S&P Global
Ratings

Credit Conditions North America Q2 2023

Coalescing Stresses

March 28, 2023

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, Europe, and North America). Discussions center on identifying credit risks and their potential ratings impact in various asset classes, as well as borrowing and lending trends for businesses and consumers. This commentary reflects views discussed in the North American committee on March 21, 2023.

Key Takeaways

- **Overall:** Borrowers in North America face a stretch of difficult financing conditions as banking-sector turmoil exacerbates credit strains and the U.S. looks set to slip into a shallow recession. Some borrowers may find financing options much more costly or, for the riskiest borrowers, unavailable.
- **Risks:** Banks will likely implement stricter lending standards, making it more difficult and costly for entities, especially small and midsize businesses, to gain funding. Lower-rated borrowers, especially those exposed to unhedged floating-rate debt, may feel more severe liquidity strains.
- **Ratings:** The net outlook bias widened to negative 8.3% as of March 26—a 21-month high. We expect the U.S. trailing-12-month speculative-grade corporate default rate to reach 4% by December.

Amid banks' potential tightening of lending standards and the erosion of investor sentiment in reaction to the recent banking sector turmoil, borrowers in North America should brace for a stretch of difficult credit conditions.

Contagion risks remain elevated. Our base case is that the Fed's emergency lending facility and other support measures for U.S. banks will ease liquidity pressures on lenders and reduce the odds that unmanageable deposit outflows spread widely. Regardless, to mitigate liquidity challenges spreading into credit concerns, **banks will likely implement stricter lending standards**. This would make it more difficult and costly for entities—especially small and midsize businesses, as well as households—to gain funding. Also, confidence-sensitivity amplified by social media, as well as app-based deposit withdrawals much less constrained by "switching costs," could push stakeholders to reduce their exposures to certain lenders—thus disrupting banking flows, fueling further market volatility, and hurting consumer confidence.

While we don't at this point expect the reaction to recent events to evolve into a full-on "credit crunch," **some borrowers may find financing options available much more costly** or, in some cases, unavailable. Whether lenders in the private credit markets, which have the capacity to step in and provide financing, will be willing to do so remains to be seen.

The banking-sector turmoil could also be felt in commercial real estate (CRE)—the office space, in particular. Regional banks have proportionately higher exposure to CRE than larger U.S. banks, and the transformational changes in how and where employees conduct business could

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significantly curb demand for office real estate in the next few years. While office leases are typically for 10 years or more, current conditions could weigh on cash flows and asset valuations, translating into significant implications for office landlords' credit quality. The combination of higher mortgage rates compounded by properties needing material investment to maximize rental potential—overlayed with more scrutiny of bank balance sheets resulting in less capital available for CRE lending—all contribute to increased refinancing risk.

At the same time, **the credit landscape proved resilient in the first quarter**. The end of COVID restrictions in China has helped ease supply constraints, which were a primary contributor to inflation. Corporate results show companies have largely managed cost pressures, bolstering profitability. Credit spreads remain relatively tight and below levels indicative of imminent stress. However, credit strains are likely to broaden in coming months. We expect negligible revenue and EBITDA growth for our rated corporate universe this year, and profit margins are likely to narrow.

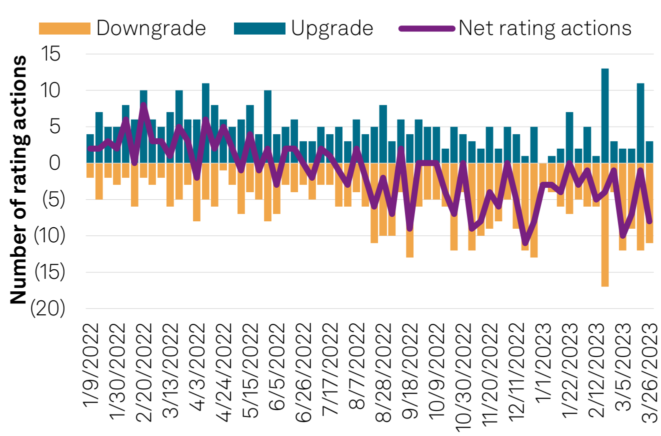
Signs of erosion in American consumers' balance sheets—most notably a surge in credit card debt among lower-income households—suggest there could be a significant pullback in discretionary spending. This could weigh more on profits in many sectors at a time when input-cost pressures persist. **The U.S. economy could suffer a sharper-than-expected downturn**. A delayed downturn or a protracted period of stagnation/stagflation could prove more harmful than a shallow near-term slump—especially as the maturity wall approaches.

And benchmark rates look set to stay elevated. With inflation still running well above the Fed's target, policy makers are likely to keep the federal funds rate higher for longer than markets seem to be anticipating. **Higher all-in borrowing costs will increase entities' debt-service burdens and could limit funding access**. Lower-rated borrowers, especially those exposed to unhedged floating-rate debt, may feel more severe liquidity strains. Political brinkmanship in Washington over the U.S. debt ceiling and the transition away from LIBOR as a debt-pricing benchmark could further tighten financing conditions.

On average, ratings are lower than they were prior to the pandemic with 11% of U.S. corporates rated 'B-' or below. Downgrades have outpaced upgrades since August, and the net outlook bias, indicating potential ratings trends, widened to negative 8.3% as of March 26—a 21-month high (although still roughly half pre-pandemic levels) (see charts 1 and 2). The aerospace and defense, and telecom sectors saw more uptick in negative bias in the recent quarter, and they joined consumer products in having more than one-quarter of issuers with a negative outlook or on CreditWatch with negative implications (see chart 3).

Chart 1

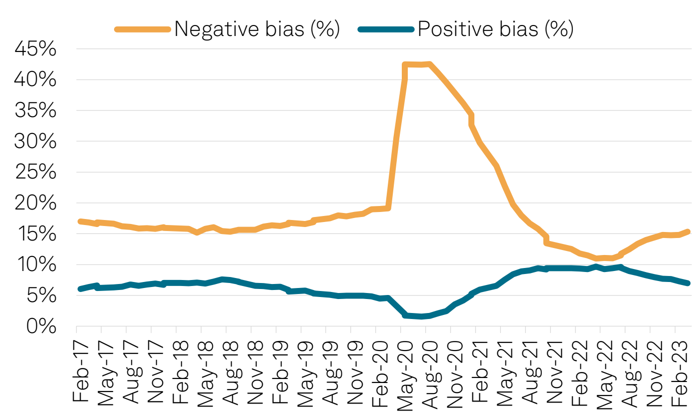
North American Rating Actions



Data as of March 26, 2023, and covers financial and nonfinancial corporates. Source: S&P Global Ratings.

Chart 2

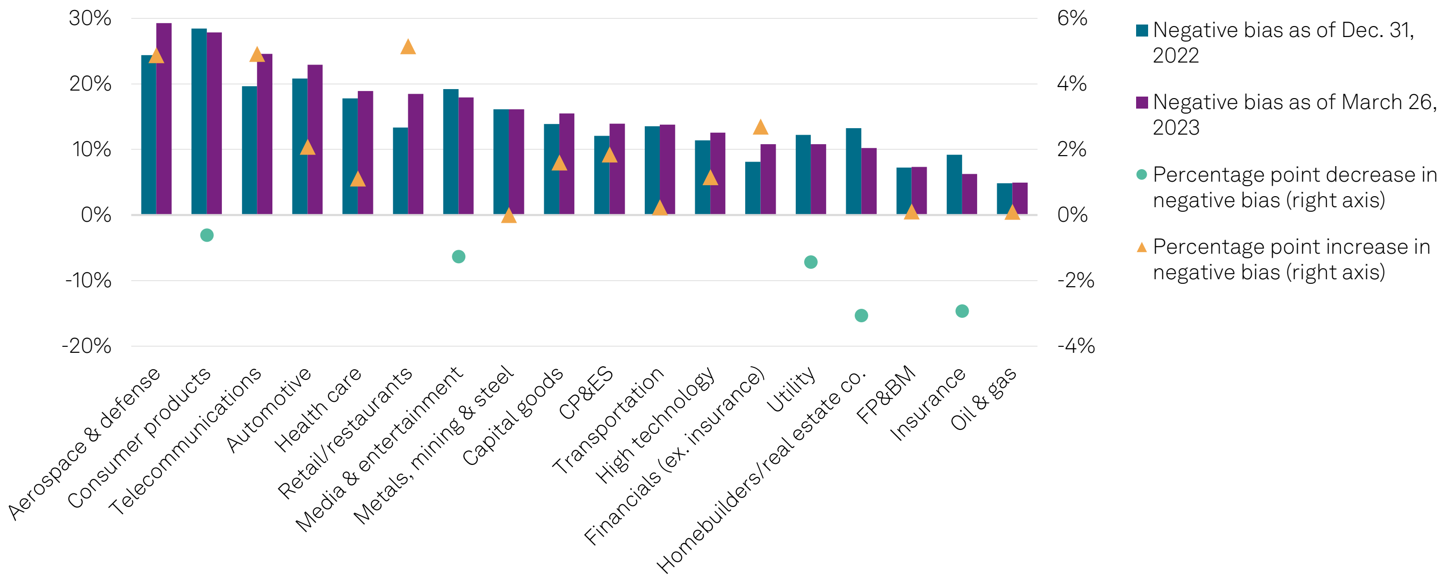
North American Ratings Outlook Bias



Data as of March 26, 2023, and covers financial and nonfinancial corporates. Negative bias--Percentage of issuers with a negative outlook or CreditWatch. Positive bias--Percentage of issuers with a positive outlook or CreditWatch. Source: S&P Global Ratings.

Chart 3

Negative Bias By Sector

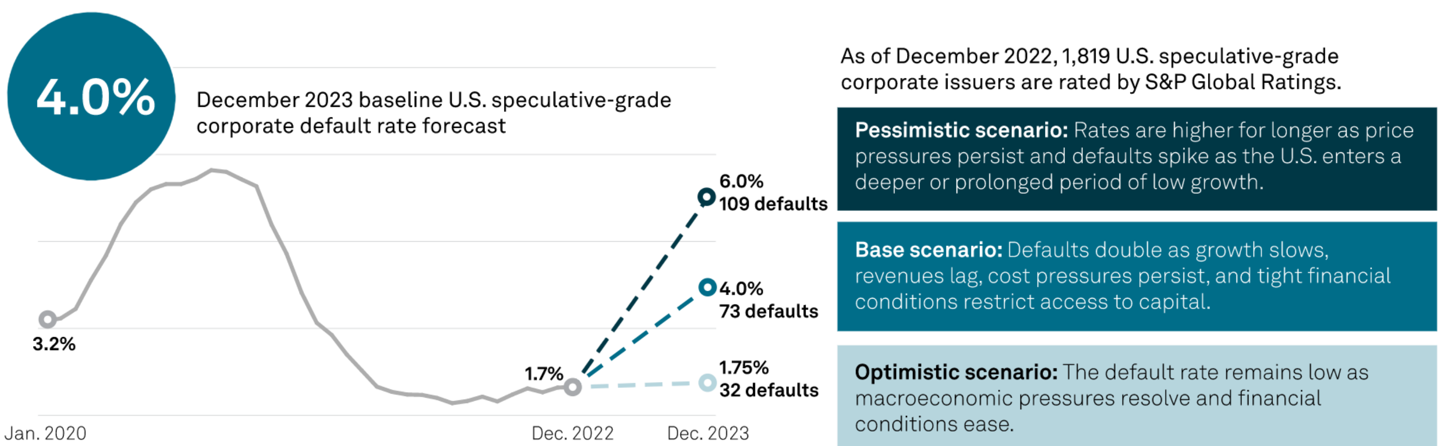


CP&ES--Chemicals, packaging & environmental services. FP&BM--Forest products & building materials. Negative bias--Percentage of issuers with a negative outlook or CreditWatch.
Source: S&P Global Ratings.

Credit quality could erode and defaults will likely rise. S&P Global Ratings Credit Research & Insights expects the U.S. trailing-12-month speculative-grade corporate default rate to reach 4% by December—just shy of the 4.1% long-term average (see chart 4). If, as we expect, unemployment rises and discretionary spending erodes, consumer-reliant sectors, which make up roughly half of borrowers in the 'CCC' to 'C' categories, will suffer most.

