S&P Global
Ratings

Credit Conditions North America Q4 2023

Shift To Low Gear

Sept. 26, 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 Sept. 19, 2023.

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Key Takeaways

- **Overall:** Higher-for-longer interest rates, the possibility of recession, and lingering inflation, suggest credit conditions for borrowers in North America will likely deteriorate.
- **Risks:** As the maturity wall approaches, the costs to service or refinance debt could be overly burdensome, especially for lower-rated borrowers, in the current interest-rate environment. Commercial real estate (CRE) loan losses could rise amid higher financing costs, declining demand, and volatile market conditions for U.S. regional banks.
- **Ratings:** North American corporates' net outlook bias, indicating potential ratings trends, is at negative 10.1%, the highest since July 2021. We expect the U.S. trailing-12-month speculative-grade corporate default rate to reach 4.5% by June next year.

Credit conditions for borrowers in North America look set to slowly deteriorate, with all-in borrowing costs unlikely to fall any time soon, inflation continuing to erode consumer purchasing power, and investor risk appetite more guarded. Amid a push-and-pull between credit risks and economic resilience, much depends on whether the U.S. will reach an ever-elusive "soft landing."

The U.S. economic expansion will likely slip below-trend next year as consumers—who drive 70% of U.S. GDP—tighten their purse strings. Excess household savings have been largely depleted, student-loan payments restart next month, and there's been a surge in subprime auto loan and credit card delinquencies, especially among lower-income (and younger) Americans. Together, this sets the stage for a sharper pullback in spending that could lead to a deeper-than-expected slowdown or recession and weigh on revenues and profits in many consumer-reliant sectors at a time when labor and input-cost pressures, while easing somewhat, remain elevated.

The Federal Reserve remains wary on inflation. While policy makers have paused their cycle of rate hikes, holding the benchmark federal funds rate at 5.25%-5.50% last week, we forecast one more increase and don't expect the central bank to lower its policy rate until mid-2024 at the earliest, as core inflation continues to run above the Fed's comfort level.

The costs of debt service and/or refinancing could be overly burdensome in this "higher-for-longer" environment, especially for lower-rated borrowers. This is especially noteworthy given the approaching maturity wall. Borrowers have reduced near-term maturities—trimming speculative-grade corporate debt due in the second half this year and full-year 2024 by 31% and 23%, respectively. However, the share of speculative-grade debt coming due rises in coming years, reaching a peak in 2028. At the same time, North American nonfinancial corporates' annual cash

Contents

interest payments rose more than 15% in the second quarter, adding to the first quarter's 10% jump. It also remains to be seen how long the (pricier) private credit markets will be able to step in to meet borrowers' rising financing needs.

Downgrades continue to outpace upgrades, and the net outlook bias, indicating potential ratings trends, was at negative 10.1% as of Sept. 14 (see charts 1 and 2). This is especially worrying, since we rate 21.3% of U.S. corporates 'B-' or below. Among sectors, consumer products still has the highest negative bias—30% of its issuers have a negative outlook or are on CreditWatch with negative implications—while health care and chemicals saw the largest increase in negative bias in the third quarter (see chart 3).

Regarding rating actions, consumer products and financials led downgrades last quarter. The health care sector also saw a large jump in downgrades, with many from issuers rated 'B' or below that grapple with EBITDA margin pressures and higher interest expenses. On the brighter side, hotels and leisure companies (which fall into our media and entertainment category) enjoyed the most upgrades, reflecting still resilient demand supporting their recovery from the COVID downturn. Homebuilders also saw a large increase in upgrades, with two rising stars.

Ratings trends contact

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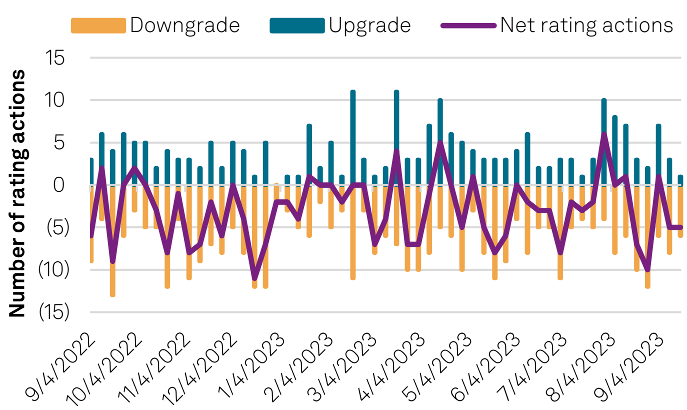
Chart 1

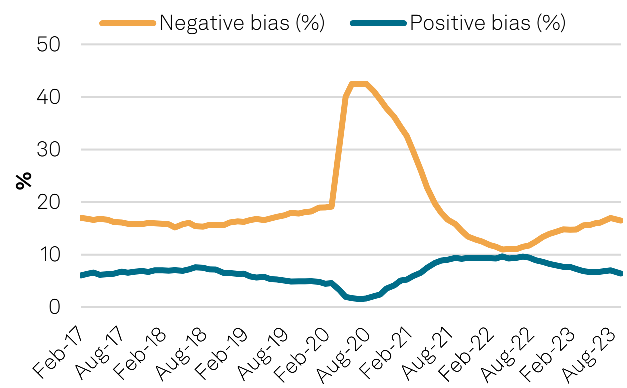
North American rating actions



Weekly data as of Sept. 14, 2023, and covers financial and nonfinancial corporates. Source: S&P Global Ratings Credit Research & Insights.

Chart 2

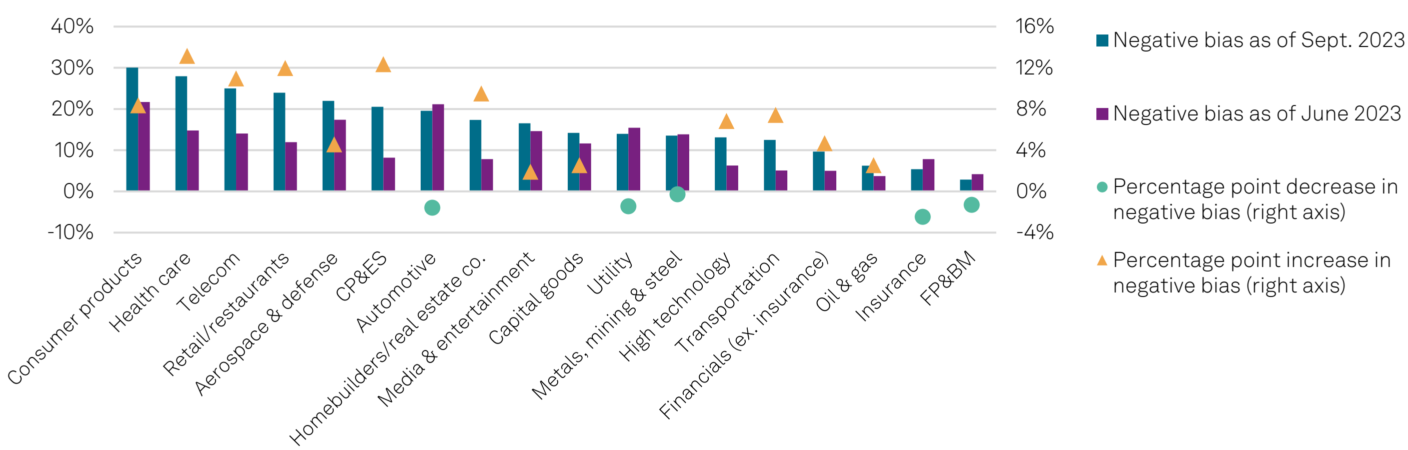
North American ratings outlook bias



Monthly data as of Sept. 14, 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 Research & Insights.

Chart 3

Negative bias by sector



Data as of Sept. 14, 2023 and June 30, 2023. 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 Research & Insights.

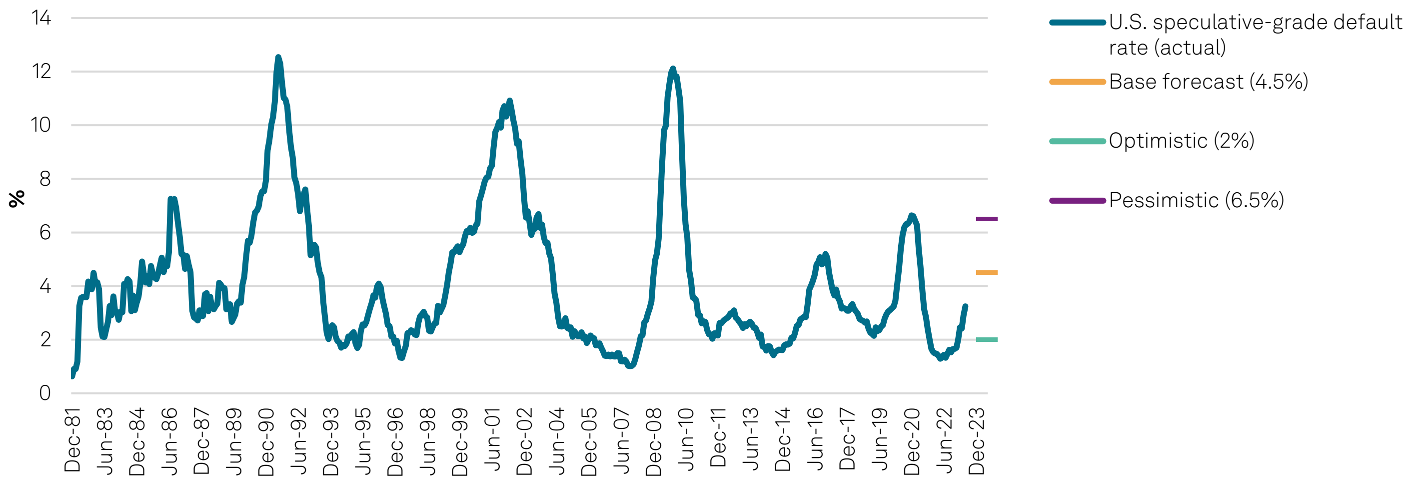
Defaults are rising, and credit quality could erode further. S&P Global Ratings Credit Research & Insights expects the U.S. trailing-12-month speculative-grade corporate default rate to reach 4.5% by June—slightly above the 4.1% long-term average (see chart 4). If, as we expect, unemployment rises and discretionary spending declines, consumer-reliant sectors, which make up roughly half of borrowers in the 'CCC/C' categories, will suffer most. But stress is being felt more broadly as well, as loan-heavy sectors like health care could also see more defaults. If the U.S. suffers a hard landing, the default rate could jump to 6.5% (our pessimistic scenario).

Thus far in 2023, most defaults have been first-time defaulters, or those who last defaulted years ago. Only about 9% are "repeat" defaulters, and nearly half of all have been selective defaults. It's likely that a large proportion of these recent defaulters will default yet again, particularly if cash flows decline further and borrowing costs stay high.

Chart 4

Defaults pick up into June 2024

U.S. trailing 12-month speculative-grade default rate and June 2024 forecast



Sources: S&P Global Ratings Credit Research & Insights and S&P Global Market Intelligence's CreditPro®.

