S&P Global
Ratings

Global Credit Conditions Q2 2021:

The Risks Of An Uneven Recovery

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Global Head of Research

Alexandra Dimitrijevic
London
(44) 20-7176-3128
alexandra.dimitrijevic@spglobal.com

Research

Gareth Williams
London
gareth.williams@spglobal.com
+44-20-7176-7226

Joe Maguire
New York
joe.maguire@spglobal.com
+1-212-438-7507

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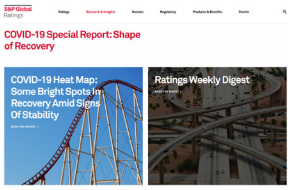

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Key Takeaways

- **Forward-looking credit trends point to a marked improvement.** The global corporate net negative outlook bias—measuring future downgrade risk—dropped to 26% in March from a peak of 40% last June. In the U.S., the rapid vaccine rollout and $1.9 trillion rescue plan have put the economy on a fast track, prompting us to revise downward the 12-month speculative-grade default forecast to 5.5% by December 2021 (from 7% previously).
- **The pandemic and an uneven "K-shaped" recovery has resulted in a near all-time high share of riskier credits.** 40% of speculative-grade corporates in the U.S., and one-third in Europe, are rated 'B-' and below, with a high concentration in industries most exposed to social distancing such as media, leisure, and retail. Upgrades slightly outpaced downgrades in the past few weeks, but an increasingly diverging path across industries may curtail the favorable impact of recovery.
- **Financing conditions remain strongly supportive across the rating scale,** on reiterated commitments from major central banks. Q1 saw record issuance on the high-yield bond and leveraged-loan markets in the U.S., including for issuers in the 'CCC' category, which have become a sweet spot for investors in search of yield.
- **Economic restart.** The economic recovery from COVID-19 looks set to accelerate in mid-2021, particularly in the U.S., on the back of a massive fiscal stimulus plan. We have revised our 2021 global GDP growth forecast upward by 50 basis points, to 5.5%, reflecting brighter prospects for North America, China, and India. We also revised 2020 growth upward.
- **Inflation and repricing risks.** In our view, the rise in long-term U.S. bond yields is an indicator of improving recovery prospects and is likely to be accompanied by controlled reflation rather than a dramatic reversal of a 40-year process of disinflation. The greater risks lie in the potential for market volatility and repricing given elevated asset prices, high debt levels, a desynchronized recovery and, ultimately, the withdrawal of extraordinary stimulus.
- **Other risks.** Significant risks continue to weigh on the credit outlook, primarily linked to potential delays and uneven rollout of vaccines, and solvency pressure from the step-up in global leverage. The pandemic has also accelerated secular shifts on energy transition and digitalization, and heightened geopolitical tensions and risks to political and social stability, bearing credit implications over the medium term.

(Editor's Note: S&P Global Ratings' Credit Conditions Committees meet quarterly to review macroeconomic conditions in each of four regions (Asia-Pacific, Emerging Markets, North America, and Europe, the Middle East, and Africa). Discussions center on identifying credit risks and their potential ratings impact in various asset classes, as well as borrowing and lending trends for businesses and consumers. This commentary reflects views discussed in the global committee on March 25, 2021.)

Credit conditions will likely remain underpinned by an improving economic sentiment, vaccine progress, and strongly supportive financing conditions. In the U.S., a rapid vaccine rollout and the $1.9 trillion American Rescue Plan (ARP) have combined to put the U.S. economy on a fast track to recovery. We have raised our U.S. real GDP growth forecasts for this year and next, to 6.5% and

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.

3.1%, respectively, from 4.2% and 3.0% in December (see "The Recovery Gains Traction As Unevenness Abounds", published March 31, 2021). For China, we have raised our growth forecast for this year to 8% (from 7%) on stronger trade and real-estate activity. With the two main pillars of the global economy rebounding strongly, and vaccination programs offering a clear exit path from pandemic restrictions, the growth backdrop is both favorable and improving.