Chart 4

Doubling Of Defaults By December 2023



Data as of Dec. 2022. Sources: S&P Global Market Intelligence's CreditPro® and S&P Global Ratings Credit Research & Insights.

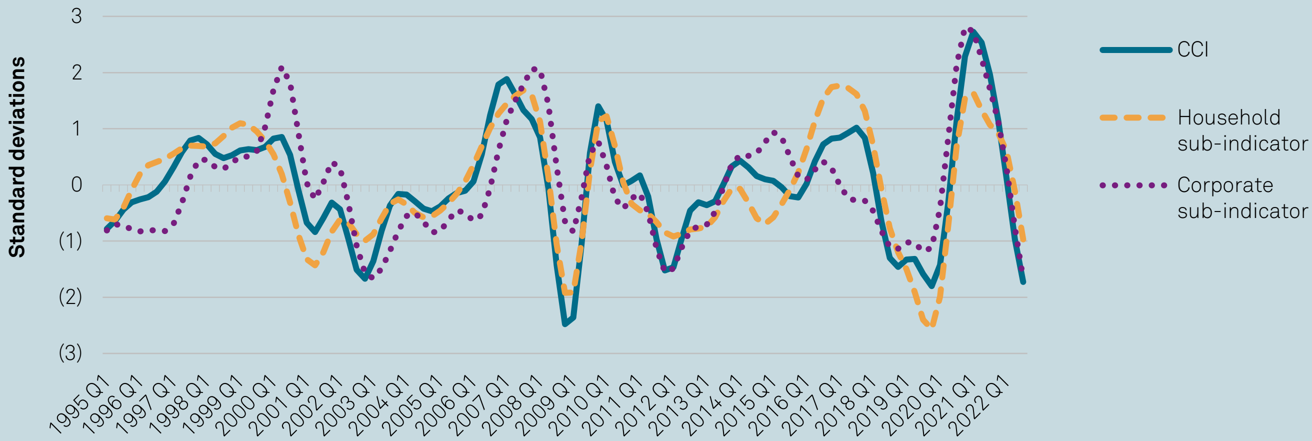
Credit Cycle Indicator

Credit stress heightens, bank turmoil could add more pain

Since the introduction of the North America Credit Cycle Indicator (CCI) in June 2022, we had signaled the risk of heightened credit stress unfolding in late 2022 or early 2023 (see chart 5). While the CCI is trending downwards from the peak of 2.7 standard deviations above historical average as of first-quarter 2021—indicating a credit correction is underway—the potential impact on nonperforming loans (NPLs) and defaults from the buildup of debt leverage and asset prices could linger beyond the current stress period, especially considering the recent turbulence in the banking sector and potential further tightening of lending conditions. For more details about our proprietary CCI, see "White Paper: Introducing Our Credit Cycle Indicator," published June 27, 2022.

Chart 5

North America CCI



Peaks in the CCI tend to lead credit stresses by six to ten quarters. When the CCI's upward trend is prolonged or the CCI nears upper thresholds, the associated credit stress tends to be greater. Sovereign risk is not included as a formal part of the CCI. The CCI period ends in Q3 2022. The North America CCI includes Canada and the U.S.
Sources: Bank for International Settlements, Bloomberg, S&P Global Ratings.

Corporates. The corporate sub-indicator has been declining steadily from the peak of 2.8 standard deviations above trend as of end-2020, reflecting moderating corporate leverage growth after the surge during COVID. However, even tighter financing conditions, more severe demand headwinds, and persistently elevated input costs could further exacerbate the debt overhang. Companies at the lower end of the credit spectrum are particularly vulnerable, facing more debt service difficulties and possible liquidity strains. Small and midsize enterprises (SMEs) could fare worse as banks tighten lending standards amid the recent failures of three U.S. regional banks (see Top North American Risks section).

Households. The household sub-indicator is also trending downward. Though excess savings accumulated during the pandemic and a tight labor market have so far supported consumer health, households' financial buffers are running thin. Lower-income households that employed leverage with floating-rate debt could become more exposed to liquidity and rate shocks (see Consumer Health section). In addition, any further correction of the U.S. and Canadian housing markets could damp perceived household wealth and have spillover effects across sectors.

Top North American Risks

Protracted tight financing conditions hurt borrowers' debt-service capacity, funding access dries up

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

A prolonged period of tight financing conditions—irrespective of the path of central bank policy rates—will increase entities' debt-service burdens and limit access to funding. As earnings remain under pressure and debt maturities creep into view, lower-rated borrowers may feel more severe liquidity strains. Political brinkmanship over the U.S. debt ceiling is complicating matters; as we approach the deadline, financial market volatility could further drive up borrowing costs. The looming end of LIBOR as a debt-pricing benchmark is another factor that could limit funding access. Tighter financing conditions could also lead to significant asset repricing—including a deeper correction in residential and commercial real estate.

U.S. economy suffers a sharper-than-expected downturn, cost pressures and persistent inflation squeeze profit margins

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

For many corporates, input prices—including wages—remain high, and they're finding it more difficult to pass along costs to consumers and customers. Profit erosion could become more widespread and steeper than we expect, which would harm credit quality. Although American households and services sectors have so far been resilient in the face of monetary-policy tightening, financial cushions are wearing thin as prices stay elevated and consumers, especially those at the lower-income scale, increase credit card borrowings. A sharp pullback in consumer spending and capital investment could push the U.S. into a harder landing than we expect. A delayed downturn or a protracted period of stagnation/stagflation could prove to be more harmful than a shallow near-term slump—especially as the maturity wall approaches.

(Geo)political tensions roil markets and weigh on growth and business conditions

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

Most borrowers in North America have limited direct exposure to the Russia-Ukraine conflict, but as the war drags on and the risks of escalation (potentially involving NATO allies) increase, the effects could deepen. Meanwhile, the U.S.-China relationship is on shaky ground. Any further worsening of tensions between the two over the South China Sea region and the Russia-Ukraine war, or an intensifying technology race, could impede supply chains, and disrupt investment and capital flows for both—and other—countries.

U.S. bank failures erode sentiment and add to credit strains

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

The failures of three U.S. regional banks could spark fears that cause stakeholders to reduce their exposures to other banks. This could disrupt banking flows, fuel further market volatility, and weigh on consumer confidence and spending. Meanwhile, banks may tighten lending conditions to preserve liquidity, which could make it harder for entities, such as small and medium-sized businesses, as well as households, to gain funding. The turmoil could also expose other vulnerabilities (e.g., CRE) and muddies the monetary-policy waters in the Fed's fight against inflation.

Secular risks

Climate risks and energy transition affect business operations

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

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. The global drive toward a "net-zero" economy also heightens transition risks (e.g., policy, 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. In the U.S. we see transition risks as less acute than in Europe, since U.S. policies focus more on subsidies and incentives rather than carbon taxes and trading. But policy, and hence transition risks, can shift quickly.

Tech transformation: Cyber attacks threaten operations; accelerating digitalization disrupts business models

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

Cyber attacks 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. On another front, the accelerating digitalization of business and economic activity—particularly the ability to influence market sentiment and shift capital rapidly and widely—adds to potential volatility in financial markets.

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.

Macroeconomic Outlook

- We expect the U.S. to slip into a short, shallow recession—with most of the weakness coming in the second quarter, followed by a tepid recovery in the latter half of the year.
- Banking-sector turbulence is muddying the monetary-policy waters for the Fed. We now expect just one more quarter-point rate hike this year, with a terminal fed funds rate of 5.0%-5.25%. However, we think it unlikely the central bank will lower the rate this year.
- For Canada we forecast a 0.8% increase in full-year real GDP, with the country likely to avoid a recession.

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U.S.

The U.S. economy is proving resilient in the face of still-hot inflation and the Fed's aggressive monetary-policy tightening, bolstered by steady consumer demand (retail sales slowed in February, but on the heels of a very strong January) and a robust labor market (there are almost two job openings for every unemployed American). After a solid start to the year for economic activity, we now forecast full-year GDP growth of 0.7%, in contrast to our November call for contraction of 0.1%.

We still expect the world's biggest economy to slip into a short, shallow recession—with most of the weakness coming in the second quarter, followed by a tepid recovery in the latter half of the year. As the Fed keeps its policy rate elevated, job losses will likely accelerate, crimping consumer confidence and discretionary spending. As it stands, headline unemployment, at just 3.6%, is well below the estimated sustainable rate of approximately 4.5%; as rate hikes bite further, we expect unemployment to overshoot that level, peaking at 5.4% in early 2025, then slowly coming down later that year.

We think the macro effects of banking-industry turmoil will be limited—for now, assuming measures by regulators to stabilize the financial markets prove successful. The most likely contagion channel to the broader economy is through consumer confidence, where uncertainty could damp spending. If widespread enough, the effects on consumption—particularly in services, which has remained strong—would weigh on employment growth.

Either way, this turbulence is muddying the monetary-policy waters. The collapse of Silicon Valley Bank, which faced a cash crunch due to rising interest rates, effectively forced the Fed to create an emergency lending facility for U.S. banks to ease liquidity pressures and reduce the odds that other regional lenders would suffer sudden and unmanageable deposit outflows. This will likely slow the central bank's tightening, as policy makers assess the damage. **We now expect just one more quarter-point rate hike this year**, with a terminal fed funds rate of 5.0%-5.25% the same as our November forecast. However, we think it unlikely the central bank will lower its benchmark rate this year. As prices begin to stabilize, we expect the Fed's first rate cut will come in the first half of next year, with the fed funds rate above 4.0% until late 2024.

Against this backdrop, whether the Fed can steer the economy into a "soft landing" or will bring about a delayed (and likely worse-than-expected) downturn largely boils down to one question: Are the financial cushions that businesses and households built up during the long stretch of low borrowing costs sufficient for them to ride out economic turmoil?

Canada

After the Canadian economy proved surprisingly resilient in the first quarter, S&P Global Ratings Economics expects economic activity to drop in the second quarter as consumer spending decelerates. But **we forecast a 0.8% increase in full-year real GDP, with the country likely to avoid a recession**. High-frequency real-time economic data point to gradual improvement in operating conditions in recent weeks. The drop in long-term inflation expectations indicates that interest rate hikes by the Bank of Canada and the decline in oil prices are swaying household expectations for consumer prices.

Meanwhile, **the worst may be over for the country's housing market**, based on February housing starts and new home sales in Canada and the U.S. In Canada, housing starts increased 12% in February, following four consecutive monthly declines, while new home sales edged up 2.3% from January. Mortgage rates inched down to 5.8% on average in February after rising to 5.9% in December of last year.

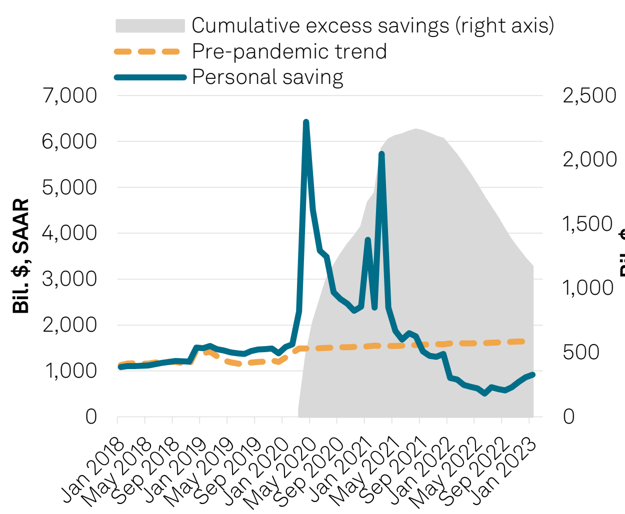
Note that we developed our forecasts amid the recent financial turmoil stemming from U.S. bank failures, which adds downside risk—particularly for the U.S economy, with knock-on effects for Canada. These forecasts assume recent measures by regulators to stabilize the financial markets are successful. A rate cut by the Bank of Canada may be on the table sooner than expected if global financial concerns spread to the real economy, but this isn't built into our March forecast. **We expect the Bank of Canada's policy rate to hold at 4.5% until early 2024**, when we expect it will start easing.

