

Risks vs. Resilience

June 27, 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 America committee on June 20, 2023.

Key Takeaways

- **Overall:** Credit conditions look set to remain tight, with benchmark interest rates unlikely to fall soon, price pressures persisting, and lenders becoming more selective. Still, credit spreads remain narrow, and the U.S. economy is proving resilient.
- **Risks:** With corporate earnings under pressure and the debt-maturity wall creeping into view, lower-rated borrowers could suffer liquidity constraints. Banks' tightening their lending standards will make it more difficult and costly for entities—especially small and midsize businesses, and households—to secure funding.
- **Ratings:** Downgrades continued to outpace upgrades, and the net outlook bias, indicating potential ratings trends, is at negative 9.3%—a two-year high. Defaults will likely rise, with consumer-facing sectors, many of which are in the 'CCC/C' categories, suffering most.

Credit conditions for borrowers in North America are caught in a push-and-pull between unyielding risks and economic resilience. Generally, conditions look set to remain tight for the foreseeable future. Benchmark interest rates are unlikely to fall any time soon, price pressures persist (eroding consumer purchasing power), and lenders are becoming more selective.

A protracted period of tight financing conditions would weigh on entities' debt-service burdens and limit access to funding. Corporate earnings are still under pressure and the debt-maturity wall is creeping into view, making lower-rated borrowers vulnerable to more liquidity constraints. Tight financing conditions could also lead to significant declines in asset valuations—including a deeper correction in commercial real estate (CRE).

We don't expect a full-on "credit crunch", although some borrowers may find financing options much more costly or, in some cases, unavailable. Banks may strive to fortify their balance sheets and tighten their lending standards, which will make it more difficult for entities—especially small and midsize businesses, as well as households—to gain funding.

Lenders in the private credit markets certainly have the capacity to step in and provide financing, but their willingness to do so to the degree necessary for borrowers to refinance upcoming maturities remains to be seen.

We no longer think it a given that the U.S. will slip into recession this year. For now, credit spreads remain narrow. This comes as the U.S. economy proves resilient to a multitude of stresses—bolstered by a pickup in private spending in the first quarter.

Regional Credit Conditions Chair

David Teshler
New York
david.teshler
@spglobal.com
+1-212-438-2618

North America Credit Research

Joe Maguire
New York
joe.maguire
@spglobal.com

Yucheng Zheng
New York
yucheng.zheng
@spglobal.com

Contents

Top North American Risks	5
Macroeconomic Outlook	7
Financing Conditions	9
Sovereigns	11
Financial Institutions	13
Nonfinancial Corporates	16
Public Finance	19
Structured Finance	20
Insurance	22
Related Research	25
Appendix 1: Nonfinancial Corporate Sectors Outlook	26
Appendix 2: Economic Data and Forecast Summaries	31
Appendix 3: List Of Analytical Contacts	32

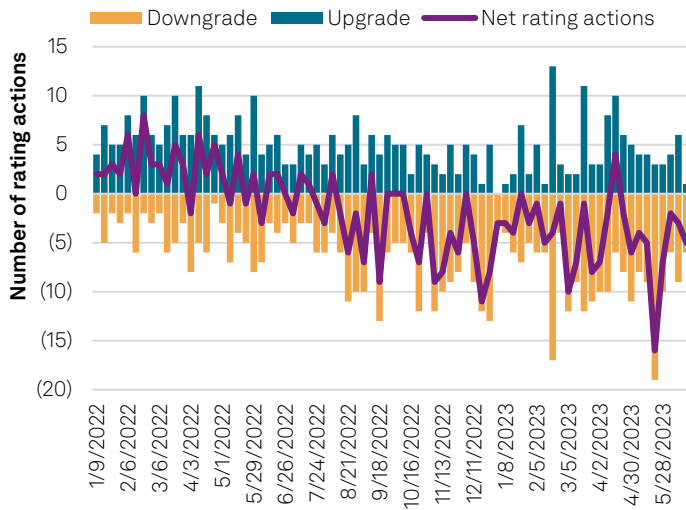
Nonetheless, this month's pause in rate hikes suggests the Federal Reserve recognizes that tighter monetary policy may be beginning to bite. Whether the central bank can steer the world's biggest economy into a "soft landing"—or will ultimately plunge it into recession—depends heavily on how long the financial cushions that businesses and households built up during the long stretch of easy money are enough for them to outlast any economic turbulence.

Consumers' balance sheets are eroding. Inflation—which has far outpaced wage gains—has eaten away at purchasing power, and households are taking on more debt. A surge in credit card borrowing among lower-income (and younger) households suggests we could soon see a significant pullback in discretionary spending. This would weigh on profits in many consumer-reliant sectors at a time when input-cost pressures, while easing somewhat, remain elevated.

We don't expect the Fed to lower its policy rate until mid-2024, as inflation remains well above the central bank's comfort level. Inflation has shown signs of easing in the U.S., with both consumer and producer prices last month posting the slowest annual gains in two years. However, we think the central bank will keep the benchmark federal funds rate "higher-for-longer" as it continues to battle price pressures.

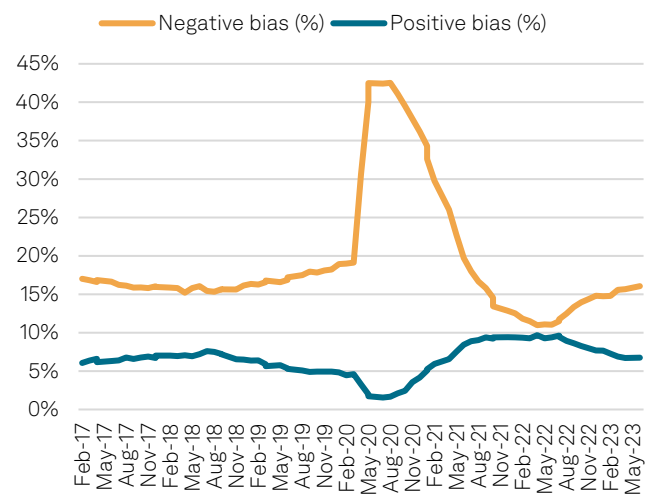
On average, ratings are lower than they were prior to the pandemic, with 26.1% of North American nonfinancial corporates rated 'B-' or below. Downgrades continued to outpace upgrades, and the net outlook bias, indicating potential ratings trends, is at negative 9.3% as of May 31—a two-year high and approaching pre-pandemic levels (see charts 1 and 2). The homebuilders and real estate sectors saw the biggest jump in negative bias in the recent quarter, and consumer products now have close to 30% of issuers with a negative outlook or on CreditWatch with negative implications (see chart 3).

Chart 1
North American rating actions



Weekly data as of June 13, 2023, and covers financial and nonfinancial corporates. Source: S&P Global Ratings.

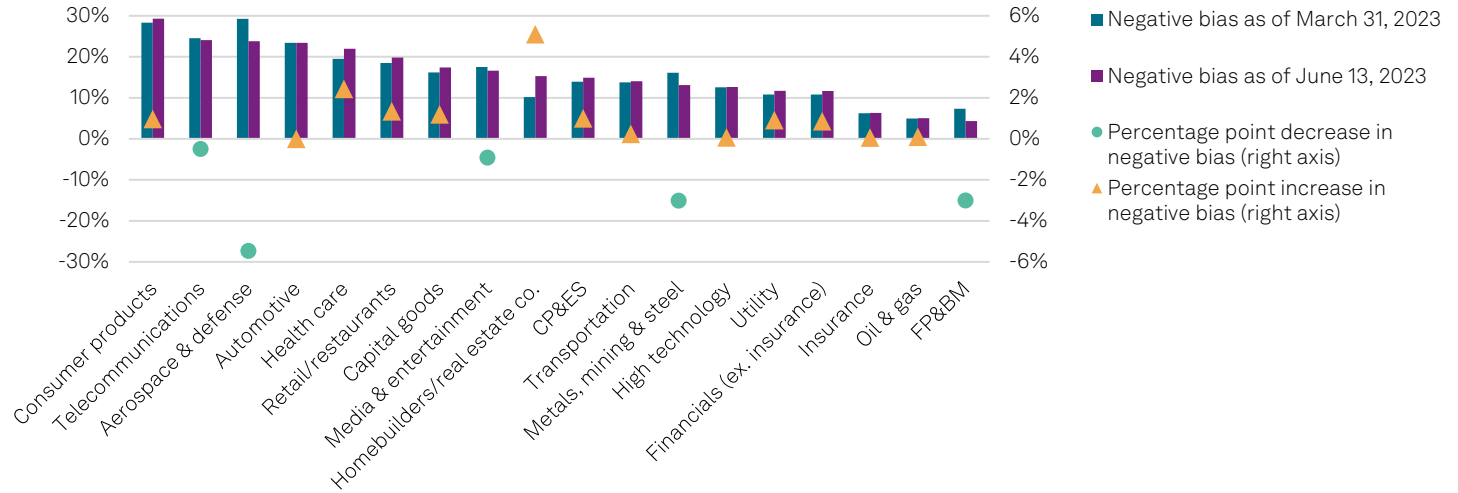
Chart 2
North American ratings outlook bias



Monthly data as of May 31, 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.

Credit Conditions North America Q3 2023: Risks vs. Resilience

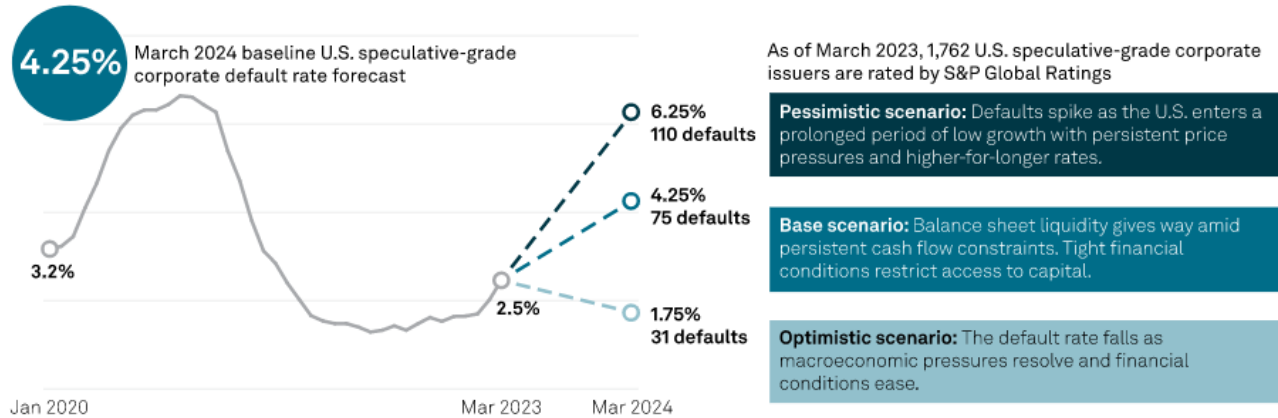
Chart 3
Negative bias by sector



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 4.25% by March—just above the 4.1% long-term average (see chart 4). If, as we expect, unemployment rises and discretionary spending erodes, consumer-facing sectors, many of which are in the 'CCC/C' categories, will suffer most. If a deeper- or longer-than-expected economic slowdown occurs, the default rate could jump to 6.25% (our pessimistic scenario).

Chart 4
Defaults pick up into 2024



Data as of March 2023. Sources: Leveraged Commentary and Data (LCD) from PitchBook, a Morningstar company; and S&P Global Ratings Credit Research & Insights. Copyright © 2023 by Standard & Poor's Financial Services LLC. All rights reserved.

