

Higher For Longer Will Fuel Ratings Divergence

June 29, 2023

This report does not constitute a rating action

Key Takeaways

- **We expect slowing growth ahead and diverging credit performance.** Investment-grade entities should remain resilient and more financially flexible while higher rates will continue to challenge those at the lowest end of the rating spectrum. This divergence is reflected in our negative bias, at 9.2% for investment grade and 35.4% for 'B-' and lower ratings.
- **The full impact of sharply higher interest rates has yet to unfold.** Defaults have picked up in recent months in light of increasing interest rates--a process we believe is going to continue to erode debt-servicing capacity for many lower-rated issuers. We forecast default rates to rise to 4.25% in the U.S. and 3.6% in Europe by spring 2024. Within emerging markets, we expect an increase in defaults from Latin America.
- **Downside risks remain high.** After avoiding numerous potential dangers so far in 2023, it is easy to have a false sense of calm. But, we believe that most of the downside risks to credit conditions remain as strong as ever and may materialize slowly over time. Higher borrowing costs, weakness in certain real estate markets, and weakening economies may lead to a bottoming of the credit cycle in the years ahead.

Global credit conditions: key highlights

Slower GDP growth in 2023

Global: 2.9%

U.S.: 1.7%, eurozone: 0.6%, China: 5.2%

CRE risks

-20.2%

U.S. REITs median discount to net asset value, **-53.1%** for office

Higher benchmarks

+5%

to SOFR since end-2021 (5 bps to 500 bps)

Diverging negative outlook bias

15.3%

Investment-grade: **9.2%**
Speculative-grade: **19.2%**
'B-' & lower: **35.4%**

Balanced credit trends

49%

downgrade ratio in 2023-to-date
59% in Q1 2022

Corporate debt

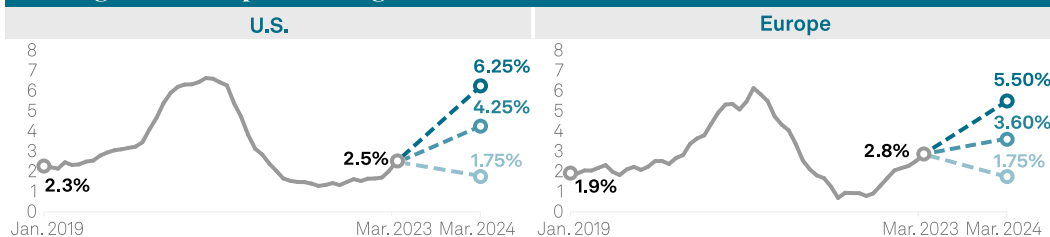
\$1.2 tril.

rated 'B-' or lower and

64%

with floating interest rates

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



Trend lines point to our optimistic-, base-, and worse-case scenarios. Data as of June 20, 2023, calculated as the percentage of ratings with negative outlooks. Downgrade ratio refers to proportion of downgrades, to the total of upgrades and downgrades. Sources: S&P Global Ratings Research and S&P Global Market Intelligence's CreditPro®.

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Global Credit Conditions And Macro Highlights

(Editor's Note: S&P Global Ratings' Credit Conditions Committees meet quarterly to review macroeconomic conditions in each of four regions: Asia-Pacific, Emerging Markets, Europe, and North America. Discussions center on identifying credit risks and their potential rating impact in various asset classes, as well as borrowing and lending trends for businesses and consumers. This commentary reflects views discussed in the global committee on June 21, 2023.)

Global Credit Conditions

A Slow Burn

Economic growth has stayed resilient, even in the face of increasing stressors from the banking system and the recent U.S. debt ceiling debate. But resilient is not the same as strong: the U.S. looks set to enter a period of below-trend growth, and China's initial boost from reopening appears short-lived.

Global creditworthiness has also held up, but divergence along credit quality lines is increasing, and many risks have more potential for disruption. A protracted period of tight financing conditions would weigh on entities' debt-service burdens and limit access to funding. In the second quarter, upgrades have outpaced downgrades, though just barely. But roughly 20% of upgrades were due to the recent stability of some of the weaker issuers in the media and entertainment sector, led by leisure operators and hotels that will benefit from a stronger summer than previously in the post-pandemic period.

Investment-grade issuers are showing more resilience overall, given stronger-than-expected consumer demand, capacity to pass on cost increases, ability to cut back on leverage in some cases, and far less floating-rate debt exposure than speculative-grade issuers. (Roughly 17% of the \$17 trillion total outstanding investment-grade debt is floating rate.) And we expect these issuers' credit quality to remain stable. The current global investment-grade negative bias is only 9.2%--nearly an all-time low.

Meanwhile, the negative bias for issuers rated 'B-' and lower has been rising, reaching 35.4% globally, fueled by the consumer products and retail/restaurants sectors (43.2% and 48.6%, respectively).

Regionally, the stress will be felt to a greater extent in the U.S., where 38% of speculative-grade issuers possess these low ratings, compared with 30% in Europe and only 16% in the rest of the world.

Higher interest rates are starting to bite lower-rated issuers. As markets move toward comparable calm, rate hikes by central banks continue, and companies have started to feel the impact (see chart 1). Cash interest paid for global nonfinancial corporations increased roughly 15% in the first quarter from a year earlier. Some regions saw far greater increases--notably in developing markets (roughly 35% in Latin America and Asia-Pacific). This leaves less room to maneuver in the event of a recession, or even a general slowdown. And we're already observing an earnings recession among corporations.

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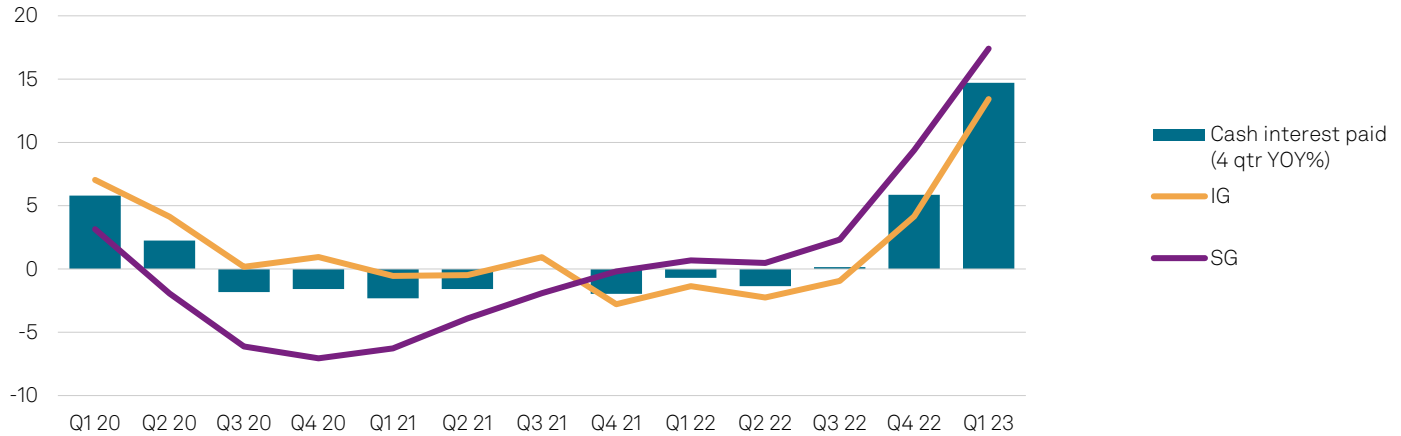
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Global Credit Conditions Q3 2023: Higher For Longer Will Fuel Ratings Divergence

Chart 1

Percentage change in cash interest paid

Rated nonfinancial corporates that report quarterly

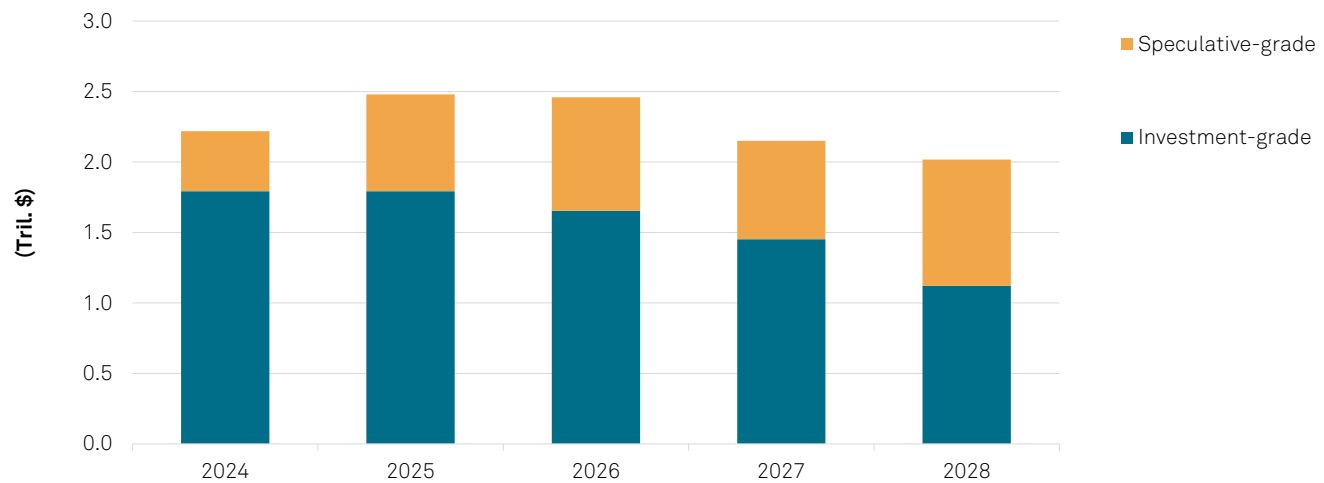


Source: S&P Capital IQ, S&P Global Ratings. Data to May 24, 2023. Nominal data, measured in U.S. dollars at historic conversion rates. Only includes companies reporting quarterly. Q1 2023 growth rate only includes companies that have reported results and is used to extrapolate the notional cash amount paid.