Consumer Health

While North American households have so far shown resiliency in the face of monetary-policy tightening—largely supported by a tight labor market—**financial cushions are eroding due to still-elevated prices, higher borrowing costs, and the stock market correction**. U.S. household excess savings, a key buffer moderating the slowdown, have fallen to $1.2 trillion as of January, from a peak of about $2.2 trillion (see chart 6). **Consumers are also taking on more debt despite higher interest rates**, with significant jumps in credit card balances in the past several quarters (see chart 7). The debt-service ratio of U.S. households has returned to pre-pandemic levels, whereas that of Canada is above the historical average (see chart 8).

Chart 6

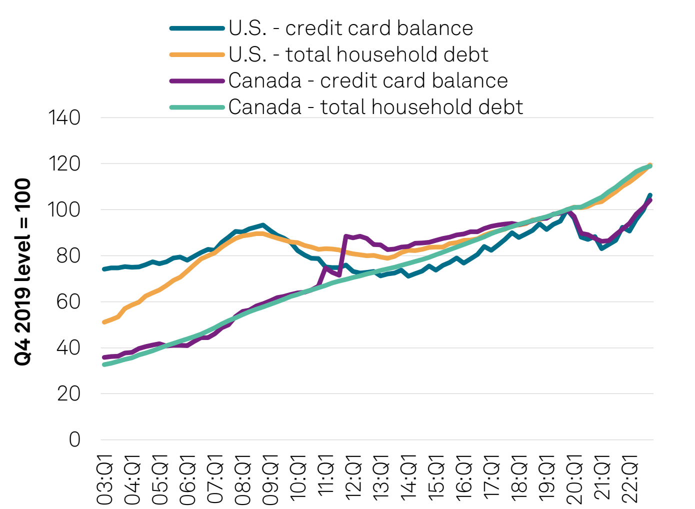
U.S. Households Excess Savings Are Declining



SAAR--Seasonally adjusted annual rate. Sources: U.S. Bureau of Economic Analysis, S&P Global Ratings Economics.

Chart 7

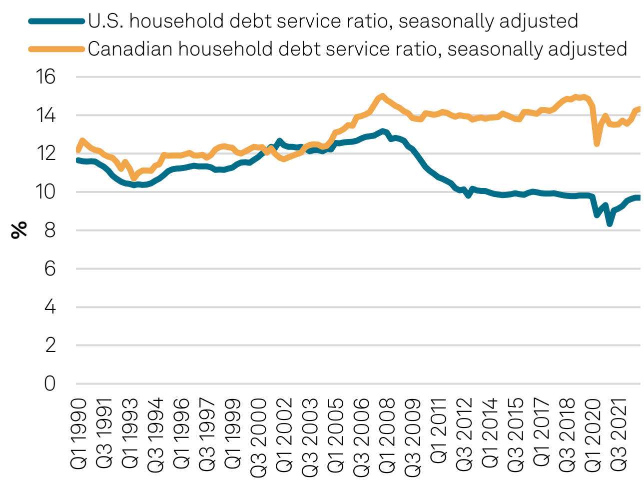
Households Are Tapping More Into Credit Cards



Data as of Q4 2022. Sources: New York Fed Consumer Credit Panel/Equifax, Statistics Canada, S&P Global Ratings calculations.

Chart 8

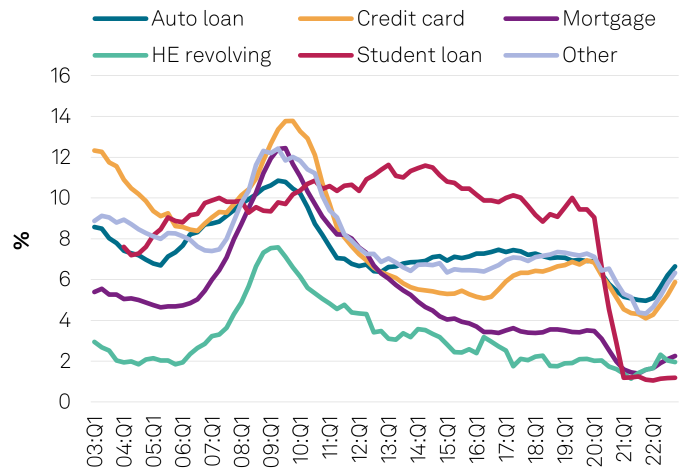
Household Debt Service Ratios Are On The Rise



Data as of Q4 2022. The household debt service ratio is the ratio of total required household debt payments to total disposable income. Sources: Board of Governors of the Federal Reserve System, Statistics Canada.

Chart 9

Transition Into Delinquency (30+Days) By Debt Type



Data covers the U.S. and is as of Q4 2022. The "Other" category includes retail cards and other consumer loans. Source: New York Fed Consumer Credit Panel/Equifax.

Delinquency data show signs of weakness. The share of debt transitioning into delinquency rose for nearly all debt types, and those of credit cards and auto loans were up more significantly (see chart 9). The lowest-income borrowers have incurred more increases in credit card balances (in percentage terms) and saw more upticks in delinquencies in recent quarters, than higher-income cohorts (see Andrew Haughwout, Donghoon Lee, Daniel Mangrum, Joelle Scally, and Wilbert van der Klaauw, "Balances Are on the Rise—So Who Is Taking on More Credit Card Debt?," Federal Reserve Bank of New York Liberty Street Economics, Nov. 15, 2022). The fact that balances continue to rise even in the current unfavorable interest-rate environment suggests that consumers are increasingly stretched, and if delinquencies rise, certain swaths of consumer demand could fade rapidly.

Meanwhile, we expect the U.S. housing market will continue to slow. Specifically, we expect the average 30-year fixed-rate mortgage to be above 6% during 2023, which would continue to strain affordability, although home prices could decrease about 5% this year because of the increased financing costs (see "2023 U.S. Residential Mortgage And Housing Outlook: Navigating A Softening Market," published Jan. 20).

For nonfinancial corporates, certain consumer-facing sectors will likely take a hit from consumers' pullback in discretionary spending. For example, consumer products and retail sectors are seeing lower- and middle-income consumers trading down within category and across channels, putting more pressures on issuers in discretionary and durable segments and those with high private-label penetration. For auto manufacturers, we expect weaker demand in the second half of this year and into 2024. The leisure and entertainment industry could be an exception as it is still recovering from the pandemic and benefiting from the pent-up demand for travel and experience.

Regarding consumer exposure within the loan portfolios of banks, we expect credit card charge-offs to normalize amid high inflation, slowing U.S. economic activity, and potentially higher unemployment. While concentration in auto loans is generally limited across the banks we rate, rising past-due loans and falling resale values that are below peak levels indicate losses will rise, particularly among nonprime borrowers.

In structured finance, the strength of the labor market and the length and depth of recession are key factors of performance. Within the rated consumer asset-backed securities (ABS) space, the subprime segment of auto loan ABS is more vulnerable than its prime counterpart—subprime 60+ day delinquencies reached record levels by year-end 2022, while prime metrics have merely normalized. At this time, most subprime classes are rated investment-grade, and for these we expect stable ratings. However, a small percentage of the ratings are speculative-grade, and for these we have a stable to negative outlook.

Credit card performance remains robust for bankcard and private-label collateral given that the securitized credit card portfolios are, for the most part, highly seasoned and include large portions of prime borrowers. Barring a rapid and severe increase in unemployment, we expect investment-grade ratings on credit card ABS to remain broadly stable.

We expect somewhat weaker collateral performance in the next 12 months for non-agency residential mortgage-backed securities (RMBS); however; ratings trends should remain stable. Given the strong home-equity positions and our forecast for unemployment to peak at only 5.4% in 2025, we don't expect a repeat of the Global Financial Crisis (GFC)—especially given the improved mortgage underwriting in the post-GFC era. Owners who hold low-rate, long-term, fixed-rate mortgages may be disincentivized to move, which will exacerbate what is already a supply-challenged market, and likely moderate overall price declines. It follows that the generally strong home-equity positions may lead to non-adverse resolutions of borrower defaults. For a more detailed view of structured finance sectors, see the Structured Finance section.

Financing Conditions

- Bank lending standards for commercial and industrial loans to large and midsize corporations have been tightening for the past several quarters.
- Spreads remain relatively narrow despite recent events, but this could prove too optimistic. For several months in a row, our estimated speculative-grade bond spread has been rising, widening the gap between it and the actual spread.
- Many newer issuers in recent years among the riskiest rating categories ('B' and 'CCC') rely on floating-rate debt, most often in the form of leveraged loans.

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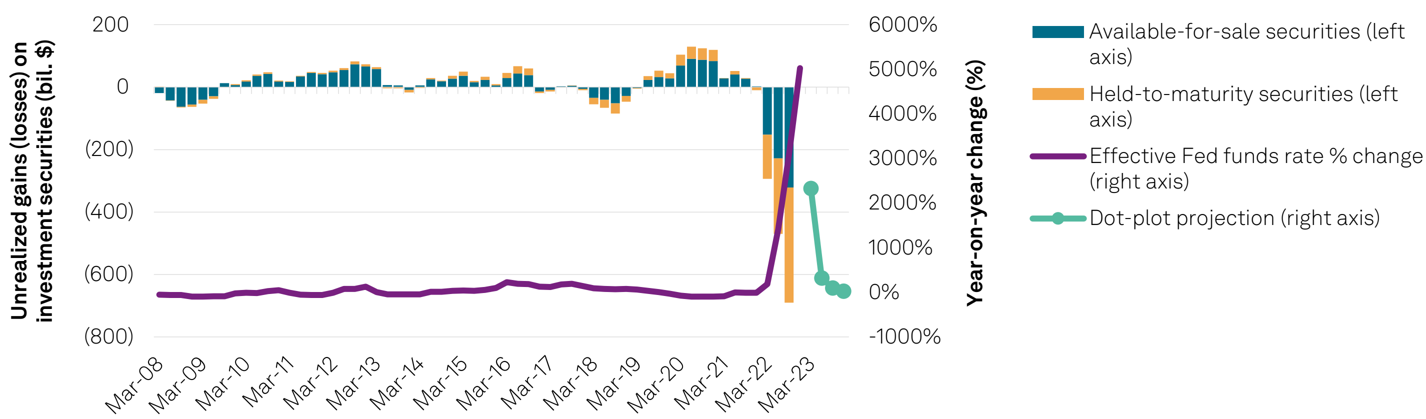
The cost of moving quickly from "free money" to 5% is more than 5%. We have been saying for some time that the full impact of rising policy rates operates with a lag on the real economy. Financial markets reacted quickly to rising rates last year, with nonfinancial corporate bond issuance plummeting 45% in the U.S. This was a particularly stark and fast reaction, perhaps enabled by the large stockpiles of cash built up in 2020-2021 amid record issuance. This allowed many firms to effectively opt out of issuing new debt amid higher, more volatile interest rates.

Rising rates have also played a role in the recent banking sector turbulence. For the larger system of insured institutions covered by the FDIC, unrealized losses easily reached an all-time high that clearly coincided with the rapid rise in the federal funds rate (see chart 10). Going back to the 1950s, there has never been such a rapid rise in relative terms for the Fed's main policy rate. A large reason for this is because it came off a protracted period of being at effectively zero since early 2020.

One reason for optimism is that even if we assume the Fed's own assumptions for the policy rate (via the dot-plot average) of 5.1% at year-end, this could result in a reduction of—or at least a stabilization in—unrealized losses for banks. And as more securities mature and are replaced with higher-yielding ones, these reported losses should reverse course. But until that happens, overall lending and economic activity are likely to both slow.

Chart 10

The Pace Of Hikes Matters For Unrealized Losses



The right axis shows year-on-year percentage change in effective Fed funds rate and projections based on dot-plot average of 5.1% for Dec.2023. Sources: S&P Global Ratings, FRED, FDIC.