On top of the prospect for higher for longer borrowing costs and the possibility of recession, **other risks to credit conditions include the squeeze that continuing cost pressures are putting on corporate profits.** Some borrowers are finding it difficult to pass along these costs to consumers and customers. If the hit to profits becomes more widespread and steeper than we expect, credit quality could suffer further.

Elsewhere, higher financing costs have weighed on asset valuations and heightened refinancing risk for most types of U.S. CRE. Declining demand for certain types of CRE—office space, in particular—is further weighing on asset valuations and curbing cash flows. All told, this may lead to elevated CRE-related loan losses for debtholders.

The U.S.-China relationship remains strained. Any further worsening of tensions, which were heightened by the U.S.'s recent restrictions on exports to and investment in China's advanced-tech sector, could disrupt trade, cause renewed supply bottlenecks, and crimp capital flows for both—and other—countries.

Top North American Risks

Higher financing costs pressure borrowers' debt-service capacity

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

With all-in borrowing costs likely to remain high for an extended period, the costs of debt service and/or refinancing could be overly burdensome for some borrowers. As earnings remain under pressure and debt maturities approach, lower-rated borrowers may feel more severe liquidity strains if investors become more risk-averse. Challenging financing conditions could also lead to significant declines in asset valuations, including a deepening correction in housing and CRE.

U.S. suffers a recession, further hurting demand

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

Higher interest rates and inflation continue to erode financial cushions and purchasing power. More subdued business investment and/or a sharper pullback in consumer spending could lead to a deeper-than-expected slowdown or recession, causing more credit stress. This comes amid slowing global growth—particularly in China. While the direct effects on the U.S. could be limited, China's slump could spread to multiple regions given the country's large proportion of global trade, thus affecting many of the U.S.'s important trading partners. The global slowdown could also have deleterious second-order effects through a hit to business and financial market sentiment.

Cost pressures squeeze profits, erode credit quality

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

For many corporate borrowers, input prices—including wages and energy costs—remain high, and some are finding it difficult to pass along costs to consumers and customers. If profit erosion becomes more widespread and steeper than we expect, credit quality could suffer further at a time when defaults and downgrades are rising.

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**

Higher interest rates/financing costs have weighed on asset valuations and heightened refinancing risk for most types of U.S. commercial real estate. Declining demand for certain types of CRE—office space, in particular—is further weighing on asset valuations and curbing cash flows. These factors, in combination, may lead to elevated CRE-related loan losses for debtholders, such as U.S. banks (with regional lenders having proportionately higher exposure to CRE than larger U.S. lenders do), insurers, REITs, and commercial mortgage-backed securities (CMBS).

U.S. bank failures erode sentiment, 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, and any renewed or heightened fears among stakeholders could further disrupt money flows, fuel market volatility, and weigh on consumer confidence and spending. As banks become more selective in lending to fortify their balance sheets and preserve liquidity, and also look to comply with more stringent proposed regulation, entities such as small and medium-sized businesses (SMBs), as well as households, may find it harder to gain funding.

Structural risks

Escalating geopolitical tensions impede trade and investment, weighing on growth

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

The U.S.-China relationship remains strained. Any further worsening of tensions over the South China Sea region and the Russia-Ukraine war, or the intensifying technology race (including the U.S.'s recent restrictions on exports to and investment in China's advanced-tech sector), could kink supply chains, and disrupt trade, and investment and capital flows for both—and other—countries. And while most borrowers in North America have limited direct exposure to the Russia-Ukraine conflict, the effects could deepen if an escalation (potentially involving NATO allies) occurs.

Climate risks intensify, energy transition adds to costs

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 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.

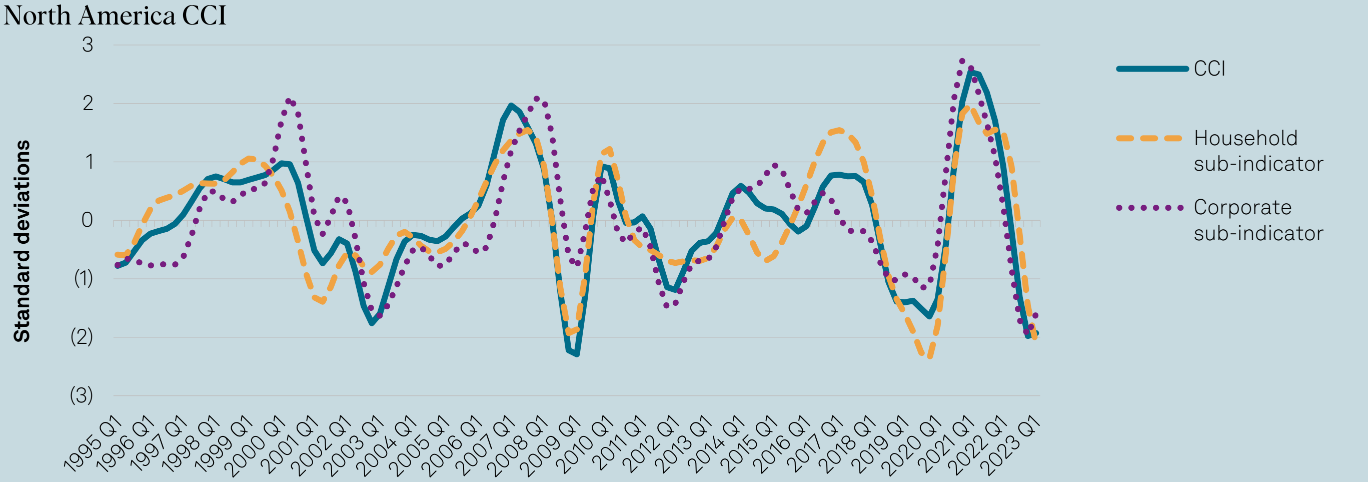
Credit Cycle Indicator

Credit correction likely continues into 2024; early signs of an upturn in 2025

A slight uptick of the North American Credit Cycle Indicator (CCI) ended the seven-quarter downward streak (see chart 5). However, the current credit correction seems yet to fully play out and could continue into next year. The impact on defaults and nonperforming loans from the buildup of debt leverage and asset prices could linger, considering the confluence of risks faced by North American borrowers (see Top North American Risks Section). Meanwhile, if the CCI trough firms up soon, we may see signs of a credit upturn around 2025, as historically the CCI tends to lead credit developments by 6-10 quarters. For more details about our proprietary CCI, see "White Paper: Introducing Our Credit Cycle Indicator," published June 27, 2022.

Chart 5

North America CCI



Peaks in the CCI tend to lead credit stresses by six to ten quarters. When the CCI's upward trend is prolonged or the CCI nears upper thresholds, the associated credit stress tends to be greater. Sovereign risk is not included as a formal part of the CCI. The CCI period ends in Q1 2023. Q1--First quarter. Q2--Second quarter. Q3--Third quarter. Q4--Fourth quarter. The North America CCI includes Canada and the U.S. Sources: Bank for International Settlements, Bloomberg, S&P Global Ratings.

Corporates. After a steady decline from the peak in the fourth quarter of 2020, the corporate sub-indicator increased to -1.6 standard deviations, mainly driven by higher equity prices. However, higher-for-longer borrowing costs in the face of looming maturity wall, along with more severe profit erosion amid demand and inflation headwinds could pressure corporate credit further. 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 continued to trend downward. While the resilience of consumers has been a bright spot of the economy, households' financial cushions are running thin as suggested by increasing credit card borrowings and rising auto loan and credit card delinquencies recently. Meanwhile, potential payment shocks for U.S. student loan holders (as the federal forbearance program came to an end on Aug. 31) and many Canadian homeowners (as their shorter-term, floating-rate mortgages come up for renewal) are also a concern. Lower-income and younger cohorts could be particularly challenged. In addition, any further correction of the U.S. and Canadian housing markets could damp perceived household wealth and have spillover effects across sectors.

Macroeconomic Outlook

- A U.S. economic slowdown is in the cards next year, with employment growth moderating, household net worth falling, and consumer discretionary spending set to decline.
- We now expect the U.S. economy to expand 2.3% this year (up from 1.7% in our June forecast), but we see growth declining to 1.3% for 2024. The balance of risks to our baseline growth forecast is tilted to the downside.
- We revised down our 2023 growth forecast for Canada to 1.2%, given a mild contraction in the second quarter, and kept our GDP growth forecast for 2024 at a still weak 1.2%.

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U.S.

U.S. economic data has been coming in stronger than expected. This suggests an ever-elusive soft landing is possible. After an economic expansion of more than 2% in the first half of the year, growth looks set to exceed 3% in July-December, which means that any slowdown will be pushed into 2024.

Still, said slowdown is sure to come. The tailwind from pent-up demand is poised to fade, employment growth is moderating, and the increase in subprime auto loan and credit card delinquencies suggests consumer discretionary spending will soon weaken. Moreover, student-loan payments restart next month at a time when excess household savings have been largely depleted. The balance of risks is clearly tilted to the downside—with the biggest threat being that if inflation proves even stickier than it has been, the Fed may raise rates even more and stay tighter for longer.

U.S. GDP growth will likely slip below trend for a drawn-out period. While we now expect the economy to expand 2.3% this year (up from 1.7% in our June forecast), we see growth declining to 1.3% for 2024—and we think the recovery will be gradual. We expect unemployment to rise to 4.8% by the beginning of 2025, above the longer-run steady state of 4%-4.5%. We see core inflation finally falling closer to 2.0% late next year.

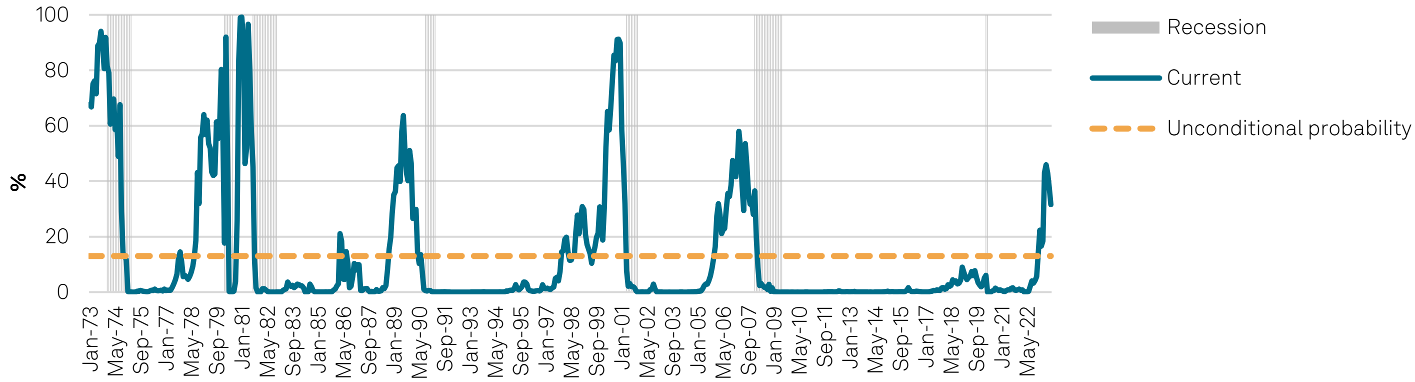
In our downside scenario, the upturn in energy prices would last long enough to slow recent disinflationary momentum. In turn, the Fed would feel compelled to raise policy rates higher than in our baseline scenario, which would hurt interest-rate-sensitive sectors and private investment more broadly. Growth would stall in the first half of 2024 and pick up only gradually thereafter—with full-year GDP eking out a 1% gain. A broad-based slowdown of this nature, combined with weak employment, would resemble the 2001 recession (as classified by the National Bureau of Economic Research).