Inflation risks overstated

Inflation risks are overstated. The rise in longer-dated government bond yields this year, particularly U.S. Treasuries, prompted debate about whether this is simply a function of improved economic prospects or a more troubling shift in real yields and inflation risk premiums. The pessimistic view is that increasingly punchy fiscal stimulus allied to powerful monetary policy support might lead to resurgent inflation, and market repricing and volatility. In our view (see "Economic Research: Orderly Global Reflation Will Support The Recovery From COVID-19", March 22, 2021), these fears are overblown. We see orderly reflation, around a return to sustainable growth, as a healthy development for macro and credit outcomes. Rising yields indicate greater confidence in a sustained economic recovery, including a normalization of both market functioning and risk pricing.

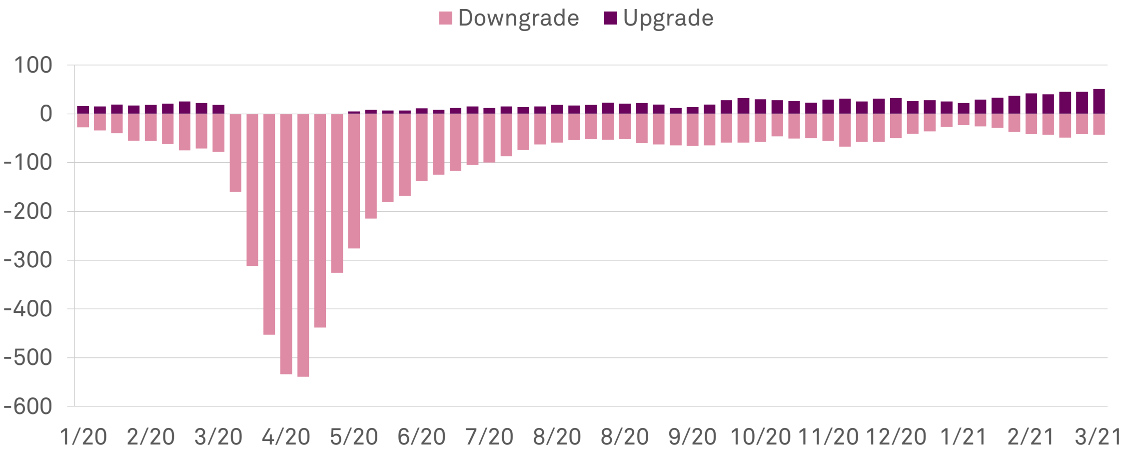
Recent ratings trends reflect an improving economic outlook

Ratings trends reflect this improving outlook. We highlight three notable turning points:

- In recent weeks, **upgrades have outpaced downgrades** (see chart 1) for the first time since December 2018. This is a significant inflection point, even though the proportion of upgrades remains fairly small.
- In addition, **the net negative outlook bias** (the percentage of ratings with negative outlooks minus the percentage with positive outlooks) **has improved significantly for nonfinancial corporates and financials** (see chart 2). The net outlook bias for nonfinancial corporates declined to 26% in March from a peak of 41% last June, led by a particularly sharp improvement in North America (see chart 3).
- **The U.S. distress ratio**—the proportion of speculative-grade ('BB+' or lower) issues with options-adjusted composite spreads of more than 1,000 basis points (bps) over U.S. Treasuries—**fell for the 11th consecutive month in February**, to 4.0%, after peaking at 35.2% just 11 months prior. The ratio has now dropped to its lowest level since May 2011, when the distress ratio reached 3.6%, as a reflection of the abundant liquidity and investors' search for yield, while credit fundamentals point to significant vulnerabilities.

Chart 1

Upgrades are now outpacing downgrades

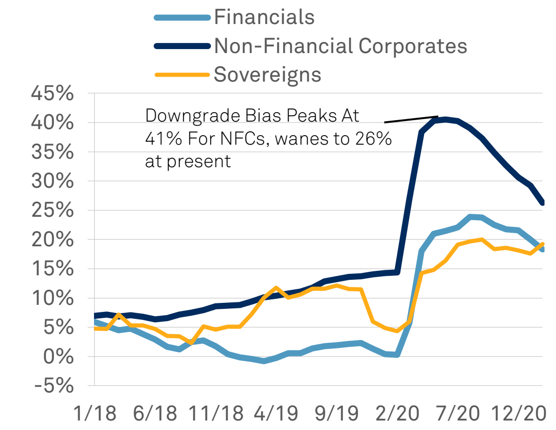


Source: S&P Global Ratings. Shows rolling four-week sum of upgrades and downgrades.

