procyclical tight fiscal stance over the next three years. This is not our base-case scenario, however. We still project a capital account surplus of around 2% of GDP per year over the next three years, and the majority of EU funds under the multi-annual financial framework to be disbursed. Nevertheless, the government's willingness to achieve political consensus on Russian sanctions and the global minimum corporate tax rate agreement suggests relations are unlikely to improve unless more concessions are forthcoming. The business cycle is rolling over very quickly in Hungary, which is coming off a period of high real wage growth and rising asset valuations (including property prices). But Hungary, like Poland does not face the same degree of external shocks as lower-rated sovereigns in EMEA. Its foreign currency reserves have increased by about €2.2 billion to €36.5 billion since the end of May.

Turkey

Turkish policymakers continue to devote most of their energies to macroprudential workarounds to hold on to foreign currency, despite deeply negative ex-ante interest rates. Under this so-called “lira-ization” policy in an effort to bring down foreign currency deposits, which now make up around 55% of total deposits (excluding foreign-exchange-protected deposits), Turkey's central bank is requiring banks to hold domestic currency fixed-rate government bonds against reserve requirements on foreign currency deposits; it has also raised reserve requirements on loans denominated in Turkish lira (TRY). This led to a collapse of domestic yields to sharply negative real interest rates, since the Turkish authorities are essentially doubling down on their strategy, while also scrutinizing any lira-denominated lending that may be finding its way into additional foreign currency demand.

What's helping margins is that, as in the case of Egypt, the parallel foreign-currency protection scheme is working, since it has stabilized the exchange rate and stemmed the tide of deposit dollarization. However, this comes at a cost of an estimated 1.5% of GDP this year in Treasury compensation to participating households and corporates for foreign exchange losses. In short, coordination between the central bank and Treasury seems imperfect, and policy settings--in particular, deeply negative real interest rates--open up the currency to further volatility. However, Turkey has had a very strong tourism season; a notable increase in foreign currency, including large errors and omissions inflows; as well as a significant foreign currency deposit inflow, which we understand is from a Russian state agency and worth close to one-third of this year’s projected current account gap.

Latin America

We expect continued economic recovery and falling unemployment in Latin America and the Caribbean in the remainder of 2022. However, the region’s GDP growth is decelerating, and long-term growth prospects remain subdued. A strong U.S. dollar will tighten financial conditions. That, plus higher U.S. interest rates and low growth in China, could dampen external demand, limiting the pace of economic recovery.

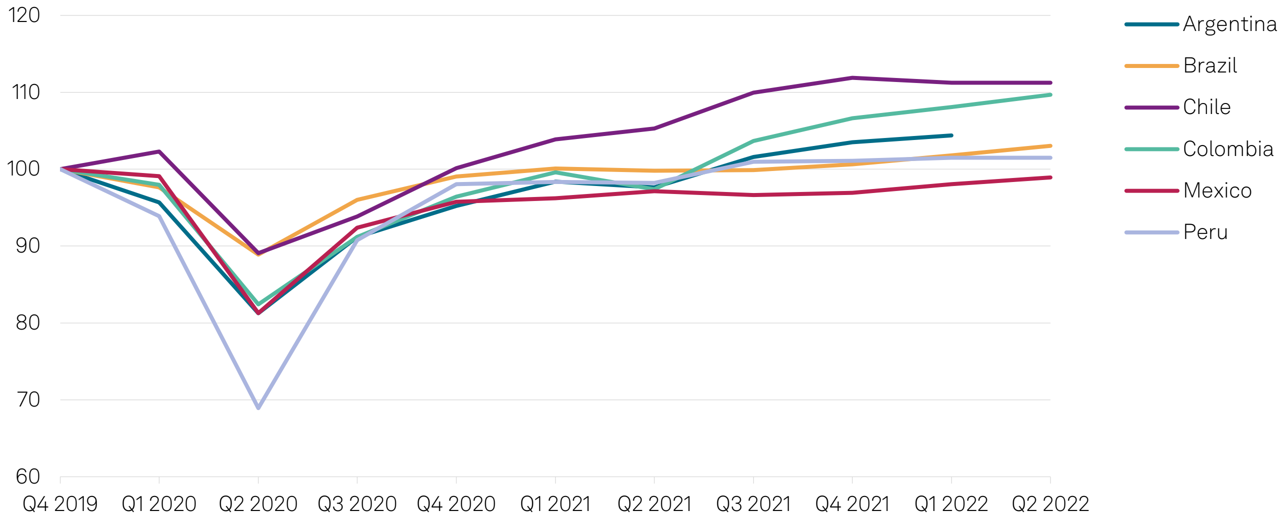
Inflation, fueled by higher food and energy prices, poses a rising challenge but it remains below the peaks of past decades, except in Argentina. But if it does not go down, even if it stays in single digits, that could trigger fears of even higher inflation than during pre-pandemic years, potentially weakening medium-term financial conditions and GDP growth prospects. We expect that the framework for monetary policy, which has strengthened in recent years in much of the region, will help contain this risk. Regional central banks face a hard trade-off, at least in the short term, between policy tightening to contain inflation (and avoid abrupt capital outflows) and more accommodative monetary policy to promote economic recovery. The prevalence of higher interest rates, combined with a sovereign debt burden that has increased throughout the region since the pandemic, reduces the fiscal room to maneuver for all governments.

On average, GDP in Latin America returned to its pre-pandemic level (Q4 of 2019) in 2022 (see chart 8). Thanks to rapid recovery, GDP in Chile and Colombia is now at least 11% above its previous peak. In contrast, GDP in Brazil is only around 5% above its pre-pandemic level. In Peru, which had the sharpest economic contraction among the larger Latin American countries, GDP has barely recovered to its pre-pandemic level. Economic recovery has been particularly slow in Mexico, whose GDP growth rate has been below that of sovereigns at a similar stage of economic development.