S&P Global Economics' Business Cycle Barometer shows the probability of a recession starting in the next 12 months remains elevated at 30%-35% (see chart 6). Data from the key indicators suggest the current economic expansion is late in its cycle, indicating that any further short-run cyclical boost to growth is limited by the economy's underlying structurally driven growth potential.

Further weighing on growth prospects are the looming possibilities of a government shutdown and an expanded strike by the United Auto Workers (UAW) union. If the former occurs but is resolved within the same (fourth) quarter, GDP figures should be largely unaffected, as economic activity will be regained once furloughed federal workers receive their back pay—with little permanent loss of GDP. An expanded UAW strike, however, could hit the economy harder, shaving 0.1 percentage point per week from GDP.

Chart 6

Probability of a recession starting within the next 12 months



Data as of Aug. 2023. Source: S&P Global Ratings Economics. U.S. Business Cycle Barometer: Recession Risk Still Elevated Amid Uncertain Growth Prospects, Sept. 20, 2023.

On the bright side, the housing market seems to have found a floor (for now), the pace of inflation has halved, and the U.S. has undergone a boom in manufacturing construction. This includes production of semiconductors, electric vehicle batteries, and other electronics in the U.S. The effects of this boom are still to materialize and could be substantial. Public-sector spending on infrastructure is adding to growth as well, which we expect to continue in coming years.

The longer-term effects of these fiscal initiatives on the economy depends primarily on how much they add to productivity, and the "bang-for-the-buck" may be smaller than standard estimates once adjusted for where the U.S. is in the economic cycle. Either way, they are almost certainly tempering the speed of a cyclical slowdown.

At the same time, we expect the slowdown in China (the world's second-biggest economy) to have only a few direct effects on the U.S. economy, given that American exports to China—while rising sharply in recent decades—make up just about 7.5% of total exports in 2022. Still, slowing global growth generally could have deleterious second-order effects through a hit to business and financial market sentiment.

Canada

Canada is suffering more economic strife than the U.S., with the possibility of a technical recession (two consecutive quarters of contraction) markedly higher. On top of the hit to the economy caused by the historic coast-to-coast wildfires—likely the worst ever, in terms of land area burned—Canada's housing market has taken a much bigger hit than the U.S.'s, and this could weigh heavily on consumer discretionary spending.

Tight supply is underpinning home prices in both countries. But differences in the way mortgages are generally structured mean that an environment of rising interest rates hits Canadian homeowners much harder than it does their American counterparts. In the U.S., most mortgages on homes are 30-year fixed-rate contracts. In Canada, home loans come up for renewal frequently, sometimes as often as annually, with borrowers paying prevailing rates.

Given the Bank of Canada's aggressive cycle of rate hikes—the policy rate is now 5%, up from just 0.25% at the beginning of last year—mortgagors are rolling over their loans at sharply higher cost. This is compounding already elevated inflation on goods and services, and eating up discretionary funds that consumers could spend elsewhere.

We forecast domestic demand to slip 0.7% this year, with full-year GDP coming in at just 1.2% this year and 1.2% in 2024 (when domestic demand recovers to 0.4% growth).

Financing Conditions

- Narrowing bond spreads in secondary markets, alongside historically lackluster issuance, may reflect markets trying to squeeze the last bits of yield out of older bonds amid a growing share of newer, riskier options.
- Issuance has been dominated by refinancings, which are coming in with interest rates roughly 2 percentage points above those on the maturing debt, and floating-rate leveraged loans have been subjected to more than 18 months of rising interest payments.
- These higher rates and market dynamics will push defaults higher through mid-2024, and the tally could go higher still if economic growth hits any headwinds.

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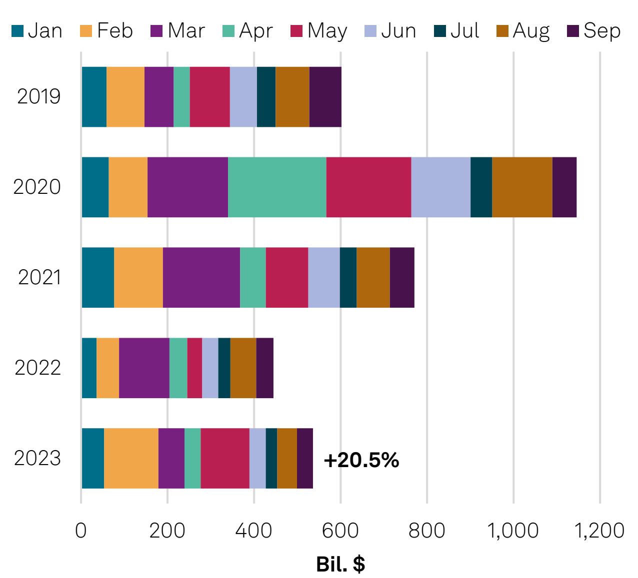
A sleepy summer that saw little movement. By and large, financial markets had a rather uneventful summer, with lower volatility among equities, and further tightening of corporate bond and loan spreads amid a quiet primary market. Treasury yields have moved slightly higher, while secondary yields on corporates remain largely unchanged.

Primary markets have had a slow summer. Though typically a season for a slower pace of issuance, this summer's totals look little different than 2022's multi-year drag (see chart 7). Nonfinancial corporate bond issuance is up more than 20% through mid-September, but this marks a relative decline to midyear, when issuance was up 32%. Bond issuance by financial services companies was comparably stronger in the third quarter, after many large banks posted solid earnings. Meanwhile, broader corporate earnings have fallen on a year-over-year basis for two straight quarters, in aggregate. A weak fourth-quarter in 2022 may support issuance growth in the near-term, but mixed signals are complicating investors' decision making, while issuers have to contend with the future course of interest rates .

Chart 7

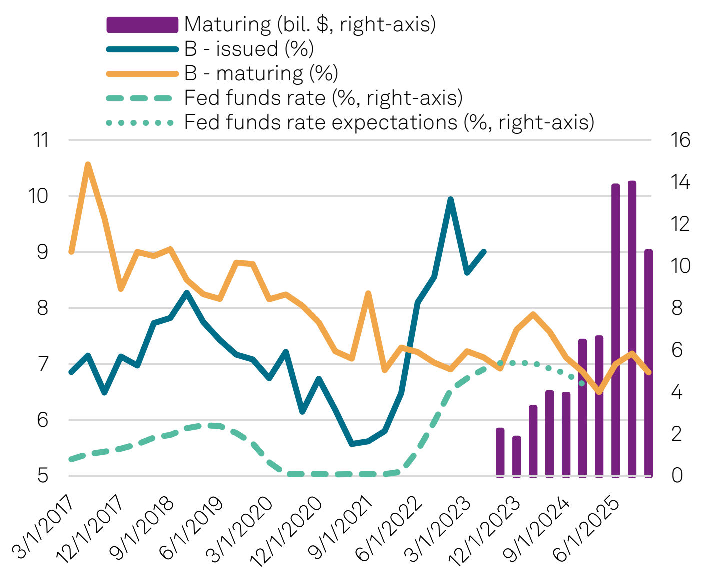
U.S. nonfinancial corporate bond issuance



Data through Sept. 14, 2023. Sources: Refinitiv, S&P Global Ratings Credit Research & Insights.

Chart 8

Some time to go before the “wall” approaches



Data through Sept. 11, 2023. Sources: Refinitiv, CME Group, S&P Global Ratings Credit Research & Insights.

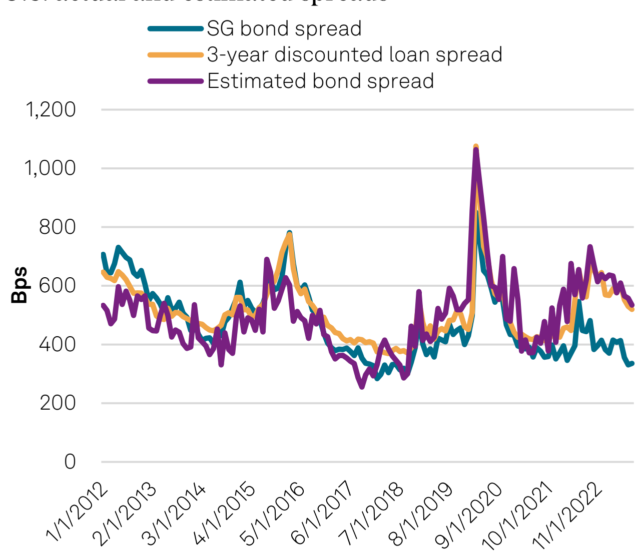
An unclear path ahead. Debt issuance this year by corporations has largely been used for refinancing, limiting organic growth from mergers and acquisitions or capital expenditures. This has helped bring down near-term maturities, even for lower-rated borrowers. But after years of refinancing at lower and lower rates, the past 15 months have seen primary market coupons roughly 2 percentage points higher than those on maturing debt (see chart 8). This rise has largely run alongside increases in the federal funds rate. Markets expect rates to begin to decline around mid-2024. Given that is still roughly 12 months ahead of the observed jump in bond maturities, it may prove tempting for issuers to hold-off coming to market to refinance their debt until then. But this is risky.

Markets have been right, but for how much longer? Through most of the post-pandemic period, bond spreads remained relatively low, particularly when pitted against our estimated spread (see chart 9). And since early 2022, these two series have moved apart again, to roughly 200 basis points (bps) through August. Similarly, bond spreads remain well below leveraged loan spreads—by roughly the same 200-bps gap.

Some divergence between bond and loan spreads seems appropriate given their different dynamics (fixed-rate payments vs. floating-rate) in the current environment. But as time goes on and more fixed-rate debt comes due amid higher rates, we expect spreads to widen as stress builds. Spreads appear overvalued against the 10-year/3-month Treasury yield curve (see chart 10). This has been both the "deepest" inversion of the curve, as well as the longest; and is typically a leading indicator of recessions as well as sharp spread widening. With economic growth and bond spreads showing resilience in the face of the inversion and other mixed signals, credit stress has remained modest. But with financing conditions tighter than spreads may suggest, a rising default rate seems unavoidable.