Chart 2

Nonfinancial Corporates Downgrade Pressure Was Greater Than For Financial And Sovereign Peers But Has Eased More Rapidly

Net Negative Outlook Bias By Asset Class (%)

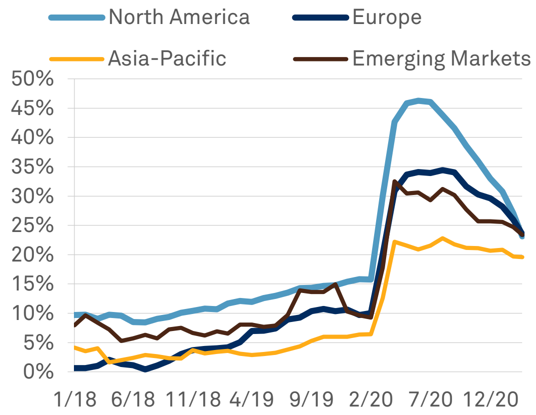


Source: S&P Global Ratings

Chart 3

North America Had The Biggest Spike In Net Outlook Bias, But Regions Have Largely Converged; Asia-Pacific Remains Most Stable But Still Elevated

Net Negative Outlook Bias By Region (%)



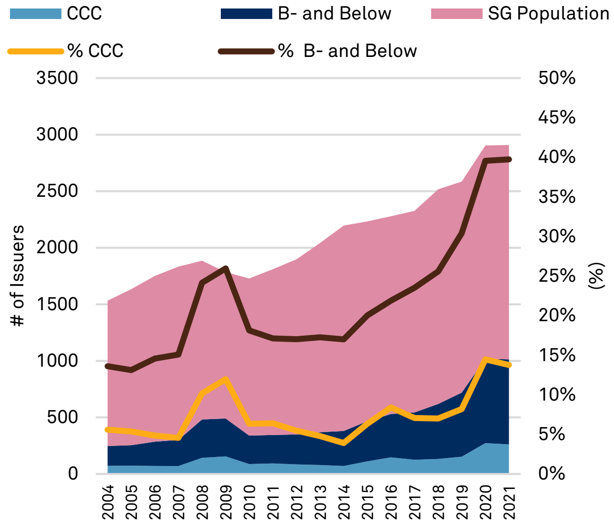
Source: S&P Global Ratings

The proportion of corporate credits assessed as most risky is still near an all-time high, while financial metrics remain stretched. Despite positive trends, the number of credits at the lower-end of the ratings scale remains near an all-time high (see charts 4 and 5), reflecting both higher leverage taken on during the pandemic and cash flows that remain well below pre-pandemic levels in industries such as airlines, leisure and gaming, and hotels. As of March 17, 40% of speculative-grade credits in the U.S. and nearly one-third in Europe were rated 'B-' and below, while 14% and 13%, respectively, were in the 'CCC' category. Leverage in the most COVID-exposed industries increased in 2020, with debt to EBITDA increasing to 5.5x, from 4.5x a year earlier. The same industries remain exposed to weak earnings well into 2022 (retail, auto) and even 2023 for some (airlines, leisure).

Chart 4

The Share Of Both 'B- And Below' And 'CCC' Rated Issuers Is Higher In The U.S. Than In Europe