Corporate cash flows remain under pressure and maturities are creeping closer. Given the lag in financial reporting, we expect to see interest rate costs rise for several more quarters, which will start to coincide with the need to address the uptick in maturities due in 2025, particularly for speculative-grade issuers (see chart 2). This will have a greater impact on lower-rated borrowers funded through leveraged loans and other floating-rate instruments, which account for half of the \$5.3 trillion in outstanding speculative-grade debt. Many issuers in emerging markets that are grappling with expensive dollar-denominated debt, and in some cases higher domestic interest rates from their central banks, are also more exposed.

Chart 2

Rate hike pain rises alongside refinancing needs



Data as of Jan. 1, 2023. Note: Includes bonds, loans, and revolving credit facilities that are rated by S&P Global Ratings. Source: S&P Global Ratings Credit Research & Insights.

Our base case assumes a protracted period of slowing economic growth and increasing debt burdens, which will be felt most by weaker borrowers with floating-rate debt.

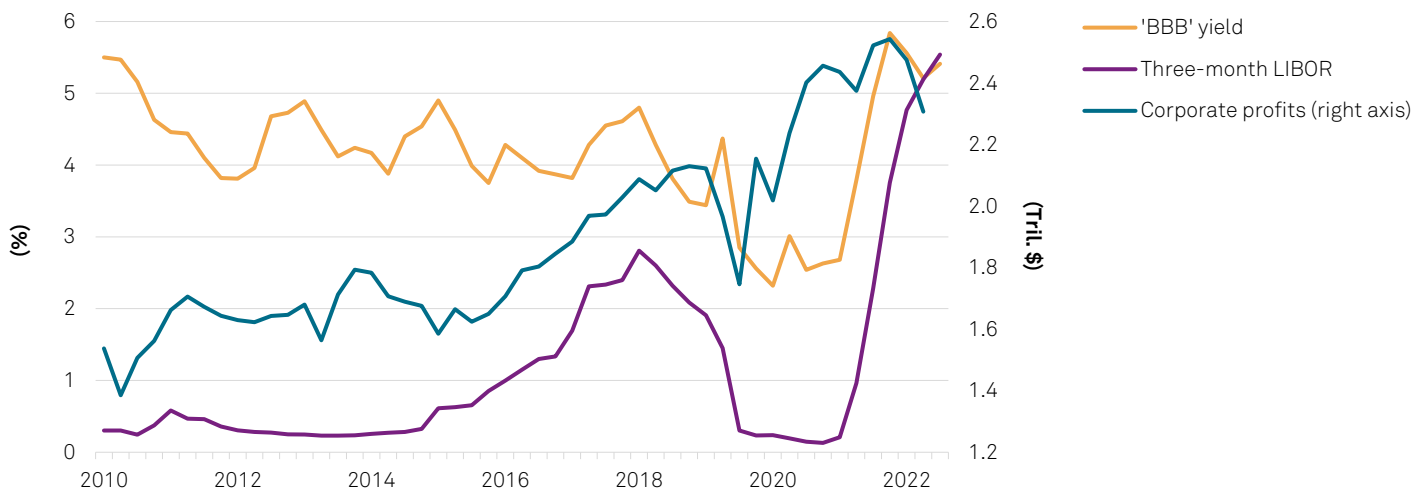
Interest rate expectations call for more monetary tightening to combat inflation this year and policy rates to stay higher for longer through at least the first half of 2024 (see table 1). We expect the Federal Reserve will raise its policy rate at least once more, to 5.5%, and keep it elevated until mid-2024. Similarly, we forecast the European Central Bank to hike the refi rate next month and finish the year at 4.25% and not start cutting before mid-2024.

Already, profits are falling in aggregate in the U.S., while interest rates either stabilize at elevated levels (as is the case with longer-dated, fixed-rate debt) or continue rising (as has been happening with floating-rate benchmarks) (see chart 3). Although still healthier in other regions, corporate earnings have been slowing globally as well.

Considering current trends, we anticipate defaults will increase through early 2024--to 4.25% in the U.S. and 3.6% in Europe. Given the large share of floating-rate debt at the weakest rating levels, default rates for bonds and loans could also diverge. Near-term maturities are limited for fixed-rate bonds rated 'B-' and lower (roughly \$51 billion globally, through 2024) compared with the overall amount of outstanding loans at these ratings (\$778 billion).

Chart 3

U.S. corporate profits dip while rates rise



Sources: FRED, S&P Global Market Intelligence, and S&P Global Ratings Credit Research & Insights.

Downside risks remain elevated. The global banking system appears on more solid footing after last quarter's events. However, stress lingers for U.S. regional banks, particularly those exposed to commercial real estate. The global commercial real estate sector, and in particular offices, has experienced large declines in property values in the last 12 months, which have quickly pushed up capitalization rates. The combination of higher interest rates and more headwinds carried over from the pandemic (from hybrid and remote work) is presenting multiple years of tough conditions ahead, particularly for those with maturities.

Bank exposures to commercial real estate in Europe and Asia-Pacific may be less acute or borne by larger, more stable institutions. But, the impact of higher rates on this sector has become an area to watch globally as asset quality is expected to decline.

Macro Highlights

Higher Rates For Longer Is The New Baseline

Despite the fastest pace of advanced country policy rate increases in decades, demand pressures remain strong, particularly for services. This, even as COVID-19 effects fade. Labor markets are still tight and core inflation remains stubbornly high, although headline has eased.

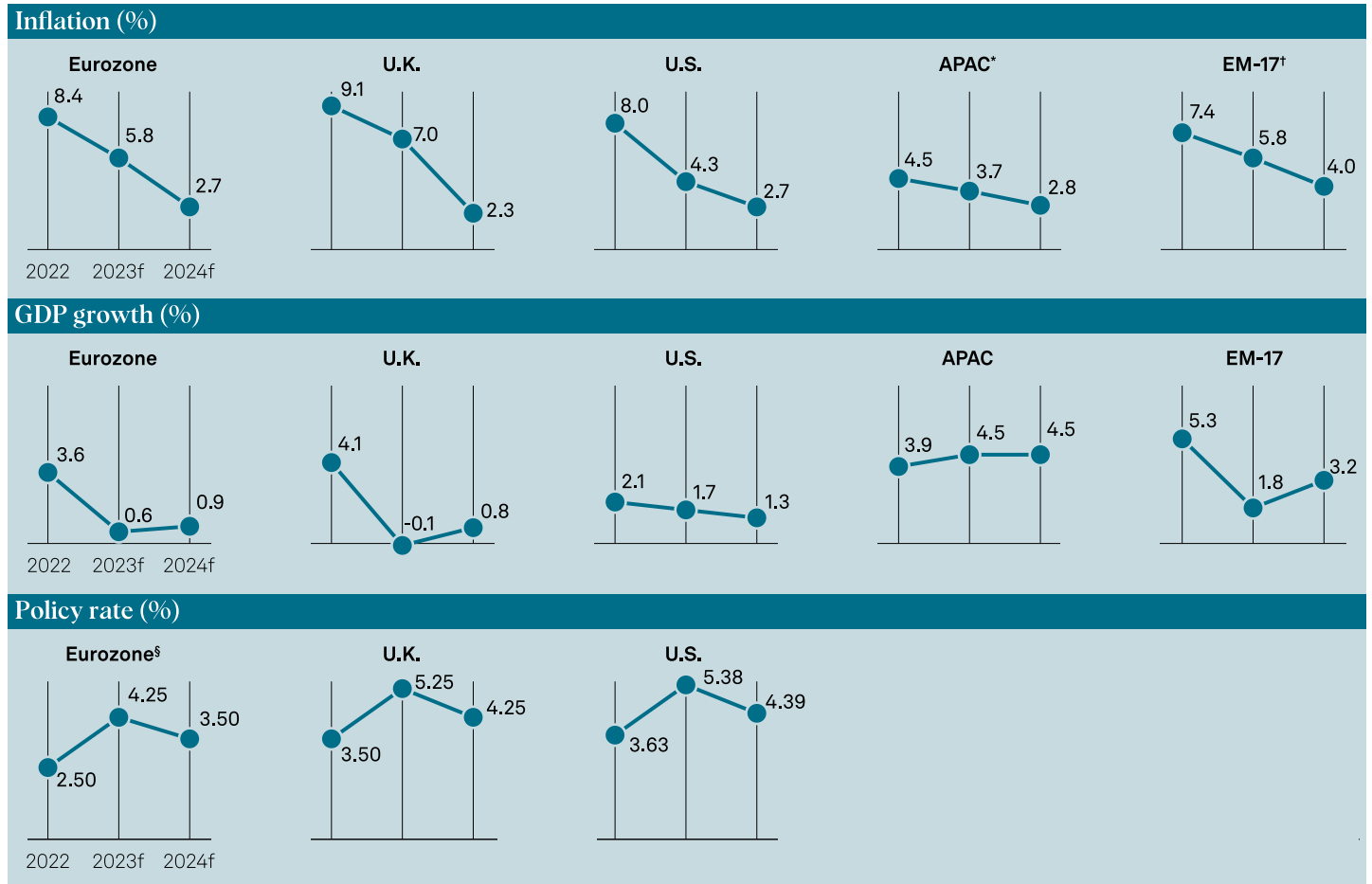
Major central banks have more work to do and are now signaling that policy rates will stay higher for longer. Moreover, financial markets agree, and rate cut expectations this year are now off the table. Higher for longer will stay the hand of emerging market central banks that want to cut rates.

