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Credit Conditions North America Q2 2021:

As Outlook Brightens, Risks Remain

March 30, 2021

(Editor's Note: S&P Global Ratings' Credit Conditions Committees meet quarterly and on an ad hoc basis to review macroeconomic conditions in each of four regions—Asia-Pacific, Emerging Markets, Europe, and North America covering Canada and the U.S. Discussions center on 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 March 24, 2021.)

Key Takeaways

- **Overall:** Credit conditions remain favorable for most borrowers, as government support underpins market liquidity, and coronavirus vaccine rollouts offer optimism that an end to the pandemic is in sight. U.S. GDP is set to grow 6.5% this year—the most since 1984.
- **Risks:** With even low-quality borrowers able to tap credit markets at welcoming rates, we see signs that investors aren't being adequately rewarded for the risks they're taking and may soon demand better yields—all against the backdrop of record-high debt.
- **Credit:** Spreads on U.S. corporate debt are tighter than they were at the start of last year; however, if inflation materializes, a selling-off of fixed-rate investments becomes more likely and would make it harder for weaker firms to tap the markets at favorable terms.

As the acceleration of vaccinations in the U.S. and Canada fuels optimism that an end to the health and economic crisis is in sight, credit conditions in North America remain remarkably favorable.

With the U.S. economy set to grow at its fastest pace in nearly four decades this year, credit quality has stabilized, with upgrades outpacing downgrades in recent weeks. The net outlook bias, measuring future downgrade risk, has improved significantly for nonfinancial corporate borrowers; the U.S. distress ratio (the proportion of speculative-grade issues with options-adjusted composite spreads of more than 1,000 basis points over U.S. Treasuries) fell for the 11th consecutive month in February; and we now expect the U.S. trailing-12-month speculative-grade corporate default rate to fall to 5.5% by December.

Underpinning these conditions are massive government support measures to combat the effects of the pandemic—notably the U.S. government's trillions of dollars in fiscal stimulus and the Federal Reserve's pumping of liquidity into financial markets. Capital markets remain welcoming to issuers even at the lower end of the ratings ladder (as well as many in industries where secular headwinds predate the pandemic), the economic recovery is strengthening, and companies are largely doing what they need to do to position themselves for growth. But while we see favorable trends in the near term, it will take some time for credit quality to recover—and low-rated borrowers with heavy debt burdens remain vulnerable to the next slump or their failure to execute on business models.

S&P Global Ratings sees clear signs that investors aren't being duly rewarded for the risks they're taking—specifically in lending to sectors that may suffer from consumers' continued reticence to resume normal social activities. This thirst for yield, and the level of liquidity it has pumped into the world's biggest economy, could create problems for credit markets in the longer term (see table 1). Debt has soared, and loose borrowing terms could translate to more defaults and lower recovery rates—with a possible drawn-out default cycle, should the demise of companies with very weak credit quality take longer to reverberate through the markets. Fiscal support will eventually end, which could expose the full extent of indebtedness and structural headwinds many firms face.

Certainly, the intervention of governments and central banks to bolster economic activity and backstop financial markets helped prevent a more severe crisis. But this may have the unintended consequence of disincentivizing markets to armor themselves against the next crisis by fostering the belief that legislators and policymakers will simply ride to the rescue at every turn.

Contents

Still, the tailwinds many borrowers enjoy are clearly blowing stronger at this point than most market watchers would have guessed when the health and economic crisis emerged. The outlook continues to brighten for the U.S. COVID-19 vaccination program as well, given the acceleration in rollouts and the launch of the single-dose Johnson & Johnson version. Our main concern is now the sustainability of the pace, as opposed to the lack of supply. At the current rate, herd immunity in the U.S. would come in late August/early September. Canada's vaccination rates have also steadily improved. However, supply remains an issue. Canada could receive 36.5 million doses by the end of June, with a heavy mix of the two-dose Pfizer and Moderna vaccines. Assuming no waste, Canada could vaccinate roughly 54% of its population by midyear.

Table 1

North American Top Risks

Record-high debt threatens credit quality if revenue rebound falters

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

North American debt to GDP has risen to record levels as governments and companies borrowed to survive the pandemic-induced crisis. While welcoming markets have eased near-term maturity pressures, and historically low interest rates have mitigated debt-servicing burdens, there's a material risk that domestic demand could remain lackluster. If income recovers more slowly than we expect, some borrowers may find it difficult to manage debt burdens; this could cause a drawn-out default cycle, given that the inevitable collapse of companies with very weak credit quality may take time to reverberate through the markets.

U.S.-China strategic confrontation escalating

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

Since taking office in January, President Joe Biden has maintained pressure on China, and tensions between the countries look set to persist, especially in areas such as technology, intellectual property, and market access. Additionally, China is continuing its drive to be less reliant on markets and technology from foreign countries, including the U.S. The strained relationship between the world's two biggest economies could intensify the pressures on economic and credit conditions in both countries.

Health crisis persists, with social restrictions continuing to hit demand

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

While we assume widespread immunity can be achieved in the U.S. and Canada by the end of the third quarter, there is a risk of potential gaps (or lackluster participation) in vaccine rollouts, and the possibility of a resurgence in COVID-19 cases as the virus' variants proliferate. This could cause continued consumer caution and delay a rebound in demand.

Investor repricing of risk reduces funding access, spurs market volatility

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

The normalization of interest rates is a natural—and desired—part of the recovery path. And while we expect policy rates to remain low until the rebound strengthens, lenders and investors could reset their risk-return demands, either because of escalating credit concerns, inflation fears, or an unexpected adverse event. This could result in the repricing of financial and real assets (such as bonds and real estate), higher debt-servicing costs, and tighter financing conditions. The eventual end of government support could expose the full extent of operational and structural headwinds many borrowers face—especially if the normalization of rates is disorderly.

Declining demand for commercial real estate could pressure landlords

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

The behavioral shifts in working, living, and spending that have been accelerated by the pandemic could result in a sustained sharp drop in demand for commercial real estate (CRE) such as office space, retail/malls, and high-end lodging. This would pressure cash flows and asset valuations, which could have significant credit implications for landlords. Moreover, we may see elevated CRE-related loan losses for debtholders, such as U.S. banks, insurers, REITs, and CMBS as the cash flows and values of many properties decline. Most banks can likely absorb the expected hit, but risks to our forecast imply that losses could be problematic.

Longer-term secular risks, including ESG-related and technology/cyber, affect business operations

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

As policymakers and investors intensify their focus on ESG factors, borrowers that are (or are perceived as being) "offside" with regard to ESG could face increasing policy risks or limited access to capital—with restrictions ranging from having to pay a premium to borrow to being shut out of the capital markets. At the same time, ongoing technology disruptions are constantly reshaping business models and operations. In particular, cyber risks continue to pose a systemic threat, as demonstrated by the so-called "SolarWinds" attack in which Russian hackers are believed to have accessed files of numerous U.S. government agencies. Entities lacking well-tested playbooks to tackle such risk could become more vulnerable to attacks.

Source: S&P Global Ratings.

* **Risk levels** may be classified as very low, moderate, elevated, high, or very high, and 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 on whether the risk level could increase or decrease over the next 12 months.

A Closer Look At CRE And ESG

Commercial real estate (CRE) continues to be an area of concern. In addition to ongoing difficulties for retail and lodging (particularly higher-end hotels), debate persists about the future for office markets—especially in densely populated cities such as New York, Boston, and San Francisco. The pandemic only accelerated the work-from-home trend that began before the crisis. This sea change in how and where employees conduct business could significantly curb demand for office real estate in the next few years, weighing on cash flows and asset valuations—and have significant implications for office landlords' credit quality.

The sea change in how and where employees work could significantly curb demand for office real estate, weighing on cash flows and asset valuations.

To gauge the potential effect on issuers we rate, we ran a scenario analysis on select office REITs and a sample set of office single-asset single-borrower (SASB) commercial mortgage-backed securities (CMBS) ratings (see "**Remote Working Is Testing U.S. Office Landlords' Credit Quality**," published Feb. 11). We tested our ratings on office REITs under a severe and prolonged change in office real estate, revealing potential downgrades of one to two notches. Still, we think REITs could mitigate the effects through measures such as cutting dividends or paying them in stock (while maintaining REIT status), cutting capital expenditures, or pausing or limiting acquisitions—although their ability to sell assets (or conduct partial sales through joint ventures) could be constrained.

For now, there isn't enough concrete data to conclude that a significant percentage of office leases aren't being renewed. It's also worth noting that office leases are typically for 10 years or more (one consequence of the crisis could be that tenants will demand shorter terms), so any distress would likely take place over an extended period. Either way, we expect the recovery for office REITs to lag the broader sector given the cyclicality of office assets and the headwinds from increased remote working. The office subsector was the last among REITs to recover after the financial crisis in 2008-2009, and the recovery took several years. Despite our forecast for robust economic growth this year, office demand will likely remain relatively muted.

Companies' environmental, social, and governance (ESG) profiles are also a burgeoning concern, given the ongoing drive toward sustainability. As investors intensify their focus on ESG factors in their asset-management decisions, borrowers that are (or are perceived as being) unusually risky from an ESG perspective could be forced to pay a premium to borrow or be shut out completely from the capital markets. Similarly, ESG exposure can run the gamut from fairly straightforward and obvious (e.g., fossil-fuel production or other carbon-intensive activities) to less quantifiable (e.g., the manufacture of alcohol or unhealthy foods).

