S&P Global Ratings

Global Credit Conditions Q2 2023

Balancing Resilience And Turbulence

March 30, 2023

This report does not constitute a rating action

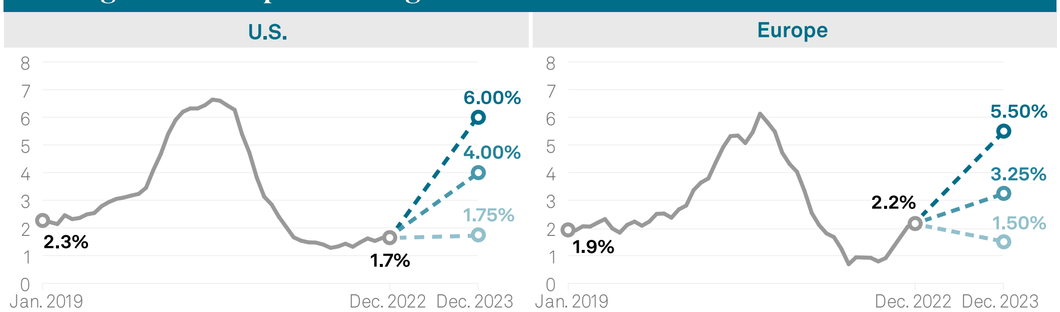
Key Takeaways

- **Credit quality continues to erode.** Despite recent economic and credit resilience, slowing economic growth, sticky inflation, and tighter financing conditions pushed the negative bias close to 15%. Credits in consumer goods, retail, media, real estate, and those at the lower end of the ratings scale are most at risk. Our base case is that default rates double this year to more than 4.0% in the U.S. and to 3.25% in Europe.
- **The full impact of sharply higher interest rates is yet to be realized.** Banking stress in the U.S. and Europe is a reminder of how quickly confidence can erode. The rapid response by authorities suggests broader contagion will be avoided. Nevertheless, high interest rates will likely further strain credit financing costs and asset prices.
- **Downside risks have increased.** Tighter financing conditions, combined with more conservative lending standards, could push many economies closer to a hard landing. Shifts in market sentiment or more revelations of hidden stress could spark renewed volatility. Geopolitical risks from the Ukraine war and U.S.-China tensions remain acute.

Global credit conditions: key highlights

Sticky inflation	Perspective	Monetary tightening
5.3% average projection for 2023 CPI across U.S., U.K., and eurozone	**1.4%** size of SVB and Signature Bank assets to total U.S. commercial bank assets	**+400 bps** on average (Fed, BoE, ECB) since 2022
Negative bias	**Declining credit quality**	**Corporate debt**
14.7% Sectors with highest bias: **23%:** Aerospace and defense **21%:** Consumer products **19%:** Transportation	**61%** downgrade ratio in 2023 to-date **66%** in Q4 2022	**$1.2 tril.** rated 'B-' or lower and **64%** with floating interest rates

Trailing-12-month speculative-grade default rate and December 2023 forecast



Trend lines point to our optimistic-, base-, and worse-case scenarios. Negative bias as of March 24, 2023, calculated as the percentage of ratings with negative outlooks or CreditWatches. Downgrade ratio refers to proportion of downgrades, to the total of upgrades and downgrades. Other chart data is as of Mar. 29, 2023. Sources: S&P Global Ratings Research and S&P Global Market Intelligence's CreditPro®.

Global Heads of Research & Development

Alexandra Dimitrijevic
London
+44-20-7176-3128
alexandra.dimitrijevic@spglobal.com

Gregg Lemos-Stein
New York
+1-212-438-1809
gregg.lemos-stein@spglobal.com

Nick Kraemer, FRM
New York
+1-347-268-5855
nick.kraemer@spglobal.com

Regional Heads of Credit Research

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

Eunice Tan
Hong Kong
+852-2533-3553
eunice.tan@spglobal.com

David Tesher
New York
+1-212-438-2618
david.tesher@spglobal.com

Paul Watters
London
+44-20-7176-3542
paul.watters@spglobal.com

Global Credit Conditions And Macro Highlights

Contacts

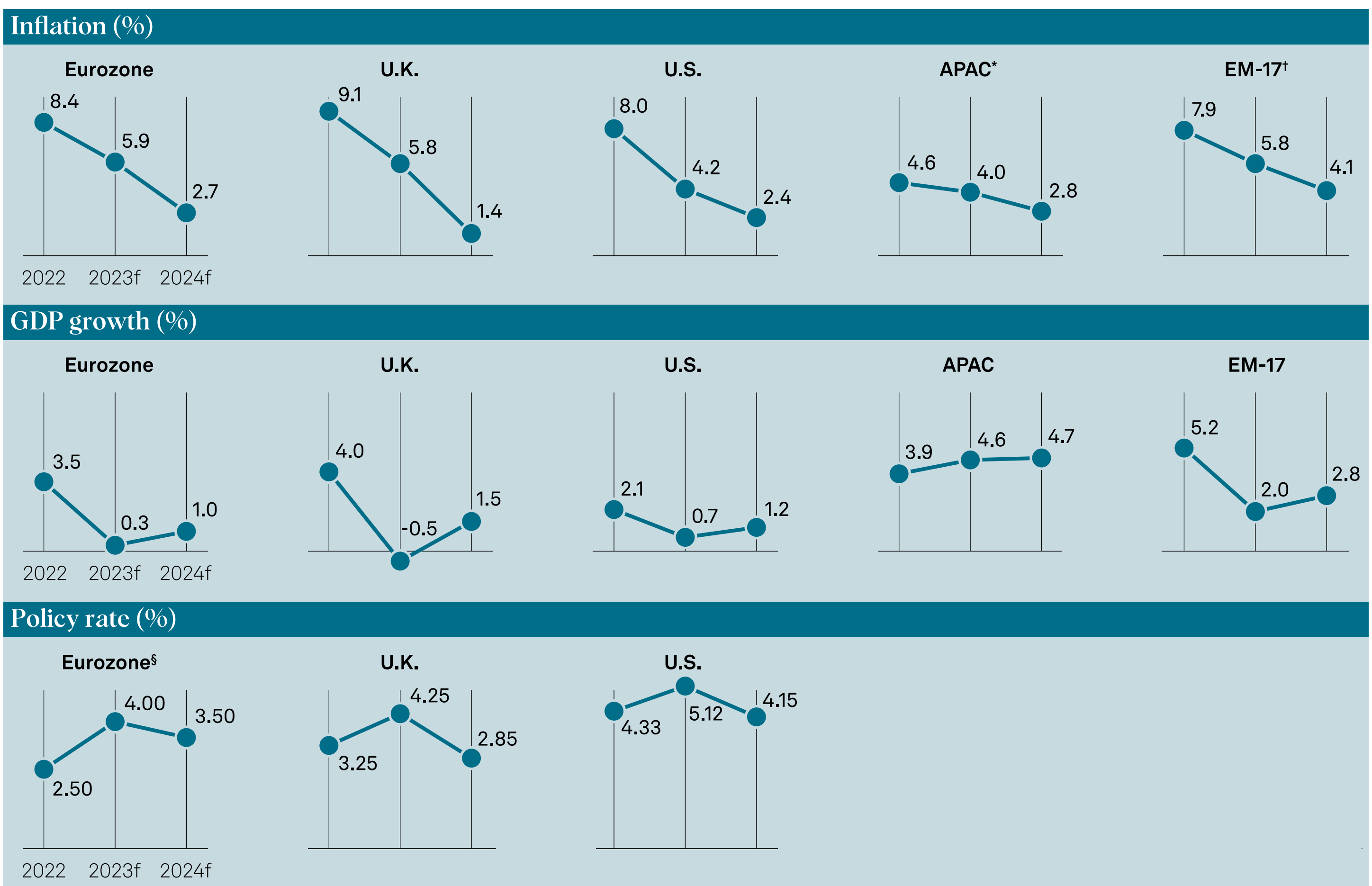
Paul Gruenwald
New York
+1-212-437-1710
paul.gruenwald@spglobal.com

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 rating impact in various asset classes, as well as borrowing and lending trends for businesses and consumers. This commentary reflects views discussed in the global committee on March 23, 2023.

Macro Highlights

Real Resilience Meets Financial Fragility

Strong turbulence in the financial markets has disrupted a relatively orderly and necessary deceleration in trans-Atlantic growth. The trigger was the realization of interest-rate risk in the U.S., amplified by the associated spillovers. The macro impact appears limited for now. The policy response was forceful in the U.S. and Europe, and markets have calmed but remain edgy. Inflation is still a concern, and major central banks have continued to hike policy rates despite the market turbulence. But with an eye on financial stability, they will proceed cautiously. Our baseline forecast and narrative are broadly unchanged in the advanced economies but are more optimistic for China. The downside risks have risen: a sharper-than-expected downturn could come from slower spending (real channel), lower lending (financial channel), or both.