Our revised GDP growth forecasts generally show faster growth in 2023 and a slower pace in 2024. We have once again pushed out the onset of a material growth slowdown to later this year. Moreover, we now see a longer and shallower slowdown, and recession probabilities have abated.

On risks, we are entering a delicate phase for monetary policy given the lags. If inflation remains sticky, rates will need to go higher. But if central banks have overtightened, growth will slow sharply. The transition to a higher rate regime also has negative implications for certain sectors.

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Inflation data as of May 2023. Policy rates as of June 22, 2023. *Simple average. †Median for EM 17 countries. ‡Refi rate. Source: S&P Global Ratings.

Top Global Risks

Higher for longer interest rates persist and limited market liquidity would hurt weaker borrowers

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

While most central banks are now at or close to peak policy rates, if core inflation remains elevated, it could force them to keep rates higher and for longer than in our base case. If bank and overall market sentiment turns more sharply negative in the next 12 months as growth slows, a resultant lack of funding would become a bigger issue as the large jump in maturities coming due in 2024 and 2025. This could push a larger share of low-rated corporates closer to our pessimistic case default rates of 6.5% in the U.S. and 5.5% in Europe. A prolonged period of U.S. dollar strength would be a headwind for borrowers in emerging markets with dollar-based debt coming due.

A harder landing would exacerbate global credit stress

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

Developed economies are expected to largely see very slow growth, and China is expected to be below pre-COVID-19 targets. Already the country's reopening has slowed, and expectations for other emerging markets remain below trend. Growth could weaken further if central banks remain too tight for too long, particularly given many governments' large debt piles accumulated during the pandemic. Should the economic trajectory fall short of our expectations by producing more widespread recessions, top-line revenues will decline more quickly. As a result, companies could have less wherewithal to service higher debt burdens.

Geopolitical tensions could intensify, roiling markets and business conditions

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

The U.S.-China relationship remains delicate and sensitive to any new confrontations. Meanwhile, the Russia-Ukraine conflict is seeing an uptick in hostilities this year. Some emerging markets are confronting increased fiscal challenges or rising attempts to centralize power. Should any of these tripwires be hit, global market volatility would increase, with a high likelihood for a repeat of recent supply-chain bottlenecks and input cost inflation.

Compounding challenges for global commercial real estate could lead to losses for vulnerable banks and other property holders

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

Global commercial real estate losses are rising as the impact of higher interest rates chips away at valuations alongside fundamental challenges for the office subsector given moves to more hybrid and work-from-home arrangements. Higher mortgage rates are slowing growth in residential home values, which could lead to a reduction in household wealth if prices fall. U.S. regional banks, already more vulnerable to depositor flight and market jitters, have elevated exposures to CRE. Larger banks in the rest of the world hold a higher share of commercial real estate. But, global stress from higher interest rates and falling valuations could still result in losses, limiting banks' appetite for increased lending.

Secular risks

Climate risks and energy transition challenges become more costly

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

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

Cyberattacks and the potential for rapid technological change threaten global business and government infrastructure

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

Amid increasing technological dependency and global interconnectedness, cyberattacks pose a potential systemic threat and significant single-entity event risk. The Russia-Ukraine conflict is raising the prospect of major attacks. Criminal and state-sponsored cyberattacks are likely to increase, and with hackers becoming more sophisticated, new targets and methods are emerging. A key to resilience is a robust cybersecurity system, from internal governance to IT software, all requiring additional costs. Entities lacking well-tested playbooks (such as active detection and swift remediation) are the most vulnerable. Meanwhile, increased digitization and the introduction of AI by public and private organizations will foster broader operational disruptions, and potentially increase market volatility for short periods or even pose greater economic adjustments.

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.

Low Growth And High Rates Weigh On Global Credit

- Balanced rating actions (between upgrades and downgrades) in the second quarter are not necessarily a signal for more improvement ahead. Global credit remains solid, but risks are tilted to the downside.
- We expect investment-grade ratings to remain resilient, with a muted negative bias of 10%. Downgrade potential is higher for 'B-' and below, with a negative bias of 35%, largely owing to the high reliance on floating-rate debt.
- Global defaults are gaining speed, and the buildup of stressed issuers points to more defaults ahead, consistent with our base-case assumption of 4.25% in the U.S. and 3.6% in Europe.
- Defaults year to date have been concentrated in consumer/service, leisure/media, and health care/chemicals.

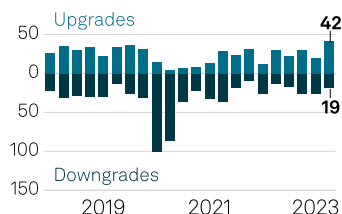
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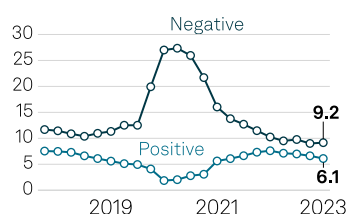
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Rating and outlook quarterly trends

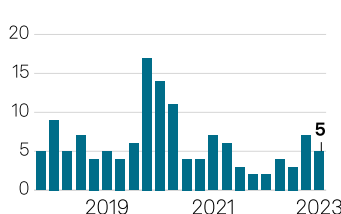
IG rating actions (No.)



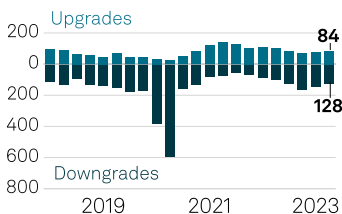
IG biases (%)



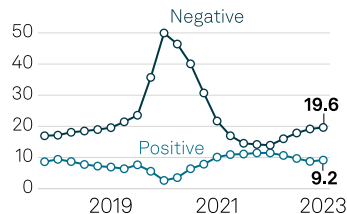
Historical fallen angels (No.)



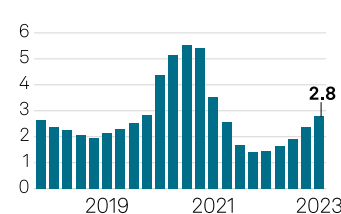
SG rating actions (No.)



SG biases (%)



Global SG default rate (%)*



Ratings at a glance (%)

	North America	Europe	Asia-Pacific	Emerging markets
Outlook bias	(9.3) ▼	(6.4) ▼	0.6 ▲	(7.5) ▲
Potential fallen angels	2.8	2.7 ▼	4.3 ▼	4.2 ▲
Weakest links (of SG)	12.9 ▲	8.9 ▲	1.9 ▼	15.3 ▲

Regional default insights (No.)