Borrowers with large, unmitigated ESG risks could be forced to pay a premium to borrow or be shut out from capital markets.

Thus far, the pressure from asset managers has ranged from setting up "ESG-compliant" funds to pushing companies to show how they're mitigating ESG risks and to enhance disclosures. The latter can be seen as a sort of "investor activism" that differs from traditional shareholder activism, which tends to focus primarily on increasing short-term shareholder value. Even before the pandemic, investor pressure and broader stakeholder engagement had begun to result in divestment from carbon-intensive industries, which many investors believe pose outsized long-term risks. Notably, international environmental organization 350.org (whose goal is a complete transition to renewable energy) has said it has commitments from institutions managing $11 trillion in assets to divest from fossil fuels. We expect governments, in developed economies as well as those in the emerging world, to fortify commitments to Paris Agreement goals, which should expedite this process.

At the same time, the global drive toward a "net-zero" economy will heighten transition risks across sectors. It will require huge investments in processes and technologies that enable a shift from fossil fuels to clean energy, as well as a devoted decarbonization of industries. We see so-called transition finance as the key to helping carbon-intensive industries and companies that don't have obvious means of abatement to raise capital for activities that help them reduce their carbon footprints (see "**Transition Finance: Finding A Path To Carbon Neutrality Via The Capital Markets**," published March 9). While this market is still quite small, we believe it will grow quickly as standards for transition instruments become more comprehensive and robust—perhaps contributing as much as $1 trillion annually (or about one-third of the estimated $3 trillion per year needed to meet net-zero emissions by 2050) in the next 30 years.

Macroeconomic Outlook

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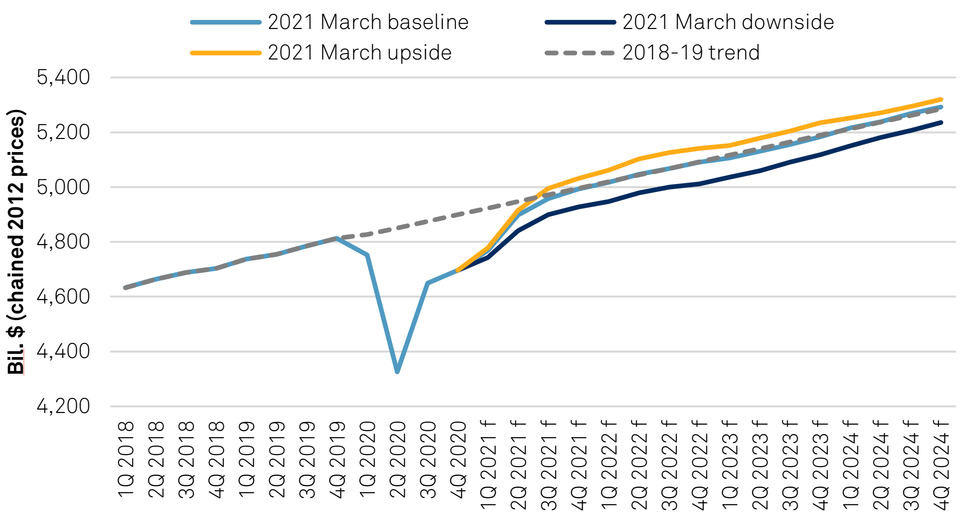
U.S.

While the rebound from the pandemic-induced recession has been bumpy and uneven, there's no question the U.S. economy is on a path to recovery. We now forecast U.S. real GDP to grow 6.5% in 2021 and 3.1% in 2022 (see chart 1). Even the jobs market, while still challenged, has shown some improvement. With vaccinations picking up and some states easing social restrictions, the U.S. added 379,000 jobs in February—with most gains in the leisure and hospitality industries, such as bars and restaurants, which have suffered most. Unemployment ticked down to 6.2%.

However, job losses among state and local governments tempered the overall gain. Moreover, U.S. labor force participation remains low, with more than 4 million people (not counted in the headline unemployment figure) having left the job market in the past year. Adjusted for this, unemployment is 8.6%; including the Bureau of Labor Statistics' adjustment for misclassification of workers, it's around 9.1%. And while weekly jobless claims have trended downward since peaking in the spring of last year, they remain more than three times the pre-pandemic average of around 200,000.

Chart 1

Evolution Of Real U.S. GDP



f—forecast. Sources: Bureau of Economic Analysis, Oxford Economics and S&P Global Economics.

The $1.9 trillion stimulus bill signed by President Joe Biden will almost certainly help offset the drag that the still-struggling labor market has on the economy. In addition to direct payments of $1,400 to many Americans, the measure extends unemployment benefits for another 25 weeks. It also earmarks $350 billion for state and local governments, many of which have seen their tax revenues decline while bearing the brunt of costs related to the pandemic and vaccine rollouts.

Against this backdrop, investors have pushed benchmark interest rates higher, with the yield on 10-year U.S. Treasuries climbing to 1.6% and fed funds futures pricing in a rate hike in 2022. S&P Global believes the first increase from Fed policymakers won't be until third-quarter 2023. Even with the recent rise, the 10-year yield is still historically low, and is just reaching the lower end of the "neutral" band.

We don't see runaway inflation as an imminent risk—and actual inflation is nowhere near what markets are pricing in. In fact, it barely edged higher in February, as rising gasoline prices lifted the overall Consumer Price Index just 0.4%; core inflation, excluding food and energy, rose just 0.1%. On an annual basis, core CPI rose just 1.3%—well below the Fed's 2% target. At any rate, we see this increase as transitory, partly the result of the "base effect" jump from last year's low inflation, and partly tied to demand spurred by stimulus, rather than the long-term trajectory of prices.

Inflation would have to persist—perhaps for several quarters—to spur policy makers to move. Fed Chair Jerome Powell reiterated that the central bank is still "a long way" from reaching its policy goals, adding that he is concerned about "disorderly" moves and any "persistent tightening in financial conditions" that would jeopardize the goals. Atlanta Fed President Raphael Bostic has echoed that view, pointing to the fact that GDP is rebounding faster than employment and stressing that the Fed's mandate is full employment, not full GDP.

Still, Americans are sitting on lots of cash (the household savings rate jumped to 20.5% in January, from 13.7% in December), so as social restrictions ease, demand for goods and services (especially the latter) will likely surge, spurring near-term inflation. Naturally, this will also goose GDP growth, which we expect to reach 6.5% for the full year in what would be the biggest jump since 1984.

Canada

Canada ended last year with better-than-anticipated growth momentum. The economy expanded 9.6% (annualized) in the fourth quarter, and the monthly data since then suggest a strong start to 2021, despite the heightened restrictions instituted in the big provinces of Ontario and Quebec.

Social-distancing restrictions have eased across provinces since February, paving the way for higher growth. About 8% of the Canadian population has already been administered at least one dose of COVID-19 vaccine, and we anticipate vaccinations to ramp up in April.

We anticipate a "full-vaccine" economy to materialize in late summer. Given the strong start to the year and better prospects for commodities sectors and the U.S. economy (Canada's primary export market), we have revised higher our real GDP growth forecast for this year, to 5.5% (from 4.5% in our December forecast). This follows a 5.4% contraction in 2020.

We expect growth of 2.4% next year and 2.8% in 2023, enough to bring the unemployment rate back down to pre-pandemic levels by early 2023. The combination of strong oil prices, base effects from the decline in oil prices this time last year, and a hike in the carbon tax mean that gasoline inflation is set to surge in the second quarter. Consumer price inflation, after a temporary spike above 3% (year over year) by midyear, will likely revert to its pre-pandemic range of 1.8%-2.1%.

The housing sector continues to remain the bright spot in Canada's economic recovery. The sector dynamics changed during the pandemic, with supply running behind demand for single-family houses. Home-price growth will probably weaken from its current pace. There remains significant uncertainty about how built-up household savings will be unleashed. Some is surely earmarked for paying down debt (either new mortgages or older debt). The risk to consumer spending growth clearly rests on how fast the accumulated excess savings will be spent when the economy gets back to pre-COVID "normal" capacity. If Canadians show greater initiative in dipping into their accumulated savings than our conservative assumption, spending would be larger than in our baseline forecast this year and next, and, in turn, there would be a higher recovery path for GDP.

The Bank of Canada emphasized its current policy stance will likely remain until into 2023. It may slow the pace of its bond purchases further as early as the second quarter as the Governing Council gains confidence in the strength of the recovery. We have penciled in the BoC's first rate hike for earlier in 2023.

Financing Conditions

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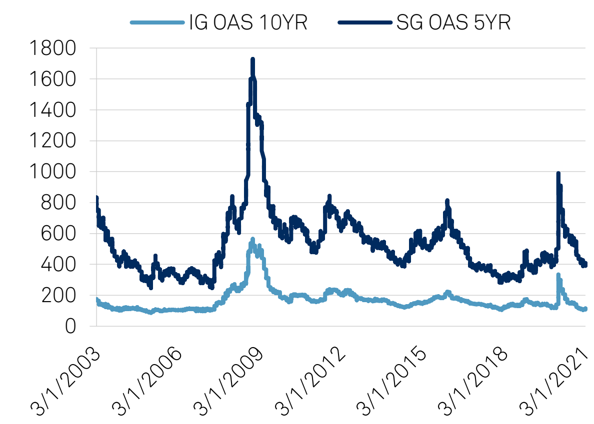
After fourth-quarter 2020 brought U.S. corporations some of the best financing conditions they've ever enjoyed, some reversal was to be expected. Secondary market yields hit all-time lows in August and remained depressed for the rest of the year before rising recently. Growing talk of inflation is prompting some asset shifts by investors, but this is still little challenge to otherwise supportive credit markets. While Treasury yields have jumped roughly 80 basis points (bps) so far this year, investment-grade yields have risen more slowly, and speculative-grade yields have barely budged. In fact, spec-grade spreads narrowed to less than 400 bps at the end of February (see chart 2).