Inflation data as of February 2023. Policy rates as of March 27, 2023. *Simple average. †Median for EM 17 countries. §Refi rate. Source: S&P Global Ratings.

Global Credit Conditions

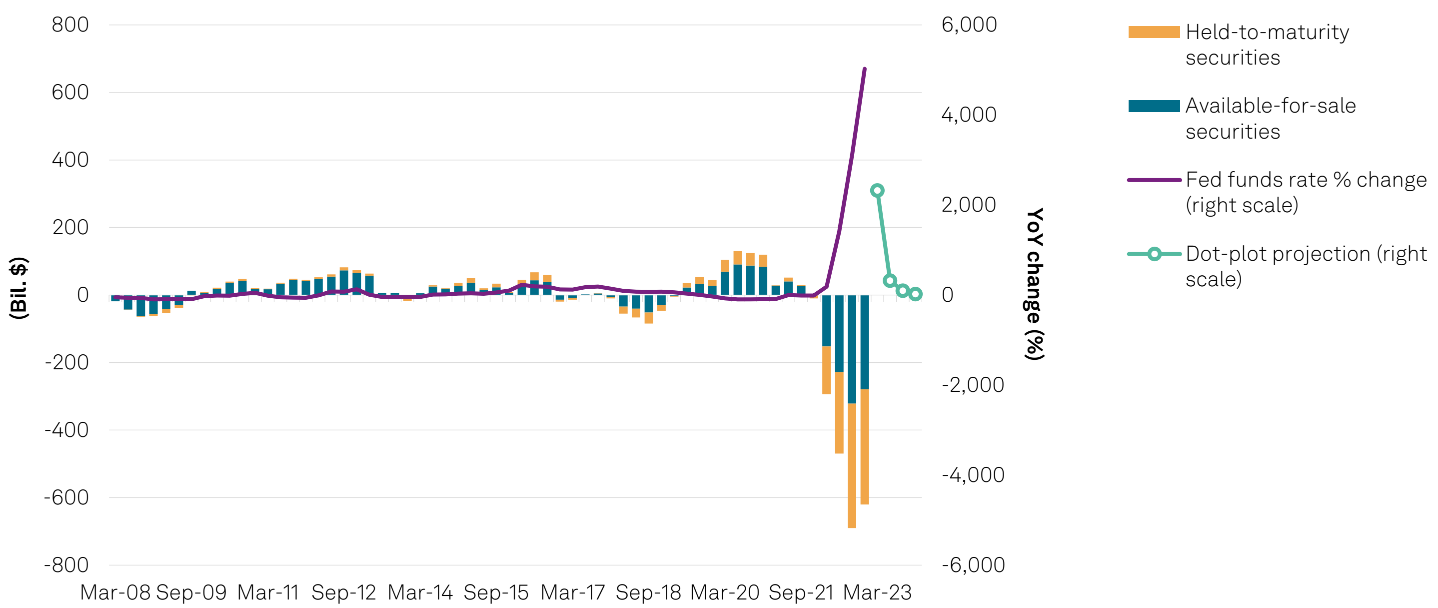
A More Difficult Way Out

Economic and credit trends have been resilient, but we doubt this can last. Contrary to earlier expectations, economic and credit trends have been stubbornly resilient in recent months. This is mirrored in relatively balanced rating trends for the corporate and government sectors in the year to date, and heightened expectations for future credit pressure--as reflected in the negative rating bias--has been mostly confined to lower rating levels ('B-' and below). The worst of the economic downturn has most likely been delayed rather than avoided, and this will likely bring sustained pressure on credit quality.

Higher interest rates will inevitably hurt, as shown in banking-sector strains. We have stated before that the full impacts of rising policy rates often come with a lag, and after several large and rapid increases last year, this now starts to show. Through 2022, the task of taming inflation for central banks has been complicated by the resilience engendered by pandemic-era refinancing and stimulus. But as the recent example of Silicon Valley Bank (SVB) shows, the unintended consequences of rapidly rising interest rates following a prolonged period of exceptionally low rates can be severe and can escalate easily in terms of sentiment, asset price declines, and risk aversion. In the U.S., for instance, unrealized losses for the banking system have surged as the Fed Funds Rate increased at its fastest pace recorded (see chart 1). Other areas of potential concern in relation to rate-sensitivity and asset valuations are housing, consumer credit, and commercial real estate (CRE). In the CRE sector, structural changes for office space resulting from more employees working remotely, combined with higher mortgage rates and properties needing material investment, could contribute to increased refinancing risk, particularly in the U.S. where a large portion of the funding comes from regional banks that might be subject to more balance-sheet scrutiny.

Chart 1

The pace of rate hikes matters for unrealized losses



Note: Year-on-year percentage change in effective Fed Funds Rate, projection based on dot-plot average of 5.1% for December 2023. YoY--Year-on-year. Sources: FDIC, Federal Reserve, S&P Global Ratings Credit Research & Insights.

Contacts

Alexandra Dimitrijevic
London
+44-20-7176-3128
alexandra.dimitrijevic@spglobal.com

Gregg Lemos-Stein
New York
+1 212 438 1809
gregg.lemos-stein@spglobal.com

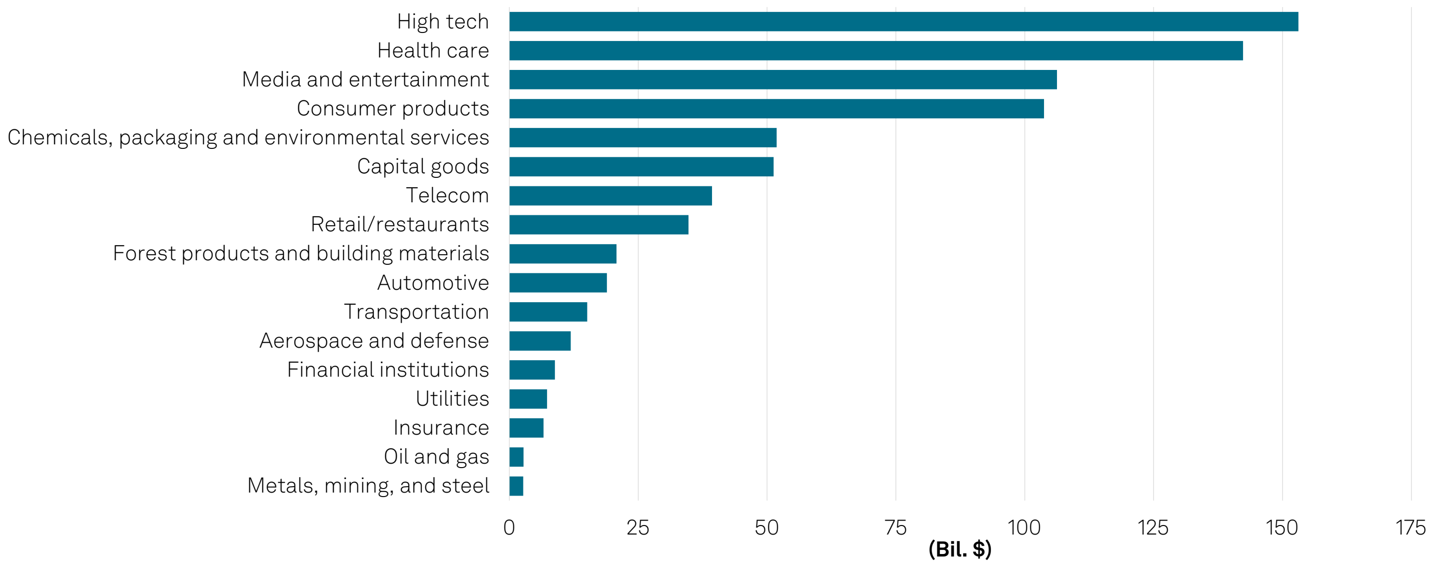
Nick Kraemer, FRM
New York
+1-347-268-5855
nick.kraemer@spglobal.com

Gareth Williams
London
+44-20-7176-7226
gareth.williams@spglobal.com

Weaker credits are particularly vulnerable to adverse developments in financing costs and economic growth. Many smaller rated borrowers carry low ratings ('B-' and lower) and floating-rate debt (mostly via leveraged loans). Currently, we rate roughly $780 billion in floating-rate debt in this rating class, globally, but much of it is in the U.S. (75%) and in a few sectors (see chart 2).

Chart 2

Global 'B-' and below floating-rate corporate debt outstanding



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. Source: S&P Global Ratings Credit Research & Insights.