Chart 8

GDP versus prepandemic level

Q4 2019 = 100



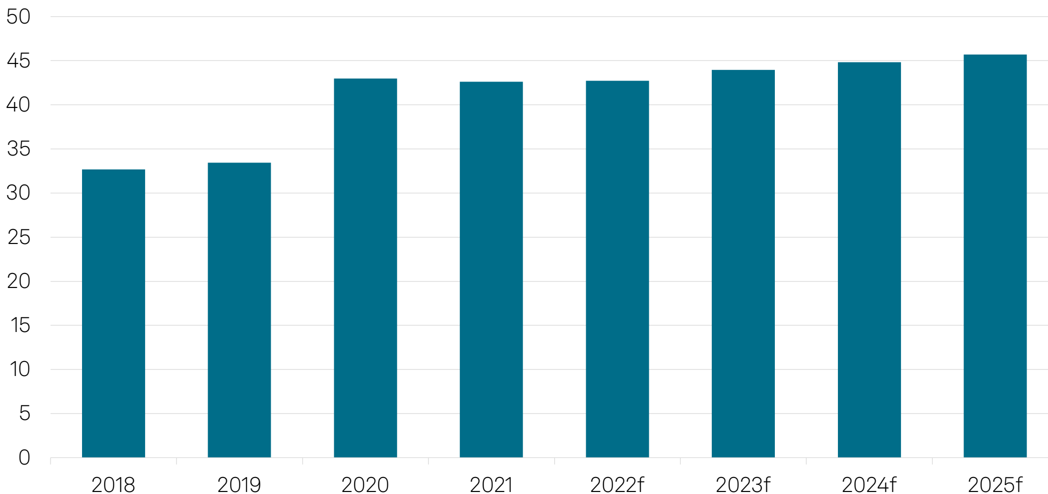
Source: S&P Global Ratings.

All countries in the region now carry higher sovereign debt, due largely to the impact of the pandemic (see chart 9). The combination of higher interest rates and increased debt constrains fiscal policy, while high inflation forces central banks to tighten monetary policy. The discouraging macroeconomic landscape increases the importance of pursuing other microeconomic policies that encourage private investment and mitigate the expected slowdown of growth across the region.

Chart 9

Government debt has increased

Net general government debt-to-GDP, simple average of LATAM 5 (%)



f--Forecast. LATAM 5--Brazil, Chile, Colombia, Mexico, Peru. Source: S&P Global Ratings.

Since the beginning of 2022, we have taken few rating actions. We have downgraded two sovereigns (El Salvador, Peru), while revising our rating outlook to negative from stable on one sovereign (Honduras), and those on five sovereigns to stable from negative (Costa Rica, Curacao, Dominican Republic, Mexico, and Trinidad and Tobago). Currently, our outlooks on four sovereign

ratings (Bolivia, Panama, El Salvador, and Honduras) are negative. Guatemala is the only regional sovereign where our rating outlook is positive.

National elections later this year in Brazil will help determine that country's economic trajectory. The next government, likely led by either current president Jair Bolsonaro or former president Lula, will face the task of achieving better GDP growth while managing spending demands that could result in modifications to Brazil's framework for fiscal policy, including potential changes in a constitutional cap on government spending.

Recent elections in Colombia resulted in a new leftist President, Gustavo Petro, a significant shift from previous centrist or right-wing presidents. Petro has built a wide coalition in both houses of Congress and proposed new tax reforms to help finance ambitious social and other policies to meet public expectations for better living standards. Colombia's rapid economic recovery from the pandemic has helped to reduce its fiscal deficit faster than budgeted and to almost regain all the jobs lost during the past recession. In addition, high prices for oil and coal (which account for more than half of all exports) have also boosted fiscal revenue. However, the government's decision to cap domestic fuel prices has contributed to a widening deficit in its fuel price stabilization fund.

Chile's efforts to create a new constitution suffered a setback after voters overwhelmingly rejected a proposed draft in a referendum held in early September. Popular discontent with the existing constitution will likely result in a second attempt to draft a new one. However, the rules and procedures for creating a new constitutional assembly, and for drafting and voting upon the new document, remain to be determined. The population's rejection of the last draft version of the constitution does not have a direct impact on economic policy but it weakens the government's position and extends the period of uncertainty about future changes, which could somewhat impinge on private investment and GDP growth.

Political developments played a key role in our decision to downgrade Peru in March 2022. We saw persistent political deadlock undermining investor confidence and constraining the country's GDP growth prospects. Similarly, political factors have had a negative impact on economic outcomes in Argentina, limiting the government's ability to take corrective action against inflation, averaging around 70% in 2022. The recent appointment of a new Minister of Economy is unlikely to result in substantial changes in economic policy in a country where the sovereign lacks access to external financial markets and continues to rely largely on the central bank for funding its fiscal deficit.

Corporates

EM Asia

Primary contacts

Diego Ocampo
Buenos Aires
diego.ocampo
@spglobal.com
+55-11-3039-9769

Xavier Jean
Singapore
xavier.jean
@spglobal.com
+65-6239-6346

Timucin Engin
Dubai
timucin.engin
@spglobal.com
+90-530-681-7943

Slowing growth prospects, inflation, and still challenging funding access are weighing on credit prospects

Revenue and profit growth prospects in 2023 are reducing amid a slowdown in China and sluggish export markets. Operating prospects are mixed across the main EM Asian markets of **China, India, and Indonesia** for the rest of 2022 and in 2023. In China, operating and credit quality pressures are mounting, given a still weak real estate market, declining domestic consumption, residual COVID-19 restrictions, and potential for a downturn in U.S. and European export markets. We see the biggest hit on the real estate sector, export-oriented manufacturing, and mobility exposed segments such as retail.

In **Indonesia**, we expect to see a widespread improvement in both top-line and bottom-line growth compared with 2021. A rebound of consumer sentiment in the first half of 2022 has given positive momentum to the consumer and real estate sectors, while commodity-linked sectors benefitted from multi-year high hydrocarbon, mineral, and agri-commodity prices. Nevertheless, we expect the positive trend to either slow or reverse in the second half of this year and in 2023. First, inflation was kept artificially low this year by petrol price caps implemented by the government, which were partly reversed in September. Full-year inflation could therefore exceed 6% in 2023, eroding purchasing power and consumer confidence and jeopardizing the relative stability of the domestic currency. Second, in our base case globally, we assume a normalization of commodity prices, which benefitted a large number of commodity-linked Indonesian companies.

The growth momentum appears more solid in **India**. Domestic consumption has been resilient so far this year, and our economists forecast continued positive growth for 2023. We project that rated companies in India will deliver the fastest increase in revenue and profits in 2023 over 2022 (high single-digit median revenue and profit growth, compared with low- to mid-single digits for **China** and **Indonesia**) amid steady domestic consumption, normalizing power demand, and a rebound for transportation infrastructure after COVID-19-related mobility interruptions.

Inflation is slowly biting into corporate margins. Half-year financial reports from rated companies in EM Asia show signs of margin compression following the rise in raw materials, energy, and transportation costs. Although cost passthrough varies from company to company (eroding consumer sentiment), slowing global GDP growth is likely to make it more difficult for most firms in EM Asia to increase prices in the second half of this year. We expect more significant margin compression in the discretionary manufacturing, retail, merchant power, infrastructure, transportation cyclical, capital goods, chemicals, and auto sectors.