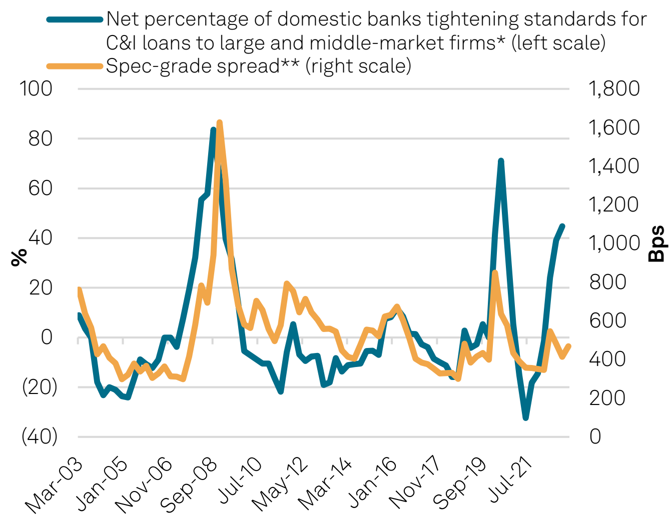
Despite market fluctuations, one thing that will likely result from the recent turbulence is that banks will reduce lending in an effort to shore up liquidity and manage capital requirements. As it is, bank lending standards for commercial and industrial (C&I) loans to large and midsize corporations have been tightening for the past several quarters, reaching levels comparable to the COVID peak period (see chart 11). And tighter lending standards for all major types of loans, including those for CRE, residential mortgages, and consumer loans has been a growing trend.

Perhaps one mitigating factor has been a concurrent drop-off in loan demand during the lead up to the recent stress—although even during the fourth-quarter 2022 survey, respondents were already anticipating a continued tightening of lending standards this year. The recent addition of potential bank liquidity reduction will only amplify this reduction in lending.

The peak rate of net tightening on C&I loans during 2020 of roughly 71% came in the second quarter (onset of COVID), before the "peak" default rate of 6.6% at the end of the year. This would have been a historically low default rate for such a high level of lending restrictions. However, bond markets remained sanguine by comparison, with the peak speculative-grade bond spread reaching 850 basis points (bps)—well below the global financial crisis peak of 1,627 bps in March 2009. The same appears to be happening now, with the spec-grade bond spreads at 460 bps.

Chart 11

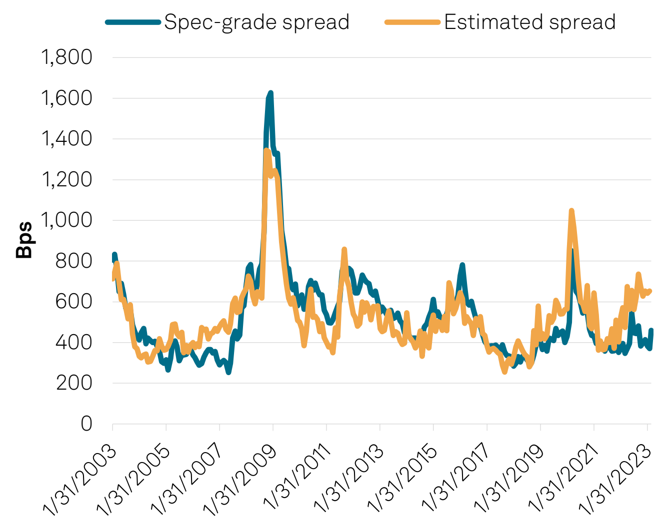
Bank Financing Had Already Swung Tighter



*Senior Loan Officer Opinion Survey on Bank Lending Practices as of Jan. 2023.
** Quarter-end spread as of March 24, 2023. Sources: Federal Reserve and S&P Global Ratings.

Chart 12

Bank Stress Pushes Spreads Up, But Still Below Estimate



Source: S&P Global Ratings.

Spreads remain relatively narrow despite recent events, but this could prove too optimistic. For several months in a row, our estimated speculative-grade bond spread has been rising, widening the gap between it and the actual spread (see chart 12). Driven largely by increasing market volatility and declining economic activity, the estimated spread of 652 bps at the end of February was 282 bps higher than the actual reading. Since then, the spec-grade spread has risen to 460 bps (as of March 23) but is still well below our estimate. Even before recent banking sector stress the estimated spread indicated an optimistic investor base for speculative-grade bonds. With the inclusion of this additional stressor, current pricing appears even more optimistic.

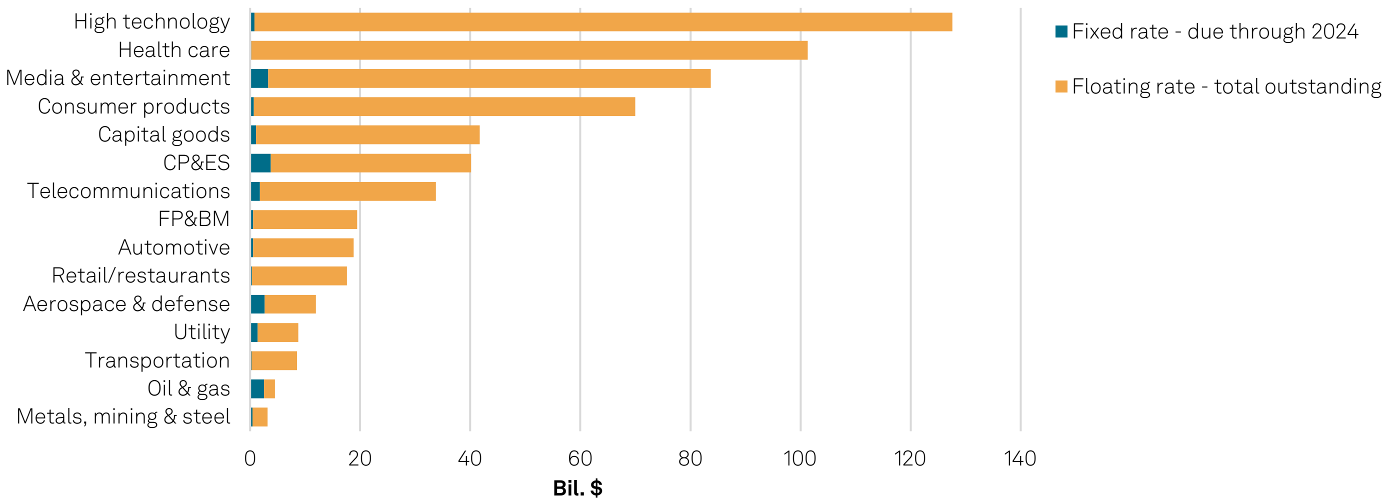
Quickly rising rates have shown themselves to be disruptive to many areas of financial markets and lending activity. The quick pace of increases proved particularly difficult to adjust to in a relatively short time, in part because expectations for pauses were dashed as inflation proved to be more stubborn than anticipated.

But higher rates that could linger longer still pose risks. Many newer issuers in recent years among the riskiest rating categories ('B' and 'CCC') rely on floating-rate debt, most often in the form of leveraged loans. As of Jan. 1, we estimate there is roughly $570 billion in outstanding nonfinancial corporate debt at the 'B-' level and lower that carries floating interest rates (see chart 13). And this is largely concentrated in a few sectors heavily reliant on consumer spending and—similar to SVB's depositor base—high tech. By comparison, only $20 billion of fixed-rate debt in this category is coming due by the end of 2024, thus minimizing any sticker shock from higher rates when this debt needs to be refinanced.

Asset-price volatility, shocks to financial market sentiment, more restrictive lending, elevated debt-service costs, and the potential for a recession will all weigh on creditworthiness.

Chart 13

U.S. Near-Term Nonfinancial Corporate Refinancing Risk: 'B-' & Below



Data as of Jan. 1, 2023. Note: Foreign currencies are converted to USD on the respective report period date. Includes bonds, loans, and revolving credit facilities that are rated by S&P Global Ratings. CP&ES--Chemicals, packaging & environmental services. FP&BM--Forest products & building materials. Source: S&P Global Ratings.

Sovereigns

- The administration of Democratic President Joe Biden did better than expected in the 2022 midterm elections, but political power remains divided at the federal level.
- Congress isn't likely to pass major fiscal legislation before the 2024 national elections.
- We assume Congress will raise or suspend the government's statutory debt ceiling to allow the Treasury to remain timely on its debt-service obligations.

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Democrats did better than expected in the 2022 midterm elections, gaining a slight majority in the Senate but losing their majority in the lower House by a slim margin to the Republicans. Despite divided government and political brinkmanship, we expect key economic policies will remain predictable.

We assume Congress will raise or suspend the government's statutory debt ceiling (which became binding in January 2023) in a timely manner to allow the U.S. Treasury to remain current on its debt-service obligations (see "Credit FAQ: U.S. Sovereign Debt Hits The Ceiling Again," published Jan. 20). Congress has raised the debt ceiling on time—including at the 11th hour—more than 80 times since 1960, during both Republican and Democratic Congressional majorities and presidencies. It would be unprecedented in modern times for an advanced G-7 country, such as the U.S., to default on its sovereign debt.

Even without an actual missed payment, the nearer we get to the deadline the greater the likelihood of investor concerns resulting in negative consequences for financial markets. Potential volatility in financial markets could drive up borrowing costs—especially for entities at the lower end of the ratings scale.

On the other hand, Congress isn't likely to pass major fiscal legislation, including reforms to tax laws needed to implement a global minimum tax agreed to by 130 countries in 2021, before the 2024 national elections.

Political disagreements on fiscal policy will likely sustain general government fiscal deficits, which consolidate the federal and subnational government deficits, at around 5% of GDP in the next 2-3 years (down from nearly 16% in 2020). Continued budget deficits will push the net general government debt burden towards 100% of GDP by 2026, close to the previous peak of 106% of GDP in central government debt during World War II.

In contrast with political acrimony on many issues, America's two political parties have broadly agreed on an aggressive policy towards China, skepticism about trade agreements, and an active industrial policy to promote high technology sectors that are seen to be strategically important for the country. Hence, the Biden administration was able to pass several important laws, including the CHIPS and Science Act ($280 billion to encourage semiconductors), the Bipartisan Infrastructure Act ($550 billion over five years to invest in highways, public works, and new green technology), the Inflation Reduction Act (as much as $391 billion in tax credits and subsidies to encourage clean energy) and the National Defense Authorization Act (as much as $278 billion to promote new technology). The long-term effects of these programs are likely to be moderately positive for continued investment, technological innovation, and economic growth.

Financial Institutions

- We believe the Fed's timely actions—as well as possible further steps by regulators, if necessary—should help banks meet their liquidity needs without having to realize losses on their securities portfolios.
- We haven't seen evidence of unmanageable deposit outflows spreading widely across rated banks.
- We expect recent events, if they persist, to weigh on bank profitability and believe they may also affect loan availability.

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Banks

In recent weeks, the failure of three U.S. banks has meaningfully raised market concerns about the banking sector's ability to maneuver the sharply higher trajectory of interest rates, following the 475-bps increase in the federal funds rates since March 2022. In particular, U.S. regional banks with high proportions of uninsured deposits and outsized unrealized losses in their securities portfolio as a result of higher interest rates faced steep selloffs in the equity markets. In response, the Fed unveiled a new emergency lending facility—the Bank Term Funding Program (BTFP) —on March 12, a collateralized facility that will offer loans for up to one year to eligible financial institutions by accepting collateral in eligible securities at 100% of par value. The Fed also announced it will lend at a 100% advance rate through the discount window, its conventional channel for extending liquidity to banks in need. We believe some banks have also reached out to the Federal Home Loan Bank (FHLB) to defensively shore up their liquidity.

We believe these timely actions—as well as possible further steps by regulators, if necessary—should help banks meet their liquidity needs without having to realize losses on their securities portfolios. As of year-end 2022, the FDIC reported that banks' unrealized losses in their available-for-sale (AFS) and held-to-maturity (HTM) securities portfolios escalated to $620 billion, from $7.9 billion a year earlier.

As of March 23, we haven't seen evidence of unmanageable deposit outflows spreading widely across rated banks. The situation remains fluid, and, given that banking is a confidence-sensitive industry, we continue to carefully monitor it. We are gauging which rated banks may be more prone to near- and medium-term pressures, focusing on both broad market conditions and bank-specific characteristics. Among other factors, we are looking at the composition of deposits and gauging deposit outflows that have resulted from the Fed's tightening of monetary policy versus those caused by confidence-sensitivity issues. We are also considering interest-rate sensitivity, the asset quality of loan portfolios, and capital, among other factors.