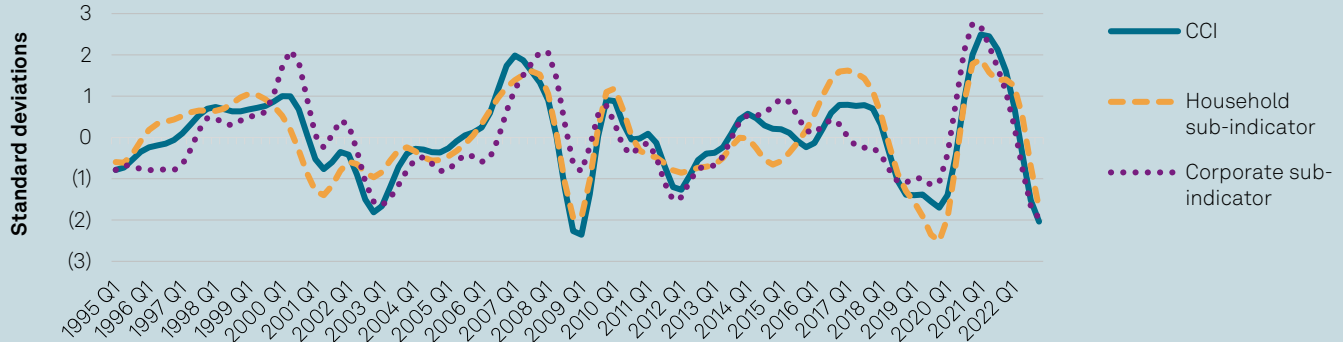
Credit Cycle Indicator

Coalescing stresses could exacerbate credit pain

Since introducing the North America Credit Cycle Indicator (CCI) in June 2022, we've pointed to heightened credit stress likely unfolding in late 2022 or early 2023 (see chart 5). The CCI has been trending downward from the peak of 2.5 standard deviations above historical average in first-quarter 2021, signaling a credit correction underway. Nonetheless, the potential impact on nonperforming loans (NPLs) and defaults from the buildup of debt leverage and asset prices could linger, considering the coalescing risks faced by North American borrowers (see Top North American Risks Section).

Chart 5

North America CCI



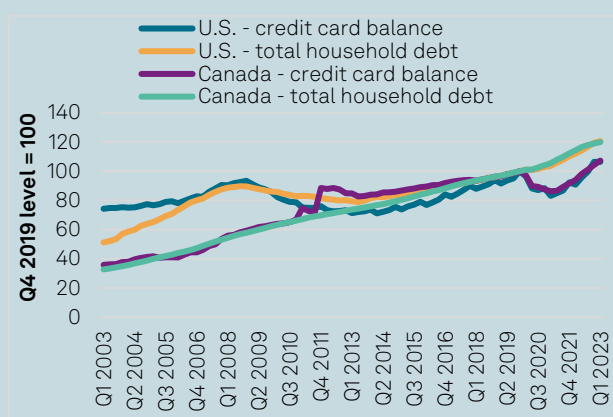
Peaks in the CCI tend to lead credit stresses by six to ten quarters. When the CCI's upward trend is prolonged or the CCI nears upper thresholds, the associated credit stress tends to be greater. Sovereign risk is not included as a formal part of the CCI. The CCI period ends in Q4 2022. The North America CCI includes Canada and the U.S. Sources: Bank for International Settlements, Bloomberg, S&P Global Ratings. For more details about CCI, see "[White Paper: Introducing Our Credit Cycle Indicator](#)," published June 27, 2022.

Corporates. The corporate sub-indicator has been declining steadily from the peak of 2.8 standard deviations above trend as of year-end 2020, in part reflecting easing corporate leverage after the surge during the pandemic. However, even tighter financing conditions amid the recent banking sector turmoil, persistently elevated input costs, and more severe earnings headwinds could 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 given their higher reliance on floating-rate debt.

Households. The household sub-indicator is also trending downward. Excess savings accumulated during the pandemic and a tight labor market have so far supported consumer health, but households' financial cushions are running thin. We see evidence of this in the increasing credit card borrowings in recent quarters, despite climbing interest rates (see chart 6). Lower-income and younger cohorts are more stretched, showing more upticks in credit card loan delinquencies. Potential payment shocks for U.S. student loan holders (as the federal forbearance program is due to expire on Sept. 1) and many Canadian homeowners (as their shorter-term, variable-rate mortgages come up for renewal) are also a concern (see chart 7). In addition, any further correction of the U.S. and Canadian housing markets could damp perceived household wealth and have spillover effects across sectors.

Chart 6

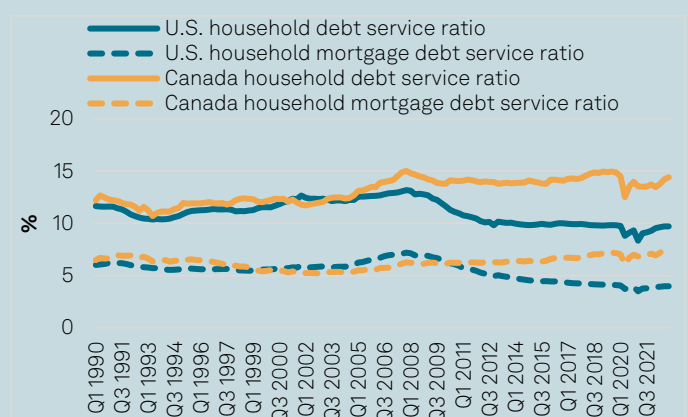
Households are tapping more into credit cards



Data as of Q1 2023. Sources: New York Fed Consumer Credit Panel/Equifax, Statistics Canada, S&P Global Ratings calculations.

Chart 7

Household debt service ratios on the rise



Ratios are seasonally adjusted data as of Q4 2022. Sources: Board of Governors of the Federal Reserve System, Statistics Canada.

Top North American Risks

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

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

Given the likelihood of "higher-for-longer" benchmark interest rates, a prolonged period of tight financing conditions and more stringent lending standards 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 suffer more liquidity constraints. Tighter financing conditions could also lead to significant declining asset valuations—including a deeper correction in residential and commercial real estate.

U.S. suffers a sharper-than-expected economic slowdown

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

Although American households and businesses—particularly in services sectors—have been resilient in the face of tighter monetary policy, financial cushions have worn thin amid elevated prices. A sharp pullback in consumer spending (which accounts for roughly 70% of GDP in the world's biggest economy) 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 corporate maturity wall approaches.

Continuing cost pressures squeeze profits, add to credit strains

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. Defaults and downgrades are rising, and we've seen signs that corporates could be entering an "earnings recession"; if profit erosion becomes more widespread and steeper than we expect, credit quality could suffer further.

(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. The recent incident involving the Wagner group and its potential ramifications adds to the uncertainty. Meanwhile, the U.S.-China relationship remains shaky. Any further worsening of tensions between the two over the South China Sea region and the Russia-Ukraine war, or the intensifying technology race, could kink supply chains, and disrupt investment and capital flows for both—and other—countries.

Falling asset values and cash flows, plus high financing costs, exacerbate CRE losses

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

Declining demand for certain types of CRE—office space, in particular—is weighing on asset valuations and curbing cash flows at a time when financing costs have increased. The entrenchment of work-from-home/hybrid agreements means that any recovery in the office sector will surely lag. Amid this longer-term decline in demand, refinancing risk is heightened, and we may see elevated CRE-related loan losses for debtholders, such as U.S. banks, insurers, REITs, and commercial mortgage-backed securities (CMBS). Compounding the sector's risks is the sharp pullback in lending, especially among regional banks, which have proportionately higher exposure to CRE than larger U.S. lenders do.

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

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

Market conditions for U.S. regional banks remain volatile following the recent bank failures. Any renewed or heightened fears among stakeholders could further disrupt money flows, fuel more market volatility, and weigh on consumer confidence and spending. As banks become more selective in lending to fortify their respective balance sheets and preserve liquidity, entities such as small and medium-sized businesses (SMBs), as well as households, may find it harder 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 and intense natural disasters increase the physical risks that 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 across many sectors and will likely require significant investments. In the U.S., transition risks are 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.

Accelerating tech transformation disrupts business models, cyberattacks threaten operations

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

Cyberattacks pose a systemic threat and significant single-entity event risk as new targets and methods emerge—with geopolitical tensions raising the prospect of major attacks. Organizations lagging on adapting to current and emerging technologies or lacking well-tested cybersecurity playbooks are more 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.

Commercial real estate

At the onset of the pandemic, much of the concerns about stresses in CRE centered on hotels and retail properties—and the effects that social restrictions would have on these industries. Now, the focus is firmly on the office sector. While lodging has largely recovered from its COVID nadir, certain types of retail properties, especially lower-quality regional malls, are still dealing with a seismic shift in consumer behavior that was merely accelerated—rather than caused—by the pandemic and continue to struggle to find long-term financing. The office sector is now facing its own shift in "consumer" behavior, namely the increasing permanence of work-from-home/hybrid situations.

Declining demand for office space is pressuring asset valuations, and properties are no longer generating the same levels of cash flows at a time when financing costs have increased. On top of that, many properties—particularly "older" properties in gateway cities—are no longer viewed as "class A" and, thus, need to incur significant capital expenditure (capex) to bring properties up to date and compete with newer and higher-quality spaces (which thus far continue to command higher rents and are holding up relatively well). Tenant improvement costs have soared to drive leasing, leading to lower profit margins along with benchmark interest rates, thus intensifying refinancing risk.

Moreover, U.S. banks are lending less in the wake of banking sector turmoil. The country's bank lending shrank a record \$105 billion in the last two weeks of March—a sharp tightening of credit conditions that included notably fewer real estate loans, which is unsurprising given that regional banks have proportionately higher exposure to CRE than larger U.S. banks do.

Office leases typically last about 10 years, and lenders are likely to extend loan maturities in some cases. Taken together, this means that distress would likely be drawn out over a longer period. But we're already three years past the start of the pandemic, and it's clear at this point that any recovery in the office sector will lag.

All told, we may see elevated CRE-related loan losses for debtholders, such as U.S. banks, insurers, REITs, and CMBS, particularly for lower quality assets. For local government issuers, delayed return to office could have implications for tax revenues and property valuation in the downtown core of urban centers.

Macroeconomic Outlook

- We no longer think the U.S. will slip into recession, as American households and businesses, particularly in services sectors, are proving resilient. Rather, we see a shallower but more protracted slowdown.
- Core inflation remains sticky, and the Fed is poised to resume its rate-hike cycle.
- A downturn of some degree is still possible since we believe the Fed would rather overshoot the mark than fall short in battling inflation.

U.S.

U.S. economic activity has remained robust. American households and businesses, particularly in services sectors, are proving resilient in the face of persistent price pressures and tighter monetary policy at the fastest pace since the 1970s.

We no longer think the world's biggest economy will slip into a recession. Rather, we see a shallower but more protracted slowdown. Recent data—on manufacturing, consumer credit, and jobless claims—all point to some deceleration ahead, but not a material downturn. While sectors most sensitive to interest rates (e.g., housing starts) have taken a hit, the worst may be over.

First-quarter GDP rose just 1.3%, but that figure was distorted by a heavy draw-down in inventories; private spending—especially on goods—actually picked up robustly in January-March. Consider, too, that the Purchasing Managers' Index (an indication of trends in manufacturing and services) is again on the rise. **The labor market remains tight**, with the U.S. adding a better-than-expected 339,000 jobs in May. Headline unemployment ticked up to 3.7%, but that's still near a 50-year low and well below the rate consistent with price stability.

Meanwhile, headline inflation has eased, but core inflation remains sticky. The consumer price index (CPI, the most widely used measure of inflation) showed prices rose 4% in May from a year earlier—the slowest pace in two years. And the producer price index (PPI, which measures wholesale inflation) rose just 1.1% annualized—the smallest gain since December 2020. But the central bank's preferred measure of inflation—the core Personal Consumption Expenditures (PCE) price index, which strips out food and energy—unexpectedly rose to 4.7% in April from a year earlier.

The Fed is poised to resume its rate-hike cycle after it held its policy rate at 5%-5.25% in June—the first time since March of last year that it has done so. But it was a "hawkish pause." Fed governors raised their policy rate forecasts for this year, indicating that the federal funds rate could climb as high as 5.50%-5.75%, which would mean two more rate hikes. Fed Chair Jay Powell said the recent decision simply gives the economy more time to adjust to previous rate increases and allows policy makers to better understand the effects the recent bank-sector turmoil has had on the financial system.

We agree the Fed will keep its policy rate "higher for longer," with no cuts before mid-2024. Markets had been underpricing Fed rate hikes, perhaps believing inflation would be less sticky or that the central bank would ease monetary policy at the first sign of trouble. But corporate and household financial cushions have eroded amid stubborn price pressures, and markets now seem to be back to a state of rising rate hike expectations. Given that we think the Fed would rather overshoot the mark than fall short in its inflation battle—on top of the inherent difficulty of steering the economy into a "soft landing"—a downturn of some degree is still possible.

Primary contacts

Paul Gruenwald
New York
paul.gruenwald
@spglobal.com

Satyam Panday
San Francisco
satyam.panday
@spglobal.com

Our baseline forecast is now for a shallower but longer slowdown. We expect headline GDP growth to fall below 1% in the second half of this year—just half the expansion we expect in the second quarter. We now forecast full-year GDP growth of 1.7% this year and 1.3% in 2024.

