

# Worse Before It Gets Better

Dec. 1, 2022

*This report does not constitute a rating action*

## Key Takeaways

- Sharply rising and higher-for-longer borrowing costs and the prospect of a U.S. recession in 2023 may further strain credit conditions.
- Credit rating trends have turned negative, and we now expect the U.S. speculative-grade corporate default rate to more than double, to 3.75%, by next September.
- The effects of high food and energy prices on discretionary spending are making it harder for corporate borrowers to pass through increased costs. And market liquidity--or the lack thereof--is a growing risk for many lower-rated borrowers.

*Editor's Note: S&P Global Ratings' North America Credit Conditions Committee took place on Nov. 21, 2022.*

**Already-strained credit conditions for borrowers in North America look set to worsen** as we head into 2023, amid the prospect of a recession in the U.S. and sharply rising borrowing costs. S&P Global's economists now expect U.S. GDP to contract 0.1% in 2023, with a mild recession in the first half and below-trend growth for the remainder of the year. And while there are signs that inflation is easing, it's still running well above the Federal Reserve's target. Any perceived monetary-policy misstep (in either direction) could push financing costs even higher and tighten liquidity further, straining borrowers' debt-service capacity.

**Credit rating trends have turned negative.** Downgrades have outpaced upgrades since August, and the negative outlook bias began to increase in the third quarter. **Defaults, too, look set to tick up.** S&P Global Ratings now expects the U.S. trailing-12-month speculative-grade corporate default rate to reach 3.75% by September 2023, from 1.4% a year earlier.

**Inflation is outpacing wage gains, squeezing consumer purchasing power**, particularly among lower-income households. As high food and energy prices weigh on discretionary spending, companies may find it even more difficult to pass through increased costs. If cost pressures don't abate soon, profit erosion could worsen, which could harm credit quality.

**Liquidity--or rather the lack of it--poses a rising risk, as well.** Borrowers and investors face a prolonged period of elevated interest rates. With the high likelihood of a recession ahead and structural changes afoot--from decreased Treasury market liquidity to the retirement of LIBOR--market liquidity could dry up in earnest. With a historically large number of corporate borrowers in the 'B-' rating category and lower, sensitivity to this risk is significant.

**Slumps in the U.S. and Canadian housing markets are adding to pressures.** While housing supply remains constrained in the U.S., the combination of economic uncertainty and higher mortgage interest rates is halting price growth, and even causing declines, in many markets. In Canada, too, home sales have slowed significantly, and prices have fallen for seven straight months. Any further correction of house prices could weaken the prospects of sectors such as homebuilders, residential mortgage-backed securities, and local governments.

**Geopolitical concerns, too, are at the forefront.** Most North American borrowers remain insulated from the direct impact of the Russia-Ukraine war, but as the conflict continues and risks of escalation increase, the effects on markets and growth could deepen. Meanwhile, with the U.S. and China in co-opetition, they may cooperate in some areas (e.g. global climate change) but compete in others (e.g. technology); any worsening tensions between the two over the South China Sea region, or an intensifying technology race, could impede trade, supply chains, intellectual property, investments, and financial transactions for both and for other economies.

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# Top North American Risks

## Higher borrowing costs erode debt-service capacity and hinder funding access

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

Investors are demanding higher returns for the risks they're assuming amid sustained elevated inflation and prospects of a recession. Any perceived monetary-policy misstep (in either direction) could roil credit markets and result in higher debt-servicing costs and tighter financing conditions. As some lower-rated borrowers begin to feel liquidity strains, this is especially concerning against the backdrop of high debt. Rising policy rates and uncertainty regarding the effects of the Fed's quantitative tightening could also lead to significant repricing of financial and real assets, including a further correction of the U.S. and Canadian housing markets.

## The U.S. economy suffers a deeper-than-expected recession and rising unemployment, amid global headwinds

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

Sharply higher borrowing costs could cause a pullback by American consumers, dampen confidence, and push the U.S. into a deeper recession than we expect, with a steep rise in unemployment. After U.S. GDP contracted for consecutive quarters to start the year, the 2.6% growth in the third quarter (and any expansion fueled by holiday shopping in the fourth) may prove to be the last hurrah for the world's biggest economy before it slips into recession. And with inflation still historically high, fears of a protracted period of stagflation are growing. Any worsening of economic momentum elsewhere, such as a further slowdown in China or contraction in the eurozone, could exacerbate a U.S. downturn.

## Sustained cost pressures squeeze profit margins and threaten credit quality

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

High input costs and supply-chain disruptions, exacerbated by elevated energy and commodities prices amid the Russia-Ukraine conflict, continue to plague companies in a number of sectors. Labor markets remain tight (notwithstanding some high-profile layoffs in the tech industry) and wages continue to rise. Many borrowers have relied on their ability to pass through increased costs to maintain profit margins, but this has become more difficult as high food and energy prices erode consumers' purchasing power and weigh on discretionary spending. If cost pressures don't ease soon, profit erosion could become more widespread and steeper than we expect. This, in turn, could harm credit quality.

## (Geo)political tensions roil markets, weighing on growth and business conditions

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

While most borrowers in North America have limited direct exposure to the Russia-Ukraine conflict, the turmoil in the food, energy, and commodities markets continues to weigh on growth prospects. As the war drags on and the risks of escalation (potentially involving NATO allies) increase, the effects could deepen. Meanwhile, the U.S. and China are in co-opetition. Any worsening tensions between the two over the South China Sea region, or an intensifying technology race, could impede supply chains and disrupt investment and financial flows for both countries and other economies.

## Structural risks

### Cyberattacks disrupt business operations and hurt credit quality

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

Cyberattacks pose a systemic threat and significant single-entity event risk as new targets and methods emerge, with geopolitical tensions raising the prospect of major attacks. As organizations accelerate their digital transformations, a key to resilience is a robust cyber security system, from internal governance to IT software. Entities lacking well-tested playbooks (such as active detection or swift remediation) are the most vulnerable.

### Climate risks and the energy transition affect business operations

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

Larger and more frequent natural disasters increase the physical risks public and private entities face and threaten to disrupt supply chains such as for agriculture and food. At the same time, the global drive toward a "net-zero" economy also heightens transition risks (e.g., policy, legal, technology, market, and reputation risks) across many sectors, and will likely require significant investments. The energy market disruption resulting from the Russia-Ukraine conflict, and concerns about energy supply and security, are adding uncertainty to this transition. In the U.S., we see transition risks as less acute currently than in Europe, since U.S. legislative policies focus more on subsidies and incentives rather than on carbon taxes and trading. But policy, and hence transition risks, can shift over time.

Source: S&P Global Ratings.

**Risk levels** may be classified as 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.

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