Looking ahead, we expect recent events, if they persist, to weigh on bank profitability and believe they may also affect loan availability. Even before the recent spate of market turbulence, we had already projected that the fourth quarter 2022 may have been the peak quarter for net interest income (NIM). Given current market conditions, we believe banks are more likely to reprice deposits faster in order to retain them and stabilize loan-to-deposit ratios, resulting in higher cost of deposits than previously expected, which could dampen NIM. If banks elect to keep more cash on hand defensively, that could also constrain profitability. Furthermore, we believe loan availability may be constrained if banks tighten underwriting standards or opt to hold extra liquidity buffers, particularly for smaller banks. According to SNL data, as of the fourth quarter of 2022, banks with less than $100 billion in assets accounted for 36% of domestic loans and 64% of commercial real estate loans.

Finance Companies

We have stable outlooks on approximately 80% of the finance companies (fincos) we rate. While there's been modest weakening in asset quality via an uptick in non-accruals and charge-offs, overall quality is steady. Market conditions have remained choppy as the Fed continues to raise interest rates and investor sentiment evolves amid the likelihood of a shallow recession this year.

We have stable outlooks on 11 of 12 business development companies (BDCs) we rate. Through the second half of 2022, rising interest rates led to decline in debt-service coverage ratios for portfolio companies and an increase in unrealized losses for BDCs. A sharp decline in the value of BDC investments would weigh not only on their earnings but could jeopardize their compliance with a key regulatory requirement to maintain certain asset levels relative to debt. We expect BDCs will maintain compliance with the required regulatory ratio. In February we revised our outlooks on two CRE finance companies, to negative from stable, as asset quality deteriorated. We expect higher rates will stress CRE markets, contributing to higher cap rates and lower property valuations, and weighing on CRE lenders—particularly those with exposure to office, retail malls, and hotels.

We expect the likelihood of higher unemployment coupled with elevated inflation will reduce purchasing power for subprime consumers and weaken consumer credit quality. The expected recession will likely have an outsized effect on lower-income workers, who are more likely to use consumer lending products. We expect weaker earnings for consumer finance companies in 2023 as delinquencies rise and consumer lenders scale back on originations by tightening their credit underwriting box. We expect the slowdown in CRE transactions that characterized the latter half of 2022 will persist through first half of 2023. Performance at residential mortgage companies continue to be affected by the 30-year mortgage rate, which briefly topped 7%, the highest level in more than 20 years. We expect market conditions to remain challenging this year and could see further negative ratings actions if weak operating conditions persist.

Asset Managers

We have a negative view of the traditional asset manager sector for 2023, while we maintain our stable sector view of the alternative asset management and wealth management sectors. We expect rising interest rates, elevated inflation, continued market volatility, and a shallow recession to pressure debt and equity markets this year. Credit metrics will weaken for some asset managers should earnings decline, and those with significant variable-rate debt exposure will see interest coverage metrics compress.

Of the three subsectors, traditional managers are the most exposed to market volatility. Net outflows could compound this pressure for some managers. While wealth managers are similarly vulnerable, their asset base is stickier due to the relationship-based nature of the business and breadth of services provided, resulting in more stable earnings. Alternative asset managers are the best-positioned of the three, considering the locked-up nature of their assets under management, solid records of performance and fundraising, diversified platforms, and dry powder available for deployment during market dislocation. That said, risks for alternative asset managers remain, as any material, protracted valuation declines could hit returns and overall performance, and fundraising could slow as limited partner investors reach allocation capacity.

Many asset managers issued debt opportunistically over the last several years, supported by low capital costs and buoyant asset valuations. As a result, most asset managers remain well-positioned from a liquidity perspective, with very few having to address near-term maturities in 2023. Low capital costs also supported rapid debt-financed growth of some managers we rate, which could be a risk to ratings as base rates rise and earnings growth slows.

Nonfinancial Corporates

- Investors are recalibrating their risk appetites and demanding higher returns on their investments. This increases refinancing costs and can lower borrowing capacity.
- Defaults are on the rise in the U.S., where the February tally reached its highest monthly level since October 2020.
- Sluggish financial results have progressed from sectors such as consumer products and retail, to the broader ratings universe—albeit in a more benign form.

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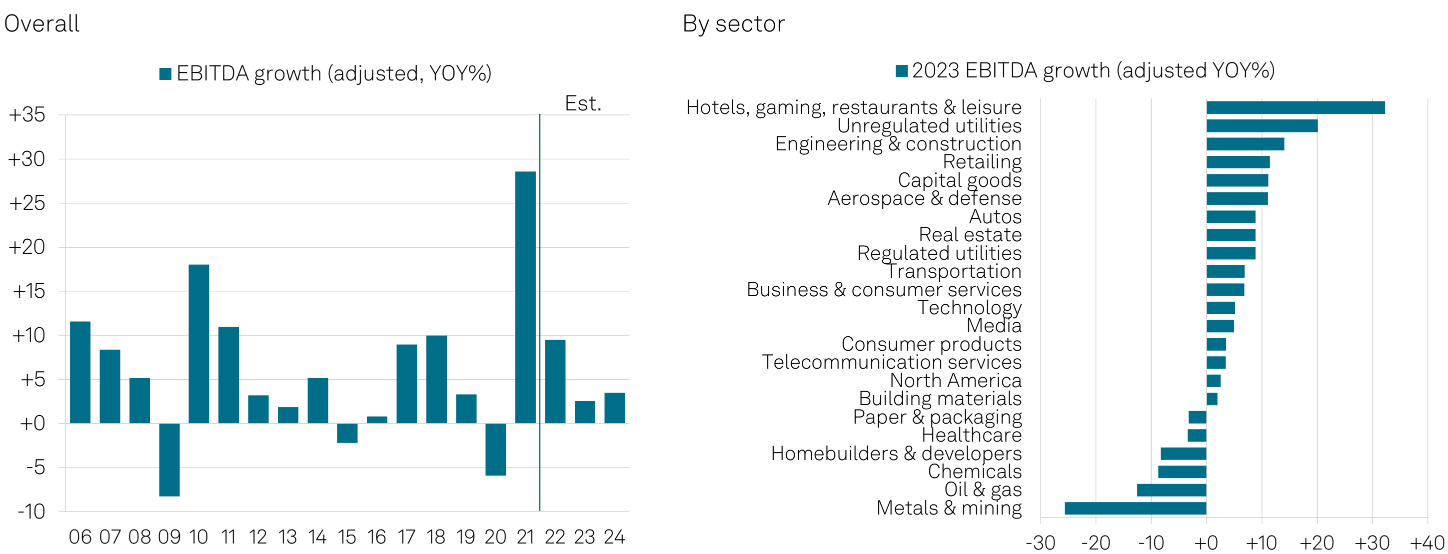
We expect nonfinancial corporate issuers to have limited direct exposure to the banking sector turmoil as depositors and borrowers, or through their customers and suppliers. This is in large part due to the steps central banks have taken to protect deposits. Nonetheless, many issuers are being proactive and revisiting their treasury management practices, including moving funds as necessary. Still, the resulting volatility is likely to constitute second-order risks. **Investors are recalibrating their risk appetites and are beginning to demand higher returns on their investments**, even as central banks are raising interest rates. This increases refinancing costs and can lower borrowing capacity if offsetting assets are considered to be devalued. Finally, longer-term considerations include how more consolidation or regulation in the banking sector could play out and what effect this might have on borrowers.

Following various exogenous shocks starting in 2020, nonfinancial corporates displayed different levels of resilience in terms of both impact and speed of recovery. Most recently, though, many industries appear to be converging toward anemic earnings as the economy shows signs of settling into a protracted period of low growth. Defensive stances defined by cost-cutting and delayed spending are becoming increasingly common as companies prioritize protecting margins and conserving cash. Overall, we expect North American nonfinancial corporate EBITDA to grow 2.5% (see chart 14).

Chart 14

North American Nonfinancial Corporate EBITDA Growth



Est.--Estimate. Sources: S&P Global Ratings, S&P Global Market Intelligence Capital IQ. Includes North American non-financial corporations currently rated by S&P Global Ratings. Calculated in US$ terms. See "U.S. Corporate Credit Outlook 2023: Profit Pressures, Refinancing Risk," published Feb. 2, 2023.

There are some signs of supply-chain easing, and certain raw commodities prices have decreased. Nonetheless, **labor costs will likely continue to rise overall.** Labor markets remain relatively tight even as the labor participation rate continues to recover from its 50-year low reached in April 2020. However, there are early indications that the labor reductions that started in some subsectors of technology may proliferate. The greatest area of differentiation we see is in the ability to pass through these costs. In general, operating conditions are beginning to erode the ability of businesses to raise prices; however, certain sectors—including health care, pharmaceuticals, and oil and gas—stand out as exceptions.

Defaults are on the rise, especially in the U.S., where the February tally reached its highest monthly level since October 2020. Retail is driving the total so far this year after very few defaults in the last few years, as retailers feel the effects of consumers pulling back on discretionary spending in response to decades-high inflation.

Sluggish financial results have progressed from sectors such as consumer products and retail, to the broader ratings universe—albeit in a more benign form. What started out as a slowing real estate market due to rising rates is now beginning to weigh on the outlooks of homebuilders and building materials companies as they exhaust their backlogs (see table 1). Telecom profits are under pressure as competition intensifies and price-sensitive customers look for better deals. Tech companies that thrived while people were confined to their homes are now finding prospective investment opportunities are no longer viable—particularly at elevated interest rate hurdles. Finally, the aerospace and defense sector is tasked with navigating unpredictable supply chains and rising costs over the coming months. This last example is notable in that the pressure is beginning to make its way up the rating scale.

Table 1

Negative Bias By Rating Category And Sector

Sector	IG	SG ex CCC	CCC/CC	Total
Aerospace & defense	44%	19%	60%	29%
Automotive	0%	13%	88%	23%
Capital goods	13%	11%	75%	15%
Chemicals, packaging & environmental services	13%	6%	88%	14%
Consumer products	17%	21%	93%	27%
Forest products & building materials	13%	4%	100%	7%
Health care	9%	13%	72%	19%
High technology	2%	13%	57%	12%
Homebuilders/real estate co.	2%	23%	100%	10%
Media & entertainment	7%	10%	71%	18%
Metals, mining & steel	10%	13%	75%	16%
Oil & gas	10%	3%	17%	5%
Retail/restaurants	6%	11%	100%	18%
Telecommunications	8%	21%	71%	25%
Transportation	10%	11%	100%	14%
Utility	9%	13%	67%	11%

IG--Investment grade. SG--Speculative grade. Data as of March 17, 2023. Source: S&P Global Ratings.

U.S. Public Finance

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- Recent developments in the banking sector have added to uncertainty, but financial reserves and federal stimulus should provide sufficient flexibility for most U.S. public finance (USPF) sectors.
- A weaker economic outlook for the year ahead could pressure revenues, while inflation and higher interest rates remain a challenge for operating and capital budgets; effective budget management will be important to fiscal performance (see chart 15).
- Extreme weather, cyber, and other risks will continue to present fiscal and operational challenges; proactive risk management will be key from a credit standpoint.

All USPF sector views are stable except not-for-profit health care and mass transit. Higher education has a mixed sector view, with lower-rated institutions and those with limited enrollment or financial flexibility facing more credit pressures. Some USPF sectors, such as not-for-profit health care and higher education, have already used their federal stimulus to address pandemic-induced fiscal imbalance, but others, such as many transportation issuers, states, and local governments, still have it to spend. For state and local governments that have weathered the COVID-19 pandemic and the economic slowdown without credit deterioration, the federal funds will provide stability and can be deployed to support capital projects that boost economic development. Federal support for recovery in the transportation sector, especially for large transit providers, remains critical for operational balance given that recovery in the sector is taking longer.

Extreme weather events, such as California's atmospheric river and severe winter storms, highlight ongoing stresses that can present fiscal and operational challenges across all sectors. S&P Global Ratings continues to view preparedness for unexpected events, from acute weather events to cyberattacks, as critical to maintaining credit quality in the long term.

Chart 15

Credit Issues That Matter

Wage growth
Issuers across USPF are experiencing budgetary pressures from rising wages. While most are able to handle the challenges without affecting general credit quality, the not-for-profit health care sector is feeling it more acutely; in some cases it has led to credit deterioration.

Inflation
In addition to wage pressure, inflation also leads to higher costs for capital projects. It's possible that some projects might be downsized, delayed, or canceled as the cost of materials and labor escalates. For capital-intensive sectors, such as transportation and utilities, there could be limited flexibility to delay or cancel projects and this will contribute to higher rates and charges in the long term.