Funding remains selective as a result of poor external conditions

Access to funding remains a key differentiator of credit quality for companies in EM Asia. Domestic funding sources are normalizing after two years of limited loan growth in India and Indonesia. We forecast corporate loan growth In Indonesia to about double that in 2021, although largely for working capital purposes rather than to refinance large debt maturities, and especially from state-owned banks.

Capital market funding remains very challenging across the region amid volatile investor sentiment, weaker investor confidence in Chinese issuers in the real estate sector, and the generally high risk premiums demanded to issue bonds. Foreign currency capital markets are likely to stay closed to most speculative-grade issuers until U.S. monetary policy stabilizes, which could be several months away. In the meantime, any fund-raising window in capital markets is likely to be short, even for more solid issuers. Reduced access to funding and refinancing risk are likely to be the main credit issues facing corporates in EM Asia over the next 12 months, with more defaults or debt restructurings as a result.

The depreciation of southeast Asian currencies has not had a major influence on credit quality so far, unlike in the previous currency cycles of 2013, 2015, 2018, and 2020. The Indonesian rupiah for example, a confidence-sensitive currency in a country where nearly half of corporate debt is denominated in U.S. dollars, has evolved within a relatively narrow band over the past two years, supported by the country's substantial exports of commodities priced in U.S. dollars. In our opinion, only a double-digit depreciation of regional currencies within a few months is likely to have a more lasting impact on investor confidence. The foreign-currency exposure of Chinese and Indian companies also tends to be a lot less widespread than for their Indonesian counterparts, given those countries' deeper domestic funding sources.

EM EMEA

Activity in Saudi Arabia's corporate market remains strong, in line with a robust economic backdrop

This is underscored by high oil prices, vigorous fiscal spending, and the country's Vision 2030-related projects. Listed companies' financial results for the first half of this year show improved performance, particularly for entities in the wider petrochemicals sector. Given the continued acceleration of Vision 2030 projects, we expect corporate activity to remain robust over the next few years, particularly in the infrastructure and contracting sectors, as well as in many others, including construction, aviation, and tourism. In particular, given targets for increased tourism flows, on Sept. 1, the Ministry of Tourism announced changes that will allow permanent residents of the U.S., U.K., and EU to get a visa on arrival or apply online, while allowing GCC residents with certain occupations to apply for a tourist visa online; both of these are very supportive measures.

Despite adverse developments in global capital markets, Saudi Arabia's equity capital market remains quite active. During the first eight months of the year, we saw several companies from diverse sectors being listed on Tadawul, the largest stock exchange in the region by market capitalization and trading volumes. We expect equity market activity to continue, given the authorities' efforts to further develop the capital markets as well as planned key projects under Vision 2030 that should drive the demand for funding. As an example, in July, the Saudi Crown Prince announced plans for an IPO of Neom on Tadawul as early as 2024. Neom is a gigantic new smart city to be built in northwestern Saudi Arabia along the cost of the Red Sea; it will reportedly cost around Saudi Arabian real (SAR) 1.2 trillion (around $320 billion) during the first phase of the project, which runs until 2030. The Public Investment Fund (PIF; the sovereign wealth fund) will reportedly finance half of the project, while officials will seek external funding (including through the IPO) for the remaining funds.

Albeit slower than in some of the other key markets, inflationary pressures are also gradually building in Saudi Arabia. We expect sectors such as utilities and telecommunications to be immune to meaningful cost increases, while some sectors catering to the domestic market, such as consumer staples, could face more pressure on pricing the incremental costs.

Overall risks for Turkish corporates remain elevated

Turkey’s dynamic private sector continues to navigate through macroeconomic challenges, including from persistent high inflation and a volatile Turkish lira. We continue to expect export-oriented sectors and companies to generally perform better than peers catering to the domestic market, while pressures in Europe could mean slower performance in some exporting sectors over the next few quarters.

Inflationary pressures accelerated following the lira's sharp depreciation from mid-November last year as a result of the sharp increase in commodity prices, including of energy and agricultural commodities, since the start of the Russia–Ukraine conflict. Higher energy and utility prices are pushing up costs, especially for industrial companies; and not all production sectors have the same ability to manage the impact on margins.

Local consumption remains more resilient than expected. However, the erosion of household purchasing power continues, meaning changes in local demand for some sectors. We see for

example weakening volumes in certain domestically focused sectors, such as consumer durables and light auto vehicles. Some companies won't be able to pass the impact of cost inflation to end customers, and inventory management--particularly for importers--remains tricky. In view of this, similar to past quarters, we expect the key priority for most corporates will be to focus on keeping their cash, while managing their liquidity and cost bases amid high inflation, and refrain from unnecessary capital expenditure.

Tourism has continued its strong recovery. In the first seven months of the year, Turkey received around 23 million foreign tourists, up by almost 130% relative to the same period of last year. Year over year arrivals of Russian tourists was up 40%, but tourism growth from other key markets such as Germany and the U.K. were even stronger. We expect similar trends for the remainder of the year.

Strong balance sheets shield South African corporates from inflation and infrastructure pressures

We continue to view exposure to geopolitical risks, inflationary pressures, and global capital markets' current risk-averse stance as broadly manageable for rated South African corporates. Specifically, elevated commodity prices, limited use of gas as a power source or industrial feedstock, and companies’ generally low leverage and improved post-pandemic operational efficiency inform our view. However, headwinds persist in the form of infrastructure and supply chain inefficiencies, and elevated inflation. There is some correlation among these factors since power supply and rail infrastructure failures require companies to use more expensive alternative solutions to get their products to market. At the same time, elevated broad-based inflation leads to rising pressure on wages, increasing the risk of strikes and civil unrest, as we saw in July 2021. We are also mindful of the increasing pressure on consumer spending and affordability as inflation erodes real disposable incomes.

Domestic-focused companies such as retailers, telecommunication companies, and health care providers could see revenue declines due to households' reduced discretionary spending. Although they are less exposed than exporters to power supply and transportation costs, a rise in such costs is likely to have a negative impact on most corporate margins. There is some relief for commodity exporters, since still-high, albeit moderating, commodity prices continue to support cash flows, and lower prices have been somewhat offset by the rand's depreciation.