	North America	Europe	Asia-Pacific	Emerging markets
Q2 2023	20 ▼	6 ▼	0	5
2023 YTD	48	13	0	10
2022 YTD	15	5	8	4
Leading sector 2023 YTD	Consumer/Service	Consumer/Service Health care/ Chemicals	N.A.	Leisure time/Media Utilities

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

Weakest links are defined as issuers rated 'B-' and below, with either a negative outlook or on CreditWatch negative. Weakest links are shown as percentage of speculative-grade population. Rating actions as of June 19, 2023. Outlook/CW as of June 20, 2023. Defaults as of May 31, 2023. Direction of arrows indicate quarter over quarter change. IG--investment grade. SC--speculative grade. Default counts may include confidentially-rated issuers. Net outlook bias refers to the percentage of issuers with a positive bias minus the percentage of issuers with a negative bias. All outlook bias calculations include global financial and nonfinancial issuers. Sources: S&P Global Ratings Credit Research & Insights and S&P Global Market Intelligence's CreditPro®.

Global Credit Conditions Q3 2023: Higher For Longer Will Fuel Ratings Divergence

Net rating actions (upgrades minus downgrades) ticked up during the second quarter. Upgrades picked up and downgrades eased in April, but in May and June, rating actions have been more balanced. Downgrade ratios fell in all regions except North America, and absent contagion, we could see regional credit risks diverge until rates bite.

Second-quarter rating actions reflect resilience in credit despite tough macroeconomic conditions. But given some unique trends in the second quarter and an expected increase in downgrades, the second quarter's balance may give way to a higher proportion of downgrades to total rating actions.

Improvement in credit quality in the second quarter is highly concentrated, with 20% coming from speculative-grade media and entertainment issuers alone. This comes as consumers continue to spend on services and leisure.

But with spending on goods waning, cost pressure persisting, and loan-heavy sectors taking a more immediate hit from higher rates, consumer products, health care, and high tech led second-quarter downgrades. Risk remains tilted to the downside for global credit--low growth, sticky inflation, and higher-for-longer rates will contribute to difficult operating conditions over the next 12 months.

As a result, we expect balance-sheet liquidity at the lower end of the rating spectrum to erode. Issuers rated 'B-' and below--now at 30% of the global total--are already driving a rise in the speculative-grade negative bias, which is up to 19.6%. The last time the negative bias rose to this level was in July 2019, roughly three-quarters before the onset of the COVID-19 pandemic. Downgrade potential for our 'B-' and 'CCC'/'C' rated entities also has sharply risen in the past 12 months, to 35.4%. As balance-sheet liquidity dries up and debt maturities pick up over the next 18 months, the sting from higher rates will increase.

Meanwhile, investment-grade companies are heading into the expected downturn on far more favorable footing. The global investment-grade negative bias is only 9.2%--a hair above its all-time low of 8.8% in April.

Investment-grade companies were largely able to lock in some of the lowest interest rates ever seen while also extending average maturity lengths on new debt in 2020-2021. For many, the impact of higher rates will be far more muted relative to speculative-grade firms in the next 18 months or so, and many have more flexibility to reduce leverage than issuers in the 'B' or 'CCC'/'CC' categories do.

In the first half of 2023, emerging market credits saw the largest increase in speculative-grade downgrade potential, with their negative bias hitting 26.6% on June 20. Speculative-grade negative biases drifted higher in Europe and North America in the first half of 2023 (to 19.6% and 17.9%, respectively, from 18.7% and 16.4% at year-end 2022). In Asia-Pacific, speculative-grade downgrade potential fell sharply in the second quarter, to 15.1% from 18.6%. The rise in the emerging markets speculative-grade negative bias has stemmed largely from Nigerian banks and Argentinian nonfinancials amid negative outlooks on the sovereign ratings for both countries.

Defaults are gaining speed this year, and we're projecting higher default rates ahead. Supporting our projection is the rising number of stressed issuers, with 316 weakest links in April, up from 276 when the year began and 170 in April 2022. (Weakest links are financial and nonfinancial corporate issuers rated 'B-' or lower with negative outlooks or ratings on CreditWatch negative.)

By sector, defaults through May have been mainly in consumer/service, health care/chemicals, and leisure/media. We expect this trend to broadly continue--consumer products, media and entertainment, and health care lead our weakest link tally.

Global Financing Conditions: Relative Calm Returns After March, But Selectivity Remains

- Financing conditions for corporations have become looser in the second quarter, but only slightly as global bond spreads have tightened below levels at the start of the year.
- We believe banks will pull back somewhat on new lending as risk aversion and interest rates both rise, as reflected in recent central bank lending surveys.
- New debt issuance has been strong relative to last year despite higher market rates, but this has largely been limited to issuers with stronger credit ratings, and mainly for refinancing, with 65% of leveraged loans issued for this purpose this year.

Market sentiment appears to reflect contained concerns from the bank sector. After an initial period of widening spreads and slowing bond issuance following the bank failures in March, markets have regained their footing in the second quarter. Although arguably less so, the pending debt ceiling debate in the U.S. also had an impact on market sentiment, but largely a positive one for secondary market pricing once resolved.

Bond spreads are now reflecting more optimism than at the start of the year. Global bond spreads across have recently tightened to levels lower than where they started the year following the debt ceiling passage in early June (see chart 4). In the U.S., our speculative-grade bond spread reached 368 basis points (bps) after hitting a peak of 470 bps on March 17--roughly a week after the failure of Silicon Valley Bank. This compares with 415 bps at the start of the year and is representative of the path spreads have taken in other regions as well.

Banks maintain more apprehension than bond markets. Even before the events of March, bank lending surveys in developed markets signaled increasingly tighter standards on new loans to businesses (see chart 5). Unsurprisingly, bank officers remained just as cautious during the first quarter. Our own estimates for loan growth are only in the single digits for this year--not a contraction, but a noticeable pullback in the face of rising risk perceptions and an uncertain economic backdrop.

Higher rates are only starting to have an impact. Even though spreads may have fallen, underlying bond and loan yields are now much higher than a year ago (see chart 6). Fixed-rate bond yields have fluctuated in recent months but have largely held steady since the end of the third quarter of last year. Most have arrived at their "new normal"--well above the prevailing yields prior to 2021 but, importantly, are not indicating any significant increases ahead.

On the other hand, floating-rate benchmarks are still rising in step with policy rate increases by central banks. This is causing the large number of lower-rated loan issuers to pay ever-increasing amounts to service their debt, stressing cash flow. As a result, and combined with a slowing economy, these issuers will, in our view, be most at risk for greater credit stress.

Bond markets are looking to lend, but only selectively. Bond issuance has rebounded year to date, but this is coming off of a low base in 2022 and is very correlated with credit quality (see chart 7). The majority of the global speculative-grade total through June 20 has been from the 'BB' rating category, which has seen a 64% increase in issuance since last year. In comparison, 'B' has seen a 44% growth rate, and 'CCC'/'C' contracted 83%.

Perhaps most telling is that second-quarter totals have been stronger than last year, but for 'CCC', the category is struggling to reach even \$1 billion in issuance. Markets are becoming selective in the face of risks, and so are borrowers, as much of the issuance this year has been for refinancing rather than mergers, capital expenditures, or shareholder-friendly purposes.

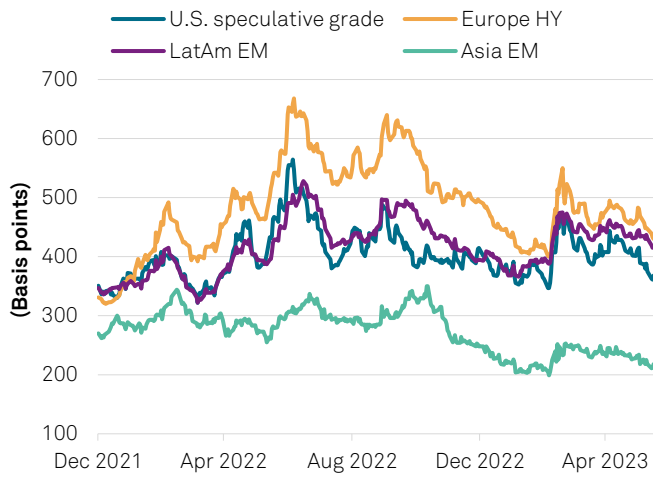
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Chart 4

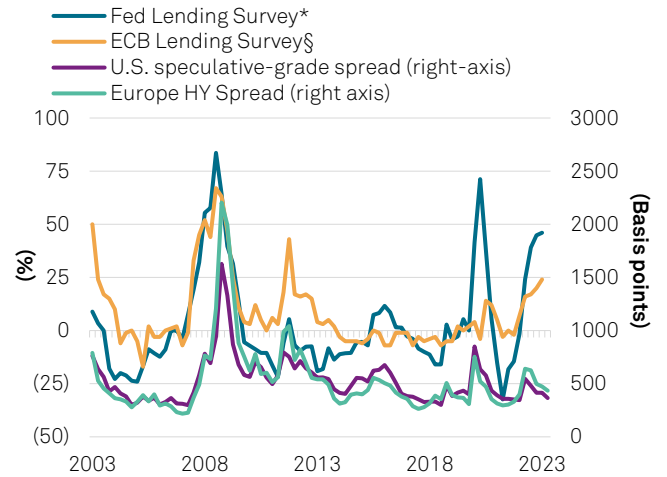
Bond spreads are now below year-end 2022 levels



Source: ICE BofA Option-Adjusted Spreads; FRED; S&P Global Ratings Research & Insights.