Our base-case assumptions are that macroeconomic resilience and contained banking stress will help maintain financial stability and limit credit deterioration in the near term. The corporate results season has improved expectations, while real-time indicators of economic growth, such as Atlanta Fed's GDPNow, point to a continuing growth momentum. Europe's winter energy crisis has been softened by a mild winter and successful supply adaptation, and China has finally ended its COVID-19 restrictions. For now, the banking system pressure appears more a reflection of entity-specific weaknesses rather than broader problems. SVB suffered a quick exit of a small, largely uninsured group of corporate depositors following the bank's decision to sell a large portion of its securities at a substantial realized loss. Credit Suisse had suffered from a series of financial and governance mishaps. Banks and banking systems continue to benefit from a large build-up in capital in the post-financial crisis period, as well as from "sticky", largely local retail depositors who are less likely to engage in bank runs. The response of central banks has been rapid and resolute, limiting broader contagion risks. To date, we have identified only limited direct exposure to SVB, Silvergate Bank, Signature Bank, or First Republic Bank in our rated portfolio of credits within other sectors--a small number of structured finance deals in the U.S.

Concurrently, China's return to normality, following the abrupt removal of COVID-19 restrictions, supports a growth rebound. Rising mobility and confidence underline increasing consumption and services. Meanwhile, conditions in the Chinese housing sector seemed to have bottomed out, given recovering sales momentum and stabilizing house prices. We see policymakers keen to contain macro leverage, along with efforts to rein in financial risks and inflation. This entails a supportive, but not significantly expansionary, macro-economic policy.

Nevertheless, hidden fragilities may yet be exposed, and downside risks have risen. In the U.S., regional banks are not out of the woods yet. There are currently about 4,200 banks in operation,

These lower-rated entities will likely come under increasing credit stress this year given the growing difficulties of refinancing this debt, particularly if banks respond to the recent turmoil by shoring up their own liquidity and pulling back on lending.

of which we rate approximately 100. Of those that we rate, most are larger institutions, including the systemically important banks, which hold a meaningful market share of the overall banking sector. Market sentiment toward smaller, unrated banks arguably remains skeptical. If poor governance or liquidity issues among these institutions come to light, there could be further depositor flight, which might necessitate further interventions. This could have negative effects for residential and small business loans, and depress business and consumer confidence and spending. We believe that the overall banking system is currently stable, with little SVB-style contagion risk or known individual parallel effects. However, the speed of recent events highlights how the potential market sentiment--arguably one of the strongest and fastest-moving channels of systemic contagion--can quickly fall because of banking pressures, even for global, systemically important institutions.

Our downside case projections are for 6.0% and 5.5%, respectively, which would entail a tripling and more than doubling of the current U.S. and European default rates through February (2.0% and 2.5%).

Despite near-term resilience, corporate profits appear to be starting to stall, particularly in the U.S. Fourth-quarter earnings showed fading revenue and cash flow momentum, and much of the aggregate resilience was a result of the benefits to energy companies from last year's war-related surge in energy prices. Forward guidance for the current quarter has been tepid. Many banks reported stocking up reserves in anticipation of a recession this year.

These downside risks could--if realized--increase default rates above our current base-case projections for December 2023 of 4.0% and 3.25%, in the U.S. and Europe, respectively. A growing proportion of recent defaults has stemmed from distressed exchanges, which could tick up further as debt holders may seek quick resolutions with minimal losses to avert near-term stress. However, experience shows that distressed exchanges often result in subsequent defaults. And given the upcoming surge in maturities in 2025, this possible pattern already has the groundwork laid out.

Geopolitical risks continue to rise, with no resolutions in sight. The Russia-Ukraine war is not expected to be resolved this year, with possible fits and starts in terms of temporary escalation. Russia-based cyberattacks against the West may pick up, as they have already been used against Ukraine. Meanwhile, diplomatic relations between China and the U.S. (and its allies) remain tense. The areas of confrontation span Taiwan, the South China Sea region, and semiconductor technology. Closer political and trade ties between Russia and China are complicating the latter country's relationship with the West. China could also move down the decoupling route, which could disrupt supply chains, financial flows, and cross-border investments, threatening a substantial economic cost for the world.

Top Global Risks

Higher interest rates persist, challenging market liquidity and hurting borrowers' debt-service capabilities

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

The lagged impacts of quickly rising interest rates by major central banks could be amplified by further stressors such as a marked divergence between market expectations for the Federal Funds Rate and the Fed's communicated path forward. Higher rates, if combined with expectations for a recession, could spark a flight to safety with increasing demand for treasuries, aggravating existing concerns over reduced liquidity for safe assets. Lower-rated borrowers, many of which heavily rely on floating-rate debt in developed markets and dollar-based debt in emerging markets, could be particularly hard hit as higher rates could see a continued strong U.S. dollar.

Sticky inflation, and a harder landing in advanced economies, strain credit quality

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

The convergence of sticky inflation, sustained higher interest rates, and a stronger U.S. dollar Is weighing on consumer sentiment and spending, stunting growth. For firms and governments, elevated input costs (including labor) could erode profits or raise deficits, straining credit quality This, combined with tighter financing conditions crimping new lending and investment, would lead to a sharper reduction in economic activity and higher unemployment than in our current base case.

Geopolitical tensions intensify, roiling markets and weighing on business conditions

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

The U.S.-China relationship has seen increased tensions recently following a series of incidents. If this continues it could affect supply chains and financial and investment flows. A strategic confrontation between the U.S. and China over the South China Sea would be detrimental for investment, trade, and supply flows within and outside the area. Meanwhile, for the Russia-Ukraine conflict, tail risks are significant. The expanding geopolitical and economic divide could further regionalize supply chains and financial systems.

Eroding confidence in banking stability sparks further market disruptions and magnifies lending constraints

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

Any further instability among U.S. regional banks or other parts of the banking and shadow banking sectors could spark contagion fears that cause stakeholders, including depositors, to withdraw funds, impacting banking flows. In particular, non-systemically important banks could risk seeing more deposit outflows. This could fuel increased market volatility, weigh on consumer confidence, and cause further bank failures or consolidation. Additional sectors could see effects from counterparty risks or unrealized losses, such as commercial real estate. In an attempt to restore confidence, banks could tighten lending conditions. Further asset sales to secure liquidity could negatively affect financial markets and asset prices. The turmoil may also complicate the monetary-policy paths for central banks in their fight against inflation.

Secular risks

Physical risks from climate change weigh on growth and food supplies, while energy-security concerns delay decarbonization of the global economy

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

Larger and more frequent natural disasters increase the physical risks that public and private entities face and threaten to disrupt supply chains, such as for agriculture and food production. At the same time, the global drive toward a "net-zero" economy heightens transition risks (e.g., policy, legal, technology, market, and reputation risks) across many sectors, and will likely require significant investments. The energy market disruption resulting from the Russia-Ukraine conflict, and concerns about energy supply and security, are increasing uncertainty over this transition.

Mounting cyberattacks from geopolitical tensions and increasing digitalization

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

Amid increasing technological dependency and global interconnectedness, cyberattacks pose a potential systemic threat and significant single-entity event risk, with the Russia-Ukraine conflict raising the prospect of major attacks. Criminal and state-sponsored cyberattacks are likely to increase; with hackers becoming more sophisticated, new targets and methods are emerging. Russia’s use of cyberattacks, while largely limited to Ukraine since the invasion, could become a new front in response to the West’s military support for Ukraine. One key to resilience is a robust cybersecurity system, from internal governance to IT software, all requiring additional costs.

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.

Global Credit Quality Continues To Erode

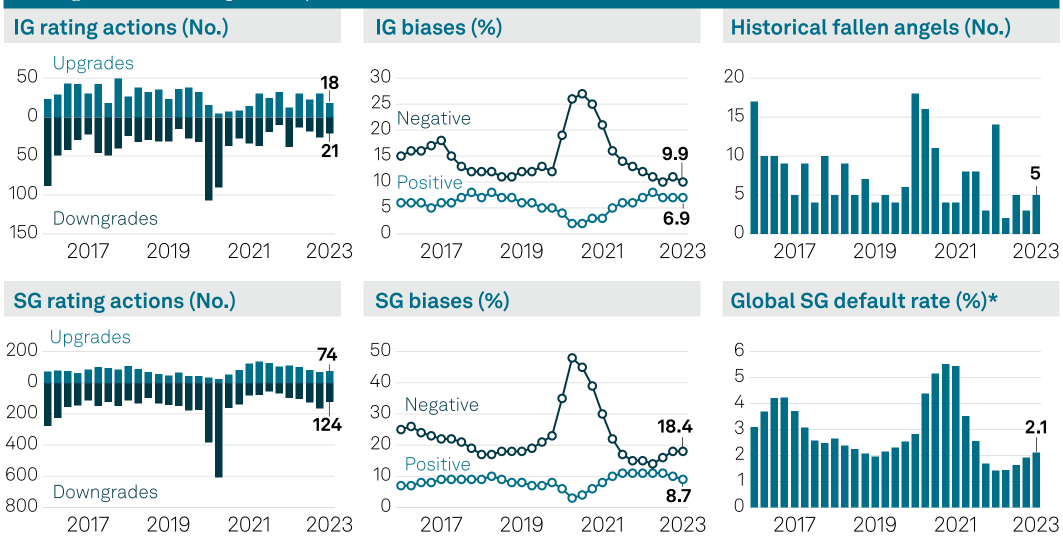
- As previously expected, global credit quality has started to decline since the third quarter of 2022, with downgrades outpacing upgrades and a rising default rate.
- Economic resilience has kept downgrade pace somewhat limited, but lingering stressors such as continually rising rates, "sticky", elevated inflation, and geopolitical headwinds continue to weigh on issuers' profits and budgets.
- Defaults in 2023 have thus far been concentrated in consumer-reliant sectors despite strong labor markets, but have also largely occurred among issuers with comparably long-standing ratings in the 'CCC' category.