Canada

The Canadian economy, too, has proved resilient so far this year. GDP growth bounced back to 3.1% (annualized) in the first quarter—well above consensus forecasts and the strongest expansion among G7 countries. The question now is: How long will this solid performance last?

There are signs that the labor market is loosening a bit. After adding jobs for eight consecutive months through April, the Canadian economy shed 17,000 positions last month. Also, total hours worked fell (0.4%), and the unemployment rate rose 0.2 percentage point, to 5.2% while the participation rate slipped 0.1 percentage point, to 65.5%. Job openings in the first quarter (latest available data) were down 14% from peak levels (in second-quarter 2022).

We expect the first half's strength to give way to weakness in the latter half of the year. While we've revised upward our forecast for full-year GDP growth, to 1.6%, because of better-than-expected domestic demand in the first half and an equally resilient U.S. growth, the full effects of the Bank of Canada's interest rate hikes have yet to manifest. When they do, this will work to weaken growth in the coming quarters.

We see one more BoC rate hike in July, which would bring the policy rate to 5%. Debt-servicing costs will continue to rise through year-end, as interest rates rise and remain higher for longer. This will create additional headwinds for households with a high sensitivity to interest rates (such as variable-rate mortgage holders) and could result in higher delinquency. A softening growth momentum in the U.S. in the next 12 months will weaken the contribution to growth from the trade channel in Canada.

In short, any near-term positive growth surprises will only delay, rather than prevent, an ultimate slowdown for the Canadian economy.

Financing Conditions

- Bond spreads have tightened to levels below where they started the year—even for the riskiest category ('CCC' and 'C').
- Corporate bond issuance is up 32% year to date, but strong investment-grade totals have been the main driver.
- We expect defaults will rise through early 2024, though not yet to elevated levels.

Market jitters over the debt ceiling and bank sector stress have largely passed. Investors have returned liquidity to financial markets for nearly every asset class. The CBOE Volatility Index, or VIX (the most popular measure of expected volatility in U.S. stocks), has fallen to its lowest level in years, and the benchmark S&P 500 Index is showing healthy gains, and in bond markets, the MOVE index of market volatility has also fallen significantly from its post-financial crisis high of 183 in late March.

Bond spreads have tightened to levels below where they started the year—even for the riskiest category ('CCC' and 'C'). In fact, the positive impact on overall relative credit risk from the debt ceiling deal was most notable for the lowest-rated bonds. And though most sector spreads are still above their 2023 lows (reached just prior to the collapse of Silicon Valley Bank), most have narrowed sharply, with the exception of the banks and brokers sector, but even there the recovery has been significant. This points to a positive turn in market sentiment—for now.

Primary markets have rebounded from an awful 2022, albeit selectively. Still, positive momentum in secondary markets hasn't resulted in the same level of demand in primary markets (see chart 8). Nonfinancial corporate bond issuance is up 32% year to date, with a solid showing in May. However, strong investment-grade totals have been the primary driver. Speculative-grade bonds have seen growth of roughly 37% through mid-June, but only because the comparable 2022 total was the weakest in more than 12 years. And lenders are getting selective—most of the speculative-grade total this year has been from the 'BB' category, with very little (\$2 billion) in 'CCC/C' (see chart 9). The \$83 billion total in issuance is one of the weakest year to date in over a decade, and floating-rate based leveraged loan issuance is set for another disappointing year, which will likely continue to suppress collateralize loan obligation (CLO) issuance as a result.

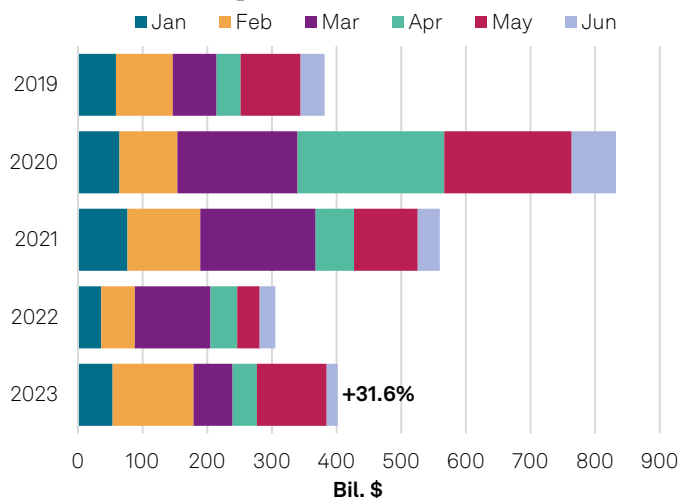
Primary contacts

Nick Kraemer
New York
nick.kraemer
@spglobal.com

Nicole Serino
New York
nicole.serino
@spglobal.com

Chart 8

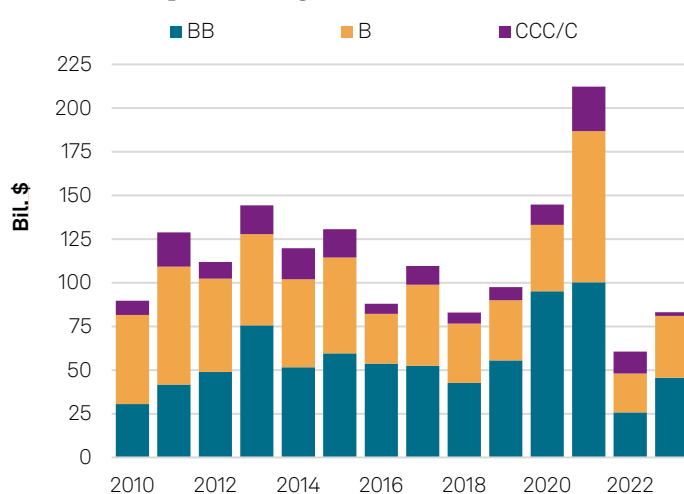
U.S. nonfinancial corporate bond issuance



Data through June 12, 2023. Sources: Refinitiv, S&P Global Ratings.

Chart 9

Year-to-date speculative-grade bond issuance

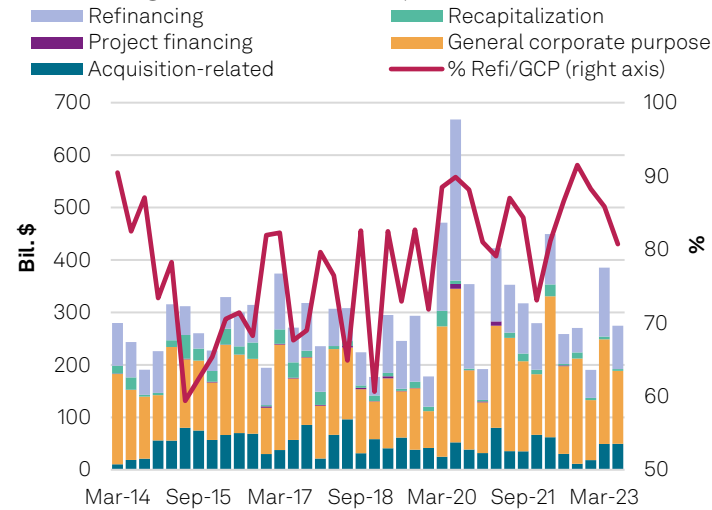


Year-to-date data through June 16. Sources: Refinitiv, S&P Global Ratings.

The bite of interest rates is starting to show. Though certainly improved from last year, lenders and borrowers alike are still trading carefully as interest rates have risen at their quickest pace in decades. The combination of higher borrowing costs and slowing growth will challenge the weakest issuers that already have declining cash flows. Those who have come to market have been focused on refinancing existing debt, and even bond-for-loan takeouts, rather than more growth-oriented uses of debt (see chart 10).

Chart 10

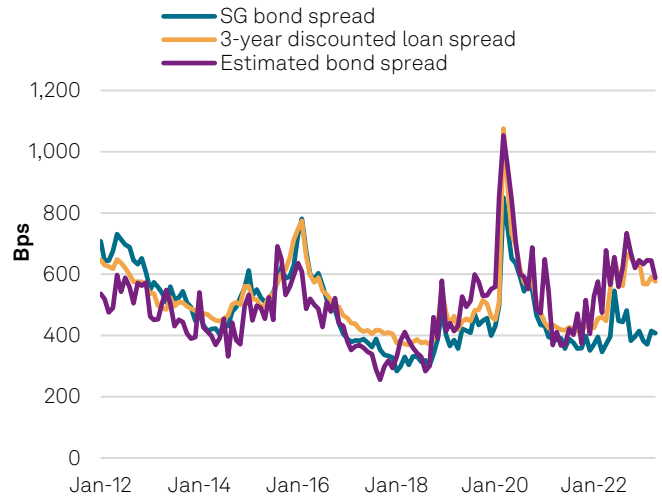
Investment-grade bond issuance by use



Data through June 15, 2023. Sources: Pitchbook LCD, S&P Global Ratings.

Chart 11

U.S. actual and estimated spreads



Data through May 31, 2023. Sources: Pitchbook LCD, S&P Global Ratings.

Given the converging challenges, and despite current market sentiment, we are projecting defaults will rise through early 2024, to 4.25%, though not yet to elevated levels. Current market sentiment may be leaning more positive than warranted as well. Our estimated bond spread is now about 181 basis points (bps) above the actual, through May, and more in-line with the current leveraged loan spread (see chart 11). Since the beginning of this recent tightening cycle by the Fed, loan spreads have diverged higher from bond spreads, given their floating-rate basis. The supply of bonds outstanding has fallen, particularly in light of weak new supply in 2022. But this wider loan spread also reflects our belief that floating rates will likely rise again if the Fed tightens down the road. Given these issuers are heavily represented by ratings at the 'B-' and lower levels, they could lead default activity—something not seen in the past.

Sovereigns

- The recent deal reached in Congress suspending the U.S. debt ceiling until January 2025 allows the Treasury to remain current on its debt-service obligations.
- We expect the general government fiscal deficit will average just over 5% of GDP in the next few years, likely pushing the net general government debt toward 100% of GDP.
- Congress isn't likely to pass major fiscal legislation before the 2024 elections, including reforms to tax laws needed to implement a global minimum tax.

Primary contact

Joydeep Mukherji
 New York
 joydeep.mukherji
 @spglobal.com

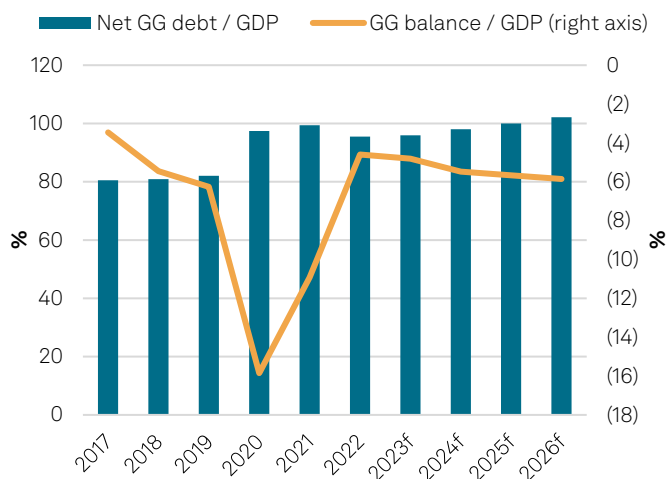
In early June, President Biden signed legislation to suspend the government's statutory debt ceiling, allowing the Treasury to remain current on its debt-service obligations. The law was approved after protracted negotiations between the president and House Speaker Kevin McCarthy on various fiscal and other policies, resulting in some modest fiscal measures.

The new law suspends the debt ceiling until January 2025 (after national elections two months earlier) setting the stage for the next Congress and administration to manage the issue. The agreement also included two-year caps on discretionary government spending, creating only a marginal decrease in spending from current projections. We expect the general government fiscal deficit (which consolidates the federal and subnational governments) will average just over 5% of GDP in the next couple of years, likely pushing the net general government debt toward 100% of GDP (see chart 12).

The lengthy negotiation between the two political parties over the debt ceiling illustrates the political challenges in reforming U.S. fiscal policy. Spending on entitlement items, mainly health care and pensions, is approaching two-thirds of total federal government spending and is set to rise in the coming years with an aging population (see chart 13). Moreover, the Social Security trust fund, which pays for pensions, is projected to exhaust its reserves in 2033 while the Medicare trust fund is projected to be exhausted in 2031, absent changes in policy.