Chart 5

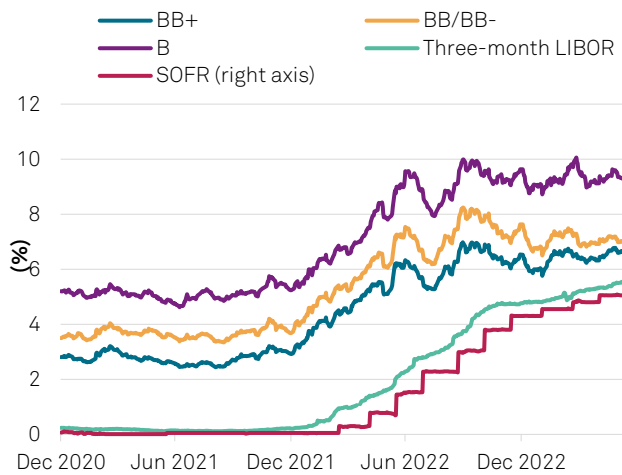
Bank lending sentiment is more sour than bond markets'



*For large and mid-sized firms. §For large firms. Source: Federal Reserve; ECB; ICE BAML Indices from FRED; S&P Global Ratings Research & Insights.

Chart 6

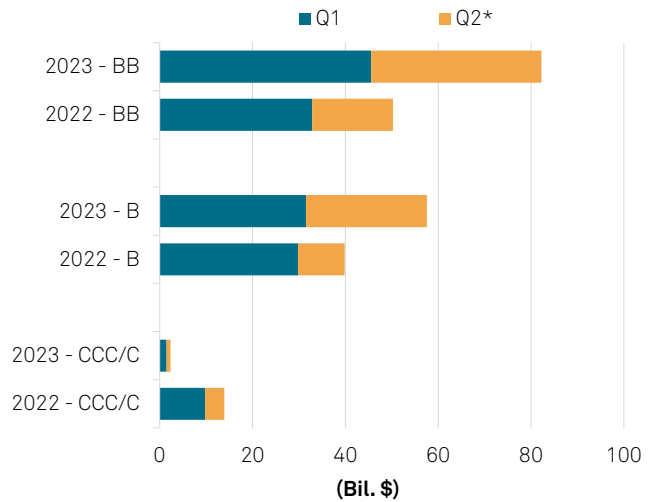
Fixed-rate yields stabilize while floating-rates rise



Source: S&P Global Market Intelligence; S&P Global Ratings Credit Research & Insights.

Chart 7

Lenders remain selective amid building pressures



*Through Jun. 20. Source: Refinitiv; S&P Global Ratings Research & Insights.

Resilience Of Sovereigns, Corporations, And Financial Institutions Ratings

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Sovereigns

Ratings Stabilizing Amid Divergent Trends And Lingering Risks

As we near the end of the first half of the year, overall sovereign credit quality is stabilizing, albeit with varying trends and a fair amount of risks lingering with very disruptive potential.

While close to 12% of rated sovereigns have negative outlooks, some stabilizing trends have added more positive outlooks, and the outlook balance is now -8, versus -13 in January 2023. That said, overall credit quality is still below where it was before the pandemic. Except for those that benefited from improvements in commodities or services, fiscal consolidation is coming at a very slow pace--or in some cases not at all.

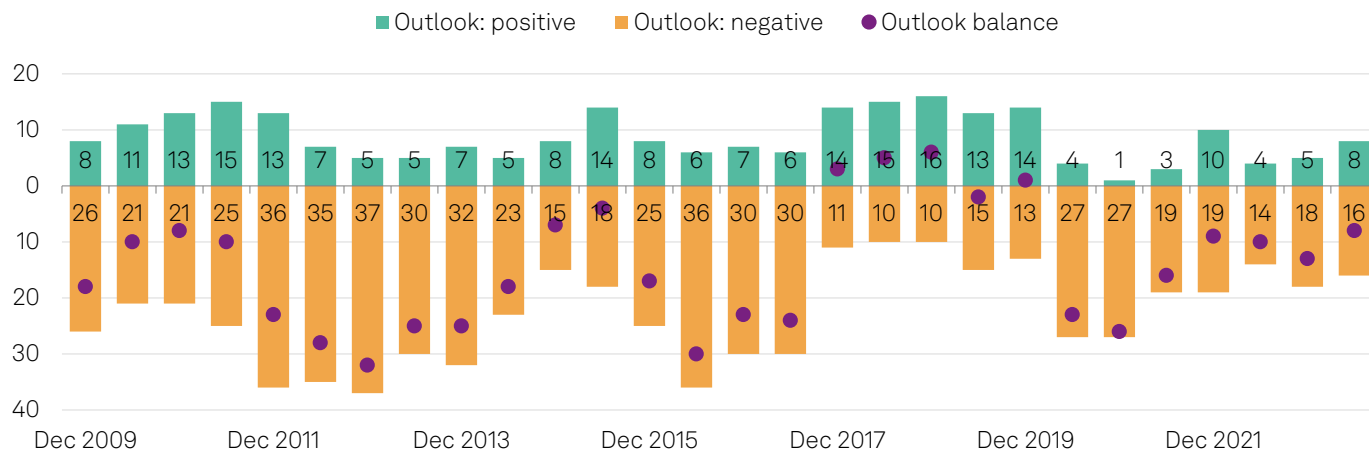
In addition, the cost of funding produced by the substantial increases in monetary policy rates makes both consolidation and deficit financing more difficult and costly. In this context, developed markets, as well as many investment-grade emerging markets, have a larger cushion until the higher financing costs make their way through all their debt profiles, given the longer tenure of their maturities--and their rating outlooks remain stable.

Most negative outlooks are on low-rated emerging and frontier markets where we see inflation, higher financing costs, and elusive growth weighing on ratings. Three sovereigns (Argentina, El Salvador, and Mozambique) have defaulted since the beginning of the year. We currently have eight sovereigns rated in the 'CCC' category--an all-time high, which highlights the risk of more defaults coming later in the year.

Finally, while the overall outlook is stable, risks remain, like the Russia-Ukraine war. The beginning of the Ukrainian counteroffensive presents lots of uncertainties about how events could turn out over the next few months. The alleged step-up in Chinese involvement in the conflict, via supplies of equipment to the Russian forces, plus the already tense situation with Taiwan, only adds more risks to the fragile geopolitical environment.

Chart 8

Global sovereign ratings outlook balance



Source: S&P Global Ratings.

Corporations

Echoing broader economic trends, nonfinancial corporates remain resilient. Nevertheless, revenue and earnings growth rates are ebbing and prospects are weakening as financing pressures start to bite. First-quarter results far exceeded market expectations, with cost increases still being passed on and wage growth lagging. Supply-chain issues have dissipated, producer input price inflation is falling rapidly, and energy costs having fallen back despite the ongoing Russia-Ukraine war. Sectors such as hotels, gaming, and leisure are still benefiting from pandemic recovery momentum.

There is considerable divergence apparent both among industries and between investment- and speculative-grade issuers. Speculative-grade issuers are more immediately vulnerable to surging interest and refinancing costs given a reliance on floating-rate debt and debt maturities they will need to address.

Even so, the broader picture is one of deterioration. First-quarter EBITDA growth overall contracted year over year for the first time since third-quarter 2020. Excluding earnings from oil, gas, and mining companies, EBITDA has now fallen for three consecutive quarters. Two-thirds of global industries saw quarterly EBITDA decline in first-quarter 2023 versus first-quarter 2022.

Financing costs are a growing pain--in particular for highly leveraged entities. Reported nonfinancial corporate cash interest payments surged 15% in first-quarter 2023 as interest rate increases started to feed through. If stubborn core inflation brings higher-for-longer interest rates, this will increase financing costs, particularly for weaker issuers.

We estimate the median effective interest rate speculative-grade entities are paying globally will rise to 6.1% in 2023, its highest level since 2010. Interest cost pressures will be a slow burn for all companies as cheaper pre-pandemic debt is replaced with more expensive borrowing. However, for weaker speculative-grade entities, reliance on floating-rate debt means the temperature is rising rapidly, and declining EBITDA and higher interest costs is a more immediate threat to credit quality.

Financial Institutions

We see confirmation that risk appetite among global financial institutions is tightening, in line with the continued tightening monetary policy in a number of regions. Typically, this has led to a slowdown in loan growth, as opposed to a decrease in lending exposures. In the eurozone, for instance, annual loan growth decreased to 2.5% from 4.6% between June 2022 and April 2023.