Contacts

Nicole Serino
New York
+1-917-664-7324
nicole.serino@spglobal.com

Nick Kraemer, FRM
New York
+1-347-268-5855
nick.kraemer@spglobal.com

Rating and outlook quarterly trends



Ratings at a glance (%)

	North America	Europe	Asia-Pacific	Emerging markets
Outlook bias	(8.2) ▼	(5.0) ▲	(0.2) ▼	(0.1) ▼
Potential fallen angels	2.3 ▼	2.9 ▼	4.7 ▼	5.2
Weakest links (of SG)	13.7 ▲	8.4 ▼	5.3 ▲	13.1 ▲

Regional default insights (No.)

	North America	Europe	Asia-Pacific	Emerging markets
Q1 2023	16 ▲	3 ▼	0 ▼	2 ▼
2023 YTD	6	0	5	6
2022 YTD	11	4	1	2
Leading sector 2023 YTD	Retail	Retail Financial institutions	N.A.	Retail Financial institutions Consumer products

▼▲ Quarter-over-quarter trend. Positive quarterly change. Negative quarterly change. No quarterly change.

Weakest links are defined as issuers rated 'B-' and below, with either a negative outlook or on CreditWatch negative. Weakest links are shown as percentage of speculative-grade population. Regions include North America (U.S. and Canada), Europe, Asia-Pacific, and EMs (countries in Asia-Pacific, Latin America, and Europe). Data as of March 24, 2023. *Captures year-to-date regional default tallies. Direction of arrow indicates quarter over quarter change. IG--investment grade. SC--speculative grade. North America includes the U.S. and Canada. Emerging Markets includes Asia-Pacific, Latin America, and emerging Europe. Default counts may include confidentially-rated issuers. Net outlook bias refers to the percentage of issuers with a positive bias minus the percentage of issuers with a negative bias. All outlook bias calculations include global financial, nonfinancial and sovereign issuers. Sources: S&P Global Ratings Research and S&P Global Market Intelligence's CreditPro®.

Since the third quarter of 2022, momentum in credit quality has shifted from positive to negative as downgrades have largely outpaced upgrades, the negative bias has begun to reverse across all regions, and historically low default rates have started to rise.

So far in 2023, the negative credit momentum has eased slightly as downgrade ratios fell across regions. This is especially the case during the first two months as economic resilience has allowed for some issuers to continue to outperform our expectations. Nonetheless, we expect downgrades to continue to rise, especially in North America and Asia-Pacific, as the negative bias--percentage of issuers with a negative outlook or on CreditWatch--has risen but coming from a very low base. Globally, the spread between speculative grade and the 'B-' and below bias is at its widest since July 2020--signaling heightened downgrade pressure for issuers rated 'B-' and below in particular. The proportion of global speculative-grade issuers rated 'B-' and lower is currently 25%, below the peak of 33% at the end of 2020, but consistent with the start of its ascent at the pandemic's beginning in March 2020.

Despite continued strength in global economies, most downgrades occurred in the consumer-reliant sectors. Downgrades of just under 20 in each of the following sectors--retail, consumer products, and media and entertainment--point to signs that consumers have already begun pulling back on discretionary spending in response to decades-high inflation. These sectors also hold a higher percentage of speculative-grade ratings, which make them more vulnerable to periods of economic instability. Along with these sectors, the net outlook bias was also highest in the aerospace and defense, and healthcare sectors. In Europe and emerging markets, in particular, the transportation, and homebuilders and real estate sectors also held a high current negative bias.

Fallen angels have re-emerged in March. The 2023 tally currently sits at five amounting to approximately $27 billion in debt--including Nissan Motor Co. Ltd., Newell Brands Inc., First Republic Bank, Globalworth Real Estate Investments Ltd., and SVB. However, the lower level of potential fallen angels than in last year signifies a lower immediate downgrade risk. The financial institutions sector continues to lead with eight potential fallen angels, spread across North American and emerging markets.

The number of defaults has picked up, reaching its highest year-to-date tally since 2009. This is no surprise given the several months of an elevated and continually rising number of issuers with weakest links (issuers with a 'B-' rating or lower that have a negative outlook or CreditWatch), which is above its long-term average. Thus far, defaults have been concentrated in consumer-reliant sectors such as retail, but largely among issuers with a comparably long-standing ratings in the 'CCC' rating category and have had previous selective defaults. S&P Global Ratings now expects the trailing-12-month speculative-grade corporate default rates in the U.S. and Europe to reach 4.0% and 3.25%, respectively, by December 2023. In the U.S., this would be double the 2% default rate at the end of February. Nonetheless, even at those levels, defaults will still only be around their long-term averages. Given the uncertainty around our top risks and so much dependent on the length, breadth, and depth of a potential economic downturn, our pessimistic forecasts for default rates of 6% and 5.5% in both regions aren’t out of the question.

Global Financing Conditions: Potentially Greater Tightening Because Of Banking-Sector Stress

- Financing conditions for corporations have become more restrictive since the collapse of SVB and subsequent banking-sector events, but only slightly more so (for now).
- We believe banks will likely pull back somewhat on new lending until the current turbulence in that sector is safely in the rear-view.
- Bond market spreads have risen in the last two weeks, but mostly because benchmark rates on government debt have declined, reflecting a flight to safety.
- Downside risks have increased: market expectations for policy rates have fallen quickly while central bank targets remain comparably elevated. And inflation remains stubborn, which could pressure emerging-market issuers even if the Fed provided a reprieve and the dollar were to decline from recent highs.

Recent stress in the banking sector has tightened overall financing conditions, but the impact has been relatively muted and contained. The March 10 failure of SVB would lead to a quick repricing of sentiment in U.S. equity markets, particularly for the regional banking sector, of which SVB was part (see chart 3). However, though the S&P Dow Jones Indices' U.S. Regional Banking Sector Index has lost roughly 24% since March 8, the S&P 500 has fallen only 1.4%. The same general observations can be made for European indices as well, and most global, broad market equity indices have fallen by similarly modest amounts as the S&P 500. In fact, most major indices are still showing expansion for 2023 in the year-to-date, indicating that while stress in the banking sector has certainly had an impact, thus far it appears modest and largely contained to smaller institutions.

Bond markets are showing similar movement in market sentiment (see chart 4). In the U.S. sector-level bond spreads, we have seen a similar targeting of negative sentiment in the month-to-date towards banks and brokers, whose spreads saw a month-to-date growth rate/relative widening of 85%. Similar to the reaction in equity markets, spread widening has occurred across the board, but the average relative increase among all other sectors is about 22%, roughly one-quarter of the widening among banks and brokers.

Globally, bond spreads for corporations have widened around the SVB collapse (see chart 5). But in contrast to global equities, regional spreads are wider than at the start of the year. That said, the main contributor to wider corporate spreads has been the decline in government bond yields since March 8 (see chart 6). This decline is likely the result of two factors: recently increased expectations for the Fed to pause, if not pivot in its interest-rate path this year, and related fears that the recent bout of banking-sector stress may not be over and that it could dent growth, prompting a flight to safety.

We anticipate a slowdown in lending by banks as a result of recent stress. Despite market fluctuations, one thing that will likely result from the recent turbulence in the banking sector is for banks to reduce new lending in an effort to shore up liquidity and manage capital requirements. As it is, standards for loans to firms have been tightening for the past several quarters in the U.S. and Europe, according to the Fed and ECB bank lending surveys. For example, according to the fourth-quarter 2022 survey, respondents were already anticipating a continued tightening of lending standards during 2023. The potential bank liquidity reduction will only further slow lending growth.