Both corporate and Treasury yields have some room to expand before reaching averages seen during the largely benign period of 2011-2018. Pent-up consumer demand and high savings, and trillions of dollars in fiscal and monetary stimulus are certainly reasons to expect inflation. However, even with a rise in Treasury yields, real yields (measured yields on Treasury inflation-protected securities) are still solidly below zero. This indicates that the real economic cost of debt remains contained.

Chart 2

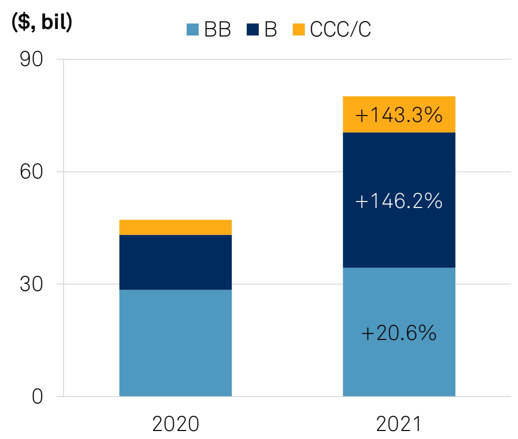
U.S. IG And SG Spreads



OAS—Option-Adjusted Spread. Source: S&P Global Ratings.

Chart 3

U.S. Nonfinancial Bond Issuance, January Through March



Note: 2021 data is through March 12. Sources: S&P Global Ratings; Refinitiv.

Favorable conditions, combined with growing worries of rising rates later this year, have prompted many firms to tap markets while the getting is still good. In fact, even without the quarter complete, issuance of debt rated 'B' and 'CCC'/'C' more than doubled last year's January-March total (see chart 3). But the Fed's announcement that it would let inflation run somewhat hot before raising policy rates stokes the potential for investors to pull some fixed-income positions in favor or equities or options beyond bond markets. Leveraged loans for example, could continue to see increased demand in a rising rate environment. And if actual inflation materializes, a selling-off of fixed-rate investments becomes more likely and would make it harder for weaker firms to tap the markets at favorable terms.

Emerging Policy Environment

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The results of the 2020 U.S. national elections, which gave the Democrats the presidency and effective control of both houses of Congress, should allow the Biden Administration to secure passage of important legislation in line with its policy agenda—at least until the midterm elections in November 2022. We expect the passage of legislation on infrastructure spending, health care, climate, energy, social issues, and, potentially, tax increases. By contrast, there has been broad continuity with the past administration in providing fiscal stimulus ($3.4 trillion passed last year under President Trump, and $1.9 trillion passed in March under President Biden) to boost economic recovery, and other matters, such as foreign policy toward China and skepticism about trade deals.

Forceful countercyclical fiscal and monetary policy since the pandemic began has helped accelerate economic recovery and limited the long-term damage caused by the downturn. However, the net general government debt burden has spiked sharply, likely reaching 107% of GDP—up from 82% in 2019 and eclipsing central government debt of 106% of GDP during World War II. While persistently low interest rates should make for lower-interest spending in absolute terms and as a share of GDP, giving the government some fiscal room, an unexpected spike in interest rates could weaken public finances and complicate economic management.

Public Finance

All USPF Sectors Stand To Benefit From The American Rescue Plan (ARP)

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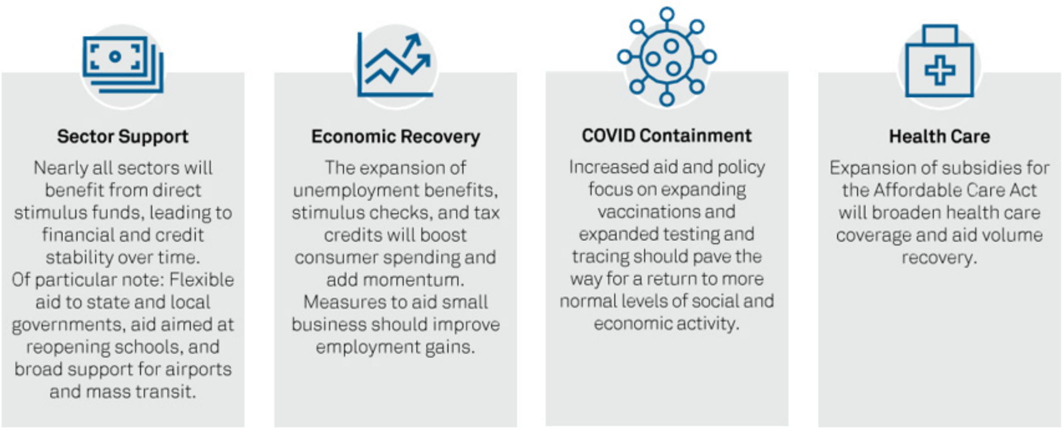
State and local governments: The ARP's $350 billion spread across U.S. states and local governments will help foster a smoother economic and financial landing from the turbulence and uncertainty of the pandemic (see chart 4). ARP dollars and a strong economic growth forecast led us to recently revise our sector view on state and local governments back to stable from negative. Positive momentum from additional aid and the economy will buoy most credits, but we expect there will still be some areas of stress. From an economic and revenue standpoint, pandemic-accelerated changes in where and how Americans work will require ongoing focus.

Chart 4

ARP: Key Credit Issues That Matter



Source: S&P Global Ratings.

Transportation: ARP stimulus will be a lifeline for many operators. The measure includes money for the hardest-hit transport sectors: $30.5 billion for public transportation, $8 billion for airports, and $18 billion for U.S. airlines and manufacturers, and prompted us to revise our sector view on airports, mass transit and toll roads back to stable from negative. Funds received thus far by transit operators and airports are expected to last until 2022-2023, so additional support will help shore up operations now and in the medium term. Since airports can pass along costs to airlines, transit operators face the most pressure and uncertainty. All eyes are on the Biden

Administration's infrastructure plan and how it could augment support for transit operators, particularly if customer usage doesn't speed up as vaccines roll out.

Higher education: There's a growing divide between stronger and weaker higher-ed institutions, and along with not-for-profit health care it remains one of only two USPF sectors where our sector view remains negative. ARP will be the third round of stimulus to support the sector, and it includes $40 billion in additional direct aid for colleges and universities, both private and public, including community colleges. Demand for big-name private universities and public flagships is up, while less-selective institutions and those with less financial flexibility face more credit pressure. Vaccination rollouts and herd immunity will be front and center through the summer and fall as schools gear up for enrollment.

Canada's Public Sector Finds Its Footing

Canada has committed to continue supporting the economic recovery through the next three years, although additional spending measures at the federal level will primarily target individuals, households, and businesses, with comparatively little direct support for local governments.

Local and regional governments: In light of expansive economic stimulus and concerted federal fiscal support, we expect most provinces and municipalities will maintain their long-term credit quality. As the recovery unfolds and federal stimulus unwinds, provinces' fiscal policy direction and debt management will determine the resolution of negative outlooks.

Transportation: The sector will continue to face headwinds. While Canadian airport authorities have mitigated the financial effects of the pandemic, significantly lower federal fiscal support than U.S. airport authorities leaves these entities less able to deal with sustained revenue losses from depressed air travel. We took negative ratings actions on four Canadian airport authorities in January, and all six entities have negative outlooks, reflecting our view that low passenger volume and an uncertain recovery will continue to pressure the ratings.

Higher education: Canadian universities face similar challenges as their U.S. counterparts, with uncertain enrollment and depressed revenue from ancillary activities among the top risks. Despite minimal government support, ratings in this sector have historically been supported by robust levels of available resources. Enrollment dynamics will play a key role in the sector's recovery; domestic demand is unlikely to be sufficient to offset further declines in international enrollment.

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As vaccine rollouts continue apace and an end to the health crisis comes into view, corporate planning for post-pandemic business conditions has taken on greater urgency. For certain sectors—e.g., retail, and media and entertainment—this means managing secular changes that the crisis has merely accelerated rather than caused. While the recovery paths for corporate borrowers we rate are generally tracking with our expectations (both positive and negative), they depend on many factors. These include companies' ability to adapt to inevitable post-pandemic changes in consumption patterns and their ability and desire to adhere to more conservative financial policies to reduce elevated debt loads in the hardest-hit sectors. After several quarters of favorable credit conditions in which borrowers piled on a historic amount of debt, credit metrics won't soon return to pre-pandemic levels—and in some cases may take several years to do so.