In the U.S., loans in first-quarter 2023 were basically flat from the prior quarter. According to the April 2023 Senior Loan Officer Opinion Survey, U.S. banks are likely to tighten lending standards in the rest of 2023 because of an expected deterioration in credit quality and a reduction in risk tolerance, as well as to shore up their balance sheets.

As a result of these tightening financing conditions, we project that banks' asset quality will weaken in a number of countries. Certain pockets of risks, for instance in commercial real estate, may negatively affect less diversified lenders, including nonbank financial institutions (NBFIs). Also, funding costs will inevitably continue to rise for most, with differences across systems and between banks and NBFIs.

Positively, this expected medium-term weakening in profitability comes on the back of generally strong bank earnings in the first quarter, with pre-provision margins often buoyed by rising rates and still benign provision levels. In the U.S. and in some other markets, while we expect competition for deposits will raise funding costs and hurt profitability, we are still expecting the industry to achieve a decent return on equity in 2023. For U.S. banks, deposits continue to

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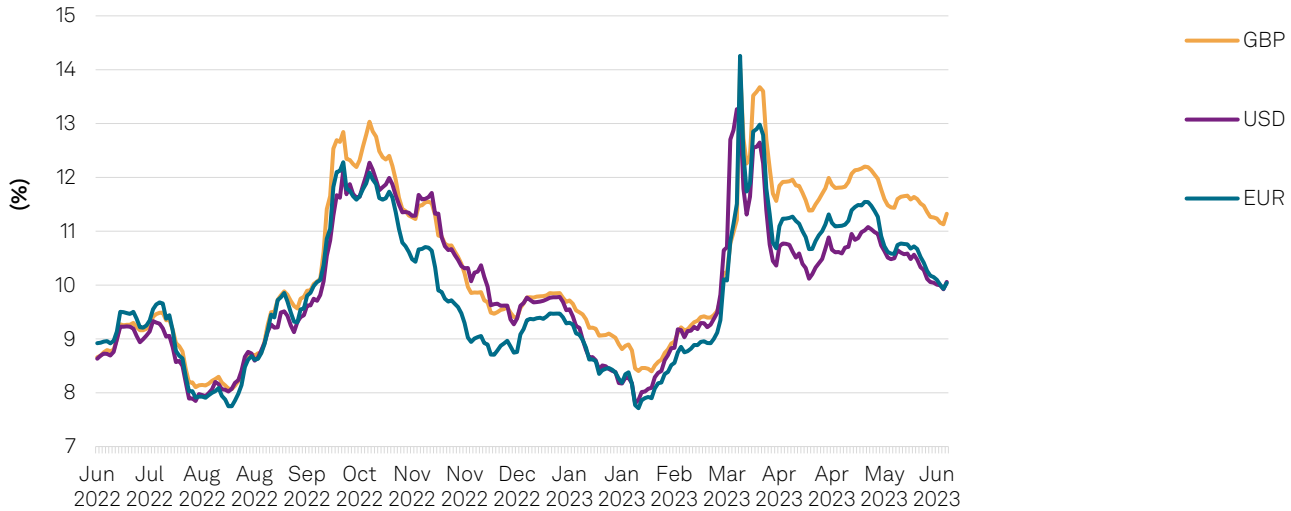
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decline (down about 2.5% in the first quarter), but the recent outflow has been at a more measured pace and within our expectations.

Separately, and contrary to our initial expectations, the full write-off of CHF16 billion Additional Tier-1 (AT1) capital instruments issued by Credit Suisse doesn't appear to have had lasting, material repercussions on the overall hybrid market (see chart 9). This was illustrated by strong demand for AT1 instruments recently issued by two European banks and a Japanese bank.

Chart 9

Pricing pain is easing gradually in the contingent convertible market



Source: S&P Global Market Intelligence Markit iBoxx Contingent Convertible, S&P Global Ratings Credit Research & Insights.

Regions Are On Different Paths

North America

Risks Versus Resilience

Credit conditions in North America look set to remain tight for the foreseeable future, with benchmark interest rates unlikely to fall any time soon, price pressures persisting, and lenders becoming more selective. But resilience in the U.S. economy is acting as a counterbalance for many borrowers.

For now, credit spreads remain fairly narrow. Bond spreads have tightened to levels below where they started the year--even for the riskiest borrowers.

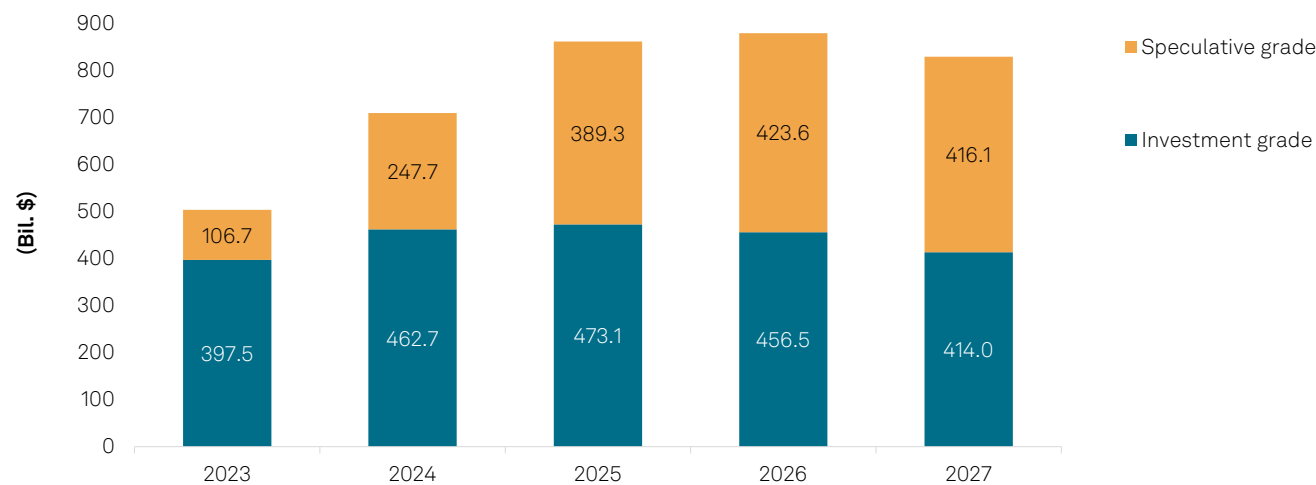
Still, with strained corporate earnings and mounting debt maturities, lower-rated borrowers could suffer liquidity constraints. Banks may strive to fortify their balance sheets and tighten their lending standards, which will make it more difficult for entities--especially small and midsize businesses, as well as households--to gain funding. We don't expect a full-on credit crunch, but some borrowers may find financing options much more costly or, in some cases, unavailable.

With benchmark interest rates unlikely to come down until mid-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 10). For the lowest-rated companies, refinancing at prevailing rates can constitute as much as a doubling of interest rate expense. Annual cash interest payments rose about 10% for North American nonfinancial corporates in the first quarter (see chart 11).

Companies are in the early stages of working through their upcoming maturity stacks. But we are starting to see cases of companies pushing refinancings closer to maturity dates to position themselves to capitalize on a potentially more favorable cost of capital.

Chart 10

Maturing debt by year in the U.S.



Data as of Jan. 1, 2023. Note: Includes bonds, loans, and revolving credit facilities that are rated by S&P Global Ratings. Source: S&P Global Ratings.

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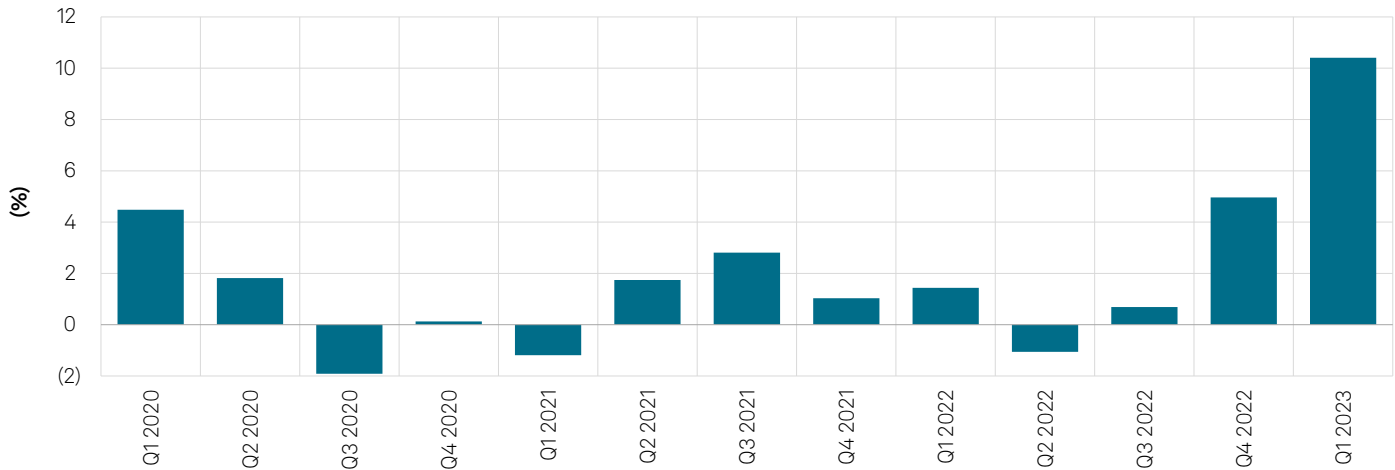
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Chart 11

Percentage change in cash interest paid

Cash interest paid (trailing 4-quarter, year-over-year %)



Data through May 31, 2023. Nominal data, measured in U.S. dollars at historic 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.