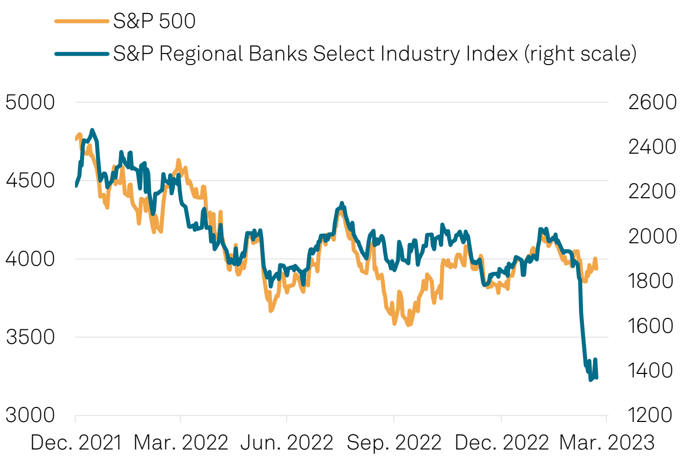
Contacts

Nick Kraemer, FRM
New York
+1-347-268-5855
nick.kraemer@spglobal.com

Recent events have amplified downside risks. Prior to the SVB failure, financing conditions saw both loosening--at the start of the year on optimism over some inflation readings--and tightening --shortly after stronger labor market trends emerged. Core inflation is proving "sticky", which makes it likely that central banks will keep interest rates high for the remainder of the year. And though SVB and Signature Bank were the two largest bank failures in the U.S. after Wamu in 2009, they only accounted for roughly 1.4% of all assets in the commercial banking system. But they are a reminder that banks are confidence-based institutions, illustrating how social media and online platforms could exacerbate the risk of run on deposits, to which smaller banks with more concentrated deposit base are more vulnerable. It is unclear if smaller, regional banks will see further episodes like SVB, but it would be wrong to assume all failures are in the past. More will only increase market fears and volatility now that investors are on guard.

Chart 3

Regional bank indices battered



Sources: S&P Dow Jones Indices, S&P Global Ratings Research & Insights.

Chart 4

Relative widening of sector spreads since Feb. 28

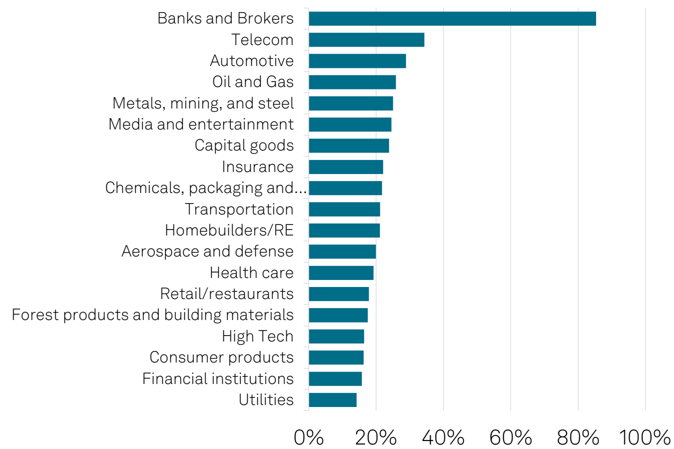
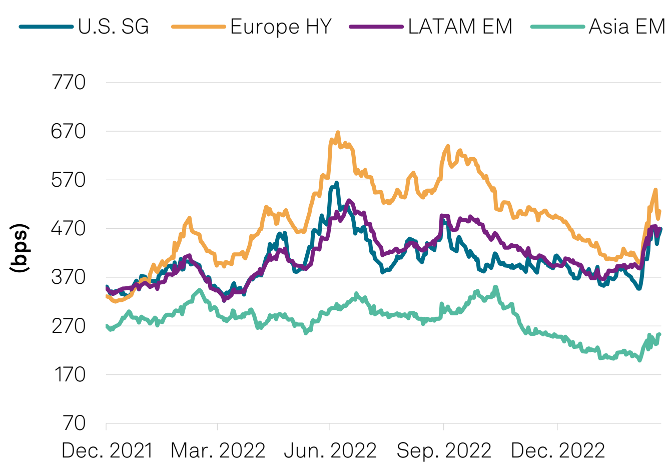


Chart shows the percentage change in sector spread growth rate since Feb. 28, 2023.
Source: S&P Global Ratings Research & Insights.

Chart 5

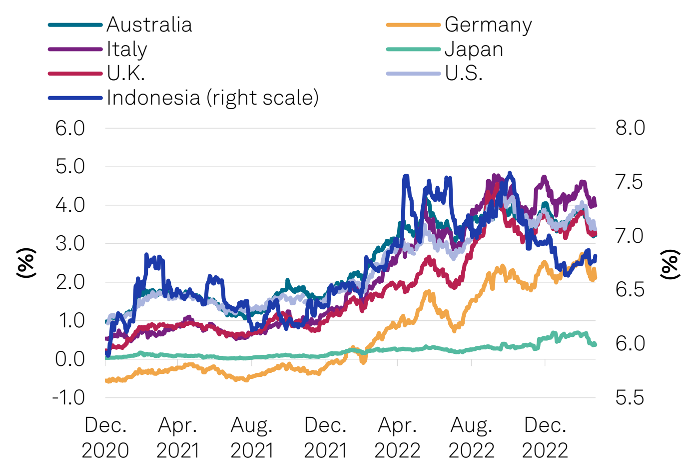
Relative risk pricing sees some contagion beyond the U.S.



Normalized for comparison, all currencies reflect their value relative to the U.S. dollar. SG--Speculative grade. HY--High yield. EM--Emerging market. Sources: ICE BofA Option-Adjusted Spreads, FRED, S&P Global Ratings Research & Insights.

Chart 6

Spreads widen on benchmarks' strength



Source: Refinitiv and S&P Global Ratings Research & Insights.

The Global Credit Cycle Indicator: Credit Correction Underway

Since the introduction of the Global Credit Cycle Indicator (CCI) in June 2022, we had signaled the risk of heightened credit stress unfolding in late 2022 or early 2023. The CCI has been trending downward since its peak in the first quarter of 2021, suggesting a period of credit correction is underway. In particular, the slowdown in credit availability will further exacerbate already-tight funding conditions for borrowers. The potential impact of the buildup of nonperforming loans (NPLs) and defaults could linger even further, 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 on June 27, 2022.

Chart 7

Recent peak in global CCI suggests heightened credit stress in late 2022 or early 2023

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. Source: Bank for International Settlements, Bloomberg, and S&P Global Ratings. For detailed CCI trends, read our regional credit conditions reports.

Resilience Of Sovereigns, Corporations, And Financing Institutions Ratings

Contacts

Roberto Sifon Arevalo
New York
+1-212-438-7358
roberto.sifon@spglobal.com

Sovereigns

As we near the end of the first quarter, sovereign credit quality remains on a downward path. After two consecutive years of lower issuances, we expect that sovereign debt issuances in 2023 will be on an upward trend, 40% above the levels of 2019 (see chart 8).

Our previous expectations of the post-pandemic economic recovery, in which governments would have been able to gradually withdraw fiscal stimulus and consolidate their fiscal position, have been disrupted by a new set of challenges. A massive shock to terms of trade, the war in Ukraine, and the tightening of monetary policy slowed economic growth and intensified pressure on governments to maintain fiscal support. We expect these dynamics to remain at least until 2024.

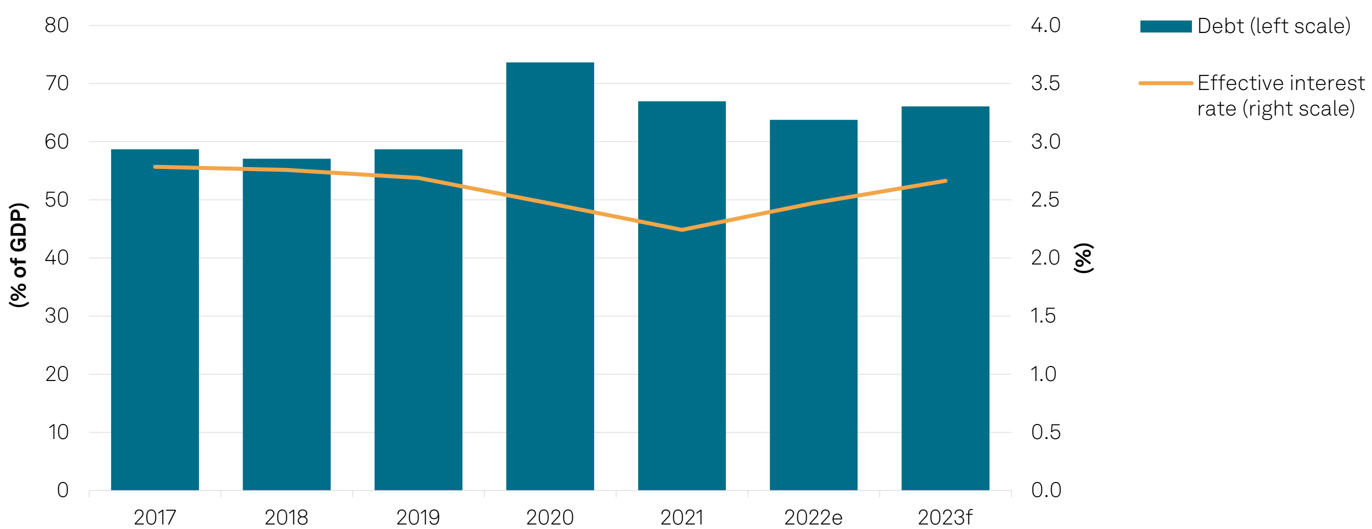
In addition, the global monetary tightening, contrary to previous periods of economic slowdown and stress, makes debt financing substantively higher and in some cases inaccessible.