On balance, significant deleveraging in recent years has given most of the private-sector corporates we rate in South Africa a substantial buffer against slower earnings growth, margin pressure, and higher funding costs. Notably, most have stronger cash flows and balance sheets than before the pandemic, and ratings are showing strong positive momentum. In most cases, creditworthiness is improving after the stresses of recent years, and some companies, notably in mining, are exhibiting better credit metrics. This is thanks to a combination of deleveraging, which started before 2020, and the cash flow boost linked to an increase in the price of certain commodities over the past two to three years.

The picture is less rosy for the largest state-owned entities (SOEs), power generation company Eskom and rail transport provider Transnet. Poor operational performance is depressing revenue, while wage and fuel inflation is squeezing margins. Both companies also have material refinancing requirements in the next 12 months, which, given volatile global market conditions, raise the risk of persistent liquidity stress. Furthermore, electricity shortages and inefficient rail and port infrastructure are dampening South Africa’s economic growth. There are some attempts at sector reforms, but progress is slow and the benefits, if any, will not be immediate.

Tight financing conditions make it difficult for high-yield issuers to refinance or issue new debt in global markets, while South Africa’s debt capital markets remain open and quite supportive of new issuance. Since private-sector entities have low refinancing needs in the next one-to-two years, it is the SOEs that face the biggest refinancing risks, both due to their large debt maturities and the limited capacity of the domestic capital markets.

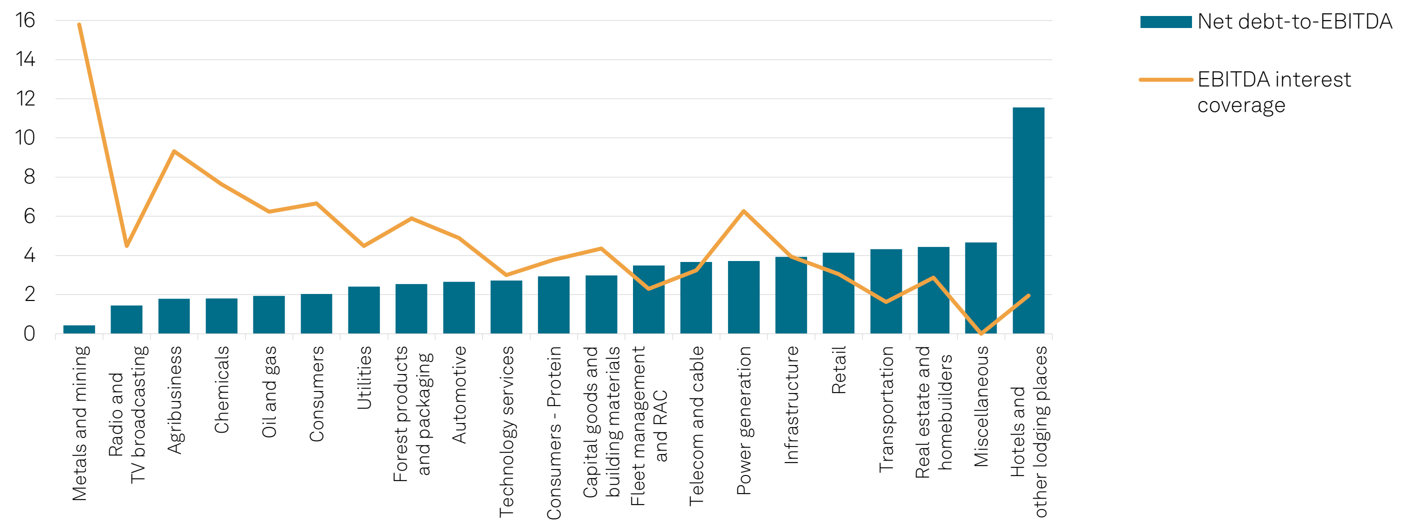
Latin America

Slower growth and inflation remain key risks

In tandem with the general macroeconomic performance, financial results and ratings in Latin America's corporate sector still show resilience across most industries. Companies continue to post better-than-expected earnings, and we consider that tougher business and economic conditions would have only a mild impact over the next few months. During the first half of 2022, credit metrics for most sectors were aligned with the 2021 average or had even improved. Leverage remains generally under control, with debt to EBITDA broadly averaging below 3.5x, considerably lower than in other regions (see chart 10). Also, short-term buffers are still in place, as demonstrated by healthy EBITDA interest coverage ratios generally in excess of 3x.

Chart 10

Latin America--Leverage and interest coverage by sector (x)



Source: S&P Global Ratings.

For the remainder of 2022, we expect some moderation of growth in Latin America

This would ultimately curb growth for the region's corporates, but for the most part, we anticipate largely stable gross margins despite high inflation. Credit quality recovered to pre-pandemic levels early this year and a slightly positive net rating bias indicates limited or at least manageable near-term risks. However, a slowdown in economic activity and the prevalence of high inflation globally still pose the main threats.

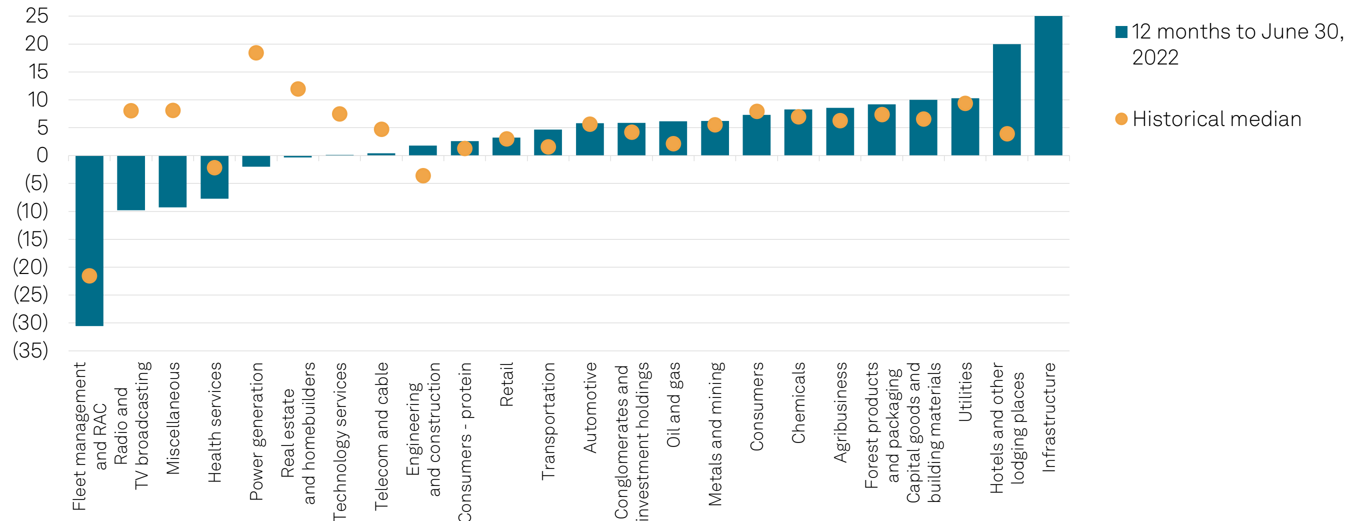
Tightening of monetary policy in major developed economies across Europe and in the U.S. to temper inflation could weigh heavily on growth beyond 2022. At the same time, the Russia-Ukraine conflict continues to feed existing energy supply and pricing pressures. In Latin America, the margins of energy- and fuel-intensive industries--including power generation and building materials--are shrinking due to rising input costs, as is the case for peers in other regions. In the commodities sector, a slight correction in prices recently could ease inflationary pressures somewhat but is starting to eat into some producers' margins. If inflation remains elevated, the incremental passthrough of costs to consumers could eventually erode household purchasing power, with a negative impact on demand.