Chart 12

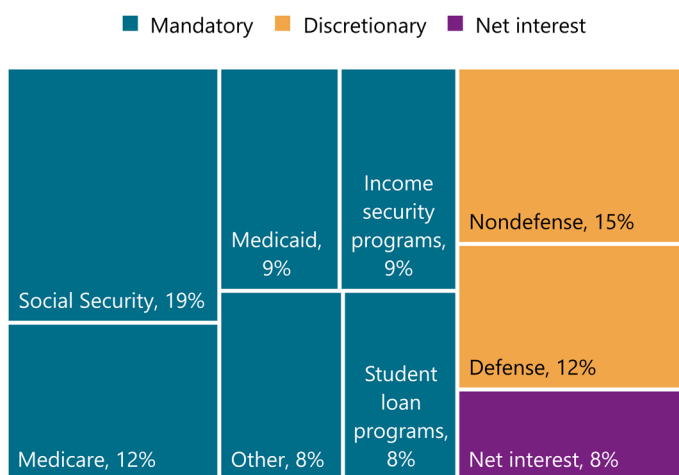
U.S. fiscal and debt indicators



f—Forecast. GG—General government. Source: *Sovereign Risk Indicators*, April 10, 2023, S&P Global Ratings.

Chart 13

U.S. federal budget in fiscal-year 2022



Source: Congressional Budget Office, March 2023.

Neither political party proposed changes to these key entitlement programs during the debt ceiling negotiations for fear of a political backlash. Moreover, both parties have shown broad support for boosting defense spending but remain reluctant to propose higher taxes. Under such

circumstances, it's likely that future attempts to control the fiscal deficit would focus mainly on cuts in nondefense discretionary spending, which is only about 15% of total spending. A substantial correction in the country's fiscal trajectory would likely require changes to the wider budget, including both revenues and expenditures (likely both discretionary and nondiscretionary).

Congress isn't likely to pass major fiscal legislation before the 2024 national elections, including reforms to tax laws. These reforms are needed to implement a global minimum tax agreed to by 130 countries in 2021. However, it may pass changes to the regulatory framework for cryptocurrencies after recent scandals.

Various laws the Biden Administration has passed, especially the CHIPS and Science Act and the Inflation Reduction Act, have created the contours of a more explicit industrial strategy to promote key technologies (such as semiconductors and electric vehicles). The strategy, which enjoys bipartisan support in Congress, relies on tax breaks, subsidies and other tools to encourage research, development and production of key products and technologies within the U.S., or within a global supply chain limited to selected countries. Successful implementation of such policies, along with planned higher investment in the country's physical infrastructure, would help sustain the country's trend rate of GDP growth at just less than 2% in the long run.

Financial Institutions

- Bank deposits are declining (down about 2.5% in the first quarter), but the recent outflow has been more measured and within our expectations.
- Persistently high interest rates could lead to more challenges for asset/liability management and increase losses in banks' securities portfolios.
- We expect finance companies to have adequate liquidity to address their debt maturities, but any refinancing will come at a higher cost and liquidity could be strained further.

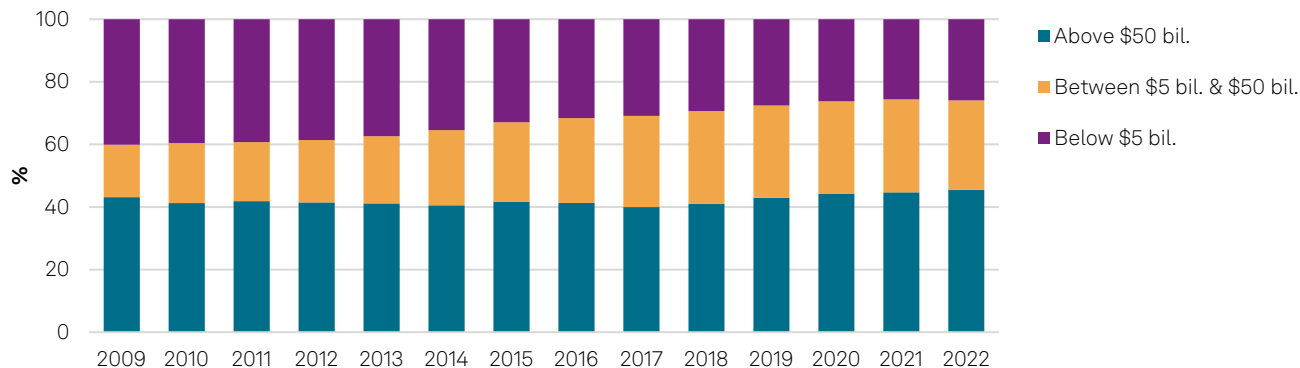
Banks

In the aftermath of three bank failures in March and April, market confidence toward the industry has settled down to some degree and volatility has abated. But the situation remains fluid. Although bank deposits continue to decline (down about 2.5% in the first quarter), the recent outflow has been at a more measured pace and within our expectations. That said, in competition for declining deposits, banks have had to increase the rates they pay, which will weigh on profitability. Banks have also increased their wholesale borrowing as a defensive measure, to bolster on-balance-sheet liquidity. As of the end of May, we had stable outlooks on roughly 85% of our U.S. bank ratings and 15% negative outlooks.

While bank profitability remained solid in the first quarter, we expect it to weaken. Still, we expect the industry to post a return on common equity in the 9%-11% range this year. We expect net interest income will tick down, driven by higher funding costs. With a loan-to-deposit ratio in the first quarter of about 65%, still below historical levels, we believe most banks have the capacity to lend. But we expect banks to be more selective in terms of the loans they make. In addition, larger banks seem to have more balance-sheet capacity to extend loans. Notably, banks with less than \$50 billion in assets account for roughly 55% of bank CRE loans (see chart 14). All told, systemwide loans were basically flat in the first quarter.

Chart 14

CRE loan by bank size



Sources: FDIC data and S&P Global Ratings.

Capital ratios for banks didn't change much in the first quarter and we expect banks to build capital not only as a defensive measure but also due to the possibility of stricter capital regulation. Notably, unrealized losses in banks' securities portfolios in the first quarter were down significantly from their peak six months ago, as long-term rates ticked down. Going forward, securities portfolio valuations will depend on the trajectory of long-term rates.

Credit quality, although still benign, will likely deteriorate, causing banks to book higher provisions. We're highly focused on banks' exposure to CRE. For most banks we rate, we believe

Primary contacts

Stuart Plesser

New York
stuart.plesser
@spglobal.com

Brendan Browne

New York
brendan.browne
@spglobal.com

Gaurav Parikh

New York
gaurav.parikh
@spglobal.com

Elizabeth Campbell

New York
elizabeth.campbell
@spglobal.com

it would take a broader asset class decline to have a more meaningful effect on bank credit quality. However, there are some banks that are more exposed than others that could suffer negative ratings effects if CRE losses rise significantly.

In terms of key risks for the banking sector, most revolve around the possibility of rates moving higher or staying high, causing issues for the economy and credit quality. In addition, persistently high rates could lead to more challenges for asset/liability management and could increase losses in banks' securities portfolios.

Finance companies

We have stable outlooks on approximately 79% 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 continues to be steady. That said, we expect credit will tighten as higher interest rates and slower economic growth will lead to lower deal flow and reduced new capital deployment opportunities.

We have stable outlooks on 11 business development companies (BDCs) we rate. With financing conditions for broadly syndicated loan and speculative-grade bond markets constrained by rising rates and economic uncertainties, direct lenders are finding more opportunities to lend to larger companies or paring up in mega club deals. Increased loan sizes could create concentration and vintage risks, and larger loans are typically associated with more-relaxed covenants. While market trends and valuation marks have been somewhat better so far this year, due to the current macroeconomic environment, we expect valuations to exhibit more volatility for the remainder of 2023. Interest coverage has declined as borrowers have limited ability to pass along higher inflation and interest rates to end users, which has led to slight rise in non-accruals and payment-in-kind (PIK) income as a percentage of gross investment income. For the remainder of the year, we expect portfolio quality will be further pressured as the lagging impact of recent rate hikes flows through borrowers' earnings coupled with a fluid operating environment. We expect BDCs will maintain compliance with the required regulatory ratio.

So far this year, of the six CRE lenders we rate, we have downgraded one by a notch and we revised our outlook on two issuers to negative, reflecting higher leverage and deteriorating asset quality. 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. Hence, we expect asset quality to deteriorate somewhat as the economic environment creates challenges for borrowers in the next few years—likely meaning a rise in nonaccruals and loan-loss reserves. We remain concerned about credit deterioration, as it could lead to foreclosures or create the need for liquidity to meet potential margin calls.

We expect the likelihood of higher unemployment coupled with elevated inflation will reduce purchasing power for subprime consumers and weaken consumer credit quality. We expect weaker earnings for consumer finance companies as delinquencies rise and consumer lenders scale back on originations by tightening their credit underwriting box. We expect the slowdown in CRE brokerage transactions will persist and that earnings for CRE servicing companies will be pressured. Performance at residential mortgage companies continue to be affected by low new housing inventory and consumers' lack of affordability as the 30-year mortgage rate remains around 7%, the highest in more than 20 years.

From a refinancing risk and liquidity perspective, we expect finance companies to have adequate liquidity to address their debt maturities. However, any refinancing will come at a higher cost and liquidity could be strained further. We have started seeing few distressed debt exchanges in the sector as companies refinance and will continue to monitor for such transactions as refinancing risk starts to rise in 2024.

Asset managers

While the markets improved in the first quarter, we expect conditions to remain difficult for the remainder of 2023. Our view of the traditional asset manager sector is negative, while we maintain our stable sector view of the alternative asset management and wealth management sectors. The macroeconomic backdrop remains demanding for asset managers due to higher interest rates and tighter credit conditions, and banking sector struggles. Market dislocations offer both challenges and opportunities for asset managers, however, as distressed valuations may grow the opportunity set for deployment.

Of the three subsectors, traditional managers are the most exposed to market volatility, and net outflows could compound this pressure. Credit metrics weakened for some asset managers as earnings declined, and those with significant variable-rate debt exposure will see interest coverage metrics compress. We have taken a couple of negative rating actions within this subsector due to declining earnings and higher leverage.

Wealth managers are similarly vulnerable, though for some their asset base may be stickier due to the relationship-based nature of the business and breadth of services provided.

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 (particularly in private equity).

Credit strategies have grown in the past few years and those asset managers that have developed broad credit platforms are well-positioned to take on new borrowers that banks may be shedding. Credit now comprises a significant portion of AUM for some issuers we rate, and we expect this strategy to be a growth driver for these alternative managers in the next few years. We have also seen traditional asset managers expanding their private credit capabilities intensifying the competition.

Refinancing exposure is low, as many asset managers issued debt opportunistically in the past several years, with support from 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 this year. 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

- We expect increasingly higher interest expense across corporates as refinanced maturities add up and the Fed keeps rates elevated.
- Companies that maximized their levels of borrowing while debt markets were open are particularly vulnerable if they operate with narrow cash flow margins.
- As we go into the second half of the year, vestiges of the pandemic continue to weigh on certain businesses.

Primary contact

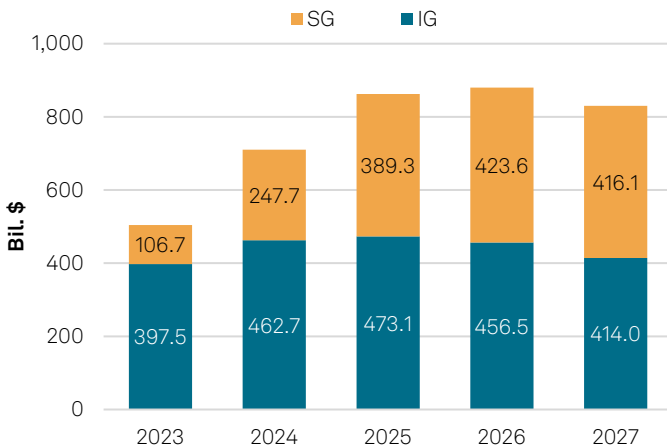
Chiza Vitta
 Dallas
 chiza.vitta
 @spglobal.com

With benchmark interest rates unlikely to come down until 2024, maturing debt (floating and fixed rate) will become more pronounced given issuers typically strive to address refinancing needs 12-18 months in advance of maturities (see chart 15). Along with hedges rolling off, all of this amounts to escalating cash interest costs in the interim. **We estimate the median effective interest rate that speculative-grade entities are paying globally will rise to 6.1% this year, its highest level since 2010** (see "[Global Nonfinancial Corporates: Interest-Rate Costs Start To Bite](#)," published June 1).