That said, the longer tenure of overall sovereign debt cushions the short-term impact of the effective interest burden. This is more likely in developed markets than in emerging markets, where we see more pressures over the medium term if high borrowing costs remain in place for a prolonged period.

Chart 8

Commercial debt stock will rise in 2023 on slower growth, wide fiscal deficits, and higher borrowing costs

Central government stock and cost of debt



Note: All figures denote central government commercial debt, budget revenue, and interest expenditure. Effective interest rate denotes interest expenditure divided by outstanding debt stock. e--Estimate. f--Forecast. Source: S&P Global Ratings.

Corporations

Contacts

Gareth Williams
London
+44-20-7176-7226
gareth.williams@spglobal.com

Chiza Vitta
Dallas
+1-214-983-6100
chiza.vitta@spglobal.com

Barbara Castellano
Milan
+390-2721-11253
barbara.castellano@spglobal.com

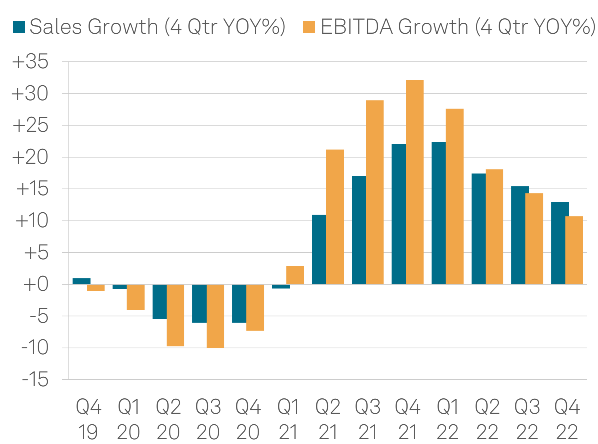
Gregg Lemos-Stein
New York
+1-212-438-1809
gregg.lemos-stein@spglobal.com

There remains a marked gap between performance and likely prospects for the nonfinancial corporate sector. Persistent inflation has generally remained manageable, with cost increases largely passed on, wage growth lagging, and little apparent erosion of profit margins. China's reopening has eased supply-chain concerns, and energy costs have fallen despite the ongoing war in Ukraine. Reported corporate results continue to show positive, if fading, momentum. With some 80% of rated nonfinancial corporates having reported end-year results, annual EBITDA growth currently tallies at 11%, down from 14% in the third quarter and 18% in the second quarter. Credit spreads remain relatively tight and far below levels indicative of imminent stress. Prospects, however, are more subdued and credit strains are likely to broaden in coming months. We expect negligible revenue and EBITDA growth among rated corporations this year, and profit margins are likely to erode. Capital market sentiment remains fragile, particularly given volatility in the banking sector, and financing costs will move inexorably higher as cheap pandemic-era financing is gradually replaced. Speculative-grade issuers with near-term financing needs are particularly vulnerable. Our base-case scenario points to deteriorating credit quality, with downgrades likely to continue outpacing upgrades along with a steady, if modest, rise in defaults. A more severe-than-expected recession remains the main downside risk, particularly with credit quality not fully recovered from the pandemic and financial market volatility likely to follow. This could unravel much of the improvement in corporate leverage and financial performance last year.

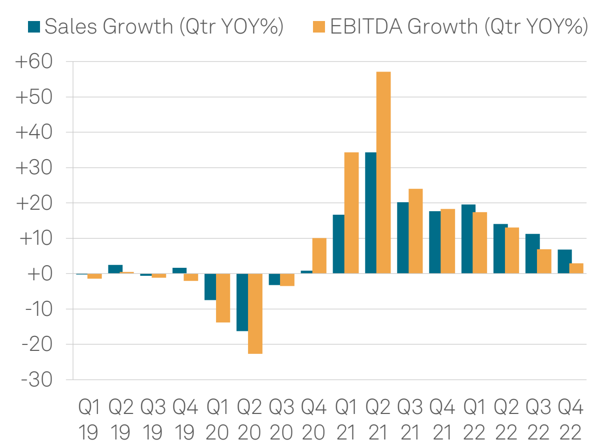
Chart 9

Rated nonfinancial corporates: global sales and EBITDA growth

Trailing four quarter sum, year-on-year



Quarterly sum, year-on-year



Data to March 24, 2023. Measured in U.S. dollars, at historic rates. Only includes companies reporting quarterly. Qtr--Quarter. YOY--Year on year.
Sources: S&P Capital IQ, S&P Global Ratings.

Financial Institutions

We expect a substantially lower risk appetite among global financial institutions following the banking events of the past couple of weeks. The decisive actions by authorities and the recognized specificity of the issues behind the SVB and Credit Suisse shocks appear to have averted contagion to the global banking system. That said, monetary policy tightening in key economies will likely accelerate divergence within an already heterogeneous financial institutions industry (see chart 10). The full write-off of CHF16 billion Additional Tier-1 capital instruments issued by Credit Suisse has undoubtedly startled many market participants and could limit the banks' access to hybrid instruments. And these specific cases have brought to light again the potential risks for banks in asset-liability mismatches and concentrated deposit bases--with the digitization of the latter adding a new dimension. In the U.S. banking system, as of March 23, we have not seen evidence of unmanageable deposit outflows spreading widely across rated entities after the failure of three banks. The situation remains fluid, however, and given that banking is a confidence-sensitive industry, we continue to carefully monitor the sector. We expect that weaker confidence will hike the cost of capital for most banks across regions and that further bouts of volatility may affect funding markets. But if authorities carefully balance tightening monetary policy with financial stability risks, banks should be able to preserve solid capitalization and funding profiles, albeit at a higher cost. Rising rates should continue to provide tailwind to many banks' net interest margins, even if operating and credit costs are set to increase as well. Banks' asset quality will weaken in a number of countries as a result of tightening financing conditions, and certain pockets of risks may affect less diversified lenders, including nonbank financial institutions (NBFIs). But the overall impact should be manageable, with provisioning charges generally normalizing rather than spiking.

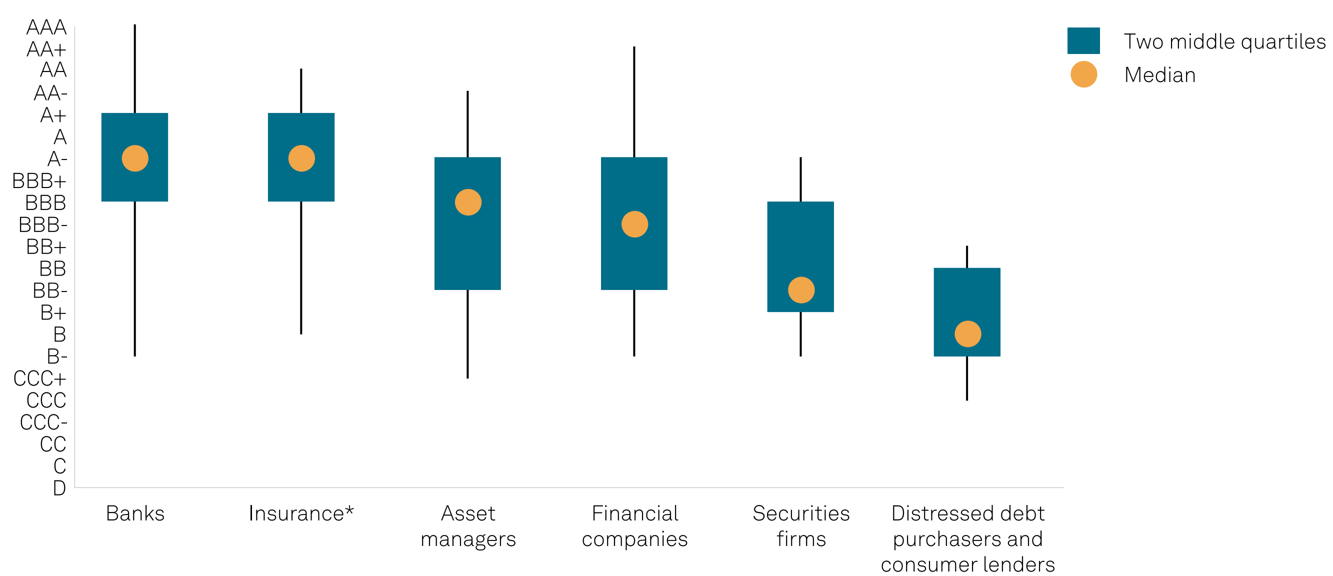
Contacts

Alex Birry
London
+44-20-7176-7108
alexandre.birry@spglobal.com

Chart 10

Credit profiles of rated financial institutions vary considerably

Rating distribution of selected financial sectors in the U.S. and Western Europe



*Excluding insurance brokers. Source: S&P Global Ratings.