Chart 9

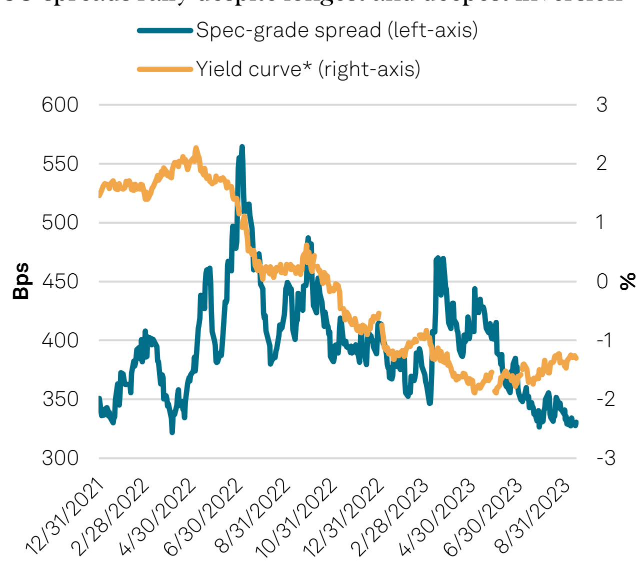
U.S. actual and estimated spreads



Data through Aug. 31, 2023. Sources: Pitchbook LCD, S&P Global Ratings Credit Research & Insights.

Chart 10

SG spreads rally despite longest and deepest inversion



*Yield curve defined as the difference between the 10-year Treasury yield and the 3-month. Data through Sept. 13, 2023. Source: Federal Reserve, FRED, S&P Global Ratings Research & Insights.

Sovereigns

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- In the event of a shutdown, we expect the federal government will continue to provide essential services and meet spending commitments (including paying for debt service) that don't rely on annual budgetary appropriations from Congress.
- A shutdown would stop or greatly reduce the government's ability to deliver many public services, as a substantial share of the federal workforce would be furloughed. Such an outcome would affect economic activity but isn't likely to affect the sovereign rating.
- Congress is unlikely to pass major fiscal legislation before the 2024 national elections, including reforms to tax laws needed to implement a global minimum tax.

Fiscal policy remains expansionary, with a central government budget deficit likely to exceed 5% of GDP this year. With persistent large fiscal deficits, the U.S.'s net general government debt is likely to approach 100% of GDP in the next couple of years.

Political disagreements may delay Congressional approval of a budget for the fiscal year beginning in October, resulting in a government shutdown. Unlike the impasse earlier this year over the debt ceiling, a shutdown doesn't raise the risk of a default. In a shutdown, we expect the federal government will continue to provide essential services and meet spending commitments (including paying for debt service) that don't rely on annual budgetary appropriations from Congress. A shutdown would stop or greatly reduce the government's ability to deliver many public services, as a substantial share of the federal workforce would be furloughed. Such an outcome would affect economic activity but isn't likely to affect the sovereign rating.

The government budget contains mandatory spending, which has been authorized either permanently or for multiple years by Congress. The budget also contains discretionary spending, which needs authorization every year. Due to the political impasse in Washington, Congress isn't likely to pass all the appropriations bills that set discretionary government spending for the fiscal year beginning Oct 1. In the absence of an approved budget, Congress typically passes a "continuing resolution" before the new fiscal year to temporarily fund the government. Congress likely will pass legislation to fund the full fiscal year (ending Sept. 30, 2024) by the end of the calendar year, largely in line with spending caps that were agreed upon earlier this year as part of a deal to raise the debt ceiling. Absent corrective measures, the government's deficit is set to rise in subsequent years due to more spending on health care and social security, partially offset in 2025 by the scheduled expiry of some tax cuts that were introduced in 2018.

Congress isn't likely to pass major fiscal legislation before the 2024 national elections, including reforms to tax laws needed to implement a global minimum tax agreed to by 130 countries. However, it is likely to approve further aid for Ukraine and perhaps changes to the regulatory framework for crypto currencies. Congress continues to hold hearings about potential rules and regulations for artificial intelligence (AI), as well. Although the novelty of the issue has perhaps limited the level of partisanship surrounding it, it's difficult to foresee what legislation may emerge from these hearings.

Despite intense partisanship, America's political leadership has advanced with policies where there is consensus or overlap in the priorities of the two parties. There is broad agreement on a toughening stance toward China (both economically and strategically), support for Ukraine, use of subsidies and tax breaks to promote certain industries deemed to be strategic, and spending on physical infrastructure. However, there is solid deadlock on immigration and social policies. Some estimates suggest that 5 million people have illegally entered the U.S. in the last two years, an influx that is changing social conditions in many urban areas and sparking calls for a more forceful response by the federal government.

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.

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Banks

Based on a review of our rated bank portfolio following second-quarter results—focusing on risks related to funding, liquidity, and asset quality—**we took rating actions on 10 banks** that we perceived to have risks in multiple areas that could make them less resilient than similarly rated peers. We lowered five of those ratings by a notch, revised the outlooks of two others to negative from stable, affirmed one with a negative outlook, and affirmed two others with stable outlooks.

Following those actions, and as of early September, about 90% of banks we rate have stable outlooks, and 10% have negative outlooks. The preponderance of stable outlooks reflects that although tough operating conditions have placed some strain on banks, stability in the U.S. banking sector has improved significantly in recent months, as evidenced by more modest deposit declines than initially feared.

Bank deposits continued to decline in the second quarter but at a more measured pace (down less than 1% sequentially) than appeared to take place following three relatively large bank failures in March and April. But to limit deposit declines, banks have had to increase the rates they pay in the face of rising yields on products such as money market funds and Treasuries, as well as competition from other banks. Also, the composition of bank deposits has shifted with a growing reliance on higher-yielding deposits such as CDs and brokered deposits, combined with a reduction in non-interest-bearing deposits. Banks have also increased their wholesale borrowing to bolster on-balance-sheet liquidity. The resulting rise in funding costs has pressured net interest margins (NIMs), which declined a median 13 bps in the second quarter.

Capital ratios for banks rose modestly in the second quarter (up 20 bps) and we expect banks to continue to build capital, not only as a defensive measure but also due to a likely tightening of capital regulation. For instance, regulators have proposed to eliminate the ability of many large banks to exclude unrealized losses from their capital ratios (the global systemically important banks and one other large bank already must count unrealized losses in their regulatory capital ratios). Notably, unrealized losses in banks' securities portfolios in the second quarter rose about 8% as long-term rates rose but remain below their peak nine months ago.

Credit quality, although still benign in most loan classes, will likely continue to deteriorate, causing banks to book higher provisions. Pressure points include higher interest rates, tightening economic conditions, and elevated inflation, all of which will likely hurt loan performance**.** We're highly focused on banks' exposure to CRE. For most banks we rate, we believe it would take a broader asset class decline to have a meaningful effect on bank credit quality. However, some are more exposed than others and could suffer negative ratings effects if CRE losses rise significantly. Most banks' criticized loans increased in the second quarter, and their allowance for CRE loans—particularly office—also increased.

Key risks for the banking sector 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 further profitability pressures, more challenges for asset-liability management and could increase losses in banks' securities portfolios.

Finance companies

We have stable outlooks on approximately 82% of the North American finance companies (fincos) we rate. Deteriorating asset quality, reduced earnings, and high interest rates continue to weigh on finance company ratings. We expect credit will remain tight as higher interest rates and slower economic growth will lead to lower deal flow and reduced capital deployment opportunities. We believe fincos with diversified revenue streams and sound balance sheets are best-positioned to meet the challenges over the next year.

We have stable outlooks on 11 business development companies (BDCs) we rate. Financing conditions for broadly syndicated loan and speculative-grade bond markets continue to be constrained due to high interest rates and economic uncertainty. Direct lenders are finding more opportunities to lend to larger companies or joining mega club deals. Increased loan sizes could create concentration and vintage risks, and larger loans are typically associated with more-relaxed covenants. In the first half, market trends and valuation marks were better-than-expected, but given the current macroeconomic environment, we expect valuations to be more volatile for the remainder of the year.

Interest coverage has declined as borrowers have limited ability to pass along higher inflation and interest rates, which has led to 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 asset coverage ratio.

Fundamentals continue to deteriorate for CRE lenders and services companies. We expect CRE lenders will prioritize maintaining liquidity over originations given the expected decline in property valuations and potential for margin calls. Of the six CRE lenders we rate, we have this year downgraded two by a notch and revised our outlook to negative on one issuer, reflecting potential liquidity strains, higher leverage, and deteriorating asset quality. We continue to see credit quality, especially in office loans, deteriorate as borrowers have difficulty making interest payments or repaying maturing loans. The companies we rate generally depend on secured financing in the form of repurchase facilities that often have an interest coverage covenant requirement.

The lagging impact of rising interest rates will further reduce the cushion to interest coverage covenant requirement. That said, we expect companies will work with lenders to amend the threshold by reducing it and remain covenant-compliant. We expect higher rates will stress CRE markets, contributing to higher cap rates and lower property valuations, and weighing on lenders—particularly those with exposure to office, retail malls, and hotels. Hence, we expect asset quality to deteriorate somewhat as the economic environment challenges borrowers in the next few years—likely meaning a rise in non-accruals and loan-loss reserves. We remain focused on credit deterioration, as it could lead to foreclosures or create the need for liquidity to meet potential margin calls.

We have taken negative rating actions on CRE servicing companies as the slowdown in CRE brokerage transactions has led to a sharp decline in earnings. This year, we have revised our outlook from positive to stable on three companies, revised one to negative from stable, and downgraded one company to the 'CCC' category for idiosyncratic reasons. For the remainder of the year, we expect the slowdown in CRE brokerage transactions will persist and that earnings for CRE servicing companies will be pressured.

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. For subprime auto lenders, we expect decline in used car prices to further pressurize their earnings. 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 above 7%, the highest in more than 20 years.

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

Asset managers

We expect U.S. equity market conditions to remain choppy for the remainder of 2023. Our view of the traditional asset management sector is negative, while we maintain our stable sector view of the alternative asset management and wealth management sectors. The economic backdrop remains difficult for asset managers due to high interest rates, tight credit conditions, and banking sector struggles. Market dislocations offer both challenges and opportunities for asset managers, however, as distressed valuations and the retrenchment of regional banks should 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 interest coverage has compressed for those with significant variable-rate debt exposure. We have taken several negative rating actions within this subsector year-to-date due mainly 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 generally locked-up nature of a large proportion 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 assets under management 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, potentially intensifying the competition. And, although many legacy real estate investments are likely to continue to face challenges, certain alternative asset managers are fundraising for real estate, as they perceive growing opportunities.

The sector has a generally low average annual volume of debt maturities in the next year. Most asset managers remain well-positioned from a liquidity perspective, with very few having to address near-term maturities. A few embraced debt-financed growth when rates were low. These managers could face higher debt costs at refinancing, which may be compounded if performance has also been weak. So far this year, one asset manager announced a distressed debt-for-equity exchange, though we don't expect distressed exchanges to become widespread.

Nonfinancial Corporates

- Operating conditions are mixed among nonfinancial corporate industries. Our expectations of a prolonged period of tepid economic growth are capping demand prospects and slowing efforts to overcome entrenched challenges.
- The strong labor market that kept the economy out of a broad recession as inflation soared is now beginning to moderate. All while certain sectors have been stifled by unsustainable labor costs and others deal with the uptick in labor disputes and strikes.
- Amid slowing economic growth and elevated borrowing costs, issuers have varying levels of flexibility to address their financing needs. As maturities increase, we'll see more varied outcomes in how refinancing requirements are resolved.