For the lowest-rated companies in the U.S., refinancing at prevailing rates can as much as double their interest rate expense. Even if maturities are many years away, speculative-grade companies typically have floating-rate debt, which allows rising interest costs to creep in gradually. Annual cash interest payments rose about 10% for North American nonfinancial corporates in the first quarter (see chart 16). As interest rates continue to rise and maturities escalate, we expect the trend to continue. Though we remain in the early stages of working through the upcoming maturity stacks, we are already seeing cases of companies pushing refinancings closer to maturity dates than is typically the case.

Chart 15

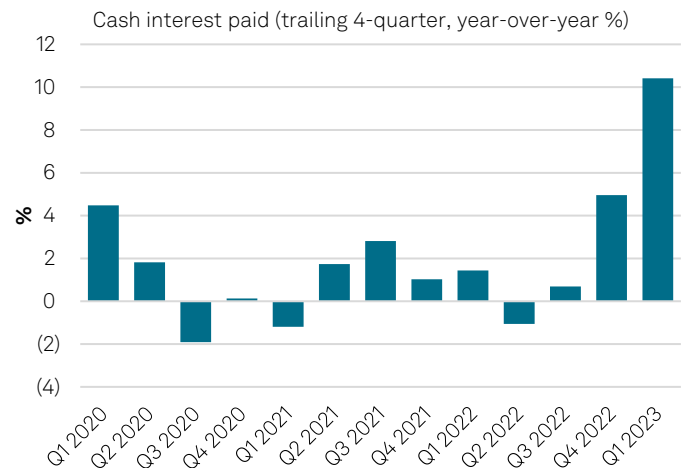
Maturing debt by year in the U.S.



Includes bonds, loans, and revolving credit facilities that are rated by S&P Global Ratings. SG—Speculative-grade. IG—Investment-grade. Data as of Jan. 1, 2023. Source: S&P Global Ratings.

Chart 16

Percentage change in cash interest paid



Data through May 31, 2023. Nominal data, measured in U.S. dollars at historical conversion rates. Only includes North American companies rated by S&P Global Ratings that report quarterly. Q1 2023 growth rate only includes companies that have reported results. Sources: S&P Capital IQ, S&P Global Ratings.

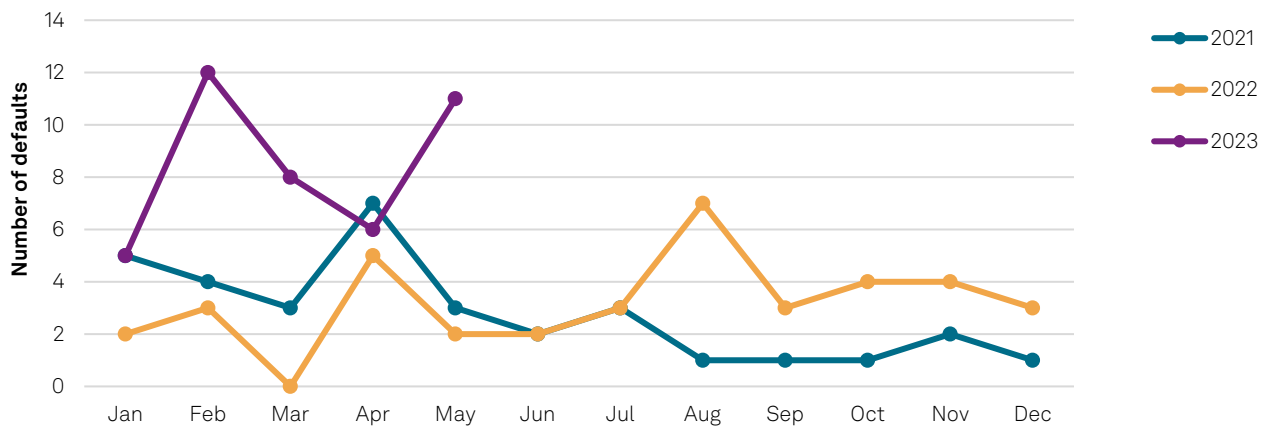
Reassessing financial policy is good practice in the current environment regardless of whether earnings are available to support additional interest expense. Beyond making operational changes to delay the deployment of, or to conserve, capital, issuers are also employing various avenues that temper the inevitable increase in cash interest expense. These include: 1) securing additional tranches of debt; 2) downsizing debt on balance sheet through repayments or shifts to

equity; 3) incorporating PIK interest; 4) shortening borrowing periods; and 5) putting interest rate hedges in place where it makes sense. Ultimately the credit quality of a company going into refinancing discussions determines the breadth of structuring options it can consider.

As both base and marginal financing rates were rising, we found that companies that have the combination of large amounts of debt along with narrow margins are most vulnerable. Broadly speaking, this includes companies operating in capital-intensive sectors that are highly competitive. To the extent that these companies are debt-financed, and particularly if inflation is increasing input and/or labor costs, even small increases in interest resulted in significant increases in interest expense, sometimes pushing businesses into insolvency. With conditions expected to get more difficult, more of these types of issuers are being pushed to default, absent a lifeline (see chart 17).

Chart 17

Monthly North America nonfinancial corporate defaults



Data covers defaults in the U.S. and Canada. Source: S&P Global Ratings.

We are also watching companies highly dependent on consumer borrowing to fuel demand.

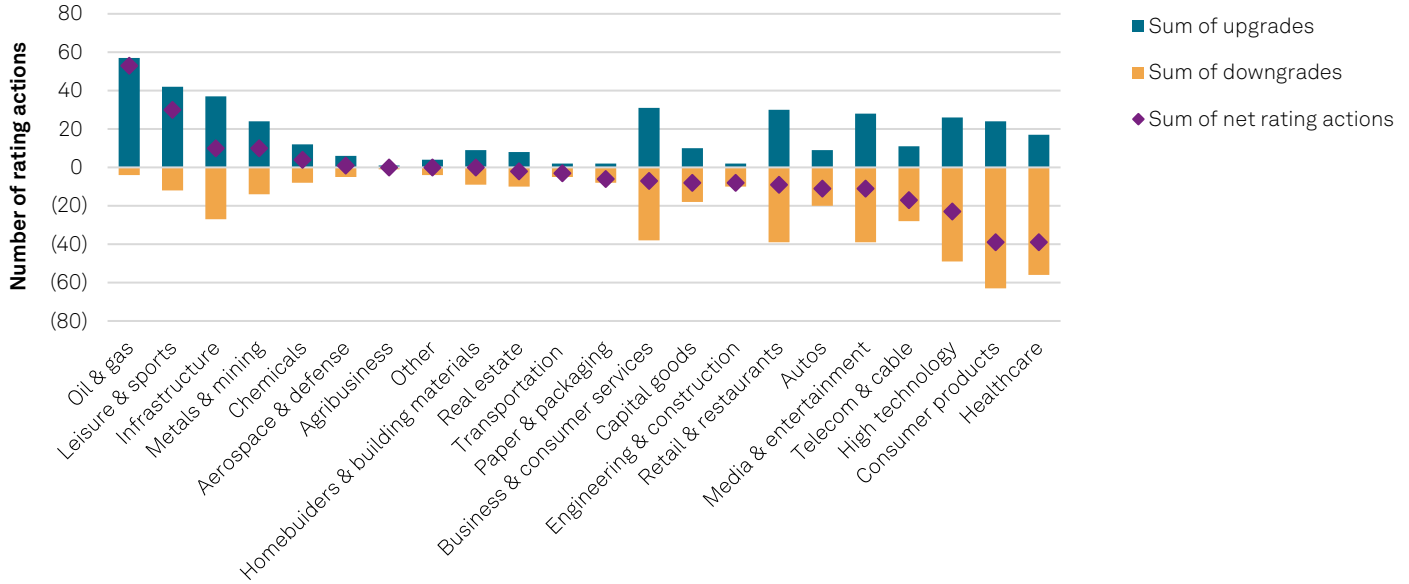
Financial companies aside, the real estate and automotive industries are key examples of this. The real estate sector overall faces headwinds that come along with higher financing costs, and for the office segment of CRE, sharply depressed demand as well. However, the robust job market and unabating levels of shorter term and credit card borrowing (see Credit Cycle Indicator section) continue to buoy vehicle sales.

Going into the second half of the year, vestiges of the pandemic and geopolitical conflicts

continue to influence certain sectors. Following the onset of the war in Ukraine, commodities prices soared as supplies were constrained. While prices have since moderated, they remain high enough to support the upgrades we see in oil and gas, as well as metals and mining, which have been among the best-performing sectors in the past 18 months (see chart 18). Perhaps a more unlikely turn of events has been the strength of the leisure and sports sector, which was among the hardest-hit when social restrictions were at their peak at the height of the pandemic. Pent-up demand has brought the sector roaring back, and the recovery seems to have staying power despite being largely driven by discretionary spending. This trend may slow as household savings dwindle and the job market cools.

Chart 18

North America nonfinancial corporate rating actions by sector in the past 18 months



Data covers rating actions in the U.S. and Canada from Dec. 14, 2021, to June 14, 2023. Source: S&P Global Ratings.

On the other end, the sectors that have performed relatively poorly have done so amid the pressures brought about by high inflation. While larger health care providers remain steady, smaller service and equipment providers simply weren't able to absorb rising input and labor prices. Likewise, the consumer products space is seeing customers trade down to cheaper products as its ability to continue passing on rising prices remains uncertain. Supply chains and trade flows will likely never go completely back to where they were prior to the pandemic, however certain areas are still on the mend as sectors such as aerospace and defense deal with delays, and retailers continue to navigate the higher costs associated with making sure their shelves remain stocked.

Public Finance

- Credit remains stable for public finance issuers, despite recent market stresses such as the U.S. debt ceiling negotiations and turbulence in capital markets and banking sector.
- The availability of federal stimulus continues to support credit quality across the sector in the U.S., despite discussion of claw back of stimulus funds during the debt ceiling debate.
- Higher interest rates and inflation are headwinds for municipal issuers, but high reserves and federal stimulus allow flexibility to delay debt issuance and/or postpone capital projects.

Most U.S. municipal issuers have good reserves stemming from strong revenue performance as well as stimulus funds. There have been some recent instances of weaker revenue collection and while not widespread, most fiscal-2024 U.S. state budgets are still flat to lower. Canadian entities, too, have largely benefited from strong revenue performance and federal spending the past two years, although some provinces' expansive spending plans for fiscal 2023-2024 come at a moment of heightened economic risk and still-elevated inflation.

Although there was discussion of federal stimulus claw back in the U.S., it would have been directed at the federal level and not the recipient level absent amendments to the authorizing legislation. This mitigated any immediate and direct risk for issuers. Funds must be obligated by Dec. 31, 2024, and spent by 2026, so we expect to see stimulus continue to support spending and capital projects in the next several years.

Chart 19

Credit issues that matter



Rates

With rising interest rates, issuance remains down, but unspent federal stimulus can help fill the gap for funding capital in the next few years.



Inflation

Higher cost of capital and supplies raise project costs, potentially limiting what can get done; any softness in revenue growth squeezes margins further, particularly in a high-wage environment.



Unemployment

Low unemployment rates and high demand for skilled labor continue to create difficulties for many issuers across public finance. Expectations for ongoing low unemployment rates don't foretell a respite from the labor shortages.



Commercial real estate

Softness in downtown real estate markets has not resulted in credit deterioration but bears watching, especially if office vacancy rates remain high and there is limited ability to raise property tax rates.



ARPA spending

With 18 months left to designate the use of ARPA, greater use of federal stimulus for programs rather than for capital projects could signal budgetary challenges. This source of ready money could be reprogrammed by U.S. issuers seeing revenue softness.



Weather events

Summer storm and fire season heightens the possibility of catastrophic events and necessitates higher reserves and good planning to respond quickly and effectively to the unexpected.



Federal budget

In addition to changes made as part of the debt ceiling deal, contentious budget negotiations later in 2023 will increase the likelihood of cuts to programs and entitlements in the U.S., which can flow through to state and local government budgets.

Source: S&P Global Ratings.
Copyright © 2023 by Standard & Poor's Financial Services LLC. All rights reserved.