U.S. Speculative-Grade Population

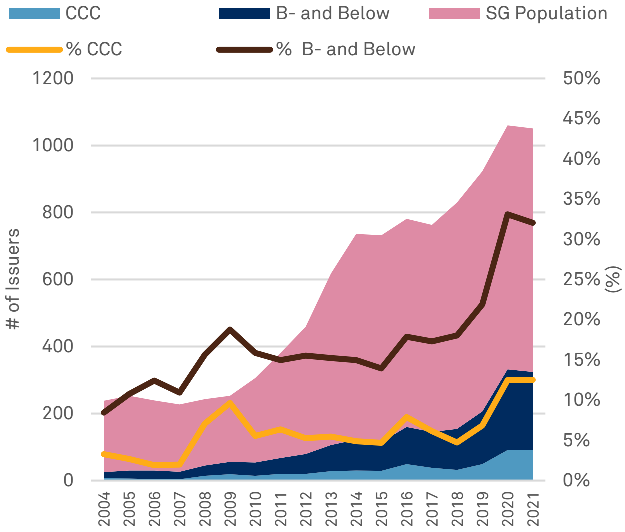


Source: S&P Global Ratings

Chart 5

Still, Nearly One-Third Of European Speculative-Grade Issuers Are Rated 'B-' And Below

Europe Speculative-Grade Population



Source: S&P Global Ratings

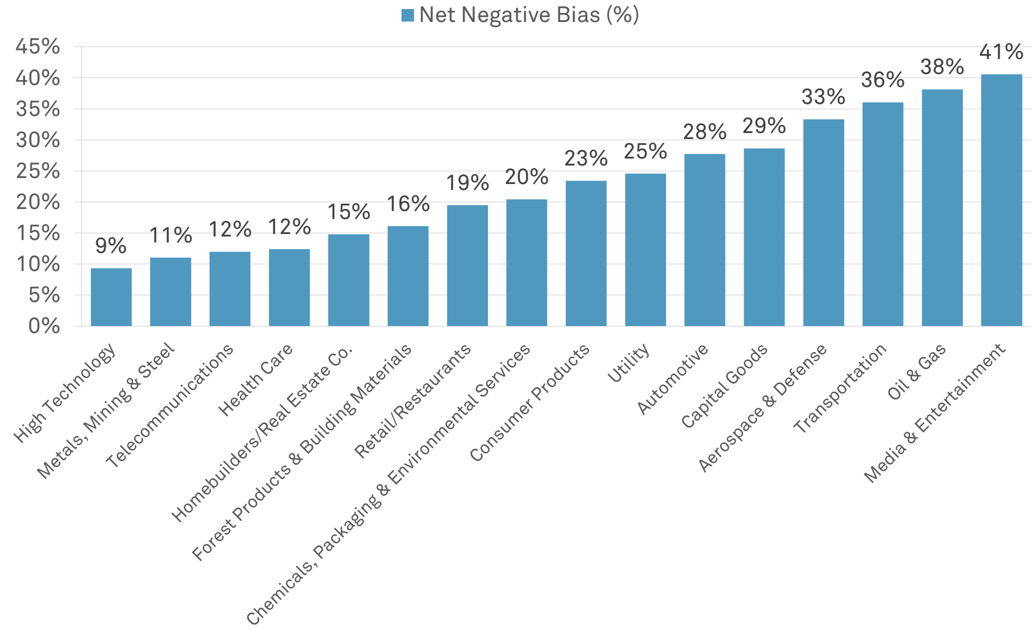
Still a K-shaped recovery. There are wide variations in regional and sectoral recovery prospects, and, if anything, the gap is growing. European economic recovery prospects have slipped behind those of the U.S. given the massive U.S. fiscal stimulus and the EU's faltering vaccination program, which has left the region struggling with an aggressive third wave of COVID-19 that will likely curtail summer tourism revenues and delay the lifting of lockdown measures. Meanwhile, Asia-Pacific's export-led economic growth rebound, is set to strengthen further, following the latest round of U.S. fiscal stimulus. However, domestic consumption remains subdued underpinning still cautious household and corporate behaviors.

Recovery prospects vary widely across regions and sectors and the gap is growing

Across industries, recovery prospects vary substantially, still largely determined by the COVID-affected operating environment. For technology, health care, and export-driven companies, cash flows have already returned to pre-crisis levels and operations are largely normal; for those dependent on unrestricted human contact, the crisis remains acute. These differences continue to be reflected in a wide variation in sector outlook biases (see chart 6).