Regions On Diverging Paths

North America: Coalescing Stresses

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 face a stretch of difficult credit conditions.

Contagion risks remain elevated. Our base-case scenario assumes that the Fed's moves will help ease liquidity pressures on lenders and reduce the odds that unmanageable deposit outflows spread widely. Regardless, banks will likely implement stricter lending standards—making it more difficult and costly for entities, especially small and mid-sized enterprises (SMEs), to access funding.

The recent banking-sector stress could also be felt in the CRE industry--the office space, in particular. Regional banks have proportionately higher exposure to CRE than larger U.S. banks. This and higher mortgage rates compounded by properties needing material investments in order to maximize the rental potential—along with greater scrutiny of bank balance sheets—heighten refinancing risk.

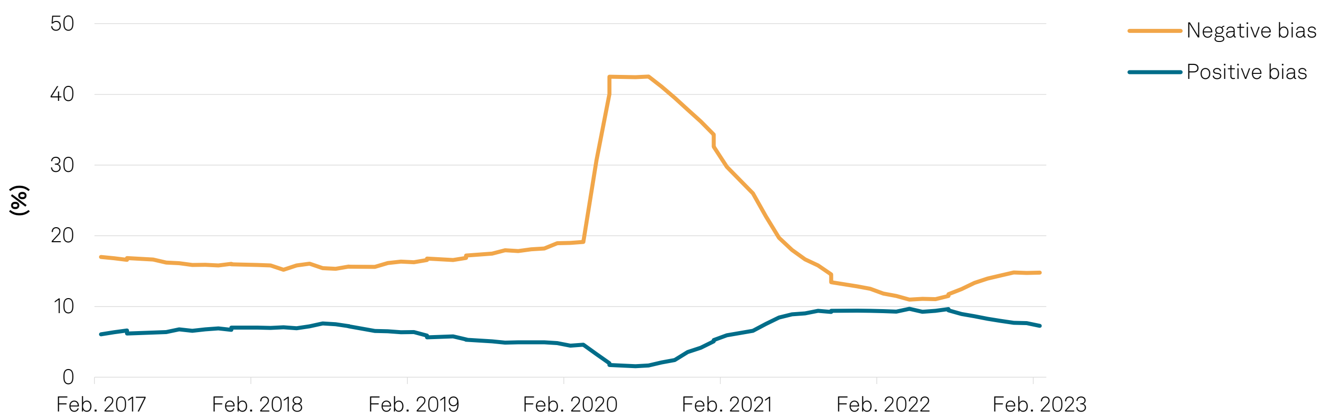
At the same time, the credit landscape proved resilient in the first quarter. The end of COVID restrictions in China has helped ease supply-chain constraints, which were a primary contributor to inflation. Corporate results show companies have largely managed cost pressures, bolstering profitability. Credit spreads remain relatively tight and below levels indicative of imminent stress. However, credit strains are likely to broaden in coming months.

The U.S. economy could suffer a sharper-than-expected downturn, as signs of erosion in household balance sheets suggest there could be a significant pullback in consumer spending. This could dampen profits in many sectors at a time when input-cost inflation persists and companies' ability to pass through higher costs dwindles.

All this could erode credit quality and likely spur higher defaults. Net outlook bias, indicating potential rating trends, widened to 8.3% as of March 26—a 21-month high (although still roughly half of pre-pandemic levels; see chart 11). S&P Global Ratings Credit Research & Insights expects the U.S. trailing-12-month speculative-grade corporate default rate to reach 4% by December.

Chart 11

North American ratings outlook bias



Data as of Mar. 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.

Contacts

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

Eunice Tan
Hong Kong
+852-2533-3553
eunice.tan@spglobal.com

David Tesher
New York
+1-212-438-2618
david.tesher@spglobal.com

Paul Watters
London
+44-20-7176-3542
paul.watters@spglobal.com

Europe: Costs Rising To Cure Inflation

Overall, central banks have lit a long fuse by raising interest rates sharply into restrictive territory. The financial implications on businesses and consumers feeds through with a lag especially where debt is locked in at fixed rates and consumers are employed and have accumulated savings during the pandemic. But combined with stagnating growth in Europe, fault lines appearing in the banking system, and the war in Ukraine dragging on, this presents a highly unsettled outlook that we expect will tighten financing conditions and weigh on credit quality through the year.

Downside risks for the economy have increased and could derail our base-case assumption of a 0.3% growth this year in the eurozone if financial markets remain volatile, core inflation peaks much later than expected, or if the war in Ukraine escalates. Any of those events could trigger a recession in Europe, working primarily through consumer confidence and financial channels. The severity of any recession would largely depend on the strength of the services sector and employment levels.

From the credit perspective, the more vulnerable corporate borrowers are those that have not fully recovered from the pandemic (e.g. transport infrastructure, some real estate subsectors); earnings of which will come under greater pressure than in the last two years (see table 1 below) as demand slows and cost pressures become harder to pass through; and/or debt service ratios of which come under strain as rising funding costs take full effect.

Table 1

Sector profitability in the eurozone

2019-2022 (%)

Sector	2020	2021	2022	2019-2022
Agriculture (2%)	-1%	9%	20%	29%
Construction (5%)	-4%	10%	15%	21%
Trade, tran., acc.,fd (19%)	-18%	18%	23%	19%
Manufacturing (17%)	-8%	15%	13%	19%
Total (100%)	-6%	9%	11%	13%
Inform. & comms (5%)	2%	6%	1%	10%
Real estate (11%)	0%	3%	4%	8%
Finance & insce (4%)	0%	1%	3%	4%
Prof. & technical (12%)	-6%	6%	3%	2%
Public admin (19%)	-4%	6%	-2%	0%
Arts, ent., & others (3%)	-24%	3%	12%	-13%

Note: Profitability comprises gross operating surplus. Trade, tran., acc., fd--trade transportation, accommodation and food. Figures in brackets are 2019 weights in total gross value added (GVA). Source: Eurostat.

In the banking arena, although confidence has taken a knock and wholesale funding markets may remain choppy for a while, household deposits, providing about 30% of funding liabilities, underpin liquidity for the majority of European banks. On the asset side, most unrealized securities losses are recognized through the profit-and-loss statement or regulatory capital. Only a manageable 5% of assets (on average) are carried at amortized cost where unrealized losses are not accounted for. Elsewhere, we expect some deterioration in asset quality for the next two years, with SME, unsecured consumer, and real estate loans to monitor. Banks with moderate exposures to the CRE sector could be more vulnerable in the form of higher financing costs, potential refinancing risk, and weaker valuations. Among banks in the large economies, Swedish and German lenders report higher exposures to the CRE sector. Overall, we expect the impact of impairments to be manageable with provisions normalizing, especially factoring in the support to banks' profitability stemming from rising rates. Nonetheless, reflecting the deteriorating risk environment, we expect banks' underwriting standards to tighten, with the pace of loan growth decelerating from still solid growth of 4.9% in January 2023.

Asia-Pacific: Banking Turmoil Risk Is Moderate

China's exit from its zero-COVID stance and bottoming out of the property sector support a rebound. This bodes well for Asia-Pacific's commodity exporters and tourism-dependent economies amid higher Chinese demand and resuming international travel. However, China's recovery path could be fragile if domestic consumption falters. Beijing's ongoing focus to rein in leverage risk could hit local government financing vehicles (LGFVs) and some SMEs as they seek to refinance existing debt.

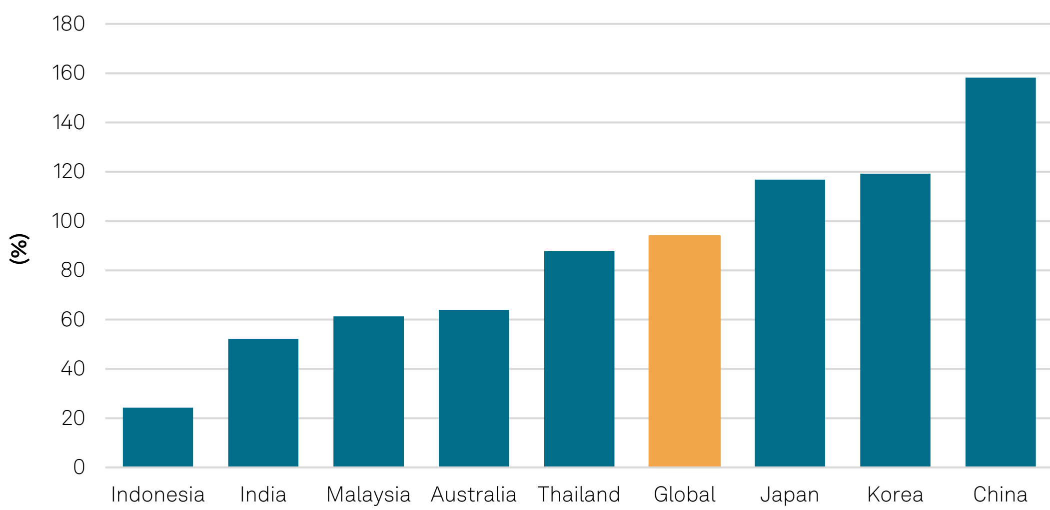
Contagion spillovers look limited, for now. A contagion spillover into Asia-Pacific is less likely, though not impossible, as the region's banks tend to be conventional broad-based commercial and retail lenders, typically with diversified deposit bases and less exposure to complex business lines.