Another hurdle for credit quality relates to the cash conversion cycle, since some sectors are struggling to catch up with the historical median (see chart 11). We expect some burden on the balance sheet of companies in the real estate, homebuilders, and power generation industries, although the absence of large investment needs should partly support cash flows and liquidity. The increase in borrowing costs is particularly concerning for speculative-grade issuers, where

median yields have gone up by more than 300 bps. Yet, refinancing needs are relatively low because only 5% of market debt outstanding is due in 2023, which should protect credit ratings. Nevertheless, for some companies, borrowing costs exceeding the return on capital would not only destroy value for shareholders, but could also result in weaker financial policy.

Chart 11

Cash conversion cycle by sector (%)



Source: S&P Global Ratings.

Financial Institutions

Primary contacts

Geeta Chugh
Mumbai
geeta.chugh
@spglobal.com
+91-992-0363-303

Cynthia Cohen Freue
Buenos Aires
cynthia.cohenfreue
@spglobal.com
+54-11-4891-2161

Mohamed Damak
Dubai
mohamed.damak
@spglobal.com
+971-4372-7153

EM Asia

Rising inflation, higher interest rates, a prolonged Russia-Ukraine conflict, and the lingering effects of COVID-19 will continue to weigh on banks in Asia Pacific's EMs. The Fed's tapering plan could also trigger capital outflows, intensify currency pressures, and hurt unhedged borrowers and their lenders. Strong capitalization, a preemptive buildup of provisioning over the past few years, and ongoing government support continue to provide a buffer.

Banks won't be immune to weakening macroeconomic conditions

Such an environment can restrain credit demand, push certain low-income borrowers to the brink of default, and strain SMEs still recovering from the impact of the pandemic. Barring China, we expect central banks in Asia-Pacific EMs to continue raising policy rates to catch up with the Fed, in an effort to prevent capital outflows and currency depreciation. A weaker local currency would favor exporters but imported inflation could hit corporates' profitability. Meanwhile, high yields increase debt-servicing burdens and erode corporates' financial buffers. Tightening lending standards may cause more pain for weaker borrowers. For China, on-again off-again lockdowns of cities have hit economic activity. The country's real estate sector is still struggling; and SMEs' strained finances are raising concerns about unemployment and weaker investor confidence. We have cut our project of China's GDP growth in 2022 to 2.7% from our previous 3.3%.

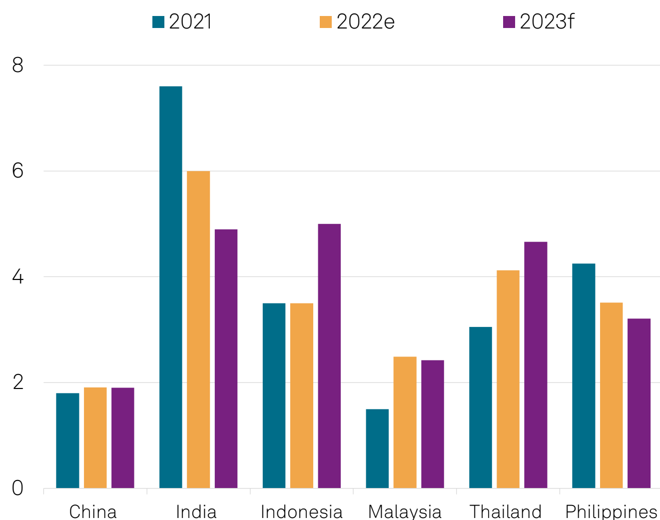
Credit risk remains high

We expect credit costs and NPLs in many EM countries in Asia-Pacific will remain higher than before the pandemic, with new risks hindering the recovery (see charts 12 and 13). We now forecast credit losses of about $425 billion this year and about $440 billion next year, about 23% higher than our projection in February 2022. The main reason is expected credit losses in China's banking sector, which reflects the sector's sheer size and the economic and property sector downturns hitting the country.

Chart 12

Asset quality is a mixed bag for banks in Asia-Pacific

Nonperforming loans (% of systemwide loans)

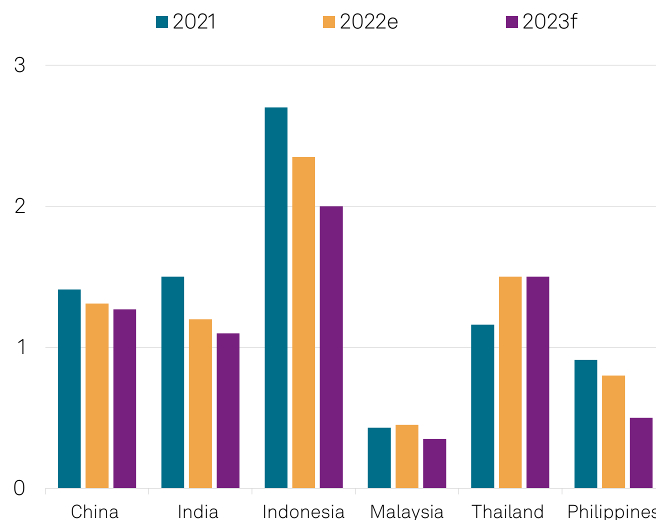


e--Estimate. f--Forecast. Source: S&P Global Ratings.

Chart 13

Credit costs are expected to improve in 2023

Credit losses (%)



Source: S&P Global Ratings.