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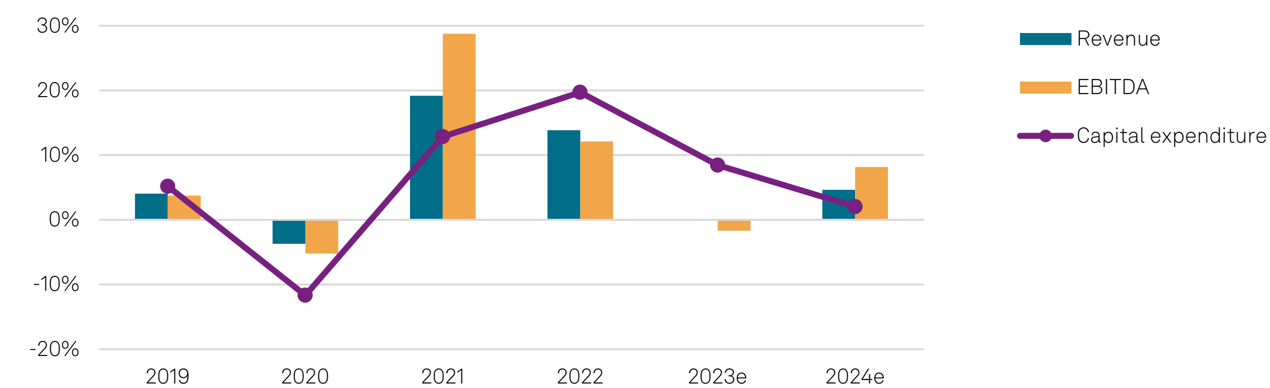
While many sectors will be squeezed by ongoing capital demands, a few industries are poised for moderate growth. Below-trend GDP growth starting next year would typically suppress sales gains, particularly for industrial sectors and others closely linked to macroeconomic expansion. At the same time, there has been a rise in capital spending as some companies that were highly aggressive in cutting maintenance spending at the toughest points over the past 24 months have to finally address these needs (see chart 11, and "Corporate Results Roundup Q2 2023", published Sept. 6); others must make growth or opportunistic investments despite expectations for limited consumer demand over the next few years. For speculative-grade companies that typically don't have the option to dip into excess cash for these expenditures, these decisions are affected by elevated financing costs. Oil and gas, and metals and mining companies must keep up with their exploration activities. Similarly, meeting energy-transition goals necessitates ongoing spending at the utilities and related industries, as does 5G upgrades for the telecommunications sector.

Chart 11

Capex has outpaced sales and EBITDA growth for North American corporates

Year-over-year change on revenue, EBITDA and capex (%)



e—Estimate. Source: S&P Global Ratings.

As has been the case for some time, **leisure and gaming remains the star sector**, continuing to post strong sales and earnings growth despite its dependence on discretionary spending. The sector was decimated during the pandemic and is rebuilding from a low base, so pent-up demand and a strong labor market buoyed by funds remaining from pandemic-related stimuli continue to drive the sector even as household savings begin to dwindle. The sectors bucking the trend with positive rating actions leading negative ones, are rounded out by oil and gas, and metals and mining, which are nonetheless slowing due do commodities prices coming off their peaks. On the other end of the spectrum, **consumer products companies remain embattled**; although the decline prompted by rising input costs, higher wages, and consumers trading down is moderating. As companies work their way through the rising maturities and we get deeper into the slow-growth period, other sectors are beginning to struggle. Specifically, **health-care services companies** are once again wrestling with rising wages, as is the media space, which had already been weakened by cutbacks in advertising spending so much so that the future of traditional TV and cable is uncertain.

Two factors have emerged as undercurrents through the entire rated portfolio: First, an increasing number of sectors are facing labor issues as a defining operational challenge; Second, although we have anticipated the rising cost of capital would result in mounting pressure on lower-rated companies, the consequences of this pressure have increased the incidence of selective defaults.

Labor has been a sticking point for many industries. The Writers Guild of America strike (now seemingly resolved) started in May at a time when the media sector was already vulnerable facing secular challenges magnified by an ad recession (see "Second-Half 2023 Media Outlook: Secular Challenges Magnified By An Ad Recession", published July 10). In late August, UPS employees approved a new contract covering close to 350,000 employees and averting a strike that would have caused widespread disruptions. And the United Auto Workers (UAW) union this month began strikes against Ford, General Motors, and Stellantis, with negotiations ongoing (see "How Will The United Auto Workers Strike Impact Ratings In The U.S. Auto Sector?", published Sept. 15). As is usually the case, wages are a key sticking point in all of these cases.

While somewhat less severely, a number of other sectors continue to face high or medium amounts of pressure due to rising labor costs or shifting labor requirements (see chart 12). For **transportation**, both higher labor costs and excess capacity have been headwinds. Our outlook on **health-care services** has turned negative, given the hit to margins and cash flows from worse-than-expected labor challenges. Issuers in the sector have had mixed success offsetting labor expenses with cost efficiencies. Labor costs are moderating but remain elevated. Lastly, **airlines have recovered** driven by the same fundamentals that boosted the leisure and gaming spaces. In this case however, rebuilding capacity has been constrained by supply-chain challenges related to procurement bottlenecks and labor issues.

Chart 12

Nonfinancial corporate sectors' labor concerns over the next year

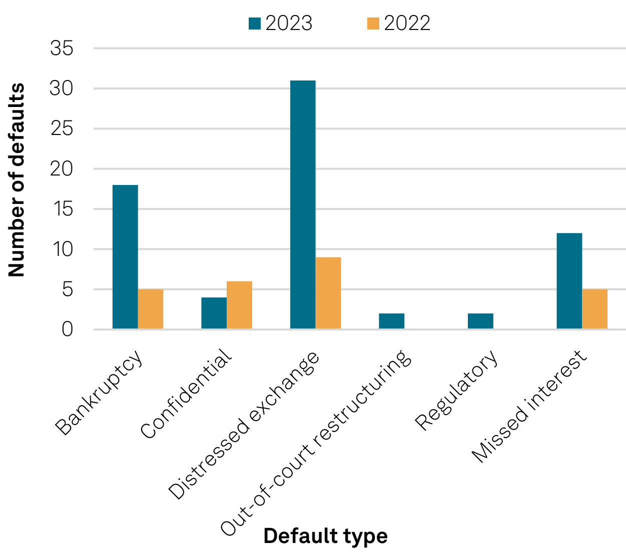
Level \ Trend	Worsening	Unchanged	Improving
Mid	• Unregulated power	• Business and tech services • Capital goods • Consumer products	
High	• Metals and mining	• Autos • Health care services • Transportation	• Aerospace and defense • Media

Note: The level of labor concerns reflects the extent to which we expect credit quality will be affected by factors such as inability to find skilled labor, prohibitive labor costs, strikes and labor disputes or restructuring costs from having to reduce or redistribute labor. The trend reflects whether the concern level could increase or decrease over the next 12 months. Source: S&P Global Ratings.

Investment-grade issuers have mitigated rising debt-service costs by resizing their balance sheets and repurposing their cash; however, **lower-rated issuers are struggling to address maturities.** Year-to-date, there's been a 176% spike in U.S. defaults compared to 2022. The largest component of defaults has been distressed exchanges (see chart 13), indicating that many issuers are compelled to restructure their balance sheets when facing upcoming maturities. We expect the trend to continue until the maturity peak in 2026, as interest rates remain higher for longer. Media and consumer products companies lead defaults, consistent with those sectors facing the most long-dated or acute levels of pressure (see chart 14).

Chart 13

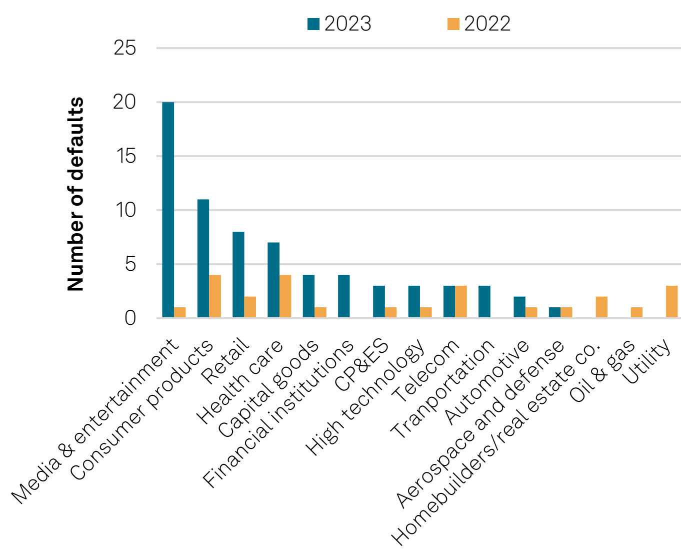
Distressed exchanges drive rising defaults in the U.S.



Data through Aug. 31, 2023, and covers the U.S. Source: S&P Global Ratings Credit Research & Insights.

Chart 14

Media and consumer products companies lead defaults



Data through Aug. 31, 2023, and covers the U.S. CP&ES—Chemicals, packaging & environmental services. Source: S&P Global Ratings Credit Research & Insights.

Public Finance

- Credit conditions have been largely stable, and upgrades have exceeded downgrades this year for most U.S. public finance (USPF) sectors.
- Higher interest rates and inflation continue to be headwinds for most issuers from a debt-issuance, and operating and capital budget perspective. Federal stimulus and healthy financial reserves continue to provide significant flexibility.

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Most USPF sectors remain stable, leaving only transportation and not-for-profit health care with negative sector views. The sector view on higher education remains mixed, with notable credit quality bifurcation between stability at the higher end of the ratings scale and prominent pressures at the lower end. However, even with a forecast for a shallower but more protracted economic slowdown, for most issuers we don't expect credit quality or stability will be impacted.

Federal stimulus continues to support credit quality across state and local governments, particularly when inflationary pressures persist. Spending requirements for money received by municipalities from the American Rescue Plan Act run through 2026, but for school districts and charter schools the deadline remains end-2024.

If a confluence of issues related to natural disaster results in a reduced—or slower—response, there could be an impact on credit stability for some issuers. U.S. wildfire season is ending, but hurricane season continues and Canada's 2023 wildfire season shattered records. Although we incorporate an entity's risk-management plans and financial readiness to respond to these events into our credit analysis, the effects can lead to ratings pressure. As losses from natural disasters mount, there has been talk about the direction of federal disaster relief funding in the U.S. and Canada; if the terms or availability of this critical support change meaningfully, it would put additional pressure on insurance and state and local governments alike. Given many insurers are already limiting new policies in some states, the availability of insurance to protect against significant catastrophes is increasingly under pressure.

Chart 15

Credit issues that matter

Looming federal government shutdown
A budget impasse for the U.S. government is unlikely to affect operations directly, but contentious budget negotiations can increase the possibility of cuts to programs and entitlements that lead to rising costs for state and local governments.