Primary contacts

Robin Prunty

New York
robin.prunty
@spglobal.com

Jane H Ridley

Centennial
jane.ridley
@spglobal.com

Sarah Sullivant

sarah.sullivant
@spglobal.com

Structured Finance

- CRE remains a focus, with rising delinquencies and special servicing rates affecting the office sector most prominently.
- We will likely see rising credit card delinquencies, but from low current levels.
- We generally expect stable or somewhat negative ratings trends over the next 12 months, with most ratings actions in the noninvestment-grade space.

The outlook for North American structured finance collateral performance is little changed from earlier in the year (see table 1). That said, distress may be more acute for certain sectors, driven by more than just mildly deteriorating macroeconomic conditions. We generally expect stable or somewhat negative ratings trends in the next 12 months, with most ratings actions in the noninvestment-grade space. However, we don't expect risks to be uniform across sectors.

Table 1

12-Month North America structured finance outlook – Q3 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. Source: S&P Global Ratings.

CRE is still a focus, with rising delinquencies and special servicing rates affecting the office sector most prominently. Lower-quality regional malls in secondary/tertiary markets remain a concern, and refinancing risk is a concern across the board, especially for more recently underwritten assets that were originated at relatively lower interest rates and with less embedded appreciation. "Higher-for-longer" interest rates are likely to cause some distress for

Primary contacts

Winston W Chang

New York
winston.chang
@spglobal.com

James M Manzi

Washington, D.C.
james.manzi
@spglobal.com

Tom Schopflocher

New York
tom.schopflocher
@spglobal.com

John Detweiler

New York
john.detweiler
@spglobal.com

leveraged loan borrowers, as single 'B' obligor concentrations remain at historical highs in broadly syndicated CLOs.

On the consumer side, the subprime auto loan asset-backed securities (ABS) 2022 vintage has come under some stress, and we downgraded five noninvestment-grade classes. However, upgrades continue to outpace downgrades by a wide margin due to the deleveraging that takes place for the more senior classes. Credit cards will likely see rising delinquencies, but from low levels. Residential mortgage-backed securities (RMBS) credit seems largely solid, with prices steady amid mostly undersupplied markets, albeit with some regional variation.

Within the esoteric/non-traditional ABS sector, ratings have been relatively stable this year. Aircraft ABS and aircraft engine lease ABS transactions represented the bulk of negative rating actions due to continued pressures from the pandemic and the Russia-Ukraine conflict. Sectors with exposure to retail obligors (e.g., triple-net lease and small business) and consumer-related sectors (e.g., timeshare) face heightened risks due to the lingering threat of a recession and the inflationary pressures on consumers.

The transition away from LIBOR is imminent, and after June 30 this rate will no longer be published. While U.S. structured finance has significant exposure to this event, with more than 4,000 transactions outstanding (rated by S&P Global Ratings) linked to the benchmark, many appear to have a path forward to an orderly transition.

For the RMBS sector, about 75% of LIBOR-linked transactions have weak liability fallbacks that will enable the federal LIBOR Act to change rates by operation of law. Moreover, most of these transactions contain a net weighted average cap coupon structure that can absorb basis risk, which could arise from asset/liability rate differentials. Federal Family Education Loan Program (FFELP) student loan ABS stand to benefit from the law, as we estimate upward of 75% of these transactions will change rates under the federal legal framework. A small portion will likely have some asset/liability rate mismatch, but that is not expected to lead to a rating impact.

In the CLO sector, the federal law is less important because almost all transactions have language that empowers the collateral manager to select a replacement rate for the liabilities, or use newer objective fallbacks recommended by the Alternative Reference Rates Committee (ARRC). Given the large volume of affected transactions, some with unique features, we continue to monitor the transition process for evidence of any latent idiosyncratic risks that could affect ratings.

Insurance

- The average financial strength rating for the core North American insurance portfolio (life, health, property/casualty) is in the upper half of the strong ('A') category.
- Major rating factors include economic concerns, capital markets volatility, pricing, rising interest rates, and catastrophe risk.
- Life insurers are exposed to CRE, with office-related properties representing roughly 22% of commercial mortgage loans on life insurers' balance sheets.

Primary contact

Joseph N Marinucci
 New York
 joseph.marinucci
 @spglobal.com

Overall, the average financial strength rating for the core North American insurance portfolio, which includes life, health, and property/casualty (P/C), is in the upper half of the strong ('A') category. Most (80% or better) of our ratings for the core portfolio have stable outlooks. Though a negative bias, which emerged mid-year 2022, persists for P/C insurers. The sector outlook has been negative since October (see table 2).

Major rating factors include economic concerns, capital markets volatility, pricing, rising interest rates, and catastrophe risk. While financial conditions have tightened, we believe there's still broad access to capital for this mostly investment-grade group, which in general isn't highly leveraged. Balance-sheets have weakened slightly in connection with portfolio devaluation but they are still strong, underpinning credit quality and providing a measure of protection from risks related to downside economic developments broadly, and the expansion or increase in the magnitude of specific current and emerging subsector risks more specifically.

Table 2
 North America insurance sector trends – Q3 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. Source: S&P Global Ratings.

Life insurance

The U.S. and Canadian life insurance sectors are still facing a mixed environment, with rising rates, global geopolitical uncertainty, and, above all, the prospect of slowing economic growth. We don't anticipate a significant number of upgrades or downgrades for life insurers this year. The long-awaited long-duration targeted improvements (LDTI) update to U.S. generally accepted accounting principles (GAAP) is here. It hasn't had any meaningful impact on life insurers' share prices, and, as we've anticipated, no impact on credit profiles. The turmoil in the banking sector has had minimal impact on life insurers, as direct exposure to the collapsed banks was limited, and overall investment in regional banking is typically well diversified and not oversized. Life insurers are relatively well-situated in terms of surrender protections and overall liquidity management.

The life industry does have exposure to CRE, a sector under stress that is expected to continue in the next few years. Office-related properties represent roughly 22% of CMLs on life insurers' balance sheets. In general, conservative underwriting of CMLs in the life industry has proven itself, with losses in both the 2008 and 2020 downturns significantly lower than those in the

broader CRE markets. While we expect some losses will occur in life insurers' CML portfolios we believe they will be manageable for the industry.

Mergers and acquisitions (M&A) have picked up after a long slumber with a few large divestitures of legacy businesses from large public companies. This continues the long-term trend toward de-risking public balance sheets and moving legacy businesses to private-equity affiliated insurers.

Health insurance

The U.S. health insurance industry remains on stable footing, reflecting favorable industry dynamics, sustained earnings growth, and sound balance sheets. Payroll development remains robust, which bodes well for ongoing commercial segment enrollment. With the public health emergency now expired, this will likely lead to an eventual transition of costs from the federal government to the private sector. Claims-utilization trends have largely continued to normalize relative to pre-pandemic levels, though higher health acuity from missed/deferred care during the pandemic could drive higher claim costs. Medicaid redeterminations (reassessment of Medicaid eligibility) which commenced in a handful of states in April and will continue into 2024 may bring some volatility to the Medicaid sector, though we expect a portion of members will likely remain insured through other coverage programs (the Affordable Care Act marketplace and employer-sponsored coverage). Also, uncertainty remains as to whether Medicaid rates will keep up with the updated risk pool as members redetermine. The industry remains acquisitive, focused more on tuck-in deals, particularly in the noninsurance space, but supportive of growing scale and increased business diversification.

P/C

In October 2022, S&P Global Ratings revised its view on the U.S. P/C sector to negative from stable, reflecting our expectation of weaker credit trends. Underwriting profitability of U.S. P/C insurers deteriorated last year and a clear divergence emerged between insurers writing predominantly commercial lines and those writing personal lines. Strong rate momentum for most commercial lines continues to match or exceed loss-cost trends, resulting in improved underwriting profitability.

Offsetting the strength in commercial lines was the deterioration in personal lines, which have come under pressure from the spike in the cost of building materials, car parts, and wages. In addition, catastrophe-related losses remained elevated for the third year in a row. Consequently, the industry overall posted an underwriting loss for the year. Personal auto insurers are pursuing rate increases, but it will take time to catch up with rising claims costs, so their results are expected to improve but not achieve pre-pandemic levels until next year.

We expect underwriting performance for commercial lines writers to be similar to last year's. Capital at year-end 2022 was down due to the impact of higher interest rates on bond valuations. This may weigh on our view of capital adequacy for some if we don't expect capital to be restored over the next three years to a level that supports the ratings. Rising interest rates will benefit investment income as new money is invested at higher rates.

Global reinsurance

Our view of the global reinsurance sector remains negative, although we expect underwriting profitability will improve in both P/C and life reinsurance. Reinsurers will continue to struggle to earn their cost of capital (COC) due to potential heightened catastrophe losses, capital market volatility, increasing COC, and inflation. Elevated natural catastrophes and pandemic-related losses have hurt performance but sparked pricing increases in the past few years, which we expect to carry on. Reinsurers' strategies diverge on catastrophe risk, and we believe alternative

capital will remain an important pillar in the space. Mark-to-market losses have eroded capital buffers, but improving underwriting earnings, increasing investment income, prudent capital management, and sophisticated levels of risk management should sustain the industry's capital adequacy.

Bond, title, and private mortgage insurers

Bond insurers continue to benefit from the growth in demand for insured bonds in the U.S. public finance portfolio, particularly in the secondary market, as well as stronger pricing trends. We expect demand will remain high given wider credit spreads than in past years and macroeconomic uncertainty. While new issue municipal bond sales are likely to remain down, new money issuance is up. We attribute much of the rise in new money issuance to state and local investment in essential infrastructure. Market participants anticipate this activity will increase further as issuers accelerate capital investment to take advantage of federal grants through the Infrastructure Investment and Jobs Act. Bond insurers' capital positions and conservative capital management plans are supportive of this potential growth in exposure.

The overall profitability and financial strength of the title insurers depends on their ability to manage operations through 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 and should enable them to maintain strong profitability. Economic uncertainty and rising interest rates remain key factors that led to a decrease in existing home sales, with the CRE market suffering a significant decline in volume. These factors shape our view that business volume will be down from 2022. However, capitalization in the title sector remains robust, benefiting from low losses and a profitable business. Title insurance results have remained strong across all rated insures with each proving successful at expense control with a solid set of risk tolerance standards including oversight of agents and we expect this trend to continue.

Private mortgage insurers (PMIs) continue to benefit from a resilient U.S. economy, with cure rates still outpacing new delinquencies, and the sector's capitalization supported by access to reinsurance capacity. While home prices have been moderating lately, the significant jump in prices since 2020 created substantial home equity cushions, which will help reduce losses for PMIs in stress periods. Mortgage originations have slowed considerably, and we expect the new premium volumes for PMIs to remain tepid, offset by increasing persistency levels (lower lapse rate in current portfolio). PMIs continue to enjoy favorable cure rates (borrowers restarting mortgage payments on previously delinquent loans) on COVID-led delinquencies, and as a result PMIs have released most of their pandemic reserves, contributing significantly to profitability. However, our view on prospective profitability is tempered by the near-term expected headwinds in economic conditions, particularly if the unemployment levels rise, mortgage delinquencies could increase and result in elevated losses. Therefore, we expect the sector's combined ratio could range from 50%-55% this year and gradually improve to 45%-50% in 2024.

Related Research

- [Economic Outlook U.S. Q3 2023: A Sticky Slowdown Means Higher For Longer](#), June 26, 2023
- [Economic Outlook Canada Q3 2023: A First-Half Resurgence Will Give Way To An Inevitable Slowdown](#), June 26, 2023
- [Stressful Conditions For U.S. Commercial Real Estate Are Raising Refinancing Risks](#), June 5, 2023
- [Credit FAQ: What Declining Commercial Real Estate Values Could Mean For U.S. Banks](#), June 5, 2023
- [Global Nonfinancial Corporates: Interest-Rate Costs Start To Bite](#), June 1, 2023
- [Growing Strains Will Push The U.S. Speculative-Grade Corporate Default Rate To 4.25% By March 2024](#), May 15, 2023
- [White Paper: Introducing Our Credit Cycle Indicator](#), June 27, 2022

Editor

Kelliann Delegro

Research contributor

Sourabh Kulkarni

This report does not constitute a rating action.

The views expressed in the Macroeconomic Outlook section (pages 7-8) are the independent opinions of S&P Global Ratings' economics group, which is separate from but provides forecasts and other input to S&P Global Ratings' analysts. S&P Global Ratings' analysts use these views in determining and assigning credit ratings in ratings committees, which exercise analytical judgment in accordance with S&P Global Ratings' publicly available methodologies.

Appendix 1: Nonfinancial Corporate Sectors Outlook

For analytical contacts, please see Appendix 3.