A notable exception is India, where a strong economic recovery and resolution of legacy problem loans have mitigated the drag on asset quality. Nevertheless, credit losses are not substantially higher than the previous year, and banks have made preemptive provisions and improved capitalization, leaving them with buffers to absorb moderate asset quality deterioration.

Banks in ASEAN (Association of Southeast Asian Nations) still have large provisions. Although they have decreased slightly since their peak during 2020-2021 at the height of the pandemic, they represent a substantial buffer against weak loans amid pressure from inflation and rising rates. Most of the outlooks on our Asia-Pacific bank ratings are therefore stable.

Weak property developers, mortgage payment strikes, and governance deficit are straining China's banking system

We forecast annual credit losses in China at about renminbi (RMB) 2.3 trillion (about $322 billion) on average from 2022-2024. We estimate that about 40% of China's property developers are in financial difficulty. The bulk of this stress will likely show up as special-mention loans or other problem loans that don't require large provisions. We expect an "L-shaped" recovery for developers, and pressure on credit quality to remain high, despite still reasonable collateral valuations. In addition, we anticipate that, by the end of 2022, NPLs in the property-developer sector will more than double to 5.5%. What's more, Chinese homebuyers are refusing to make mortgage payments on delayed residential projects, which could add almost RMB1 trillion to banks' at-risk loans. In our downside scenario, potential at-risk mortgages comprise just 1.3% of the banking system's loan book. However, we believe this situation points to weakening confidence among homebuyers, which could dent the sales of all developers and delay the property sector's recovery. A sharp decline in house prices could threaten financial stability. The government views this as important enough to warrant rapid relief funds to stem declining confidence.

Small banks in China are more prone to weak governance than larger peers

Panic has gripped customers after some faced barriers to withdrawing funds at four village banks in Henan province and another two in Anhui province. If this situation spreads, small banks would likely lose deposits to their larger peers. The outcome of such a scenario hinges on public perception of the deposit-protection system and whether an institution has government backing. We believe prudential regulators are assessing potential financial gaps and trying to strike a balance between protecting depositor confidence while not appearing to guarantee investment-like products and other concessions that could give rise to moral hazard.

In our stress scenario, a 300 bps rise in interest rates and inflation could double the list of loss-makers

Adverse macroeconomic conditions can exacerbate credit risks for banks. We examined the potential impact of a 300-bps increase of both interest rates and inflation on unrated corporates and SMEs. The results suggest that the share of companies making losses could more than double to 20% in Asia Pacific (excluding China) and 22% in China. This could have a knock-on effect on banks.

Thus far, government support has ensured that, in most EM Asian countries, only a small proportion of loans required restructuring. Notable exceptions are Thailand and Indonesia, where 8%-12% loans are still under moratorium and present a latent risk to asset quality. Furthermore, higher interest rates will be particularly painful for Thai borrowers because household debt to GDP is elevated, at around 90%. We see negative economic risk trends for both banking systems.

Finance companies are more at risk

Nonbank financial institutions (NBFIs) in Asia Pacific's EMs are more vulnerable than banks to disruptions in funding access, given challenging operating conditions. Refinancing risk will be greatest for NBFIs with a large portfolio of near-term debt maturities. Companies with weak operating performance over the next one to two years would be required to refinance at higher

interest rates and wider spreads, which would strain debt-service coverage ratios and creditworthiness. Institutions with longer-dated debt and healthy liquidity can wait for market turbulence to subside. But this is a very confidence-sensitive sector, and the mood of markets can change quickly, as could the fortunes of the region's NBFIs.

EM EMEA

The longer the Russia-Ukraine conflict lasts, the bigger the impact on EM EMEA

The direct exposure of rated Middle Eastern and African banks to Russia and Ukraine is very limited and not a source of concern. The impact is materializing through the increase in commodities prices and, for some, the disruption of supply chains. While higher oil and gas prices are benefiting GCC countries with the financial muscle to absorb the increase in food prices, they are hurting North African countries (particularly Egypt and Tunisia). This is exacerbated by the Fed's continued tightening of monetary policy, which is making it harder and more expensive for some countries and their banking systems to tap the international capital markets. In this context, Turkey, Tunisia, and to some extent Egypt and Qatar are the countries to watch.

In GCC, high oil prices are boosting growth and overall market confidence

The impact is visible in the banking system where, in the first half of 2022, asset growth for the region's top 45 banks was 4.8% and for loans 4.7%. We expect this momentum will continue in the second half, supported by Saudi Arabia's Vision 2030 and improving sentiment in the United Arab Emirates. In Qatar, we expect growth may decline after the completion of the majority of projects related to the football World Cup this year, implying future expansion will be led primarily by loans for working capital and consumption. In Kuwait, growth will depend on the government's capacity to push projects forward.

Positive developments in the region are also visible in asset quality indicators, with the NPL ratio stabilizing at 3.5% at midyear 2022. We observed a general drop in the cost of risk to 74 bps from 106 bps in 2021 for the top 45 banks. We expect to see a slight deterioration of NPL ratios and anticipate that the cost of risk will continue normalizing. The measures enacted by various central banks have given corporate and retail borrowers time to get back on their feet. A lower cost of risk and increasing interest rates mean that profitability has improved, with banks' return on assets increasing to 1.4% as of June 30, 2022, from 1.2% at year-end 2021. Margins have also improved for some banks and the cost-to-income ratio remains relatively strong in an international comparison.

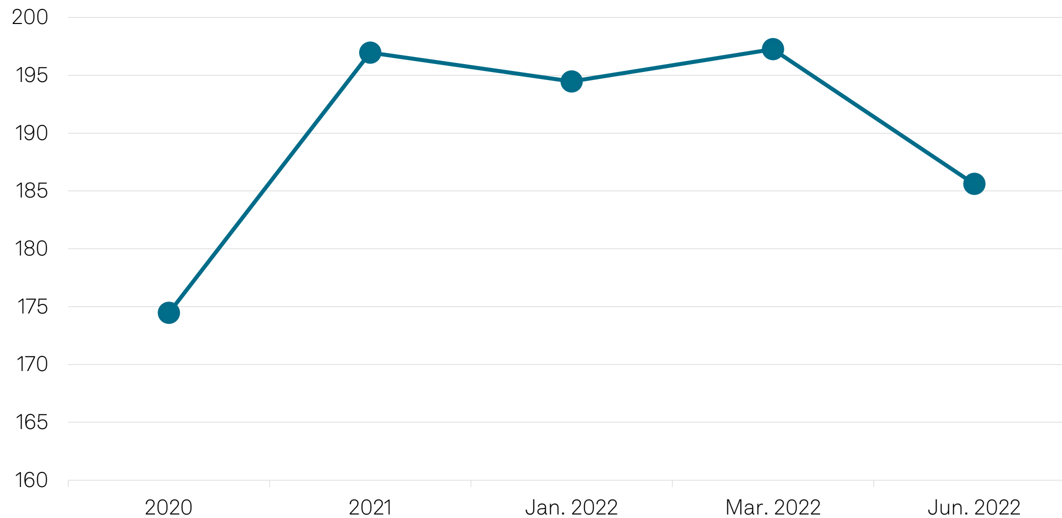
Regarding funding and liquidity, we have observed pressure mainly in Saudi Arabia as lending growth exceeded that of deposits. This has prompted the central bank (SAMA) to intervene and inject SAR50 billion into the banking system. We expect SAMA to step in again if needed but we think that, in the second half of 2022, oil money will start flowing into the banking system, which will ease the pressure further.