Ongoing slowdown in consumer spending
Overall, U.S. sales tax collections have been flat, but we have observed some variation among governments; personal income taxes are showing more change to date and are down 50% year-over-year. In Canada, we expect growth will weaken this year and remain subdued into next, at a time when labor costs in particular have not yet caught up with inflation. Labor costs lagging inflation in both the U.S. and Canada could lead to a weakening economic picture in the year ahead.

Higher-for-longer interest rate expectations foretell ongoing pressure
Higher interest rates and inflation remain headwinds for most issuers, in particular for new debt issuance and the affordability of capital projects.

Rising costs pressure balance sheets and can create budgetary imbalance
Increased labor and materials costs contribute to a higher cost of doing business. Issuers experiencing slower, or stagnant, revenue growth will be challenged to adjust to even tighter operating margins.

Pace of return to office continues to pose long-term uncertainties
Falling commercial real estate valuations, particularly in the downtown core, could become a growing problem for cities experiencing a stark contrast between pre- and post-pandemic. If valuation changes lead to falling revenues, credit stability could be affected.

Source: S&P Global Ratings.

Structured Finance

- Higher benchmark interest rates and capitalization rates have weighed on asset valuations and heightened refinancing risk for most types of U.S. commercial real estate.
- Specific to office, declining demand for space is further weighing on valuations via lower occupancy and rents.
- We generally expect stable or somewhat negative rating trends over the next 12 months, with most rating actions in the speculative-grade space.

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The outlook for North American structured finance collateral performance is similar to that in the second quarter. This reflects our base-case economic forecast for low growth (as opposed to mild recession) with generally benign overall unemployment rates. As a result, we have most sectors showing stable or somewhat weaker collateral performance (see table 1). However, distress may be more acute for certain sectors, especially those that are more sensitive to a higher-for-longer interest rate environment.

Overall, we generally expect stable or somewhat negative rating trends in the next 12 months, with most rating actions in the speculative-grade space**.** As alluded to above, we don't expect risks to be uniform across sectors.

CRE is the most stressed, although at present most of the distress is focused on specific property types. That said, higher benchmark interest rates and capitalization rates have weighed on asset valuations and heightened refinancing risk for most types of U.S. commercial real estate. Specific to office, declining demand for space is further weighing on asset valuations via lower occupancy and rents. And all but the best regional malls continue to struggle to find long-term refinancing capital.

Table 1

12-Month North America structured finance outlook – Q4 2023

	Collateral performance outlook	Rating trends
Residential mortgages (RMBS)		
RMBS	Stable	Stable to positive
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	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 to negative

FFELP—Federal Family Education Loan Program. Source: S&P Global Ratings.

On the CLO side, high interest rates and their potential impact on refinancing leveraged loans, persistent cash flow deficits, and slower earnings growth among the weakest loan issuers, the considerable growth of CLO 'CCC' exposures, and a still elevated 'B-' bucket, remain of interest.

With regard to auto loan asset-backed securities (ABS), subprime losses have surpassed June 2019 pre-pandemic levels, and the deterioration wasn't confined to the deep subprime space, because the modified subprime composite, which excludes the three large deep subprime securitizers (Exeter, Santander's Drive platform, and American Credit Acceptance) reported record high July losses. In addition, 60-day-plus delinquencies rose to the highest ever July level in our composite for subprime. While the month-to-month deterioration is expected due to seasonal patterns as we move further away from tax-refund season, subprime losses rising above pre-pandemic levels is concerning. We attribute this trend to diminishing COVID-related savings, inflationary pressures, growth in lending from 2021 through first-quarter 2022, and lower recoveries. Still, rating trends for the sector remain stable.

Insurance

- The U.S. and Canadian life insurance sectors face a mixed environment in terms of factors that could affect their credit profiles.
- Strong rate momentum for most commercial lines continues to match or exceed loss cost trends, resulting in improved underwriting profitability for property/casualty insurers.
- Much-needed structural changes in reinsurance underwriting, including tighter terms and conditions and repricing of risk, have shifted pricing power back to reinsurers.

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There was one rating change (Allstate Corp. downgraded by one notch) in the three-month period ended Aug. 31. Also, we updated our current business conditions outlook for global reinsurers upward to strong from weak and revised our sector outlook to stable from negative (see table 2).

The average financial strength rating for the core North American insurance portfolio—life, health, property/casualty (P/C)—is at the upper half of the strong ('A') category. This reflects stability for the three-month period ended Aug. 31. Most (80% or better) of our ratings for the core portfolio maintain stable outlooks. Though a negative bias, which emerged mid-year 2022, persists for P/C insurers, with the sector outlook negative since October 2022.

Major rating factors include pricing, capitalization, acquisitions/share repurchases, rising interest rates, and catastrophe risk. We believe there to still be broad access to capital for this mostly investment-grade portfolio of companies that in general aren't highly leveraged. Balance-sheet strength has diminished in connection with portfolio devaluation but continues to underpin credit-quality support for the portfolio, providing a measure of protection from risks related to downside economic developments broadly, as well as the expansion or increase in the magnitude of specific current and emerging subsector risks more specifically.

Table 2

North America insurance sector trends – Q4 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	Strong	No change	Stable
Bond insurers	Satisfactory	No change	Stable
Title insurance	Satisfactory	No change	Stable
Mortgage insurers	Satisfactory	Somewhat weaker	Stable

Note: Business conditions and sector outlook are for the next 12 months. The shaded cell indicates changes since Q3 2023.
Source: S&P Global Ratings.

Life insurance

The U.S. and Canadian life insurance sectors face a mixed environment, in terms of factors that could affect their credit profiles This includes high interest rates, choppy equities markets, global geopolitical uncertainty, and the potential for a slowing economy. We believe these forces will largely balance each other out, and we don't anticipate a significant number of ratings changes for life insurers in the coming months.

Higher interest rates, compared to the pandemic and pre-pandemic era, continue to fuel healthy sales of fixed annuities and other institutional spread-based products. Life insurance sales have slowed compared to the previous two years.

The life industry does have meaningful exposure to CRE—with roughly 16% of invested assets across commercial mortgage-backed securities (CMBS), commercial mortgage loans (CMLs) and real estate equity. Office 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 in insurers' CML portfolios, they should be manageable.

Health insurance

The U.S. health insurance industry remains on stable footing based on favorable revenue growth prospects, strong cash flows, and sound balance sheets. Continued strength in employment bodes well for commercial membership growth, while the aging of Baby Boomers continues to support robust Medicare enrollment growth. In Medicaid, we expect a significant number of Americans will lose health coverage due to the Medicaid redeterminations process (to confirm eligibility), which will take place from May 2023 for 12-14 months.

From an earnings perspective, health insurers continue to vary in claims trends, with differences by geography and product line. In Medicare Advantage, many insurers have noted higher-than-expected outpatient utilization from pent-up demand and improved provider capacity. In Medicaid, insurers have noted potential claims pressure from Medicaid redeterminations.

On M&A, the industry remains relatively acquisitive; however, leverage and integration risks remain balanced by strong cash flows and the manageable tuck-in aspect of many deals. Health insurers are using M&A to strengthen their core businesses and to diversify into non-insurance lines, including primary care, home health, and health care technology. These provide some element of virtual integration, as well as unregulated cash flows, which can be useful for financial flexibility and capital deployment.

P/C

In October 2022, we revised our view on the U.S. P/C sector to negative from stable, reflecting our expectation of weaker credit trends in the ensuing 12 months. Since then, there have been six negative outlook changes and three ratings downgrades. Underwriting profitability of P/C insurers deteriorated in 2022 and a record 15-point divergence in the average combined ratios 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 for insurers in that sector.

Offsetting the strength in commercial lines has been 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 losses remained elevated for the third year in a row, a trend that has continued in the first half of 2023. The industry overall posted an underwriting loss for 2022, with a combined ratio of 102.7%. 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 in 2023 but not achieve profitability until 2024.

We expect underwriting performance for commercial lines writers to be similar to 2022. However, the industry combined ratio deteriorated to 104.4% for the first six months of this year, and we now expect the full year 2023 ratio to be in the 102%-105% range. Capital at year end 2022 was down due to the impact of higher interest rates on bond valuations. This has weighed on our view of capital adequacy at year-end 2022 for some insurers and could lead to outlook or rating changes if we do not expect capital to be restored over the next three years to a level supportive of their current rating.

Global reinsurance

We changed our view of the global reinsurance sector to stable from negative because we expect it will earn its cost of capital in 2023-2024. This followed the 2023 renewals, during which there were much-needed structural changes in reinsurance underwriting, including tighter terms and conditions and repricing of risk, resulted in the hardest market in decades in short-tail lines, shifting pricing power back to reinsurers. We based the revision on favorable P/C reinsurance pricing conditions, pre-pandemic earnings levels in life reinsurance, and increasing net investment income.

We expect recent structural changes to provide a long-lasting tailwind, but elevated natural catastrophes, increasing cost of capital, financial market volatility, and inflation risk persist. Mark-to-market losses eroded aggregate capital buffers for the reinsurance sector to a position just redundant at the 'AA' confidence level at year-end 2022, but some of those losses are beginning to unwind, and improving operating results should sustain the industry's capital adequacy. While we believe the recent structural changes should allow the industry to better earn its cost of capital, reinsurers must navigate complex and increasingly unprecedented conditions to sustainably post returns that exceed their cost of capital.

Bond, title, and private mortgage insurers

Bond insurers continue to benefit from growing demand in the USPF market. High interest rates continue to be a headwind for most issuers from a debt-issuance perspective. We expect demand will remain high given wider credit spreads and macroeconomic uncertainty. Insured issues within the USPF market represent greater than 90% of total par insured by the bond insurers in recent years with the underlying credit quality of the insured issues remaining at 'A'/'A-'. While pressures related to inflation or the lower consumer spending could affect collections of economically sensitive revenues, the bond insurers' underwriting strategies and conservative capital management plans are supportive of the potential growth in exposure.

The overall profitability and financial strength of title insurers depends on their ability to manage operations through the mortgage and economic cycles, as well as to employ proper risk and underwriting controls during periods of high business volume. Title insurers' efforts have served them well, as pre-tax margins, though lower than 2020-2021, are strong. Economic uncertainty, high interest rates, and low inventory continue to be key factors that have seen existing-home sales fall. These factors shape our view that business volume will be down from 2022. However, capitalization in the sector remains robust, benefiting from low losses and a profitable business.

Private mortgage insurers (PMIs) continue to benefit from a resilient economy, with a relatively strong labor market. Mortgage delinquencies remain lower, and cure rates continue to outpace delinquencies. While home prices have moderated, loan portfolios continue to have substantial home-equity cushions, which will help reduce losses for PMIs in stress periods. Rising mortgage rates have reduced refinancing originations and have amplified affordability challenges. As a result, mortgage originations have slowed considerably, resulting in tepid new premium volumes, offset by increasing persistency levels (lower lapse rate in current portfolio).