Table 3

North America nonfinancial corporate sectors outlook

Sector	Comment
Aerospace and defense	<p>All signs point to a strong 2023 for air traffic, as airlines expect to meaningfully increase capacity to capture continued growth in demand for travel. The ongoing recovery in air travel should benefit commercial aerospace companies as it drives increased demand for aircraft, aftermarket parts, and services. The backlog for new aircraft over the next several years remains high, and future deliveries should contribute to cash flow growth. However, there remains a negative outlook bias for this segment owing mainly to well-documented supply constraints—notably for narrowbody planes (e.g., Boeing 737 Max, Airbus A320 family)—that continue to persist. Many commercial aerospace suppliers are operating below capacity due to labor shortages and procurement issues (namely component suppliers), which are showing no appreciable signs of easing. While our outlook has modestly improved from last year, due mainly to resilient/increasing demand, credit profile stability increasingly depends on operational execution. Defense companies are facing similar challenges, but the impact has been less acute on earnings and cash flow. 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) lends support for steady revenue and demand. 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. Moreover, shareholder returns have been more pronounced for defense companies compared to commercial aerospace, which tempers the pace of forecasted credit measure improvement.</p>
Autos	<p>We don't anticipate substantial downgrades, as ratings for many issuers are already below pre-pandemic peaks. Most companies rated 'BB' and above have focused on reducing debt and building liquidity. Working capital investments to support higher production levels and cost inflation will add downside risks to a few weaker issuers, especially if internal cost reduction prospects appear limited. Credit metrics should stabilize to pre-pandemic levels by late 2023 as most companies will look to preserve liquidity, maintain prudence on reinstating dividends and share buybacks, and limit large debt-financed acquisitions. We expect margins and cash flow improvement to be somewhat limited due to higher interest rates and pricing pressure amid potential demand volatility once supply gradually normalizes.</p> <p>For automakers operating in North America, the combined impact of marginally higher production volumes and lower commodity costs could offset most other cost inflation. However, we don't assume material recovery in profit margins or cash flows given pricing and product mix pressures amid tough macroeconomic conditions, higher costs related to electric vehicles (EVs), and potentially higher costs associated with negotiating a new contract with the United Auto Workers (UAW) union in the fourth quarter.</p> <p>A key rating assumption is that the industry will exercise discipline while rebuilding capacity toward its revised inventory targets, which will be roughly 30% below pre-pandemic levels. This will ensure reduced pressure on automakers to raise incentives and lower price, hence protecting their margins somewhat, even if consumer demand weakens over the next 18 months. Suppliers will likely start to show improvement in both margins and free cash flow going forward as raw material and freight inflation moderates, volumes improve, and operating volatility falls with less supply chain uncertainty at original equipment manufacturers (OEM) customers. However, labor availability and wage inflation along with overall higher energy prices limit margin upside. We expect larger auto suppliers (mostly Tier 1, rated 'BB-' or above) that produce high value-add components will continue to have more success in pushing through these higher costs to OEMs. Lower-rated auto suppliers continue to struggle to pass on higher costs, and we expect these suppliers, especially those focused on discretionary aftermarket parts could also face greater problems refinancing their debt as maturities come due.</p>
Building materials	<p>Building materials issuers at the lower end of the spectrum may suffer declining margins and profitability due to high debt leverage and heightened financing costs and may face ratings pressure. We anticipate modest revenue declines (about 5%–10%) and narrower profit margins, with EBITDA declining 10%–15%, due to slower demand for building and home repairs combined with ongoing cost pressures. We forecast issuers exposed to the aggregates segment will continue to be more resilient than those exposed to discretionary products and new home construction. Some of the declines in the cyclical single-family residential end market may be less severe than we initially projected given the rise in residential multi-family development and expectations for an increase in nonresidential spending as a result of investments in infrastructure projects. Due to the sector's weaker earnings and higher financing costs, we anticipate a growing negative rating bias over the coming year. Our current outlooks are stable for 95% of the rated issuers, negative for 3%, and positive for 2%.</p>
Capital goods	<p>The credit outlook for U.S. capital goods is holding steady as large backlogs generally offset pockets of lower demand. Some customers have been destocking amid easing supply chains, so that a large working capital investment for manufacturers should start converting into cash. The JPMorgan Global PMI Composite Output Index—produced by S&P Global—marked the fourth monthly expansion and fastest rate since July 2021, 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.</p>

	<p>Commodity input costs are mostly lower, but labor remains tight. Our net outlook bias is modestly negative at about 10%, but most of this negative rating pressure is concentrated in the risky 'B' category. Low free cash flow, rising interest costs, and maturities in the next 18-24 months are heaping credit pressure on a group of smaller companies that relies on a big bounce in 2023 profits to improve ratios and financial performance. 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 negative outlook bias for this cohort is about 20% and pricing for many tranches of debt are well below par, indicating some potential credit stress as maturities roll over unless earnings rise in the next two years.</p>
Chemicals	<p>We believe the destocking-related demand compression in the fourth quarter of 2022 and early this year is easing, albeit unevenly across companies. 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 chemical demand may weaken from some end markets such as housing but remain stable in others. 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. The first half of 2023 is likely going to be weaker than the second half for many companies. 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.</p>
Consumer products	<p>Inflation in inputs, freight, and shipping is moderating, but labor remains very tight. Margins should improve as the last pricing actions are passed through. Supply chains have loosened with only a few pockets of constraints. Fill rates are nearly at 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 have resumed orders after working down excess inventory but intend to keep stocks tight in the uncertain environment. Rating outlooks for issuers in discretionary, durable, and categories with high private-label penetration are negatively biased, while staples are in better shape.</p>
Containers and packaging	<p>Sector-wide destocking impacting issuers that began in the latter half of 2022 continued into this year, as expected. Pandemic spending that boosted consumption of goods and resulted in a shortage of product has given way to an inventory overhang as spending shifted toward services and inflation impacted consumer buying power. Although we believe this is transitory and expect inventory rebalancing will bring demand back to more normalized level, the slowdown in demand, destocking, and rising interest rates have had an impact on lower rated issuers. This is particularly for those with higher exposures to discretionary end-markets, which have been more impacted. Issuers in the 'CCC' category increased to about 9% of rated U.S. packaging issuers. Refinancing risk for 'B' or lower issuers with upcoming maturities continues to be our largest concern, particularly as debt markets remain volatile and if performance continues to be impacted by aforementioned issues.</p>
Gaming, leisure, and lodging	<p>Still-low unemployment, residual savings, and pent-up demand for experiences are leading to another good summer in travel and leisure, and we expect revenue and profitability in the sector broadly to continue to recover at least through this year. Except in the cruise sector and in Macao gaming, ratings have largely recovered from the pandemic and outlooks are mostly stable across the sector. Ratings activity this year has been decidedly positive for some companies that haven't yet restored ratings and where cushion in credit measures is building. Still, the sector mostly relies on discretionary spending, so the risk of an overheated U.S. economy leading to interest rates that are higher for longer could increase downside risks once the economy lands. 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 Macao gaming market. As a result of these trends, revenue per available room (RevPAR) in U.S. and European lodging will 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 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.</p>
Health care and pharmaceuticals	<p>We revised our outlook on health care services to negative from stable, given the adverse impact on margins and cash flow from worse-than-expected labor challenges, impact of inflation on overall operating expenses, significant increase in interest expense from the elevated interest rate environment, and for some companies some lingering impact from the pandemic. While we expect some improvement in 2023 due to moderating labor challenges, declining inflation, and patient volume improvement, we believe margins will remain generally below pre-pandemic levels. We expect cash flow to remain problematic for many companies due to the interest rate environment and rising working capital needs as we return to normal claims adjudication processes with payors, and due to the adverse impact on working capital that some companies are experiencing from the No Surprises Act.</p> <p>The outlook for pharma remains stable for 2023, as moderate deleveraging in recent years is likely to be offset by a moderate increase in M&A. We see slower than usual revenue growth given subsiding demand for various COVID-19 related products, limited inflationary pressures supporting continued strong margins. We see a moderate increase in the</p>

pace of M&A (e.g., recent acquisition announcements by Amgen and Pfizer) particularly for companies with below average revenue growth, following muted levels of M&A in 2022, supported by the need for some companies to reinvigorate product pipelines and in the face of increased pricing pressures. We expect the Medicare drug price negotiation provision in the Inflation Reduction Act (IRA) will be a drag on future industry growth and the effects will be felt more by select pharma companies than others, though implementation first begins in 2026.

Homebuilders	<p>The homebuilders' sector suffered a decline in revenue and margins in the first quarter due to higher rates and the weaker economic outlook. However, due to limited inventory and resilient demand, their performance wasn't as poor as we had anticipated. Because the inventory of existing homes remains low, builders have been able to increase their market share in recent months. Consumers are also adjusting to much-higher mortgage rates, which builders have attempted to counteract with lower home prices and higher incentives during the spring selling season. We had expected revenue declines of 20%-30% and EBITDA contractions of 25%-30% for our rated homebuilders in 2023. That said, given their stronger-than-anticipated start to the year, we now think the declines will be more moderate, with revenue and EBITDA falling by the lower end of our forecast ranges. Meanwhile, homebuilders have increased their cash balances and reduced debt, which has given them a significant cushion relative to our downgrade triggers despite our projection for deteriorating EBITDA in 2023. Additionally, reduced working capital utilization, as builders cut back on land acquisitions, could become a source of revenue and enhance their financial flexibility. About 30% of the rated homebuilders have positive outlooks. The positive rating bias has moderated a bit since early 2023, given our expectation for a weaker performance.</p>
Media and entertainment	<p>Our sector outlook remains negative. The media sector faces both weak near-term macroeconomic trends and negative long-term secular pressures. This is 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 the pay-TV bundle collapses, and what happens to advertising over the long term.</p> <p>A weakening economy hurts near-term sector performance as many media companies depend heavily on cyclical consumer and advertising spending. Advertising remains weak and vulnerable to macroeconomic shocks, such as the regional bank failures. While trends appear to have stabilized, 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.</p> <p>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 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.</p> <p>Unfavorable capital markets, as interest rates have risen to generational highs and speculative-grade debt issuance has stalled, are putting increasing pressure on lower-rated ('B' and lower) media companies. Many of these companies were levered up with floating-rate debt to take advantage of then low interest rates. The combination of now-elevated rates and worsening secular or cyclical media trends has weakened, or even eliminated, the flow cash flow generation of these companies. We have already seen rising default rates among these companies (six defaults year to date) and anticipate more, especially as access to spec-grade debt markets remain limited and expensive and interest rates remain elevated.</p>
Metals and mining	<p>Credit quality remains robust, even with lower prices for most metals. Our outlook bias remains modestly positive, even though we estimate profits across the sector will weaken about 30% peak-to-trough from the recent spike. Prices eased from record levels in 2022 but generally remain above their long-term averages, while cost pressures eat into profits. The buffer appears good for a downturn in this highly cyclical sector, because many issuers strengthened credit quality with disciplined capital spending and debt reduction in the past 3-5 years. Even with weaker sentiment and prices, output for many metals remains constrained by limited recent investment, declining ore grades, elevated energy costs, and unexpected operating disruptions. Meanwhile, growing credit buffers globally contributed to the most upgrades in a decade in the capital-intensive metals and mining industry, but 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 around the world have been improving credit quality for a few years, as defensive trade moats form in some markets, while output remains constrained by unpredictable factors like energy inputs and even pollution controls. 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.</p>
Midstream energy	<p>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. Inflation is 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</p>