For now, the disparity in the shapes of recoveries remains pronounced. For example, leisure and travel companies—especially those focused on more-profitable business and international travel—remain pressured, compounding the effects of higher debt loads and, in many cases, potentially further delaying a recovery (see appendix 1 for details). On the other hand, consumer staples, technology, health care, and homebuilders have fared well—in some cases, better than we initially expected. Massive fiscal stimulus should continue to bolster consumer spending, and easing social restrictions in many regions will likely boost economic activity (though to what degree remains uncertain). We continue to expect a return to some semblance of normal later this year once widespread vaccination has been achieved, but continued reticence by consumers to resume some forms of travel and leisure activities may keep related sectors under pressure.

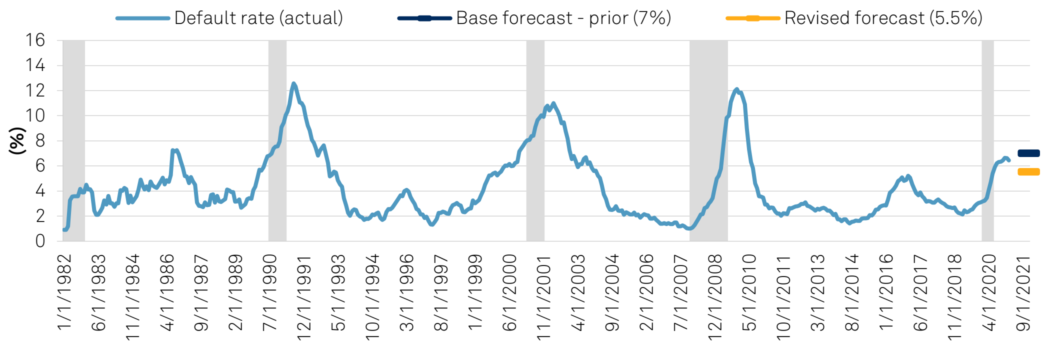
Moreover, it's clear that some borrowers have capital structures that can't be supported by ultimately unviable businesses and remain afloat only because investor thirst for yield has allowed them to borrow at nearly ideal conditions. While many can point to the pandemic as the primary reason they've been bereft of cash for a year or more, others won't be lucky enough to survive, even once the lingering effects of the health and economic crisis pass.

Still, economic growth is kicking into high gear, and upgrades have begun to outpace downgrades. The net outlook bias (the percentage of ratings with negative outlooks or on CreditWatch negative minus the percentage with positive outlooks or on CreditWatch positive) has improved significantly, and the U.S. distress ratio has dropped to its lowest level in a decade, down to 4.0% (after peaking at 35.2% just 11 months prior).

While credit stress remains elevated for many sectors with high proportions of 'CCC' to 'C' ratings—such as leisure, nonessential retail, and consumer products—we now expect the U.S. trailing-12-month speculative-grade corporate default rate to fall to 5.5% by December, from our prior estimate of 7% (see chart 5). Along with our updated forecast for stronger economic growth, our outlook and CreditWatch placements have shifted to reflect much lower downgrade potential for our U.S. speculative-grade population.

Chart 5

U.S. Trailing-12-Month Speculative-Grade Default Rate And December 2021 Forecast



Note: Shaded areas are periods of recession as defined by the National Bureau of Economic Research. Sources: S&P Global Ratings and S&P Global Market Intelligence's CreditPro®.

Structured Finance

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In 2020 (through mid-December), roughly 2,300 North American structured finance (SF) rated tranches—about 6.3% of the region's tranches outstanding that we rate—suffered at least one negative rating action (placement on CreditWatch negative, downgrades, or both) due to the effects of the COVID-19 pandemic or the decline in oil and gas prices. We don't foresee another wave of similar magnitude this year, especially as the vaccine rollout progresses, and the overall economy improves. However, there remain pockets of risk in some SF asset classes.

Overall, we'd characterize our SF outlook as stable to improving (see table 2). Performance among consumer asset-backed securities (ABS), equipment ABS, and residential mortgage-backed securities (RMBS) has been largely resilient, although performance depends on the shape of the recovery, especially for borrowers with weaker FICO credit scores. That said, recent fiscal stimulus should bolster collateral performance across consumer-related sectors. We continue to assess performance data for loans emerging from forbearance agreements. COVID-related forbearance on student loans has led to some Federal Family Education Loan Program (FFELP) ratings being lowered to speculative-grade in transactions with near-term maturities, and performance could be affected (perhaps positively) by proposals the new administration is considering. Legacy RMBS continue to see rating actions, mainly stemming from smaller pool factors as older deals wind down.

Ratings performance among U.S. collateralized loan obligations (CLOs) will depend on the ratings performance and defaults of speculative-grade corporate loan issuers. Based on this (and our economic outlook) we don't expect large-scale CLO rating actions this year, but there may be scattered downgrades for transactions with weaker-than-average collateral or higher-than-average exposure to loan defaults. Based on our scenario analysis, we expect fewer rating actions on middle-market CLOs than for broadly syndicated loan CLOs. Collateral credit metrics are much better than they were last summer, but they're still not back to where they were in January 2020. Due to factors including a combination of relatively strong ratings performance during the COVID-19 downturn and investors' search for yield/increased attractiveness of floating-rate debt, overall CLO issuance this year (including refinancings and resets) could well set records. The influx of money into the market will end up fueling the leveraged loan market, potentially eroding spec-grade credit metrics as a result. The CLO and leveraged loan markets have grown in tandem since the end of the Great Financial Crisis, with both markets roughly doubling in size in the past 12 years.

Within certain areas of CMBS and esoteric ABS we see relatively higher risk regarding any hiccups in vaccine rollout, and the knock-on effects. Mall-based retail and higher-priced lodging—especially properties with relatively more exposure to corporate and convention business—continue to struggle. A full recovery for properties in both those areas will likely take years, rather than quarters, and some loans/properties—especially select secondary/tertiary and B/C class malls—may not ultimately recover. The effects of working from home and demographic trends on office and multifamily could lead to a bumpy year for rents and vacancies, although the longer-term credit ramifications remain unclear. We expect positive effects for multifamily, retail, and lodging CRE from the huge stimulus package. On the esoteric ABS side, aircraft seems the most vulnerable to any delays in vaccinations, while small business also maintains a "stable to negative" rating outlook.

Table 2

North America Structured Finance Sector Trends (12-Month Outlook) Q2 2021

	Collateral performance outlook	Rating trends
Residential mortgages		
RMBS	Somewhat weaker	Stable to negative
RMBS - servicer advance	Somewhat weaker	Stable
Commercial mortgages		
CMBS - N.A. conduit/fusion	Somewhat weaker	Stable to negative
CMBS - large loan/single borrower	Somewhat weaker	Stable to negative
CMBS - large loan/single borrower (retail)	Weaker	Stable to negative

CMBS - large loan/single borrower (lodging)	Weaker	Stable to negative
Asset-backed securities		
ABS - prime auto loans	Stable	Stable
ABS - subprime auto loans	Somewhat weaker	Stable to negative
ABS - auto lease	Stable	Stable
ABS - auto dealer floorplan	Stable	Stable
ABS - credit cards	Somewhat weaker	Stable
ABS - unsecured consumer loans	Weaker	Stable to negative
ABS - FFELP student loan	Somewhat weaker	Stable
ABS - private student loan	Somewhat weaker	Stable to negative
ABS - commercial equipment	Stable	Stable
Asset-backed commercial paper	Somewhat weaker	Stable
Structured credit		
CLOs	Somewhat weaker	Stable to negative
Timeshares	Stable	Stable
Small Business	Somewhat weaker	Stable to negative
Tobacco	Somewhat weaker	Stable
Transportation - aircraft	Weaker	Stable to negative
Transportation - container	Stable	Stable
Transportation - railcar	Stable	Stable
Whole business	Stable	Stable
Triple-net lease	Somewhat weaker	Stable

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

Financial Institutions

Banks

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With the passage of the $1.9 trillion fiscal stimulus and a steeper yield curve, the outlook for U.S. banks has improved since the beginning of the year. This supports the stable outlooks we have on most rated U.S. banks and may lower the downgrade risk on the roughly one-third of banks on negative outlook. Those negative outlooks largely reflect concentrated exposure to either consumer lending or business activity most hurt by the pandemic.

At the end of last year, more favorable economic projections and vaccine rollouts led us to lower our expectations for pandemic-related credit losses for the U.S. banking industry, to 2.2%, from our previous estimate of 3.0%. A drop in the median proportion of loans on deferral for rated banks to about 1% at year end, from 8% in second-quarter 2020, further supported that change. We also believe banks—which last year reported provisions for loan losses equal to about 1.2% of loans—were fairly well positioned to absorb the additional necessary provisions to cover our 2.2% loss estimate. With the recent stimulus package, loss rates may trend lower, and banks may have less left to provision. Even if provisions drop from our previous expectations, charge-offs—which have likely been delayed by the prior rounds of stimulus—will likely pick up later this year and in 2022, leading to declining allowances for credit losses.

Still, there is much uncertainty and stress in particular loan classes. Criticized loans also remain high, (about 3.6% for the banks we surveyed) particularly in the hardest-hit industries. We also remain cautious about CRE; despite lowering our expected loss rates in other sectors, we have kept our initial base-case loss rate of 3.0% for CRE.

Bank revenues, which we believe will remain pressured due to persistently low interest rates, may beat our initial forecasts, assuming the steeper yield curve can be sustained. Overall we believe bank profitability will be higher this year, due to favorable year-over-year comparisons (bank profitability was down about 35% in 2020, with a return on equity of 7%, versus roughly 10% the year before) and less need for provisions, as we expect allowances this year to decline from current levels, albeit moderately.