Another country where we have some funding concerns is Qatar, due to the banking system's high dependence on external debt. Positively, the authorities have intervened to make recourse to external debt more onerous from a regulatory standpoint. As such, we think the amount of external debt will drop. Already, in the first half of this year, it declined by 5.8% (see chart 14) with $15.8 billion of nonresident deposits leaving the system and being partly compensated by an increase in international interbank deposits of $6.5 billion.

Chart 14

Qatari banks external debt started to decline

Total external debt (bil. US$)



Source: S&P Global Ratings.

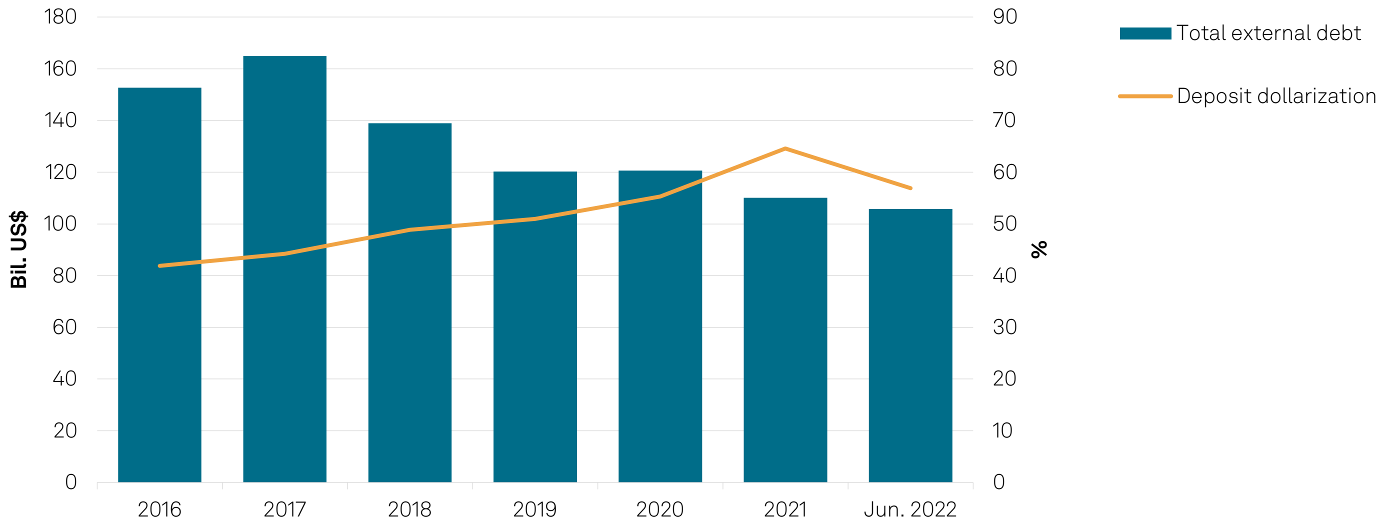
Turkish banks have become more vulnerable to a reversal of capital flows

This is due to scarcer, more expensive global liquidity, increasing risk aversion, and Turkey's unconventional monetary policy despite extremely high inflation. As of June 30, 2022, Turkish banks had $138.4 billion of external debt, of which $82.8 billion matures during the next 12 months. Although, in theory, banks had sufficient foreign currency-denominated assets (about $156 billion on June 30, 2022) that they could use to offset the impact of a drop of rollover rates, a large portion of these assets ($76.5 billion or 49% of foreign currency liquid assets) are with the central bank. Under a hypothetical extreme scenario, Turkey's central bank could restrict access to those assets, given its already weak foreign currency reserves, pushing some banks toward a default.

The other risk we foresee for Turkish banks is the increase in deposit dollarization and, ultimately, deposit withdrawals if residents start to lose confidence in the system. As of Aug. 19, 2022, 54.7% of deposits were denominated in foreign currencies compared with 44% in 2017. Since the steep currency devaluation in December 2021, local authorities have implemented several measures to push banks and depositors to convert their foreign currency deposits into Turkish lira, including a foreign-exchange-protected deposit scheme. Banks that don't comply with regulators' requirements could face penalties.

Chart 15

Turkish banks remain vulnerable to rollover risk



Source: S&P Global Ratings.

High inflation, a weak lira, and slower economic growth will further strain retail and corporate customers' creditworthiness, increasing risks for the banking system. Although NPLs reduced in the first half of this year, we expect they will gradually increase again and surpass 9% of system loans by 2023, compared with 2.6% as of June 30, 2022, with the cost of risk rising further from 1.5%.

Credit growth in South Africa is set to average 5% over the next three years

This will be mainly underpinned by lending to the private sector. Credit conditions will likely tighten through 2023. The SARB raised its main lending rate for the fifth time in 2022, to 6.25%, the same level as before the pandemic. We expect the SARB to raise the key policy rate to 6.75% by year's end and further to 7% by the first quarter of next year. Although households in South Africa are used to volatile interest rates, we expect their disposable income to be stretched in 2022 because inflation remains above the SARB's 3%-6% target range. Retail lending growth will be muted, averaging 5% through 2023. Corporate lending has recovered, however, up 6% after a small contraction in 2020.

We expect credit losses to average 1.0% of total loans through 2023, down from a high 2.1% in 2020. Top-tier banks posted an average credit loss ratio of 0.8% for 2021, in line with historical averages. We also expect NPLs to gradually reduce to around 4% of systemwide loans by 2023. Lower impairment charges and higher net interest margins will support the return on equity, which we expect will reach 16% in 2022 from 14% in 2021. Banks resumed dividend payments in 2021 and we expect they will remain well capitalized through 2022 and likely start building additional loss-absorbing capital instruments (ALAC) next year as the SARB gets ready to implement an effective resolution regime.