Rates
High interest rates have contributed to slower issuance volume. Funds on hand, particularly if from unspent federal stimlus, can help close the gap for many issuers, but a higher-for-longer rate environment will eventually cause some market participants to issue more costly debt to fund capital requirements.

Equity market
Ongoing volatility in the equity market can make budgeting a challenge for states and higher education institutions that rely on revenues based on market returns. These issuers are used to managing these fluctuations, but prolonged volatility exacerbates the possibility of budgetary shortfalls.

Housing market
Despite persistently low supply in the housing market, rising interest rates are contributing to a slowdown in the housing market. With reports of ongoing overvaluation in the housing market, issuers reliant on property taxes could start to see changes in the tax base, but there will be time to respond given that the impact generally lags.

Source: S&P Global Ratings.

Structured Finance

- We expect most North American structured finance asset classes to show slightly weaker or stable collateral performance.
- Rising rates, among other factors, are likely to continue to affect underlying asset values in mortgage products, especially in certain CRE sectors, such as office.

Given our call for a mild recession, **we expect most North American structured finance asset classes to show slightly weaker or stable collateral performance**. Ratings trends are largely stable or modestly negative (see table 2). While we expect most ratings actions in speculative-grade, we don't expect risks to be uniform across sectors. Rising rates, among other factors, are likely to continue to hurt underlying asset values in mortgage products, especially in certain CRE sectors, such as office. Labor market strength remains the linchpin for many consumer sectors; however, we see a widening performance gap between prime and non-prime collateral.

Table 2

12-Month N.A. Structured Finance Outlook – Q2 2023

	Collateral performance outlook	Rating trends
Residential mortgages (RMBS)		
RMBS	Somewhat weaker	Stable
RMBS – service advance	Stable	Stable
Commercial mortgages (CMBS)		
CMBS - N.A. conduit/fusion	Somewhat weaker	Stable
CMBS - large loan/single borrower (retail)	Weaker	Stable to negative
CMBS - large loan/single borrower (lodging)	Stable	Stable
CMBS - large loan/single borrower (office)	Weaker	Stable to negative
CMBS - large loan/single borrower (all else)	Stable	Stable
Asset-backed securities (ABS)		
ABS - Prime auto loans	Somewhat weaker	Stable to positive
ABS - Subprime auto loans	Weaker	Stable
ABS - Auto lease	Stable	Stable
ABS - Auto dealer floorplan	Stable	Stable
ABS - Credit cards	Somewhat weaker	Stable
ABS - Unsecured consumer loans	Somewhat weaker	Stable to negative
ABS - FFELP student loan	Somewhat weaker	Stable
ABS - Private student loan	Somewhat weaker	Stable
ABS - Commercial equipment	Stable	Stable
Asset-backed commercial paper	Stable	Stable
Structured credit		
CLOs	Somewhat weaker	Stable
ABS - Non-traditional		
Timeshares	Stable	Stable
Small business	Somewhat weaker	Stable
Tobacco	Somewhat weaker	Stable
Transportation - aircraft	Somewhat weaker	Stable to negative
Transportation - container	Stable	Stable
Transportation - railcar	Stable	Stable
Whole business	Somewhat weaker	Stable
Triple net lease	Somewhat weaker	Stable

FFELP--Federal Family Education Loan Program. Most subprime auto ABS classes are currently rated investment grade, for which we expect stable ratings. However, a small percentage are non-IG, and for those we have a stable to negative outlook.
Source: S&P Global Ratings.

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The credit story for commercial mortgage-backed securities (CMBS) is one of mixed performance by property type and subsector, even at the level of the individual buildings. The challenges facing the office market revolve around low utilization and elevated vacancies—especially in high-profile coastal markets. Indeed, the most recent data from Green Street's Commercial Property Price Index show values broadly down 25% year-over-year. It's clear that lower-quality properties with near-term tenant lease rollovers are at elevated risk. CMBS delinquency and special servicing rates for office-backed loans were up about 50 bps each in February, and are now at 2.3% and 4.2%, respectively. Retail still has issues with underperforming malls, but there's outperformance in some areas, such as grocery-anchored shopping centers.

Collateralized loan obligations (CLOs) face the potential for credit migration for companies at the 'B-' level. Exposure to loans from 'B-' companies in broadly syndicated loan (BSL) CLO collateral pools increased to 30.5% in February, from about 27% a year earlier and less than 13% at the end of 2017. By definition, a company rated 'B-' will end up in the 'CCC' range or lower if it is downgraded, and with the large exposure to these companies it wouldn't take many downgrades to materially impact CLO 'CCC' baskets. While corporate downgrades have outpaced upgrades since last May, 'CCC' buckets are in the 5% range, below the typical 7.5% threshold at which managers need to begin "hair-cutting" and deal cash-flow dynamics change. Higher-for-longer interest rates would add stress to companies with floating-rate obligations.

A growing gap in the performance of prime and subprime asset-backed securities (ABS) collateral is causing non-prime originators to tighten credit. Subprime 60+ day delinquencies in auto-loan ABS reached record highs at end-2022, while prime metrics merely normalized. The subprime 2022 cohort shows the most stress with losses exceeding historical levels. The high seasoning and stronger borrower profile in credit card securitizations is evident in the most recent delinquency statistics, with 60+ day past due accounts under 1% for bankcards and about 1.5% for private label cards. Outstanding credit card balances rose 16% in 2022. While the utilization rate increased during the same period, it remained below levels in Q4 2019.

Residential mortgage-backed securities (RMBS) benefited from rising home prices in recent years. We expect only moderate overall price declines this year. There will likely be regional variation, but widespread declines seem unlikely in the near term. Unemployment has remained historically low and many households have equity to protect, which has kept performance strong. Meanwhile, low-coupon RMBS issued in recent years continue to experience historically low prepayment rates, in turn extending bond lives and reducing deleveraging.

LIBOR Cessation

Financial markets are entering the final phase of LIBOR transition, with this key benchmark set to end by June 30. While legacy LIBOR securities exist in all structured finance asset classes, they are concentrated in the CLOs, RMBS, and student loan ABS. Our base case view is that, largely due to the presence of a federal LIBOR law, the ratings impact is likely to be minimal.

While we expect the federal LIBOR Act to apply to replacement rates on liabilities for more than half of legacy RMBS and student loan ABS, we anticipate a limited role for the CLO sector, as most CLO transaction documents have fallbacks tied to recommendations from the Alternative Reference Rates Committee or that empower collateral managers to select replacement rates. To date, there's been limited progress among the loans collateralizing CLOs in amending their interest rates away from LIBOR, mainly because higher market rates and wider spreads have slowed refinancing activity in the leveraged loan market. The debate about the appropriate spread adjustments on assets and liabilities is expected to continue. Because the transaction party selecting asset rates isn't necessarily the same as the one selecting liability rates, we will be monitoring the impact of their choices.

Insurance

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- Overall, the average financial strength rating for the core North American insurance portfolio is in the upper half of the strong 'A' category.
- While financial conditions have tightened, we believe there to be broad access to capital for these mostly investment-grade borrowers that, in general, aren't highly leveraged.

There were three rating changes (one up in the mortgage sector, one up in the life sector, one down in property/casualty (P/C)) in the three months ended Feb. 28, with no assessed changes to 'satisfactory' business conditions for North America-focused insurers. We revised our business conditions outlook for mortgage insurers downward to 'somewhat weaker' from 'no change' (see table 3). This follows similar downside revisions for property/casualty, life, and health (to 'no change' from 'somewhat stronger') throughout 2022.

Overall, **the average financial strength rating for the core North American insurance portfolio is in the upper half of the strong 'A' category**. More than 80% of our ratings for the core portfolio have stable outlooks—although a negative bias emerged in mid-2022 for P/C insurers (and the sector outlook was revised to negative in October).

Major ratings factors include volatile capital markets, rising interest rates, inflation, pricing, public policy, catastrophe risk, and employment. While financial conditions have tightened, **we believe there is broad access to capital for these mostly investment-grade borrowers** that, in general, aren't highly leveraged. Balance-sheet strength has marginally diminished in connection with portfolio devaluation but remains a pillar of credit quality, providing a measure of protection from risks related to downside economic development broadly, and the expansion or increase in the magnitude of specific and emerging subsector risks more specifically.

Table 3

North America Insurance Sector Trends – Q2 2023

Sector	Current business conditions	Business conditions outlook	Sector outlook
Life insurers	Satisfactory	No change	Stable
Health insurers	Satisfactory	No change	Stable
Property/casualty insurers	Satisfactory	Somewhat weaker	Negative
Global reinsurers	Weak	Somewhat stronger	Negative
Bond insurers	Satisfactory	No change	Stable
Title insurance	Satisfactory	No change	Stable
Mortgage insurers	Satisfactory	Somewhat weaker	Stable

Note: Business conditions and sector outlook are for the next 12 months. The shaded cell indicates changes since Q4 2022.
Source: S&P Global Ratings.

The **U.S. and Canadian life insurance sectors face a mix of good and bad news**. Factors that could affect life insurers include rising rates, choppy equity markets, geopolitical uncertainty, and, above all, the threat of recession. Meanwhile, changes to financial reporting standards in the U.S. might cause more confusion than clarity, and COVID, while seemingly on the decline, still carries meaningful uncertainty. We believe these conflicting forces will largely balance each other out, and we don't anticipate a significant number of upgrades or downgrades for life insurers.

S&P Global Ratings has a stable view on the U.S. health insurance sector. Credit quality for the industry will remain strong based on favorable long-term themes, including public policy that supports coverage stability, strong growth prospects in government-sponsored programs, and the ability to re-price products annually. Sound balance sheets will continue to be industry strengths. We believe the growing scale and diversification into non-insurance health care services will give the industry new revenue and earnings sources, while helping to advance value-based care so that payors can better manage medical and pharmacy costs. These trends will solidify the industry's long-term barriers to entry and sustain its earnings growth.

In October **we revised our view on the U.S. P/C sector to negative, from stable,** reflecting our expectation for weaker credit trends in the next 12 months, Underwriting profitability remained solid in 2022, but a clear divergence emerged between insurers writing mostly commercial lines and those writing personal lines. Catastrophe losses and expense ratios declined somewhat, but this was offset by inflationary pressures on claims costs, particularly in property and auto lines. Strong rate momentum for most commercial lines continues to match or exceed loss-cost trends, resulting in generally stable underwriting margins. Overall, we expect underwriting performance this year to be similar to last year's for commercial lines writers. Capital adequacy has been a relative strength for most P/C insurers; however, rising rates have erased much of the unrealized capital gains insurers had accumulated in their fixed-income portfolios, which may weigh on our view of capital adequacy for some. Rising interest rates will gradually benefit net investment income as new money is invested at higher rates.

Our view of the global reinsurance sector remains negative as reinsurers continue to struggle to earn their cost of capital. Elevated natural catastrophes, pandemic losses, and losses related to the Russia-Ukraine war have hurt performance but sparked pricing increases, with momentum continuing. Rising rates weighed heavily on reinsurers' balance sheets, with unrealized losses on bond portfolios chipping away at capitalization. However, a portion of the unrealized losses could recover in the next couple of years as these securities are held-to-maturity. In addition, expected improving underwriting earnings, increasing investment income, prudent capital management, and sophisticated levels of risk management should sustain the industry's capital adequacy.

Bond insurers continue to benefit in the USPF market from greater demand for insured bonds as well as stronger pricing. This first emerged during the pandemic. Insured issues within the USPF market represent more than 90% of total par insured in recent years. While 2022 USPF issuance fell and insured new issue penetration was flat, at about 8%, secondary-market insurance Is growing strongly. Higher rates and spread widening also create a strong pricing opportunity and long-term profitability for bond insures.

The overall profitability and financial strength of the title insurers depends on their ability to manage operations throughout the mortgage and economic cycles, as well as employ proper risk and underwriting controls during periods of high business volume. **Title insurers' efforts have served them well in the past three years** and should enable them to maintain strong profitability.