We don't expect a fundamental overhaul from the Biden Administration, vis-à-vis banking sector policy, but it's still early days, and changes could occur as key appointments are made. That said, we could see stricter regulation, especially for consumer protection, and banks' profits may suffer if the administration seeks to increase the corporate tax rate. Another recent development for U.S. banks is the Fed's announcement that its temporary change to the supplementary leverage ratio (SLR), which allowed for the exclusion of Treasuries and cash parked at the central bank when calculating the ratios, will expire March 31. The temporary change to SLR was made alongside other capital-easing initiatives to ensure banks could continue lending during the pandemic amid strained profitability and balance sheet bloat. We believe the inclusion of Treasuries and central bank cash will result in a decrease of about 110 bps in SLRs for most of the eight largest banks. Based on end-2020 figures, most remain well above the 5% minimum.

With the recent $1.9 trillion stimulus package, bank balance sheets will likely grow even larger than fourth-quarter levels as more deposits flow in and demand for loans should pick up. Together, this will likely further pressure bank SLRs. This could result in some of the larger banks being more cautious regarding deposit intake and lending growth. It could also result in some banks keeping a lower level of trading inventory, which could result in wider bid-ask spreads and less liquidity for certain securities. That said, banks have other offsets. For example, they can issue preferred shares to bolster their SLR or reduce planned share repurchases.

Nonbank Financial Institutions (NBFI)

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Overall, the average rating for our NBFI portfolio (asset managers, financial market infrastructure (FMI) companies, finance companies, and securities firms) is around 'BBB-'. Slightly more than half of our NBFI portfolio is speculative grade—with approximately 28% on negative outlook and 4% on positive outlook (as of Feb. 25).

Key risks include weaker economic conditions, potential deterioration in asset quality, weaker funding and liquidity, asset-price volatility, the interest rate path, and regulation.

Balance sheet strength, a low rate environment that allows for cheaper funding costs, recovering asset prices, high trading volumes, and low leverage remain pillars of credit quality for some of our NBFI portfolio. On the other hand, exposure to CRE, energy, financial sponsorship-induced high leverage, or overreliance on secured funding remain risks. Asset-price volatility is usually a positive for FMIs and high-frequency trading firms but is in most cases a negative for the asset managers we rate. Similarly, a low rate environment boosts revenues for residential mortgage originators and servicers and provides cheap financing for most NBFIs but could hurt profits for retail securities firms.

Our outlook on traditional and alternative asset managers is stable after placing the sector on negative outlook at the beginning of 2019. This reflects our belief that, in the next year, prolonged industry headwinds will be offset by elevated asset prices, supporting assets under management (AUM) levels and margins. We continue to believe that alternative asset managers are less exposed to many of the challenges facing traditional managers, since their AUM is largely locked up, and strategies are harder to index. Alternative asset managers have enjoyed significant net inflows due to good investment returns and general expansion—both in size of average fund and broadening platforms.

Balance-sheet strength, low rates, recovering asset prices and high trading volumes, and low leverage support credit quality for some NBFI issuers.

We anticipate less cyclical support to trading volumes this year, but we expect that revenues in the global financial market infrastructure sector will continue to grow due to organic initiatives and acquisitions. FMIs will remain acquisitive, but new transactions will likely dip as a series of major deals just closed or will do so in the first half. Despite higher leverage arising from these deals, strong cash flow generation and disciplined financial risk appetite remain supportive, and cheap debt financing will likely remain readily available.

We expect most U.S. finance companies we rate to face continued challenges related to COVID-19 and perhaps tighter regulation, but to generally navigate such obstacles. We expect they'll benefit from a rebounding economy, good balance sheet management, and active funding markets. Nevertheless, and at least until vaccines reach wide distribution, we see significant uncertainty related to CRE lending, and residual risks related to leveraged lending, consumer loans, money transfer, and student lending. These may lead to rising charge-offs and some need to continue allocating provisions for loan losses this year, and will be a headwind to earnings. Mortgage companies, which benefited from a surge in origination volumes linked to low rates in 2020, will likely see lower volumes this year. Consumers lenders, which, to an extent, staved off asset quality problems thanks to forbearance and eviction moratoriums in 2020, may have to grapple with delayed asset problems this year. On top of that, the Biden Administration and a Democratic-controlled Congress increase the odds of tighter regulation and enforcement in some areas—including the Consumer Financial Protection Bureau, which may take a more aggressive approach. Additionally, a higher corporate tax rate could eat into earnings.

Our outlook for securities firms is stable, supported by the prospects for economic recovery. We expect short-term interest rates to remain low, which may bolster economic and market conditions but could cause asset-price bubbles and reduce revenue from spread and clients' cash. We don't anticipate increased ratings volatility, given our expectations that most rated firms will maintain relatively consistent risk-adjusted capitalization, funding, and liquidity.

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Ratings activity has been strongly affirmation-oriented in the first quarter of this year. There have been no sector outlook changes, but our business conditions outlook has improved for the life, health, reinsurance and mortgage sectors (although all borrowers in mortgage insurance still have negative outlooks) (see table 3). Overall, the average financial strength rating for the core North American insurance portfolio (life, health, property/casualty [P/C]) is at the upper range of the strong ('A') category.

Key risks include pricing adequacy, profitability, investment yields, and policy. Balance sheet strength remains a pillar of credit quality support for the portfolio, providing a measure of protection from risks related to downside economic developments and the expansion or increase in the magnitude of specific current and emerging subsector risks, more specifically.

Table 3

North America Insurance Sector Trends Q2 2021

Sector	Current business conditions	Business conditions outlook	Sector outlook
Life insurers	Satisfactory	Somewhat stronger	Stable
Health insurers	Satisfactory	Somewhat stronger	Stable
Property/casualty insurers	Satisfactory	No change	Stable
Global reinsurers	Weak	Somewhat stronger	Negative
Bond insurers	Satisfactory	Somewhat weaker	Stable
Title insurance	Satisfactory	No change	Stable
Mortgage insurers	Weak	Somewhat stronger	Negative

Note: Business conditions and sector outlook are for the next 12 months. The shaded cells indicate changes since Q3 2020.
Source: S&P Global Ratings.

While we believe that life insurers will continue to deal with stresses on their investment portfolios, muted earnings due to low interest rates, challenges to distribution, and elevated mortality claims, most of our ratings remain stable. Strong capital buffers—further bolstered last year due to high levels of debt and hybrid issuance, and capital preservation—remain key to helping the industry deal with the headwinds and will likely limit downward ratings movements. Sales will remain somewhat challenged as long as some pandemic restrictions remain in place but are poised to rebound as the economy opens. The low rate environment, coupled with low equity valuations for life insurers, will continue to fuel mergers and acquisitions (M&A). We believe companies will continue to look for opportunities to exit or divest nonstrategic businesses and simplify their balance sheets.

For health insurers, regulatory risk remains at the top of the list. That said, the Biden Administration's moves thus far appear to be generally favorable for the industry. The federal stimulus package includes funding that will expand the Affordable Care Act (ACA) exchange program and incentivize Medicaid expansion. We believe talk of a "public option" could resurface at some point, but passage would likely be difficult given the Democrats' slim majority in Congress.

The pandemic-related economic and health fallout has been manageable for the industry. Most health insurers reported favorable operating results last year as reduced costs from lower-than-normal non-COVID utilization more than offset the addition of pandemic-related testing/treatment costs. Most health insurers assume costs will pick up this year due to higher utilization, elevated COVID testing/treatment costs, and higher acuity/high-cost claims. We believe the industry's capital positions give it sufficient cushion to absorb earnings volatility with limited rating actions.

While loss emergency from COVID and natural catastrophes has persisted so far this year, the U.S. P/C industry came into 2021 with strong balance sheets, attributed to capital raising and a strong market recovery. Momentum on rate increases should buoy adequate returns on capital similar to the prior cycle, but low interest rates remain a damper on net investment income. In anticipation of an economic recovery, insurers will be less likely to provide another around of premium relief to auto policy holders. This should allow for gross premiums written at or above GDP growth. Ice storm Uri in the first quarter could stress catastrophe budgets for the full year among insurers exposed to the event. We believe Uri losses could turn out to be an earnings event mainly for less-diversified insurers. With demonstrated resiliency during the pandemic from stronger balance sheets, we still expect insurers to focus on utilizing excess capital through expanding underwriting opportunities, resuming shareholder returns, and pursuing opportunistic tuck-in acquisitions.

The global reinsurance sector has struggled to earn its cost of capital in recent years due to large natural-catastrophe losses, adverse loss trends in certain U.S. casualty lines, and fierce competition among reinsurers exacerbated by alternative capital, which over the years has eaten up margins in the property catastrophe line of business. As a result, our outlook on sector remains negative, but we may revise our view back to stable if we believe it can sustainably earn its cost of capital. The sector capitalization remains robust benefiting from capital raises last year and the financial markets' recovery from March 2020 lows. Reinsurers' investment returns will likely suffer in the next couple of years because of low interest rates and higher credit losses. As a mitigating factor, reinsurance pricing has been hardening through the January 2021 renewals, supported by COVID and Winter Storm Uri losses, which we believe will carry the positive reinsurance pricing momentum throughout 2021.