Chart 6

Global Nonfinancial Sectors: Net Negative Bias



Source: S&P Global Ratings

Abundant liquidity and strong risk appetite remain critical support pillars. Credit conditions for borrowers across regions remain largely favorable in the context of the reiterated commitments of the major central banks to support market funding conditions well into 2023. Despite some volatility, spreads on corporate debt are remarkably tight, and issuers up and down the ratings scale (as well as in industries where secular headwinds predate the pandemic) have been able to tap markets at welcoming terms. The first quarter of the year has been the busiest on record for U.S. high-yield bonds, with almost $120 billion placed, according to International Financing Review (IFR). At the same time, institutional leveraged-loan issuance was also at an all-time high for any quarter, at $172 billion, according to S&P Global Market Intelligence's Leveraged Commentary & Data (LCD) offering. Thirst for yield has pushed investors to move now lower down the rating spectrum, resulting in 'CCC's outperforming the broader market and spurring 'CCC' issuance 20% higher than at this point last year.

Central bank liquidity support remains a critical support pillar

For emerging markets, too, funding conditions remain broadly favorable, with hard-currency spreads remaining near recent lows, despite a modest increase in volatility in recent weeks, spurred by the increase in the U.S. long-term treasury yields.

Chart 7

Secondary Spreads Remain Tight Across The Spectrum In The U.S....

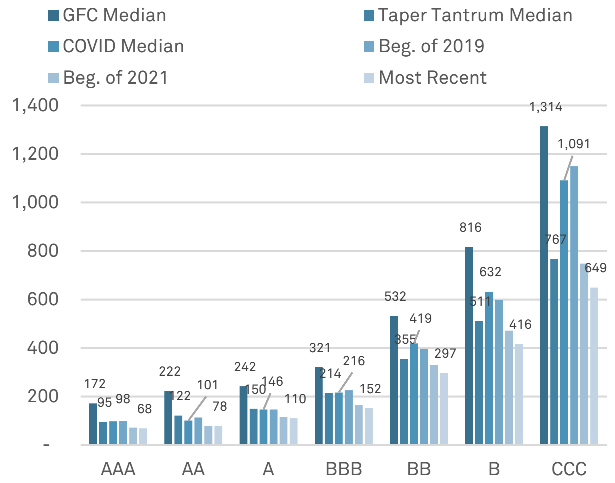
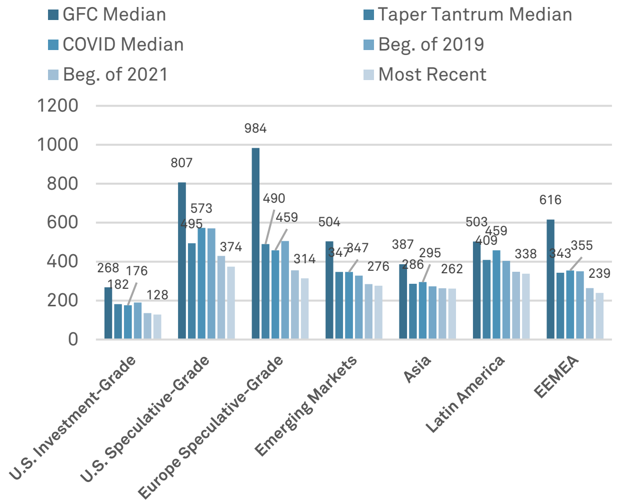


Chart 8

... And Across Geographies, Though Regional Differences Are Rising



Source: S&P Global Ratings; Federal Reserve Bank of St. Louis; Bank of America Merrill Lynch.

Risk premiums may not sufficiently reflect fundamental risks and uncertainty

Risk repricing may occur. We see signs that investors aren't being duly rewarded for the risks they're taking—specifically in lending to sectors that may suffer from consumer's continued reticence to resume normal social activities. This thirst for yield, and the level of liquidity it has pumped into the global economy, could create problems for credit markets in the longer term. Soaring debt and loose borrowing terms could translate into 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.