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 will 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	Despite supportive action from OPEC, oil prices have slowly retreated in the past several months. The U.S. banking crisis along with speculative money leaving the sector for better returns and what we believe is a decline in the risk premium despite a war going on, has been partly responsible for the decline in prices. We believe that headlines about China's re-opening being delayed or not as robust as expected, have damped oil price expectations. Russia continues to surprise with its ability to maintain production levels despite sanctions. Hence, we still believe oil prices don't reflect underlying fundamentals and expect inventory drawdowns will assert themselves and result in higher prices, especially when the recent announcement by Saudi Arabia to lower its production by over 2 million barrels per day begins to take effect. For natural gas prices, it's hard to be sanguine about prices through mid-2024. 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 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	Tighter lending conditions amid weaker fundamentals raises refinancing risk. Office REITs are facing increasing pressure due to the slow recovery in office utilization, weak leasing activity, and high concessions. Therefore, we still expect flat to modestly negative net operating income (NOI) growth for them in 2023. Given the recent wave of retailer bankruptcies, concerns about tenant quality are growing for retail REITs. Industrial REITs performed slightly better than we expected, supported by resilient demand and mark-to-market opportunities for rents, even as economic activity slowed. The performance of rental housing REITs moderated in the first quarter due to difficult comparisons with their strong results in 2022, though we still expect they will improve their NOI by the mid-single digit percent area in 2023. In many markets—particularly those that experienced greater housing price appreciation—it remains more economical to rent than to buy. About 50% of our rated office REITs have negative outlooks, indicating the possibility of downgrades in the next year, with some becoming fallen angels if the recovery in their credit metrics is less robust than we anticipate. The volatility in the capital markets, with widening bond spreads and steep discounts to the net asset values (NAVs) of publicly traded REITs, will remain challenging for some REITs.
Regulated utilities	The sector outlook was recently revised to stable from negative, reflecting the increasing percentage of utilities with a stable outlook and gradually improving economic indicators. At year-end 2020, about 35% of the sector had a negative outlook compared with only about 13% as of July 2023. Furthermore, for the first time in years, the percentage of utilities with a positive outlook (14%) is higher than those with a negative outlook. More recently, economic indicators have gradually improved. Inflation is growing at a considerably slower pace. Additionally, natural gas prices have significantly retreated from August 2022 highs when prices at Henry Hub approximated \$9 per MMBtu. These improving economic indicators are important for the utility industry. When gas prices peaked during 2022, many utilities deferred the recovery of these higher costs and are only now starting to bill ratepayers. The recent drop in natural gas prices provides some customer bill cushion, allowing the utilities to bill customers for the previously deferred higher commodity costs without overwhelming the customer.
Retail and restaurants	Grocers, dollar stores, and discount and off-price retailers are faring relatively well on the topline, as consumers shift spending to basics and trade down. However, within channels, consumers are increasingly reducing purchases of discretionary items, which tend to be more profitable for deep discounters like dollar stores. Discretionary (apparel, department stores, specialty) carries more risk on the topline, for which we expect elevated promotional activities. Luxury retailers are starting to feel the pain as well. Many reported increasing weaknesses in the first quarter as even high-income consumers grow cautious. Restaurants continue to benefit from pent-up demand but are reporting lower foot traffic and value-seeking consumers, making it difficult for operators to pass on costs.
Technology	Tech companies' performance in the first quarter were in line with expectations, but second-quarter guidance is slightly weaker than we anticipated. As such, we recently revised down our IT spending growth rate to 2.4% for this year, down from 3.3% forecast in January. Deterioration has become more broad-based, affecting consumer-oriented products such as PCs, smartphones, and gaming, to enterprise and data-center end markets. Profitability is also being pressured as a result of customers tech spending scrutiny, and companies have been actively managing their cost base including reduction in force. We anticipate a second-half rebound, but it will likely be more modest than previously expected given the uneven goods recovery in China, inventory digestions at tech hardware and semiconductor firms, macroeconomic uncertainty and elevated interest rates. The need for refinancing isn't a big concern for the sector given strong liquidity and access to capital markets for higher-rated tech companies. Near-term debt maturities aren't a big concern for most of the speculative-grade rated tech issuers.

Telecom	<p>While the telecom and cable sector is fairly recession-resilient, increasing competition, technology convergence, inflation, and higher interest costs are likely to pressure EBITDA and free cash flows for the sector. Wireline operators are building out fiber to the home (FTTH) to better compete with cable for high-speed data customers. However, inflation and higher interest rates are causing these issuers to slow their FTTH builds to conserve cash flow, although delays in deploying fiber prolongs the amount of time they are exposed to market share losses to cable. In wireless, mature industry conditions and competition are contributing to slower service revenue growth, while massive spending in mid-band spectrum auctions and higher capex to support network upgrades pushed up leverage and weakened their financial flexibility. And the ability to monetize these investments has been difficult since 5G revenue opportunities have been slow to materialize. The only current 5G application is fixed wireless access (FWA). While this product has been successful in taking market share, it still hasn't contributed to meaningful revenue growth as the carriers are more focused on bundling it at a discounted price with their mobile product to reduce churn. While incumbent cable providers will continue to benefit from rising demand for broadband, customer growth is slowing due to increasing competition FWA and FTTH for broadband customers, which is their primary source of revenue and cash flow.</p>
Transportation	<p>U.S. airlines are heading into the seasonally stronger summer travel season, and we expect improving profitability and credit measures for most carriers this year. Passenger traffic is expected to further expand amid robust demand, which, along with system-wide capacity constraints, should support high fares. We expect earnings growth for the three largest airlines (the bulk of domestic airline revenue), led by the recovery in long-haul international traffic. A U.S. recession remains a risk to our estimates, but demand has so far been resilient, and jet fuel prices have recently eased. Freight transportation companies are exposed to the slowdown in spending on both consumer and industrial goods, but the picture varies across sectors. Package express companies are facing slowing package volumes following an e-commerce-led boom in second half of 2020 through 2021. However, there is ample ratings cushion that supports our stable outlook. Slowing spending on goods and low spot rates affects trucking and logistics companies (warehouse providers to truck brokers (or freight brokers/forwarders)). The outlook for railroads remains stable, reflecting a diversified traffic mix, pricing power (above inflation), 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.</p>
Unregulated (merchant) power	<p>While the forward power calendar strip for 2024 and 2025 is still modestly higher (\$5-\$7/MWh) than at year-end 2021, calendar 2023 prices are now on average 55% off September 2022 highs (\$35/MWh compared with \$75/MWh). Some of the decline is fortuitous, owing to a mild winter in Europe. The natural gas markets, traditionally regional, have now become more intertwined because of LNG. The 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 \$2.5/Mcf from \$5.1/Mcf (a 50% decline), resulting in much of the decline in power. We see a similar drag in forward natural gas prices that are now below \$4/Mcf through 2026. Given the increase in renewable resources, power prices are now inextricably linked to winter weather. Retail power providers will see modestly higher margins as wholesale prices decline. Overall, we still expect reasonably strong performance from all generators as they typically hedge forward, but the EBITDA is now backwardation for future years.</p>

Appendix 2: Economic Data and Forecast Summaries

Table 4

U.S. – S&P Global Ratings economic outlook

	2022	2023f	2024f	2025f	2026f
Real GDP (year % ch.)	2.1	1.7	1.3	1.5	1.8
Real consumer spending (year % ch.)	2.8	2.0	1.2	1.4	2.1
Real equipment investment (year % ch.)	4.3	(0.7)	1.4	2.0	2.7
Real nonresidential structures investment (year % ch.)	(6.5)	8.0	0.2	(0.3)	1.1
Real residential investment (year % ch.)	(10.5)	(11.5)	1.1	4.4	1.8
Consumer price index (year % ch.)	8.0	4.3	2.7	2.3	2.1
Core CPI (year % ch.)	6.2	5.0	3.3	2.4	2.2
Unemployment rate (%)	3.6	3.5	4.0	4.5	4.6
Housing starts (annual total in mil.)	1.6	1.4	1.3	1.4	1.4
Federal funds rate (%)	1.7	5.1	5.2	3.6	2.7

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 5

Canada – S&P Global Ratings economic outlook

	2022	2023f	2024f	2025f	2026f
Real GDP (year % ch.)	3.4	1.6	1.2	1.7	1.9
Real consumer spending (year % ch.)	4.8	2.8	1.3	1.9	2.2
Real nonresidential fixed investment (year % ch.)	3.9	0.0	1.7	1.5	1.9
Real residential fixed investment (year % ch.)	(11.1)	(10.2)	(0.6)	0.4	1.7
Consumer price index (year % ch.)	6.8	4.3	2.2	2.1	1.9
Core CPI (year % ch.)	5.6	3.7	1.8	1.9	2.1
Unemployment rate (%)	5.3	5.3	5.9	5.1	4.8
Government of Canada 10-year bond yield (%)	2.8	3.3	3.3	3.1	3.0
Bank of Canada policy rate (%)	4.3	5.0	4.1	2.8	2.5
CAD/USD exchange rate (per US\$1, period average)	1.30	1.33	1.32	1.29	1.27

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.

Appendix 3: List Of Analytical Contacts

Sector	Analyst Name and Contact
Aerospace and defense	Jarrett Bilous +1 (416) 507-2593 jarrett.bilous@spglobal.com
Autos	Nishit Madlani +1 (212) 438-4070 nishit.madlani@spglobal.com
Building materials	Ana Lai +1 (212) 438-6895 ana.lai@spglobal.com
Capital goods	Donald Marleau +1 (416) 507-2526 donald.marleau@spglobal.com
Chemicals	Paul Kurias +1 (212) 438-3486 paul.kurias@spglobal.com
Consumer products	Sarah Wyeth +1 (212) 438-5658 sarah.wyeth@spglobal.com
Containers and packaging	Michael Tsai + 1 (212) 438-1084 michael.tsai@spglobal.com
Financial institutions - banks	Stuart Plesser +1 (212) 438-6870 stuart.plesser@spglobal.com Brendan Browne +1 (212) 438-7399 brendan.browne@spglobal.com
Financial institutions - nonbanks	Sebnem Caglayan +1 (212) 438-4054 sebnem.caglayan@spglobal.com Gaurav Parikh +1 (212) 438-1131 gaurav.parikh@spglobal.com Elizabeth Campbell +1 (212) 438-2415 elizabeth.campbell@spglobal.com
Gaming, leisure, and lodging	Emile Courtney +1 (212) 438-7824 emile.courtney@spglobal.com Melissa Long + 1 (212) 438 3886 melissa.long@spglobal.com
Health care and pharmaceuticals	Arthur Wong +1 (416) 507-2561 arthur.wong@spglobal.com
Homebuilders	Ana Lai +1 (212) 438-6895 ana.lai@spglobal.com
Insurance	Joseph Marinucci +1 (212) 438-2012 joseph.marinucci@spglobal.com
Leveraged finance	Steve Wilkinson +1 (212) 438-5093 steve.wilkinson@spglobal.com Minesh Patel + 1 (212) 438 6410

Credit Conditions North America Q3 2023: Risks vs. Resilience

	minesh.patel@spglobal.com
Media and entertainment	Naveen Sarma +1 (212) 438-7833 naveen.sarma@spglobal.com
Metals and mining	Donald Marleau +1 (416) 507-2526 donald.marleau@spglobal.com
Midstream energy / oil refineries	Michael Grande +1 (212) 438-2242 michael.grande@spglobal.com
Oil and gas	Thomas Watters +1 (212) 438-7818 thomas.watters@spglobal.com
Public finance	Robin Prunty +1 (212) 438-2081 robin.prunty@spglobal.com Jane Ridley +1 (303) 721-4487 jane.ridley@spglobal.com Sarah Sullivant +1 (415) 371-5051 sarah.sullivant@spglobal.com
REITs	Ana Lai +1 (212) 438-6895 ana.lai@spglobal.com
Regulated utilities	Gabe Grosberg +1 (212) 438-6043 gabe.grosberg@spglobal.com
Retail and restaurants	Sarah Wyeth +1 (212) 438-5658 sarah.wyeth@spglobal.com
Sovereigns	Joydeep Mukherji +1 (212) 438-7351 joydeep.mukherji@spglobal.com
Structured credit	Stephen A Anderberg +1 (212) 438-8991 stephen.anderberg@spglobal.com
Structured finance	Winston Chang +1 (212) 438-8123 winston.chang@spglobal.com James Manzi +1 (202) 383-2028 james.manzi@spglobal.com
Technology	David Tsui +1 (415) 371-5063 david.tsui@spglobal.com
Telecom	Allyn Arden +1 (212) 438-7832 allyn.arden@spglobal.com
Transportation	Jarrett Bilous +1 (416) 507-2593 jarrett.bilous@spglobal.com
Unregulated (merchant) power	Aneesh Prabhu +1 (212) 438-1285 aneesh.prabhu@spglobal.com

Copyright 2023 © by Standard & Poor's Financial Services LLC. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses, and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives. Rating-related publications may be published for a variety of reasons that are not necessarily dependent on action by rating committees, including, but not limited to, the publication of a periodic update on a credit rating and related analyses.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw, or suspend such acknowledgment at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal, or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.spglobal.com/ratings (free of charge) and www.ratingsdirect.com (subscription) and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.spglobal.com/ratings/usratingsfees.

STANDARD & POOR'S, S&P and RATINGSDIRECT are registered trademarks of Standard & Poor's Financial Services LLC.