Private mortgage insurers (PMIs) continue to benefit from current trends, including a strong labor market, cure rates outpacing delinquencies, and strengthened capitalization supported by access to reinsurance. The run-up in house prices in recent years created significant home equity cushions, which will help reduce losses in stress periods. Though home price appreciation has moderated, tight supply has checked price decreases. Mortgage originations have slowed considerably, and we expect that to continue. Hence, we expect the new business volumes for PMI's to remain tepid, substantially offset by increasing persistency levels (lower lapse rate in current portfolio). Our view on profitability is tempered by the near-term headwinds in economic conditions, particularly that a rise in unemployment could result in elevated mortgage delinquencies. Therefore, we expect the sector's combined ratio could range from 50%-55% this year and gradually improve to 45%-50% in 2024. While we expect losses to increase, we believe they could be contained within PMIs earnings, and not impact their capitalization.

Related Research

- Economic Outlook U.S. Q2 2023: Still Resilient, Downside Risks Rise, March 27, 2023
- Economic Outlook Canada Q2 2023: A Dip Is Expected, Though Resilience Persists, March 27, 2023
- Unrealized Losses: The Rate-Rise Risk Facing Banks, March 16, 2023
- Rated U.S. Banks Haven't Seen Widespread Deposit Outflows But Uncertainty Continues, March 14, 2023
- Credit FAQ: U.S. Sovereign Debt Hits The Ceiling Again, Jan. 20, 2023
- 2023 U.S. Residential Mortgage And Housing Outlook: Navigating A Softening Market, Jan. 20 2023
- White Paper: Introducing Our Credit Cycle Indicator, June 27, 2022

Editor

Sam Zanger

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Appendix 1: Nonfinancial Corporate Sectors Outlook

For analytical contacts, please see Appendix 3.

Table 4

North America Nonfinancial Corporate Sectors Outlook

Sector	Comment
Aerospace and defense	We expect the continued recovery in air travel should benefit commercial aerospace companies as it drives increased demand for aircraft, aftermarket parts, and services. New aircraft demand is unquestionably strong, but ongoing supply constraints are delaying aircraft deliveries likely beyond this year. This is most notable for narrowbody planes (i.e., Boeing 737 Max, Airbus A320 series) and there has been a recent uptick in widebody orders (as international travel rebounds). We believe cash flow should improve and benefit liquidity, but the pace is likely uneven through this year. Our outlook has modestly improved for many commercial aerospace suppliers, but they continue to operate below capacity due to persistent supply chain issues (i.e., labor, component suppliers) and negative outlooks remain (Boeing). We view the sector as somewhat insulated from recession risk; pent-up demand for new aircraft and constrained supply should support steady sales for original equipment manufacturers (OEMs). Defense demand is supported by a higher U.S. defense budget (up 10% year-over-year in 2023, and a 3.2% increase is requested for 2024), and increased spending by European allies, related to the Russia-Ukraine conflict. Certain sectors already considered key (intelligence, reconnaissance, cyber) will be even more in demand. That said, U.S. tax rules now require research and development (R&D) spending to be capitalized, which has weakened our cash flow estimates for certain issuers.
Autos	We don't expect the auto sector to see substantial credit quality deterioration in 2023. Most of our rated issuers have stable outlooks, indicating there is sufficient ratings headroom to absorb a mild recession and some residual supply-side disruption. We think ratings downside is likely limited to credits at the lower end of the rating spectrum where issuers might need to refinance debt with higher interest rates. In the U.S., we don't expect a recovery of pre-pandemic volumes before 2026. OEMs will benefit from sound order books and the improved pricing in 2021- 2022 for at least the first half of 2023. But we project these issuers will face weaker demand conditions in the second part of 2023 and into 2024. Risks could mount if economic conditions weaken beyond our expectations and eventually affect the labor market.
Building materials	While 2022 operating results benefited from order backlogs and ability to raise pricing, we expect revenue and profitability pressure in 2023 given a weaker housing market and declining spending on renovations/remodels. For 2023 we expect modest declines in revenue and narrowing profit margins as the ability to pass on costs diminishes through the year and input costs remain elevated. Given expectations for an increase in nonresidential spending from investments in infrastructure, these could mitigate some of the declines in the cyclical residential end market. Across the segments, we expect aggregates to be better-positioned than discretionary products. Most ratings are in the 'B' category; issuers with upcoming debt maturities could face growing refinancing risk. Reduced investments in working capital (from slower conditions and deflating commodity costs) would provide some support for better free cash flow generation and liquidity. We expect negative rating bias to increase in 2023 given weaker performance and increasing refinancing risk.
Capital goods	The credit outlook for U.S. capital goods is generally steady, as easing supply chains and goods pricing enable the profitable delivery on large backlogs, while a large working capital investment starts converting into cash. That said, higher costs and tight labor markets persist for several issuers with elevated debt levels, pushing our negative outlook bias to about 10%. The Global Purchasing Managers Index (compiled by S&P Global Market Intelligence) has rebounded to expansion from contraction, which supports our assumption of continued favorable order intake in 2023. Demand remains strong for machinery, with high industrial output driving replacement volumes, while onshoring and infrastructure investments lay a foundation of longer-term projects. Commodities costs remain elevated, however, with persistently tight conditions for inputs including some metals. About 45% of issuers in the U.S. portfolio are rated 'B' or lower, owing to a preponderance of financial sponsor-owned companies, often with weaker competitive characteristics or undergoing transformation through acquisitions. The sharp rise in interest rates has hit the pricing of low-rated debt tranches, many of which are trading at discounts and could indicate refinancing stress unless earnings rise in the next two years.
Chemicals	Based on limited reporting of 2022 financials, we believe the destocking-related demand compression in the fourth quarter of 2022 and early this year is easing. It’s a little early to call this a definitive end to what was always likely to be a temporary, albeit sharp, decline in demand for many chemicals. Still, many companies expect stable to slightly improving demand this year, although there are exceptions. Our view is that demand should be stable to slightly negative to mirror GDP growth. Pricing at some subsectors, such as petrochemicals and agrichemicals (together about 20%-25% of rated chemical companies) will decline irrespective of the market position of these companies. At other subsectors, company market position will play a role in determining pricing. Overall, earnings and margins should weaken relative to 2022. Credit metrics are likely to follow suit but generally remain appropriate for ratings. As always, companies at the lower end of the ratings scale ('B' and below) are more vulnerable to an earnings weakness at a time of rising interest rates, and inflation. Their high leverage results in lower cushion for unexpected mishaps or variances from plan. There are few meaningful maturities over the next 12-18 months. For companies that do have near term maturities, refinancing risk is a rating factor.

Consumer products	Inflation in inputs, freight, and shipping is moderating but still high. Labor remains very tight. Margins should improve as the last pricing actions are passed through. Supply chain has improved but there are still pockets of constraints. Fill rates are approaching but still lower than pre-pandemic levels. Risk on the topline is rising as consumers pull back discretionary spending, mostly lower and middle-income consumers. Consumers are trading down within category and across channel. Retailers are resuming orders after working down excess inventory. Rating outlooks for issuers in discretionary, durable, and categories with high private-label penetration are negatively biased, while staples are in better shape.
Containers and packaging	Although we continue to have an overall stable outlook for the sector, a sharp slowdown in demand coupled with high inventory levels impacted the fourth quarter of 2022 and we expect this to continue in the first half of 2023. Early in 2022, many packaging customers built inventory due to forecasts of high demand and supply chain issues, causing many to carry additional safety stock. As demand softened and supply chains improved, we saw a strong destocking occur, and expect this to continue into the second quarter. Although we believe this is transitory and expect inventory rebalancing will bring demand back to more normalized level, this has had some impact on leverage and cash flows, which have been a bit more problematic for lower rated issuers. In addition, the higher interest rates are lowering their margin for error on performance, and delays from our expectation of recovery in the second half of 2023 could cause us to reevaluate our ratings/outlooks for these issuers. Refinancing risk for 'B' or lower issuers with upcoming maturities continues to be our largest concern, particularly as debt markets remain choppy and if performance has been impacted by aforementioned issues.
Gaming, leisure, and lodging	While our base case continues to assume a shallow recession at some point, it may be later this year. The U.S. job market remains robust, as evidenced by still-strong employment numbers in February, and global unemployment remains low. Given the ongoing shift toward consumer spending on experiences is likely to persist, several leisure sectors are still recovering from the pandemic, and given the propensity for consumers to travel in the U.S. and Europe, the impact from a possible recession may just slow down growth rates rather than cause the decline in revenue and profitability that typically occurs in the leisure sector during downturns. In addition, China's reopening offers a likely tailwind for global leisure spending this year and offers an enormous boost to the Macau gaming market. If the employment picture remains reasonably healthy, even if the U.S. and eurozone unemployment rates eventually rise later this year, then business travel will likely continue on its recovery trend. As a result of these trends, revenue per available room (RevPAR) in U.S. and European lodging may grow this year, and many regional gaming markets may also have a reasonably good year. Las Vegas continues to experience strong leisure travel and the convention and group market continues to recover. Our base case for the cruise sector assumes that strong forward bookings suggest demand for cruises in 2023 could absorb higher capacity, and occupancy likely recovers to historical levels by summer, causing a material improvement in EBITDA and credit measures from unsustainable levels. These drivers could cause many companies in leisure to increase cash flow this year and build in more cushion in credit measures, limiting downside rating risks. Additional cushion in measures and ratings could also lead to leveraging shareholder returns, investment spending, or mergers and acquisitions (M&A) later this year, which could introduce incremental risk if they happen at the wrong moment. Spending on leisure products that typically require financing--like RVs, boats, and motorcycles--may get hurt more given higher financing rates. The ratings bias in the sector remains stable to positive, as many sectors continue to recover from the pandemic and even leisure manufacturing companies facing a pullback in demand have cushion in credit measures.
Health care and pharmaceuticals	We are revising our outlook on health care services to negative from stable, as we remain concerned about the mix of rising-faster-than-normal labor costs, lingering inefficiencies left from the now-receded pandemic, and still-elevated interest rate environment leading to compressed margins and cash flows, weighing on ratings. Health care service companies have lower margins (mid-single digit to low teens percentage) and higher leverage, with a significant private equity involvement. Labor cost increases have moderated but remains elevated and we are skeptical that efficiency and cost-cutting efforts will offset shortfalls in reimbursement negotiations. The outlook for pharma remains stable and should remain so into next year, given continued strong margins, moderate inflationary cost pressures, and sales growth following normalization of patient volumes post-pandemic. However, we do see M&A volumes returning in full force (e.g., recent acquisition announcements by Amgen and Pfizer) given the increasing need for M&A to reinvigorate new product pipelines in the face of increasing pricing pressures. The increases in M&A could pressure ratings, although many companies have built large cash cushions/capacity given the strong cash flows in previous years and relative dearth of M&A in the two prior years. The Medicare drug price negotiation provision in the Inflation Reduction Act (IRA) will be a drag on future industry growth and the effects may be felt more by select pharma companies, but implementation is years away and will be gradual.
Homebuilders	We expect a significant drop in revenues and profits for homebuilders in 2023 given the sharp increase in mortgage rates weakening demand. Builders reported higher cancelations and lower orders in the fourth quarter of 2022 as consumers paused purchases and adjust to the much higher financing costs. We expect higher incentives (rates buydown, lower selling prices) to put significant pressure on margins, reversing a period of strong performance and reverting toward more normalized level of margins in 2023. Elevated mortgage rates could dampen demand into 2024. Despite our expectations for a decline in 2023 EBITDA, builders have increased their cash balances and reduced debt, resulting in significant cushion vs. downgrade triggers.
Media and entertainment	Our sector outlook remains negative. The media sector faces both weak near-term macroeconomic trends and negative long-term secular pressures. This will be a year of significant uncertainty, with many questions related to the long-term direction of the industry, including what the path to profitability for streaming looks like, how long linear TV has before it turns unprofitable, and what happens to advertising over the long term.