In the first half, PMIs' profitability remained robust, continuing to benefit from the release of the pandemic loss reserves as those borrowers restarted making mortgage payments. However, our view on the prospective profitability is tempered by the expected headwinds in economic conditions, particularly because if unemployment rises, mortgage delinquencies could increase and result in elevated losses. Therefore, under our base case, we expect the sector's combined ratio could range 45%-50% in 2024-2025. While the losses are expected to increase, we believe they could be contained within PMIs earnings, and not hinder their capitalization.

Related Research

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- Economic Outlook Canada Q4 2023: Sluggish Growth Ahead, Sept. 25, 2023
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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	The outlook for commercial aerospace is generally stable as companies navigate robust demand amid ongoing supply constraints. Strong new aircraft orders have contributed to backlogs for planes that extend beyond this decade and should translate into material future cash flow growth. Airlines continue to refresh and expand their fleets toward newer, more fuel-efficient aircraft. The post-pandemic recovery in travel has also driven heightened demand for aftermarket parts and services. On the other hand, supply chain challenges (namely labor and procurement, including critical parts defects) remain a constraint to earnings growth likely through next year. Issues with newer aircraft-engine reliability have heightened and pose a headwind to capacity expansion for airlines and engine producers' margins. Defense companies also face inefficiencies related to supply constraints, but the impact has been less acute on earnings and cash flow. Expected ratings stability incorporates a higher U.S. defense budget requested for 2024 (3.2%) and higher spending by European allies that lends support for steady revenue and demand. In addition, it reflects estimated shareholder returns that are likely to be more pronounced relative to the broader commercial aerospace sector.
Autos	We expect fairly steady credit quality across the sector, despite slowing volume growth and the potential for near-term disruption from the union strike. Most issuers have sufficient liquidity, low inventories, and their ratings 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 modestly 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 early 2024 as most companies 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 limited by higher interest rates and pricing pressure amid potential demand volatility once supply gradually normalizes. For automakers 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 economic conditions, higher costs related to electric vehicles (EVs), and potentially higher costs associated with the new contract with the UAW. 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 in the next 18 months. Suppliers will likely start to show improvement in both margins and free cash flows 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 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.
Building materials	Slowing operating fundamentals and a weakened ability to manage inflationary pressures are constraining building materials companies' profitability. Spending on renovations has come under pressure as consumers shift spending toward travel and dining. Even though volumes have weakened, higher prices are providing some offset for top-line growth and profits. Despite weakness in the residential end market, existing backlogs will likely support nonresidential construction spending, limiting revenue declines we expect for 2023. Companies that focus on nondiscretionary products, such as roofing or HVAC, should remain more resilient than manufacturers of more discretionary products, such as kitchen cabinetry and bath wares. storm activity has contributed to higher demand for repairs, particularly for roofing manufacturers and distributors. Despite some margin pressure, we expect relative ratings stability for the sector given that more 90% of ratings have stable outlooks. However, we see potential for more negative rating actions based on slowing operating fundamentals and diminished ability to manage inflationary pressures.
Business and technology services	Our sector ratings outlook bias is shifting increasingly negative, due to higher interest rates and slowing economic growth. For instance, in North America, the negative bias for business and technology services issuers rose to over 20% at the end of August, from 13% a year earlier, reflecting our expectation for greater pressure on margins and cash flows. Higher interest rates for most issuers, inflationary challenges, rising wages for labor-intensive operations, high gas prices for distributors, and cyber risk for some information, payment, and technology-service providers remain key risks. This will weaken cash flows for several issuers and slow the deleveraging assumed in our ratings. Demand remains steady, and we expect median revenue growth of about 5% this year, aided by increased market penetration, stable retention rates, cross-selling, and higher pricing for many companies. Companies will mostly pass costs to customers by year-end, although intra-year earnings volatility is likely as price increases gradually reset. Several issuers also can quickly reduce idle capacity in their labor forces, which aids near-term earnings visibility. As a result, we expect a year-over-year increase in EBITDA margins for roughly two-thirds of issuers we rate given the digitalization of their workflow/services and lower staffing requirements, partially offset by inflationary pressure. A few issuers, especially in

	the U.S., have also cut capital spending modestly to adjust for the lower backlogs or order delays. Based on our assessment of inflation and labor market risks, we believe distributors, facilities maintenance providers, and software and information services providers are most vulnerable to downside risks. Conversely, we believe the impact on companies providing education and publishing services, security and safety services, insurance services and payment services will be minimal. Despite these factors, given the outsize impact of higher interest expenses, we still expect about 57% of the U.S. issuers we rate to report year-over-year free operating cash flow declines in 2023. Lower-rated companies have sharply cut M&A, although higher-rated companies remain active. Large bid-ask spreads between buyers and sellers, and high interest rates continue to hamper M&A. This also limits upside for several issuers' competitive positions with niches in highly fragmented sectors because they depend on inorganic growth to expand their breadth of offerings and geographic presence. Refinancing risks in the U.S. business and technology services sector will increase with rising cash flow pressure and upcoming debt maturities, with more than $57 billion of debt coming due through 2025. Interest rates will remain high, and uncertainty in financial markets will likely persist, complicating otherwise straightforward refinancing transactions. With a large majority of the sector coverage rated 'B' or below, we expect an increase in downgrades to the 'CCC' category as distressed exchanges and payment default scenarios intensify.
Capital goods	Demand for capital goods is holding up well despite higher interest rates, as large fiscal incentives in the U.S. support increased investment in manufacturing, particularly for electronics capacity. The credit outlook is steady as large backlogs and lower costs generally offset destocking amid easing supply chains, so that a large working capital investment for manufacturers should start converting into cash. The J.P. Morgan Global PMI Composite Output Index, produced by S&P Global, expanded at a lower rate for the third straight month in September. On the other hand, demand remains strong for machinery, with high industrial output driving replacement volumes, while onshoring and infrastructure investments lay a foundation of longer-term projects. Commodities costs are mostly lower, but labor costs are still rising as availability remains tight. Our net outlook bias is modestly negative at about 10%, but most of this negative ratings pressure is concentrated in the 'B' category. Poor free cash flows in 2022, rising interest costs in 2023, and maturities in 2024-2025 are heaping credit pressure on a group of smaller companies that will need a big bounce in profits to improve ratios. 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 over 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.
Chemicals	Chemical demand remains uneven—delinked from positive GDP growth and weak at some companies, but in line with GDP growth and positive or stable at others. Companies at the speculative-grade level with relatively weak market positions and without scale advantages seem especially affected by somewhat erratic demand. Destocking by some chemical customers, and ongoing weakness in demand from China and Europe are contributing to demand pressures. Destocking is—somewhat unexpectedly—once again a prominent issue at some companies, after previously showing signs of easing. Still, at the investment-grade level, where companies' market positions tend to be more favorable, many are benefiting from more favorable demand. However, pricing at even investment-grade commodities producers, such as petrochemicals and agrichemicals, will remain low relative to record levels of 2022 irrespective of the market position of companies. Overall, earnings and margins should weaken this year. As always, companies at the lower end of the ratings scale ('B' and below) are more vulnerable to the somewhat unexpected persistence of demand weaknesses at a time of rising interest rates. Demand is likely to improve for these companies over the next 12 months, if economic growth continues, and at some point customers will need to reorder at higher than current levels. However, the timing and extent of a demand recovery will vary across companies. There are few meaningful maturities in the next 12-18 months. For companies that do have near term maturities, refinancing risk is a rating factor.
Consumer products	Consumers continue to trade down and limit discretionary spending. Strains in household budgets are evident in lower volumes for nondiscretionary staples, as consumers destock pantries. Inflation in inputs, freight, and shipping is moderating, but labor remains tight, and energy is on the rise again. Margins should improve in the second half as the last pricing actions are passed through. Improved supply chains allow retailers to remain cautious in replenishment as they work down the last of the excess inventories they built in 2022. Ratings outlooks for issuers in discretionary, durables, and categories with high private-label penetration are negatively biased, while staples are in better shape. As post-pandemic consumer behaviors normalize, consumer packaged-goods companies can turn their attention to large M&A for growth and to reposition portfolios. Large debt-funded transactions are likely to weight on credit quality.
Containers and packaging	Destocking trends which were expected to abate in the second half has persisted to drag on the sector more than expected. Improving supply chains have added to this dynamic, as customers are able to hold less safety stock, and inflation continues to impact consumer buying power. Most packaging issuers have exposure to both higher-end and lower-priced goods (e.g., branded and private labels, restaurants and quick service, etc.), and have been able to capture volumes as the consumer trades down within categories. However, overall volumes have declined from the previous year, and issuers that have higher exposure to discretionary end-markets have shown deeper revenue and EBITDA declines as demand has significantly weakened. We expect destocking to slowly unwind into early 2024, and a more gradual volume recovery with sequential improvement as the year progresses. As a whole, issuers have pulled back on M&A, and reduced growth capital spending, which should help preserve liquidity. Risks remain higher for lower-rated issuers, as high interest rates and lower cash flows could further tighten liquidity, particularly if recovery comes slower than expected. Though a few issuers moved into the 'CCC' category this year due to high debt leverage, negative cash flows and/or upcoming debt maturities, more than 90% of U.S. rated packaging issuers remain on stable outlooks.

Gaming, leisure, and lodging	A potential economic slowdown poses risks to discretionary consumer spending and to further growth in the leisure sector. However, still-low unemployment, some residual savings, and pent-up demand for experiences led to another good summer in travel and leisure, and we expect revenue and profitability 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 cushions in credit measures are 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 slowdown may just slow 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 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 regional gaming growth has slowed and performance across markets is mixed. Las Vegas continues to experience strong leisure travel and the convention and group market continues to recover. Strong forward cruise bookings are absorbing higher capacity, and occupancy is recovering to historical levels, causing a material improvement in EBITDA and credit measures this year from unsustainable levels.
Health care and pharmaceuticals	The outlook for the health care services remains negative, as we expect inflationary pressures, particularly labor, to persist into 2024, given the specialized nature of health care labor. Patient and procedures volumes have largely returned, and companies have negotiated higher reimbursement rates and implemented efficiency measures to counter inflation. However, while we project EBITDA margins to improve over 2022, they will likely remain under pre-COVID levels. Meanwhile, we expect cash flow to remain problematic for many highly leveraged companies in the sector due to the interest rate environment and rising working capital needs that some companies are experiencing from the No Surprises Act and Medicaid redetermination. Meanwhile, the outlook for pharma remains stable for 2023, as the industry, despite increasing scrutiny on pricing, continues to maintain its high margins. We do see slower-than-usual revenue growth in 2023, given subsiding demand for COVID-related products as well as increased biosimilar competition to major products such as Humira. However, we see the industry returning to mid-single-digit growth in 2024-2026. The health care industry, particularly the pharmaceutical industry, has seen a resurgence in M&A, despite high interest rates, as companies, after a period of muted acquisition activity in 2021-2022, seek 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	We expect conditions for homebuilders will continue to normalize. Despite mortgage rates rising above 7%, homebuyers have returned to the market and are acclimating to higher rates. A limited supply of homes, the healthy labor market, and a resilient economy are driving demand for homes despite worsening affordability. Most homeowners are paying much lower rates than what is currently available, so they are hesitant to move. Consequently, the inventory of existing homes remains low. This has enabled homebuilders to gain market share in recent months--they accounted for 40% of new home sales in the first quarter. We still expect revenues to decline and profit margins to narrow relative to a strong 2022. As demand recovers, we expect reduced discounts and incentives to offset some of our expected declines in operating margins and revenues to be more moderate than we anticipated. Ratings actions have been mostly positive, with a few large homebuilders upgraded in recent months, while credit metrics remained strong. About 24% of the homebuilders are investment-grade compared, with 18% at the end of May. While the positive bias has moderated to about 10%, versus 20% a month ago, we expect upgrades to outpace downgrades over the next year.
Media and entertainment	Our sector outlook remains negative. The media sector continues to face 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. A persistently weak economy hurts near-term sector performance as many media companies depend heavily on cyclical consumer and advertising spending. Advertising remains weak and vulnerable to economic shocks. While recent trends seem to have improved slightly, especially for short-lead-time digital advertising, visibility remains limited as advertisers delay commitments until the last minute as they try to anticipate consumer behavior. Longer-lead-time ad media such as TV remain mired in an ad recession, though it isn't clear if it's driven more by secular issues than economic weakness. These near-term pressures are being exacerbated by the writers' and actors' strikes, which has shuttered scripted content production. If these strikes persist through year-end, the lack of new content will hurt not just the movie and TV studios but the entire media and entertainment industry, including TV networks, streaming services, theaters, and ancillary businesses, such as film studio lots, cast and crew, and talent agencies that support the Hollywood studios. 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. Distribution of content faces the greatest disruption as highlighted by Walt Disney's recent carriage dispute with Charter Communications; 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 by U.S.-focused companies as they must wean themselves from high-margin affiliate fee revenues.