Economic slowdown curtails ability to pass through costs. The region's inflation woes are a concern, particularly in Australia, India, and the Philippines. Still weak local currencies are keeping imports (commodities and energy) costly. Concurrently, the unwinding of energy-price controls by some governments (implemented to support households and businesses) could reverberate through the supply chain, causing resurgence of inflation. Some central banks in the region will need to raise rate to narrow the interest-rate gap with the U.S. amid current account deficits.

Chart 12

Corporate leverage is high in east Asia

Nonfinancial corporate debt to GDP (%)



Data as of September 2022. Sources: Bank for International Settlements, S&P Global Ratings.

Emerging Markets: Enduring Risks

Credit conditions will remain tight across emerging markets through 2023, despite some positive factors. The circumstances that helped corporations, households, and banks face inflationary pressures in 2022 are quickly fading. Slower economic activity, along with stubborn inflation and rising financing costs, will undermine corporations and households' payment capacity. Sovereigns are also withdrawing support measures linked to the pandemic to pursue fiscal consolidation. At the same time, social demands are increasing as households remain in a fragile position, given lingering high prices. Sovereigns will tread carefully to avoid social unrest; therefore, we expect fiscal consolidation will be gradual, at the risk of weakening credit quality. On a positive note, supply chains continue normalizing, which should help ease logistics costs. China's reopening may also support some emerging markets, and Purchasing Managers' Indices continue improving. Still, these factors are not sufficient to offset risks at this point.

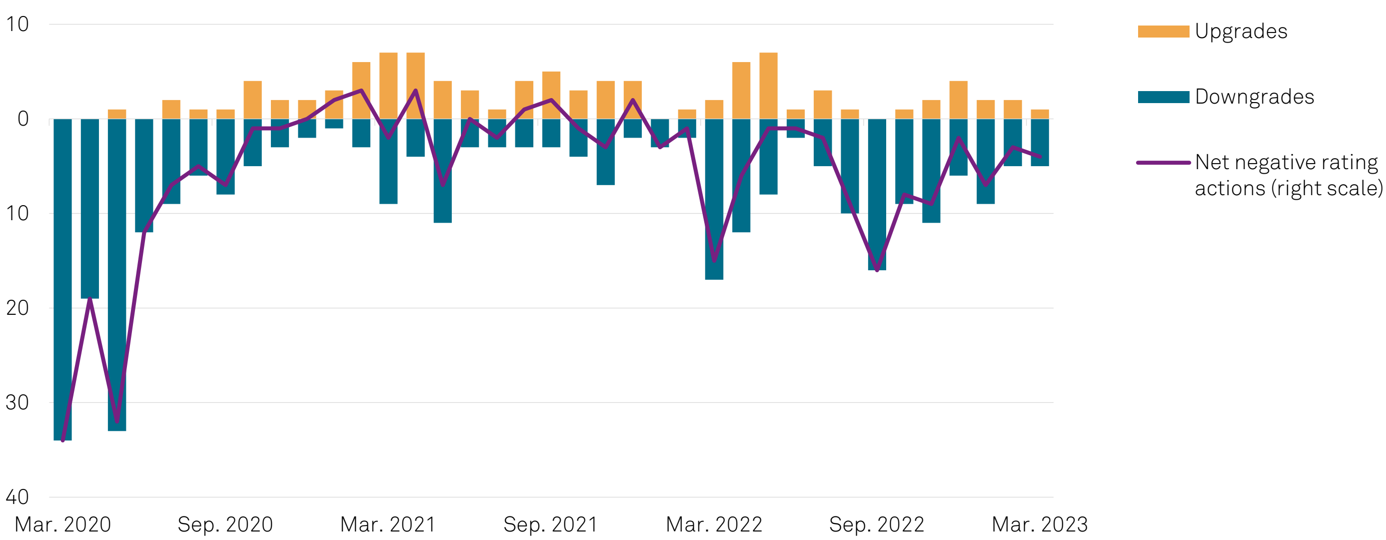
Contagion from recent banking-sector turmoil remains limited across emerging markets. Banks' direct exposure to recently failed financial institutions is low although the confidence shock is unwelcome. Large, systemic emerging-market banks have sound liquidity and capitalization metrics. Moreover, their funding structures are generally composed of retail deposits, which are usually more stable under stressful circumstances. However, the indirect effects of recent turmoil in the U.S. banking sector could amplify existing challenges, especially for small banks and NBFIs.

Rating trends show that emerging-market issuers have not fully recovered from the shocks stemming from the pandemic and the war in Ukraine. Downgrades have outpaced upgrades since December 2021 (see chart 13), even though at the start of 2023, several economic indicators pointed to improving economic conditions, easing inflation, and the tapering of monetary tightening. Positive momentum has faded as inflation proved more persistent than anticipated, and we now expect high interest rates to linger potentially through the first quarter of 2024. The combination of slower economic activity, stubborn inflation, and rising financing costs will undermine corporations and households' payment capacity, likely further weakening credit quality across key emerging markets.

Chart 13

Emerging market downgrades will likely accelerate

Number of rating actions in key emerging market



Data as of March 14, 2023, financial and nonfinancial corporates, including sovereigns Argentina, Brazil, Chile, Colombia, Mexico, Peru, India, Indonesia, Malaysia, Thailand, Philippines, Vietnam, Hungary, Poland, Saudi Arabia, South Africa, Turkiye, and Greater China. Source: S&P Global Ratings Research & Insights.

Appendix 1

Table 2

Updated GDP forecast

Annual percentage change (%)

	Latest forecast				Change from Nov. 2022		
	2023	2024	2025	2026	2023	2024	2025
U.S.	0.7	1.2	1.8	2.0	0.8	-0.2	0.0
Europe							
Eurozone	0.3	1.0	1.7	1.6	0.3	-0.4	0.2
Germany	0.0	0.9	1.8	1.7	0.5	-0.1	0.5
France	0.4	1.2	1.6	1.4	0.2	-0.4	0.1
Italy	0.4	1.0	1.4	1.4	0.5	-0.4	0.2
Spain	1.1	1.6	2.3	2.2	0.2	-0.3	-0.2
U.K.	-0.5	1.5	1.8	1.6	0.5	0.2	0.3
Asia-Pacific							
China	5.5	5.0	4.7	4.5	0.7	0.3	0.1
Japan	1.0	1.1	1.1	1.0	-0.2	0.0	0.0
India*	6.0	6.9	6.9	7.1	0.0	0.0	0.0
Emerging economies							
Mexico	1.3	1.7	2.1	2.1	0.5	-0.3	-0.1
Brazil	0.8	1.7	2.0	2.0	0.2	-0.2	-0.2
South Africa	0.8	2.1	1.7	2.2	-0.7	0.5	0.0
World	2.7	3.1	3.4	2.9	0.4	0.0	0.1

*Fiscal year, beginning April 1 in the reference calendar year.
Sources: S&P Global Market Intelligence, S&P Global Ratings (forecasts).

Table 3

Updated CPI inflation forecast

Annual percentage change (%)

	Latest forecast				Change from Nov. 2022		
	2023	2024	2025	2026	2023	2024	2025
U.S.	4.2	2.4	1.6	1.5	-0.1	-0.3	-0.7
Europe							
Eurozone	5.9	2.7	2.0	1.9	0.2	0.2	0.1
Germany	6.7	2.9	2.0	1.6	-0.6	-0.1	0.2
France	5.4	2.3	2.0	2.1	1.0	-0.1	-0.3
Italy	6.5	2.3	2.0	2.0	0.4	0.0	0.0
Spain	4.6	3.2	1.7	2.0	-0.5	0.9	0.2
U.K.	5.8	1.4	1.1	1.7	-1.2	0.5	-0.5
Asia-Pacific							
China	2.3	2.7	2.2	2.2	-0.3	0.3	0.0
Japan	2.8	1.8	1.5	1.2	1.3	0.6	0.3
India*	5.0	4.3	4.4	4.7	0.0	-0.2	-0.1
Emerging economies							
Mexico	6.4	4.1	3.2	3.0	0.6	0.4	0.0
Brazil	4.8	4.5	3.6	3.5	0.5	0.3	0.2
South Africa	5.5	4.1	4.4	4.5	-0.3	-0.2	0.3

*Fiscal year, beginning April 1 in the reference calendar year.
Sources: S&P Global Market Intelligence, S&P Global Ratings (forecasts).

Related Research

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