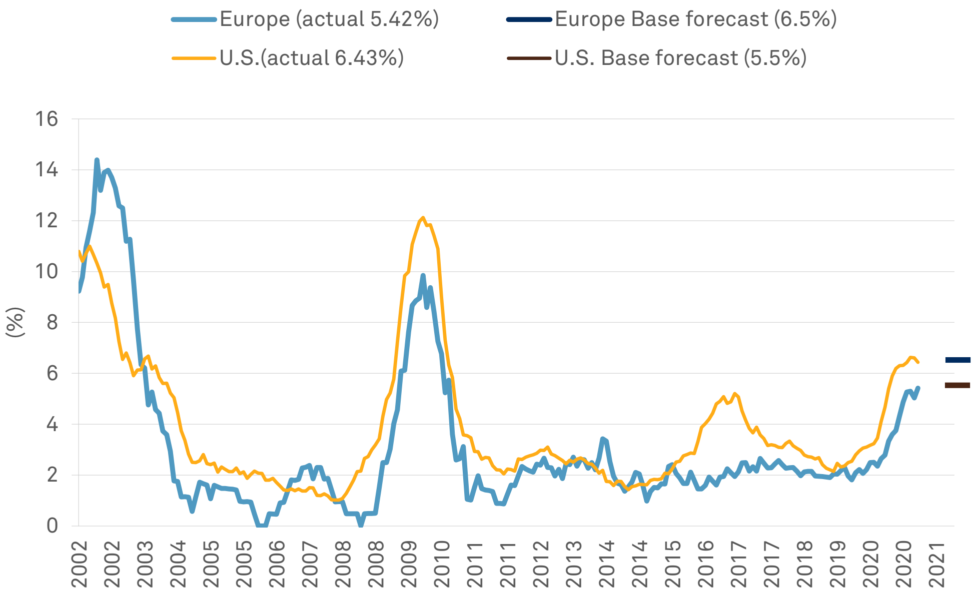
Defaults are likely to remain elevated, at 5%-6% globally, through 2021. For many credits, 2021 will remain a balancing act between the economic rebound, vaccine rollout, and favorable funding conditions on the one hand, but still high leverage and subdued earnings on the other, affecting vulnerable credits in most exposed industries. There remains a wide disparity in the credit outlook across and within regions, countries, and industries, which will leave many pockets of risk lingering, despite the broader economic recovery under way. Vaccination progress will remain patchy and slow in many parts of the world. Recovery itself will also bring challenges related to the withdrawal of extraordinary fiscal stimulus, working capital needs, cost pressures, and supply-chain challenges.

We forecast a U.S. SG default rate of 5.5% by year-end; 6.5% for Europe

Overall, we expect default rates to remain elevated through 2021, reflecting these pressures. **Following the upward revisions in the U.S. GDP forecast, we adjusted the U.S. 12-month speculative default forecast downward to 5.5% by December 2021** (from 7% previously). The U.S. default rate stood at 6.6% in December. and started easing slightly to 6.4% in February. We expect it to peak between 6.5% and 7% in Q1 then trend downward as the spike in defaults from 2020 exits the 12-month count. **In Europe, we forecast the 12-month speculative default rate will continue to increase to 6.5% by year-end**, from 5.4% in February and 5.3% in December. This is more than double the long-term average and the 2019 level. Given the high levels of lingering debt and slow return to pre-COVID credit metrics for some industries, the historically high proportion of issuers with 'B-' and 'CCC/C' ratings remains a risk. We anticipate that default rates in both regions may remain historically elevated in the future, perhaps evolving along a different course than the usual cycles of the past. Different from a typical cycle, we expect an elevated plateau for longer rather than a peak and trough. We expect distressed exchanges to continue to represent more than half of these defaults, reflecting accommodative market conditions.

Chart 9

U.S. And European 12-Month Speculative Grade Default Rate



Source: S&P Global Ratings

The global economy is carrying a record debt burden

Unwinding record global leverage will take time. Despite the positive impulse from the economic rebound, the global economy is carrying a record debt burden. We estimate global debt to have hit a record $201 trillion by end-2020, equivalent to 267% of GDP, largely driven by a surge in government debt. (see "Near-Term Crisis Unlikely, Even As More Defaults Loom", March 10, 2021).