Latin America

Weak economic performance and political uncertainty will pressure asset quality.

We expect real lending growth to slowly moderate in 2022, due to lower credit demand from the corporate sector, banks' stringent risk appetites, and weaker growth of mortgage loans because of rising interest rates. Moreover, soft economic performance and political uncertainty, which limit investment and internal demand, will also curb credit growth. We expect the retail sector to mainly fuel credit growth, as it did during the past 12 months, while corporate lending continues to decline.

Weaker economic performance and the absence of extraordinary government measures, along with lower credit growth and weaker income capacity, will continue to pressure asset quality metrics in the next 12-18 months, but we expect it to remain manageable. In general, we expect asset quality metrics to return to pre-pandemic levels, thanks to banks' conservative underwriting practices over the past few years.

Profitability will likely remain resilient, although weakening slightly, owing to depressed net interest margins and deteriorating asset quality leading to higher provisions. Although banks could transfer the mounting financing costs to borrowers, that could be difficult with corporates amid intense competition for strong borrowers. The ongoing shift in the product mix toward retail lending will help cushion margins, which we expect will remain healthy.

Chart 16

Asset quality metrics to weaken across the region

e--Estimate. f--Forecast. Source: S&P Global Ratings.

Appendix: Economic Data And Forecast Summaries

Table 4

Real GDP

(%)

	2021	2022f	2023f	2024f
Argentina	10.4	3.3	1.0	2.3
Brazil	4.9	2.5	0.6	2.0
Chile	11.9	2.4	0.3	2.9
Colombia	10.7	6.5	1.9	3.0
Mexico	5.0	2.1	0.8	2.0
Peru	13.5	2.2	2.5	3.1
China	8.1	2.7	4.7	4.8
India	8.7	7.3	6.5	6.7
Indonesia	3.7	5.4	5.0	5.0
Malaysia	3.2	6.6	4.4	4.6
Philippines	5.7	6.3	5.7	6.4
Thailand	1.5	2.9	3.5	3.5
Vietnam	2.5	6.6	6.5	6.8
Poland	5.8	4.0	1.2	3.2
Saudi Arabia	3.2	7.5	2.9	2.7
South Africa	4.9	2.0	1.6	1.7
Turkey	11.6	5.2	2.8	3.4

f--S&P Global Ratings forecast. Source: S&P Global Market Intelligence.

Table 5

CPI inflation

Year average (%)

	2021	2022f	2023f	2024f
Argentina	48.4	70.0	90.0	70.0
Brazil	8.3	9.6	5.1	4.4
Chile	4.5	11.5	8.0	4.5
Colombia	3.5	9.9	6.4	3.8
Mexico	5.7	7.9	6.1	4.1
Peru	4.0	7.9	5.6	2.9
China	0.9	2.4	2.7	2.2
India	5.5	6.8	5.0	4.5
Indonesia	1.6	5.0	6.2	3.7
Malaysia	2.5	3.2	2.6	2.4
Philippines	3.9	5.3	4.1	2.8
Thailand	1.2	6.8	3.1	1.1
Vietnam	1.8	2.9	2.7	2.7
Poland	5.2	13.3	11.7	4.4

Saudi Arabia	3.1	2.5	2.7	1.8
South Africa	4.6	6.8	6.4	4.5
Turkey	19.6	74.0	40.1	18.0

f--S&P Global Ratings forecast. Source: S&P Global Market Intelligence.

Table 6

Policy rates

End of period (%)

	2021	2022f	2023f	2024f
Argentina	38.0	80.0	70.0	55.0
Brazil	9.3	13.8	10.8	7.5
Chile	4.0	11.5	9.0	6.5
Colombia	3.0	11.0	9.0	6.0
Mexico	5.5	10.0	8.5	6.5
Peru	2.5	7.5	6.0	4.5
India	4.0	5.9	5.3	5.0
Indonesia	3.5	4.5	5.5	5.5
Malaysia	1.7	2.8	3.3	3.5
Philippines	2.0	5.0	4.3	3.5
Thailand	0.5	1.5	3.3	2.3
Poland	1.8	7.5	7.0	5.5
Saudi Arabia	1.0	4.5	4.3	3.5
South Africa	3.8	6.8	6.5	6.0
Turkey	14.0	12.0	12.0	10.0

f--S&P Global Ratings forecast. Source: S&P Global Market Intelligence.

Table 7

Exchange rates vs. US$

Year average

	2021	2022f	2023f	2024f
Argentina	95.1	130.0	230.0	325.0
Brazil	5.4	5.1	5.2	5.2
Chile	759.1	865.0	893.0	898.0
Colombia	3742.0	4100.0	4275.0	4325.0
Mexico	20.3	20.2	20.8	21.3
Peru	3.9	3.8	4.0	4.0
China	6.4	6.7	7.0	6.8
India	74.5	80.0	81.9	82.6
Indonesia	14306.5	14714.2	15112.5	15205.0
Malaysia	4.1	4.4	4.5	4.4
Philippines	49.3	54.2	56.1	54.3

Thailand	32.0	35.3	36.3	35.6
Poland	3.9	4.5	4.6	4.3
Saudi Arabia	3.8	3.8	3.8	3.8
South Africa	14.8	16.2	17.0	17.3
Turkey	8.9	16.9	21.8	23.0

f--S&P Global Ratings forecast. Source: S&P Global Market Intelligence.

Table 8

Unemployment

Year average (%)

	2021	2022f	2023f	2024f
Argentina	8.8	8.4	9.8	9.1
Brazil	13.5	10.0	10.5	10.1
Chile	9.1	7.9	8.8	8.1
Colombia	13.8	11.3	11.3	10.5
Mexico	4.1	3.5	3.9	3.8
Peru	5.9	4.7	5.8	5.3
China	5.2	5.1	5.2	5.2
Indonesia	6.4	5.9	5.6	5.5
Malaysia	4.6	3.9	3.6	3.3
Philippines	7.8	5.8	5.9	5.3
Thailand	1.2	1.8	1.6	1.4
Poland	3.4	3.2	3.0	2.9
Saudi Arabia	6.6	5.9	5.2	5.3
South Africa	34.3	35.9	34.6	34.3
Turkey	12.0	11.2	11.5	10.4

f--S&P Global Ratings forecast. Source: S&P Global Market Intelligence.

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