Bond insurers continue to capitalize on investor caution due to financial uncertainty for municipal issuers brought about by the pandemic. Demand for insurance in the USPF new issue market has remained elevated, with insured penetration rising well above levels of recent years. Additionally, growth in insured secondary market issues continues as investors prove to be credit-sensitive. We don't expect these trends to change materially as economic recoveries will continue to be uneven across issuers. We don't foresee defaults of issues insured by the bond insurers to be widespread, but there continues to be potential for ratings migration for some insured issues.

Capitalization in the title sector remains robust benefiting from capital raises last year and low levels of losses. Rising interest rates combined with negative existing home supply dynamics could damp home purchases. However, rates are still low enough the support strong refinancing demand. Additionally, a rebound in the commercial market in the fourth quarter of last year may be a sign of positive performance throughout 2021. The overall profitability of title insurers will depend on their ability to manage operations throughout the mortgage cycle. This is especially true in an environment where the product mix is more heavily weighted toward residential mortgage refinancings, and, as a result, the premiums are lower per transaction.

Private mortgage insurers reported positive earnings last year despite a significant increase in delinquencies and higher-than-average mortgage credit losses. The number of delinquent loans outstanding continues to improve since its June peak. In addition, home purchases have been more robust than anticipated, supporting house-price increases, and refinancing activity was high due to low interest rates. Housing fundamentals are supportive, with relatively low interest rates and first-time buyers strengthening demand across the U.S., although we expect mortgage origination volume to be lower than last year's as refinancings decline. Mortgage insurers have strengthened their capital positions by issuing debt, raising equity, and accessing reinsurance to lessen their net exposures, although at an elevated cost. Additional fiscal stimulus and extended forbearance relief should help borrowers with the transition as employment improves. These factors should support positive earnings. However, headwinds remain, as continued social distancing could hamper economic activity and slow down the recovery. Also, a key sensitivity remains regarding the transition period when payment forbearance subsides.

Related Research

- Credit Conditions Asia-Pacific Q2 2021: Uneven Recovery, March 30, 2021
- Credit Conditions Emerging Markets Q2 2021: Brighter Prospects Prone To Setbacks, March 30, 2021
- Credit Conditions Europe Q2 2021: New Horizons, Old Risks, March 30, 2021
- U.S. Speculative-Grade Corporate Default Rate Forecast For Year-End 2021 Falls To 5.5%, March 30, 2021
- Economic Outlook Canada Q2 2021: Consumer Spending Could Set The Pace Of Recovery, March 30, 2021
- Economic Outlook U.S. Q2 2021: Let The Good Times Roll, March 24, 2021
- Orderly Global Reflation Will Support The Recovery From COVID-19, March 22, 2021
- Central Banks, Credit Markets, And The Catch-22 Taper, March 22, 2021
- Across U.S. Public Finance, All Sectors Stand To Benefit From The American Rescue Plan, March 18, 2021
- Global Debt Leverage: Near-Term Crisis Unlikely, Even As More Defaults Loom, March 10, 2021
- Transition Finance: Finding A Path To Carbon Neutrality Via The Capital Markets, March 9, 2021
- COVID-19 Heat Map: Some Bright Spots In Recovery Amid Signs Of Stability, Feb. 17, 2021
- Remote Working Is Testing U.S. Office Landlords' Credit Quality, Feb. 11, 2021

S&P Global Ratings believes there remains high, albeit moderating, uncertainty about the evolution of the coronavirus pandemic and its economic effects. Vaccine production is ramping up and rollouts are gathering pace around the world. Widespread immunization, which will help pave the way for a return to more normal levels of social and economic activity, looks to be achievable by most developed economies by the end of the third quarter. However, some emerging markets may only be able to achieve widespread immunization by year-end or later. We use these assumptions about vaccine timing in assessing the economic and credit implications associated with the pandemic (see our research here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

This report does not constitute a rating action.

Appendix 1: Nonfinancial Corporate Sectors Outlook

For analytical contacts, please see Appendix 3.

Table 4

North America Nonfinancial Corporate Sectors Outlook

Sector	Comment
Aerospace and defense	The severe decline in global air travel due to the pandemic resulted in aircraft manufacturers cutting production 30%-50% last year, depending on the model. This had a material negative effect on the earnings and cash flows of most companies in the supply chain, many of which were already being hurt by the grounding of the 737 MAX, which was finally lifted in late 2020. Except for the MAX, which is ramping back up after the grounding, we don't expect an increase in commercial aircraft production this year. Earnings and cash flow will at best stabilize for most firms but will vary depending on how successfully they reduced costs and business mix. If the recovery in air travel doesn't accelerate later in the year as vaccinations increase, production may remain flat through 2022 or decline further. Conversely, if air travel recovers faster, production of narrow-body aircraft (used on domestic routes, which are likely to recover first) could start to increase in late-2021 or early 2022. The rebound in aftermarket demand will likely be slower than recovery in air traffic due to the large number of retired aircraft. The effect on defense contractors should continue to be modest, with some delays in new contracts and, in certain cases, less efficient operations due to safety protocols or other disruptions. Defense spending could be slightly below previous expectations as the government extends substantial spending in economic relief to offset the impact of the pandemic, but we do not anticipate significant cuts.
Autos	Credit quality in the sector will likely improve this year because of better factory utilization and a more favorable product mix (more pickup trucks and SUVs, together classified as trucks) than in previous years. Despite some downside risks to auto production from semiconductor shortages, volume levels should remain healthy enough for most automakers and suppliers to operate with relatively strong EBITDA margins, especially given the higher profits they earn on trucks. Given the supply chain issues, adverse weather-related effects on auto sales, and vaccine rollout uncertainty, we expect the industry to operate with less than optimal capacity in the first half, resulting in lower inventories than planned. This should be mostly offset by a strong recovery in the second half. In addition, even though gasoline prices are rising, we believe significant new product launches—along with better fuel efficiency, higher perceived safety for trucks, and steady incentives—will support automakers' product mix; trucks accounted for 76% of sales last year. Automakers will adjust by shifting production from slower-selling vehicles (such as sedans in the U.S.) to divert the chips to hotter segments of the market, including pickup trucks and SUVs.
Building materials	The outlook for credit quality in U.S. building materials is bouncing back, with net negative outlooks receding to about 25% of the portfolio, from more than 50% in mid-2020. The sector will lap an unusual 2020, where second-half demand and revenue boomed by double digits in North America because consumers redirected discretionary spending into their homes amid lockdowns. Correspondingly, the pace of vaccinations could reverse consumer spending habits in the summer of 2021, but underlying trends like home sales still appear favorable. Sharply higher commodity prices in 2021will test issuers' pricing power, while labor availability and supply chain backlogs could affect efficiency and profits. Prices for lumber, metals, glass, and gypsum are all at multiyear or multidecade highs as output is slow to return to 2019 levels despite strong demand. Production lines for several commodities were shuttered at the start of the pandemic, some permanently, and it can take weeks or months to ramp up or ramp down large production facilities, and it's usually costly. Receptive capital markets and a positive industry trend have enabled more debt-funded acquisitions and dividends, with higher debt and associated restructuring costs dragging on credit measures. Since the first quarter of last year, we have downgraded 18 times and upgraded seven times, mostly among a large cohort of financial-sponsor-owned companies, for a net downward migration in the portfolio of more than 20% despite the pandemic-induced boom.
Capital goods	The effects of COVID-19 and the sharp economic contraction resulted in significant revenue and EBITDA declines in second-quarter 2020, pressuring the credit quality in the capital goods sector, though conditions improved in the second half and the declines moderated in the third and fourth quarters. Overall, rated capital goods issuers reported revenue declines of 10%-20% and EBITDA declines of 15%-30% in fiscal 2020. The extent of the effects depends on the issuers' exposure—those in weaker end markets such as oil and gas, autos, commercial aviation, and metals and mining face greater pressure. We expect revenue and profitability to rebound this year, with flat to slightly higher revenues and modest improvement in profitability from a broad recovery of industrial activity and higher capital spending. Given improving operating conditions, we expect our negative ratings bias to ease.