The additional financial cost to governments to support their economies through the pandemic will likely reach $10.9 trillion in 2020 and 2021 (over 13% of global 2020 GDP). This will bring the total stock of commercial debt to a record of $67.5 trillion (75% of global GDP) by year-end. The unprecedented monetary stimulus buys time for governments. The cost of financing debt continues to be effectively zero for developed sovereigns and near all-time lows for most of those in emerging markets, which helps maintain a relatively stable interest burden. However, borrowing conditions for frontier markets are more nuanced, with many weaker sovereigns facing debt sustainability risks (see "**Sovereign Debt 2021: Global Borrowing Will Stay High To Spur Economic Recovery**", March 1, 2021).

Yet, as the global economy emerges from the pandemic, governments will have to overcome political and economic risks to begin stabilizing public finances and put debt on a downward trajectory while implementing growth-enhancing structural reforms.

We estimate that over two-thirds of developed and emerging sovereigns should manage to either stabilize debt to GDP or put it on a downward path by 2023, although from historically high levels. That still leaves around one-third of governments facing rising debt beyond the outer year of our forecast horizon (for more, see "**Sizing Sovereign Debt And The Great Fiscal Unwind**" Feb. 2, 2021).

Key risks to our base case

Corporate insolvency and global leverage. With the pandemic pushing global debt to GDP to new highs, some governments and corporate borrowers are vulnerable to credit deterioration and defaults, especially as the cost of debt starts to rise. Welcoming markets have eased near-term maturity pressures, and historically low interest rates have mitigated debt-servicing burdens, but if economic growth and income recovers more slowly than we expect, some borrowers may find it difficult to manage debt burdens. This could prolong the default cycle, given that the inevitable collapse of borrowers with very weak credit quality may take time to play out.

As governments and central banks scale back stimulus measures, credit pressures will intensify on corporate issuers in industries, whose earnings may not fully recover until 2022 or later. This could also spur credit losses at banks, and weigh on investments and long-term growth. For sovereigns, the effects of historically high debt on credit quality depend on how governments restore growth, their fiscal and monetary flexibility, and their exposure to shifts in market conditions.

A persisting health crisis. There's been significant variance in the rollouts of vaccines at the global level, and the emergence of more transmissible and deadlier coronavirus variants could make it hard for many countries to contain the pandemic. This could delay economic recovery, with heavy credit implications for certain countries and sectors. Emerging markets generally face comparatively high risks because of their health-care infrastructures and limited resources. Moreover, many developing economies rely heavily on tourism, so any resurgence in COVID-19 cases would present a material risk. For developed economies, the risks associated with a persistent health crisis lie largely in the potential for diminished consumer demand.

Disorderly reflation and risk-repricing. Central banks may find it difficult to carve out an exit path for stimulus and to normalize credit conditions without triggering financial-market volatility (see "**Orderly Global Reflation Will Support The Recovery From COVID-19**" and "**Central Banks, Credit Markets, And The Catch-22 Taper**", both published March 22, 2021). Emerging economies that rely heavily on external financing are exposed to often-volatile capital flows, while any appreciation in the U.S. dollar amid tightening of financing conditions in the world's biggest economy could hit markets with material foreign-currency borrowings.

Geopolitical/social and trade tensions. Amplified geopolitical tensions and economic nationalism are weighing on global trade and could prompt long-term structural shifts in global supply chains. U.S. 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.

At the same time, "vaccine nationalism," in which developed economies far outpace emerging markets in supply and distribution of doses, could exacerbate international tensions. Within borders, the economic consequences of the pandemic have exacerbated socio-economic inequalities. Job losses have disproportionately hit lower-income workers, widening the already troublesome wealth gap in the largest economies and increasing poverty rates in low-income economies, thus heightening risks to political and social stability.

Secular shifts. The pandemic has thrown climate change and the drive toward a carbon-neutral economy into greater relief. Shifts in governmental policy and the focus on energy transition is likely to accelerate regulatory change and disrupt some operating models—and environmental, social, and governance (ESG) factors are increasingly becoming material to credit quality. As investors intensify their focus on ESG, borrowers in carbon-intensive industries may see their access to capital diminish—either paying a premium to borrow or being shut out from the capital markets. With the global drive toward a "net-zero" economy requiring huge investments in processes and technologies. S&P Global Ratings sees so-called transition finance as they key to help carbon-intensive industries and companies 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, 2021).