Europe

The Slow Burn Of Rising (Real) Rates

Although European economies, households, and enterprises have demonstrated remarkable resilience in the face of systemic shocks in recent years, the fallout from central banks' pursuit of price stability targets has yet to take full effect. Short rates are moving into restrictive territory--and are not expected to start falling until the second half of 2024--while real rates are turning positive.

From a credit perspective, we think this will translate into a growing divergence in ratings performance, coverage ratios, and spreads between investment-grade and speculative-grade entities. With the exception of real estate, investment-grade companies are seeing a positive ratings transition as they've benefited from their adaptability to slow growth, elevated inflation, and higher rates. Barring a recession and a substantial increase in unemployment (that we don't anticipate under our base case), we expect negative rating actions in investment-grade territory to be limited.

Concerns center mostly on speculative grade. The pain of higher financing costs will be most acute for highly leveraged entities that may generate little or no free operating cash flow and with maturities in the two years.

The outlook for key segments within European real estate is darkening. With rising interest rates, a price correction is underway in most European commercial real estate markets, and we think prices will continue to fall until the end of the year.

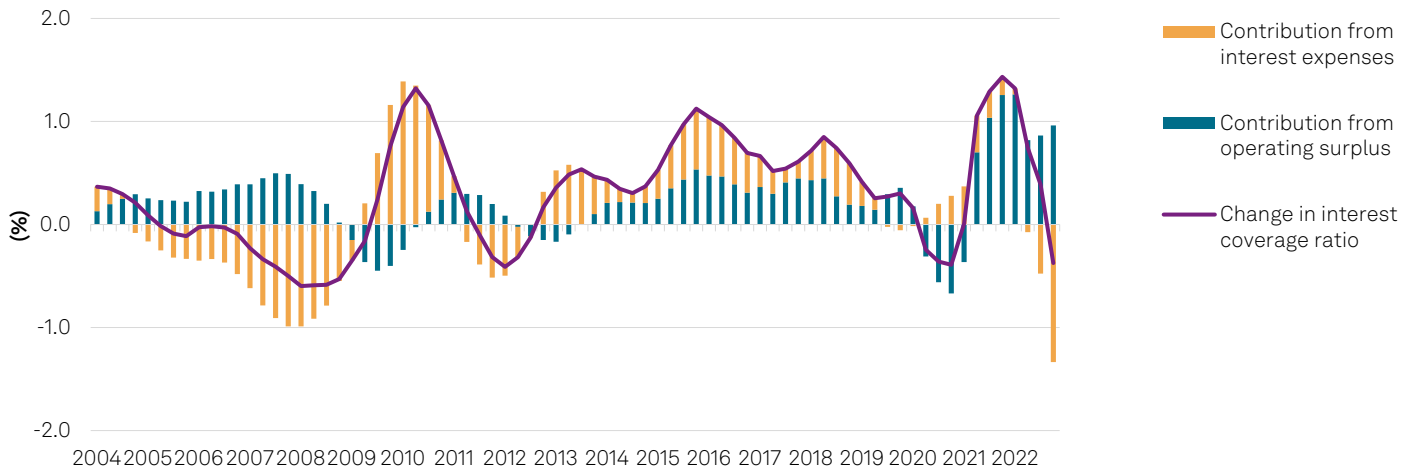
We maintain a stable outlook for the banking sector, reflecting improving profitability despite some deterioration in asset quality (including on commercial real estate) that is likely to modestly increase credit costs for banks. Most commercial real estate bank lending in the EU is from larger banks, which tend to have a greater capacity to absorb potential losses. But any surge in distressed sales could undermine market sentiment, exposing banks to higher credit losses.

The Russia-Ukraine war is entering a new and potentially dangerous phase as Ukraine seeks to go on the offensive to regain its territory, while sensitivities in Russia have edged higher following

the recent mutiny of the Wagner group. Our base case is that a military stalemate remains the most likely outcome, as both sides resign themselves to an extended war, but the unpredictable nature of the war keeps tail risks high.

Chart 12

Change in interest coverage ratio and its driving components



Source: S&P Global Ratings.

Asia-Pacific

China Grapples With An Uneven Recovery

Credit conditions across Asia-Pacific face evolving risks--desynchronized global growth, inflation, and policy interest rate trends--that are complicating the region's credit outlook. Weakening global demand and souring household sentiment will curtail export activities and consumption, hitting corporate revenues. Financial markets could stay volatile for longer if a protracted period of tighter liquidity recalibrates asset values and risk pricing, which would particularly hurt lower-rated and highly leveraged borrowers and prompt defaults to spike. Fears of a global hard landing could see business and consumer sentiments falter further, weighing on capital expenditures and consumption.

Although cross-border and domestic financing availability seem to have stabilized, further funding cost increases remain a risk. Offshore markets are raising their expectations for major central banks' terminal policy rates, affecting Asia-Pacific borrowers' access. Local currency financing access remains available but uneven.

Pricing challenges are most prominent for speculative-grade corporate entities, particularly because of virtually nonexistent issuance for the majority of this year (compared with nearly record-high levels for investment grade). One indication is the movement of Asian U.S. dollar bond spreads so far in 2023, which reflects investors' continued selectivity and risk aversion. If activity doesn't improve over the rest of the year and into 2024, dollar refinancing risks for lower-rated borrowers will rise when refinancing needs begin to increase.

The post-pandemic recovery will prompt the region's credit landscape to diverge even more. China's recovery should continue but remain uneven much of this year owing to weakened business and household confidence alongside high youth unemployment, with GDP growth of 5.2% (a decrease from our previous quarter's forecast of 5.5%). The country's property sector will

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continue an "L-shaped" recovery. Other Asia-Pacific economies are on track to slow because of the global slowdown and interest rate hikes.

Overall, we broadly maintain our outlook for a slowdown in Asia-Pacific (excluding China) to 3.8%, from 4.7% in 2022. Economies heavily exposed to constricted global trade, interest rate headwinds, and high inflation from increases in global energy and commodity prices will endure a more pronounced deceleration. Monetary policy risks prevail in Japan, which has maintained its near-zero interest rate policy, along with Australia and New Zealand.

From a credit perspective, lending growth could slow, and financiers' higher risk premia could keep refinancing costs high. While banks are still generally able and willing to lend, many regions' banks are becoming more selective.

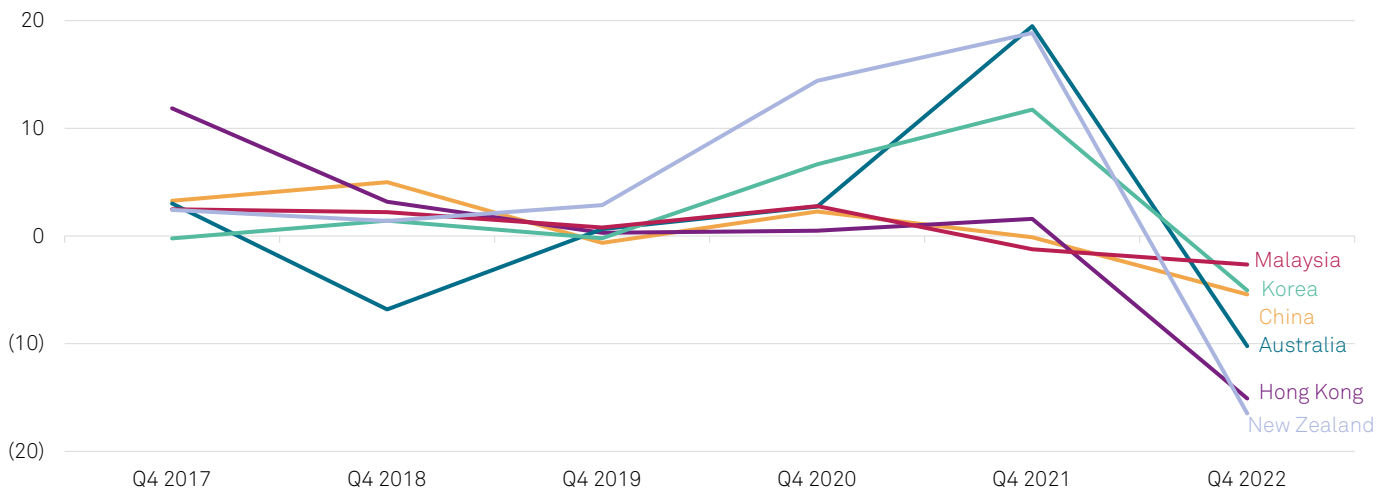
Slowdowns in some geographies' property sectors are reinforcing strains across Asia-Pacific's real estate sector, where properties face revaluation risk from high mortgage rates and oversupply (see chart 13). Office REITs are being squeezed by structural and cyclical strains, which will have implications for cash flows and asset valuation over the coming years.