Chemicals	A demand recovery from the recessionary conditions of 2020 is well underway in the chemical sector. While a small number of chemical products and companies benefitted from demand growth during 2020, most chemical companies will see demand recover in the next 12 months or so. However, we also expect input costs to come off of their 2020 lows and working capital requirements to rise. The impact on each company of these variables will depend on several factors including their market position, cost position relative to competitors, and the specific end markets they serve. In general, our expectation is that credit metrics will recover to 2019 levels by next year for most companies. There may be exceptions, including those created by more aggressive financial policies than before, or from subsector dynamics especially in commodity chemicals if new supply additions pick up pace, post-recession. A recovery in the sector is tied into the larger economic recovery and a recovery in crucial chemical end markets such as auto, housing, and general industrial. A reversal in this recovery remains a risk factor.
Consumer products	We expect foodservice distributors, apparel manufactures, and cosmetics companies to still face an uneven recovery. These subsectors were materially hurt by consumers' stay-at-home behavior during the pandemic. We see ratings stability for large players with significant scale and financial flexibility. The outlook for smaller, less-diversified issuers that have less scale and financial flexibility remains negative. Credit metrics won't likely recover to pre-COVID levels until next year for most companies. The rated durables issuers have performed better than we had expected because of their exposure to the housing, home improvement and decorating markets. U.S. consumer products companies in food, home-cleaning products, and hygiene continue to benefit from consumer trends and behavioral changes associated with the pandemic, including increased at-home food consumption, more products in their pantries, a heightened personal wellness focus, and increased online purchases. We expect most companies in these sectors to maintain some of the share gains they achieved last year even as consumers resume most of their pre-COVID activities. During the pandemic consumers navigated back to familiar and trusted brands, and they also improved their relationship with their retail customers because of their flexible supply chains. We expect these sectors' sales and EBITDA to remain above 2019 levels. M&A slowed in the food sector in 2020 as companies focused on meeting higher demand. This has resulted in stronger balance sheets. We expect companies in these sectors to resume repositioning their product portfolios to strengthen their long-term growth prospects and will use their increased financial flexibility for bolt-on acquisitions. In addition, we expect them to resume pre-COVID shareholder returns and in some cases increase share repurchases if they do not pursue M&A. We expect rating stability for these sectors; however, financial policy will be a key factor given our expectation for strong acquisition activity and debt-financed dividends to equity sponsors.
Forest products	Wood products makers are enjoying some of the highest prices in history because capacity closures at the outset of the pandemic sparked a price spike when demand improved against expectations. Credit quality is getting a much-needed boost after a weak 2019, with windfall profits from higher prices and tight supply. Wood producers have not kept pace with the 15% increase in demand, so that sawmill operating rates jumped above 90% in 2021 across most of North America, contributing to record cash flows. Incremental output has often kept a lid on wood products prices over various cycles, but near-term marginal capacity appears modest for lumber and oriented strandboard. Pulp and paper markets have largely remained soft due to excess capacity amid lower business demand for paper in light of COVID-19. That said, packaging markets have remained fairly resilient, supported by the growth in e-commerce during the pandemic. Ongoing paper supply curtailments owing to structural demand declines will likely accelerate and provide some price stability.
Gaming, leisure, and lodging	Travel bans, stay-at-home orders, and restrictions on consumer activity continue to loosen, but nearly all cruise, lodging, theme park, fitness, and sports issuers are still facing diminished revenues and ongoing cash burn. Regulatory oversight poses a particular risk to the cruise recovery. Further delay in our current assumption that U.S. cruising resumes sometime in the third quarter could result in a longer cash burn for operators. A successful vaccine rollout in the U.S. that results in widespread immunization is more important to recovery in the overall leisure sector than the recent stimulus legislation because the pace and extent of a reduction in safety concerns will drive the shape of the recovery. Still, if recent increased levels of fiscal stimulus help the economy grow faster, then it would help once safety concerns are sufficiently reduced. Some regional gaming companies and outdoor recreational activities like RVs and boats, are faring much better than the overall sector with some experiencing year-over-year growth relative to pre-COVID performance. In addition, debt markets continue to finance incremental debt to cover cash burn or refinance upcoming maturities, with much less stringent terms and conditions than at the beginning of the pandemic. While issuance has helped to bolster balance sheets and stave off near-term bankruptcies, depending on cash burn rates companies will be saddled with a significant amount of incremental (and in some cases high-cost) debt as they navigate recovery and the potential for years of lower revenues. As various U.S. states continue to reopen, some subsectors such as local drive-to markets and outdoor recreational activities are recovering faster, but we believe there could be a moderation in this trend later this year and in 2022, particularly for some outdoor recreation segments that benefited during the pandemic. Given the material impact COVID-19 has had on the leisure sector, we believe longer-term structural changes could have a lasting impact on credit quality. This could include properties that never reopen, permanent supply and demand imbalances, and disruption to operations that could affect future profitability. As a

	result, for many subsectors, we expect a multiyear recovery for credit metrics to reach to pre-pandemic levels.
Health care and pharmaceuticals	The health care industry continues to recover from the pandemic, with elective procedure volume, recovering to within 5%-10% of pre-COVID-19 levels. The recent significant improvement in vaccination rates have helped lower infection and hospitalization rates, putting less strain on stressed regional health care systems and providers. Meanwhile, the pharmaceutical and biotech industry was relatively insulated from the worst effects of the pandemic and we believe have already fully recovered. With the successful launch of multiple vaccines and continued growing demand for vaccine-related research and development and manufacturing supplies, diagnostic tests, and personal protective equipment, we are seeing positive ratings pressure on select subsectors, such as life sciences and medical products. The demonstrated resilience of the health care industry through the pandemic, along with what we believe will be a measured pace of legislative change for health care policy, have led us to revise our ratings outlook for the industry to stable from negative. With the recent passing of the $1.9 trillion stimulus, President Biden has shown that his main focus on health care will be on expanding coverage, which on the face of it, is a credit positive for the health care industry.
Homebuilders	We have a positive outlook on more than one-quarter of issuers in the U.S. homebuilder industry, because financial discipline before and during the pandemic is yielding stronger ratios and a growing credit buffer. The industry's credit outlook further benefits from good long-term demand, stronger pricing amid tight supply and record-low mortgage rates, good cost management, and judicious capital allocation. U.S. household formation appears solid, and the current peak in housing starts only recently neared the long-term average of 1.5 million-1.6 million. Slower foot traffic and a potentially slower closing process for social distancing has accelerated the digitization of homebuying, enabling better sales conversion from more serious buyers and potentially lower costs. On the other hand, a rise in mortgage rates off record lows could sap the important price growth that has sustained margins amid higher costs and an industrywide shift to lower price points. A few homebuilders still had higher debt leverage from lower earnings last year, but most have generated good cash flow amid more conservative policies. Looking ahead, however, homebuilders will likely spend significantly more on land in the next few years just to maintain output, because they're replacing four- to five-year-old inventories (and some older) with land values that have risen more quickly since 2018. The shift to land options versus outright purchases is much different than the housing boom in late 2000s. Homebuilders now have less debt during a market upswing covering a smaller pool of illiquid real estate assets.
Media and entertainment	The recovery of the media sector from the pandemic remains a tale of two sectors. Even as the general economy continues its path to recovery, the near-term outlook for out-of-home entertainment remains uncertain as many venues remain closed or under strict government-mandated social distancing measures, which severely limits attendance. The pace of recovery for these sectors is highly correlated to the pace of vaccinations and so any delays in efforts to reach herd immunity could lead to governments extending social-distancing measures, setting back recovery. Longer term, even with widespread immunity, lingering consumer fears about returning to large public events may ultimately affect any return to normalcy, although anecdotal evidence (theme parks, advanced ticket sales for music concerts) currently points to strong consumer demand. Ad-based media sectors such as television, radio, and outdoor, on the other hand, have continued to see improving advertising trends since the bottom in the second quarter of last year—though the rate of recovery is mixed. TV and billboards are pacing ahead of our expectations, while radio and transit are pacing below. Television's recovery, in particular, benefitted from record political advertising in the second half of last year (on the local side), the return of sports programming (on the national side) and generally on advertisers scrambling to get their products or services in front of consumers in a recovering economy. We expect many of these sectors could return to pre-pandemic revenue levels by the second half, if not sooner. Still, longer term, we expect that the pandemic will accelerate secular pressures from falling audience ratings, cord-cutting, and growing alternate entertainment options that are ad-free, on traditional advertising-based media.
Metals and mining	Credit quality among metals producers is rebounding along with robust demand from most industrial sectors and lower costs and output during pandemic-induced shutdowns. As the sector recovers, inflation, interest rates, and the U.S. dollar could be important factors for prices, considering the long-standing inverse relationship of metals and the dollar, and the inherent inflation protection from these hard assets. Good demand and bullwhip restocking have sparked a 30%-60% surge in most metals prices, with steel backlogs at historical highs. The industry's outlook and response mirrored that in the 2008 financial crisis and other sharp downturns like in 2013 or 2016, closing plants to rebalance markets and reduce costs in these high fixed-cost industries. Spot prices are outperforming our higher metal price assumptions in 2021, so we expect a 15%-20% bounce in year-over-year revenue and more than 20% stronger EBITDA almost across the board. The North American sector is characterized by elevated credit risk, with almost 50% rated 'B' or lower, but the negative outlook bias has abated to about 20% from 50% in early 2020. Downgrades peaked in the first two quarters of 2020 with weaker earnings and looming maturities, but better market conditions, several