	A weakening economy hurts near-term sector performance as many media companies depend heavily on cyclical consumer and advertising spending. Advertising had softened as early as the first quarter of 2022, but weakened further in the latter months of the year. While trends appear to have at least stabilized in early 2023, advertising visibility remains limited as advertisers delay making commitments until the last minute as they try to anticipate consumer behavior. This wait-and-see tactic has impacted all media with both bottom-of-the-funnel transactional advertising (digital, social media, and radio) and longer lead time media (television and billboards) seeing weaker demand. Longer term, operating and credit metrics will remain weak as the industry struggles with ongoing secular pressures and business model disruptions. Film and TV content creators have seen their profitable monetization streams decline significantly as their parent companies prioritize new and library content to their in-house streaming initiatives. Still, the old adage about media--content is king--remains true, as content remains the anchor of the sector. Distribution of content faces the greatest disruption; linear TV and theatrical cinema are being supplanted by streaming as the primary distribution medium. This decline will take years even in the U.S., where it has been underway since the Great Recession. The credit impact will be felt more harshly by U.S.-focused companies as they must wean themselves from high-margin affiliate fee revenues.
Metals and mining	Credit quality is stabilizing at a stronger level, but prices are dropping for most metals, and profits will likely weaken in 2023 from the recent spike. That said, the buffer appears good for an inevitable downturn in this highly cyclical sector, because many issuers strengthened credit quality with disciplined capital spending and debt reduction over the past 3-5 years. Even if sentiment and demand weaken, output for many metals remains constrained by limited new investment, declining ore grades, elevated energy costs, and unexpected operating disruptions. Prices eased from record levels in 2022 but generally remain above their long-term averages. Meanwhile, growing credit buffer contributed to the most upgrades in a decade in the capital-intensive metals and mining industry, but now we expect good cash flows will be directed more to corporate development and shareholder returns than debt reduction. We expect recent capital spending restraint, and a favorable long-term demand outlook could prompt more greenfield investment, especially as the world eyes more nickel and copper for electrification. Steel and aluminum producers in North America, and gold producers around the world, have been improving credit quality for a few years. Coal producers, meanwhile, are benefiting from sharply higher prices amid high fuel costs for electricity, so that higher credit ratings depend on competitive prospects like product and demand horizon, as well as financial capacity to fund obligations amid declining sources of capital.
Midstream energy	The North American midstream-energy industry's credit quality continues to exhibit strength given stable demand and strong free cash flow generation, despite a pullback in prices. Domestic upstream producers have remained disciplined, generally living within cash flows, which has led to more modest growth expectations but high utilization midstream rates in the most-favorable basins such as the Permian, Williston, and the Appalachian. Inflationary pressures are a headwind for the sector, but companies with strong credit fundamentals appear to be in a better position than some of their speculative-grade counterparts in terms of refinancing. Most companies have allowances for inflation in their contracts that protect them at least partially from cost increases. We expect modest capital spending increases, primarily among the large, diversified companies that are finishing multiyear growth initiatives or small bolt-on organic growth projects. Companies that are more volume-dependent are spending modestly to maintain current volumes or to expand processing capacity in areas with higher natural-gas and natural gas liquids volumes. Most of this spending with be funded internally, protecting balance sheets. Liquidity is adequate across ratings, although weaker issuers in the 'B' category may find it harder to refinance in the capital markets and will likely have a more difficult time with the current banking problems.
Oil and gas	Oil prices retreated in mid-March largely owing to the banking sector development and concerns about recession. We believe it's largely related to speculative positions liquidating and not reflective of underlying fundamentals, which--specifically related to the supply side--are somewhat supportive of prices above $75/barrel. OPEC remains attentive and supportive to market dynamics and will unlikely remain on the sidelines if oil prices were to dip below $75-$80 for any length of time. The EU ban against Russian oil products such as diesel has yet to manifest itself on the supply side. Although Russia has been successful in finding a home in Asia for most of its crude, the product embargo that started on Feb. 5 should lower Russian crude production anywhere between 500,000-800,000 barrels/day. Lastly, on the supply side, U.S. producers remain constrained, bowing to public investors demanding cash flow be returned and production growth contained. Moreover, the effects of China reopening should begin to pull barrel on the demand side. Natural gas prices in the U.S. have declined mostly due to unseasonable weather patterns this winter and the Freeport LNG facility being down since last summer (recently reopened). The supply side appears to be responding with rigs being laid down in certain higher-cost plays. We believe, barring a deep recession, natural gas prices may be nearing a floor and should trade range-bound for the next couple of years until LNG facilities--to address Europe's needs replacing Russian gas--begin to come online in late 2025 into 2026.
Oil refineries	North American refiners will likely have another strong year as margins remain very strong, albeit below the super-cycle peaks of 2022. We still forecast most refiners will generate EBITDA well above their midcycle run rates. The underlying factors for margins remaining above midcycle are unchanged from last year: stronger post-pandemic demand, higher crude prices, and lower inventory levels. Utilization rates are strong, and the ability to increase capacity is limited because refineries are running close to the peak capacity of about 18 million barrels per day. We expect refiners to continue to chip away at higher debt burdens, which they used to bolster liquidity when demand fell in 2020-2021. We also believe shareholders could benefit from a return of capital as balance sheets strengthen. Latin America will likely see mixed results due to more systemic operating challenges and possible shifts in political views. China continues to manage domestic capacity, closing smaller refiners in favor of large, integrated refining and petrochemical complexes and a strong push to electrify the vehicle fleet.

REITs	We expect slower growth across all property types, though industrials and housing rentals will remain resilient. Retail assets performance have largely returned to pre-pandemic levels with stable occupancy, though weaker consumer spending and inflationary pressure could pressure tenants in a downturn. Office remains a sector of focus given slowing demand from remote working and weaker economic outlook. We expect low-single-digit growth for most property types with the exception of the office sector where we think rent and occupancy could be pressured. The office sector also has relatively higher debt leverage given development exposure. We expect the negative bias for office REITs will increase in 2023. Capital access has improved somewhat with recent large debt issuances by a few REITs, though the volume is still much lower year over year. We expect access to capital to remain constrained given higher rates and valuation pressure, pressuring fixed charge coverage.
Regulated utilities	The sector outlook has been negative since early 2020. Credit quality for the investor-owned North America regulated utility industry weakened in 2020-2021 with the median rating falling for the first time ever to the 'BBB' category. Given the relatively high percentage of the industry with a negative outlook (about 20%), the strategic management of financial measures with only minimal cushion from the downgrade threshold, the industry's high capital spending, ESG credit risks, inflation, rising interest rates, and higher commodity prices, it is more likely that downgrades will again outpace upgrades this year. Should this occur, it would be the first time in more than 30 years that downgrades outpaced upgrades for three straight years.
Retail and restaurants	Grocers, dollar stores, discount, and off-price are faring well as consumers shift spending to basics and trade down. Discretionary (apparel, dept stores, specialty) carries more risk on the topline, for which we expect elevated promotional activities. Luxury retailers are relatively well-positioned. Restaurants continue to struggle with inflation and will likely take the hit to margins, despite relatively healthy demand thanks to still pent-up demand for experiences.
Technology	While we expect IT spending growth rate to still be higher than global GDP in 2023, there is increasing scrutiny on IT budgets. Tech companies are increasingly pressured to help their customers optimize costs, which has negative implications to their own business performance. As such, tech layoffs have become more widespread to proactively manage their cost base against possibly lower revenue in order to preserve profitability. PC, smartphones, and suppliers into these major product areas are still reeling from the slower demand and inventory correction cycle, which we believe will be extended into 2Q23. Need for refinancing is not a big concern for the tech sector given strong liquidity and access to capital markets for higher-rated tech companies and no near-term maturities for most of the speculative-grade rated tech issuers.
Telecom	Overall, the outlook for U.S. telecom and cable is modestly negative, although the industry is fairly recession-resistant relative to other sectors. Inflationary pressures are leading to higher costs and consumers will extend their payments to conserve cash, contributing to higher DSOs in some cases. In wireless, we expect competitive intensity to increase, primarily from cable, while the carriers try to differentiate their 5G capabilities. Macroeconomic headwinds could prompt increased switching activity and customers look for value. Further, aggressive spending in recent auctions and higher capex reduced overall financial flexibility for some operators if operating conditions worsen. While incumbent cable providers will continue to benefit from rising demand for broadband, we expect growth to moderate because of increasing competitive pressures from fiber to the home (FTTH) and fixed wireless in home broadband service. Inflation has pushed up the cost per passing for U.S. wireline issuers. Along with higher interest rates, these companies to lowering their FTTH build targets for 2023 in order to reduce capex and free cash flow deficits.
Transportation	U.S. airlines continue to see strong bookings, and we have a growing positive bias for ratings. Material pent-up demand remains, and tight capacity is supporting high fares. We expect earnings and cash flow growth for the three largest airlines (the bulk of domestic revenue) will be led by higher passenger traffic in 2023. A U.S. recession remains a key risk, particularly if jet fuel prices remain elevated. However, there are limited signs of looming weakness in demand (yet to be fully realized post-pandemic). Freight transportation companies are exposed to the slowdown in spending on goods, but the picture varies across sectors. Package express companies are facing slowing package volumes following an e-commerce-led boom in second-half 2020 through 2021. However, there is ample rating cushion that supports our stable outlook. Slowing spending on goods affects logistics companies (warehouse providers to truck brokers) as well. The outlook for railroads remains stable, reflective of a diversified traffic mix, pricing power, and high free cash flow generation. Intermodal and certain merchandise segments are most exposed to a slowing economy, but the impact on earnings should be mitigated by robust bulk commodity shipments. Recent high-profile derailments have received widespread attention that could lead to increased regulatory and political scrutiny, but we don't expect an impact on credit profiles.
Unregulated (merchant) power	Power prices that had more than doubled from January to September 2022 have fallen precipitously. While they are still high relative to year-end 2021, calendar 2023 prices are now, on average 45% off September 2022 highs. Calendar 2024 and 2025 power prices are similarly 25% and 15%, respectively, below September 2022 price levels. Counterintuitively, the decline is from a sharp decline in power prices in Europe. The natural gas markets, traditionally regional, have now become more intertwined because of LNG. A mild winter in Europe has reduced the pull of LNG from other markets. A concomitant increase in gas production in North America has resulted in calendar natural gas prices declining to $3.3/Mcf from $5.1/Mcf (a 35% decline), resulting in much of the decline in power. Overall, we still expect reasonably strong performance from all generators as they typically hedge forward, but the EBITDA is now backwardated for future years. Retail power providers will see modestly higher margins as wholesale prices decline.

Appendix 2: Economic Data and Forecast Summaries

Table 5

U.S. – S&P Global Ratings Economic Outlook

	2022	2023f	2024f	2025f	2026f
Real GDP (year % ch.)	2.1	0.7	1.2	1.8	2.0
Real consumer spending (year % ch.)	2.8	1.2	0.9	1.8	2.2
Real equipment investment (year % ch.)	4.3	(1.0)	0.6	1.6	2.3
Real nonresidential structures investment (year % ch.)	(6.9)	1.5	0.3	1.4	2.1
Real residential investment (year % ch.)	(10.7)	(17.0)	3.8	7.3	3.3
Consumer price index (year % ch.)	8.0	4.2	2.4	1.6	1.5
Core CPI (year % ch.)	6.1	4.7	3.0	1.9	1.6
Unemployment rate (%)	3.7	4.1	5.0	5.1	4.6
Housing starts (annual total in mil.)	1.6	1.2	1.2	1.4	1.4
Federal funds rate (%)	2.3	5.1	4.7	3.2	2.6

Note: All percentages are annual averages, unless otherwise noted. Core CPI is consumer price index excluding energy and food components. f--forecast. Sources: U.S. Bureau of Economic Analysis, U.S. Bureau of Labor Statistics, the Federal Reserve, S&P Global Market Intelligence, and S&P Global Ratings Economics' estimates.

Table 6

Canada – S&P Global Ratings Economic Outlook

	2022	2023f	2024f	2025f	2026f
Real GDP (year % ch.)	3.5	0.8	1.5	1.8	2.0
Consumer price index (year % ch.)	6.8	3.7	1.7	2.1	2.0
Core CPI (year % ch.)	5.6	3.6	1.6	1.9	2.3
Unemployment rate (%)	5.3	5.5	6.0	5.1	4.8
Government of Canada 10-year bond yield (%)	2.8	3.4	3.1	2.8	2.7
Bank of Canada policy rate (%)	4.3	4.5	3.5	2.3	2.3

Note: All "year % ch." are annual averages percent change. Core CPI is consumer price index excluding energy and food components. f--forecast. Sources: Statistics Canada, S&P Global Market Intelligence, and S&P Global Ratings Economics' estimates.

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