Metals and mining	Several years of capital restraint, good equity returns, and improving credit quality have bolstered financial capacity for potentially large investments or acquisitions. Our outlook bias remains modestly positive, even though we estimate profits across the sector will weaken about 30% peak-to-trough from the spike in 2022. Prices eased from record levels in 2022 but generally remain above their long-term averages, while cost pressures eat into profits. Even with weaker sentiment and prices, output for many metals remains constrained by limited 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. 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 solid prices amid high fuel costs for electricity, so that higher credit ratings depend on competitive prospects like product and demand horizon, as well as financial capacity to fund obligations amid declining sources of capital.
Midstream energy	The North American midstream energy industry's credit quality continues to be resilient as it confronts higher interest rates, slower growth, and persistent regulatory, environmental, and social headwinds. Demand for natural gas and crude-based refined products remains strong, despite increased economic uncertainty. Cash flow generation remains robust, however, there is some softening in volumes of companies with exposure to dry-gas basins due to weaker natural gas prices. The lack of egress out of regions like the Marcellus Shale, and the inability to build new pipeline infrastructure in many areas could limit production growth, which would ultimately affect midstream companies that rely on new well development. Mergers and acquisitions are heating up, with the larger, diversified companies at a distinct advantage; stronger balance sheets, more financial flexibility, and more bolt-on opportunities in their vast geographical footprints. We view the smaller more regional peers at a distinct disadvantage in this regard, which could result in more industry consolidation during the next few years. We expect modest capital spending increases, primarily among the large, diversified companies that are finishing multiyear growth initiatives or bolt-on organic growth projects.
Oil and gas	After dipping due to reduced demand from China and banking crisis concerns, oil has rebounded nicely largely after Saudi Arabian and OPEC production cuts and continued production discipline from U.S. producers. We believe OPEC is targeting holding oil prices above $80 to support its countries' socioeconomic programs. Inventory levels remain supportive for prices, and it appears the U.S. may avoid recession. The medium-term demand outlook appears to be supportive for oil. For natural gas, it's hard to be sanguine about prices through 2024. Inventory levels remain well above the five-year average, and associated gas production from the Permian has continued to pressure prices. The supply side appears to be responding with rigs being laid down in certain higher-cost plays, which we believe has set a floor for pricing. Record summer electricity demand and slowing production have combined to marginally boost prices, but inventory levels will continue to limit pricing upside. Natural gas prices should be 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 strong, above historical midcycle averages, 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 shift from repaying debt to rewarding shareholders, mostly through share buybacks and higher dividends, while keeping higher cash balances for additional liquidity. Refineries continue to explore conversions of conventional capacity to renewable fuels such as renewable diesel and sustainable aviation fuel.
REITs	REITs continue to face slowing earnings growth, given macroeconomic headwinds and higher rates. Conditions remain challenging for office real estate as the return to office has been slow, and occupancy remains under pressure while leasing remains below pre-pandemic levels. Performance of other property types such as industrials, residential, and retail remain resilient given good demand and limited supply. Downgrades have outpaced upgrades in 2023, and we maintain a negative ratings bias. About 15% of ratings having negative outlooks, which largely reflects our strong negative bias on office REITs. Access to capital remains tight but has been improving compared with last year as interest rates are nearing our projected peak. Higher-for-longer interest rates will likely remain a significant headwind for the real estate sector, slowing external growth and limiting access to capital markets. Refinancing remains a key risk given tighter credit conditions, while higher financing costs will exert significant pressure on cash flow coverage metrics.
Regulated utilities	We recently revised the sector outlook 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. 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 gas prices peaked in 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 cushion, allowing the utilities to bill customers for the previously deferred higher commodity costs without overwhelming the customer.
Retail and restaurants	Retailers that offer value (e.g., off-price, warehouse, and mass retailers) are faring relatively well on the top line, as consumers remain cautious in discretionary categories and trade down. However, some deep-value players, such as dollar stores, are seeing profits squeezed because staples are lower-margin than seasonal and discretionary products. Many apparel, department stores, and specialty retailers are suffering same-store sales declines as consumers pull

	back, especially in categories that were popular during the pandemic, such as basics and sportswear. Retailers report increasingly widespread theft (aka, "shrink") eating into margins, possibly as an indication of consumers' financial strain. We don't expect theft to grow to an extent that would drive ratings changes. Restaurants continue to benefit from pent-up demand but are reporting lower traffic and value-seeking consumers, making it difficult to pass on costs.
Technology	North American technology sector revenue was down 0.8% year-over-year in the second quarter due to economic uncertainty, excess inventory, and an uneven recovery in China. We recently reduced our 2023 forecast for global IT spending growth to 2.2%, from 3.3% at the start of the year, despite a change to our U.S. economic forecast that no longer anticipates a recession in the next 12 months. We believe the slower-than-expected IT spending growth in the first half will be followed by a more meager second-half cyclical recovery than we anticipated. Nevertheless, we believe PC and smartphone markets are stabilizing, enterprises are gaining confidence in an economic picture that is turning out to be better than feared, and cloud customer purchase rationalizations are winding down. AI is attracting significant investment among hyperscale data center customers but given tight IT budgetary environment, is crowding out spending in other areas such as CPUs, memory, hard disk drives and networking equipment. Refinancing will become a bigger concern for the sector, especially those at the lower-end of the rating spectrum that have negligible free operating cash flows and significant variable debt outstanding in the next 12-24 months.
Telecom	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 time they are exposed to market share losses to cable. In wireless, mature industry conditions and competition are contributing to slower postpaid subscriber additions although service revenue growth has held up well. At the same time, massive spending in mid-band spectrum auctions and higher capex to support network upgrades pushed up leverage and weakened their financial position. And the ability to monetize these investments has proven 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. We expect the incumbent cable providers will continue to benefit from rising demand for broadband, although customer growth has stagnated due to increasing competition FWA and FTTH for broadband customers, which is their primary source of revenue and cash flow.
Transportation	Airline industry fundamentals remain favorable, notably for large network carriers that are benefiting from the recovery in international travel. Passenger traffic is expected to meaningfully expand this year, and ongoing system-wide capacity constraints will support relatively high fares. Jet-fuel prices have increased and remain a risk, but we continue to expect materially higher year-over-year earnings growth. We recently upgraded two airlines, and our ratings outlook is likely to remain stable heading into 2024. Our view is more subdued for freight-related transportation companies, namely in the air cargo, package express, trucking, and logistics segments that are dealing with slowing goods consumption (consumer and industrial) that are leading to lower shipments and domestic production. Higher labor costs and, in certain cases, excess capacity are additional headwinds. Most of these issuers have sufficient ratings buffers to manage near-term earnings and cash flow pressures, but downside risk is elevated for certain lower-rated entities. Railroads are also being impacted by lower imports that have led to declining intermodal volumes relative to last year. However, they are somewhat insulated from the current freight volume recession, reflecting a diversified traffic mix that includes meaningful shipments to non-cyclical end-markets, pricing power (above inflation), and high free cash flow generation.
Unregulated (merchant) power	While the forward power calendar strip for 2024-2026 is still modestly higher than at year-end 2021, 2023 prices are on average 55% off September 2022 highs. 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 $3.2/Mcf, from $5.1/Mcf (a 37% 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 are seeing modestly higher margins as wholesale prices decline. Still, power prices are higher than their lows in the first half. ERCOT (Texas), in particular, saw strengthening in the forward power curve over the summer. Overall, we still expect reasonably strong performance from all generators in 2023 as they typically hedge forward.

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	2.3	1.3	1.4	1.8
Real consumer spending (year % ch.)	2.7	2.5	1.4	1.5	2.1
Real equipment investment (year % ch.)	4.3	(0.8)	1.4	1.7	2.2
Real nonresidential structures investment (year % ch.)	(6.6)	7.6	1.1	0.5	3.2
Real residential investment (year % ch.)	(10.6)	(11.1)	0.7	3.2	1.8
Consumer price index (year % ch.)	8.0	4.1	2.4	1.9	2.3
Core CPI (year % ch.)	6.2	4.7	2.6	2.3	2.3
Unemployment rate (%)	3.6	3.6	4.1	4.7	4.8
Housing starts (annual total in mil.)	1.6	1.4	1.4	1.4	1.4
Federal funds rate (%)	1.7	5.1	5.2	3.2	2.8

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 Economic Simulink, and S&P Global Ratings Economics' forecasts.

Table 5

Canada – S&P Global Ratings economic outlook

	2022	2023f	2024f	2025f	2026f
Real GDP (year % ch.)	3.4	1.2	1.2	1.5	1.8
Real consumer spending (year % ch.)	4.8	2.0	1.0	1.9	1.8
Real nonresidential fixed investment (year % ch.)	4.6	1.3	1.2	1.4	1.4
Real residential fixed investment (year % ch.)	(11.2)	(12.8)	(0.9)	1.0	1.8
Consumer price index (year % ch.)	6.8	3.9	2.2	2.5	2.1
Core CPI (year % ch.)	5.6	3.7	2.4	2.1	1.9
Unemployment rate (%)	5.3	5.4	6.0	5.4	5.1
Government of Canada 10-year bond yield (%)	2.9	3.4	3.3	2.9	2.8
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: StatCan, Bank of Canada, S&P Global Market Intelligence Economic Simulink, and S&P Global Ratings Economics' forecasts.

Appendix 3: List Of Analytical Contacts

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