	years of financial discipline, and receptive capital markets have since bolstered credit quality. The improving outlook for metal producers is mixed, however, with a multiyear slowdown for metal consumers in aerospace, but a bounce in ground transportation and packaging. We expect volumes will lag in some key industries, so that a rebound to 2019 volumes still appears to be in 2022. The turnaround could provide a catalyst for further transformative investment to improve assets and competitive positions because of global pressure and ESG considerations for greenhouse gas emissions in the steel industry.
Midstream energy	The sector continues to stabilize, with cash flow declines abating and more speculative-grade companies forecasting positive discretionary cash flow. About 33% of the sector outlook is on negative outlook or CreditWatch negative. Commodity prices have strengthened, which we view as more supportive of midstream infrastructure utilization and credit quality. We also believe production will be slightly better than our previous expectations, although we do not believe this will lead to higher levels of capital spending for midstream companies. Volume declines and counterparty credit quality are key risks to the sector but the uncertainty around the timing and pace of any recovery makes it difficult to predict the severity of impacts on midstream credit profiles. We believe the midstream sector recovery will largely be in sync with an improvement in the upstream sector, which we think will pick up in the second half. We think midstream companies will focus on using excess cash flow to repay existing debt, thus improving credit quality even with a delay in upstream or general economic recovery.
Oil and gas	The recent rally in hydrocarbon prices from the depths of their lows in mid-April has been supported by massive supply cuts from OPEC and Russia, positive vaccine news and the gradual reopening of global economies. Current oil prices, if sustainable, are largely supportive of credit stabilizations for the upstream space. We remain concerned about the 7.5 million barrels or so of OPEC supply that is still off-line but believe that OPEC will remain supportive, meeting any increase in demand and will likely target a $60-$70 oil price range. Despite oil prices that are well above most shale producers break-evens, we do not expect shale production to rebound rapidly. Rather, we believe producers will continue to target reinvestment ratios of 70%-75% and will only nominally increase production. We believe producers will either utilize excess cash flow to either improve the balance sheet or fund returns to shareholders. This reinvestment rate is not supportive for many oilfield service (OFS) companies that had to concede further price concessions to producers last year due to extremely weak market conditions. However, increases in rig count and well completion activity given the rally in oil prices should provide a floor to OFS margins and possibly lead to some pricing power.
Oil refineries	The refining sector will likely see improvement this year but will still have profitability and cash flow that is well below mid-cycle conditions and lower credit metrics compared with those maintained pre-pandemic. Independent oil refiners' margins are improving from inventory levels that are more in balance with demand expectations, which we believe will strengthen as the vaccine rollout continues through the summer. That said, weaker first-quarter results from outages due to Texas Storm Uri and a heavy incremental debt burden exceeding $10 billion to shore up liquidity means that refiners will continue to face an uphill battle. We now expect the recovery to be pushed out until the second half, and possibly early 2022. Refineries are trying to mitigate weak demand by keeping utilization in the mid- to low-80% area and converting refining capacity to renewable bio-diesel or shuttering. A prolonged demand response due to COVID-19 could further weaken credit quality.
REITs	REITs faced significant earnings pressure in fiscal year 2021, which is in line with our expectations due to the impact from the lockdown, store closures and social-distancing measures. Retail and senior housing assets were hurt most. Senior housing assets were affected as fewer move-ins hurt occupancy. Rent collection has improved following store reopening for retail properties, increasing to the low-90% area in the fourth quarter from 30%-70% in the second quarter, with malls collecting the least and net lease assets collecting the most within retail real estate. Rent collection for most property types remain resilient at above 90%. We expect a multiyear recovery with credit metrics recovering to pre-COVID levels by next year, though retail and office could take longer. Gradual economic growth driving employment and consumer spending should support recovery in real estate demand, though potential for longer term changes in consumer behavior could result in greater pressure in retail, office, and multifamily assets.
Regulated utilities	The regulated utility industry remains on target with recovery. Key credit risks for the industry remain related to ESG and generally weak financial measures for current ratings. Last year was the first in a decade that downgrades outpaced upgrades, and 2021 year-to-date downgrades are again outpacing upgrades by more than 10x. Although it is still early in 2021, it appears that 2021 will be the second consecutive year of downgrades outpacing upgrades. Additionally, while the industry's median rating remains at 'A-', the industry only needs about another 15 downgrades for the median rating to be lowered, for the first time ever, to the 'BBB' category. Given that about 35% of the industry has a negative outlook, it is possible that the industry's median rating falls to the 'BBB' category before year-end.
Retail and restaurants	Although credit risks in the retail and restaurant sector remain elevated due to uncertainty around containment of the pandemic and consumer behavior in a new normal, we are starting to see recovery or stabilization in some areas. Margin and cash flow adequacy will continue to be weak for most issuers exposed to mall-based retailing and dine-in restaurants due to pressure on the topline and increased costs

	for health and safety. Grocers and specialty retailers that have benefitted from nesting face difficult comps in the back half of the year that will be amplified by consumers' gradual return to activities outside the home. The positive effects of Biden's $1.9 trillion stimulus will likely be uneven across the sector and hinge on consumer's comfort level in returning to travel, dining, and other experiences. In the longer term, retailers and restaurants will have to adapt to changed consumer shopping habits, such as a higher proportion of spending via digital channels, in addition to food and labor inflation and incremental costs associated with health and safety measures. Full-service restaurant chains could gain market share due to permanent closures of independents. We don't expect 2019 levels of mall-based retailing to return for years, if ever.
Technology	Our view of the sector outlook has improved compared to last quarter, as economic growth improves and enterprise IT spending needs rise. Hardware and IT services subsegments are the laggards in tech spending recovery due to their reliance on large transactional revenues or difficulty in winning new businesses when work-from-home practices are being extended until effective vaccinations are broadly available and it's safe to return to offices. Still, we believe most IT spending is merely delayed instead of lost, which bodes well for a second-half demand recovery. Semiconductor and software segments continue to performance well and should see at least mid-single digit percentage growth. Tech companies have been proactive in accessing the debt capital market to refinance debt at lower interest rates and extend maturities. M&A will likely be the driver for additional debt issuances this year. However, many tech M&A announcements since mid-2020 include all or partial equity financing, which we view favorably from a credit perspective.
Telecom	Overall, telecom and cable providers have been resilient to COVID-19 with limited impact to credit quality given their recurring, subscription-based business models. In fact, in-home broadband providers have benefitted from the surge in data consumption, which resulted in outsized earnings growth for many cable operators. We expect earnings growth to normalize in the mid-single-digits for these providers but don't expect trends to reverse, as shifting technology and consumer behavior will continue to result in rising data usage and continued cash flow growth. We believe that fiscal stimulus will support consumer demand for wireless and wireline broadband servicer near-term but overall sensitivity is low as internet connections are utility-like services that are one of the last things consumers are likely to drop due to economic hardship. However, there are a handful of companies that have exposure to vulnerable sectors such as transportation, retail, and tourism, which hurt financial performance last year. In addition, issuers that have exposure to small- and mid-sized business (SMB) customers are more at risk since they will most likely reduce telecom spending in a recession. We believe that issuers with more exposure to SMB customers are the most sensitive to the risk of a potential delayed vaccine rollout (and the achievement of herd immunity) and the potential need for ongoing fiscal stimulus.
Transportation	COVID-19 is having a disparate impact on transportation companies, depending on which subsector they are in. Passenger airlines continue to be under severe pressure, with the first half likely to remain weak, but a second half rebound in domestic leisure travel as vaccination becomes widespread. We expect full-year revenues to be only 40%-60% of 2019 levels, improving to 70%-80% next year. Liquidity is mostly adequate because of federal aid and active debt raising in the capital markets or from the U.S. Treasury (CARES Act). Aircraft leasing companies are suffering from airline customer defaults and lower lease rates, but their global diversity, mostly good quality young aircraft, and successful unsecured borrowing put them in a much better position than their airline customers. By contrast, freight transportation companies were hurt less by the pandemic and have mostly recovered to or close to pre-pandemic revenue levels. Indeed, some, notably the big package express companies, are benefiting from the surge in online ordering by consumers. If COVID is brought mostly under control and further federal fiscal stimulus succeeds in boosting the economy, there will likely be capacity shortages in some freight transportation markets, such as trucking and package express.

Appendix 2: Economic Data And Forecast Summaries

Table 5

U.S. – S&P Global Ratings Economic Outlook

	2020	2021f	2022f	2023f
Real GDP (year % ch.)	(3.5)	6.5	3.1	1.7
Real consumer spending (year % ch.)	(3.9)	6.9	4.2	2.1
Real equipment investment (year % ch.)	(5.0)	13.5	2.9	3.7
Real nonresidential structures investment (year % ch.)	(10.6)	0.6	5.9	5.6
Real residential investment (year % ch.)	6.0	11.9	(0.6)	2.0
Core CPI (year % ch.)	1.7	2.1	2.2	2.2
Unemployment rate (%)	8.1	5.5	4.6	3.9
Housing starts (annual total in mil.)	1.4	1.5	1.4	1.5
Federal Reserve's fed funds policy target rate range (year-end %)	0-0.25	0-0.25	0-0.25	0.25-0.50

Note: All numbers are in annual average basis, except the Fed's policy rate and housing starts. Core CPI is consumer price index excluding energy and food components. f—forecast. Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, The Federal Reserve, Oxford Economics, and S&P Global Economics forecasts.

Table 6

Canada – S&P Global Ratings Economic Outlook

	2020	2021f	2022f	2023f
Real GDP (year % ch.)	(5.4)	5.5	2.4	2.8
Real consumer spending (year % ch.)	(6.1)	4.6	4.1	2.7
Real private business fixed investment (year % ch.)	(11.5)	3.8	6.4	5.4
Core CPI (year % ch.)	1.1	2.0	1.9	1.9
Unemployment rate (%)	9.6	7.6	6.5	5.8
Housing starts (annual total in thousands)	219	231	210	211
CAD/USD exchange rate (per US$1)	1.34	1.27	1.27	1.24
Government of Canada 10-year bond yield (%)	0.8	1.7	2.0	2.3
Bank of Canada overnight rate (%, end of period)	0.25	0.25	0.25	0.50

Note: All numbers are in annual average basis, except central bank rates and housing starts. Core CPI is consumer price index excluding energy and food components. f—forecast. Source: StatCan, Oxford Economics, S&P Global Economics Forecasts.

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