Credit Conditions North America Q1 2024

A Cluster Of Stresses

Nov. 28, 2023

This report does not constitute a rating action.

S&P Global Ratings

Key Takeaways

- Credit stresses are growing, and borrowers will need to adjust to a new playing field in which financing conditions could become even tighter. The costs of debt service and/or refinancing could be overly burdensome, especially for lower-rated borrowers.
- Other high risks include the chance of recession in the U.S. and persistent cost pressures.
- The net outlook bias for North American corporates was negative 10.9% as of Nov. 15. We expect the U.S. trailing-12-month speculative-grade corporate default rate to reach 5% by September.

Editor's note: S&P Global Ratings' North American Credit Conditions Committee took place on Nov. 20, 2023.

Credit stresses are growing for borrowers in North America, and near-term relief seems unlikely, as all-in borrowing costs look set to stay elevated, investors become more cautious, and U.S. GDP growth looks set to slow.

We expect the Federal Reserve to raise its policy rate once more and then wait until June to begin a cycle of rate cuts, assuming inflation approaches the central bank's target. The Fed has paused its cycle of interest rate hikes, holding the benchmark federal funds rate at 5.25%-5.50% at its November meeting, but the "longer" part of higher-for-longer has taken center stage.

Against this backdrop, the costs of debt service and/or refinancing could be overly burdensome, especially for lower-rated borrowers. Borrowers have reduced near-term maturities—trimming speculative-grade corporate debt due in 2024 by 34%. However, the share of spec-grade debt coming due rises in coming years, especially for those rated 'B-' and lower.

As higher interest rates and inflation erode financial cushions, **more subdued business investment and/or a sharper pullback in consumer spending could lead to a recession, causing more credit stress**. Consumers are already showing signs of weakness. American households (especially in the lower-income cohort) have been tapping more into their credit cards, with delinquencies on the rise. If consumers become more frugal than expected this holiday season, it could lead to downgrades in the retail and consumer products sectors. Meanwhile, mortgage-payment shocks are pushing Canada's household debt-service ratio close to its historical high.

The Israel-Hamas war adds another dimension to the geopolitical strife. The potential for the conflict to escalate and spread—and to affect the rest of the world through energy supply shocks, risks to social cohesion, and/or supply chains—is a key concern, as the U.S.-China strategic confrontation and the Russia-Ukraine war continue.

Downgrades continue to outpace upgrades, and the net outlook bias, indicating potential ratings trends, for North American corporates was at negative 10.9% as of Nov. 15. This is a worrisome level given that we rate 20% of the region's corporates 'B-' or below. Health care, telecom, and consumer products are the sectors with the highest negative bias.

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 5% by September—above the 4.1% long-term average. 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.

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Top North American Risks

Tight financing conditions pressure borrowers' liquidity

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

If interest rates rise further or remain elevated for even longer than we expect, and investors become more selective, the costs of debt service and/or refinancing could be overly burdensome for some borrowers. Increased volatility in the U.S. Treasury market could add to credit stress. With earnings under pressure and debt maturities approaching, lower-rated borrowers may feel more severe liquidity strains.

U.S. suffers a recession and rising unemployment, 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 recession and a jump in unemployment, causing more credit stress. This comes amid slowing global growth, which could have deleterious second-order effects in the U.S. 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 more 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.

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 financing costs are weighing on commercial real estate valuations and heightening refinancing risk. Declining demand for office space--the focus of CRE markets right now--is further weighing on asset valuations. This may ultimately lead to elevated loan losses for debtholders.

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 challenging, and any renewed fears around profitability and equity levels could accelerate deposit outflows. As banks have become more selective in lending, commercial and consumer customers 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 Israel-Hamas war adds another dimension to the geopolitical strife already intensified by the Russia-Ukraine conflict. The potential for the war to escalate—and to affect the rest of the world through energy supply shocks, supply disruption and risks to social cohesion—is a key concern. Meanwhile, any further worsening of U.S.-China tensions could also kink supply chains, and disrupt trade, and investment and capital flows.

Climate risks intensify, energy transition adds to costs

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

More frequent natural disasters increase the physical risks that public and private entities face and threaten to disrupt supply chains, such as for agriculture and food. The global drive toward a net-zero economy also heightens transition risks across many sectors, requiring large investments.

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. Businesses may need to incur more costs to adapt to technological advances. The accelerating digitalization of business and economic activity also adds potential market volatility.

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.

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