Navigating geopolitical uncertainty and balancing energy and commodity supply and security will be key. Any intensification of tensions between China and the U.S. that are already weighing on business confidence and supply chains will affect investments, trade, and supply flows. Recent extreme weather across the region--high temperatures in major cities and floods in key areas--threaten agriculture production and energy supply, raising the chances of another round of global inflation. Globally, energy and food security concerns are complicating geopolitical relationships.

Chart 13

House prices across Asia-Pacific take a dip

Real residential property prices (y-o-y % change)



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

Emerging Markets

Inflation Peaked, Risks Remain

Credit conditions in emerging markets will remain tight through year-end, with weakening economic activity, tight monetary policy, and still-restrictive financing conditions. Although, inflationary stresses are cooling and risks are stabilizing.

Banks and domestic capital markets have provided critical financing, and corporations have remained resilient as cost pass-through continues. But, lower-rated entities are encountering difficulties in accessing capital markets, and recent refinancings show a steep increase in rates. We see two threats ahead: the Federal Reserve could further increase rates if inflation doesn't cool down, and higher interest rates could linger for longer, which would weigh on debt-laden businesses.

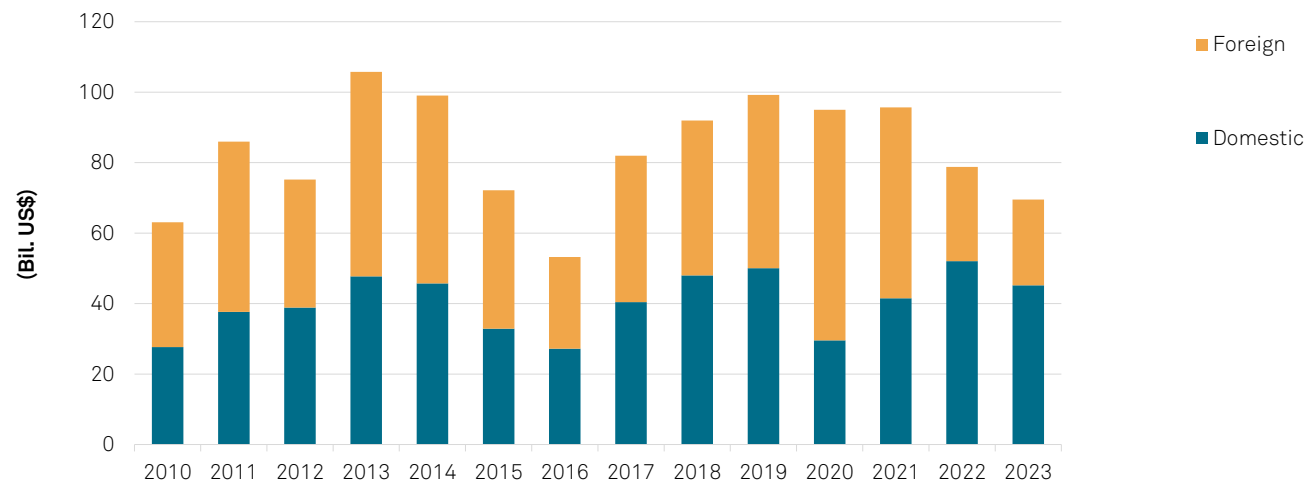
We expect real GDP growth to slow sharply this year in most emerging markets after remarkably strong performance in 2022, though China and Thailand are notable exceptions. We expect core emerging market countries in Europe, the Middle East, and Africa (EMEA) and Latin America to grow well below longer-run trends the next 12 months, while India and countries in Southeast Asia will grow a tad under their trends. We nudged down our 2023 growth forecast for China, though it is still above the country's 5% official target.

We expect financing conditions to stay tight in the third quarter with material divergence across regions. Latest readings confirmed a slowdown in inflation across many emerging market countries. However, levels are still above central banks' targets in many countries, likely forcing monetary authorities to hold the line, or limit rate cuts. Contrasting inflation and economic trends are likely to lead to diverging paths across regions and countries.

External surprises could complicate matters. Many emerging market central banks have enough cushion to begin easing their monetary policies. But higher interest rates in the U.S. and other advanced economies, including the eurozone, U.K., and potentially Japan, would strain financing conditions in emerging markets and make it difficult for central banks to ease monetary policy, fearing capital outflows and weaker currencies.

Chart 14

Domestic markets partially compensated for tight financing conditions abroad



Source: S&P Global Ratings.

Appendix 1:

Table 1

Updated GDP Forecast

Annual percentage change

	Latest forecast				Change from March 2023			
	2023	2024	2025	2026	2023	2024	2025	2026
U.S.	1.7	1.3	1.5	1.8	1.0	0.1	-0.3	-0.1
Europe								
Eurozone	0.6	0.9	1.6	1.6	0.3	-0.1	-0.1	0.0
Germany	-0.1	0.8	1.6	1.7	-0.1	-0.1	-0.2	0.0
France	0.7	0.9	1.5	1.4	0.2	-0.3	-0.1	0.0
Italy	1.0	0.6	1.3	1.3	0.7	-0.4	0.0	-0.1
Spain	1.6	1.3	2.3	2.2	0.5	-0.3	0.0	0.0
U.K.	-0.1	0.8	1.7	1.7	0.4	-0.7	0.0	0.1
Asia-Pacific								
China	5.2	4.7	4.7	4.5	-0.3	-0.3	0.0	0.0
Japan	1.2	1.1	1.0	0.9	0.2	0.0	-0.1	-0.1
India*	6.0	6.9	6.9	7.1	0.0	0.0	0.0	0.0
Emerging economies								
Mexico	1.8	1.5	2.1	2.1	0.5	-0.2	0.0	-0.1
Brazil	1.7	1.5	1.8	1.9	1.0	-0.2	-0.2	0.0
South Africa	0.6	1.7	1.7	2.3	-0.2	-0.4	0.0	0.1
World§	2.9	2.9	3.3	3.3	0.2	-0.1	-0.1	0.4

*Fiscal year, beginning April 1 in the reference calendar year. §World is in purchasing power parity terms, based on a sample of the 33 countries we cover (this no longer includes Russia).

Sources: S&P Global Market Intelligence, S&P Global Ratings (forecasts).

Table 2

Updated CPI inflation forecast

Annual percentage change (%)

	Latest forecast				Change from March 2023			
	2023	2024	2025	2026	2023	2024	2025	2026
U.S.	4.3	2.7	2.3	2.1	0.2	0.3	0.7	0.6
Europe								
Eurozone	5.8	2.7	2.0	1.8	-0.1	0.0	0.0	-0.1
Germany	6.5	2.9	2.0	1.6	-0.2	0.0	0.0	0.0
France	5.6	2.4	2.0	1.9	0.2	0.1	-0.1	-0.3
Italy	6.5	2.3	2.1	2.0	0.0	0.1	0.0	0.0
Spain	4.1	3.0	1.9	1.9	-0.6	-0.2	0.2	0.0
U.K.	7.0	2.3	1.6	1.9	1.2	1.0	0.5	0.2
Asia-Pacific								
China	1.2	2.8	2.1	2.2	-1.1	0.1	-0.1	0.0
Japan	2.8	1.5	1.5	1.4	0.0	-0.3	0.0	0.2
India*	5.0	4.5	4.5	4.8	0.0	0.2	0.1	0.1
Emerging economies								
Mexico	5.7	4.2	3.2	3.0	-0.7	0.1	0.0	0.0
Brazil	5.2	4.2	3.8	3.6	0.4	-0.3	0.2	0.1
South Africa	6.1	5.1	4.1	4.5	0.6	1.0	-0.3	0.0

*Fiscal year, beginning April 1 in the reference calendar year.

Sources: S&P Global Market Intelligence, S&P Global Ratings (forecasts).

Related Research

- [Global Economic Outlook Q3 2023: Higher For Longer Rates Is The New Baseline](#), June 28, 2023
- [Credit Conditions North America Q3 2023: Risks vs. Resilience](#), June 27, 2023
- [Credit Conditions Europe Q3 2023: The Slow Burn Of Rising \(Real\) Rates](#), June 27, 2023
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- [Economic Outlook Emerging Markets Q3 2023: A Slowdown Ahead After Beating Expectations](#), June 26, 2023
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