COVID has also accelerated some secular shifts, including digitalization across a range of industries, as well as for work and consuming habits, which has intensified the business risks of technological obsolescence and increased systemic exposure to cyberattacks. Entities lacking well-tested playbooks to tackle such risk could become more vulnerable to attacks. These secular shifts also offer significant opportunities for building more sustainable growth.

Table 1

Top Global Risks

Near-Term Risks

Debt: Corporate solvency risk and new highs in government debt

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

After the pandemic pushed debt levels to new highs in 2020, some corporates and governments remain vulnerable to credit deterioration and defaults if income recovers slower than expected, while cost of debt starts to pick up. As extraordinary stimulus recedes, credit pressure will continue to build on corporates in industries that are not expected to fully recover earnings by 2022 or later. This could keep default rates higher for longer, fuel credit losses at banks, and weigh on investments and long-term growth. For sovereigns, the impact of high debt on credit risk will depend on policies to restore growth, fiscal and monetary flexibility, and exposure to shifts in market conditions.

COVID-19: Uneven and slow global vaccine rollout and material new variants

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

Slow and uneven rollout of vaccines at the global level, and risks of new variants with limited vaccine efficacy, could make it difficult to contain the pandemic and delay the economic recovery, with challenging credit implications for some countries and sectors. Many emerging markets face higher risks due to their health-care infrastructure and more limited resources, with some also heavily dependent on tourism.

Markets: Disorderly reflation and market repricing risk

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

he recent rise in U.S. Treasury yields, and its spillover into corporate bond yields, suggests that central banks may not easily be able to steer an exit path and normalize credit conditions without triggering excessive market volatility. A rapid and volatile market repricing or inflation shock, affecting financial and real asset prices, debt servicing costs, and funding access, would hurt lower rated corporates and some emerging markets. Those emerging markets most reliant on external financing are exposed to volatile capital flows and fragile investor sentiment, while those with material foreign currency borrowings could suffer from an appreciation in the U.S. dollar concomitant to tightening of financing conditions in the U.S. dollar market.

Longer-Term Structural Risks

Secular shifts: Energy transition, accelerated digitalization, cyber-risk disrupting operating models

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

The pandemic has increased global awareness on climate change, physical risks, biodiversity, and the need to transition to a carbon neutral economy. Heightened policy and popular focus on energy transition and environmental considerations is likely to accelerate regulatory changes, disrupt some operating models, and affect funding access for carbon-intensive industries. At the same time, climate-related risks are increasingly becoming material to credit risk factors. COVID-19 also accelerated some secular shifts, with a step-up in digitalization across a range of industries, different working and consuming habits that intensify risks of technology obsolescence for traditional businesses, and increased systemic exposure to cyberattacks. These secular shifts also offer significant opportunities for building more sustainable growth.

Politics: Economic and social spillover from geopolitical tensions, vaccine nationalism and rising inequalities

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

Amplified geopolitical tensions and economic nationalism amid the pandemic weigh on global trade and could prompt long-term structural shifts in global supply chains. Under President Biden, the U.S.–China strategic confrontation could change tone but will unlikely change direction. Tensions between the two biggest economies look set to persist, especially in technology, intellectual property, and market access. Vaccine distribution is another source of tensions, with the vaccine spat between Europe and the U.K., and more importantly between rich countries and some low-income countries relying on the COVAX program.
The economic consequences of the pandemic have increased socioeconomic inequalities. Job losses have hit low-income workers harder--widening the wealth gap in the largest economies and increasing poverty in low-income economies--heightening risks to political and social stability.

Sources: S&P Global Ratings.

***Risk levels** may be classified as very low, moderate, elevated, high, or very high, 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.

Related Research

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Economic Outlook

- Global Economic Outlook Q2 2021: Global Recovery Gains Traction As Unevenness Abounds, March 31, 2021
- Economic Outlook Asia-Pacific Q2 2021: Three-Speed Recovery Will Benefit From Faster Global Growth, March 25, 2021
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Credit Market Research

- U.S. Speculative-Grade Corporate Default Rate Forecast For Year-End 2021 Falls To 5.5%, March 30, 2021
- Orderly Global Reflation Will Support The Recovery From COVID-19, March 22, 2021
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